Defects in company organisation caused by deadlock

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Introduction

The Federal Supreme Court recently clarified in two appeals how to deal with defects in company organisation caused by deadlock between two equal shareholders, particularly if they are both board members. Courts often have to intervene in such cases on request of one of the two affected shareholders or a creditor, or when the Commercial Registry becomes aware of the deadlock (for further details please see "Code of Obligations: organisational defects"). The Federal Supreme Court has now confirmed for the first time that courts are also authorised to order a share auction in such cases (ie, not only to resolve the deadlock by appointing new company board members and auditors under Article 731B of the Code of Obligations). However, it is strongly recommend that such a harsh outcome be avoided by implementing suitable measures to resolve conflicts from the outset.

Case histories

The court's most recent deadlock decision (SFCD 4A_147/2015, July 15 2015) involved B AG, a Swiss stock company owned by a married couple. Each spouse held 50% of the shares and was also elected to the board by the company's annual general meeting (AGM). In early 2014 a private dispute arose between them, which led to a deadlock in the company. The owners could no longer agree on who to elect to the board and to appoint as auditors. Subsequently, C, one of the two shareholders, invoked Article 731B and asked the court to appoint a third-party board member as well as a new auditor. D, the other shareholder, requested to be appointed as board member and to re-appoint the former auditor until the next AGM. After the lower court decided in favour of D, C appealed to the Federal Supreme Court.

In another deadlock decision (SFCD 138 III 24FF), two shareholders, AX and B, each owned 50% of the shares and could no longer agree on the due appointment of the statutory auditors. As a result, the Commercial Registry requested to have the company dissolved and forced into liquidation, which the lower-instance court approved. The company and B appealed against the dissolution and liquidation to the Federal Supreme Court.

Decisions

In both cases, the Federal Supreme Court held that courts have wide discretion to define of the most suitable measures in cases of company organisation defects under Article 731B caused by deadlock and should, in this respect, pursue an escalation strategy over time.

Courts should limit themselves to setting the affected company a deadline to resume orderly organisation through the election of necessary board members and auditors. If the company fails to do so, courts can, for example, reinstall a former board member in that function for a certain time, even if he or she was not re-elected by an AGM because of deadlock. This can be particularly suitable

if the former board member is also entrusted with the management of the company and is therefore familiar with the company's business and business relations. Likewise, courts can also reinstall former auditors and a company can even be ordered to pay the auditors' fees.

Should deadlock continue, courts should resort to auctioning the company shares between the two shareholders. Generally, in the presence of mere organisational defects caused by deadlock, courts should not resort to dissolution and liquidation of the affected company, but not because of the other stakeholders' interests at issue (eg, employees and creditors). Dissolution and liquidation of the affected company should take place only in the presence of important reasons listed under Article 736(4) of the code – in cases in which, under the principle of good faith, minority shareholders can no longer be expected to tolerate the company continuing under the rule of a majority shareholder (ie, not only because of deadlock).

Based on these considerations, the Federal Supreme Court upheld the lower court decision in the final deadlock case in favour of D. However, in the penultimate case, the Federal Supreme Court overturned the lower court decision for the dissolution and liquidation of the company at issue in favour of company B and its stakeholders by installing new auditors.

Comment

Despite clear Federal Supreme Court guidance, it is strongly recommended to keep the deadlock scenario in mind when two equal shareholders are still on speaking terms and willing to negotiate. At present, the following can be envisaged at corporate level:

- AGM voting rights in a 50:50 shareholding can be altered by creating voting shares in the company's articles in favour of only one shareholder (if the other is interested mainly in dividends and share capital increase participations, and not in the runningof the company).
- Another option is to invest the AGM chairman with the power of a final ballot if deadlock occurs (but this would not resolve the question of how the chairman would be elected in case of deadlock and it has not yet been confirmed as a possible solution by court guidance).
- The voting rights of two equal shareholders both represented on the board can be altered in the company's articles by granting the chairman the casting vote and possibly by foreseeing an annually altering chairmanship of the board and AGM in a shareholders' agreement.

In such shareholders' agreements, various other deadlock resolution mechanisms can be tailored to suit almost any circumstances of a particular case. Some of these solutions seem to be rather draconian; however, they may entice parties to compromise rather than face these solutions.

In case of a manifest deadlock, one of the two parties may, for example, be contractually required to serve notice to the other party and name an all-cash price at which it values its half-interest in the whole business. The party receiving the notice will have the option to either buy the other party out at that price or sell its own shares to the other party at that price (a so-called 'Russian roulette' clause). Other mechanisms are similar. For example, both parties may agree to sending out their sealed bids to an umpire, indicating the minimum price at which they would be prepared to sell their half-interest in the whole business (or a part thereof with a view to overcoming deadlock). Whichever bid is highest wins and the bidder must buy the losing bidder's shares at the price indicated in the loser's sealed bid (a so-called 'Texas shoot-out' clause).

If the parties do not wish to commit themselves to such dramatic termination procedures – which could turn against either party – softer options are available:

- Parties can agree on deadlock in the election of board members or auditors that a third independent person (ie, a mediator) decides on their behalf.
- 50:50 shareholders can also commit to elect a neutral third-party board member which possibly holds a small percentage of the company's shares and who will, as a result of his or her expertise in the company's field of activity, help the parties to find the most reasonable solution for the company and its stakeholders.

With regard to all such 50:50 shareholdings, it is paramount to avoid affecting the ongoing business of the company under a future deadlock by creating suitable deadlock resolution mechanisms from

the outset (ie, well before any dispute between the shareholders arise).

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