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**Franchise Council of Australia
National Franchise Conference 2015 Legal Symposium
Royal Pines, Gold Coast**

WORKSHOP MASTERCLASS – Structuring of Franchise Systems: Options, choices available and issues

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1 Introduction

- 1.1 Good afternoon. As our Chairman has indicated this is to be a workshop style event.
- 1.2 Joe and Greg have discussed aspects about the structuring of franchise systems. I propose to illustrate some issues which arise if proper attention is not paid to what they have said. Like all legal agreements there is the potential for unforeseen consequences to occur if the legal draftsmen do not address the particular circumstances of their clients. This is particularly so where a 'precedent' is used, without any attempt to tailor it to meet the client's circumstances.
- 1.3 To highlight some issues, I will refer to some clauses from a licence agreement and others from a shareholders' agreement. The issues are similar whether they arise from a shareholders agreement, a unit holders' agreement, joint venture arrangements and so on.
- 1.4 In the limited time available, I will touch upon some of these common issues that have occurred. This is not a Geoffrey Robertson hypothetical.
- 1.5 Also, for various reasons, the identity of the draftsmen of the clauses will remain anonymous. It is not my firm. Indeed, the identity of the original draftsmen is often unknown. However, if someone recognises their work and requires attribution, please let us know.
- 1.6 We propose to let you consider a clause and then briefly discuss the issues that arise.

2 Holding entity → licence to operating entity

- 2.1 Let's postulate this scenario. As has been outlined, the client's business has grown. They have sought your advice about expansion. After discussing the various alternatives, they have established a franchise company which owns the IP and confidential information, assets etc.
- 2.2 This gives a licence to a separate entity to grant and operate the franchises.
- 2.3 So there are the terms of the licence agreement to consider. In a non-arm's length transaction, there is a temptation or desire from the client to use the KISS principle. However, this has risks, particularly where at some stage the ownership (whether by shares, units, trusts or whatever other mechanism is used) varies between the holding entity and the operating entity.
- 2.4 The risks may arise for a number of reasons, such as the ownership of one or more of the entities changing. Say the operating entity wants to give incentive to directors, executives or key

- employees by allotting shares, particularly now with the recent changes to the legislation and tax treatment of shares to employees.
- 2.5 Let's say that, in this instance, the holding company was owned and control by two partners. One of these had the interest in the operating entity but introduced a new key professional whose expertise and contribution was seen as critical to the operations of the franchise 'the third party shareholder'. Let's say on an equal shareholding basis in the operating entity. As you may have experienced, it is not uncommon, particularly in the early stages of a commercial relationship, for parties to be harmonious and not wishing to consider what happens if that relationship falters. In this scenario you may well ask why the initial shareholder who held the interest in the holding entity did not retain sufficient shares to, at least, have a voting majority.
- 2.6 No matter what structure evolves after the considerations raised by Joe and Greg are taken into account, you often find yourself under pressure from the clients to produce 'off the shelf' or veneer type documents and to contain fees. Whilst there are pressures to do this, there are risks in doing so. Both to you as a lawyer and to the client. There are also the possible conflict issues where you need to identify to the proposed joint venturers, unit holders, shareholders etc that they should get independent advice and be separately represented. Often, clients do not see the necessity of this when they are in the formative stages. Alternatively, if the clients want you to proceed to prepare the documents on their behalf jointly, you need to ensure you have their fully informed consent.
- 2.7 Here, in our example the draftsman and, perhaps this was on instructions, treated the initial partner and 'the third party' in the operating entity as equal. That is, no provision for a casting vote or recognition that the partner was also the owner of the holding entity and providing for a majority or controlling interest. As you will see from the handout, the licence agreement was sparse, and the ability to terminate in the event of significant functionality in the operating entity, was not addressed. See clause numbers 3, 7, 11 and 12 of the handout of the Licence Agreement.
- 2.8 What if the two equal shareholders fall out, for whatever reasons, with claim and counterclaims being made, but the end result is a dysfunctional relationship and inability for the company to function effectively. The detriment can quickly extend to the employees, franchisees, customers and suppliers. The director of the holding company, with no direct shareholding in the operating entity, wants to terminate the licence. That depends on the termination clause. Let's look at that, clause 11 of the Licence Agreement.
- 2.9 Maybe it is not so easy to do ... what are the problems?
- 2.10 The holding company threatens to terminate only to be met by an injunction application. This is not brought by the operating company because the two directors/shareholders are in deadlock and so there could be no Board of Directors' resolution to do so. So the application was brought by the affected third party shareholder in the operating entity as an 'interested person' pursuant to s.236 of the Corporations Act. To remind you, s.236 states that "*A person may bring proceedings on behalf of a company, or intervene in any proceedings to which a company is a party for the*

purpose of taking responsibility on behalf of the company for those proceedings ... if ... the person ... is a member ...".

3 Shareholder rights

- 3.1 What if the 'third party' shareholder, which was a company, changed its sole director without informing the remaining equal shareholder? Does that constitute a change of control? Let's look at the change of control provision (clause 11 of the Shareholders Agreement).
- 3.2 Does changing the sole director of a private company shareholder constitute change of control? Either under this clause or anyway?
- 3.3 And, if so, look at the deemed transfer of shares that comes into play under clauses 11.2 and 11.3. Can the initial shareholder partner seek specific performance?
- 3.4 What other options? An independent valuation under clause 11.4 et seq? What if the Institute of Chartered Accountants will not appoint a Valuer despite the provisions of the clause, unless both parties agree? What then?

4 Dispute resolution

- 4.1 So, moving on from those issues, what happens next? Is a shareholder in default under clause 12.3? What if the shareholder was acting in a way which was causing real loss and damage to the operating entity, either through misconduct, negligence or the like. Is this a default under clause 12?
- 4.2 On what basis can the Shareholder's Agreement be terminated? Is clause 14 effective?
- 4.3 If the operating entity does not have a functioning Board and the two shareholders are at odds and cannot agree on critical decisions, the dispute resolution provisions come into play. Let's see what they say. Go to clause 15 dealing with Dispute Resolution.

5 A Winding Up

- 5.1 What is the next step for a dysfunctional company where the directors and shareholders are in deadlock?
- 5.2 Perhaps you did not think that a session on structuring and the options would lead to a winding up? Well, this is where it can get to if insufficient attention is paid to how the documents are structured and the possible scenarios, good and bad, are not covered well enough. Otherwise, you will have to consider s.461 of the Corporations Act and the ground upon which the company would be facing a winding up, and all that involves.

6 Summary

- 6.1 Canvassing the options identifying the risks and making sure the client makes fully informed decisions, which you record, are as critical today, if not more so, than ever.

