TAKE THE MONEY AND RUN – LIQUIDITY OF MINORITY SHARES

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Should a shareholder in a close company[1] have a statutory right to demand a mandatory buyout, whenever he/she wishes to leave the company? This, in a nutshell, is the problem discussed in this article. It touches on a host of questions – members' expectations; creditors' protection; corporate governance; majority rule versus minority protection; mobility of capital versus maintenance of capital; liquidation of a viable company – you may think of a few more yourself. Not for nothing has it been described in the United States as "the remaining close corporation problem".[2]

In the absence of an established market for private shareholdings, liquidation of the investment (equity) can be achieved in one of two ways: through a pro rata share of the realised assets in a winding up; or a buyout of the shares in question by either the remaining shareholders, or, exceptionally, the company itself.[3] Obviously, if either of these can be arranged amicably, there is no problem. But often a member's wish to withdraw is a result of a conflict, or itself causes a conflict as to the fair price of the shares. In simple words, the problem is how to balance the right of a private shareholder to liquidate the investment by quitting, or by forcing a dissolution, with the financial stability of the company and the right of the majority to rule?

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1 Defined as a company with a small number of shareholders (normally known to each other) and no available market for the shares – cf O'neill *Close Corporations* (2nd ed 1971, Cum Supp 1981) ss1.02 and 1.04. This is a more accurate characterisation than our "small private company", since a close company is not always small in terms of the enterprise, eg joint venture companies.

2 Hetherington and Dooley, "Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem" (1977) 63 Virg LR 1. This valuable article has provided much of the stimulus for the present paper. I have drawn liberally on Hetherington and Dooley's analysis (for which I am grateful) attempting to relate it to the New Zealand situation. To my knowledge the problem has not yet been discussed as such in New Zealand, the United Kingdom or Australia, either judicially or academically. Since our prospective new Companies legislation (*Company Law Reform and Restatement,* Law Commission Report No 9 (Wellington, June 1989), hereinafter the *Report*) has a distinct North American flavour, the United States perspective deserves close attention.

3 The common law maintenance of capital doctrine prohibits the company from purchasing its own shares – *Trevor* v *Whitworth* (1887) 12 App Cas 409. Return of capital to shareholders requires a formal reduction of capital subject to the supervision of the court: Companies Act 1955, ss75-79. The court has express power to order reduction of capital corresponding to a remedial buyout order – Companies Act 1955, s209(2)(c). New Zealand is still to introduce a restricted power for the company to purchase its own shares – see *Draft Companies Act* (hereinafter the *Draft Act*) in Chapter V of the *Report,* ss49-54.

Traditional Anglo-New Zealand company law has answered this question in two ways. One is a remedy against "minority oppression" under the relevant provision.[4] The other is dissolution under section 217(f) of the Companies Act 1955 and its equivalents – winding up on the "just and equitable" ground. Under the former, an "oppressed" shareholder could obtain an order that his/her shares be bought by the company, or by fellow shareholders, at a fair price. Under the latter he/she could recover the investment by forcing a winding up of a company deadlocked by an irreconcilable dispute.

The two escape routes – winding up and relief against oppression – have been available on different grounds. Arguably, a winding up could be justified by a breakdown of relationship leading to a deadlock, while oppression always required proof of majority fault. This distinction has contributed to the separate development of the two jurisdictions. In both cases, though, the inquiry has centred on the fault/deadlock issue, rather than on the right to leave the company. No attempt has as yet been made to formulate an arguable *right* to liquidate the equity by leaving the company when the shareholder wishes to do so, on grounds of equity and efficiency.

This is not a mere restatement of the same problem – it signifies an alternative approach. High liquidity for minority interests would not only facilitate withdrawal – it would also, as discussed below, have an impact in other areas of intra-corporate relationship.

Under the suggested approach, the liquidation of the investment is no mere relief in settling a dispute. It is to be regarded as a *facility,* ranking together with, say, the transferability of the share and the right to vote it. The question thus becomes not merely one of remedy, but also one of "right" – serving certain policy objectives. High or low liquidity has bearings on ongoing relationship in the company, as well as on the very decision whether to invest in a close company. It also affects management efficiency and resource allocation in the capital market.

Effect of Withdrawal/Dissolution Rules

The ease or otherwise with which individual members may liquidate their investment in a small firm has bearings on other matters: protection of parties' expectations; attitudes to settling disputes; and, on a different level – efficient allocation of resources in the capital market.

As in much of the discussion of the close company, the starting point here is the dual nature of this entity. While legally a company, it is, in reality,

4 Originally the now repealed section 210 of the Companies Act 1948 (UK). Its New Zealand progeny was the former version of section 209 of the Companies Act 1955 (since amended by the Companies Amendment Act 1980, s11).

a partnership.[5] Should it therefore be treated, essentially, as a de facto partnership, or should the legal consequences be determined conclusively by its corporate status?

Opinions vary. On the one hand, it is argued that to subject the close company to the full rigour, formalities and strictures of company law would be to work to a wrong model. Company law is about the large public company. It caters for a distinction between capital, management and labour. Investors accept distant involvement, leaving everyday management to professional strangers. They can, at any time, liquidate the investment by selling in official markets.

Functionally, the close company is an altogether different creature. The participants expect a close involvement, including, often, employment; equal say in the running of the business, independent of the amount of capital invested; and an informal, close and harmonious cooperation with the other participants, whom they know personally. There is no market for the shares, so liquidation of the equity depends on consensus, a right of withdrawal, or a power to dissolve the firm. These are, of course, some of the hallmarks of a partnership.

The argument for applying strict company law to members of the close corporation rests mostly on the choice to incorporate. The consequences of incorporation must be accepted in full. This is a fair price for the privilege of limited liability, better debt raising facilities (the floating charge) and other real or perceived benefits (ie tax advantages). Most of the ensuing obligations are for the benefit of the creditors (maintenance of capital; disclosure; corporate capacity); but they also apply to internal organisation – fiduciary relationships between partners are replaced by contractual relationships between shareholders, and there is the vigour of majority rule unbridled by fiduciary relationship. The parties, the argument goes, are to be "held to their bargain". They must accept the full legal consequences of their decision to incorporate.

There is another aspect to this debate. Whatever the legal regime – company or partnership – constructive cooperation between the members is vital to the small firm's success. The welfare of the small business association, it has been observed, largely depends on the[6]

> . . . ability [of the members] to sustain a close, harmonious relationship over time. The continuance of such a relationship is crucial because it reflects what is perhaps the fundamental assumption made by those who decide to invest in a close corporation: they expect that during the life of the firm the shareholders will be in substantial agreement as to its operation.

While most of the time members of the small firm would work together towards a common goal (a consensus facilitated by, inter alia, equal access

5 For a fuller discussion of the partnership analogy in the context of shareholders' protection see Shapira, "Minority Shareholders' Protection – Recent Developments" (1982) 10 NZULR 134 at 146 et seq.

6 Hetherington and Dooley, op cit, n2 at 2.

to information), divergence does, of course, occur. It may be caused by time, human nature, or change of circumstances, either commercial or personal. The odd dispute may be resolved by an agreed mechanism, such as arbitration. Deeper conflicts, however, which persist, get compounded and destroy the consensus – deprive the firm of its maximum efficiency – and may be, in the long run, fatal. The legal regime, therefore, should be as conducive as possible to harmony and consensus.

On our particular interest – withdrawal and dissolution rules – partnership and company law take exactly opposite positions. Partnership law assumes a voluntary association which lasts only as long as each partner wants it to last. Each partner therefore can dissolve the firm by a mere notice to the other partners.[7] Alternatively, a partnership might be set up for a fixed period, at the end of which it dissolves automatically.[8] Company law, on the other hand, assumes the existence of the company "in perpetuity". The association is terminable, voluntarily, only by the company itself (ie super majority of members).[9]

In addition, creditors' protection (the capital maintenance doctrine) proscribes the company buying out its own shareholders, except by a formal reduction of capital. With no established market for the shares, the locked-in private shareholder's only hope is to convince fellow shareholders to join him/her in winding up the company, or to buy him/her out fairly. Naturally, in a conflict situation, this is hardly likely. The answer is, therefore, judicial remedies – dissolution, or a buyout order as relief against unfair prejudice.

The high liquidity of the investment resulting from partnership rules helps promote harmony and cooperation, while restrictive withdrawal rules act in the opposite way. They prolong conflict because the majority would be in a position to exploit the minority.

The power of the minority to dissolve the business at any time (in effect, to force the others to buy it out) would provide a strong incentive to accommodate the views of the minority and restore consensus. Failing this, the majority will be at risk of losing the minority's investment. On the

7 Partnership Act 1908, s35. Commercial inconvenience due to each partner's unrestricted power to dissolve the partnership is overcome in practice by special contractual arrangements. The basic statutory rule, however, demonstrates the policy objectives and would benefit the member wishing to withdraw, when the parties had failed to plan for withdrawal, in an oversight, or when the contractual arrangements unwittingly fail to displace the basic rule.

8 Partnership Act 1908, s35(1)(a). Where the partnership continues after its agreed term has expired, it continues as partnership at will – s30.

9 Companies Act 1955, s268(1)(b). A company stated by its memorandum or articles to be formed for a definite period still does not dissolve automatically at the expiration of the period. A resolution is required to that effect by the company in general meeting – s268(1)(a). Constitutional (statutory) powers of the company cannot be varied by special contractual arrangements, so no right to dissolve the company, at will or upon conditions, can be established by contract. A special contractual right to demand a buyout (which may be included in the articles would be effective, but its practical benefit to the private shareholder is doubtful; see discussion post p299.

other hand, if dissolution is up to the majority, it will not be forthcoming, because of the incentive to exploit a locked-in minority.

"Exploitation" in this context has been described as follows:[10]

> . . . one shareholder exploits another when he uses his position to capture a significant portion of the other's "share" of the firm's income and profits; the other's share may be defined as the portion of income and profits the parties would agree, through arms-length negotiations, belonged to that shareholder. Such exploitation is likely to occur when the majority can simply ignore the minority wishes by using managerial and voting control, and the minority is powerless to liquidate the investment.

This would happen when one faction is in control of both the board of directors and the general meeting – a situation not uncommon in close companies – allowing the majority ". . . to cause a wealth transfer to itself from the minority at any time".[11]

On the "macro" level, a position which allows a lock-in of dissenting minorities is fostering an inefficient allocation of resources in the capital market:[12]

> A free enterprise system is based on the assumption that optional allocation of resources will result from the individual decisions of resource owners acting in their own perceived self-interests. Obviously, what an individual owner believes to be in his self-interest is subject to change over time as he acquires information about alternative uses to which his resources might be put or as his personal needs and circumstances change. Accordingly, efficiency requires that an owner be able to redirect the use of his resources in accordance with his changing perceptions. Liquidity is thus essential to the efficient allocation of resources in the capital market, and a system that freezes allocation at the time of initial investment is inherently inefficient.

On both equity and efficiency grounds, therefore, company law withdrawal/dissolution rules appear inadequate. The minority can only withdraw with the consent and cooperation of the majority, or must prove it had suffered some wrong before being allowed to liquidate the investment. This position does not accord with parties' expectations of having partners' rights to liquidate the investment in an irreconcilable conflict situation. It leaves the minority vulnerable to exploitation, thus tempting the majority to prolong disputes; and it fosters inefficient allocation of resources in the capital market by locking in the investment of reluctant members.

Those considerations, of course, must be balanced against (assuming creditors' rights are secured) the normal right of the majority to manage the company and to rely on its equity base without being unduly subjected to the costs and difficulties of the need to refinance.

10 Hetherington and Dooley, op cit, n2 at 4.
11 Ibid at 5.
12 Ibid at 44.

The Current Position

Dissenting minority investment can be liquidated by either a judicial dissolution under section 217(f) of the Companies Act 1955, or a buyout relief under section 209.

(i) Just and equitable winding-up

The court has had the power to equitably wind up viable companies, at a member's behest, for over a century now. A descendant of the law of partnership, this power has been interpreted by a close analogy to partnership rules on judicial dissolution.

In the early leading English authority,[13] the two, equal, warring shareholders, were treated as "in substance . . . partners".[14] Consequently, partnership principles were applied whereby,[15]

> Refusal to meet on matters of business, continued quarreling, and such state of animosity as precludes all reasonable hope of reconciliation and friendly co-operation has been held sufficient to justify dissolution. It is not necessary, in order to induce the Court to interefere, to show personal rudeness on the part of one partner to the other, or even any gross misconduct as a partner. All that is necessary is to satisfy the Court that it is impossible for the partners to place that confidence in each other which each has the right to expect, and that such impossibility has not been caused by the person seeking to take advantage of it.

Most important here is the recognition that a "pure deadlock" makes it "just and equitable" to wind up the company. I use "pure deadlock" to describe a deadlock which does not involve oppression or unfair prejudice. It is created by an irreversible breakdown of relationship, mutual loss of confidence and inability to cooperate. It requires no fault by the majority, and would exist notwithstanding the majority's formal legal power to continue to run the company without the minority's cooperation.[16] In short, a pure deadlock means permanent inability to cooperate for which neither party is particularly to blame, or for which both parties are equally to blame.

13 *Re Yenidje Tobacco Co Ltd* [1916] 2 Ch 426.

14 Ibid at 434, per Warrington LJ.

15 Ibid at 430, per Cozens Hardy MR, quoting with approval *Lindley on Partnership.*

16 "Deadlock" may mean either a permanent inability *to cooperate,* or a permanent inability *to act.* The majority would normally be able to continue to act legally even without co-operation of the minority, using incorporation and by-default powers to overcome absence of quorum and to fill vacancies on the board. Significantly, *Yenidje Tobacco,* supra n13, recognises inability to cooperate as a deadlock, not because the company cannot function, but because the parties' expectations of cooperation had been destroyed: "If ever there was a case of deadlock I think it exists here; but, whether it exists or not, I think the circumstances are such that we ought to apply, if necessary, the analogy of the partnership law and to say that this company is now in a state which could not have been contemplated by the parties when the company was formed and which ought to be terminated as soon as possible": ibid at 432, per Cozens Hardy MR.

Later cases,[17] however, took a less kindly view of a deadlocked minority's predicament. Emphasising the contractual arrangements underlying the incorporation, it had been doubted that a just and equitable winding up was a proper means to resolve a pure deadlock. A company was not a partnership and members were bound by contractual arrangements contained in the articles. A minority, even a disenfranchised one, could not sue for a dissolution unless it could show that the majority had acted oppressively or in an overbearing manner. An irreversible breakdown in relationship was not enough, as long as the majority had acted within its legal powers and could continue to run the company by using them.

This view, later described as "... the undue emphasis ... [put] on the contractual rights arising from the articles, over the equitable principles which might be derived from partnership law ...,[18] has been expressly overruled by the House of Lords.[19] In a landmark decision, *Ebrahimi* v *Westbourne Galleries Ltd*[20] the House made it clear that a just and equitable winding up might be granted to a locked-in minority even if the majority had exercised apparently valid legal power (in that case a statutory power to remove a director). The test was based on individual expectations underlying the quasi partnership company. In particular, management participation was "... an obligation so basic that, if broken, the conclusion is that the association must be dissolved".[21]

Equity, said Lord Wilberforce,[22]

> ... enable[s] the court to subject the exercise of legal rights to equitable considerations; considerations, that is, of a personal character arising between one individual and another, which may make it unjust, or inequitable, to insist on legal rights, or to exercise them in a particular way.

Ebrahimi clearly establishes that a pure deadlock justifies judicial dissolution. True, the expectations test still needs to be satisfied — this means that, for instance, change in *personal* circumstances of the locked in member might not, in itself, be enough. Thus, if a member, unable to work because of failing health, is deprived of salary and director's remuneration by which profits are effectively being divided (the typical close company method), he/she would not be able to force a dissolution, even if the majority refuses to change the profit-sharing method. At the same time, the close company association is replete with expectations — as to participation in management, as to sharing in decision-making, as to regular distribution of profits, and above all, as to harmonious cooperation — so that most serious disputes would be caused, or would constitute, a breach of some such expectations — and grounds for dissolution.

17 Notably in *Re Cuthbert Cooper & Sons Ltd* [1937] Ch 392, and a united English Court of Appeal in *Re Westbourne Galleries Ltd* [1971] Ch 799; reversed, *Ebrahimi* v *Westbourne Galleries Ltd* [1973] AC 360 (HL).

18 *Ebrahimi,* supra n16 at 377, per Lord Wilberforce.

19 Idem, and see at 385, per Lord Cross.

20 Supra n 17.

21 Ibid at 380, per Lord Wilberforce.

22 Ibid at 379.

By doing away, as it does, with fault as a prerequisite for dissolution, *Ebrahimi* goes a long way towards establishing a liberal alternative withdrawal rule.[23]

Still, the matter remains one of "protection" rather than "right". Moreover, the remedy itself is a problem. Winding up a viable company is a wasteful process. The break-up value of the assets is often below the value of the business as a going concern. Business and goodwill are lost, and legal and financial costs incurred. The shareholder seeking dissolution ends up with a diminished own share. A more economic way for all concerned would be a buyout of the complainant by the other shareholders or (financial stability permitting) the company itself. However, to achieve this under the present law the member must first show statutory "oppression" or "unfair prejudice" – bringing him/herself within the jurisdiction of the court to make a buyout order.

(ii) Buyout as relief against unfair prejudice

Before focusing on the buyout remedy itself, we need to briefly reflect on the broader aspects of the current statutory protection of members. Early judicial interpretation of the original legislation against minority oppression had been most restrictive.[24] Despite extended statutory protection, the common law legacy had lingered on. The courts were still looking for traditional elements of impropriety – fraud on the minority, bad faith, or breach of contractual arrangements – as prerequisites for relief. This approach had left out a wide area of corporate practice in which minority interests could be harmed without manifest fraud or bad faith. The "unfair prejudice" revolution of the early 1980s[25] has made all the difference by extending protection not only against "oppression" and "discrimination", but also against "unfair prejudice". As I have suggested

23 For a strong illustration see *Re North End Motels (Huntly) Ltd* [1976] 1 NZLR 446; noted (1977) 93 LQR 22. Although it had revolutionised minority *shareholders'* protection, *Ebrahimi* is merely old wine in a new carafe. The very same principles have been known to the law of partnership for a hundred and fifty years: "The transactions of partners with each other cannot be considered merely with reference to the express contract between them. The duties and obligations arising from the relation between the parties are regulated by the express contract between them, so far as the express contract extends, and continues in force; but if the express contract or so much of it as continues in force, does not reach all those duties and obligations, they are implied and enforced by the law . . .; and it is often a matter to be collected and inferred from the conduct and practice of the parties, whether they have held themselves, or ought or ought not to be held, bound by the particular provisions contained in their express agreement. When it is insisted, that the conduct of one partner entitles the other to dissolution, we must consider, not merely the specific terms of the express contract, but also the duties and obligations which are implied in every partnership contract . . .": *Smith* v *Jeyes* (1841) 4 Beav 503 at 505, per Lord Langdale MR. Note that winding up under section 217 would only be ordered if the court is of the opinion that no other remedy could reasonably be pursued by the petitioner – Companies Act 1955, s220(2)(b).

24 For discussion of the common law position as a background to current developments, see Shapira, op cit, n5 at 142-143.

25 See Shapira, op cit, n5.

elsewhere,[26] this concept should be understood by reference to the North American "squeeze-out" – which has been defined in the United States as:[27]

> . . . the use by some of the owners or participants in business enterprise of strategic position, inside information, or powers of control, or the utilization of some legal device or technique, to eliminate from the enterprise one or more of its owners or participants.

Tactics which go only part of the way towards eliminating minority interests are "a partial squeeze out", namely:[28]

> [An] action which reduces the participation or powers of a group of participants in the enterprise, diminishes their claims on earnings or assets, or otherwise deprives them of business income or advantages to which they are entitled. A squeeze-out normally does not contemplate fair payment to the squeezees for the interests, rights, or powers which they lose.

Recent judicial interpretation of "unfair prejudice" has indeed adopted, in substance, the squeeze-out concept.[29] It is characterised by shifting the emphasis from the fault of the majority to the harm of the minority. Majority conduct prejudicial to the minority though short of fraud or bad faith is the trigger element. Most corporate internal disputes raise this kind of issue -- a fact which gives the legislation its main bite.

The Anglo-New Zealand formulation of "unfair prejudice" has been greatly assisted by the *Ebrahimi* principle. It has been transposed without much difficulty from the winding up jurisdiction, into which it was born, to the emerging remedies against oppression and unfair prejudice under the revamped section 209 of the Companies Act 1955.[30] As broken underlying expectations may now constitute "unfair prejudice", as well as grounds for winding up, the locked-in member can sue for a buyout order under section 209 and alternatively for a winding up order under section 217(f). The cases, however, continue to draw distinctions as to the availability of each remedy. A brief review of recent decisions illustrates the point.

26 Shapira, "Statutory Protection of Minority Shareholders: Towards the 'Squeeze-out'?", *Contemporary Issues in Company Law* (Farrar ed 1987) 205.

27 O'Neal and Thompson, *O'Neal's Oppression of Minority Shareholders* (2nd 3d 1985) 1-01.

28 Idem. Typical squeeze-out tactics are: exclusion of the member from employment and from management participation; withholding dividends; sale of company's assets or opportunities which benefits the majority in some other capacity; reducing the minority's proportion of voting control by "tactical" share allotments; and, in particularly nasty cases, most or all of the above.

29 See *Morison's Company Law* (4th ed 1982) 2, 20.39, where the cases are now grouped under headings of specific squeeze-out ("unfair prejudice") tactics.

30 *Thomas* v *H W Thomas Ltd* [1984] 1 NZLR 686. For a discussion and further illustrations of the applicability of the expectation test to minority oppression and unfair prejudice, see Shapira, op cit, n26 at 208-210.

(iii) Relationship between winding up and buyout orders

Recent dissolution cases make it clear that the partnership nature of the close company would justify a dissolution in a pure deadlock situation. The position has been stated in the following passage:[31]

> The case is therefore one in which, as I find, the parties, when they acquired their shares in the company, entered into an arrangement, which was no doubt implied rather than expressed, the substance of which was that they constituted a partnership in corporate form. That arrangement was a family arrangement in which their expectation was that they would act in the affairs of the company in a spirit of friendly co-operation for their common benefit and not one in which they contemplated that their rights and relations *inter se* would be governed by a strict application of the rules of company law. It is no part of my function to attempt to analyse or apportion the reasons for the animosity that has grown up between the parties. The divorce, and the inevitable litigation that has preceded or accompanied it, has in my view, destroyed the relationship of mutual trust and confidence which might otherwise have been expected to subsist between them as members of the same family group. It is no longer possible for them to work together for the common good or to rely, for the protection of their interests and investments in the company, upon the goodwill which they supposed would exist between them. The point has now been reached where such a state of animosity exists between them as precludes all reasonable hope of reconciliation and friendly co-operation in the affairs of the company . . . . [T]he petitioner is in consequence entitled to a winding up order on the just and equitable ground . . . .

This passage clearly demonstrates the shift from the classical company law position of holding the parties to their bargain, absent distinct fault, to the quasi partnership approach of dissolving hopelessly deadlocked firms irrespective of fault. The husband and wife relationship in the case was not necessarily a distinctive feature – many such cases perpetuate family feuds in the courts. And where the parties are not family members, the relationship is often close enough to found the trust and confidence which underlie this relationship.

The massive New Zealand litigation in *Vujnovich* v *Vujnovich*[32] has drawn recent attention to the question – dissolution or buyout – as a resolution to a bruising domestic dispute. The three brothers, equal owners and co-managers of three property development companies, had had an initial period of fruitful cooperation. But after the good seven years, differences arose. Attempts at a reconciliation were unsuccessful. One brother, Tony, emerged as the dominating personality, in charge of the everyday operations. The other brothers' role had gradually diminished, until they ceased all active participation. They continued, though, to invest in the companies, and between them held the majority voting power. While the companies prospered under Tony's management, he felt that his brothers, with whom tensions persisted, were not pulling their weight. He tried to buy them out, but they refused. Eventually he brought an action asking for an order under section 209 to make his brothers sell their shares

31 *Re Dalkeith Investments Pty Ltd* (1984) 9 ACLR 247 at 252, per McPherson J (SC(Qld)).

32 [1988] 2 NZLR 129 (HC and CA) affirmed [1989] 3 NZLR 513 (PC). For a detailed discussion of the litigation prior to the Privy Council appeal, see Shapira, "Deadlock in the Domestic Company: Buyout or Winding Up?" [1989] NZLJ 178.

to him, or, alternatively, that the companies be wound up (under section 217(f)). The other brothers reacted by seeking a section 209 order that Tony sell his shares to them. They opposed the winding up.

The Court of Appeal found prejudice on both sides. The two brothers' withdrawal of services was unfairly prejudicial to Tony, while some of Tony's transactions as general manager were affected by self-interest. Yet, the Court refused to order either party to sell its shares to the other. It saw the unfair prejudice as symptomatic of an irreconcilable family feud, which could only be resolved by dissolution of the companies. The decision was upheld by the Privy Council.

Vujnovich leaves one with the impression that in a deadlock situation for which both parties are equally to blame, dissolution, rather than a buyout, is the suitable remedy. If so, the message is painfully simple – if you cannot hang together, you will hang separately.[33]

This might be a counsel of despair. Allowing a viable company to go to the wall because the parties can no longer live together, rather than forcing one to buy out the other (even by bidding for each other's shares in a mutual auction, if necessary) is less than ideal. Surely, if the matter is considered as entirely private, dissolution is the obvious answer. But consideration should also be given to loss of jobs, investment and production which can be avoided if one party is allowed to continue while the other departs the enterprise with adequate compensation.

Surprisingly, in the next case, winding up, the easier of the remedies to obtain, was also refused. The warring parties in *B W Broughton* v *Longview Products Ltd*[34] were father and son. The son held half the shares in the farm company (the other half being held by another son who had no active involvement and was not a party to the proceedings). The father kept a nominal holding which, however, entitled him to full control. The plaintiff son had worked in the company since he was at school. For more than 10 years prior to the dispute he had been principal employee and managing director, working full-time for the company. Differences arose in respect of certain financial matters, both business and personal. Life together became impossible and the father exercised his voting control to dismiss his son from his employment with the company, and, following this, from his position on the board. Since the company had never paid a dividend, Bruce, the son, was excluded from participation in both management and profits (his share of the profits previously being paid as salary and director's remuneration).

Holland J acknowledged the authority of *Ebrahimi* and *Vujnovich,* but saw a crucial difference.[35] As the plaintiff's shares were a gift from his father,

33 Such conclusions, however, must be qualified in view of the unusual facts. The minority was not locked in – in fact it had managerial control. Both parties wished to buy out the other, rather than be bought out. In the absence of outstanding fault on either side, the Court was reluctant to order a compulsory acquisition, seeing dissolution as more equitable.

34 (1989) 3 BCR 395.

35 Ibid at 400.

the expectations were not the same as in the authorities he cited. Parties expect to participate in management and profits when they form an incorporated partnership in normal circumstances, but here the gifting of the shares to Bruce was more of an estate planning exercise. His Honour acknowledged the similarity with *Re Harmer,*[36] where the shares were also gifted by the father to the sons, but distinguished it[37] on the (curious) ground that in that case the remedy sought and obtained was against oppression (in *Broughton* only winding up was ultimately sought). His Honour did find that the removal of Bruce from the board was "oppressive" to him, entitling him in principle to a winding up order. Nevertheless, he ultimately refused such an order, in view of the harsher consequences of a winding up to the defendant father (whose residential home was on the company's property).

The decision is hard to explain as Holland J's reasoning often does not seem to dovetail with his conclusions. The plaintiff had a strong case, summarised by the Judge as follows:[38]

> From the plaintiff's point of view, he is at present deprived of any benefits that would be available to him in the company as a shareholder and he is unable to sell his shares. He is, to all intents and purposes, locked in and it is obvious that his father is not willing to exercise his right to purchase his shares at valuation or it may be that his father simply does not have the money to do so.

In view of these observations, sending the plaintiff away empty-handed is most surprising, to say the least.[39] As to the legal position, dismissal from employment, removal from management, withholding financial benefits and being locked in without an opportunity to sell the shares are prime examples of unfair prejudice. In fact each one of those should entitle a plaintiff to a buyout or a winding up order.

Crucial to the decision was the judge's observation that the normal individual expectation attending the formation of an incorporated partnership did not exist in the case. While this was true when Bruce was first brought in as a shareholder by his father, surely such expectations had developed over time. Who would not expect his position in the company, which he had served altogether for twenty-two years, and of which he had become managing director and a major shareholder, to be protected against arbitrary total exclusion by exercise of superior legal power? The point here is that expectations deserving equitable protection need not necessarily exist at the time of formation of the company — they may develop over time. Unfortunately, the chance to make this point was lost because of the narrow view taken of the *Ebrahimi* test.

36 [1958] 3 All ER 689.
37 Supra n34 at 401.
38 Ibid at 403.
39 The Judge did deliver a stern warning to the father to find a workable solution with his sons, or else . . ., idem.

At the end of the day, *Broughton* illustrates the ultimately discretionary nature of the remedy. It also demonstrates judicial thinking according to which a winding up is a more practical solution to a deadlock than a buyout order.[40]

Interestingly, in the next case, *Re Waitikiri Links Ltd,*[41] the application for a winding up was made under section 209 (minority oppression) rather than the standard section 217(f) (just and equitable winding up). Doubts have occasionally been expressed whether jurisdiction existed under section 209 to make a winding up order. This is because winding up is not one of the specific remedies in section 209(2). The better view is that the language of section 209(2) –

> . . . the Court may make such order as it thinks fit, whether for – [list of specific remedies] or *otherwise* [emphasis added] –

is broad enough to accommodate a winding up order. This was taken for granted in *Re Waitikiri* (the point was not argued).

Winding up in this case was sought as a back-up alternative to certain orders sought under section 209. Considering the relationship between minorities' remedies under section 209 and the section 217(f) just and equitable winding up, Hardie Boys J said:[42]

> Section 209 is to be contrasted with s217(f) which confers a power to make a winding-up order where the Court is of opinion that it is just and equitable to do so. Section 209 confers more extensive powers than section 217(f), but is directed to a specific kind of situation. The very statement of that situation [in s209(1)] shows that it provides the foundation for the jurisdiction. This seems to be the view taken by the Court of Appeal in the recent case of *Vujnovich & Anor* v *Vujnovich* (CA) (1988) 4 NZLC 64, 474 . . . as against that taken by Henry J at first instance (1988) 4 NZLC 64, 179 at p64, 185.

In *Waitikiri Links* the majority argued oppression, claiming that the company was being run solely for the interests of the majority. The judge upheld this claim on the facts, holding that disregard for minority interests by adopting a course of action beneficial to the majority in disregard of the minority was oppressive. The situation, however, changed once the majority offered to buy out the minority interests. That represented a satisfactory compromise between the conflicting interests. When a fair price was offered, the unfair oppression came to an end. The petition was adjourned to enable the parties to arrange a buyout settlement.

The effect of these cases can be summarised as follows: despite the unifying effect of *Ebrahimi,* the "remedy in cases of oppression" (section 209) and the "just and equitable winding up" (section 217(f)) are still essentially distinct jurisdictions. In particular, the courts are inclined to order dissolution, rather than a buyout, in a pure deadlock situation which

40 Ibid at 396.
41 (1989) 4 NZCLC 64, 922.
42 Ibid at 64, 925.

involves no outstanding fault. This, the cases imply, resolves two difficulties. It provides a practical solution to a deadlock irrespective of unfair prejudice, and at the same time, avoids a forced purchase on a party not at fault. Other reasons for opting for winding up in preference of buyout are narrow interpretation of the unfair prejudice provision,[43] and court's discretion.[44]

This attitude to the consequences of intra corporate conflicts, it is submitted, is imperfect. It represents an historical position rather than a rational approach. Surely, whether the member should be bought out or be allowed to recoup his/her investment by liquidation of the assets should be considered within a unitary system. A streamlined approach is vital to a consideration of the options, and the pros and cons of the alternative remedies in the circumstances – and perhaps also to the taking into account of the public interest, on the assumption that the public has an interest in the continuation of profitable firms. (We will return to reform proposals along these lines at a little later.)

Practical Considerations

An action seeking minority remedies against oppression will almost invariably be accompanied by a prayer for a just and equitable winding up as an alternative. This reflects the profession's view that a winding up order, while not really desirable, might be easier to obtain (because it requires no proof of fault) than a section 209 order (which does require such proof).

Whether on its own or as a fall-back position, an involuntary winding up application is more than likely a tactical move. Winding up of a profitable business, as mentioned above, is a no-win proposition. The plaintiff does not seriously intend to liquidate the business, even if successful. His/her intention is to put pressure on the majority to settle on the best available terms.

Unless acting irrationally, the plaintiff seeking dissolution of a profitable company will be motivated by one of three aims: (1) to withdraw his/her investment from the firm; (2) to induce the other shareholders to sell out; or (3) to use the threat of dissolution to induce the other shareholders to agree to a change in the balance of power or in the policies of the firm. None of these objectives *necessitates* a dissolution – they can all be achieved by other means. It follows that,[45]

> Since the petitioner can always achieve his purposes without dissolution, and since the defendant will always oppose it, the dispute is very likely to be settled without liquidating the firm's assets and terminating its business. The court's decision to grant or to deny dissolution is significant only as it affects the relative bargaining strength of the parties; negotiations will go forward in any event. If the petitioner's purpose in bringing the action is to liquidate his investment, he will be receptive to a settlement

43 See per Henry J in *Vujnovich* v *Vujnovich* [1988] 2 NZLR 129, corrected on this point by the Court of Appeal, ibid at 153. And in the context of the English provision, *Re a company* (No 00370 of 1987), *ex p Glossop* [1988] BCLC 570.

44 See *B W Broughton* v *Longview Products Ltd,* supra n34.

45 Hetherington and Dooley, op cit, n2 at 27-28.

> offer which approximates the amount he could reasonably expect to receive as his pro rata share from a sale of the business as a going concern to outsiders. The defendant shareholder will make a similar calculation to determine the price he must pay if he wishes to continue the business. Both sides have significant incentives to settle. For the petitioner, sale of the business involves the risk that the business may not bring a good price. The defendant may be the only bidder and will surely bid low. The defendant's worry is that outsiders may bid against him at the sale, and he may lose the business or have to pay a premium to retain control. Legal and other expenses in connection with a sale also will increase the costs to the defendant and decrease the net amount received by the petitioner. Settlement therefore will be beneficial to both parties.

The chances are, therefore, that where the petitioner wants to liquidate his/her investment and the defendant wishes to continue the business, a settlement will be reached prior to actual liquidation of the business. This analysis is backed up by an American survey of cases,[46] which shows that almost all involuntary dissolution petitions are settled prior to actual liquidation of the business.

No such data is available in New Zealand, but there is no reason to believe that the situation here is very different. Support for this is drawn from the well-known practice of the court to stay the operation of a winding up order so as to give the parties a last chance to settle.[47]

The foregoing analysis strongly suggests that dissolution proceedings of profitable companies function primarily as a price-fixing mechanism for an eventual buyout. Obviously, this is a circuitous, costly and most inefficient way towards this end. It takes up courts' time (spent mostly in argument about grounds for winding up) and creates uncertainty costs for the petitioner. And a petitioner who fails is entirely at the mercy of the majority, who can buy him/her out at a fire sale price.

Evaluation

The entitlement of a member to leave a small business organisation without losing too much of his/her investment can be approached in two ways; one is "right", the other is "remedy". The difference is best illustrated by the respective positions of partnership and company law on this matter. To quote Hetherington and Dooley again:[48]

> The consequences of the failure of the parties in a partnership to plan for dissolution or withdrawal of one party are diametrically opposed to the results of a similar failure in a close corporation. In a partnership, the partner's investment is liquid because of his right to dissolve the firm; in a close corporation, absent unlawful conduct by the majority faction, the minority investment is locked in. Furthermore, the consequences of a disagreement between one partner and his copartners while he remains in the firm are much less drastic from the minority's viewpoint. A majority of partners cannot legally prevent another partner from participating in the business

46 Ibid at 30-34 and 63-75.

47 See eg, *Re Waitikiri Links Ltd,* supra n41. For a similar practice in Australia see *Re City Meat Co Pty Ltd* (1984) 2 ACLC 149.

48 Hetherington and Dooley, op cit, n2 at 42-43 (footnotes omitted). For the partnership principles mentioned compare Partnership Act 1908, ss29(1), 35(1), and 27(a) and (e).

> and from withdrawing his share of the earnings. If they attempt to exclude him from the business, he may maintain an action for an accounting. While these remedies are not without cost to the minority, they are nevertheless clearly available if oppressive conduct occurs and impose definite costs on the majority defendants. In a close corporation, on the other hand, the minority shareholder can be lawfully excluded from participation in the firm and denied any return on his investment. Since the majority cannot easily exclude a partner from participating in a firm so long as he remains a member, the majority is compelled at some level to tolerate his participation, which may be highly undesirable from its point of view. This fact may give the majority a substantial incentive to settle with a minority partner if it wishes him out of the firm. No such pressure bears on the majority in a close corporation. The majority's position enables it to banish the minority shareholder from the scene, leaving behind only his investment under the majority's control. These differences may account for the lack of reported cases dealing with oppression in partnerships.

While this analysis underestimates the role of a well developed statutory minority protection, it nevertheless highlights an important truth. An unrestricted withdrawal/dissolution rule is much more useful to the minority shareholder than judicial protection. Only a major shareholder in a substantial company would be able to afford litigation on a scale coming anywhere near *Vujnovich.* Issues of unfair prejudice, or who is to blame for a deadlock, are complicated and costly to prove. The lock-in may be caused not by of absence of legal remedies but because they are *practically* unaffordable to the small shareholder.

Under our current system, a troubled minority may be bailed out by judicial intervention. Secured right to withdraw can also be achieved by prior contractual arrangement. However, the practical value of contractual protection to the minority is doubtful. In fact, such provisions in company's articles are much less common than rights of first refusal to the majority over minority shares offered for sale.

As Hetherington and Dooley point out,[49] parties often fail to plan for contentious withdrawal. Even if this point is contemplated, the minority will be reluctant to insist on an unrestricted right to be bought out at a fair price (likely to be resisted by the majority for the substantial obligations it imposes) as the minority would not wish to appear to question the trustworthiness of the majority and risk the whole deal.

A conditional agreed right of withdrawal might be more acceptable to the majority. But it is likely to run into definitional problems as to the events triggering the right, and so, by itself become a source of litigation. The sophisticated legal drafting required would impose excessive costs on the small business.

How do the current withdrawal/dissolution rules affect the efficiency of the firm?

Directors of *public* companies must keep a wary eye on the price of the shares. If management is inefficient or unlawful, disgruntled shareholders, who can compare performance to that of other companies, will sell on the stock exchange and take their investment elsewhere. Selling pressures

49 Ibid at 36-38.

will cause further drop in the shares' price. Eventually the company will become vulnerable to a takeover with a view of replacing inefficient management. Hence,[50]

> The mere threat of displacement whether or not realised, is a powerful incentive for managers of [public companies] to promote their shareholders' interests so as to keep the price of the company's shares as high and their own positions as secure as possible.

Competitive market forces do not have the same effect on the close company. The absence of market for the shares and restrictive withdrawal rules allow the majority to exploit and ignore a locked-in minority without concern over costs of replacement capital. The directors need not strive for efficiency in a constant bid for the minority's capital:[51]

> . . . the absence of an established market, combined with the use of an organisational structure characterised by indefinite existence and nonredeemable equity, substantially reduces the liquidity of all close corporation shares.

Therefore,[52]

> . . . majorities in closely held corporations are insulated from capital market competition for the minorities' investment to a much greater extent than are participants in any other form of business . . .

On the foregoing analysis, there is a strong case for providing the minority shareholders with some measure of liquidity, on both equity and efficiency grounds.

Suggested and Proposed Reform

The present remedial system can be greatly improved by a relatively simple legislative reform: delete section 217(f) and replace it by an express power in section 209(2) to wind up the company.

Putting the remedies on an equal footing would allow the court to focus on the real issue: whether, in the circumstances, a buyout, or dissolution, is, practically and equitably, the most adequate.

This would also help to highlight winding up as a *last resort* remedy, namely, available only if no other remedy (ie buyout) is practically available and the petitioner had not acted unreasonably in seeking a winding up.[53] This approach recognises the public interest in the continuation of profitable companies, and, tacitly, that the buyout of one party's interest of the other, rather than winding up the business, is the ultimate aim in these disputes.

50 Hetherington and Dooley, ibid at 40 (footnote omitted).
51 Ibid at 43.
52 Ibid at 44.
53 Companies Act 1955, s220(2). For the application of a similar provision in the United Kingdom and Australia, see eg, *Re a company* [1983] 2 All ER 854; *Re Dalkeith Investment Pty Ltd,* supra n31.

A radical reform – adopting an alternative approach – would require a departure from traditional rules. The objective – a measure of liquidity for a minority interest would be achieved by statutory rules:[54]

> ... entitling a minority ... to demand that the corporation or the remaining shareholders purchase [its] shares. If the parties fail to agree on price and terms of payment, the petitioner would be entitled to a decree fixing both; if the defendants continue to refuse to purchase at the price fixed by the court, the firm would be dissolved.

A halfway house would recognise a *restricted* buyout right triggered by specified events. Since this is the position of the Law Commission's *Report,* we might want to consider it in some detail.

The *Draft Act* confers a buyout right on a dissentient shareholder where there is a fundamental change to the company,[55] or an alteration of class rights.[56] Under the proposals, a shareholder may require the company to purchase his/her shares if s/he was outvoted in a "shareholders meeting"; on constitutional changes removing restrictions on the company's activities; the approval of a "major transaction";[57] the approval of an amalgamation; or alteration of class rights.[58]

The *Draft Act* then prescribes procedures for a buyout demand: the company must agree to the purchase of the shares, or "arrange for some other person to agree to purchase the shares". If the price cannot be agreed on, the matter is referred to arbitration. The company may seek the court's exemption from minority buyout obligation, on defined grounds. Finally the company[59] *must* seek the court's exemption if because of the purchase of the shares it will not satisfy "the solvency test",[60] and it was unsuccessful in "reasonable endeavours to arrange the purchase of the shares" by a third party.

The *Report's* position must be explained in the wider context of the reform.

A major obstacle for liquid shareholders' investment under the current system is the protection of creditors. "Reduction of capital" is one of company law's most sacred taboos. The cushion for creditors provided by the company's capital must remain intact (as a corollary of limited liability). Contributed capital (measured by the nominal value of the shares and any premium thereon) constitutes creditors' "guarantee fund" and is not to be returned to shareholders. Contributed capital thus marks the minimum,

54 Hetherington and Dooley, op cit, n2 at 45.
55 *Draft Act,* ss81-86. For commentary see *Report,* paras 202-207.
56 *Draft Act,* ss88(4).
57 Defined (narrowly) in section 99 as the acquisition of assets equivalent to the greater part of the assets of the company, or the disposition of the greater part of the assets of the company.
58 *Draft Act,* s88(4).
59 S86.
60 Defined in s2(3).

as well as maximum, liability of the shareholders. Allowing the company to buy back its own shares would be in breach of this principle.

By comparison, partners who wish to continue the business can pay a retiring partner his share of the firm's assets. For the reasons explained, this option is not open to a company — not even a profitable one. It follows that buyout rights cannot be financed from the company assets — the price would have to come from the pockets of the other shareholders. Such an obligation would be too onerous on the majority.

A principal feature of the *Draft Act* is the relaxation of capital maintenance. In this it prefers the North American position over the traditional English doctrine. The company has wider powers to make distributions of its assets to shareholders, including redeeming its own shares, provided such distribution do not render it insolvent or nearly insolvent.[61]

Within the proposed regime the "return of capital" objection to buyout rights is much reduced. It is quite proper for the *Draft Act,* therefore, to impose the primary obligation to purchase the shares on the company itself (subject to solvency). In this respect (at least regarding profitable companies) the position is, in effect, similar to that of a partnership — the right of a partner to dissolve the firm at will being, in effect, a right to recover the pro rata share of the firm's capital.

While the introduction of the new buyout right is welcome in principle, its particular application is open to question.

The right is triggered by fundamental matters which must be taken to the "shareholders' meeting". Clearly, it is designed to benefit shareholders of *public* companies, to whom such matters are relevant. Permissive constitutional changes, "major transactions" (as defined in section 99 of the *Draft Act*), amalgamations and alterations of class rights, resolved upon by the general meeting, are hardly common events in the life of the small company. Of much greater concern are everyday management matters and policy decisions made by the board. These do not come within the ambit of the provision.

The *Draft Act,* therefore, gives shareholders of public companies a second string to their bow (they can always sell on the market) and leaves members of a close company largely unaided. The proposed provisions' main effect is some extra check on management by members of public companies. Its effect on the liquidity of the small company shares would be minimal.

Conclusions

The choice is between the current, remedial, system, which bails out a harassed or marginalised shareholder, and a system which also provides

61 See generally *Draft Act,* ss42-61 and the accompanying commentary in the *Report.* For the definition of the solvency test see *Draft Act,* s2(3).

a largely unrestricted right of withdrawal, backed up by a power to dissolve the company. The latter measure would feature –

- A statutory unrestricted right to call on the company to buy out the member (or nominate a willing buyer); and the procedure towards this end, including (absent agreement) the price fixing mechanism.
- If the company does not abide, the right to dissolve the company.
- The above is subject to special contractual arrangements.
- The company may apply to the court for an exemption from this duty.
- The company must apply to the court for an exemption if the buyout threatens its solvency.

A buyout provision along these lines has a number of advantages which may be summarised as follows:

- Approximating the partnership position, it upholds parties' expectations not to be locked in an unfriendly firm.
- The risk that the minority might reclaim its investment would put pressure on the majority to accommodate minority views. It would act as a disincentive to exploitation of the minority.
- Efficiency would be served by exposing minority investment in a close company to competitive market forces. The majority will have to continuously bid for the minority's capital by efficient performance.
- It will eliminate the high cost circuitous practice of suing for dissolution as a bargaining chip, by providing a low cost process whereby the only litigable issue is the price of the shares.

Hetherington and Dooley argue, and I respectfully agree, that the right to withdraw should be unconditional and not dependent on proof of fault:[62]

> The elimination of the fault principle is absolutely essential if the proposed [statutory reform] is to bring minority shareholders in close corporations into parity with investors in other forms of business organisations.

And,[63]

> Given the inherent costliness of fault-based remedies, retaining the concept in any form appears unwarranted. The concept of legal fault is irrelevant to a decision to maximize personal wealth by moving from one investment to another. Therefore, its elimination can only enhance the efficient allocation of resources.

62 Op cit, n2 at 46.

63 Idem.

64 Dooley argues that buyout rights should entirely replace existing minority statutory remedies which are "hardly conducive to either efficient or fair trading". Professor Hetherington believes that the provision of liquidity is the principal benefit to be gained from statutory buyout rights and therefore concludes that the repeal of statutory minority remedies is not essential: ibid at 47, n148.

Unlike Professor Dooley[64] I recommend that current remedies against oppression and unfair prejudice should remain, and continue to operate alongside the buyout provision. The former will still be useful in cases of a confined dispute which can be healed by a one-off injunctive or monetary relief. It will also discourage the majority from squeezing out a minority reluctant to sell by *forcing* it to seek a buyout, the majority taking a chance on the price of the shares. In such a situation, there is place for relief against fault which might include a compensatory element.[65]

A buyout provision along the lines described above would have a dramatic effect on the full spectrum of close companies shareholders' litigation. Many of the squeeze-out cases (coming now before the courts in growing numbers) will disappear. The costly litigation addressing the fault element would be replaced by a low cost straightforward process concerned with the only real issue — the fair price to be paid for the minority shares.

65 For a striking example of a compensatory element built into minority statutory remedy see *Re Cumana Ltd* [1986] BCLC 430.