When Shareholder Relationships Go Bad

Having just spent a few interesting months dealing with a client company that had become locked in a stalemate with shareholders, I have a few insights to offer on this. I love to use analogies, they can really clarify complex concepts by drawing a great parallel.

A shareholder stalemate can be very dangerous for small companies, especially for start-ups that are hungry for money and are still very much in set-up mode. Your typical stalemate is where two to four major shareholders fall out about the direction of the Company and who is going to contribute more money to keep the start-up moving forward.

Factions then develop and no particular shareholder or group of shareholders can agree on the way forward and carry enough votes to actually implement the desires of the Company.

Desires of the Company? What exactly are they? Surely it's the desires of the shareholders that are important? Well in a word, No. You see, accountants and lawyers are brought up in a world where the Company is a "separate legal entity" and as such, we as advisers are generally independent and can offer an objective view and assist the Company in voicing its desires. As you will see from what follows, a clear distinction can be drawn between the desires of the Company and its shareholders.

The desires of the Company are in the mission statement, vision statement, policies and procedures manuals, business plans and projections. Their foundations are to be found in the Company's constitution and shareholders agreement (if there is one).

The voice of the Company can truly be heard in independent directors (non shareholder directors appointed for their professional guidance and services to the Company). But what small to medium company can afford such resources? Not many that's for sure.

The reality is, most shareholders are not highly experienced and well-rounded business people, they tend to be You and I and our friends and associates. We all have our own perspectives on what business is and how it should be done and we all have different views on the value of money. So, as soon as there is an opportunity for all of these different perspectives to start affecting the direction of the company, havoc ensues. In a stable and mature company this will show up as rash decisions, changes in direction, knee-jerk reactions and the like. Things just don't go right for the Company, relationships between shareholders deteriorate and profit drops. If it's not dealt with it can cause a downward spiral.

For the cash hungry start-up, it normally hits much faster and results in some shareholder(s) disagreeing about whether to continue to fund the company through loans in the ratio of their shareholding. This can be navigated through, but only if the balance of the shareholders agree to continue lending the Company money, or can force the Company to issue shares to them for the money it needs. When this cannot be achieved, a stalemate occurs. The death spiral from here can be pretty quick and not always stoppable. This one is all about time and money and the powerful influence that money has.

So, how to resolve a stalemate? Obviously the first place to start is to stop it from occurring in the first place. This starts with a well-crafted shareholders agreement. When you are considering a shareholders agreement, contemplate what may go wrong in the relationships and how the agreement will help or hinder solving these potential problems. In a small company this is all about ordinary resolutions and special resolutions. You could describe these resolutions as being the very word of the Company, it does not get any closer to the heart of the matter. If you can pass a resolution, you can influence the Company in many important ways.

Generally an ordinary resolution is a majority in favour of the resolution of greater than 50% of the votes in the company (generally one vote per ordinary share). A special resolution is usually 75% or greater. What you can do with each type of resolution is detailed in the shareholders agreement.

So, this is all about control and manipulation and nasty things like that is it? Well, again, No, or at least it shouldn't be. When you sit down to a game of Monopoly you play the game according to the rules, or perhaps your group of friends have developed their own subtle changes to the rules. You don't write these changes down and so when a new friend joins for a game, you patiently describe the rule changes that will of course affect this game because, well, it's your group of friends and heck, it's your place anyway...

It's the same for companies, the rules of the game are clearly described in statute – The Companies Act being the main one, but many others impact the likes of taxation, commerce, contract law etc. Then the next layer is the Constitution, then the Shareholders Agreement, Mission Statement, Vision Statement etc. If you can get enough votes to carry appropriate resolutions you can change any of these rule documents, apart from the statutes (for that, I suggest you become a politician in your spare time!).

So the key here is to set up the rules carefully, or keep all of the control by not bringing in any other shareholders!

But, as often happens, you now find yourself in a stalemate, what to do? I think the answer is a bit of a checklist:

- Gather all the available documentation on the "rules of the game"
- Read and understand the rules as best you can
- Identify if the Company has a true independent Chartered Accountant and Lawyer, ones that appear to proactively assist their clients in navigating these types of problems (it's a skill)
- If not, seek advice from your own Chartered Accountant and Lawyer
- Encourage everyone to be open and honest in their communications
- Ensure a strong Chairperson is appointed to chair director and shareholder meetings
- Run these meetings according to previously circulated agendas

With skilful and assertive handling of meetings, a way can be found to navigate through the problems. As is often the case, none of the parties are going to feel they "won" but if the Company is saved and lives to see another day, the job is done. It's all about rules and logic together with smoothing the ruffled egos along the way. Whenever you can, try stepping out of your own point of view and try your best to step into the Company's point of view when addressing the curly issues – you might be pleasantly surprised about where this takes you.

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