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PROMISSORY NOTES BETWEEN PARENTS AND THEIR MARRIED CHILDREN

When parents lend money to a married child, unintended consequences can materialize if the child's marriage breaks down. In the property equalization that occurs on a separation, a spouse's debt will benefit her because the debt has the effect of reducing her net worth. Often, parents will take back a promissory note from their child to document the loan. Documenting the loan is prudent. But if the parents and child are not careful, the transaction may be regarded as a gift rather than a loan. When that happens, the child may be penalized in the property equalization because she may not be able to deduct the amount received from her parents, from her net worth.

A CAUTIONARY TALE

Let's first look at a case in which a husband and his mother did everything wrong. In *Zanewycz v. Zanewycz*, 2010 ONSC 726 (CanLII), the judge had ample justification for being skeptical of the promissory note given by Walter Zanewycz to his mother:

- The hand written promissory note was prepared and witnessed by the husband's sister.
- The husband and his mother testified that the promissory note was prepared long after the funds were advanced and its amount was based

on their recollection of amounts advanced by the mother early in the marriage.

- The mother kept no paper records of the money advanced to the husband. She testified that “she kept all the records in her head.”
- The husband made no repayments to his mother.
- The mother never made a demand for repayment.
- The husband had no documentary evidence to counter the wife’s testimony that she had no knowledge of the alleged debt until her lawyer was given a copy of the promissory note after litigation had ensued, and that the husband must have fabricated it.

It is not surprising Warkentin J. decided that the husband had failed to prove that he was legitimately indebted to his mother.

PROPERLY PREPARING THE PROMISSORY NOTE TRANSACTION

It is tempting for family members to treat a parent-child loan casually. But *Zanewycz v. Zanewycz* illustrates that doing so leaves the transaction vulnerable when a matrimonial dispute arises. A promissory note between child and parent will be strengthened by carrying out the transaction in a careful businesslike manner.

Drafting the promissory note

A promissory note should be prepared by a lawyer to ensure that it is properly drafted and enforceable. An experienced lawyer will be able to clearly set out

the important terms which will include the amount of the loan, the interest rate (if any), and repayment terms.

A boilerplate form lifted from the internet might seem sufficient, but without legal expertise the parties will be unable to determine if it really fulfills their needs.

Interest

There is no requirement for the promissory note to bear interest, but if there is interest, the rate should not be inordinately high. If the interest rate is too high, the validity of the note may be called into question. Mesbur J. cited the “high” interest rate for rejecting the validity of a promissory note in *Lafazanidis v. Lafazanidis*, 2014 ONSC 3287 (CanLII). Thus, a rate that exceeds commercial lending rates increases the risk that a promissory note will be found to be invalid.

The promissory note should be executed when the loan is advanced

A time gap between the advance of funds and the execution of the promissory note weakens the argument that the advance was intended to be a loan. The promissory note should always be executed when the loan is advanced. In *Vhora v Vhora*, 2016 ONSC 2951 (CanLII), a promissory note purported to secure a series of loans to the husband from his father. However, the husband had not signed the promissory note until 7 months after the largest advance and 2 months after the final advance. McDermott J. decided that the husband had failed to prove that the funds paid by his father were loans.

Evidence that the parents actually advanced the money to the child

A promissory note alone, does not necessarily establish that a debt exists. A debt cannot exist unless the parent actually advances the money to the child. Therefore, it is important to maintain a paper trail as proof that the parent paid the money to the child. This is illustrated in *Lafazanidis v. Lafazanidis*, 2014 ONSC 3287 (CanLII). Despite the existence of a promissory note, Mesbur J. found that the husband failed to prove that he had received the money from his parents. The husband produced a bank deposit slip but the slip did not establish that the bank account was owned by him. The paper trail was incomplete.

A cancelled cheque from parent to child, together with the child's bank statement with a deposit entry matching the cheque, will provide evidence that the parent's money was received by the child.

Guarding against an allegation that the promissory note was fabricated
A spouse may allege that the promissory note was fabricated after matrimonial conflict arose. This is a strong possibility if the spouse is not informed of transaction at the time that it occurred. To guard against this possibility, the following steps should be taken:

- The promissory note should be witnessed by one or two reliable people who would be available to testify that the note was executed at the

proper time. To avoid an allegation of bias, the witnesses should not be related to the parents or their child.

- The child's spouse should be informed of the transaction without delay. An email to the spouse confirming the terms of the loan, with a copy of the promissory note attached, will provide evidence that the spouse was informed of the loan in a timely way. A reply from the spouse should be requested to confirm that the spouse received the email. If the promissory note was prepared by a lawyer, the lawyer could send a copy to the spouse.

A mortgage strengthens the promissory note

A promissory note that is secured by a mortgage on the child's property is more likely to be upheld. In *Barber v Magee*, 2015 ONSC 8054 (CanLII), a reason given by Fitzpatrick J. for disallowing a series of alleged loans, was that they were not secured by a mortgage. The absence of a mortgage will not necessarily be fatal, but when a mortgage is feasible, it will be strong evidence that the money was advanced as a loan.

CONTINUING VIGILANCE AFTER THE LOAN IS MADE

The behaviour of the parent and child continue to be important after the promissory note has been executed and the loan made. Their acts and omissions can influence the treatment of the promissory note by a court.

Repayments

A history of repayments on the promissory note will be strong evidence that money received from a parent is a loan rather than a gift.

No Repayments or demands

On the other hand, when no repayments are made and the parent makes no effort to collect, the validity of the promissory note may be called into question. In *Tran v Le*, 2016 ONSC 8098 (CanLII), the wife's mother and uncle advanced money to her in exchange for promissory notes. But the mother and uncle never asked her to pay anything on account of the promissory notes. Aston J. decided that the wife had not proved that any debts actually existed.

Was the debt forgiven?

Parents should guard against any behavior that might be construed as forgiving the debt. They should avoid making statements that they don't expect repayment. Sometimes parents explicitly forgive a child's debts in their wills. Such a provision could lead a court to conclude that there was no expectation of repayment and the debt was forgiven even while the parents are still alive. If the debt is forgiven, the child will be unable to deduct it in the property equalization.

Discounting the debt

Even if a promissory note is valid and has not been forgiven, the debt may be discounted if there is a low probability that the parents will collect it. Discounting

the debt will result in the child receiving only a partial benefit in the property equalization. Often the discount is very large. Some examples are:

- 90% discount in *Poole v. Poole*, 2001 CanLII 28196 (ON SC)
- 95% discount in *Cade v. Rotstein*, 2002 CanLII 2811 (ON SC)
- 100% discount in *M.B. v. D.T.*, 2012 ONSC 840 (CanLII)

Factors that have induced judges to discount a promissory note debt include:

- Parents did not demand payment until the husband and wife separated.
- The loan was old and the parents were elderly and in poor health.
- The parents did not need the money.
- The parent stated that he would never take action to collect the debt.
- The child did not include the debt to his parents on applications for credit with a bank, leading to an inference that the he felt that he would not actually have to repay his parents.
- The child did not intend to repay his parents.

Limitation Period for Promissory Notes Payable on Demand

As noted above, if a parent makes no demand for payment before the husband and wife separate, the promissory note may be weakened. However, making a demand on a promissory note, may create a dilemma by triggering a limitation period. The limitation period on a demand promissory note expires 2 years after a demand is made. Once the limitation period expires, the promissory note can

no longer be enforced. In that case, the child will be unable to deduct the loan in the property equalization. The steps that may be taken to avoid this result are beyond the scope of this article. A parent who is contemplating making a demand on a promissory note should obtain legal advice before making the demand.

LESSONS LEARNED

In seeking to make the promissory note impregnable, we can cull an overarching theme from the case law. The closer the parent-child transaction resembles a business transaction between a lender unrelated to the borrower, the stronger it is. Family members lose protections that commercial parties take for granted when they fail to observe important formalities and take shortcuts.

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