



Wisewould Mahony | Lawyers

Franchisee Fraud

Should the Franchisor terminate without notice?

Introduction

When acting for franchisors, an issue will often arise where a franchisee is clearly acting in a fraudulent manner. Should the franchisor confront them, disclose the information it has and give them a right of reply, or just terminate?

The Franchisor might have clear evidence of fraudulent activity. There are still risks in terminating a franchisee without notice, even though the Franchise Code gives franchisors that right.

Normally, the Franchising Code of Conduct requires franchisors to provide notice of an intention to terminate. Clause 23(f) of the Code, however, gives the franchisor the right to terminate immediately without giving notice and without giving a reasonable time to a franchisee to remedy the breach where the franchisee is “**fraudulent in connection with the operation of the franchise business**”.

What is fraud?

Fraud is not defined under the Code. A common legal definition of fraud is “**an intentional dishonest act or omission done with a purpose of deceiving**”. A franchisor needs to be extremely cautious in relying on this provision of the Code to terminate a franchisee. Each case must be examined on its own facts.

Is it fraudulent for a franchisee to fail to account for takings or deliberately doctor the weekly takings and alter its POS system? What evidence do you need and how much to support the allegation of fraud? There are many grey areas when dealing with allegations of fraud.

The risk a franchisor runs is an allegation by the franchisee that they have acted unconscionably. The franchisor may be ordered to pay damages and the individual director and officers may be made personally liable.

Like any consumer Code, the Franchising Code of Conduct protects the party considered to be at a disadvantage, the franchisee. The Code is aimed at protecting franchisees and ensuring minimum standards are complied with. Franchisees make a substantial investment, particularly with a retail franchise where the upfront capital costs could be in the order of \$250,000.00 to \$500,000.00.

The franchise’s return on investment can only be recovered from the business activities over the term of the Franchise. If the franchise is terminated at an early stage, the franchisee has no ability to get a return on its investment and will undoubtedly crystallise a loss.

The Courts are mindful of protecting the interests of a franchisee on the basis that the franchisor is in a dominant position, and retains the goodwill and has the ability to bring in a new franchisee and/or on sell the franchise after termination.

On one view, a franchisor may well consider it has the evidence of dishonest conduct. The franchisee may nevertheless allege the termination without notice was inappropriate and unconscionable and seek injunctive relief under the Trade Practices Act (section 80 or 87) 1974 (Cth) or alternatively rely on the Court's power to grant injunctive relief.

The decision by a franchisor to terminate without notice must be carefully considered due to the franchisee's rights, both prior and post termination.

The case of *Bingham v 7-Eleven Stores Pty Ltd* considered the issue of alleged franchisee fraud and the validity of immediate termination notices.

In this case, a termination notice was issued. The franchisees lawyers requested particulars of the alleged fraud. The response by the franchisor's lawyers was 'not able at this stage to provide you with material that evidences fraudulent operation by [the franchisee]'. The franchisee sought an injunction preventing the franchisor from acting on the termination notice. As is often the case, the Court granted an interlocutory injunction. The matter progressed to trial. The franchisor failed to adduce evidence of the alleged fraud, and was restrained from acting on the termination notice. An appeal to the Queensland Court of Appeal by the franchisor was dismissed.

The Test

The case seems to balance the right of a franchisor to terminate without notice against the irreparable harm to a party (the franchisee) arising from the termination.

There has been a shift in that the Courts have imposed a greater burden on franchisors to establish that there is fraud, or a risk of further fraud occurring.

Current decisions seem to suggest that where a franchisor has credible evidence of fraud (irrespective of the gravity of the fraud), they should have the right to terminate without notice, without fear of injunctive relief being granted to the franchisee.

However, this does not prevent a franchisee from seeking or threatening injunctive proceedings preventing the termination.

It is important therefore to consider the evidence of fraudulent conduct and have it analysed objectively by legal advisors before terminating.

Other risks to the franchisor post termination

A franchisee will undoubtedly allege that the franchisor has acted unconscionably where there has been a termination for fraud, particularly where there is some doubt.

Allegations of unconscionable conduct are difficult to prove by a franchisee. There are implied terms of good faith and fair dealing. The case of *Priority Management Systems NSW 2007* established that the implied term of good faith requires a franchisor to exercise its powers under the Franchise Agreement **reasonably and honestly, considered objectively and not rely on information provided by third parties.**

Other considerations are:

- whether the franchisor acted for some "ulterior motive" or was acting legitimately to protect its commercial interests;
- whether the franchisor stands to benefit from termination after taking control of the business.

The Judge in the Priority case, suggested that it is not likely that exercising a termination right would be unconscionable by a franchisor in equity, where the franchisor had not

engineered or contributed to the default and the franchisor was protecting its legitimate interests by terminating the Contract, for example, by ensuring it can collect its own franchise and other fees.

Conclusion

Ultimately, there are risks for franchisors in terminating without notice. The franchisee has equitable rights and rights under the Trade Practices Act. Termination without notice should be carefully considered by franchisors as an action of last resort and only where there is clear evidence of fraud.

Raising the allegation of fraud with the franchisee may be an option. This will give the franchisee a right to respond and provide an explanation. That will aid the franchisor's case against any allegation of unconscionable conduct.

Proceeding to mediation may be an option before terminating without notice, however in some circumstances that may be adverse to the franchisor's interests.

It may well be that there is no option but to terminate a fraudulent franchisee. That could be the case if there is compelling evidence that the franchisee has acted in an intentionally dishonest way and their conduct is likely to continue to cause loss to the franchisor and possibly to the franchise system as a whole.

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