International Franchise Association
46th Annual Legal Symposium
May 5-7, 2013
JW Marriott Hotel, Washington, DC

Advanced FPRs: Writing, Using, Attacking and Defending Financial Performance Representations

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Financial performance representations need no introduction to experienced legal practitioners in franchising. To introduce this paper, then, we begin simply with two fundamentals. One is the official definition of "financial performance representation" in the Federal Trade Commission (FTC) Franchise Rule:

> *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. The term includes a chart, table, or mathematical calculation that shows possible results based on a combination of variables.[1]

The other fundamental is what the FTC has called "the implicit assumption" underlying financial performance representations – namely, "that a prospective franchisee may achieve at least the same level of performance."[2] Although the FTC acknowledges there is "no guarantee" that this will happen, and in fact directs franchisors to say as much to prospective franchisees, this implicit assumption is the source of much interest and angst about FPRs.

I. <u>CURRENT PRACTICES IN WRITING FPRS</u>

A franchisor—whether a start-up or a mature entity—must decide whether it wants to communicate its system's historical or projected financial performance to prospective franchisees in connection with the formal franchise sales process. Franchisors are not obligated, of course, to provide such information directly to their prospects. There are other lawful means by which prospective franchisees may obtain such information. However, if a franchisor wants to furnish financial performance information directly to its prospective franchisees (other than the actual operating results of a specific outlet being offered for sale), the FPR must appear within the text of Item 19 of the FDD[3] and be prepared following Item 19's strict mandates, including passing certain reasonableness, relevancy, and substantiation thresholds.

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[1] 16 C.F.R. §436.1(e).

[2] Federal Trade Commission, *Franchise Rule Compliance Guide* (May 2008) (hereinafter cited as "FTC Compliance Guide").

[3] The FTC staff clarified in FAQ #33 that FPRs may not be simply referenced in Item 19 and then appear in a separate FDD exhibit or attachment. Franchise Rule Section 436.5(s)(3) specifies that a franchisor must state the representation "***<u>in the Item 19 disclosure</u>***" (emphasis added); placing the financial performance representation anywhere else "would not be in the public interest because it could confuse and potentially mislead potential purchasers." Federal Trade Commission, *Amended*

There are no set rules for the type of information that a franchisor may include in an FPR or the manner in which the franchisor presents that information within Item 19. The FTC Franchise Rule and NASAA Disclosure Guidelines give franchisors considerable latitude regarding the type of information (*e.g.*, top line sales vs. bottom line profits, historical vs. projected, *etc.*,) and the manner of presentation (*e.g.*, charts, graphs, prose, *etc.*).

Nevertheless, the disclosure rules do impose certain inflexible prerequisites for a franchisor wishing to prepare an FPR. The franchisor must have a reasonable basis and written substantiation for the FPR when it is made; the franchisor bears the burden of proving that it had a reasonable basis; the FPR must state that written substantiation will be made available to the prospective franchisee on reasonable request; the FPR must state that a new franchisee's individual financial results may differ from the results stated in the FPR; and the FPR must be relevant to prospective franchisees.

A. <u>The Lawyer's Role in Creating FPRs</u>

Once a franchisor decides to make an FPR, the first question is: who prepares it? Who actually puts pen to paper to memorialize the FPR? It is no great revelation that the franchisor is responsible for furnishing the truthful numbers that serve as the "meat" of the FPR. But then what?

Franchise lawyers obviously will contribute meaningfully to the process. Counsel will discuss whether the franchisor should make an FPR in the first place. If the franchisor has been subject to franchisee complaints or lawsuits alleging unlawful "earnings claims," the lawyer might recommend including a lawful FPR in Item 19 in order to parry further disputes. The same holds true if the lawyer believes that franchise sales personnel or others within the organization are providing pre-sale financial information absent an Item 19. A properly developed and disclosed FPR will limit a franchisor's exposure to future fraud claims. If the franchisor's franchise sales are lagging or if its major competitors furnish an Item 19, counsel might tout an FPR's benefits to even the playing field and jump-start franchise sales.

Given the franchisor's decision to make an FPR, counsel must take steps to ensure that the FPR complies with the disclosure laws, imparts relevant, worthwhile information to prospective franchisees, and is defensible if (or when) challenged. Yet counsel should be very cautious when helping the franchisor prepare its FPR. In what seems like an eternity ago, a California court held that the plaintiff properly pleaded a negligence claim against the franchisor's attorney who prepared a disclosure document allegedly withholding material information, knowing that potential franchise purchasers would rely on that disclosure document.[4] There has been a perceptible up-tick in recent

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Franchise Rule FAQs (available at http://www.ftc.gov/bcp/franchise/amended-rule-faqs.shtml).

[4] *Courtney v. Waring,* 191 Cal. App.3d 1434, 1442 (1987).

years in claims against counsel representing franchisors (or “business opportunity” sellers) for their alleged negligence or malfeasance in counseling their clients.

Reviewing data to be presented and the accompanying bases and assumptions require counsel’s careful scrutiny. Enlisting the assistance and expertise of the franchisor’s accountants, auditors, and operations personnel is essential to develop an accurate, reliable, “real world” presentation. Documenting the FPR development process itself may very well protect both franchisor and counsel when they are asked to defend the FPR.

Practically speaking, preparing the FPR is a collective, collaborative effort among the franchisor (in particular, its financial officers), outside accountants, and outside counsel. It is customary for a franchisor to ask counsel for samples of publicly-available FPRs so that the franchisor can assess the type of information it might prefer to disclose and the format in which to do so. Sometimes the request will be limited to FPRs of competitive franchise systems. The reality is that the franchisor—whether a start-up or a mature entity—does not know immediately how best to proceed when it first decides to make an FPR. It knows that it wants or needs to make one but is uncertain about the process itself. So, it looks to outside counsel.

Outside counsel’s role might range from, on the one hand, actually crafting the FPR—using numbers provided and the preferred format chosen by the franchisor—for the franchisor’s and its accountants’ review and refinement to, on the other hand, simply reviewing, critiquing, and poking holes in the FPR prepared by the franchisor and its other advisors. Experienced franchise counsel should know the pressure points in preparing an FPR—in terms of required material bases, explanations, caveats, and disclaimers—and therefore might be best-suited to prepare the initial FPR draft (using the franchisor’s numbers) to ensure coverage of all required topics, of course flagging critical issues for the franchisor’s review, consideration, and confirmation. Conversely, franchise counsel might simply review the FPR prepared by the franchisor and its other advisors and question the inclusion or exclusion of certain information or discussion, ensure the presence of required caveats and admonitions, and the like. Irrespective of how responsibility is allocated for preparing the FPR, franchise counsel’s ultimate responsibility will be the same, *i.e.*, ensuring that Item 19’s strict mandates have been followed.

Once the FPR is included in the FDD, counsel’s role is to educate corporate executives and sales personnel about proper use and discussion of FPRs with prospects in order to limit franchisor liability, strengthen the franchise system, and promote positive franchisor-franchisee relationships. An important responsibility obviously is identifying and safeguarding the substantiating materials that may be requested by prospects.

B. The FPR Self-Examination Process

Franchisors must decide which data to present in the FPR. Many franchise systems, particularly mature ones, have wondrously varied operations. A given franchise system could include company-owned and single unit operations; units operated by area developers, subfranchisors, and subfranchisees; competing units operating under different trademarks; co-branded units; and others. Other franchise systems might be start-ups with few units from which to draw data.

If the most important reason to include an FPR in the FDD is to increase franchise sales, the start-up franchisor will want to examine closely the available information when it begins its FPR preparation. With a small number of units from which to draw information, the danger of presenting misleading information to a potential franchisee, and the risk of resulting litigation, are heightened. The FPR preparer must carefully explain the numbers used. What is the reason for the small sample size? Are the units company-owned, affiliate-owned, or franchised? Where are they located geographically? Is there anything about these units that differs from the unit to be operated by the prospect? Does the information accurately show the entire system's financial operations? If not, why not?

The challenge of limited available data also exists if financial reporting is either non-uniform or not required or if there is substantial financial reporting non-compliance. Preparing an FPR without considering the possible impact of data exclusion could considerably increase the franchisor's risk. There is no requirement that an FPR contain performance data from all franchised and company-owned operations. However, including data from only accurately-reporting units (including company-owned) may result in misleading information and, depending on the reasons for non- or under-reporting, possibly more favorable numbers. Consequently, the preparer must discover why the reporting problems exist, who is not reporting, and what is the probable impact on the FPR if information from those units were to be considered. Will inclusion or exclusion of the data materially alter the representation? In either event, the issue should be discussed in the FPR.

A franchisor's inability to collect data from every franchised unit does not prevent the franchisor from making an FPR because portions of a sampled universe may be randomly excluded and the results still will be projectable to a statistically acceptable margin of error. When exclusions do not occur randomly, however, the preparer must be cautious that there is no factor common to the excluded outlets; otherwise, reported results may not be applicable to future outlets also having this common factor. A franchisor therefore needs to know (i) why the non-reporters did not report, and (ii) whether the FPR would change materially if the results of the non-reporting franchisees were included in the sample. The key is not necessarily adding the results of the non-reporting outlets to the sample (though that would be the best solution); rather, it is being confident that the non-reporters' results, if included in the sample, will not have a material downward impact nor be misleading for any prospective franchisee whose outlet may have the factor common to the non-reporters.

There might be differences in data between franchised and company-owned businesses. Cost and expense figures might not be available from franchisees. Even if available, however, they might be poor indicators of the actual expenses incurred in operating the business, as franchisees often try to run personal items through the business. Royalties will be paid by the franchisee but not by the franchisor. The franchisor might have achieved certain economies of scale in operating its units; small franchisees probably have not. The franchisor might be more skilled and experienced at controlling costs and increasing revenues than is the franchisee. In addition to royalties, franchisees and franchisors may have different expense items.

If the franchisor considers franchisee data to be unreliable, it might prefer to base its FPR only on financial information from company-owned units. Barring unusual circumstances, this generally is not an acceptable practice (see discussion below). The FPR is for use by prospective franchisees. Therefore, the FPR must contain data that assists the franchisor in reasonably concluding that the information is relevant to its franchisees. To the extent company-owned unit information appears in the FPR, the franchisor should accompany the data with detailed explanations about the nature of the information disclosed (company store and/or franchise), the differences in expected expense items, and benefits the franchisor might have achieved through economies of scale, such as lower per-unit management costs and volume purchasing discounts.

A relatively young franchise system, or one with a substantial number of new units, can face interesting issues when preparing an FPR. Although a prospective franchisee might be particularly interested in performance levels potentially achieved during the early years of operation, new units might not operate as efficiently or profitably as more mature units, resulting in a potentially misleading claim.

The *Colish* Informal FTC Staff Advisory Opinion[5] (issued shortly after passage of the original FTC Rule) discusses the length of time (in that case one month) a unit must be in operation before a representation (then called an "earnings claim") about sales, income, or profits could be made to prospective franchisees. The FTC Rule never has required that specific units have a minimum period of operation; however, FTC Staff suggested that the risks were great that the "reasonable basis" requirement would not be met. The opinion suggested that data from one month of operations might not be the "best information reasonably available" nor represent the "single most probable result." Seasonal earnings fluctuations, should they occur, could make the one-month earning disclosure so atypical that the claim would lack a reasonable basis. Further, any attempt to make projections based on one month's data likewise would lack the necessary reasonable basis.

Reciting that a prospective franchisee to whom an earnings claim is made must be notified of any material change in the information at least 10 business days before paying any money or signing a franchise agreement (the then-applicable mandatory

[5] Bus. Franchise Guide (CCH) ¶ 6408 (April 22, 1980).

disclosure period), FTC staff suggested that frequent revisions and updates to the claim would be required "at regular intervals that are at least as short as the reporting period on which the original claim was based."[6] So, while not prohibiting outright a franchisor's FPR that is based on very limited operations, the FTC staff essentially admonished that frequent amendments/updates would be necessary as operations continued and the franchisor obtained new and updated financial information. In fact, under Section 436.7(d) of the FTC Rule, franchisors must—when furnishing the FDD—notify prospective franchisees of any material change that the franchisor knows or should have known occurred in the information appearing in Item 19 (*i.e.*, more frequent updating than the quarterly updating obligation appearing in Section 436.7(b) for other matters addressed in the FDD).

Another consideration when reviewing data from new units is that, depending on the type of franchised business, many businesses experience substantial sales as customers visit for the first time, especially as the result of a marketing blitz. Sales then may taper off before eventually leveling out. Without this "trend" information, an FPR based on early results might be deceptive. Conversely, including data from new units reporting significantly lower sales than those of more established operations might tend to lower the claim presented. In such circumstances, the franchisor might wish to consider bifurcating the "new" (however defined) units from the more mature units by length of time of operation and discussing the reasons for that bifurcation.

It always is possible that, after the data has been collected and analyzed and averages have been determined (assuming averages are used), the results present a potentially misleading, although mathematically correct, picture of system performance. The preparer should carefully examine the resulting information to assess what contributed to this. Were all business operations substantially similar in products or services offered? Were the businesses substantially similar to those being considered by prospects? Were there different allocations between company and franchised units regarding royalties, advertising, overhead, and other expense items? Was all financial reporting uniform? Was data from underreporting, underperforming, or substantially over-performing units used? Once the preparer identifies which units' performance is skewing the results, it probably is necessary to exclude those from the calculation in order to improve accuracy. Any exclusions from or modification of the sample used should be disclosed and explained in the FPR.

The disclosure rules require that all FPRs have a "reasonable basis" at the time they are made. The franchisor bears the burden of showing reasonable basis. What does "reasonable basis" mean? Presumably, the FPR must consider significant matters, including economic or market conditions, affecting sales, costs, and operating expenses. The facts in-hand must reasonably support the FPR as a reasonable prospective franchisee is likely to understand it. The facts must be the type of information upon which a prudent businessperson would rely in making an investment

[6] *Id.*

decision. Obviously, the quality and quantity of information constituting a reasonable basis will vary from case to case.

The goal for FPR drafters is to compare “apples to apples” as much as possible. If other fruit is thrown in, the drafter must explain why and what it means because the differences could impact the data. The drafter must avoid making misleading disclosures by accurately describing relevant franchise system characteristics. Differences within a given franchise system, depending on its history/maturity, may include some, all, or a combination of the following:

- Type of location: free-standing, enclosed shopping mall, strip shopping center, interior mall, lifestyle center, kiosk, non-traditional (university, airport, office building, *etc*.), and co-branded (which presents its own unique issues);

- Size: total square feet, usable square feet, available parking, *etc.*;

- Geographic: metropolitan, rural, suburban, ex-urban, or particular region of country;

- Company-owned: with potential differences in management, operations, and advertising expertise;

- Single unit or multi-unit: franchised locations owned and operated by single unit franchisees versus multiple franchised locations owned and operated by larger, more “sophisticated” “multi-unit operators” with accompanying economies of scale, increased advertising dollars, and management and operations expertise;

- Markets: already established with multiple franchise locations vs. “greenfields” (new markets);

- Name recognition;

- Competition: from same-system franchisees, independent businesses, and other franchise systems;

- Age of units: “mature” vs. “start-up”;

- Economic characteristics of market when unit was established and during period of operation: active and vibrant? depressed? Up-and-coming?

- Regional acceptability of product or service offered by franchised business;

- Franchisee capitalization: availability of financial resources for increased marketing, advertising, and operational needs;

- Similarity/differences: of product or service offerings; of franchise agreement requirements, including scale of operations, operating hours, signage, appearance, on-going fee requirements, cooperative marketing, trademarks, and the like; of company-owned versus franchised units;

- Operational/business capabilities of franchisees;

- Reporting vs. non-reporting franchisees (addressed above); and

- Available pool of labor to staff the business.

A franchisor must be sensitive to atypical results skewing a mean average, which, in turn, could make the mean average misleading even though mathematically correct. Where atypical results exist, or if a relatively normal distribution curve does not exist, a median average result might be a more accurate representation. Another possibility is to exclude from the sample (with appropriate disclosures) the atypical performers and report on only those remaining outlets whose results are more typical of what could be achieved (*e.g.*, excluding sales from airport locations from an "average gross sales" presentation). Finally, it might be useful to present the claim as a combination of ranges and percentages. The franchisor might consider reporting results by quarters, *e.g.*, top quarter, second quarter, *etc*., and, within each quarter, by high, low, and mean average for the quarter.

C. Historical FPRs vs. Projections

The disclosure rules permit both historical representations (how much existing franchisees have, in fact, earned in the past) and projections (how much an individual prospective franchisee may or is likely to earn in the future). Item 19's requirements depend on whether the franchisor makes an historical FPR or a projected FPR. In fact, a franchisor must state expressly whether its FPR (1) pertains to "historic" performance of all or a subset of existing franchised outlets or (2) is a forecast of future potential performance.

1. Preparing Historical FPRs

The FPR, if based on historical information, must include a description of the material bases and assumptions underlying its preparation and presentation, including: (1) whether the FPR relates to the performance of all existing outlets or only a subset of outlets sharing particular characteristics (*e.g.*, geographic location, type of location, degree of competition, length of time in operation, services or goods sold, services supplied by the franchisor, and whether the outlets are franchised or franchisor-owned and operated); (2) the dates when the reported financial performance level was achieved; (3) the total number of outlets existing during the relevant period and, if different, the number of outlets with the described characteristics; (4) the number of outlets with the described characteristics whose actual financial performance data were used to create the FPR; (5) of those outlets whose data were used to create the FPR, the number and percent that actually attained or surpassed the stated results; and (6) characteristics of the included outlets that may differ materially from those of the outlet offered to a prospective franchisee.[7]

The FTC Compliance Guide gives further color to the requirements that the franchisor must expressly address:

(1) *The Group Measured — Did All Outlets in the System, or Only Some of Them, Achieve the Stated Level of Performance?*

A franchisor making an historical FPR must state whether the representation covers the performance of all existing system outlets or only a subset of them having some common characteristic (*e.g.,* same geographic region or locale, all occupying a certain type of premises, or all in operation for some specific timeframe). Nothing prevents a franchisor, of course, from basing its FPR on system-wide data, for example, average sales of all units in the system. However, the FTC now accepts an FPR based on data from fewer than all units in a system if these outlets share one or more common characteristics. The franchisor obviously must disclose the characteristics of the units from which data is gathered to form the basis of the FPR and the total number of franchised units in the franchise system.

(2) *Are the Outlets in the Measured Group Franchised Outlets? Company-owned? Outlets of an Affiliated System with Similar Operations?*

The group from which data is gathered need not include only franchised outlets. It may — with two provisos —[8] consist of company-owned outlets or, in limited circumstances, reasonably similar affiliated outlets with operations reasonably similar to those for which the franchisor is offering franchises. The first (self-evident) proviso is that the FPR must be reasonable and supported by the data collected from the group. The second proviso is that the disclosure must clarify whether the claim is based on the experience of company-owned outlets, affiliated outlets, or franchised outlets in the same system.

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[7] 16 CFR § 436.5(s).

[8] As noted, all FPRs must have a reasonable basis. When a franchisor has adequate performance data of its own upon which to base a performance representation, basing an FPR on affiliate information likely would not be reasonable. Nevertheless, if the franchisor lacks adequate operating experience of its own, it may base a financial performance claim upon the results of operations of a substantially similar business of an affiliate. As in any case when an FPR is based on a subset of outlets that share a particular set of characteristics, the franchisor must also disclose any characteristics of these outlets that may differ materially from the outlets being offered for sale.

(3) *Time Period Measured — When Was the Stated Level of Performance Achieved?*

Franchisors have flexibility to use any reasonable time period. However, using an older time period could generate performance results that no longer are relevant to current market conditions and therefore would not be a reasonable basis for an FPR. Similarly, representations based on reasonably similar affiliate operations could be inaccurate or misleading, despite their recency, given the actual operating experience of system franchisees.

(4) *Number of Outlets Measured — How Many Outlets Are in the Group That Achieved the Stated Level of Performance, and How Many Are in the Entire System?*

A franchisor must disclose the number of franchisees in the group or subgroup measured *vis-à-vis* the total number in the system during the relevant time period.

(5) *Number of Outlets Reporting — How Many Outlets in the Relevant Group Supplied the Performance Data Underlying the Representation?*

Franchisors must disclose the number of franchisees in the group about which the FPR is made and from which the performance data was gathered. Data may be gathered from all, or fewer than all, members of a group sharing the specified characteristics.

(6) *Number and Percentage of Outlets that Achieved the Stated Level of Performance — What Proportion of the Group Measured Achieved the Results Claimed?*

With respect to the units providing the data serving as the basis for the FPR, franchisors must disclose both the number and percentage that actually attained or surpassed the stated results.

(7) *Distinguishing Characteristics — What Are the Common Attributes of the Outlets That Achieved the Stated Level of Performance?*

The implicit assumption underlying any historical FPR is that a prospective franchisee might achieve at least the same performance level (although there is no guarantee this will happen). Factors potentially impacting that implicit assumption must be disclosed. Consequently, Item 19 requires disclosure of any characteristic of the group or subgroup on which the representation is based that might distinguish that group from units for which the franchisor currently is offering franchises.

2. **<u>Preparing a Projection</u>**

If the FPR is a forecast of future financial performance, the franchisor must, just as for a historical FPR, provide the material bases and assumptions on which the projection is based. However, the franchisor does <u>not</u> have to address the list of specific factors described in the previous section. "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."[9]

The old UFOC Guidelines attempted to mitigate the risk of projections by stating that a reasonable basis would be presumed for projections prepared in accordance with certain standards of the American Institute of Certified Public Accountants. The AICPA standards discuss factors to be considered in making projections and forecasts and provide general guidance, but no clear assurances. They have nothing to do with franchising *per se*! A franchisor making projections must consider that its assumptions about the future might be no more insightful than those of prospective franchisees and that every projection overstating actual performance involves a mistaken assumption. Hindsight is more accurate than foresight and, when projections go sour, there is a great temptation to hold the franchisor accountable for the mistaken assumption. A franchisor in litigation might have the unenviable task of having to convince a jury that its assumptions were reasonable when made.

While the current disclosure rules no longer <u>*expressly*</u> presume a reasonable basis for projections prepared in accordance with AICPA standards, projections still are presumed to have a reasonable basis, according to the FTC Compliance Guide, if franchisors follow the highly recommended process for preparing them.[10]

> With respect to projections of potential performance, franchise sellers should consult with the current standards for projections issued by professional organizations such as the American Institute of Certified Public Accountants, *e.g., Prospective Financial Information: AICPA Audit and Accounting Guide* (2006). As a general matter, the following should be considered when making reasonable forecasts:
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> • Financial forecasts should be prepared in good faith;
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> • Financial forecasts should be prepared with appropriate care by qualified personnel;

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[9] 16.C.F.R. § 436.5(s)(3)(iii).

[10] Item 19 itself provides no practical guidance on how to prepare a projection.

> - Financial forecasts should be prepared using appropriate accounting principles;
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> - The process used to develop financial forecasts should provide for seeking out the best information that is reasonably available at the time;
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> - The information used in preparing financial forecasts should be consistent with the plans of the entity;
>
> - Key factors should be identified as a basis for the assumptions;
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> - Assumptions used in preparing financial forecasts should be appropriate;
>
> - The process used to develop financial forecasts should provide the means to determine the relative effect of variations in the major underlying assumptions;
>
> - The process used to develop financial forecasts should provide adequate documentation of both the financial forecasts and the process used to develop them;
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> - The process used to develop financial forecasts should include, where appropriate, the regular comparison of the financial forecasts with attained results; and
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> - The process used to prepare financial forecasts should include adequate review and approval by the responsible party at the appropriate levels of authority.
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> This is not to suggest that these points constitute the complete test for whether there exists a reasonable basis for a performance projection. Nonetheless, in the view of Commission staff, projections made in accordance with the standards issued by the AICPA (or its successor) presumptively have a reasonable basis.

The point, in the FTC's opinion, is that if a franchisor makes a projection in Item 19, the franchisor must describe sufficient facts to enable a prospective franchisee to judge independently the projection's validity. Disclosures should include a description of the material information on which the franchisor relied in making the representation, including, for example, market studies, statistical analyses, franchisee profit-and-loss statements, and other types of information upon which "prudent" persons customarily rely in making business decisions. Assumptions underlying an FPR must be disclosed because they go to the heart of the probability that a prospective franchisee will achieve performance similar to that projected.

3. **Which Type of Presentation Should the Franchisor Use?**

Despite the flexibility to use projections in Item 19 and the less specific requirements for preparing them, franchisors overwhelmingly make FPRs based on historical system numbers. Virtually everyone seems to agree that historical data, when available, is more reliable, and in practice very few FDDs present forecasts of future financial performance.

The assumption, no doubt, is that financial projections based upon some formula or prediction will be examined and questioned by an "underachieving" franchisee more closely than will statements of historical "truth" buttressed by hard copies of substantiating information. While representations of past performance do carry an implicit assumption about their relevance for future results, claims describing past performance still are less risky than projections of future results. Past results are a fact. If the sample is appropriate, the franchisor's arithmetic is correct, and the presentation is not misleading, the numbers speak for themselves.

Projections involve the same compilation and presentation elements, but they also entail a series of assumptions about the future that need not be made with historical data. These assumptions increase the franchisor's risk profile because the franchisor assumes the burden of justifying the reasonableness of its assumptions. In contrast, when the FPR is based on historical information, *it is the prospective franchisee and its advisors – not the franchisor – who try to determine how past performance might predict future performance*.

D. **The "Affiliate-Owned" Outlets Issue**

Under the UFOC Guidelines, a start-up franchisor without "an adequate operating experience of its own" was permitted to base its earnings claim "upon the results of operations of a substantially similar business of a person affiliated with the franchisor or franchisees of that person; provided that disclosure is made of any material differences in the economic or market conditions known to, or reasonably ascertainable by, the franchisor."[11] The absence of that language in the new disclosure rules prompted an inquiry to the FTC about whether the agency intended to prohibit franchisors from basing their FPRs on the results of affiliate-owned operations. In its FAQ #8, the FTC staff responded in pertinent part as follows:

> When a franchisor has adequate performance data of its own upon which to base a performance representation, basing a financial performance representation on affiliate information likely would not be "reasonable." Nevertheless, in limited circumstances, a franchisor may base a financial performance claim upon the results of operations of the substantially similar business of an affiliate. […]

[11] UFOC Guidelines, Item 19, Instruction B(i).

> The amended Rule does not incorporate this specific language [referring to the original language in the UFOC Guidelines]; nevertheless, consistent with the UFOC Guidelines, the amended Rule does allow franchisors to use affiliate information as a basis for a performance claim in certain narrow circumstances – specifically, when the franchisor lacks an adequate operating experience of its own. However, as in the case of using any financial performance representation based on a subset of outlets that share a particular set of characteristics, the franchisor must also disclose any characteristics of such outlets that may differ materially from the outlets being offered for sale.

This is clear as mud – so what does it mean for the disclosure in an FPR of the financial performance of franchisor-owned and affiliate-owned units?

The ubiquitous key is what is reasonable under the circumstances. There is no absolute bar to including affiliate-owned information, but the context is important. But context likewise is important when disclosing the financial performance of franchisor-owned outlets and franchised outlets!

It is undeniable that a franchisor's FPR may include information about *franchisor-owned* units. Item 19's mandated first preamble expressly permits it: "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* . . ." (emphasis added). Similarly, for FPRs relating to past performance of the franchise system's existing outlets, the franchisor must disclose the representation's material bases, including "whether the outlets are franchised or franchisor-owned or operated."[12]

However, such acceptance does not mean that a franchisor should or may include in a gross sales-only FPR the performance of its airport-based outlets substantially exceeding the system's average gross sales, the inclusion of which would inappropriately skew upward the reported numbers. We use the word "inappropriate" because airport-based outlets are one type of venue to which the "typical" franchisee will have no access. Such an outlet's performance therefore would not be representative of system performance, relevant to a prospective franchisee, or reasonable for inclusion in Item 19. However, the same would be said for franchised outlets operating in "atypical" locations the results of which also could improperly skew upward the system's average gross sales.

An affiliate-owned unit's status as an "affiliate" often is attributable to nothing more than the fortuity of ownership. In other words, an operating business deciding to launch a franchise program could choose to be the franchisor entity as well. Under Item 19's language, that operating business then could (barring "reasonable basis" issues) disclose the performance of its own units in Item 19. Indeed, that franchisor could

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[12] Item 19(3)(ii)(A).

"back-door" its historical operating information into the FDD, even without making a formal FPR, via the financial statements attached to the FDD as an exhibit.

Now suppose the operating business deciding to launch a franchise program instead forms a sister entity to be the franchisor because it wants to shield the assets of its operating business from the franchise program's potential liabilities or, conversely, wants to shield the assets of its franchising business from the potential liabilities of its operating business (*e.g.*, lease liability, product liability, etc.). Are the performance results of the operating business that the franchisor now would like to include in its Item 19 any less reliable just because the operating business now is a sister entity to the franchisor and not part of the franchisor's overall operations? That makes little sense.

How does one reconcile the FTC's admonitions with empirical realities? The key is whether the franchisor has franchised units in operation, the results of which can form the basis for the FPR. There are multiple possibilities:

1. If there are no franchised outlets, or if the franchised outlets have not operated long enough so that reporting their results would be reasonable, the franchisor may prepare an FPR based on either franchisor-owned outlets or affiliate-owned outlets, assuming these latter operations are representative of the type of outlets to be operated by franchisees.

2. If there *are* franchised outlets that have operated long enough so that reporting their results would be reasonable, and assuming they are representative of the type of outlets to be operated by prospective franchisees, the franchisor may *not* exclude those franchised outlets from its FPR in favor of the results of only franchisor-owned or affiliate-owned outlets, even if the latter operations also are representative of the type of outlets to be operated by prospective franchisees. However, it does not follow that the performance of franchisor-owned or affiliate-owned outlets *must* be excluded from the FPR if those outlets otherwise are representative. The franchisor should be able to include in its FPR the operating results of all system outlets. Barring unusual situations, the franchise registration states permit these types of Item 19s without comment. A franchisor nevertheless should consider whether there is reason to segregate within the FPR franchised outlet performance, on the one hand, and franchisor-owned or affiliate-owned outlet performance, on the other hand. The FTC cautions in its Compliance Guide that if an FPR "is based upon both types of outlets – franchise and company-owned – the data for each type ordinarily should be separated to avoid potential misrepresentations."[13]

3. Franchisors typically may include in the FPR the operating cost (and even net profit) experience of outlets owned and operated by the franchisor or its affiliates *if* the franchisor does not have reliable cost (or profit) information from franchised outlets and the cost (and profit) experience of the outlets owned and operated by the franchisor

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[13] FTC Compliance Guide at p. 137.

or its affiliates has a reasonable basis and is representative of actual or expected system performance.

4. If the franchisor does have reliable cost (and profit) information for franchised outlets, it may *not* exclude those franchised outlets from its FPR in favor of the results of only franchisor-owned or affiliate-owned outlets, even if the latter operations also are representative of the type of outlets to be operated by prospective franchisees. Again, however, it does not follow that the performance of franchisor-owned or affiliate-owned outlets *must* be excluded from the FPR if those outlets otherwise are representative. The franchisor should be able to include in its FPR the operating results of all system outlets. As noted in #2 above, however, a franchisor should consider whether there is reason to segregate within the FPR franchised outlet performance, on the one hand, and franchisor-owned or affiliate-owned outlet performance, on the other hand.

E. Disclaimers

The only disclaimer that Item 19 specifically requires is a "clear and conspicuous admonition that a new franchisee's individual financial results may differ from the result stated in the financial performance representation." However, Item 19 does not prescribe the language for this admonition. How does the franchisor comply with this requirement?

Section 19.3 of the NASAA Commentary on the 2008 Franchise Registration and Disclosure Guidelines concedes that Item 19 "does not require any specific language." Nevertheless, it advises that franchisors "should use" one of the following admonitions in a separate paragraph (which, frustratingly, does not match the sample language in the FTC's Compliance Guide):

For historical representations—

> "Some [outlets] have [sold] [earned] this amount. Your individual results may differ. There is no assurance that you'll [sell] [earn] as much."

For projections—

> "These figures are only estimates of what we think you may [sell] [earn]. Your individual results may differ. There is no assurance that you'll [sell] [earn] as much."

In either case, franchisors may not include additional language that serves to disclaim the financial performance representation they have just made or state that a franchisee may not rely on the information presented.[14]

[14] The admonition in the FTC's Compliance Guide reads as follows: "Some outlets have sold this amount. There is no assurance you'll do as well. If you rely upon our

The last sentence of course reflects NASAA's concern that franchisors make FPRs — providing all sorts of numbers — and then litter those FPRs with caveats, disclaimers, and no-reliance language effectively eviscerating the meaningfulness, relevance, and reliability of the FPR itself, so much so that a franchisee might face insuperable obstacles in potentially challenging an FPR's propriety and integrity because of such caveats, disclaimers, and no-reliance language. Despite this prohibition, one still finds in FDDs many examples of caveats, disclaimers, and no-reliance language that regulators could be expected to find offensive.

The problem with NASAA's proffered language is that it often does not "match up" with the variety of FPRs that franchisors make. Does this language make sense for a hotel franchisor's FPR disclosing average system occupancy rates? An oil change franchisor's FPR disclosing the average number of cars serviced per day at its outlets? Any franchisor's focus in its FPR on costs as a percentage of sales rather than on gross sales? Fortunately, most franchise registration states (except for Maryland) have tended thus far not to comment when franchisors slightly massage this disclaimer in a non-misleading manner to fit the precise FPRs they have made.

Besides this disclaimer, franchisors are to present no other "disclaimers" other than that allowed by FTC FAQ #27:

> Other than the preceding financial performance representation, [name of franchisor] does not make any financial performance representations. 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.

Unlike Item 19's mandatory preambles, this statement is permissive. Yet a franchisor choosing to make this statement must use it "in exactly the wording set out above, with no additions, deletions, or modifications." FTC staff believes this language to be in the public interest because it "serves to alert prospective franchisees that no representative or employee of the franchisor is authorized to embellish the disclosure document by making a financial performance representation. It also tells prospective franchisees what to do if they receive such unauthorized financial performance representations."[15]

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figures, you must accept the risk of not doing as well." FTC Compliance Guide at page 94.

[15] Franchisors making gross sales only FPRs must include an additional disclaimer if registering in California, *i.e.*, "The figures below do not reflect the costs of sales, operating expenses, or other costs or expenses that must be deducted from the gross sales figures to obtain your net income or profit. You should conduct an independent

Despite the prohibition of wide-ranging disclaimers, may franchisors otherwise caution prospective franchisees about their possible or expected performance without making a frontal assault on the prohibition? Of course. In presenting the FPR's material bases and assumptions and explaining the derivation and meaning of the numbers, a franchisor can subtly transmit to the prospective franchisee additional sensible cautionary measures, such as "the prospective franchisee is responsible for developing its own business plan and should consult with its own professional advisors," "the prospective franchisee must understand that a newly-opened business cannot be expected to achieve sales similar to those achieved by an established business," "actual results vary from area to area," and the like. That said, the simplicity of NASAA's required disclaimer could arm the franchisor with a defense shield. When asked in litigation why it did not provide more relevant or tailored disclaimers in its FDD, the franchisor can truthfully and accurately reply that NASAA prohibits them.

II. <u>SUBSTANTIATION OF FPRS</u>

A franchisor making an FPR must have <u>*written substantiation*</u> of the information comprising the FPR. The franchisor must have that written substantiation in its possession <u>*when the FPR is made*</u> and must provide that substantiation to a prospective franchisee upon reasonable request. The franchisor's failure to do so is an independent violation of the FTC Rule. Two questions logically follow from this requirement: (1) What constitutes "written substantiation"? and (2) How does a franchisor mechanically comply with its obligation to provide written substantiation to a prospective franchisee upon reasonable request?

A. <u>What Constitutes "Written Substantiation"?</u>

Substantiation means possessing in writing the supporting data underlying the FPR. The "written" material can be in electronic form or any other form capable of being reviewed. According to the Compliance Guide, supporting data can include, for example, market studies, statistical analyses, franchisee profit and loss statements, and other types of information upon which prudent persons customarily rely in making business decisions. For gross sales FPRs, that data would include a compilation of franchisee royalty reports.

The bottom line is that franchisors must have proof "in hand" that the financial information communicated in its FDD is real and documentable. Manifesting the illogical extreme, the Compliance Guide comments that "impressionistic" or anecdotal information, such as a rough counting of a show of hands by franchisees attending the franchisor's convention, does not meet the standard necessary to substantiate an FPR. One can discern from the FTC's willingness to allow franchisors to share franchisee profit and loss statements and disseminate other franchisee-generated information that

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investigation of the costs and expenses you will incur in operating your [insert applicable franchise brand]. Franchisees or former franchisees, listed in the Franchise Disclosure Document, may be one source of this information."

the FTC is not overly concerned with franchisee "privacy" or "confidentiality" claims. The FTC guidance says nothing about a franchisor's right or obligation to redact identifying information during the substantiation process.

Data from company-owned or affiliate-owned outlets may provide a reasonable factual basis for FPRs if the representation is properly prepared. When company-owned or affiliate-owned outlet data is used, the franchisor must clearly disclose that the FPR is based on the performance of those company-owned or affiliate-owned outlets, and the representation must account for differences among company-owned, affiliate-owned, and franchised outlets (not a major revelation inasmuch as franchisors must make the same distinctions among franchised outlets where appropriate). If an FPR is based upon both types of outlets — franchised and company-owned (or affiliate-owned) — the FTC notes that the data for each type ordinarily should be separated to avoid potential misrepresentations. The word "ordinarily" suggests that there might be occasions where this segregation is not necessary, for example, if including the performance of company-owned or affiliate-owned units in the FPR does not skew the reported results because there are no operating or other peculiarities of those company-owned or affiliate-owned units needing to be highlighted.

B. <u>How Does a Franchisor Provide Written Substantiation to a Prospective Franchisee</u>?

The FTC advises that the term "reasonable," in terms of the prospective franchisee's request for substantiation, relates to time and location. A prospective franchisee's request is reasonable when the franchisor has sufficient time to produce the substantiation at a convenient location, for example, at franchisor headquarters or the place where the substantiation is stored if it contains confidential information or is voluminous. According to the Compliance Guide, franchisors are not expected to bring substantiation to a trade show. So, a trade show attendee's request for substantiation that afternoon at the trade show likely is unreasonable.

Must a franchisor send written substantiation to a prospective franchisee in a manner enabling the franchisee to forward or otherwise disseminate the substantiating information to third parties who are not prospective franchisees? Unlikely. A franchisor should be able to control the dissemination of what it considers to be sensitive, semi-private information that is not freely available to the public and is being shared only with prospective franchisees.

What are the franchisor's options? Obviously, the franchisor can make the substantiating information available for physical inspection at its headquarters or at another physical location convenient to the franchisee (for example, a branch office or company-owned unit closer to the franchisee). With current technology, most franchisors also should be able to allow electronic access to substantiating information on a password-protected, read-only website or franchise system intranet that bars downloading or copying. Nowhere has the FTC or a regulatory state suggested that a franchisor must physically visit prospective franchisees at their homes or places of business to reveal the substantiating information. One would assume that such a prospective franchisee's request would not be considered "reasonable."

III. SUPPLEMENTAL FINANCIAL PERFORMANCE REPRESENTATIONS

A supplemental financial performance representation ("Supplemental FPR") is not unlike Bigfoot or the Loch Ness monster — people have heard about it but rarely, if ever, actually have seen it. In fact, many people might not know exactly what it is considering there is no handy, precise definition. A franchisor's right to prepare and use a Supplemental FPR currently is found in Item 19(s)(5) of the disclosure rules.

> If a franchisor furnishes financial performance information according to this section [Item 19], the franchisor may deliver to a prospective franchisee a supplemental financial performance representation about a particular location or variation, apart from the disclosure document. The supplemental representation must:
>
> (i) Be in writing.
>
> (ii) Explain the departure from the financial performance representation in the disclosure document.
>
> (iii) Be prepared in accordance with the requirements of paragraph (s)(3)(i)-(iv) of this section.
>
> (iv) Be furnished to the prospective franchisee.

That is the entire guidance found in the disclosure rules themselves. The FTC Compliance Guide sheds little additional light on Supplemental FPRs. It states summarily that:

> If a franchisor has furnished an Item 19 disclosure, it may furnish a prospective franchisee with a supplemental financial performance representation pertaining to a particular location or pertaining to a particular variation (e.g., a kiosk, as opposed to a standard free-standing restaurant). Any such supplemental representation must be in writing, explain the departure from the financial performance representation set forth in the Item 19 disclosures, and be prepared according to the standards for financial performance claims noted above.

Nor is there any discussion of Supplemental FPRs in the FTC's Statement of Basis and Purpose for the amended FTC Rule. The only tidbit added by the FTC Compliance Guide is the illustrative parenthetical "(e.g., a kiosk, as opposed to a standard free-standing restaurant)."

What does the FTC's example mean? Is the FTC saying simply that the franchisor can tell the prospective franchisee how kiosk locations (in which the prospect ostensibly is interested) encompassed in its FPR have performed when compared to standard free-standing restaurants also encompassed in its FPR? After all, a franchisor disclosing average system-wide sales, for example, typically makes no distinction among the peculiarities of the system's outlets (other than explaining or excluding outliers and atypical outlets the inclusion of which would improperly skew the FPR's numbers and/or otherwise impact the franchisor's "reasonable basis" for making the FPR). As a result, the FPR within the FDD alone might be of little use to a prospective franchisee interested in a particular type of location, at a particular site, and within a particular locale, at least not without further explication. The Supplemental FPR provides this further explication.

Alternatively, does the FTC's parenthetical mean that, if a franchisor makes an FPR about standard free-standing restaurants in its system but the prospective franchisee wishes to develop the franchisor's brand at a kiosk location, the franchisor may "adapt" its FPR for the prospective franchisee's circumstances and, taking certain assumptions into effect, prognosticate how the prospective franchisee might do with a kiosk taking into account the different types of locations, different sizes, etc.?

The answer is not clear. Focusing on the purposes of FPRs and disclosure as an overall concept, the FTC's illustration might be viewed as an example of the proposition that a greater right (*i.e.*, to make an historical FPR) includes the lesser right (*i.e.*, to include a subset of that FPR in a Supplemental FPR). It would be an unusual principle of law, so the proponents of this view would argue, under which the greater right (*i.e.*, to make an historical FPR) includes a ***different*** right (to make a projection FPR via a Supplemental FPR). It is doubtful, they would claim, that the disclosure rules intended a franchisor to have an "official FDD Item 19" and then, during the franchise sales process and negotiations, to distribute a second "supplemental" representation to every prospective franchisee providing completely different information from that included in Item 19.

Yet the language in Item 19 and the FTC's Compliance Guide is not crystal clear — vague and imprecise might be better words — and, given the conditions for making Supplemental FPRs, it certainly is possible that a franchisor has considerable leeway in its Supplemental FPR's contents.

What do we actually know about Supplemental FPRs?

1. If an FPR appears in the franchisor's FDD, the franchisor may subsequently make a Supplemental FPR directly to a prospective franchisee.

2. This Supplemental FPR need not be included in the FDD or registered in any state.

3. It must be in writing.

4. It must be prepared in compliance with the same requirements applicable to the underlying FPR (*i.e.*, Item 19(s)(3)(i)-(iv)).

5. It must be left with the prospective franchisee.

6. It must explain the departure from the FPR contained in the FDD.

7. Supplemental FPRs may be used to provide specific information about a particular location or variation.

Depending on one's view, prudence and logic might dictate that a Supplemental FPR cover only the same subject areas covered by the primary FPR. For example, if the FPR covers only sales, then the Supplemental FPR also should be limited to sales, although it may describe sales in a different manner from the account present in the primary FPR, such as focusing on specific variables about sales that are of special interest to the prospective franchisee. The Supplemental FPR should not then expound on profits, costs (as a percentage of sales), and the like. The following are illustrative scenarios that would seem to be prototypical for use of a Supplemental FPR where Item 19 discloses average sales for all units in a franchise system:

- Disclosing the actual or average sales of all units in a particular geographic region (*e.g.*, Boston)

- Disclosing the actual or average sales of all units operating in suburban areas or urban areas having particular population ranges or household income

- Disclosing the actual or average sales of all free-standing units

- Disclosing the actual or average sales of all units operated in shopping malls or strip shopping centers

- Disclosing the actual or average sales of all kiosk units (the example in the FTC's Compliance Guide?)

- Disclosing the actual or average sales of all units open for variable minimum timeframes (*e.g.*, at least 1 year, 2 years, 3 years, etc.)

- Disclosing the actual or average sales of all units operated by multi-unit franchisees versus single unit franchisees

- Disclosing the actual or average sales of all units falling within a particular size range (*e.g.*, less than 1,000 square feet, 1,000 to 2,000 square feet, over 2,000 square feet, etc.)

- Disclosing the actual or average sales of all units operated by the same franchisee in the same market

- Disclosing the actual or average sales of all units operated by conversion franchisees

May a franchisor use a Supplemental FPR to provide, for example, some sort of profit and loss statement for a particular location or set of locations? While the knee-jerk reaction might be "of course not!," we know that costs no longer are deemed to be FPRs (if not provided as a percentage of sales). So, why couldn't a franchisor, as a Supplemental FPR, take actual sales for a subset of the units comprising its primary FPR and then give actual average dollar costs for various expense items (which no longer are covered by Item 19)? If providing each "input" is lawful, why should the sum of the parts make it unlawful?! Truth be told, the substantiation process described earlier also could be used to provide information that otherwise would be deemed to be a Supplemental FPR.

How aggressively may a franchisor use a Supplemental FPR? May the franchisor use a Supplemental FPR proactively to market to franchisees generally? In other words, armed with an FPR in its FDD, may a franchisor create one or more Supplemental FPRs to target particular groups of prospective franchisees for particular circumstances? When does a Supplemental FPR cease being a "Supplemental FPR" and become a "regular" FPR that must be included in Item 19 itself? Must a Supplemental FPR used in this fashion be registered in states still requiring the filing of franchisee solicitation materials? If so, how does that work in Maryland and Minnesota, whose franchise laws prohibit franchisee solicitation pieces from containing Item 19 information even if there is an Item 19?

There is not much guidance for franchisors in this area. The "legislative history" is sparse on this topic; few, if any, publications delve into the nitty-gritty of this area; and no cases come to mind that address the use of Supplemental FPRs in these (or any other) contexts. The ambiguity is a sword for some and a shield for others. At day's end, franchisors must consider whether their actions satisfy the literal language of Item 19 and are in accord with the spirit of the disclosure laws.

IV. <u>USING FPRS IN FRANCHISE MARKETING</u>

A principal benefit of making an Item 19 FPR is the opportunity to use the FPR "outside of the confines of the disclosure document," to quote the FTC Compliance Guide. If one believes the conventional wisdom that candidates rarely read the FDD, an FPR is more likely to be seen by a prospective franchisee in marketing materials than in Item 19 itself. The rules for using an FPR in marketing therefore deserve close attention.

Franchisors are taking greater advantage of this opportunity, but it comes with closer scrutiny. For example, in conducting due diligence on franchise systems for potential private equity buyers, counsel will specifically focus on the degree of consistency between the franchisor's Item 19 and its marketing materials.

A franchisor with a well-crafted, substantiated FPR could conceivably alert prospective franchisees to the information in a wide variety of ways, including:

Face-to-face conversation
Trade show display
Print brochure
Discovery Day presentation
Direct mail campaign
Email blast
Print advertising
TV and radio advertising
Web page directed at prospective franchisees
Online advertising on third-party sites
Social media platform
Tweet
Mobile app

The FTC Compliance Guide lays down instructions for making representations in the "general media" – a term that has a much wider meaning than one might initially assume:

> The term "general media" is to be read broadly to include all forms of advertising, including radio, television, magazines, newspapers, and billboards. It also includes electronic advertisements such as those placed on a franchisor's website or on a web site operated by a broker or some other third party. Electronic advertisements include both static advertisements, as well as pop-up screen and banner advertisements. Unsolicited bulk email sent to the public – sometimes referred to as "spam" – is also a form of general media advertising since these messages are widely disseminated to create interest in the franchisor, possibly leading to franchise sales.[16]

A Discovery Day presentation presumably would not constitute "general media" because it is directed to a small, invited audience. A direct mailing (or emailing) may or may not constitute "general media," depending on whether it is an unsolicited distribution to a broad list or a mailing limited only to individuals who have requested to

[16] FTC Compliance Guide at p. 132. Note that a general media FPR cannot qualify as a "supplemental FPR" because the latter, by definition, is not directed to a general audience.

be contacted about the franchise opportunity.[17] A face-to-face conversation is obviously not "general media." Pages of the franchisor's website that are directed to prospective franchisees are "general media," but not necessarily other pages of the website even if they contain the same information.[18] Company press releases and speeches by executives are not considered "general media representations" *unless* specifically directed at members of the public interested in purchasing a franchise.[19] Similarly, communications to the trade press and financial journals in connection with bona fide news stories are not considered "general media" representations.[20] The latter point is true even though the resulting press articles might be widely disseminated by their publishers and "create interest in the franchisor, possibly leading to franchise sales."

Whether or not a communication is in the "general media" makes a difference because of the specific FTC instructions for general media representations. The Compliance Guide states, not surprisingly, that "financial performance representations made in the general media are subject to the requirements that apply to all financial performance representations, i.e., that they be truthful and reasonable [sic] backed by substantiating written information the franchisor possesses when the representations are made." It is the next statement in Compliance Guide that is more troubling:

> In addition, general media financial performance representations must state:
>
> - 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;

[17] Unsolicited bulk email is considered general media "even if the messages are sent to members of the public who have expressed an interest in receiving franchise information." FTC Compliance Guide at p. 132. Thus, "unsolicited" appears to be the primary criterion.

[18] "Financial performance information appearing in . . . the investors section of the franchisor's website ordinarily would not be deemed a general media representation because such information is not necessarily directed at, or intended for, potential franchisees. The mere fact that those interested in purchasing a franchise can find such information . . . online does not make it a general media claim." Id.

[19] *Id*.

[20] See FTC Compliance Guide p. 133. This raises the question of what constitutes a "bona fide news story." Suppose the franchisor arms a public relations firm with financial results to try to persuade news outlets to compose stories about the franchise system? On the one hand, efforts to "plant" financial information in the press may not seem like the type of communications contemplated by the Compliance Guide, but in fact news stories are no less "bona fide" when suggested by a PR firm than when initiated by reporters, because trade press and financial journals have complete independence to determine newsworthiness.

- the time period when the performance results were achieved; and
- a clear and conspicuous admonition that a new franchisee's results may differ from the represented performance.[21]

These bullet points are familiar from Section I.C.1 of this paper – specifically, they represent three of the six factors that the franchisor must disclose in Item 19 in connection with historical FPRs.

This raises two practical questions. The first one is, can a franchisor use FPR *projections* in the general media *at all*? We know that the use of Item 19 projections is rare in practice, but these FPRs do exist and they are clearly permitted. But if the franchisor wants to use its Item 19 projection in the general media, the franchisor runs into a problem: there is no way for the franchisor to comply with the first two of the three points that, according to the Compliance Guide, the franchisor "must state" in the general media. These two points are among the six factors applicable to *historical* FPRs, and they simply do not apply to Item 19 *projections*. The franchisor logically cannot provide either the "number and percentage of outlets" nor the "time period when the performance results were achieved" for a *projection*. So does this mean the franchisor simply cannot use its Item 19 projection in the general media? It seems likely that the FTC would have been much clearer on this point if that were the agency's intent.

The second practical question arising from the Compliance Guide is: how does the franchisor fit the three required disclosures in the general media representation? The challenge may not be daunting for a brochure or email, but it may be much greater for media that are constrained by space and time, such as radio, TV, some print ads, and Internet and mobile advertising. The Compliance Guide does not offer help on this question, other than in a sample general media FPR – in which the mandatory disclosures are longer than the primary text of the ad!

The Compliance Guide does offer help, however, on the relationship between general media FPRs and Item 19 disclosures. The basic rule is simple: "A franchise seller making a financial performance representation in the general media [must] ensure that a full disclosure of the financial performance representation – including the material bases and assumptions – appears in Item 19 of the franchisor's disclosure document." This is just another way of saying that the FPR must appear in Item 19 before it can be used anywhere else. But the next part of the Compliance Guide is a head-scratcher:

> A franchisor running an advertisement containing financial performance information at the very least must furnish any prospective franchisees with the required Item 19 disclosures while the advertisement is running. If a franchisor stops running the advertisement and makes no additional financial performance

[21] *Id*.

> representations in the general media, *it nonetheless must continue to disclose information required by Item 19 for a reasonable period of time thereafter. A reasonable period of time is not less than six months.*[22]

This passage simply cannot be read literally. It seems to introduce a new requirement: that if the franchisor has made a general media FPR, the franchisor is bound to maintain the corresponding Item 19 disclosure for at least six months after the general media FPR last appears. But what if the franchisor stopped running the ad because the franchisor concluded that the FPR was no longer reliable? In that case, the franchisor would be compelled to amend Item 19 by many state laws – though not by the Franchise Rule itself, which merely requires the franchisor to notify the prospective franchisee of the material change when furnishing the FDD.[23]

The passage has to be read as a more general instruction that a prospective franchisee who sees (or hears) the general media FPR must be able to turn to Item 19 of the FDD for the full story. This reading is consistent with the next paragraph of the Compliance Guide, which addresses changes and variations in a general media FPR.

The next paragraph says, unremarkably, that if the franchisor replaces an ad with a new one containing updated financial information, the updated information must be included in Item 19. Timing-wise, this sounds backwards – the franchisor should not be publishing a new ad until *after* Item 19 has been updated. But the real point is that general media FPRs and Item 19 must travel together – if either of them changes, both must change, at least if the change is due to less favorable results.

With the foregoing FTC guidance in mind, we consider three specific questions about using FPRs in franchise marketing.

1. How much can marketing materials condense or vary from the Item 19 presentation?

The franchisor clearly can use an FPR outside of the confines of the FDD without including the entire set of data, bases and assumptions in Item 19. In fact, the Compliance Guide expressly envisions "multiple advertisements containing different types of financial performance claims," as long as each claim is supported by the Item

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[22] FTC Compliance Guide at p. 134.

[23] See FTC Compliance Guide at p. 129: "If the broker knows of a material change in information underlying the Item 19 representation – such as new survey results that cast doubt on the accuracy of the Item 19 financial performance representation – the broker must notify the prospective franchisee of that fact when furnishing the disclosure document. *The term "notify" does not mean furnishing an updated disclosure document all over again. A seller may inform the prospective franchisee of the material change underlying the Item 19 in any reasonable manner, such as by letter, telephone call, or email*." (Emphasis added.)

19 disclosures.[24] So, for example, a franchisor that has four different tables in its Item 19 presentation might use Table 1 data in one general media channel and Table 4 data in a different channel.

Some amount of selecting, summarizing and/or condensing is inherent in most settings where the FPR would be used outside of the FDD. But this selecting, summarizing and/or condensing creates a tension, because some level of risk is inherent in using any kind of external FPR that does not simply copy the Item 19 presentation. The risk is that if the franchisor selects too narrowly or condenses too much, the claim turns into a different or new FPR – one that isn't in the FDD and is thus illegal even if true.

Obviously, the bigger the difference, the greater the risk. At a minimum, if the external presentation of the FPR (let's assume it's in an ad) differs from the Item 19 presentation, the ad must very clearly explain how it is, in fact, the same information as in Item 19.[25] This may result in fine print that the franchisor does not want in the ad – in which case the lawyer can respond that explanation is not necessary if the ad simply parrots the Item 19 configuration.

As noted at the outset of this section, not just prospective franchisees and their counsel, but also others who might become key business partners of the franchisor, have incentive to focus on the degree of consistency between the franchisor's Item 19 and its marketing materials. Thus, the franchisor must be absolutely certain of its ability to stand behind the numbers in an ad. If the franchisor has any insecurity about selecting, summarizing and/or condensing an Item 19 representation, the franchisor should simply mirror the representation or not run the ad at all.

2. What should the small print say in the marketing materials?

Marketing materials that use FPRs frequently advise the reader to "see Item 19 of our Franchise Disclosure Document." Referring the reader to Item 19 is good practice, because that is where the reader will find the assumptions and explanatory information that put the ad's figures into context. Interestingly, however, the sample general media FPR in the Compliance Guide does <u>not</u> contain such a statement, despite the Guide's emphasis on coordinating the information within and outside of Item 19.

Better practice is to refer, not just to the FDD, but to the *specific* FDD from which the FPR was derived. FDDs are updated every year, and often amended during the year, and the changes may include Item 19. The franchisor should direct the reader to the version of the FDD that contains the exact set of data, assumptions and explanations

[24] FTC Compliance Guide at p. 134.

[25] Note the link to the concept of a "supplemental" FPR – which essentially allows variance from the information in Item 19, but not in an ad.

corresponding to the FPR in the marketing materials – so, for example, the small print should say "See Item 19 of our May 5, 2013 FDD for details."

General principles of FTC advertising law help carry this disclosure a step further. The FTC, in its recently-updated guidance on making effective disclosures in digital advertising, discusses what to do when space constraints preclude disclosure in the text of the ad:[26]

> [W]hen it is not possible to make a disclosure in a space-constrained ad, it may, under some circumstances, be acceptable to make the disclosure clearly and conspicuously on the page to which the ad links. . . . When using a hyperlink to lead to a disclosure, make the link obvious [and] label the hyperlink appropriately to convey the importance, nature, and relevance of the information it leads to.[27]

This guidance could be applied directly to an FPR in an online ad, but it is useful by analogy even for a print ad or brochure containing an FPR. In the quoted passage, the term "disclosure" refers to additional information necessary to qualify an ad or make it not misleading. In the context of franchise marketing materials using an FPR, the "disclosure" effectively would be Item 19 of the FDD. Because the whole of Item 19 cannot fit within the marketing materials, it is common practice, as noted above, to include in the ad a textual link to Item 19, such as: "See Item 19 of our May 5, 2013 FDD for details." But by analogy to *.com Disclosures,* the franchisor can do more: it can make sure that the link to Item 19 is "obvious," meaning that the link is (1) clear and conspicuous given its size, color, and graphic treatment in relation to other parts of the marketing materials, and (2) positioned as close as possible to the FPR in the marketing materials. Better yet, the franchisor can label the link "to convey the importance, nature, and relevance of the information it leads to." So, for example, the link might say: "See Item 19 of our May 5, 2013 FDD for important assumptions and qualifiers relating to these figures."

Is a clear and conspicuous reference to Item 19 sufficient, or should the "small print" do more? The Franchise Rule Compliance Guide, as previously discussed, actually calls for three specific disclosures alongside general media FPRs. These disclosures, however, seem to be ignored in the small print most of the time, without adverse legal consequences to the franchisor as far as the author is aware. Perhaps this is a reflection of reality – as the FTC's own sample general media FPR demonstrates, the disclosures, even if brief, can be longer than the FPR itself. Or perhaps it is a recognition that these three disclosures are effectively subsumed (at least for historical

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[26] Federal Trade Commission, *.com Disclosures: How to Make Effective Disclosures in Digital Advertising* (March 2013) (hereinafter cited as "*.com Disclosures*"). Like the Compliance Guide to the Franchise Rule, this report is a staff guidance document, not a binding regulation or statement of the law.

[27] *Id*. p. iii.

FPRs) within a broader disclosure referring to Item 19, where not just the three points but all other details of the FPR will be found.

3. Do the practicalities and parameters change for different types of media? If so, how?

There is no doubt that the chosen medium of franchise marketing will change the regulatory expectations for how an FPR is presented. As *.com Disclosures* makes plain for digital advertising and other FTC guides make plain in other areas, the FTC emphasizes the reasonable and the practical in assessing advertising and marketing practices. If the nature of the activity allows for more disclosure at the time and place of the FPR (e.g., an in-person discussion of the franchise opportunity or a printed brochure), more disclosure will be expected. "When practical, advertisers should incorporate relevant limitations and qualifying information *into the underlying claim*, rather than having a separate disclosure qualifying the claim."[28]

On the other hand, if the nature of the activity imposes constraints on additional disclosure at the point of the claim (e.g., the small screen of a mobile device or a 15-second radio ad), the franchisor will have more leeway in delivering the information necessary to ensure that prospective franchisees have what they need to make better-informed decisions. However, there is a limit to this leeway:

> If a disclosure is necessary to prevent an advertisement from being deceptive, unfair, or otherwise violative of a Commission rule, and it is not possible to make the disclosure clearly and conspicuously, *then that ad should not be disseminated*. This means that if a particular platform does not provide an opportunity to make clear and conspicuous disclosures, *then that platform should not be used to disseminate advertisements that require disclosures*.[29]

Again, while this guidance is not specifically geared to franchise marketing, the same principle applies and it requires the franchisor to consider whether a particular medium for marketing an FPR is so constrained that clear and conspicuous disclosure of, say, the link to Item 19 cannot be made. If that is the case, the medium simply should not be used for an FPR.

Another parameter, besides space and time constraints, is the proximity of the marketing activity to the actual purchase. In this respect, franchising has an advantage over many goods and services to which general principles of advertising law apply. Specifically, the advantage is that a full FDD will be delivered at some point between the marketing activity and the purchase of the franchise. By contrast, guides such as*.com Disclosures* are directed toward consumer advertising that may lead to an immediate purchase in person or online (and in any case without an intervening disclosure

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[28] *.com Disclosures* at p. I (emphasis added).
[29] *Id*. p. iii (emphasis added).

document). This parameter argues for greater flexibility regarding the level and detail of disclosures necessary when using FPRs in marketing materials.

As the FTC declares for digital advertising, "the ultimate test is whether the information intended to be disclosed is actually conveyed to consumers."[30] If the franchisor keeps this and the other principles discussed above in mind, the franchisor should be able to use its FPR in franchise marketing without undue risk.

V. LITIGATING FINANCIAL PERFORMANCE REPRESENTATIONS

Those litigating financial performance claims should remember that the capital offenses in franchise sales are false financial performance representations. In the 1970s, the original Statement of Basis and Purpose of the seminal FTC Franchise Rule found:

> One of the reasons accounting for the involvement of such persons in franchising is the "get rich quick" claims utilized by many franchisors in advertisements and other promotional materials. As indicated by numerous franchisee complaints, such claims often induce a person who has had little or no formal business training into believing that he or she may earn a great deal of money with little effort and in spite of a lack of experience. As further illustrated by such complaints and related public record materials such "get rich quick" claims frequently either are unsubstantiated by the franchisor, or they misrepresent material facts with regard to the "potential earnings" of a particular franchise business. The credibility of such claims is often compounded by headline stories in the press as to those franchisees who were able to obtain great personal wealth from the operation of a franchise outlet.[31]
>
> The typical investor in a franchise, in a very real sense, is "buying a job." Hence the item of information about which the prospective franchisee is most concerned is the amount of earnings he can expect to derive from the franchise. The franchisor, who has a strong interest in selling franchises to garner the initial franchise fee, has a great incentive to be overly optimistic about future earnings. It is no surprise, therefore, that there have been many abuses in the area of earnings predictions. Indeed, misrepresentation in the disclosure of earnings is probably the most crucial disclosure problem in the franchising area.[32]

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[30] *Id*. p. 1.

[31] FTC Statement of Basis and Purpose Relating to Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, Bus. Franchise Guide (CCH) ¶ 6304, p. 1 (footnote omitted).

[32] *Id.,* Bus. Franchise Guide (CCH) ¶ 6306.

A. Statutory Disclosure Liability For Item 19 Claims

1. Statutory Liability for Non-Disclosures and Unsubstantiated Disclosures

A franchisor making undisclosed financial performance representations, i.e. not included in an Item 19 disclosure, is committing a statutory disclosure violation. Such undisclosed earnings claims occurred in the sale of Minuteman Press and Speedy Print franchises in *FTC v. Minuteman Press.*[33] The district court found statutory violations from the very act of verbal undisclosed earnings claims:

> Each corporate defendant filed UFOCs to comply with the disclosure requirements of the FTC Act and Section 436 of 16 C.F.R. In those documents, the franchisor indicated that no earnings claims were being made, and that none of its officers, directors or employees were authorized to make such statements. Nonetheless, as noted previously, such representations were made on a regular basis to prospective franchisees. That conflict, *viz*, between the disclaimers in the UFOCs and the representations embodied in sales presentations, is violative of the Franchise Rule. 16 C.F.R. § 436.1(f); Final Interpretive Guides, 44 Fed. Reg. at 49,971.[34]

A franchisor making affirmative Item 19 financial representations in its FDD must possess a reasonable basis for the financial representations.[35] Moreover, "[a] franchise seller must possess, in writing, the supporting data underlying any financial performance representations at the time it makes the representation."[36] In *FTC v. Tashman*,[37] a trial court judgment for a franchisor was reversed after the Eleventh Circuit found the trial court erred in not finding a lack of a reasonable basis for representations by the franchisor of revenue levels based on numbers of hours worked.

2. Statutory Liability for Misrepresentations and Omissions

Misrepresentations and material omissions in financial performance representations by franchisors constitute a separate ground for statutory liability beyond

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[33] *FTC v. Minuteman Press*, 53 F. Supp. 2d 248, 256 (S.D.N.Y. 1998).

[34] *Id*. at 259 (footnotes omitted).

[35] 16 C.F.R. § 436.9(c).

[36] FTC Compliance Guide (2008) at p. 137.

[37] *FTC v. Tashman*, 318 F.3d 1273, 1278 (11th Cir. 2003).

any nondisclosures.[38] Under the Amended Franchise Rule, 16 C.F.R. 436.1 *et seq.,* it is an unfair or deceptive practice in violation of not only the Amended Franchise Rule but also Section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45, for any franchise seller to make any claim or representation that contradicts the information presented in the FDD, or to misrepresent that any person purchased a franchise from the franchisor or operated a franchise similar to the franchise offered by the franchisor.[39] Neither Section 5 of the FTC Act nor the Amended Franchise Rule creates a private remedy, however, and enforcement at the federal level is left to the Federal Trade Commission.[40]

State "Little FTC Acts," discussed further below, often bridge the gap between a franchisee's need to seek redress from a franchisor's material misrepresentations and the absence of a private cause of action under the Amended Franchise Rule. Moreover, fifteen states have franchise investment laws that require franchisors to provide pre-sale disclosures to potential purchasers.[41] These states, California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin provide the right to bring private lawsuits for violation of state disclosure requirements.[42]

3. Common Law Fraud Liability

Common law fraud has been an available remedy for false financial performance representations long before franchise disclosure statutes. Thus, common law fraud claims were long ago recognized for false representations of sales of a restaurant business,[43] misrepresentations of net profits,[44] false opinions of "immediate cash flow"[45] or of "a viable distributorship."[46]

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[38] *E.g., FTC v. Minuteman Press*, 53 F. Supp. 2d 248, 259 (S.D.N.Y. 1998); *FTC v. Kitco of Nevada, Inc.,* 612 F. Supp. 1282, 1291 (D. Minn. 1998); *Austin Blvd. Rest. Corp. v. Iacono*, 2010 N.Y.Misc. LEXIS 2599, at *60 (N.Y. Sup. Ct. 2010).

[39] 16 C.F.R. § 436.9(a)(b) (2012).

[40] 16 C.F.R. § 436.10(a) (2012).

[41] *FTC Consumer Protection website*, http://www.ftc.gov/bcp/franchise/netdiscl.shtm (last visited March 5, 2013).

[42] *Id.*

[43] *Rogers v. Bill & Vince's, Inc.,* 203 Cal. App. 2d 292, 294-95, 21 Cal. Rptr. 269 (1962).

[44] *Hansen v. Ford Motor Co.,* 278 F.2d 586, 591-92 (8th Cir. 1960).

[45] *Fritzmeir v. Krause Gentle Corp*., 2003 S.D. 112, 669 N.W.2d 699, 706 (S.D. 2003).

[46] *Wagstaff v. Protective Apparel Corp. of Am.*, 760 F.2d 1074, 1077-78 (10th Cir. 1985).

Sometimes a financial performance claim fails to establish intentional fraud, but the franchisee may nonetheless prevail under the lesser requirements of negligent misrepresentation.[47] The negligence standard for false financial statements was described by one court in the denial of summary judgment for a franchisor: "[o]ne who, in the course of his business supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining the information."[48]

4. Little FTC Act Liability

Most states have unfair trade practices acts, or "Little FTC Acts" which may proscribe violations of the FTC Amended Franchise Rule. Violations of the FTC Amended Franchise Rule are *per se* violations of the New Jersey Consumer Fraud Act.[49] Violations of the FTC Rule have also been held to violate the Texas Unfair and Deceptive Trade Practices Act.[50] Likewise violations of the FTC Act in the sale of franchises are actionable under the Massachusetts Little FTC Act.[51]

Little FTC Acts, state Uniform Unfair Trade Practices Acts, and various other business and consumer protection acts may all proscribe franchisor liability and afford franchisees private remedies. Franchisee counsel should however take note that some of the statutes do not apply to franchise agreements and are only applicable to consumer transactions.[52]

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47 *Hockey Enters., Inc. v. Talafous,* No. 10-2943, 2012 U.S. Dist. LEXIS 3322, at *25 (D. Minn. Jan. 10, 2012); *Zantum, LLC v. Wencel*, No. H034533, 2010 Cal. App. Unpub. LEXIS 4954, at *28 (Cal. Ct. App. 6th 2010).

48 *Hockey Enters., Inc. v. Talafous,* No. 10-2943, 2012 U.S. Dist. LEXIS 3322, at *25 (D. Minn. Jan. 20, 2012).

49 *Morgan v. Air Brook Limousine*, 510 A.2d 1197, 1205 (N.J. Super. Ct. Law Div. 1986).

50 *Texas Cookie Co. v. Hendricks & Peralta, Inc*., 747 S.W.2d 873, 877-79 (Tex. App. 1988).

51 *Brennan v. Carvel Corp*., 929 F.2d 801, 811-14 (1st Cir. 1989).

52 *See, e.g.* District of Columbia Consumer Protection Procedures Act, D.C. Code Ann. §§ 28-3901-3908; Tenn. Code Ann. §§ 47-18-101-117.

B. Defenses

1. Contractual - Integration, "No Representation" and "No Reliance" Clauses

Franchisors invariably include integration, "no representation" and "no reliance" clauses in their operative franchise documents which may later be used to defend franchisee financial performance representation claims. Enforcement of integration, "no representation" and "no reliance" clauses varies depending on the jurisdiction and also the type of claim, i.e. among breach of contract, common law fraud, franchise disclosure statutes, and Little FTC Acts.[53] Some courts will decline to distinguish between integration, "no representation" and "no reliance clauses," and treat the clauses in total or interchangeably, while other courts separately analyze each of these provisions. Franchisors are advised to make use of all of these clauses, as well as other contractual provisions, to maximize the protections afforded to them under their franchise agreements and disclosure documents. These clauses should be asserted as affirmative defenses to financial performance representation claims.

Franchisors using these contractual provisions as a defense to a financial performance representation claims should be aware of federal and state disclosure statutes prior to drafting contractual provisions seeking to disclaim or otherwise bar claims based on representations made during the franchise sales process. For example, federal law prohibits a franchisor from disclaiming financial performance representations made in the FDD or from asserting that a franchisee may not rely on such representations.[54] The anti-waiver provisions of state franchise acts or business opportunity laws may also prohibit franchisors from relying upon the protections of contractual provisions.

a. Integration Clauses

Contractual integration or merger clauses state that the written contract represents the sole agreement between the parties and that the written contract supersedes any oral or written representations not contained within the final contract. Franchisors use integration clauses to invoke the parol evidence rule. This famous rule bars evidence of additional contract terms beyond the terms of an integrated contract, thereby barring evidence of other oral or written agreements not expressed in the franchise agreement.

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[53] Portions of this article were presented at the American Bar Association Forum on Franchising in 2011 entitled, "*Comparison of the Trilogy: Common Law Fraud, Franchise Investment Laws, and Little FTC Laws Remedies for Misrepresentations and Omissions in the Offer and Sale of Franchises."*

[54] 16 C.F.R. § 436.9(h) (2012); *see also*, FTC Franchise Rule Compliance Guide 131 (2008).

Issues can arise, however, when franchisors seek to use the parol evidence rule to bar fraud in the inducement claims. For example, the parol evidence rule does not bar proof of fraud or other civil wrong in most states. Restatement of Contracts 2d § 214 recognizes that the parol evidence rule does not apply to "illegality, fraud, duress, mistake, lack of consideration, or other ground for invalidation."[55] The theory behind the above Restatement exceptions allowing evidence despite the parol evidence rule is that fraud in the inducement vitiates the entire contract including the integration and related clauses.[56]

Many courts address integration and related "no representation" and "no reliance" clauses under a fraud in the inducement approach. Namely, a party committing a fraud ought not to be able to use fine print in the contract obtained through the fraud to negate a fraud claim at the outset. Thus, these courts, notwithstanding the integration and related clauses, allow plaintiff franchisees to present evidence of factual misrepresentations.[57]

The rationale for allowing evidence of fraud in the inducement despite integration and related clauses was lucidly stated by the Massachusetts Supreme Court in *Bates v. Southgate*:[58]

> As a matter of principle it is necessary to weigh the advantages of certainty in contractual relations against the harm and injustice that result from fraud. In obedience to the demands of a larger public policy the law long ago abandoned the position that a contract must be held sacred regardless of the fraud of one of the parties in

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55 Restatement (Second) of Contracts § 195(1) provides that: "exculpatory clauses are unenforceable on public policy grounds where the alleged harm is caused intentionally or recklessly."

56 *Essex v. Getty Oil Co*., 661 S.W.2d 544, 549 (Mo. Ct. App. 1983) (applying Missouri law); *Slater v. KFC Corp*., 621 F.2d 932, 935-36 (8th Cir. 1980) (applying Missouri law); *Salkeld v. V.R. Business Brokers*, 192 Ill. App. 3d 663, 548 N.E.2d 1151, 1157-58 (Ill. App. Ct. 1989) (applying Illinois law).

57 *Scott v. Minuteman Press Int'l, Inc*., Bus. Franchise Guide (CCH) ¶ 10,344 (N.D. Cal. 1993), *aff'd*, Bus. Franchise Guide (CCH) ¶ 10,795 (9th Cir. 1995); *Ron Greenspan Volkswagen, Inc. v. Ford Motor Land Dev. Corp*., 32 Cal. App. 4th 985, 38 Cal. Rptr. 2d 783, 788 (1995) (applying California law); *Water Craft Mgmt., L.L.C. v. Mercury Marine*, 2011 U.S. App. LEXIS 2138, at *7 (5th Cir. 2011) (applying Louisiana law). *Radioshack Corp. v. Comsmart, Inc*., 222 S.W.3d 256, 260 (Ky. Ct. App. 2007) (applying Kentucky law); *Thrifty Rent-A-Car Sys., Inc. v. Brown Flight Rental One Corp.,* 24 F.3d 1190, 1195 (10th Cir. 1994) (applying Oklahoma law); *Marsala v. Mayo*, 2007 U.S. Dist. LEXIS 81550, at *30 (E.D. La. 2007) (plaintiff must seek to rescind the contract to pursue a fraud in the inducement claim).

58 *Bates v. Southgate*, 308 Mass. 170, 31 N.E.2d 551, 558 (Mass. 1941).

> procuring it. No one advocates a return to outworn conceptions. The same public policy that in general sanctions the avoidance of a promise obtained by deceit strikes down all attempts to circumvent that policy by means of contractual devices. In the realm of fact it is entirely possible for a party knowingly to agree that no representations have been made to him, while at the same time believing and relying upon representations which in fact have been made and in fact are false but for which he would not have made the agreement. To deny this possibility is to ignore the frequent instances in everyday experience where parties accept, often without critical examination, and act upon agreements containing somewhere within their four corners exculpatory clauses in one form or another, but where they do so, nevertheless, in reliance upon the honesty of supposed friends, the plausible and disarming statements of salesmen, or the customary course of business. To refuse relief would result in opening the door to a multitude of frauds and in thwarting the general policy of the law.[59]

Typical of more recent rulings is *Ron Greenspan Volkswagen, Inc.* and *Ford Motor Land Development Corp*.:

> A party to a contract who has been guilty of fraud in its inducement cannot absolve himself from the effects of his fraud by stipulation in the contract, either that no representations have been made or that any right which might be grounded upon them is waived. Such a stipulation or waiver will be ignored, and parol evidence of misrepresentations will be admitted for the reason that fraud renders the whole agreement voidable, including the waiver provision.[60]

Courts allowing evidence of factual misrepresentations despite integration clauses, will, however, often not allow evidence of additional promises which would vary the terms of the integrated contract.[61]

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[59] *Bates v. Southgate*, 308 Mass. 170, 31 N.E.2d 551, 558 (Mass. 1941).

[60] *Ron Greenspan Volkswagen, Inc. v. Ford Motor Land Dev. Corp*., 32 Cal. App. 4th 985, 38 Cal. Rptr. 2d 783, 788 (1995) citing 1 Witkin, Summary of Cal. Law (9th ed. 1987) Contracts § 410, at 368-69); see also, *Riverisland Cold Storage, Inc. v. Fresno-Madera Prod. Credit Ass'n*, 55 Cal. 4th 1169, 1183 (Cal. 2013).

[61] *Scott v. Minuteman Press*, Bus. Fran. Guide (CCH) ¶ 10,344 (N.D. Cal. 1993), *aff'd*, Bus. Franchise Guide ¶ 10,795 (9th Cir. 1995); *Radioshack Corp. v. Comsmart, Inc*., 222 S.W.3d 256, 262 (Ky. Ct. App. 2007) (applying Kentucky law); *see also, Marsala v. Mayo*, 2007 U.S. Dist. LEXIS 81550, at *30 (E.D. La. 2007) (applying Georgia law); *Scotsman Group, Inc. v. Mid-America Distribs., Inc.*, 1994 U.S. Dist. LEXIS 4127, at *14 (N.D. Ill. 1994).

But some states differ and strictly enforce integration and related clauses to bar fraud claims. For example, "Pennsylvania law prohibits recovery on a claim of fraud in the inducement where the contract represents a fully integrated written agreement."[62] And the District of New Jersey has held that where the "License Agreement is explicit that any oral representation not provided for in the terms of the instrument are disclaimed and superseded," claims for fraud-in-the-inducement should be dismissed.[63] Other examples of franchisors successfully defeating common law fraud claims arising from alleged earnings misrepresentations with integration or similar clauses are plentiful.[64]

b. "<u>No Representation" and "No Reliance" Clauses</u>

"No representation" clauses go beyond standard integration clauses to state that nothing was represented to induce the parties to enter the contract beyond the franchise agreement and the FDD. "No reliance" clauses add that the parties are not relying on any representations not contained in the franchise agreement or the FDD. Many franchise agreements also add specific acknowledgements the franchisees are asked to execute at time of contract execution, such as acknowledgements that no additional representations were made beyond the franchise agreement and FDD; that nothing else was relied upon by the franchisee, that no earnings claims were made, and that any franchisee receiving an earning claim should state it in writing and immediately contact management of the franchisor.

Courts differ on the application of "no representation" and "no reliance" clauses in franchise agreements with respect to fraud in the inducement claims. Some courts adhere to the premise that the fine print in a contract obtained by fraud should not bar a claim for deceit. Nonetheless, some of these courts may allow the "no reliance" clause as evidence to the fact finder to consider regarding justified or reasonable reliance, a required element of a fraud claim and an often required element of a misrepresentation

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62 *Morales v. Superior Living Prods., LLC*, 2009 U.S. Dist. LEXIS 91578, at *20, Bus. Franchise Guide (CCH) ¶ 14,276 (E.D. Pa. 2009); *Cottman Transmission Sys., LLC v. Kerschner*, 536 F. Supp. 2d. 543, 552-553 (E.D. Pa. 2008).

63 *Ramada Worldwide, Inc. v. Hotel of Grayling, Inc.*, No. 08-3845, 2010 U.S. Dist. LEXIS 65186, at *13 (D.N.J. June 30, 2010).

64 *See, e.g., AAMCO Transmissions, Inc. v. Wirth,* No. 11-4250, 2011 U.S. Dist. LEXIS 140457, at * 5-7 (E.D. Pa. Dec. 7, 2011); *Cousins Sub Sys., Inc. v. Better Subs Dev., Inc.*, No. 09-C-0336, 2011 U.S. Dist. LEXIS 112903, at *7 (E.D. Wis. Sept. 30, 2011) (stating basic fraud claims "cannot be maintained against the no-reliance and integration clauses of the contracts."); *7-Eleven, Inc. v. Spear,* No. 10-CV-6697, 2011 U.S. Dist. LEXIS 67415, at *6-7 (N.D. Ill. June 23, 2011).

claim under state franchise acts or business opportunity laws.[65]

Other jurisdictions invoke a *per se* rule; that a plaintiff who executed a "no reliance" clause may not establish the element of reasonable reliance because of the disclaimed reliance.[66] *Guesthouse International Franchise Systems, Inc. v. British American Properties Macarthur Inn, LLC*,[67] is illustrative of such jurisdictions. The district court started with a premise under Tennessee law that "proof of fraud in the inducement or promissory fraud is limited to subject matter which does not contradict or vary the terms that are plainly expressed in the written agreement."[68] The *Guesthouse International* integration clause included no representation and no reliance provisions, namely that there were no representations relied upon in entering the license agreement not set forth in the license agreement. In dismissing the fraud claim based on this no representation and reliance language, the district court also noted that the plaintiffs included sophisticated purchasers with substantial involvement with hotels and franchising.

Other courts have declined to enforce "no reliance" clauses due to the absence of any dispute for which reliance would have been relevant at the time of execution of the franchise agreement. Such a result occurred in *Carousel's Creamery, LLC v.*

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65 *Commercial Prop. Inv. v. Quality Inns., Inc.* 938 F.2d 870, 875-77 (8th Cir. 1991); *Essex v. Gritty Oil*, 661 S.W.2d 544, 549 (Mo. Ct. App. 1983) (applying Missouri law).

66 *Anderson v. Chevron Corp*., 933 F. Supp. 52, 60-61 (D.D.C. 1996) (applying Virginia law); *Carlock v. Pillsbury Co*., 717 F. Supp. 791, 829 (D. Minn. 1989) (applying New York law); *Hotels of Key Largo, Inc. v. RHI Hotels, Inc*., 694 So. 2d 74, 76 (Fla. Dist. Ct. App. 1997) (applying Florida law); *Sherman v. Ben & Jerry's Franchising, Inc.,* No. 1:08-CV-207, 2009 U.S. Dist. LEXIS 102123, at *4 (D. Vt. 2009); *see also*, *Westerfield v. Quizno's Franchise Co*., 527 F. Supp. 2d 840, 844 (E.D. Wis. 2007) (No representation and no reliance clauses have been used to bar RICO claims)(reversed by 2008 U.S. Dist. LEXIS 74398); *compare*, *Carousel's Creamery, Inc. v. Marble Slab Creamery, Inc.*, 134 S.W.2d 385, 393 (Tex. App. 2004).

67 *Guesthouse Int'l Franchise Sys., Inc. v. British Am. Props. Macarthur Inn*, LLC, 3:07-0814, 2009 U.S. Dist. LEXIS 8570, at*21-22 (M.D. Tenn. 2009); *compare*, *Water Craft Management, LLC v. Mercury Marine*, 2011 U.S. App. LEXIS 2138 (5th Cir. 2011) (reliance found unreasonable due to integration clause); *Dannan Realty Corp. v. Harris*, 5 N.Y.2d 317, 184 N.Y.S.2d 599, 601-02, 157 N.E.2d 597 (N.Y. 1959) (New York distinguishes between general merger clauses and specific disclaimers with the latter enforced as to the subject of the specific disclaimer).

68 *Guesthouse Int'l Franchise Sys., Inc. v. British Am. Props. Macarthur Inn*, LLC, 3:07-0814, 2009 U.S. Dist. LEXIS 8570, at*21-22 (M.D. Tenn. 2009).

Marble Slab Creamery, Inc.,[69] with the court examining the circumstances at time of execution of the franchise agreement including the fact that no dispute existed at time of signing the franchise agreement, the franchisee did not have legal counsel at the time, and there was no negotiation at arm's length of the franchise agreement.

In 2008 the FTC Amended Franchise Rule prohibited franchisors from "disclaim[ing] or require[ing] a prospective franchisee to waive reliance on any representation made in the disclosure document or in its exhibits or amendments."[70] In *Martrano v. Quizno's Franchise Co*.,[71] the sandwich maker franchisor unsuccessfully invoked a non-reliance clause in a Rule 12(b)(6) motion. The "no reliance" provisions were in a disclosure acknowledgment statement stating that the franchisee did not rely on anything not in the UFOC or in the franchise agreement. Because the franchisee alleged that UFOC statements regarding negotiation with suppliers were fraudulent, the express disclaimer allowing reliance on representations in the UFOC allowed the claim to proceed.

In *Siemer v. Quizno's Franchise Co.*, the United States District Court for the Northern District of Illinois held that the franchisee plaintiffs failed to plead a claim for fraudulent inducement based upon alleged misrepresentations made to the franchisees during the sales process, when the franchisees signed franchise agreements containing integration clauses and stating that "they could not rely on representations made outside the UFOC and the [franchise] agreement."[72] The District Court, in holding that the franchisees failed to plead a fraud claim, stated:

> [T]he UFOC and Franchise Agreement each contain disclaimers and non-reliance clauses that are repetitive and easily seen by any party who takes the time to read them. Faced with these "unambiguous" clauses, plaintiffs cannot have reasonably relied

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69 *Carousel's Creamery, Inc. v. Marble Slab Creamery, Inc.*, 134 S.W.2d 385, 394 (Tex. App. 2004).

70 16 C.F.R. § 436.9(h) (2012); *see also*, *Carousel's Creamery, Inc. v. Marble Slab Creamery, Inc.*, 134 S.W.2d 385 (Tex. App. 2004).

71 *Martrano v. Quizno's Franchise Co., LLC*, 2009 U.S. Dist. LEXIS 52025, at *53 (W.D. Pa. 2009); *see also General Retail Services, Inc. v. Wireless Toyz Franchise, LLC*, 255 Fed. Appx. 775, 2007 U.S. App. LEXIS 23513, at *41 (5th Cir. 2007) (franchise agreement integration clause expressly stated "Except as provided in the Offering Circular" for which fraud was alleged); *see also Motor City Bagels, L.L.C. v. Am. Bagel Co*., 50 F. Supp. 2d 460, 470 (D. Md. 1999) ("Moreover, the plaintiffs could argue that their reliance was reasonable as the franchisors disclosed [in the UFOC] information to aid potential franchisees assess the merits of a Chesapeake Bagel Bakery as a business opportunity.").

72 *Siemer v. Quizno's Franchise Co., LLC*, No. 07 C 2170, 2008 U.S. Dist. LEXIS 25907, at *8 (N.D. Ill. Mar. 31, 2008).

> upon any oral statements concerning likely profits and expenses in deciding whether to invest in a Quizno's franchise . . . Plaintiffs reviewed and even signed representations affirming that they would not rely on any statements outside the corners of the contractual documents.
>
> . . . In the Franchise Agreement, each Plaintiff signed an integration clause agreeing not to rely on any statements not contained in the UFOC or Franchise Agreement. The Franchise Agreement also contained an Acknowledgment Clause, in which Plaintiffs acknowledged that no statement, representation, act, event, or communication not contained in the document is binding on Quizno's. . . . [I]t is unreasonable for Plaintiffs to claim reliance on extra-contractual representations despite having stated in writing that they would not rely on representations outside the UFOC and Franchise Agreement.[73]

Franchisors should be wary that the contractual protection from common law fraud claims arising from alleged financial performance misrepresentations may not protect the franchisor from a misrepresentation claim made under statute. For example, in *Randall v. Lady of America Franchise Corp.*, a federal court held that the anti-waiver provisions of the Minnesota Franchise Act rendered "no representation" and "no reliance" clauses within a franchise agreement void.[74] Thus in *Randall*, the District Court held that the integration clause had a narrow application to claims brought under the Minnesota Franchise Act and that the parol evidence rule would not bar fraudulent earnings claims asserted under the statute. Other courts have also held that integration and related clauses may not bar claims for violation of franchise disclosure laws due to anti-waiver provisions in the statutes.[75]

Courts examining claims of fraudulent misrepresentation outside of anti-waiver statutes have denied claims of franchisees for asserted financial performance misrepresentations based on integration, "no representation" and "no reliance" clauses.[76] For example, in *Wingate Inns, Int'l, Inc. v. Swindall,* the United States

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[73] *Id.* at *8 (internal citations omitted).

[74] *Randall v. Lady of Am. Franchise Corp.*, 532 F. Supp. 2d 1071, 1088-89 (D. Minn. 2007); *see also*, *Commercial Prop. Invs., Inc. v. Quality Inns Int'l, Inc.*, 938 F.2d 870, 874 (8th Cir. 1991).

[75] *Emfore Corp. v. Blimipie Assocs., Ltd.*, 51 A.D.3d 434, 435, 860 N.Y.S.2d 126 (N.Y. Sup. Ct. 2008); *A.J. Temple Marble & Tile, Inc. v. Union Carbide Marble Care, Inc.*, 162 Misc.2d 941, 948-49, 618 N.Y.S.2d 155 (N.Y. Sup. Ct. 1994).

[76] *See, e.g., AAMCO Transmissions, Inc. v. Wirth,* No. 11-4250, 2011 U.S. Dist. LEXIS 140457, at * 5-7 (E.D. Pa. Dec. 7, 2011); *Cousins Sub Sys., Inc. v. Better Subs Dev., Inc.*, No. 09-C-0336, 2011 U.S. Dist. LEXIS 112903, at *19 (E.D. Wis. Sept.

District Court for the District of New Jersey held that the franchisee could not establish an element of her claim, reasonable reliance, based upon the integration and "no representation and no reliance" clauses within the franchise agreement.[77] Specifically, the court held that the provisions of the franchise agreement stating "[n]either we nor any person acting on our behalf has made any oral or written representation or promise to you on which you are relying to enter into this Agreement . . .", that the franchise agreement is the entire agreement between the parties and there are no other oral or written representations, and that "no salesperson has made any promise or provided any information to [the franchisee] about projected sales, revenues, income, profits, or expenses" bars any finding that the franchisee's reliance on any alleged prior statements is reasonable.[78]

2. *Contractual – Arbitration and Mediation Clauses*

Arbitration and mediation clauses within franchise agreements may also be used to dismiss financial performance representation claims wrongfully initiated in state or federal court. For example, in *Delamater v. Anytime Fitness, Inc.*, a federal court sitting in California dismissed a franchisee's complaint where the franchisee commenced an action without first submitting the dispute to mediation as required by the parties' franchise agreement.[79] The federal court held that the mediation clause contained within the franchise agreement, requiring the parties to mediate all disputes related to the franchise agreement or franchise relationship before initiating legal action or arbitration, except for actions seeking equitable relief, was not void under the California Franchise Relations Act, nor was it invalidated by California public policy.

30, 2011) (stating basic fraud claims "cannot be maintained against the no-reliance and integration clauses of the contracts."); *7-Eleven, Inc. v. Spear,* No. 10-CV-6697, 2011 U.S. Dist. LEXIS 67415, at *6-7 (N.D. Ill. June 23, 2011); *Ramada Worldwide, Inc. v. Hotel of Grayling, Inc.*, No. 08-3845, 2010 U.S. Dist. LEXIS 65186, at *13 (D.N.J. June 30, 2010) (dismissing franchisee's counterclaim for fraudulent inducement where the "License Agreement is explicit that any oral representation not provided for in the terms of the instrument are disclaimed and superseded.").

[77] *Wingate Inns, Int'l, Inc. v. Swindall*, Bus. Franchise Guide (CCH) ¶ 14,945, at *3-4 (D. N.J. Oct. 22, 2012).

[78] *Id.; but see Randall*, 532 F. Supp. 2d at 1086 (questioning whether justifiable or reasonable reliance is a required element of a claim for misrepresentation under the Minnesota Franchise Act); *contra Ellering v. Sellstate Realty Sys. Network, Inc.*, 801 F. Supp. 2d 834, 844-45 (D. Minn. 2011) (dismissing franchisees' claims for misrepresentation under Minnesota Franchise Act where UFOC stated the franchisor did not "furnish or authorize [its] salespersons to furnish any oral or written information concerning . . . actual or potential sales, costs, income or profits.").

[79] 722 F. Supp. 2d 1168, 1180-81 (E.D. Cal. 2010); *see also Brosnan v. Dry Cleaning Station, Inc.*, No. C-08-02028 EDL, 2008 U.S. Dist. LEXIS 44678, at *2 (N.D. Cal. June 6, 2008); *3-J Hospitality, LLC v. Big Time Design, Inc*., No. 09-61077-CIV, 2009 U.S. Dist. LEXIS 100601, at *3 (S.D. Fla. Oct. 27, 2009).

Similarly, courts have dismissed franchisees' earning misrepresentation claims, where the franchisees failed to first submit the dispute to arbitration as required by the franchise agreement. For example, in *Gold v. Melt, Inc.*, several franchisees brought a class action alleging they were fraudulently induced into joining the franchise.[80] The California court dismissed the complaint as barred by a dispute resolution provision contained within each franchise agreement, requiring all disputes to be arbitrated on an individual basis. Other courts have similarly dismissed earnings misrepresentation claims or compelled arbitration for failing or refusing to submit the dispute to arbitration.[81]

3. *Contractual – Limitations Clauses*

Contractual limitations clauses may also be used by franchisors to defeat earnings misrepresentation claims brought by franchisees. In *Massey, Inc. v. Moe's Southwest Grill, LLC*, the federal court sitting in the Northern District of Georgia dismissed the claims brought by some of the franchisee plaintiffs on the basis that the franchise agreement required all claims arising out of or relating to the franchise agreement or the relationship between the parties to be commenced within one year from the discovery of facts giving rise to the claim and that those particular plaintiffs had discovered or should have discovered the facts giving rise to the claim.[82] Both franchisees and franchisors are therefore advised to be aware not only of the applicable statute of limitations, but also any contractual limitation provision within the franchise agreement.

4. *Contractual – Choice of Law and Forum Selection Provisions*

Franchisors use choice of law provisions in their franchise agreements to control the substantive law that will govern the agreement. Franchisees seeking to later avoid the enforcement of these provisions, particularly if the provisions seek to circumvent applicable state franchise or business opportunity acts that may afford significant protections to the franchisees, should conduct a conflict of law analysis to determine whether the state in which they reside or operate their franchise has any anti-waiver laws that would void the choice of law provision in the franchise agreement, or whether the public policy of the state is harmed by the enforcement of the choice of law

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80 *Gold v. Melt, Inc.*, Bus. Franchise Guide (CCH) ¶ 14,371 (Cal. App. April 16, 2010).

81 *See, e.g., Ace Hardware Corp. v. Advanced Caregivers, LLC,* No. 1:12-cv-01479, 2012 U.S. Dist. LEXIS 150877, at *18 (N.D. Ill. Oct. 18, 2012); *MKJA, Inc. v. 123 Fit Franchising, LLC*, 119 Cal. Rptr. 3d 634, 647 (Cal. Ct. App. 2011); *Roberts v. Synergistic Int'l, LLC,* 676 F. Supp. 2d 934, 938 (E.D. Cal. 2009).

82 *Massey, Inc. v. Moe's Southwest Grill, LLC*, No. 1:07-CV-741-RWS, 2012 U.S. Dist. LEXIS 109081, at *7-8 (N.D. Ga. April 17, 2012).

provision.[83]

Forum selection provisions may also be used to deter franchisees from litigating financial performance representation claims because a forum selection clause may dictate that the forum of the litigation is in a state far from where the franchisee resides or does business, often in the franchisor's home state. Similarly, a franchisor may use forum selection clauses to transfer the venue of an action commenced by a franchisee in his or her home state to the forum designated in the franchise agreement.[84] Enforcement of forum selection clauses are met by courts with varying degrees of success and attempts at enforcement may be thwarted by state franchise acts that, like choice of law provisions, may void forum selection clauses.[85]

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[83] *See Ohio Learning Ctrs., LLC v. Sylvan Learning, Inc.*, No. RDB-10-1932, 2012 U.S. Dist. LEXIS 102784 (D. Md. July 24, 2012); *Red Roof Franchising, LLC v. Patel,* 877 F. Supp. 2d 124 (D.N.J. June 28, 2012); *Red Roof Franchising, LLC v. AA Hospitality Northshore,* 877 F. Supp. 2d 140 (D.N.J. June 28, 2012) (holding that the Minnesota Franchise Act voids a choice of law clause in a franchise agreement selecting Texas law where the franchise was operated in Minnesota).

[84] *See, e.g., Weight Loss Services, LP v. Herbal Magic, Inc.,* No. 11-3859, 2011 U.S. Dist. LEXIS 108043, at *9 (E.D. Pa. Sept. 22, 2011); *but see JTH Tax, Inc. v. Houle*, No. 2:11cv66, 2011 U.S. Dist. LEXIS 122319, at *14 (E.D. Va. Sept. 23, 2011).

[85] *See, e.g., id.; see also Tilted Kilt Franchise Operating LLC v. Helper,* No. CV10-1951-PHX-DGC, 2010 U.S. Dist. LEXIS 130709, at *4-5 (D. Ariz. Dec. 9, 2010) (enforcing forum selection clause); *Van Buren Lodging, LLC v. Wingate Inns Int'l, Inc.*, No. CIV 10-1016, 2011 U.S. Dist. LEXIS 29029, at *8 (D.S.D. Mar. 16, 2011)(declining to enforce forum selection clause). An increasing number of states have adopted anti-waiver laws that limit the contracting rights of parties to a franchise agreement and govern the place for litigation or arbitration of contract related actions. These states include California, Connecticut, Florida, Idaho, Illinois, Indiana, Iowa, Louisiana, Maryland, Michigan, Minnesota, New Jersey, New York, North Carolina, North Dakota, Rhode Island, South Dakota, Texas, Washington, and Wisconsin. *See* Cal. Bus. & Prof. Code § 200040.5 (2011); Con. Gen. Stat. § 42-133g (2011); *Pepe v. GNC Franchising, Inc*., 750 A.2d 1167 (Conn. Super. Ct. 2000); Fla. Stat. § 501.204 (2008), *Am. Online, Inc. v. Pasieka*, 870 So.2d 170 (Fla. Dist. Ct. App. 2004), *rev. denied*, 880 So.2d 1209 (Fla. 2004); Idaho Code Ann. § 29-110 (2011); 815 Ill. Comp. Stat. 705/4,(2011); Ill. Admin. Code 200.608 (2008); Ind. Code. Ann. § 23-2-2.7 (2011); Iowa Code § 523H.3 (2011); La. Rev. Stat. Ann. § 32:1269 (2010); MD Code Ann. Bus. Reg. §§ 14-201-14-233 (1992); Mich. Comp. Laws § 600.745 (2011); Minn. R. 2860.4400 (2011); N.J. Comp. Stat. Ann. § 56:10-7.2 (2011); *Kubis & Perszyk Assocs. v. Sun Microsystems*, 680 A.2d 618 (N.J. 1996); N.Y. Gen. Bus. Law § 687(5) (McKinney 2007); N.C. Gen. Stat. § 22B-3 (2011); N.D. Cent. Code § 51-19-09(9) (1996); R.I. Gen. Laws § 19-28.1-14 (2010); S.D. Codified Laws § 37-5-11 (2011); Tex. Occ. Code § 2301.478 (West 2011); Wash. Rev. Code § 46.96.240 (2011); Wis. Stat. §553.76 (2011); Wis. Admin. Code § 32.06 (2011).

5. Procedural Defenses

In addition to the contractual defenses available to franchisors outlined above, franchisors and their counsel are advised to explore the procedural defenses that may be available to defend financial performance representation claims. These include statute of limitations defenses, both for common law claims and claims asserted under state franchise or trade practices acts, as well as the heightened pleading standards that accompany fraud claims under the Rules of Civil Procedure.

a. <u>Statutes of Limitation</u>

Statutes of limitations may also be useful tools for defeating financial performance representation or related claims. For example, in *Ellering v. Sellstate Realty Sys. Network, Inc.,* the Minnesota District Court dismissed several "unpleaded" financial performance misrepresentation claims under the Minnesota Franchise Act because they were not brought within the applicable three-year statute of limitations.[86]

b. <u>Heightened Pleading Standards – Pleading Fraud with Particularity</u>

Another procedural defense available to franchisors comes in the form of a Rule 12(b) motion for failing to state a claim with particularity. If a franchisee fails to satisfy the heightened pleading standards required by Rule 9 for pleading a claim of fraud, franchisors are advised to make use of this tool.

In *Chicago Male Med. Clinic, LLC v. Ultimate Mgmt., Inc.*, the court dismissed a medical clinic franchisee's claim for misrepresentation under the Illinois Franchise Disclosure Act, a common law fraud claim, and a claim for violation of the Illinois Consumer Fraud & Deceptive Business Practices Act, or Illinois Consumer Fraud Act ("ICFA"), arising from alleged false financial performance representations based upon the franchisee's failure to plead the "who, what, when, where, and how" of the circumstances constituting the fraud.[87] With respect to the ICFA claim, the court held that the conclusory statement that the franchisor made false "financial performance representations in violation of the applicable regulations promulgated by the FTC" was insufficient to state a claim.[88]

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[86] *Ellering v. Sellstate Realty Sys. Network, Inc.*, 801 F. Supp. 2d 834, 843 (D. Minn. 2011); *see also RWJ Mgmt. Co., Inc. v. BP Prods. No. Am., Inc.*, No. 09 C 6141, 2011 U.S. Dist. LEXIS 2928, at *2 (N.D. Ill. Jan. 12, 2011).

[87] *Chicago Male Med. Clinic, LLC v. Ultimate Mgmt., Inc.*, No. 12 C 5542, 2012 U.S. Dist. LEXIS 183257, Bus. Franchise Guide (CCH) ¶14,972, at * 3-6 (N.D. Ill. Dec. 28, 2012).

[88] *Id.*, at *5-6; *see also Window World of Chicagoland, LLC v. Window World, Inc.*, No. 12 C 579, 2012 U.S. Dist. LEXIS 71615 Bus. Franchise Guide (CCH) ¶14,836 (N.D.

C. Discovery Issues

Even in the presence of integration, “no reliance” and “no representation” clauses, as explained above, franchisees may succeed on financial performance representation claims. To do so, franchisee counsel is advised to seek discovery of all communications between the franchisee and its agents and the franchise seller and its agents, from the initiation of contact between the parties, including any advertisements used by the franchisor, through the sales process. Franchisee counsel should also obtain and review a copy of the disclosure documents to determine whether the franchisor made any material misrepresentations or omissions.

D. Evidence Issues

The first step in any financial performance claim is determining what financial performance representations were made. Were historical earnings or sales figures presented? Were future projections or pro formas presented with or without supporting historical data? Were promises of sales or revenues made? Were general statements made of profits and revenue? Generally the representations must have occurred before the franchisee has purchased the franchise to be actionable.[89]

The second step in a financial performance claim is how will the financial performance representations be proven at trial? In many cases the representations were made in writing ranging from Item 19 disclosures to brochures and articles provided the prospective franchisee containing financial information, to the proverbial cocktail napkin. But in other cases the representations were only verbal, but verbal proof is generally proper notwithstanding the parol evidence rule to prove fraud or statutory violations.[90] And corroboration can often be found in written sales scripts used by franchise salespersons,[91] or by other franchisees who received the same type of financial representations.[92]

Ill. May 23, 2012)(dismissing common law fraud claim asserted by franchisee for failure to plead fraud with particularity).

89 *Moua v. Jani-King of Minnesota, Inc*., 810 F. Supp. 2d 882, 891 (D. Minn. 2011) (Franchisee claims of earnings representations of earnings as much as a doctor were not actionable as franchisee testified that the representations occurred after the purchase negating reliance).

90 *See* footnote 56 and accompanying text.

91 *FTC v. Minuteman Press*, 53 F. Supp. 2d 248, 251 (S.D.N.Y. 1998).

92 *FTC v. Minuteman Press*, 53 F. Supp. 2d 248, 252 (S.D.N.Y. 1998); *Fitzmeier v. Krause Gentle Corp*., 2003 S.D. 122,669 N.W.2d 699, 704 (S.D. 2003); *California v. SpeeDee Oil Change Sys., Inc*., 1997 Cal. LEXIS 2179, Bus. Franchise Guide (CCH) ¶ 11,548 (Cal. Super. Ct. 1997).