

Case studies

Truth and Ethics in Franchising: A Case Study

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In this case, two franchisees provide fraudulent financial information in order to purchase their franchise. Acting as the franchisor, students must deal with this ethical issue and decide on the appropriate course of action for the business as a whole.

Case Synopsis

The franchisor/franchisee relationship is built on principles of truth and honesty. When a franchisor discovers that two franchisees (a husband and wife) lied about their financial qualifications to become franchisees, what are the franchisor's options? Should the franchisor terminate the relationship with the franchisees and keep their \$50,000 franchise fee? Should the franchisor terminate the relationship but refund all or part of the franchise fee? Should the franchisor overlook the lie but keep a close watch on the franchisees' performance? In this case, students are asked to play the role of the franchisor and make the difficult decision.

Learning Objectives

1. Compare how buying a franchise unit from a franchisee differs from buying from the franchisor
2. Explain why trust is a critical component in the franchising relationship
3. Identify ethical situations franchisors confront
4. Develop ideas for how a franchisor can protect the system from applicant fraud even if the system is being sold by a franchisee

Franchise Company Background

Real Property Investors, Inc. (RPI) is a franchise company headquartered in Dutton, Ohio. RPI franchisees are real estate investors who buy properties, mostly private homes, condominiums, apartments, and apartment houses for the purpose of reselling or renting the properties. The founder of RPI, Bart Furman, had been a Dutton, Ohio real estate agent for many years, and a broker as well for a short period of time. In the mid-1980s, Furman decided to offer real estate investors what he described as his "personal system for acquiring real estate and building wealth." His reputation for real estate investing had mushroomed across the USA, especially in the Mid-Atlantic region. He was known as "the investor's investor" because he not only could teach an individual how to buy and sell investment properties, but he was a hard money lender, too. In 1988,

Furman incorporated his business, Real Property Investors, for the purpose of selling franchises.

Many investors wanted to work with Furman personally and they were willing to pay substantial fees for his attention. Furman, however, was concerned about his reputation. When Furman evaluated a property to acquire it, he insisted on using "comps". He never wanted to be characterized as a businessman who took advantage of other people. As a member of National Real Estate Investors Association (National REIA), Furman supported ethical behavior in his profession. He kept up with real estate laws and regulations and taught them as part of his workshops and eventually as part of his training for franchisees. He believed in treating customers honestly.

Furman would often describe his business as the "McDonald's" of the real estate investment world. McDonald's was known as an outstanding franchise opportunity and McDonald's franchisees were known for expert business practices, high quality customer service, and clean facilities. Furman wanted to create a similar reputation for real estate investors. Ethical behavior was a requirement for anyone who joined his franchise network. Ethical behavior required truthfulness as well as following through on any commitments made by a franchisee to a customer. Ethical behavior also included following the law, including the terms of a franchise agreement. Furman's franchise training program included a session dedicated to ethical behavior in real estate investing. As part of the training, Furman contracted with a real estate attorney to speak to his franchisees. He stressed the importance of "doing business by the letter of the law." He often told his franchisees that there would never be a "second chance" for a franchisee who violated a real estate law, whether it was a national or local law. The franchise contract of any violating franchisee would be immediately terminated. Furman made certain that the franchise contract he used when he sold a franchise gave him the right to cancel the contract if a franchisee lied or knowingly provided misleading information.

While there were other experts around the USA teaching people how to become real estate investors, only Furman and Real Property Investors, Inc. offered franchises. More and more would-be investors wanted to join RPI and become franchisees. More and more property owners hoped

to sell their properties to RPI franchisees, who quickly developed a reputation for making an honest offer and closing the deal within days, meaning that the sellers received their money in quick order. While franchisees were not required to borrow money from Furman to purchase properties, most RPI franchisees would eventually do so. Franchisees started out buying one house at a time. Some franchisees bought multiple houses monthly. Eventually, the top producing franchisees were buying more than 100 properties annually! Most franchisees who bought more than two or three properties needed to find sources of capital, which included borrowing money from RPI or other “hard money” lenders.

At the time of this story, RPI included 95 franchise locations in the United States and primarily in Ohio, Michigan, Pennsylvania, Indiana, Kentucky, Georgia, Florida and Texas. Acquiring an RPI franchise required an investment between \$78,000 and \$103,000, depending on the size of the territory. In addition, franchisees were required to spend at least \$6,000 per month for advertising – mostly consisting of the firm’s famous TV ad. Most RPI franchisees said they invested in the business for two primary reasons:

- First, to learn how to become successful real estate investors, which RPI promised to teach.
- Second, because they needed a steady supply of leads from potential home sellers.

How A Franchisee Can Sell to a Prospective Buyer

In 1997, a couple, the Bowmans, were looking to buy an RPI franchise in Palm Beach County, Florida. They contacted Furman and he explained that the market was sold out, but he would introduce the Bowmans to an existing franchise in Palm Beach Gardens, William R. Nolan, who might be interested in selling his business. Nolan had purchased his franchise in 1989, was 65 years old at the time, had expressed the desire to sell so he could move back to his hometown in Michigan. Nolan operated his franchise under the name, Florida House Buyers, Inc. He quickly agreed to meet the Bowmans.

Furman was relieved that Nolan wanted to sell his franchise because Furman considered Nolan a “needy” franchisee who complained frequently. Furman also suspected that Nolan underpaid royalty dollars due to RPI, but he could not prove it. What irritated Furman most was that Nolan had on more than one occasion told a prospective franchise buyer not to buy an RPI franchise because he didn’t think it was worth the investment! Meanwhile, Furman had taught Nolan how to succeed as a real estate investor and Furman knew, based on the number of houses Nolan reported buying, that Nolan had done very well financially. Furman never openly expressed his feelings about Nolan, but members of his corporate team knew how he felt. There were even some concerns by Furman that Nolan was not always ethical in his real estate dealings. Given these circumstances, Furman already had decided not to renew Nolan’s franchise license, but he had yet to inform Nolan of that decision. RPI franchise licenses were sold for 10 years after which time they could be renewed

for another 10 years. However, both franchisor and franchisee had to agree to the renewal. Furman had already decided not to renew Nolan’s license so it was fortuitous that a prospective buyer – the Bowmans – came onto the scene.

In a situation where an existing franchisee offered a franchise for sale, the existing franchisee, and not the franchisor, established the sale price for the business. At this time, the cost of a new RPI franchise was \$50,000 plus required funds to advertise the business. But in a market where RPI had no additional licenses to sell, the local franchisees could establish the market price for a franchise. RPI still held the right to approve the buyer who would then become an RPI franchisee, but RPI did not get involved in establishing the sale price for the existing franchisee’s business. RPI also would not get involved in any negotiation between a franchisee and a buyer. After Furman introduced the Bowmans to Nolan, Nolan set a value for his business and eventually the two parties entered a negotiation.

Nolan made sure the Bowmans were aware that they would have to meet RPI’s requirements to officially become franchisees. But he didn’t think that would be an issue especially since Furman, the franchisor, had introduced the Bowmans to him. Would Furman introduce a prospective franchisee who he would not approve for the purchase of a franchise? Nolan didn’t think so.

Furman explained to the Bowmans that they had to complete RPI’s franchisee application, provide comprehensive financial information to establish their financial qualifications, and ultimately, complete RPI’s franchisee training program. In addition to whatever amount of money the Bowmans agreed to pay to Nolan for his business, the Bowmans also had to pay the franchise fee of \$50,000 to the franchisor, RPI. In addition to the franchise fee, the Bowmans would have to demonstrate that they had at least another \$50,000 to devote to working capital, which would include the initial costs for advertising the RPI business.

After several weeks of negotiation, the Bowmans finalized their deal with Nolan and submitted the franchise application with required documents to RPI. The Bowmans stated that they paid Nolan \$350,000 for his franchise. The Bowmans also stated that they had additional cash assets of about \$150,000 and RPI confirmed that information with the Bowmans’ bank in Florida.

RPI accepted the Bowmans’ franchise application and the Bowmans paid RPI a \$50,000 franchise fee. RPI scheduled the couple for franchise training to occur at the franchisor’s Ohio headquarters for 8 days. The franchise fee was refundable up until the Bowmans completed the first 8 hours of RPI’s franchise training program. In other words, if the Bowmans decided they did not want to become franchisees of RPI, they had until the end of the first day of franchisee training to get their money refunded. However, Nolan would not be required to refund the \$350,000 the Bowmans paid to him. That sale was already completed and it was between Nolan and the Bowmans and did not include the franchisor. Nolan had accepted the funds and moved back to his home state.

The Ethical Dilemma the Franchisor Confronts

On the fourth day of the RPI franchisee training program that included the Bowmans the Vice President of Operations for RPI, Lance Craven, approached Furman in his office and said there was a potential problem with the Bowmans. Craven oversaw the training program and participated as a course instructor. He said there was evidence that the Bowmans had misrepresented their financial information when they submitted it to RPI to be accepted as franchisees. While socializing during lunch on day four of training, Mrs. Bowman was overheard saying to another franchisee that she was concerned about money. “We paid too much money to the franchisee who owned our territory,” she explained. The other franchisee asked her, “How much did you pay?” and Mrs. Bowman said, “About \$450,000. And that’s about all the money we have.”

When Craven overheard this discussion he knew that the Bowmans had stated they had paid \$350,000 for the franchise. At the time of the sale between Nolan and the Bowmans, RPI executives including Furman and Craven were impressed by the sale price. During a meeting when it was reported that the Bowmans had paid Nolan \$350,000, Furman said he was happy for Nolan, even though he didn’t particularly like him, and happier for other franchisees in the Palm Beach market because they now knew their businesses might also be worth at least \$350,000. If Nolan could sell his business for \$350,000, others (with comparable sales performance) could, too. This also meant that franchisees in other “sold out” markets would be able to sell their franchises for a premium. “That’s the way it should work,” Furman told his executives. “If a franchisee invests with us, we want them to be able to sell their business for more money when they decide to retire or move on.” But Craven’s information was alarming. If, in fact, the Bowmans paid \$450,000 to Nolan for the franchise territory then they might not have the additional capital necessary to qualify as franchisees. The VP thought the CEO should be informed of the situation. If the CEO was going to consider voiding the Bowmans’ franchise agreement it would be better done sooner than later. RPI shared what it considered confidential information during training and once the information was shared with the franchisees it could not be recovered. That’s why RPI offered a refund of the franchise fee only through the first day of training. Beginning with the second day of training RPI shared proprietary and sensitive information related to building a business as a real estate investor. Some of the information was considered “secret” to the RPI franchise network. Once the Bowmans had this information it could not be taken back from them. They could use the information and compete with the other RPI franchisees in Palm Beach County who would then be upset with RPI for sharing information with a competitor. Of course, the franchise contract the Bowmans signed also included a “non-compete” clause, but RPI had never tried to enforce that clause. No matter how they looked at it, Craven’s news was troubling, and Furman had to make a decision.

After hearing from Craven, Furman decided to meet with the Bowmans. He wanted to meet immediately but it was already late afternoon by the time Craven shared the news and the franchisees in training had all returned to their hotel for the evening. “Get word to the Bowmans tonight at their hotel that they need to come to my office upon arrival tomorrow at headquarters,” Furman instructed Craven.

The next morning the Bowmans entered Furman’s office and they were visibly uneasy. Furman was not his friendly self. He was now in business mode. He had spent the evening thinking about his options, none of which was good. He hated the thought that franchisees had lied to him. A franchise relationship is built on trust between franchisor and franchisee. If Furman thought he could not trust a franchisee he’d rather not have that franchisee in his business network. His first mission during the meeting with the Bowmans was to get the truth from them. *How much did they pay Nolan?* If it was any number other than what they reported, Furman would have to make a difficult decision, one he’d never made before. The way he saw things, if he found out the Bowmans had lied, he had three choices:

1. Void the Bowmans’ franchise agreement and keep the \$50,000 franchise fee.
2. Void the Bowman’s franchise agreement but refund all or part of the \$50,000 franchise fee.
3. Let the Bowmans complete franchise training and if they succeeded, they would become franchisees. But put them on formal notice.

Furman didn’t like any of the choices. He hated the idea of what his decision might mean for the Bowmans. The franchise agreement was very clear. Furman had the right to void a franchise agreement if a franchisee committed fraud and it was fraudulent for the Bowmans to misrepresent the sale price they paid to Nolan as well as the financial information submitted to RPI. Furman also had the right to keep the \$50,000 franchise fee especially since the Bowmans were still in training after the first day. He could send the Bowmans home with nothing – they would no longer be RPI franchisees, and they would forfeit their \$50,000. And even if Furman graciously decided to refund all or part of the franchise fee, which he did not have to do, he knew that Nolan was not going to refund the money the Bowmans paid him – that amount was either \$350,000 or \$450,000. The Bowmans would lose that money! But if Furman decided to let the Bowmans complete franchise training and graduate as full-fledged franchisees in the Palm Beach County market, they had to meet the advertising requirements. If they had less working capital than they had reported at the time of becoming franchisees, they would be short of cash, and if they could not meet their advertising requirements that would jeopardize the performance of other franchisees in the Palm Beach County market. Jeopardizing the work outcomes for other franchisees was not something Furman wanted to think about.

Franchisees depended on each other to pay the minimum advertising requirements in a market. Franchisees depended on RPI to verify that a franchisee had the money to invest and to pay for ongoing advertising. Doing less ad-

vertising would result in fewer opportunities to buy houses for all of the franchisees. Fewer transactions not only negatively impacted the franchisees, but it also negatively impacted RPI, which collected a royalty fee every time a franchisee purchased a house. Franchisees could be angered knowing that the Bowmans were not paying their fair share of advertising. Why did RPI allow that to happen?

At one point Furman worried that the other franchisees might turn on RPI. The situation was not going to be resolved simply by voiding the franchise contract and sending the Bowmans home with nothing. The Bowmans already had benefited from the four days of training they had received. They were given information and insights to the success of RPI franchisees. They had been exposed to RPI's "secret sauce," so to speak, and once it was shared with them it could not be "un-shared." If the Bowmans returned to Palm Beach County and decided to compete with RPI's local franchisees, Furman imagined the local franchisees might have a legal case to bring against him and his company. He had never been sued by a franchisee and he wanted to avoid a lawsuit at all costs. Still, a decision had to be made. He couldn't just ignore it. He prayed that Craven's information was wrong. Or if it was correct, and the Bowmans had paid \$100,000 more than reported, perhaps the Bowmans would have access to additional working capital, and they could meet the advertising requirements. It would be easier, Furman thought, to deal with them lying about the sale amount if they could still meet the requirements of the franchise agreement.

When Furman saw Mrs. Bowman sit down across from him and immediately start sobbing, he knew the worst was about to come. Furman broke the ice. He said, "Good morning" and he slightly smiled. Franchisees knew Furman had a friendly personality and that's part of what endeared him to them, but he was troubled as he began to speak to the Bowmans. He slowly explained what he had heard without revealing all the details of who reported the information to him. When he finished talking, he looked silently at the Bowmans and then said, "Please tell me what happened."

Mr. Bowman immediately admitted the information was true and justified himself. "The franchisee we bought the territory from, Nolan, told us not to tell you the real purchase number."

"Why would he do that?" asked Furman.

"I don't know," Mr. Bowman replied. "But Nolan knew we would not meet your financial requirements to buy the franchise if we revealed how much we actually paid and how much working capital we actually had left."

"So you lied?" asked the CEO.

Mrs. Bowman's sobbing intensified and she said, "Please don't take the franchise away from us. We will lose all our money."

"I understand that," Furman replied, while speaking slowly in hopes of not agitating Mrs. Bowman all the more. "But I'd like you to understand that franchising is built on a trust relationship. If you lie to us about how much you paid for another franchisee's business, why would we think you'd tell us the truth about anything else? We're always going to be thinking we can't trust you. So when you report

activity about your business, or you pay your royalties, or you tell us what you're going to do, we're always going to suspect that you are not telling the truth. We're always going to think you're hiding royalties from us. Do you understand that?"

The Bowmans both responded yes and apologized. "I wouldn't normally lie about something like this," said Mr. Bowman, "but we want to get into this business so badly that I was willing to lie in this situation. Besides, my wife's father is about to give us \$250,000 and so we'll have more than enough money to get our franchise started."

Furman perked up at that information. "When are you going to get this money?"

Mrs. Bowman said, "It's not for sure, but we think we'll get it in thirty days."

"So you don't know that you will get it?" asked the CEO.

"No," said Mrs. Bowman. "I talked to my father about it and told him that I needed some money and we talked about \$250,000. That would give us money to invest in our franchise and also to pay some bills that we have. He said he thought he could get the money to us in about forty-five days and that was two weeks ago."

"What are you going to do if you don't get the money?" the CEO asked.

"I don't know," cried Mrs. Bowman. "But we can't afford to lose half a million dollars. Please." She looked at her husband and said, "We should not have done this."

"You should not have done what?" asked the CEO.

Mr. Bowman looked at his wife and said, "It's going to be okay." Then he told Furman, "My wife is upset but it's going to be okay. If her father doesn't give us the money we will get it another way. I've been in the real estate investment business for several years already and I know how to make some quick money. You know that I own some rental properties and I could sell them to raise some cash. It will be okay."

"Did you report those rental properties in your financial statement?" the CEO asked.

"Yes, of course. I don't make it a habit to hide information from people in a situation like this. I'm an honest businessperson." Said Mr. Bowman.

The CEO looked at him for a long moment and said, "Franchising doesn't work, or doesn't work as well, unless both the franchisor and the franchisee are honest business people. Honesty is very important to me personally and professionally. We have a large network of real estate investors and it's important that all of them operate ethically at all times. That means telling the truth and doing what's right all the time. One franchisee's dishonesty can negatively impact other franchisees. If the marketplace begins to think that we are not honest businesspeople our brand name is in trouble. This is a very serious matter. Your actions could jeopardize other franchisees in Palm Beach County and I've got to take all of that into consideration. You've put me in a very bad situation."

"Are you going to take away our franchise?" Mrs. Bowman pleaded.

"I don't know," Furman said.

“Please don’t do that,” she continued. “We’ll do a good job. We already know the other franchisees in the market, and we can all work together. We know how to buy and sell properties. We’ll make you a lot of money if you give us a chance.”

“Mrs. Bowman, I appreciate that, but making a lot of money isn’t what this is all about. We don’t sell franchises just to make money. We have an obligation to each other and to our customers to do the right thing. Doing the wrong thing and making a lot of money just doesn’t work for me.”

Furman continued by telling the Bowmans that he was disappointed that they had put him in a situation where he was being forced to make a difficult decision. “I do thank you for being honest this morning and I appreciate your time. I wish we didn’t have to meet like this.” The CEO then went on to deliver the decision that determined whether or not the Bowmans would continue to be HVA franchisees.

Conclusion

This case study reveals the importance of truth in franchising and how failure to reveal truthful information required by a franchisor can jeopardize a new franchisee’s relationship with the franchisor. In this case the franchisees could lose their franchise license and if that occurs the franchisees will forfeit not only their franchise fee but additional money they paid to acquire an existing franchisee’s business. Upon selling an existing franchise business, the selling franchisee has a lot of leverage, but the ultimate decision to sell or not to sell almost always rests with the franchisor. An existing franchisee cannot control who a franchisor selects as a succeeding franchisee. It’s important for franchisees who acquire an existing franchisee’s business to follow the franchisor’s requirements as outlined in the Franchise Disclosure Document and then provide truthful information about the terms of the sale consummated with the existing franchisee. If discovered, dishonest answers could result in the franchisor denying a sale or voiding the sale after it was agreed upon.

Questions for Discussion

1. If you were the CEO, what decision would you make to resolve the matter? Explain the decision. Describe in detail why you made that decision.
2. Where did this matter go wrong? Who’s to blame? And what, if anything, could have occurred to prevent

this type of situation? What, if anything, could the franchisor have done to prevent this situation?

3. List and describe the consequences that would occur if the CEO decided to terminate the Bowmans’ franchise license. What are the consequences for the Bowmans? What are the consequences for RPI?
4. What responsibility, if any, does the franchisee (Nolan) who sold his business to the Bowmans share in this matter? Can RPI or the Bowmans take any action against him? Can he be held accountable for any of the consequences?
5. If the Bowmans remain franchisees of RPI, how do you think you, as an executive of RPI, would perceive and treat the Bowmans going forward? If you’re the CEO or the Training Director or the Operations Director would you trust them? When they answer a question, or work with a customer, or pay their royalty . . . would you trust them? If yes, present your rationale and elaborate. If no, present your rationale and elaborate.
6. How do franchisor and franchisee value and maintain a relationship when one party doesn’t trust the other?
7. As the CEO of RPI part of your responsibility is to protect the company’s intellectual property. Intellectual property was shared with the Bowmans during franchise training. If the decision is to terminate the Bowmans’ franchise license and prevent the Bowmans from continuing with training, what steps would you take to protect RPI’s intellectual property?
8. When the Bowmans purchased the franchise from Nolan, they received confidential information from that franchisee. For example, the franchisee gave them his local database of buyers and sellers. The information also included contact information and relationship details about vendors/suppliers of RPI. The sale also included some leads – people who had contacted the existing franchisee to sell their house – the Bowmans would have the opportunity to follow up with those leads and acquire properties. If the Bowmans are not franchisees of RPI, but they have access to this information and to these opportunities, does that present challenges for RPI? Answer that question in detail.

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