LITIGATING UNLAWFUL FPR’S
AND
PRACTICAL TIPS FOR DOING SO

W. Michael Garner
W. Michael Garner, P.A.

and

Earsa R. Jackson
Strasburger & Price, LLP

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LITIGATING UNLAWFUL FPR’S AND PRACTICAL TIPS FOR DOING SO

I. INTRODUCTION

Financial performance representations (“FPR”) are at the heart of the franchise sales process. No prospective franchisee buys a franchise without considerable thought as to how it will perform financially. The franchisor is the most obvious, comprehensive and, ultimately, authoritative source for at least some aspects of franchisee financial performance and, usually, all aspects of the performance of company-owned stores. In the years preceding franchise sales regulation, franchisor promises of riches, performance at particular levels and financial security were widely found to be misleading, and the damage to individuals was widespread and serious. As a result, the FTC and registration/disclosure states began to grapple with false representations of financial performance some 40 years ago. Since then, financial performance representations or, previously, “earnings claims” have been a constant source of debate as well as of radically changing regulation.

An early version of Item 19 had two alternatives, 19A and 19B. The 1993 Guidelines adopted a single standard that was enforced for most disclosure purposes until the Amended Rule in 2007-08. The Amended Rule is the product of robust debate, with some advocates supporting mandatory financial performance representations and others suggesting a complete ban. The Amended Rule strikes a balance that requires the franchisor to tell franchisees that the franchisor may make financial performance representations, but if it does so, it must do so in the FDD or pursuant to the FTC’sGuidelines. The rules for making an FPR are somewhat streamlined from the prior rule for earnings claims.

Litigation under the Amended Rule over misleading or unauthorized FPRs is likely to be similar to litigation under the UFOC Guidelines and the original FTC Rule. The substantive issue of whether the allegedly wrongful claim complied with the rules will be central as will the issue of the franchisee’s reliance. Because financial performance representations go to the heart of a franchise purchase, a case involving such claims is likely to be hotly contested. The issues for litigators are comprehensive and complex: Evidence must be collected and evaluated; the law, which is a web of contradictions, must be appraised; themes must be developed; and witnesses prepared.

This paper will review the substantive law concerning financial performance representations and present the viewpoint of a lawyer for the franchisee and a lawyer for the franchisor in approaching such claims.

II. DIFFERENCES BETWEEN THE OLD AND NEW ITEM 19

More and more franchisors now recognize the importance of financial performance representations in the sales process. The Amended Rule presents new options for franchisors to present information in Item 19. The Amended Rule defines a financial performance representation as:

[A]ny representation, including any oral, written, or visual representation, to a prospective franchisee, including a representation in the general media, that states, expressly or by

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1 This paper will refer to 16 C.F.R. 436 (2007) as the "Amended Rule". The prior version of 16 C.F.R. 436 will be referred to as "original FTC Rule".
implication, a specific level or range of actual or potential sales, income, gross profits, or net profits. The term includes a chart, table, or mathematical calculation that shows possible results based on a combination of variables. 16 C.F.R. § 436.1(e).

Under the original FTC Rule, an earnings claim was defined as:

An oral, written or visual representation to a prospective franchisee or for general dissemination in the media which states or suggests a specific level or range of potential or actual sales, income, gross or net profits. 16 C.F.R. § 436.1(b) and (c).

The Amended Rule prohibits franchisors from representing to prospective franchisees that they are not permitted to make a financial performance representation. This change was designed to force franchisors to inform prospects that they are not prohibited from making an FPR but have chosen not to make an FPR. In prior years, salespeople would routinely tell prospects that franchisors were not permitted to make earnings claims. That was not true even under the original FTC Rule but served as an excuse for many franchise systems when historical performance data would have clearly been a deterrent to prospective franchisees purchasing a franchise from the system. Like the intent of the original FTC Rule, the Amended Rule was written to ensure franchisees were getting accurate and sufficient information to make an informed decision. The disclosure document must state at the opening of Item 19:

The FTC Rule permits a franchisor to provide information about the actual or potential financial performance of its franchised and/or franchisor-owned outlets, if there is a reasonable basis for the information, and if the information is included in the disclosure document. Financial performance information that differs from that included in Item 19 may be given only if: (1) a franchisor provides the actual records of an existing outlet you are considering buying; or (2) a franchisor supplements the information provided in this Item 19, for example, by providing information about possible performance at a particular location or under particular circumstances. 16 C.F.R. § 436.5(s)(1).

A franchisor choosing to make an FPR has a great number of options for constructing an FPR so long as the franchisor has a reasonable basis for the representations, and the franchisor can substantiate the claim. The franchisor must specifically state that it will make substantiation materials available upon reasonable request.² The flexibility provided to franchisors can prove to be both a virtue and a vice as it can help a franchisor catapult its franchise above competitors but can also serve as a trap for the unwary when done incorrectly. Franchisors that are now beginning to appreciate the advantage of FPRs might become overzealous in making FPRs.

² For articles regarding tips for FPRs and opportunities for franchisors, see Lane Fisher and Joseph Dunn, Hidden Opportunities in Financial Performance Representations, Franchise Law News Q2 2010, and Rochelle Spandorf, Ten Tips for FPRs, Franchise Update Q2 2010.
A. A Negative Disclosure That Lay People Can Understand

The Amended Rule requires franchisors to make a negative disclosure if they choose not to make an FPR. Any franchisor not electing to make an FPR must provide the following specific preamble without any modification of the language:

We do not make any representations about a franchisee’s future financial performance or the past financial performance of company owned or franchised outlets. We also do not authorize our employees or representatives to make any such representations either orally or in writing. If you are purchasing an existing outlet, however, we may provide you with the actual records of that outlet. If you receive any other financial performance information or projections of your future income, you should report it to the franchisor’s management by contacting [name, address, and telephone number], the Federal Trade Commission, and the appropriate state regulatory agencies.

When a franchisor elects not to make a written FPR in its disclosure document, the franchisor is prohibited from making any such representation outside the disclosure document. Franchisors need to be sure they educate their sales teams about this. This is often an area where franchisors fall short. Getting the written document correct is just the beginning. In addition to monitoring what oral representations are being made by their sales teams, franchisors must also be careful about what is written elsewhere, such as on websites and in advertisements. Representations in media will be discussed later in this paper. Violations outside the disclosure document constitute independent violations of the Amended Rule.

B. More Explicit Explanation Of What Is Being Disclosed

Franchisors have more latitude under the Amended Rule when it comes to deciding the format for its FPR; however, a franchisor electing to make an FPR must proceed with caution. The franchisor must state the material facts underlying the representation. There are two general types of financial performance representations: (1) historical and (2) forecast. The FPR must explicitly state whether it is historical or a forecast.

The forecast is obviously riskier and invites more opportunities for litigation when the actual performance does not match or resemble the forecast. Even with the best drafted disclaimers, litigation is much more likely with a forecast. The FPR based on historical performance is not without its own complications as franchisors with many franchised units rely on the accuracy of data reported by its franchisees; however, litigation might arise in a scenario in which the franchisor blindly relies on the data reported by franchisees when the franchisor or a reasonable person would question the accuracy of the information. While the franchisor is not required to verify every piece of financial information provided by franchisees, franchisor does have a responsibility to investigate when such data appears unreasonable. Preparation of the historical performance FPR will require the franchisor to figure out how to slice the data to report it in a reasonable fashion so as to avoid misleading a prospect. One wrong slice and a franchisor could find itself in litigation.
C. More Explicit Explanation Of The Factual Basis

The Amended Rule requires that franchisors tell franchisees in plain language the basis for the financial performance representation. There are six separate elements comprising the material basis for an historical financial performance representation:

1. the group measured;
2. time period measured;
3. number of outlets measured;
4. number of outlets reporting;
5. number and percentage of outlets that achieved the stated level of performance; and
6. distinguishing characteristics.  

Franchisors should include a statement that actual results might differ from the representation to try to deter prospective franchisees from assuming that their actual results will match historical performance. The Amended Rule includes the following example for use with historical performance representations:

Some outlets have [sold] [earned] this amount. There is no assurance you’ll do as well. If you rely upon our figures, you must accept the risk of not doing as well.

If the FPR is a forecast, the representation must state:

The material basis and assumptions on which the projection is based. The material assumptions underlying a forecast include significant factors upon which a franchisee’s future results are expected to depend. These factors include, for example, economic or market conditions that are basic to a franchisee’s operation, and encompass matters affecting, among other things, a franchisee’s sales, the cost of goods or services sold, and operating expenses. 16 C.F.R. §436.1(s)(iii) (2007).

The Amended Rule does not set forth particular elements for forecasts other than requirement of reasonable basis and assumptions upon which projection is based. 4 The Amended Rule leaves it to the franchisor to determine what facts would enable a prospective franchisee to make an independent judgment as to the validity of the projection. The FTC Compliance Guide suggests that a forecast might reasonably rely upon market studies, statistical analysis, franchisee profit-and-loss statements, in addition to any other information customarily relied upon in the industry to make a business decision. 5 If the forecast is based on prior franchisees’ performance, the franchisor is required to disclose characteristics which

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3 A sample financial performance representation based on historical performance is provided in Appendix A.

4 A sample financial performance representation based on a forecast is provided in Appendix B.

typically account for the differences in performance among franchisees. Those can include geographic location, type of business premises, extent of competition in market area, services or goods sold, assistance or services supplied by the franchisor, and whether the outlets are franchised or company-owned or operated.⁶

A forecast, like an historical performance representation, should contain a statement advising the prospective franchisee that actual results might vary. The Amended Rule contains a sample statement which franchisors can use:

These figures are only estimates of what we think you may earn. There is no assurance you'll do as well. If you rely upon our figures, you must accept the risk of not doing as well.

D. Costs Only Are Not Included

Costs alone do not constitute a financial performance representation. However, costs coupled with any other figures from which a prospective franchisee can derive average net profits rise to the level of a financial performance representation. This is another area where disputes will likely arise. Franchisors should be careful not to make an accidental FPR by giving costs information in combination with other information which the prospective franchisee can use to do its own math to derive profits. A franchisor violates the Amended Rule where it provides the prospective franchisee with information on operating expenses as a percentage of revenue if information is not provided in Item 19 and in accordance with the rules for FPRs.⁷

E. Clearer Rules On Supplemental Representations – There Must Be An Item 19 Representation

Once a franchisor has made a financial performance representation, the franchisor is permitted to provide a supplemental representation as long as it is (1) in writing, (2) provides an explanation for the deviation from the financial performance representation contained in Item 19, and (3) is prepared according to the standards for financial performance claims required under the Amended Rule.

F. Prohibitions Go Beyond Item 19 (436.9(c) and (d))

The reach of the Amended Rule extends far beyond the confines of Item 19. Franchisors often times will make “accidental” financial performance representations. This typically occurs in the form of an advertisement or general media claim. Like an Item 19 FPR, general media claims must be truthful and reasonable. The scope of what constitutes a general media claim is to be broadly construed and includes: all forms of traditional advertising (radio, television, magazines, newspapers, and billboards) and electronic advertisements such as those placed on a franchisor’s website or on a website operated by a broker or some other third party (including both static advertisements, as well as pop-up screen and banner advertisements).⁸ Also, unsolicited bulk emails sent to the public (“spam”) qualify as

⁶ Compliance Guide at 91-92.


⁸ Compliance Guide at 131-34.
representations since these messages are widely disseminated to create interest in the franchisor, possibly leading to franchise sales. This is true even if the messages are sent to members of the public who have expressed an interest in receiving franchise information. There is no material difference between sending email messages to members of the public who happen to have expressed some interest in the area of franchising and including financial performance representations in advertisements in franchise-related magazines or newspapers distributed to subscribers. In both scenarios, the financial performance message contained in the ad constitutes a general media claim and triggers the Amended Rule's disclosure and substantiation requirements.

Franchisors are not able to circumvent the Amended Rule merely by dressing up a financial performance representation as a general media claim. The general media financial performance representation must state:

1. the number and percentage of outlets from which supporting data for the representation were gathered that actually attained or surpassed the represented level of financial performance;
2. the time period when the performance results were achieved; and
3. a clear and conspicuous admonition that a new franchisee’s results may differ from the represented performance.\(^9\)

When the franchisor makes the FPR in a general media claim, the rules regarding supplementation apply to subsequent representations.

**G. Prohibition On Disclaimers**

Franchisors have historically asked franchisees to sign disclaimers prior to or simultaneous with the signing of the franchise agreement stating that the franchisee is not relying on any representations outside the franchise agreement, including the disclosure document. Such disclaimers often require franchisees to confirm they have not been provided any earnings information outside the disclosure document. Section 436.9(h) of the Amended Rule states that it is an unfair and deceptive trade practice for the franchisor to disclaim or require a prospective franchisee to waive reliance on any representation made in the disclosure document or in its exhibits or amendments. The purpose of this rule is to prevent fraud by preserving the completeness and accuracy of information contained in the disclosure documents.\(^10\) The Commission, however, adopted only a “limited” disclaimer prohibition, in contrast to many state franchise statutes. While a franchisor may not require the prospective franchisee to waive reliance on information in the disclosure document or the franchise agreement, the franchisor may disclaim responsibility for unauthorized claims made outside of those documents or by unauthorized persons. The prohibition does not reach statements made in the franchisor’s advertising materials. Thus, extraneous statements—which comprise most unlawful financial performance representations—may be disclaimed under the Amended Rule,

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\(^9\) Compliance Guide at 133.

although the making of them is prohibited by the ban on statements that are contradictory to the offering circular.\textsuperscript{11}

The Amended Rule therefore sidesteps the issue whether a disclaimer of statements made outside of the franchise agreement or offering circular would be effective to bar the franchisee from relief in an appropriate case. Where only the Amended Rule is at issue, then, the question whether a disclaimer of FPRs outside the FDD or agreement is effective will turn on common law principles. (See below).

State franchise laws, however, usually contain “anti-waiver” provisions that state that a franchisor may not require a prospective franchisee to waive the protections of the law. The effect of these laws has varied from jurisdiction to jurisdiction. Some states have held that an integration clause that barred proof of FPRs was not an invalid waiver or release;\textsuperscript{12} likewise, a clause in a franchise agreement that disclaimed any warranty or guaranty of profit, income or success was not invalidated by the anti-waiver provisions of the Washington Franchise Act.\textsuperscript{13} In \textit{Meehan v. United Consumers Club Franchising Corp.}, the court upheld the trial court’s dismissal of franchisee’s claims of false and misleading earnings representations because the express no-reliance disclaimers in the franchise agreement and the offering circular precluded the franchisee from proving justifiable reliance under Indiana law.\textsuperscript{14} The court stated that “it is simply unreasonable to continue to rely on representations after stating in writing that you are not so relying.” Other courts, however, have held that the purpose of the anti-waiver provisions is to prevent the franchisor from avoiding liability, and that disclaimers and integration clauses are therefore ineffective to nullify liability under state franchise acts. In \textit{California Bagel Co., 18 LLC v. Am. Bagel Co.}, the court found that reliance on the franchisor’s oral statements concerning earnings was manifestly unreasonable.\textsuperscript{15} The disclaimer in the UFOC stated that the franchisor does not furnish or authorize its salespersons to furnish any oral or written information concerning the actual or potential sales, costs, income, or profit of a franchise and that actual results vary from unit to unit.

In \textit{Motor City Bagels, L.L.C. v. The American Bagel Co.}, franchisee claimed that franchisor misrepresented average annual sales of stores in the franchise system.\textsuperscript{16} The court found that the franchisees’ reliance was unreasonable as a matter of law in light of the experience and sophistication of the franchisees, their representation by counsel in negotiating the agreements, and the unambiguous language of the integration clause in the franchise agreements and the disclaimer in the UFOC.

In \textit{Randall v. Lady of Am. Franchise Corp.}, the franchisor made a “negative earnings claims” in Item 19 of its UFOC, disclaiming that it furnished or authorized any of its salespeople

\textsuperscript{11} See 16 C.F.R. 436.9(a).


\textsuperscript{14} 312 F.3d 909, 911-12 (8th Cir. 2002).


to make financial performance representations or estimates of earnings.\textsuperscript{17} Despite this disclaimer, the franchisor's salespeople made representations to franchisees. Ultimately, the court allowed the introduction of parol evidence regarding the oral representations made by the franchisor, finding that such evidence was admissible since it did not directly contradict the written contract. As to franchisor's argument that summary judgment was proper in its favor because the franchisee could not have justifiably relied on the representations at issue, the court (1) questioned whether justifiable reliance was an element of a claim for misrepresentation under Minnesota Franchise Act and (2) emphasized that contractual disclaimers were to be given only limited effect in defeating a reliance element of a fraud claim.\textsuperscript{18} The court's rationale for not requiring reliance as an element of a claim under the Minnesota Franchise Act is that this statute was designed as a remedial statute to favor franchisees over franchisors.\textsuperscript{19}

An anti-waiver provision may or may not reach a choice-of-forum clause that would take a case out of a jurisdiction with a franchise law.\textsuperscript{20}

\section*{III. SOME OPEN QUESTIONS}

\subsection*{A. Public Information – e.g., SEC Disclosure Documents From Which Financial Performance May Be Derived}

Under the UFOC Guidelines, the question had sometimes arisen whether information in publicly available documents, such as SEC filings by publicly held franchisors, could be treated as earnings claims and subjected to the requirements of Item 19 and the original FTC Rule. SEC filings may contain information on revenue per store, either company-owned or system wide; increases or declines in same-store sales and entries on their financials, such as royalty income that, combined with other information can be used to estimate gross revenue per store.

The FTC's solution in the Amended Rule was to define a Financial Performance Representation as "any oral, written, or visual representation, to a prospective franchisee" (emphasis added).\textsuperscript{21} The statement of Basis and Purpose makes clear that "such filings are already publicly available and, more important, have indicia of reliability."\textsuperscript{22} Another, and perhaps more compelling argument, is that information contained in SEC filings is compiled under a different statute for a different purpose. SEC filings speak to the health of the franchisor as a corporate entity for the purpose of the public and its stockholders. The information is

\begin{itemize}
  \item \textsuperscript{17} 532 F. Supp. 2d 1071, 1075, 1080 (D. Minn. 2007).
  \item \textsuperscript{18} Id. \textit{But see} Cook v. Little Ceasar Enters., Inc. 210 F.3d 653, 659 (6th Cir. 2000) (holding that reasonable reliance is an element of a misrepresentation claim under Michigan’s franchise law); 
  \textit{Hardee’s of Maumelle, Ark., Inc. v. Hardee’s Food Sys., Inc.} 31 F.3d 573, 579 (7th cir. 1994) (observing that lower Indiana courts have read a reasonable reliance requirement into Indiana’s franchise law, but not reaching question); 
  \item \textsuperscript{19} Id. at 1087. \textit{See also} Emfore Corp. v. Blimpie Associates, Ltd., 51 A.D.3d 434 (1st Dep’t 2008); 
  \item \textsuperscript{21} 16 C.F.R. § 436.1(e).
  \item \textsuperscript{22} Statement of Basis and Purpose, 72 Fed. Reg. at 15457 (March 30, 2007).
\end{itemize}
directly relevant to the purchase or sale of stock in that company, not to the purchase or sale of a franchise. The distinction is important. While the financial health of the franchisor is certainly relevant to the decision whether to purchase a franchise, it is information that falls into a different category.

The existing law potentially leaves some loopholes open. First, prudent franchisors that are publicly held should consider including a disclaimer in their franchise materials stating that SEC information is not offered, and is specifically disclaimed, as information that bears on the financial performance of a franchise. This provides some level of protection against the zealous potential franchisee who gathers all possible information and then engages in number crunching.

The Amended Rule does not address specifically what might happen with publicly available SEC information in the hands of franchise salespersons and brokers. For example, a broker could use such information to derive financial performance representations to show to prospective franchisees, or guide prospects to or through such information. Such a representation would clearly violate the spirit of the Amended Rule, but might technically fall outside of it. As noted, a vigilant franchisor will at least provide a disclaimer addressing such conduct.

B. Applicability Of GAAP To Projections

The Commission changed the original FTC Rule by eliminating the requirement that historical data be provided in accordance with Generally Accepted Accounting Principals ("GAAP"), bringing the Amended Rule in line with the UFOC Guidelines. The Commission considered GAAP to be unduly burdensome and that there were adequate safeguards for protection against misleading FPRs through the requirement that such representations have a reasonable basis.  

The Commission’s position leaves a number of questions open: can a deviation from GAAP be used as evidence that the FPR is unreasonable or lacks a reasonable basis, or does the Commission’s position make the absence of GAAP compliance irrelevant? Conversely, does compliance with GAAP in any way immunize an FPR from attack?

While the Amended Rule and Statement do not provide answers to these questions, it is likely that a significant departure from GAAP can be some evidence of lack of reasonableness. For example, if a franchisor alters certified financials materially, to create an FPR, when unaltered data would satisfy the requirements, the failure to use GAAP might be significant.

While the FTC takes the view that such an FPR may not “cherry pick” the franchisor’s outlets, and the Amended Rule requires that the franchisor disclose how the groups were selected, in actual practice, the nature of the information has the potential to be misleading.

C. Is Truth A Defense, Even If There Is A Violation?

The Compliance Guide clearly states that a franchisor may not provide information to a franchisee which contradicts information in the disclosure document, but questions often arise

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24 Statement at 15499.
regarding whether franchisors can provide information outside the disclosure document which is truthful. According to the Compliance Guide, "[F]ranchise sellers are always free to disseminate additional truthful noncontradictory information to a prospective franchisee, especially if required to do so by state law or at the written request of state franchise examiners."25

If franchisor has failed to supply all required information in Item 19 but provides some truthful information outside Item 19, does the truthful information provide a defense to the franchisor for violation of the Amended Rule? Truth is probably not a defense where franchisor fails to comply with rules regarding financial performance representations. There were no cases located which dealt specifically with this issue; however, cases dealing with good faith, not truth, might shed light on the question. Courts have held that good faith is not a defense to a violation of the original FTC Rule.

Regarding a claim for violation of the original FTC Rule for failure to provide "audited" financial statements, the court noted that while "good faith may be germane to [the directors'] personal liability in this matter, it does not mitigate [the franchisor's] failure to comply with the UFOC requirements."26 In Bldg. Inspector of Am., the principals of the franchisor claimed not to know that the CPA who prepared the statements had not audited the statements as he represented.27 The court accepted the fact that the principals might be telling the truth but still held that the franchisor violated the original FTC Rule.28

D. Does Partial Compliance Save A Defective Disclosure?

Partial disclosure will probably not save a defective disclosure. The purpose of the Amended Rule is to provide prospective franchisees with sufficient information to make an informed decision. Where a franchisor falls short of this obligation, franchisor is unlikely to be able to rely on a defense that it made a partial disclosure. Absent full, accurate disclosure, the franchisor is in violation of the Amended Rule. In FTC v. USA Beverages, Inc.,29 franchisor provided a basic disclosure document to prospective franchisees, but it failed to provide any material that would substantiate the earnings claims it made to prospective franchisees. The obligation to substantiate is critical, and a franchisor must make substantiation materials available upon reasonable request.30

E. Does An FPR Have To Be "Representative"?

Under the Amended Rule, it is lawful for a franchisor to select a group of franchisees whose results will be presented in a financial disclosure document. This contrasts with the old UFOC Guideline, which required a franchisor to disclose how performance of a given franchisee

25 Compliance Guide at 38. (emphasis in original).
27 894 F.Supp. at 518.
28 Id.
30 Compliance Guide at 92.
or group compared to the entire universe of franchisees. Now, the rule permits the franchisor to choose a "universe" of franchisees, or a subgroup of franchisees, so long as it discloses certain types of information.

Thus, historical financial performance representations must be "representative" in that they must include:

1. The group measured to obtain the performance information (i.e., in calculating how many outlets of the system (partial or system-wide) were counted and whether outlets are company-owned, franchised, or affiliated);

2. The time period measured (i.e., when was the stated level of performance achieved);

3. Number of outlets measured (i.e., how many in the group measured versus the entire franchise system);

4. Number of outlets reporting (i.e., how many outlets supplied performance data underlying the representation);

5. Number and percentage of outlets that achieved the stated level of performance (i.e., what proportion of the group measured that achieved the results); and

6. Distinguishing characteristics (i.e., what are the common attributes of the outlets that achieved the stated level of performance). 31

In addition to being truthful and reasonably backed by substantiating written information like historical FPRs, a general media claim must also be "representative" in that it must state:

1. the number and percentage of outlets from which supporting data for the representation were gathered that actually attained or surpassed the represented level of financial performance;

2. the time period when the performance results were achieved; and

3. a clear and conspicuous admonition that a new franchisee’s results may differ from the represented performance. 32

F. Does A Franchisee Have To Prove Damages?

A civil action filed by a franchisee is distinguishable from an action initiated by the FTC with regard to damages. The FTC may sue for civil penalties based on an actual violation of the Amended Rule, and penalties may be imposed regardless of whether consumer injury occurred. A franchisee, pursuing an action under state law, will likely be required to prove damages in order to get redress. As a practical matter, the FTC is probably more likely to pursue a matter where there are extensive damages at issue given to FTC's limited resources.

31 16 C.F.R. § 436(5)(ii)(A)-(F); Compliance Guide at 86-88.

32 Compliance Guide at 133-34.
In FTC v. Transnet Wireless Corp., the court noted that in an FTC Act Section 13(b) enforcement action in which the government seeks restitution to compensate thousands of individual victims of unlawful practices, the FTC does not need not present proof of subjective reliance or damages by each victim. The court noted that in contrast to a private action for fraud, representative proof of injury suffered is sufficient to justify the requested relief because "[r]equiring proof of subjective reliance by each individual consumer would thwart effective prosecution of large consumer redress actions and frustrate the statutory goals of the section." The court found that the total amount of money defrauded from consumers was $48,117,765.49 based on earlier undisputed statements that Transnet's sales after refunds equaled $17,447,409.00 and Nationwide's deposits after refunds equaled $30,908,752.66. Accordingly, based on the evidence provided by the FTC, which included the profit and loss spreadsheet of Transnet and various deposits slips of Nationwide on official bank records, the court accepted the numbers as the total amount of consumer damages. Ultimately, the court ordered as redress for the consumers complete restitution of the $48,117,765.49 in order for the defrauded consumers to be returned to the status quo.

In FTC v. Wolf, the court found that franchisor's violated the original FTC Rule for failure to disclose information about the franchise and for making unsubstantiated and misleading earnings claims. Accordingly, after evidence that the aggregate amount invested by purchasers of the defendants' business opportunities was $31,362,576 and with no record that the defendants paid refunds to victims of their fraud, the court found the defendants jointly and severally liable to the FTC for consumer redress in the amount of $31,362,576.

In private action, failure to prove any damages has been held fatal to a plaintiff's cause of action for improper earnings claims.

G. Public Information

The Commission also cleared up a potential area of confusion by providing that financial information that appears on a franchisor's website, including links to press releases, interviews or articles, is not a financial performance representation, provided that the dissemination online or in press stories is for the benefit of more than prospective franchisees. The Commission said that there was a distinction between information disseminated in advertisements that are directed at franchisees and information disseminated to the general public. Deeming financial performance information disseminated publicly to be financial performance representations would have a chilling effect that would discourage franchisors from furnishing truthful information to the public. Where, however, the franchisor uses that information to disseminate its franchise promotional materials, it becomes subject to the disclosure and substantiation requirements of the rule.

At the same time, however, the Commission retained the application of the Amended Rule to general media claims, which still must have a reasonable basis.

34 Id. at 1266-67.
37 16 C.F.R. 436.1(e); Statement at 15457.
The distinction between general media claims that are FPRs and financial information on a website works in theory, but creates issues in practice. Newspaper stories on a website often refer to franchisees opening in particular communities and contain statements of their gross sales, profits or numbers of customers. Such information can then be used by a broker or salesperson to represent earnings. Further, the distinction that the Commission draws—between information "intended to educate the general public" and information "to attract prospective franchisees" may be impossible to apply.

IV. TYPES OF FINANCIAL PERFORMANCE REPRESENTATION VIOLATIONS

While the definition of an FPR is fairly detailed, what constitutes an actual FPR is often litigated as franchisors will often claim that a representation does not rise to the level of an FPR but instead is a statement of puffery. In Emfore Corp. v. Blimpie Assocs., Ltd., the franchisee claimed that franchisor's salesperson made pre-contract earnings claims stating future profitability of the particular store location.38 Specifically, the salesperson stated that "if you are still behind [the] counter in six months, you are doing something wrong." The court found that such pre-contract statements regarding the potential profitability of plaintiff's prospective store were mere "puffing" or opinions as to future events and profitability. As such, the court held that they could not form the predicate of a fraud claim. Another court, however, found assurances that franchisees would become millionaires rose to the level of an earnings claim in violation of the original FTC Rule.39 Similarly, another court held the following statement an earnings claim in violation of the original FTC Rule: "... We are looking for someone ... who requires a minimum of $50,000-plus yearly ..."40

A. The Blatant Violation

Despite guidance provided by the FTC and state regulators, some franchisors still commit blatant violations of the Amended Rule. The most obvious violation are FPRs made outside Item 19. The Amended Rule now requires a franchisor to advise prospects via the FDD (1) it is permitted to make an FPR and, if not making an FPR, (2) explicitly state that it is not making an FPR.

One of the most egregious cases of blatant violations was the Lady of America's case in which the salespeople engaged in rampant practice of unlawful financial performance representations.41 Some of the representations included the following: (1) expect $22,000 per month in profit; (2) another franchisee had revenues of $40,000 per month, so franchisee should expect the same; (3) will break even in about six months; (4) earn enough money to buy a new Porsche and (5) 100% return on investment within first year of operation. This is one of the more egregious cases, but the unlawful violations come in many forms.

1. **Outside Item 19**

The Amended Rule makes clear that the FPR must be contained within the body of Item 19. A franchisor’s failure to provide the FPR in Item 19 is a technical violation of the Amended Rule. Additionally, the franchisor cannot make a statement in Item 19 that it is not making a FPR and then authorize others to provide an FPR. This would be inconsistent with the Item 19 representation and a violation of the Amended Rule. If franchisor represents in the FDD that it is not making an FPR, the franchise salespeople cannot then make and FPR outside the FDD.

2. **Unsupported**

A franchisor must be prepared to provide support for any financial performance representation, and it is a clear violation to fail to do so. Further, a franchisor must have a reasonable basis for any representations. In *Network Services Depot*, the franchisor made numerous representations, including a representation that purchasers of the opportunity would have a guaranteed monthly income generated by the internet kiosks and an annual return of 12% or more. Defendants had no basis for the representations. The Court deemed the business offering a franchise under the original FTC Rule and held that defendants made improper earnings claims in violation of the FTC Act and the original FTC Rule. As a result of this egregious behavior, the court imposed an $18.9 million judgment against defendants.

3. **Misleading**

While franchisors have a great deal of latitude when preparing FPRs, franchisors must be sure that the FPR is not misleading. The goal of an FPR is to assist a prospective franchisee with making an informed decision regarding purchase of the franchise. Not only must a franchisor concern itself with compliance with the Amended Rule, it must also be mindful of state prohibitions against misleading disclosure documents. For example, Minnesota forbids a franchisors from "mak[ing] or caus[ing] to be made any untrue statement of material fact in any application, notice, report or other document filed with the commissioner under sections 80C.01 to 80C.22, or omit to state in any such application, notice, report or other document any material fact which is required to be stated therein . . . ."

**B. The Violation Via Outside Sources**

Section 436.9(b) specifically makes it an unfair or deceptive practice or act for a franchise seller to misrepresent that any person can provide an independent and reliable report about the franchise or any experiences of any current or former franchises. The purpose of this prohibition is to prevent the use of shills or persons who are paid to discuss a franchise with great enthusiasm when in fact they have no experience with it or their experience is less than what they represent. Included in the prohibition are institutional shills as well as individuals.

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45 *Id*.

46 Minnesota Statutes § 80C.13 subd. 1.
"institutional" shill might include a company that is paid to give an endorsement or reference that the franchisor's product or services are good or worthwhile.\textsuperscript{47}

In real life, shills may be direct references by the franchisor to a third person or may arise through the franchisor's selection of certain franchisees for the prospect to speak to. The rationale for preventing shills from talking to prospects is twofold. First, it is an indirect way for the franchisor to do what is prohibited from directly in the rules; second, a shill potentially has greater credibility with the prospective franchisee than the franchisor might have.

The Amended Rule does not address specifically the obverse problem. In one recent case, for example, a franchisor explained to prospects that they should not speak to existing franchisees because existing franchisees were not their agents and therefore could not speak for the franchisor. Accordingly, prospects were discouraged from speaking with franchisees who would have told them that the system was failing. While this is unquestionably an actionable fraud and deception, proof of it is somewhat harder than if the prohibition were explicit.

C. The "Backhanded" FPR – "How Does My Pro-forma Look?" "Fine." (Representations Made By "Implication")

An issue that arose under the old rule and UFOC Guidelines was the issue of the "backhanded" financial performance representation—\textit{i.e.}, a calculation of revenue or profits that the franchisee made, and then showed to the franchisor to see if it was "okay." Often times, the franchisor would furnish the franchisee with a dummy template for a "business plan" that the franchisor would then instruct the franchisee to complete for the purposes of applying for loans, SBA financing or finding space. Frequently, such dummy business plans would include templates for pro formas (see below).

While the Amended Rule does not specifically define this practice as FPR, certainly, if the franchisee completes the numbers on a proforma and then shows them to the franchisor, they will constitute an FPR as surely as an express statement.

D. Non-monetary Measures Of Performance

The Amended Rule defines a financial performance representation as including any representation that states "expressly or by implication" a specific level or range or actual or potential sales, income, gross profits or net profits. Therefore, as under the original FTC Rule, non-monetary representations such as occupancy rates for a hotel or numbers of members of a health club will be treated as financial performance representations.\textsuperscript{48}

E. The Blank Proforma Or "Budget Template"

Like the backhanded financial performance representation, where a franchisor provides a blank pro forma to a franchisee, it may be providing a financial performance representation, depending upon how much information is contained in the proforma. For example, one type of budget template, provided in the form of a spreadsheet, shows the percentage of revenue that

\textsuperscript{47} Statement at 15531.

each expense should constitute. No actual numbers are given. The franchisee fills in the amount of revenue it believes it will make and the spreadsheet calculates the costs and bottom line. Standing alone, this type of a budget template might not constitute a financial performance representation, but used in connection with cost figures contained in the FDD, it likely will constitute an unauthorized FPR.

F. General Media Claims

Not all general media advertisements qualify as financial performance representations. The following are excluded:

- Most company statements in speeches, press releases, and information on websites for investors will not be considered “general media representations” unless they are specifically directed at members of the public interested in purchasing a franchise. SEC statements are also not considered general media representations.49

- Cost or expense data, such as fees required for purchase or expenses reported in Items 5 through 7, alone is not a financial performance representation. But if a general media presentation of cost data is coupled with additional sales or earnings figures from which prospective franchisees could readily calculate average net profits, it would constitute a financial performance representation, triggering the Item 19 disclosure obligation.

A number of courts have held general media claims to be earnings claims or financial performance representations. The cases discussed below were decided under the original FTC Rule; however, the Amended Rule would dictate a similar result.

In FTC v. Tashman, a company’s radio advertisements claiming franchisees could make $600 to $700 per week by working only three to five hours and directing prospective customers to call the company constituted financial representations since these figures did not match the company’s Item 19 documents and lacked a reasonable basis, thus violating the original FTC Rule.50

Further, in FTC v. Transnet Wireless Corp., the court held that television, radio, and internet advertisements claiming 100% return on investment within first year and soliciting prospective consumers to salespeople, who made further earnings claims, lacked a reasonable basis and were part of franchisor’s misrepresentations in violation of the original FTC Rule.51

Additionally in FTC v. Holiday Enters., Inc., a company’s promotion of business ventures to prospective purchasers through a variety of media, including newspapers, television advertisements, and internet web-sites, claiming, for example, that purchasers could expect

49 Compliance Guide at 131.

50 318 F.3d 1273, 1276, 1278 (11th Cir. 2003).

annual incomes ranging from $50,000-$250,000, were part of explicit and implicit misrepresentations of financial performance in violation of the original FTC Rule.\textsuperscript{52}

Finally in \textit{FTC v. Wolf}, business opportunities advertised by a franchisor in classified sections of newspapers throughout the United States and through direct mail solicitations promising substantial potential profits of $3,000 to $4,000 per month and instructing interested readers to call the defendant's toll free telephone numbers violated the earnings claims disclosure requirement under the original FTC Rule.\textsuperscript{53}

Franchisors should be mindful of landmines with their general media materials as this could be a trap for the unwary. Getting the FDD correct is just the tip of the iceberg.

\section*{V. Ways to Attack Financial Performance Representation Violations}

\subsection*{A. Initial Case Assessment}

An unauthorized FPR will usually be readily apparent to a lawyer representing the franchisee: The client or prospective client will say that he or she was told how much money could be made. If the representation was made outside of the FDD, or, if it was in the FDD and was defective, the client may have a case, but this is only the beginning. In preparing a case based on a wrongful FPR violation, the lawyer must assess the evidence of the FPR, and then evaluate each of the elements of the claim. We will consider these steps in turn.

\subsection*{B. Gathering The Evidence Of The FPR}

Counsel for the franchisee should gather all possible evidence of an unlawful financial disclosure, not only from the client, but from other franchisees, from third parties, the franchisor's statements on the Internet, and in discovery. Frequently, a client's only evidence of an unlawful representation will be an oral statement, and the challenge for the lawyer is making these statements hold up against what will undoubtedly be a series of strongly worded disclaimers, integration clauses and written admonishments. Where oral statements have been made, it is good practice for the franchisee lawyer to obtain as many records of such oral statements as possible. Three cases,\textsuperscript{54} show that when the representations are oral, proof from multiple witnesses of similar financial performance representations will overcome the reluctance of a fact-finder to discount undocumented representations. From an evidentiary standpoint, getting the testimony of non-party franchisees before the court may be a challenge, but some courts have allowed such testimony.\textsuperscript{55}

The franchisee lawyer needs to develop evidence to support the claim of a wrongful FPR. These types of evidence can include:

\textsuperscript{52} 2008 WL 953358, at *2-4, *6-7 (N.D. Ga. 2008).


\textsuperscript{55} See, e.g., \textit{Fritzmeier v. Krause Gentle Cop.}, 669 N.W.2d 699 (S.D. 2003)(testimony of non-party franchisees was relevant to franchisor's intent and therefore admissible).
(a) **Scripts or guidelines for sales presentations.** A script can give the franchisee's lawyer a roadmap to cross examination—what was the basis for the statements made in the script? Did the person delivering the script know what that basis was? Did anyone do any research into what the script said? Who wrote the script and on the basis of what?

(b) **Franchisor guidelines with respect to FPRs.** The franchisee's lawyer should demand in discovery and follow through with depositions on the issue whether the franchisor has a set of written or oral guidelines with respect to the making of financial performance claims. The significance of such guidelines cannot be understated. On the one hand, if there are guidelines and they follow the requirements of the Amended Rule and state law, then the franchisee's lawyer is in the position to argue that statements made outside of the guidelines were knowingly made and were deliberately misleading. On the other hand, if the franchisor has no such guidelines, then the franchisee's lawyer is in a position to argue that standard industry practice calls for the franchisor to have a compliance manual, a compliance officer, and a set of guidelines that are in the hands of every franchise sales person and officer of the company. If the proof then shows that this was not done, then the franchisee's lawyer is in a position to argue that the franchisor was set up to violate the law.

(c) **The records of actual performance by franchisees and company-owned stores.** It is important for the franchisee's lawyer to obtain, preferably in electronic form, all of the franchisor's sales records with respect to franchise stores and company-owned outlets for the time in question. Many, if not most, franchisors will have databases of information that permit this information to be extracted in any number of useful forms: The number of outlets exceeding a certain level of sales; average revenues; performance of franchisees at various levels of development, such as franchisees in operation after one year. In addition to this raw information, the franchisee lawyer should press for the franchisor's factual basis for any financial performance representations. The franchisee lawyer should consider asking for this information in an interrogatory so as to get a specific narrative description of what the basis was or is. The response can then be aligned with the actual underlying data to determine whether the stated basis conformed to the actual data and proof.

(d) **The franchisee witnesses.** A good plaintiff witness can be the strongest evidence to put on to support a financial performance representation case. The witness, however, must be prepared to testify as to what he or she was told and why he or she believed it. One of the strongest themes that franchisor attorneys sound in fighting financial performance representation suits by franchisees is that the franchisee was sophisticated and should have known better. This defense is particularly applicable today when there are large numbers of sophisticated investors buying franchises. And, even if the franchisee is not particularly sophisticated, it needs to be fully prepared to respond to questions such as whether it spoke to other franchisees before buying, whether it simply took the franchisor's word at face value and did nothing more; whether it read the disclaimers and understood them; and whether it consulted any advisors or experts. The franchisee's lawyer needs to be prepared to deal with the fact that many franchise purchasers "shop around" for a franchise less than they would shop around for a house or a car even though the franchise purchase may be
substantially more. The franchisee should be prepared to testify that it performed
due diligence, and the due diligence that it performed needs to be convincing.

(e) **Website Information.** The presence of financial representations on the
franchisor’s website cannot be underestimated. These types of statements may
be direct representations or indirect, in the form of quotes from third parties or
newspaper articles, but their presence will also amplify the weight of oral
testimony. Finally, the presence or absence of a proper FPR in the FDD has to
be weighed against whatever was told to the prospective franchisee outside of
the FDD. If Item 19’s disclosure of financial performance is substantially the
same as the representations outside of the FDD, then there may be no violation
of law. On the other hand, if a proper FDD in Item 19 contradicts statements
made outside of the FDD, then the franchisee has a problem if it was given the
FDD. There will have to be an explanation for why the franchisee chose to rely
on the FPR outside of the document as opposed to the one that was in it; the
franchisee’s lawyer has to give serious thought to what the client will say when
confronted on cross examination with Item 19.

(f) **Former Franchisor Employees.** The franchisee’s lawyers should try to locate and
obtain sworn statements from the franchisor’s former employees, if they are in a
position to testify with respect to FPRs. The lawyer should, of course, be mindful
of ethical constraints on contacting former employees, as well as the potential
existence of agreements with the franchisor governing the ex-employee’s
conduct.

C. **Assessing The Elements Of The Violation**

A wrongful FPR will usually provide the factual basis for three types of claims: common
law fraud, including negligent fraud; violation of a state franchise statute; and violation of a state
unfair trade practice or “Little FTC” Act. The elements of these claims vary from one to another
and from state to state, so it is critical that the attorney for the franchisee allege the elements of
each claim properly, and then develop the proof to back up that claim.

In general, it is a “best practice” to “test” the evidence against the elements of a common
law fraud claim, even though a little FTC Act claim or a franchise act claim will almost always be
more lenient in terms of elements and proof. While states vary in their formulation of common
law fraud, it generally requires:

- A false statement of a material fact;
- Made with the knowledge that it was false;
- With the intent that the franchisee rely upon it;
- That the franchisee in fact relies on reasonably;
- And that causes injury.

For purposes of this discussion, we will use these elements as a guide in order to show
how the evidence may be developed, with reference to differences in state franchise laws, the
Amended Rule and little FTC Acts.
1. **A False Statement Of A Material Fact**

   a. **Common Law**

   Traditional common law fraud requires that statement relied upon be a false statement of an existing, present fact. At common law, opinions, "puffing" and predictions may not be actionable, in the absence of qualifying factors, because they are not statements of fact.

   An FPR, however, by its nature, may be a prediction or opinion, and therefore not actionable at common law. Under the Amended Rule and state franchise statutes, however, a claim may arise and be viable simply by virtue of the fact that the franchisor has violated the guidelines. In *California v. Speedee Oil Change*, the court assessed civil penalties against a franchisor for making earnings claims in violation of California law without regard to whether they were truthful or not. Similarly, in *Randall v. Lady of America*, the court considered earnings claims made outside of a UFOC a violation of the Minnesota Franchise Act's prohibition on false statements and deceptive conduct.

   Thus the Amended Rule and state franchise laws do not require that an FPR be false in the common law sense in order to be actionable.

   **Nonetheless, the lawyer representing a franchisee with an unauthorized FPR claim should seek to prove that the representation was “false” to the extent that the proof will allow. A false representation is far easier for a jury to comprehend than a technical violation.**

   Proving falsity, however, presents a conundrum because FPRs, even if made outside the FDD -- or even if made on a cocktail napkin -- may have more than a ring of truth. For example, there may be some franchisees that have been able to “buy a Porsche,” or there may be some franchisees who have indeed made the amount stated in an FPR, even if the technical violation -- not telling the franchisee that backup information was available, for example -- is clear and undisputed.

   The cases in which franchisors have been held liable for wrongful FPRs demonstrate how the plaintiffs showed that, beyond the technical violations, the unauthorized FPRs had the hallmarks of false statements. To show falsity, plaintiffs have argued:

   - The representation was not **typical or representative**, even if it was otherwise true.

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56 See, e.g., *Vaughn v. General Foods Corporation*, 797 F.2d 1403 (7th Cir. 1986).

57 See, e.g., *America's Favorite Chicken Company v. Cajun Enterprises, Inc.*, 130 F.3d 180, 186 (5th Cir. 1997)(claim that sales figures and profits were false was not actionable); *Lang, Lang & Suhor Investors, LLC v. The American Bagel Co.*, Bus. Franchise Guide (CCH) ¶ 11,447 (D. Md. 1998)(statement that franchisee would “make lots of money” was not actionable); *Papa John's Intern., Inc. v. Dynamic Pizza, Inc.*, 317 F. Supp. 2d 740, 748-49 (W.D. Ky. 2004).


• If a franchisor has made unlawful FPRs that in fact were authorized, or that the franchisor knew about, then some courts hold that a negative disclaimer – i.e., the franchisor does not make FPRs, nor does it authorize them – is false.
• The FPR was substantively defective – i.e., the numbers themselves were misleading.
• A number of cases have been decided on the basis that the FPR was supposedly made by a third-party source that in fact was not a third party or that was under the control or direction of the franchisor.

I. Typicality

One of the key cases in understanding this aspect of financial performance representations is *FTC v. Minuteman Press*. In that case, salespersons and officers of a franchisor made the following types of financial performance representations:

- Representation of past monthly sales figures that “a number of stores” were “doing well over $150,000 to $200,000 a month.”
- Representations of “typical or average” revenues for existing stores of $30,000 monthly gross sales.
- Representations of potential sales for a franchisee of “$30,000 to $35,000 per month gross sales after the first year.”
- Representations that an existing company store in “an average type of town” “did over $20,000 in sales the second month.”
- Representations that “existing stores did up to $20,000 by the end of the first year.
- Representations that franchisees “could expect that one-third of gross sales would be for fixed costs, one-third for variable costs, and one-third for profit.”

The Commission’s principal hurdle at trial was overcoming the fact that to some degree, the statements were true: some franchisees did make $30,000 per month; some made more. The franchisor put in evidence that the “range” of franchisee revenues was between $24,000 and $30,000 per month.

The court framed the issue of falsity as whether the representations of gross sales were those typically realized by Minuteman franchisees. By framing the issue in terms of typicality, the significance of the franchisor’s proof, which showed that the overall range of franchisee sales was between $24,000 and $30,000, was measurably decreased.

The FTC went so far as to offer expert testimony of an economist. The expert reviewed royalty statements from between 55 and 80 percent of the franchisees and determined that median sales were between $18,000 and $19,500 and that the average was between $22,000 and $23,000. The defendants attacked the expert’s conclusion because the sample was not statistically reliable. The court, however, found that the expert’s task was simply to determine whether it was “more likely than not that the defendants’ claims of typical or average sales were valid.”

The franchisor offered its own expert opinion that average sales for franchisees and business one year or more was somewhat ever $29,000. The court found that the defendant’s expert’s data was unduly weighted towards the high end and chose to rely on the FTC’s data.

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*60 FTC v. Minuteman Press, 53 F. Supp.2d 248 (E.D.N.Y. 1998).*
ii. The False Negative Disclaimer

Some cases have held, either directly or in dicta, that a franchisor's statement that it does not make, and does not authorize, FPRs were false when the evidence showed that it did. *Lady of America* turned largely on this argument. In that case, there was extensive evidence presented by the plaintiffs of FPRs:

- The franchisee could expect to have 150 members in its franchised health club when the franchise opened and eventually make $22,000 per month.
- The franchisee could expect to sign up 100 to 150 members on opening and to add 15 to 20 members per week thereafter.
- The franchisor showed financial statements of existing franchisees and stated that the prospect should anticipate some more revenues. The franchisor took a prospect on a tour of a franchise and represented that the franchise had revenues of over $40,000 per month.
- The franchise would break even after enrolling 110 to 120 members, which could be expected within about 6 months.
- A slide presentation showed that many existing locations had 500 to 1,000 members and that all existing locations were profitable.
- The prospect could expect to make $30,000 per month in profits after being in business for 6 months.
- The prospect would be "driving a Mercedes" within 6 months after opening.

The franchisor moved for summary judgment on the grounds that the statements were barred by the extensive disclaimers in the UFOC and the franchise agreement, as well as a questionnaire the franchisees had completed certifying that no representations had been made outside of the UFOC. The court's analysis focused on the anti-fraud provision of the Minnesota Franchise Act, which prohibits the sale of the franchise by means of any untrue statement of a material fact or fraudulent omission. The court found, initially, that the UFOC's negative disclaimer at Item 19 was a statement of fact—"We do not furnish or authorize sales persons to furnish any written or oral information concerning the actual or potential sales, costs, income or profits of your franchise." This, the court found, was a false assertion of fact that violated the anti-fraud provision of the act in two ways—by making earnings claims that were false, or stating that none were made.

iii. The Substantively Misleading FPR

Substantive defects in an FPR, such as misstatement of income, omission of expenses, mathematical miscalculations, will also form the basis of a claim of a false FPR.

*Carousel's Creamery, LLC v. Marble Slab Creamery Inc.*,61 illustrates a substantively misleading FPR. In that case, the franchisee contended that the franchisor was guilty of negligent misrepresentation because the earnings claim failed to disclose that catering revenue was part of the total food sales of the company-owned store whose results were contained in the UFOC. Further, the franchisee contended that the earnings claim understated labor costs because corporate employees sometimes worked at the store, and their wages were not attributed to it; and that the franchisor understated freight charges that were charged to a franchisee outside of a particular geographic area. The court found that these allegations formed a basis for the claim of misrepresentation. Interestingly, the court noted that there was

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evidence that the franchisee justifiably relied upon these representations in that the cover page of the UFOC indicated that the Federal Trade Commission had set rules and regulations requiring the information in the UFOC be truthful, accurate and concise. Therefore, the franchisee could legitimately expect that the information in the earnings claim would be accurate and not presented in a misleading fashion. The case ultimately, however, was decided against the franchisee for lack of reasonable reliance.

iv. Misrepresentations Concerning The Party Making The Representation

The use of shills, or third parties who make false representations about a franchise's potential financial performance, is specifically prohibited by the Amended Rule; apart from this, however, the misleading use of a third party to make FPRs has been the anchor of claims for misleading FPRs. Thus, for example, where a franchisor provided a pro forma that appeared to contain numbers from a reputable third party, but the numbers in fact had been provided solely by the franchisor, the court found that the franchisor had engaged in "a practice or course of business that operated as a fraud or deceit" in violation of the Illinois franchise act and in violation of the requirements of Item 19 of the UFOC Guidelines. The court also found a violation of Illinois law in the fact that the pro-forma was not included in the UFOC, did not include a detailed description of factual basis and material assumptions and did not carry a conspicuous admonition that a new franchisee's individual results were likely to differ from those contained in the earnings claim. Significantly, however, the lynchpin of the court's decision was the falsity rooted in the misrepresentation of the source of the numbers.

b. State Franchise Laws

As noted above, state franchise laws typically do not require that an FPR be false in the common law sense in order to constitute a violation of the state law. A technical violation, however, that is not false may not be actionable by a private party. Most franchise statutes, however, have anti-fraud provisions modeled on Securities and Exchange Commission Rule 10b-5 that prohibit a much broader range of fraudulent conduct than is allowed at common law fraud. These statutes typically prohibit not only false statements but any omission or conduct that is misleading or acts as a fraud.

c. State Little FTC Acts

To the extent that Little FTC Acts incorporate the FTC Act and the decisions under it, they will apply the FTC's standard of misrepresentation of a "tendency to deceive." This is a much more lenient standard than common law fraud: it only requires proof that the average person hearing or seeing the representation would be likely to be deceived by it. Thus, under this standard, as is likely under the standard for state franchise laws, the quantum of proof necessary to show falsity will be much less.

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63 See, e.g., Randall v. Lady of America, 532 F.Supp. 2d at 1076 (D. Minn. 2007).
2. Knowledge Of Falsity And Intent To Deceive

a. Common Law

At common law, it is typically required that a plaintiff show that the defendant had scienter, or an intent to deceive the listener. In general, scienter can be difficult to prove because it turns upon intent, and witnesses will be reluctant to confess that they intended to deceive the listener.

The cases, in general, do not discuss scienter, possibly because they are more easily decided on the basis of reliance. In this regard, the franchisor’s use of disclaimers to state that it does not give FPRs or does not authorize them might well be a defense against the scienter element.

b. State Franchise Laws

Again, the element of scienter is really discussed in cases concerning state franchise laws, although the ones that have discussed it have found that scienter is not an element of the violation.65

c. Little FTC Acts

In general, Little FTC Acts do not require scienter. They may, however, have other requirements, such as an adverse effect upon the public interest that, if not alleged, will cause the complaint to be dismissed.66

3. Reliance

One of the thorniest issues that a lawyer representing the franchisee must confront in prosecuting a case for a wrongful FPR is the issue of reliance as framed by the disclaimers, integration clauses and, sometimes, questionnaires that franchisees complete, affirming that they have not been given any financial representations except as contained in the offering circular. Probably no single issue leads to franchisor victories on summary judgment more than the issue of reliance. From a strategic and planning standpoint, therefore, the franchisee lawyer needs to frame the pleadings and develop the evidence so that the financial representations, as much as possible, dodge the language of the disclaimers and integration clauses. The objective should be to get beyond the motion to dismiss or summary judgment stage, so that reliance is an issue of fact.

Thus, in evaluating and preparing a claim for an unlawful FPD, the franchisee lawyer should, at the least, follow the following steps of analysis.

- Do the disclaimers actually meet the substance of the representation? Although many disclaimers purport to be comprehensive, they are often not. For example, many disclaimers state that the franchisor has made no representation as to the

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profits or performance that the franchisee might obtain. Without more, this
disclaimer does not cover one of the most common types of financial performance
representation: the statement as to performance of existing stores. Likewise, many
disclaimers are focused on terms of “guarantees” or “assurances” of results. A
representation of performance is not a guarantee or assurance, and therefore may
fall outside of the scope of the disclaimer.

Did the franchisee read the disclaimers, complete a questionnaire, and if so, under
what circumstances? Some courts have found significance in the fact that the
franchisor’s representatives were required to instruct the franchisee to complete the
questionnaire by checking “no” to questions of financial performance representations
outside the FDD. Other courts have found that a franchisor’s representations that it
was not supposed to disclose the information to the franchisee to be significant
because it highlighted the importance of the information and in fact caused the
franchisees to rely on it more than they otherwise would have.

a. Common Law Fraud

The principal hurdle that franchisee lawyers face in prosecuting a FPR claim at common
law is that extensive disclaimers or integration clauses frequently defeat a claim of reasonable
reliance upon financial performance representations. As one court has stated: A plaintiff
cannot justifiably rely on a representation if it is “so patently and obviously false that he must
have closed his eyes to avoid discovery of the truth.”67 Cases disposing of common law fraud
claims by franchisees at the dispositive motion stage are legion.68

Avoiding a dispositive motion requires a thorough knowledge of the law and astute
handling of the facts. The principal avenue to avoid disposition of common law claims is to seek
determination of this issue under the law of a jurisdiction that will allow the issue of reliance to
be treated as an issue of fact. Some courts, usually in the face of blatant misrepresentations,
refuse to enforce disclaimers on policy grounds. Thus, the Eighth Circuit summed up this
position in these terms: “Where a party to whom a representation has been made has not made
an investigation adequate to disclose the falsity of the representation, the party whose
misstatements have induced the act cannot escape liability by claiming that the other party
ought not to have trusted him.”69 Another court refused to enforce franchise agreement
disclaimer provisions on the ground that either that public policy forbids contractual preclusion
of liability for intentional fraud or that a party cannot waive the right to sue for fraud in the
inducement by a provision in the contract. The court also commented that the disclaimer itself
was deceptive:

“If, as has been alleged, Quizno’s pursued a policy of requiring all franchisees to
write "none" in the blank ostensibly provided for identification of statements relied

disclaimer of information concerning earnings negated franchisees’ reliance on oral statements of actual sales).

68 Hardee’s of Maumelle, Ark., v. Hardee’s Food Systems, Inc., 31 F.3d 573 (7th Cir. 1994); Carll Carl, Inc. v. BP Oil
Corp., 554 F.2d 623, 632-632 (4th Cir. 1977); Cathoune v. Exxon Corp., 64 F.3d 656 (4th Cir. 1995); Knight v. Snap-On
Tool Corp., Bus. Franchise Guide (CCH) ¶ 9622 (D NM 1990); Schubot v. McDonald’s Corp., 757 F. Supp. 1351
(S.D. Fla. 1990); aff’d, 963 F.2d 385 (11th Cir. 1992).

upon, then the inclusion of a blank to be filled in by the franchisee in lieu of a pre-printed provision amounts to a sham, whose apparent purpose to mislead a subsequent reviewer, such as this court, into believing that Quizno’s unilaterally-prescribed disclaimer language was actually authored without constraint by the franchisees.”

A more common position, articulated in Randall v. Lady of America Franchise Corp., holds that the disclaimer or integration clause must specifically address the type of representation made. A general boilerplate merger and integration clause or disclaimer will be insufficient to negate the franchisee’s reliance upon a franchisor’s representation, and reliance, therefore, is an issue of fact. This is known as the “direct contradiction test.” In Lady of America, therefore, the franchisor’s representations that franchisees could expect a certain number of members for their health clubs and would make certain levels of revenues were not barred by general disclaimers.

Other courts have held that integration clauses did not bar fraud claims because they were rooted in contract law, not tort.

b. State Franchise Laws

Most state franchise laws have “anti-waiver” provisions that provide that a franchisor may not cause a franchisee to waive the effect of the state law by a release, waiver, novation or other contractual provision. Some courts have held that integration clauses or disclaimers are not invalid as waivers or releases notwithstanding anti-waiver provisions. But most courts that have considered the issue, have held that anti-waiver provisions invalidate disclaimers, integration clauses and even questionnaires in which the franchisee claimed that no representations had been made. If, however, the state franchise law does not have an “anti-waiver” provision, a claim may be barred by the disclaimer or integration clause.

c. Little FTC Act Claims

The status of disclaimers with respect to Little FTC Acts has not been litigated extensively, if at all. Lady of America considered claims of unauthorized FPRs under the Florida Little FTC Act, but did not discuss reliance.


75 532 F. Supp.2d 1071.
4. Causation And Injury

In investigating and preparing an FPR case, the franchisee's attorney must look to the question of what injury the franchisor's violation actually caused. If the franchisee would have proceeded with the transaction anyway, then there is no causation as a result of the violation. Likewise, the damage sustained by the franchisee as a result of the transaction must be assessed. Would the franchisee have entered into the franchise agreement but for the financial performance representations? What is the measure of damages for such a violation? At common law, fraud damages may be determined by a restitution measure or by a benefit of the bargain measure. Some state statutes provide for rescission; some provide for rescission or "other damages," which might encompass benefit of the bargain damages. If both measures are potentially authorized by the statute, it is probably a good idea to plead both in the alternative in order to lay a foundation for establishing a range of damages from which a fact finder can choose.

A potential trap for the unwary in framing a claim under a state franchise law providing for rescission is the requirement of actually tendering rescission to the franchisor prior to or at least contemporaneous with the complaint. For example, in one case, the court observed that because the remedy under the Michigan Franchise Investment Law is rescission, and the plaintiffs had not tendered their franchises back to the franchisor, they were barred from relief, and their case was dismissed.

D. Proof Of An FPR Violation

An ultimate test of a claim of violation of the financial performance representation rules is whether the franchisee, and its lawyer, can prove a violation and recover for it at trial. Some key strategies for trial of an FPR case to consider:

(a) Demonstrative evidence. The franchisee's lawyer should consider working with an expert and a graphic artist to prepare demonstrative evidence that will illustrate, vividly, the falsity of the FPRs. This can be critical in demonstrating to a fact finder the lack of typicality of a claim. For example, the actual language of the claim and the actual experience of franchisees can be compared graphically, and the difference demonstrated.

(b) Expert testimony. The franchisee's attorney should not underestimate the power of expert testimony, particularly where the nature of the violation and its falsity may not be readily apparent to the finder of fact. Consider the following types of expert testimony:

- Testimony concerning the purpose and meaning of the franchise rule or state franchise laws. Some courts have allowed testimony of this type in cases alleging violations of state or federal franchise laws. Significantly, they have not gone so far as to allow testimony that there was a violation of the rule, but testimony by a former federal official or a state official explaining the rule and its requirements, as well as its

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77 U.S. v. Parker, 364 F.3d 934 (9th Cir. 2004); but see Interim Healthcare of Northeast Ohio, Inc. v. Interim Services, Inc., 12 F. Supp. 2d 703 (N.D. Ohio. 1998).
purpose, can go a long way to giving weight and credibility to the
distributor's claims.

- Expert testimony with respect to industry practice. An overlooked area for
  expert testimony is with respect to industry practice in franchising. At the
  outset, it should be noted that there is respectable body of literature,
  including Forum papers and publications, that counsel franchisors to have
  compliance manuals and programs to ensure compliance with applicable
  franchise sales regulations. Franchise consultants can be engaged to
  testify that industry practice calls for compliance with the rule and that
  franchise executives and sales people known or should know the
  contents of the rule and ways to comply with it. In this regard, it is well to
  remember Speedee Oil’s admonition that the franchisor had not
  adequately provided for compliance with the rules on earnings claims by
  having a system in place to detect whether its sales people were making
  unlawful claims. Additionally, it may be possible that an expert will testify
to industry standards that are in fact higher than called for by the rule.

(c) **Expert testimony that the representations were misleading.** As was seen in
  *Minuteman Press*, an expert may be necessary to show that an FPR that is
  arguably truthful on its face ("some units make $200,000") were in fact
  misleading because they were not typical.

(d) **Expert testimony regarding the franchisee’s due diligence.** The franchisee’s
  lawyer may want to consider testimony that the franchisee’s due diligence was
  adequate. In *Carousel Creamery*, the franchisor put on the expert testimony of
  an accountant who systematically went through the UFOC, the franchisee’s
  financial information and evidence presented to the franchisees prior to purchase
  of the franchise, focusing particularly on the prospect’s investigation of the
  investment and management subsequent to purchase. The expert testified that
  the franchisee “made so many mistakes and errors of business judgment and
  missed so many red flag warnings . . . that they only have themselves to blame
  for the troubles that they had.” He further testified that the UFOC contained
  caveats that a reasonable investor should heed, that it was unreasonable for
  them to have relied on the UFOC and that their investigation and due diligence
  was negligent. He further testified to the franchisee’s “abominable” accounting
  practices and the apparently unbridled use of cash to pay vendors. The
  franchisor then put on the testimony of a well-known franchise expert, who
  testified that it was “silly, foolish, and improper” for the franchisee to rely on the
  UFOC’s Item 19. While such a strategy leaves the franchisor open to a charge
  that it promulgated an unreliable, indeed false, document, the strategy worked: a
  jury returned a verdict for the franchisor, and the appeals court upheld the
  verdict.

(e) **Damages.** The last area that the franchisee lawyer needs to be prepared for in
  preparing a financial performance claim is damages. At the outset, it is important
  to establish what the relevant measure of damages is. As noted above, some
  jurisdictions allow for rescission; some follow a benefit of the bargain rule; and,
  where the rescission is the measure, there are varying definitions as to what a
  franchisee can recover in a rescission scenario. In either event, it is probably
wise to have an expert testify as to any measure of damages. On the rescission side, that calculation will be essentially a straightforward calculation; on the benefit of the bargain side, it may well be necessary that the franchisee put in proof what it would have earned over the life of the franchise if the franchisor’s representations would have been true. This, in turn, may require a calculation of the present value of the lost profits that would have been earned if the franchisor’s representations had been true. At the same time, however, depending upon the nature and extent of the franchisor’s financial performance representations, the proof may come from the franchisor. (E.g., you will have profits of $100,000 a year.)

VI. WAYS TO DEFEND ALLEGATIONS OF FINANCIAL PERFORMANCE REPRESENTATION VIOLATIONS

A claim for an unlawful FPR may be brought by the FTC through its enforcement powers under the FTC Act to prosecute violations of the Amended Rule. Similarly, a state may prosecute allegations of improper earnings claims under its state statute. A claim may also be asserted by individuals under state franchise statutes creating a private right of action, state deceptive trade practices acts (also known as “little FTC Acts”) or at common law. Individual plaintiffs will typically assert a laundry list of claims in hopes of prevailing on at least some of the causes of action. The next section will first deal with FTC enforcement actions generally and some items unique to this type of enforcement action. The latter sections will address claims under state laws, as well as preliminary and strategic defense considerations.

A. FTC Enforcement Actions

The FTC, like other governmental entities, has limited resources and must sift through the multitude of complaints it receives to determine which complaints to pursue. The FTC’s enforcement powers are derived from Section 5(a) of the FTC Act which makes unlawful any unfair or deceptive acts or practices in or affecting commerce. Additionally, the FTC is provided enforcement powers in the Amended Rule. The FTC may initiate suit in federal district court to enjoin violations of the Amended Rule and secure any equitable relief appropriate and consumer redress.

By the time a franchisor gets wind of an investigation, the FTC has likely amassed a wealth of information about the franchisor putting the franchisor in a catch-up mode. In years past, the FTC has created taskforces to attack rampant violations often reaching numerous, unrelated entities who are engaging in similar practices in the same industry.

When the FTC comes knocking, its reach is expansive. Individuals associated with franchise systems should be aware that they may be subject to liability for the actions of the entities or its principals, agents and sales team. "Individuals are personally liable for restitution


80 16 C.F.R. §436.

81 15 U.S.C. §§ 53(b) and 57(b).
for corporate misconduct if they 'had knowledge that the corporation or one of its agents engaged in dishonest or fraudulent conduct, that the misrepresentations were the type upon which a reasonable and prudent person would rely, and that consumer injury resulted.'\textsuperscript{82} The knowledge requirement is satisfied where evidence establishes that the individual had "actual knowledge of material misrepresentations, reckless indifference to the truth or falsity of the representations, or an awareness of a high probability of fraud coupled with intentional avoidance of truth."\textsuperscript{83} The FTC need not show the individual actually intended to defraud consumers.\textsuperscript{84}

Like lay individuals, attorneys might find themselves inextricably tied to actions of their franchisor clients. In Network Services Depot, the court took up the issue of whether a sizable retainer paid to the franchisor's attorney should be sought for redress of consumers. NSD's attorney was paid $375,000 for defense of the action; however, the FTC argued that the fees should be returned because the fees were paid with funds from NSD's illegal operations and should be used to reimburse victims of the scam. In Final Judgment and Order for Permanent Injunction and Other Equitable Relief dated March 5, 2009, the court ordered the attorney to turn over $238,300 to the FTC.\textsuperscript{85} The court reasoned that the attorney was properly put on notice by the court that it would consider whether a portion of the retainer should be turned over and that the attorney took the risk that fees incurred after said date could be taken for consumer redress.

1. **Process And Procedure**

Once the FTC makes a determination to pursue an investigation, it will often times ask the company targeted to voluntarily produce documents, including the disclosure document, advertisements and any other materials made the basis of the consumer complaint. If the company is not cooperative or the FTC believes that the company has not been forthcoming in its production, the FTC may issue a Civil Investigative Demand ("CID") to produce documents and/or provide testimony. This is a compulsory process, and the recipient of the CID must comply.

It is not uncommon for the FTC to investigate a number of companies in the same industry accused of similar bad acts under a large scale crack-down operation. These investigations are confidential, and the FTC cannot be compelled to disclose to the public information obtained in its investigation. Upon the conclusion of an investigation, the FTC staff will either (1) close the investigation and issue a no further action letter; (2) seek a consent decree or (3) recommend that a formal complaint be filed. Upon the occurrence of the latter, the Commission will vote on whether to authorize the staff to file a complaint.

In the event a consent decree is advisable, franchisors should know that the terms of a consent decree may be negotiated. Counsel for franchisor should familiarize himself or herself with some of the FTC's other consent decrees to get a sense of recurring themes to serve as a

\textsuperscript{82} FTC v. Network Services Depot, No. 2:05-cv-0440-LDG-LRL (Doc. 143 at p9) (D. Nev. 2006) (quoting FTC v. Affordable Media, 179 F.3d 1228, 1234 (9th Cir. 1999)).

\textsuperscript{83} FTC v. Network Services Depot, No. 2:05-cv-0440-LDG-LRL (Doc. 143 at p9) (D. Nev. 2006) (quoting FTC v. Pantron I Corp., 33 F.3d 1088, 1095 (9th Cir. 1994)).

\textsuperscript{84} Id.

guide when negotiating consent decrees. All consent decrees will contain some type of injunctive relief as the primary goal of a consent decree is to stop illegal and unfair conduct.

If suit is filed, the FTC may seek damages, rescission, injunctive relief and restitution.\(^86\) The court is empowered to grant ancillary relief “necessary to accomplish complete justice.”\(^87\) In instances in which the FTC is concerned that a company might hide or dispose of assets if forewarned of impending enforcement, the FTC may see ex parte relief from the court such as an asset freeze.

2. Statute Of Limitations

Section 5 of the FTC Act, which provides for civil penalties for violations of the Amended Rule, does not contain a statute of limitations. But courts have held that violations of the original FTC Rule involving civil penalties have a five-year statute of limitations under 28 U.S.C. 2463, which provides a “catch-all” provision.\(^88\) For consumer redress actions, the statute of limitations under § 19b(d) of the FTC Act is three years and runs from the date the disclosure was made, not the discovery of the violation.\(^89\)

3. FTC Not Required To Prove Reasonable Reliance

In FTC v. Transnet Wireless Corp., the FTC filed suit against a franchisor for a violation of the original FTC Rule in connection with earnings claims made about internet kiosks.\(^90\) Since numerous people fell victim to the claims, the FTC sought consumer redress from the franchisor. The court held that, in contrast to a private action for fraud, the FTC did not have to prove subjective reliance by each victim. To “[r]equir[e] proof of subjective reliance by each individual consumer would thwart effective prosecution of large consumer redress actions and frustrate the statutory goals of the section.” Rather, the court found that “[a] presumption of actual reliance arises once the Commission has proved that the defendant made material misrepresentations, that they were widely disseminated, and that consumers purchased the defendant's product.” Further, “[e]xpress claims, or deliberately made implied claims, used to induce the purchase of a particular product or service are presumed to be material.” Accordingly, in an FTC action, representative proof of the injury suffered is sufficient to justify the requested relief and reasonable reliance is not required.

Similarly, in FTC v. Minuteman Press, the court distinguished an FTC enforcement action from one pursued by a private citizen.\(^91\) In its UFOC, the franchisor disclaimed that it was making earnings claims or that its representatives were authorized to make any earnings claims. Nonetheless, the franchisor made deliberate and systematic earnings claims. The court found that, unlike in private rights of action, “[a] conflict between a specific disclaimer and a contrary oral representation—typically fatal to a reasonable reliance argument, in a purely

\(^86\) 15 U.S.C. § 45(b); § 57(b).

\(^87\) FTC v. H.N. Singer, 668 F.2d 1107, 1113 (9th Cir. 1982).


\(^90\) 506 F. Supp. 2d 1247, 1266-67 (S.D. Fla. 2007).

private suit—is . . ., actionable by the FTC as violative of the original FTC Rule 436.1(f) if the disclaimer is in a UFOC. 92

While is does not appear that the FTC is currently pursuing any financial performance representation claims, one must not assume that the FTC is pre-occupied with other types of matters. It is not unusual for the FTC to operate just below the radar until it has enough evidence to commence a full-scale operation.

B. Actions Under State Laws And Common Law

States are given enforcement power to pursue allegations of unlawful FPR’s under state statutes. Like the FTC, states have limited resources to pursue claims. States, like the FTC, will only pursue the most agregious matters. Most actions are brought by individual franchisees under common law for fraudulent inducement and fraud or under state statutes such as the franchise act, state consumer protection statutes know as “little FTC Acts” or business opportunity laws. The statutory protections in general were designed to provide a remedy for an injured party who may not be able to meet the more stringent requirements for proof of common law fraud.

State franchise laws generally provide a private right of action for any misleading and fraudulent schemes. An improper FPR would fall into this category creating an avenue for a private citizen to pursue such claims under state law.

1. Misleading Or Fraudulent Scheme

State franchise acts generally provide a private right of action and make it unlawful for any person in connection with the sale of a franchise to knowingly employ a device, scheme or artifice to defraud, make any untrue statement of material fact or omit a material fact or engage in a practice which operates as a fraud or deceit upon any person. 93

2. Statute Of Limitation

The statute of limitation under state laws generally ranges from three years to five years. Some statutes explicitly recognize the discovery rule while courts in other states have applied the discovery rule in the furtherance of public policy.

3. Persons Responsible For Violation

State statutes will often identify the person or persons responsible for the violation. Under California’s franchise statute, anyone who directly or indirectly controls a person responsible for the improper action may be held liable. 94 Under Illinois law, individuals are personally liable when the individual “materially aids in the act or transaction constituting the violation.” 95

92 Id.
4. **Damages And Penalties**

Most state franchise laws provide for both civil and criminal penalties ranging from an amount per violation to a felony conviction with imprisonment. Under California’s franchise law,

Any person who willfully employs, directly or indirectly, any device, scheme, or artifice to defraud in connection with the offer or sale of any franchise or willfully engages, directly or indirectly, in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the offer, purchase, or sale of any franchise shall upon conviction be fined not more than one hundred thousand dollars ($100,000) or imprisoned in the state prison, or in county jail for not more than one year, or be punished by both that fine and imprisonment.\(^96\)

Upon proof of a violation in a private action, a franchisee generally has two options: (1) rescission or (2) restitution.\(^97\) Florida’s franchise law provides that a franchisee “may receive a judgment for all moneys invested in such franchise or distributorship,” and any recovery beyond the investment would seem counter to the express language in the Florida statute.\(^98\)

Restitution may include return of purchase price, installment payments, rent and/or security deposits which are non-refundable to franchisee, payments for improvements, system fees, supplies, and any obligation related to the franchise assumed by the franchisee as result of buying franchise.

C. **Preliminary And Strategic Considerations**

1. **Initial Case Assessment/Internal Investigation**

As soon as the franchisor learns of an alleged FPR, the franchisor should commence its own investigation in short order as such allegation deserves full attention. The franchisor must quickly make a determination as to the validity of the alleged violation. If there is a violation, the franchisor should seek to reach a quick resolution. In the case where the FTC is bringing the action, the franchisor should try to negotiate a consent decree (or similar procedure if state brings action). When the case is brought under state law by a private individual, the franchisor should move quickly to settle the matter if it concludes there was a violation. The franchisor should also give some thought to other franchisees potentially affected and be prepared to take proactive steps to avoid large scale litigation.

a. **What Is Contained In The FDD And Other Advertisements?**

At the outset, the FDD must be reviewed to see what was represented. Are there any deficiencies on the face of the FDD? More often than not, the violation is not on the face of the FDD but relates to representations made outside the FDD. The franchisor should also review its website, advertisements and any other written materials, including training materials and

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\(^96\) Cal. Corp. Code § 31411.


\(^98\) Fla. Stat. § 817.416(3).
scripts provided to salespeople. Sections II and III above provide valuable guidance for analyzing any alleged unlawful FPR.

b. **Interview Company Representatives And Employees Involved In Transaction**

Next, the franchisee’s file should be reviewed to determine everyone at the company who was involved in the sales process. Each individual involved needs to be interviewed extensively. A franchisor should be sure to review all available information and not just rely upon what the salesperson reveals in the interview. With the widespread use of text messaging, electronic mail and other methods of communicating, the franchisor should consider nontraditional communications. If it is determined that a salesperson has made an improper FPR, the franchisor must consider what action should be taken against the salesperson who caused the violation. At a minimum, there should be a notation in the salesperson's file that he or she was disciplined. A drastic, but sometimes necessary, step is termination.

c. **Get Legal Team Involved Early**

The legal team should be involved in this process early on as the legal team can provide valuable counsel and can assist with the assessment. The legal team can also assist with preserving information and preparation of legal hold notices to ensure that all information is preserved while the case develops. With an eye of suspicion already upon the franchisor, the franchisor should be careful not to draw unnecessary negative attention to it by having to defend a spoliation allegation.

Legal counsel can advise as to the strength of the case, strength of witnesses and whether early settlement attempts are advisable. Due to the nature of these cases, a franchisor might feel compelled to vigorously defend the case to judgment just to protect its image and reputation.

d. **Role Of Experts In Case Assessment And Defense**

An expert can make all the difference in the investigation and defense of allegations of unlawful FPR’s. Perhaps the best demonstration for the use of experts is *Carousel's Creamery, L.L.C. v. Marble Slab Creamery, Inc.* where the franchisee claimed that the disclosure document provided by Marble Slab mischaracterized the ice cream shop's earnings because it did not disclose that the shop's labor costs were reduced by the use of corporate employees and franchisee-trainees, and that the store had increased its profits by catering corporate events. The franchisee argued that Marble Slab's failure to make proper disclosure of these facts amounted to a negligent misrepresentation under Texas law and violated the Texas Deceptive Trade Practices Act. Marble Slab admitted it did not generate contemporaneous documents in the form of time cards to track time worked in the stores by corporate employees though it was capable of tracking these numbers. Marble Slab prevailed in large part because its experts (a CPA and franchise expert) were able to establish the failure of the franchisee's business was a direct result of the franchisee's lack of an independent investigation of the

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100 Id.
101 Id.
business venture prior to purchasing it and poor operations.\textsuperscript{102} Marble Slab's CPA testified franchisee's investors "made so many mistakes and errors of business judgment and missed so many red flag warnings that came to their attention that they only have themselves to blame for the troubles that they had."\textsuperscript{103} The CPA noted specific areas of deficiencies and/or neglect as follows:

1. franchisee failed to hire attorney or CPA prior to purchasing;
2. franchisee failed to perform a market demand study;
3. franchisee failed to prepare a written plan for the business venture;
4. franchisee failed to either read disclosure document or follow-up on caveats contained in disclosure document;
5. franchisee failed to discern "big red flag" in financials provided on stores prior to closing;
6. franchisee's accounting and booking deficiencies (including overlooking red flags that franchisee's employee was stealing money); and
7. franchisee failed to manage labor costs.

The CPA concluded that the franchisee's financial records were "totally unreliable."\textsuperscript{104}

Marble Slab also called a franchise expert to testify regarding the type of due diligence typically done in the industry and opine regarding whether franchisee was reasonable in relying on the disclosure document. The franchise expert's testimony emphasized that none of franchisee's investors actually read the disclosure document from cover to cover as the record only indicates that one of the investors might have skimmed the document. The expert testified that while the franchisee's investors were sophisticated individuals, they failed to do any of the normal due diligence things like contact existing franchisees, hire an attorney, review financial documents and prepare a business plan. The expert testified to the historic correlation between pre-sale due diligence and "ultimate degree of success one enjoys as a franchisee."\textsuperscript{105} In short, the expert concluded franchisee failed to conduct an independent investigation. As a result, the court concluded franchisee lacked sufficient evidence to support a finding that Marble Slab's representations were a cause-in-fact or a substantial factor in causing franchisee's injuries.

A franchisor faced with defending an FPR should use this case as a roadmap for use of experts.

e. **Should Questionable Practice Continue Even Though Franchisor Concludes No Violation?**

Should the franchisor continue the same practices which lead to the allegation while the litigation proceeds? The answer to this question will vary from situation to situation. If the practice is ceased pending a determination, does this send a negative message that franchisor believes the practice is unlawful? The franchisor must also consider the ramifications if its conclusion is wrong.

\textsuperscript{102} ld.

\textsuperscript{103} ld.

\textsuperscript{104} ld.

\textsuperscript{105} ld.
2. Preliminary Issues

Franchisor should consider whether a challenge to standing is warranted. A franchisee might improperly assert a claim under the original FTC Rule where there is no private right of action. In such case, the franchisor should be ready to challenge standing. If the claims are filed under state law, the franchisor must look carefully at the language in the statute defining the "consumer," "purchaser" or other terms of art to describe the benefactor of the statute.

Additionally, there might be a valid question about whether the alleged bad actor is a franchisor.

a. Is the Business Arrangement a Franchise?

At the outset, it is necessary to ascertain whether the business arrangement is a franchise and subject to the Amended Rule. In FTC v. Jordan Ashley, the FTC brought action against a business opportunity that sold greeting cards and racks for its failure to make any of the required § 436.1 disclosures, including substantiation of earnings claims. Under the original FTC Rule and the Amended Rule (16 C.F.R. § 436.1(h)), a commercial business arrangement is a "franchise" if it satisfies three definitional elements. Specifically, the franchisor must: (1) promise to provide a trademark or other commercial symbol; (2) promise to exercise significant control or provide significant assistance in the operation of the business; and (3) require a minimum payment of at least $500 during the first six months of operations. The business argued it was not a franchise as defined under the original FTC Rule. Under the original FTC Rule and the Amended Rule (16 C.F.R. § 436.1(h)), a commercial business arrangement is a "franchise" if it satisfies three definitional elements. Specifically, the franchisor must: (1) promise to provide a trademark or other commercial symbol; (2) promise to exercise significant control or provide significant assistance in the operation of the business; and (3) require a minimum payment of at least $500 during the first six months of operations. The court, however, found that it was a franchise because it gave the franchisees greeting cards that bore the business' trade mark, the business required them to use a locating service and gave substantial tips explaining how to conduct business, and the business required payments as a condition to receiving the product. Therefore, as a franchise it was in violation of the Amended Rule. Accordingly, the court ordered the company pay $9,165,567 in restitution for consumer redress.

b. Does Franchisee Have Standing?

When examining standing, it is important analyze each cause of action separately as a plaintiffs might have standing under one cause of action but not another. In Hetrick v. Ideal Image Dev. Corp., franchisee-plaintiffs suing in their individual capacities under the Florida Franchise Act for claims regarding deceptive earnings representations did not have standing to bring the claims because the "person" who invested in the franchise was the corporation and not the individual, and Florida law prohibits shareholders from initiating actions to pursue individual

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108 Id.

109 16 C.F.R. § 436.1(h).


111 Id.
The individuals also sued under Florida's little FTC Act, and the court held that the individuals actually had standing under the little FTC Act because they sustained pre-incorporation injuries which were separately cognizable. The little FTC Act does not limit standing to only the person who invested but extends protection to anyone who was a victim of an unfair or deceptive trade practice.

Franchisors must always familiarize themselves with the reach of the statute upon which the franchisee sues. In Sherman v. Ben & Jerry's Franchising, Inc., franchisees did not have standing under the Vermont's consumer fraud protection act because the statute protected only the state's citizens and the franchisees were not citizens of the state.

c. Has Franchisee Met Prerequisite To Sue?

A franchisor should analyze whether a franchisee has fulfilled all the prerequisites to assert claims under state law. In a recent action filed under the Virginia Retail Franchising Act, a franchisee's claim was dismissed because the Act did not provide a direct action for violation of its anti-fraud provision. The Virginia statute required the franchisee to first void the franchise agreement pursuant to the anti-fraud provision and then sue for damages resulting therefrom. The franchisee failed to void its franchise agreement, and the time to do so had expired. Thus, the franchisee's claims under the VRFA were dismissed.

d. What Law Governs?

State laws vary greatly from state to state. Practically every franchise agreement contains a choice of law provision. Is the choice of law provision enforceable? Jurisdictions adopting Section 187 of the Restatement Second of Conflict of Laws ("Restatement") will engage in a three step analysis: (1) does the chosen state ("State A") have a substantial relationship to the parties or transaction; (2) if yes, is State A's law contrary to fundamental policy of State B; (3) if yes, does State B have a materially greater interest in determination of issue? If State B does have a greater interest in the determination of the dispute, the choice of law provision should not be enforced.

Once the party seeking to enforce the choice of law provision demonstrates that the chosen state has a substantial relationship to the parties' transaction, the burden shifts to the opponent to demonstrate that the laws of the state designated are contrary to a fundamental policy of its proposed state's law. Restatement § 187, comment g, provides guidance on the definition of a fundamental policy and states that a fundamental policy must be "substantive"

113 id.
114 id. (citing Fla. Stat. §501.211(2)).
115 id. (citing Fla. Stat. §501.211(2)).
118 id.
and "may be embodied in a statute which makes one or more kinds of contracts illegal or which is designed to protect a person against the oppressive use of superior bargaining power."

A California court recently held that both the California Franchise Investment Law and the New York Franchise Sales Act expressed fundamental state policies to provide a heightened degree of protection to perspective franchisees to guard against misrepresentations in the franchise sales process. In It's Just Lunch Intern'l v. Island Part Enterprises Group, Inc., franchisee asserted counterclaims against franchisor for violations of California and New York's franchise laws and California's little FTC Act. The franchisor was incorporated in Nevada but was a citizen of California where it filed suit for moneys owed by the franchisee. The franchise agreement's choice of law provision selected Nevada law. The court held that while Nevada had a substantial relationship to the transaction, the franchisee met its burden of showing that both California and New York franchise laws "express[ed] a clear policy to provide a heightened degree of protection to prospective franchisees regarding misrepresentations about a franchise system." The court stated that "[t]here is no franchise disclosure law in Nevada, and, thus, to enforce the choice of law provision in this case would defeat the strong fundamental policy of California's law."

As to franchisee's claim under California's little FTC Act, the court acknowledged that courts had differed as to whether it embodied a fundamental policy. Since the burden was on the franchisee to demonstrate that the California little FTC Act embodied a fundamental policy and it failed to articulate a particular policy, the court held that the choice of law provision selecting Nevada law would be enforced and dismissed franchisee's claim under the little FTC Act.

e. Has The Fraud Claim Been Plead With The Requisite Specificity?

The standard of proof for a fraud claims is "clear and convincing" evidence, not a "preponderance." Fraud must be plead with specificity. In Sherman v. Ben & Jerry's Franchising, Inc., the court dismissed the franchisee's allegations that franchisor's financial performance disclosures on its website were fraudulent or misleading because the franchisee failed "to specify the most basic circumstances constituting fraud, such as what information plaintiffs claim was misleading or how the information led Plaintiffs to continue in the franchise," as required under FRCP Rule 9(b).
Rule 9(b) of the Federal Rules of Civil Procedure provides as follows:

Fraud or Mistake; Conditions or Mind. In alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake. Malice, intent, knowledge, and other conditions of a person's mind may be alleged generally.

In order to prevail on a fraud claim, a plaintiff must plead and prove the following: (1) a material representation was made, (2) the representation was false, (3) when the representation was made, the speaker knew it was false or made it recklessly without any knowledge of the truth and as a positive assertion, (4) the representation was made with the intention that it be acted upon by the other party, (5) the party acted in reliance upon the representation, and (6) the party suffered injury.127

In Juarez v. Jani-King of California, Inc., the plaintiffs came close to sufficiently pleading allegations of fraud but fell short of Rule 9(b)'s heightened pleading requirements.128 The complaint alleges that a Jani-King representative guaranteed a certain income and if franchisee did not obtain said level, Jani-King would either refund the money paid or make up the difference on the shortfall.129 Allegedly, the representative knew that Jani-King did not have sufficient business to generate the level of business promised – all while allegedly underbidding contracts and misrepresenting hours.130 The franchisee’s claims fell short of the pleading requirements because "[p]laintiffs do not identify a single Jani-King representative by name, and they provided no additional information that might aid Jani-King in identifying which representatives made these claims to Plaintiffs."131 Further, the franchisee failed to provide any specific evidence as to why the alleged income guarantees were false.132 "It is not merely a defendant’s misrepresentations that must be plead with particularity, but rather all of the ‘circumstances constituting fraud.’"133

The elements and proof requirements will vary from jurisdiction to jurisdiction, but franchisors should use the elements as the starting point for building their defenses.

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129 Id.
130 Id.
131 Id.
132 Id.
133 Id. (citing Fed. R. Civ. P. 9(b)).
3. Defenses

When allegations of unlawful FPRs are lodged against a franchisor, the franchisor is essentially put in a position of not only defending the particular transaction in question, but indirectly defending the entire system. This type of litigation has been referred to by many practitioners as "bet the system litigation." This section will discuss a number of defenses a franchisor might use to defend against an alleged unlawful FPR.

a. Alleged Earnings Claim Not Factual And, Therefore, Not Actionable

Franchisors have had moderate success with a defense that the representation is not factual in nature and, therefore, is not actionable under a fraud theory. In *Cook v. Little Caesar Enter., Inc.*, the franchisor was successful in arguing that the alleged fraudulent statement was not factual because it did not relate to a past or existing fact. Under Michigan law, "an action for fraudulent misrepresentation must be predicated upon a statement relating to a past or an existing fact. Future promises are contractual and do not constitute fraud." Consequently, the franchisee’s statements regarding future earnings were held not to be fraudulent.

Similarly, Indiana law precludes a franchisee from asserting a claim for recovery where the alleged false statement relates to a promise of future conduct.

A franchisor’s ability to prevail on this defense will vary from jurisdiction to jurisdiction as some courts have refused allow franchisors to prevail under this theory. In *Randall v. Lady of Am. Franchise Corp.*, in response to franchisee earnings-claims-based allegations, the franchisor argued that representations as to future franchise earnings or profitability cannot provide a basis for action in fraud. The franchisor relied on an Eighth Circuit case, *Morrison v. Back Yard Burgers* which held that a franchisor could not be held liable for fraud for profit projections because the franchisor “could not have know that his projections” would be false. The district court, however, disagreed, and ruled that under Minnesota common law and the state’s franchise act, if the franchisor made assurances regarding profitability that did not “accurately reflect surrounding past and present circumstances,” then the franchisor may be held liable under those assurances.

Similarly, a franchisor was unsuccessful at raising this defense in *Joe Wright v. The Spaghetti Place, Inc.* where the franchisee took position that franchisor’s statement in its promotional brochure forecasting future sales was not an opinion of future sales but instead

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135 210 F.3d 653, 658 (6th Cir. 2000).

136 Id.

137 Ind. Code §23-2-2.5-27.

138 532 F. Supp. 2d 1071, 1089-90 (D. Minn. 2007).

139 91 F.3d 1184, 1186-87 (8th Cir. 1996).

140 532 F. Supp. 2d at 1089-90.
fraudulent. The brochure stated that gross sales for its first restaurant were $220,000 when they were only $190,000. Moreover, the brochure specifically stated, “The gross sales figure used is based on the actual production of our first store in its first year of operation.” Thus, it was not an opinion but a misrepresentation of fact.

b. The Statement In Question Is True

One obvious defense is that the statements in question are true, which can be used to attack the franchisee’s lack of proof of falsity. In Qdoba Restaurant Corporation v. Taylors, LLC, plaintiffs alleged violations under the Florida Franchise Act, the Florida and Colorado little FTC Acts and for fraudulent inducement and misrepresentation for, among other things, alleged misleading financial performance representations. Qdoba moved for summary judgment on franchisee’s claims. The franchisee complained of the following statements contained on Qdoba’s website: Qdoba has an excellent sales-to-investment ratio; and Qdoba has seen 33 consecutive quarters of single restaurant growth. The court noted that summary judgment is usually not appropriate for a fraud claim but noted that the franchisee presented no evidence that any of the statements were false. Accordingly, summary judgment was appropriate given no genuine issue of material fact based upon website statements.

c. Franchisee Did Not Reasonably Rely On The FPR

Though most state franchise statutes do not explicitly require reliance, many courts have read a reasonable reliance requirement by the franchisee into the acts. This defense is probably one of the most frequently used defenses. It should be noted that where the FTC brings an action, it need not show reliance.

In Peterson v. Sprock, the franchisee sued the franchisor for fraud and other theories stemming from oral and written earnings representations made by the franchisor in its UFOCs and the franchise agreement. The court dismissed the franchisee’s fraud claims, finding that it was unreasonable for the franchisee to rely on any representations of prospective earnings when the franchise system was only in its preliminary stages.

In Hardee’s of Maumelle v. Hardee’s Food Systems, Inc., the Seventh Circuit upheld the dismissal of the franchisee’s allegations that the franchisor violated the Indiana Franchise Act,

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142 Id.
143 Id.
145 Id.
146 Id.
147 For a detailed discussion of the role reliance plays in these disputes, see Karen B. Satterlee & Kerry L. Bundy, “You Made Me Do It”: Reliance in Franchise Fraud Cases, Franchise L.J., at 191 (Spring 2007).
149 Id.
which prohibits franchisors from making untrue statements or omitting material facts that would act to defraud a franchisee. 150 The court found that even though the franchisee did not actually rely on the statement that estimated gross sales on the new location would be between $800,000 and $825,000, it would read a reasonable reliance requirement into the statute as lower Indiana courts had done. 151 Reading the requirement of reasonable reliance into the statute, the court concluded that it was unreasonable for the franchisee to rely on any projections of gross sales for an undeveloped business enterprise.152 The franchisee had prepared its own proforma which included a range of estimated gross sales in first year between $600,000 and $1.2 million. 153 Actual gross sales in the first year were $508,000 and $611,000 in the second year. 154 As a practical matter, defendants were able to minimize this fact because the franchisee undertook a separate analysis to try to determine gross sales prior to purchasing.

Courts have held that disclaimers in franchise agreements and acknowledgements may serve to void a franchisee's claim for lack of reasonable reliance. In Emfore Corp. v. Blimpie Associates, Ltd., 155 the court held that the franchisor's disclaimers were sufficient to bar the franchisee's common-law fraud claims, but that the anti-waiver provisions of the New York State Franchise Sales Act made the disclaimers ineffective with respect to the franchise act claims.

A franchisor should consider arguing no reasonable reliance by a franchisee where the franchisee did not actually read the alleged misstatements prior to signing the franchise agreement. In California Bagel Co., 18 LLC v. Am. Bagel Co., the franchisee alleged that the franchisor violated California's Franchise Investment Law by making various misstatements and omissions in its UFOC, which the franchisee admitted not reading. 156 The court relied on the authority interpreting Illinois, Indiana, and Michigan statutes as requiring reasonable reliance and found that language in the California statute required a similar interpretation. 157 Accordingly, the court dismissed the franchisee's claim.

Franchisors litigating under Minnesota law should be aware that a court in Minnesota might not give any credence to this defense as "unreasonable" reliance might give rise to a cause of action. In Lady of Am. Franchise Corp., the court held that despite the interpretation of other courts requiring justifiable reliance under similar statutes, the Minnesota Franchise Act does not appear to require reasonable reliance as an element in a claim for a misleading earnings claim. 158 The court noted, however, that reliance is required to some degree as an

150 31 F.3d 573, 578-79 (7th Cir. 1994).
151 Id.
152 Id.
153 Id.
154 Id.
157 Id.
158 532 F. Supp. 2d 1071, 1085-87 (D. Minn. 2007).
element of causation, but stated that under Minnesota law such reliance may very well be unreasonable and still give rise to a cause of action.\textsuperscript{159}

d. **Franchisee Ratified The Fraud By Continuing To Operate**

Franchisors should consider arguing that a franchisee’s claims are barred because the franchisee ratified the fraud by continuing to operate the facility after learning of the alleged fraud. In *American Nursing Care of Toledo, Inc. v. Leisure*, the court found that the franchisees were not induced by the franchisor’s fraudulent representations since all the representations were substantially accurate and based on the operating experiences of the company.\textsuperscript{160} In addition, the court noted that the franchisees’ continued operation of the franchise after the discovery of the alleged fraudulent representations barred any recovery of damages or any right to rescind or terminate the contract.\textsuperscript{161} The plaintiffs discovered the alleged falsity of the representations within the first year of operations.\textsuperscript{162} But they continued to adhere to the contract for two and one-half years, during which time they opened a second franchise, before attempting to renounce it on the basis of fraud.\textsuperscript{163} The court found that this “conduct is inconsistent with the plaintiffs having been defrauded” such that it “constitutes waiver and ratification of the fraud and eliminates any claim of such fraud.”\textsuperscript{164}

e. **Franchisee Suffered No Damages**

In an action brought by a private individual, the franchisor should always question whether the party has actually been damaged. In *Layton v. AAMCO Transmissions*, the claims were dismissed where the franchisee’s gross revenues exceeded the estimates in question.\textsuperscript{165} Under these facts, the court reasoned that the franchisee was not harmed.

f. **Are The Damages Sought Too Speculative? (Lost Profits)**

A franchisor might be able to limit exposure if the damages sought are too speculative. In *Joe Wright v. The Spaghetti Place, Inc.* the trial court found that the franchisor made fraudulent representations as to future earnings.\textsuperscript{166} Accordingly, the trial court awarded damages for out-of-pocket losses but did not award any benefit-of-the-bargain damages, including lost profits, since it deemed them too speculative to calculate for a new franchise in an untested market.\textsuperscript{167} On appeal, the court upheld the trial court’s finding since the franchisee failed to establish its lost profits by sufficiently definite evidence.

\textsuperscript{159} Id.

\textsuperscript{160} 609 F. Supp. 419, 428 (D. Ohio 1984).

\textsuperscript{161} Id.

\textsuperscript{162} Id.

\textsuperscript{163} Id.

\textsuperscript{164} Id.

\textsuperscript{165} 717 F. Supp. 368 (D. Md. 1989).

\textsuperscript{166} Bus. Franchise Guide (CCH) ¶ 8,582 (Ohio Ct. App. 1984).

\textsuperscript{167} Id.
g. Merger And Integration Clauses Bar Introduction Of Evidence Of Fraud

Courts are split over the effect of merger and integration clauses. Some courts have found that a merger or integration clause, as a matter of law, bars a party from introducing evidence of fraud based on prior oral statements that affect the written agreement because reliance on prior contradictory statements is unreasonable as a matter of law.\(^\text{168}\) Yet others have held that merger and integration clauses do not preclude fraud claims.\(^\text{169}\) Still others have taken a middle ground approach and held that merger and integration clauses only negate false statements when the clause specifically negates the false statement at issue.\(^\text{170}\)

In Sherman v. Ben & Jerry's Franchising, Inc., the franchisor alleged fraudulent inducement, fraudulent nondisclosure, negligent misrepresentation, and other claims based in part on the franchisor's UFOC Item 19 disclosures.\(^\text{171}\) The court dismissed the claims because language in the franchise agreement and the UFOC Item 19 disclosure explicitly disclaimed the franchisee's reliance on any representation outside the contract and included "specific, clearly stated warnings and disclaimers relating to [the franchisee's] expected profits."\(^\text{172}\) In particular, the warnings recommended independent investigation and cautioned that the numbers were only general estimates and that actual results were dependent on a number of external factors.\(^\text{173}\) While the court noted that boilerplate integration language and disclaimers will not necessarily preclude claims of fraudulent inducement, it held that such express disclaimers concerning specific representations that are expressly acknowledged by the franchisee, along with the recognition of the need for independent investigation, are enough to preclude fraud claims as a matter of law.\(^\text{174}\) A number of other courts have issued similar rulings.\(^\text{175}\)


\(^{169}\) Mfrs. Hanover Trust Co. v. Yanakas, 7 F.3d 310, 315 (2d Cir. 1993) (while party not permitted to argue fraudulent inducement when specific provision in the contract contradicts the alleged statement upon which a party claims reliance, a party is not precluded from introducing evidence where merger clause is vague).


\(^{172}\) Id.

\(^{173}\) Id.

\(^{174}\) Id.

\(^{175}\) See Cook v. Little Caesar Enter., Inc., 210 F.3d 653, 658 (6th Cir. 2000) (under Michigan law, "reliance upon oral representations or prior documents, even if false, is unreasonable if the party enters into a subsequent agreement."); Schubot v. McDonald's Corp., 757 F. Supp. 1351, Bus. Franchise Guide (CCH) ¶ 9,737 (S.D. Fla. 1990) (court concluded an integration clause, a disclaimer of any prior oral representations, and the absence of any evidence that the parties did not intend the writing to be the final and complete expression of their agreements barred the claims); Quality Inns Int'l, Inc. v. Dollar Inns of Am., Inc., Bus. Franchise Guide (CCH) ¶ 10,007 (D. Md. 1989) (disclaimer and integration provisions barred fraud, contract, and statutory claims based on prior misrepresentations because

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h. "No-Reliance" Clause

Franchisors have a better chance to dismiss a franchisee's fraud and negligent misrepresentation claims when there is a no-reliance clause in addition to a merger or integration clause.\textsuperscript{176} Courts are also more likely to find reliance on oral representations was unreasonable when the disclosure document expressly states that the franchisor is not providing any information about sales, profits, or earnings projections, and that no agent or representative of the franchisor is authorized to make any sales, profit, or earnings projections.\textsuperscript{177}

In \textit{Kieland v. Rocky Mt. Chocolate Factory}, the court dismissed the franchisee's claim that the franchisor misrepresented and failed to provide a reasonable basis for it earnings claims.\textsuperscript{178} The court found that the franchisee had signed an agreement and was aware of the franchisor's UFOC disclaimers that its agents were not authorized to provide the information at issue and that any representations were unauthorized.

In \textit{Sangemino v. Money Mailer, Inc.}, the court held it was unreasonable as a matter of law for the franchisee to rely upon a gross sales chart he had been given when the franchise agreement provided that the franchisor "does not furnish or authorize its sales persons to furnish any oral or written information concerning actual or potential sales, costs, income or profits of the franchised business in connection with the offer and sale of its franchises."\textsuperscript{179}

When the no reliance clause addresses the exact issue upon which the franchisee wishes to introduce evidence, a court is much more likely to enforce the no-reliance clause.\textsuperscript{180}

4. Evidentiary Issues

a. Standard Of Proof

The standard in a fraud action is clear and convincing – a much stricter standard that preponderance of evidence. A franchisee's proof of fraud must reach the higher showing in order for franchisee to prevail. The Third Circuit has held that it was plain error for the trial court to instruct the jury that the standard of proof on a fraud claim was a preponderance of the evidence.\textsuperscript{181}

\textsuperscript{176} See \textit{Hall v. Burger King Corp.}, 912 F.Supp. 1509 (S.D. Fla. 1995) (no reliance clause stated franchisees had conducted their own investigation). But see \textit{Carousel's Creamery, L.L.C. v. Marble Slab Creamery, Inc.}, 134 S.W. 2d 385 (Tex. App. – Houston [1st Dist.] 2004, pet. dism’d by agr.)

\textsuperscript{177} See Karen B. Satterlee & Kerry L. Bundy, "You Made Me Do It": Reliance in Franchise Fraud Cases, Franchise L.J. 191, 193-94 (2007).

\textsuperscript{178} Civil No. 05-150 (DWF/SRN), 2006 WL 2990336, at *6, *8 (D. Minn. Oct. 18, 2006).


Practitioners should familiarize themselves with any applicable state standard which could vary from state to state.

b. **Parol Evidence Rule**

Franchisors often allege that the parol evidence rule forbids a franchisee from introducing evidence of FPRs. The general rule is that parol evidence is appropriately used where a contract is at issue but is not appropriate to void introduction of such evidence where a cause of action is created by statute. In *Lady of America*, the franchisor unsuccessfully argued that the parol evidence rule under Minnesota law barred the evidence of alleged earnings claims that franchisee sought to introduce.\(^\text{182}\) The court distinguished an instance in which a party seeks to set aside an entire agreement because of deceptive and fraudulent conduct from an instance in which a party seeks to modify a term in a written agreement. In the latter instance, only, will the parol evidence bar introduction of evidence under Minnesota law.\(^\text{183}\) The former scenario sounds in tort. The parol evidence rule will only be applied when the alleged fraudulent statement directly contradicts a substantive contract term.\(^\text{184}\) This direct contradiction test is narrowly applied.\(^\text{185}\)

It should be noted that the court in *Lady of America* acknowledged that the distinction between the applicability of parol evidence rule to contract claims versus tort claims is not consistent across all jurisdictions. New York, for instance, has applied the parol evidence rule to fraud cases.\(^\text{186}\) The New Hampshire Supreme Court has considered this issue and rejected the applicability of the parol evidence rule to fraud cases.\(^\text{187}\)

5. **Dispositive Motions**

Franchisors should always consider whether summary judgment is appropriate. Summary judgment is appropriate "if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law."\(^\text{188}\) A fact is material only if its resolution affects the outcome of the suit.\(^\text{189}\) The court must assume that the nonmoving party's evidence is true for purposes of consideration of a motion for summary judgment. For this reason, summary judgment is extremely difficult.

However, franchisor might consider summary judgment where there is a question regarding whether a party is a franchisee or consumer. Additionally, a motion for summary

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\(^{182}\) *Randall v. Lady of America Franchise Corp.*, 532 F. Supp. 2d 1071, 1082 (D. Minn. 2007).

\(^{183}\) *Id.*

\(^{184}\) *Id.*

\(^{185}\) *Id.* at 1084.

\(^{186}\) *Id.* at 1083 (citing *Danann Realty Corp. v. Harris*, 157 N.E.2d 597, 598-600 (N.Y. 1959)).

\(^{187}\) *Id.* (citing *Van Der Stok v. Van Voorhees*, 866 A.2d 972, 976 (N.H. 2005)).

\(^{188}\) *Fed. R. Civ. P.* 56(c).

judgment might be a useful tool where the claims asserted are outside the applicable statute of limitation. Summary judgment might also be appropriate where the accused entity is arguably not a “franchisor” under the Amended Rule.

While a motion for summary judgment might be difficult to win in many instances, with the right facts, it provides a great tool for a franchisor to use for damage control and it may save time and expenses.

VII. CONCLUSION

FPR’s will continue to be litigated as long as franchising continues. On the mind of every prospective franchisee is “How much money can I make?” It is the ultimate pink elephant in the room. Some franchisors will continue to ignore the pink elephant (make no FPRs). Others will acknowledge the pink elephant and wink (unauthorized and unlawful FPRs). Finally, some will acknowledge the elephant and figure out a way to use it to benefit the system (make an affirmative, lawful FPR).
Appendix A

Sample Item 19-1: Financial Performance Representation
(Based on Actual Historical Performance Results)190

ITEM 19: FINANCIAL PERFORMANCE REPRESENTATION

The FTC’s Franchise Rule permits a franchisor to provide information about the actual or potential financial performance of its franchised and/or franchisor-owned outlets, if there is a reasonable basis for the information, and if the information is included in the disclosure document. Financial performance information that differs from that included in Item 19 may be given only if: (1) a franchisor provides the actual records of an existing outlet you are considering buying; or (2) a franchisor supplements the information provided in this Item 19, for example, by providing information about possible performance at a particular location or under particular circumstances.

Half of existing Belmont Mufflers franchisees in large metropolitan areas have had at least $200,000 in annual sales. Some outlets have sold this amount. There is no assurance you’ll do as well. If you rely upon our figures, you must accept the risk of not doing as well.

Bases

These sales figures are derived from the actual historical performance of Belmont franchisees in four large metropolitan areas: New York City, Boston, Chicago, and Los Angeles. These sales figures were achieved over calendar years 2005 and 2006.

There are 258 Belmont franchisees in the entire Belmont system, of which 100 are in New York City, Boston, Chicago, and Los Angeles. Of the 100 Belmont Muffler franchisees in these cities, we studied the sales figures from 90 standard 6-bay franchised outlets. Of the 90 franchisees, 50 attained at least $200,000 in annual sales, which is 50% of the franchisees in these cities.

Assumptions

Our study measured Belmont franchisees’ performance in large metropolitan areas. The market where your Belmont Muffler shops is located, however, may be in a smaller urban or suburban area.

Accordingly, the results achieved by these franchisees may not be typical for those in your area.

Further, each of the franchises studied has been in business at least three years. A separate market study we commissioned that was prepared by HFG Associates, an independent consulting firm, indicates that Belmont franchisees in their first year of operations are likely to achieve half the sales of those operating in business for three years or more.

Our study, the HFG Associates study, and other financial information that forms the bases for our financial performance representation are available to you upon reasonable request.

190 This sample was taken verbatim from the FTC Compliance Guide p.93-94.
Appendix B

Sample Item 19-2: Financial Performance Projection
(Based on Projected Results)\textsuperscript{191}

ITEM 19: FINANCIAL PERFORMANCE PROJECTION

The FTC's Franchise Rule permits a franchisor to provide information about the actual or potential financial performance of its franchised and/or franchisor-owned outlets, if there is a reasonable basis for the information, and if the information is included in the disclosure document. Financial performance information that differs from that included in Item 19 may be given only if: (1) a franchisor provides the actual records of an existing outlet you are considering buying; or (2) a franchisor supplements the information provided in this Item 19, for example, by providing information about possible performance at a particular location or under particular circumstances.

We estimate that the most probable net income for your first twelve months of operation is $50,000.

This income figure is only an estimate of what we think you can earn. There is no assurance that you'll do as well. If you rely upon these figures, you must accept the risk of not doing as well.

Bases

This projected income figure is derived from the actual historical performance of first-year Belmont franchisees.

There are 258 Belmont franchisees in the entire Belmont system, of which 70 began their first year in operation in calendar years 2005 or 2006. Of these, 54 franchisees responded to our survey and submitted data, and 35 (or 50\% of first-year franchisees) reported attaining at least $50,000 in annual income from their franchises.

Assumptions

Forty-five of the franchisees included in our survey are located in large metropolitan areas. The market where your Belmont Muffler shop will be located, however, may be in a smaller urban or suburban area. Accordingly, the results achieved by the these franchisees may not be typical for those in your area.

The above projection also assumes a stable supply of pipe, no additional competition for muffler parts and services, and retail price increases of no more than 3\% in the next year.

Our survey and other financial information that forms the bases for our financial performance representation are available to you upon reasonable request.

\textsuperscript{191} This sample financial performance representation was taken directly from the FTC Compliance Guide, p. 94-95.
<table>
<thead>
<tr>
<th>STATE</th>
<th>STATUTE</th>
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<tbody>
<tr>
<td>Hawaii</td>
<td>Franchise Investment Law, Haw. Rev. Stat. § 482E-8</td>
</tr>
<tr>
<td>Illinois</td>
<td>Franchise Disclosure Act of 1987, Ill. Comp. Stat. § 705/22-23, and</td>
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<td></td>
<td>705/31</td>
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<tr>
<td>Indiana</td>
<td>Franchise Law Ind. Code, tit. 23, art. 2, ch. 2.5 § 32</td>
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<tr>
<td>Maryland</td>
<td>Franchise Registration and Disclosure Law, Md. Code Ann., § 14-210</td>
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<tr>
<td>Minnesota</td>
<td>Franchise Law, Minn. Stat. § 80C.16</td>
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<tr>
<td>North Dakota</td>
<td>Franchise Investment Law, N.D. Cent. Code § 51-19-13</td>
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<tr>
<td>Oregon</td>
<td>Franchise Transactions, Oreg. Rev. Stat. § 650.055</td>
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<tr>
<td>South Dakota</td>
<td>Franchise for Brand-Name Goods and Services Law, S.D. Codified Laws § 37-5A-72 (among others)</td>
</tr>
<tr>
<td>Wisconsin</td>
<td>Franchise Investment Law, Wis. Stat. § 553-55</td>
</tr>
</tbody>
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## APPENDIX D
STATE ENFORCEMENT POWERS UNDER STATE BUSINESS OPPORTUNITY STATUTES

<table>
<thead>
<tr>
<th>STATE</th>
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<tbody>
<tr>
<td>Alaska</td>
<td>AK Stat. § 45.66.200</td>
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<tr>
<td>California</td>
<td>Contracts for Seller Assisted Marketing Plans, Cal. Civil Code § 1812.203</td>
</tr>
<tr>
<td>Florida</td>
<td>Sale of Bus. Opportunities Act, Fla. Stat. § 559.813</td>
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<tr>
<td>Iowa</td>
<td>Iowa Bus. Opp. Promotions Law, Iowa Code § 523B.8</td>
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</table>
SPEAKER BIOGRAPHIES

W. Michael Garner

W. Michael Garner, of W. Michael Garner, P.A. in Minneapolis and New York, is one of the country’s leading trial lawyers for franchisees and dealers in their disputes with their franchisors and suppliers. He has stopped terminations and non-renewals; won damage awards for fraud and termination in the hundreds of millions of dollars; advised people on buying a franchise; helped folks get out of their franchise; protected franchisees when their franchise systems got bought, sold or spun off; formed and advised groups and associations of franchisees; and protected franchisees when their franchisor was trying to invade, or encroach on, their territory.

Michael is also the author of Franchise and Distribution Law and Practice, a three-volume legal treatise described by the American Bar Association's Business Lawyer as the work that "eclipses the literature previously available . . . in the realm of franchising." He served as the editor-in-chief of the American Bar Association's Franchise Law Journal from 1988 to 1993, and authored the New York forms of jury instructions on franchise law. He is also editor of the Franchise Desk Book, a leading reference work for franchise lawyers published by the ABA. His articles for franchisees have appeared in Entrepreneur and Franchise UPDATE, and he has been quoted by The Wall Street Journal, New York Times and Business Week. He has served on the Governing Committee of the ABA Forum on Franchising.

As a recognized authority on franchise law, Michael has testified before Congressional and state legislative committees in support of franchisee rights. He has been a featured speaker before the International Franchise Association, the American Bar Association Forum on Franchising, the Practicing Law Institute, the National Franchise Law Institute and various other bar and franchise industry associations. His writings have been cited by several courts, including the United States Supreme Court.

Michael is listed in The Best Lawyers in America, was named an "Attorney of the Year" by Minnesota Lawyer, and was named one of Minnesota's "Super Lawyers" by Minnesota Law & Politics. He has won the Chairman's Award of the American Association of Franchisees and Dealers. He holds an A.B. from Columbia University and is a 1975 graduate of New York University School of Law.

Earsa R. Jackson

Earsa R. Jackson is a partner at Strasburger & Price LLP in Dallas, Texas, and she is the practice area leader for the firm's Franchise & Distribution group. Ms. Jackson structures franchises for start-up franchisors and assists existing franchisors with on-going transactional needs.

Ms. Jackson also handles litigation matters in the following areas: business and commercial, False Claims Act, business torts, franchise and distribution, trademark infringement, contract disputes, probate, and both commercial and residential landlord/tenant disputes.

Ms. Jackson is the director for the Litigation and Dispute Resolution Division of the American Bar Association Forum on Franchising. She is past-chair of the Dallas Bar Association's Franchise & Distribution Law Section, and she serves on the steering committee for the Franchise Business Network-Dallas, Texas. She has been a speaker, writer, panelist and/or
facilitator on franchise and distribution topics for seminars hosted by such organizations as the ABA Forum on Franchising, International Franchise Association, National Association of Women Business Owners, Association of Small Business Development Centers, and the Dallas Bar Association, among others.

Ms. Jackson has been named among Best Business Lawyers in Dallas in Franchise and Development by *D Magazine* (June 2009), Legal Eagle by Franchise Times (2009-2010), Best Lawyers in America in Franchise Law by Best Lawyers (2008-2010), and Best Lawyers in Dallas in the area of Franchise and Development by D Magazine in 2007 and 2008. She was named a “Texas Rising Star” by Texas Monthly magazine in 2006-2010. She was also named among Most Power and Influential Women in Texas by Texas Diversity magazine in April 2008.