WeirFoulds LLP

Out of the “Frye” Pan and into the Fire

March 1, 2010

Counsel advising shareholders of private corporations need to pay careful heed to the Ontario Court of Appeal decision in *Frye v. Frye* Estate. There, the Ontario Court of Appeal determined that clauses in constating documents such as Articles of Incorporation or Letters Patent, or in shareholder agreements that purport to restrict the transfer of shares do not prevent shareholders from bequeathing their shares in a manner inconsistent with those documents.

Background

In *Frye v. Frye Estate*, the litigation centred on shares of George H. Frye Holdings Ltd. (the “Company”). When George, the founder of the Company, died in November 1991, his will provided for the equal distribution of the shares amongst his five children (Bing, Cam, Cheryl, Jack and Donny) one of whom (Bing) later sold the shares back to the Company, leaving the other four children each with a 25% interest in the Company.

RESTRICTIONS ON SHARE TRANSFER

The Letters Patent

The Letters Patent of the Company provided a restriction on share transfer clause. Specifically, shares in the Company could not be transferred without the express sanction of the board of directors, evidenced by a resolution passed by the board of directors.

The Shareholders’ Agreement

In June 1991, all of the siblings signed a shareholders agreement which provided for restrictions on the ability to transfer shares (the “Shareholders’ Agreement”). Each of the siblings agreed that he or she would not “sell, assign, transfer, grant option in respect of or otherwise deal with any of his shares in the capital of the Corporation, except in accordance with the provisions of this Agreement.” According to those provisions, a shareholder that wished to sell his or her shares had to first offer the shares to the Company, and then to the other shareholders on a *pro rata* basis. Only after those offers had been declined could the shareholder transfer shares to a non-shareholder. In addition, any transfer of shares required the approval of at least three of Bing, Cam, Cheryl, and Jack (Donny was disabled). Further, as part of the Shareholders’ Agreement, the siblings acknowledged and agreed that their father’s intention was to “preserve the Frye group as a family business and for all his children to share equally therein.”

ONE SHAREHOLDER’S DEATH

Cam died in April 2002. In his will directed that his estate trustees:

. . . transfer and deliver to [his] sister Cheryl [], if she outlives me, all of the shares I own at the time of my death in [the Company.]

If lawful, that bequest would result in Cheryl owning outright 50% of the shares of the Company and controlling a further 25% as trustee of her brother Donny's share. Jack objected that this was contrary to both the terms of the Shareholders' Agreement and the Letters Patent. He sued.

THE DECISION AT TRIAL

At trial, the Court found that the Shareholders' Agreement prohibited Cam's bequest of his shares to Cheryl. The Court reasoned that the phrase "otherwise deal with the shares" was broad enough to apply to a testamentary transfer. It found that the disposition was null and void and severable from the will. The Court then directed that the shares be sold on terms consistent with the Shareholders' Agreement. If this decision had survived appellate scrutiny, the proceeds from the sale of the shares would have fallen into the estate's residue, which, according to Cam's will, was to be distributed equally amongst the remaining siblings.

COURT OF APPEAL

On appeal, Justice Juriansz writing for the Court, agreed with the trial judge's decision that the Shareholders' Agreement and Letters Patent applied to a testamentary disposition of the shares. However, he also concluded that contracts do not prevent a person from bequeathing property by will: that is, as in any contractual situation, a party can choose to breach the contract and suffer the consequences of the breach. That the breach occurs by virtue of a testamentary disposition does not change this result. The remedy for such conduct lies in a breach of contract suit against the estate. The will or a part thereof cannot be invalidated as a result of the breach. Accordingly, the decision of the trial judge on that point was reversed.

Perhaps more importantly, the Court of Appeal also considered the application of s. 67(2) of the *Business Corporations Act (Ontario)* to the facts (The section had not been brought to the attention of the trial judge).[2] That section reads as follows:

Representatives, etc., may exercise rights of security holder

67(2) A corporation whose articles or unanimous shareholder agreement restrict the right to transfer its securities shall, and any other corporation may, treat a person referred to in clause (a), (b) or (c) as a registered security holder entitled to exercise all the rights of the security holder that the person represents, if that person furnishes evidence as described in section 87 of the Securities Transfer Act, 2006 to the corporation that the person is,

(a) the executor, administrator, estate trustee, heir or legal representative of the heirs, of the estate of a deceased security holder;

Cheryl and Todd Burns were the estate trustees of Cam's estate. The Court concluded that consistent with section 67(2)(a) they were entitled to be treated as a registered shareholder of the Corporation. The Court further concluded that they were bound by the Shareholders' Agreement and could not transfer the shares to Cheryl unless the consents required by the Agreement and the Letter Patent were fulfilled. It appeared therefore that Cheryl's victory on appeal was to be pyrrhic; she would be registered as Estate Trustee but would not be able to receive the shares in her personal capacity. Fortunately for Cheryl, the Court went on to conclude that the estate trustees of Cam's estate held the shares as bare trustee for Cheryl and therefore must exercise the rights associated with the shares as she directed. Cheryl could therefore indirectly act as shareholder; the very thing she was prohibited from doing by the clear wording of the Letters Patent and Shareholders Agreement.

An application for leave to appeal the *Frye* decision to the Supreme Court of Canada was dismissed on February 5, 2009.[3]

ANALYSIS

The Decision Itself

The Court of Appeal's decision raises serious issues. In particular, persons drafting shareholders' agreements will need to be cognizant that restraint on alienation clauses, on their own, are ineffective to prevent a testator from bequeathing his or her shares to someone in breach of such clauses. Moreover, they will need to make it clear to clients that a beneficiary of shares pursuant to such a bequest can effectively operate as a shareholder by simply requiring the estate trustee of the deceased shareholder's estate to do their bidding – thus, never engaging any existing restraint on alienation clause.

Persons advising estate trustees will, in turn, have to advise that estate trustees have a duty to engage in what are likely to be lengthy negotiations to accomplish a transfer to a beneficiary who is an unwelcome shareholder and in the meantime keep the estate and administration open indefinitely.

Other Possible Consequences

Accepting that the Court was correct in its application of s.67(2)(a) it is possible, and perhaps probable, that in a subsequent case s.67(2)(a) may lead to an even more startling result. Subsection 67(2) makes it mandatory for a corporation with restrictions on alienation of its shares contained in its articles of incorporation or in a unanimous shareholders agreement to treat persons listed in clause (a), (b) and (c) of the subsection as a registered security holder with all the rights that entails. Among the persons listed in clause (a) are personal representatives and executors, as the Court of Appeal pointed out in *Frye*.

Subsection 67(7) and 67(8), in turn, confer on any person listed in clause (a) the right to become a registered holder or to designate someone else as the registered holder of the deceased's securities. Subsection 67(9) then empowers the corporation to register the transmittal of the deceased's securities to the person referred to in clause (a) and to thereafter treat such person as the owner of the securities. Subsection 67(4) specifically relieves the corporation from inquiring into or seeing to the performance of any duty owed to a third party (such as a party to a applicable shareholders' agreement) by the registered holder or by any person required to be treated as a registered holder pursuant to section 67.

Clause (a) of subsection 67(2) is not restricted to personal representatives of a deceased person. It includes any "heir". Therefore, pursuant to the terms of section 67 of the *OBCA*, once presented with the specified documentation, a corporation incorporated under the *OBCA*, when requested to do so, must transfer shares left by will to a particular heir, regardless of any restrictions on alienation that may be contained in its constating documents or any shareholders' agreement. It would not, however, be clear that an heir, once registered as a shareholder, would be bound by the shareholders' agreement.

Such a result would, at least, relieve estate trustees from the burden of serving as bare trustees for their lifetime of shares for which the requisite consents to transfer cannot be obtained. This would, however, be of little comfort to the remaining shareholders of the corporation in question.

Are Preventative Steps Available?

Much discussion has been had at the bar about what steps, if any, solicitors advising clients might recommend to avoid a result similar to that in *Frye*.

Joint Tenancy

Consideration has been given to the idea of having shareholders hold shares as joint tenants so as to avoid an unwanted testamentary disposition to a third party. The problems with this suggested solution approach are legion. First, following the Supreme Court of Canada decision in *Pecore v. Pecore*[4] it is possible for a Court to conclude that such a creation of joint interest is one of convenience only and gives rise to a resulting trust in favour of the donee of the interest.[5] If a resulting trust of shares was found, they would pass through the estate in any event, making it ineffective as a means of circumventing the *Frye* decision and the *OBCA*. It would be up to the surviving party to rebut the presumption of a resulting trust and show that the deceased intended the survivor to have the property pass immediately to the survivor and not through the deceased's estate.[6] In determining the intention of the deceased, the Court would look at all of the surrounding circumstances,[7] thus leaving legal advisors unsure of the effectiveness of having put the shares into joint tenancy. Second, if the joint tenancy was successfully established among existing shareholders there would arguably be a disposition for tax purposes by each shareholder, resulting in potentially serious adverse tax consequences. Third, and most importantly, joint tenancy would negate any economic value the deceased had by virtue of the share ownership.

Drafting

It has been suggested that a shareholders' agreement could be drafted to avoid this problem. However, given the mandatory language in section 67, it would require careful craftsmanship to successfully contract around its provisions. This is particularly so given that the same section encompasses the rights of trustees in bankruptcy to be registered as shareholders and it is unlikely a Court would accept any interpretation that would undermine the mandatory nature of the corporate statute and therefore the bankruptcy regime.

Nevertheless, it seems that a shareholders' agreement that qualifies as a unanimous shareholders agreement ("USA") under the *OBCA* could be drafted in such a way to permit the application of s.67 to occur without resulting in the inheriting shareholder acquiring effective rights to the shares if they are transferred in violation of the provisions of the USA. One alternative to consider would be to have the USA contain provisions requiring a mandatory sale, purchase for cancellation or redemption by the corporation or the other compliant shareholders, as the case may be, of any shares which are transferred in violation to the USA. The buy-out price could range from a nominal amount to fair market value depending on the circumstances. The USA would also contain complementary powers of attorney, undertakings to take all necessary steps plus provisions that cause the transfer or cancellation of the shares to occur automatically upon actions taken within the control of the corporation or the other compliant shareholders. Alternatively, careful structuring of call options or mandatory transfer provisions in a USA that are binding on the inheriting shareholder may also effectively address the issue. Such provisions could for all practical purposes leave the inheriting shareholder with no value or no rights in the shares.

In summary then, the joint tenancy alternative is too problematic to be a practical strategy to circumvent the result in *Frye*. However, with some creative drafting a unanimous shareholders' agreement governed by the *OBCA* may well serve to relieve shareholders from the unpalatable situations to which the *Frye* decision could otherwise give rise.

____

1 Partner and Senior Tax Lawyer, respectively, at WeirFoulds LLP. The authors wish to thank their colleagues, Ryan Filson and Cherylyn Dickson, for their help with this article.

2 R.S.O. 1990, c. B-16. Similar sections appear in *The Canada Business Corporations Act* and the corporation statutes of Saskatchewan, Manitoba, New Brunswick, Newfoundland, Nova Scotia and Prince Edward Island.

3 ([2009]) CanLII 4209 (S.C.C.)

4 [2007] 1 S.C.R. 795.

5 *Saylor v. Madsen Estate,* [2007] 1 S.C.R. 838.

6 *Ibid.*

7 *Pecore v. Pecore,* [2007] 1 S.C.R. 795.

WeirFoulds LLP

www.weirfoulds.com

Toronto Office
4100 – 66 Wellington Street West
PO Box 35, TD Bank Tower
Toronto, ON M5K 1B7

Tel: 416.365.1110
Fax: 416.365.1876

Oakville Office
1320 Cornwall Rd., Suite 201
Oakville, ON L6J 7W5

Tel: 416.365.1110
Fax: 905.829.2035