Franchisee Fraud:
When Fraud Threatens a Franchisor's Good Name

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The typical response of a victim of fraud is to wage a full-scale attack on the perpetrator—report them to the authorities and seek to recover the maximum amount of damages without regard to the harm inflicted on the bad actor. However, this standard playbook would be counterproductive when a fraud is perpetrated by a franchisee on a franchisor or the public, and it is the franchisor seeking relief.

The public pursuit of legal remedies in such a scenario would put the spotlight on the party that the franchisor entrusted with its brand and reputation. For this reason, franchisors must approach these situations with more nuanced strategies to avoid damaging their reputation in the marketplace. While most franchise agreements contain contractual provisions designed to address this unique problem, the enforcement of those provisions can be impeded by state and bankruptcy laws.

If the continuing problems in the retail sector are any predictor of things to come, more restaurant and retail franchises will begin to experience financial distress. As a result, instances of fraud are also likely to increase as franchisees push the bounds of acceptable conduct in the misguided hope of improving their bottom line. Many strategies that can be implemented by franchisors to prevent this abuse are also useful to franchisee lenders. Therefore, it is crucial for franchisors and franchisee lenders to understand and implement appropriate strategies to prevent and address fraud.

Almost every franchisee uses the franchisor's brand name, trademarks, and, of course, goodwill, which is at the very heart of most franchise agreements. To many consumers, the difference between a franchisor and its franchisee is hazy. Every public action or remedy that assaults the franchisee's conduct and reputation may appear to consumers to be an assault on the brand itself. Even worse, a franchisor may have to consider whether it may have exposure for their franchisee's bad acts under an agency or other theory of liability.[1]

All in the Family

Many franchisors describe their franchisees as members of their franchise "family" and, for better or worse, family members know each other's weaknesses and vulnerabilities. Advisors working with franchisors must fully understand a franchisor's vulnerabilities and how they may be used against it.

For example, does the franchisee know about past claims that have been asserted against the franchisor by other franchisees? Are there any significant supply chain problems which may be contributing to a franchisee's difficulties? Have any of the franchisor's employees acted inappropriately? The disclosure of these vulnerabilities in a public forum, without proper planning, may exacerbate customer confusion over who the bad actor actually is.

Advisors to franchisors must probe their clients carefully with respect to potential weaknesses before exercising rights and remedies against franchisees. This is especially true for newer franchises that may not have the professional systems, reputation, or customer loyalty of larger, more established national brands.

In most instances, franchisee fraud is not discovered for years. During the time it has been part of its franchisor's system, the franchisee has learned the franchisor's weaknesses from inside the closet. It can use that knowledge to its advantage either by exploiting those weaknesses to continue perpetrating the fraud (*e.g.,* when franchisor oversight fails to catch accounting irregularities) or by using them as an excuse or defense for its own misconduct.

Contractual Remedies

The most basic franchisor-franchisee relationship involves a franchise agreement. When a franchisee commits fraud, remedy provisions typically allow a franchisor to:

- Terminate the relationship and require "de-identification"
- Take over the franchisee's operations and leases
- Seek other injunctive relief and monetary damages

However, in many cases, both in the United States and abroad, the enforceability of these provisions is governed by state law protections, which are often designed to protect franchisees from improper termination.[2] These state law constraints must be analyzed before a franchisor can exercise its remedies.

Other common contracts among franchisors and franchisees include: area development agreements (ADAs), equipment supply agreements, and loan arrangements that come with their own set of remedies. In many instances, franchisors lend to their franchisees to facilitate the opening of new locations or to address earlier defaults. Such loan documents, especially if the loan is secured, provide the franchisor with valuable remedies beyond those contained in the franchise agreement, and any cross-default provisions should be analyzed early in any dispute.

Franchise agreements are executory contracts that can be assumed in a bankruptcy case if they have not been terminated prior to the commencement of the bankruptcy.[3] While the analysis of whether a franchisor can or should terminate a

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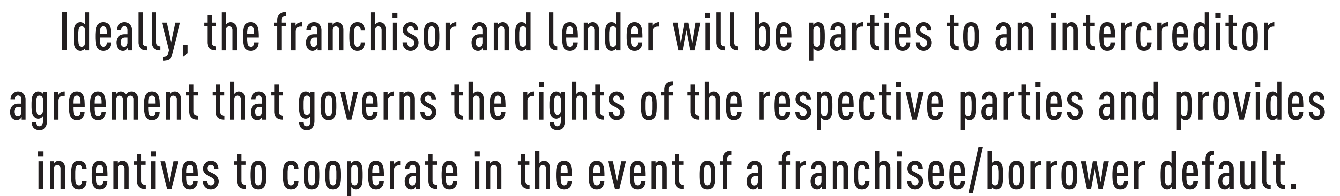

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franchise agreement is multifaceted, in most cases the franchisor will want to terminate the contract to strip the franchisee's opportunity to cure defaults in a bankruptcy. Similarly, a franchisee will be motivated to file for bankruptcy protection before the agreement is terminated to preserve any perceived value it holds.

In instances involving franchisee fraud, a franchisor should seek to terminate the franchise agreement as quickly as possible, after which it can consider offering the franchisee a limited-term license to operate. This strategy allows the business to remain open, permits the continued accrual (or payment) of royalties, and deprives the franchisee of leverage that may otherwise be available in a bankruptcy case.

Cross-Default Risks

Most franchisees, and nearly all that engage in fraud, are heavily leveraged. In many cases, the franchise agreement, leases, and equipment required for operations are part of the lender's collateral package. In all cases, the franchisor needs to evaluate the franchisee's loan documents and determine how any bad conduct will result in a default. Franchisee fraud will likely result in both the franchisor and the lender racing to exercise their remedies first if there are no, or insufficient, intercreditor agreements between them.

Any attempted concerted effort between a franchisor and franchisee to delay disclosure of alleged fraud to a lender must be carefully analyzed. While a defaulting franchisee is bad news for a franchisor, a lawsuit by a lender against the franchisor as a co-conspirator is worse.

Ideally, the franchisor and lender will be parties to an intercreditor agreement that governs the rights of the respective parties and provides incentives to cooperate in the event of a franchisee/borrower default. In some instances, a franchisor may want to consider purchasing the lender's position to increase its leverage against the franchisee and avoid unpredictable and disruptive lender conduct.

Typical lender-friendly forbearance agreements contain broad release and other protections for lenders. In a brewing franchise dispute, franchisors may consider whether to obtain similar protections in a forbearance agreement, especially when a franchisee has engaged in potentially fraudulent conduct. To obtain some breathing space, many franchisees will agree to mechanics for the franchisor's investigation and other useful disclosures as well as provide releases for the franchisor.

Commonly, when a franchisee defaults a franchisor discovers that its file is incomplete or outdated. As part of the forbearance process, the franchisor should cure any defects in its documents and otherwise address, or at least identify, any vulnerabilities.

Practical Resolution Processes

In light of the limitations on the enforcement of remedies, franchisors faced with franchisee fraud should search for a quick, private, and, when possible, economical resolution. Rarely will an all-out attack on a franchisee achieve the ultimate goal of preserving the franchisor's goodwill and brand reputation, nor will it necessarily serve as a deterrent against bad conduct by other franchisees. Ultimately, a franchisor should arm itself with a pressure-inducing litigation strategy but hope that it not be forced to deploy it.

In most instances, brand value can be preserved by quickly channeling a dispute through mediation—with all the major constituents present at the table. This type of intervention often leads to results-oriented solutions without suppliers or customers ever becoming aware of the dispute. A successful mediation can result in a successful business transaction, such as a sale of the franchisee's locations, that can further bolster the brand's strength. The earlier the third party is brought in to expedite the negotiated business resolution, the better it will be for the brand and the bottom lines of all concerned.

Franchisor and lender responses to franchisee fraud and potential insolvency require a distinctly different approach from what would be deployed in many other industries. Franchisors and lenders ultimately want to preserve goodwill and brand value. As such, before exercising remedies against

a franchisee perpetrating a fraud, franchisors and lenders must consider the potential impact of pursuing those remedies in a public forum. Ultimately, planning for potential defaults, particularly defaults triggered by fraud, before they occur will help protect the larger enterprise and allow franchisors to better control their fate.

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[1] See *e.g. Theos & Sons, Inc. v. Mack Trucks, Inc.*, 431 Mass. 736 (Mass. 2000), *Hong Wu v. Dunkin' Donuts, Inc.* 4 Fed.Appx. 82 (2d Cir. 2001), *Crinkley v. Holiday Inn*, 844 F.2d 156 (4th Cir. 1988).

[2] For example, in *1-800-Got Junk? LLC v. Superior Court*, 189 Cal.App.4th 500, 519-520 (Cal. 2010), the court held that a franchisee's fraud did not allow termination without notice and an opportunity to cure absent a demonstration that the exceptions in Washington's Franchise Investment Protection Act were applicable.

[3] See *e.g. In re ERA Cent. Regional Serv., Inc.*, 39 B.R. 738 (Bankr. C.D. Ill. 1984); *In re Wills Motors, Inc.*, 133 B.R. 297 (Bankr. S.D.N.Y. 1991), *Krystal Cadillac Oldsmobile GMC Truck, Inc. v. GMC (In re Krystal Cadillac Oldsmobile GMC Truck, Inc.)*, 142 F.3d 631 (3d Cir. 1998).

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