

# Addison Aaron

SOLICITORS

Summer Newsletter 2010

## Franchising - the pathway to wealth creation

Developing a business using the franchising model has been a major feature of retailing in the USA for many years. In this country it is more associated with US based fast food outlets such as McDonalds and KFC although recently the UK has seen an explosion in both the number and type of franchises available. In fact there seems little limit on what sort of business can be franchised from oven cleaning at domestic premises to specialist repairs servicing the garage trade.

Franchising works because no-one works harder for anyone than for himself. Franchising incentivises the local management or operator as his income depends on performance. In businesses where there are problems with staff theft, franchising provides the local management with an incentive to keep on top of the problem as the loss falls directly on the franchisee and not the central organisation. The proof of the pudding is always in the eating. Have you noticed how fast and aggressively mini-cabs are driven from one fare to another? The driver gets paid per fare, the more fares he carries the more money he earns. Likewise the franchisee will maximise turnover and minimise shrinkage to ensure he receives maximum personal returns on his investment. Little wonder franchising has been so popular in the USA.



Franchising works well for the franchisor (the business that owns the franchise rights) as it is able to develop its business using other people's money without taking on any liability and thus obtain massive returns on investment. It allows the franchisor to build its business at an accelerated pace, far faster than the franchisor could hope to achieve by more traditional business methods. Getting its chain across the country

helps eliminate potential competitors maximising the long term returns too. Further, now that the labour market is highly regulated, it insulates the franchisor from that labour risk associated with employing people in local branches too! The franchisor need only concern itself with its central organisation; each franchisee (the local operator) takes on all the regulatory risk including the labour risk himself. Of course, a good franchisor will be able to provide guidance and support where necessary but that can be subcontracted out to an appropriate professional firm as and when required.



The franchisor usually receives an up front fee from the franchisee when he takes on the franchise. Generally this fee should only reflect the costs of setting up the franchise including training. Some of the more established franchisors initial fees do include some contribution towards paying for goodwill. The bulk of the profits come from the ongoing management fee which is usually based on turnover. In a fast food outlet this can vary between 3% and 12% of turnover. Even at 3% the rewards for the franchisor can be very significant. A reasonably successful fast food outlet or sandwich shop should turnover around £250,000 per annum (excluding VAT). At 3% the management fee would be £7,500 per annum, multiply that by 250 shops and the gross fee is nearly £1.9 million. At say 5% (the percentage used by some of the market leaders) comparative figures would be £12,500 and over £3 million. Those fees are gained by getting others to pay to open stores on the franchisors behalf, thats good business. Franchisors can also make additional profits by selling products into the franchise chain. For example in fast food there will be branded packaging not to mention manufactured food items for example pies.

**Continued on Page 3**



In this issue:-

- 1) Franchising P.1
- 2) Fraud P.1
- 3) Partnerships P.3
- 4) Employment P.3

## Mortgage Fraud

Anecdotal evidence suggests that mortgage fraud is one of the fastest growing industries in the UK.

A few years ago mortgage fraud was a cottage industry with many otherwise law abiding citizens committing mortgage fraud without even considering they were doing so. The availability of self certification mortgages was almost like a bank opening its vault and asking members of the public to borrow what they like and leave an IOU for the details. Needless to say many such applications contained inflated income statements enabling those who were struggling to get on the housing ladder to do so. There is evidence that applicants were encouraged to make false applications by unscrupulous mortgage brokers. Many of the people involved will not have seen their actions as criminal but just doing what was necessary to provide a home for themselves and their children. Nevertheless it was fraud.

Today, self certification mortgages are not generally available but fraudsters are out making substantial profits from mortgage fraud.

Professional fraudsters will usually do several frauds at the same time and disappear with the profits, often using ordinary people to front the fraud for an expected fee (but this is rarely paid) or by assuming an innocent person's identity.

**Continued on Page 2**

## Pre-nuptial Agreements a pre-requisite to new business partnerships

Going into business with another is just like getting involved in marriage.



On the wedding day, the couple look dewy-eyed at each other and each share a common vision of future happiness. With the divorce rate being around 50% many an idealistic visionary joins the ranks of the disappointed. In business things are not better. Marriage is hard when you are "in-love" with your partner - how much more difficult is a business partnership when generally the basis of the relationship is often a friendship based on common ground such as previous work or a hobby? Not surprisingly many business partnerships (whether partnerships in the strict sense or limited companies) fail quite early on with partners bickering about who put in the most effort and who has the right to take the business forward. Such arguments frequently destroy what is left of the business leaving nothing for the partners' efforts.

No agreement can guarantee that a business will be successful or even that the partners will remain in harmony. However, it can save them considerable amounts of money when things go wrong.

We advised a couple of women who had been friends for years to have a

Partnership agreement when they started a shop together. They didn't want to spend the money, when you start a business you want to spend your cash on things that have a perceived immediate value. Within a year each one of the partners were blaming the other for bad business decisions. In the end they could not even agree on selling the shop. Eventually the business was abandoned and all the effort and money spent on stock and fixtures and fittings was just thrown away. Things could have been worse, fortunately the premises were taken on by a new tenant so they were not paying out for rent on a premises they did not use for too long. This was a small business and a simple partnership agreement dealing with the normal issues that arise in running a partnership would have been money well spent.

Some entrepreneurs will attempt to cut corners by using the internet and not getting proper legal advice. We had the unhappy situation of dealing with a client who had set up a very substantial business and raised over £2 million of capital using information and agreements he found on the internet. Unfortunately he did not have a proper understanding of company law and having appointed some professionals to help him run his company he found himself removed from the board of the company, his shares forfeited and facing the possibility of being made bankrupt. He could have avoided all of these problems had he got advice off a suitably experienced solicitor.

It is far better to spend money at the beginning when a relatively small amount of money will produce a good agreement than in litigation later on that may run into tens of thousands of pounds or more in legal costs.

## Addison Aaron

Addison Aaron is a corporate, commercial and business defence firm of solicitors, with a wealth of experience from raising corporate finance to franchising, from corporate insolvency to corporate crime. We are part of a large group of independent law firms providing national coverage and expertise in depth.

We represent a number of franchise businesses. Should you or your clients be interested in taking on a franchise please contact Addison Aaron.

Addison Aaron your partner in business.

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## Mortgage Fraud - Continued from page 1

Empty properties are more likely to be targeted by fraudsters as the property provides an easy method of collecting any mailings by the lender. Sometimes the fraudsters will use property they own or owned by paid accomplices but where the targeted property is owned by an innocent individual in residence it is still possible for a fraudster to use the property provided he has the assistance of a dishonest postman and/or solicitor.

In its simplest form mortgage fraud is based on an application for a mortgage on a property usually using an inflated valuation. The lender forwards money and the fraudsters disappear. Generally speaking it is necessary to use a solicitor or licensed conveyancer as mortgage companies frequently will insist that the money is paid to a solicitor. Unfortunately solicitors are often used in such frauds without being aware that the transaction is fraudulent. Nevertheless the solicitor may and often is sent to prison for his involvement. Mortgage fraud implicating solicitors (whether innocent of the fraud or not) has become all too common in recent years and once again anecdotal evidence suggests that the collapse in the property market and the effect that has had on the income of solicitors firms specialising in conveyancing has made solicitors easy targets for fraudsters.

A slightly more sophisticated version of the above fraud involves a second mortgage application with a second higher property valuation. The second buyer may be fictitious or using a false ID. In this version of the fraud, the original mortgage is cleared and the loss falls on the second lender. Clearly this fraud works better in a rising boom market. However, a fraudster seeking to maximise his potential earnings will be looking for a grossly inflated valuation and his success will depend on finding a valuer who can be persuaded to give the property an inflated value (perhaps due to his own inexperience or commercial pressures or by becoming part of the fraud). Sometimes the first mortgage is not registered against the property by the time of the second sale and is not

**Continued on Page 4**

The franchise system works well for the franchisee too. He gets expert help in setting up his business including a proven business model, training and the benefit of the experience of a successful entrepreneur in that business. It is little wonder that franchises are far less likely to fail than other businesses. This makes it easier for a franchisee to raise capital to support his business than if he had gone it alone, it also makes him much more financially secure from the start. A good franchise system is a win win for both parties.

### Is my business suitable for franchising?

Franchising a business can be a great opportunity but is the business suitable? Take a quick look at any franchise magazine and you will see that almost any type of business can be franchised. However, franchising works best for high margin businesses where the start-up costs are not too significant. Hence why franchising has had such success with fast food. However, the ideal franchise opportunity is one requiring only a small personal investment with the bulk of the start-up costs being met by asset finance and producing a realistic income of around £40,000 to £50,000 for the franchisee. The franchisor is selling its expertise and therefore crucial to the franchisee that the business must perform better than the market average for non-franchise businesses. For example, a typical fish and chip shop may turnover £160,000 per annum. A good chip shop will turnover £250,000 plus and the franchisee is paying a fee to ensure his business turnover is the good figure not the typical one.

From the above it stands to reason that the strongest propositions for franchising will be businesses that have already developed into small chains, say 3 or more outlets. The franchisor is then clearly in the position to prove it has a viable business model and the experience at transferring it to new sites. However a single site business can still franchise successfully, it just needs a little more to sell it to the potential franchisee. Therefore award winning businesses are clearly at an advantage.

### Is my existing business safe if I franchise?

Yes it is, at Addison Aaron we would always recommend that you set up a new business separate from your existing business to do the franchising. There are lots of advantages to doing this, more than just protecting your existing business assets, for example using a new company may allow some inheritance tax planning. We will be happy to advise you on franchising at a free consultation, please call our office to make an appointment.

Frequently we are asked about protecting the reputation that the franchisor has worked hard to build up. The franchise agreement should provide measurable quality standards for the franchisee to maintain with the provision that the franchise agreement can be terminated should the franchisee fail to work to the franchise standard. You remain in control of your reputation.

### Is it a good time to franchise my business, we are in a recession?

Absolutely, many quality people are or have been made redundant. The over forties traditionally struggle to find fresh employment and many of them will have received substantial severance packages. Without the prospects of getting back into work, taking on a franchise frequently looks like a very attractive option. We even know of professionals who took on a sandwich franchise. Now is very definitely the right time to franchise a business.



## Extending Employer's liability for wrongful acts of their employees.

It has long been established that the employer is vicariously liable for the wrongful acts of an employee committed as part of that employment. Consequently, an electrical contractor cannot avoid liability for burning a client's house down by a bodged rewire job merely by saying it was the responsibility of the individual electrician who carried out the work. Over-time this vicarious liability has been extended to include acts done ancillary to the job which the employee was paid to do including liability for driving accidents. However, where the conduct was clearly outside the remit of the employment no liability would attach to the employer.

It then follows, therefore in the case of *Howe v Trotman v North Yorkshire County Council* (1999) that the Court of Appeal found no vicarious liability attached for sexual abuse to the employer because it could not be regarded as connected with or ancillary to the carrying out of the employee's duties. This was reversed by the House of Lords in *Lister v Hesley Hall Ltd* (2002) where a boarding school was held liable for the sexual abuse of a pupil committed by a warden of a boarding house.

Child abuse cases are always emotive, even for the courts and in a recent case vicarious liability of the employer was rather worryingly extended. In *Maga v The Trustees of the Birmingham Archdiocese of the Roman Catholic Church* [2010] a catholic priest abused a boy who was not a member of the congregation. Further, the pair did not meet consequent to any of the priest's duties but rather extraordinarily when the boy was admiring the priest's classic sports car. It has to be said some of the abuse did take place on premises owned by the church but not exclusively so.

In finding liability against the priest's employer Longmore LJ considered the progressive stages of intimacy were only possible because the priest had the priestly status and authority which meant that no one would question his being alone with

**Continued on Page 4**

## Extending Employer's Liability Continued from Page 3

the claimant. That provided the close connection between the abuse and what the priest was authorised to do. Worryingly therefore this potentially extends vicarious liability beyond the work place everywhere an employee has some pastoral role be it teaching, medicine or childcare. By similar logic it may also apply to voluntary sectors such as Scouts or mother and toddler groups. Further, it is by no means certain that it would not extend to anyone work brings them into contact with children. Lady Justice Smith suggested that liability may attach to an employer where the employee is able to use their ostensible authority to create situations which they can then subvert for their own purposes (which can be outside of that employment).

Employers who have employees who could as a consequence of their work be in contact with children should, as a matter of course regularly CRB check each relevant employee. Further, employers should act in a precautionary manner if anyone raises concerns regarding an employee and children and remove them from any duty which may bring them in contact with children whilst conducting a thorough investigation into the matter. Some employers may not be in a position to reassign an employee to avoid him working with children, either because the nature of the work brings the employee in contact with children or because the employer does not have sufficient work without contact with children to fill the employee's day. If the employee resigns the employer may face a claim for constructive dismissal. If the employer does not reassign the employee he may commit further offences for which the employer may become liable. Employers finding themselves in this situation should enlist professional legal advice.



## Mortgage Fraud - Continued from Page 2

re-paid on completion. In such cases the fraudsters can walk with two mortgage receipts.

The buy to let market was also used by mortgage fraudsters. In this fraud the property is mortgaged and tenants are often installed in the property. However, the mortgage is not paid and the tenants, who may have paid rent, find themselves made homeless through no fault of their own.

Mortgage fraud is sometimes perpetrated through sale and rent back schemes. A home-owner often in financial difficulty will answer an advertisement for raising funds on a sale and rent back. The fraudster (buyer) obtains a mortgage on the property borrowed on the basis of an inflated value, the original loan is paid off. The fraudster will disappear with the equity in the house plus the overvalue sum leaving his tenant to be evicted from the house he once used to own. It is of course possible he may be accused of complicity in the matter.

An opportunist fraud is one of interception. The fraudsters take control of a legitimate mortgage application or sale using fake letterheads and false bank details. They may well use the details of an innocent solicitor who would thereafter be first in the frame for the fraud. This would only require the assistance of a very junior member of staff in many solicitors' offices. The fraudsters receive the mortgage advance purportedly on behalf of the buyer or the completion monies on behalf of the seller, and disappear.

Fraudsters may also use the court system by obtaining judgement for a non-existent debt. By not giving notice to the alleged debtor, summary judgement can be obtained because no defence has been filed (the defendant being in total ignorance of the claim). Fraudsters usually target property-owners with properties that are unoccupied and un-mortgaged. By way of enforcement, an order for sale is made and the property is bought at an inflated price by a conspirator and mortgaged at an

inflated value.

The true owner is oblivious to what has happened. No repayments are made and the fraudster disappears with the proceeds.

Mortgage fraud is on the increase and many innocent people have found themselves unknowingly caught up in it.

Professionals are particularly at risk as many fraudsters will require assistance to make the fraud work and solicitors, accountants and valuers should be particularly on their guard if offered the promise of ongoing work at a higher fee while discouraged from carrying out too many "unnecessarily" diligent checks.

Solicitors should refuse to complete a sale and transfer of title on contracts that have already been exchanged. Similarly solicitors should not alter the value on the certificate of title given to the lender and must work to the obligations in the CML Handbook (Council of Mortgage Lenders).

Mortgage Lenders rely on the professionals involved in a transaction to establish the legitimacy of the transaction. At the end of the day, the fraudster will have disappeared and the lender will look to the professionals who have assisted in the fraud to meet the lenders losses. Civil negligence is not the only issue facing the unfortunate professional. He may soon find his livelihood liberty are just a distant memory as he faces criminal sanctions under the Money Laundering Regulations.

