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Why Have the Rule? Recent Opinion May Decrease Compliance with FPR Disclosure Requirements

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In the recent decision of Ellering v. Sellstate Realty Systems Network, Inc., 2011 U.S. Dist. LEXIS 75852, Bus. Franchise Guide (CCH) ¶ 14,664 (USDC Minn., July 13, 2011) ("Ellering"), the court granted summary judgment in favor of the franchisor on a franchisee's claim for statutory fraud under the Minnesota Franchise Act because of a "no reliance" clause in the parties' franchise agreement. That decision, and others similar rulings nationwide, may have the unfortunate effect of implicitly encouraging franchisors to provide a financial performance representation ("FPR") outside of their Franchise Disclosure Document ("FDD"), despite a "negative disclosure" in Item 19, since they are unlikely to face civil liability even if the informal disclosures are false or misleading.

The FTC Franchise Rule and Item 19 FPRs

The FTC Franchise Rule applies to all franchise sales in the United States and its territories. 16 C.F.R. ¶ 436. The section of the Rule entitled "Additional Prohibitions," 16 C.F.R. ¶ 436.9, states:

> It is an unfair or deceptive act or practice in violation of Section 5 of the Federal Trade Commission Act for any franchise seller covered by part 436 to:
>
> (a) Make any claim or representation, orally, visually, or in writing, that contradicts the information required to be disclosed by this part.
>
> * * *
>
> (c) Disseminate any financial performance representations to prospective franchisees unless the franchisor has a reasonable basis and written substantiation for the representation at the time the representation is made, and the representation is included in Item 19 (§ 436.5(s)) of the franchisor's disclosure document.

The term "financial performance representation" means "any representation, including any oral, written, or visual representation, to a prospective franchisee, including a representation in the general media, that states, expressly or by implication, a specific level or range of actual or potential sales, income, gross profits, or net profits." 16 C.F.R. ¶ 436.1(e).

Most state franchise disclosure laws contain similar requirements. For example, both a "prospectus" that must be provided to prospective franchisees under the Maryland Franchise Registration and Disclosure Law, Md. Code Ann. Bus. Reg. §14-216(c)(20), and a "public offering statement" that must be provided under the Minnesota Franchise Act, Minn. Stat. §80C.04(p), must contain, "A copy of any statement of estimated or projected franchisee earnings prepared for presentation to prospective franchisees, subfranchisors, or others and a statement of the information on which the estimation or projection is based". In each state with a franchise disclosure law, no person may offer or sell a franchise "by means of any written or oral communication which includes an untrue statement of a material fact or which omits to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." *See, e.g.,* Md. Code Ann. Bus. Reg. §14-229(a)(2), and Minn. Stat. §80C.13, subd. 2. Many state franchise laws also contain a broad "anti-waiver" provision providing that "a franchisor may not require a prospective franchisee to agree to a release, assignment, novation, waiver, or estoppel that would relieve a person from liability under this subtitle." Md. Code Ann. Bus. Reg. §14-226. *See also* Minn. Stat. §80C.21 ("Any condition, stipulation or provision . . . purporting to bind any [covered person acquiring a franchise] to waive compliance or which has the effect of waiving compliance with any provision of [the Franchise Law] or any rule or order thereunder is void.").

Randall v. Lady of America Franchise Corporation: The Interplay of "No-Reliance" Contractual Provisions and Statutory Fraud Claims

The landmark ruling of Randall v. Lady of America Franchise Corporation, 532 F. Supp. 2d 1071 (D. Minn. 2007) ("Randall") involved claims brought by several former "Ladies Workout Express" franchisees, most of whom closed their franchises after finding them to be unprofitable. While the facts alleged by each plaintiff varied, several recalled attending a "Discovery Day" event at the headquarters of the defendant ("Lady of America") in which senior executives provided them with specific statements (some oral and some in a slide presentations) about the levels of revenues and, in some cases, net profits being earned by existing Ladies Workout Express businesses.

Lady of America had registered its Uniform Franchise Offering Circular ("UFOC", which today is known as the "FDD") with Minnesota and provided it to each plaintiff. Item 19 of the UFOC contained a "negative disclosure" stating, "We do not furnish or authorize [our] salespersons to furnish any oral or written information concerning the actual or potential sales, costs, income or profits of your Franchise." 532 F. Supp. 2d at 1075.

All of the franchise agreements issued by Lady of America contained a "no reliance" provision that read, "The franchisor expressly disclaims the making of, and the franchisee acknowledges that he or she has not received, any promises or representations, express or implied, orally, in writing or otherwise of assistance, expenses, benefits, sales volumes, profits, success or any other matter except as expressly made in this agreement or the franchisor's franchise offering circular." *Id.* That sentence was succeeded by the following less common sentences: "If any promises or representations have been made, the franchisee must list them below. The franchisor is relying on the franchisee to see that all matters are included in writing in this agreement, if they are not, the franchisee will not be able to rely in any way on any

promises or representations and the franchisor will not be bound by them." *Id.* The aspect of "listing the representations" is more typically seen in a "franchise disclosure questionnaire" to be completed by the prospective franchisee before completing the purchase.

The franchisees who alleged receiving an FPR claimed that some of the information provided was outright false and that other claims made were misleading because Lady of America omitted material facts. Lady of America moved for summary judgment on the plaintiffs' claims for violations of the Minnesota Franchise Act, principally on the basis that, in the face of the language in Item 19 of the UFOC and the "no reliance" contract clause, none of the plaintiffs could have justifiably relied on the claims made at Discovery Day.

Judge Schiltz held that, as a matter of Minnesota's common law of fraud, a question of fact exists as to whether each plaintiff reasonably relied on representations made outside of the written contract, in the face of specific contract provisions disclaiming reliance on such outside representations. The court acknowledged that this aspect of Minnesota law is distinct from the common law of New York and other states that broadly apply the parol-evidence rule in fraud cases. However, the court also denied the motion for summary judgment on two alternative grounds: (a) justifiable or reasonable reliance is not a required element of a civil claim under the Minnesota Franchise Act because the statute contains no such requirement; and (b) the anti-waiver provision of the statute rendered the disclaimer of reliance provision void as a defense against a statutory fraud claim. 532 F. Supp. 2d at 1085 – 1089.

In so doing, the court emphasized that Minnesota's appellate courts "have repeatedly observed that the Minnesota Franchise Act is a remedial statute designed to favor franchisees over franchisors." 532 F. Supp. 2d at 1087. The court stated that the effect of the anti-waiver provision was that it "voids anything in a contract that explicitly waives compliance with a provision of the Act or that has the *effect* of waiving compliance with a provision of the Act. One such provision that cannot be waived is §80C.13's prohibition of material false statements." 532 F. Supp. 2d at 1088. In short, the court held that a jury had to decide whether Lady of America made the statements alleged by the franchisees, whether they were materially misleading, and whether the franchisees relied on them to their detriment.

The 2007 amendments to the FTC Franchise Rule substantially liberalized both the type of data that can be provided in a written FPR and its form of presentation. That development, when combined with decisions such as the *Randall* case, has had the salutary effect of encouraging franchisors to provide an FPR in Item 19 of the FDD. In my experience, this has occurred because the burdens presented in compiling and disseminating the FPR are outweighed by both (a) the benefit of having control over the information that franchise sales staff can credibly provide to prospective franchisees, and (b) the perception that a failed franchisee will not be able to credibly claim having received and relied on an informal FPR that was substantially more "optimistic" than the Item 19 presentation.

However, this risk calculus may change if written or oral statements made by franchise sellers that go beyond or contradict the FDD are not binding on the franchisor, or subject these individuals to personal liability.

Ellering: A Disincentive to Make FPRs?

The plaintiffs in *Ellering* are a husband and wife who purchased the master franchise rights of a real estate brokerage concept for the entire state of Minnesota. Prior to purchase, the couple received a UFOC containing a negative disclosure in Item 19, after which they had their first in-person meeting with Sellstate Realty's officers. The plaintiffs claimed that at that meeting, Sellstate's *President* told them, "(i) they could earn $37,000 per month as Sellstate franchisees, *as confirmed in handwritten notes he provided to them*, and (ii) he had recently earned $250,000 in one month." 2011 U.S. Dist. LEXIS 75852, at *4 (emphasis added).

The area representative agreement and franchise agreement between the parties each contained the following "no reliance" clause:

> You acknowledge that neither [Sellstate] nor any other party has guaranteed to you or warranted that you will succeed in the operation of the Area Representative business nor provided any sales or income projections, forecasts or earnings claim of any kind to you. You have not relied upon any guarantee, warranty, projection, forecast or earnings claim, whether express, implied, purported or alleged, in entering into this Agreement.

2011 U.S. Dist. LEXIS 75852, at *5.

In their own real estate brokerage franchise, the plaintiffs did not achieve nearly the level of income claimed by Sellstate's President, and they also were unable to sell any Sellstate franchises. When they asserted a claim for statutory fraud under the Minnesota Franchise Act, the court granted summary judgment on the claim, holding that the plaintiffs "could not, as a matter of law, justifiably rely" on the representations of the franchisor's President, *because of* the "no reliance" clause in the Franchise Agreement. *Id.* at *30 - *31. In so doing, the court asserted that the *Randall* holding regarding the anti-waiver provision of the Franchise Act solely concerned whether a negative disclosure in Item 19 could be used to defeat a claim for misrepresentation. *Id.* at *28 - *29. The *Ellering* court simply ignored the question of whether the "no reliance clause" had the effect of waiving the franchisees' rights under the anti-fraud provisions of the Franchise Act.

The *Ellering* decision follows the majority view of courts in the United States, as most reported decisions have held that a franchisee cannot pursue a misrepresentation claim under a state franchise law concerning an FPR made outside of the FDD. *See, e.g., California Bagel Company 18, LLC v. American Bagel Company*, 2000 U.S. Dist. LEXIS 22898, Bus. Franchise Guide (CCH) ¶ 11,880 (C.D. Cal. 2000), following *Cook v. Little Caesar Enterprises, Ltd.*, 210 F.3d 653, 659 (6th Cir. 2000); *Motor City Bagels, L.L.C. v. American Bagel Co.*, 50 F. Supp. 2d 460, 472 (D. Md. 1999); *Bonfield v. AAMCO Transmissions, Inc.*, 708 F. Supp. 867, 876 (N.D. Ill. 1989); *Rosenberg v. Pillsbury Co.*, 718 F. Supp. 1146, 1153-52 (S.D.N.Y. 1989); *Master Abrasives Corp. v. Williams*, 469 N.E.2d 1196, 1201 (Ind. App. 1984); and *Travelodge Int'l, Inc. v. Eastern Inns, Inc.*, 382 So.2d 789, 791 (Fla. App. 1980).

However, there are notable exceptions. In *Emfore v. Blimpie Associates, Ltd.*, 51 A.D.3d 434, 860 N.Y.S.2d 12, Bus. Franchise Guide (CCH) ¶13,889 (N.Y. App. Div., 1st Dept. 2008),

the court held that a "franchise disclosure questionnaire" completed at the time of the franchise sale, in which the franchisee did not identify any earnings information that the franchisor provided outside of the FDD, could not be used to bar the franchisee from pursuing claims under the anti-fraud provisions of the New York Franchises Law. More recently, in Cousins Subs Systems, Inc. v. Better Subs Development, Inc., 2011 U.S. Dist. LEXIS 112903, Bus. Franchise Guide (CCH) ¶14,705 (E.D. Wis., Sept. 30, 2011), the court held that a "no reliance" clause in the franchise agreement could not be used to bar claims under the anti-fraud provisions of the Wisconsin Franchise Investment Law and the Indiana Franchise Disclosure Act.

Conclusion

As the *Cousins Subs Systems* court wrote, "Ingenious wrongdoers cannot immunize their wrongdoing from the law with a single [contract] clause." *Id.*, 2011 U.S. Dist. LEXIS 112903, *24. On the other hand, as emphasized in the FTC's process of revising its Franchise Rule, there are justifiable policy reasons to permit "no reliance" clauses to be enforced with regard to truly unauthorized earnings claims made by a "rogue" salesperson. *See, e.g.*, Statement of Basis and Purpose for the Amended FTC Franchise Rule, 72 FR 15444, Bus. Franchise Guide (CCH) ¶6066, G. (commentary on 16 C.F.R. ¶ 436.9(h), which prohibits franchise sellers from disclaiming or requiring "a prospective franchisee to waive reliance on any representation made in the disclosure document or in its exhibits or amendments.")

However, in my opinion such policy justifications are untenable when the provider of the alleged FPR is a senior executive officer of the franchisor, such as its President, Chief Executive Officer, Chief Financial Officer or General Counsel, who has made or had significant influence over the franchisor's decision not to provide a written FPR. In such situations, the courts should allow the fact-finders to decide whether a franchise sale was procured by the provision of misleading financial performance information, despite a "negative disclosure" in Item 19 of the FDD. Otherwise, courts are defeating the purpose of requiring that franchisors' financial performance representations be in writing and are putting franchisors that provide written FPRs at an unfair disadvantage.