

DEADLOCK

Have you prepared for the worst?

THE CRUCIAL IMPORTANCE OF DEADLOCK CLAUSES

INTRODUCTION TO DEADLOCK CLAUSES

You've got your business up and running. You're working alongside your best friend and/or trusted business partner. Nothing could go wrong, right? Unfortunately, there have been numerous examples in the past of once rosy working relationships turning sour, with resentful partners dragging the company and its operations to the ground with them.

This instalment of our Start-Up Toolkit brings you an overview of the various types of deadlock clauses that can be drafted into your shareholders' agreement and/or company in Singapore, to assist you in choosing the most appropriate combination of clauses for the continued success of your business.

TYPES OF DEADLOCK CLAUSES:

Continuation
Divorce



WHY DO I NEED DEADLOCK CLAUSES?

Properly planning ahead for uncomfortable situations like a deadlock is key to ensuring the long term survivability of your company.

A deadlock typically arises when in a matter, shareholders in a 50:50 joint venture are unable to agree, or when they hold disproportionate board seats or shareholdings but the matter requires either unanimous or super-majority approval. Failure to reach agreements on matters of significance invariably leads to an almost complete paralysis of the company's operations and jeopardises its future prospects.

Without a deadlock resolution clause in the shareholders' agreement and/or company constitution, the main remedy available to aggrieved parties would be to engage in expensive and time-consuming litigation to obtain a court order as to the fairest way forward. A much cheaper alternative would be the inclusion of deadlock resolution provisions at the outset, setting out the methods to be employed for shareholders to either set aside their differences and continue working together, or to acknowledge their differences and go their separate ways.

Well drafted deadlock resolution provisions typically consist of two parts:

- (i) A mechanism focused on enabling the "continuation" of the working relationship; and
- (ii) If irreconcilable, a mechanism focused on enabling "divorce" i.e. the termination of the working relationship.

CONTINUATION

The disagreement resulting in the deadlock may be one which is easily resolved and shareholders still wish to continue working with one another. In such a scenario, it is highly advisable for parties to draft into their shareholders' agreement and/or company constitution a "continuation" mechanism and fall back on it to amicably find the best path forward for themselves and the company. The following are commonly used "continuation" mechanisms shareholders may wish to consider.

Mechanism	How it works	Advantages	Disadvantages	Remarks
Chairman casting vote	A clause which grants the chair of the board a casting vote in a deadlock at the board level	Quick resolution of deadlock Decision reached internally	The chairman may be biased toward one party and make decisions favourable to that party	Parties may wish to include a separate provision for the rotation of chairman between parties every few years
Outsiders' swing vote	A clause which grants an outsider a "swing vote" to resolve deadlocks	Quick resolution of deadlock	Decision reached externally Third party may be biased	It is essential to ensure the third party has sufficient business expertise to reach a commercially sound decision Make sure to vet the third party thoroughly and ensure no possibility of bias
Mediation/expert/arbitration	A clause which refers any deadlock or dispute to a third party	Faster and more cost effective than court proceedings Effective for legal and technical disputes	Ineffective for business disputes as the third party may not have sufficient business expertise	Even if the decision of the arbitrator is not ideal for either party, it may be legally binding
Escalation	A clause which refers any deadlock to the senior management of the respective shareholders, stipulating a timeframe to discuss and resolve the deadlock	Senior management are outsiders – they are not directly involved in the disputes and can start the discussion on a clean slate Senior management, unlike outsiders, understand the commercial objectives of the company and can come to a commercially sound decision for the company	Senior management are insiders – they likely share the same commercial objectives as their respective shareholders Escalation is thus ineffective when deadlock is due to differences in future vision of the company, as the respective upper management is likely to share the same view	Escalation should be only be used when the senior management is sufficiently detached from the business decision in particular that cause the deadlock, and where the deadlock does not arise from differing views on the running of the company

DIVORCE

In the scenario where parties are unable to see eye to eye anymore and working together paralyses the company's operations due to indecision, it might be best to have a corporate "divorce". Although the majority of "divorce" mechanisms allow for the continued operation of the company, albeit with the removal of one group of shareholders, parties are advised to seriously consider the implications of utilising this mechanism. Different groups of shareholders bring different expertise and skillsets to the table. Cutting one group off from the business, while it may allow the business to continue operations in the short term by releasing the company from its state of paralysis, could severely hinder the future prospects of the company due to the loss of expertise, resources or funding that the shunned shareholder once provided.

Regardless, it is highly advisable to have such "divorce" mechanisms drafted in for parties to rely on should the need arise. To carry out this process efficiently and effectively, "divorce" mechanisms should be drafted into the shareholders' agreements to allow parties to part ways without causing too much collateral damage. The following are commonly used "divorce" mechanisms shareholders may wish to consider.

Mechanism	How it works	Advantages	Disadvantages	Remarks
Russian Roulette	<p>A clause through which a shareholder is entitled to issue a notice to other shareholders to either buy out his shares at a price specified by him, or offering to buy the other shareholders out at that same specified price</p> <p>The recipient shareholder has the option to either buy the other shareholders' shares at the specified price, or sell its shares at the specified price</p>	<p>The company will survive</p> <p>A fair price will be offered as the either party may be the buyer or seller</p> <p>Saves on costs as no external valuation is required</p>	<p>There is no certainty as to whether the party issuing the notice will be the buyer or the seller</p> <p>The shareholder with stronger financial capabilities could potentially manipulate the outcome knowing the other shareholder cannot afford to buy his shares at the specified price</p>	<p>If the shareholder wishes to buy out the other, this mechanism may not be ideal as he could potentially be bought out instead and be ousted from the company, and vice versa</p>
Sealed bid	<p>A clause through which each shareholder submits a sealed offer for the others' shares to an independent third party</p> <p>The bids are opened simultaneously and the shareholder who had a higher bid will be required to purchase the others' shares at the stated bid price</p>	<p>The company will survive</p> <p>Saves on costs as no external valuation is required</p>	<p>The final bid may be much higher than fair value of the shares</p>	<p>If the shareholder wishes to buy out the other, this mechanism may not be ideal as he could potentially be bought out instead and be ousted from the company, and vice versa</p>

<p>Call option (Compulsory buyout)</p>	<p>A clause entitling one shareholder to buy the others' shares in the event of a deadlock</p>	<p>The company will survive</p> <p>Save on costs as no external valuation is required</p> <p>A fair price is offered as the price is either a pre-determined and agreed upon fixed price or formula that is drafted into the shareholders' agreement and/or constitution</p>	<p>If no formula is used, the pre-determined price may be significantly higher than the fair value of the shares at current valuation</p> <p>(If the company is in a decline)</p>	<p>It is advisable to use a pre-determined formula instead of price to more accurately reflect the fair market value of the shares</p>
<p>Put option (Compulsory sellout)</p>	<p>A clause entitling one shareholder to sell his shares to the other in the event of a deadlock</p>	<p>The company will survive</p> <p>Save on costs as no external valuation is required</p> <p>A fair price is offered as the price is either a pre-determined and agreed upon fixed price or formula that is drafted into the shareholders' agreement and/or constitution</p>	<p>If no formula is used, the pre-determined price may be significantly lower than the fair value of the shares at current valuation</p> <p>(If the company is doing well)</p>	<p>It is essential to ensure the third party has sufficient business expertise to reach a commercially sound decision</p> <p>Make sure to vet the third party thoroughly and ensure no possibility of bias</p>
<p>Liquidation</p>	<p>A clause which necessitates the winding up of the company upon deadlock</p>	<p>Parties are able to recover their assets in the company when it is evident the company cannot move forward, instead of having their assets trapped in a paralysed company</p>	<p>The company will not survive</p>	<p>This should be used as a last resort as it results in the dissolution of a potentially profitable company</p> <p>It is advisable to make reference to this clause only after other deadlock mechanisms are unsuccessful after a pre-determined period of time following the deadlock</p>

WHICH MECHANISM SHOULD I EMPLOY?

Each deadlock mechanism, be it a “continuation” or “divorce”, has its pros and cons. It is highly recommended that shareholders take their time to sit down and evaluate the most appropriate exit options they require to be drafted into their shareholders’ agreement and/or company constitution. Despite the inherent discomfort of broaching such a topic with your fellow shareholders and business partners, planning for the worst might be the best decision you can make for the future of your company.

If you are a shareholder who requires assistance in drafting your shareholders’ agreement and/or company constitution to best protect you and your company’s interests, please feel free to contact our Corporate team at corporate@jtlegal.com.sg or +65 6809 5145.

The contents of this article are owned by JT Legal LLC and subject to copyright protection under the laws of Singapore and, through international treaties, other countries. No part of this article may be reproduced, licensed, sold, published, transmitted, modified, adapted, publicly displayed, broadcasted (including storage in any medium by electronic means whether or not transiently for any purpose save as permitted herein) without the prior written permission of JT Legal LLC.

The information provided in this article is for general informational purposes only, and is not intended to nor should it be treated as a substitute for professional legal advice for any particular course of action. All information in this article is correct only to the best of our knowledge and at the time of writing. You should seek legal advice from a qualified legal professional before taking any action or omitting to take any action in relation to the matters discussed herein.