CLIFFORD GOULDSON
LAWYERS

War stories from the front line of advising on business risk | Litigation war stories

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1. Disenfranchised

1.1 Commercial litigation 101

(a) A friend once told me that in his schooldays he never lost a playground fight. He was, he said, the fastest kid in his class. Sometimes in the grown-up world, we can't avoid fights. Especially this is so when the other party is a practiced litigator and knows full well that the opposition has neither the money nor the will to fight. Sadly, this kind of attitude is not uncommon in the business world in our experience.

(b) A client who negotiated with the late Alan Bond reported that: "It's like fighting with a pig in mud. And you know what? The pig loves it." So, for most franchisees our primary advice is: "Is there any reasonable way to settle this promptly and without going to court."

(c) That may seem trite, but when we look at the supposedly formidable range of protections accorded to franchisees, it may seem that the franchisee has a strong hand. The truth is though that vindicating rights through litigation is seldom straightforward, quick or cheap. We have a general rule of thumb that unless litigation can be resolved in the current financial year or, at worst, the next one, the outcome is irrelevant to the survival of a business.

(d) More than ever, businesses depend on cash flow and cash whose receipt is uncertain as to time, entitlement and quantum, if any, can't be part of a business plan.

(e) However, if a court proceeding can't be avoided, another basic rule of commercial litigation is to keep excellent paperwork and chronological records. The party who does so has an immense advantage in credibility when it comes time to persuade a court as to what really happened.

1.2 Franchising: the acquisition phase

(a) In recent years, there have been improvements in the disclosure an intending franchisee must receive from the franchisor. These flow from the Franchising Code of Conduct (the Code). This material includes:

(i) An Information Statement to be given at least 14 days before signing a franchise agreement;

(ii) A copy of the Code;

(iii) A Disclosure Document in the required form; and

(iv) The Franchise Agreement in its intended final form.

(b) The Disclosure Document will be the foundation of the intending franchisee's due diligence. The disclosure required under the Code traverses about 250 items. Akin to a prospectus review, the franchisee's due diligence must comprehensively review and pursue as necessary all that disclosure.

1.3 Statutory and regulatory protections

(a) As well as the mandated disclosure, there are particular obligations and protections which arise under statute and regulation. Principally:

(i) From inception and throughout the franchise period, the Code requires both franchisor and franchisee to act in good faith towards each other;

(ii) The *Competition and Consumer Act 2010* (Cth) also forbids "unconscionable conduct" and provides a range of possible remedies; and

(iii) A number of industries are subject to a further regulatory code of conduct, which can apply to franchises in that industry. For example:

- Oil Code;
- Dairy Code; and
- Horticultural Code.

1.4 The lesson

(a) Whilst these protections sound impressive, a franchisee needs to be cautious in pursuing allegations of wrongful conduct by their franchisor. Experienced litigators are well aware of the high standard to which allegations must be proven in court proceedings and the inherent complexity, time, cost and uncertainty of pursuing relief under the Code and/or the *Competition and Consumer Act 2010* (Cth) more broadly.

(b) In one case in which we acted, the franchisor promised our franchisee client, a sixty-day fight in the Federal Court if an allegation (supported by solid evidence) of anti-competitive conduct was pursued.

(c) In another case in which we were involved, our client entered into a contract to sell their business to a large national corporation. The sale proceeded relatively smoothly until towards the end when the purchaser alleged certain non-disclosure, misrepresentation and breach of the sale contract that, according to the purchaser, inflated the purchase price. The purchaser then refused to pay the balance of the contract price alleging that the business was not worth as much as previously agreed. Little did we or our client know at the time, but the purchaser had used this approach many times in the past seemingly as a tactic to acquire the business for a lower price knowing that the seller would likely choose accepting less over a protracted battle in court.

(d) As legal advisors, we don't want our client to be the unfortunate opponent of the pig in mud. This is why we advocate the most thorough due diligence possible at the outside and, wherever possible, compelling, simple and binding Alternative Dispute Resolution processes in the relevant contract.

(e) The option of Federal Court action to resolve a franchise dispute is ordinarily not viable. The costs of such an action will in many cases outweigh the total worth of the franchise business. As hard as it may be to walk away, it is often better to leave the pig in mud undisturbed.

2. My Shares, Your Shares, We all scream for more shares

2.1 Corporate control

Rich folks do not get that way by giving their money away. Shareholders Agreements in the setting of proprietary corporations are often touted as a means to achieve amicable management and cool-headed dispute settlement. Beware: if you are a financial David aligning with a fiscal Goliath, the Shareholders Agreement may be more about control than mateship. And much more about return on Goliath's investment than about equity between the parties.

2.2 Learning from history

To learn the strategy and tactics of fights for corporate control, the USA is a good place to start. American corporate battles are conducted in a bare-knuckle style exceeded only by the Yakuza and Russian Mafia. Case in point: at the dawn of the Gilded Age, the brawl for control of the New York and Erie Railroad between the law-abiding Cornelius Vanderbilt and the notorious Jay Gould. Jay Gould was not just any old Robber Baron. He was known in his time as the "Robber of Orphans and Widows" and the "Mephistopheles of Wall Street". At one point, opposite ends of the Railroad were controlled by armed mercenaries of the contenders. When it was all over, Cornelius, less rich than

before, was asked what he'd learned from the experience. His reply: *"I've learned not to kick a skunk."*

2.3 **What can happen?**

(a) Experts in the USA identify a control strategy which they call: "freeze out, lockout, squeeze out". Can that happen here in Australia? The short answer is yes. We have seen an attempt to do just those things by a corporate Goliath who precisely followed the American template in attempting to shut our David-like client out of a company.

(i) "Freeze out": David finds that he doesn't know what's going on in the company. Critical decisions are made at the CEO level and David, as a shareholder, finds out ex post facto.

(ii) "Lockout": Precisely as noted in the USA commentary, David is accused of trivial "dishonesty" (a few post-conference drinks on his credit card which he had in fact reimbursed) and informed he is excluded from the corporate premises whilst Goliath's CEO "investigates the allegation".

(iii) "Squeeze out": Goliath's board representatives attempt to trigger compulsory divestment clauses in the Shareholders Agreement.

(b) What was wrong with the Shareholders Agreement (which, by the way, had been prepared by or for Goliath)? From our client's perspective, plenty. Put another way, very little about the Shareholders Agreement was right or fair.

(c) The Chair - a Goliath employee - had a casting vote based on board votes, not share volume.

(d) David's position as director was not protected. Hence Goliath's board members, with the Chair's casting vote, could purport to kick David off the board.

(e) Even though David was the largest shareholder (but not the majority holder) and even though he could muster up more than 51% support, the Shareholders Agreement purported to allow the board's decisions to prevail over those of the shareholders.

2.4 **What to do?**

(a) The parties were beyond compromise relatively quickly. The only way to go for our client (because it was the only step of which Goliath would take notice) was an application to the Federal Court. We initiated Federal Court proceedings for our client, but they did not progress to final hearing as they were resolved by a confidential settlement agreement.

(b) The settlement terms allowed our client to exit the unhappy business relationship and gave control of Goliath to a third party, itself a Goliath.

(c) From quite early on, our strategy for our client was to engender the third party's support and provide our client with an exit from the unfavourable Shareholders Agreement on favourable financial terms in circumstances where Goliath was seeking to destroy his livelihood by acquiring his assets for a pittance.

2.5 **The lesson**

(a) The *Corporations Act 2001* (Cth) and the general law potentially allow various paths forward for disputing shareholders:

(i) The deadlock provisions, which can lead to a court-ordered winding up of the company in which they hold shares on what's known as the just and equitable ground (section 461);

(ii) The shareholder oppression provisions (section 232); and

(iii) The appointment of a receiver to the company by the court.

(b) None of these are cheap, easy or straightforward. The court is reluctant to intervene in the operation of a solvent company. Sometimes though, these bombshell tactics are the only options.

(c) The far better course is to ensure that the Shareholders Agreement is fair. When preparing or reviewing a proposed Shareholder Agreement, we identify the focus areas to consider as including:

(i) maintain shareholder parity and beware dilution and ceding control;

(ii) do not allow the board's powers to override shareholder wishes. In particular, be extremely wary of casting vote provisions;

(iii) beware breach and forced buy out provisions;

(iv) ensure shareholder rights to access books and records are maintained and that timely notice is given of intended key managerial decisions;

(v) ensure your right to maintain a board position until voluntary resignation; and

(vi) in the event of death, it may be desirable that your executors can appoint a nominee to the board.

(d) Above all, as with so much else, no one should ever enter into a Shareholders Agreement without proper independent legal advice.

3. Baked Desire

3.1 The parties

Our clients in this tale were a husband and wife, and a company that owned two bakeries. The other side was our male client's son from a previous marriage who was a director, shareholder and employee of our corporate client.

3.2 Setting the scene

(a) Another of our male client's companies ("the Old Company") carried on one of the bakery businesses from 2008 to 2013. In or about July 2013:

(i) our corporate client ("the New Company") was incorporated and took over the existing bakery business from the Old Company;

(ii) the New Company began the second bakery business;

(iii) the son was gifted 30 shares in, and made a director of, the New Company; and

(iv) the Old Company was issued the other 60 shares in the new company.

(b) In early 2015, on advice from his then accountant, our male client's Self-managed Superannuation Fund sold the first bakery premises to the son and used the proceeds of that sale to purchase the shares that our male client's ex-wife held in the Old Company. The son borrowed the whole amount required to complete the purchase of the first bakery premises from the Commonwealth Bank of Australia ("CBA") without any deposit. The New Company paid the son's CBA loan repayments in lieu of rent. The CBA loan was secured by mortgages over the first bakery premises, our male client's residence and the son's home, and guarantees from our male client, the son and the New Company.

3.3 The dispute

(a) The son's wife is a former employee of the bakery business – in fact, our first involvement with these clients was responding to an unfair dismissal claim made by the son's wife against the

New Company. In an interesting turn of events, our clients became aware that their daughter-in-law had been having an affair with a co-worker at the bakery, whilst the son and his new bride were on their honeymoon! Upon making this steamy discovery, the New Company terminated the co-worker's employment and he too made an unfair dismissal application - apparently, with help from the son! Unfortunately, the New Company's termination of the daughter-in-law's employment was the flour that broke the loaf's back in terms of the relationship between our male client and his son, which irretrievably broke down.

(b) The son was clearly conflicted, torn between his legal duties as a director and employee of the New Company, his ties to his immediate family, and moral duties as a husband. Ultimately, the son resigned as a director and employee of the New Company – love won despite his new wife's infidelity!

(c) Over the ensuing days, our male client attempted to get his son to return property belonging to the New Company and transfer the bakery premises back to him, but to no avail. The son was really on a roll as he:

(i) permitted his wife to work in the bakery after her employment had been terminated;

(ii) deleted bakery CCTV footage;

(iii) allowed his wife to enter the bakery after hours without our clients' consent;

(iv) took business documents relevant to his wife's unfair dismissal claim; and

(v) installed remote access software on an office computer.

(d) On 20 April 2016, our male client inadvertently accessed the son's Facebook account, which was linked to the Facebook page for bakery business. Upon being informed that someone had entered his Facebook account, the son published a defamatory Facebook post about our clients.

3.4 **The action**

(a) On 21 April 2016, we sent the son a Concerns Notice under the *Defamation Act 2005* (Qld). Concerns Notices:

(i) identify the defamatory publications and the imputations arising from them;

(ii) demand what the defamed person requires the defamer to do to make amends, including for example ceasing and desisting any further defamatory conduct, issuing a written apology and retraction, and paying the defamed person's legal costs; and

(iii) put the defamer on notice that unless they meet the defamed person's demands, that we will seek the defamed person's instructions to commence a court proceeding against them.

(b) In one of the more brash responses to a Concerns Notice that we've seen, the son brazenly indicated that he had no intention to comply with our Concerns Notice. On our clients' instructions, we briefed a Barrister who agreed with our assessment that the son's Facebook post was defamatory of our clients. We then sent letters of demand to the son noting our clients' rights against him both in defamation law and for breach of his legal duties as a director and employee, which include:

(i) a duty of employees to serve their employers with loyalty and fidelity. This common or general law duty arises from the employment relationship, even if there is no formal contract or written agreement, survives resignation;

(ii) a fiduciary duty of directors to act in good faith for the benefit of their company and in their company's interests. A very similar duty to this equitable duty is owed by virtue of the *Corporations Act 2001* (Cth);

(iii) a duty that both directors and employees owe their companies and employers respectively not to share confidential information of which they're only aware due to their position as a director and/or employee and, if disclosed, would be harmful to their company and/or employer. In certain circumstances, this common or general law duty can survive resignation as a director and termination of employment;

(iv) the statutory duty owed by both directors and employees by reason of section 182 of the *Corporations Act 2001* (Cth) that they must not improperly use their position to gain an advantage for themselves or someone else or cause detriment to their company and/or corporate employer;

(v) the similar statutory duty owed by current and former directors and employees under section 183 of the *Corporations Act 2001* (Cth) who have obtained information because of their position to not improperly use that information to gain an advantage for themselves or someone else or cause detriment to their company and/or corporate employer.

(vi) the obligation created by section 184 of the *Corporations Act 2001* (Cth), which provides that a director will be guilty of a criminal offence if they:

I. are reckless; or

II. are intentionally dishonest; and

III. fail to exercise their position and discharge their duties:

(i) in good faith in the best interests of their company; or

(ii) for a proper purpose.

(c) also pursuant to section 184 of the *Corporations Act 2001* (Cth), the criminal offence that a director or employee commits if they use their position dishonestly:

(i) with the intention of directly or indirectly gaining an advantage for themselves, or someone else, or causing detriment to their company and/or employer; or

(ii) recklessly as to whether the use may result in themselves or someone else directly or indirectly gaining an advantage, or in causing detriment to their company and/or employer.

(d) The son then engaged his own lawyer who flatly denied our client's claims and basically refused to negotiate, which was disappointing given the strength of our clients' claims. The son offered to enter into new lease of the bakery premises to our clients, but that negotiation didn't go too far in circumstances where we described the proposed rent as extortionate. Unfortunately, from a legal perspective, our clients did not wish to spend any more dough on suing the son so unlike the bakery's bread, the dispute ultimately didn't rise to any great heights.

(e) You might be interested to know that at least when our involvement came to an end, the son and his wife remained together and were both allegedly working for the son's mother and our male client's ex-wife…in her bakery, of course.

3.5 **The lesson**

(a) At times, this dispute became more heated than the bakery's ovens, but at least some of our clients' pain could have been avoided had the bakery premises not been transferred into the son's name. Ownership of the bakery premises, the most valuable asset within the family business structure, gave the son unfettered access to the place where our clients kept their confidential business information and almost complete control over the place from where they ran their business and derived their livelihood.

(b) Business disputes between family members are often full of emotion and hard to see coming (most people don't want to even consider the prospect of suing their children), but the same

potential risks that can arise when one unrelated business partner gives too much access and control to another apply in the family business context. Had this family taken advice on what can go wrong between business partners when they restructured, they might not have given the son as much access or control. Such advice may also have unearthed where the son's true loyalty lay.

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