

Buying a Franchise and related Purchasing of Business Contracts, Leasing & Finance/Guarantor Arrangements

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Tom has over 25 years' legal and business experience including:

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- Previously being the WA Legal Technology Group Manager for a National Law Firm;
- Owning and managing an IT consultancy business; and
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He is also a regular publisher of articles and is one of Australia's leading presenters of legal seminars to and for various professional bodies, associations and government authorities on a wide range of business law and professional development-training topics including:

WA Department of Commerce • Chartered Accountants Australia and New Zealand • Law Society of WA • Innovation Centre of WA • LegalWise CLE • The Tax Institute • Institute of Public Accountants • Governance Institute of Australia • National Electrical & Communications Association (WA) • Australian Hotels Association (WA) • Small Business Development Corporation • Australian Institute of Conveyancers (WA) • CPA Australia • Mortgage & Finance Association of Australia • City Insolvency Discussion Group • Forum for Directors of Indigenous Organisations (FDIO) • Stirling Business Centre • Institute of Certified Bookkeepers • Western Suburbs Business Association • Business Foundations Inc. • WA Business Assist • WA Reckon Partners • WA Indian Docs Inc.



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This seminar is not legal advice and must not be relied on as such.

The information presented in this seminar is intended only as a guide, as to the topic and the matters discussed.

If you have a matter which relates to this seminar or you require legal advice, careful review and analysis of your matter's particular facts, information and documents are required before proper legal advice can be given or applied to that matter.





Overview

- A. Purchase of Franchise Business Agreement.**
- B. Franchise Agreement and Disclosure Document.**
- C. Franchise Business' Lease/Licence-to-Occupy.**
- D. Loan and Security for Payment/Guarantor documentation.**
- E. Franchisee Independent Advice Certificates.**

What is a Franchise?

- Not absolutely legally certain.
 - Broadly described as an arrangement where:
 - one party (the Franchisor) allows another party (the Franchisee) to operate a business under:
 - a brand (e.g. a trade mark); and
 - a system (e.g. operations manual),
- that provides goods and/or services (e.g. parts and labour) in consideration for a fee or royalty.

See s. 5(1) of Franchising Code for definition of a “franchise agreement”

<https://www.legislation.gov.au/Details/F2014L01472>

Franchise Systems

- ✓ Franchise industry in Australia is strongly regulated and well established.
- ✓ Regulated by the *Competition and Consumer Act 2010 (Cth)*.
- ✓ Regulator is the Australian Competition and Consumer Commission (ACCC).
- ✓ Franchising Code of Conduct applies.
- ✓ Must comply with the Trade Practices (Industry Codes Franchising).
- ✓ Highly involved and requires appropriate consultation with professional advisors (e.g. lawyers, accountants, franchise consultants).



A. Purchase of Franchise Business Agreement

From the buyer-franchisee-lessee's perspective, buying a franchise business may be exciting *BUT FIRST*:

- Remember the Seller is usually:
 - not the franchisor for an existing franchise but rather a third party, outgoing franchisee (why?); or
 - if the franchisor, commonly through a related entity and for 'greenfields' (i.e. new) 'untested' site (note: rarely 'territories' now!)
- If a broker is involved and/or the franchisor is facilitating the sale, remember they do not act for the buyer. Therefore the buyer must get independent, professional advice and representation.
- Ensure correct franchisee entity establishment (e.g. usually a family trust using a corporate trustee. Unless intending to have other 'non-family' equity holders, then use company with shareholders agreement etc).

A. Purchase of Franchise cont'd

Mandatory conditions precedent:

- Subject to due diligence – both financial and legal:
 - Financial Statements
 - P&E Depreciation Schedules and actual inspection.
 - ASIC, ABN, and PPSR & Credit search
- Satisfactory review and acceptance of Franchise agreement and Disclosure Document*
- Satisfactory review and acceptance of current Lease/licence to occupy**.



A. Purchase of Franchise cont'd

- Satisfactory review all employee details (e.g. notices, complaints, workplace incidents), entitlements and contracts/awards; and
 - Subject to unconditional Finance Approval***
- Only then consider paying a non-refundable deposit.

Deposits

- How much? - Usually no more than 10% of purchase price and commonly much less (but for the Seller, ensure that its not a nominal amount too)
- Up-front and refundable until/if settlement?
- Single or 'phased deposit(s)' ?



A. Purchase of Franchise cont'd

Purchase Price and Adjustments

- Purchase Price = P&E plus Goodwill* and PSAV .
 - However, franchises, remember there will also most likely be franchisor documentation and training fee, the exiting Seller franchisee will also be paying an assignment fee) plus deposit and the like
- P&E agreed to be higher than written down-down value. What are the tax consequences to Seller.
- In relation to “goodwill” for franchisee businesses, very important note such is *nominal*. As no ownership or any of the business’ IP, clients/ Customers and the like post-termination of franchise...



A. Purchase of Franchise cont'd

Stock and valuation

- 'Estimated Stock' level to be at settlement.
- Aged and good-condition stock?
- Stock-take adjustment mechanism and still proceeding with settlement.



Settlement

- Settlement "Date" - highly recommend the later of:
 - the parties' desired, specific date; and
 - say, (at least) 2 business days after last of the conditions precedent met or waived by Buyer.
- Also, has the buy considered Stamp/Transfer Duty and Working Capital requirements?



B. Franchise Agreement & Disclosure Document

What the Buyer needs be given (and review):

- The current:
 - *Franchise Agreement* (which needs to be in final form)
 - Disclosure Document (check date of issue. Not ‘financially refreshed’ until 1 November). This will also include *the Franchising Code*.
- Franchisee (personal) *Guarantor* documents,
- any related, mandatory franchise supply or licence contracts ; and
- *the Information Statement* (read this first!)
<https://www.accc.gov.au/publications/franchisor-compliance-manual/the-franchisor-compliance-manual/pre-entry-disclosure-and-cooling-off/information-statement>

B. Franchise Agreements cont'd



What the Buyer needs be given (and review!):

- They need to be fully aware this will be a substantial/confronting number and volume of legal documentation, but must be read and understood by the proposed franchisee.
- In the Franchise Agreement: be very sure to carefully check the schedule of all the fees and charges specific to this franchise, and that such aligns with what is in the disclosure document.
 - e.g. Franchise Fees I.E. Royalties, Marketing Levies, Local Promotion Sums, Minimum Performance Criteria, Systems Licenses etc.
- In the Disclosure Document: non-legal advisors need to work very carefully through all the franchisor's stated Establishment and ongoing Franchise costs (plus help prepare model budgets & cashflow forecasts etc)

B. Franchise Agreements cont'd

What the Buyer needs be given (and review!):

➤ In the Disclosure Document:

- Work very carefully through all the Franchisor's stated Establishment and Ongoing Franchise cost\$.
- Ensure they contact as many as possible of the current and former Franchisees of the system (details of which are specified in the DD);
- Do due diligence on the Franchisor – not just their financial information, but also check their:
 - Intellectual Property (IP) rights; and
 - whether the ACCC has noticed issued any infringements or penalty notices against them
<https://www.accc.gov.au/business/industry-codes/franchising-code-of-conduct/franchising-penalties-infringements>



B. Franchise Agreements cont'd

What the Buyer needs know:

- Once they are in a franchise agreement, there are *very limited options for them to be able to easily get out of such* i.e. they will need to be able to sell or have the franchisor buyback (rare).
- If they simply 'walk away' this can be (and usually is) financially-apocalyptic; not just for the franchisee but also for the guarantors.
- Franchise Agreements still have one of the most draconian contractual provisions of many purported 'independent contractor' arrangements:
 - namely that, upon default and termination, a franchisor can simply buy-back just the franchisee's P&E and stock and pay nothing for their goodwill (i.e. clients and whatever nominal goodwill earlier paid). This because the franchisor already 'owns' all Franchise's IP, goodwill, clients etc...

B. Franchise Agreements cont'd

What the Buyer needs know:

- A franchisee needs to understand they usually have a very finite life expectancy within the franchise business (7 years is long),
- This largely determined by the shorter of:
 - the length of their franchise agreement and their lease
 - LESS any reasonable period of time in which they may be able to on-sell such with sufficient term remaining,
to another buyer/franchisee so that that person can obtain an ROI.
- For example, in a Shopping Centre retail franchise, they are *rarely longer than 5 year terms* on both the franchise and lease.
- Therefore, arguably, the franchisee will need to start thinking about selling their business in this 2nd or 3rd year of the franchise business, at the latest!





C. Lease and Occupancy Rights

- No.1 one thing to check first, before even considering buying the business and/or taking on a franchise, is there sufficient Term (together with any options to renew) to achieve a realistic Return on Investment (ROI)?
- Remember the term of lease is quite often *independent of the term of the franchise*.
- Sometimes a direct Lease with an independent Lessor (which will commonly mean the franchisor will require a tripartite "right of re-entry").
- More commonly the franchisor, or their related entity, takes the (head)Lease and then either:
 - subleases; or
 - even just grants a 'licence to occupy' to the prospective franchisee.



C. Leases cont'd

- Therefore the Franchisor has more control' over the site. Especially if the franchise business' location involves valuable 'site-based goodwill'.
- Again the buyer will need to do substantial financial & legal due diligence on these occupancy rights, including the head lease and to make sure all the various terms costs and charges are 'aligned'.
- The Lease may also comprise prior variations, extensions & assignments.
 - Note: a compliant Disclosure Statement should also have been issued, if such occupancy rights are not being just assigned.
- Must check and understand the Rent Review provisions:
 - note: unlike Franchise Fees, commonly these *just go up* in a predetermined formula,
 - as opposed Franchisor Royalty and Marketing Fees, which *can travel up and down* on a % of turnover.

C. Leases cont'd

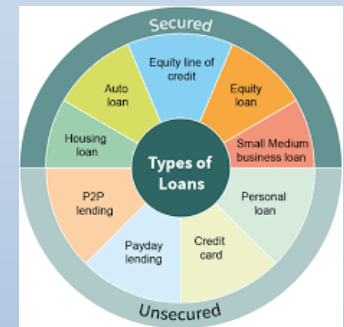
- Need to watch for things such as:
 - *Redevelopment and Relocation clauses* -
 - these can be financially crippling if invoked
 - *Security Amount/Bank Guarantee* (in addition to personal guarantees) –
 - they can tie-up working capital, and are rarely understood by the buyer in their original earlier (unrepresented) negotiations...
 - *'Make Good' and Yielding up cost\$* –
 - These can be particularly catastrophic for distressed franchisees who are unable to sell their franchise business or have such bought back by the lessor, or if they simply walk away from such...



D. Loans, Guarantees and Security

A franchisee needs to understand that there may be many financiers/ creditors of 'their' business:

1. This could be the *Seller*, possibly under a vendor finance arrangements
2. Their *Bank*, to help buy the business*;
3. The *Franchisor* for their fees and charges
4. The *Lessor* for the rent, out goings and other tenancy costs;
5. *Suppliers* to business, providing credit for stock and equipment; and
6. **Themselves personally* if they've actually had 'on-loaned' the those purchase monies and/or working capital to their franchisee entity**.





D. Loans, Guarantees and Security cont'd

A franchisee needs to understand :

- Any form of loan is highly likely to, in addition to registered securities, have personal guarantees:
 - in which in themselves may also have rights to taking securities may include but not limited to (unusually) mortgages and caveats; and
 - certainly security interests under the *Personal Property Securities Act*.
- However most persons don't understand these 'guarantees' actually are guarantees and indemnities.
 - Which, in addition to any guarantors usually also being joint & severally liable, have different much more adverse consequences and recourse by the creditor!

D. Loans, Guarantees and Security cont'd

- So where do all these creditors sit in terms of:
 - the priority of any of their related securities over each other; and
 - what about any 'guarantees that have been personally given by the franchisee's directors/key persons?
- Firstly, we're most likely talking here about *registered* security interests over 'personal property' registered on the **Personal Property Securities Register** (PPSR) <https://www.ppsr.gov.au/>
- If any such security interests exist but are not effected in time , they lose their priority and, if it's within 6 months of an insolvency event, then such may be unenforceable!



D. What is a “Guarantee” and What is an “Indemnity”?

Guarantee

- a) A contract of guarantee arises where one person contracts with another to pay some debt or perform some act or duty, owed by a third person who remains primarily liable for such payment or performance. (*Coutts & Co v Browne-Lecky* [1947] KB 104 at 111; [1946] 2 All ER 207 at 210)
- b) The person giving the guarantee only becomes liable on the default of the third person (*Turner Manufacturing Co Pty Ltd v Senes* [1964] NSWLR 692). Without a principal obligation, there can be no accessory obligation of guarantee.



D. What is a “Guarantee” and What is an “Indemnity”? cont’d

Guarantee cont’d

- c) The essential common law requisites of a guarantee do not differ from those of any other contract, and involve:
- the mutual assent of two or more parties;
 - competency to contract on the part of those entering into it; and
 - where the agreement is not under seal, valuable consideration, which may be entire or fragmentary.
- d) The absence of any one of these requisites is as fatal to the formation of the contract of guarantee as it is to the formation of any other contract.



D. What is a “Guarantee” and What is an “Indemnity”? cont’d

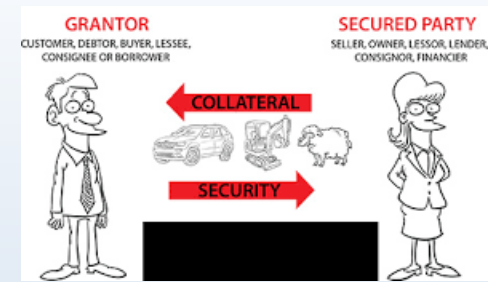
Indemnity

An indemnity may be defined as a contract by which one person agrees with another to make good all loss which that other person may suffer by:

- doing some act,
- exercising some forbearance, or
- assuming some liability,

at the request of the person by whom the indemnity is given or of some third party.





D. Loans, Guarantees and Security cont'd

- So who trumps who?
 - Like registering mortgages and caveats on land titles, are those security parties registering *first in time* takes priority over the other subsequent registered secured parties;
 - subject to any qualifying, other types of secured other security such as PMSIs and PPS leases.
- This could mean is that there could be up to 6 different secured parties/creditors secured over the franchise business and its assets by various parties.
- This can have dramatically different outcomes for those relevant, respective parties; dependent on who has priority who.
 - For example, if the franchisee defaults: both the franchisor and lessors want to claim an interest in the fit-out and P&E of the franchise business. Strategically, if the lessor outranks the franchisor, this can significantly, adversely affect the franchisor's buy-back intentions.



D. Loans, Guarantees and Security cont'd

Mum & Dad on-loans to their new Franchisee business entity:

- ❖ Very commonly individuals personally-borrow money and then loan that money on to their new entity to say: buy a franchise business, acquire equity, help provide a loan for working capital to help privately fund their business etc.
- ❖ Nowadays, for the preceding reasons, banks are not keen to lend directly against the franchise business itself. If they do, they take a huge level of other securities and personal guarantee secured by way first registered mortgage over franchisees personal parties etc.
- ❖ However it is still rare to find that (despite their being a 'bank' for their business entity and usually seeking their accountant's advice) individuals:
 - actually *act like a bank*; and
 - therefore also put in place the requisite finance document and security arrangements from the outset.
- ❖ Further I can absolutely assure you that a 'loan' merely written into a balance sheet has zero security effect...



D. Loans, Guarantees and Security cont'd

Mum & Dad on-loans to their new Franchisee business entity example

1. Mum and Dad are directors and shareholders (say through a family trust) of a newly-formed Company and they wish to buy a franchise business with the Company.
2. They use their home as both a source of equity to obtain a loan from a bank and establish a personal line of credit.
3. Mum & Dad then effectively:
 - On-lend this money to their new Company (i.e. an entirely separate entity but they think “Well, it’s my company too. So what do I have to worry about...”) to buy the franchise business
 - yet their informal/undocumented loan is not secured against their buyer Company...
4. * However the last thing you want to see is that later on down the track, then other parties (e.g. overdraft financiers, a lessor, franchisor, suppliers etc) have subsequently secured priority on the Company over and ahead of Mum and Dad.



E. Independent Advice Certificates

Independent advice for Franchisees

- Much recent legal commentary relating to franchising is focused on changes to the mandatory *Franchising Code of Conduct* , which came into effect in 2015, and other new or amended legislation that's affects franchising.
- However, many prospective franchisees are not aware or do not take advantage of the rights which were included in the original Code in 1998; including those related to independent advice.
- The Code requires that franchisors allow, and in fact recommends, that franchisees obtain *independent legal, financial and business advice*.
- Further, franchisees must provide signed certificates from those independent advisors or waive their right to seek such advice, having acknowledged the franchisor's recommendation to do so.

E. Independent Advice Certificates

What are your Duties and Obligations

1. Duty of Care vs. Franchisor's 'Duty of Explanation'.
2. Professional Conduct Rules 2010 Rules cf. APES 110 Code of Ethics (amended 2017)
3. Recommend not to act on a 'limited retainer basis', otherwise should also give a detailed disclaimer.
4. Consider relevant external advice to recommend, such as:
 - a) Accounting and tax advice; and
 - b) Licensed Financial Advice.

And vice versa!





E. Independent Advice Certificates

What sort of other advice and accountant or business advisor to provide?

- Accountants and business advisers can develop a financial strategy for the finite period of time that the franchisee will own the franchised business.
- Such a financial strategy should include, but not be limited to:
 - ✓ determining how the franchisee will fund the purchase of the franchised business;
 - ✓ determining the appropriate working capital required to operate the franchised business in the early stages and then moving forward;
 - ✓ assessment of the potential return on investment; and
 - ✓ determining break-even thresholds.
- This is in addition to the previous aspects of discussed about what will happen at the expiry or termination of a franchise and the appropriate exit strategy, together with all the other relevant financial advices and due diligence on the particular franchise business and system itself.



E. Independent Advice Certificates

Sample Pre-Guarantor Engagement Queries & Requests

1. Ensure you are dealing with only the guarantor, not the broker or borrower etc. Also speak with them ASAP (rather than just via email) as they are your client, and advise you will need ID verification confirmation at the meeting (e.g. driver's license or passport).
2. Have they read all the documents or undertake they will have before you meet - only confirm your meeting if this has been done.
3. Do they have a broad understanding of what is involved? (they're not "just signing some documents"...). Guarantors usually required to sign Franchise Agreement giving a *Guarantee and Indemnity*. Remember also all the other collateral aspects attaching to such i.e. the lease, business loans etc
4. Are they literate/ is English their first language (remember also to 'calibrate' your advice to the type client e.g. generally a related party (e.g. director of franchisee but can sometime also be the franchisee's parents...))
5. When are the signed and completed Guarantor Documents required by? (reminder: don't accept a grenade if you can't locate the pin...)
6. You should sight all relevant documents before giving any fee estimate (unless risk giving a 'fixed-price quote') for Guarantor advice.

Thank You!

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