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DEATH UNDER SHAREHOLDERS' AGREEMENTS AND CORPORATE ARTICLES

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The recent decision of the Ontario Court of Appeal in *Frye v. Frye Estate*¹ underlines that the death of a shareholder should be addressed in a shareholders' agreement or corporate articles in order to help transmit or transfer shares of a private company in accordance with the deceased's intentions and as clearly as possible.

Background

Frye concerns a family corporation governed by a shareholders' agreement. A principal purpose of unanimous shareholders' agreements is to govern the corporation including by transferring powers of management from the corporation's directors to its shareholders (s. 146(1) of the *Canada Business Corporations Act* ("CBCA"), s. 108(2) of the *Ontario Business Corporations Act* ("OCBA") and s. 123.91 of the *Quebec Companies Act* ("QCA")). In *Frye*, the shareholders' agreement was used to impose upon the shareholders (four siblings) an obligation to maintain existing proportional shareholdings among themselves, and to give each shareholder a

right of first refusal in relation to shares that another shareholder wished to sell.

When one of the shareholders passed away, at issue was whether the specific bequest in the deceased's will of his shares to his sister (which would override the pre-existing proportionate shareholdings) was valid. The Ontario Court of Appeal did not set aside the bequest, but assimilated the transmission of shares on death to *inter vivos* transfers for the purposes of dealing with transferability restrictions, and in essence did not give full effect to the bequest due to it violating both the above-mentioned transferability provisions of the shareholders' agreement, and those contained in the corporation's letters patent indicating that share transfers were subject to approval by the corporation's board of directors. The Court's judgment leads to some uncertainty and appears to leave the bequeathed shares in limbo at least in certain respects, as the executors were held to be entitled to registered title to the shares, with the obligation to exercise shareholder rights as

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¹ 2008 ONCA 606, 2008 CarswellOnt 5207, leave to appeal refused 2009 CarswellOnt 615 (S.C.C.) ("*Frye*").

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directed by the specific beneficiary, but with full title to the shares being withheld from the beneficiary pending possible future consent to the transfer by the other shareholders.²

Among the tax issues raised in light of the judgment, one wonders if income earned after the death with regard to shares held under such an arrangement is to be taxed in the hands of the beneficiary, or if the uncertainty as to title at least can allow the income to be taxed at a possibly lower

2 In this regard, Juriansz J.A. writes as follows in *Frye* at paragraphs 18, 22 and 23: "I agree that the shareholders' agreement and the letters patent apply to a share transfer by testamentary disposition. . . Legal title to the shares is transmitted by the Will to the estate trustees, who hold them in trust for [the beneficiary]. However, the estate trustees are bound by the shareholders' agreement and cannot distribute the shares out of the estate to [the beneficiary] without complying with the requirements of the shareholders' agreement and the letters patent. . . [The estate trustees] must attempt to accomplish the transfer of the shares to [the beneficiary] in whatever manner they think most advisable. They have discretion as to when and how to seek the necessary consents and, if the consents are not forthcoming, they have some discretion to await a change of circumstances, or attempt to effect such a change. . . [Prior to the shareholders consenting to the transfer], the estate trustees, as bare trustees for [the beneficiary], must exercise the rights associated with the shares as [the beneficiary] directs."

rate in virtue of a designation to tax in the hands of the estate under subsections 104(13.1) and (13.2) of the *Income Tax Act* (Canada). The arrangement in *Frye* is referred to by the Court as a bare trust (in Quebec, this would be characterized as a kind of mandate or agency), for which such designations appear to be unavailable.³ However, the estate trustee's role in *Frye* with regard to the shares does not appear to be entirely passive, providing a good argument that income earned on the shares can be taxed in the hands of the estate for a period extending beyond the initial period after the death.

Stipulate clearly

Nevertheless, clarity with regard to a share transmission or transfer is often the most desired result. The judgment in *Frye* therefore underlines that parties wanting clear transmission of shares of a private company upon the death of a shareholder should expressly stipulate for such rights in a shareholders' agreement, or in the articles of incorporation in the absence of a shareholders' agreement. For example, the shareholders' agreement and/or articles could stipulate that a shareholder has the right on death to transmit shares to a limited group of individuals such as a surviving spouse and descendants, without receiving the prior approval of the other shareholders or the board of directors. It could also be advisable to stipulate that a will beneficiary or legal heir, in order to receive shares, is required to adhere to any existing shareholders' agreement.⁴

In this regard, it is notable that provisions in both the CBCA (ss. 51(2) and (7)) and OBCA (ss. 67(2) and (7)) that seem to have the purpose of overriding share transfer restrictions upon the death of a shareholder, are not a reliable solution in relation to the goal to achieve clarity, because they do not seem to provide for a complete

3 See Hassan, Sandra, "Impact of Canadian Bijuralism on the Taxation of Certain Types of Trusts", in *The Harmonization of Federal Legislation with Quebec Civil Law and Canadian Bijuralism*, Second Collection of Studies in Tax Law 2005, Montreal, APFF, 2005, at pp. 5:15 and 5:18-5:20.

4 This avoids having to decide whether a will beneficiary or legal heir receiving shares is automatically bound by an existing shareholders' agreement in the same manner as, for example, a transferee giving value. See ss. 146(3) and (4) CBCA, ss. 108(7) and (8) OBCA and s. 123.93 QCA.

transfer in all situations.⁵ For example, the CBCA provisions apply only to transfer restrictions found in corporate articles (the OBCA provision applies also to unanimous shareholder agreements), and there seems to be a question as to whether the recipient of a specific bequest, in addition to a residual heir, can fully benefit from these provisions.⁶ Furthermore, such provisions are not even contained in the current QCA, or in Quebec's recently introduced and passed Bill 63 (the new Quebec *Business Corporations Act*, S.Q. 2009, c. 52, passed into law on December 4, 2009 but as yet unproclaimed) that is meant to replace the QCA and to introduce a more modern corporate statute in Quebec when it comes into force by perhaps 2011. Effectively, there is reason to believe that as regards the need to stipulate for clarity with respect to share transmissions and transfers on death as implied by *Frye*, a substantially similar decision would have been reached in Quebec.⁷

It should not be forgotten that securities rules (see *National Instrument 45-106 Prospectus and Registration Exemptions*, hereinafter "NI 45-106", at section 2.4) require shares of a private corporation (a private issuer) to be subject, among other things,

to share transfer restrictions in constating documents or security holders' agreements. However, stipulating in advance to allow the transmission or transfer of shares on death to family beneficiaries without corporate approval apparently would not affect a corporation's private issuer status. After all, such transmissions or transfers are not distributions or trades of the shares, and do not lead to the shares being offered to the public, and are in that context a minor attenuation of the corporation's share transfer restrictions.⁸

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8 See generally "Frequently Asked Questions" concerning NI 45-106, issued by the Québec Autorité des marchés financiers on March 31, 2006, which *inter alia* may imply the view that if a potential transferee of shares is sufficiently linked to the corporation so as to have little interest in carrying out due diligence on the corporation, that person is not in relation to the corporation a member of the public.

5 Subsection 51(2) CBCA reads in part as follows: "... a corporation whose articles restrict the right to transfer its securities shall ... treat a person as a registered security holder entitled to exercise all the rights of the security holder that the person represents, if the person furnishes the corporation with evidence ... that the person is ... the heir of a deceased security holder, or the personal representative of the heirs, or the personal representative of the estate of a deceased security holder. ..." (emphasis added) Subsection 67(2) OBCA reads in part as follows: "A corporation whose articles or unanimous shareholder agreement restrict the right to transfer its securities shall ... treat a person ... as a registered security holder entitled to exercise all the rights of the security holder that the person represents, if that person furnishes evidence ... to the corporation that the person is ... the executor, administrator, estate trustee, heir or legal representative of the heirs, of the estate of a deceased security holder. ..." (emphasis added)

6 See *Frye*, at paragraph 20, footnote 1. Quebec law also distinguishes between recipients of specific bequests (legatees), and heirs (see articles 738-9 of the *Civil Code of Quebec* ("CCQ")).

7 Although s. 85 of the *Quebec Act Respecting the Transfer of Securities*, R.S.Q. c. T-11.002, which states a general requirement to respect share transfer restrictions, does not expressly refer to a transmission or transfer to a legatee or heir as being a transfer subject to restrictions, note that ss. 42 and 43 of the QCA foresee that executors (liquidators) may become registered shareholders in a representative capacity. Furthermore, Article 842 CCQ may require shareholders' agreements to be respected when settling the residue of an estate. Quebec does not distinguish between legal and beneficial title, but liquidators settling estates can be "seized" of estate assets to the exclusion of heirs and legatees (article 777 CCQ).

PROROGATION OF PARLIAMENT

After weeks of rumours that it would happen, just before New Year's the Prime Minister took the decision to prorogue Parliament for two months.

The House of Commons and the Senate will come back on March 3, after the Vancouver Olympics, for a Speech from the Throne and a budget tentatively slated for March 4. The move will have the effect of killing all bills currently in Parliament, including crime bills that the government had said were being delayed by the opposition. (These bills *could* by unanimous agreement return at the stage they were at when prorogation was announced.)

A post-Olympic return would also shut down government committees, which would stop MPs from pursuing the Afghan detainee controversy until Parliament returned.

Before then the government will likely fill five vacancies in the Senate, providing the Conservatives with more seats than the Liberals. When Parliament is reconvened, new Senate committees will be