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INTRODUCTION

Welcome to the HWL Ebsworth Newsletter for November.

In recent years, we have seen the abolition of a number of types of stamp duty in New South Wales. Effective 1 January 2011, stamp duty will be abolished on the transfer of business assets other than land. There are anti avoidance provisions designed to ensure that duty is payable on any pre 1 January 2011 transaction.

The Federal Government has now capped the guarantee of deposits in eligible Australian Banks, Building Societies and Credit Unions.

Franchise arrangements in the Australian retail sector are common. It is important for Franchisors and Franchisees to have a good working knowledge of the relevant property laws affecting their franchise and lease arrangements and to understand the effect of insolvency on these arrangements.

Government announcement – guarantee of deposits

In a move to support Australian Financial Institutions in the current economic climate, the Government has announced guarantee of deposits in eligible Australian Banks, Building Societies and Credit Unions.

Initially, the Government announced an uncapped guarantee, however it has since changed its policy after receiving pressure from the RBA and various economists to cap the guarantee. It is likely to extend to \$1 million, with a fee payable for amounts higher. A decision is expected to be made in the near future.

The move comes as Australian Financial Institutions need to compete with foreign financial institutions who now have the advantage of a Government Guarantee.

Federal Opposition Leader, Malcolm Turnbull supported the Government's position and assured the financial sector that the Coalition would assist the Government in ensuring the necessary legislation would pass through Parliament promptly.

This is positive news for landlords of commercial premises holding cash security deposits provided that the cash security deposit is deposited in an institution guaranteed under the proposal. The Australian Government website: www.treasury.gov.au offers a comprehensive list of institutions and deposits eligible to be guaranteed.

Under the *Retail Leases Act 1994*, cash security deposits for retail leases are required to be deposited with the *Director General of the Department of State and Regional Development*. These deposits are secured by the NSW State Government. In light of the current climate, landlords of commercial premises may need to consider:

- a. transferring deposits that are not held by guaranteed institutions; and/or
- b. accepting a cash security deposit in lieu of a bank guarantee or a mixture of both to spread the risk.

Written by Vincent Tripodina, Solicitor

Abolition of duty on transfer of business assets

On 1 January 2011, duty on the transfer of "business assets" (other than land) will be abolished.

"Business assets" for this purpose is defined in the *Duties Act 1997 (Act)* to be:

1. the goodwill of a business created through the sale of goods and/or services to NSW customers in the previous 12 months; and/or
2. the intellectual property that has been used or exploited by the business in NSW during the previous 12 months; and/or
3. a statutory licence granted under a Commonwealth Law, if the rights under the licence have been used in NSW during the previous 12 months.

The abolition is subject to anti-avoidance provisions, in particular, if the parties enter into an option arrangement for the purchase of a business exercisable after 1 January 2011 and enter into a subsequent agreement for management of the business until that time, duty will be payable on exercise of that option.

The provision is designed to ensure duty is payable on any transaction that was made or entered into before 1 January 2011, the only purpose of which was to defer the transaction until after 1 January 2011, so that duty would not be chargeable.

Written by Vincent Tripodina, Solicitor

Important issues for franchisees and franchisors in securing an appropriate lease arrangement

Franchise networks are common in the retail sector. Franchising has afforded many retail brands with a cost effective way to expand their store numbers and penetrate the market. A crucial element of goodwill in many retail franchise systems is the location of its stores. Accordingly, it is important for franchisors to have a good working knowledge of the relevant property laws to understand the key terms of leases and have the ability to negotiate them, as well as to have a clear strategy for the holding of sites and the occupation thereof by franchisees.

Relevant property laws

If the premises are retail premises, State based retail legislation creates certain obligations for landlords, lessees and sub-lessees of premises such as disclosure requirements and minimum lease terms. These requirements will affect the grant of and terms of retail leases or licences to occupy granted by franchisors (or their associated leasing company). For example, under the *Retail Leases Act 1994* (NSW), a retail lease must be for a term of no less than 5 years (including any renewal term), unless the lessee's solicitor certifies that the lessee understands that by giving the certificate, the minimum term does not apply. The term of the lease may affect the term for which the franchise is granted as it will be important for the franchisee to ensure that the lease will be available for the duration of the franchise agreement. Also, the landlord is required to provide the lessee with a disclosure statement prior to entering into the lease. The disclosure statement must also be provided if the premises are sub-leased at any time.

Other legislation may have an indirect effect on the grant and operation of leases such as the *Trade Practices Act 1974* (Cth). An example can be seen by the recent action commenced by the ACCC against the shopping centre owner Dukemaster Pty Ltd for misleading and

deceptive conduct during negotiations with lessees. Franchisors and franchisees should bear in mind their rights and obligations under the Trade Practices Act when negotiating the terms of a lease or licence to occupy.

Relationship between the franchise agreement and the lease

Both franchisees and franchisors must be aware of the challenges involved in leasing arrangements in a franchise context.

When purchasing a retail franchise, a franchisee needs to consider the rights to occupation of the site. In many retail franchise systems, the franchisor holds the head lease and grants a sub-lease or licence to occupy to their franchisees. Franchisees should be aware of the terms of the head lease and ensure that they are reflected in their occupation agreement. If there are additional or more onerous terms in the occupation agreement, the franchisee should re-negotiate with the franchisor.

The Franchising Code of Conduct (**Code**) recognises the complexity of leasing arrangements in a franchise context. Consequently, section 14 of the Code requires franchisors to provide certain leasing information to the franchisee.

Lease, sub-lease or licence?

There are a number of options available to permit a franchisee to occupy premises. For example:

1. The franchisee could take a direct lease from the landlord. In this arrangement the franchisor has no direct relationship with the landlord. Its only relationship is with the franchisee, through the franchise agreement.

While some franchisors may relish the idea of not having the leasehold liability, not holding the lease may be a risky option for a franchisor as it has no control over the lease arrangement. As a result:

- a. it may be more difficult to enforce non-competition restraints and it will have no control over the premises for future franchisees; and
 - b. if the franchisee defaults under the lease, the franchisor will receive no notification from the landlord.
2. The franchisee could take a direct lease from the landlord but additionally, the landlord, the franchisor and the franchisee could enter into a tripartite or re-entry deed by which the franchisor agrees to step into the franchisee's shoes, as lessee, in the event that the franchisee defaults in its obligations to the landlord under the lease.

This addresses the balance between the franchisor retaining some control without assuming all the risk and the franchisee having some security of tenure.

3. The franchisor could enter into the lease direct with the landlord and either sublet or grant a licence to occupy the premises to the franchisee.

In these circumstances, the landlord's pre-approval to sublet or licence the premises must be sought and arrangements put in place to enable the franchisee to pay the rent direct to the landlord and provide the bank guarantee (or other security) direct to the landlord without the requirement for security direct from the franchisor. Such arrangements

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reduce the risk the franchisor is assuming.

This is a risky option for a franchisee as its fate is tied in with that of the franchisor, i.e. if the franchisor defaults under the lease and the landlord terminates the lease, the sub lease or licence will also terminate. There are also risks involved for the franchisor in holding the lease as they have assumed all the liabilities and obligations as the lessee under the lease.

As franchise systems develop then their strategy for holding leases may also develop and/or be tailored to different categories of site.

Options to renew

Franchisees and franchisors both need to consider the length of the term of the lease. The term should, as far as possible, mirror the term of the franchise agreement. In the event that the term of the franchise agreement exceeds the term of the lease, the franchisee and franchisor are both potentially left in a difficult position, if this situation was not anticipated and adequately drafted for in the franchise agreement. Where the term of the lease is less than the term of the franchise agreement:

- a. the franchisor may need to consider whether it will grant an extension to the franchise or will take over the premises itself;
- b. the franchisee may need to relocate once the lease term expires which will affect the goodwill of the business.

Where the term of the franchise agreement is less than the term of the lease:

- a. the holder of the lease (whether the franchisee or franchisor) will have a

potential ongoing liability under the lease;

- b. the franchisor may need to appoint a new franchisee to the territory or grant an extension of the existing agreement.

The term of the lease and any options to renew should ideally match the term of the franchise in the franchise agreement. In other words, both arrangements should terminate simultaneously.

If the franchisor holds the lease and sublets or licences to the franchisee, the term and the options in the sublease/licence must match the term and option provisions in the lease. In these circumstances, franchisors must have adequate systems in place to ensure they exercise option rights under the lease. A failure on the part of the franchisor to exercise the option in time could result in the franchisee having a claim against the franchisor for failure to secure the premises for a further term as well as breach of the sublease/licence terms.

Relocation clauses

Franchisees and franchisors must also be particularly mindful of relocation clauses in leases. The franchisee may have developed a great deal of goodwill through operating at a particular site. Relocation to other premises (whether through the operation of a relocation clause or as a result of a franchise agreement term extending beyond a premises lease term) may involve the franchisee or franchisor in additional significant expenditure in respect of new premises that may not have the same attributes as the previous premises.

Franchisees should ensure that their franchise agreements contain clauses which allow a relocation of the franchise in the event that the rights to occupy the particular premises are lost (e.g. as a result of a relocation clause or inability to renew). Franchisors are usually better

placed to negotiate a new lease and their assistance may be required by the franchisee.

Insolvency

Both parties need to adequately consider the effect on both the franchise agreement and the lease arrangement of an event of insolvency by one party.

From a franchisee's point of view, if the franchisor holds the lease and the franchisor defaults, the landlord can also terminate any sub lease or licence to the franchisee. Additionally, any incentive in the franchise agreement (such as rent subsidies and income guarantees) will have a knock on effect on the financials of the franchisee if the franchisor is not performing. As has been seen with the Kleins demise (see below), the franchisee's destiny was caught up in the franchisor's business model failure.

From a franchisor's point of view, if the franchisee holds the lease and the franchisee does not perform its obligations, the franchisor will lose the premises as a future franchise site.

Ideally each party should have arrangements in place to step into the others shoes in the event of default by one party. This could be achieved through a tripartite deed with the landlord, the franchisee and the franchisor.

The Kleins franchise business is a good example of the impact of leasing arrangements on a franchise business. Despite being around for 26 years, having a large number of stores and wholesale and international operations the Kleins franchise went into administration in May 2008. There was significant interest in purchasing the business, including from the Kleins franchisees. Up to 70 franchisees each offered to contribute \$1,000 to finance the initial stages of a bid to buy the franchisor business. Representing about half of the Kleins franchise network, the franchisee bid

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was among 36 other expressions of interest to purchase the business. Despite the expressions of interest, none were prepared to buy the business. The Kleins franchise business ceased to operate in June 2008.

One of the biggest problems for Kleins was the structural issues with the franchise. The franchisor entered into the lease arrangements for every franchise premises and in some cases provided income guarantees and rent subsidies to franchisees. This set up combined with challenges such as an increasingly competitive market and a failure of the brand to adapt to changing styles and trends resulted in the ultimate demise of the Kleins franchise.

Franchisees have in many cases lost their right of occupation and are now paying the price as they have little or no recourse for the loss of the value of their assets. Many franchisees still hold a significant number of products which will be difficult to sell and shop fit out which cannot be used. This case highlights the significance of leasing arrangements in a franchise relationship.

Legal advice

The occupation of premises is often an integral part of the goodwill and success of a franchised business. It is also usually one of the major overheads of the business. As a result both franchisors and franchisees should take the time to understand the terms of the lease, to review the required disclosure statements and obtain legal advice in relation to the lease terms. Overlooking a relocation clause or failing to exercise an option to renew, may well lead to the loss of the key asset of the business.

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