Frye Ruling a Recipe for Litigation

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By Clare Burns

Anyone advising shareholders of private corporations needs to pay heed to the Ontario Court of Appeal decision in *Frye v. Frye Estate*. The ruling makes it clear that clauses either in constating documents, such as articles of incorporation and letters patent, or shareholder agreements do not prevent shareholders from bequeathing their holdings in a manner inconsistent with those documents.

In the *Frye* case, the corporation at issue had letters patent providing that there could be no transfer of shares unless it got approval from the board of directors, a restriction common to private corporations.

After the death of the founder, his children, who remained shareholders, entered into a unanimous agreement in 1994 that required approval by three of the four siblings for any transfer of shares.

The agreement also required that anyone wishing to sell shares had to offer them first to the company and then, on a pro rata basis, to the other shareholders.

One of the siblings, Cameron Frye, died and left a will in which he bequeathed all of his shares in the corporation to his sister Cheryl Sylvestre. A third sibling objected that this was contrary to the terms of the shareholders' agreement and the terms of the letters patent. He sued.

At trial, the court held that the gift was null and void as it was contrary to the shareholders' agreement. The judge ordered the shares sold and that the proceeds form part of the residue of Frye's estate (which, according to his will, would be divided equally among the siblings).

But on appeal, the court concluded that contractual obligations do not constrain a person's ability to bequeath property through a will.

The ruling referred to the provisions of s. 67(2) of the *Ontario Business Corporations Act*. Noting that this provision hadn't gone before the trial judge, the court held that it made clear that on Frye's death, the shares passed to his estate trustees, who were entitled to be treated as registered holders of the shares regardless of any transfer restrictions in the constating documents or in any shareholders' agreement.

Once the shares devolved to Frye's estate, the appeal court agreed with the trial judge that the estate was bound by the terms of the constating documents and the shareholders' agreement, although it noted there could yet be an overriding provision in the governing corporate statute.

As a result, the fact that the gift was in breach of the contract didn't cause it to fail. Rather, the estate trustees held those shares as bare trustees for Sylvestre but faced constraints in how to transfer them to her.

The judge concluded the estate trustees had discretion as to when to seek the consents necessary to effect the transfer to Sylvestre and were at liberty to wait for a change in circumstances or to try to bring about a change in the consent procedure.

In the interim, the estate trustees had an obligation to exercise the rights associated with the shares as Sylvestre directed. Consistent with the law governing estate representatives, their obligations were duties held for life unless released by a court after passing accounts.

The decision brings some serious issues to light. In particular, people drafting shareholders' agreements will need to be cognizant that restraints on alienation clauses are, on their own, unable to prevent a testator from bequeathing their shares to someone in breach of them.

At first blush, it appears that estate trustees must consider the possibility of lengthy wrangling to accomplish a transfer to a beneficiary where it results in such a breach.

Moreover, the intended recipients of the shares can effectively operate as shareholders by simply requiring the estate trustees to do their bidding and thereby never engaging the restraint on alienation clause.

In February, the Supreme Court of Canada dismissed an application for leave to appeal the *Frye* decision. Nevertheless, it seems likely there will be efforts to "draft around" it. For example, the shareholders' agreement could provide that any transfer inconsistent with its provisions is void *ab initio*.

The shareholders could also include companion provisions in their wills to provide an immediate remedy to the others.

Another approach is to provide that the shareholders own the shares jointly so that they pass directly to the surviving joint tenants. However, such a move would require addressing issues surrounding joint tenancy such as the tax implications and whether the right of survivorship would withstand the scrutiny of a court.

But if revisions to shareholders' agreements and wills or joint tenancy rights don't solve the problem, will estate trustees in these circumstances find themselves languishing indefinitely?

A closer read of s. 67(2) may hold a startling solution. The provision makes it mandatory for a corporation with restrictions on alienation of its shares to treat designated people as registered security holders with all the rights that entails. Among the people listed are personal representatives and executors, as the Court of Appeal pointed out in *Frye*.

S. 67(7) and 67(8), in turn, confer on any person listed the right to become a registered holder or to designate someone else as the registered holder of the deceased's securities.

S. 67(9) then empowers the corporation to register the transmittal of the deceased's securities to the designated person and to thereafter treat the holder as the owner of them. S. 67(4) specifically relieves the corporation from inquiring into or seeing to the performance of any duty owed to a third party by the registered holder or by any person treated as such.

But here's the kicker: provisions in s. 67(2) aren't restricted to personal representatives of a deceased person; they also include any heir in the list.

Therefore, pursuant to the terms of s. 67, once presented with the specified documentation, a company incorporated under the *Ontario Business Corporations Act*, when requested to do so, must transfer shares left by will to a particular heir regardless of any restrictions on alienation in its constating documents or any shareholders' agreement.

Note as well that the *Canada Business Corporations Act* has a similar series of rules. So let the lawsuits begin.

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