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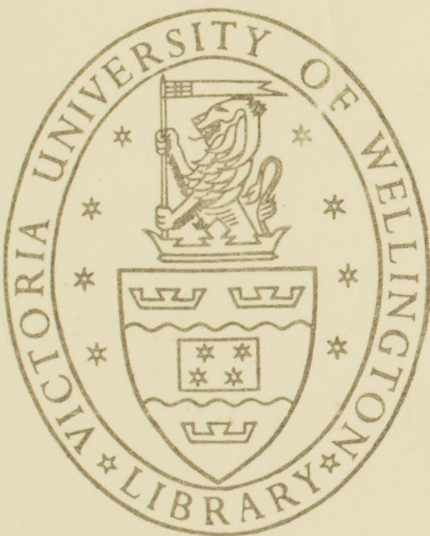
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SHAREHOLDER AGREEMENTS

IAN GORDON STEWART

RESEARCH PAPER FOR BODIES CORPORATE AND UNINCORPORATE

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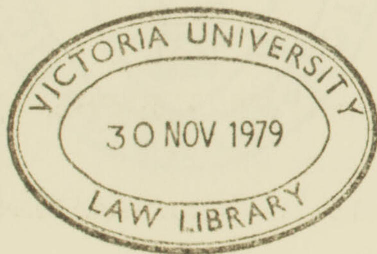

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CHAPTER 1

WHAT IS A "SHAREHOLDER AGREEMENT"?

As its name suggests, a shareholder agreement is an agreement entered into by shareholders of a company. Spelling this out in the lengthier form may appear to be merely stating the obvious - as indeed it does; it does however, highlight an important aspect that perhaps becomes neglected in a detailed investigation into shareholder agreements - that they are contracts, and as such "governed by the general law of contract."[1] The "agreement" aspect owes its primary allegiance to the law of contract. This aspect of the agreement is obviously crucial, initially, to any consideration of the topic: when all is said and done, a shareholder agreement must pass muster as a valid contract. The fact that few problems are raised by the shareholder agreement as a contract does suggest that fulfilment of this requirement is not an onerous one. In contrast to this tranquility, the operation of the shareholder agreement in company law, flowing from its "shareholder" ingredient, does raise some major problems; likewise, it is in this field of the law that the shareholder agreement stands to make its richest contribution.

Nevertheless, the shareholder agreement can be regarded as simply another contract entered into by parties dealing with their property. The contract is peculiar, however, in that it involves parties who are shareholders, dealing with a special type of property - company shares. This provides the nexus, then, between this contract and company law: it is this link which brings onto the scene a presence that ultimately dominates the discussion - true principles of company law. The definitions of shareholder agreements, in reflecting this duality of contract and company law could be regarded as slightly misleading because in reality, it is through its involvement in the corporate world, rather than in its contractual aspects, that the shareholder agreement is most important. Being a contract, and consequently (in the anglo saxon context) enjoying the benefits of freedom of contract has one other consequence - namely that no two

1 Pickering - "Shareholders' Voting Rights"; 1965 81 Law Quarterly Review 255-6

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shareholder agreements are identical: there is no such thing as a 'standard' shareholder agreement . To the extent that these contracts all involve to some degree, parties whose status is identical (in that they all involve, by definition, shareholders) and the property involved is likewise similar in nature - the shares owned by the parties, are similar. This, however, is where the similarity ends, rendering a meaningful description of shareholder agreements, of necessity, general in nature. The definitions offered correspondingly reflect this level of generality.

In deference to their unparalleled involvement in shareholder agreements, a recent American interpretation is offered first. In Blount v Taff[2], Judge Clark described the shareholder agreement as "a contract between shareholders which may apply broadly to the rights of the shareholders in conducting the business of the corporation, so long as their purposes are legal and not contrary to public policy".[3]

The distinction between this contract and any other contract lies in the participation of shareholders dealing with a special type of property - their shares. As will be seen later in the paper, most shareholder agreements can be further divided into recognisable sub-categories;this description merely describes the basic structure upon which any shareholder agreement is based.

Finn takes as his starting point the same level of generality but proceeds to give a little more precision tothe context and purpose of such agreements:

"At its crudest, a shareholder agreement is simply a contract executed by some or all of the members of a company, at the time of its formation, requiring that they vote their shares in a particular way on certain defined matters and resolutions. These matters may, for example, encompass appointments to the board, the dividend policy of the company or the conditions subject to which the company's under-

2 225 S.E.R. 2d 583 (1976)

3 Ibid p 586

taking may be sold. More sophisticated types of agreements can go far beyond a simple voting agreement and may regulate in some detail the rights of the individual members. They may, for example, provide for the compulsory buying out of members in certain events; they may prohibit members from participating in other businesses which compete directly or indirectly with that of the company; they may oblige particular members to sell or lease property to the company so as to enable it to begin business operations."[4]

As this description indicates the subject matters covered by shareholder agreements, and the means by which this is achieved, may vary considerably. The simplest agreements fix on the voting power of the parties' shares as the vehicle by which the purposes of the agreement are carried into effect: they are consequently labelled "voting agreements". These types of agreements are the most common, and themselves can reach sophisticated levels in their regulation of the company's affairs. The agreement considered by the court in Re A & BC Chewing Gum[5] provides an example of the range of corporate activities and the degree of particularity that may be achieved in what essentially remains a voting agreement. The agreement bound the only shareholders of the company to use their voting power to control the composition and remuneration of the board, the distribution of at least 60% of the net profits after tax as dividends, and bound them to ensure by their voting rights that the company would not make decisions on any of the following matters without the unanimous consent of all the shareholders, including:

"

i) the issue by the company of any shares, debentures or loan capital or the creation by the company of any mortgages, liens or charges (including a floating charge) upon or in respect of the business or undertaking or assets or any part thereof or the grant of any share or stock options.

4 P. Finn "Shareholder Agreements"; Australian Business Law Review 1978 Vol 6 [No 4] 97 For an example of the variety of subject matters that may be covered in a shareholder agreement, see the precedent suggested by Taube in "Estate and Tax Planning" (1978) p 308

5 (1975) 1 WLR 578

ii) the lending or borrowing of money, the giving of any guarantee or entering into any contract for indemnity or suretyship or for services or agency or any contract for hire or rent or hire purchase or purchase by way of credit sale where the individual amount involved exceeds £3,000

v) the sale otherwise than in the normal course of trading of any property of the company or the purchase otherwise than in the normal course of business of any property by the company;

vii) allocation to reserves;

viii) payment or recommendations of dividends or any other distribution of capital or profits;

ix) amounts to be written off assets or against profits in respect of bad debts redundant obsolete or slow moving stock, wear and tear and depreciation.

x) the writing up or revaluation of any assets or change in the method of valuing stock;

xii) the liquidation of the company;

xiii) matters of policy affecting sales;

xvii) the grant of any licences in respect of know how or under any letters patent trade mark or similar monopoly rights for the time being owned or controlled by or licensed to the company or the acceptance termination or renewal of any such license.

xviii) the initiation or abandonment of any litigation or arbitration."[6]

As the shareholder agreement grows more sophisticated, creating "in some detail the rights of the individual members", it may supersede, in reality, the company's Articles of Association, becoming the foundation of the members' rights - at least those parties to the agreement.

6 Ibid 582

As he points out, a shareholder agreement may be created by "some or all of the members" of a company: there is no definitional, nor necessarily a practical requirement that all the shareholders be party to the agreement:- a shareholder agreement may be, and often is entered into by two shareholders, or one shareholder contracting with an outsider. Furthermore, for definitional purposes, it is clear that a shareholder agreement need not necessarily be limited to shareholders only - the minimum requirement would appear to be that at least one shareholder be a contracting party. The other parties may be non-shareholders - either other members of the company, the company itself or outsiders.[7]

The second point raised by Finn's description relates to the timing of when such an agreement is entered into: though there may be very good practical reasons why it should be executed "at the time of its formation", this cannot be considered a definitional prerequisite. Clearly a shareholder agreement may be entered into at any stage during the currency of the company's life - by definition, wherever there are 'shareholders' in existence. Thus the reference "at the time of its formation" may be a little misleading. In this context, it is clear that an agreement entered into by parties in contemplation of becoming shareholders in an enterprise yet to be incorporated - regulating their future voting pattern for instance - remains for definitional purposes, a "pre-incorporation contract" or a "promoters' contract"[8]: it cannot be considered strictly speaking a "shareholder agreement", for the simple reason that no shareholders, at present, exist. After the company has been incorporated, such an agreement, being equally binding on its parties as one entered into after incorporation, has the same effect as the latter thoroughbred variety. Likewise, for the same reasons, an agreement entered into by parties in contemplation of becoming shareholders in an existing company is excluded from the definition of shareholder agreements. In the absence of statutory regulation of "shareholder agreements" these

7 In Canada, the inclusion of non-shareholders is provided for by statute: Section 11 (2) of the Canada Business Corporations Act 1975 defines a unanimous shareholder agreement as "An otherwise lawful agreement among all the shareholders of a corporation or among all the shareholders and a person who is not a shareholder."

8 O'Neal initially distinguishes between "pre-incorporation contracts" or "promoters contracts" and "shareholder agreements" but almost immediately abandons the distinction - O'Neal Close Corporations 2nd Ed. (1971) 5.03, p6.

distinctions in real terms are unimportant. If, however, the contract purports to bind the company, the distinction becomes obviously fundamental: it is established that a pre-incorporation contract cannot bind a company subsequently incorporated.[9]

Where the shareholder sells all the shares he owns in a company, this sale is not regarded as a shareholder agreement for the simple reason that upon the sale, the seller ceases to be a shareholder. Kruger, however, maintains:

"If the seller parts with some of his shares, there is a shareholder-agreement to the extent that the contract between the parties relates to both purchaser and seller as shareholders"[10]

The precise classification of this agreement, once it is recognised as being binding, however described, is not too important. Within the definitional realm, however, Kruger's interpretation of this agreement is open to the objection that while the transaction may be labelled a shareholder agreement because it is a contract between parties who ultimately both are shareholders, it is not accurate to describe the purchaser, till the contract is executed, as a shareholder. This would not necessarily detract from its classification as a shareholder agreement because as we have seen such agreements may be entered into with "outsiders," and this is what the purchaser is till the contract is completed and the formal requirements of becoming a shareholder are fulfilled.[11] It is, therefore, a shareholder agreement but not, it would appear, on the grounds advanced by Kruger. In relation to the shares sold, the seller cannot obviously be regarded as a shareholder apart from the shares retained. It could be argued that the basis of classification, in order to attribute a meaning to the transaction under scrutiny should fix solely on the property involved in that transaction, because that is what is being classified. The most that can be said for Kruger's approach is that it is flexible.

9 Kelner v Baxter (1866) LR 2 CP 174

10 "Pooling Agreements Under English Company Law" - 94 Law Quarterly Review (1978) 557 Footnote 6

11 Greenhalgh v Mallard (1943) 2 ALLER 234 illustrates such an agreement entered into by the present shareholders of a company with an outsider in contemplation of the latter becoming a shareholder - and director: see post p 29 for a discussion of this case.

A further description of these agreements recognises that the various types have resulted in a variety of subcategories within which any agreement may be slotted : the "shareholder agreement" in itself is relatively meaningless when divorced from these various subcategories. Consequently, it may be more meaningful to describe what a shareholder agreement is in terms of the particular subcategory into which it fits. It is to this level of categorisation that we now turn to.

THE DIFFERENT TYPES OF SHAREHOLDER AGREEMENTS

The shareholder agreement is in many respects the generic term used to described a variety of means by which shareholders bind themselves by contract in respect of the range of corporate activity permitted to them. The means by which this influence is exerted, and the areas of corporate activity influenced by them vary considerably : by and large, classification of shareholder agreements has traditionally not been based on either one of these factors, or even a combination of them. Hornstein concedes the influence that a minority shareholding may play in determining the nature of the agreement entered into, but certainly does not accept proportion of shareholding covered within the agreement as a necessary determinant of its type; likewise the means employed to exert influence in the company, and the areas of corporate activity, do not serve as the basis of distinction:

"The first of these groups, the "Clark-Dodge" type involves a minority shareholder who wants protection in the form of a 'veto power' against conduct which he thinks may prejudice him. The other, the 'Long Park Type' involves one or several shareholders who want assurance that they will be able to control the enterprise either for a period of years or for the life of the corporation. They may own any amount of stock, yet regardless of how the stock ownership may vary at the time or in the future, they want control vested in themselves". [12]

12 "Stockholders Agreements in the Closely Held Corporation" (1950) 59 Yale Law Journal 1041

Kruger subdivides the types of shareholders in the following manner.

i) revocable and irrevocable proxy agreements
ii) voting trust agreements
iii) agreements limiting transferability of shares
iv) pooling agreements
v) agreements for corporate dissolution[13]

There appears from these divisions no logical or symmetrical basis of distinction apart from the popular labels that have come to be attributed to them. Clearly a "voting trust agreement" or a "pooling agreement" is so labelled in recognition of the means employed by which the will of the shareholders is brought to bear on corporate policy; equally clearly, the means by which this is achieved is submerged in (iv) and (v), their classification being a product of the areas of corporate policy contemplated by the agreement. There appears little logic to the divisions which have emerged. It would appear quite possible, for example, to set up an agreement that was at the same time both a pooling agreement and an agreement for corporate dissolution. Regulation of the parties voting power would not appear to be the common thread running through them all as (iii) clearly is independent of this power. In terms of underlying rationale, these distinctions are no distinctions at all : they are, therefore, merely descriptive. And yet the approach adopted by Kruger is invariably that taken by most writers interested in the subject. O'Neal, though running them together a little more, nevertheless maintains the broad divisions set up by Kruger.

"A shareholder agreement may take a number of forms. It may be a simple joint voting contract (sometimes called a "pooling agreement") providing that the contracting shareholders will vote their shares as a unit in elections of directors and perhaps on other matters. Under such an arrangement, each shareholder retains title to his shares and

13 Supra Note 10

and the right to vote them, he merely binds himself contractually to vote in accordance with a pre-arranged plan. The agreement, however, may be something more than a mere voting agreement, it may attempt to create irrevocable proxies which take away the owner's power to vote their shares and transfer this power to other persons. Finally, the agreement may establish a trust or a voting trust, the shareholders transferring the legal title to their share to trustees, who vote the shares in accordance with the terms of the trust"[14]

The thread running through this progression is the decreasing autonomy which the shareholder exercises over his shares as expressed in the increasing areas of corporate activity in which the manner he will vote is prescribed, till finally, in the voting trust, the shareholder has abdicated that power to vote, and indeed, legal title to the share is transferred to the trustee. This decreasing autonomy of action as a shareholder does serve as a coherent basis of distinction between the various types of agreements in which this occurs. It does not, however, touch on agreements that do not involve the voting power of the shareholders - for example, one restricting the transferability of the parties' shares, or one committing a shareholder to lease land or buildings to the company. It does, however, provide an underlying rationale on which voting agreements (which are by far the most common) may be distinguished.

The temptation, in light of the apparent inconsistency that prevails in distinguishing between the various types of agreements would be to rest content with the single label of shareholder agreement as referring to any contract entered into by shareholders affecting their involvement in the company without attempting a more precise definition of its type. O'Neal warns against this :

"These various devices may be used to achieve the same or similar objectives, but conceptually and technically they are different - not that the courts always recognise the differences. In passing on the

14 O'Neal op cit

validity of a pooling agreement, for instance, a court sometimes discusses decisions dealing with voting trusts or irrevocable proxies with no apparent realisation that the different concepts involved might point to differences in result."[15]

Given this conceptional and technical difference, it would appear that some division is required if the full potential of these agreements is to be appreciated. Consequently, it is proposed to divide such agreements into the following categories, giving individual attention to each one. They are shareholder voting agreements,(excluding the recocable and irrevocable proxy), the pooling agreement and the voting trust. Thus, the broad division established is between the shareholder voting agreement as such and the voting trust, the latter distinguished by the legal tital of the shareholder having passed to the trustees.

VOTING AGREEMENTS IN GENERAL

Finn draws a distinction between the type of shareholder agreement which requires the shareholder to vote in a particular way on certain defined matters and resolutions, for example, appointments to the board, the dividend policy of the company or the circumstances under which the company's undertaking may be sold - which he labels a "simple voting agreement" and those more sophisticated agreements which "regulate in some detail the rights of the individual members".[16] These may provide for example, the compulsory buying out of members in certain events, prohibiting members from participating in other businesses which compete with the company or oblige particular members to sell or lease property to the company in order that it may commence business operations. The distinction between the two categories appears to be both one of object and means - the voting agreements naturally enough are orientated directly toward the direct interests and operation of the company - for example its dividend policy[17]; naturally enough, the means by which such a directly corporate interest is catered for is linked with the shareholders most direct

15 Ibid p 6

16 Finn op cit p97

17 Normally this is determined under the Articles of the Company, by the directors : on the consequences of such a division between director and shareholder, see later discussion at p 48

means of participation in the affairs of the company - his vote. The agreements entered into in the latter category differ from the voting agreement in that the rights and obligations created attach on the shareholders much more in a "private" capacity rather than in their capacity as members of a company, or in its inner workings. Significantly, the rights and obligations created by agreements in the latter category are not inextricably or necessarily linked to the most characteristic shareholder act - voting : a prohibition against a member from entering into a competing business may stand quite independently of that shareholder's vote. A distinction between the two types of agreements exists, in both types, the party is contracting as a shareholder, but whereas in the former that capacity is fundamental and necessary to the agreement because it regulates an act that can only be performed by a shareholder i.e. voting, in the latter types, due to the different nature of the rights or obligations created, such capacity is not a fundamental pre-requisite of that party's fulfilment of the obligation : an agreement to lease land to the company, for example, could be and is entered into equally by a non-shareholder.

O'Neal proceeds from one basic assumption, namely, that the ultimate purpose of a shareholder agreement is the control or at least influence in the management of the corporation, either the board of directors or management (and preferably both) and perhaps, it is implied, the only method by which the shareholder agreement will embrace real power. Certainly it appears to be assumed that this is the typical form of a shareholder agreement: as he points out, the motives of the minority shareholder in entering into such an agreement are "to obtain membership on the board of directors, some voice in management of the corporation";[18] likewise, majority shareholders "may enter into an agreement among themselves to assure their continuing to act together in making corporate decisions".[19] Consequently, the areas covered by such agreements tend to be geared toward the management sphere, binding its parties to vote in the election of directors, for example, or officers of the corporation or providing a

18 O'Neal op cit

19 Ibid

method of resolving corporate disputes - such as an arbitration provision or some method for dissolving the corporation. It is significant that in describing the areas generally covered by shareholder agreements, O'Neal automatically gravitates towards the management sphere, because this latter control appears to endow the agreement entered into by shareholders with the most effective means of control. It is an agreement entered into by the parties in their capacities of shareholders, but the principal concern of such an agreement appears to be orientated toward control, or at least influence of the management structure - either directly in stipulating who the directors or officers will be, or indirectly in prescribing a policy on a management matter for example, the dividend policy. O'Neal does concede:

"Shareholder agreements often contain provisions on non-management matters. Perhaps the most important items of the non-management kind typically included in shareholder agreements are restrictions on the transfer of shares and buy out arrangements. Another common undertaking among shareholders is to refrain from engaging in a competing business"[20]

It is significant - certainly to any overview of shareholder agreements, and equally to an assessment of their strategic role in the corporate scheme of things, that this comment is relegated to a distant footnote. Certainly the impression created is that the thrust of most shareholder agreements in the United States, is in the direction of control at the level of management.[21] Two broad types of clauses emerge from this analysis - those that allow the shareholder to exercise control over the management of the company, either directly or indirectly (in effect transforming him perhaps into an informal director) and those that, because of the nature of the rights and obligations created leave the contracting party fundamentally still a shareholder without entering the domain of management.

The discussion so far has proceeded on the assumption that all shareholder agreements bind the parties by contractual force to a

20 Ibid p 5

21 Unlike in New Zealand, most states in America give directors a statutory power to manage the corporation under the relevant corporation law. The consequences of this difference between America and New Zealand are examined at p 71

particular course of action or policy - indeed the obligation sealed by contract emerges as the most characteristic feature of the shareholder agreement. Even the existence of this contractual obligation, however, cannot strictly be regarded as the lowest common denominator to which all shareholder agreements must subscribe : another type of shareholder agreement, not based on a contractual obligation, exists. The agreement in these cases is not backed by contractual force but rather by an "understanding" - normally that the votes will be voted in a particular way. The best example of such an agreement is to be found in Greenhalgh v Ardene Cinemas Ltd [22] in which one of the nominee directors "was asked in the course of his evidence whether he was ever instructed how to vote in respect of these shares, to which he replied "No, there were only three directors. I knew perfectly well what they desired done and I did it." [23]

Clearly such an "understanding" could also exist between shareholders who are not also directors. Though such an agreement lacks the force of a contractual obligation, and may be dissolved at will, it is nevertheless an agreement, and while acted upon, results in the same consequences as one sealed by contract. Though the overwhelming majority of shareholder agreements involve a contractual obligation, for that, in many respects constitutes the essence of the agreement's security, and hence, it is those agreements that this paper is principally concerned with - one should also bear in mind the existence of theseuunderstandings.

POOLING AGREEMENTS

In order to appreciate the structure of a shareholder voting agreement, it is proposed to examine a particular type of agreement - the pooling agreement, which, by way of contrast, will give an indication of the nature of other types existing.

Pennington accepts that the pooling agreement is valid under English

22(1950) 2 All ER 1120

23 Ibid p 1125

law by analogy with the proxy agreement:

"A member may validly contract to give a permanent and irrevocable authority to exercise the members' voting rights and it therefore seems certain that a member may enter into a valid agreement with other members to pool their voting rights and to vote on all their shares as the majority of them from time to time decide".[24]

As O'Neal points out, a pooling agreement is in many respects the simplest type of shareholder agreement:

"It may be a simple joint voting contract (sometimes called a pooling agreement) providing that the contracting shareholder will vote their shares as a unit in elections of directors and perhaps on other matters."[25]

This type of shareholder agreement has been widely recognised by statute in various states of America. Section 620 (a) of the New York Business Corporations Law provides:

"An agreement between two or more shareholders, if in writing and signed by the parties thereto, may provide that in exercising any voting rights, the shares held by them shall be voted as therein provided..."

In the absence of statutory regulation, however, it is clear that, being a contract, such an agreement may be concluded orally between the shareholders. Certain other requirements on the other hand, must be fulfilled:

"A pooling agreement must specify its objectives (election or corporate control or both) and its immediate aim (who or what or both). If the immediate aim is not specified, there must be set forth an agreed procedure where under the immediate aim can be determined, and made binding upon the parties to the pooling agreement".[26]

24 Company law 3rd Ed 1973 555

25 O'Neal op cit

26 Kruger op cit p 560

The pooling agreement is described as such because, after the agreement has been completed, the total number of votes covered by the agreement in respect of the specific matters stipulated are "pooled" together and voted as a single unit whereas before the agreement the votes of these shares were not mandated in any particular direction. The agreement brings together previously dispersed individual shareholdings. Thus the pooling agreement requires all the votes to be voted together and further stipulates how they will be voted on in the specific areas covered by the agreement. As the Manitoba Court of Appeal explained:

"In order to constitute a pool, there must be an 'aggregation of interest or property' or a throwing of revenue or property into one common fund or a sharing of interest in that fund by all on an equal previously agreed basis".[27]

The legal consequence of this type of agreement is that each contracting shareholder has an undivided interest in the casting of the votes for the objectives specified in the agreement; in other words, they become joint tenants of all the votes in the pool.

This device may be contrasted with, for example, the proxy arrangement in which the proxy is the agent of the shareholder to carry out a course dictated by that shareholder; in a pooling agreement, on the other hand, no principal/agent relationship arises between the shareholders - indeed, if the analogy were to succeed, the shareholder would have to be regarded as the agent of the agreement. The shareholders in a pooling agreement merely bind one another to vote as they initially agree. Likewise a voting trust agreement differs conceptually and practically from a pooling agreement in that in the former the voting right is separated from the beneficial ownership of the share - the right to vote is transferred, for a period, to the trustees. In contrast to this result, the shareholder, after a pooling agreement has been concluded, retains both legal and beneficial title to his shares :

27 per Beaubieur J.A. in Canadian Fur Auction Sales Co. Ltd v Neely (1954) 11 WWR NS p 265

his vote is only prescribed in the specific areas laid down by the agreement. Outside those areas, his freedom to vote remains unimpaired. This is not the case after a voting trust has been executed; no "outside" areas can remain. The areas governed by the voting trust then, are wider than that of a pooling agreement.

THE VOTING TRUST

A voting trust is created when the voting rights of some or all of the shares in a company are settled upon trust : the title of their shareholders passes to the trustees. The types of trusts created vary considerably : it may include all the shares with voting rights or only some of them; the power given to the trustees under the trust may be an absolute and unfettered discretion to act or these powers may be restricted. Likewise, the objects of the trust may be general or confined to certain specific matters. Professor Ballantine described the effect of the voting trust as giving "what is in essence a joint irrevocable proxy for a term of years the 'protective colouring' of a trust, so that the trustees may vote as owners rather than as their agents".[28]

Pennington concludes in relation to the English scene :

"It is unusual for contractual arrangements for the exercise of voting rights to be carried so far as the participating members transferring their shares to trustees ... such voting trusts are not uncommon in the United States, where they are valid at common law, and if set up in this country they would appear to be valid by English law"[29].

In support of this conclusion, it should be noted that a somewhat similar plan to a voting trust, whereby trustees were given the power by the articles of a company to appoint the managing director was upheld as valid in New Zealand in Woodlands Ltd v Logan.[30] The court held that a company could, by its articles, hand over the management of its business to a stranger. From this it follows that a voting trust entered

28 Ballantine "Corporations" Rev Ed (1946) p 184

29 Op cit

30 (1948) NZLR 230

into by shareholders supported by appropriate articles, could confer on the trustee of the trust power to regulate the company's affairs that are regulated in general meeting : clearly these could include "management powers". It would appear that this trustee, though in effect acting as a director, may be subject to no fiduciary obligations to the company, being the representative of the shareholders. The only possible basis on which such a trustee could have fiduciary obligations imposed on him would be through the statutory definitions of "director" contained in certain sections of the Companies Act 1955.[31] Perhaps this formula would include such a trustee : the company must have at least 2 directors, and though the Articles may empty those positions of any real powers, by leaving all matters to be decided in general meeting, the involvement of directors at any stage in the exercise of such powers may render such a trustee "a person in accordance with whose directions or instructions the directors of a company are accustomed to act.[32] If the trustees, by the Articles, were able to exercise their powers independently, then this formula would appear to have been avoided; likewise, they would only be "directors" for those specified sections of the Companies Act 1955. The submission of a resolution by the directors to the shareholders in general meeting on which the trustee's powers could be exercised does appear to be written in this formula.

In any event, such a trustee may be deemed to be a director under the general definition of director in the Companies Act:

"Director includes any person occupying the position of director, by whatevery name called".[33]

Clearly, therefore, if such a trustee's powers go beyond merely confirming or vetoing the exercise of the directors' powers, reducing the involvement of these two formal directors in the exercise of such powers to a bare minimum or to a mere formality, and in reality the powers of management are exercised by the trustee of the shareholders,

31 Section 130 (7) Companies Act 1955

32 Section 299 (9) (a) Companies Act 1955

33 Section 2 Companies Act 1955

this fact may render him a "person occupying the position of director", and hence subject to the fiduciary duties of directors to their company. Whether such a conclusion is reached depends it is submitted, on the nature, and extent, of powers exercised by the trustee : if in reality this trustee is managing the company, because the articles specify that such management powers are to be exercised in General Meeting, this appears to be caught by the general definition of director, pitched as it is to the reality, rather than the formality of the person's position.

In contrast to the previous shareholder agreements examined so far, the voting trust may be employed equally effectively in companies with a large number of shareholders as one with a small number of shareholders. Traditionally it has been regarded as a "big business" device. However, as O'Neal points out:

"It is a flexible device and can be exceedingly useful in working out control arrangements in a close corporation".[34]

Pickering concedes its flexibility but focuses on three situations where a voting trust will be found especially useful and they are:

"Where there is a close association of members and directors each individually having a comparable status within the company the existence of independent trustees with powers to appoint or supervise the appointment of directors and managing directors may prevent undesirable internecine strife. Secondly, where a company is incorporated for objects which require for their proper implementation the continued control of persons holding certain beliefs or opinions, a voting trust may be one way of achieving this. Thirdly, in very large companies where the membership is both great in number and dispersed in area the interest of shareholders may be more effectively and continuously safeguarded by trustees acting on their behalf than by the efforts of individual members in general meeting".[35]

34 O'Neal op cit 5.31

35 Supra Note 1 p 258

This type of shareholder agreement, though very popular in the United States is practically non-existent in the United Kingdom or Commonwealth jurisdictions. In fact, a device analogous to a voting trust, the unit trust, is being employed increasingly frequently in these countries. The "unit" is similar to the voting trust certificate issued to the beneficiaries of a voting trust in America. The unit holders have the beneficial ownership of shares comprised in the trust fund which are vested in the trustees; however, under the trust deed power to exercise these voting rights invariably is assigned to trust managers. Nevertheless, the unit trust affords a useful analogy by which the problems created by voting trusts may be assessed to the extent that similar questions of control regarding the management of the trust itself, and also in respect of companies of which the trust is a member, may arise.[36]

WHY ENTER INTO A SHAREHOLDER AGREEMENT?

Perhaps the first question to answer is the most obvious one : why do shareholders enter into such agreements? Why is a contract between shareholders considered necessary in addition to the "contract" embodied in the Memorandum and Articles of Association to which they are already parties, stipulating their rights and obligations by virtue of being shareholders? - For as Gower points out:

"The Memorandum and Articles constitute a contract between the company and each member.[1] This has been called a contract of "the most sacred character" since the shareholder advances his money in reliance on it ..... Secondly, the contract under section 20 [2] is enforceable among the members inter se.[3]" [37]

This is the background against which shareholder agreements are concluded. At this introductory stage it is proposed to answer the

36 For a description of the operation of unit trusts, see the judgement of McLelland J in Australian Fixed Trusts v Clyde Industries (1959) 59 SR NSW 41-42

37 Gower: The Principles of Modern Company Law 3d (1969) 261-2
citing 1 - Hickman v Kent or Romney Marsh Sheepbreeders Ass (1915) 1 Ch 881
2 - in New Zealand, Section 34 (1) Companies Act 1955
3 - Rayfield v Hands (1960) Ch 1

question from "first principles" concentrating on the circumstances which lend themselves to the intervention of such an agreement.

The first point to note is that the shareholder agreement is usually created between shareholders in a small private company, or to use the American term, in a "close corporation". This is so for two reasons: the first is that the problems generated within a small company are particularly susceptible to regulation by an agreement taking effect outside the company's Memorandum or Articles. The second reason is that a company with a great number of shareholders is, practically speaking, generally an unsuitable arena in which a shareholder agreement can operate. This does not mean of course, that a shareholder agreement could not be entered into by shareholders in a large public company - and indeed, this does happen - though in most cases the initial observation holds good. The susceptibility of the small company to a shareholder agreement is dealt with first, which may in itself indicate its unsuitability in larger companies.

The small company generally has problems peculiar to itself. Typically in a small company, the shareholders, directors and often officers of the company will be united in the same persons - or at least a close intimacy will exist between these persons. The shareholder agreement here provides the participants with a degree of flexibility independently of the Memorandum and Articles - O'Neal explains:

"The participants in a close corporation often want to depart from the traditional corporate management framework and agree among themselves on how control of the corporation will be allocated and on who will be directors and officers. Although they value the limitation on personal liability that the corporation form furnishes, they want to retain all the freedom that partners have to determine who is to control the enterprise and how that control is to be exercised. As has often been said, shareholders in a close corporation not uncommonly desire to

be shareholders to the outside world but partners among themselves".[38]

Here, therefore, the Memorandum and Articles maintains the incorporated image to the outside world;the shareholder agreement ensures that within that corporate structure a more fluid relationship, analogous to that of a partnership, may exist between the participants. The agreement in this instance in reality qualifies the impact of the Memorandum and Articles.

The agreement serves this purpose therefore, it allows the participants in the company to define their relationship outside the "traditional corporate management framework" normally established under the Memorandum and Articles. To this extent, the agreement confers a greater degree of flexibility, allowing the participants to enjoy the benefits of a partnership between themselves while retaining the shield of limited liability from the corporate structure.[39]

The agreement also serves another purpose one which, ironically enough, tends to qualify the flexibility conferred by these agreements. Finn explains:

"When forming a company the individual corporators will usually have some clear understanding of what their roles are to be in the enterprise, of what the objectives of the business are to be, and of how these are to be achieved. The agreement device can be employed so as to ensure from the outset that these understandings are not later frustrated in the case of any particular corporator by subsequent disputes and divisions between them."[40]

The agreement, then, creates rights as well as providing a greater degree of flexibility. To this extent, the shareholder agreement, and particularly the formation agreement, works to regulate the relationship between the participants in a small company, in elevating a mere

38 Op cit 5.02

39 The reasons why the terms of the agreement are not incorporated in the Memorandum or Articles, which is quite possible in light of the freedom allowed under the Companies Act 1955 the shareholders to draft whatever articles they choose, is dealt with subsequently- p74

40 Finn op cit 102;classic example of such an understanding in a small company subsequently being frustrated is provided by Re Westbourne Galleries Ltd (1973) AC 360;this case is discussed in detail in Chapter 7

understanding to a contractual obligation and injecting an element of certainty in areas perhaps left uncovered by the Articles or on which the Articles stipulate that any decision shall be taken in General Meeting. In this way, the agreement can supplement or add precision to the general mandate of the Articles. Indeed often the agreement will constitute a crucial supplement to the operation of the Memorandum or Articles, of which the latter, if applied independently or without reference to the agreement, could either lead to injustice or bring the company to a standstill. This is a unique problem of the small company in that the vitality of such companies often depend on the maintenance of harmonious relationships between the participants: the rupture of this relationship invariably leads to the rupture of the business. The strategic importance of the participants in a small company, therefore, often results in substantial restrictions being imposed on the sale of the company's shares which in small companies has a greater consequence than merely dictating the personality of the shareholding. The ownership and management of the small company are often combined in the same people. The shareholder - managers are, therefore in constant and intimate contact with each other; decisions are often made with little or no attention to their respective shareholding. It is not surprising therefore that they should wish to retain the power to choose their future associates by imposing a restriction on the transfer of shares. Such a restriction may also guard against the purchase of such shares by competitors.

This restriction on the power to sell shares [41] is a perfectly valid requirement in itself, but one which lends itself to abuse if not controlled in some way because it may deprive the minority shareholders of their ultimate protection : selling their shares. It is indeed one of the classic sources of abuse. Finn outlines that in guarding against this possibility, the shareholder agreement has a major contribution to make:

41 How absolute this restriction on the power to sell shares is may in itself prove all important : see the later discussion at p 29 of Greenhalgh v Mallard (1943) 2 All ER 234

"Such agreements can be used to prevent oppression or the "locking in" or "squeezing out" of minority shareholders by, for example, the utilization of clauses giving rights (1) to participate in management (2) to be bought out and (3) in defined circumstances, to have the company put into voluntary liquidation".[42]

Where restrictions are placed on the transfer of shares in the Memorandum or Articles - and often in small companies this is found necessary to maintain control, the shareholder agreement confers a degree of security on the minority shareholder, by giving him membership on the board of directors and some voice in the management of the company, for instance - that could not, based on the shareholding alone, exist due to the ultimate control exercised by the majority. The agreement likewise serves the interests of the majority shareholders who may be willing to share their control in order to attract into the company persons who otherwise would not buy a minority interest in a small company.

The attraction of the shareholder agreement is that it allows a minority shareholding to be raised to a level of parity, in some respects, with that of the majority shareholding : it allows the creation of rights by fixing them to the shares, thereby taking them out of the realm where they would be vulnerable to the power of majority rule.[43]

Where, as is often the case in small companies, the shareholding is evenly balanced, a dispute between the parties may result in deadlock. Likewise a small company may be based on the clear understanding that all its members will participate actively in the running of the business: the retirement of one of its members may consequently result in serious dislocation of its management or the death of a member might result in the ills of an "inactive shareholding" in the company. These problems result from the fact that the shareholders, directors and managers are

42 Finn op cit 98

43 The agreement remains vulnerable however, unless the ownership of the shares and the personal obligation of the other parties to vote (on which this "creation of rights" normally will depend) are expressly tied by contractual force : again, see later discussion of Greenhalgh v Mallard (Supra note 41) at p 29

commonly united in the same persons. To overcome this potential vulnerability, a shareholder agreement may stipulate independent arbitration over a matter in dispute between the members;it may provide for a dissenting member to be bought out by the remaining members, which that member may enforce, or it may require the company to be put into voluntary liquidation. Such problems are unique to the small company. There is, however, a practical consideration to be taken into account. Finn observes :

"The potency of the shareholder agreement device is most obviously related to the size of a company's membership. The possibilites for forming and policing an agreement tend to evaporate as membership increases".[44]

This is certainly a practical reason militating against the use of shareholder agreements in a larger company. Kruger, on the other hand, indicates that certain types of shareholder agreements are not necessarily restricted to companies having a small number of shareholders.

"Though pooling agreements are thought of in relation to control of private companies and of small public companies, pooling agreements are not so restricted in law or in practicability. A pooling agreement can be effectively used in the larger public companies as well. With scattered holdings, and poor attendance at stated and other shareholders meetings, a determined minority can exercise effective control as the majority or largest minority block among the shareholders or shares present and voting. Whatever the size of company, a pooling agreement may be utilised in connection with election of directors and shareholders resolutions" [45]

Thus it is clear, that the shareholder agreement is not exclusively limited to companies having a small number of shareholders (the number of shares, in this respect is irrelevant to the practical question of

44 Finn op cit 102

45 Kruger op cit 561

creating and policing an agreement) though it is generally entered into between shareholders in these types of companies. Broadly speaking, the effect of a shareholder agreement is twofold : on the one hand, it allows a degree of flexibility to be achieved in the regulation of the members relationship outside the "corporate norms", allowing a greater degree of individual definition which may be inappropriate if inserted in the articles (though there is nothing in fact to prevent the parties from inserting "personalised" articles). It also confers flexibility in the sense of allowing a group of shareholders, though not all, to enter into obligations meant to be relevant only to that smaller group;on the other hand, once the redefinition of obligations has been worked out within the flexibility provided, it fixes those obligations with the force of contractual law, thereby freezing those redefined positions. What these introductory observations do reveal is possibly a recognition of the share in the company as potentially the most secure foundation, within its limits , on which a member's rights may be fixed:consequently it is only logical that members should create rights and obligations in their capacity as shareholders, because it is only through that shareholding that the potential exists for "ultimate control" of the company.

The creation of rights within the corporate structure immediately involves a comparison with the company's Memorandum and Articles of Association, traditionally regarded as the company's constitution and source of members' rights. The comparison will be developed in the course of this paper: at this stage, the main difference that stands out is that the rights created from the Articles are enjoyed by all the members, whereas any rights created from an agreement are only, obviously, limited to those members party to the agreement. The Articles, moreover, are very directly linked with the company , whereas the link between a shareholder agreement and the company is more indirect - formally at least, it stands outside the company; the Articles, on the other hand, stand very much "inside" the company. At this preliminary stage, it is apparent that in certain circumstances, it will be more appropriate to

establish rights by an independent contract rather than incorporating them in the company's Memorandum or Articles. The first consideration is a practical one. O'Neal observes:

"Some draftsmen prefer to use shareholder agreements rather than (or in supplement to) charter or bylaw provisions to cover many matters, such as restrictions on the transferability of stock and the allocation of control among the various participants;and in many localities matters of that kind are nearly always covered by agreement among the shareholders rather than by charter or bylaw provision. The principal reasons for this are probably the bulkiness of some of the provisions and the uncertainty of the draftsmen as to whether such matters can properly be covered in the charter or bylaws".[46]

This, then is one practical reason why rights may be incorporated in an independent agreement: There is, however, a more substantial reason. Where the Memorandum and Articles have already been registered, those articles will only be able to be altered by S.24 of the Companies Act 1955 by a special resolution: thus if shareholders wish to create certain rights, and they are not already included in the company's constitution, this will only be able to be achieved if they are able to command a special resolution. Obviously in some cases this will not be possible, leaving the shareholder agreement the obvious alternative as the basis on which rights can be created.

The shareholder agreement is, independently of this consideration, a superior device as the foundation of a shareholder's rights compared to the Memorandum and Articles : as Gower points out, although the latter can be regarded as a contract:

"It is a contract with various special characteristics. Section 20[47] expressly provides that it is subject to the provisions of the Companies Act. The latter includes the sections which permit of alterations in the objects clause of the memorandum and in the Articles of

46 O'Neal Close Corporations 3.79

47 S 34 (1) Companies Act 1955 (NZ)

Association by means of a special resolution. Thus the shareholder is making a contract on terms which are alterable by the other party by a special majority voting at a general meeting". [48]

Any minority shareholder holding a quarter or less of the present voting power in the company places any "rights" he may enjoy under the Articles in very real jeopardy, because these rights can be altered or abrogated by the emergence, often present in a small company due to the small number of shareholders, of a majority able to pass a special resolution even where this combination has not yet materialized.[49] In contrast to this situation, a right enjoyed under a shareholder agreement is not subject to this particular statutory vulnerability : however much of a minority the shareholder is vis a vis the other members of the company, the rights created under that contract, like any other contract, cannot be unilaterally altered by the superior shareholder. From this elementary viewpoint, the shareholder agreement appears a superior and certainly a simpler device by which rights of a minority shareholder may be secured. There is, as well, another factor to be taken into account in making this comparison, as suggested by O'Neal:

"Perhaps the fact that a corporate charter is a public document tends to discourage the inclusion in it of some optional items for example matters the participants would prefer to keep confidential."[50]

This, then, may be another reason why an agreement will be preferred over the Articles as the foundation of certain rights.

Again looking at the comparison from the preliminary point of view, it would appear that certain matters are excluded from treatment by a shareholder agreement because their incorporation in the Company's Memorandum is commanded by a statutory provision : for example Section 14 (1) (a) of the Companies Act 1955 provides:

"The memorandum of every company must state the objects of the company."

48 Gower op cit 262

49 Subject, of course, to fraud on the minority.

50 O'Neal op cit 116

This would render ineffective an attempt to stipulate the company's objects within the framework of a shareholder agreement, even if the company's articles provided that such matters were to be regulated by General Meeting. To this extent, the shareholder agreement is limited by the corporate norms created by statute. In fact these limitations are not onerous, because the Companies Act 1955 lays down very little in the way of substantial provisions on what must be included in the company's Memorandum and nothing in relation to its Articles.[51] It is the absence of any substantial requirements, particularly in relation to the latter, that allows the shareholder agreement potentially an unlimited scope of operation.

The purpose of this introduction has been to indicate the potential utility of a shareholder agreement in the corporate structure : the essence of its attraction lies in its flexibility. Where it is impossible or involves a cumbersome procedure in altering the Articles, the agreement offers a relatively simple alternative by which shareholders may redifine their rights and obligations.

51 Apart from the minimal requirements under sections 20 (stipulating that the registration of Articles for a company limited by shares is optional) and section 22 Companies Act 1955, which stipulates that in the absence of any Articles registered, the "regulations contained in Table A shall be the regulations of the company, which shall apply even in so far as the Articles do not exclude or modify the regulations" of Table A.

CHAPTER 2

THE VOTING AGREEMENT AS A CONTRACT:

The heart of a shareholder agreement lies in the contract created between the parties : it is this contract that gives the agreement binding force.[1] Whether the shareholders are contracting among themselves or with outsiders in respect of their voting rights, the agreement created is governed by the general law of contract. As suggested earlier, however, the validity of the voting agreement as a valid contract seldom poses many problems, because its ingredients are, by and large, not onerous. Certain aspects of the agreement as a contract should, nevertheless, be pointed out.

The most obvious point is that in relation to the consideration supporting the contract, a distinction exists between a voting agreement between shareholders and one between a shareholder and an outsider. In the latter situation, independent consideration must flow from the outsider to support the promise;in the former the mutual promises of those shareholders are sufficient consideration to support the agreement. This is an established principle of contract law and applies to voting agreements, accepted as they are in England as normal contractual acts.[2] This it is submitted, is the view that will be followed in New Zealand.

Being a contract has another important consequence for the shareholder agreement - namely, that the parties will be bound by the express terms of the contract, and perhaps what is more important, any terms outside these will seldom be implied. This point is forcefully illustrated by Greenhalgh v Mallard.[3] Three directors of a company entered into a collateral agreement with the plaintiff, binding them to vote with and support him, giving him effective majority control. The directors, however, subsequently sold their share, to which the plaintiff alleged:

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1 We leave behind, at this stage, mere "understandings".

2 Greenwell v Porter 1902 1 Ch 530

3 (1943) 2 All ER 234

1) breach of their contract with him, by putting it out of their power to support him, based on the principle of Stirling v Maitland:[4]

"If a party enters into an arrangement which can only take effect by the continuance of an existing state of circumstances, I look on the law to be that ... there is an implied engagement on his part that he shall do nothing of his own motion to put an end to that state of circumstances, under which alone the arrangement can be operative."[5]

2) That the burden of the contract ran with the shares and later purchasers with notice were bound by its terms.

The Court rejected both arguments as a matter of the construction of the contract, refusing to imply the term argued for under (1);as there was no express restraint on the power ofthe directors to sell their shares, held no breach of the contract had occurred: As Greene MR commented:

"A mere undertaking by the shareholder to vote in a particular way cannot by implication impose upon him a prohibition against the sale of his shares".[6]

The court refused to apply restrictive covenants to personalty. Lord Greene MR also held that though an obligation entered into for an unlimited duration would be recognised, such recognition would only follow on the strength of explicit words to this effect. An instinctive wariness against an obligation of unlimited duration pervades the judgment : the prospect of the agreement being binding forever was the dominant factor in the court's refusal to accept as an implied term of a voting agreement an obligation not to sell the shares:

"Any other construction would mean that never could any of them sell one single share; there would have been an obligation to keep the

4 (1864) 5 B & S 841

5 Summarised by Lort Atkin in Southern Foundries v Shirlaw (1940) AC 717.

6 (1943) 2 All ER 240

shares and if the appellant had survived the three directors or any of them, it would have passed to their legal personal representatives ... I cannot bring myself to see that this document can be construed as imposing an absolute duty on the owner of the shares not to sell them. An obligation of that kind might have unforseeable results. If it had been intended, nothing would have been easier than to say so".[7]

Thus, though an agreement may validly stipulate that the obligations are to endure forever, the bias of the courts is to construe most agreements, in the absence of explicit words to this effect, for a more limited duration - which itself affects their interpretation of the contract.

Subsequently, the company implemented a scheme of subdivision of one class of its ordinary shares which had the effect of increasing the voting strength of that class five times, denying Greenhalgh any degree of effective control. In Greenhalgh v Ardene Cinemas Ltd [8], Greenhalgh argued that this action constituted a breach of the original voting agreement, arguing for an implied term that the company should be precluded from acting in any way which jeopardised the voting control apparently secured by the agreement. The court indicated that it would condone such an implied term in a contract in a very exceptional and clear case. Lord Greene MR indicated the court's reluctance to do so for the following reasons:

"For a court to imply, in a complicated business agreement, a far reaching term is a very serious matter. There is the pronouncement of Scrutton LJ (see Reigate v Union Manufacturing Co. Ramsbottom) which is very frequently referred to, that the clause must be such that an impartial onlooker who asked whether the parties intended it would in effect be met with the answer "of course we did". For the court to say that such an answer would be given, without the assistance of knowing all the circumstances is in any case a very serious responsibility"[9].

7 Ibid 239-240

8 (1946) 1 All ER 312

9 Ibid 514

In fact reluctance on the part of the courts to read implied terms into shareholder agreements is discernible from the first judicial pronouncements on such agreements : the agreement involved in Greenwell v Porter[10] included the apparently broadly worded provision that:

"(1) The executors shall take all steps and do all things within their power which may be required for obtaining the election, as directors, of ... The executors shall at all times to the best of their ability, by their votes and otherwise support them and each of them in their office. Each of them agrees that the provisions of this clause shall apply to him or her and to any shares not or at any time hereafter held by him or her in his or her own personal capacity".[11]

Mr. Greenhalgh would have recognised this type of clause, since it was similar to the one he committed himself to. The interpretation of this clause by the court in Greenwell v Porter [12] should have served as adequate warning to Greenhalgh's advisors, predicting accurately:

"It will be observed that the sale of the shares retained by the executors is not tied up ... the executors do not bind themselves not to part with the whole of the shares next day".[13]

The executors therefore, could have circumvented the agreement simply by selling the shares - and stipulating perhaps an agreement with the purchaser that they should retain the manner of voting the shares, which on the strength of Greenhalgh v Mallard[14], would liberate the voting power from the original agreement.

It is quite clear, that the security conferred on a party by such an agreement involves a little more than merely an initial vote of acceptance as a valid contract-this indeed may be regarded as the minimum test of security. A variety of threats to the effectiveness of such an agreement remain, once its legal validity has been assured, threatening to empty the agreement of any meaning as effectively as an

10 (1902) 1 Ch 531

11 Ibid

12 Ibid

13 Ibid 535

14 (1943) 2 All ER 234

initial verdict of legal invalidity leaving the valid agreement little more that a burnt out frame. The first and most obvious lesson to be learnt from the Greenhalgh experience, applicable generally to all shareholder agreements, relates to the collateral voting agreement involved. The obligation to vote the shares according to an agreement exists, in the absence of specific words to the contrary contained in either the agreement or the Articles only as long as the parties to the agreement own these shares : clearly, therefore, the agreement itself must restrict in some way the ability of the parties to sell those shares or else the obligation will be left hanging in mid air when the shares are sold. The obligation to vote is emptied of all meaning if the parties may with impunity sell the shares involved in the agreement. Furthermore, as the experience of Greenhalgh v Mallard[15] highlights, the restriction imposed must not be limited to sales to non-members of the company, but must expressly include any sale.[16] Such a provision would be enforceable despite the provision in the company's articles stipulating a different restriction on transfer. Clearly a minority shareholder commanding less than 25% of the voting power of the company would be ill-advised from relying on any restrictions on transfer of shares as this will be subject to alterations under S 24: the appeal of fixing such a restriction on the parties shares is that it is not subject to any alteration.

But any security conferred by such a restriction in an agreement giving a shareholder or shareholders control of the company is subject as Greenhalgh v Ardene Cinemas[17] illustrates, to the power of the company to subdivide the voting power of outstanding shares : obviously the number of votes that can be secured by a voting agreement only gives control relative to the number of outstanding votes competing with it. Thus a shareholder agreement must seek to prevent the company from increasing the voting power through subdivision of the outstanding shares, thereby diluting the voting power of the agreement. Such a result may be achieved, depending on the relative voting power of the agreement originally, by including the obligations on its parties to:

15 Ibid

16 A suggested precedent for such a restriction is to be found in Appendix B.

17 (1946) 1 All ER 512

1) Alter the Articles (if necessary) to make the voting strength of present and future shares a matter to be decided in General Meeting.

2) Vote against any alteration of the present Articles.

3) Vote against any resolution subdividing any shares.

4) Vote against any resolution which would interfere with the voting control of a party to such an agreement.

These provision, coupled with an effective restriction on the power of the parties to sell their shares would have prevented the subdivision of shares that occurred in Greenhalgh v Ardene Cinemas Ltd.[18]

In light of Greenhalgh's experience, inclusion of such clauses would appear essential to the security enjoyed under an agreement. The effect of such an agreement is to freeze the present structure of the company's shareholding in that position giving him control. Though Lord Greene MR in Greenhalgh v Ardene Cinemas[19] denied that this was the effect of the agreement in question, this conclusion would appear to be more a comment on the inadequacy of the particular agreement in question rather than a denial that the effect argued for could not be achieved. In fact, Lord Greene recognised that a shareholder could contract to achieve this result:

"If it had been the intention of the parties that Greenhalgh's position should be secured in a manner which would be effective at law, there are various devices by which that result could have been achieved, but those methods were not incorporated in the bargain which the parties made."

Likewise, Vaisey J at first instance advised that the plaintiff "ought to have stipulated from his point of view for some permanence

18 Op cit
19 Ibid

of control.[20] Clearly therefore, the courts recognise that a shareholder may "by way of various devices" secure "some permanence of control". The provisions suggested above are one means, it is submitted of securing this permanence of control : the result achieved indeed enjoys express judicial support.

Some aspects of a shareholder agreement may, on whatever basis, be held to be unlawful, and hence invalid. The most common ground of invalidity of such agreements involving shareholder-directors is that they contain an unlawful fetter on the exercise of the directors' discretions. The question arises as to whether the whole agreement falls because it contains an invalid provision or whether only the invalid provisions are struck down. This issue,[21] the determination of which is obviously of vital concern to the parties of the agreement, since all agreements are potentially liable to a charge of invalidity, is the last area in which the principles of contract play a leading role:

"The principles governing the severability of valid from invalid provisions in contracts generally are applicable to shareholders' voting agreements".[22]

The general rule governing shareholder agreements in this respect is that the courts will attempt to give effect to the valid elements of a contract containing invalid elements. The Supreme Court of Alberta in Motherwell v Schoof[23] outlined the criterion on which the courts will enforce the valid elements of an otherwise invalid agreement.

"The attempt to bind the directors ... is in my opinion invalid ... I do not think, however, that this should be held to be the sole or controlling purpose of the pooling agreement so as to invalidate the whole

20 [1945] 2 All ER 719

21 The issue of severance of the obligations undertaken by the Mallard directors pursuant to the collateral agreement with Greenhalgh arose in the unreported judgement of Morton J, described by VaiseyJ in Greenhalgh v Ardene Cinemas Ltd (1945) 2 All ER 719: "One of the points was that the obligation .. extended to both directors' meetings and to shareholders' meetings .. and .. could not be divided .. the collateral agreement was construed as binding the signatories as shareholders" Ibid 721. The case provides no criterion on when severance will be available to shareholder agreements.

22 O'Neal op cit 5.25 p89

23 (1949) 2 WWR 537

... the clauses providing for each object are not dependent upon one another but may be separated ... Those circumscribing the discretion of the directors are in addition to the (valid) clauses.[24]

Thus two factors emerge clearly as decisive in determining whether the valid parts of the agreement may be upheld : if the invalid part is the "sole or controlling purpose" of the whole agreement, then it is likely that the whole agreement, valid and invalid parts, will fall; likewise, the independence of each clause will influence the court in its decision. The operation of the latter factor in action can be appreciated by reference to the minority judgement in Ringuet v Bergeson[25] holding that the invalid clause requiring the unanimous vote was not separable from the other provisions of the contract. Consequently, the minority judgement would have invalidated the whole agreement:

"It appears equally that each of the parties wanted to guarantee against all contingencies in preventing the realisation of the common intention in adopting the most efficacious measure to ensure the maintenance of the obligations taken to this end ... this clause could not be considered as a purely accessory clause and cannot be considered as not playing a determinative role in the completion of the contract"[26].

Where the agreement is entire and indivisible, the invalidity of one aspect of it will permeate the whole agreement. The ultimate basis on which the purposes of the contract will be judged are the intentions of the parties:

"The intentions of the parties to an agreement control whether valid provisions will be given effect where part of the agreement is held invalid. The intention of the parties, it has been said "must be determined from the terms and subject matter of the contract together with any pertinent explanatory circumstances."[27]

24 Ibid

25 (1960) SCR 672

26 Ibid p 676-7

27 O'Neal op cit quoting Equitable Trust Co. v Delaware Trust Co. 30 DCL Ch 118

Another element to be considered in the court's refusal to enforce other elements of an agreement containing invalid elements was suggested in Motherwell v Schoof [28] : the court indicated that the existence of "undue pressure" or "undue influence exerted on the party agreeing to the agreement would render it void in a court of equity.[29] The absence of such elements paves the way for upholding the otherwise separable valid aspects of it.

Lastly, it should be pointed out that an agreement to agree on a particular mode of voting entered into by shareholders, though probably not in itself a "shareholder agreement" is, in any event, an unenforceable contract : as Parker J held in Von Hatzfeldt - Wildenburg v Alexander:[30]

"There is no enforceable contract ... because the condition is unfulfilled or because the law does not recognise a contract to enter into a contract" [31].

The Greenhalgh saga, apart from highlighting the need for tight draftsmanship, also illustrated the significance of such agreements as contracts. Indeed initially, the Greenhalgh cases remained basically within the realms of contract law. Though this element will from now on retire to the background, one should bear in mind that the voting agreement as a contract may, as Greenhalgh v Mallard[32] and Greenhalgh v Ardene Cinemas Ltd [33] dramatically and rather sadly illustrated, come very much to the fore.

REMEDIES FOR BREACH OF A SHAREHOLDER AGREEMENT:

"The question of the relief to be granted for violation of such an arrangement raises problems more vexing difficult and real than ever were to be found on the validity side. What is in issue, is the specific performance of an ongoing, intimate personal consensual relation. This is something the

28 (1949) 2 WWR 537

29 Ibid

30 (1912) 1 Ch 284

31 Ibid p 289

32 (1943) 2 AllER 234

33 (1946) 1 AllER 512

Anglo-American legal system has - wisely it may be supposed - not lightly granted as a matter of course.[34]

With this warning in mind, we proceed to examine the possible remedies available where a shareholder refuses to abide by the terms of a valid agreement entered into by him.

As Finn points out, the shareholder agreement holds one advantage over the Articles of Association as the foundation of a shareholder's rights:

"Breach of an agreement will sound in damages - a remedy generally regarded as not being available to a shareholder complaining of a breach of the 'statutory contract!'"[35]

In fact, it may be doubted whether the possibility of claiming damages against a breach of a valid shareholder agreement is a satisfactory form of redress. As O'Neal points out:

"Although the breach of a valid shareholders' voting agreement gives rise to an individual right of action for breach of contract, damages are usually so speculative that a suit for damages is not a practical remedy. Further, whatever injuries result from the breach may in law be injuries to the corporate entity and not injuries to the shareholder who considers himself aggrieved[36]."

Thus, on its own, the remedy of damages suffers from two main disadvantages: due to the type of obligations involved, establishing any meaningful personal damage from the breach of that obligation invariably proves difficult, but more importantly, it is seldom the redress the aggrieved party seeks : thus the damages involved are unlikely to be adequate, but further, damages themselves are unlikely to be an adequate remedy. Wright, in setting out the options available arising from the

34 Chayes:"Madame Wagner and the Close Corporation" 73 Harvard LR 1535 (1960)

35 Op cit p 103

36 O'Neal op cit 192

breach of a shareholder agreement, discounts the availability of damages:

"The possible alternatives are in line with traditional contract law : damages for breach of contract or specific performance. But the uniqueness of the corporate status as well as the inadequacy or impossibility of standard remedies requires alternatives. One is to impress a proxy on the recalcitrant shareholder allowing the other to vote his shares;another is the use of arbitration provisions, still another is the denial of voting rights of the recalcitrant shareholder".[37]

The same author concludes:

"The only true relief would be to specifically enforce the agreement or to grant irrevocable proxies. Both of these remedies fully uphold the intentions of the parties. An unenforceable agreement, although valid and binding, is of little use to anyone - either the participants or the corporation".[38]

O'Neal suggests yet another remedy:

"Parties to a shareholders voting agreement have been able to obtain in adjudication of their rights under the agreement by an action for a declaratory judg ment."[39]

It is clear that the most effective remedy for breach of a shareholder agreement in the contractual sphere is that of specific performance. From the outset, it has been recognised that this remedy is generally available against the breach of a shareholder voting agreement. In Greenwell v Porter[40], the court granted an injunction restraining the executors to a voting agreement from voting against the terms of an agreement as they threatened to do. In Puddephatt v Leith[41], Sargant J held that the courts would be prepared to grant a mandatory injunction

37 "Shareholder Pooling Agreements" Arkansas Law Review Vol.24 p 517 [1970]
38 Ibid
39 O'Neal op cit 103
40 (1902) 1 Ch 539
41 (1916) 1 Ch 200

to enforce the terms of an agreement:

"In as much as there is one definite thing to be done about which the mode of doing there can be no possible doubt, I am of opinion that I ought to grant not only the prohibitive but also the mandatory injunction."[42]

Clearly, therefore, the remedy of injunctions, analogous to a decree of specific performance, is available under English and New Zealand law in enforcing the terms of a voting agreement. The court appears to have accepted counsel's argument.

"The true test is whether the agreement in question is one within the principle of specific performance".[43]

Though in fact, the remedy granted in Pudde phatt v Leith[44] was a mandatory injunction against the defendants, it is implicit in the judg - ment of Sargant J that enforcement of a shareholder agreement by decree of specific performance fell outside any of the exceptions to this remedy, and hence would be available. It would appear from the grant of a mandatory injunction that the remedy of specific performance is likewise available - especially considering how blurred the distinction between them became in Puddephatt v Leith.[45]

It is clear, therefore, that the"problems more vexing, difficult and real " referred to in the opening quote do not present themselves where the obligation, enforcement of which is sought, is one to vote in a particular manner; where the agreement is based on an "ongoing" intimate relation "it is true that specific performance becomes problematical : breach of such an obligation, however, will provide a strong ground on which the company may be wound up under the just and equitable ground of Section 217 (f) Companies Act 1955.[46]

42 Ibid p 202

43 Ibid

44 Op cit

45 Ibid

46 In re Westbourne Galleries (1973) AC 360;the statutory remedies for breach of a shareholder agreement are considered separately in Chapter 7

CHAPTER 3

THE SHAREHOLDER AGREEMENT IN LAW

Before embarking on an examination of the legal position of the shareholder agreement, it is important to bear in mind the immaturity of the topic in New Zealand. For various reasons, the shareholder agreement has only seldom been considered by English or Commonwealth courts, and to the present writer's knowledge, never by a New Zealand court. By and large, this relative scarcity is reflected in the Commonwealth textbooks on company law. Gower for example, speaking of the United Kingdom, scarcely touches upon them, limiting his comments to a footnote:

"Voting agreements are not uncommon in this country, although we have nothing comparable to the American voting trust".[1]

Though it is accorded a slightly longer glance by Afterman[2], consideration of shareholder agreements is, nevertheless, limited to a rather short single paragraph. The point of these observations is to show that, to date, the shareholder agreement is a relatively neglected topic in academic circles, Commonwealth courts and practice - in sharp contrast to the slightly daunting abundance of case law, statutory regulation and academic comment on the subject in America. It is obvious therefore, given the immaturity and relatively untried nature of the shareholder agreement in the Commonwealth sphere that resort to the American experience may validly be made as, after translating these lessons into the New Zealand context, a useful guideline of the result likely to arise in that context. Though it would be possible from the "inside" - by the application of known principles that have developed in the Commonwealth jurisdiction in the corporate sphere to its basic ingredients - to ignore the American experience completely would represent nothing short of academic myopia.

1 Gower : The Principles of Modern Company Law 3rd Ed 1969 p 562
2 Company Directors and Controllers 1970 p 30

It is impossible to begin a consideration of the validity or utility of the shareholder agreement under New Zealand law without initially indicating the legal framework within which these agreements operate, focusing on the place of the shareholder in the scheme of things as well as a consideration of the source of that status - the share. On this preliminary basis, the concept of a shareholder agreement will be tested, providing an indication of their position in law to be kept in mind as their evaluation progresses.

THE SHARE: Because the foundation of any shareholder agreement by definition is the share, an examination of its nature is warranted. In fact, it is surprising, considering the strategic importance of the share in the shareholder agreement, how little discussion on the nature of shares is raised in assessing the validity or invalidity of a shareholder agreement. One would have thought that such an evaluation would have frequently returned to the apparently basic question "what is a share?" In fact this is not so. The validity or otherwise of these agreements seldom directly turns on the philosophical or legal characterisation of the share, but rather on its relationship to other principles within the general framework of company law, and the consequences on these principles of employing the share in such agreements. It is in this latter context that the rights of the shareholder are argued, rather than in relation to the nature of the type of property he holds - the share. The preliminary question - whether a share can be the object of a contract, like any other chattel, entered into by its owner is seldom raised - due in large part to the favourable answer to this question delivered by the courts as early as 1887.[3] The issue, therefore, was settled early on in the piece, conferring a broad mandate to enter into agreements involving shares. Implicit in this view is the idea that whatever else, the rights "in respect of dividends return of capital on

3 North West Transportation v Beatty (1887) 12 App Cases 589 (PC)

a winding up, voting and the like"[4] conferred on a shareholder are proprietary rights. This certainly is the prevailing view - and yet it is quite clear, philisophically speaking, that a different conclusion could have been reached on the nature of a share. As Farwell J in Borland's Trustee v Steel[5] explained:

"A share is the interest of a shareholder in the company measured by a sum of money for the purpose of liability in the first place, and of interest in the second..."[6]

Thus, a shareholder as well as enjoying rights against the company, is also under an obligation to it. Furthermore, the rights of the shareholder, stipulated in the Articles of Association of the company, while conferring on him some sort of proprietary interest in the company, do not create purely personal rights;they confer no proprietary interest in the company's property itself. These facts must qualify the extent to which a shareholder may be regarded as "owning" the rights created by his shares and yet, an element of proprietary interest does exist : emphasis on this aspect, coupled with a practical reaction to the rights created by a share inevitably resulted in the treatment of the share, to all intents and purposes, as any other piece of property. Gower outlines the contrast between the philisophical and practical positions:

"While it may be doubtful whether the rights which a share confers on its holder can be classified as "proprietary" in the usual sense, one thing, at least, is clear : the share itself is an object of dominion of rights in rem and not so to regard it, would be barren and academic in the extreme. For all practical purposes shares are recognised in law, as well in fact, as the objects of property which are bought, sold, mortgaged and bequeathed ... this emphasis on the proprietary and financial aspects of a shareholders rights obscure the important fact that his shares cause him to become a member of an association with the right to

4 Gower - op cit 344
5 (1901) 1 Ch 279
6 Ibid p 288

take part in its deliberations by attending and voting at general meetings".[7]

The immediate consequence to the present discussion of this attitude to the share - that the rights conferred on its holder-from a practical standpoint - are proprietary, or proprietary enough, is the generably favourable reception in the English and Commonwealth jurisdictions of an agreement entered into by shareholders in relation to their shares. Indeed, the acceptance of such agreements is now cited as the ultimate evidence of the proprietary nature of the rights in shares. This attitude had already consolidated when the first shareholder agreement came to be considered by the court in Greenwell v Porter[8]. Viewed as proprietary rights, it is obvious that a broad general mandate to enter into contracts touching those rights is given to the shareholder and this, indeed, is the position. As will be shown however, the consequences of this shareholding - that "cause him to become a member of an association" indeed results in a qualification being placed on their initial general validity: from such membership, and all its implications, the agreement may come under fire. As a person dealing with its property the agreement is secure;as a shareholder being a member of a company, dealing with the nexus between him and the company, it is more problematical. This possibility is the type of situation envisaged by Gower in reminding us of the consequences of such membership, and the folly of simply regarding the above divorced from this context as merely another piece of property like a chattel. The general proposition stands,however: the rights created by a share are proprietary rights, and as such can be subjected, like any other property, to a valid contract. In particular, this is true of the most important right conferred by that share - the right to vote. As Pickering points out:

7 Gower op cit 346-7

8 (1902) 1 Ch 530: though not expressly stated, the rejection of the defendant's argument (supported by no authority) attacking the validity of the agreement implies acceptance of the plaintiff's argu ment that voting rights are proprietary rights

"Powers of control conferred by voting rights are perhaps primarily important because through their exercise true proprietary rights or rights to income and capital may be obtained, modified or denied ".[9]

It is no coincidence that it is precisely this right to vote that most frequently is the means by which the objectives of a shareholder agreement are attained. Indeed it is in the pursuit of a possible limitation on this power that Gower runs across the shareholder agreement, pausing briefly to offer some observations on the topic -which have invariably been accepted by those interested in the subject as establishing the validity of the voting agreement in English company law. In deference to the significance attached to them, those comments, brief as they are merit, reproduction here:

"It has been repeatedly laid down that votes are proprietary rights, to the same extent as any other incidents of the shares, which the holder may exercise in his own selfish interests even if these are opposed to those of the company. He may even bind himself by contract to vote or not to vote in a particular way and his contract may be enforced by injunction".[10]

The proprietary element in the tenure of these shares certainly appears at this stage paramount. On acquiring shares in a company, a person acquires rights which are proprietary rights.

The suggestion inherent in the earlier warning however, not to concentrate exclusively on the proprietary aspect, is that this membership may affect in some way the otherwise unlimited exercise one would

9 "Shareholders Voting Rights" Pickering (1965) 81 Law Quarterly Review 248-9

10 Gower op cit 562;Foster J in Clemens v Clemens (1976)2 All ER 268 appears to suggest a radically different interpretaion of the obligations of a shareholder from that emphasised by Professor Gower in the statement quoted above: Foster J's interpretation of "bona fide for the benefit of the company as a whole" (Allen v Gold Reefs of West Africa (1900)1Ch 671) includes the requirements that one shareholder in voting, must honestly believe the resolution, when passed, will be for the benefit of another individual shareholder, and specifically, for the benefit of the shareholder complaining to the court - p 281

expect of a proprietary right. Because the shareholder agreement seeks its justification almost exclusively from the proprietary nature of the share, this warning cannot be disregarded lightly.

THE SHAREHOLDER AGREEMENT AND THE COMPANY:

Despite the level of sophistication achieved in some shareholder agreements which might suggest the contrary, it is quite clear that whatever else they purport to be, a shareholder agreement at the very least must be precisely that - a shareholder agreement. Though some agreements are so complex and far reaching in their regulation of the company's affairs that, in effect, they appear to compete with, and sometimes even replace, its Articles of Association, and incorporate what appears in reality to be also a "director's agreement" and perhaps a manager's agreement too, one should not lose sight of the fact that however top heavy the agreement may appear, all the rights created are linked, directly or indirectly, and initially limited, to the power of shareholders. It is the fact that at least one of the contracting parties is a shareholder that gives the agreement its name.

It is difficult to proceed with an examination of the validity or potential of such agreements without initially establishing the structural framework within which such agreements operate - indeed, the structure of this framework results in certain "in built" limitations on the agreement. Because one of the parties to such an agreement is contracting in his capacity as shareholder, it is proposed to consider briefly the structural limitations on any agreement entered into by him depending on that capacity; this will of necessity incorporate a consideration of the place of the director in the scheme of things - a happy link, because often the contracting party to such agreements is both a shareholder and a director. A distinction exists between "(1) agreements

binding shareholder - directors in their capacity both as shareholders and as directors and (2) agreements by shareholder purportedly taking on some of the functions of the directors".[11] Discussion of the problems created by the combination of functions under (1) relates more to the shareholder agreement in action, and is, therefore, left till then: at this stage is is proposed to limit the investigation to a definition of the limits imposed on any shareholder agreement (where the parties are merely shareholders) by the structure of the company, and the balance reached therein. Consequently, the approach taken at this stage will be more a "static" one, concentrating on the relevant principles operating within the company rather than on the agreement, and its impact on that structure. This will reveal the scope of a shareholder's power in the company, and this, at least initially, represents the limit imposed on a shareholder agreement. As has been recognised in America, shareholders may "join together and pool their votes in order to accomplish what they could as individuals"[12]; this principle is equally true in England and New Zealand. The powers of the individual shareholder is the scope, initially at least, permitted to a shareholder agreement.

The source of these limitations is threefold : the Companies Act 1955, the company's Memorandum and Articles of Association and cases on shareholders rights.

The fact that emerges is that there is no area of corporate activity that is inherently prohibited from being controlled or exercised by the shareholders of the company : this is the result achieved by the Companies Act 1955. The only inherent limitation from the Act arises as a result of the provisions giving the shareholders certain exclusive powers in the company, since these also stipulate the manner in which these powers must be exercised;being a statutory standard this cannot be varied. These provisions, therefore, represent one limitation on the freedom of a shareholder.

11 Tilden P Wright III "Shareholder Pooling Agreements" Arkansas Law Review vol 24 (1970) 504

12 Smith v San Fransisco & Northern Pacific Ry Co. 115 Cal 584 (24) p 501 (1897)

Considering the Act does not prohibit any area of corporate activity from regulation by the shareholders - thereby clearing the way for such regulation - it would appear that a high price is paid for this express reservation to shareholders - namely, the intrusion of a statutory requirement that cannot be varied. The fields specifically reserved to the shareholders by the Companies Act 1955 are:

1) Alteration of the company's Articles of Association - Section 24
2) The formation of the company - Section 13
3) The winding up of the Company - Section 217 (a)
4) Changing the company's objects - Section 18
5) Appointment of auditors - Section 163 (1)
6) Appointment and removal of directors - Section 187 (1)

Regardless, therefore, of the individual articles of association involved, a voting agreement by shareholders in relation to these areas of corporate activity will be valid, initially at least, because these areas are specifically reserved to the hareholders by statute.

It has been said that potentially, there is no inherent limit on the scope of corporate activity which may be regulated by the shareholders and consequently, by an agreement entered into by them; the reality of the company structure however, stands in sharp contrast to this potential freedom. As Gower points out:

"In practice, the initial constitution of the company will provide for the appointment of a board of directors and expressly delegate all powers of management to them." [13]

It is this practice - not necessarily of appointing a board of Directors[14], but delegation of all powers of management to them, that

13 Gower op cit p 127

14 A statutory requirement in any event-S. 180 Companies Act 1955

constitutes the most effective limitation on the scope of shareholder involvement in the company, and consequently, on the range of activites regulated by a shareholder agreement. The reason why delegation of management powers to the directors should result in such a limitation is due largely to the English Court of Appeal's decision in Automatic Self Cleansing Syndicate Co. v Cunninghame[15] in which it was held that where the articles of association vest in the board certain powers, the general meeting of shareholders could not interfere with the exercise of such powers by the directors. This acts as a very real limitation on the scope of shareholder intervention, since invariably, the company's articles will include Article 80 of Table A of the Third Schedule of the Companies Act 1955 which stipulates that "the business of the company shall be managed by the directors". Greer LJ explained the consequences of such a provision in Shaw & Sons (Salford) Ltd. v Shaw:[16]

"If powers of management are vested in directors, they and they alone can exercise these powers. The only way in which the general body of the shareholders can control the exercise of the powers vested by the articles in the directors is by altering the articles or, if opportunity arises under the articles, by refusing to re-elect the directors of whose actions they disapprove. They cannot themselves usurp the powers which by the articles are vested in the directors any more than the directors can usurp the powers vested by the articles in the general body of shareholders".[17]

The consequences of this interpretation for the shareholder agreement are fundamental, since it takes all the powers of management, if the articles stipulate such powers, beyond the reach of such an agreement: the only effective means by which such an agreement could in any event affect the exercise of these powers would be through the voting power of the parties to it at a general meeting. Such a vote is clearly ineffect-

15 (1902) 2Ch 34

16 (1935) 2 KB 113

17 Ibid p 134

ive if the exercise of such powers need never be submitted to the general meeting - and more important, if the exercise of these powers cannot be directly impugned by the shareholders through their voting power: on the strength of Shaw & Sons (Salford) Ltd v Shaw[18] such a vote, if taken, would in any event be a nullity. Whether an agreement between shareholders purporting to commit them to vote on a "management power" would likewise be held to be a nullity is a separate question, independent of its practical deficiencies.

The powers of management, currently viewed as prerogative powers of directors[19] are, therefore, immune to a shareholder agreement. The only "management power" that could be regulated at this level would be an agreement by shareholders binding them to vote in favour of commencing legal proceedings on behalf of the company if the directors fail to do so. This appears to be the result of Marshall's Valve Gear Co v Manning, Wardle & Co.[20]

Goldberg[21] takes issue with this interpretation of Article 80 (Table) arguing persuasively that the literal application of the formula employed in that provision "Subject .. to such regulations .. as may be prescribed by the company in general meeting" is the correct one : the "regulation" referred to here can only be a "resolution passed by a simple majority of the general meeting"[22] The same writer relies on Marshall's Valve Gear Co. Ltd v Manning Wardle & Co. Ltd [23] for explicit judicial support of this interpretation arguing forcefully that the line of judg ments [24] on which it has been concluded that directors, by virtue of Article 80 enjoy prerogative powers, do not justify this conclusion, and that, in any event, the articles involved in these cases differed substantially from Article 80. Goldberg concludes:

18 (1935) 2 KB 113

19 Gower op cit p 131 accepts this interpretation of Article 80

20 1909 1 Ch 267

21 "Article 80 of Table A of the Companies Act 1948" 33 Modern Law Review 1970 177

22 Ibid p 178

23 (1909) 1 Ch 267

24 The cases are - Automatic Self Cleansing Filter Syndicate Co. v Cunninghame (1906) 2Ch 34 ; Quinn & Actens v Salmon (1909) AC 442; Shaw (John) & Sons Salford v Shaw (1935) 2 KB 113; Scott v Scott (1943) 1 AN ER 582 : Sullivan (Post Note 27) views this case as "Standing in genuine contrast to Marshall Valve v Manning" Ibid 577

"Residuary powers of the company do reside in the general meeting of shareholders acting by ordinary resolution; it is not true that the shareholders are powerless to act save by special resolution even as regards matters not specifically delegated to the directors"[25].

Clearly such an interpretation of Article 80 Table A increases the scope in which a shareholder agreement may operate effectively it permits interference by the shareholders in the exercise of "management" powers and secures regulation of these powers by ordinary resolution: such powers may, therefore not only be brought directly under the control of an agreement but the proportion of voting power needed by the agreement to control the exercise of these powers is less (i.e. 51%) than that required under the alternative interpretation of Article 80, which only concedes such control indirectly by the passing of a special resolution altering the articles. Even on Goldberg's interpretation of Article 80, however, a limit is imposed on such an agreement, it cannot bind its parties to regulate the directors' "day to day control of the business is in the hands of the directors... this cannot be taken away nor interfered with by the shareholders without a change in the articles ... To have it otherwise would be not to manage the business subject to the regulations by the general meeting, but not to manage it at all".[26]

Sullivan[27] agrees that, even accepting that directors are delegates and not representatives of their shareholders, a limit is imposed on the extent of shareholder intervention - and hence on the effectiveness of a shareholder voting agreement - where Article 80 is employed delegating power of management to directors:

"If intervention is frequent and sufficiently detailed so as to exclude discretion in the implementation of policy, it will be unjustified under the terms of the regulation"[28].

25 Op cit 183
26 Ibid 182: Directors, where Article 80 is employed, must still manage the company. The prohibition on robbing directors of their day to day control under Article 80 is similar to the American prohibition against "Sterilisation of the Board of Directors"(Long Park v Trenton-New Brunswick Theatres Co. 77 WE 2d 633 (1948)) Though the latter stems from a statutory provision, they are similar to the extend that both involve a power of management.
27 "The relationship between the Board of Directors and the General Meeting in Limited Companies" 93 (1977) Law Quarterly Review 569.
28 Ibid p 578

Even accepting this limitation, it is quite clear that the scope of a shareholder agreement is greatly expanded by this interpretation of Article 80, in that the alternative interpretation of this provision, in giving directors exclusive powers represents, in practice, the most effective limitation on a shareholder voting agreement. It is important therefore, to bear in mind that the interpretation of Article 80 accepted by Professor Gower is not the only one available, and that the position is not as settled as might appear from his treatment of the topic. An alternative interpretation, from which the shareholder agreement can only gain, does exist.

Even under the interpretation of Article 80 which views the exercise of management as the exclusive right of directors, the shareholder agreement is not totally excluded from the exercise of these powers: quite clearly it may be employed to attack indirectly the prerogative powers of the directors by an agreement among the shareholders to vote for an alteration of the articles, or more simply, to remove the directors from office under S.187 of the Companies Act 1955: the former attacks the power, by removing it, the latter attacks the director in a similar fashion. In this more indirect way, therefore, the shareholder agreement may be relevant in relation to management powers. It should be pointed out here that we are only concerned with the operation of a shareholder agreement which does not involve the participation as contracting parties of directors - at least in their capacity as such. The possibility of the latter may indeed prove an effective means to pierce the shield created for directors by Automatic Self Cleansing Filter Syndicate Co. v Cunninghame.[29]

In fact, the shareholder agreement may operate directly, even in respect of these management powers in certain circumstances committing its contracting parties to vote in a certain way on a power that has been delegated to the directors, and this agreement will in fact be effective and undoubtedly valid. Gower describes the circumstances in which this

29 (1906) 2 Ch 34

apparently heretical suggestion is valid.

"It seems that if for some reason the board cannot or will not exercise the powers vested in them, the general meeting has been held effective where there was a deadlock on the board,[1] where an effective quorum could not be obtained,[2] where the directors are disqualified from voting,[3] or more obviously, where the directors have purported to borrow in excess of the amount authorised by the articles"[4] [30]

Quite clearly, a shareholder agreement stipulating the manner in which the contracting shareholder is to vote will be effective in these circumstances, because the shareholder is here exercising a normal shareholder function: he will be directly influencing a decision normally exclusively within the sphere of management. To this limited extent, the shareholder agreement may play a direct role in relation to management powers. A problem is raised in relation to its validity however, one that has already been touched on. Undoubtedly an agreement binding the contracting shareholders to vote in default of the exercise of these powers by the directors in spheres that normally would be the sole preserve of those directors is, prima facie, valid. The difficulty arises where this is not expressly provided. Clearly the practical result does not vary, whether the express default power is included or not: where no default occurs, any agreement simply cannot be acted on, and if acted on, any votes cast are a nullity. In default, the votes must be cast according to the terms of the contract. Where an agreement purports to bind a shareholder in relation to management powers , the possibility of those votes actually being exercised validly in default circumstances, though the contract remains silent on the matter, would appear to militate against regarding the agreement itself as a nullity, though the default has not occurred as yet, and may not even be forseeable

30 Gower op cit 136 citing 1. Barron v Porter (1914) 1 Ch 895
2. Foster v Foster (1916) 1 Ch 532
3. Grant v UK Switchback Rys (1888) 40 Ch D135
4. Irvine v Union Bank of Australia (1877) 2 App Cas 366 PC

Indeed, the exercise of such votes in default circumstances, being the only occasion when the agreement will be able to be acted on may be regarded as an implied term in all such agreements that otherwise would not appear to make much sense.

This discussion indicates that, whatever the individual articles of association provide, even in relation to powers delegated exclusively to the drectors, the shareholder agreement may nevertheless play an effective role. Gower views the power of ratification as the carrier of this potentially unlimited scope of action:

"Although the transaction concerned may relate to ordinary management, and, therefore be within the powers of the board, the ratification of it will always be a matter appropriate for the general meeting, which can waive what would otherwise be a breach of duty. As a result, the activities of general meetings may indirectly extend over the whole sphere of the company's operations and ultimate control revert to the shareholders who are free from duties of good faith to which the directors are subject"[31]

This being so, a shareholder agreement likewise may "extend over the whole sphere of the company's operations" if it stipulates how the parties are to vote in ratifying a breach of the fiduciary duty owed by the directors, in addition to the default circumstances. It is debatable whether a shareholder agreement purporting to bind a member to vote in a certain manner over a management power [and hence ineffective, though not in itself necessarily a nullity] would bind him in voting in relation to that same sphere in ratifying a breach of the directors' fiduciary duty. Such an extension is unlikely, because the vote relates to the ratification of the breach of fiduciary duty, and not a purported control on the exercise of that directors' power from which the breach stemmed. But sub-

31 - Gower - Op cit p 563

ject to the subsequent investigation it would appear that a shareholder agreement could bind the parties to a predetermined course of action, in ratifying or not ratifying, a breach of duty on the part of the directors. In this way again, the agreement may affect all the powers previously excluded to them because they were delegated to the directors in the company's articles. Added to the areas in which shareholder control is reserved by statute, very little remains immune from the shareholder agreement - precisely because the shareholder wields ultimate control of the company.

THE VALIDITY OF A SHAREHOLDER AGREEMENT IN NEW ZEALAND:

The starting point of such an inquiry must be the proposition that as a general rule the shareholder agreement per se is valid under New Zealand law. Some undoubtedly will be invalid because of a particular requirement of law - most likely, a principle of company law : what these threats are, and how they may possibly be avoided will be dealt with independently but the general proposition - that shareholder agreements are valid under New Zealand law serves as an accurate point of departure into the more detailed examination.

This proposition can be confidently asserted, despite the absence of judicial comment in this country on shareholder agreements by reference to the acceptance of such agreements by courts in the United Kingdom and Canada, and partly as a result of the prevailing judicial conception of the company share as conferring on its holder a proprietary right. This view of the company share as a proprietary right, established by the Privy Council in North West Transportation Company Ltd v Beatty[32], is the foundation of the validity of the shareholder agreement. From this viewpoint, it followed naturally that a shareholder could contract to vote or not vote in a particular way, and this indeed was accepted as the law

32 (1887) 12 App Cas 589 PC

by the defendant executors in Greenwell v Porter.[33] The right of a shareholder to bind himself to vote in a particular way was accepted as interest in the nature of the share in Puddephatt v Leith[34]: Sargant J simply commented of this right:

"In my opinion, therefore, the right of the plaintiff is clear"[35]

These cases stand for the proposition that the shareholder has a right to enter into contracts specifically in respect of the way he will vote at the general meeting, and generally it is implied, all the incidents of a share, being proprietary rights, are liable to contractual regulation. This, it is submitted will be the starting point of a court in New Zealand in determining the validity of an agreement.

An American view of such agreements - that they represented a fraud on the non contracting shareholders;[36] conformed with the view taken originally by the courts in England to such agreements. In Elliot v Richardson[37], the court held:

"A consequence of such an agreement is that the whole body of ... shareholders may be deceived and think when one shareholder gives advice ... that he is exercising his own judgement and sense of equity."[38]

Clearly this objection could not apply to an open agreement executed by all the company's shareholders or, for that matter, one known to the other non contracting shareholders. It is interesting, however, that even in cases accepted as supporting the general validity of the shareholder agreement, based on the proprietary nature of the share, the invalidity of a secret agreement persists. In Goodfellow v Nelson Line Liverpool Ltd.[39] Parker J commented:

33 (1902) 1 Ch 535
34 (1916) 1 Ch 202
35 Ibid
36 Odman v Oleson 64 NE 2d 439 (1946)
37 (1870) LR 5 CP 744
38 Ibid p 751
39 (1912) 2 Ch 333

"A secret bargain by one debenture holder for special treatment might be considered as corrupt and in the nature of bribery"[40]

It is inconceivable today, in light of the greater emphasis placed on the proprietary aspect of the shares that an otherwise valid agreement would be struck down because the other share or debenture holders were not privy to it.

For reasons closely allied to the fraud argument, it has been held in England that a contract in which a shareholder agreed to vote in a particular way for some purely personal pecuniary interest was illegal.[41] This would be unlikely to invalidate an agreement supported by the mutual promises of the shareholders, but the question remains whether the former type of contract would likewise be invalidated today. Again, the prevailing view of the share as conferring on its holder proprietary rights would appear to exclude, by definition, this ground of invalidity where the shareholder contracted for a purely pecuniary benefit.

A uniquely American objection to some shareholder agreements, especially relevant to those entered into by shareholders of a small private company, arise when that agreement in effect put the management practices of the company on the basis of a partnership.[42]

In fact, this view is on the defensive in America itself. If imported into New Zealand it would represent a limitation on the result able to be achieved by a shareholder agreement because such agreements would have to conform to the corporate norm. It is unlikely to succeed in New Zealand. The philosophy of the Companies Act 1955, apart from the requirement that a company have at least two directors [43] (which, in itself, does not exclude the possibility that the company internally be

40 Ibid The same rule, applies for these purposes, to shareholders

41 Elliot v Richardson op cit p 751

42 Jackson v Hooper 76 N.J Eq 592

43 Section 180 Companies Act 1955

a partnership : this would depend on the powers these directors exercised, and this is left ultimately to the shareholders) as reflected in the case law on the subject [44] is that the internal management is a matter to be settled by the Articles of Association, and hence by the members. In South Africa, a country operating under the same relevant statutory regime as New Zealand, the court upheld a 'partnership' agreement entered into by the shareholders of a private company : the agreement considered in Stewart v Schwab and others[45] was described in the judgement:

"A written agreement was entered into ... which is stated to be an agreement of 'partnership'. The material terms of this agreement are that the sole shareholder of the company shall be the applicant and the first and second respondents ... that the applicant and the first and second respondents shall be the directors of the company ... that notwithstanding the disparity in shareholding each director shall have 'equal power' ... that the partnership shall continue for an indefinite time".[46]

The court accepted this agreement, putting the management of the company on the basis of a partnership, as valid. It is submitted that the same verdict would be reached in New Zealand. Furthermore, it would appear that deviations from the strict corporate norms are recognised as valid, by implication, in relation to the case law on S 217 (f) of the Companies Act 1955 - indeed, not only are these deviations indirectly recognised, but would appear to create unique legal rights, as indicated by the House of Lord's judgement in Ebrahimi v Westbourne Galleries Ltd.[47]

44 Automatic Self Cleansing Filter Syndicate Co. v Cunninghame (1906) 2 Ch 34

45 (1956) 4 S. Af. LR 791

46 Ibid p 792

47 (1973) AC 360

CHAPTER 4

THE "FETTER" RULE:

The potentially unlimited scope of a shareholder agreement made possible by the Companies Act 1955 will seldom be fully realised because invariably the powers of management of the company will, to a lesser or greater extent, be relegated to its directors by Articles of Association. This, then, normally is the framework in which a shareholder agreement will be entered into. The single most dangerous threat to the validity of a shareholder agreement stems from this allocation of spheres of activity between shareholder and director, particularly acute in a small company where often these roles are combined in the same persons and where, as already pointed out, control of the board or securing a say in management are the plumbs that the parties, by such agreement, seek to pick : this threat is the "fetter" rule. The essence of the rule is relatively simple. Finn explains:

"The objection to a shareholder - director so binding himself in his capacity as director stems from the fiduciary nature of that position. As a donee of fiduciary powers he is obliged to exercise his discretions in what he believes to be the interest of his company and the discharge of this obligation usually necessitates that he retains his discretions unfettered in any way for anterior contracts or understandings. The vice in a contract which binds him to a particular course of action is that it obliges him to act "in a specified manner to be decided by considerations other than his own conscientous judgement at the time as to what is best in the interest of (his company)"[1].

It is clearly established that a director standing in a fiduciary capacity, cannot fetter his discretion in relation to the spheres of

1 Finn op cit 100-1 quoting Fletcher Moulton LJ in Osborne v Amalgamated Society of Railway Servants (1909) 1 Ch 163

activity of the company assigned to him,[2] where Article 80 of Table A is included in the Company's Articles of Association (as it invariably will be) this will include all matters "not specifically delegated to the directors provided they are not expressly reserved to a general meeting by the Act or the articles"[3]. From this it follows that a shareholder agreement involving a director binding him in that capacity over a matter on which the Articles or the Act are silent as to how this power will be exercised prima facie constitutes a breach of his fiduciary duty. The same prohibition it would appear applies in relation to a power subject to the approval of the shareholders in general meeting. Any agreement in this situation could only relate to whether the power of the director is exercised at all - for example, where the power to issue new shares is made subject to the approval of the shareholders, whether those new shares are issued in the first place - since the submission of the resolution obtaining the approval of shareholders is mandatory under the company's articles in any event: in relation to the original exercise of discretion, the director is under the same fiduciary obligation, including obviously a prohibition on fettering his discretion, arising from an exclusively management power. Where under the company's articles, a power is stipulated to be exercised exclusively by the shareholder, excluding the directors totally, the issue does not arise, since the directors here have no discretion to exercise.

2 Gower op cit 525: The appointment of nominee directors, for example, creates a very real possibility, through the nominator's persisting influence, of a breach of the fetter rule. Likewise in theory the appointment of government directors, could result in a fetter being placed on their duty to act in the best interest of the company due to their co-existing duty, as civil servants, to act in the public interest. Kyle concludes, however, in relation to government directors the danger of a fetter being placed on their discretion as company directors, due to their loyalty to the public interest is more apparent than real. The danger in relation to nominee directors, however, is very real - Kyle : "The Government Director and his conflicting duties" (1973) 7 VUWLR 75.

3 Gower Ibid 132

The application of the fetter prohibition to shareholder agreements arises where the agreement binds a shareholder-director in his capacity both as a shareholder and director[4]. One point, however, is clear : there is abundant authority for the proposition that the mere fact that a shareholder to such an agreement is also a director of the company will not, of itself, attract the operation of the fetter rule, through infection, where that contracting party enters into obligations in his capacity as a shareholder. Case law has consistently maintained the distinction in roles, and consequently in duties owed, maintaining this distinction where the two roles are combined in the same person.[5] Where the types of obligations undertaken permit, the capacitites of the party as shareholder and director will be treated in isolation from each other. This certainly applies where the obligations stipulated in the agreement clearly relate only to the parties' capacity as shareholders. Even, however, where the agreement leaves it unclear what capacity an obligation extends to, the legal distinction remains decisive in determining whether the operation of the agreement extends to the party's capacity as a director, because it necessarily proceeds on the assumption that two separate roles are involved.

The basic proposition underlying the fetter rule appears relatively simple; the determination of its breach on the other hand, proves more difficult, suggesting that the original simplicity of the rule may be a a little deceptive.

4 If Gower's interpretation of Article 80 Table A, and the cases cited to support his conclusion is correct (op cit p 132), the other type of agreements, "agreements by shareholders purportedly taking on some of the functions of the directors" (T.P. Wright op cit 504) would appear to be ineffective, since shareholders by their voting cannot intervene in powers of management. If, however, the interpretation of Article 80 argued by Goldberg (op cit : see ante p 50) is correct, this latter type of agreement, binding its parties to vote in relation to a "management" power, clearly is effective unless by such intervention, the directors are deprived of 'day to day' control. The possibility of such shareholder intervention cannot alter the application of the fetter rule on directors or confer on the latter a mandate to enter into an agreement with the shareholders, or anyone for that matter : till the shareholders intervene, the director must exercise his discretion unfettered, because he is in the same position as a director exercising exclusive management powers on the view of Article 80 advanced by Gower (supra). After the shareholders have intervened, the director has no direction to exercise. There is, therefore no possible twilight zone in relation to fiduciary powers.

5 North West Transportation Co. Ltd. v Beatty (1887) 12 App Cas 589.

The main problem in applying this prohibition lies in the distinction between a fetter on that discretion and an exercise of it. Gower explains this distinction :

"(the fetter rule) does not mean that if, in the bone fide exercise of their discretion, the directors have entered into a contract on behalf of the company, they cannot in that contract validly agree to take such further action at board meetings as are necessary to carry out that contract".[6]

The judgment of the High Court of Australia in Thorby v Goldberg[7] is now accepted as representing the most indulgent approach to an exercise of discretion permitted to directors short of being labelled as a fetter on that discretion[8] in that it recognised the validity of a contract entered into binding directors to a predetermined course of conduct over a period of time. Gower quotes the following extract from the case:

"There are many kinds of transactions in which the proper time for the exercise of the directors' disctretion is the time of the negotiation of a contract and not the time at which the contract is to be performed ... If at the former time they are bona fide of opinion that it is in the best interests of the company that the transaction should be entered into and carried into effect, I can see no reason in law why they should not bind themselves to do whatever under the transaction is to be done by the board"[9].

Gower appears to take this statement of the law as standing for the proposition that the fetter rule will not be breached - and hence the agreement will be valid - if the commitments undertaken by the directors are the product of, or at least can be linked with the original exercise

6 Gower op cit 525
7 (1964) 112 CLR 597
8 Finn goes as far as regarding it as an exception to the rule-op cit 101
9 Gower op cit 525 quoting Thorby v Goldberg op cit 605-6

of discretion made 'bona fide in the interests of the company'. The full text of the statement subsequently introduces, or at least suggests, the existence of a further requirement before the validity of the agreement as a valid exercise of discretion is assured. The apparent qualification to the proposition is contained in the line of the judgment omitted in the quote presented in Gower:

"Where all the members of a company desire to enter as a group into a transaction ... the transaction being one which requires action by the board of directors for its effectuation, it seems to me that the proper time for the directors to decide whether this proposed action will be in the interests of the company as a whole is the time when the transaction is being entered into and not the time when their action under it is required".[10]

It is immediately on the heels of this apparent prerequisite that Kitto J reaches the conclusion quoted in Gower at page 525. The question is unclear, however, because the opening sentence of the statement would certainly appear to support the wider proposition accepted by Gower : the requirement of unanimous participation on the part of the members of the company appears out of nowhere. It may be purely illustrative of the "many kinds of transaction" suggested earlier, rather than definitive of such transactions. Given this ambiguity, and partly because the consequences of unanimity are to be dealt with shortly, it is proposed to proceed on the basis that the wider construction placed on this statement by Gower is correct.

From the Thorby v Goldberg[11] interpretation, it follows that a contract by directors binding themselves to pursuing a particular policy in the future cannot be regarded per se as a fetter on their discretion

[10] (1964) 112 CR 605
[11] op cit Note 7

or automatically invalid. The relevance of such an interpretation to the shareholder agreement is immediate because it recognises as valid, under certain circumstances, an ongoing obligation undertaken by directors in regard to future acts, without it necessarily being labelled as a fetter on that discretion. The exercise of this discretion at one point produces a momentum taking it a certain distance into the future. Clearly the case is only relevant to shareholder agreements in so far as the latter involve parties who are directors as well as shareholders : as this combination frequently occurs, however, the interpretation is fairly directly relevant to their permitted scope in allowing the possibility of a director - shareholder lawfully binding himself to a particular course of conduct (eg. dividend policy) for the future in his capacity as a director as well. The precise nature and extent of the obligation will determine its actual validity, but the possibility of validity remains as long as the obligation is bona fide in the interests of the company". The obligations contemplated may be limited however here the parties to the agreement are directors as well as shareholders, the obligations they undertake in that former capacity will only avoid the fetter rule as long as they may be regarded as carrying into effect of their original exercise of discretion 'bona fide in the interests of the company' made in the agreement : this requirement tends to limit the extent of obligations that may be included in this capacity in such an agreement. The type of transactions envisaged by the court itself tended to involve short term commitments in order to effectuate a once only transaction - the example given was a "sale of land".[12] Thus, the case recognises the validity of the directors binding themselves in an ongoing way to a particular course of action, but it would appear, this obligation must necessarily bear the imprint of the causative transaction, and was envisaged as a relatively short term one. Perhaps the case also suggests that the transactions causing the directors to bind themselves are commercial in nature and may not extend to a purely voting policy for example -

12 Ibid 605

unless it can be shown to be bona fide in the interests of the company. Another limitation stems from this : if the validity of the obligations undertaken in their capacity as directors is to hinge on being accepted as flowing necessarily from the original exercise of discretion, thereby avoiding the fetter rule, it will have to be made clear that the obligations being undertaken in the agreement are a caryying into effect of this original exercise of dscretion made "bona fide in the interests of the company", whether or not that original exercise of discretion is contained in the agreement. It would appear difficult to pass this test in an agreement which does not made clear the capacity in which the particular obligations are being accepted by the parties. In effect, therefore, to avail themselves of the Thorby v Goldberg[13] interpretation, the "directors' agreement" must be set apart from the shareholder agreement : it would not appear to protect an agreement involving an obligation undertaken by parties who are both directors and shareholders to vote for a particular dividend policy where the agreement does not clarify whether the obligation is limited to voting at the GM or extends to voting at the directors' meetings as well because, in light of this obscurity, it is less likely that the latter obligation could be accepted as an exercise of discretion.[14]

13 (1964) 112 CLR 597

14 There appears, therefore, no advantage in deliberately leaving ambiguous the capacity the party is contracting in, in an effort to bind the party in his capacity as a director. If this is the intention of the parties, they will act according to this term while both parties are happy with the agreement : it is only when one of theparties challenges the validity of the agreement that its terms will be relied on through action in court - but this is precisely when the agreement will be limited by judicial pronouncement to the capacity of the parties as shareholders, and its extension to their capacities as directors denied-subject of course to the Thorby v Goldberg (Supra) interpretation. . Moreover an element of ambiguity may lead the court to strike down the whole agreement:for this reason, It would appear wise to specify the capacity the parties are contracting in is that of shareholders, especially in order to derive the benefits of the Thorby v Goldberg [Supra] interpretation.

So far the discussion has proceeded on the assumption that if a shareholder agreement involving shareholder-directors does bind a party in that latter capacity - beyond a carrying into effect of an exercise of discretion - this commitment is a fetter on his discretion, and hence, invalid. However, a number of cases suggest that this verdict of invalidity need not always follow or, more accurately, that the normal consequences of such an invalid contract need not necessarily be applicable. This subsisting possibility of validity lies in a distinction that has found legislative acceptance in America and Canada[15] between a shareholder agreement involving all the members of the company and one involving only some of its members. The latter, by and large, stands or falls according to its success or failure in avoiding the "fetter" prohibition. It is possible that the validity of the former type of agreement may survive a breach of the fetter rule. Dicta supporting this suggestion do exist. At the very least, and indirectly touching on the question of validity in general, it appears that if a voting agreement provides that all the parties shall vote together at general meetings or directors meetings, the parties to that agreement will be bound inter se if the agreement is entered into by all the members and directors : the following statement of Menzies J in Thorby v Goldberg[16] stands as authority for this proposition:

"I have not in this case found any ground for objection to the directors of the company committing themselves as I think they did to act as set out in the agreement. All the shareholders were party to the agreement, and what the directors undertook to do was all the shareholders committed themselves to ensure that they did."[17]

Thus if would appear, that the director may be bound inter se where all the shareholders are parties to the agreement. Menzies J was at pains however, "to guard against being understood as deciding that a director of a company, can in an ordinary case bind himself to exercise his power

15 Section 140 (2) Canada Business Corporation Act 1975
16 (1964) 112 CLR 597
17 Ibid 605-606

as a director in a particular way".[18] The possibility that such an agreement involving all the members is binding inter se remains; however, perhaps it is implied also in this last statement that in some extraordinary cases - such as the involvement of all the members or perhaps independent of the effect of the agreement inter se, a director may so bind himself. What the case does appear to suggest is that such an agreement will, at least, be binding inter se.[19] Gower agrees that such an agreement, even if binding inter se would be liable to attack as invalid by subsequent members of the company who were not parties to it: only therefore, "if other members or directors existed who were not parties to the agreement could it be attacked".[20] The conclusion - that the agreement is binding inter se may, however, be more important than its limited sphere of validity because the most frequent attacks on an agreement, on the basis of a fetter on the directors discretion having occurred, is made by a party to the agreement attempting to "welch" on his commitment. In such a situation, obviously the case is highly pertinent.

Gower claims that dicta of the minority judgement of the Supreme Court of Canada in Ringuet v Bergeson[21] support the proposition that the participation of all the members may render the agreement valid inter se.

"The minority held it extended also to directors meetings and was void, but they conceded that the position might have been different had

18 Ibid 616

19 This derives further support from Grant v Grant (1950) 82 CLR 1 where the court appears to have accepted that unanimous participation of the members prevented an act being challenged:
"A departure from the articles is always prima facie challengeable unless all the members of the company have agreed to the departure and the transaction is not otherwise open to objection"per Fullager J at p 48. (Emphasis mine)

20 op cit 525: guarding against attacks by subsequent members may be achieved by stipulating on the share certificate, and new ones issued, that the share is taken subject to the agreement;guarding against attack by a new board is more problematical, and against a liquidator, well nigh impossible.

21 (1960) SCR 672.

all the members originally been parties to the agreement : see at p 677"[22].

Standing on its own, this statement could be taken to suggest that the participation of all the members to the agreement could render the agreement valid inter se and against the whole world. The context in which this footnote appears in Gower militates against this : it would appear that the suggestion is limited to the issue of the validity of the agreement inter se. The problem is that, on the present writer's interpretation of that minority judgment a reference to the consequences of a unanimous agreement does not appear, let alone a "concession" that such participation could have resulted in a different verdict being entered on its validity. In any event, this suggestion does not appear to have found acceptance in the common law.[23] Three years after it was suggested, a Manitoba Court in Atlas Development Co. Ltd. v Calof & Gold[24] held that even an agreement to which all the company's shareholders and directors were parties is subject to the fetter rule: participation of all the shareholders in the agreement, or that of the directors for that matter carried little weight : the full rigour of the fetter rule applied regardless.

The common law position appears unsettled, therefore, on the effect of unanimous participation of the shareholders and directors on the validity of the agreement inter se. In no case is the suggestion made clearly that such participation will render the agreement generally valid - this at least, can be stated with sufficient certainty . The participation of all the members of a company to a voting agreement could only validate an agreement otherwise struck down as falling foul of the "fetter rule" in relation to the parties to the agreement ie inter se; hence, a new Board, a later member, or the liquidator could attack it. Furthermore, it would appear that such participation will not exclude

22 Gower op cit 525

23 The common law position differs from the Canadian Statutory provision in that the former requires, it would appear, unanimous participation, to be valid in the present, on the part of the shareholders and directors. The latter (supra note 15) requires only unanimous shareholder participation.

24 (1963) 41 WWR 575

the operation of the rule in relation to such an agreement, but rather that those members participating in the agreement will not be entitled to complain by invoking it : its operation, therefore, appears suspended due to that participation in an agreement. If, however, the common law position does support the proposition of validity inter se it will apply between the members of the agreement whether it includes all the shareholders and directors or not : if present shareholders or directors choose not to attack it, the validity of the agreement stands between those parties to it. The unanimous participation of all the shareholders and directors cannot be regarded as a pre-requisite of the validity of the agreement inter se. Whether the common law position does support the proposition of validity inter se, as already incidated, is unsettled. There is a strong suggestion in Thorby v Goldberg[25] that this is so. The possibility is implicitly rejected in Atlas Development Co. Ltd. v Calof and Gold.[26] Gower himself remains undecided, opting subsequently, it would appear, more in favour of the possibility than against it[27] - though, as indicated, on doubtful authority. The general rule remains that an agreement which results in a fetter being placed on the company's directors, apart from the position of the members inter se, is in general terms invalid : this clearly is the verdict of the common law[28], and it is submitted, the result which a New Zealand court would reach. Whether or not this is the approach a court should adopt, however, is another issue. There are persuasive arguments in favour of recognising an agreement between all the shareholders of the company as valid despite the fact that it results in a "fetter" being placed on the discretion of the directors. The Canadian reaction to the common law position in validating such agreements was that it was "unnecessarily rigid"[29] and acting on this, gave statutory recognition to such agreements. McCarthy, expanding on this criticism of unnecessary rigidity, argues forcefully against the common law position:

[25] (1962) 112 CLR 597

[26] 1963 41 WWR 575

[27] op cit Footnote 64

[28] Atlas Development Co. Ltd v Calof & Gold (1963) 41 WWR 575

[29] Commentary: Proposals for a New Business Corporations Law Paragraph 299

"Why should a director be permitted to ignore such restrictions on the ground that he owes his fiduciary duty to the company, not to the shareholders?... Indeed, the distinction between the company, on the one hand, and the shareholders acting unanimously, on the other, has little real meaning. Yet, under our present last, that distinction must apparently be made".[30]

Conceptually, the criticism that the distinction between the "company" and all its shareholders is an artificial one has some force.[31] Its application to shareholder agreements in New Zealand is more doubtful however : if all the company's shareholders are agreed upon a restriction being placed on their directors, the simple expedient of altering the company's Articles under Section 24 of the Companies Act 1955, and reclaiming the power originally delegated to the directors and stipulating that this power be exercised in the General Meeting (i.e. by the shareholders) is available to them. This possibility (unavailable in Canada because of the statutory right of directors to manage the company) provides a practical solution to many of the worst consequences flowing from the distinction between a "company" and all its shareholders; it dilutes much of the force behind the arguement that such an agreement should be recognised as valid, and correspondingly, supports the view that in the areas delegated to the directors, the exercise of their powers must remain unfettered. This latter view, it is submitted, would be that taken by a court in New Zealand if faced by an agreement between the directors of a company and all its shareholders that resulted in a fetter being placed on the former's discretion.

30 "Shareholder Agreements" Meredith Memorial Lectures 1975 p 468 McGill Uni.

31 Subject, however, to the growing recognition of theinterests of employees, creditors, and consumers.

CHAPTER 5

STATUTORY LIMITATIONS ON SHAREHOLDER AGREEMENTS:

The regime established by the Companies Act 1955 is particularly susceptible to the operation of a shareholder agreement in that it imposes no inherent limitation on the areas of corporate activity that may be regulated by its shareholders, and hence, by an agreement entered into by them. In the American context, O'Neal observed:

"Attacks on shareholder agreements are often based on a claim that they violate a statute, usually one or more sections of the corporation act ... The most frequently used statute is the widely prevalent section which provides that the business of the corporation shall be managed by its board of directors. Other statutes on which attacks on shareholder agreements may be grounded include those with provisions somewhat to the following effect: ... specified kinds of shareholder action (e.g. that required for charter amendment or dissolution) shall be passed by stated percentages of the stock vote"[1]

Translated into the New Zealand context, it is clear that the first comment is inapplicable because no statutory requirement exists that the business of the corporation be managed by the directors : this is only inserted at the company's option in Article 80 of Table A, but this can hardly be considered equivalent to the American statutory provisions. The only relevant statutory requirement in relation to directors is Section 180[2], stipulating that every company shall have a least two directors. It is accepted however, that the extent of the powers exercised by these directors is a matter to be settled by the Articles of Association, and hence, by the shareholders of the company.[3] From the Companies Act 1955 alone, independently of any Articles of Association, it appears quite possible to establish a company in which every facet of the company's activities, including those traditionally regarded as "management powers"

1 O'Neal op cit p 18

2 Companies Act 1955

3 Automatic Self Cleansing Filter Syndicate Co. Ltd v Cunninghame (1906) 2 Ch 34.

is regulated by the company in general meeting : i.e. the shareholders. From this, it follows that a shareholder agreement, regulating the voting of its parties on all issues, could dictate the activities of the company if the agreement contained a majority of the shareholding. To be effective, obviously the division of powers would have to be supported by appropriate articles of association. In such a situation, it is clear that the shareholder agreement is, in effect, the decisive constitution of the company. Kruger, speaking in the English context, argues :

"A pooling agreement may not be used to supersede the directors' statutory right to manage the company".[4]

The same writer cites as authority for this Article 80 Part 1 Table A Schedule 1 of the English Companies Act 1948, equating this provision with the American statutory provisions on company management. The prohibition Kruger views as arising under English company law is identical to the American prohibition against "Sterilisation of the Board of Directors".[5] The foregoing discussion reveals that the position in New Zealand is different. It is submitted that the conclusion arrived at by Kruger in relation to English company law is likewise incorrect : Article 80 is not a "statutory" provision of the Companies Act 1948 : it applies, as in New Zealand, only in the absence of an alternative provision being inserted in the Articles, and may, in any event, be altered by special resolution.[6] Under English and New Zealand company law, there is, therefore, no such thing as a "statutory right to manage the company". Subsequent comments by the same writer indicate that perhaps the reference to "statutory right" may mean little more than the fact that Article 80 is included in the Companies Act 1948, applicable in the absence of alternative arrangements agreed upon by the company:

"As applicable to English company law it seems that no shareholder agreement may encroach, however slightly, on the boards' statutory powers. Thus, except in instances where the articles provide for shareholder approval of certain business.."[7]

4 "Pooling agreements under English Law" 1978 94 Law Quarterly Review p 861
5 Long Park v Trenton New Brunswick Theatres Co. 77 NE 2d 633 (1948)
6 Section 24 Companies Act 1955
7 op cit 563-4

If the above interpretation of "statutory powers" is the one intended by the writer, then strictly speaking, it is a misuse of the term : it implies that such powers are exercised by force of statute, and hence, like S. 24 of the Companies Act 1955, may not be altered. In relation to Article 80[8], this is clearly not the case : it only operates by force of statute if no alternative arrangements are made, and even then, may be altered by special resolution and in any event, if the term is a reference to the position where management powers have been delegated to a board of directors, the alleged prohibition on a shareholder agreement encroaching on those powers is immediately derived from case law,[9] not statute. The impression created - wrongly it is submitted - by the use of this term is that Article 80 is similar to the American provisions, the latter which truly confer "statutory powers" on directors to manage the corporation. This limitation on the scope permitted to a shareholder agreement, based on the existence of statutory powers of management, does not exist in New Zealand or England.

However, the second ground dited by O'Neal on which shareholder agreements have been attacked - "specified kinds of shareholder action shall be passed by stated percentages of the stock vote".[10] - is relevant in the New Zealand context. The Companies Act 1955 stipulates that certain actions may only be taken with the approval of a specified percentage - either a simple majority or a three fourths majority - of the votes cast by the shareholders. Section 187 (1) stipulates that a director may be removed by ordinary resolution;Section 18 (1) provides that the objects of the company, expressed or implied in its memorandum, may be altered by a special resolution. Section 24 (1) requires a special resolution before the company's articles may be altered. It is proposed to examine the consequences of these statutory standards on shareholder voting agreements, as grounds on which the latter might either be invalidated or their scope limited, in the context of Section 24 (1) - partly because this section is especially important to shareholder agreements, and partly because it is a statutory provision on which an

8 Table A Third Schedule Companies Act 1955
9 Shaw (John) & Sons (Salford) Ltd v Shaw (1935) 2 KB 113
10 op cit

extensive body of caselaw has developed. The answers arrived at in relation to Section 24 are applicable however, to all sections[11] of the Act involving the statutory formula by which the requirements of a stated percentage of valid votes being in favour of a resolution before the company may do a particular act is imposed.

THE SHAREHOLDER AGREEMENT AND THE COMPANY'S ARTICLES OF ASSOCIATION:

The shareholder agreement is in large part dependent for its validity, scope and efficiency on the company's articles of association : an investigation into the effectiveness or limitations on such an agreement is frequently driven back to the articles for an answer, suggesting that the relationship between the two is especially important. This, indeed is the case.

The discussion so far has investigated the consequences of the company's articles in a particular form on any agreement. The argument so far has proceeded on the assumption that, however, the individual content of companies' articles may vary, certain consequences on an agreement can be predicted given a particular content. The most important consequences for our discussion are:

- where the company's articles delegate management powers to the board of directors under Articles 80 Table A, a shareholder agreement touching those powers, following Automatic Self Cleansing Syndicate v Cunninghame[12], and the line of cases endorsing this interpretation of Article 80, is ineffective and any vote pursuant to such an agreement a nullity.[13]

- where such delegation has occurred, an agreement involving a shareholder-director must not bind the party in his latter capacity in order to avoid the fetter rule.

[11] Those sections are: Section 18 (1), 24 (1), 32, 69, 75 (1), 187 (1), 217 (a), 268 (b)

[12] (1906) 2 Ch 34 : subject to the interpretation of Article 80 argued by Goldberg (ante p 50) and Sullivan (ante p 51)

[13] Shaw (John) & Sons (Salford) v Shaw (1935) 2 KB 113

there is no inherent limitation from the Companies Act 1955 placed on the competence of the shareholders in respect of areas of corporate activity.

In practice, however, both the fetter rule and Article 80 Table A, which is invariably incorporated in the company's Articles of Association, exclude the shareholder agreement from the sphere most coveted by such agreements - management.[14] This highlights the dependence of the agreement on the Articles. Finn suggests the obvious solution:

"As the law now stands, the only safe course to take if it wished to have the exercise of certain powers regulated by the shareholder agreement is to provide in the articles that those powers areto be exercised by the company in general meeting. So if, for example, the shareholders wish to control the composition of the board, dividend policy and the transfer of profits to reserve, the sale of the company's undertaking, corporate borrowing or the issue of new shares, then the powers to appoint directors etc. should be vested in the company in general meeting and the voting agreement should stipulate the manner in which the shareholders areto vote in their exercise".[15]

An excerpt from the judgement in Re A & BC Chewing Gum [16] illustrates the dependence of such an agreement on the Articles in action:

14 Again subject to the interpretation of Article 80 argued by Goldberg supra note 12.

15 Finn op cit 191; clearly in relation to the issue of new shares such a stipulation will be rendered unnecessary in England if the new Companies Bill 1978 becomes law as Clause 13 (1)(a) of that Bill prohibits directors from aloting securities "unless .. authorised to do so by (a) the company in general meeting" (Companies Bill 1978) under this provision, an agreement to vote in a particular way in respect of the issue of new shares will aways be effective, giving the shareholder a statutory right of authorisation which may override the Articles-Clause 13 (6). Even under this provision, it may be necessary to stipulate in the Articles a right of initiative by shareholders to issue shares if the shareholder agreement envisages complete control of the power - which Finn's comments indicate is the extent of control secured by the agreement.

16 (1975) 1 WLR 581

"Topps came into the company on the basis .. that though it was to be a minority shareholder, it should have equal control with the Coakleys. In order to achieve this position, the company ... adopted a new set of articles, and on the same day, Topps, the Coakley and the company signed and sealed an agreement which has been called .. the shareholder agreement".[17]

The new articles stipulated that the 19 matters covered in the shareholder agreement should be regulated by the general meeting : the agreement bound the parties to it "To ensure that the company shall not make decisions on any of the following matters without unanimity of all the shareholders".[18]

The action of adopting a new set of articles was so fundamental to the agreement entered into that the former could almost be viewed as part of the transaction culminating in the shareholder agreement.

If, as is the case, the basis of effective shareholder participation in the affairs of the company rests ultimately in the content of the company's articles, it would appear that a fundamental ingredient of the agreement's security is that these articles remain pitched toward supporting such regulation by the shareholders : it is this aspect - the immutability of the Articles of Association that we consider now.

The scope of a shareholder agreement is obviously related to the powers enjoyed by the shareholders in the company ; the latter, in turn, are mainly determined by the Articles of the company - but, to complete the circle, the Articles themselves are determined by the shareholders, under Section 24 of the Companies Act 1955. From this last element of control stems the foundation of the unlimited potential of a shareholder agreement. If it is true that the validity of the shareholder agreement lies in part on sympathetic Articles specifically allowing it to operate, it follows that the security of that agreement for the future depends equally on the resistance of those articles to future

17 Ibid 583
18 Ibid 584

alteration. A hypothetical example illustrates the apparent vulnerability of the shareholder agreement to an alteration in articles:

A shareholder owing 10% of the shares enters into an agreement with another shareholder faction owing 90% of the shares, who include the company's directors. The company's Articles stipulate that the dividend policy of the company is to be determined by the directors. The 90% shareholder faction contract with the minority shareholder -

1) to alter the articles to provide that the dividend policy of the company be determined in general meeting.

2) that the parties to the agreement will ensure, by use of their votes, that a particular dividend policy be adopted.

The contract apparently assures the minority shareholder of a certain dividend. Subsequently, however, the majority shareholder faction, exercising their statutory right under Section 24 of the Companies Act, pass a special resolution altering the Articles once again, returning the dividend policy of the company to the directors. The agreement has apparently been torpedoed : the minority shareholder has been excluded from the dividend policy of the company.

This simple example does illustrate the strategic part played by the Articles in the security of the shareholder agreement : if the objects of that agreement are to be achieved, it is clear that the agreement itself must attempt, as far as possible to guard against any alteration in the Articles by binding its contracting parties to oppose any relevant alteration in them. The agreement could bind the parties to vote against any resolution to alter the articles unless they are all agreed, or bind them to vote against any relevant alterations as long as the agreement lasts.[19] As has been repeatedly laid down, the share is a proprietary right, the shareholder "may even bind himself by contract to vote or not vote in a particular way":[20] prima facie, an obligation of

[19] Clearly this would only be effective if the agreement commanded more than 25% of the present shareholding.

[20] Gower op cit 562

voting in a particular way in respect of an alteration of articles is no different an obligation from a voting obligation in any other area, and hence valid. The only ground on which alteration of the company's articles could differ from any other obligation to vote in a particular way stems from Section 24 of the Companies Act 1955 which provides that "a company may by special resolution alter or add to its articles". On the basis of this provision, it has been established that a company cannot be deprived of its power to alter its articles : in Allen v Gold Reefs of W. Africa [21], Lindley LJ held:

"Be its nature what it may, the company is empowered by the statute to alter the reulations contained in its articles from time to time by special resolution; and any regulation or article purporting to deprive the company of this power is invalid on the grounds that it is contrary to statute".[22]

What is certainly prohibited by this statement is the inclusion in the company's Articles of an article that purports to prevent the Articles from being altered in the future. The only way that such an invalid article could be included in the first place would be through the votes of three fourths of the shareholders; presumably these votes are likewise invalid as being contrary to statute. On the same basis it has been held that a company cannot contract out of its power to alter its articles[23] by its directors, for example, entering into an agreement that the articles will remain unaltered. Is, therefore, the prohibition on the company contracting out of its power to alter the articles applicable to an agreement entered into by shareholders binding themselves to opposing any alteration in the articles? If the basis of the prohibition is that "the company is empowered .. to alter the regulations, "this is a strong argument in favour of viewing such a shareholder agreement as subject to the same prohibition when the only way a "company" can alter its regulations is through the votes of its shareholders. If shareholders may not vote in favour of an article which prevents subsequent shareholders from altering the Articles, is it implied in this prohibition that shareholders may not contract among themselves to oppose an alteration in the Articles?

21 1900 1 Ch 656

22 Ibid 671

23 Southern Foundries (1926) Ltd v Shirlaw (1940) AC 701

Where the parties to the agreement command more than 25% of the share holding of the company, such an agreement effectively prevents a resolution being passed altering the Articles and may be viewed as akin to the typeof article clearly prohibited.

The reference to any "regulation or article"[24] suggest that not only is a company not entitled to include an article freezing its articles, but extends to any regulation : could this, then, include a shareholder agreement, thereby invalidation it? Or is the caselaw prohibition limited to the company including an article stipulating the articles are not to be altered or a contract entered into by the company to this effect? Prentice accepts that a distinction exists between the caselaw prohibition on a company contracting out of its statutory power to alter its articles and a shareholder agreement binding its parties to vote against such an alteration : the shareholder agreement, falling outside this established prohibition,is consequently valid:

"A provision in the Articles of Association attempting to achieve this directly would run foul of the principle that a company is unable to contract out of the right to alter the articles of association .. A simpler and more efficacious method of guaranteeing unanimous shareholder approval for any basic change in the corporate constitution is for the shareholders to enter into a voting agreement containing suitable restrictions on the way in which the parties to the agreement will cast their votes".[25]

Returning for the moment to the prohibition on a company including an article that purports to deprive the company of this power to change its articles : this is invalid on the ground that it is contrary to statute. The only way that such an article could be inserted would be through the passing of a special resolution by the shareholders of the company, therefore, this resolution is likewise invalid. Would an agreement binding shareholders to vote for it be likewise invalid as contrary to statute? The answer to this is unclear and not directly relevant to

24 Supra Note 21
25 op cit p 110

the issue of an agreement opposing a resolution to alter thearticles, but it does illustrate how the principles developed in respect of the prohibition on the company's shareholders voting for such an outlawed article may be applied to the latter type of agreement. Certainly it is true that the established prohibition so far has only concerned it self with invalidating articles that purport to prevent the company from altering its articles or contracts entered into by the company as a party, (as opposed to its shareholders) containing a similar obligation. Cn these principles be extended (and it would, on present authority, be an extension) to prohibiting an agreement by shareholders which purport to prevent such an alteration? As has been indicated, references to the "company" mean also the shareholders of the company : where the distinction thus appears to be ignored, there would appear to be very sound reasons for extending the prohibition to an agreement entered into by enough shareholders - if such a prohibition did not already apply. Certainly it would appear to invalidate any agreement between a shareholder and the company itself in which the former contracted to vote against any alteration in the company's articles, because this would appear to be squarely within the prohibition on a company contracting not to alter its articles. As will be shown,however, if a shareholder agreement involving such an obligation, in the absence of any vestiges of participation in it by the company, is outside the established prohibition, it would appear that one involving the company as a contracting party may likewise be excluded because the obligation to vote against an alteration, by definition, can only be carried out by the shareholder. The apparent inclusion of this type of agreement simply on the basis of participation in it by the company, in the prohibition on a company contracting out of its power to alter its articles, therefore, is illusory because the company itself, in this instance, is not contracting to do this (indeed it cannot) the shareholder is.

Superficially, the extension of the established prohibition to a shareholder agreement as suggested has some appeal. Its extension does raise problems however .Clearly it could only invalidate an agreement to oppose an alteration in articles : an agreement to vote in favour of

such a resolution could not possibly be regarded as preventing the "company" or its shareholders from altering its articles. Is an agreement containing less than 25% of the voting power of the company likewise prohibited, even though the resolution to alter the articles may nevertheless be passed by the statutory majority? Does an agreement among shareholders to vote against any alteration in the articles unless they all agree to the alterations fare any better against the prohibition on a company being prevented from altering its articles, than one which flatly prohibits its parties to agree to any alteration in the company's articles. The possibility of a difference result occurring from the application of the established prohibition in these different circumstances is perhaps, an indication that the extension of this prohibition to shareholder agreements is founded more on a logically literal definition of the prohibition than on substantial conceptual grounds.

There are substantial objection to extending the prohibition on the company to an agreement entered into by shareholders, stemming initially from the nature of a share and the shareholder. It is a fundamental principle of English company law that a share is a proprietary right.[26] The shareholder, as Gower points out "may even bind himself by contract to vote or not to vote in a particular way"[27]. It follows, therefore, that prima facie shareholders may contract with each other or with outsiders to vote against an alteration in the articles of association : such a prima facie right can only be denied because it contravenes a superior right - a statutory right as Section 24 for example. It is submitted that such an agreement does not contravene Section 24. The objection to a company including an article prohibiting any alteration in the company's articles is that, if allowed to stand, the statutory power of alteration of articles, established under S 24 of the Companies Act 1955 could not be exercised : a special resolution if passed, to alter the articles would otherwise be ineffective.[28] On the other hand a shareholder agreement binding the parties to oppose any alteration of articles, though it ensures that the articles will not be altered if the

26 North West Transportation v Beatty 1887 12 App Cas 589

27 Gower op cit 562 citing Greenwell v Porter (1902) 1 Ch 530 and Puddephatt v Leith (1916) 1 Ch 200

28 Unless one accepts that the article, though allowed to stand, is itself subject to the statutory power of alteration.

shareholding commanded by that agreement exceeds 25% of the voting power, can be regarded as an exercise of that statutory power. In Bushell v Faith[29] the court held valid an article which worked to contrive a majority against a resolution proposed under statutory powers. The court accepted that this article did not vary the statutory standard. In determining the validity of a weighted voting clause established in the company's articles, Lord Upjohn commented of the English statutory requirement that an ordinary resolution sufficed to remove a director:

"All that Parliament was seeking to do thereby was to make an ordinary resolution sufficient to remove a director. Had Parliament desired to go further and enact that every share entitled to vote should be deprived of its special rights under the articles it should have said so in plain terms by making the vote on a poll one vote one share".[30]

In recognising that such an article effectively prevented the director from being removed and yet upholding it as an exercise of that statutory power, the court emphasised the freedom of companies to attach whatever voting rights they chose to shares under their Articles. This freedom was one major factors influencing the court in their decision that such an article constituted ultimately an exercise of the statutory power. Likewise, the freedom to contract in the manner in which a shareholder will vote stands as a factor indicating such an agreement represents an exercise of the statutory power. The most telling indication of this exercise of statutory power is that the votes are cast. A shareholder agreement is it is submitted akin to the type of article involved in Bushell v Faith.[31] The court's reaction to that type of article, it is submitted is equally applicable to such an agreement : it does not purport to deprive the company of its statutory power to alter its articles but rather binds the parties to opposing a resolution when that statutory power is being exercised. The fact that the resolution is submitted is indicative that the statutory power is being exercised.

29 (1870) AC 1099
30 Ibid p 1109
31 op cit

Section 24 only seeks to achieve the alteration of the company's articles if a special resolution is passed to this effect: it does not concern itself with the manner in which that special resolution is passed or defeated. Thus it is submitted that a voting agreement between 26% of the shareholders binding them to vote against an alteration of the company's articles cannot be treated any differently from any other shareholder agreement. It represents a legitimate exercise of their rights as shareholders, and does not violate section 24. This, then, is the principal reason why the prohibition applicable to shareholders voting for an article that purports to freeze the Articles or to a company contracting out of its statutory right to alter its articles should not apply to a shareholder agreement.

It is obviously crucial to determine whether the shareholders can be regarded as the 'company' for these purposes: if they can, then clearly the line of cases prohibiting the 'company' from contracting out of its power tp alter its articles or prohibiting the general body of shareholders from voting in favour of a prohibited article may apply to shareholder agreements. The Court of Appeal in Baily v British Equitable Assurance Co[32] recognised a distinction :

"But the case of a contract between an outsider and the company is entirely different and even a shareholder must be regarded as an outsider in so far as he contracts with the company otherwise than in respect of his shares.[33]

Certainly the shareholder in a shareholder agreement is contracting in respect of his shares but not in the sense intended in the quote, and not necessarily with the company. There is a fundamental distinction between the company and the shareholders for these purposes; the prohibition applies only to the former. It is fundamental to the conclusion arrived at by Prentice[34] in the quote referred to earlier that a distinction exists between the 'company' and the shareholder in relation to the effect of s24 of the Companies Act 1955. Likewise, the court in Stewart v Schwab[35] in considering the effect of a statutory provision identical to s187(1) of the Companies Act based its

32 (1904) 1Ch 374
33 ibid
34 op cit
35 1956 4 S. Afr LR 791

decision on the distinction between the company and its shareholders and directors:

"This section should not be interpreted so as to authorise a breach of an agreement between shareholders and a director because in terms the provision only authorises the disregard of the Company's articles and of agreements between the Company and a director[36]."

Viewing the shareholders in this context as subject to the same prohibition on them from voting in favour of an article that freezes the Articles has some appeal because the reality achieved by the contract is that the articles will not be altered, which appears similar to the effect of an article prohibiting future alteration. Lord Reid in Bushell v Faith[37] did concede that the effect of the weighted voting clause, whose validity the shareholder agreement, in this context, by analogy relies on heavily "makes it impossible in the circumstances....for any resolution for the removal of any director to be passed if that director votes against it".[38] It is implicit in the court's acceptance of such a clause that the end result achieved is not determinative of whether the statutory provision has been violated. This applies to a shareholder agreement, despite the apparent violence done to Section 24. The meaning of the established prohibition appears limited to preventing shareholders from inserting an article that purports to freeze the articles, and preventing the company itself from entering into a contract whereby it purports to promise that the articles will not be altered: the only method by which such a promise could be made good, it transpires, is by fixing this commitment to a shareholding representing more than 25% of the company voting power.

THE AVAILABILITY OF AN INJUNCTION:

It appears to be generally accepted that a mandatory, as well as a prohibitive injunction will be granted

36 ibid p 794
37 op cit
38 ibid 1105

to enforce the terms of a voting agreement - Puddephatt v Leith[39] stands as authority for this proposition. From this it follows that an injunction would be granted by the courts to enforce a voting agreement to oppose an alteration of the company's articles if the agreement stipulated this. Admittedly, the early cases do not specifically establish the availability of an injunction to enforce a contractual obligation to vote against an alteration of articles, but the generality of the obligations undertaken in those agreements held to be enforceable by injunction suggests that these two cases are capable of supporting this conclusion. The agreement in Greenwell v Porter[40] held to be enforceable by prohibitive injunction stipulated that the executors:

"shall not... take any steps or do any acts to induce or compel them or either of them to relinquish their or his office of director, but shall at all times to the best of their ability, by their votes and otherwise, support them and each of them in their office."[41]

Presumably this term would extend to obliging the parties to the agreement to vote against an alteration of the company's articles if by such an alteration the company acquired the power to remove the plaintiff from his office as director.

There appears no reason why a voting agreement including an obligation on its parties to oppose any alteration in the company's articles should be treated differently from any other voting agreement enforceable by injunction. However, it is equally generally accepted, despite suggestions to the contrary,[42] that an injunction will never lie to prevent a company from altering its articles of association. In Punt v Symons[43] the court refused an injunction preventing the passing of a resolution because "the company cannot contract itself out of the right to alter its articles."[44] The problem is that the only way that a company's articles can be altered is through the shareholders voting for such a resolution, as established by section 24 Companies Act 1955: the implication of this case appears to be that the courts will never interfere against shareholders voting in favour of a resolution being

39 (1916) 1 Ch 200
40 (1902) 1 Ch 530
41 ibid 531
42 British Murac Syndicate Ltd v Alperton Rubber Co Ltd 1915 2 Ch 186
43 (1903) 2 Ch 506
44 ibid 511

passed altering the company's articles. This, it is submitted is misleading. It is quite true that "a company cannot contract itself out of the right to alter its articles - but, as already indicated, a shareholder may contract to vote against an alteration, as may a group of shareholders representing 26% of the company's voting power. (In this respect, the "company" and its shareholders are necessarily separate). Being a valid agreement, an injunction enforcing the terms of the agreement should certainly lie. A conflict would exist between Puddephatt v Leith[45] and Punt v Symons[46] if the latter supported the proposition that an injunction will never prevent shareholders, regardless of their contractual obligations, from approving an alteration in the company's articles. The case certainly supports the proposition that a company can never be prevented from submitting the resolution to a vote - but does it extend to justify a shareholder from voting contrary to a binding agreement? The answer, initially, must be no. The reason for this limitation on the case is to be found in the court's reasons for rejecting the injunction - because "a company cannot contract itself out of the right to alter its articles.[47]" As has been shown, a voting agreement binding the parties to oppose an alteration is not analogous to this prohibition but more akin to an exercise of that statutory, and shareholder power: if this distinction exists, therefore, there is no foundation for refusing an injunction to enforce the terms of the agreement at the resolution, and being a valid contract, and not contrary to statute, very strong reasons for granting one.

The cases certainly establish the unalienable right of the company to alter its articles. In Southern Foundaries v Shirlaw,[48] it was held that an injunction cannot be granted to prevent alteration of articles. In Peters American Delicacy Ltd v Heath,[49] it was held that an injunction cannot prevent an alteration to articles on the grounds that it will result in a breach of contract. Trebilcock concludes

"It now seems the case that an injunction will never lie to to prevent an alteration to articles of association in a way which

45 Supra Note 39
46 Supra Note 43
47 Supra Note 43
48 (1940) AC 741
49 (1939) 61 CLR 457

is inconsistent with a subsisting contract".[50]

The comment "an injunction will never lie to prevent an alteration to articles of association" means, it would appear, that a court will never intervene to prevent the company's shareholders from voting for a resolution altering the articles despite the fact that doing so is "inconsistent with a subsisting contract". From this it would appear that a party to a shareholder's contract may vote inconsistently with the obligation undertaken in the agreement to oppose a resolution to alter the articles, and an injunction preventing him from doing this will not be granted: the only remedy of his co-contractors, it would seem, would be damages. This is so if the case law establishing the inalienable right of the company to alter its articles also means the inalienable right of its shareholders to vote for such an alteration if they so wish regardless of a contractual obligation to oppose such an alteration. Logic appears to force this conclusion: there is little meaning to the established prohibition on the inalienability of the company's right to alter its articles if this does not confer on its shareholders the same right because it is they, and only they, who have the power to alter these articles. This produces a strange result in that despite the fact that such a voting agreement is a valid one, an injunction will not lie to enforce its terms: it is a valid contract because it breaches no statutory power, (in being an exercise of that power) and hence the case law on a company being prohibited from contracting out of its power to alter its articles is inapplicable; yet in relation to the availability of an injunction, the principles developed in refusing an injunction on the basis shown to be inapplicable to agreements by force of logic are particularly compelling in relation to enforcing such an agreement by injunction. Such a result is completly inconsistent with the fundamental nature of a share as a proprietary right, and imposes a limitation on the otherwise unrestricted ability of a shareholder to "bind himself by contract to vote or not to vote in a particular way and his contract may be enforced by injunction"[51] - in respect of contracts to vote against an alteration of articles, this would appear not to be so.

50 The Effect of Alterations to Articles of Association (1967) 31 The Conveyancer 114

51 Gower op cit 562

If the line of cases affirming the inalienability of the "company's" right to alter its articles operates also on the micro level of its shareholders, rendering an agreement by them to vote against an alteration of articles unenforceable by injunction, this result appears in conflict with the two cases[52] establishing the availability of prohibitive and mandatory injunctions in the enforcement of shareholder agreements. The solution to this conflict may be in the qualification introduced by Sargant J in Puddephatt v Leith[53] in affirming generally the availability of such injunctions in enforcing shareholder agreements:

"Prima facie this court is bound ... to give effect to a clear right by way of mandatory injunction. There are no doubt certain exceptions from this rule, as in the case of a contract of service, because in such cases it is impossible for the court to make its order effective."[54]

Many of the cases from which emerged the principle that a company cannot be prevented from altering its articles dealt with directors' contracts of service.[55] Is Sargant J, in referring to cases of a "contract of service", intending these cases? I do not think so. The recognition of exceptions to the availability of injunctions does recognise a limitation on the availability of such a device to enforce a shareholder agreement. There is, however, no reason why an agreement to vote against an alteration in articles should represent such an exception, especially on the criterion cited by Sargant J - that "it is impossible for the Court to make its order effective". As Puddephatt v Leith[56] illustrates, it is easy for the court to enforce the terms of a voting agreement by prohibitive or mandatory injunction : the Court simply orders the shareholder to vote in the manner agreed. The nature of this obligation clearly does not render it "impossible for the Court to make its order effective". Enforcing an agreement by the company on the other hand, not to alter its articles, in light of the statutory power of the shareholder to do so under section 24 of the Companies Act 1955, is impossible. This, then, is one indication that the effect of a statutory power such as S. 24 is limited to the company, and not its shareholders, and that this dis tinction, consistent with the distinction operating in relation to the validity of agreements, applies equally to the question of the availability of injunctions, despite

52 Greenwell v Porter (1902) 1 Ch 530 and Puddephatt v Leith (1916) 1 Ch 200

53 (1916) 1 Ch 200

54 Ibid at 202

55 Southern Foundries v Shirlaw (1940) AC 701; Carrier Australasia Ltd v Hunt (1939) 61 CLR 534; Shuttleworth v Cox (1927) 2KB 9 (CA)

56 (1916) 1 Ch 200

the apparently logical application of the case law to shareholder agreements. In light of this distinction, an injunction to enforce such an agreement, in line with their availability in general, is available. The reference by Sargant J to "exceptions ... as in the case of a contract of service" does not appear to be reference to the managing director cases[57] from which the established prohibition sprang, nor the impossibility of the Court making its order effective a reference to the inalienable right of the company to alter its articles, but rather a reference to a basic principle of contract law in relation to a typical employer-employee situation, which is indeed an established exception to the availability of injunctions. As is stated in Cheshire and Fifoot:[58]

"It is undesirable, and indeed in most cases impossible to compel an unwilling party to maintain continuous personal relations with one another ... it is well established that a contract for personal services is not one specifically enforceable at the suit of either party".[59]

This, then, is the "impossible" element referred to by Sargant J.

As has been shown, a literal application of the established prohibition on a company logically could be extended to encompass a shareholder agreement. The different circumstances arising from a shareholder agreement - quite apart from the fundamental conceptional objections to the extension of such a prohibition - may prompt the courts into reaching the result that the established prohibition on a company does not extend to a contract entered into by the shareholders. The prohibition developed in the framework of a contract involving the company. However, as Trebicock points out:

"an alteration to articles can never itself constitute a breach of contract. The breach is only committed when the company attempts to act upon the alteration."[60]

This is one very good reason why the unavailability of an injunction to prevent a company from altering its articles should not be extended to a shareholder agreement binding the parties to oppose an alteration : voting in favour of such an alteration does result in a

57 Supra Note 55

58 The Law of Contract 1978 Fifth New Zealand Edition

59 Ibid 534

60 op cit

direct breach of contract - indeed, it is the breach of contract. It is submitted that the correct principles governing this latter situation correspond more accurately with the position of the company after the articles have been altered, on which Trebilcock concludes that an injunction should be available to prevent a company from breaching a contract:

"its position vis-a-vis the party contracting with it in relation to a contract becomes the same in all respects as that of any other person in the same position, and all ordinary contractual considerations apply to it"[61].

It is submitted that the position of a shareholder to an agreement opposing an alteration of articles is identical. In considering such an agreement, a choice will have to be made between extending the established case law prohibiting a company from alienating its rights to alter its articles to theshareholder or opting in favour of a recognition of the proprietary nature of a share. There are suggestions in the cases themselves establishing the prohibition on the company that such recognition would follow, and that established prohibition on a company limited to situations involving an article or contract to which the company is a party. The judgement of Dixon J in Peters American Delicacy Co. Ltd. v Heath[62] is accepted as supporting the prohibition on a c ompany alienating its right to alter its articles, and that an injunction will not lie to prevent its shareholders from doing this:

"the better opinion still appears to be that the fact that to alter an article involves a breach of contract can be no more than an evidenciary consideration and does not in itself make the alteration invalid."[63]

This apparently supports the proposition - at least the language appears wide enough to include it - that a shareholder cannot be restrained by injunction from voting in favour of an alteration to articles. Dixon J also recognised however, that shareholders

"vote in respect of their shares, which are property, and the right to vote is attached to the share itself as an incident of property

61 Ibid 115:the writer acknowledges that no judicial authority supports this conclusion, but neither has it been denied.

62 (1939) 61 CLR 457

63 Ibid 503

to be enjoyed and exercised for the owner's personal advantage"[64].

One interpretation of this comment - that "the right to vote - is .. an incident of property to be enjoyed .. for the owner's personal advantage" could be that this right may be exercised despite any contractual limitations imposed on the shareholder. This, it is submitted, is not the correct inference to be drawn. As soon as one recognises the proprietary nature of a share - being "property", one has to admit, prima facie, the right to enter into contractual obligations in relation to that property - and equally important, the right of that obligation to be enforced by injunction. The quote itself specifically cites the right to vote flowing from that property. If such a right to contract is recognised in relation to other spheres of corporate activity, as undoubtedly it is, there appears no reason why voting in respect of an alteration of articles should be regarded in any other light and consequently an injunction enforcing the terms of this valid contract should be granted. Ultimately, the justification for this is identical to the reasons establishing the validity of the shareholder agreement : such an agreement is an exercise of the statutory power under S. 24, akin to a weighted voting clause rather than an abrogation of that power. Being a valid contract, in contrast to an invalid article, its terms should, in accordance with the mainstream of judicial opinion on voting agreements in general be enforced either by mandatory or prohibitive injunction. Such a result is sanctioned by the original attitude of thecourts affirming the availability of an injunction to enforce voting agreements.[65] This, it is submitted, should be the position adopted today in relation to one including an obligation to vote against an alteration inthe company's articles.

Reference to the court's reaction to shareholder agreements binding the parties voting in relation to other acts required by statute to be approved by a certain percentage of the shareholder votes supports this. The court's reaction to a shareholder agreement relating to these similar provisions are relevant to the issue of an agreement relating to alteration to articles. In Stewart v Schwab[66], the court had

64 Ibid 504

65 Puddephatt v Leith (1916) 1 Ch 200

66 (1956) 4 S. Afr LR 791

no hesitation in granting an injunction against parties to a shareholder agreement who threatened to vote in favour of a resolution, in breach of the agreement, to remove the applicant from his office as a director despite the fact that an identical statutory power to S.187 of the Companies Act 1955 was involved. It is submitted in light of the essential similarity for our purposes between S24 and S 187 (i.e. both employ the statutory formula) that an injunction will be granted to prevent parties to a shareholder agreement binding themselves to oppose an alteration to articles from breaching that agreement. In fact, if anything, S187 provides a better foundation on which it could be argued that such an agreement is invalid in that it contains an explicit mandate to disregard in this context "anything in its articles or in any agreement between it and him". If the company is to be assimilated with its shareholders this mandate would appear to furnish a strong ground on which such an agreement could be disregarded. The reaction of the court to this provision is, therefore, significant because it sheds some much needed light on what can be regarded as the "company" under such statutory provisions. The court in Stewart v Schwab[67] held:

"It seems to me that the words "notwithstanding anything in its articles or in any agreement between it and him give a clue to the intended scope of sub sec (1). In the absence of clear words to that effect it seems to me that this section should not be interpreted so as to authorise a breach of an agreement between shareholders and a director because in terms the provision only authorises the disregard of the company's articles and of agreements between the company and a director".[68]

If, therefore, a distinction exists between "an agreement between shareholders and a director" and "agreements between the company and a director" - the former lying outside the established prohibition based on s. 187 (1), it is clear that, in the context of agreements, a crucial distinction exists between the "company" and its shareholders - or else, the distinction made in the passage quoted would not be a distinction at all. Quite clearly there are limits to this distinction; where the shareholders purport to vote in an Article stipulating that no

67 Ibid

68 Ibid p 794 (emphasis mine)

further changes will be made to the Articles, the court's invalidation of this vote is based on the assimilation, for these purposes, ofthe company and its shareholders. To this extent, the statutory based prohibitions clearly do extend to the actions of shareholders. On the other hand, where the company purports to contract out of its statutory power to alters its articles, the distinction between the company and its shareholders is a sharp one[69]. If, however, the distinction drawn in Stewart v Schwab[70] is a valid one - and it is submitted it is - in the realm of agreements, the company and its shareholders are distinct from each other, and this applies, if anything, more forcefully to an agreement entered into by shareholders amongthemselves than one between shareholders and a director. An agreement between a company and a director stipulating that the latter will not be removed from office is invalid, because it breaches S187 (1); such an agreement between a shareholder and a director does not: an agreement between shareholders binding themselves to oppose an alteration in the company's articles clearly falls in the second category of agreements. Section 24 does not, therefore, give the individual shareholder, or all the company's shareholders an unalienable right to vote in favour of a resolution held under statutory powers regardless of their contractual obligations, nor does it qualify their contractual freedom to vote in a particular way on such a resolution. If a party to such an agreement threatened to vote in favour of the resolution, an injunction, it is submitted, would be granted to prevent the breach of agreement as it was granted in Stewart v Schwab[71] in relation to a similar statutory power : section 24, like section 187 (1) "should not be interpreted so as to authorise a breach of an agreement between shareholders..."[72]

69 Southern Foundries (1926) Ltd v Shirlaw 1940 AC 701

70 op cit

71 Ibid

72 Ibid 794

A PROBLEM:

The result of the preceeding discussion is the proposition that the established prohibition on a company contracting out of its statutory power to alter its articles,[73] is not applicable to an agreement between shareholders by which they bind themselves to vote against an alteration in the articles of the company. One of the distinctions on which the inapplicability of this prohibition in relation to agreements rests is that between a "company" entering into such an obligation because it breaches S.24 of the Companies Act, and a shareholder binding himself to vote against an alteration. A few lines of Lord Greene MR's judg ment in Greenhalgh v Ardene Cinemas Ltd[74] however, appear to suggest that in fact the distinction may be immaterial ; the consequence of such an interpretation for the shareholder agreement on the other hand, are nothing short of traumatic. To appreciate their significance, it is proposed to refresh the reader's memory of the original agreement entered into in this series of cases. The headnote of the first action summarises that agreement accurately; it reads:

"the appellant entered into an agreement by which he undertook to provide £11,000 in the form of subscriptions for debentures in a private company which was in urgent need of that sum. The agreement also provided for the allotment of certain shares to the appellant and to 3 directors of the company. By a collateral agreement made about the same time it was provided that the 3 directors should vote with and support the appellant, who would thus gain control of sufficient votes to enable him to carry an ordinary resolution".[75]

Lord Greene MR in that case explained the effect of the agreement:

"The effect of that agreement, as far as the voting control of thecompany was concerned, would have been this. The appellant would have been a minority shareholder, and would not by himself have been in a position to control the company, either in respect of an ordinary resolution or a fortiori, in respect of an extraordinary or special resolution.

By way of collateral agreement, on or about the same date .. the parties attempted to make provision for the voting control That agree-

73 Southern Foundries (1826) Ltd v Shirlaw op cit

74 (1946) 1 All ER 512

75 (1943) 2 All ER 235

was made between the 3 directors and the appellant in the following terms..."[76]

From this, it would appear that two agreements were entered into: the first between Greenhalgh and the company, the former lending the latter £11,000, secured by debentures and also in consideration of certain shares being alloted to him; the collateral agreement was entered into by the three directors, at the very least, in their capacity as shareholders in the company with Greenhalgh.

Of this agreement, Lord Greene stated in subsequent litigation involving the same parties - and the same agreement:

"it is said that in the original agreement which was signed when the appellant first became associated with the company, a term is to be implied as a result of which the company would be precluded from acting in any way which would interfere with the voting control which he acquired as a result of that agreement. The agreement to which (it is now admitted) the company must be treated as being a party.."[77]

Lord Greene MR appears to have accepted that the company was a party to "the agreement". As already indicated, there were in reality two agreements: if this "agreement" is a reference only to the issue of shares and debentures receiving the loan of £11,000, then no problem is posed: the company would naturally be a party to such an agreement. It is more likely, however, that the reference is not so limited. It would appear that the agreement to which the company was admitted to be a party included the collateral voting agreement - because it was this collateral agreement which gave the plaintiff "voting control". "The agreement to which (it is now admitted) the company must be treated as a party" appears therefore, to be a reference to the voting agreement because it follows immediately on the heels of the agreement giving the plaintiff "voting control"[78] and because there was never any doubt about the company's participation in the agreement securing debentures and issuing shares: the only agreement about which any uncert-

76 Ibid p 237

77 (1946) 1 AU ER 513-4

78 as Lord Greene MR had observed earlier in Greenhalgh v Mallard (1943) 2 AU ER 237 the effect of the agreement alloting shares was to leave Greenhalgh as a minority shareholder.

tainty could have existed which ("it is now admitted") was the voting agreement between the 3 directors as shareholders. If the courts are prepared to recognise the company as a party to such a shareholder agreement (and there is no doubt that it was this, since it bound the parties to vote in a particular way as shareholders - the fact that the parties were also directors, and that the agreement was collateral to an agreement to which the company was a party, is irrelevant) then it would appear that the prohibition on the company contracting out of its right to alter its articles could apply to a shareholder agreement binding its parties to vote against any alteration because the company it would appear, will be treated as a party to that agreement. To view the company as a party to a shareholder agreement in these circumstances is a rather startling proposition; it is nevertheless, the view of Pickering: in describing both actions, he states:

"In Greenhalgh v Mallard under the terms of a collateral agreement three directors of a company had bound themselves to vote with and support the plaintiff and so to give him effectively majority control .. In later litigation the latter (Greenhalgh) instituted proceedings in which he contended (inter alia) that this action (the subdivision of one class of its ordinary shares) constituted a breach of the original voting agreement because this contained an implied term to the effect that the company would be precluded from acting in any way which would interfere with the voting control which it conferred."[79]

In a footnote, Pickering observes:

"It was "admitted" in argument that the company "must be treated as being a party to the agreement".[80]

Thus, on this view, the "agreement" to which the company is to be treated as a party certainly appears to include the shareholder agreement; certainly this collateral agreement which the passage opens with is the shareholder agreement: again, the "original voting agreement" appears a direct reference to this shareholder agreement because it was the only voting agreement involved; indeed, the topic of this part of the article is concerned with shareholder agreements. Throughout the treatment of this area, Pickering appears to accept that this

79 op cit 256 (emphasis mine)

80 Ibid Footnote 35

company was "admitted" to be a party to the shareholder agreement, raising the spectre of invalidity by the application of the established case law on a company contracting out of its ability to alter its articles.

Much of the confusion stems from the apparent ambiguity in the statement of Lord Greene MR "The agreement to which it is now admitted the company must be treated as being a party"[81].

The court had already pointed out, two agreements had been entered into - one alloting shares to Greenhalgh, the collateral agreement binding the three shareholders to vote with the latter. The line immediately preceeding this statement would appear to indicate that "the agreement" referred to is the agreement giving the plaintiff "voting control" referred to in the previous line. Which agreement, then, gave the plaintiff voting control? The statement made by Lord Greene in Greenhalgh v Mallard [82] that the effect of the agreement alloting shares to the plaintiff would have left the plaintiff a "minority shareholder"[83], and that it was the collateral agreement which gave the plaintiff "voting control"[84] - suggest that "the agreement" referred to in Greenhalgh v Ardene Cinemas Ltd [85] giving the plaintiff voting control can only be a reference to the collateral shareholder agreement. There are, however, other indications that the "agreement" giving the plaintiff "voting control" may have been a reference merely to the agreement alloting shares to him. The first indication of this is the comment on p 514 following shortly after the statements giving rise to so much trouble, "the clauses of the agreement" which is the same agreement to which the company is admitted to be a party: the point is however, that the clauses then referred to belong to the agreement alloting shares, not the collateral voting agreement. The possibility that the "agreement" to which the company must be treated as a party as the one giving the plaintiff voting control is the agreement alloting shares and does not include the collateral voting agreement derives further support from the following comment:

81 (1946) All ER 814
82 (1943) 2 All ER 234
83 Ibid 237
84 Ibid
85 (1946) All ER 514

"The effect of that transaction, the subdivision and issuing of those unissued ordinary shares, was to put the appellant in a position in which by force of his own voting power alone, he could prevent the passing of a special resolution. He obtained control of a further measure of voting power by means of a collateral agreement with the other principal shareholders[86].

If, therefore, the reference made by Lord Greene to the agreement giving the plaintiff "voting control" - to which His Lordship appears to have accepted that the company was a party - means no more than the ability to block a special resolution, clearly this is only a reference to the main agreement. It appears, however, that the agreement referred to does include the collateral voting agreement, because "voting control" means naturally, the ability to pass or block an ordinary resolution: in his own right, Greenhalgh controlled only 19,213 votes out of a total of 49,820. It was only through the collateral voting agreement that he was able to pass an ordinary resolution i.e. exercise voting control. Therefore, it would appear that the company was accepted as a party to the voting agreement as well, simply through the participation of the three Mallard shareholder-directors. If in the Greenhalgh v Mallard[87] situation the company is to be treated as a party to the voting agreement, it would appear that an agreement by the parties to oppose any alteration in the company's articles breaches the prohibition on a company contracting out of its power to alter its articles, because the company itself will be treated as a party to it, and the fact that the obligations involved in the collateral agreement were limited to the parties capacities as shareholders does not alter that conclusion. The agreement, therefore, breaches the prohibition.

86 Greenhalgh v Ardene Cinemas (1946) 1 AU ER 514 (emphasis mine)
87 1943 2 All ER 234.

CHAPTER 6

OTHER LIMITATIONS ON A SHAREHOLDER AGREEMENT:

The discussion so far has revealed few grounds on which the validity of a shareholder agreement can be attached. The most important danger appears to be the "fetter rule" - but as a ground of invalidity, it could be said to be limited more to invalidating "directors'" agreements than, strictly speaking, the shareholder agreement: if the inclusion of one in the latter type of agreement invalidates the agreement in toto, the liability being admitted arises from the "directors' agreement", or obligations tantamount to this prohibited species, rather than from the shareholder agreement. Generally speaking, the rule remains true in New Zealand that "shareholders may join together and pool their votes in order to accomplish what they could as individual".[1] If a shareholder agreement binds the parties to vote in a particular way on a matter that, as individuals they could have voted on, it appears clearly beyong the reaches of any claims of invalidity stemming from its collective aspect. As has been repeatedly recognised, a vote is a proprietary right which its holder may exercise as he wishes[2]; the shareholder, unlike the director, is not a fiduciary under English and New Zealand company law[3] liberating the shareholder agreement from any restriction that would be imposed on its operation by virtue of that position. Though this is generally true in respect of an individual shareholder, some restraint is imposed on majority shareholders in the exercise of their votes and, a fortiori, on an agreement binding its parties to vote in specified way where those parties together constitute a voting majority. This restraint is that of "fraud on the minority". Application of the principle appears to be limited, initially at least, to an agreement regulating the voting power of the majority shareholders, as opposed to an agreement by parties who happen to represent a majority interest in the company binding one member to lease land, for example, to the company. First, however, it is proposed to deal with the grounds on which a shareholder agreement may be invalidated independently of "fraud on the minority".

1 Smith v San Fransisco & Northern Pacific Railway Company 115 47 p 584 (1897)

2 North West Transport v Beatty (1887) 12 App Cas 589

3 Gower op 862

The general limitation to which the shareholder agreements are subject, like any other contract is outlined in the Commentary to the Canadian Business Corporations Act 1975:

"The common law rule is generally stated to be subject to the qualification that the agreements must be for a lawful purpose"[4]

Clearly this requirement applies to any agreement entered into in New Zealand: one entered into for an "unlawful" purpose is clearly invalid. The application of this criterion may raise minor problems. As the commentary points, the most likely instance where such an agreement is likely to be held unlawful arises in breach of the "fetter rule". There is a distinction however, in that Canada, the breach of this rule entails a breach of staturoty law; in New Zealand, an agreement involving a fetter on the directors' discretion could only breach the company's articles since no statutory management provision exists. Strictly speaking, therefore no breach of statutory law is involved. The distinction may be unimportant: where an agreement involving a shareholder-director involves a fettering of his discretion as a director, the absence of a statutory basis does not dilute, in any way, the unlawfulness of such an agreement: it is equally unlawful as being in conflict with case law establishing the fiduciary duty and hence, the fetter rule.[5] Such an agreement therefore remains invalid.

This does suggest, however, that a shareholder agreement binding the parties solely in their capacity as shareholders to vote on matters delegated in the articles to the company's directors, though ineffective and hence in practice not a fetter on the directors' powers, still has -for precisely the reason on the prevailing view of Article 80[6] - an unlawful purpose in binding its parties to do an act that is not permitted by law.[7] The general requirement of legality - or more pointedly, the avoidance of unlawfulness - has to be satisfied. The agreement could therefore, become subject to attack on unforeseen grounds. McCarthy gives such an example

"An agreement among...the shareholders which...constitutes a combination in restraint of trade, for example, will remain invalid"[8]

4 Para. 299

5 Clark v Workman (1920) 1 Ir.R. 197

6 Gower op cit 132

7 The opposite conclusion is arrived at on the interpretation of Article 80 argued by Goldberg op cit ante p

8 Meredith Memorial lectures op cit 468

At first sight this statement appears correct. The problem is that the prohibition on a shareholder agreement that constitutes a restraint on trade stems ultimately from the application of the principles of public policy.[9] Statements made by Judson J in Ringuet v Bergeson[10], admittedly in another context, nevertheless appear wide enough to support the inclusion generally of the principles of public order to shareholder agreements:

"I have the greatest difficulty in seeing how any question of public order can arise in a private arrangement of this kind. The possibility of injury to a minority interest cannot raise it. If this were not so, every arrangement of this kind would involve inquiry... Minority rights have the protection ofthe law without the necessity of involving public order. This litigation is between shareholders of a closely held company... No public interest or illegality is involved."[11]

Where however no such "independent" protection is involved, as arising from an agreement that represents an unwarranted restraint of trade, perhaps the application of the principles of public order may be involved. It must be conceded that the opening statement admits the exclusion generally of such principles to such a "private" arrangement. Judson J cannot have intended such a general exclusion of the principles of public policy: the operation of the prohibition could not be excluded merely on the basis that the agreement is a "private arrangement" or else it is difficult to amagine how any contract could be held to be a restraint of trade. As is pointed out in Cheshire and Fifoot

"The concept of public interest admits of no precise limitation"[12]

The emphasis of Judson J's words, it is submitted, was placed on the absence, in the agreement being considered, of any harm to anyone but the partners-hence 'public order' was inapplicable. But an agreement, however "private", that represents an unwarranted restraint of trade, it is submitted, is invalid on public policy grounds because it does, by definition, harm the public.

9 "The doctrine of restraint of trade is based upon public policy" - Cheshire and Fifoot: The Law of Contract 1978 5th N.Z. Edition p229

10 24 DLR 2d 449

11 ibid 489-60

12 op cit 306

Another limitation is apparently imposed on a shareholder agreement, though it has affiliations with the limitations about to be examined.

"anyone, and a fortiori a dominating shareholder, may be liable if he knowingly participates in a breach of trust by the directors"[13]

Thus it would appear clear that a shareholder agreement which purports to bind the parties in their voting to releasing the directors of the company from their fiduciary duties leading to a breach of trust will result in the liability of the contracting parties, and presumably such an agreement would be invalid, likewise independently of fraud on the minority, as being contrary to law. Likewise, on the authority of Torquay Hotel Company Ltd v Cousins [14], a shareholder agreement binding its parties to cause the directors to breach any contractural duties which they owe to the company will similarly result in the liability of those parties - though it is doubtful whether this would constitute a ground of invalidity.

FRAUD ON THE MINORITY

There is no doubt that the principle expressed as "Fraud on the minority", whatever its ingredients or limitations, represents a ground on which votes cast at a general meeting of the company may be invalidated. From this, it may appear logical that an agreement binding its parties to vote in a manner that will result in a fraud on the minority would likewise suffer the same fate as the votes cast in pursuance of the agreement: indeed the existence of an agreement binding its parties to vote in such a manner appears to sit squarely in the sights of the prohibition precisely because it does bind its parties to vote in such a manner unless, of course, all its parties agree not to act on it. If fraud on the minority is a ground for invalidating votes which-it certainly is-despite the insistence that a share is a propriety right of the shareholder, the limitation thereby imposed might appear logically to extend to another incident of this proprietary right - the power to bind himself by contract to vote in a particular way. Such an extension it is clear, would represent, potentially, a very real limitation on agreements entered into shareholders. It is proposed to offer a brief outline of the areas of corporate activity covered by an agreement whose validity may be threatened by the application of this rule.

13 Gower op cit 561
14 (1969) 2 WLR 289

It is clear that if the rule does apply, the agreements affected are not simply those entered into by majority shareholders, nor is it limited to "secret" agreements. Gower explains:

"There need not be an actual deceit... "Fraud" here connotes an abuse of power analagous to its meaning in a court of equity to describe a misuse of fiduciary position. Nor is it necessary that those who are injured should be a minority; indeed, the injured party will normally be the company itself, though sometimes those who have really suffered will be a class, or section of members, not necessarily a numerical minority who are outvoted by the controllers"[15]

Gower proceeds to outline the circumstances in which the courts will intervene to annul a resolution on the grounds that that resolution perpetrates a "fraud on the minority". They are:

(a) Expropriation of the company's property: the courts will intervene to annul a resolution passed by the majority if by such a resolution the majority "make a present to themselves"[16] of property that belongs to the company

(b) Release of directors' duties of good faith.

"If the directors have acted in their own interests or those of a third party rather than in the interests of the company or have not directed their minds to the question whether what they are doing is in the best interests of the company, a resolution of the general meeting will not protect them"[17]

(c) Expropriation of other members' property.

If the controllers use their voting power to deprive the other members of their shares in the company, such action will represent a "fraud on the minority" unless it can be shown that the resolution was passed in the interests of the company as a whole.

(d) "Bona fide for the benefit of the company as a whole":
It appears that any resolution will be invalidated as a fraud on the minority if it can be shown that the object of the resolution, as judged by those passing it, is an improper purpose.[18]

15 op cit 864

16 Cook v Deeks (1916) 1 AC 564

17 Gower op cit 566

18 Some sort of objective test, however, does appear to exist - See Gower op cit 521

This obviously is only a brief outline of the ingredients of fraud on the minority - brief because there is a strong suggestion that the above considerations, are irrelevant in determining the validity of a shareholder voting agreement. Clearly the validity of any votes cast at a general meeting will depend, for their validity in large part on avoiding the above results prohibited by the rule: to this extent, the prohibition of "fraud on the minority", on whatever view taken ofthe agreement, will speak very directly to the effectiveness of any agreement binding its parties to vote in a manner that results in this state of affairs. Whether the principle prevents those vote s being cast in the first place - because by doing so would perpetrate a fraud on the minority is a separate, and for present purposes, more important question because it threatens the validity of the agreement itself. The examination of shareholder agreements so far has suggested that a close relationship between the validity of the objects achieved and the validity of the agreement itself, exists: the latter, it has been shown depend in large part upon the validity of the former - subject to the principle of severability. From this general approach, it was suggested that an agreement which bound the parties to vote in favour of a resolution that resulted in a fraud on the minority, as the vehicle of such a result, f ll alongside the votes cast. This possibility stems from the introductory qualification to which all shareholder agreements, like any other contract, are subject - that of "lawful purpose". If an agreement, in binding the parties to vote on a resolution results in a fraud on the minority, the link between the latter and the agreement appears intimate - intimate enough to be included as a "purpose" of the agreement: to accept that the purpose of agreement stops short at the obligation to vote, without inquiring into the effect of that voting, appears at first sight unrealistic. This, however, was not the view of the court (admittedly obiter) in the only case in the Commonwealth which the present writer has found dealing with this matter Judson J in Ringuet v Bergeson[19] observed:

"It is important to distinguish the present action, which is between contracting parties to an agreement forthe voting of shares from one brought by a minority shareholder demanding a certain standard of conduct from directors and majority shareholders. Nothing that can arise from this litigation and nothing that can be said about it can touch on that problem.The fact that this agreement may potentially involve detriment to the minority does not render it illegal and contrary to public order.

19 24 DLR 2 d 449

If there is such injury, there is a remedy available to the minority shareholder who alleges a departure from the standards required of the majority shareholders and directors. The possibility of such injurious effect on the minority is not a ground for illegality.[20]

Certainly such an interpretation encompasses fraud on the minority. Thus the effect of the votes cast and the validity of the agreement binding the parties to cast their votes, on this view, are separate issues: the former it would appear, can never undermine the validity of the agreement itself because the focus of attack must be directed against the votes cast in fulfilment of the agreement, and not against the agreement itself. The terms of an agreement, it follows, will be enforced, despite the "possibility"of a fraud on the minority resulting; likewise, the probability or certainty of this result occuring would appear irrelevant as a consequence of this interpretation, separating as it does the validity of the agreement and its effect. The agreement is not infected by subsequent attacks made on the validity of the votes cast under the resolution. Likewise, Judson J rejected any possibility of the principles of "public order" as a ground for invalidating a shareholder agreement on the basis that it injures minority interests.[21]

This, it is submitted, is the interpretation that would be followed in New Zealand. It is not, however, the only view. The American position is expressed in Ecclestone and Indiatlantic Inc[22] where the court cited with approval the following statement:

"the propositions that it is as legitimate for a majority of stockholders to combine as for other people... the combination is unlawful only if 'the gain was to be at the expense of the corporation or in some way was to work a wrong to the other stockholders' are generally recognised as sound law."[23]

This view assimilates the validity of the agreement with that of its objects: if the effect of votes cast in pursuance of an agreement result in a 'fraud on the minority', the agreement itself would, like any votes cast, be invalidated. It should be pointed out that the origin of this view point can be traced back to the uniquely American attitude that a controlling shareholder is under some sort of fiduciary duty to the other shareholders: it is but a short step from this attitude, to

20 ibid 459

21 ibid - see discussion ante p 101

22 29 NW 2 d 619 (1947)

23 ibid 681

invalidating a shareholder agreement that contains an inbuilt fraud on the minority. No such foundation for invalidating such an agreement exists in New Zealand or England where it is accepted that a shareholder is not a fiduciary relation with his fellow shareholders: to invalidate an agreement on this basis would therefore take a much longer step in New Zealand.

Finn remains undecided on this point[24]; nevertheless, Kruger indicates that under English law, the effect of the votes cast in pursuance of an agreement remains a factor to be considered in assessing the validity of the agreement.

"Given no intention on the part ofthe parties thereto to oppressive or illegal conduct, a pooling agreement properly written ought to be enforceable"[25]

If "oppressive conduct (significantly separate from illegal conduct) is a pre-requisite to the agreement's enforceability, it would appear that the effect of the votes cast, likewise, must be included before the agreement is granted a clean bill of health.

It is submitted, however, that the view of the court in Ringuet v Bergeson[26] would prevail in New Zealand. The principle of "fraud on the minority" acts as one limitation on the power of a shareholder to vote as he pleases.

The limitation is imposed only against the prevailing conception of a share being a proprietary right which its holder may otherwise excercise as he pleases. In which category, then does a shareholder agreement binding its parties to vote in a manner that results in a fraud on the minority fit? The "first principle" of such an enquiry must be the proposition that shares are proprietary rights, and, it is submitted, this is where the assessment of an agreement will end:

24 op cit 100 Footnote 9
25 op cit 565
26 24 DLR 2d 449

The possibility of an attack being made on the casting of those votes, on the ground that they constitute a fraud on the minority, is precisely the reason that consideration of this ground of invalidity will be postponed till those votes are cast:[27] In any event, it is the votes, and not the agreement, that will become subject to the attack, and hence invalidated. The agreement remains in the realms of a legitimate exercise of a proprietary right, the recognition of which will subsist because its limitation operates independently.

There is, finally, a practical factor to be taken into consideration. As Gower points out:

"it seems clear that a resolution only impeachable as a fraud on the minority is merely voidable and will be invalid until successfully attacked"[28]

The foundation for invalidating an agreement binding its parties to vote in a particular way is that the fraud on the minority resulting from these votes infects the agreement itself. If however, the votes themselves may be valid, however precariously, does this not serve as a strong caution against automatically invalidating the agreement binding its parties to vote in this way? It would appear strange to invalidate the agreement if the votes subsequently cast remained valid because they were not attacked, giving added justification forthe courts view in Ringuet v Bergeson[29] that 'the possibility of such injurious effect on the minority is not a ground for illegality'.[30]

27 The distinction argued by Trebilcock (op cit, ante p) in relation to an alteration in the company's articles can be invoked to support this conclusion: if an alteration in the company's articles cannot be prevented because this act in itself will not breach an existing contract, since this will only occur when the company acts on the alteration, likewise it can be argued that a voting agreement, even one of which it can be predicted with certainty that a fraud on the minority will result if the votes sre cast, should not be invalidated until it is in fact acted on. The possibility that the company will not act on its altered articles, militating against preventing such an alteration, applies equally to the shareholder agreement: if all the parties to it agree, it too may never be acted on.

28 op cit 563 Footnote 18

29 op cit

30 ibid 459

It is submitted therefore that although shareholder agreements must be for a lawful purpose, the principles invalidating the votes cast in pursuance of this agreement as a fraud on the minority do not extend to invalidating the agreement itself.

This interpretation has one further consequence: it disposes of any possible attack being made on an agreement on the ground that by such an agreement, "control" of the company is being sold. Gower recognises that the American doctirne, as expressed in Perlman v Feldmann[31], that a majority shareholder, in selling his shares may have to account to the other shareholders if he receives a larger price for that controlling block than they can, on the basis that control of the company is a corporate asset, could be introduced into English, and hence New Zealand law, under the head of expropriation of company's property. The application of this doctrine to shareholder agreements could only arise where a shareholder contracts to sell his majority shareholding but retains some shares,[32] or where a majority shareholder contracts to vote as another person wishes in respect of shares representing a majority: in both cases, there is a shareholder agreement, and in both, effective control of the company has been transferred. As Gower points out:

> "the only reason why they get a larger price is because their shares enable the holders to appoint a board, and thereby gain control of assets which belong not to themselves but to the company as a whole"[33]

An agreement by a majority shareholder to vote in respect of his majority shareholding according to the wishes of another likewise may, if the price paid reflects an element in consideration of "control" being purchased, become subject to an attack on the ground of expropriation of the company's property - and hence a fraud on the minority; a voting agreement threatened by the "sale of control" principle would necessarily have to relate to voting at the General Meeting, which in fact, is no real extension of the fraud on the minority principle. However, an agreement whereby the majority shareholder sells a block of shares giving the purchaser control but retains some shares himself[34] could become liable to attack on the 'sale of control' principle as a fraud on the minority.

31 219F 2d 173 (1955)

32 if the majority shareholder sold all his shares, it wouldn't be a shareholder agreement.

33 op cit 578

34 such an agreement, on Kruger's definition (op cit 557) is a shareholder agreement - ante p

It is, however, precisely because of this identification of 'sale of control' as a fraud on the minority that "sale of control" could not render an agreement invalid - because as has been shown, an agreement should not be invalidated through the possibility that when carried out, the votes cast will perpetrate a fraud on the minority. Even if the agreement, and the effect of votes cast pursuant to it, were assimilated in determining its validity, the likelihood of 'sale of control' being accepted as a ground of accountability as a fraud on the minority is slim, and was rejected by Kuper J in United Trust Pty v S. African Milling Co.[35] - though however did concede:

"The action of the majority can only be impeached if they receive a larger price at the expense of other shareholders"[36]

Gower interprets this apparent rejection of his suggestion as a recognition that the majority may be liable if the result of the sale is to harm the company or the minority.[37]

The sale of control has traditionally been limited to selling a majority shareholding. It need not, however, be limited to selling the majority shares: if control of the company is the guiding criterion, then this may equally be sold by putting the control of voting those shares in another's hands, as a typical voting agreement with an outsider involving a majority shareholding. Regulating as it does majority voting power at the General Meeting however returns us to the sphere where the principle of fraud on the minority ; therefore, nothing new would emerge from the application of the Perlman v Feldman[38] doctrine in relation to shareholder agreements.

35 (1959) 2 SAfrLR 426
36 ibid 433-4
37 op cit 579
38 op cit

CHAPTER 7

STATUTORY REMEDIES AGAINST BREACH OF A SHAREHOLDER AGREEMENT:

The ultimate justification for entering into a shareholder agreement in a small company is that it minimises many of the problems inherent in this structure. One of the fundamental dangers of any involvement in such an organisation however stems not so much from the peculiar ingredients of its commercial success but rather from the inability of a member to withdraw if necessary. O'Neal describes the problems created by this structure:

"An unhappy shareholder in a close corporation often cannot get out of the enterprise without serious loss. All of a large part of his assets may be tied up in the business... He ordinarily does not have a partner's power to dissolve the business unit... he cannot dispose of his stock easily ... if there are restrictions on the transferability of the corporation's shares ... irritated and obstinate associates can prevent a sale"[1]

The same writer isolates the two principal dangers created within such a structure:

"Deadlocks: The distribution of voting shares in a close corporation is often such that an eventual impasse is probable ... persons who are to hold minority interests ... often bargain for and obtain a veto over corporate policies and decisions. Veto powers of course greatly enhance the risk of eventual corporate paralysis. In the colourful language of a Virginia Court, veto arrangements empower a recalcitrant shareholder or director to "embalm his corporation and hold it helpless ... in a state of suspended animation". Squeeze Outs ... whenever control is not evenly divided ... and minority share holders do not have a veto over corporate decisions, majority controllers and the directors and officers whom they control often try to squeeze out the

1 "Oppugnancy and Oppression in Close Corporations" (1959) 1 Boston College Industrial and Commercial Law Review 2

minority shareholders ... A "squeeze out is a manipulative use of corporate control to eliminate minority shareholders from an enterprise, reduce their voting power or claims on corporate earnings and assets or otherwise deprive them of corporate income or advantages."[2]

The forms of squeeze-outs vary considerably. The most common form occurs when the shareholder-director-executives refuse to declare dividends but provide high compensation for themselves in the form of salaries or the perks enjoyed by directors, leaving the minority shareholder who does not hold corporate office with little return on his investment. An example of such a case is provided In Re Jermyn Street Turkish Baths Ltd.[3] A director in a small company died. The only interest that passed to the administrators of the estate was the director's shares in the company. Such an interest, divorced from participation in management, was rendered worthless by the subsequent actions of the two remaining directors - "no dividends were ever declared and ... P's remuneration from the company was excessive."[4] The appeal against the order under s.209 (Companies Act 1955) was allowed. Another frequent form of squeeze out occurs when the shareholder-director-executives cause the company to issue a large number of new shares, which they themselves buy at a grossly inadequate price, thereby increasing their proportionate control.[5] Other forms of squeeze outs include:

2 Ibid 3 quoting Kaplen Block 31 SE 2d 896.7 (1944)
3 (1971) 1 WLR 1042
4 Ibid
5 The reduction of a shareholder's proportionate shareholding, even where the price paid for the new shares is adequate, may be a ground on which the issue of new shares will be invalidated under s.209 Companies Act 1955 under the equitable jurisdiction if it can be shown that the action was framed so as to put into the hands of the majority shareholder-directors "complete control of the company" and to deprive the minority of his "existing rights as a shareholder" - per Foster J in Clemens and Clemens Bros Ltd (1976) 2 All ER 268 at p 282.

- majority shareholders causing the company to sell its assets at an inadequate price to the company they hold an interest in and then liquidate the old company
- exhorbitantly high rents may be paid by the company for property owned by the shareholders.

The shareholder agreement can go some way to providing a solution to these problems. The most common type of agreement between shareholders is the one by which they bind themselves to vote for a certain person, often themselves, as directors, of the company. Another guard against "lockins", "deadlocks", or "squeeze outs" is an agreement entered into by shareholders compelling one to buy the shares of the other, if the seller so wishes. Or a shareholder agreement may provide that the parties to it, under certain circumstances will vote to have the company put into voluntary liquidation. The existence of a shareholder agreement may be relevant in solving the problems engendered by the structure of a small company in another context - namely its relevance under s.217(f) of the Companies Act 1955, which states that

"a company may be wound up by the court if ... the court is of the opinion that it is just and equitable that the company should be wound up".

Two cases [6] stand for the proposition that the repudiation of obligations accepted in an agreement entered into by the members of a company will constitute strong grounds on which the court will be prepared to exercise its discretion to wind up the company. The foundation for this prediction is particularly compelling: through Lord Wilberforce in Re Westbourne Galleries Ltd[7] discounted the utility or desirability of categorizing the circumstances in which this discretion will be exercised, the existence of a shareholder agreement was specifically cited as a typical element likely to result in the application of equitable principles:

6 Re Westbourne Galleries Ltd (1973) AC 360 and A and BC Chewing Gum (1975) 1 WLR 579

7 (1973) AC 360

"The superimposition of equitable considerations requires something more which typically may include one, or probably more, of the following elements ... (ii) an agreement, or understanding that all, or some (for there may be sleeping members) of the shareholders shall participate in the conduct of the business"[8]

Thus it appears that the existence of an agreement between shareholders stipulating participation in the management of the company will prove a strong ground on which the court will exercise its discretion if that obligation is broken. If, however, the breach of such an agreement is a persuasive factor in favour of the court's discretion being exercised, equally the existence of an agreement allowing the act complained of will militate against the court's discretion being exercised. The essence of Lord Wilberforce's judgment in Re Westbourne Galleries Ltd[9] is that in the "quasi partnership" situation, the Articles often embody only imperfectly the total relationship of the members, and that understandings contributing to this relationship existing outside the Articles are to be given effect on the just and equitable ground; where, however, the acts complained of by the applicant are done in pursuance of an agreement, the existence of such an agreement would appear to fill the gap (created by the incomplete nature of the Articles alone) on which the intervention of the just and equitable ground is based. In this respect, the creation of rights and obligations by such an agreement is identical to the situation that would exist if such rights had been contained in the Articles. In this situation, it would appear that the just and equitable principle is excluded. Nathan and Goldfarb support this view:

"If a written agreement setting out a code of procedural and substantive rights of all shareholders exists in a particular case, we believe that the courts would be inhibited in exercising their equitable jurisdiction"[10]

8 Ibid 379

9 op cit

10 "Compulsory Winding Up by Court" (1978)54 Canadian Bar Review 514. The authors argue, however, that a difficult result applies in relation to oral agreements:

"Where the agreement is unwritten and established to the satisfaction of the court on oral evidence ... no such stricture exists"(ibid)

It is difficult to see why the distinction should exist: the only ground would appear to be the possible difficulty the respondent may experience in proving an oral agreement, and yet the distinction is made precisely after the oral agreement has been "established to

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Prentice however argues in relation to breach of such an agreement:

"a shareholder would be able to invoke as gounds for winding up his company ... the failure of the other members of the company to observe the terms of avoting agreement" [11]

Whether the existence of a voting agreement per se, and its breach, affords sufficient grounds on which the court's discretion may be involved is unclear. The implication of the reference in Prentice's quote to "a voting agreement" without any further qualification to what type of voting agreement, suggests that this is so. Lord Wilberforce subsequently elaborated on this point:

"The just and equitable provision nevertheless comes to his assistance if he can point to, and prove some special underlying obligation of his fellow member(s) in good faith or confidence that so long as the business continues he shall be entitled to management participation, an obligation so basic that if broken, the conclusion must be that the association must be dissolved" [12]

As indicated by the earlier quote, the obligation need not be limited to one of "good faith" or "confidence" but includes "an agreement" [13]. The question remains, however: is the obligation in itself sufficient to attract the intervention of the equitable principle or must the obligation in addition be "so basic that if broken, the conclusion must be that the association must be dissolved"? Another question of particular relevance to our present inquiry is whether the agreement contemplated is limited to a voting agreement securing participation in management, or o any voting agreement?

With respect to the first question, Plowman J In Re A & BC Chewing Gum [14] considered:

"There Lord Wilberforce speaks of entitlement to management participation as being an obligation so basic that, if broken, the conclusion must be that the association must be dissolved" [15]

the satisfaction of the court": where this is so, in theabsence of any peculiarity arising from orality, the consequences on the availability of the equitable jurisdiction of an oral agreement should be identical to those arising from a written agreement.

11 "Winding-Up: The Partnership Analogy": 89 Law Quarterly Review (1973) 122-3

12 op cit 380

13 ibid 379

14 (1978) WLR 591

15 ibid p 591

The implication of this is that any "entitlement" alone to management participation is sufficient to attract the court's intervention because it involves, necessarily it would appear, such a basic obligation. The result reached in that case, where no enquiry into the significance of the right to participation in management was undertaken reinforces the view that such an assumption was being made. Such an interpretation excludes, it would appear, further enquiry into the question of how basic the obligation proved because its sufficiency flows naturally from the object of entitlement: participation in management[16]. If this is the correct interpretation, then it follows that a shareholder agreement stipulating participation in management will always be a ground on which the company will be wound up under section if the agreement is repudiated.

Perhaps, in any event, if a further test of sufficiency of "basic-ness" is being set up by Lord Wilberforce's quotes the reduction of it to contractual terms will always fulfil this requirement. It is submitted, however, that a further test before the "just and equitable discretion" will be exercised is being imposed - that the comment "so basic ..." is expanding on the nature of the obligation required rather than necessarily following from the nature of any such obligation. To accept that the breach of an obligation per se, without further inquiry into the significance of this obligation runs contrary to the rationale set up initially justifying the intervention of the court as expressed by Lord Wilberforce:

"The foundation of it lies in the words" just and equitable" ... The words are a recognition of the fact that a limited company is more than a mere judicial entity with a personality in law of its own: that there is room in company law for recognition of the fact behind it, or amongst it, there are individuals, with rights, expectations and obligations inter se which are not necessarily submerged in the company structure"[17]

16 Support for this conclusion is derived from Re Westbourne Galleries Ltd (op cit) itself and the Canadian case Re Rogers and Agincourt Holdings Limited (1977) 14 OR 2d 489: in both cases, the winding up application under section 217(f) (equivalent) was successful despite the fact that the respondent majority shareholders could have kept the applicant on the Board with no adverse consequences to themselves because they controlled the Board; this fact suggests that the mere removal of a director is the influential factor in the court's decision.

17 op cit 379

Such a clear mandate to recognise the reality of the company structure implies, likewise, that the court will scrutinize carefully the reality of an obligation: a contract among shareholders, for example, may well not qualify as embodying the required obligation if it transpires that its terms had lapsed voluntarily, or in some other way, the terms of the agreement had never been acted upon and that the party seeking the winding up had acquiesced in this state of affairs.

It may be, wondered, in fact, whether the fact that a shareholder agreement securing participation in management has the force of contract and hence law behind might not by definition exclude the availability of the equitable principle. Certainly the express inclusion of an "agreement" as a circumstance likely to result in the exercise of the judicial discretion suggests the contrary, and "agreement" appears naturally to encompass a contract. Yet there are statements in Lord Wilberforce's judgment that suggest that including such a circumstance might in fact be inconsistent with the rationale behind intervention in the first place:

"The just and equitable provision does, as equity always does enable 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."[18]

It would appear, however, that the existence of a legal right to enforce a contract entered into by shareholders which one would have thought excluded the necessity of falling back on equitable principles, does not exclude the equitable jurisdiction being invoked - either in conjunction, or in substitution to that remedy. In any event, the agreement entered into by that shareholder may prove deficient in some manner, requiring the intervention of equity. The larger question remains, however, - namely, the availability of the winding up order on the "just and equitable" ground where the respondent is acting inconsistently with the applicant's legal rights. The need for the intervention of the court arises precisely in order "to subject the exercise of legal rights to equitable considerations"[19] - which appears

18 ibid

19 ibid

to imply that its availability might be limited to situations where the defendant is exercising a legal right. This might appear to cast doubt on the availability of the discretion of the courts to intervene against a defendant in breach of a contractual right stipulated in an agreement entered into by shareholders. However logical such a limitation may appear to be, Plowman J In Re A & BC Chewing Gum[20] granted a winding up order under the just and equitable principle precisely on the basis of a breach of a shareholder agreement securing for the plaintiffs participation in management. The exclusion resulted, therefore, not from the exercise of the defendant's legal rights which the equitable discretion should temper but rather in defiance of the plaintiff's legal rights - specifically his contractual rights - from which foundation theequitable discretion was granted.

"I have come to the conclusion that I ought to exercise my discretion by making a winding up order. The fact remains that the Coakleys have repudiated the relationship established by the shareholders' agreement and the articles. The case, is, in my judgment analogous to the expulsion type of casewhich the House of Lords was considering in the Westbourne Galleries case, although, as I have said, this is not a case of one side making use of its legal rights to the prejudice of the other. The Coakleys had no legal right to do what they have done. Lord Wilberforce said at p 380 ... There Lord Wilberforce speaks of entitlement to management participation as being an obligation so basic if broken the conclusion must be that the association must be dissolved. In the present case, management participation was secured by Topps' right to appoint and remove an "A" director, and that entitlement hasz been repudiated. I do not read the passage which I have read from Lord Wilberforce's speech as depriving me of a discretion, but in the exercise of that discretion, I propose to make a winding up order[21]

Clearly, therefore, the fact that the plaintiff has an enforceable legal right, which presumably could be enforced independently of section 217(f) of the Companies Act 1955, and the fact that the defendant is in breach of this legal right will not preclude the court

20 1975 1 WLR 519

21 1975 WLR 591

from winding up the company on the just and equitable ground. On the other hand, Plowman J's statement"I do not read the passage which I have read from Lord Wilberforce's speech as depriving me of a discretion"[22] serves as some recognition of the conceptual inconsistency of granting an order on the just and equitable ground where the plaintiff is enforcing a legal right and the defendant is in breach of this right. This does indicate that the existence of a legal right on the applicant's part, arising from the breach of a shareholder agreement, will not necessarily strengthen the case of that applicant seeking a winding up order on the just and equitable ground.[23]

One thing, however is clear as aresult of these two cases: in determining whether it is just and equitable that a company should be wound up on an application for such an order under section 217(f) of the Companies Act 1955, the existence of an agreement between the shareholders securing participation in the management of the company will be a decisive factor in the success of such an application.

22 ibid

23 Could the just and equitable ground be invoked if another understanding, independent of the rights created by the company's articles and independent of a supplementary agreement entered into by the company's shareholders, be pointed to? It is doubtful. The existence of an independent agreement between the shareholders is likely to be accepted as embodying the limits of any rights existing outside the articles which, in equity, ought to be enforced. The only relevance such an alleged understanding existing beyond the shareholder agreement might have would be possibly as constituting an implied term of that former agreement. If such an understanding is to be relied on to invoke the just and equitable ground, it meets the objection that if it was intended to create rights by such an understanding, it could have been included in the shareholder agreement. The same argument however is inapplicable in relation to the shareholder agreement/Articles comparison, due to the special features of the latter.

What is less clear, however, is the significance to be attached to a shareholder agreement dealing with matters other than participation in management in the determination of whether it is "just and equitable" that such an order should be granted. Some statements in Lord Wilberforce's judgment indicate that such an agreement would be on a par with one dealing with participation in management.

"It would be impossible, and wholly undesirable, to define the circumstances in which these (equitable) considerations may arise."[24]

This suggests that the existence of an agreement stipulating a dividend policy, if breached, might, identically to a breach of an agreement securing participation in management, be a ground of winding up.[25] Subsequent statements indicate however that the criterion later outlined on which the assessment of a winding up order will be made, are orientated principally to the exclusion cases. For present purposes, it is especially important that in citing the relevance of "an agreement" to the assessment in progress, the apparent qualification "that all or some of the shareholders shall participate in the conduct of the business"[26] is introduced, thereby creating the possibility that an agreement dealing with other aspects of corporate activity will not command the immediate relevance (if any at all) as one securing participation in management. Such a possibility becomes more probable by the undoubted categorisation subsequently introduced (but perhaps with retroactive effect): "My Lords, this is an expulsion case"[27]. This must serve as a caution on assuming that an agreement securing a minimum dividend policy will be equally relevant as a ground on which the company will bewound up. Little justification for this distinction, if there is one, exists: the circumstances justifying the court's equitable

24 op cit 379

25 Support for this view is gained from In Re Rogers & Agincourt Holdings Limited (1976) 12 OR 2d 386: the Divisional Court accepted repudiation of an agreement that the applicant should be entitled to a shareholding in the company as a ground for winding up the company on the just and equitable ground if such repudiation showed that the confidence the applicant had in the respondent had been destroyed - supra p 396.

26 ibid

27 ibid 380

intervention under section 217(f) as Lord Wilberforce appears originally to have recognised - may arise equally from the denial of an agreement securing participation in management. Indeed, where the Articles subject the dividend policy to the general meeting, and an agreement binding the shareholders to vote with a certain party on dividends is thwarted by an alteration in the Articles (making the dividend policy of the company the preserve of management) exclusion of that party from any influence in that policy because he is not a director, appears a prime candidate for the intervention of the courts on the just and equitable basis under section 217 (f) . However the distinct orientation toward exclusion of management cases that developed in Lord Wilberforce's judgment casts some doubt on the availability of the winding up order where the agreement pleaded relates to matters other than participation in management.

There is a strong suggestion in Re Empire Building Limited[28] that in certain circumstances, the existence of a shareholder agreement will be relevant to an application under section 209 Companies Act 1955. In defining the ingredients of "oppressive conduct", Turner P observed

"I much doubt whether a decision by a majority vote of shareholders not to alter the Articles of Association ... can ever, in any circumstances amount to conduct ... in a manner oppressive to those sponsoring the proposal. Certainly it cannot amount to oppressive conduct unless there is shown some undertaking, express or implied, on the part of the majority that they would agree to such an alteration."[29]

Clearly, therefore, the existence of a shareholder agreement containing a commitment by the majority of shareholders to agree to an alteration in the company's articles may, if breached, constitute "oppressive conduct" on the part of the majority, and hence justify an order under s.209 of the Companies Act 1955. Furthermore, Turner P's comments indicate that the refusal per se of the majority to alter the articles in breach of the "undertaking, expresss or implied" may of itself fulfil the criterion of oppression advanced by Buckley LJ in Re Jermyn Street Turkish Baths Ltd:[30] on this new, such refusal will

28 [1973] 1 NZLR 214

29 ibid 229

30 (1971) 1 WLR 1942

itself result in the minority being "constrained to submit to something which is unfair to them"[31]; such refusal is the "overbearing act or attitude on the part of the oppressor."[32] The alternative interpretation of Turner P's comments is that other circumstances must also exist - such as the division of proceeds of a sale of the company's assets on the basis of the nominal value of the shares, resulting in an inequitable distribution - which render the refusal of the majority not to alter the articles oppressive but that there may be circumstances when a refusal to do so, though in breach of an undertaking will not automatically be construed as "oppressive conduct". This, it is submitted is the better approach: it does not necessarily follow that a refusal on the part of the majority to alter the articles, though in breach of an undertaking, will be "unfair" to the minority or that such refusal is "some overbearing act". The context of Turner P's comments does lend support to the stricter approach however, in that His Honour was considering specifically the possibility of viewing as "oppressive conduct", the refusal of a majority to alter the articles in isolation: it is in this context that the proviso "unless there is shown some undertaking, express or implied ..." appears. It could be concluded from this that the refusal, if such an undertaking exists, would constitute oppressive conduct; the better interpretation of Turner P's comments, in light of the whole case, is that as a general rule, the refusal of a majority to alter the company's articles will never constitute oppressive conduct, but the existence of an undertaking by that majority to alter the articles when breached may render such refusal oppressive: the breach of the undertaking, therefore, creates the possibility of such a refusal being oppressive conduct, which will be judged by the court in light of all the relevant circumstances of the case, but that the breach of such an agreement or the refusal per se will not necessarily render the majority's refusal oppressive conduct.

A further point is raised by Turner P's comments in <u>Re Empire Building Ltd</u>:[33] the undertaking envisaged is an "expresss implied" one that the majority "would agree to such an alteration". It would

31 ibid 1060
32 ibid
33 op cit

appear therefore that where a shareholder agreement has as one of its implied terms an undertaking by the majority to alter the articles, breach of this implied term will be a elevant factor in the court's assessment of whether the efusal of the majority is oppressive. Could therefore an agreement by majority shareholders securing participation of a minority shareholder as a director give rise to such an implied term if, in their present form, the articles make this impossible, and hence, to fulfil the principal obligation, the majority must alter the articles? Logically, such a term would appear to be implied by the agreement. Against this however, is the established reluctance of the courts to read any implied terms into shareholder contracts.[34] It is doubtful therefore whether such an undertaking will be accepted as existing by implication in relation to a shareholder agreement. If it is implied however, clearly it is relevant to an application under s.209 Companies Act if breached. This reluctance casts some doubt on whether such a term will be implied in a shareholder agreement, though clearly such a possibility was envisaged by North P.

34 Greenhalgh v Mallard (1943) 2 AllER 234: see discussion at p

CHAPTER 8

THE SHAREHOLDER AGREEMENT AS AN ESTATE PLANNING DEVICE

Perhaps one of the most effective uses of the shareholder agreement lies in the potential as an estate planning device, especially in the context of small private companies. Before appreciating its potential in this sphere, it is necessary initially, to understand the problemsconfronting the small company and its members and dependants when one of its members dies.

The small company is characterised by its shareholding being held by relatively few people who are actively involved in its management. Generally this shareholding will represent the members' major asset upon death;while alive, their participation in the company will constitute the members' principal means of livelihood. The death of a member of such a company, flowing from these characteristics, poses acute problems for the estate and heirs of the deceased as well as for the corporation;more over the problem is compounded by the divergence of interest be tween the estate of the deceased and the sur ing members resulting from the death of that member. The interests of both camps are briefly examined independently.

The interest of the estate, family or heirs of the deceased is dominated, initially, by a need for cash to pay for funeral and probate costs, estate taxes and debts: since the principal asset of the deceased lay in his shareholding in the company, resort will inevitably be had to this asset in order to pay these costs: some of these shares will have to be sold in order to produce the required cash: in a private company however, this is no simple procedure. The company's articles may establish a restriction on sales; even in the absence of such restrictions, shares in a private com pany command no ready market, since buyers will seldom be interested in anything less than a controlling interest. Thus, the only real market for these shares lies in the remaining members of the company; if if the deceased held a minority shareholding, however, the remaining shareholders will still be able to maintain control ind - pendently of this shareholding: there will consequently be little incentive for them to buy out this remaining shareholding.

And yet, independently of the need for ready cash, it is clear that the interests of the estate lie in selling the shares. The first reason is peculiar to a small company: usually its shareholders taketheir profits from the company in salaries, rather than dividends: this makes the shares a particularly unattractive investment for the estate and heirs, their interest naturally lies in a high dividend policy which a small company will seldom pursue - normally they will not benefit at all from payment in salaries because they will seldom be managers. The death of the member usually cuts off all revenue and income for his family. In addition, keeping the shares renders the estate's security dependent on the fortunes of a small business which, without the participation of the member now deceased, may not be an attractive proposition.

The position of the surviving shareholders is likewise jeopardised by the death of a member. As has already been pointed out, continuous harmony and mutual confidence are crucial to the success of such an operation. The tension generated by the estate re taining the shares, resulting in an unwanted associate or an "inactive shareholding" is detrrimental to the success of the operation, dependent as it is on harmony. Identical results may occur where the members own a minority interest: they may be completely at the mercy of this unknown newcomer, represented by the estate, or an outsider to whom the estate has sold its shareholding: the survivors may find themselves with a frozen investment.

The death of a key shareholder in the company may also be detrimental to the company itself: its credit position may be affected, or employee morale may be harmed.

The foregoing is sufficient to indicate that all parties concerned have an interest in finding a scheme whereby the shareholding of the deceased shareholder in the company can be transferred smoothly to the surviving members of the company . It will come as no surprise to the reader, to learn that that scheme is the shareholder agreement.

Huberman explains:

"The most satisfactory solution will be to provide, through an appropriate agreement entered suring the lifetime of the parties for the controlled liquidation, through purchase and sale, of the shares of each shareholder upon death... The only effective solution therefore would seem to be a mutually binding agreement under which, upon the death of the decedent the estate is bound to sell and the survivors are bound to purchase all the shares of the decedent at a specified or future determinable price." [1]

An example of such an agreement is to found in Gasparini v Gasparini [2] described in the judgement:

"an agreement made between the late Dante Gasparini and his four surviving brothers... the five brothers signed an agreement which provided that upon the death of one of the parties, the survivors would purchase from the personal representatives of the deceased party all his shares in the corporation at a price equal to the value of such shares as set out in schedule A" [3]

The appeal of such a scheme to the estate is that it assures them a market - often the only market for the deceased's shareholding, guaranteeing a fair price for that interest, and removing the element of uncertainty or delay that might otherwise arise if an outside buyer had to be found. To guard against the worst consequences of delay in the implementation of such a scheme, the agreement may stipulate that an income be paid to the estate in the interim period till the cash in received from the sale of the shares. Again we turn to Gasparini v Gasparini [4] as the example:

"The agreement contained the following provision: until the balance of the purchase price of the shares of the deceased party to this Agreement... is paid, the widow of the deceased pary to this Agreement shall receive from the Company, and the surviving parties to this agreement shall cause the Company to pay to the widow of the deceased party to this Agreement a salary...." [5]

1. "Buy and Sell Agreements for Canadian Close Corporations" Canadian Bar Review 1963 VOL XLI 543
2. (1978) 20 OR 113
3. ibid 114
4. op cit
5. ibid 114

The court held that in her capacity as executrix and trustee of the estate of her husband the widow could sue on the agreement. The case illustrates the advantage of fixing such an obligation on to the shareholding of the company: [6] if fixed to the company itself, it could be attacked as being ultra vires and not "bona fide in the interests of the company".7 Being held to be a valid agreement, however, it assures the surviving members of the company full ownership of the company and freedom from interference from outsiders, removing the dangers of unwarranted associates or an inactive shareholding, thereby reducing the possibility of future conflict fatal to a small company. The agreement likewise confers on the company continuity and stability through ensuring harmonious and familiar management, and the prospect of security and certainty in the future achieved by the agreement could enhance - at least maintain - the company's present credit rating. Indeed the execution of such an agreement is likely to result in a similar element of security enjoyed by the parties to the agreement while alive in charting a certain course in an area otherwise only viewed with uncertainty - in addition to fixing a value on the interest of the shareholder that his family will receive.

Validity of the Agreement in New Zealand:

The validity of such an agreement, in line with shareholder agreements in general, appears assured in New Zealand. The power of disposition of a share, inherent in the nature of a share as a proprietary right [8] is fundamental. Such an agreement is no different from any other contract having present effect but postponed enjoyment.

6. Quaere: how could the brothers "cause" the company to fulfill the obligation? If the obligation is in the management sphere, absent an alteration of articles, they could not direct the directors to pay out, and they themselves cannot contract as directors, due to the prohibition on directors' agreements due to the fetter rule. At some stage would not such a gratuitous payment be ruled ultra vires or expropriation of the company's property?

7 - Parke v Daily News

8. North West Transport Co. v Beatty 1887 12 App Cas 589

As a contract, it is supported by mutual consideration. Though not considered to be testamentary, it would appear wise to include in the will of the parties a specific reference to the agreement. From Gasparini v gasparini,[9] it would appear that the heirs of deceased estate cannot enforce the agreement in their personal capacity since they are not parties to the agreement;the executor or the trustee of the deceased's estate,however, will be entitled to enforce the agreement, and may be granted specific performance of the agreement.

More problems arise however in relation to obligations contained in such agreements undertaken by the shareholders of the company causing the company to perform an act: it is one thing to allow a non-party to enforce an agreement under which he is entitled to a benefit, it is another to hold a non-party to a contract to be subject to the burden of that contract - and the company in such agreements is seldom a party. The court in Gasparini v Gasparini [10] found no difficulty with this problem, and was even prepared to grant specific performance of the obligation on the company. It held:

"It is our view that this priciple does not preclude the order... where the real interests of no persons other than the contracting parties are affected by the order. The corporate defendant "the third party" is nothing more than the instrument by which the five brothers carried on business. No one else had any interest in it and therefore, no one else but the shareholders can be affected by any practical burden or liabilities imposed on it".[11]

It should be pointed out that imposing the burden of buying the deceased's shares on the shareholders of the company in New Zealand has another practical advantage in that the only alternative purchaser of these shares - if the same advantages of such a scheme are to be reaped - would be the company itself; such a possibility does not exists in New Zealand as a company is prohibited from buying its own shares.[12] Through lack of any valid alternative, the shareholder agreement may prove the only device by which the problems arising from the death of a member inherent in the small company itself, may be minimized. This leaves however, one major problem: how to finance the purchase of the deceased's shares. If convenience and security are the ultimate benefits of such a scheme to all the parties involved, clearly the ability of the survivors to purchase the deceased's shares,

9. op cit
10. op cit
11. ibid 116
12. Trevor v Whitworth 1887 12 AC 409

once the contractual obligation to do so has been entered into, plays a key role in achieving these goals: it is indeed "the flesh which covers and gives life to the skeleton" [13] ie the legal structure of the agreement. The most effective guarantee of adequate finance being available when it is needed is that of business life insurance. Huberman explains:

"The purchase of business life insurance is usually found to be the most satisfactory method of funding the buy and sell agreement, for the disaster which will create the need for the cash can also be utilized to provide that cash. The main advantage of life insurance is that it creates, at moderate cost, a special kind of sinking fund which guarantees that a definite amount will be available at an uncertain time in the future, that is, the death of one of the parties." [14]

In view of the prohibition in New Zealand on a company purchasing its own shares, such a scheme must necessarily be limited to the participation of the shareholders. Such schemes are labelled "cross purchase" schemes under which each shareholder insures the lives of his fellow shareholders, naming himself as beneficiary of each policy. Again, Gasparini v Gasparini [15] provides an example of such a scheme:

"the five brothers, the only shareholders of the defendent corporation, took out insurance policies on each other's lives in the amount of $100,000." [16]

Outside the field of family companies, a problem may arise because normally the relationship existing between shareholders is insufficient to support an insurable interest. In relation to a small company, however, its dependence on the personal participation of its members would appear to confer upon each shareholder a pecuniary interest, and hence insurable interest, in the lives of his fellow shareholders: clearly the death of one of them will cause financial loss to the company and hence, to the surviving shareholders. It would appear unlikely however whether such an interest arises in relation to a "sleeping" member - though he, of course, would have a financial interest in the lives of the active members.

The effectiveness of a buy and sell agreement will depend, initially, on its validity under the law; being an agreement, this will tend to be mainly the principles of the law of contract. Once its validity has

13. Lawthers: "Business Purchase Agreements" 1950 p3
14. op cit
15. op cit
16. ibid p 114

been sanctioned as a valid contract however, the effectiveness of the agreement, as with any other contract, will then depend upon the precise provisions of the agreement being enforced. Beacause most buy and sell agreements are entered into for similar reasons in the(estate context) inclusion of the following provisions is suggested as necessary ingredients of a water tight agreement that will be appropriate in most cases:

1. - The names of the parties to the agreement
2. - A description of the parties' shareholding in the company
3. - The preamble - stating the purpose of the Agreement
4. - The obligation on the parties to purchase the required life insurance policies
5. - The obligation to maintain payment of the premiums on such policies
6. - A restriction on the exercise of ownership rights in these policies till the death of a party to the Agreement
7. - The commit ment on the parties, their heirs, executors, administrators and assigns to sell those shares
8. - Inclusion of a formula by which the shares are valued
9. - Stipulation that the insurance proceeds of the survivors are to be used solely for the purchase of the deceased's shares
10.- Restrictions on inter vivos sale or transfer
11.- Provision for the amendment, revocation or termination of the Agreement with the mutual consent of all its parties, and automatic termination of the agreement upon the:
   - bankruptcy, receivership or dissolution of the Company
   - death of both shareholders within a short space of time
   - at the option of any insured upon the failure of the owner of any policy to pay the premiums, or if the owner assigns, surrenders or borrows against the policy
12. - Binding the heirs, executors, administrators and assigns of the parties to the Agreement.

Appendix A

"Each party hereto respectively covenants to exercise all the voting and other rights vested in him as holder of the said shares in the Company to ensure as far as each are able so to do the due fulfilment by the Company of any act or thing necessary to implement this Agreement[1]. and oppose any act done by the Company likely to frustrate or hamper the voting control of the Company held by AB"

Appendix B

"Neither party hereto shall at any time sell or attempt to sell or otherwise dispose of any shares in the Company beneficially owned by him and registered in his name or in the name of his nominee unless he shall first offer to sell such shares to the other party to this Agreement."

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