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Shareholder Agreements Gone Wrong

February 10, 2009

By Clare Burns and Lori M. Duffy

Any person advising shareholders of private corporations needs to pay careful heed to the Ontario Court of Appeal decision in Frye v. Frye which makes it clear that clauses in Letters Patent and shareholder agreements restricting share transfers do not prevent shareholders bequeathing their shares in a manner inconsistent with those documents.

In the Frye case, the holding company at issue was incorporated in 1968.

Its Letters Patent required that there be no transfer of shares unless the transfer was approved by the Board of Directors. After the death of the founder, his four children, who remained as shareholders, entered into a unanimous shareholders' agreement in 1994 that required that any transfer of shares be approved by three of the four siblings. The agreement also required that any shareholder wishing to sell their shares had to offer them first to the company and then, on a pro rata basis, to the balance of the shareholders. There was also a clause recording the founder's desire that the company continue as a family business with all of his children sharing equally therein.

One of the siblings, Cam, died leaving a will in which he bequeathed his shares in the company to Cheryl, another of the siblings. 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, that the shares should be sold, and that the proceeds would fall into residue (which, according to Cam's will, would be divided equally among the siblings).

On appeal, the Court concluded that contractual obligations do not constrain a person's ability to bequeath property by means of a will. In the result, pursuant to a provision in the Ontario Business Corporation's Act, the shares passed to Cam's estate trustees. The Court held that Cam's estate trustees held those shares as bare trustees for Cheryl. The Court concluded that the Estate Trustees were bound by the shareholders' agreement but had discretion as to when to seek the consents necessary to effect the transfer to Cheryl. The Estate Trustees were at liberty, in the Court's view, to await a change in circumstances or to wait to try to effect a change in the consent procedure. In the interim, the Estate Trustees, who held shares as bare trustees for Cheryl were, in the Court's opinion bound to exercise the rights associated with the shares as Cheryl directed.

The decision gives rise to some serious issues. In particular, it suggests that restraint on alienation clauses in shareholders' agreements, on their own, are ineffective to prevent a testator leaving shares to someone in breach of such clauses. Moreover, it suggests that the intended recipient of shares pursuant to such a bequest can effectively operate as a shareholder by simply requiring the estate trustees of the deceased shareholder's estate to do their bidding. Thus, never engaging the restraint on alienation clause.

Prudent advisors should consider reviewing their clients' shareholders agreements with them in order to determine what amendments or other external arrangements might be made to decrease the risk of such an unpalatable result.

For more information or inquiries:

Clare Burns

Toronto
416.947.5002

Email:
cburns@weirfoulds.com

Clare Burns is an experienced litigator who acts in complex and highly sensitive matters. Her practice focuses on trusts, estates and capacity litigation. In 2014, Clare received the Lexpert Zenith Award for her demonstrated excellence and thought leadership in trusts and estates.

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