

## SHAREHOLDERS AGREEMENTS AND COMPANY CONSTITUTIONS

Shareholders agreements should always be read in conjunction with the constitution, notwithstanding the 'inconsistency clause'.

### The Inconsistency Dilemma

The 'inconsistency clause' often found in shareholders agreements plays a key role in settling internal company disputes. Where an inconsistency exists between a shareholders agreement ("SA") and a company constitution, an inconsistency clause within the SA will generally state that the SA prevails. Consequently, a common assumption exists that where an internal company dispute arises the SA will always prevail.

However, the decision of *Cody v Live Board Holdings Ltd*<sup>1</sup> by the NSW Supreme Court has highlighted a flaw in this assumption and has underlined the dangers of reading the SA to the exclusion of the constitution.

### The Facts

Directors of the defendant company, Live Board Holdings Ltd ("LBH") sought to raise capital by issuing preference shares to new shareholders. A dispute arose between an existing shareholder (the plaintiff) and the company regarding the validity of the share issue. Both the SA and the LBH constitution contained provisions regarding the power of the directors to issue shares.

### The Shareholders Agreement

The LBH shareholders agreement reserved for the shareholders the general power to issue shares. Where a decision by the Board was made to issue shares, the SA stated that the issue required approval by a simple majority of shareholders.

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<sup>1</sup> *Cody v Live Board Holdings Ltd* [2014] NSWSC 78.

### The Constitution

Consistent with the SA, the LBH constitution stated that the Board could cause the company to issue shares. However, the constitution further stated that where an issue of shares affected the rights of existing shareholders, it required approval by a special resolution.<sup>2</sup>

### The Issue

The ultimate dispute related to whether or not the SA or constitution applied. Both parties acknowledged that the Board had the power to issue shares<sup>3</sup>, however the arguments put forward by the plaintiff and defendant both sought to establish that different provisions of either the SA or LBH constitution prevailed regarding the issue of shares.

The defendants relied on the inconsistency clause to argue that the SA prevailed and permitted the issues of shares without the special resolution. The plaintiff submitted that the constitution clause was not superseded by the clauses in the SA.

As a result of s198A *Corporations Act 2001* (the "Act") and the SA, acknowledging that an issue of shares and variation of shareholder rights was a decision to be made by the board, the inconsistency regarded the type of majority required for a Board decision regarding shares to be approved. It was either to be a special majority (75% shareholder approval) as stated in the company constitution, or a simple majority (50%), allowed by the SA.

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<sup>2</sup> A "special resolution" refers to a resolution that has been passed by at least 75% of the votes cast by members entitled to vote on the resolution (s 9, *Corporations Act 2001* (Cth)).

<sup>3</sup> The business of a company is to be managed by or under the direction of the directors (s 198A(1) *Corporations Act 2001* (Cth)).

## **Inconsistency? What Inconsistency?**

The Court held that no inconsistency existed, and the inconsistency provision in the SA was not enlivened. The LBH constitution prevailed and a special majority was held to be required to issue preference shares. In coming to its decision, the Court looked to the purpose for which each provision had been drafted.

Firstly, clause 6 of LBH constitution existed to protect the rights of its existing shareholders. Brereton J held that by issuing preference shares only to new shareholders, LBH had indirectly varied the rights of existing shareholders by issuing shares that would rank ahead of their interest. As such, clause 6 of the constitution directly applied – LBH could not validly issue preference shares unless passed by special majority.

The provision in SA existed simply to reserve the power to issue shares to the shareholders. Brereton J held that the SA provision was therefore not inconsistent with clause 6 of the constitution and therefore, approval of the issuing of preference shares by special majority was consistent.

Brereton J ultimately held that the combined effect of the SA and constitution was that, in ordinary circumstances, shareholders had the power to approve the issue of shares by simple majority. However, where the issuing of shares would affect the rights of existing shareholders, a special majority would be required.

## **Implications for Directors**

Company directors should be aware that the SA and company constitution should be read in conjunction, not in isolation. The judgment of the Court makes it clear that

one instrument can serve as a guide for interpretation of the other and a purposive approach should be taken in resolving any potential inconsistencies. The judgment highlights the pitfalls associated with relying too heavily on inconsistency provisions.

The Courts will preserve the power of directors to exercise control over business matters. However, clauses designed to protect the interests of minority shareholders will prevail, particularly where the shareholder(s) interests are directly or indirectly affected by the proposed director resolution. A company constitution creates a statutory contract between the company (and, by extension, its directors) and the shareholders, as per s140(1)(a) of the Act.

## **Conclusion**

Shareholders agreements should be read in conjunction with the company constitution, even when an 'inconsistency clause' exists. Directors should consider clauses aimed at protecting minority shareholder interests before making resolutions affecting shareholders, in both the constitution and any shareholders' agreement, as these clauses are likely to prevail in the absence of clear contrary intent.

**For further information about directors' duties, corporate governance, shareholder agreements or similar topics, please contact:**

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