



Using the Economic Loss Rule to Your Client's Benefit

By Sam Wolf

ALL LAWYERS CAN BENEFIT from having a toolbox of general legal knowledge with which to frame a case to their client's advantage. For business attorneys the economic loss rule is a particularly useful tool. At its simplest, the rule prohibits a claimant from recovering damages for purely economic loss unless the claimant also suffered directly related physical injury to his or her person or property from another's tortious conduct.¹ First recognized in products liability cases, the economic loss rule has been applied across a broad spectrum of commercial relationships based in contract.²

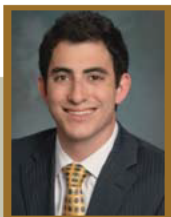
The economic loss rule can be stated with seeming clarity, but when

it comes to applying the rule, appellate courts have struggled. Moreover, exceptions and nuances vary among jurisdictions. Some jurisdictions limit the rule to products-liability, sales, and construction cases. Some do not apply its damages limitation in fraud claims.³ The most common approach in fraud cases strikes an uneasy balance by permitting an intentional fraud action to proceed as long as the claimed damages arise from a representation of fact not contained in the parties' contract.⁴

Fraud in the inducement is an exception to the economic loss rule. This type of fraud presents a special situation in which the contracting parties appear to have negotiated, which would normally be grounds to invoke the rule's limitation of damages. But one party's

ability to negotiate fair terms and reach an informed decision is undermined by the other party's fraudulent behavior.⁵ Thus, the reason courts do not apply the economic-loss rule to fraud in the inducement is that the fraud destroys consent, thereby vitiating the contract.

To invoke the fraud exception, a transacting party's failure to disclose material facts serves as a basis to claim fraudulent inducement. In the context of business transactions, such as franchisor-franchisee relationships, one party (such as a franchisee), may show that there was an intentional misrepresentation by the other party (the franchisor), that the misrepresentation occurred before the contract was formed, and that the fraud concerns a matter not covered by the contract.



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Common law fraud requires proof that a claimant reasonably relied on the defendant's false statement. To neutralize this claim, many commercial contracts include a "disclaimer of reliance" provision, requiring an investor or buyer to agree that it did not receive or rely on any extra-contractual representation from the seller.

Under California law, a contract's integration or merger clause will not bar a fraudulent inducement claim if fraud is alleged sufficiently.⁶ Common statements that form the basis of fraud in the inducement claims, such as an alleged representation concerning profits a franchisee or other investor can expect, can potentially be avoided if the agreement includes statements that explicitly disclaim such representations or advice that the franchisee make its own investigation.⁷ Though a merger provision and "disclaimer of reliance" clause may not be enough to win a demurrer or summary judgment, the clauses are still factors tending to disprove the justifiable reliance element of fraud.⁸


In assessing reliance, courts look to all the factual circumstances, including the parties' relative knowledge of specific facts; the speaker's position within a defendant's corporate organization and his authority to make the statements; whether the defendant gave plaintiff access to the underlying information; sophistication and experience of the plaintiff; and the context in which the statements were made.⁹ Moreover, whether a plaintiff justifiably relied is judged subjectively.¹⁰ In litigation, attorneys for franchisors or other defendants should consider the business experience of a failed franchisee or other plaintiff. If a particular plaintiff is sophisticated, a fact-intensive inquiry may be to the defendant's advantage. If a plaintiff knew or should have known that a speaker had no authority, the plaintiff could not have justifiably relied on the statement.¹¹

Analytically, it is important to remember that the fact of reliance is different from the right of reliance.¹² Under California law, justifiable reliance cannot be established where the complaining party's conduct was manifestly unreasonable in light of his intelligence and information, or ready availability of information.¹³ Accordingly, a plaintiff usually will be charged with increasing knowledge and sophistication as time passes, and failure to discover the fraud at some point in time will break the chain of reliance.¹⁴ Moreover, at some point a claimant's actual or constructive knowledge of acquiescence in the fraud may be deemed ratification.¹⁵

A number of courts have held that it is unreasonable as a matter of law for a plaintiff to rely on oral statements that are directly contradicted by the written contract.¹⁶ Some courts have imposed a duty on franchisees to inquire further and obtain assurances or clarification before relying on oral statements.¹⁷ At the other end of the spectrum, a sophisticated plaintiff who has access to the relevant facts but chooses to ignore them cannot as a matter of law have relied on the misrepresentation.¹⁸ The evidentiary presumptions in Evidence Code Sections 622 and 623 have been cited to estop a franchisee from pursuing claims based on alleged pre-contract misrepresentations concerning profitability where an acknowledgment in the franchise agreement states that the franchisee received "no warranty or guarantee, expressed or implied," regarding the "potential sales, income, profits or success" of the business.¹⁹

For franchise and other business attorneys, knowing the intricacies of the economic loss rule is important. Franchise lawsuits and most business litigation are usually economic in nature, and application of the rule will often narrow the scope of the claims and damages available as a remedy.²⁰ Litigation attorneys who possess a solid understanding of the

rule can use it to develop a framework to successfully nail down a claimant's theories at deposition or trial.

Familiarity with the rule is important to transactional attorneys as well, because the terms of the parties' agreement often become the focal point in litigation and the rule can be helpful in deciding what contractual disclaimers to include when drafting franchise and other business agreements. Quite simply, all general business litigators can benefit from being familiar with cases on the economic loss rule as a way to obtain an advantage over opponents. The stakes are far from academic as the availability of tort and punitive damages may hinge on whether or not a court decides to apply the rule. 

¹ See R. Joseph Barton, Note, *Drowning in a Sea of Contract: Application of the Economic Loss Rule to Fraud and Negligent Misrepresentation Claims*, 41 Wm. & Mary L. Rev. 1789, 1795-96 (2000).

² See, e.g., *State Ready Mix, Inc. v. Moffatt & Nichol*, 232 Cal.App.4th 1227 (2015) (construct defect); *Food Safety Net Servs. v. Eco Safe Sys. USA, Inc.*, 209 Cal. App.4th 1118, 1132 (2012) (sales).

³ See, e.g., cases from Florida and Arizona; *Tiara Condominium Association, Inc. v. Marsh & McLennan Companies*, 110 So. 3d 399, 407 (Fla. 2013) (holding that the economic loss rule only applied to product liability cases); *Cook v. Orkin Exterminating Co.*, 227 Ariz. 331, 334-346 (2011) (applying the economic loss doctrine to service contracts).

⁴ Sean Trende, *The Economic Loss Rule and Franchise Attorneys*, Hunton & Williams—Virginia, USA (January 2008).

⁵ See R. Joseph Barton, Note at 1789, 1810 (2000).

⁶ See Cal. Code Civ. P. §1856(g); see also *It's Just Lunch Int'l, LLC v. Polar Bear, Inc.*, No. Civ. 03-2485 WHQ (JFS), 2004 WL 3406117 at *2-3 (S.D. Cal. Apr. 29, 2004); *It's Just Lunch Int'l LLC v. Island Park Enter. Grp., Inc.*, No. Civ. 08-367 VAPJ (CRX), 2008 WL 4683637 at *5 (C.D. Cal. Oct. 21, 2008).

⁷ See *California Bagel Co. v. Am. Bagel Co.*, 2000 WL 35798199 (C.D. Cal. 2000) (granting summary

judgment on fraud and negligent misrepresentation claims of franchisee finding that written disclaimer of information concerning earnings contained in franchise agreement negated oral statements concerning actual sales); *Carlock v. Pillsbury Co.*, 719 F. Supp. 791, 1989-2 Trade Cas. (CCH) ¶ 68833 (D. Minn. 1989) (where offering circular specially recommended that potential franchisees make their own investigation to determine profitability, franchisor was not under a duty to disclose that revenues were on the decline nationally).

⁸ *People ex rel. Dept. of Corporations v. Speedee Oil Change Systems, Inc.*, 95 Cal.App.4th 709, 725-726 (2002) (Under California law the fact of reliance is a question for the jury).

⁹ See W Michael Garner, *Laws of Torts and Franchising*, 2 Franch & Distr Law & Prac §9:15.

¹⁰ *Brownlee v. Vang*, 235 Cal.App.2d 465, 473-474 (1965)—test is actual effect of misrepresentation “on [plaintiff's] particular mind”.

¹¹ See *Call Carl, Inc. v. BP Oil Corp.*, 554 F. 2d 623, 631-32 (4th Cir. 1997) (franchise agreement showed the speaker had no authority, thus, plaintiffs could not have reasonably relied on oral statements); *California Bagel Co. v. Am. Bagel Co.*, 2000 WL 35798199 at *13-14 (C.D. Cal. 2000) (“This disclaimer makes it clear that representations regarding the actual performance of existing franchises were not authorized, and thus that plaintiffs could not reasonably rely upon them.”)

¹² *Vaughn v. General Foods Corp.*, 797 F.2d 1403, 1415 (7th Cir. 1986).

¹³ *Kahn v. Lischner*, 128 Cal.App.2d 480, 488 (1954).

¹⁴ *Royal Business Machines, Inc. v. Lorraine Corp.*, 633 F.2d 34, 44 (7th Cir. 1980); see *Kahn, supra*, at 488 (1954) (justifiable reliance cannot be established where the conduct of the complaining party was manifestly unreasonable in light of his intelligence and information, or the ready availability of information).

¹⁵ See W. Michael Garner, *Laws of Torts and Franchising*, 9.15 Reliance, 2 Franch & Distr Law & Pract §9.15.

¹⁶ See, e.g., *California Bagel Co. v. Am. Bagel Co.*, 2000 WL 35798199 at *15 (C.D. Cal. 2000) (“[i]n the face of a disclaimer contained in the Offering Circular, it was unreasonable for plaintiffs to rely on representations regarding the actual profits of existing Chesapeake Bagel Stores as a matter of law.”); *Rosenberg v. Pillsbury Co.*, 718 F.Supp. 1146, 1153-52 (S.D.N.Y. 1989) (concluding that plaintiffs' purported reliance on oral representations was unreasonable because, inter alia, the offering circular stated that “[n]either franchisor's sales personnel nor any employee or officer of the franchisor is authorized to make any claims or statements as to the earnings, sales, or profits or prospects or chances of success that any franchisee can expect or that present or past franchisees have had”).

¹⁷ *Payne v. McDonald's Corp.*, 957 F. Supp. 749, 760-2 (D. Md. 1997) (unreasonable for franchisee to rely upon projection of future profits).

¹⁸ See *Century Pacific, Inc. v. Hilton Hotels Corp.*, 354 Fed. Appx. 496 (2d Cir. 2009) (plaintiff was sophisticated investor represented by counsel).

¹⁹ See *California Bagel Co. v. Am. Bagel Co.*, 2000 WL 35798199 (C.D. Cal. 2000); *Cal. Evid. Code* §622 (“The facts recited in a written instrument are conclusively presumed to be true as between the parties thereto ...”); *Cal. Evid. Code* §623

“Whenever a party has, by his own statements or conduct, intentionally and deliberately led another to believe a particular thing and to act upon such belief, he is not, in any litigation arising out of such statement or conduct, permitted to contradict it.”)

²⁰ Sean Trende, *The Economic Loss Rule and Franchise Attorneys*, Hunton & Williams – Virginia, USA (January 2008).