

Corporate deadlock and judicial winding up

Madrid, June 2019

Companies may become deadlocked when there are two shareholders or groups of shareholders holding equal stakes and the right to designate the same number of directors or when the by-laws require an enhanced majority to pass resolutions on relevant matters and one or several shareholders have a veto as a result.

In order to remedy this kind of situations, the Spanish Companies Act provides for the mandatory dissolution and subsequent winding up of a company when its governing bodies (in particular the shareholders' meeting) come to a standstill that makes its operation impossible. Should the dissolution not be agreed upon at the general shareholders' meeting, any interested party is entitled to request it from the competent court.

The Madrid Court of Appeals has recently analysed the scope of this rule in an interesting case¹ which may be summarised as follows. Two shareholders, each of them with a 50% stake in the company, who were also joint and several directors, had been unable to approve the financial statements corresponding to the last three financial years. One of the shareholders asked the commercial first instance court of Madrid to dissolve the company on that basis, but the other opposed and the court dismissed the claim. It considered that there was not a permanent deadlock of the general shareholders' meeting since both shareholders had voted the same regarding the financial statements (namely, rejecting their approval).

The decision of the first instance court was challenged before the Madrid Court of Appeals, which pointed out that a company must be dissolved due to a deadlock of its governing bodies when there are reasons to conclude that such a circumstance is "permanent and definitive". Confrontation between two shareholders or groups of shareholders does not lead by itself to the mandatory dissolution of the company but may be the reason for a deadlock capable of justifying the judicial dissolution.

The Court of Appeals considered that, in the case at hand, the functioning of the company was not possible and therefore annulled the decision of the first instance court and decided to dissolve the company. The judgment was founded on the following considerations:

- (i) Although both shareholders had voted against the approval of the last three annual financial statements, this does not allow to conclude that they should be able to pass corporate resolutions in the future, since they had done so because both denied having drawn up the financial statements in their capacity as directors, a fact that evidenced the magnitude of the conflict.

¹ Judgment of the Madrid Court of Appeals nº 42/2019, dated 5 April 2019.

- (ii) The company itself had appeared in the proceedings represented by two different attorneys, holding opposite positions, which was a significant indication of the "bipolar situation" affecting the operation of the company.
- (iii) Both shareholders were also shareholders in another company and one of them intended to bring an action against the other for the damages allegedly caused to the company by the latter in his capacity as a director; this would probably exacerbate the conflict.

In short, as the Madrid Court of Appeals put it, when the deadlock is such that the corporate bodies, and in particular the shareholders' meeting, cannot function and the company cannot carry out its corporate purpose the consequence must be the compulsory winding up.

The proceedings in this case went on for almost three years, a reason why it is advisable to lay down contractual mechanisms for a quick and effective solution of deadlocks in companies with two shareholders holding each 50% of the shares or in which the veto power of certain shareholders can block important decisions.