



# Federal Judge: Franchising Sounds Like Ponzi Scheme

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Is franchising "a modified Ponzi scheme?" Last week, a federal judge said it might be.

Janitorial franchises have long been a source of embarrassment for the franchise industry, and frequently attract purchasers with few assets and poor command of English. [A 2001 report](#) by the [GAO](#) on FTC [enforcement](#) of the [Franchise Rule](#) found that from 1993-2000, [Coverall](#) violations had affected **2591** investors, and [JaniKing](#) violations affected 900 investors.

Coverall is one of the largest franchisors, and has been aggressive in making earnings claims; [in an August 2009 interview with \*Franchise Times\*](#), reporter Julie Bennet quoted Coverall making this claim:

Jacqueline Vlaming, Coverall's general counsel, said, ***"Every franchise owner who runs it like a business can make money."***

Pius Awuah and 10 other franchisees related similar stories:

1. They paid Coverall North America a "franchise fee" in exchange for which
2. They were promised a minimum dollar amount of client accounts to service each month.
3. Coverall entered into the contract with the clients and billed the clients.
4. Coverall assigned the franchisees to clean the client premises, and
5. Coverall would remit money to the franchisees after deducting various charges.

The franchisees alleged in their [Complaint](#) that they were never given the amount of business they had been promised, and that the degree of control which Coverall exercised over them meant that as a matter of Massachusetts law that they were really employees of Coverall.

After filing suit, the franchisee attorneys uncovered damaging information and Coverall moved to seal court documents. In an interlocutory appeal, a 3 judge panel of the 1st Circuit [Court of Appeals said](#) in October 2009:

*Coverall has been charged--it has not been found liable in this case--with activities that could be viewed as highly unattractive[cite omitted]*

*It is not necessarily the disclosure **to competitors** that makes the district court's order a matter of concern. Others, including enforcement agencies and potential plaintiffs, may find the disclosures of interest in ways that would not serve Coverall's interests. [emphasis underlined in original]*

The lawsuit continued and on March 23, 2010 the District [Court ruled in favor of the "franchisee" plaintiffs](#), holding that they are in fact employees.

What has attracted attention within the franchise community is the Judge's comments about Coverall's assertion that its business was actually the sale of franchises. Traditionally industry trade groups such as the IFA have maintained that franchising is **not** an industry but rather a business model (although the IFA has on other occasions defined franchising as an industry).

Judge Young stated:

*Describing franchising as a business in itself, as Coverall seeks to do, sounds vaguely like a description for a modified Ponzi scheme – a company that does not earn money from the sale of goods and services, but from taking in more money from unwitting franchisees to make payments to previous franchisees.*

The Judge went on to say that he believed that in fact Coverall was in the business of janitorial services and that under Massachusetts law the "franchisees" were really employees of Coverall. But the use of the term "**Ponzi scheme**" and the interlocutory ruling have caused this case to gain wide attention.

An interesting issue [raised by franchise law firm Nixon Peabody](#) is the impact of the Massachusetts statute and case law on post-term non-compete clauses.

The IFA issued a [press release](#) criticizing the ruling as a threat to franchising in Massachusetts. As far back as 1998, the IFA took the (then) unheard-of step and filed an *amicus* brief opposing a janitor who filed for unemployment after being fired from his job at [West Sanitation Services](#). (*Matter of Francis*, 688 N.Y.S.2d 55)

A bigger threat to Coverall might be the bad publicity which has caused it to lose contracts with Boston-area clients such as Legal Sea Foods and [Cheesecake Factory](#) (NASDAQ: CAKE). Both restaurants paid Coverall, but the mostly Hispanic cleaning staff did not get paid.

Coverall said it had properly sent money to the Boston "franchisee" and that it bore no responsibility for seeing that the workers were paid. After media reports, Coverall paid the wages. Legal Sea Foods terminated Coverall due to concerns about worker mistreatment, Cheesecake Factory terminated Coverall due to a number of concerns, and the Massachusetts Attorney General is investigating the janitorial industry, according to the [Boston Globe](#).

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***Awuah et al v. Coverall***, D. Mass. 1:07-cv-10287, March 23 2010

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