No-Reliance Provisions

Making Franchising Safer for Fraud

By Howard Yale Lederman

During the last few decades, many contracts, including franchising agreements, have contained no-reliance provisions. These may stand alone or be part of other provisions. If upheld, a no-reliance provision means that a party's reliance on the other party's precontract statements—no matter how fraudulent the statements—is unreasonable as a matter of law. The provision's purpose is to bar fraud claims.[1] Other ostensible purposes are promoting adherence to the written word and preventing the negative effects of fabrication and faulty memory on contracting.[2] But no-reliance provisions are dangerous because they promote franchise fraud. They destroy the essential balance between franchise law public policy, the antifraud protections of the Michigan Franchise Investment Law (MFIL), and freedom of contract.

The franchise relationship begins with a potential owner, or *franchisee*, seeking to buy a franchise from a seller, or *franchisor*. In Michigan, a franchise must meet three requirements: (1) a franchisee right to operate a business identified or associated with the franchisor's trademark or similar intellectual property, (2) significant franchisor control over or assistance to the franchisee, and (3) a required franchisee payment—a franchise fee—to enter the business.[3] The franchise sale process involves communication carrying an inherent risk of fraud.

The MFIL has antifraud provisions.[4] However, for the franchise fraud plaintiff, proving reasonable reliance on the defendant's precontract statements is essential to prove fraud—whether statutory MFIL fraud or common-law fraud.[5] Michigan appellate courts have not published any decisions regarding no-reliance provisions. In an unpublished decision, the Michigan Court of Appeals upheld a no-reliance provision as applied to extra-contractual representations, but rejected it as applied to contractual representations.[6] However, other courts have considered no-reliance provisions, and four approaches have emerged.

Four approaches

The first approach is freedom of contract making a party's reliance on the statements referred to in the provision unreasonable as a matter of law.[7] The Michigan Supreme Court has adopted

almost unrestricted freedom of contract, acclaiming "the 'fundamental policy of freedom of contract' under which 'parties are generally free to agree to whatever specific rules they like.'"[8] The Court has narrowly defined any countervailing public policy.[9] In adopting freedom of contract regarding no-reliance provisions, another court reasoned: "[I]t is hardly justifiable for someone to rely on something that they have agreed not to rely on."[10]

The second approach is factors analysis to determine whether to enforce the no-reliance provision. While recognizing the need for reliance on written contract provisions for predictability and stability, courts taking this approach have rejected unrestricted freedom of contract as undesirable for failure to address fraud prevention. Even with a no-reliance provision, "it would be unreasonable to expect a person to pore through a 427 page document looking for 'nuggets of intelligible warnings,' [but] a person may not claim reasonable reliance when a written disclaimer is apparent in an eight page document."[11]

One Michigan-based court has summarized factors law:

> First, courts are more willing to enforce a no-reliance clause if the provision disclaiming reliance is its own separate clause rather than a provision embedded within another [contract] clause…, such as a merger clause or an exculpatory clause….Second, courts are more willing to enforce a no-reliance clause if it expressly mentions and disclaims "reliance."…Third, courts are more willing to enforce a no-reliance clause if the contracting parties are sophisticated.[12]

The third approach is enforcement only under certain conditions, such as when the provision is reasonable under the circumstances or specific enough.[13]

The fourth approach is invalidation attributable to the need to prevent fraud.[14] As two courts emphasized:

> [I]t is necessary to weigh the advantages of certainty in contractual relations against the harm and injustice [resulting] 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 [one party's] fraud…in procuring it….The same public policy [sanctioning] the avoidance of a promise obtained by deceit strikes down all attempts to circumvent that policy by means of contractual devices….To refuse relief would result in opening the door to [numerous] frauds and in thwarting the general policy of the law.[15]

The FTC's franchise disclosure rule and its impact

The Federal Trade Commission's franchising rule substantially restricts the no-reliance provision in any franchise agreement. The rule compels franchisors to disclose 23 categories of information to potential franchisees before signing a franchise agreement.[16] The rule's goal is "preventing deceptive and unfair practices through presale disclosure of material information necessary to make an informed decision…."[17]

Category examples include the franchisor's business experience; litigation and bankruptcy histories; initial franchise and subsequent fees; estimated initial investment; franchisee obligations; franchisor assistance; training; territories; and renewal, termination, transfer, and dispute resolution provisions. All franchisor financial performance representations must be complete and truthful. A no-reliance provision barring potential franchisee reliance on any documents or information disclosed under the rule is invalid. While reducing franchise fraud suits, the rule has not eliminated them. Thus, the no-reliance provision controversy continues in franchising.

No-reliance provisions and experience

As Justice Holmes recognized, "[t]he life of the law…has been experience," including the "felt necessities of the time" and "intuitions of public policy."[18] Historical experience has proven almost unrestricted freedom of contract destructive because it has become freedom to defraud. During the 1920s, the securities markets were full of fraud, leading to the Great Depression and federal and state securities laws. During the 1960s, the franchise markets were full of fraud, almost destroying franchising and leading to the FTC rule, the MFIL, and other state franchising laws.[19] Thousands of franchisees lost their life savings and hundreds of franchisors went broke. Franchisor representatives admitted rampant abuses and fraud and urged responsive government action.[20] Even then California Gov. Ronald Reagan, not known for supporting government regulation, signed the California Franchise Investment Law, the MFIL's model. Thus, almost unrestricted freedom of contract in franchising became almost unrestricted freedom to defraud.

This fraudulent franchise market was the functional equivalent of a no-reliance provision franchise market. "Buyer beware" ruled. Defrauded franchisees had little recourse. Franchise disclosure

FAST FACTS

A growing number of contracts—including franchise agreements—include no-reliance provisions, which bar one party's reliance on another's precontract statements.

In franchise agreements, no-reliance provisions cannot bar one party's reliance on another party's mandatory Federal Trade Commission disclosures.

The courts are divided on whether to enforce or restrict no-reliance provisions.

laws did not exist. Common-law fraud suits faced tough going, as proving reasonable reliance was difficult or impossible.

No-reliance provisions also make proving reasonable reliance difficult or impossible. Thus, fraud increases. So these provisions partially restore this fraudulent franchise market full of tremendous abuses and suffering.

Barring no-reliance provisions is imperative

The state, franchisors, and franchisees have "a legitimate and compelling interest in preserving a business climate free of fraud and deceptive practices….a contract is not a license allowing one party to cheat or defraud the other."[21] "Commercial parties should be entitled to rely on the representations their contractual partners make. Indeed, the stability of commercial relationships depends on such trust, and the legal rules governing those relationships should foster it."[22] "'[P]arties need a background of truth and fair dealing in commercial relationships.'"[23]

Preserving a fraud-free franchise market must override promoting freedom of contract. Putting freedom of contract first threatens to destroy that market. If fraud pervades the franchise marketplace, potential franchisees will buy fewer franchises and franchisors will be less able to grow. The franchise marketplace will decline. Just as the old de facto no-reliance regime almost destroyed franchising before 1970, a new no-reliance regime will threaten to destroy franchising in the present. The factors and conditions approaches are not good enough. While these approaches increase franchise fraud less than almost unrestricted freedom of contact, they still increase it. Barring no-reliance provisions alone promotes a more fraud-free franchise marketplace. Therefore, barring these provisions is imperative. ■

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ENDNOTES

1. *Extra Equipamentos E Exportação Ltda v Case Corp*, 541 F3d 719, 723 (CA 7, 2008); *Oki America, Inc v Microtech International, Inc*, 872 F2d 312, 315 (CA 9, 1989).
2. *Rissman v Rissman*, 213 F3d 381, 384 (CA 7, 2000).
3. See 16 CFR 436.1(h); MCL 445.1503.
4. MCL 445.1505 and MCL 445.1508.
5. See *Hord v Environmental Research Institute of Michigan*, 463 Mich 399, 404; 617 NW2d 543 (2000); *Hamade v Sunoco, Inc*, 271 Mich App 145, 171; 721 NW2d 233 (2006); *Cook v Little Caesar Enterprises, Inc*, 210 F3d 653, 658 (CA 6, 2000).
6. *Federated Capital Servs v Dextours, Inc*, unpublished opinion per curiam of the Court of Appeals, issued April 26, 2002 (Docket No. 228208).
7. *Rissman*, 213 F3d at 384; *MBIA Ins Corp v Royal Indemnity Co*, 426 F3d 204, 218 (CA 3, 2005).
8. *Zahn v Kroger Co of Michigan*, 483 Mich 34, 46; 764 NW2d 207 (2009), quoting *Port Huron Educational Assoc v Port Huron Area School District*, 452 Mich 309, 319; 550 NW2d 228 (1996).
9. See *DeFrain v State Farm Mutual Auto Ins Co*, 491 Mich 359, 372–373; 817 NW2d 504 (2012); *Rory v Continental Ins Co*, 473 Mich 457, 471; 703 NW2d 23 (2005).
10. *Schrager v Bailey*, 973 NE2d 932, 937 (Ill App Ct, 2012).
11. *Rissman*, 213 F3d at 389.
12. *Whitesell Corp v Whirlpool Corp*, unpublished memorandum opinion of the U.S. District Court for the Western District of Michigan, issued October 5, 2009 (Docket No. 1:05-CV-679), p *4.
13. See *Restatement (Second) of Contracts*, § 196; *Danaan Realty Co v Harris*, 5 NY2d 317, 320–321; 184 NYS2d 599; 157 NE2d 597 (1959); Wingate Inns Int'l, *Inc v Swindell*, unpublished opinion of the U.S. District Court for New Jersey, issued October 23, 2012 (Docket No. 12-248).
14. See *Turkish v Kasenetz*, 27 F3d 23, 27–28 (CA 2, 1995); *Ron Greenspan Volkswagen, Inc v Ford Motor Land Development Corp*, 32 Cal App 4th 985, 994 n 7; 38 Cal Rptr 2d 783 (1995).
15. *Westerfield v The Quiznos Franchise Co*, unpublished opinion of the U.S. District Court for the Eastern District of Wisconsin, issued April 16, 2008 (Docket No. 06-CV-1210), p *10, quoting *Anderson v Tri-State Home Improvement Co*, 268 Wis 455, 460; 67 NW2d 853 (1955) (citation omitted).
16. 16 CFR 436.5.
17. 72 Fed Reg 15444, 15448.
18. Holmes, *The Common Law* (Boston: Little Brown, 1881), p 1.
19. See Chisum, *State regulation of franchising: The Washington experience*, 48 Wash L R 291, 299 (February 1973); Axelrod, *Franchising—Changing legal skirmish lines or Armageddon? Some observations from the foxhole*, 26 Bus Lawyer 695, 704 (January 1971); Lefkowitz, *Franchising abuses—One state's approach*, 75 Case & Com 13, 14 (July–August 1970).
20. See Senate Select Committee on Small Business Report 91-1344, Statement of John Y. Brown, president of Kentucky Fried Chicken, and Philip F. Zeidman, Washington counsel, International Franchising Association, 91st Cong, 2d Sess (1970), pp 42, 190.
21. *Robinson Helicopter Co, Inc v Dana Corp*, 34 Cal 4th 979, 992; 22 Cal Rptr 3d 352; 102 P2d 268 (2004); accord *Kaloti Enterprises, Inc v Kellogg Sales Co*, 283 Wis 2d 555, 600; 699 NW2d 205 (2005).
22. *Robinson Helicopter*, 34 Cal 4th at 996–997.
23. *Kaloti Enterprises*, 283 Wis 2d at 587.