

LEGAL FOCUS: FRANCHISING & CORPORATE STRUCTURES



Leonid Ervits, Senior Solicitor at DC Strategy explains the various business structures potential franchisees may encounter when exploring business opportunities.

1. Single Company vs. Corporate Group

My franchisor has a number of companies for the operation of the franchise network. Why do franchisors do this?

Franchisors may choose to conduct the franchise either through a single company or through a number of separate companies forming a corporate group of companies.

Conducting the operations of a franchise through one company is the most simple and straightforward method when it comes to the cost of operating the business and simplicity of administration. However, most franchisors elect to utilise corporate structures with a number of companies to run the operations of their business, due to a number of operational and risk management benefits that come with efficient corporate structure.

2. Corporate Structure Form – Horizontal vs. Vertical

What are the typical corporate structure arrangements used by franchisors?

Some franchisors may develop the corporate structure of the business horizontally, while others prefer a more hierarchical or vertical structure. However, the majority of franchisors prefer a horizontal corporate structure.

In a horizontal corporate structure, the franchisor will have a number of companies operating at the same level in a production and distribution process. For example, a franchisor may establish a holding company in which he/she is a shareholder. That holding company would then in turn be a 100% shareholder in other companies within the group, each of them on the same corporate level. Those companies would ordinarily be functioning as distinct business units,

some being operational companies, while others simply holding intellectual property rights of the franchise.

On the other hand, franchisors may choose a vertical structure where each company is provided with limited rights and obligations, each offering a particular service when put together, creating a full business opportunity.

3. Corporate Structure – Business Operations

How will the choice of a corporate structure affect the operations of the franchise?

Regardless of whether the franchisor ultimately elects to utilise a two tier corporate structure or a more complex multi-layered structure, the degree of financial and operational autonomy of companies within the group can vary considerably. Accordingly, within either organisational structure, each company will have identified functions with primary responsibility for their own business goals, activities and finances, while others may simply be companies holding intellectual property rights utilised by other group companies through various licence and other agreements.

Most importantly, the choice of the corporate structure by the franchisor should not affect the day to day operations of the franchise.

4. Multi-Layered Corporate Structure – Benefits

What are the benefits of operating the franchise through a multi-layered corporate structure?

Traditionally, the following benefits have been identified as key benefits of conducting a business through a multi-layered corporate group structure rather

than a single entity structure:

- a. Limiting risk of litigation and loss and maximising financial return (i.e. tax and related costs) company;
- b. ability to attract investors to the business without forfeiting control (e.g. in a situation where a business owner may wish to attract outside investment into a part of the business, a company within the group which controls that aspect of business can be acquired by a perspective investor);
- c. reduction of risk of legal liability by confining high liability risks to particular group companies, with a view to isolating the remaining group assets from the potential liability;
- d. ability to ultimately simplify the process of selling the business or part of the business operated by the group of companies, rather than having to sell discrete assets as would be necessary if the business was conducted through divisions of one company.

There are many economic and commercial benefits in conducting a business through a corporate group structure rather than through a single company and the above benefits are equally applicable to franchisees. However, two of the main reasons why franchisors elect to conduct the operations of a franchise via a group of companies rather than through a single company are:

- a. ability to achieve organisational efficiencies by segregating different businesses, functions and management of different aspects of the enterprise into separate companies; and
- b. ability to maximise the protection of assets by isolating the risk of business

failure in a single entity, thereby effectively quarantining the risk of one part of the enterprise from the assets of the remainder of it.

5. Limited Liability

How does "limited liability" operate to protect the franchise?

By and large, limited liability means that when you deal with a company, liability in respect to generally any matter is limited only to the company and no other person (i.e directors or shareholders) or other companies.

In other words, each company in a corporate group retains its distinct entity status with its own separate liabilities and assets, and the separate legal status of each company in a corporate group is not diminished by the fact of its membership in that group.

That means that the debts incurred by each company in a group are debts of that company and not of the corporate group collectively; and companies within the group are not automatically parties to contracts with external parties entered into by other group companies.

Consequentially, creditors of each company within the group are entitled to look only to the resources of that company for discharge of their debts and obligations.

In other words, the franchisor is able to effectively quarantine the risk of commercial and legal issues to particular group companies, thereby protecting vital assets of the business which should be held by non-trading companies within the group structure.

6. Exceptions to Limited Liability

Are there exceptions to the limited liability?

It should be noted that "limited liability" is susceptible to abuse by entrepreneurs who put personal economic interests ahead of commercial morality. The courts however have the ability to overturn the concept of "limited liability" in a number of circumstances.

The safety mechanisms are designed to protect the interests of creditors and shareholders who often fall victim to elaborate fraudulent schemes which utilise complex vertically integrated corporate structures. For example, there are a number safety mechanisms designed to protect shareholders and creditors of companies from the possibility of the company's assets being eroded, or its financial position otherwise undermined, through undisclosed intra-group dealings (e.g. related party transactions).

Overall, while there are substantial commercial and legal benefits of conducting operations of a franchise through a multi-layered corporate structure, that structure should not serve as a platform for unconscionable (unfair or unreasonable) dealings by the franchisor.

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