W-5 - Plowing New Ground
Litigating Non-Traditional FDD Disclosure Issues

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Plowing New Ground
Litigating Non-Traditional FDD Disclosure Issues

I. INTRODUCTION

Pursuant to the franchise rule promulgated by the Federal Trade Commission (the “FTC”) as amended in 2007 (the “FTC Rule”), franchisors are required to provide prospective franchisees with specific prescribed disclosures of information about the franchised business, the franchisor, the franchisee’s initial investment and the relationship between the parties. This disclosure is provided in a franchise disclosure document (“FDD”) (previously referred to as a uniform franchise offering circular or UFOC) and contains twenty-three substantive categories of information referred to as Items. In addition to the FTC Rule, there are fourteen states that require that the FDD be filed with the state agency. If a state grants more protection to franchisees than the FTC Rule requires, that state law supersedes the FTC Rule, and the franchisor’s compliance with the FTC Rule may not be sufficient to comply with state law. In addition to information franchisors must include, they are “prohibited from including in a disclosure document any information that is not required or expressly permitted either by the Amended FTC Rule or by state law.” However, if literal compliance with a particular disclosure requirement would result in confusing, misleading or unclear information, additional clarifying footnotes are permitted.

When it comes to disclosure violations, practitioners often think of Item 19 of the FDD as fertile ground for claims by franchisees. Nonetheless, other items of disclosure may also result in litigation. These include disclosures made in connection with Items 1, 3, 7, 8, 11 and 12.

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1 Michael Gray would like to acknowledge the assistance of Gray Plant Mooty Summer Associates Olivia Garber and Robert Gallup. Julie Lusthaus would like to acknowledge the assistance of Einbinder Dunn & Goniea Associate David Chaise.


5 Id. at 15.


7 Id. at 102.

8 Item 19 permits, but does not require, franchisors to include financial performance representations. See 16 C.F.R. § 436.5(s). Item 1 discloses information about the franchise company and any parents, affiliates and predecessors. See, infra Section III. Item 3 sets forth litigation involving the franchisor, as well as entities and persons associated
This paper will address the franchisor’s disclosure obligations under these items, how franchisors can minimize their exposure in drafting these items and theories used by franchisees to attack these disclosures in litigation.

II. RESOURCES FOR UNDERSTANDING DISCLOSURE OBLIGATIONS

In addition to the FTC Rule and state statutes and regulations, there are secondary sources for use by practitioners drafting FDDs. For example, The FTC’s Franchise Rule Compliance Guide (“Compliance Guide”) is intended to help franchisors comply with the Franchise Rule. The FTC’s Statement of Basis and Purpose was published to explain differences between the original FTC Rule and the 2007 amendments to the FTC Rule. The FTC has also issued Amended Franchise Rule FAQs and Staff Advisory Opinions. Any and all of these sources may be useful for drafting a FDD in compliance with the FTC Rule.

Other useful materials have been published by the North American Securities Administrators Association (“NASAA”) which created guidelines to help standardize the state disclosure requirements for the preparation of UFOCs (“UFOC Guidelines”) in 1994. When the FTC Rule was revised in 2007, incorporation of the UFOC Guidelines was among its revisions. NASAA then published the Franchise Registration and Disclosure Guidelines (“NASAA Guidelines”) in 2008 to incorporate the revisions made to the FTC Rule. NAASA has also published its Commentary on the 2008 Franchise Registration and Disclosure Guidelines (“NASAA Commentary”), which provides practical information about the disclosure requirements and instructions adopted under the NASAA Guidelines.

Another resource for practitioners is the American Bar Association Forum on Franchising (“Forum”). Each year the Forum holds its annual Forum on Franchising at which there are programs and papers presented on various topics including franchisor disclosure obligations and claims asserted by franchisees. Papers from past Forums may also be available to Forum members through the ABA Forum website. In addition, the Forum has published several books on disclosure such as: the Franchise Law Compliance Manual, Second Edition; The FTC Franchise Rule: Analysis and Commentary; the Franchise Desk Book; and Fundamentals of

with the franchisor. See infra Section IV. Item 7 requires disclosure of the franchisee’s estimated initial investment in tabular form. See infra Section V. Item 8 discloses the franchisor’s purchase obligations, among other things. See infra Section VI. Item 11 requires the franchisor to provide information regarding assistance offered to franchisees, advertising programs and training, and franchisees’ costs associated with implementing computer systems. See infra Section VII. Item 12 sets forth possible locations of the franchised business and any territorial protections. See infra Section VIII.


Franchising, Fourth Edition. For all franchise counsel who are members of the Forum, there is also access to the Forum’s electronic discussion list (“ListServ”) which is intended to facilitate the exchange of ideas and general information among Forum members. Forum members frequently post queries relating to franchisor disclosure obligations on the ListServ. In response to these questions, Forum members often provide thoughtful and educated responses. These discussions afford members the opportunity to learn from colleagues how others have handled (or may handle) similar situations.

III. ITEM 1

A. Required Disclosure

In Item 1 of the FDD, franchisors must disclose background information about the franchise company, any parent companies, affiliates and any predecessors during the past 10 years. Information about predecessors is intended to prevent franchisors from using new corporate entities to hide the negative background of a company. Item 1 must also contain a description of the business to be operated by the franchisee, identification of the franchisor’s agents for service of process and the industry competition for the franchise. Finally, the franchisor must disclose any applicable government regulations unique to the franchised business. For example, a real estate brokerage franchisor would disclose that franchisees will be subject to broker licensing laws. A franchisor offering franchises that sell insect control services must disclose that franchisees will have to comply with licensing laws and regulations pertaining to the use, disposal and storage of pesticides. If the franchised business will sell regulated products such as beer, wine or liquor, Item 1 should disclose that the franchisees will have to comply with liquor licensing requirements and Dram Shop laws. These disclosures can help franchisees understand certain risks particular to the offering and relating to the investment.

B. Item 1 Claims

14 Brimer, supra note 3; Susan Grueneberg & Ann Hurwitz, The FTC Franchise Rule: Analysis and Commentary (American Bar Association 2008); Garner, supra note 6; Fundamentals of Franchising, supra note 2.

15 ABA Forum on Franchising, http://mail.americanbar.org/scripts/wa.exe?A0=FRANCHISING.


18 Id.

19 Compliance Guide, supra note 9, at 31.

20 Id.


Claims arising from Item 1 disclosures often result from a franchisor’s failure to include in its FDD material information that would clarify confusing, misleading or unclear information. In *Morris v. International Yogurt Company*, franchisees of a yogurt store asserted claims against the franchisor in connection with disclosures about the purported uniqueness of the product sold by franchisees.\(^{23}\) The franchisor stated in its UFOC that the “yogurt mix used in the preparation of ‘The Yogurt Stand’ frozen yogurt is considered unique and a special formula.”\(^{24}\) The franchisor neglected to disclose that the yogurt mix was available to third parties and the franchisees asserted a claim for misrepresentation in violation of the Washington Franchise Investment Protection Act (“WFIPA”). The lower court ruled against the franchisees, holding that there was no basis for the franchisees to presume that the yogurt mix would not be available to others and the franchisor could not be held responsible for their mistaken belief.\(^{25}\) On appeal, the Washington Supreme Court reversed this part of the ruling finding that the yogurt mix was a “fundamental ingredient” contributing to the distinctiveness of the franchisor’s final product. The court held that the yogurt mix was a significant factor to potential franchisees and the franchisor’s failure to disclose that the yogurt mix was available to non-franchisees was an omission of a material fact necessary to make the statements the franchisor made not misleading.\(^{26}\)

The franchisees were also successful in *Dunhill Franchisees Trust v. Dunhill Staffing Systems, Inc.*\(^ {27}\) There, a New York federal court upheld an arbitrator’s award against a franchisor that failed to disclose in its FDD that the opening of a franchise was no longer a viable business opportunity for a new business entrant without prior experience. The arbitrator ruled that this omission supported a finding of fraud, which the court held was not a manifest disregard of the law.\(^ {28}\) However, the franchisee was not as successful in *Something Sweet, LLC v. Nick-N-Willy’s Franchise Company*.\(^ {29}\) The FDD indicated that the franchisor offered two different models of franchises: outlet stores which sold “take and bake” pizzas that customers purchased and baked at home; and restaurants which permitted customers to either, “take and bake” the pizza or purchase a cooked pizza to eat on premises. The franchisee had chosen to open an outlet model. The franchisee claimed that the franchisor knew and failed to disclose that it was planning to discontinue the outlet store model when the franchisee purchased the franchise.\(^ {30}\) The appellate court upheld the lower court’s grant of summary judgment to the franchisor. Distinguishing this case from *Morris v. International Yogurt Company*, the court found that the franchisee failed to show that “the nationwide mixture of outlet and restaurant models was a key feature of the franchise agreement.”\(^ {31}\) The court held that “even assuming


\(^{24}\) Id. at 34.

\(^{25}\) Id.

\(^{26}\) Id. at 40.


\(^{28}\) Id.


\(^{30}\) Id. at 925.

\(^{31}\) Id. at 927.
[the franchisor] was considering a change to the way new stores might operate in the future, [the franchisee] failed to show that disclosure of this fact would have been necessary to make the franchise [disclosure document] not misleading.”32

In Century Pacific v. Hilton Hotels Corporation, the franchisee was persuaded by Hilton to convert its hotel to a Red Lion Hotel, a brand owned by Hilton. In choosing to convert, the franchisee relied on Hilton’s oral representations that it had long term plans to grow and own the Red Lion brand and that the franchisee would benefit from the value of the Hilton name and the system.33 Unbeknownst to the franchisee, at the time the franchisee entered into the franchise agreement, Hilton had plans to sell, and subsequently did sell Red Lion. The franchisee sued Hilton for violations of the New York Franchise Sales Act (“NYSFA”) and common law fraud, arguing that Hilton failed to disclose its intent to sell the Red Lion franchise system. Although the court found that the NYFSA did not apply and dismissed those claims, it denied the motion to dismiss the franchisee’s claims for common law fraud. The court determined that: (i) Hilton’s express right in the franchise agreement to transfer Red Lion did not contradict or supersede oral statements by Hilton about its present intent to retain Red Lion; (ii) the merger or integration clause in the franchise agreement did not bar admission of the franchisor’s previous oral statements because the merger clause did not specifically contradict the oral representation; and (iii) Hilton’s representations about its present intent to retain Red Lion could not be summarily dismissed as “puffing.”34

In Hockey Enterprises, Inc. v. Total Hockey Worldwide, LLC, the franchisees survived a motion to dismiss their claims against the franchisor including claims for violations of the Minnesota Franchise Act (“MFA”) and common law fraud and misrepresentation.35 The franchisees alleged, inter alia, that the franchisor failed to disclose the franchise should be located near an ice rink, the franchisee needed significant hockey experience, the franchisor’s facilities were not financially successful and a significant number of facilities had closed.

The franchisor argued that the franchisees failed to state a claim for misrepresentation because the alleged misrepresentations were specifically addressed and contradicted by the parties’ franchise agreements. Further, the franchisor contended that in light of various disclaimers in the franchise agreements and UFOC, the franchisees could not demonstrate justifiable reliance on the alleged misrepresentations.36 After determining that the MFA did not apply, the court considered the franchisees’ common law claims for fraud and misrepresentation. Although the court acknowledged that the agreements between the parties, which contained both disclaimer and integration clauses, presented compelling evidence that could refute the reasonableness of the franchisees’ reliance on the alleged misrepresentations,

32 Id.
34 Id. at *6-7.
36 Id. at 1147.
the court denied the motion to dismiss the claims holding that the issue was inappropriate for resolution on a motion to dismiss.\footnote{Id. at 1148; However, see Yogo Factory Franchising, Inc. v. Ying, 13-CV-630 (JAP)(TJB), 2014 WL 1783146 (D.N.J. May 5, 2014) (finding even if defendants had pled their counterclaims for fraud with particularity, their reliance on alleged prior misrepresentations as to how much money the franchises would generate and how much support the franchisor would provide, was not reasonable in light of the integration cause in the franchise agreement and the franchise questionnaire).}

Other Item 1 disclosure claims arise when a franchisor fails to disclose required information accurately. In \textit{Salkeld v. V.R. Business Brokers}, the putative franchisor provided the franchisee with a sales manual that stated there was no competition for its Cocktails Naturally product and its unique system.\footnote{\textit{Salkeld v. V.R. Business Brokers}, 192 Ill. App. 3d 663, 548 N.E.2d 1151 (Ill. App. Ct. 1989).} The franchisee submitted evidence at trial that there was a product in direct competition with the Cocktails Naturally product to support the claim for misrepresentation. Nonetheless, the trial court directed verdict in favor of the franchisor, its principal and other associated defendants. The franchisee appealed. The putative franchisor argued “that the representation of ‘virtually no competition’ was simply an opinion or mere ‘puffing,’ and therefore was not a fraudulent misrepresentation.” The appellate court disagreed. It determined that a jury could have reasonably found that the franchisee relied on franchisor’s representations as statements of fact, not subjective descriptions or mere opinion and that the trial court had erred in directing a verdict in favor of the franchisor and other associated defendants.\footnote{Id. at 1158.}

Misrepresentations or omissions in Item 1 can also support a claim of a pattern and practice of failing to comply with disclosure requirements. In \textit{The Matter of the California Corporations Commissioner v. Play-N-Trade Franchise, Inc.}, the California Corporations Commissioner brought an enforcement action against Play-N-Trade’s franchisor.\footnote{In the Matter of the California Corps. Comm’r v. Play N Trade Franchise, Inc., Nos. 993-5595 and 993-5596 (April 14, 2009).} The Commissioner found that the franchisor had engaged in a pattern and practice of failing to comply with the Franchise Investment Law by, among other things, failing to make several required disclosures. These included the existence of an affiliate of the franchisor; the fact that the franchisor negotiated terms of the franchise agreement with franchisees; the fact that certain area franchisees had been terminated; and the fact that a lawsuit had been filed against the franchisor by a former Vice President involving allegations of violations of franchise laws. The Commissioner revoked the franchisor’s franchise registration; fined the franchisor $132,500; and required the franchisor to offer rescission to California franchisees and pay each of them restitution in an amount equal to the franchise fee paid.

C. Practice Pointers

Franchisors will want to ensure that they disclose all required information in Item 1. If necessary, additional information should be disclosed to ensure that the information provided is not confusing, misleading or unclear. For example, a franchisor that has agreed to acquire an additional brand may want to disclose that fact, particularly if a contract to purchase has been signed even if the closing has not occurred. This fact may be material to a franchisee with

\begin{footnotesize}
\begin{enumerate}
\item Id. at 1148; However, see Yogo Factory Franchising, Inc. v. Ying, 13-CV-630 (JAP)(TJB), 2014 WL 1783146 (D.N.J. May 5, 2014) (finding even if defendants had pled their counterclaims for fraud with particularity, their reliance on alleged prior misrepresentations as to how much money the franchises would generate and how much support the franchisor would provide, was not reasonable in light of the integration cause in the franchise agreement and the franchise questionnaire).
\item Id. at 1158.
\end{enumerate}
\end{footnotesize}
concerns that such a franchisor will be more focused on developing the new brand than supporting the existing franchise system. Of course this may raise an issue if the franchisor has agreed with the seller to keep this information confidential. The franchisor should consider the implications of such an agreement and may want to consider suspending the sale of franchises during the confidentiality period. As indicated, franchisors are also required to disclose applicable government regulations unique to the franchised business. A question may arise as to the extent of a franchisor’s obligation to research and disclose laws that may be uniquely applicable to the franchised business.\textsuperscript{41} The FTC Rule and state statutes do not provide a clear answer to this question. Of course, if the franchisor knows the applicability of a law unique to the franchised business, even one that may only be applicable in certain jurisdictions, prudence may dictate that the franchisor disclose that law and details about its applicability in certain states.\textsuperscript{42} The franchisor will also likely want to disclose that franchisees are required to comply with all applicable laws and encourage franchisees to consult with lawyers regarding laws applicable to the franchised business in the franchisee’s state.\textsuperscript{43}

To determine if the franchisor has complied with its Item 1 disclosure obligations, franchisee counsel can conduct online research since much of the information required to be provided in Item 1, that is information about the franchisor, its history, its affiliates and predecessors, may simply be public information and available via the internet. A comprehensive inquiry may reveal additional information that should have been disclosed. Counsel will also want to inquire of the client why he or she chose to purchase that particular franchise. What about the franchisor’s story made the franchise appealing? Why was that brand chosen and not a competitive brand? Counsel can inquire whether the franchisee’s experience met his or her expectations. Understanding the answers to these questions can help counsel determine whether the Item 1 disclosure was sufficient. For instance, a franchisor of a home health care franchise may disclose that the franchisee will need a license to operate the franchise. However, the franchisor may not disclose that in some jurisdictions, the licensing process can take more than a year. This fact may be material to a franchisee’s decision to buy the franchise and counsel may want to inquire further as to the representations made by the franchisor about the licensing process to determine if there is evidence of an Item 1 violation.

IV. ITEM 3

A. Required Disclosure

Item 3 of the FDD must include certain litigation about the franchisor, its officers, parents and predecessors. There are four categories of actions required to be disclosed: (i) pending government injunctive or restrictive actions or actions that are otherwise material to a reasonable prospective franchisee; (ii) actions involving the franchise relationship; (iii) certain prior actions; and (iv) currently effective injunctive or restrictive orders or decrees resulting from

\textsuperscript{41} Fittante et al., supra note 2, at 8; Rocky Mountain Chocolate Factory, Inc. v. SDMS, Inc., No. 06-CV-01212 (WYD)(BNB), 2007 WL 4268962, at *4 (D. Colo. Nov. 30, 2007). (Franchisor’s motion for summary judgment on the franchisees’ counterclaim regarding competition in the marketplace was granted. The franchisees argued that the franchisor was required to disclose all known market competition, and that it failed to disclose itself as a significant competitor through its substantial sales to third-party retailers. The court found that the franchisor had disclosed that it would sell its product to third party retailers, which was sufficient to defeat the franchisees’ counterclaim.)

\textsuperscript{42} Id.

\textsuperscript{43} Id.
pending or concluded actions that were brought by a governmental entity.\textsuperscript{44} The term “actions” includes arbitrations and foreign litigation.\textsuperscript{45} A mediation need not be disclosed unless the mediation resulted in the settlement of an ongoing litigation.\textsuperscript{46} The parties’ agreement to keep a settlement confidential will not operate to preclude the requirement that the material terms of the settlement be disclosed if disclosure would otherwise be mandated.\textsuperscript{47}

For each action disclosed, the franchisor must include the initial filing date, title, case citation, names of the parties, forum and the relationship of the opposing party to the franchisor. In addition, the franchisor must include a factual and legal summary of the claims, the relief sought and any conclusions of fact or law that came out of the action.\textsuperscript{48}

i. Pending Actions

There are two types of pending actions that must be disclosed. The first includes administrative or criminal actions in which there is an alleged violation of a franchise, antitrust or securities law, or allegations of fraud, unfair or deceptive practices or comparable allegations. The second type of pending actions are those other than ordinary routine litigation incidental to the business and which are material in the context of the number of franchisees and the size, nature or financial condition of the franchise system or its business operations.\textsuperscript{49} For example, a lawsuit involving a claim by a supplier to recover $10,000 on a debt may not be material. However, a litigation in which the franchisor may be found liable for a multi-million damage award will likely be considered material as the impact of such an award may have a significant impact on the franchise system.

ii. Actions Involving the Franchise Relationship

Item 3 must also include material actions in the past fiscal year, involving the franchise relationship. In actuality, all actions that “pertain to the franchise relationship” except perhaps those related to “isolated, non-traditional franchise sales” are likely material for purposes of Item 3 disclosures.\textsuperscript{50} These disclosures are important and can provide prospective franchisees with valuable information about the system and franchisor. For example, extensive disclosure may indicate problems in the franchise system. Conversely, disclosure indicating that that the franchisor actively pursues claims relating to the intellectual property may be a sign to franchisees that the franchisor will aggressively protect its brand.\textsuperscript{51}

iii. Prior Actions

\textsuperscript{44} Christopher Drahozal, Disclosure of Franchise Disputes, 19 Stan. J. L Bus. & Fin. 281 (2014).

\textsuperscript{45} Garner, supra note 6, at FTC-105.

\textsuperscript{46} Compliance Guide, supra note 9, at 34-35.

\textsuperscript{47} Id. at 38.

\textsuperscript{48} Curran & Mitchell, supra note 2, at 9.

\textsuperscript{49} Compliance Guide, supra note 9, at 35.

\textsuperscript{50} Garner, supra note 6, at FTC-105

\textsuperscript{51} Id.
The franchisor must also disclose certain prior actions including those in which the franchisor, its affiliate, or principals were convicted of a felony or pleaded nolo contendere to any felony in the prior ten years. In addition, the franchisor must disclose all civil actions in the past ten years, in which the relevant party was ‘held liable’ for violations of a franchise, antitrust or securities laws or involving allegations of fraud, unfair or deceptive practices or comparable allegations. Held liable means that a party was required to pay money or other consideration, reduce an indebtedness, cannot enforce its rights or take action adverse to its interests. Thus, if a litigation or arbitration is resolved with the franchisee’s debt being reduced, that would fall under the definition of ‘held liable’ and the franchisor will want to disclose the action.

iv. Government Injunctive Actions

The final category of actions required to be disclosed are certain government injunctive actions. These involve a party being subject to a currently effective injunctive or restrictive order or decree resulting from a pending or concluded action brought by a governmental agency, such as the FTC or a state attorney general, under a federal, state or Canadian franchise, securities, antitrust trade regulation or trade practices law or that otherwise relates to franchising.

For the first three categories of actions, franchisors must disclose those involving itself, its predecessors and all individuals listed in Item 2 (the franchisor’s directors, trustees, general partners, principal officers and others with management experience (“Item 2 Individuals”)). The franchisor must also disclose these categories of actions for a parent or affiliate who induces franchise sales by promising to back the franchisor financially or otherwise guarantee the franchisor’s obligations under the franchisor’s trademarks. Finally, the franchisor must disclose these categories of actions where they involve affiliates who sell franchises under the franchisor’s trademarks. For the fourth category of actions (government injunctive actions), the franchisor must disclose actions involving itself, its predecessors, Item 2 Individuals, any affiliate or parent who guarantees the franchisor’s performance and any affiliate who has offered or sold franchises in any line of business in the prior 10 years and that guarantees the franchisor’s performance.

B. Item 3 Claims

The court’s decision in *U.S. v. Building Inspector of America, Inc.* (“TBIA”) is instructive as to what litigation must be disclosed. The FTC brought an action against TBIA and

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52 Compliance Guide, *supra* note 9, at 37; Fittante et al., *supra* note 2, at 9.
53 16 C.F.R. § 436.5(c)(iii)(B)
54 Compliance Guide, *supra* note 9, at 38.
55 16 C.F.R. § 436.5(b) (note that for injunctive actions, disclosure is required for the franchisor, its predecessors, parents, and affiliates, as well as the “franchisor’s directors, trustees, general partners, principal officers, and any other individuals who will have management responsibility”).
56 NASAA Guidelines, *supra* note 12, at 37.
57 *U.S. v. Bldg. Inspector of Am., Inc.*, 894 F. Supp. 507 (D. Mass. 1995). The original FTC Rule did not require franchisors to disclose routine litigation that was material because of the size, nature or financial condition of the franchise system or business operations. Nor were franchisors required to disclose the existence of all settlements or the terms of confidential settlements. *See* 43 Fed. Reg. 59614 (Dec. 21, 1978). For information on the changes to Item 3 disclosures as a result of the amendments to the FTC Rule, see Howard E. Bundy, Craig Tregillus & Dennis E.
three of its officers seeking penalties, consumer redress and injunctive relief for violations of the FTC Rule. The FTC claimed that TBIA had made improper representations about potential earnings of franchisees; failed to properly disclose information concerning TBIA’s officers; failed to disclose prior litigation; failed to disclose prior bankruptcies; and failed to have its financial statements properly audited. The FTC submitted evidence of 11 civil lawsuits and one arbitration that TBIA had failed to disclose.

In defense, TBIA argued: (i) disclosure of one of the lawsuits was not required because it was “pending on appeal;” (ii) the arbitration was not material because it only involved an amount ($15,000) which was less than 15% of TBIA’s assets and therefore did not need to be disclosed; and (iii) there was an issue of fact as to whether the other lawsuits involving counterclaims against TBIA were material which would require disclosure, because most suits were settled before motions for summary judgment.58

The court did not buy TBIA’s arguments. It held that even if an appeal was pending, because it would not deprive the trial court’s judgment of its “final character,” it must be disclosed. Indeed, the term “final judgment” refers as a matter of law to the judgment of a trial court from which an appeal may be taken.59 With respect to the arbitration, the court noted that although the definition of materiality contained in the UFOC requirements at that time used a 15% test, an action must be disclosed if a “reasonable prospective franchisee would consider it important in the making of a decision relating to the named franchise business.” The court continued that it was “pure sophistry on TBIA’s part to argue that a reasonable prospective franchisee would not consider it important that another franchisee was claiming that TBIA violated the FTC Rule by making unsupported representations concerning potential earnings. Such a claim would bring into doubt the integrity and competence of the franchisor regardless of the amount of damages claimed.”60 With respect to the remaining items of litigation, the court held that the materiality of the counterclaims was “self-evident.” They involved claims by almost 10% of the franchises that TBIA violated the FTC Rule when selling franchises and they were settled for undisputed amounts. The court held that this is “clearly the kind of information that a reasonable prospective franchisee would consider important in making a decision relating to buying a TBIA franchise.”61

In GNC Franchising, Inc. v. O’Brien, the franchisees alleged, inter alia, that the franchisor had made misrepresentations regarding the disposition of litigation with another franchisee.62 In particular, they asserted that they relied on false statements made by GNC in its 1997 UFOC that GNC “had resolved a franchisee litigation without payment when in fact the litigation was settled by GNC’s payment of $325,000.” Notwithstanding that the falsity of GNC’s UFOC was easily demonstrated, the franchisees failed to submit any evidence that they relied


59 Id. (quoting 16 C.F.R. § 436.5(c)(iii)).

60 Id.

61 Id. (quoting UFOC Guidelines, Item 3 Definitions at iii), Business Franchise Guide (CCH) ¶ 5803 (1980)).

upon the omission prior to signing their franchise agreements. As a result, the court granted GNC summary judgement.63

Coffee Beanery, Ltd. v. WW, LLC is a complicated case addressing many issues. However, as relevant here, the arbitrator in that case determined that the conviction of an officer of the franchisor for grand larceny was not the type of conviction that Coffee Beanery was required to disclose under the Maryland Franchise Registration and Disclosure Law (“Maryland Franchise Law”). The district court denied the plaintiffs’ motion to vacate the award. On appeal, the Sixth Circuit determined that the failure to disclose a conviction for grand larceny is a violation of the Maryland Franchise Law. The court found that the arbitrator had showed a manifest disregard for the law in concluding otherwise; reversed the judgment of the district court; and vacated the award. 64 The Sixth Circuit further held that because The Coffee Beanery’s failure to disclose its officer’s conviction deprived WW, LLC, “of a mandatory, statutorily required notice” prior to signing the agreement, WW, LLC was “fraudulently induced into signing” the franchise agreement and it “need not resort to arbitration to vindicate its statutory rights but may instead seek appropriate relief in a court of law.”65

In Sferrino v. Custom Food Franchise Group, a Love’s Wood Pit Barbeque restaurant franchisee alleged, inter alia, that the franchisor failed to disclose that the Department of Corporations had issued a cease and desist order precluding the franchisor from selling franchises in California. The franchisee claimed that this was a “material misrepresentation” and a “violation of the California Franchise Law” (“CFL”). The franchisor moved for summary judgement arguing that the franchisee had waived and released its claims pursuant to an executed release. The court first recognized that the franchisee had stated a claim against the franchisor for willfully omitting a material fact in an offering circular which was required to be stated in violation of the CFL. The court then denied the motion holding that under California law, there was a material question of fact as to whether the franchisee’s claim was subject to the release.66

The failure by a franchisor to properly provide Item 3 disclosures has also been used by a competitor franchisor to support a claim of unfair competition. In Edible Arrangements International (“EAI”) v. Notaris, Fresh Fruit Bouquet Company, Inc. and Fresh Fruit Franchising LLC (collectively “Fresh Fruit”), EAI was successful in obtaining an injunction, albeit unopposed, preventing Fresh Fruit from selling franchises in California. EAI claimed that Fresh Fruit had failed to disclose in its UFOC that there was a lawsuit pending in Connecticut; misrepresented that the financial statements attached to the UFOC were audited; and offered to sell franchises in California before it was properly registered. The court found that these violations of

63 Id.
64 Coffee Beanery, Ltd. v. WW LLC, 300 F. App’x 415 (6th Cir. 2008).
65 Id. at 421. WW, LLC proceeded on its claims against the Coffee Beanery, LLC in the district court. The court granted Coffee Beanery’s motion for summary judgment. Instead of submitting evidence of the conviction, the franchisees had sought to rely on the Sixth Circuit’s opinion and invoke the doctrines of estoppel and law of the case. Unfortunately for them, the court held that those doctrines did not apply and as a result, there was no evidence of the conviction before the court. WW, LLC v. Coffee Beanery, Ltd., No. 05-CV-3360, 2013 WL 3776944 (D. Md. July 17, 2013).
California’s franchise law gave Fresh Fruit an unfair competitive advantage over EAI in violation of the California Unfair Competition Law.67

C. Practice Pointers

Franchisor counsel will want to ensure that all necessary litigation concerning pending actions, actions involving the franchise relationship, certain prior actions, and government injunctions is disclosed. With the access many attorneys have to court dockets through e-filing systems and other third-party websites, franchisee counsel will be able to locate litigation not identified in the FDD. As indicated in Section IV(A)(i) and (ii) above, franchisors must include actions that are ‘material.’ The FTC Rule does not define what constitutes a “material action” but the Compliance Guide explains that materiality is determined from the viewpoint of the ‘reasonable prospective’ franchisee and an action is material if it is likely to influence a prospective franchisee’s investment decision.68 Materiality may depend in part on the industry as well as the size of the franchisor and will likely have to be considered on a case-by-case basis.69

As noted earlier, franchisors must disclose the terms of settlement agreements even if they are marked confidential by the parties. In light of that requirement, counsel will want to ensure that any such settlement agreements permit disclosure “when required by law” and may even want to indicate expressly that the terms of the settlement agreement may be included in the franchisor’s disclosure documents. At least one court has denied a motion to dismiss a plaintiff’s claim that a franchisor violated a settlement agreement by disclosing its terms in its FDD. The franchisor argued that it was required to do so as matter of law. The settlement agreement did not provide for such disclosure and as a result, the court found that the plaintiff’s complaint alleging that the franchisor breached the confidentiality provision of the settlement agreement was “plausible.”70

Franchisee counsel are encouraged to conduct due diligence when it comes to determining if a franchisor has violated its obligations regarding Item 3 disclosure. Counsel should not assume that all litigation or actions have been disclosed. Particularly with the onset of e-filing, conducting litigation searches for the franchisor and Item 2 individuals is easier than ever. Also, counsel can review, where possible, court filings for all actions listed in the FDD. Analyzing pleadings and court decisions may reveal that the franchisor has failed to summarize accurately the legal and factual nature of each claim in the action, relief sought or any conclusions of law.71

V. ITEM 7


71 NASAA Guidelines, supra note 12, at 37.
A. Required Disclosure

Item 7 requires disclosure of the franchisee’s estimated initial investment in tabular form. The table should include each expense required for the franchisee to begin operations. Although the FTC Rule does not prescribe an exhaustive list of what should be included, it does provide examples of typical pre-opening expenses. These include the initial franchise fee, training expenses, real property, equipment, and beginning inventory.

The disclosures are not limited to payments to the franchisor. The FTC Rule also requires estimates of payments to third parties, such as utility deposits and business licenses. Furthermore, franchisors must estimate various expenses, including payments to third parties, the franchisee will incur during the initial period of operations. The FTC Rule defines a “reasonable initial period” as at least three months or a reasonable period for the industry. 72

For each expense listed, franchisors must state the amount of the payment. If the amount is unknown, franchisors may use a low-high range based on their current experience. In addition, franchisors must disclose the method of payment, when the payment is due, and to whom the payment will be made.

The disclosures in Item 7 require a delicate balance of providing specific information while emphasizing that the numbers are only estimates. The title itself helps give franchisors an additional layer of protection. Amendments to the FTC Rule in 2007 changed the title of Item 7 from “Initial Investment” to “Estimated Initial Investment.” 73 The FTC Rule states that Item 7 is not meant to capture all expenses. If prospective franchisees want a more detailed estimate of long-term expenses, the FTC suggests that prospects speak directly with existing franchisees. 74

Although the numbers may only be estimates or ranges, the information contained in Item 7 is more comprehensive than in other sections, such as Item 5 (initial fees) and Item 6 (other fees paid to the franchisor or affiliates). Its purpose is to arm prospective franchisees with a clear picture of the financial means necessary to get the franchised outlet operational. 75

Despite the thorough requirements of Item 7, the Compliance Guide is careful to emphasize that the numbers are still only estimates or ranges. Importantly, these figures do not constitute a financial performance representation that would trigger an Item 19 disclosure. Prior to 2007, the original rule promulgated by the FTC and the UFOC Guidelines were unclear as to whether a disclosure under Item 7 gave rise to an Item 19 claim. The new language now limits “financial performance representation” to any representations that implicate sales, income or profits—a clear exclusion of estimated start-up costs. 76

72 16 C.F.R. § 436.5(g).
73 SBP, supra note 10, at 15473.
74 Id. at 15486.
75 Id.
76 16 C.F.R § 436.1(e).
Although the estimates are usually not enough to trigger an Item 19 Financial Performance Representation, that should not diminish the importance of Item 7. When properly drafted, the information in Item 7 should give prospective franchisees a clear picture of the amount needed to invest in the franchise. These numbers should be reviewed regularly in order to be as accurate as possible. The Compliance Guide recognizes that these figures cannot be certain, but advises franchisors to use their current experience. For example, if franchisors do not have a set estimate of real estate costs, they should describe the approximate size of the property, and the probable location of the building (such as free standing, a strip mall or highway).

In addition to the tabular contents, Item 7 also requires that franchisors disclose additional information in the footnotes. This information includes whether each payment is non-refundable, or the circumstances under which a payment is refundable. If a franchisor is willing to finance part of the initial investment, it must disclose the amount it will finance, the required down payment, the annual interest rate, rate factors, and the estimated loan repayments.

B. Item 7 Claims

Because Item 7 initial expense disclosures are just estimates or ranges, courts have been reluctant to impose liability on franchisors for inaccurate information. Also, although judicial guidance on Item 7 may be scarce, the cases that do address start-up expense disclosures illustrate the most common situations that lead to litigation.

The seminal case involving Item 7 litigation came from the District of Maryland. In Motor City Bagels, L.L.C. v. American Bagel Co., the court found that a franchisor could be liable for inaccurate Item 7 information in its UFOC. The defendant franchisor, American Bagel Company, gave the plaintiffs its 1993 UFOC, which provided an estimate for initial investment costs “based on the latest available data.” However, at the time the plaintiffs received the UFOC, American Bagel Company had actually already filed an updated 1994 UFOC, which contained a higher range of estimated initial investment costs. The plaintiffs claimed they never received a copy of the updated 1994 UFOC.

Evidence revealed that although the franchisor did mail plaintiffs another UFOC, it was the same 1993 version. The franchisor might have avoided liability if it had a copy of the second UFOC it mailed to the plaintiffs. All it could produce, however, was an Acknowledgement of Receipt by Prospective Franchisee form. This was not enough for the court to find as a matter of law that the franchisor sent an updated 1994 UFOC.

77 See David A. Beyer & Scott P. Weber, Estimated Initial Investment Claims: Strict Liability or Strictly Folly?, 19 Franchise L.J. 103 (Winter 2000) (noting that many cases addressing franchisor liability for allegedly inaccurate disclosure of start-up costs were summarily dismissed).

Assuming that the plaintiffs never received the updated 1994 UFOC, the court found a triable issue of fact whether the franchisor could be liable under the anti-fraud provisions of the Indiana Franchise Act.\(^{79}\)

First, the initial investment costs provided in the 1993 UFOC would constitute a false statement as they would not have been based “on the latest available data.” In addition, the representation of the cost figures in the disclosure document would be actionable as “they did not accurately reflect past or present circumstances.”\(^{80}\)

In addition to finding that the 1993 UFOC contained false data, the court held that the information was unquestionably material. The initial investment costs reported in the 1994 UFOC were more than 20 percent higher than what was projected in the 1993 UFOC. Furthermore, the court stated that the plaintiffs could demonstrate that they were harmed by reliance on the franchisor’s misrepresentations.\(^{81}\) For these reasons, the court denied the franchisor’s motion for summary judgment.

The franchisor faced similar liability in *Hanley v. Doctors Exp. Franchising, LLC* after unsuccessfully attempting to distinguish *Motor City Bagels* on the grounds that its FDD did not contain the express assertion that the estimates were “based on the latest available data.”\(^{82}\) In this case, the plaintiffs alleged that before they signed the franchise agreement, the franchisor knew the Item 7 estimates were materially lower than the actual opening costs for the franchise. This claim was supported by the fact that two weeks after signing the franchise agreement, the franchisor began using an updated FDD that estimated start-up costs at 10-15 percent higher than the information contained in the FDD provided to plaintiffs. The plaintiffs were not re-disclosed with the new FDD.

The court rejected the franchisor’s argument that it had no duty to disclose new information because it did not state that the estimates were “based on the latest available data.” The court noted that the Maryland Franchise Law not only bars affirmative misrepresentations, but also prohibits a franchisor’s “omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading.”\(^{83}\) The franchisor also attempted to shift the burden of inquiry to the plaintiffs, arguing that because the plaintiffs knew the estimates in the FDD were based on data from the previous two years, they should have requested the updated data for the current year. The court hinted that this argument could be persuasive, but determined that at the pleading stage, it was not enough to undermine the legal sufficiency of the plaintiffs’ claims.\(^{84}\)

\(^{79}\) *Id.* at 469. The court found that the franchisor could be liable under all three anti-fraud provisions, one of which required proving that the franchisor knowingly or intentionally defrauded the plaintiffs. The other provisions were based on strict liability.

\(^{80}\) *Id.* (citing *Commercial Property Invs., Inc. v. Quality Inns Intl., Inc.*, 938 F.2d 870, 876 (8th Cir. 1991)).

\(^{81}\) *Id.* at 470.


\(^{83}\) *Id.* (quoting B.R. § 14-227(a)(1)(ii)).

\(^{84}\) *Id.* at *23.
These cases demonstrate the importance of providing the most current Item 7 information in the FDD. This is especially true if the franchisor knows that the data is stale and more recent actual costs vary significantly from the data being disclosed to prospects. The plaintiffs in both cases survived motions to dismiss and for summary judgment by demonstrating that the franchisors possessed information contradicting the estimates in Item 7 being disclosed to prospects. Although the franchisor in *Motor City Bagels* had actually prepared an updated UFOC by the time the plaintiffs signed their franchise agreement, that alone did not establish liability. The franchisor in *Hanley* provided the plaintiff with the most current effective FDD at the time. However, the fact that the FDD was updated two weeks after plaintiff signed its franchise agreement was sufficient evidence of the franchisor’s knowledge that the data in the FDD given to the plaintiff was stale. The plaintiff thereby defeated the franchisor’s motion to dismiss.

In *A Love of Food I, LLC v. Maoz Vegetarian USA, Inc.*, a franchisee alleged the franchisor violated state franchise disclosure laws by failing to update its disclosure with new information.\(^85\) Maoz Vegetarian was initially a European-based company that sold vegetarian restaurant franchises. When Maoz first drafted its offering circular in 2007, it had yet to open any U.S. franchise operations. The start-up costs and other estimates were based on numbers from the company’s European franchises and flagship company store in Philadelphia. Maoz was careful to disclaim its estimates, and emphasized that “when it came to U.S. franchises, the company was, in a sense, exploring new territory.”\(^86\) When Maoz updated its 2008 FDD, it based its Item 7 numbers on information gathered after opening other stores in the U.S. These start-up costs were significantly higher than what was initially estimated in 2007.

The plaintiff claimed that when it signed a franchise agreement in August 2007, the UFOC contained fraudulent cost estimate information. First, the plaintiff claimed that Maoz based its estimates on such little information, it constituted reckless disregard for the truth. The plaintiff also asserted that Maoz willfully failed to provide updated information during the negotiations period.

Although Maoz had yet to open any U.S. based franchises when it wrote the 2007 UFOC, a franchisee had completed build-out of a New York location when Maoz disclosed the UFOC to the plaintiff. The New York franchise had significantly higher start-up costs than what the 2007 UFOC estimated. The plaintiff claimed Maoz should have updated the costs in the 2007 UFOC to reflect the experience of the New York franchisee, or at least disclosed the new information to the plaintiff during its negotiations.

The court found this situation somewhat related to *Motor City Bagels*, but noted a factual distinction. In *Maoz*, there was no updated offering prospectus in existence when the parties signed the franchise agreement. However, the court found Maoz could still be liable based on the statements in the UFOC.

There is a question of fact, however, regarding whether Maoz had the information regarding increased costs at its disposal before it completed the 2008 Offering Prospectus; specifically, at the time Maoz executed the Franchise

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\(^86\) *Id.* at 385.
Agreement. Failure to provide updated information that the defendant knows of—whether that information has made it into a formally registered offering prospectus or not—gives rise to liability under [the Maryland State Franchise Act].87

Although the plaintiff succeeded in this respect, the court denied plaintiff’s cross-motion for summary judgment. To succeed on a misrepresentation claim under Maryland law based on the initial start-up costs estimates, the plaintiff had to show that it reasonably relied on those estimates. The court found there was a question of fact as to whether plaintiff’s reliance was reasonable in light of the extensive disclaimers in the 2007 UFOC stating that the estimates were just approximations. Additionally, the evidence showed that the plaintiff hired a team of accountants to conduct their own in-depth estimate of potential start-up costs.88 The court therefore denied the plaintiff’s motion for summary judgment.

Showing reliance on estimated initial start-up costs has historically been difficult for plaintiffs. A snapshot of cases which were predicated on fraud and misrepresentation claims illustrates that for the most part, predictions are not actionable as fraud.89 The court in Fabbro v. Drx Urgent Care, LLC, affirmed dismissal of plaintiffs’ claims for similar reasons.90 Claims brought under the state franchise acts were dismissed because they were time-barred, but the court also dismissed claims brought under common law fraud and negligent misrepresentation.

Predictions or promises regarding future events—such as the expenses involved in starting a Doctors Express franchise—are necessarily approximate. In Maryland, the general rule is that predictions or statements which are merely promissory in nature and expressions as to what will happen in the future are not actionable as fraud. Under New Jersey law, statements as to future events, expectations, or intended acts, do not constitute misrepresentations despite their falsity, if the statements were not made with the intent to deceive.91

Similarly, a franchisee’s counterclaims of common law fraud and negligent misrepresentation regarding initial start-up costs were dismissed in Yogo Factory Franchising,87 Id. at 400.

88 Id. at 401.

89 See, e.g., TLH Int’l v. Au Bon Pain Franchising Corp., No. CIV. A. 86-2061-MA, 1986 WL 13405 (D. Mass. Nov. 13, 1986) (dismissing plaintiff’s claims because the figures provided in the disclosure statement were all clearly marked as estimates. The court also noted that there was nothing to indicate that the figures were fraudulently derived); Kelly Tire Stores, Inc. v. Kelly-Springfield Tire Co., 338 F.2d 248 (8th Cir. 1964) (affirming directed verdict in favor of the franchisor. The claims based on misrepresentation projected start-up costs were not actionable because the projections were predicted goals, not ironclad guarantees); Carlco v. Pillsbury Co., 719 F. Supp. 791 (D. Minn. 1989) (finding that plaintiffs did not justifiably rely on start-up costs estimates because there were disclaimers concerning variances in costs and advice to franchisees to make their own independent survey of start-up costs); Kohr v. Gropp & Lehman Enterprises, Inc., No. 78-71707, Business Franchise Guide (CCH) ¶ 8123 (E.D. Mich. Aug. 17, 1981) (dismissing plaintiff’s claim because the franchisee had conducted its own research that showed the initial investment costs would be higher than what was disclosed).

90 Fabbro v. Drx Urgent Care, LLC, 616 F. App’x 485 (3d Cir. 2015).

91 Id. at 488 (internal citations and quotations omitted).
The court found that the estimates in Item 7 were not actionable under a fraud theory because they were future predictions, not a statement of past or present fact. Therefore, the franchisee could not plausibly argue reliance on those estimates.

Estimated expense disclosures that contain express statements disclaiming reliance make it hard for plaintiffs to prevail on claims of common law fraud. In Coraud LLC v. Kidville Franchise Co., LLC, the plaintiff alleged fraud and negligent misrepresentation relating to projected start-up costs. The court granted the franchisor's motion to dismiss the fraud claims, holding that the plaintiff could not prevail because when it signed the franchise agreement, it expressly disclaimed reliance on statements made outside of the FDD. However, the court denied the franchisor's motion to dismiss the plaintiff's claims under the New York Franchise Sales Act based on the Act's anti-waiver provisions that prohibit treating a contractual disclaimer as a waiver of fraud claims. Therefore, the court denied the franchisor's motion to dismiss this claim.

Although the plaintiff survived the franchisor's motion to dismiss, the court denied its subsequent motion for summary judgment, holding that factual issues precluded summary judgment on the plaintiff's New York Franchise Sales Act claim. The plaintiff claimed the franchisor misrepresented the start-up costs of a franchise—specifically, the cost of leasehold improvements and fixtures. The FDD stated a range between $22,500 - $137,600. However, two of its four franchisees reported significantly higher costs. One franchisee spent $338,797 to open a facility and the other spent $556,587. The franchisor claimed the costs incurred by these franchisees were not representative and that landlord's contributions to construction may vary, thus accounting for the differences.

These allegations were enough for the court to find a fact dispute regarding whether the franchisor's stated cost of leasehold improvements and fixtures in Item 7 constituted a material misstatement. The court also declined to grant plaintiff summary judgment on other elements of its fraud claim. First, the court found there was a fact issue as to whether the plaintiff reasonably relied on the Item 7 data in the FDD. Before signing the franchise agreement, the plaintiff spoke with other franchisees, who warned it of the high start-up costs and low revenue.

These communications provided the Wilders with reason to question the figures with which they were allegedly most concerned—the initial investment costs disclosed in Item 7—and to question the entire body of information that Kidville had provided, as both franchisees also reported that their anticipated revenues were inflated. Nevertheless, the Wilders continued to rely on the disclosures

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94 Id. at 621.
96 Id. at 394.
contained in Item 7 without obtaining any documentary proof or any specific representations as to the accuracy of that information.\textsuperscript{97}

The plaintiff tried unsuccessfully to downplay the significance of its communications with other franchisees. The court stated those arguments were better suited for trial than for summary judgment.\textsuperscript{98}

The nature of Item 7 disputes indicates that they are fact-intensive. Although franchisees can survive motions to dismiss if they have evidence that the franchisors possessed information contrary to what was disclosed in the FDD, these allegations often are not enough to get past the franchisor’s motion for summary judgment, especially given the expansive explanations and warnings in most FDDs and the reasonable reliance requirement.

\textit{California v. Speedee Oil Change Sys., Inc.} is an example of a plaintiff successfully imposing liability for misleading Item 7 start-up disclosures.\textsuperscript{99} The California Corporations Commissioner brought an action against Speedee Oil Change for misleading prospective franchisees about start-up costs. During pre-sale discussions, sales personnel would “low-ball” start-up costs in verbal representations to prospects. Even though the franchisee’s actual costs were usually within the range specified in the UFOC, the court found the salesperson’s statements to be “a material misrepresentation in that it was designed to lull the prospective franchisee into a false sense that he/she had enough money and was intended to disparage the information in the UFOC.”\textsuperscript{100}

Interestingly, the court in \textit{Speedee} did not discuss intent or whether the franchisees had relied on the misrepresentations.\textsuperscript{101} Under the California Franchise Investment Law, “[i]t is unlawful for any person \textit{willfully} to make any untrue statement of a material fact . . . ”\textsuperscript{102} Furthermore, California is one of six states which allow defendants to assert an affirmative defense that it exercised reasonable care and did not know, or could not have known, of the untruth or omission.\textsuperscript{103} This adds another dimension to the Item 7 analysis under California law. The focus is not only on what the franchisee believed, but also takes into account the franchisor’s intent.

C. Practice Pointers

\textsuperscript{97} Id. at 395.

\textsuperscript{98} Id. at 396.


\textsuperscript{100} Id.

\textsuperscript{101} See Beyer et al., supra note 77, at 105.

\textsuperscript{102} Cal. Corp. Code § 31200 (West 2006) (emphasis added).

Franchisors should ensure that the information they provide to prospective franchisees is as up-to-date as possible. Although Item 7 only provides an estimate or range, franchisors can be liable for misrepresentations if they do not disclose current information. This is the most important aspect of Item 7 disclosures.

If the franchisor possesses initial investment information that is materially different from what is in the FDD, it should make sure to disclose that information to prospective franchisees. Merely updating the information annually may not be enough, especially if there is information that contradicts the disclosed numbers.

If a franchisor begins operations in a new territory and does not possess actual cost information, it should make that fact clear to prospective franchisees and emphasize that the numbers are merely estimates. If new information becomes known as franchisees develop in the new territory, franchisors should disclose that information to prospective franchisees, even if it requires a post-effect amendment.

Franchisors should always include disclaimer statements in the footnotes to Item 7, specifically disclaiming reliance on the estimated information. The following language is typical of most Item 7 footnotes.

These figures are estimates and we cannot guarantee you will not have additional expenses either in starting the business or during the first three months. Your costs will depend on factors like: how closely you follow our methods and procedures; local economic conditions; the local market for your products and services; the prevailing wage rate; competition; the size of your territory; and the sales level reached during the initial period.

In putting together these estimates, we relied on the experience of our affiliate during its X years of operation. Your actual investment could be different from this experience, particularly if you decide to add services that are beyond those we initially recommend you provide.104

Incorporating such language can help defeat common law claims of fraud, which require a showing of reliance. Franchisors should also strongly encourage prospective franchisees to speak with other franchisees and to review the figures carefully with a business adviser before making any decisions.

Franchisors should also be aware of any changes to state regulations that could impose more stringent disclosure requirements. General knowledge of the state’s laws is key because some allow for affirmative defenses. Additionally, a state’s statute of limitations may also block Item 7 litigation.105

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104 Fittante et al., supra note 2, at 13.

105 See Athlete’s Foot Mktg. Assocs., Inc. v. Inner Reach Corp., No. 1:99-CV-2928 (BBM), Bus. Franchise Guide (CCH) ¶ 12,349 (N.D. Ga. Mar. 13, 2002) (holding that a franchisee should have been able to discover that its stores had greater-than-expected start-up costs within the one-year statute of limitations).
Overall, the most important thing a franchisor should do regarding Item 7 is make sure it is disclosing the most current information possible. Franchisors have several layers of protection through disclaimer statements and cautionary language delineating the numbers as mere estimates, but those might not be enough if a franchisee can show that the numbers used were actually false at the time they signed the franchise agreement.

Franchisee counsel are encouraged to review the Item 7 information and speak with their clients about whether the estimates were consistent with the franchisee’s actual expenditures. An example of an expense line that is frequently inaccurate is professional services. Franchisors often indicate costs that are significantly lower than are actually incurred by franchisees who retain professionals such as attorneys and accountants for assistance acquiring and developing the franchise. Although misrepresentations regarding this one line item may not be sufficient to establish an Item 7 violation, it may be a sign of problems with other disclosure items and further inquiry may be warranted. Similarly, franchisors may fail to update their information timely. It is not uncommon for a franchisor to indicate that the Item 7 information is based on an affiliates’ experience in opening a location. However, those locations may have been opened several years prior to the franchisor commencing franchise sales so the cost information is stale.

Emerging franchisors often underestimate the investment costs for geographic locations where they have limited experience. For example, where a franchisee leases a location with a rent obligation significantly greater than the estimate indicated in Item 7, franchisee counsel may want to inquire as to whether the franchisor provided any advice or assistance in finding the location. If the franchisor reviewed and approved the lease, what advice did it provide the franchisee about the required rent? Did the franchisor warn the franchisee that the rent was significantly higher than is appropriate for the franchise? Answers to these types of questions may support an Item 7 violation.

VI. ITEM 8

A. Required Disclosure

Item 8 requires the disclosure of the franchisee’s obligations to purchase or lease goods, services, supplies, fixtures, equipment, inventory, computer hardware and software, real estate, or comparable items related to establishing or operating the franchised business either from the franchisor, its designee, or suppliers approved by the franchisor, or under the franchisor’s specifications, including any obligations to purchase imposed by the franchisor's written agreement or by the franchisor's practice.106

Item 8 requires detailed disclosure of the nature, substance, and magnitude of purchase obligations established by the franchisor. It also requires disclosure of the policies and procedures governing alternative sourcing, including the approval process for alternative suppliers and the specifications for required goods.

The purpose of Item 8 is to make the supply and monetary relationship between franchisor and franchisee as transparent as possible. Over the years, franchisors have derived significant revenues from costs and fees that were effectively “baked into” the prices charged to

106 16 C.F.R. § 436.5(h).
franchisees for required purchases as simple as janitorial supplies or paper products. Prior to the existence of these robust disclosure requirements, franchisees often had no idea that they would be forced to buy particular products from the franchisor or its designated suppliers, even though those goods were often locally available for less from independent, third-party suppliers. The FTC Rule now requires that prospective franchisees have full disclosure of potentially unfavorable supply terms before they enter into long-term franchise agreements.

The detailed disclosures required under Item 8 are remarkably effective at preventing surprise profit centers for unscrupulous franchisors. Since the amendments to the FTC Rule in 2007, the late discovery of a franchisor’s gambit for additional revenue is a rare occurrence.

Item 8 disclosure requirements are extremely detailed. They require disclosure of effectively any required purchase from designated or approved suppliers (and any revenue to the franchisor) or the terms and conditions that govern entering into alternative supply arrangements. Careful disclosure of Item 8 restrictions ensure that no misrepresentations are made and that both parties are fully informed of the real-world costs associated with the franchise before entering into the relationship.

Item 8 requires disclosure any time a franchisee is required to purchase or lease anything from the franchisor or an affiliate of the franchisor. Any time a purchase transaction is required, the FTC Rule requires multiple detailed disclosures for each transaction. The FTC noted that these disclosures “inform prospective franchisees about critical restrictions on how they will have to operate the franchise, which comprise a vitally important aspect of the franchise relationship.” To that end, the full nature, profitability, and restrictive character of the relationship must be disclosed.

Most required disclosures are relatively clear, but there are some gray areas. The most commonly litigated issue is what constitutes a “payment” from a supplier to a franchisor. From the time of the original UFOC Guidelines to the amendment to the FTC Rule in 2007, franchisors have attempted to hide kickbacks from vendors in a wide variety of alternative arrangements. A cash payment tied directly to franchisee purchases clearly must be disclosed. But at one time, it was unclear if unequal pricing or volume discounts available only to the franchisor required disclosure. Now any scheme that benefits the franchisor financially must be disclosed.

Disclosing the existence of franchisor income from required purchases is just one aspect of Item 8 disclosure. The magnitude of income must also be disclosed, including the actual quantity and proportion of the franchisor’s total revenue attributable to such income. Further, any revenue received by the franchisor’s affiliates must be disclosed in similar detail. Although it may be difficult to identify precise amounts of revenue attributable for some complicated rebate schemes, or for intangible benefits, the relationship itself and the benefits flowing from it must be disclosed.

107 “Affiliate” is defined as “an entity controlled by, controlling, or under common control with, another entity.” FTC Franchise Rule Definitions, 16 C.F.R. § 436.1(b). This includes all subsidiaries, parents, and joint ventures.
108 16 C.F.R. § 436.5(h).
109 SBP, supra note 10, at 15487.
110 These are expressly required to be disclosed by the text of the FTC Rule, see 16 C.F.R. § 436.5(h)(8).
To the extent that the disclosure requirements seem to leave space open for unreported revenue or other material benefits, one must always remember that the goal of Item 8 is nearly complete disclosure of all material information so that prospective franchisees can make an informed decision. Hiding the true nature of the financial relationship, making obligations unclear, or obscuring the benefits a franchisor realizes from the franchise relationship are clearly not in the spirit of Item 8 and may rise to the level of a violation.

The broad disclosures required by Item 8 are clarified and given pointed applicability by the Compliance Guide. This guidance, although not binding, gives franchisors insight into what the FTC staff envisions a compliant disclosure document contains.111 The Compliance Guide suggests separating disclosures into eleven broad areas. These eleven disclosures collapse into four general categories:

- first, the required purchases, from whom such purchases must be made, and whether or not the franchisor is affiliated with or interested in the supplier;
- second, the amount of money that the franchisor derives from the required purchases, how payments are calculated, and how big a business this is for the franchisor;
- third, whether a franchisee can get approval of an alternative supplier, how the approval process works, whether the specifications for any required goods or services are available, and importantly, how they may be modified by the franchisor; and
- finally, whether there are purchasing cooperatives or group-buying discounts, who benefits from the discounts, and if the franchisee derives any benefits from using particular suppliers.

Combining disclosures in this way ensures that all material information is collected into one, easy to follow narrative, keeping in the spirit of the FTC’s emphasis on usability for franchisees.

The Compliance Guide emphasizes disclosing all required purchases that are supplied by the franchisor or one of its affiliates. If the items are provided as part of the initial franchise fee, there’s no need to disclose the information in Item 8 because they aren’t future required purchases. Optional purchases are also outside the scope of Item 8, and need not be disclosed, even if they are only available from the franchisor.112

Franchisor ownership interest in suppliers and revenue derived from suppliers will often be a large component of the Item 8 disclosure. The FTC indicates that “supplier” is meant to be construed very broadly, capturing the entirety of the supply chain from manufacturer to final sale.113 Likewise, “ownership interest” is similarly broad, ranging from wholly-owned subsidiaries to any person with decision making authority at the franchisor who directly owns stock in a

111 Compliance Guide, supra note 9, at 51-55.
112 Id. at 52.
113 Id. at 53.
supplier. If an officer of the franchisor stands to benefit personally from a franchisee’s purchase, the interest should be disclosed in Item 8.

If the franchisor provides specifications to enable the franchisee to find alternative suppliers, it must disclose the terms on which the specifications are made, in what form, to whom, and how and when specifications may be changed or modified. Note, if a franchisor represents that specifications are available for a particular type of product, the franchisor must make those specifications available to franchisees.¹¹⁴

When confronted with required purchases from the franchisor or an affiliate, prospective franchisees often wonder if they can negotiate a more favorable alternative deal with a different supplier. Whether a franchisor permits these alternative suppliers must be disclosed, along with the details about the approval process. This particular issue was the subject of robust debate during the comment period prior to the 2007 Amendment to the FTC Rule, with advocates for franchisees emphasizing that seeking approval is often a fool’s errand.¹¹⁵ In response, the FTC found that “the record is insufficient to justify a sweeping consumer warning that assumes delay . . . as a matter of course.”¹¹⁶ To address the perceived difficulty associated with getting approval for alternative suppliers, the FTC requires detailed disclosures about the process, any associated fees, approval timelines, whether the franchisor may modify the specifications to make alternative supply arrangements impracticable, and importantly, how approvals can be revoked. However, there is no requirement to disclose the specific criteria used to evaluate proposed alternative suppliers.

Picking up on the concerns made by commenters to the Amended FTC Rule, it may be prudent to describe how often alternative supply arrangements are approved, and under what terms. The FTC determined that more detailed disclosures need not be mandated, because standards and procedures may change over time.¹¹⁷ Moreover, if specifications are likely to change often, it may be prudent to indicate that although approval may be granted, it is likely to be for a relatively short period of time, as new specifications may require revocation of old suppliers and approval of a new supplier. There is, however, no affirmative requirement to provide specifications to franchisees or to approve alternative supply arrangements.

The other major requirement for Item 8 disclosures is accounting for the money that flows to a franchisor based on the purchases made by its franchisees. The FTC made the determination that full disclosure of the ways that a franchisor receives money was preferable to an outright ban on any sort of rebates or kickbacks, which some commenters proposed.¹¹⁸

¹¹⁴ Bores et al. v. Domino’s Pizza LLC, 489 F. Supp. 2d 940 (D. Minn. 2007), rev’d, 530 F.3d 671 (8th Cir. 2008).

Although this case was reversed by the 8th Circuit, the lower court opinion is instructive for the principle that a franchisor that states it will make specifications available to enable a franchisee to obtain permitted purchases from third parties, it must do so. The decision was reversed at the Eighth Circuit based on the specific contract language at issue, not the underlying legal principle.

¹¹⁵ SBP, supra note 10, at 15487 n.456.

¹¹⁶ Id.

¹¹⁷ Disclosure Requirements and Prohibitions Concerning Franchising, 72 Fed. Reg. 15487 (March 30, 2007) (codified at 16 C.F.R. § 436) (“It is sufficient to warn prospective franchisees about source restrictions, purchase obligations, and approval of alternative suppliers, without requiring franchisors to disclose their past practices regarding approving alternative suppliers (which may be irrelevant to their current practices) or their future intentions (which may be proprietary information or misleading if the franchisor abandons the intended direction.”).

¹¹⁸ SBP, supra note 10, at 15488 n.457.
required disclosures are nearly absolute. The Compliance Guide takes the position that “[a]ny payment or benefit that a franchisor may receive as a result of franchisee purchases must be disclosed in Item 8.”\footnote{Compliance Guide, \textit{supra} note 9, at 54.} Included are classical direct payments or kickbacks based on purchases made by a franchisee. Also within the contemplation of the rules are any special pricing available only to the franchisor, rebates, or in some cases, the absence of a special markup that is charged only to franchisees.\footnote{\textit{Id.}} Any benefit that flows back to a franchisor must be disclosed.

Item 8 goes beyond merely requiring disclosure that schemes exist; it requires a detailed accounting showing the amount of revenue a franchisor derives from affiliates, ownership interests and kickback schemes. The FTC requires that franchisors report gross revenue, revenue from all required purchases, the percentage of the franchisor’s total revenue that required purchases represent, the revenues received by affiliates from the required purchases, and finally, the proportion of required purchases to total purchases made by the franchisee. In disclosing the amount of revenue received from suppliers, the franchisor need only disclose the percentage of purchases it receives as a payment, or the total amount received by the franchisor from that supplier. There is, however, no requirement that there be a chart clearly listing which supplier pays what rebate. A range within which all rebates fall is sufficient. The level of detail required can illustrate just how lucrative required purchases are for some franchisors. It also puts the franchisee on notice of how much the franchisor depends on supply chain revenue.

Diverting benefits or payments to third parties will not obviate the Item 8 disclosure requirements. The FTC’s position is that any third-party organization controlled by the franchisor (or its owners) that receives payments or benefits because of franchisee actions must be disclosed in Item 8. The only way to escape this disclosure requirement is to cede control of the third party and make it a truly independent organization. The classic example is the independent advertising cooperative, funded out of required contributions and directed by the franchisees themselves. This alternative arrangement is not subject to Item 8 disclosure.

The final set of Item 8 disclosures touches on the existence of negotiated buying power, purchasing cooperatives, and the disclosure of benefits that accrue to franchisees by buying from approved suppliers. Negotiated buying power disclosures can be complicated. For example, if a franchisor does in fact get better prices, but declines to pass along the better prices to its franchisees, it may need to disclose the disparity as a payment accruing to it from a supplier because of franchisee purchases.\footnote{See \textit{CKH, L.L.C. v. The Quizno’s Master, L.L.C.}, No. 04-RB-1164 (BNB), Bus. Franchise Guide (CCH) ¶13,027 (D. Colo. Mar. 25, 2005).} This is important lest a franchisee believe it is getting a better deal than otherwise available based on a “negotiated buying power” representation made in the FDD. Similar to the method of disclosing payments from suppliers, the actual specific terms of a negotiated pricing agreement need not be disclosed. Purchasing cooperatives or distribution cooperatives should be disclosed in general terms, even if participation is optional. If participation is mandatory, disclosure of the specific cooperative is required.

Perhaps the most important disclosure is that of “material benefits” that accrue to franchisees based on their purchases of required goods from approved suppliers. These benefits could range from special discounts to increased chances of renewal or even granting
additional franchises in the geographic market. Whatever the claimed benefit that flows to the
franchisee, disclosure is required. This avoids the situation where a lack of disclosure induces a
franchisee into buying more with the misplaced expectation of some benefit based on more
purchases.

At least one state disclosure law has requirements that are arguably more demanding
than the FTC Rule.\textsuperscript{122} Maryland’s franchise law generally requires that any relationship between
designated suppliers and the franchisor be fully disclosed, along with pricing information.\textsuperscript{123}
Unlike the FTC Rule, this requirement is not enumerated in the disclosure provisions, but is
found in a list of fraudulent and deceptive practices. Thus, any misstep here is likely actionable
without regard to detailed proof of actual fraud or actual deception.\textsuperscript{124}

The additional disclosures required by Maryland law include a disclosure of the price a
franchisee will be charged for required goods and services, the prevailing market price for such
goods or services, and any relationship between the price charged and the market price.\textsuperscript{125}
Failure to do so constitutes a fraudulent representation or deceptive statement.\textsuperscript{126} Disclosure of
the wholesale cost of goods sold to franchisees is also required, allowing a franchisee to
determine the exact markup it is charged.\textsuperscript{127} Interestingly, a franchisor is required to disclose the
prevailing market price of any goods or services required to be purchased, and if none is
available, an explanation why. Franchisors are also required to disclose any mechanisms to
ensure that required goods and services remain available for purchase.\textsuperscript{128} Failure to disclose
these last two items constitutes a false, fraudulent or deceptive omission under Maryland law.\textsuperscript{129}
Maryland may be unique in requiring detailed disclosure of pricing information and information
about the continued availability of required goods and services, but liability can be minimized by
carefully disclosing relationships, benefits that accrue to the franchisor, and the required pricing
information.

B. Item 8 Claims

i. Breach of Contract

A Minnesota federal court held that the plain language of the franchise agreement
required the franchisor to provide franchisees the specifications for a computer system so that
they could obtain it from a third party.\textsuperscript{130} The franchise agreement stated that the franchisor
would provide specifications to franchisees for a variety of items so that franchisees could
purchase goods from any approved supplier that could meet the franchisor’s specifications,
including computer hardware and software. When the franchisor subsequently attempted to

\textsuperscript{122} See Fittante et al., \textit{supra} note 2, at 22.

\textsuperscript{123} Id.


\textsuperscript{125} Md. Code Regs. 02.02.08.16(E)(2).

\textsuperscript{126} Id. at 02.02.08.16(B).

\textsuperscript{127} Id. at 02.02.08.16(J)(2).

\textsuperscript{128} Id. at 02.02.08.16(J)(2)(d).

\textsuperscript{129} Id. at 02.02.08.16(J).

\textsuperscript{130} Bores et al. \textit{v}. Domino’s Pizza LLC, 489 F. Supp. 2d 940 (D. Minn. 2007), rev’d, 530 F.3d 671 (8th Cir. 2008).
require franchisees to purchase computer hardware and software solely from the franchisor, the franchisees brought suit alleging breach of contract for refusing to provide specifications, and violation of the Minnesota Franchise Act for failing to disclose the required purchases.

The court reasoned that because the contract unambiguously stated that the franchisor would make specifications for computer hardware and software available to franchisees, the franchisor breached the contract by failing to make the specifications for its new, proprietary computer system available to franchisees. However, the court was unwilling to find a violation of the Minnesota Franchise Act in the absence of evidence demonstrating that at the time of the disclosure, the franchisor was already planning on requiring the purchase and use of a proprietary computer system. As mentioned above, this decision was ultimately reversed by the Eighth Circuit, which held that the lower court used an unreasonably restrictive definition of “specification” and “any.” The Eighth Circuit held that “the plain and ordinary meaning of specification includes both a list of the component parts necessary to construct or described an item, as well as a single, finished, product.” The court also found the term “any” includes “one, some, every or all” citing the American Heritage Dictionary 81 (4th ed.2000). Thus the court found that the franchise agreement allows the franchisees to purchase the specified computer system from any available source, be they one or many. Because the franchisor was the only source for the proprietary computer system, the franchisees were required to purchase it from the franchisor.131

ii. Fraud/Misrepresentation

In Tubby's #14, LTD., et al. v. Tubby's Sub Shops, Inc., the franchisor formed a separate supply company to negotiate contracts with manufacturers and then sell goods to franchisees.132 The franchisor’s FDD truthfully disclosed both the existence of the affiliated supply entity and the existence of a small kickback amount. However, the FDD failed to disclose the true magnitude of the kickback scheme, most notably hiding large portions of the kickback in artificially increased prices charged by the manufacturers and passed along to the franchisees. On the franchisor’s motion for summary judgment, a Michigan federal court held that there were issues of material fact regarding the franchisee’s reliance on representations about the rebate or kickback amounts in the FDD. Further, the court found an issue of material fact as to whether or not the franchisor’s failure to disclose the existence of the kickback arrangement amounted to a fraudulent act.

The court found that the franchisee should have the opportunity to prove that the franchisor fraudulently failed to disclose adequately the existence of the kickback scheme. Such a showing would allow franchisee to prove that it relied on the statements in the disclosure document to its detriment and that the franchisor failed to disclose that it was deriving significant benefits from encouraging franchisees to participate in the consolidated sourcing plan. The court found that any money that flows to the franchisor because of money spent by franchisees should be disclosed, especially if the franchisor is requiring or otherwise inducing franchisees to purchase from a particular supplier.133

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131 Bores v. Domino’s Pizza, LLC, 530 F.3d 671, 676 (8th Cir. 2008)
133 Id.
In CKH, L.L.C. v. The Quizno’s Master, L.L.C., the franchisor represented in its UFOC that it negotiated supply arrangements for the benefit of franchisees, which included volume pricing.\(^\text{134}\) The UFOC also stated that the franchisor had a right to receive payments from suppliers based on franchisee purchases and that the franchisor could do anything it wanted with that revenue. When the franchisee learned that it was not receiving all of the volume discounts, it sued the franchisor for breach of contract and negligent misrepresentation.

The franchisee alleged that franchisor breached the franchise agreement by not passing along volume discounts and negligently or intentionally misrepresented that it would negotiate supply agreements and pass along the savings. The court dismissed the negligent misrepresentation claim as an attempt to side-step the lack of a private right of action under the FTC Franchise Rule. The court also dismissed the breach of contract claim because it found no language in the franchise agreement suggesting that any volume discounts be passed along to the franchisee. Language suggesting that such discounts could trickle down was not enough to sustain an action for breach of contract.

iii. Failure to Disclose

Team Tires Plus, LTD. v. Heartlein involved a failure to disclose under Item 8. Although this case was adjudicated prior to the 2007 amendments to the FTC Rule, the case is instructive.\(^\text{135}\) In 2007, Item 8 only required disclosure of rebates on revenues derived from required purchases under the terms of the franchise agreement. There was no requirement to disclose a rebate system from one supplier where that supplier represented but one of many available franchisee suppliers. Here, the franchisee learned that certain vendors rebated between five and ten percent of the franchisee’s purchases to the franchisor. The franchisee asserted that the franchisor had a duty to disclose these arrangements under Item 8 of the UFOC guidelines. The franchisee also alleged that the failure to disclose the rebates constituted fraud by omission. The court dismissed the franchisee’s claims on summary judgment.

For the franchisee to prevail on its claim of fraud by omission, it needed to demonstrate that it detrimentally relied on inaccurate statements and that it was damaged by paying an inflated price to the franchisor. The Minnesota federal court found that the franchisee’s admission that it was free to purchase goods from any third party vendor was fatal to its fraud by omission claim. There was simply no evidence of false representations in the UFOC. With respect to the Item 8 claim, the court found significant that under the Item 8 guidelines (as they existed in 2007), the franchisor was required to disclose revenue received as a result of required purchases. Because the franchisee was free to purchase goods from any vendor, its claim failed as a matter of law. Additionally, there was no indication that the vendor payments resulted in any negative price differential to the franchisee.

Were this case litigated after the 2007 amendment of the FTC rule, there is little doubt that the failure to disclose the rebates from multiple suppliers would violate the current Item 8 guidelines. In fact, it is this type of case that the Amendments to Item 8 disclosures were intended to address.

C. Practice Pointers

\(^{134}\) CKH, L.L.C., supra note 121.

As a franchisor, if you indicate that you will make specifications available to franchisees so they can obtain goods or services from third-parties, carefully draft language regarding the nature of the specifications and available sources to avoid confusion about the process. If certain types of proprietary products or services must be purchased only from approved vendors, while commodity products or services can be purchased elsewhere, specificity will prevent future disputes.

Franchisors must disclose all monetary relationships with suppliers, no matter how superficial or complicated they are. Any means that a franchisor derives income from the activities of a franchisee should be disclosed. For example, if a franchisor represents that franchisees get a volume discount from a particular supplier, the franchisor should consider making the pricing transparent. This goes above and beyond the Item 8 disclosure requirements, but it may help prevent claims of reliance on a franchisor’s representation of lower prices.

Franchisors should not imply they will negotiate for the benefit of franchisees if the franchisees don’t receive any actual benefit. If a franchisor indicates that it will negotiate, this should be combined with a statement that any discounts or benefits derived from negotiating a supply arrangement are the property of the franchisor and may be distributed to the franchisee or used solely for the franchisor’s benefit at its sole and absolute discretion.

Franchisors should follow the FTC guidance documents carefully. They are very detailed and give answers for almost all complicated or questionable Item 8 situations. If there is a doubt about whether disclosure is required, franchisors should err on the side of disclosure, especially if the franchisor derives any benefit from purchases made by franchisees.

VII. ITEM 11

A. Required Disclosure

Item 11 generally requires four different categories of disclosure. These include information about the assistance that the franchisor will provide to the franchisee before the franchisee commences operations as well as ongoing assistance; information about any system advertising program; identification of any mandatory computer or software purchases and related costs that a franchisee will incur; and the training program provided by the franchisor to franchisees. The franchisor must also include the table of contents and identify the number of pages of the operations manuals and an estimated range for the length of time it takes between signing the franchise agreement and opening the franchised business.136

i. Franchisor Assistance

The NASAA Guidelines provide a list of areas in which a franchisor may provide assistance that may be applicable. These include guidance on site selection; employees; signs and equipment; establishing prices; establishing and using administrative processes such as those related to bookkeeping, accounting and inventory control; and resolving operating


137 Curran & Mitchell, supra note 2, at 18; 16 C.F.R. § 436.5.
problems that may be encountered by the franchisee. In addition to disclosing the assistance the franchisor will provide, it must also include a specific disclaimer indicating that except as provided in Item 11, the franchisor is not required to provide any other assistance. This is intended to dispel any misconceptions the prospective franchisee may have about the assistance that will be provided by the franchisor. The franchisor can include information about optional assistance that it is not obligated to provide, but this information must be set forth separately and it must be clearly indicated that this assistance is not guaranteed.

ii. Advertising

The franchisor must indicate whether it has any obligation to conduct advertising, whether franchisees are permitted to use their own advertising materials; whether the franchise system has an advertising council and whether the franchisee has an obligation to participate in advertising cooperatives.

iii. Computers

The franchisor must also describe certain information about any required electronic cash register or computer system including hardware and software components and the estimated costs for such systems as well as the obligation of the franchisor, if any, to provide any ongoing support or maintenance. Franchisors must include any obligation of the franchisee to upgrade or update any system during the term of the franchise agreement and the annual cost of any optional or required maintenance or updates. Finally, the franchisor must disclose whether it will have independent access to the information generated by or stored in any electronic cash register or computer system. Information about the franchisee’s computer system is intended to permit a prospect to weigh the costs and benefits of purchasing a specific franchise and to enable it to ascertain readily whether it may be at a technological advantage or disadvantage compared to franchisees of competing franchise systems. If start-up franchisors have not yet determined their computer requirements they must disclose this fact.

iv. Training

Item 11 must also include a description of the training program in tabular form and must indicate how often training classes are held; the location or facility where training is held; the nature of instructional materials; the instructor’s experience, including the instructor’s length of experience in the field and with the franchisor; any charges franchisees must pay for training and who must pay travel and living expenses of the training program enrollees; who may and

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139 Garner, supra note 6, at FTC-111.
140 Id.
141 Compliance Guide, supra note 9, at 66.
142 NASAA Guidelines, supra note 12, at 48.
143 Compliance Guide, supra note 9, at 67.
144 Garner, supra note 6, at FTC-112.
who must attend training; and whether additional training programs or refresher courses are required.

B. Item 11 Claims

Item 11 claims have been asserted with little success. In America’s Favorite Chicken Company v. Cajun Enterprises, Inc., the franchisee claimed that the franchisor breached the franchise agreement by, among other things, failing to provide continuing advisory assistance in the operation of the franchise. The court granted the franchisor’s motion for summary judgment relying on the franchise agreement, which indicated that the franchisor will “make available such continuing advisory assistance …as [AFC] may deem appropriate.” The court found that the franchisor had complete discretion as to the extent of assistance to provide.

The franchisor was also successful in Healy v. Carlson Travel Network. The franchisee asserted claims including that the franchisor misrepresented the support the franchisor would provide by promising future services that the franchisee did not receive. On the franchisee’s claim under the Illinois Franchise Disclosure Act (“IFDA”), the court found that although there were problems with some of the services provided, the franchisee failed to assert that the franchisor intentionally caused these failures or knew that the representations about these benefits would prove to be inaccurate. As there were no representations regarding the quality of support to be provided, the franchisee could not demonstrate that the franchisor acted with an intent to defraud him into entering in the franchise agreement. The court held that absent a showing that alleged misstatements of future events were made with an intent to defraud, the claim under the IFDA could not be sustained.

However, in Hanley v. Doctors Exp. Franchising, LLC, the franchisee’s claims for violation of the Maryland Franchise Law and fraud survived the franchisor’s motion to dismiss its claims. In addition to its claims relating to Item 7 and Item 19, the franchisee alleged that the franchisor misrepresented that it would offer significant expert assistance in the credentialing and contracting process in connection with its urgent medical care management franchise and that it would take only 3 months to complete the process. The franchisor argued that the franchisee’s claims based on misrepresentations concerning the credentialing and contracting process should be dismissed because the franchisee allegedly admitted that the misrepresentations were made by a third party. The Maryland federal court held that the document relied on by the franchisor did not conclusively establish an admission and it would be improper to consider the document at the motion to dismiss stage.

In Kieland v. Rocky Mountain Chocolate Factory, Inc., the franchisees asserted claims for violation of the Minnesota Franchise Act due to, among other things, the franchisor’s

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145 America’s Favorite Chicken Co. v. Cajun Enters., Inc., 130 F.3d 180 (5th Cir. 1997).
147 Id. at 1092.
148 Hanley, 2013 WL 690521, at *6. The franchisor argued in its motion to dismiss that the franchisee had admitted in an email that the representations were made by a third party. The court found that at best, the statement in the email might be a statement against interest, but it was not sufficient to “carry the day” for the franchisor.
misrepresentations regarding the required point-of-sale ("POS") system. The franchisees alleged that the franchisor represented in the UFOC and otherwise that the cost of the POS system would not exceed $7,000; that it would be state of the art; and that it would provide productivity reporting, simplified payroll, complete data for use in financial reporting and other supportive services. The franchisor had also disclosed in its UFOC that it had the right to require franchisees to “upgrade or update” their POS systems and that there were no contractual limitations on the frequency or cost of this obligation.” After signing the franchise agreement and during training, the franchisees were told that they would need to purchase a different, new POS system at a cost of almost $20,000 and an annual maintenance fee of almost $2,000.

The court granted the franchisor summary judgment, finding that the franchisor's representations that the POS would perform certain functions were accurate. Because the franchisor did not represent the specific nature or quality of those functions, there were no misrepresentations made that would support the franchisees’ claims regarding the performance of the POS system.

Other areas of Item 11 litigation involve claims relating to system advertising. In Cousins Sub Systems v. McKinney, the court dismissed the franchisee’s claims for violation of the Minnesota Franchise Act. The franchisee asserted, among other things, that the franchisor had represented that it would provide advertising in excess of the amount paid by the franchisees but failed to do so. The UFOC expressly stated that the franchisor was not obligated to spend any specific amounts on advertising in the area where the franchisee was located and the franchise agreement contained an integration clause. This was sufficient to defeat the claims. In JMF, Inc. v. Medicine Shoppe International, Inc., the franchisee failed to succeed on its claim that the franchisor failed to provide advertising as represented because the franchise agreement clearly stated that the services would be provided in the sole discretion of the franchisor.

C. Practice Pointers

Franchisors will want to give careful consideration to their actual practices. For instance, they will want to ensure that they are not obligating themselves to provide support that in practice is not always provided. In addition, franchisors should be reminded about disclosures made in Item 11 on an ongoing basis. For example, franchisors are required to disclose whether company-owned outlets will contribute to the advertising fund on the same basis as franchisees and many indicate that they will. Indeed, those franchisors may intend for those units to make contributions but in reality, those contributions are not made or may be made on a different basis than franchisees. If such an affirmative disclosure is made, franchisors should be careful to ensure that company-units are in compliance on an ongoing basis and/or update

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150 Id. at *7.
151 Id. at *8.
154 Fittante et al., supra note 2.
the FDD accordingly. Another area where franchisors may have trouble relates to the use of the advertising fund. Franchisors are required to indicate whether they will use the advertising fund to solicit principally new franchisees and many indicate that they do not do so. However, franchisors likely use the advertising fund to develop and maintain a website and that website may have a page for information about buying a franchise. To avoid any appearance of misrepresentation, franchisors may want to indicate that although the advertising fund is not used principally to solicit franchisees, it may be used to update the website and that such updates may include updates to the franchise opportunity page.  

Franchisee counsel should understand that Item 11 generally includes a lot of information. Some franchisors use this section of the FDD to include marketing information and to demonstrate to prospects the extensive support that will be provided to them if they buy a franchise. However, particularly as the system grows or management changes over time, some of that support may not always be provided. Franchisee counsel will want to question their clients to determine if they relied on representations regarding such support and whether it was provided. If not, there may be a viable claim.

VIII. ITEM 12

A. Required Disclosure

In Item 12 of the FDD, the franchisor must disclose certain details concerning the possible location of the franchised business and any protected territory. These disclosure obligations were expanded by the 2007 amendments to the FTC Rule to more adequately address franchisees' concerns relating to encroachment and cannibalization. The disclosure now required in this Item includes: (a) whether the franchisee will receive an exclusive territory; (b) the conditions required, if any, for relocation of the franchised business; (c) whether the franchisor can solicit or accept orders from customers within the franchisee's territory; (d) whether the franchisor has the right to use alternative channels of distribution within a franchisee's territory; (e) whether the franchisee will receive any compensation if the franchisor does solicit or accept orders from inside the franchisee's territory; (f) the extent to which a franchisee will be restricted from soliciting business or accepting orders from outside the territory; and (g) whether the franchisor has any present plans to operate a competing franchise system offering similar goods or services. Item 12 must also include information about the use of the internet to achieve sales and the use of alternative channels for distribution of the franchisor's goods and services and how conflicts between franchisees in each system relating to territory, customers or franchisor support will be handled.

The extent of territorial protection granted by franchisors to franchisees may differ significantly depending on the franchise system. Some franchisors grant actual exclusive

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155 Id. at 16.

156 Curran & Mitchell, supra note 2, at 20.


158 Id. at 10.

159 Oppenheim & Prince, supra note 2, at 111.
territories where the franchisees will have the sole right to market and sell goods and/or services using the franchisor’s trademarks within a territory. Others do not provide franchisees with any territorial protection. Frequently, franchisors provide some amount of protection. For instance, franchisees may be protected from others opening and operating locations within the territory but the franchisor will maintain the right to sell goods or services within the territory through alternative methods of distribution such as through the internet. Some franchisors also reserve the right to develop or franchise another location within the territory provided it is located within a “non-traditional” location such as a military base, sport stadium, lodging facility and the like.

Exclusive territories are only those in which the franchisee is granted all rights to use the franchisor’s trademarks in association with goods or services within a particular territory. A territory is not exclusive if the franchisor reserves rights to establish company-owned or franchised outlets, even at “non-traditional locations” within the territory.\(^{160}\) If a franchisor does not offer an exclusive territory, it must include a prescribed statement to that effect and a warning about the consequences of purchasing a non-exclusive territory.\(^ {161}\) The Amended Franchise Rule FAQ 25 asks the following question: What constitutes an “exclusive territory” that would permit a franchisor to omit the disclaimer that the franchisor “does not provide an exclusive territory?” The FTC staff construed the term “exclusive territory” to mean a geographic area granted to a franchisee within which the franchisor promises not to establish either a company-owned or franchised outlet selling the same or similar goods or services under the same or similar trademarks.\(^ {162}\) The Amended Franchise Rule FAQ 37 asks whether a franchisor can state in Item 12 that it grants an exclusive territory if it reserves the right to open franchised or company outlets in “non-traditional” venues such as airports, stadiums, hospitals, hotels, malls, military installations, national parks, schools and arenas. The answer is no. A franchisor may only state that it grants exclusive territories if it commits not to establish company-owned or franchised units within the geographic area or territory granted to a franchisee. A reservation of rights to open outlets negates any such commitment even if those rights are limited to non-traditional locations.

B. Item 12 Claims

Historically, Item 12 disclosures (or omissions) resulted in claims by franchisees that the franchisor had encroached on the franchisee’s business by competing in a way that was not expressly addressed in Item 12.\(^ {163}\) These included situations where franchisors sold products into a territory through the internet or from other non-traditional locations. For example, in the arbitration of In re Arbitration Between Franklin 1989 Irrevocable Family Trust & H&R Block, Inc., the question was whether the franchisor was violating the franchisee’s territory rights by

\(^{160}\) Kanouse et al., supra note 136.

\(^{161}\) Compliance Guide, supra note 9, 72-73.

\(^{162}\) Amended Franchise Rule FAQs, supra note 11, FAQ 25. The disclaimer requires the following language: “You will not receive an exclusive territory. 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.

\(^{163}\) For an informative review of Item 12 litigation arising before the application of the 2007 amendment to the FTC Rule, see Rubenstein & Salkowski, supra note 157.
providing services in the franchisee’s territory via the internet.164 The franchise agreement precluded the franchisor from operating a location within the franchisee’s territory but was silent on the issue of the internet. Indeed, the arbitrators found that the internet was never contemplated at the time the franchise agreement was executed and that the term “operating from a location” became ambiguous when the franchisor began selling services via the internet. Nonetheless, the panel determined that the franchisor’s internet services served a different market than that of the franchisee and that as a result, there was no violation. In Silverman v Carvel, the franchisee asserted claims against the franchisor for selling products from supermarkets and convenience stores whereas in the past, Carvel ice cream was only sold through Carvel branded stores.165 The court found that no provision in the franchise agreement prohibited the distribution of the franchisor’s products in supermarkets and convenience stores, and therefore, the franchisor’s motion to dismiss was properly granted.166 Now, however, after the 2007 amendments to the FTC Rule, franchisors frequently reserve all rights not expressly granted to the franchisee and there seem to be fewer reported cases on these issues.

Disputes have also arisen relating to claims that a franchisor or its affiliate operated a competitive brand with locations within a franchisee’s exclusive territory, albeit under different trademarks. In Oganesov v. GNC Franchising, Inc., the court awarded the franchisee damages when it found that the franchisor had encroached upon the franchisee’s territory. There, the location for the Oganesov franchise was changed after the franchise agreement was signed and the location identified. Unfortunately, the parties never amended the territory to account for the new location. When the franchisor acquired a competing franchise system, it converted two stores to GNC franchises even though those stores were located within a quarter mile of the franchisee’s store.167 Item 12 of the FDD had indicated that franchisees would receive protected areas of up to a one mile radius from the approved location. The parties agreed that a new protected area should have been established but disagreed on how large it would have been if it had been determined at the time the Oganesov location was determined. The court settled on the midpoint and inserted a .5 mile radius into the franchise agreement. As the converted locations were only .2 miles from the Oganesov franchise, the court determined that the converted locations violated the Oganesov protected area.168

C. Practice Pointers

The easiest way to minimize exposure is to not provide protected territories of any kind. Alternatively, franchisors should take great steps to delineate clearly the rights that they are reserving for themselves and other franchisees to conduct business within a franchisee’s territory.169 A franchisor will want to disclose whether it retains the right to operate similar

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166 Id.
167 Oganesov, 2001 WL 37074710.
168 Id.
169 Cottage Inn Carryout & Delivery, Inc. v. True Freedom Invs., LLC, No. 10-CV-12833, 2010 WL 4188311 (E.D. Mich. Oct. 20, 2010) (holding franchisor was not liable for delivery by a franchisee into another franchisee’s protected area when the contract limited territorial protection to the establishment of a physical location within that protected area). For a detailed discussion regarding granting franchisees exclusive territorial rights, see Philip F. Zeidman, Legal Aspects of Selling and Buying § 9:60 (3d ed. 2015).
businesses under the trademarks provided that they are located outside of the territory; whether it will have the right to service national accounts with locations within the territory; and whether the franchisor has the right to acquire, operate and or franchise competitive businesses within the territory. The franchisor may also want to include a merger and integration clause in the franchise agreement specifically addressing the limitations on the territorial protections granted to franchisees. This may serve to protect the franchisor from claims that a franchisee received representations regarding the territory beyond those contained in the franchise agreement.\textsuperscript{170}

Initially, franchisee counsel will want to determine the franchisee’s territorial rights, if any. Additionally, a review of the franchisor’s reservation of rights should reveal whether there is any ambiguity between the franchisee’s territory and the franchisor’s rights. Is the act at issue, e.g., servicing national accounts or selling goods or services into the territory through the internet, expressly addressed in the FDD? Where a franchisor has not imposed on the territory protections expressly granted to a franchisee, counsel will have to think outside the box to find a way to protect the franchisee from seemingly unfair encroachment. For example, assume the franchisor opens a unit outside of a franchisee’s territory but uses the franchisee’s customer zip code information to determine where to locate that unit. Assume further that as a result of these actions, the franchisor usurps many of the franchisee’s existing customers. Although no case was located addressing these facts, might there be a viable claim for improper competition based on the franchisor’s requirement that the franchisee collect and provide to the franchisor this customer information? As franchisors continue to limit territorial protections provided to franchisees, franchisee counsel will need to be creative in asserting claims against competition that threatens the profitability of their clients’ franchised locations.

IX. CONCLUSION

Although Item 19 may get most of the spotlight when it comes to litigation involving alleged disclosure violations, there are many other disclosure obligations that when mishandled, can lead to claims against the franchisor. Many of these potential hazards can be avoided by carefully following the disclosure guidelines and following the golden rule of disclosure: If the information would be material to a prospective franchisee in making a decision to purchase a franchise, disclose it.

\textsuperscript{170} Cook \textit{v. Little Caesar Enters., Inc.}, 210 F.3d 653 (6th Cir. 2000).
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Mike is currently on the Governing Committee of the ABA Forum on Franchising where he serves as it Finance Chair. Mike has been named as one of the “Best Lawyers in America” by Woodward/White, a "Super Lawyer" by Minnesota Law & Politics, a "Legal Eagle" by Franchise Times, is listed in The International Who’s Who of Franchise Lawyers and is a “Certified Franchise Executive” by The International Franchise Association. Mike is admitted to practice in Minnesota and Wisconsin as well as numerous Federal District and Appellate Courts throughout the United States.

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