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Shareholders' agreements – a key lesson about planning for the future

The Court of Appeal has recently released a decision that relates to the actions of a minority shareholder in the context of a business sale.The case highlights the importance of having a well thought-out shareholders' agreement that anticipates the likely needs of shareholders, both now, and in future.

What is the case about?

Dold v Murphy [2020] NZCA 313 centered around the sale of Cruise Whitsundays Pty Ltd (which, as the name suggests, is a cruise ship operator based in Australia's Whitsunday Islands).

Cruise Whitsundays was owned by two majority shareholders (46.9% each) and one minority (6.2%) shareholder.

The shareholders received a lucrative offer to sell their business to a private equity firm, which the majority shareholders wished to accept. The minority shareholder refused to participate in the sale unless he received $5 million more than his pro-rata share of the sale proceeds.

The majority shareholders ultimately agreed to pay the minority shareholder an additional $4 million to allow the transaction to proceed.

Once the sale had completed, one of the majority shareholders sued the minority shareholder. The majority shareholder argued that the minority shareholder's conduct was unlawful, as it amounted to:

- a breach of the shareholders' agreement;
- a breach of a fiduciary duty owed to the majority shareholders by the minority shareholder; and
- economic duress.

Analysis

Did a breach of the shareholders' agreement occur?

While the shareholders' agreement did not include what are commonly known as "drag-along"[1] and "tag-along"[2] clauses, it contained relatively bespoke provisions that required the parties to maximise each shareholders' return and to manage the company in such a way that a sale could be facilitated within five to ten years. It also contained more commonly-seen provisions that prevented the shareholders from carrying on their business in a manner that was inconsistent with the main operating objectives of the company, and to ensure that all business opportunities contemplated by the company were referred to the company in the first instance.

The majority shareholder argued that the above provisions barred the minority shareholder from seeking a premium on the sale of his shares. The Court of Appeal rejected this argument, as it said that doing so would unjustifiably convert those clauses into a "drag-along" clause, which would be inappropriate, as no such clause was specifically included in the shareholders' agreement.

Did the minority shareholder's conduct breach a fiduciary obligation owed to the majority shareholders?

The Court was unwilling to accept the proposition that shareholders generally owe fiduciary duties to each

[1] A "drag-along" clause is a clause that allows majority shareholders to force minority shareholders to participate in a sale (usually on the same terms as the majority shareholders)

[2] A "tag-along" clause is a clause that allows minority shareholders to join in on a majority shareholders' sale (usually on the same terms as the majority shareholders)

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other, and instead held that shareholders are, in most instances, entitled to act in their own self-interests in their dealings with each other. Further, when the relationship between the parties is fundamentally a contractual one (e.g. a relationship that exists pursuant to a shareholders' agreement), priority must be given to the contract in the first instance.

Did the demand amount to economic duress?

In order for "economic duress" to be found, there needs to be "an exertion of illegitimate pressure" on the victim, and that pressure needs to compel the victim to enter into the obligation.

The Court of Appeal held that the minority shareholder's threat to withdraw from the sale unless he received a premium was lawful. As a general rule, a party can contract with whoever it pleases and on the terms that it pleases. Although the demand from the minority shareholder was unexpected, it was not illegitimate. The majority shareholders had time to consider matters before negotiating payment of a lesser sum in the days that followed.

Key lessons

When setting up a new business, a shareholders' agreement can be viewed as an unnecessary expense. Shareholders are often excited by the prospect of the new venture, and feel like they can trust those who they are involved with, particularly when it comes to resolving any disputes or exit arrangements. However, shareholders' motivations may change over time and a trusted relationship can quickly turn into something different. Without a robust shareholders' agreement that deals with the tough issues, parties can find themselves in a deadlock or a bargaining position that isn't what they thought.

A shareholders' agreement needs to be tailored to reflect the needs of the shareholders and the ultimate goals of the business. For example, if the shareholders intend to sell the business within a specified timeframe, then the shareholders agreement should set out the mechanics by which that sale will occur, and what each party will do to facilitate that sale. At its simplest level, this could be achieved by providing the shareholders with "drag-along" or "tag-along" rights, which would have given the minority shareholder in *Dold v Murphy* no room to demand the extra payment. It is also possible to include more detailed provisions that relate to "liquidity events" - e.g. if a sale or listing is proposed. The level of detail will depend on the goals of the shareholders, and the nature of the business itself.

Dold v Murphy serves as a timely reminder that shareholders can act in their own interests and should not rely on the intervention of the Court to resolve an unanticipated dispute in their favour (either by "reading words into the agreement", or finding an "implied duty"). A well-considered shareholders' agreement will help to manage each party's expectations and provide protection/certainty.

Want to know more?

If you have any questions about this decision or its potential implications for you, please contact one of specialists in our Corporate Team.

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