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FRANCHISE LAW

Troubled Waters Ahead? High Court Expands RICO

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Racketeer. Con artist. Professional fraudster. Although these stigmatizing labels hardly resemble franchisers — indeed, they often bear little resemblance to most defendants in civil lawsuits — many franchisees have leveled serious allegations of racketeering, corruption and fraud at franchisers in federal lawsuits premised on the Racketeer Influenced and Corrupt Organizations Act, or RICO.

With increasing frequency, disgruntled franchisees assert allegations of RICO violations — the legal equivalent of a nuclear strike — against franchisers along with routine claims for breach of contract, breach of the duty of good faith and fair dealing and unjust enrichment. A franchisee's decision to include a RICO claim in a lawsuit against a franchiser is with good reason: The statute provides a winning franchisee with an award of three times its actual financial losses and reasonable attorney fees. In *Bridge v. Phoenix Bond & Indemnity Co.*, the Supreme Court issued a decision that likely will increase the number of RICO claims filed by franchisees against franchisers.

Although it initially enacted the RICO statute to combat organized crime, Congress also allowed civil claims to be brought by a person injured in his or her business or property as a result of a RICO violation. In order to state a civil claim under RICO, a plaintiff must allege (among other elements that are beyond the scope of this article) that a defendant engaged in at least two acts of criminal activity over a significant period of time, usually at least 12 months. The types of criminal activity — also known as "racketeering" — that may give rise to a civil RICO claim include bribery, embezzlement, extortion, mail fraud and wire fraud. A person violates the mail and wire fraud statutes if he or she knowingly participates in a scheme to defraud and advances the scheme through the use of the U.S. mail or interstate wires. Because virtually all businesses — legitimate or otherwise — conduct affairs by mail, telephone, fax machine and e-mail, the most commonly asserted civil RICO claims are predicated on allegations of mail or wire fraud.

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In the franchise context, disputes between a franchisee and franchiser often take the form of a complaint by the franchisee that the statements made by the franchiser in the franchise disclosure documents were fraudulent and made with the intention of inducing the franchisee to enter into a written franchise agreement. These claimed misrepresentations often include allegations that the statements made by the franchiser regarding the profitability and cost of operating the franchise were fraudulent, that the support to be provided by the franchiser and value of the experience of the franchiser was misrepresented or that the financial health of the franchiser was materially weaker than depicted. The franchisee's complaint also will include a RICO claim based on the franchiser's use of mail, telephone, fax machine or e-mail to further its alleged scheme to defraud the franchisee.

In many cases, courts have resolved disputes such as this by dismissing the franchisee's common law fraud and RICO claims based on the terms of express disclaimers of reliance or integration clauses contained in the franchise agreement or the franchise offering disclosure documents. These provisions generally provide that the franchisee has agreed that it is not relying on any oral or written representations made by the franchiser outside of the written disclosure documents or franchise agreement. As such, when a franchisee files a complaint based on a franchiser's alleged fraudulent representations aimed at inducing a franchisee to enter into a franchise agreement that contains express disclaimers of reliance or integration clauses, many courts have dismissed the franchisee's common law fraud and RICO claims because the franchisee's reliance on the franchiser's alleged fraudulent representations was simply not reasonable.

Enter the Supreme Court's decision in *Bridge*. Although *Bridge* did not involve a franchise dispute, the Supreme Court's decision may change how express disclaimers of reliance or integration clauses affect a franchisee's RICO claim predicated on allegations of mail fraud. *Bridge* involved a

dispute between competing purchasers of tax liens at an annual public auction held by the Treasurer's Office in Cook County, Ill. Because of the fierce competition between purchasers at the auction, and to foster a balanced allocation of tax liens among purchasers, Cook County required each prospective purchaser of a tax lien to submit an affidavit stating that no agent, employee or related entity would bid on the same tax lien.

In *Bridge*, the plaintiff filed a complaint alleging that between 2002 and 2005 the defendant acquired a disproportionate share of tax liens by having multiple related entities submit affidavits in support of bids in which the defendant (or its related entities) was ultimately the successful bidder. The plaintiff asserted that the defendant violated RICO by engaging in a pattern of racketeering activity predicated on mail fraud by, among other actions, mailing false affidavits to the Cook County treasurer. The defendant responded that the plaintiff's RICO claim was legally insufficient because the plaintiff did not rely on any of the allegedly false affidavits that the defendant submitted. The Supreme Court ruled in favor of the plaintiff and held that a plaintiff asserting a RICO claim predicated on mail fraud need not show that it relied on a defendant's alleged misrepresentations.

In the wake of *Bridge*, franchisers are not likely to defeat a RICO claim predicated on mail or wire fraud based solely on the existence of express disclaimers of reliance or integration clauses in their franchise agreements or franchise offering disclosure documents. Notably, in most circumstances, these provisions should continue to operate to bar a franchisee's claim against a franchiser for common law fraud. The *Bridge* decision is particularly significant in light of the Federal Trade Commission's recently amended Rule on Franchising, which became effective for all franchisers July 1, 2008, and the amendment's anticipated effect of increasing voluntary disclosures of actual or potential financial performance data (and related information) by franchisers to prospective franchisees.

There are no sure-fire ways to avoid a RICO claim. The best way that a franchiser can protect itself is to ensure that any information that it discloses to potential franchisees is accurate and complete. Although the impact of *Bridge* on the franchise industry will not be known for some time, it no doubt heightens awareness of the need for franchisers to make careful, controlled and deliberate disclosures to potential franchisees and to be prepared for a potentially costly and time-consuming RICO experience. •