

## RESOLVING A MANAGEMENT DEADLOCK

In this paper we look at different ways to resolve a management deadlock. We focus on companies, but the concepts are adaptable to partnerships and joint ventures.

We assume a company with two shareholders, each holding 50% of total issued shares and each having one nominee director on the board of the company. There arises a matter for decision (say next year's business plan) on which those directors disagree. A deadlock exists. It must be resolved, or become poisonous to the company.

### Strategies

If you anticipate a deadlock may arise in the future, you may:

- do nothing – the argument for this is that in a deadlock both shareholders will be in a “Mexican standoff” and, having no alternative but to liquidate the company, they will be forced to compromise and agree to an ad hoc solution
- provide in the Constitution (memorandum and articles of association) or in a Shareholders Agreement a mechanism to break a deadlock (see next heading)
- leave it to a judge to sort out (see later).

### Constitution (or Shareholders Agreement)

There are various provisions that could be made:

- give the chairman of board meetings a casting vote (but who gets to be chairman?)
- the shareholders personally (or, if they are themselves companies, their respective managing directors) must meet in an attempt to resolve the deadlock
- appoint a third director who is independent of the two shareholders (if you can find a candidate willing to act and acceptable to both shareholders, and does the third director resign after the deadlock is broken?)
- refer the deadlock to an independent expert who decides the issue (a good solution for technical issues, but not for commercial issues)

- refer the deadlock to mediation (a good solution if the parties approach it in good faith and intending to compromise, as a mediator has no power to impose a solution on the parties)
- refer the deadlock to arbitration (similar to litigation, adversarial but private, and the arbitrator has power to impose a solution on the parties)
- “Russian Roulette” under which a shareholder must offer to sell their shares and, at the same time and for the same price per share, offer to buy the shares of the other shareholder; the other shareholder may accept either offer, thus one of the shareholders leaves the company (or if the initial offers are declined, the mechanism may require escalating offers and counteroffers being made until the price offered is irresistible) (a solution that favours the financially stronger shareholder who can afford to buy out the other shareholder)
- “Fairest (highest) sealed bid” under which both shareholders must make a sealed offer to buy the shares of the other shareholder, which offers are given to a third party who decides which offer price is the fairest and must be accepted – the loser selling to the winner (again a solution that favours the financially stronger shareholder)
- agree to sell the assets and wind up the company voluntarily if the deadlock continues for a stated period of time (usually with either shareholder being at liberty to bid for the assets) (an end game to the “Mexican standoff” approach mentioned earlier)
- agree that one shareholder is authorised for a time to find and contract with a buyer for 100% of the issued shares, for the same price per share and, if that shareholder cannot find a buyer, the authority rotates to the other shareholder.

When does a deadlock exist, for these provisions?  
The document might say that before a deadlock mechanism operates there must be both:

- o a failure to agree about a serious matter, like next year's business plan or a proposal to issue additional shares; and
- o a specific proposal for the matter must be voted on (but not pass) at a board meeting at least twice within say 3 months.

### **Leave it to a judge**

This is not a good fallback solution for several reasons:

- litigation is costly, adversarial (someone wins, someone loses) and usually not fast enough to meet commercial imperatives
- a judge will not substitute his or her commercial judgment for that of the directors, but will make an order (such as for compulsory sale of shares) against a person found guilty of oppression, prejudicial conduct or other manifest unfairness - this means finding some wrongdoing and laying blame
- the outcome may not be one you expected if, say, the judge finds an irretrievable breakdown of trust and cooperation between the shareholders and orders that the company be wound up under the "just and equitable" ground of the *Corporations Act*.

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