CITY INSOLVENCY
DISCUSSION GROUP

Wednesday, 3 April 2019

TOPIC

Shareholders and Directors Disputes in Private Companies

PRESENTED BY

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SHAREHOLDERS AND DIRECTORS DISPUTES IN PRIVATE COMPANIES

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Murray Thornhill

Director and Notary Public, Commercial Litigation & Dispute Resolution

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Topics

- Background
- Considering the Company Constitution
- Shareholder Agreements
- Optional and More Sophisticated Clauses
- Common Problems to Avoid
- Grounds for Winding Up
- Just & Equitable Winding Up
- Oppression
- Alternatives to Court
- Novel Approaches
- Recent Western Australian Cases
- Recent Federal Court Case
- Where to from now?

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Background

“Dance first. Think Later. It’s the natural order”

- Samuel Beckett

- Standard constitutions/articles are generally inadequate for preventing and managing disputes
- Limitations and scope of *Corporations Act 2001* and replaceable rules
- The broader legal context for shareholder relations – misrepresentation, fiduciary obligations, misleading conduct, good faith etc

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Considering the Company Constitution

- Pro forma Company Constitutions often will not contemplate:
  - Dispute resolution mechanisms
  - Compulsory buy-back provisions either by the company or by the remaining shareholders
  - Consequences of a director/employee shareholder resigning
  - Deadlock provisions

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Shareholder Agreements

- The Business 'Pre-Nup' - agreeing on specific matters outside the basic corporations law/common law/constitution frameworks including:
  - Adoption of business plans
  - Financial reporting
  - Funding and capital
  - Pre-agreed dividend distributions
  - Veto, deadlock and special majority decision making
  - Share valuation methodology
  - Alternate methods and remedies for dispute resolution
  - Changes in share ownership
- Is it necessary or appropriate? Party goals, attributes, interests, sophistication of business and the parties
- Shareholder's agreements are always a bespoke exercise

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Shareholder Agreements

- Shareholder’s agreement should account for:
  - Client’s objectives and business’ objectives
  - Flexibility around lifestyle and work
  - Why grow? How much growth? What is the growth strategy?
  - Different classes of shares
  - Having other professional advisers in place and part of the process (business “coach”, accountant, corporate adviser)
  - Initial contributions – shareholder loans, client lists, “intellectual property”, are they equal or intended to be?

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Optional and More Sophisticated Clauses

- Put and Call Options
  - Broadly, 'put' options are seen to benefit minority shareholders 'call' options are seen to benefit majority
- Tag Along and Drag Along clauses
- Mandatory adoption of business plan/work program/budget "The shareholders must ensure that the board considers …."
- Financial reporting and auditing rights (cf s247A to 247D CA). More common where the shareholders agreement provides for an IPO exit

Common Problems to Avoid

- Restraints clauses
- Pre-emptive rights – drafting needs to take account of attempts to dispose of interest without triggering the rights; preventing upstream change of control: *Lion Nathan Australia Pty Ltd v Coopers Brewery* (2006) 156 FCR 1; *Kawasaki (Australia) Pty Ltd v ARC Strang Pty Ltd* [2008]FCA 461
- Pre-emptive rights clause must state clearly how a price is to be expressed. The offer itself must be certain and precise*: Phillip Jones v BWE International Limited* [2003] EWCA Civ 298

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Grounds for Winding Up

- *Corporations Act 2001* (Cth)
  - s461(1)(a) – Special resolution
  - s461(1)(e) – Directors acted in own interests
  - s461(1)(f) – Affairs of company are oppressive
  - s461(1)(g) - Act or omission of the company was/would be oppressive
  - s461(1)(k) – "Just and equitable grounds"
  - s467(4) – No winding up order if some other remedy and acting unreasonably in seeking winding up

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Just and Equitable Winding Up

- Just and Equitable" are interpreted broadly
- The foundation for the application lies in "justifiable lack of confidence" in the conduct and management of a company's affairs (*Loch v John Blackwood Ltd [1924]* AC 783, 788)
- A strong argument is needed to wind up a solvent company, e.g. systematic or recurring conduct

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Just and Equitable Winding Up

- Major Categories
  - Company abandoned its main objects (failure in the substratum)
  - Fraud or misconduct by directors
  - Lack of confidence, fairness and public interest and corporate morality
  - Deadlock or disagreement in management

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Just and Equitable Winding Up

- **Breakdown in Mutual Trust and Confidence**
  - *Ebrahimi v Westbourne Galleries Ltd* [1973] AC 360
  - s461(1)(k) enables the court to subject the exercise of legal rights to equitable considerations
  - In small closely held companies (quasi-partnerships) there is an expectation of continuing mutual trust and confidence
  - However, to wind up such a company, something more is needed than just a break down in mutual trust and confidence

- <u>Elements necessary to wind up:</u>
  - Formed on basis of a personal relationship, involving mutual confidence
  - An agreement/understand that all/some of the shareholders shall participate in conduct of business
  - Restriction upon transfer of members' interests in the company

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Just and Equitable Winding Up

- Remedy of last resort (*Re Dalkeith Investments Pty Ltd* (1984) 9 ACLR 247)
- Courts are reluctant to wind up a solvent company (s467(4)):“must make a winding up order unless it is also of the opinion that some other remedy is available to the applicants and that they are acting unreasonably in seeking to have the company wound up instead of pursuing that other remedy”
- “Remedy” includes non-statutory remedies, e.g. transfer rights or offer to purchase shares
- Court may postpone a winding up order to allow the parties an opportunity to negotiate a buy-out eg *Re Amazon Pest Control Pty Ltd* [2012] NSWSC 1568 [33]

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Oppression (Grounds s 232)

- Court may make an order if:
  - The conduct of a company's affairs; or
  - An actual or proposed act or omission by or on behalf of a company; or
  - A resolution, or a proposed resolution, of members or a class of members of a company; is either:
  - Contrary to the interests of the members as a whole; or
  - Oppressive to, unfairly prejudicial to, or unfairly discriminatory against, a member or members whether in that capacity or in any other capacity

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Oppression

- There are two independent grounds for relief – whether conduct of affairs or actual/proposed acts/omissions are either:
  - Oppressive to, unfairly prejudicial to, or unfairly discriminatory against a member (*Tomanovic v Global Mortgage Equity Corp Pty Ltd* (2011) 288 ALR 310; or
  - Contrary to the interests of the members as a whole

Turnbull v NRMA Ltd (2004) 186 FLR 360

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Oppression

- The test is whether, objectively in the eyes of a commercial bystander, there has been commercial unfairness (Morgan v 45 Fleurs Avenue Pty Ltd (1986) 10 ACLR 692
- ‘Unfairness’ is considered in the particular commercial context. Relevant considerations may include:
  - Nature of the enterprise
  - Terms of the company’s constitution
  - General intention and common understanding of the members as to the substratum of the company

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Oppression

Jenkins v Enterprise Gold Mines NL (1992) 6 ACSR 539

- The Court decides whether in balancing the interests of the company as a whole against minority interests, the directors have acted so as to unfairly prejudice the interests of the minority
- This is decided "according to ordinary standards of reasonableness and fair dealing"
- Whether the conduct is 'oppressive' is judged on standards which reasonable directors, acting bona fide, with such skills as directors should have, would think to be fair

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Oppression

- Mere mismanagement or poor management is not oppression (*Shirim Pty Ltd v Fesena Pty Ltd* (2000) 35 ACSR 221)
- Conduct may be oppressive even though it accords with the company's constitution (Ford at [10.450.21])
- Conduct may be oppressive even if directors act within power in good faith and for a proper purpose (*Wayde v New South Wales Rugby League Ltd* (1985) 180 CLR 459)

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Oppression (Main Categories)

- Misappropriation or misuse of company funds or assets
- Board decisions not in the interests of the company
- Failure to hold/conduct of directors or members' meetings
- Excessive director/executive remuneration or other "management" fees.
- Unfair restriction of dividends (although non-payment of dividends is not oppressive, without more, where there is a countervailing increase in shareholders' funds: *Thomas v H W Thomas Ltd* [1984] 1 NZLR 686.)
- Issue of shares to dilute minority interest or ensure that directors / executives maintain control.
- Unlawful divestiture of shares.

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Oppression

Main Categories

- Calling up of “shareholder loans” (particularly in the context of a “family” company.)
- Denial of management expectation / improper exclusion from participation in management.
- Inability to sell shares in a private company.
- Failure to provide information.
- Failure to prosecute an available action.
- Payment of legal fees, e.g. use of company funds to defend oppression proceedings where contest one between members.
- Departure from core business.

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Oppression

Remedies (s 233)

- Winding up
- Modification or repeal of the company’s constitution
- Regulating the future conduct of the company’s affairs
- Purchase of a member’s shares by another member
- Purchase of a member’s shares by company
- Company to commence, defend or discontinue legal proceedings
- Member to commence, defend or discontinue legal proceedings on behalf of company
- Appoint receive or a receiver and manager
- Restraining a person from engaging in conduct
- Requiring a person to do a specified act

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Oppression

Remedies

- Court may make other remedial orders
- The remedy that will eliminate the oppression and is the least intrusive will be the most appropriate relief (*Nilant v RL & KW Nominees Pty Ltd* [2007] WASC 105)

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Remedial Action to Address Oppressive Conduct

- Where oppressive conduct has already occurred an offer, **in some cases**, to purchase the minority's shares **may** act as a cure to the oppressive conduct. T*omanovic v Global Mortgage Equity Corporation Pty Ltd [2011] NSWCA 104 at [226] – [237]*
  - The onus is on the oppressor to establish that a fair offer was made.
  - Whether or not an offer is fair will depend on the circumstances of the matter, including whether the oppressed party has access to relevant information to properly consider the offer.
  - Best practice is to jointly appoint an independent valuer.
- Where an oppressed party is removed from a position in management either as an employee or director, the company should seek legal advice whether it is appropriate to reinstate them.

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Alternatives to Court

Alternative Dispute Resolution

- ADR designed to:
    - Be less costly
    - Be more timely
    - Avoid publicity or media attention
- Possible ADR options:
    - Mediation
    - Expert determination (binding or non-binding)
    - Jointly appointed senior counsel to provide opinion
- Common Traps
    - Non-mandatory ADR clauses
    - Agreements to negotiate
        - Clause must clearly describe the process, nominate who is to appoint, who bears costs of mediator
        - Beware the “good faith” minefield

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Novel Approaches

Pilot Program in Victoria

- In September 2014, the Victorian Supreme Court announced a 6 month pilot programme to deal with applications for oppression. That trial programme was extended to April 2018 and applied to all relevant proceedings in the Commercial List of the Court.
- Given that the pilot programme resulted in the early resolution of numerous matters and/or significantly narrowed issues in dispute, the Victorian Supreme Court decided to continue the procedure implemented in the pilot programme on an ongoing basis, which was set out in a Practice Direction in May 2018.
- The Court identified that most claims relate to small businesses (esp family businesses where the value of business is not substantial)
- Modified the application process
  - Originating process supported by affidavit (max 3pgs) setting out a summary, including the value of the shares and annexes current ASIC search – that is all

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Novel Approaches

Pilot Program in Victoria

- Heard before an Associate Judge (master) or Judicial Registrar following entry into the programme, for a conference to explore options for resolution
- Matter will be referred to mediation prior to pleadings and detailed affidavits being exchanged
- Matter may also be referred to external private mediation if appropriate
- If matter is not resolved at mediation, consent directions may be made for future conduct of the matter. Following these steps, the application may be referred to a judge for further directions or hearing

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Novel Approaches

Applications in the Federal Court

- Since the pilot programme in Victoria, the Federal Court has implemented a similar procedure to deal with applications for oppression.
- The application is made by originating process, supported by an affidavit (max 5pgs), contains a succinct and clear summary of oppressive acts, and exhibits only a current ASIC search of the company.
- Similar to the Victorian Supreme Court programme, the matter will usually be referred to a mediation if it is not resolved at the initial hearing. Further case management orders may be made if the matter is still not resolved after mediation.

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Recent Western Australian Cases

- A provisional liquidator was appointed whilst oppression proceedings were ongoing for the purpose of preservation of the assets of the company as well as independent examination of accounts and financial transactions: *Glendining v Pham* [2015] WASC 419
- A "best guess" valuation of shares may be sufficient, where a party is denied all relevant material to make a proper valuation and no evidence is led to contradict that evidence: *Murabito v Conspect Construction Pty Ltd* [2014] WASC 474
- A shareholder with 50% shareholding (or more) of a company can be oppressed provided they do no control a majority of the votes *Patterson v Humfrey:* [2014] WASC 446

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Recent Federal Court Case

- Director misconduct such as issuing large numbers of shares to themselves at gross undervalue, misleading investors and making unauthorised and exorbitant expenditures is sufficient for a court to order winding up of the company on just and equitable grounds: *Australian Securities and Investments Commission v Aviation 3030 Pty Ltd* [2019] FCA 377

THANK YOU FOR ATTENDING

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Next CIDG Session

Wednesday, 1 May 2019

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