NAVIGATING A SHAREHOLDERS AGREEMENT: THE KEY TO SURVIVING A DEADLOCK

In the second of our HFW Insights: Navigating a shareholders agreement series, in which we distil common corporate and transactional issues into bite-sized insight, we examine the options available to overcome deadlocks – a stressful period that is disruptive to the business and, invariably, detrimental to shareholder value.

What is a deadlock?

One of the biggest challenges for shareholders in any joint venture is decision making. The inability to reach a consensus on key matters will result in a deadlock, which may bring the company's business to a halt or standstill. The corresponding issue in shareholders agreements lies in breaking any deadlock between the shareholders.

Deadlocks do not only occur in 50:50 joint ventures. Companies where shareholders have disproportionate shareholdings or board seats often stipulate in their shareholders agreements where a super-majority or unanimous consent is required at shareholder and/or board levels, as a form of minority protection. Failure to reach an agreement on such reserved matters constitutes a deadlock.

How can deadlocks be resolved?

A well-considered shareholders agreement will contain deadlock mechanisms (otherwise known as deadlock provisions or deadlock resolution clauses) to facilitate a quick resolution.

A good deadlock provision usually consists of two parts:

- The first step is an 'escalation mechanism' whereby the deadlock is escalated to the designated senior management of each shareholder for consultative resolution within a set timeframe. This aims to be sufficient to achieve deadlock resolution.
- The second step provides for a mechanism to be used when a deadlock cannot be amicably resolved by the consultative resolution of Part 1.

Type	Key features	Key implications
Russian roulette	This mechanism entitles any shareholder to issue a notice to the other shareholders, offering to either buy out the other shareholders out at a specified price or requiring the other shareholders to buy it out at the specified price. The shareholder receiving the notice then has the option to sell its shares at the specified price, or buy the other shareholders' shares at the specified price. The purpose of this mechanism is to ensure that a fair price is offered as the shareholder issuing the notice bears the risk that if the specified price is too low, it could be compelled to sell its shares at that price.	It may favour the shareholder with the greater financial ability. A shareholder with 'deep pockets' who knows that the other shareholder does not have the financial muscle to buy its shares may take advantage of the mechanism and offer a low offer price. As such, a 'weaker' shareholder may want to insist on a minimum 'floor price' that must be offered before the mechanism can be triggered.
Texas shoot-out (aka 'sealed auction')	When triggered, it requires each shareholder to submit a sealed offer to an independent third party (usually the auditors of the company or an established accounting firm) offering to purchase the other shareholder's shares at a stated price. The submitted bids areopened simultaneously at a predetermined time and the shareholder who placed the highest bid is required to purchase the other shareholder's shares at the stated price.	As with most other auction processes, this mechanism may potentially result in a higher premium being achieved for the sale price.
Put option	One shareholder is entitled to require the other shareholder to buy its shares at a pre-determined or fair market value.	It is, potentially, more beneficial to a shareholder with a minority stake or a weaker financial ability, as it enables this party to exit the deadlocked company at a fair price.
Call option	This entitles a shareholder to compel the other shareholder to sell its shares at a pre-determined or fair market value.	It will benefit the shareholder with the majority stake or greater financial muscle.
Liquidation	This should be the mechanism of last resort as it will result in the demise of the company that could be otherwise financially sound. Indeed, if none of the above mechanisms are triggered by any shareholder after a pre-determined period of time when a deadlock has occurred, the shareholders agreement would typically contain a clause providing for the liquidation of the company.	

Key takeaways

There are pros and cons for each of the different deadlock mechanisms, as outlined above. Shareholders should carefully consider which to incorporate into their shareholders agreement and agree upfront at the time of drafting the shareholders agreement how any deadlock is to be resolved.

Shareholders may even get creative and come up with a hybrid mechanism or 'modify' a mechanism that they agree best manages any future impasse between them.

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