# Commercial insights

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## *Commercial insights* Editors – August edition:

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In this edition of *Commercial insights* we focus on recent legal developments which, where relevant, may impact on SMEs, professional practices, private businesses, companies and associations and highlight recent legislative changes to the Retail Leases Act in NSW, which import new protections for commercial tenants. Also, we discuss some recent cases in the franchise sector concerning disclosures made by a franchisor and a recent decision of the Queensland Supreme Court emphasising the importance of contractual rights under a shareholders' agreement to protect minority shareholders. In addition, we remind professional practices to review their arrangements with their associated service entity to ensure continuing compliance with the relevant Tax Ruling.



SHAREHOLDERS' AGREEMENTS

# Put it in writing: Tools to protect and enforce minority shareholder rights

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## A shareholders' agreement is a separate contract

A shareholders' agreement is a private contract between the shareholders of a company under which they agree to regulate their rights as owners and shareholders of the business.

It is distinct from the company's constitution which is regulated by the Corporations Act. In the absence of a shareholders' agreement, minority shareholders are at risk that, pursuant to the constitution, the majority of shareholders constituting 75 per cent or more of voting rights, may amend the rights of all shareholders.

If there is a conflict between the shareholders' agreement and the constitution then it is common for the terms of the shareholders' agreement to provide that the terms of the shareholders' agreement prevails.

A shareholders' agreement, is an enforceable contract agreed between all shareholders and which can generally only be varied with the consent of all parties. Therefore, it operates to protect shareholders by creating contractual rights particularly in the case of minority shareholders.

It can deal with a range of issues relating to 'control' for example upon the transfer or issue of shares by giving existing shareholders an equal right of pre-emption or an option to purchase the shares of an existing shareholder.

## Minority shareholder oppression

The recent case of *SDW2 Pty Ltd v JLF Corporation Pty Ltd & Ors* [2017] QSC 001 (16/7342) in the Supreme Court of Queensland demonstrates the utility and importance of a shareholders' agreement in protecting the rights of a minority holding.

The dispute involved shareholders of Custodian Funds Management Group Limited (*CFMG*). CFMG's principal business was to hold interests in and to raise funds to support the businesses of its subsidiary entities that provided property development, syndication and asset-backed income stream investment opportunities for investors located throughout Australia.

The plaintiff, Shareholder 1, who was a shareholder in CFMG, sought an interlocutory injunction to restrain CFMG from holding certain meetings and restraining another shareholder from casting votes on particular resolutions on the basis of an alleged breach of the option rights in a shareholders' agreement which permitted Shareholder 2 to acquire the shares of other shareholders and which had not been afforded to Shareholder 1.

The shareholders' agreement provided that upon an 'Event of Default' by a shareholder, the non-defaulting shareholders would have an option to acquire the defaulting shareholder's shares. Shareholder 1 alleged that five events of default had occurred including that Shareholder 2 was in breach of a non-compete prohibition in the shareholders' agreement which provided that each shareholder and its affiliates must not compete with CFMG or do business with its customers and each shareholder.

Accordingly, the breach by Shareholder 2, gave rise to an option right for Shareholder 1, as a non-defaulting shareholder, to acquire the shares of the defaulting shareholders. In the interim, Shaw Investment (*Shareholder 3*) had sought to transfer its shares to Shareholder 2 in contravention of the shareholders' agreement.

Shareholder 1 commenced proceedings which alleged that a transfer of shares by Shareholder 3 to Shareholder 2 was void, and that it (Shareholder 1) was therefore entitled to purchase the shares of Shareholder 2 and Shareholder 3 as both had breached the shareholders' agreement.

The case primarily considered whether there was a 'prima facie' case for the purposes of interlocutory relief and whether the application ought to be refused because there is no relevant threatened infringement of the rights of Shareholder 1.

The shareholders' agreement provided that Mr Watson, who controlled Shareholder 1, and was a director of CFMG's three subsidiary entities, could only be removed from the three subsidiary entities' boards by way of a resolution of a 'Special Majority' of shareholders which, though commonly 75%, was <u>85%</u> of the ordinary shareholders in CFMG. CFMG had called a meeting of shareholders for the purpose of removing Mr Watson.

Shareholder 2 intended to remove Mr Watson from the board and to control the company, and sought to increase its holding to <u>88%</u> by acquiring the 14% interest held by Shareholder 3.

On the other hand, Shareholder 1 intended to retain Mr Watson on the various boards in the group and sought to increase its holding by commencing proceedings seeking an order to permit it to acquire the combined interests of Shareholder 2 and Shareholder 3 as a result of their default under the shareholders' agreement. As a consequence, if successful, Shareholder 1 would then increase its holding to 96% and acquire control of the company.

Bond J found that there was a prima facie case that there is a real risk of harm to the value of the option rights of Shareholder 1 (*SDW2*) as a result of the actions of Shareholder 2 (*JLF*) to the following effect:

> "I am satisfied that SDW2 has established a prima facie case that the purported acquisition by JLF of Shaw Investments' 14% shareholding of CFMG was void and that JLF threatens to exercise a voting entitlement which there is a prima facie case that it does not have. That voting entitlement would be critical in JLF's ability to establish the special majority which would be necessary to remove Mr Watson as director."

The case underscores the importance of protecting the rights of a minority shareholder by way of contract. Without the option rights in the shareholders' agreement, Shareholder 1 would not, in the event of anti-competitive behaviour by other shareholders, have a contractual right to exert control over the ownership of the company or otherwise restrain anti-competitive conduct of other shareholders, other than by utilising the minority shareholder oppression provisions in the Corporations Act.

SHOULD YOU REQUIRE ASSISTANCE OR ADVICE ON THE PREPARATION OF A SHAREHOLDERS' AGREEMENT, STRATEGIES REGARDING OWNERSHIP AND CONTROL OF YOUR BUSINESS OR PROTECTION OF SHAREHOLDER'S RIGHTS SUCH AS A MINORITY SHAREHOLDING OR ANTI-DILUTION OF A MAJORITY SHAREHOLDING, PLEASE CONTACT OUR COMMERCIAL AND CORPORATE ADVISORY PRINCIPALS MICHAEL BRACKEN OR MARK FITZGERALD.

COMPANY ARRANGEMENTS

# 'Phillips arrangements': It may be time to review your service company arrangements

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Many professional practice owners including medical practitioners and pharmacists enter into an agreement with an associated entity to provide services to the practice such as the provision of staff, administrative or clerical services, premises, plant or equipment in consideration for the payment of a services fee.

Depending on its structure, these service arrangements may have a number of potential benefits including asset protection, quarantining business risk and tax planning.

The particular service arrangements for a practice can vary widely, however if set up in accordance with Tax Ruling TR 2006/2 they can deliver advantages to a practice owner to facilitate claiming a deduction for service fees and charges as expenditure which the practice incurs in the conduct of its professional services.

Service fees and charges are usually calculated by way of mark-up on the base costs incurred by the service entity. Based on the ATO's guidance, it is important that service fees are paid for the provision of services and equipment in the production of income and that the fees charged are commercially reasonable and properly calculated.

The ATO's guidance in *Your Service Entity Arrangements* provides some parameters in determining whether service fees have been correctly calculated.

Ultimately the deductibility of service fees is a question of fact, however if ambiguities arise and a service might otherwise be characterised as being for some other purpose, it may invite a presumption that has been established solely for the purpose of obtaining a tax benefit.

There have been recent cases where the ATO has successfully challenged the deductibility of alleged service fees due to a lack of evidence which otherwise confirms that the fees were appropriate or that the service arrangement was legitimate.

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## Review of service arrangements?

Service agreements between a practice and an associated service entity can be a useful addition to your business structure and if established properly, the payments you make under your service arrangements can be deductible under income tax law.

Tax Ruling 2006/2 was issued 11 years ago, and many practice owners may not have recently reviewed their service arrangements for compliance with the ATO's guidance in *Your Service Entity* Arrangements, which was last modified in May 2013.

SHOULD YOU REQUIRE A REVIEW OF YOUR SERVICE ARRANGEMENTS, ADVICE ON THE PREPARATION OF A NEW SERVICE AGREEMENT, OR ASSISTANCE WITH STRATEGIES INVOLVING A SERVICE ENTITY, PLEASE CONTACT OUR COMMERCIAL AND CORPORATE ADVISORY PRINCIPALS MICHAEL BRACKEN OR MARK FITZGERALD.

FRANCHISING

# ACCC increases franchisor scrutiny

Under the Franchising Code of Conduct (FCC) a franchisor is obliged to update a disclosure document which has previously been issued to a franchisee within 4 months after the end of each financial year.

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Recent proceedings initiated by the ACCC suggest an increasing focus on and scrutiny of disclosure obligations in the protection of franchisees.

## Disclosure exemption

Updated disclosure is not required under a Disclosure Exemption where a franchisor:

i. during the last financial year – did not enter into more than one franchise agreement (including transferring, renewing or extending a franchise agreement) and
ii. in the following financial year – does not intend to enter into another agreement.

However, in each 12 month period, if a franchisee makes a written request for a disclosure document then, within 14 days of the franchisee's request, a franchisor must provide a franchisee with a copy of its latest disclosure document so that it reflects the position of the franchise as at the end of the financial year before the financial year in which the request is made.

If a franchisor does not have an updated disclosure document, as it is otherwise covered by the Disclosure Exemption, then the FCC provides a franchisor with an additional period of up to two months to update the disclosure document and to provide a copy to the franchisee.

## Scope of update

A franchisor is obliged to provide franchisees and prospective franchisees with updated disclosure of matters that are 'materially relevant facts'.

A material relevant fact is a key piece of information about a franchisor or its franchise system, which could have an effect on a franchisee's business and includes:

a. ownership and control – a change in majority ownership or control of the franchisor, franchise system, or an associate of the franchisor;
b. litigation – relevant court proceedings or judgments against the franchisor or one of its directors;
c. intellectual property – a change in the intellectual property, or ownership or control of the intellectual property that is material to the franchise system.

## Breach of disclosure obligations

In a recent ACCC Media Release the ACCC indicates that it intends to take court action relating to alleged breaches of the revised FCC (which was introduced in 2015), to demonstrate that the new model Code has the power to penalise franchisors in breach.

### Ultra-Tune and Geowash proceedings

In May 2017, the ACCC commenced Federal Court proceedings against a franchisor (Ultra-Tune) for alleged breaches of the FCC which include:

a. failure to update its disclosure document, or provide copies of it, to a franchisee within the specified time period;

b. failure to provide a prospective franchisee with disclosure documents which must be provided before accepting a non-refundable payment.

In addition, in early June 2017, the ACCC applied to the Federal Court for leave to commence proceedings against Geowash Pty Ltd (subject to Deed of Company Arrangement) (Geowash), a national car wash franchisor that has been marketing and selling hand car wash franchises since 2013.

Amongst other things, the ACCC alleges that Geowash directors failed to disclose commissions paid to directors from franchisee funds. The ACCC has stated that it is "particularly concerned" about the allegations of improper payment of commissions from franchisee funds and franchise company directors using funds in a way other than what is permitted by franchise agreements.

If granted leave to commence proceedings against Geowash, the ACCC has the capacity to seek declarations, injunctions, an order for the payment of pecuniary penalties, orders for non-party consumer redress, corrective notice orders, and costs.

## What to do?

The proceedings in Ultra-Tune and Geowash signal that franchisors and their directors must be particularly vigilant when it comes to the disclosure requirements under the FCC.

In prosecuting franchisors who are in breach of the disclosure requirements in the FCC, the ACCC has a range of penalties it can impose including issuing infringement notices (up to $9,000 per breach), or the initiation of court proceedings and to seek civil penalties (currently up to $54,000 per breach).

Franchisors should be aware of their disclosure obligations under the FCC. Compliant disclosure documents must be provided within the prescribed timeframes and particularly in circumstances where a pre-existing franchise agreement is renewed, transferred or varied.

SHOULD YOU REQUIRE ADVICE ABOUT YOUR OBLIGATIONS UNDER THE FRANCHISING CODE OF CONDUCT, OR REQUIRE ASSISTANCE IN PREPARING A VARIATION TO YOUR PRE-EXISTING AGREEMENTS, PLEASE CONTACT: COMMERCIAL AND CORPORATE ADVISORY PRINCIPALS MICHAEL BRACKEN OR MARK FITZGERALD OR SPECIAL COUNSEL GEORGINA ODELL.

RETAIL LEASES ACT

# NSW landlords and tenants affected by changes to the Retail Leases Act

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Recent amendments to the *Retail Leases Act 1994* (NSW) *(RL Act)* will affect both landlords and tenants of retail premises.

Under the *Retail Leases Amendment (Review) Act 2017* (NSW) *(Amending Act)* various changes will apply to retail shop leases, the rights and obligations of retail landlords and tenants, leasing processes and dispute resolution procedure.

Generally speaking, the amendments, which came into effect from 1 July 2017, seek to ensure that the protections provided by the RL Act to tenants are more aligned with the protection of consumer and small businesses. The amendments extend certain protections to tenants.

## Some of the key changes are:

1. Proposed retail leases

   Agreements to lease are now captured by the RLA including proposed tenants and landlords and the RL Act applies to agreements to lease in the same way that it applies to a lease.

2. Minimum term

   The previous legislative requirement that a retail lease must be for a minimum term of 5 years has been removed and there is no longer a minimum term. Therefore, more flexible terms can be negotiated. However, if the term of a lease is 3 years or longer, then the lease must be registered.

3. Disclosure of outgoings

   Under section 12A if a landlord's disclosure statement given to a tenant fails to properly disclose outgoings it may result in the retail tenant not being liable to the extent of the non-disclosure. The definition of 'outgoings' has been extended to include fees charged by a landlord for services which the landlord provides in connection with the management, operation, maintenance or repair of the retail shop building or land. The effect of including these fees in outgoings is to protect tenants by preventing landlords from avoiding the provisions under section 12A by providing their own services, such a repairs, cleaning or maintenance. Landlords will need to be diligent in preparing their outgoings calculation and include these fees accurately.

4. Documents to be given to the tenant

   A retail tenant must be provided with a copy of executed lease within 3 months of its execution and an executed Bank Guarantee within 2 months of its execution.

5. Assignment of lease

   The process by which a retail tenant obtains the consent to assignment of the lease from the Landlord has been streamlined.

   The RL Act now separates and clarifies the steps involved for a current tenant to:

   a. obtain the consent of the landlord to an assignment of a retail shop lease; and

   b. to be released from liability to the landlord after assignment.

   This includes a new requirement for giving the proposed assignee disclosure statements when requesting consent to assign the lease. Where previously the tenant was entitled to ask the landlord for a copy of the lessor's disclosure statement to pass on to the proposed assignee, the requirement of the tenant to provide it no longer applied if the landlord was unable or unwilling to comply with the request within 14 days. Now, the landlord *is required* to provide the tenant with the *'updated lessor's disclosure statement'* within 14 days of the request, and the tenant *is required* to give the updated lessor's disclosure statement to the proposed assignee. This will allow proposed assignees to be properly informed in a timely manner as if they were entering a lease from the beginning.

   The process also *requires* the tenant to provide the landlord with such information as the landlord may *reasonably require* to satisfy themselves, specifically, that the "financial resources and retailing skills of the proposed assignee are not inferior to those of the tenant", whereas previously the tenant was required only to provide information to the landlord "concerning the financial standing and business experience of the proposed assignee."

6. Compensation on termination for non-compliant lessor's disclosure statements

   The RL Act currently requires a landlord to provide a tenant with a lessor's disclosure statement at least 7 days before the lease is entered into by the tenant. If the landlord either fails to comply with its obligation to provide the tenant with a lessor's disclosure statement, or provides an incomplete, false, or misleading lessor's disclosure statement the tenant will be entitled to terminate the lease within the first 6 months. The Amending Act includes a new provision that where a tenant terminates its lease in either of these circumstances, it will be *entitled* to compensation from the landlord for reasonable costs incurred in entering into the lease, including expenditure in connection with fit-out of the premises. Importantly, this right will apply to leases entered before 1 July 2017 and which are terminated after 1 July 2017.

7. Recovery of expenses by landlord

   Currently, a tenant cannot be required to pay lease preparation expenses. A landlord will not be entitled to recover any expenses from a tenant involved in obtaining the consent of the mortgagee of the leased retail premises, as these costs are now included in the definition of *'lease preparation expenses'*.

8. Demolition

   Where a retail lease includes a provision for termination by the landlord of the lease on the grounds of proposed demolition of the building, the RL Act imposes specific requirements to be met before the termination on these grounds is permissible, including that the proposed demolition cannot be carried out practicably without vacant possession of the premises. The Amending Act protects tenants when the landlord proposes to terminate the lease due to demolition of *'any part of the building'*, where the term demolition includes *'repair, renovation and reconstruction'*.

9. Online sales

   The definition of turnover no longer includes online transactions where goods or services are not delivered or provided from the retail premises. This amendment will benefit tenants who conduct segments of their business online. As a result, tenants cannot be required to provide the landlord with information regarding these online transactions for the purposes of assessing turnover.

## What to do next?

Both landlords and tenants of retail premises in New South Wales will be affected by the amendments to the RL Act.

SHOULD YOU REQUIRE ADVICE ABOUT HOW THE REFORMS MAY IMPACT YOU OR YOUR BUSINESS, OR ON PREPARING OR AMENDING A RETAIL LEASE, PLEASE CONTACT OUR COMMERCIAL AND CORPORATE ADVISORY PRINCIPAL MICHAEL BRACKEN OR SPECIAL COUNSEL GEORGINA ODELL.

FIRM NEWS

## Finalists in InfoTrack Client Centricity Awards

Meridian Lawyers has been nominated as a finalist in two categories in the InfoTrack Client Centricity Awards for 2017. Recognising excellence in client services and customer experience in the legal and accounting industries, Meridian is a finalist for **Client Service and Delivery** and **Employee Engagement**. Winners will be announced on 24 August.

## Industry recognition

Meridian Lawyers congratulates seven Principals for their recognition as amongst the best in Australia in the 10th edition of **Best Lawyers®**. In Sydney, **Michael Bracken** is recognised by Best Lawyers for Commercial Law. Five Principals are recognised in Insurance Law: Paul Baker, Nevena Brown, Kellie Dell'Oro, Robert Minc and Robert Crittenden, as well as Consultant Catherine Osborne. Principal Marianne Nicolle, based in the firm's Newcastle office, is nominated for Health and Aged Care Law and Medical Negligence for the second time.

Meridian has been shortlisted as a finalist in the Insurance Law Firm of the Year category at the nationally-recognised 2017 **Australian Law Awards** hosted by *Lawyers Weekly*. In addition, Meridian's Paul Baker has been shortlisted in the **Managing Principal of the Year** category.

The Australian Law Awards winners will be announced on 1 September.

Find out more about Meridian Lawyers at www.meridianlawyers.com.au – our team's contact details are provided on the following page

# Meet our team

## Commercial, commercial litigation and employment team

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