

Unreasonable Reliance—Defending a Claim for an Alleged Item 7 Misrepresentation

*Marshall T. Kizner**

When a franchise does not succeed financially, franchisees often look for both a reason for the failure and someone to blame for it. Franchisees who do not thrive often bring claims against franchisors based on the failure to make disclosures at the time of sale. One type of franchisee claim is alleging that the franchisor made inaccurate Item 7 disclosures in a Franchise Disclosure Document (FDD). Item 7 disclosures are estimates concerning the costs and expenses required to start a franchise.¹ Specifically, a franchisee may claim that it received false or misleading estimates of the cost developing a franchise under Item 7 and that it reasonably relied on those estimates, to its detriment.



Mr. Kizner

This article focuses on strategies for a franchisor to utilize when defending a common law claim premised on a false or misleading Item 7 disclosure. A defense lawyer's first reaction is likely that "estimates," inherently, should not be reasonably relied upon since an estimate is speculative as to future performance. That an estimate should not form the basis for a viable reasonable reliance claim should be axiomatic, yet many courts find that such claims present an issue of fact. Despite the fact-sensitive nature of the inquiry, franchisors can take steps to strengthen their defenses to aid in a prompt and favorable outcome.

Part I of this article details a franchisor's obligations under Item 7. Next, in Part II, the article addresses the general law concerning common law fraud, with an emphasis on the reasonable reliance requirement. Part II(A) reviews how courts across the country have handled common law claims for fraud raised by franchisees due to an alleged Item 7 misrepresentation. Part II(B) focuses on cases from other areas of law that have addressed the issue of reasonable reliance based on an alleged false estimate. Part II(C) reviews

1. See 16 C.F.R. § 436 *et seq.*

**Marshall T. Kizner (mkizner@stark-stark.com) is a Shareholder in the Princeton, New Jersey, office of Stark & Stark, P.C., where he focuses on franchise litigation, commercial real estate litigation, and business litigation.*

the impact the pandemic and resulting supply chain problems have caused to the construction industry, and, in turn, how that impacts estimated start-up costs for a franchisee. Finally, in Part III, the article addresses strategies for a franchisor to defend against an Item 7 claim alleging common law fraud.

I. Item 7 Required Disclosures

The Federal Trade Commission's Franchise Rule requires a franchisor to provide prospective franchisees with a complete and accurate basic disclosure document, known as a Franchise Disclosure Document (FDD),² containing twenty-three categories of information.³ Item 7 of the FDD requires franchisors to disclose estimated initial costs of investment.⁴ A franchisor is required to have a "reasonable basis" for providing specific figures in Item 7.⁵ The governing regulations require the disclosure to be made in a tabular form.⁶ In column one, franchisors must describe, in detail, all estimated expenditures that its franchisees will have to make to fund the obligations that are necessary to develop, construct, and open the franchised business.⁷ The regulation requires a franchisor to provide the following: (a) the initial franchise fee; (b) training expenses; (c) cost of purchasing or leasing the premises; (c) construction and fit-out costs; (d) equipment, fixed and other fixed-asset costs; (e) inventory requirements; (f) advertising; (g) working capital needed for at least three months of operations; (h) legal and professional fees; (i) insurance fees; (j) security deposits; (k) utility bills; (l) business licenses; and (m) "other prepaid expenses."⁸

In column two of the table, a franchisor must "state the amount of the payment."⁹ If the amount is unknown, the franchisor can disclose a low-high range based on the franchisor's current experience.¹⁰ If real property costs cannot be estimated in a low-high range, the franchisor can describe the approximate size of the property and building and the probable location of the building (for example, retail strip center, downtown, rural, or highway).¹¹

2. The Franchise Disclosure Document (FDD) is important to a potential franchisee because it provides economic estimates, which should allow the franchisee to conduct its own due diligence and make a decision about whether to pursue the franchise opportunity. *See Creative Am. Educ., LLC v. Learning Experience Sys., LLC*, 2015 U.S. Dist. LEXIS 102460, at *21-22 (S.D. Fla. July 31, 2015). For example, the FDD should allow the prospective franchisee to consult with professionals concerning the viability of the prospective franchise's business plans and engage other franchise owners to learn about their experiences with the franchise system.

3. 16 C.F.R. §§ 436, 437.1.

4. *See id.* § 436.5(g).

5. *See id.* § 436.9(c). Additionally, a franchisor selling franchises is required to fully update the FDD once a year, *id.* § 436.7(a), and to make quarterly updates "to reflect any material change to the disclosures," *id.* § 436.7(b).

6. *See id.* § 436.5(g).

7. *Id.*

8. *Id.* § 436.5(g)(1)(i).

9. *See id.* § 436.5(g)(2).

10. *Id.*

11. *Id.*

Columns three, four, and five require the method of payment, due date, and to whom payment shall be made, respectively.¹²

For each of these categories, the franchisor must specify how the payments are determined, and whether part or all of any payment is refundable.¹³ If any part of a franchisee's initial investment may be financed by the franchisor, then the required down payment must be disclosed, along with the estimated effective annual interest rate imposed and the estimated loan repayment schedule.¹⁴

Importantly, Item 7 is a disclosure of the *estimated* initial investment and does not require the disclosure of all potential fees or costs associated with the franchise. Specifically, costs that may be incurred beyond the start-up and an initial period of operation do not need to be disclosed. Further, certain expenses do not need to be disclosed, such as the franchisee's salary.

Should Item 7 contain a misrepresentation, a franchisee does not have a private cause of action under federal law for an alleged violation of the Franchise Rule;¹⁵ however, a franchisee may have rights under state statutory law and common law theories.¹⁶ Numerous jurisdictions have enacted statutory protections for franchisees.¹⁷ However, aggrieved franchisees will usually seek recourse under both state statutory law, if available, and common law claims of fraudulent inducement or concealment. This article will focus on the common law fraud claims of franchisees.

II. Fraud and the Element of Reasonable Reliance

A claim for common law fraud requires a litigant to prove: (1) a material misrepresentation or omission of fact; (2) made by defendant with knowledge of its falsity; (3) an intent to defraud; (4) reasonable reliance on the part of the plaintiff; and (5) resulting damage to the plaintiff.¹⁸ The plaintiff must demonstrate its case through clear and convincing evidence.¹⁹ To prevail on common law fraud claim, all of the elements of the claim must be satisfied,

12. See *id.* § 436.5(g)(3)–(5).

13. See *id.* § 436.5(g)(7).

14. *Id.*

15. See 16 C.F.R. § 436, *et seq.*

16. See, e.g., *Schwartz v. Pillsbury, Inc.*, 969 F.2d 840, 842, 846–47 (9th Cir. 1992) (alleging claims under the New York Franchise Sales Act, N.Y. GEN. BUS. LAW § 680 *et seq.*); *Drone Nerds Franchising, LLC v. Childress*, 2020 U.S. Dist. LEXIS 257805, at *4 (S.D. Fla. May 19, 2020) (involving alleged FDD violations and resulting damages under the Florida Deceptive and Unfair Trade Practices Act, FLA. STAT. § 501.204(1), and the Florida Franchise Act, FLA. STAT. § 817.416(2)(a)).

17. Due to the number of franchise statutes and the nuances of those statutes, this article focuses on common-law claims.

18. *Hindsight Sols., LLC v. Citigroup Inc.*, 53 F. Supp. 3d 747, 772 (S.D.N.Y. 2014) (detailing the test under New York state common law); see also *Connick v. Suzuki Motor Co.*, 675 N.E.2d 584, 591 (Ill. 1996) (stating the test for common-law fraud in Illinois); *Jewish Ctr. of Sussex Cty. v. Whale*, 423 A.2d 521, 524 (N.J. 1981) (providing the standard under New Jersey law).

19. *Hindsight Sols., LLC*, 53 F. Supp. 3d at 772; *Gennari v. Weichert Co. Realtors*, 691 A.2d 350, 368 (N.J. 1997).

including the reasonable reliance element. Determination of the element of reasonable reliance requires a court to review “the entire context of the transaction, including . . . its complexity and magnitude, the sophistication of the parties, and the content of any agreements between them.”²⁰ As it relates to the sophistication of the parties, the court must also consider the aggrieved party’s intelligence, experience, and opportunity to investigate the facts at issue.²¹ As a result, when a party engaged in an independent factual investigation before it enters into a commercial transaction and it has all of the facts available to it (or potentially knowable through reasonable efforts), that party should not be able to reasonably rely on a prior alleged misrepresentation.²² From an evidentiary position, the issue of reasonable reliance is ordinarily an issue of fact unless the facts are clear and one-sided.²³

PNC Bank, N.A. v. Dominion Energy Management is instructive on the element of reasonable reliance in the context of a fraud in the inducement claim.²⁴ In that matter, the U.S. District Court for the Eastern District of Virginia noted the importance of due diligence by the claimant alleging fraud and characterized such diligence as the “the touchstone of reasonableness.”²⁵ The court stated that, under Virginia law, a plaintiff “cannot claim that its reliance was reasonable and justified when it makes a partial inquiry, with full opportunity of complete investigation, and elects to act upon the knowledge obtained from the partial inquiry.”²⁶ The court also provided two examples of unreasonable reliance: first, “where a party had information that would excite the suspicions of a reasonably prudent person”;²⁷ second, “where one relies upon an oral statement that is contrary to a written statement in his possession.”²⁸ Under the facts in *PNC Bank*, the claimant, a borrower, could not prove reliance because he was armed with the documents and details necessary to conduct his own due diligence.²⁹ In granting summary judgment, the court ruled that the claimant could not justifiably rely on alleged statements contrary to the terms of the documents he signed.³⁰

20. *FIH, LLC v. Found. Capital Partners LLC*, 920 F.3d 134, 141 (2d Cir. 2019) (quoting *Crigger v. Fahnestock & Co.*, 443 F.3d 230, 235 (2d Cir. 2006)).

21. *Valspar Refinish, Inc. v. Gaylor's, Inc.*, 764 N.W.2d 359, 369 (Minn. 2009).

22. *Id.*

23. *FIH*, 920 F.3d at 141; *Abbingtion SPE, LLC v. U.S. Bank, Nat'l Ass'n*, 352 F. Supp. 3d 508, 518 (E.D.N.C. 2016).

24. *PNC Bank, N.A. v. Dominion Energy Mgmt.*, 2018 U.S. Dist. LEXIS 62577, at *31 (E.D. Va. Apr. 12, 2018).

25. *Id.*

26. *Id.*; see *Hitachi Credit Am. Corp. v. Signet Bank*, 166 F.3d 614, 629 (4th Cir. 1999) (citing *Harris v. Dunham*, 127 S.E.2d 65, 71–72 (Va. 1962)).

27. *PNC Bank*, 2018 U.S. Dist. LEXIS 62577, at *31.

28. *Id.*; see also *Kwon v. Yun*, 606 F. Supp. 2d 344, 357–58 (S.D.N.Y. 2009) (detailing two situations where a merger clause will defeat a reasonable reliance claim: (a) where a merger clause expressly references a specific subject of the past representations; and (b) where a sophisticated party is on notice of undocumented material facts and should be deemed to have assumed the risk).

29. *PNC Bank*, 2018 U.S. Dist. LEXIS 62577, at *39, *47–49.

30. *Id.* at *39, 47–49.

A. Claims for Fraud Based on Alleged Item 7 Misrepresentations

Item 7 disclosures have been the subject of an extensive amount of litigation over whether they contain actionable fraudulent misrepresentations and if there is sufficient reliance to support those claims. In most cases, the courts have determined that the claims presented issues of fact and denied dispositive motions. For example, in *Coraud LLC v. Kidville Franchise Co.*, the franchisee-plaintiff's principal opened a child entertainment facility franchise, pursuant to a franchise agreement with the franchisor-defendant.³¹ The franchisee business was not successful, and, after a year and half, it closed.³² The franchisee filed suit in the U.S. District Court for the Southern District of New York and asserted claims against the franchisor for violation of the New York Franchise Sales Act and various common law fraud and negligence claims.³³ The claims focused on the franchisor's alleged Item 7 omissions and misstatements.³⁴ Specifically, the franchisee contended that the estimated costs for leasehold improvements excluded expenses and failed to account for various costs.³⁵ All in all, the franchisee spent approximately \$750,000 to open its business, more than \$300,000 above the top-end estimate disclosed in Item 7.³⁶

The franchisee filed a motion for summary judgment on its claims asserting violations of New York State franchise laws and various common law causes of action.³⁷ It relied upon evidence showing that the cost to open a franchised business was higher than the costs listed in Item 7.³⁸ Among the evidence presented, the franchisee showed that two other franchisees incurred costs at least \$200,000 greater than the Item 7 disclosure's top-end estimate.³⁹ In response, the franchisor argued that the costs presented by the franchisee did not include "landlord contributions" (i.e., rent abatements or build out allowances), which offset the higher opening costs.⁴⁰ Further, the franchisor asserted that the construction of the two other reference franchise locations was higher because they were in "high-end" neighborhoods.⁴¹ The court denied summary judgment and found that there was a genuine issue of material fact as to whether the franchisor's cost estimates were materially misleading.⁴² Further, the court ruled that there was an issue of fact as to

31. *Coraud LLC v. Kidville Franchise Co.*, 121 F. Supp. 3d 387, 390 (S.D.N.Y. 2015).

32. *Id.* at 392.

33. *Id.* at 390.

34. *Id.* at 390–92.

35. *Id.* at 392.

36. *Id.*

37. Specifically, the franchisee moved for relief under New York General Business Law Section 687. *Id.* at 393. Under that provision, the claimant must plead that, (1) the defendant made an untrue or misleading statement of material fact, and that (2) the claimant reasonably relied on that statement, (3) causing harm to the claimant. *Id.*

38. *Id.*

39. *Id.*

40. *Id.* at 394.

41. *Id.* at 393.

42. *Id.* at 394.

whether the franchisee could reasonably rely on the Item 7 data because it had actual knowledge that the two other locations incurred higher costs than those disclosed in Item 7, yet relied on the disclosure anyway.⁴³

A franchisor could not obtain summary judgment in another case alleging an Item 7 misrepresentation, *A Love of Food I, LLC v. Maoz Vegetarian USA, Inc.*⁴⁴ That case dealt with a dispute between a defendant-franchisor of a European-based restaurant business, and a plaintiff-franchisee, an entity that purchased a franchise in the Washington, D.C., area.⁴⁵ Initial start-up costs were disclosed in Item 7, with a range of \$149,000 to \$269,000 and included a variety of expenses.⁴⁶ Several disclaimers about each estimated dollar figure were included, as well as about the total cost estimates.⁴⁷ Significantly, the franchisor's offering prospectus disclosed that the franchisor had yet to open any U.S. franchises.⁴⁸ The only existing restaurant in the United States was a corporate-run store in Philadelphia.⁴⁹ The estimates in Item 7 of the 2007 FDD were made by relying on "industry experience" and operation of twenty-three franchises overseas.⁵⁰ However, after finalizing its FDD, the franchisor completed construction on a corporate store in New York, with significantly higher costs than those set forth in Item 7.⁵¹

Before the franchisee secured a location and opened its business, the franchisor updated the cost estimates in its FDD based on the information gathered from the New York corporate location and the costs associated with the franchisee's efforts to open its D.C. location.⁵² The 2008 Item 7 disclosure reflected substantially higher costs than the 2007 figures, estimating a range between \$282,000 to \$494,500.⁵³ The franchisor never shared its 2008 Item 7 updates with the franchisee.⁵⁴ The franchisee alleged that it would not have signed a lease and moved forward with its project had it known of the updated figures.⁵⁵ The franchisee proceeded to complete its construction and incurred \$637,203 in its initial investment; twice the high-end range estimated in the 2007 Item 7 disclosure and still well beyond the high range of the 2008 disclosure.⁵⁶ The restaurant opened and operated for approximately two years, but sustained losses and closed.⁵⁷

The franchisee filed suit seeking damages under New York and Maryland's franchise statutes, along with asserting common law claims for fraud

43. *Id.* at 395.

44. *A Love of Food I, LLC v. Maoz Vegetarian USA, Inc.*, 70 F. Supp. 3d 376 (D.D.C. 2014).

45. *Id.* at 384, 411.

46. *Id.* at 383–84.

47. *Id.*

48. *Id.* at 384.

49. *Id.*

50. *Id.*

51. *Id.* at 389.

52. *Id.*

53. *Id.*

54. *Id.*

55. *Id.*

56. *Id.*

57. *Id.* at 389.

in the inducement.⁵⁸ The parties completed discovery and cross-moved for summary judgment.⁵⁹ The court held that there was a question of material fact as to whether the initial start-up estimates in the 2007 FDD were false and whether the franchisee reasonably relied on those initial start-up estimates, which precluded summary judgment in either party's favor.⁶⁰

In *Motor City Bagels, L.L.C. v. American Bagel Co.*, a franchisor could not obtain summary judgment in a case where the franchisee alleged misrepresentations in Item 7.⁶¹ In that matter, the U.S. District Court for the District of Maryland determined that failure to provide corrected or updated start-up cost data could amount to a material misrepresentation in violation of the Indiana franchise statute and could be the basis for common law fraud.⁶² By way of background, the plaintiff-franchisees obtained from the defendant-franchisor, an FDD⁶³ that contained estimated start-up expenses, along with the assertion that those estimates were “based on the latest available data.”⁶⁴ The plaintiffs utilized those cost estimates as a key assumption of their extensive business plan to analyze the viability of opening a franchise.⁶⁵ Before the franchisees’ purchase, the franchisor completed and filed an updated FDD detailing increased estimated costs.⁶⁶

Importantly, the franchisees received another updated FDD, but argued that the start-up cost estimates were the same as those disclosed in the previously received FDD.⁶⁷ In other words, the franchisees claimed that the franchisor had withheld the increased cost information because the FDD that they received did not detail the increased estimated costs.⁶⁸ The franchisees then purchased two franchises and, subsequently, decided to sign another agreement to open several more locations.⁶⁹ Between signing the first and second agreement, the franchisor again updated its FDD and disclosed additional higher estimates for construction of a franchised business.⁷⁰ The franchisees’ start-up costs “greatly exceeded the amounts represented by the defendants” in the first FDD.⁷¹ After opening its original two locations, the franchisee failed to open any additional locations and ceased paying franchise fees.⁷²

58. *Id.* at 380–81.

59. *Id.* at 380.

60. *Id.* at 403.

61. *Motor City Bagels, L.L.C. v. Am. Bagel Co.*, 50 F. Supp. 2d 460 (D. Md. 1999).

62. *Id.* at 469–71.

63. Before 2008, the FDD was referred to as the Uniform Franchise Offering Circular (UFOC). For purposes of consistency and brevity throughout the article, any reference to a UFOC shall be substituted with the term FDD.

64. *Id.* at 466.

65. *Id.*

66. *Id.*

67. *Id.*

68. *Id.*

69. *Id.*

70. *Id.*

71. *Id.* at 467.

72. *Id.*

The franchisee alleged that it could not afford usinssfully operates its usinss because the start-up estimates contained fraudulent misrepresentations, among other things.⁷³ The franchisor moved for summary judgment, seeking dismissal of the claims brought under state and common law. The court found that there was a genuine issue of material fact regarding whether there was a colorable misrepresentation claim. The court largely based this conclusion on the fact that the franchisor did not provide the franchisee with updated information even though an updated offering FDD existed, there was data detailing the increased estimates, and the updated FDD was filed with the state.⁷⁴

In *Hanley v. Doctor's Express Franchising, LLC*, the court denied a franchisor's motion to dismiss a franchisee's fraud claims based on Item 7 misrepresentations.⁷⁵ The franchisee-plaintiff claimed that the franchisor-defendant understated the required initial investment and operating capital requirements in Item 7 of its FDD, in violation of Maryland statutory law and common law.⁷⁶ The franchisor provided its 2009 FDD to the franchisee before the sale of the franchise.⁷⁷ Two weeks after the franchisee signed a franchise agreement, franchisor filed its 2010 FDD, which contained start-up costs ten to fifteen percent higher than the 2009 FDD.⁷⁸ The franchisee opened its franchised medical center and then closed it approximately six months later for a variety of performance- and financial-related issues.⁷⁹

The franchisor filed a motion to dismiss.⁸⁰ The court granted the franchisor's motion to dismiss the franchisee's constructive fraud claim for failure to show the kind of confidential relationship necessary to support the claim, but denied the franchisor's motion to dismiss the count alleging a violation of the Maryland Franchise Registration and Disclosure Law and for fraud.⁸¹ That statute prohibited an "omission to state a material fact," and the court did not adopt franchisor's argument that the FDD did not represent that the estimates were "based on the latest available data."⁸² The franchisor argued that the onus was on the franchisee to request the latest available data.⁸³ The court, at the pleading stage, did not agree, but it noted that such an argument may be persuasive at a later stage with "respect to the materiality

73. *Id.*

74. *Id.* at 471.

75. *Hanley v. Doctor's Express Franchising, LLC*, 2013 U.S. Dist. LEXIS 25340, at *112 (D. Md. Feb. 25, 2013).

76. *Id.*

77. *Id.* at *4-7.

78. *Id.* at *21-22.

79. *Id.* at *12.

80. *Id.* at *32.

81. MD. CODE ANN. BUS. REG. § 14-201 *et seq.*; *Hanley*, 2013 U.S. Dist. LEXIS 25340, at *80-81.

82. *Hanley*, 2013 U.S. Dist. LEXIS 25340, at *67, 80-81.

83. *Id.* at *71.

of the alleged misrepresentations and omissions and the reasonableness of plaintiff's reliance on them."⁸⁴

Unlike the cases discussed earlier, *Fabbro v. Drx Urgent Care, LLC*, provides an example of a case where the franchisor successfully defended an alleged false statement claim under Item 7 on a motion to dismiss.⁸⁵ In that matter, the plaintiffs-franchisees filed suit under state statutory law and common law, alleging fraudulent estimates under Item 7.⁸⁶ The franchisees argued that the costs to open the franchise exceeded the franchisor's estimates by a sizeable margin.⁸⁷ The franchisor defended by arguing that the Item 7 start-up costs were estimates and, significantly, that the FDD contained specific disclosures advising that the data was based on information collected from an affiliate that operates a franchise in another state, along with the caveat that a franchisee's "costs will depend on a number of factors including local economic and market conditions."⁸⁸ The Third Circuit affirmed the trial court's dismissal of the Item 7 claim in this particular case because the franchisee did not plead facts to support that the franchisor breached the franchise agreement, committed fraud, or violated the pertinent franchise statutes pled. The alleged misrepresentations were not actionable because the fraud claim was solely based on breach of contract claims, without detailing allegations concerning fraudulent conduct.⁸⁹ Further, the court reasoned that "predictions or promises regarding future events" are not generally actionable.⁹⁰

As the cases discussed previously show, most courts addressing the issue of false claims under Item 7 have ruled that sufficient fact issues allowed the matter to proceed to discovery or trial.⁹¹ However, in the right set of circumstances, it is possible to obtain a pre-answer and/or pre-discovery dismissal.

84. *Id.* at *89.

85. *Fabbro v. Drx Urgent Care, LLC*, 616 F. App'x 485 (3d Cir. 2015).

86. *Id.* at 486.

87. *Id.*

88. *Id.* at 490. *But see* *Cluck-U Chicken, Inc. v. Cluck-U Corp.*, 358 F. Supp. 3d 1295, 1311 (M.D. Fla. 2017) (stating that "disclaimer provisions in the franchise agreement do not make Plaintiffs' reliance on Defendants' alleged misrepresentations unreasonable as a matter of law but instead may be relevant to the reasonableness of Plaintiffs' reliance").

89. *Fabbro*, 616 F. App'x at 487–488.

90. *Id.* at 488.

91. For additional cases concerning fraud based on alleged false statements in Item 7 disclosures, see *MTR Capital, LLC v. Lavidia Massage Franchise Dev., Inc.*, 2020 U.S. Dist. LEXIS 208061 (E.D. Mich. Nov. 6, 2020) (ruling that failure to provide an accurate Item 7 disclosures violated Florida statutory law, but was not sufficient to prove negligent misrepresentation claims under common law); *Interim Healthcare, Inc. v. Health Care@home, LLC*, 2019 U.S. Dist. LEXIS 61996 (S.D. Fla. Mar. 19, 2019) (rejecting argument that alleged Item 7 misrepresentation under Florida statutory law, where Item 7 disclosures could not be relied on under the facts and circumstances); *Cornerstone Inv. Partners, LLC v. Steak 'N Shake Enters.*, 2015 U.S. Dist. LEXIS 87533 (D.N.J. July 6, 2015) (granting franchisor's motion to dismiss, where franchisee failed to set forth facts to support claims for fraud and misrepresentations concerning a violation of the FDD); *Robinson v. Wingate Inns Int'l, Inc.*, 2015 U.S. Dist. LEXIS 86720 (D.N.J. June 30, 2015) (granting franchisor's motion to dismiss common law fraud claims based

B. Claims for Fraud Based on False Estimates in Other Contexts

Several courts across the country outside the franchise context have adjudicated claims for fraud grounded in an alleged false misrepresentation of an estimate. Those cases are instructive because they contain the same basic premise of wrongdoing as the Item 7 cases discussed in Part II(A).

Livick v. Gillette Co. provides an example of a court ruling, as matter of law, that it is unreasonable for a litigant to rely on “estimates” to form the basis of a reasonable reliance argument.⁹² In that case, a former employee sued his employer and its retirement plan concerning the amount of his pension benefits that he received under the plan.⁹³ The employee claimed that the employer and the retirement plan administrator provided a faulty estimate of his retirement benefits.⁹⁴ The plaintiff’s “theory of his case [was] largely built on a reliance argument: that he relied to his detriment on the mistaken pension estimates he received.”⁹⁵ In affirming the district court’s summary judgment ruling in defendants’ favor, the First Circuit held, *inter alia*, that plaintiff could not demonstrate “reasonable reliance” based on the receipt of “estimates.”⁹⁶

Similarly, in *Gregory Lumber Co. v. United States*, a plaintiff-lumber company sued the United States for misrepresenting the quantum of timber sold under a contract.⁹⁷ The plaintiff claimed that it received twenty-five percent less timber under the contracts on which it bid and that the estimates provided by the United States Bureau of Land Management (BLM) were misleading.⁹⁸ Importantly, the BLM had expressly disclaimed the accuracy of its estimates, encouraged timber bidders to conduct their own estimates, and mandated an inspection warranty from the winning bidder that its bid

on alleged FDD statements because franchisee could not substantiate material misrepresentations made by franchisor); *Yumilicious Franchise, L.L.C. v. Barrie*, 2015 U.S. Dist. LEXIS 52503 (N.D. Tex. Apr. 22, 2015) (granting franchisor’s motion to dismiss alleged fraud violating Texas statutory law because franchisee failed to allege required elements of fraud including misrepresentations, omissions, or inaccurate disclosures pertaining to start-up costs contained in Item 7).

92. *Livick v. Gillette Co.*, 524 F.3d 24, 32 (1st Cir. 2008).

93. The plaintiff sued defendants for violations of the Employee Retirement Income Security Act (ERISA), 29 U.S.C. §§ 1001–1461. *Livick*, 524 F.3d at 26.

94. *Id.* at 26–28.

95. *Id.* at 29.

96. *Id.* at 33. In contrast to *Livick*, the district court in *DePace v. Matsushita Electric Corp. of America* denied the defendant-employer’s motion to dismiss. *DePace v. Matsushita Electric Corp. of Am.*, 257 F. Supp. 2d 543, 574 (E.D.N.Y. 2003). The defendant there argued that the plaintiff-employee could not reasonably rely on “estimates” of benefits in the face of detailed disclosures advising the employee of the nature of the figure as “estimates.” *Id.* at 553. The facts, as pled, specified that the dates provided in the estimates were erroneous and there was no evidence that defendant corrected those dates. *Id.* Further, and importantly, the plan documents were ambiguous on the issue that was the subject of the lawsuit. *Id.* In denying the motion, the court held that it “cannot conclude that plaintiffs’ reliance on the statements sent by [defendant] was unreasonable as a matter of law. This is especially true if it is assumed, as it must be on a motion to dismiss, that the allegations of intentional misrepresentations in the complaint are true.” *Id.* at 553–54.

97. *Gregory Lumber Co. v. United States*, 11 Cl. Ct. 489, 496 (1986).

98. *Id.* at 493–94.

was based on its independent calculation of the value of the available timber on the land.⁹⁹ In addressing the misrepresentation claim, the court noted that the plaintiff's reliance on the estimates must be "reasonable" to prevail.¹⁰⁰ "In general, the test of reasonableness focuses on whether through such knowledge, or through some affirmative signal from the [defendant], the [plaintiff] was on notice *not* to rely on the utterance in issue, or that all such statements should be investigated for the reasons given."¹⁰¹ The court further reasoned that "plaintiff is warned, in writing, to beware of the need to determine for itself what it is bidding on. Indeed, *ab initio*, plaintiff was alerted to the principle *caveat emptor*. We believe that to claim reasonable reliance on the estimated quantity, . . . in light of the foregoing considerations, could in no way be characterized as reasonable."¹⁰² The court, accordingly, granted summary judgment in favor of the defendant.¹⁰³

Haggerty v. Comstock Gold Co. is informative on the issue of a claim founded on reasonable reliance by an aggrieved party based on alleged false projections in an offering statement.¹⁰⁴ In that matter, the plaintiff-investors brought an action for violation of § 10(b) of the Securities Exchange Act and regulations thereunder, as well as state law claims for breach of contract, recession, and fraud.¹⁰⁵ The plaintiffs argued that several statements in an offering memoranda provided by the defendant were materially misleading in making estimates concerning profits, losses, and cash flow, among other things.¹⁰⁶ The court granted summary judgment in favor of the defendants on the grounds that the plaintiffs, who were sophisticated investors, could not have reasonably relied on the estimates contained in the offering memoranda as an accurate forecast of the future performance of their investments.¹⁰⁷ In making its ruling, the court relied on precedent supporting the proposition that a party cannot reasonably rely on estimates under § 10(b), especially when the offering memorandum provided warnings, disclaimers, and cautionary language concerning future forecasts.¹⁰⁸

Likewise, in *Holder v. Home Savings & Loan Ass'n*, a California appellate court affirmed the trial court's dismissal of an action against a mortgage and escrow agent concerning the issue of alleged misrepresentations and concealment of the quantum of property taxes due by the plaintiffs.¹⁰⁹ The plaintiffs

99. *Id.* at 496.

100. *Id.* at 503.

101. *Id.* (emphasis in original) (quoting *H. N. Bailey & Assocs. v. United States*, 449 F.2d 376, 386 (Ct. Cl. 1971)); *Rixon Elecs., Inc. v. United States*, 536 F.2d 1345, 1349–50 (Ct. Cl. 1976).

102. *Gregory Lumber*, 11 Cl. Ct. at 503.

103. *Id.*

104. *Haggerty v. Comstock Gold Co.*, 765 F. Supp. 111 (S.D.N.Y. 1991).

105. *Id.* at 112.

106. *Id.* at 114.

107. *Id.* at 116.

108. *Id.* at 114 (citing several authorities under the Second Circuit). The author notes that securities fraud cases are heavily litigated and this article does not endeavor to capture all of the case law surrounding claims relating to securities fraud. Rather, the *Haggerty* case is simply one example of how courts have dealt with estimate cases outside of the franchise context.

109. *Holder v. Home Sav. & Loan Ass'n*, 72 Cal. Rptr. 704, 717 (Ct. App. 1968).

alleged that the tax estimates were intentionally misrepresented and inaccurate.¹¹⁰ However, the appellate court, in upholding the lower court, found that the “amounts necessary to be paid monthly to take care of future taxes could not reasonably be relied upon as statements of what the future taxes would be.”¹¹¹

C. *The Role of COVID-19, Supply Chain Disruptions and Inflation*

The supply chain disruptions and inflation resulting from the aftermath of the COVID-19 pandemic are now factors that should be considered in defending an Item 7 misrepresentation claim. It is now more than a year since the beginning of the drastic increase in inflation and escalation of construction material costs caused by supply chain disruptions. These increases have significantly impacted the construction industry by increasing prices,¹¹² creating labor shortages,¹¹³ and delaying construction projects¹¹⁴ throughout the global economy. Statistics regarding material cost increases demonstrate the stark reality of the scale and scope of inflation. According to the Associated General Contractors of America, costs for materials for nonresidential construction rose by 17.3% between January 1, 2022, and January 1, 2023.¹¹⁵ While cost increases are present across the industry, petroleum-based products, such as asphalt, tar for roofing and siding, road paving material and diesel fuel, have surged by the greatest proportion.¹¹⁶

It is not known exactly when construction costs will stabilize. In the meantime, this new reality is likely going to lead to a divergence in Item 7 estimates and final construction and start-up costs incurred by a franchisee. To that end, to protect against future litigation, franchisors should be mindful of the reporting requirements under the Federal Trade Commission’s Franchise Disclosure Rule. In general, the Franchise Rule only requires an

110. *Id.* at 707–12.

111. *Id.* at 715.

112. ABC: *Construction Materials Prices Rise 1% in January; Up 5% From a Year Ago*, ASSOCIATED BUILDERS & CONTRACTORS (Feb. 16, 2023), <https://www.abc.org/News-Media/News-Releases/entryid/19802/abc-construction-materials-prices-rise-1-in-january-up-5-from-a-year-ago> (reviewing the increased construction material prices, machinery and equipment prices over the last year).

113. *Construction Workforce Shortage Tops Half a Million in 2023, Says ABC*, ASSOCIATED BUILDERS & CONTRACTORS (Feb. 9, 2023), <https://www.abc.org/News-Media/News-Releases/entryid/19777/construction-workforce-shortage-tops-half-a-million-in-2023-says-abc> (discussing estimated 546,00 shortage of construction workers according to the Associated Builders and Contractors).

114. ABC’s *Construction Backlog Indicator Down to Start 2023; Contractor Confidence Rises*, ASSOCIATED BUILDERS & CONTRACTORS (Feb. 14, 2023) <https://www.abc.org/News-Media/News-Releases/entryid/19787/abcs-construction-backlog-indicator-down-to-start-2023-contractor-confidence-rises> (reviewing construction backlog statistics over a twelve month span).

115. Ken Simonson (compiled by), *Percentage Change in Producer Price Indexes (PPIs) and Employment Cost Indexes (ECIs) for Construction, 2017-2023*, ASSOCIATED GEN. CONTRACTORS OF AM. (last updated Feb. 16, 2023), <https://www.agc.org/sites/default/files/Files/Communications/January%202023%20PPI%20Tables.pdf>.

116. *Id.*

annual FDD update.¹¹⁷ However, franchisors have additional obligations in the event of a material change.¹¹⁸ Franchisors must, “within a reasonable time after the close of each quarter of the fiscal year, prepare revisions to be attached to the disclosure document to reflect any material change to the disclosures included.”¹¹⁹ Once a revised document is made, potential franchisees should receive an FDD that reflects any revisions as of the “most recent period available at the time of disclosure.”¹²⁰ In view of the ongoing obligation to update, franchisors should be mindful of any increased construction costs trends, which may trigger its obligation to make a quarterly update. An extra layer of “policing” a franchisor’s construction costs during this time of uncertainty may pay dividends in future disputes.

III. Strategies for Defending Misrepresentation Claims Focused on Item 7 Disclosures

Although claims based on misrepresentations are fact-sensitive, a franchisor can position itself to defeat a claim through motion practice or, at a minimum, build a strong defense for adjudication at trial. Franchisors should focus on the steps that franchisees took to conduct their own due diligence. For example, was the franchisee working with a business consultant, accountant, lawyer, broker, or other experienced professional to aid in the completion of a business plan *before* signing a franchise agreement? Did it review the FDD *before* entering into the business and ask questions of the franchisor and, more importantly, the franchisee’s counsel? Did the franchisee seek and review the franchisor’s financial records? Did it research the franchisor, including its directors and executives? Did it have a realistic business plan, adequate start-up funding, and sufficient funding for the first several months of operation? Did the franchisee discuss the business opportunity with current or former franchisees? Did it request and review records evidencing start-up costs incurred by other franchisees? Did the franchisee visit several locations owned by existing franchisees and company-run locations? Did it compare the FDD to other FDDs for similar franchise concepts to try to identify any issues or red flags? Did the franchisee consider alternative franchise opportunities? Did the franchisee access publicly available documents that may be relevant to the opportunity? The greater the extent of the due diligence engaged in, or opportunity to conduct due diligence, the more difficult it will be for a claimant to argue its reliance on estimates was reasonable. Perhaps paradoxically, showing the franchisee engaged in little to no due diligence despite having the opportunity to do so may also strengthen a defense to a fraud claim because the franchisee will appear careless.

117. 16 C.F.R. § 436.7(a).

118. *See id.* § 436.7(b).

119. *Id.*

120. *Id.*

The franchisor should also focus on the sophistication of the franchisee. What is the franchisee's educational background, experience with similar industries, managerial experience, and business experience, in general? The more sophisticated the owner/decision maker, the more difficult it will be for an aggrieved franchisee to prove reasonable reliance. It is important that the franchisor detail and save its communications with a prospective franchisee.

The franchisor should review the franchisee's compliance with the franchisor's start-up specifications and procedures. For example, did the franchisee follow the specifications in starting its business? Any deviation from the franchisor's specifications weakens the reasonable reliance argument.¹²¹

Along these same lines, franchisor should document its interactions and takes note of all information it learns about a particular prospective franchisee's due diligence process during the sales period. A robust inventory of communications and information shared with the prospect could be valuable in a subsequent dispute.

To the extent available,¹²² franchisors should rely on strong disclaimers concerning the nature of Item 7 disclosures, as mere estimates.¹²³ Franchisor should also review its pre-sale compliance questionnaire, wherein franchisee should acknowledge that the franchisor has complied with its disclosure obligations, including an acknowledgment that any figures provided are estimations. The franchisor should be mindful of whether questionnaires will hurt or help its case depending on the state where the franchisee is located,

121. See *Cluck-U Chicken, Inc. v. Cluck-U Corp.*, 358 F. Supp. 3d 1295, 1312 (M.D. Fla. 2017). There, the franchisor defended an Item 7 claim on the grounds that franchisee "acknowledged that they had independently investigated the franchise, were ready to open for business, and unilaterally upgraded equipment and decor (which increased the amount of [franchisee's] initial investment)."

122. In recent years, state regulators have scrutinized the use of disclaimers in FDD disclosures and pre-sale compliance questionnaires. That may limit a franchisor's opportunity to rely on language in FDD disclaimers and questionnaires going forward, but that opportunity may be available for disputes concerning older fraud claims stemming from FDD disclosures.

123. A body of case law has developed over the enforceability of disclaimers and exculpatory clauses, with mixed results. Compare *Hanley v. Doctor's Exp. Franchising, LLC*, 2013 U.S. Dist. LEXIS 25340, at *21 (D. Md. Feb. 25, 2013) (noting that FDD's "inaccurate projections" could . . . be considered fraudulent if there was evidence that [franchisor] knew they were inaccurate at the time they were made"); *Colo. Coffee Bean, LLC v. Peaberry Coffee Inc.*, 251 P.3d 9 (Colo. App. 2010) (reversing trial court's dismissal of fraudulent concealment and negligent misrepresentation claims against franchisor and its officers, where trial court ruled that integration and non reliance clauses in the transactional documents precluded, a matter of law, plaintiffs' reliance on nondisclosure claims), and *Burton v. Linotype Co.*, 556 So. 2d 1126, 1127 (Fla. Dist. Ct. App. 1989) (stating that exculpatory clauses are not enforceable to release future claims of fraud), with *Wauwatosa Hotel Grp. v. Days Inn Worldwide, Inc.*, 2014 U.S. Dist. LEXIS 194570, at *23–24 (E.D. Wis. Dec. 12, 2014) (granting franchisor-defendants' motion to dismiss claims of fraudulent misrepresentation, in part, based on integration and no-reliance clauses contained in the franchise agreement and reasoning that franchisees "are sophisticated in business matters and must live with the Agreement that they signed"), and *Peterson v. Cornerstone Prop. Dev., LLC*, 720 N.W.2d 716, 726 (Wis. Ct. App. 2006) (stating that although "exculpatory clauses are closely scrutinized and void if they violate public policy . . . they are enforceable so long as they 'clearly, unambiguously, and unmistakably inform the signer of what is being waived'" (internal citations omitted)).

in light of the recent changes to guidance published by the North American Securities Administrators Association.¹²⁴

IV. Conclusion

Fraud or misrepresentations arising from Item 7 disclosures are often part of a laundry list of claims filed by a disgruntled franchisee seeking recourse in the aftermath of a failed business. Item 7 disclosures are simply estimates and, if properly prepared and framed in the FDD, should not be a sufficient basis to support a common law claim against a franchisor for an improper disclosure. Although litigation may be inevitable, by taking proper steps, both before and during litigation, a franchisor can weaken a franchisee's showing of reasonable reliance and place itself in a position to succeed in defense fraud or misrepresentation claims based on Item 7.

124. *NASAA Statement of Policy Regarding the Use of Franchise Questionnaires and Acknowledgments*, N. AM. SECS. ADM'R ASS'N (Sept. 18, 2022) <https://www.nasaa.org/wp-content/uploads/2022/09/NASAA-Franchise-Questionnaires-and-Acknowledgments-Statement-of-Policy-9-18-2022.pdf>.

