

PRINCIPAL & AGENCY AGREEMENTS

Introduction

The funding of hiring contracts by way of principal and agency agreement (“P&A”) is a common financing technique for the supply of business equipment across all Australian states.

The rationale for the P&A structure is that it permits one party, usually the equipment’s supplier, to retain its personal relationship with the customer, while at the same time, creating a legal relationship between the customer and the agent’s principal, usually the deal’s ultimate funder.

The legal effect of a P&A sometimes appears unclear because commercial practice often gives a different meaning to the word “agent” as compared to what the law understands “agent” to mean.

In a general commercial sense an agent is a person who introduces parties that may wish to transact business, but who, by the act of introducing those parties, in no way binds them. This is often the role of a finance broker.

Under a P&A though, the agent is a person who is able, by virtue of the specific authority conferred upon him, to create legal rights and duties between one party, who is called the principal, and the customer who is unrelated to either of them.

The law’s flexibility with regard to its rules concerning agency permits an exception to the basic legal principle of “privity of contract”; that is, parties to a contract cannot confer rights or impose obligations in respect of the contract upon anyone but themselves. A P&A permits a party such as a broker, (but quite often a goods supplier or “vendor”), to create legal relations (for example a lease agreement) binding a third party funder with the end-user customer.

Thus, through the technique of the P&A, funder and borrower/lessee are as directly and as completely bound to each other under the lease agreement as if each had contracted direct with the other.

Undisclosed Principal

The key plank upon which legal and commercial practice of the P&A is built is the law of the undisclosed principal.

In legal terms, the doctrine of the undisclosed principal says that where a party makes a contract with another party, and the first party is the duly authorised agent of a principal, the principal can itself enforce that contract. This is so even though, when the contract was entered into, the first party (agent) did not necessarily disclose to the other party (customer) that it was entering into a contract in the capacity of agent of a principal.

So, even though a lessee may enter into a lease agreement in the belief that the party with whom it is contracting is the actual lessor, the validity of the lease is not affected by the fact that the latter party was not the true owner of the leased goods, provided the necessary P&A was in place.

An agent/broker or an agent/vendor gains the flexibility to create and preserve the customer relationship under the doctrine of the undisclosed principal. The principal may, because of its

funding of the deal, assumes all rights against the customer, however from the customer's point of view, by virtue of its commercial relationship it is contracting with the agent.

Default and Enforcement

The other advantageous aspect of the doctrine of the undisclosed principal is that the principal/funder may at any time, but usually following breach or default on the part of the customer, disclose its existence to the customer. The principal/funder may then itself commence recovery action directly against that customer either by specifying continuation of the contract, or by demanding a payout.

In other words, the undisclosed principal always has the right to intervene and assume what are, in fact, its own rights and obligations under the contract with the customer. The fact that the underlying contract was made without disclosure of the principal's existence or authority is irrelevant.

So, a customer/lessee cannot dispute the contract on the basis that the principal's identity was unknown to it at the time it signed its contract with the agent. The principal's identity is immaterial to the validity of the transaction.

Note too that the right of a principal/funder to enforce a contract prevails over the rights of the agent. Generally speaking the courts will not regard the terms of a contract as excluding the intervention of an undisclosed principal, except in the unlikely event that the agent as sole contracting party is clearly intended and so documented.

Similarly, describing the agent as "owner" of goods under, for example, a lease agreement does not cut across the rights of the principal to its ultimate ownership of those goods. The purpose of such a statement in the underlying lease is simply to make it clear to the customer/lessee that, as between it and the agent, the agent has the better title to the goods.

In any event, it is immaterial to a lessee who owns the goods. What is relevant is that the goods are made available to it in accordance with the terms of the lease. Personal performance by the agent/owner is not important to the performance of such a contract. What is fundamental is that the customer/lessee has possession of the goods and is able to freely use them in the intended manner.

Limitations upon a Principal's Legal Rights

The authority of an agent to act for a principal must have existed at the time a contract was entered into. Thus, for example, in relation to a lease agreement, if as at the commencement date the vendor/broker was acting on its own behalf and not on behalf of a principal/funder, the vendor/broker cannot subsequently claim that the deal was struck under the umbrella of a P&A.

In other words, a vendor/broker cannot retrospectively say that a deal was done under a P&A structure if it was not, in truth, acting at a principal's agent at the time the underlying deal was entered into. This is so whether or not the P&A existed at the time. The vendor/broker must be acting as a funder's agent when it signs up a customer. Should it not be so acting, but subsequently realise that financing for the deal is required then it can only achieve this by an assignment or discounting of the applicable cash flows, with or without transfer of equipment ownership.

So, the message is that a P&A must be entered into at the outset of the relationship between the principal and the agent, in order that, going forward, deals can be written under it.

Other Advantages

If a vendor and a funder agree on a P&A structure, this will permit the funder to obtain the tax benefits of depreciating the equipment by virtue of owning the equipment. Such a benefit is not available to the funder from simply purchasing the underlying lease cash flows, nor from lending on the basis of loan servicing via recourse to those cash flows.

For the agent/vendor, a P&A facility should enable the GST component of the equipment's sale price to be funded on an "all-up" basis. Once again, assigning or pledging underlying lease cash flows will not confer this kind of advantage. In the absence of a P&A the vendor would be obliged to allot working capital to deal with the timing of applicable tax payments.

Further, under a P&A structure the funder will most likely assume the administrative burden of registering title to the equipment, where applicable. Conversely, the vendor will usually be freed from this tedious but increasingly important chore.

The value of avoiding such a regulatory imposition is not to be underrated, given Australia's fragmented and often obscure title and security registration laws. Even with the forthcoming introduction of a harmonised and all-embracing personal property securities registration regime, a vendor may consider itself better off to dispense, via a P&A, with such an administrative obligation.

Conclusion

The P&A is a powerful financing tool in the hands of a properly appointed agent. For both principal and agent it is a simple yet effective marketing vehicle. Each gets the "sale" it might not otherwise have made, without the other. However, the P&A comprises a fragile legal mechanism as well. The agent/vendor must have specific authority to sign up customers. Without that authority the P&A is of no use in the funding of third party deals.

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