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"IT'S FREEZING IN HERE: THE ESTATE FREEZE AND THE OPPRESSION REMEDY"

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It's Freezing In Here: The Estate Freeze and the Oppression Remedy

By Brad Phillips and Gregory Sidlofsky[1]

Estate freezes, conceptually, are all about deferring or reducing taxes. In a nutshell, an estate freeze allows an owner of a business to freeze the value of his or her shares in a business today, while enabling the future growth of the business (and any capital gains on the future increase in value) to pass onto the next generation.

Unfortunately, when prudent financial planning intersects with the "next generation", problems can (and do) arise.

An estate freeze typically involves the creation and allocation of new shares that go to the business owner's children. But, to horribly paraphrase Peter Parker's Uncle Ben, "with great new shares, come great new shareholder rights" and the ability to complain to the Court when something happens in the business that they do not like.

This paper will look at how an estate freeze can result in litigation when the "next generation" is not happy about how its rights and interests are being impacted by decisions of the original owner. Such unhappiness can often result in the "next generation" seeking relief under provincial or federal Business Corporations Acts - and in particular, seeking what is known as relief for oppression.

The Freeze

An "estate freeze" is a term used to describe various forms of reorganization in which the value of an enterprise is "frozen" in fixed-value preferred shares equal to the fair market value ("FMV") of the business or holdings at the date of the freeze. This allows the future growth in the value of a corporate entity to be attributed to common shares held by others – typically children of the principal of the business, or a family trust.

A typical arrangement would involve the principal of a business – let's call him Daddy Warbucks – transferring his shares in his operating company ("Acme Inc.") to a new corporation, Holdco, in exchange for preference shares of Holdco with a redemption/retraction amount equal to the FMV of the common shares in Acme Inc. as of the date of the freeze.

Daddy Warbucks will still want to maintain control over Holdco and thus indirectly over Acme Inc. There may be sufficient votes attached to the preference shares to achieve this purpose, or a further class of preference shares with a nominal value redemption/retraction amount may be created to ensure he has the votes to control Holdco and Acme Inc.

[1] With special thanks to Brendan Donovan for his assistance.

This arrangement allows for the minimization or deferral of capital gains tax upon Daddy Warbuck's death because an estate freeze allows the freezor to avoid paying capital gains tax on the entire amount of the future increase in a corporation's value, which would otherwise occur under the *Income Tax Act ("ITA")* upon the death of the freezor.[2]

Here's an example of what an estate freeze can do to defer or minimize such taxes:

In Year 1 of his new dog washing business (with Sandy as his cartoon mascot), Daddy Warbucks held common shares with an adjusted cost base ("ACB") of $100 per share.

By Year 10, the business has grown to a value of $5-million. While his advisers strongly encourage him to implement an estate freeze and pass on the growth of the company to his daughter Annie, Daddy Warbucks is having none of it.

Sadly, Daddy Warbucks passes away, leaving little Annie an orphan yet again. By the time of his passing, the value of his business had risen to $10-million. The capital gain realized upon his death would be equal to the difference between the FMV of the shares at the date of death ($10-million) and Daddy Warbuck's original ACB in the shares ($100) (i.e. $10-million - $100 = $9,999,900) – one half of which would be included in Daddy Warbuck's income for the terminal taxation year (i.e. $4,999,950).

In contrast, Daddy Warbucks could have listened to his advisors and implemented an estate freeze when his advisers recommended it in Year 10. This would be achieved by having him exchange his common shares in his corporation for fixed-value preferred shares with a value equal to the FMV of the corporation in Year 10. The common shares, to which the future increase in value of the corporation would accrue, could then be acquired by Annie for a nominal cost. By proceeding in this manner, upon Daddy Warbuck's death, his capital gains would be capped at the difference between the value of the corporation at the date of the freeze in Year 10 ($5-million) and the ACB of the freezor's shares ($100) (i.e., $5-million - $100 = $4,999,900), half of which would be included in Daddy Warbucks income for the terminal taxation year (i.e., $2,499,950).

As you can see from the above example, an estate freeze would have enabled Daddy Warbucks' estate to avoid a $2,500,000 capital gain and the taxes that would have been owing on such a gain. That $2,500,000 gain would instead be attributable to Annie's shares under the freeze and taxes on that gain would have been deferred until Annie sold her shares, died or did her own estate freeze in the future.

[2] Specifically, subsection 70(5) of the *ITA* provides that when a taxpayer dies, he or she is deemed to have disposed of his or her property immediately before his or her death for proceeds equal to the FMV of such property immediately before death.

All in the Family

While an estate freeze certainly makes financial sense to minimize taxes payable by an estate, it does not come without consequences – even when Daddy Warbucks believes the arrangement ensures that he maintains control over the business.

The precedent case of *Naneff v. Con-Crete Holdings Ltd.* 1995 CarswellOnt 1207, demonstrates the risks that come with estate freezes. In *Naneff,* the patriarch of the family through "keen business sense and hard work", built a very successful business operation. As the Court of Appeal for Ontario noted, "most of this growth and expansion took place well before" his two sons joined the family business.

It was the patriarch's desire that his sons come into the business with him and succeed him when he died or chose to retire. While his sons were still in high school, the patriarch implemented an estate freeze with respect to one of his companies, making his two sons equal owners of all of the common shares of the company through which the business was being operated.

While he gave his sons equity in his business, he did not give them control. Like the example cited in this paper above, he retained complete control of the business through redeemable voting special or preference shares.

Eventually his sons did join the company and worked well together for a time. The patriarch, however, remained the "boss".

At some point, the patriarch began to have concerns regarding his elder son's lifestyle outside of work and his choice of life partner. This led to a major family blow up, followed shortly by a director's meeting in which the elder son was removed as an officer of all the companies comprising the family business, and he was ordered to stay off the business premises.

As a result of these acts, the elder son pursued litigation relying upon s. 248 of the *Business Corporations Act*, R.S.O. 1990, c.B16 (the "O*BCA*"), better known as the oppression remedy. The oppression remedy provides a very broad discretionary power to the Court to fashion remedies once a finding of oppression is made. Section 248(2) of the O*BCA* provides:

> (2) 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, d*irector or officer of the corporation*, the court may make an order to rectify the matters complained of. [emphasis added]

Section 248(3) of the O*BCA* empowers a court upon a finding of oppression to "make any interim or final order it thinks fit" to remedy the oppressive conduct.

In accepting that oppression had occurred in the *Naneff* case, the Court of Appeal expressly found that while the family perceived the son's personal failings and the interests of the company to be one and the same, they were in fact not. The Court specifically found that the son's personal life had no adverse effect on his business/company performance.

While the Court of Appeal did agree with the lower court that oppression had occurred, it disagreed with the remedy fashioned by the lower court (which had ordered that the companies be sold).

The Court of Appeal found that ordering the public sale of the companies forming the business as a going concern (which would have enabled the eldest son to force his father to sell the business he built) was not reasonable.

In coming to this conclusion, the Court of Appeal reiterated the well-established principle that in determining whether there has been oppression, the court must determine what the reasonable expectations of that person were according to the arrangements that existed between the principals.

In *Naneff,* the Court of Appeal found that compelling the sale of the company was inconsistent with the reasonable expectations of the son, as he had understood that so long as his father lived, his Dad would remain the "boss". The Court of Appeal also found that his father's interest in sharing one-half of the equity of the family business was premised on his sons working with him in his business. But as those family bonds ceased to exist, the son's reasonable expectation had to factor in the realities of the family relationship.

On this basis, the Court concluded that the appropriate remedy for the oppressive conduct was that the patriarch and his other son had to acquire the eldest son's shares at fair market value without minority discount.

While the Court of Appeal did conclude that the patriarch of the family should not be forced to sell the business he had built, it still compelled him to give his son what essentially amounted to a very generous advance “inheritance” by way of the purchase of shares he had received for little or no consideration.

The recent Divisional Court case of *Strauss v. Wright*, 2017 ONSC 5789 was another case involving an estate freeze. However, in contrast to *Naneff,* the Court essentially overlooked the acknowledged expectation that the patriarch would continue to control the business he built in fashioning a remedy for what the Court found to be oppressive conduct. The patriarch instead was effectively forced out of the business that he had started and was ordered to sell his shares to his daughters against his wishes.

Unlike in *Naneff,* the estate freeze in *Strauss* was implemented using a family trust. Specifically, the Wright Family Trust was created to hold all of the common (growth) shares of the company that Mr. Wright had built. Allegedly because of solicitor negligence, Mr. Wright was not named as a beneficiary of the Wright Family Trust and he did not have control of the trust. In any event, the existence of the trust did not factor into the remedy the Court granted.

By virtue of the voting rights set out in Mr. Wright’s preference shares and common shares, Mr. Wright retained voting control of his company, just as the patriarch had done in *Naneff.* The evidence filed with the Court was clear that Mr. Wright did not intend to give up control over his business prior to his death and no one expected that he would do so.

Like in *Naneff,* Mr. Wright’s daughters became actively involved in the day-to-day operation of the family business. Also like in *Naneff*, there was a falling out between the daughters and their father, although in this case the cause of the friction was that Mr. Wright had married a woman that his daughters did not approve of and he had sought to give her expensive gifts.

When his daughters refused to pay him dividends and sought to control how he spent money from the business, Mr. Wright attempted to remove funds from his companies’ bank accounts to try to stop his daughters from accessing the funds. Despite returning the funds following his daughters’ complaints, his daughters pursued an oppression application seeking to remove Mr. Wright from the business.

At the hearing of the application, the judge ordered that Mr. Wright be removed as both an officer and director of his own company, and ordered that his shares be redeemed by the company and shareholder loans owing to Mr. Wright be repaid.

On appeal, the Divisional Court agreed with the relief granted in the Court below, distinguishing the case from *Naneff* on the basis that the father breached fiduciary

duties to the company by withdrawing funds from the business, and that this negated any reasonable expectation that he could remain as an officer and director of the company. This was the analysis notwithstanding that he built the company and that he was always intended to maintain control of the company until his death.

As can be seen from the *Strauss* case and the case referred to below, it appears that the Court's perception of the propriety of certain corporate manoeuverings will have a significant impact upon its analysis of whether there has been oppression and what the appropriate remedy may be for the oppressive conduct.[3]

Such was the situation involving the much beloved former owner of the Toronto Maple Leafs, Harold Ballard. His relationship with his children appears to have been as happy and loving as his relationship with the team and the fans under his stewardship.

As set out in *820099 Ontario Inc. v. Harold Ballard Ltd.*, 1991 CarswellOnt 427 (Div. Ct.), Ballard implemented an estate freeze in 1966 and gave his three children non-voting common shares of his holding company, while retaining voting control. At the time of the freeze, his shares were worth about $3-million. By the late 1980s, the value of his children's shares had increased dramatically to about $60-million.

A deterioration in family relations occurred, and Ballard sought to reacquire his children's shares. In 1989, he purchased his daughter's shares for about $15.5-million and one of his son's shares for about $21-million. However, his third child, William Ballard ("William"), refused his father's offers to purchase his shares.

To solve this slight logistical problem, Ballard, with the approval of his board of directors, instituted a corporate reorganization that had the "hat trick" effect of (1) financing the buyout of his cooperative children's shares, (2) ensuring Ballard's control over the operating company, Maple Leaf Gardens, and (3) freezing William out of the business.

Like Borje Salming on an end-to-end rush, William swiftly brought an action to nullify the re-organization on the basis that it constituted oppressive conduct. The court held that in effecting the re-organization, the directors had acted for an improper purpose, that they acted only in the interests of the majority shareholder, and that they did not

[3] That being said, it is not clear to the writers why the withdrawal of corporate funds that resulted in no proven damages breached a fiduciary duty that relieved the Court from considering whether Mr. Wright's reasonable expectations and those of his daughters required that he be kept in charge of the company he built. In contrast, in *Naneff* the Court found that the patriarch had removed his son as an officer and director of the corporation without any justifiable basis (and arguably to the detriment of the business), but this did not preclude the Court from considering the patriarch's expectation that he would remain in charge of the business he built.

consider the interests of the minority shareholder. As a result, the Court set aside the re-organization.

More recently, the British Columbia Court of Appeal in *Hui v. Hoa*, 2015 BCCA 128 dealt with the familial fallout from an estate freeze. In a nutshell, a then-10-year-old Camille found himself the proud holder of non-voting (growth) shares in a company ("Bon") started by his parents.

Later, after his parents briefly separated, a new holding company ("E & C") was incorporated, which again placed virtually all of the non-voting shares in this company in the hands of the now-15-year-old Camille.

The Court (reasonably) concluded that at the time Camille first received these shares, it was not the intention of his parents that he would become the manager of valuable assets, but rather that the structure of these corporations was created as estate freeze vehicles.

In February 1981, however, Camille's mom altered the share structure of Bon so that all classes of shares had voting rights. This had the effect of transferring control of the company to Camille.

From 1980-1994 Camille managed Bon and both Camille and his mother received income from it.

By 2007 however, it appears that the mother-son relationship had grown a little chilly. Camille advised Mom that he planned to remove her as a director and officer of Bon if she did not resign voluntarily (given that he controlled the voting rights of the company).

When Mom didn't resign, the board of directors (controlled by Camille) followed through and removed her. In return, Camille's mother used her voting control of E & C to exclude Camille from the board of directors of that company.

By 2008, Mom had initiated an oppression proceeding complaining about her treatment in Bon and Camille had commenced his own oppression proceeding concerning his treatment in E & C and sought a winding up of the company.

Amidst these dueling oppression applications, the British Columbia Court of Appeal stepped into the fray.

The Bon Claim

In rejecting that corporate oppression had occurred, the Court of Appeal overturned the lower court in respect of Bon, concluding that the judge had erred in not factoring in the

corporate structure in place at the relevant time in determining what the reasonable expectations of the parties were.

In particular, the Court of Appeal relied heavily on the fact that, as of 2007, the corporate structure of Bon did not reflect the estate freeze that originally was put in place. By that point, Mom had long ago relinquished voting control of Bon to her son.

The Court of Appeal went on to conclude that while it may well have been Mom's expectation that she would control the income from Bon during her life, these expectations no longer derived from an estate freeze structure (or any other recognized legal structure) and as such it was not an appropriate case to "engage the oppression remedy to resolve this unfortunate family dispute".

The Court found that while Camille's conduct was not conducive to family cooperation, it was not corporate oppression.

The E & C Claim

In contrast, the Court of Appeal noted that the structure of E & C remained an estate freeze plan, largely as it always had. In light of the fact that the controlling votes in E & C passed to Mom from Dad upon his death, the British Columbia Court of Appeal analogized Camille's position to being the same as what the Court of Appeal for Ontario dealt with in *Naneff* – namely that he was seeking to obtain now what the estate freeze was established to provide only upon the death of his parents. Accordingly his oppression remedy appeal was dismissed.

The Moral of the Story

While an estate freeze can be an effective tax planning strategy, once the next generation of family members acquire an ownership interest in a business, it is entirely possible that family relationships may turn frosty, leading to litigation over control of the business and profits. Such litigation can lead to dramatic results that parents never would have countenanced at the time of the freeze. As a result, despite the financial savings that can arise, parties should very carefully consider the potential downsides of pursuing an estate freeze.