Traps For The Unwary: Preserving Claims When a Franchisee Files for Bankruptcy

While most franchise owners invest in a business with a focus on positive goals, sadly businesses do not always succeed as planned, and many franchised businesses end in financial distress. In such circumstances, the failed franchisee may have claims against the former franchisor (or others) to recover some or all of the business losses.

Unfortunately, some former franchisees that file for bankruptcy before engaging qualified franchisee counsel fail to preserve their potential claims against their franchisor in the bankruptcy. Such a failure is extremely unfortunate and can result in harsh consequences.

When a debtor files for relief under any chapter of the U.S. Bankruptcy Code, the debtor must fully disclose all of its assets in its bankruptcy petition. The bankruptcy trustee, who represents the interests of the creditors, reviews the petition to determine if the estate contains any assets from which the creditors can collect. While real estate, motor vehicles, cash and investments are obvious assets, any actual or potential claim that the debtor has against any other party is also an asset that must be disclosed.

This author has had the misfortune of screening potential claims by former franchise owners that had not been disclosed in a prior bankruptcy. Unfortunately for such persons, the doctrine of *judicial estoppel* can be used to preclude pursuing well-founded claims against their former franchisor.

Judicial estoppel is intended to prevent unfair manipulation of the bankruptcy system, particularly in cases were the debtor has filed a “no asset” petition – meaning that if the debtor’s petition is approved, the unsecured creditors will recover little or no compensation for their claims. In such cases, the trustee and the court rely on the debtor’s disclosures to decide whether to contest the non-asset discharge.

Often the distressed franchisee either hasn’t realized that there may be claims against the franchisor, or simply does not think of a legal claim as an asset that should be disclosed to the bankruptcy court. In fact, in most instances, bankruptcy trustees have little interest in pursuing such franchisee claims, and are likely disposed to abandon even substantial claims back to the debtor franchise owner.

Nevertheless, Courts almost always apply the doctrine to prevent the debtor franchisee from pursuing an undisclosed claim, even where the debtor’s creditors, rather than the person or entity trying to defeat the claim (such as the former franchisor), were the parties prejudiced by the omission of the claim from the bankruptcy. Courts generally consider two factors in deciding if the former debtor can pursue the claim: (1) did the party make representations in the bankruptcy that were inconsistent with its claim, and (2) were the inconsistencies calculated to make a mockery of the judicial system and/or to gain an unfair advantage.

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If a franchisee files for bankruptcy after failure of the franchised business, the franchisee usually will be deemed to have known the factual basis for its claims against the franchisor – even if he or she did not realize that such facts supported a legal claim. Therefore, the real issue is whether the court will find that the franchisee, by omitting a description of the claim, intended to mislead the bankruptcy court or simply made a good faith mistake.

Courts have held that, where the debtor forgets to disclose potential liabilities as well as assets in its schedules, intentional manipulation of the process could not be inferred and judicial estoppel was not appropriate. Nevertheless, if the bankruptcy resulted from the failed franchise, a court may find it hard to believe that the franchisee simply forgot about the franchisor when preparing the petitions. This would be true even if the franchisor’s potential claim for franchise fees is not listed as a liability.

Moreover, while some courts have been reluctant to dismiss a claim on this basis because it would be an unfair windfall for the defendant, such a result is not likely to benefit the franchisee plaintiff. Instead, the court’s likely course of action is to allow the bankruptcy case to be re-opened to permit the trustee to pursue the claim on behalf of the creditors, but to bar the franchisee from pursuing the claim independently or receiving any damages award.

By contrast, if the franchisee discloses the potential claim in the bankruptcy petition, the trustee will have the ability to take discovery from the debtor concerning the basis for the claim and decide whether to pursue the claim on behalf of the creditors. If the trustee decides to pursue it, and the franchisee lost personal assets in the business substantially in excess of the creditors’ claims, then the franchisee will receive the balance of any damage award.

If the trustee decides not to pursue the claim, as is usually the case, the trustee will likely “abandon” the claim to the debtor franchisee to be pursued in an independent action.

Accordingly, franchisees that find themselves in financial distress should be careful to list all claims that they have against their franchisor as an asset in bankruptcy – and remind their attorney to do so, even if that attorney doesn’t think to ask. To do otherwise could be the legal equivalent to pouring money down the drain.

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