Shareholder's "Lock-In" Agreements and the Oppression Remedy

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FACTS

- A proposed shareholder's agreement contains a "lock-in" provision, which restricts the ability of shareholders to redeem or sell their shares for a proposed minimum period of 7 years, except with unanimous shareholder approval.

- After the 7 years, if the majority of the Board of Directors does not approve a requested redemption, then the company is to be wound up.

ISSUES

- Is this type of shareholder's agreement valid?

- Would such an agreement be subject to an oppression remedy application under s. 248 of the Ontario *Business Corporations Act*, R.S.O. 1990 c. B.16 (the "Act")?

SUMMARY OF CONCLUSIONS

- The shareholder's agreement to restrict their own transfer rights, as proposed, is probably acceptable.

- However, it may be more prudent to put restrictions on share transfer into the articles/by-laws of the corporation.

- The director's right to restrict share transfers after 7 years may be objectionable if not expressly authorized *via* by-law.

- Historically, similar shareholder's agreements have not been attacked on an oppression remedy basis.

LEGISLATION

The relevant provisions of the Act are as follows:

42. Restrictions on issue, transfer, etc. — (1) A corporation shall not impose restrictions on the transfer, or ownership of shares of any class or series except such restrictions as are authorized by its articles.

248. Oppression remedy — (1) A complainant and, in the case of an offering corporation, the Commission may apply to the court for an order under this section. [1994 c27 s71]
(2) Idem — Where, upon an application under subsection (1), the court is satisfied that in respect of a corporation or any of its affiliates,

(a) any act or omission of the corporation or any of its affiliates effects or threatens to effect a result;
(b) the business or affairs of the corporation or any of its affiliates are, have been or are threatened to be carried on or conducted in a manner; or
(c) the powers of the directors of the corporation or any of its affiliates are, have been or are threatened to be exercised in a manner,

that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of any security holder, creditor, director or officer of the corporation, the court may make an order to rectify the matters complained of.

ANALYSIS

There are two elements to the proposed shareholder's agreement which bear scrutiny: 1) the 7-year restriction on redemption or sale of the shares pursuant to the shareholder's agreement; and 2) the subsequent discretion of the Board of Directors to approve or deny the redemption. Each of these will be considered separately.

The 7-year restriction

Proposed Agreement Provision:

- The shareholder's agreement contains a "lock-in" provision, restricting the shareholders' ability of shareholders to redeem or sell their shares for a proposed minimum period of 7 years, except with unanimous shareholder approval.

1) The transfer right, generally

Generally speaking, a shareholder is entitled to transfer shares to anyone else, subject to compliance with the provisions of the Act (or other pertinent legislation), the articles and by-laws of the corporation, and any unanimous shareholder agreements. For example, share-transfer restrictions instigated by the company must be set out in the articles of the corporation[1], as required by s. 42 of the Act.

However, there is nothing to prevent shareholders from entering into contracts among themselves which limit the right to transfer. In fact, these agreed-to

[1]The Act, s. 5(1)(d).

restrictions can be *greater* than those imposed under the articles of the corporation[1] The case law establishes three conditions/guidelines, however:

- the shareholder's agreement must be for value[2];
- the restrictions against transfer should be reasonable[3]; and
- the restrictions cannot[4] (or else should not[5]) be absolute or indefinite.

Where a shareholder agreement purports to restrict the transfer of shares, the scope of that restriction will be subject to normal contract-interpretation rules[6]. Moreover — except in unanimous shareholder agreements — the contract (and any breach) affects only the shareholders who are party to it, and not the corporation[7].

2) The proposed agreement

<u>The ability of shareholders to restrict their transfer rights</u>

It is clear that shareholders can agree to restrict their own rights to transfer shares, as discussed above. In particular, the leading case is *Ontario Jockey Club Ltd. v. McBride* [1927], A.C. 916 (P.C.) (which went to the Supreme Court of Canada and was ultimately confirmed by the Privy Council), in which the court stated at p. 35:

> That restrictions may be placed upon a shareholder's right of transfer of his shares cannot be questioned. The cases are numerous in which such restrictions have been upheld. Shares are *prima facie* transferable. But there is no law which precludes the shareholders from contracting for value that they shall each submit to any reasonable restriction which they choose to agree to. [I]t may be for the benefit of the company that, for instance, shares shall not be transferred to rivals in the company's trade. A restriction which precludes a shareholder altogether from transferring may be invalid, but a restriction which does no more than give a right of pre-emption is valid.

[1] *Ontario Jockey Club Ltd. v. McBride*, [1927] A.C. 916 (Privy Council) (Ont.).

[2] *Ontario Jockey Club Ltd. v. McBride* [1927], A.C. 916 (P.C.).

[3] *Ontario Jockey Club Ltd. v. McBride* [1927], A.C. 916 (P.C.).

[4] *Ontario Jockey Club Ltd. v. McBride* [1927], A.C. 916 (P.C.).

[5] In one case, a restriction which did nothing more than give the shareholder a right of pre-emption was held valid: *Ontario Jockey Club Ltd. v. McBride* [1927], A.C. 916 (P.C.).

[6] *Litz v. Litz* (1957), 65 Man. R. 103 (Q.B.)

[7] For example, the Directors could not refuse to register a transfer of shares on the grounds that to do so violates the shareholder's agreement: *Re Belleville Driving & Athletic Association* (1914), 31 O.L.R. 79 (C.A.).

The time limit

It appears that restricting transfer for a particular time-period is not prohibited, provided it does not offend the "unreasonable" guidelines discussed above. This is likely a determination of fact.

In *Litz v. Litz* (1957), 65 Man. R. 103 (Q.B.), all five shareholders entered into an agreement by which they agreed not to sell their shares in the company for four years, after which time one of the parties was given an option to sell his shares to the others. The court proceeded to interpret the agreement and determine the rights of the parties accordingly.

No recent cases appear to have considered this type of provision.

Transfer only with consent of all shareholders

An shareholder's agreement which prohibits transfer except where all shareholders agree also appears to be acceptable.

In *Re Belleville Driving & Athletic Association* (1914), 31 O.L.R. 79 (C.A.), this type of shareholder's agreement was considered; however, the case turned on the distinction between such restrictions embodied in the *company's articles* as opposed to a *collateral agreement* merely between the shareholders. (It was held that the breach of the shareholder's agreement did not prevent the directors from registering a share transfer, since it was a private matter between the contracting shareholders, whose remedy was in damages or an injunction). A similar conclusion was reached in *Barnard v. Desautels* (1909), 19 Que. K.B. 114 (C.A.).

In a similar vein, a shareholder's agreement placing restrictions on share transfer in absence of notice to the company was also valid: *Ontario Jockey Club Ltd. v. McBride* [1927], A.C. 916 (P.C.).

Restriction included by-laws

If the prohibition against transfer except with shareholder's approval is embodied in the company's by-laws, it may have enhanced validity; shareholders can then bind themselves in accord with the terms of that by-law.

The leading case in this area is *Ontario Jockey Club Ltd. v. McBride* [1927], A.C. 916 (P.C.). In that case, the shareholders agreed not to transfer their shares except in accord with a restrictive by-law. The court held that the shareholders were capable of binding themselves to such a restriction, as follows (at p. 35):

> Whether By-law No. 37 was or was not binding as a by-law, it was competent to the shareholder to bind himself to the restriction expressed in it, and by signing the agreement he became, and by virtue of their signatures given on receiving the additional shares every shareholder became, bound by that restriction.

Barnard v. Desautels, supra, makes it clear that a shareholder's agreement does not have the same force as a by-law. Furthermore, in *Barnard v. Duplessis*

Independent Shoe Machinery Co. (1907), 31 Que. S.C. 362, it was unsuccessfully argued that the shareholder's agreement was "equivalent" to a by-law, because it had been signed by all of the shareholders and deposited in the company's archives. The directors could not refuse to register.

Many cases exist relating to restrictions to transfer included in articles and by-laws; summaries of several have been included in the materials for your information.

Director's refusal to approve redemption

Proposed Agreement Provision:

- Once the 7-year initial "lock-in" has expired, the Directors have the discretion to refuse a requested redemption, in which case the company will be wound up.

Where no power expressly granted in articles/by-law

Unfortunately, there appeared to be no considered cases in which the proposed type of power — refusal to redeem after a specified period of "lock-in" — was given to the directors by way of a shareholder's agreement.

However, in *Belleville Driving & Athletic Association* (1914), 31 O.L.R. 79 (C.A.), the court dealt with a shareholder's agreement which restricted the shareholders' transfer rights except with the directors' consent. The corporation was enacted through letters patent, which contained no authorization allowing the directors to restrict share transfers in this manner. The court stated at p. 84:

> In Buckley on Companies, 9th ed., p. 35, the law as to restrictions upon the rights of shareholders to transfer their shares is thus stated: 'In the absence of restrictions in the articles the shareholders may transfer their shares without any consent. In their absence the directors have no discretionary power of refusing to register a transfer *bona fide* made'. ... ' In construing a clause giving directors a discretionary power of rejection, it is necessary to bear in mind, on the one hand, that, apart from such a clause, the right of transfer is unlimited, and, on the other, that the object of such a clause is the protection of shareholders'.

Thus, in light of this statement, the rejection by the directors at the end of the 7-year period may be troublesome.

Where articles/by-laws authorize director's powers

In the event that the by-laws of the company will be changed to allow share transfer restrictions, the following points may be helpful:

Naturally, and aside from a voluntary shareholder's agreement described above, any restrictions on the transfer of shares must first be authorized in the corporation's articles (the Act, s. 42). Assuming such power is granted to the directors to regulate share transfers, they can then, for example, refuse to approve or register transfers, although the following rules apply:

- the powers cannot be exercised arbitrarily;[1]

- they must be exercised in the corporation's best interests, and must be exercised reasonably;[2] and

- they cannot be exercised for the directors' personal benefit[3].

Note also that in *Re Good and Jacob Y. Shantz Son & Co. Ltd.* (1911), 23 O.L.R. 544 (C.A.), a by-law which attempted to restrict transfer of fully paid-up shares except with the consent of the directors was held invalid.

The oppression remedy

At the end of 7 years, the directors could refuse to redeem the shares and effectively wind up the company. Unfortunately, none of the similar shareholder agreement cases has such a feature; nor were they dealt with on an oppression remedy basis. Instead, they were all either attacked or upheld on the grounds and concerns expressed above.

Nonetheless, various materials on the oppression remedy have been compiled for your convenience, including an excellent summary of the various elements comprising the oppression remedy taken from Peterson, *Shareholder Remedies in Canada,* 1993, Butterworths, and an article titled "Shareholder's Agreements and the Oppression Remedy — A Lesson in the Fragility of a Contract", B.V. Slutsky, 1990 *The Advocate*, 375.

In particular, under oppression remedy principles, when evaluating the conduct of the directors at the end of the 7-year period, the following factors should be addressed:

- whether there will be a valid corporate purpose for the transaction;

- whether the conduct will display a lack of good faith on the part of the director's of the corporation;

- whether the conduct will discriminate between shareholders, e.g. by benefiting the majority shareholder to the exclusion or to the detriment of the minority shareholder;

- whether the conduct will be accompanied by a lack of adequate and appropriate disclosure; and/or

- is the conduct part of a plan or design to eliminate the majority shareholder[1]

[1] *Smith v. Canada Car Co.* (1876), 6 P.R. 107 (Ont. C.L.) [copy of case unavailable]

[2] *Panton v. Cramp Steel Co.* (1904), 9 O.L.R. 3 (C.A.).

[3] *Corp. de Placement Renaud Inc. v. Nor-Mix Ltee*, [1980] Que. S.C. 980 [case unavailable].

CONCLUSIONS

The agreement as proposed is likely satisfactory, although it may have its dangers.

Consideration should be given to putting restrictions on transfer into the by-laws; the subsequent discretion by directors to refuse to redeem the shares after the 7-year period may be objectionable, and at the very least must be exercised reasonably and in good faith.

RESOURCES CONSULTED

Canadian Encyclopedic Digest (Ont. 3d) “Corporations”

Peterson, *Shareholder Remedies in Canada,* (Markham: Butterworths, 1993).

QUICKLAW databases: CJ, BLR, ORP, ABRD, QC

Slutsky, “Shareholder’s Agreements and the Oppression Remedy — A Lesson in the Fragility of a Contract”, 1990 *The Advocate*, 375.

[1]Peterson, *Shareholder Remedies in Canada,* 1993, Butterworths at para. 18.40.1.