

**BUSINESS LAW FOR TRUST AND ESTATES LAWYERS:
EFFECTIVE SUCCESSION PLANNING TO MINIMIZE THE RISK OF
LITIGATION**

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PROMISSORY NOTES

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Promissory Notes

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1. INTRODUCTION

Promissory notes are credit instruments typically used in connection with sales financing and business loans.¹ While their legal development is largely within the context of commercial trade and financing, they are used in a variety of contexts that affect estates law. This paper introduces the basic legal requirements of promissory notes through case law and other legal commentary to demonstrate their application to the estates context.

2. WHAT IS A PROMISSORY NOTE?

Promissory notes belong of a class of contracts known as negotiable instruments, together with bills of exchange, cheques, drafts and certificates of deposit. Each type of negotiable instrument has specific formalities that must be met in order to be valid. Generally a negotiable instrument is transferable by delivery, thereby enabling a transferee to take the instrument free of defects and bring an action to enforce the instrument, if necessary.²

Although the legal parameters of promissory notes developed in common law, they have been statutorily regulated for some time.³ In Canada, they are governed by the *Bills of Exchange Act*⁴ (the “**BEA**”), which provides that they are unconditional promises in writing, made by one or more persons to another, engaging to pay a certain sum of money subject to certain requirements as to the promise.⁵ The note must be signed by the promisor and can be payable to either the person holding a note or to a person specified in the note.⁶ Furthermore, a note may be

¹ Bradley Crawford, *The Law of Banking and Payment in Canada*, loose-leaf (Toronto: Canadian Law Book, 2012); Ian F. G. Baxter, *The Law of Banking*, 4th ed. (Toronto: Carswell, 1992) at 43.

² Crawford, *ibid.* at ¶ 20:20.10.

³ See e.g. *Bills of Exchange Act 1882*, 1882 c. 61 45 & 46 Vict (U.K.).

⁴ *Bills of Exchange Act*, R.S.C., 1985, c. B-4 [BEA].

⁵ Baxter, *supra* note 1 at 43; BEA, *ibid.* ss. 176(1) & 179 (s. 179 provides that a promissory note may have two or more makers who will be jointly liable or jointly and severally liable according to the note). For the purposes of this paper, unless stated otherwise, promissory notes will be discussed in the context of having only one maker.

⁶ For ease of reference, the person who makes a promissory note is the “*promisor*”, the person who endorses a promissory note is the “*endorser*”, the person who holds a promissory note is the “*bearer*”, and the person who is meant to receive the payment (if not the *bearer*) the “*payee*”.

payable on demand (a “**demand note**”) or at a future date that is either fixed or determinable (a “**term note**”).

176. (1) A promissory note is an unconditional promise in writing made by one person to another person, signed by the maker, engaging to pay, on demand or at a fixed or determinable future time, a sum certain in money to, or to the order of, a specified person or to bearer.⁷

There is a *prima facie* presumption that the bearer (the person who holds a note and who is meant to receive the payment), has good title. When a note is transferred to another person in accordance with certain conditions, the holder may become a “holder in due course” and will be free from defenses which would apply to the original promisor, such as defective goods or fraud.⁸

The courts have confirmed the contractual nature of promissory notes in the estates context. In *Hutton v. Lapka Estate*⁹ (“**Hutton**”) the British Columbia (“**BC**”) Court of Appeal confirmed that forgiving a promissory note in a will is not tantamount to a testamentary disposition. In *Hutton*, one of the issues heard by the court concerned an interest-free promissory note signed in favour of the testatrix before her death to secure a loan for a land purchase by her grandson. The will specified that the note was to be forgiven when the testatrix died, but the trial judge held that the forgiveness provision was ineffective because the note constituted a testamentary disposition and thereby violated the prohibition imposed by the *Wills Act* (BC)¹⁰ against testamentary gifts to attesting witnesses.¹¹ Because the grandson was a witness to the execution of her will, the BC Supreme Court considered the forgiveness provision in the will to be void.¹²

The BC Court of Appeal disagreed with the lower court’s assessment and found instead that it was a contract which had immediate effect. The Court held that the forgiveness clause should not be considered in isolation from the provisions of the note as a whole, and did not require separate consideration. The consideration received by the testatrix was the promisor’s promise to pay; therefore the requirement for contractual consideration was satisfied and

⁷ *BEA, ibid.* s. 176(1).

⁸ *BEA, ibid.* s. 55(1); “Holder in due course” is discussed at greater length below in section 2.5.

⁹ *Hutton v. Lapka Estate* (1991), 5 B.C.A.C. 222, 1991 CarswellBC 327 [*Hutton BCCA*].

¹⁰ *Wills Act*, R.S.B.C. 1979, c. 434, s. 11(1).

¹¹ Similar to s. 12 of the *Succession Law Reform Act*, R.S.O. 1990, c. S.26.

¹² *Hutton v. Lapka Estate*, 1988 CarswellBC 1343 at paras. 90-95.

pursuant to the forgiveness clause in the will, the grandson had been relieved of the debt evidenced by the note.¹³

2.1. Promise to pay

It is not required that a promissory note include the specific phrase “promise to pay”, but it must include language that clearly undertakes payment.¹⁴ In *Srinivas v. Panchapakesan*¹⁵ (“*Srinivas*”) the Ontario Court of Justice commented the following:

The defendant ... argued that the Note does not contain a promise to pay and is therefore not a true promissory note, but rather a mere receipt. I disagree. The promise to repay is, in my view, clear from the reference to the money being “on loan for a period of one year” as well as the statements that the interest payments “will be made” and that the balance of interest and principal “will be repaid”. It is not necessary to use the specific words “I promise to pay” in order to create a promissory note. If the words used are the equivalent of a promise to pay, that will suffice.¹⁶

Similarly, the requirement for a promissory note to undertake payment is reflected in the Ontario Court of Appeal decision in *McCauley v. Fitzsimmons*¹⁷ (“*McCauley*”). This case concerned a dispute between the active and retired beneficiaries of a benevolent fund set up by union members of the City of Toronto Fire Department in 1918 to provide members with money for burial. By the mid-1990s the fund had become untenable and the union resolved to collapse it with a limited payout to the beneficiaries. Union pensioners opposed the limit on the payout and argued that the letter they received on retirement (or withdrawal from service) regarding the status of their entitlement under the fund constituted a promissory note, and that they were entitled to payment of those notes when due. The following excerpt is an example of one of the letters sent to the pensioners:

Dear Brother Herb,

Enclosed please find a cheque in the amount of \$1,559.92. This represents twenty percent of your Benevolent Fund entitlement. Method of payment was passed by the members of Local 113 at a Union meeting held May 8, 1980. Payment is based on the year

¹³ *Hutton BCCA*, *supra* note 9 at paras. 72-79.

¹⁴ *Crawford*, *supra* note 1 at ¶ 35:10.29

¹⁵ *Srinivas v. Panchapakesan* (1996), 3 O.T.C. 81, 1996 CarswellOnt 1657 (Gen. Div.) [*Srinivas*].

¹⁶ *Srinivas*, *ibid.* at para. 30.

¹⁷ *McCauley v. Fitzsimmons* (1998), 112 O.A.C. 293, 1998 CarswellOnt 3589 (C.A.) [*McCauley ONCA*].

base rate, which is \$6,324.00. This amount is divided by 30 years and then multiplied by your number of completed years which is 37 years. The remainder of your entitlement in the amount of \$6,239.68 will be payable to you at age 65 or to your beneficiaries upon your death, whichever is first.

We wish to remind you that this money is income tax free, and does not have to be declared upon your income tax return. Congratulations on your retirement, we wish you good health and the very best in your years ahead and in your future endeavours.

¹⁸
...

The trial judge recognised that the fund constituted a trust, but rejected the argument that the letters were promissory notes. The Court held instead that they could be enforced against the trust on different grounds.¹⁹

Overturning the lower court ruling, the Ontario Court of Appeal held that the primary issue was how the fund could be distributed in the most equitable way possible for all members regardless of their employment status.²⁰ With respect to the pensioners' position that the letters were promissory notes, the Court commented the following:

I agree with the judge below that the letter sent to retiring or withdrawing members is not a promissory note. It is clearly intended as a simple statement of a future fact. It was not intended to be, and did not constitute a promise to pay. Nothing in the letter suggests any intention on the part of anyone to create a contract or contractual relations. There was no promise to pay anything — simply a statement that the balance of the addressee's entitlement would be payable to him or her at age 65, or upon death, whichever happened first.²¹

2.2. Unconditional promise

A promissory note is required to be an unconditional promise to pay.²² The general principal is that a note cannot contain any words that limit the promise or impose conditions at odds with the *BEA*,²³ however it is possible that the note be made with reference to a fixed period

¹⁸ *McCauley v. Fitzsimmons*, 25 O.T.C. 124, 1997 CarswellOnt 5729 at para. 11 (Gen. Div.) [*McCauley*].

¹⁹ *BEA*, *supra* note 4, s. 176(1), *McCauley*, *ibid.* at para. 32.

²⁰ *McCauley ONCA*, *supra* note 17 at para. 53.

²¹ *McCauley ONCA*, *ibid.* at para. 44.

²² *Lecomte v. O'Grady* (1918), 57 S.C.R. 563, 1918 CarswellMan 71, *Shaw v. Agnew*, [1941] 2 D.L.R. 587, 1941 CarswellOnt 9 at para. 18.

²³ Crawford, *supra* note 1 at ¶ 22:20.10 .

or an event that is certain to occur.²⁴ So, like the requirement to be payable on demand or on a specified date, other triggering events for payment can be a term of the note as long as they don't impose on the requirement for an unconditional promise to pay.

In *Shaw v. Agnew*²⁵ (“**Shaw**”) the Ontario Court of Appeal confirmed the requirement for unconditionality and held that a note marked as “collateral security” failed to meet this requirement. Writing for the Court, Gillanders J.A. commented the following:

I am of opinion that the document signed by the defendant was not a promissory note nor in the form signed by him could it have become a promissory note by virtue of delivery. The defendant himself inserted the provision “This note to be held as security for cheques given.” The effect of this provision was, I think, to attach a condition by which it was not payable absolutely and unconditionally, but was limited to being collateral security for the payment of the cheques given to the plaintiff. The effect of similar words has been considered in other cases.²⁶

Evidently, any language that imposes a condition on payment will render the note unconditional and therefore not negotiable or enforceable as a promissory note.²⁷

Determining whether a note contains a forbidden condition will require legal interpretation where it is not immediately apparent on a plain reading.²⁸ The Supreme Court of Canada has provided interpretive guidance in *Canada v. McLarty* (“**McLarty**”) where Rothstein J. stated that the “test is simply whether a legal obligation comes into existence at a point in time or whether it will not come into existence until the occurrence of an event which may never occur.”²⁹ The focus of the analysis being on the uncertainty of whether an event may or may not occur, and the uncertainty of whether a liability depends for its existence upon whether that event may or may not happen.³⁰ Rothstein J. further clarified the kinds of uncertainty that, on their own, would not determine whether a liability is contingent:

- a. Uncertainty as to whether the payment will be made. For example, a liability may be incurred when the taxpayer is in financial difficulty and there is a significant risk of non-payment. That does not mean the obligation was never incurred;

²⁴ *BEA*, *supra* note 4, s. 23(b).

²⁵ *Shaw v. Agnew*, [1941] 2 D.L.R. 587, 1941 CarswellOnt 9 (CA) [*Shaw*].

²⁶ *Shaw*, *ibid.* at para. 16.

²⁷ See *contra Lecomte v. O'Grady* (1918), 57 S.C.R. 563 at para 6.

²⁸ Crawford, *supra* note 1 at ¶ 35:10.10.

²⁹ *Canada v. McLarty*, 2008 SCC 26, [2008] 2 S.C.R. 79 [*McLarty*].

³⁰ *McLarty*, *ibid.* at para. 17.

b. Uncertainty as to the amount payable. There is always uncertainty as to the amount that may be payable. There is never certainty that the borrower will be able to pay the amount owing when the note comes due. That type of uncertainty does not make a liability contingent;

c. Uncertainty as to the time by which payment shall be made. An obligation is not contingent because payment may be postponed if certain events occur.³¹

In the context of trusts, where a trustee undertakes to pay a note absolutely but is limited in the ability to pay by the adequacy of the value of the trust's assets, the instrument would likely be contingent and therefore not be negotiable.³²

2.3. Liability

A promissory note is incomplete until delivered to the payee or bearer.³³ Generally, the promisor (the maker of the note), engages to pay the note according to its tenor and may not deny the note holder's capacity to endorse³⁴ the note in due course. The promisor of the note has primary liability for its fulfilment and endorsers have secondary liability.³⁵

Where a promissory note has two or more promisors,³⁶ liability becomes a question of interpretation. The *BEA* provides that where the note includes the words "*I promise to pay*" and is signed by more than one party, then liability is deemed to be joint and several.³⁷ Otherwise, the court will analyze the language of the note to determine liability between the parties.

Estate trustees should be mindful of the liability they incur in entering contractual obligations on behalf of the estate.³⁸ Efforts to limit their personal liability must be carefully

³¹ *McLarty, ibid.* at para. 18.

³² Crawford, *supra* note 1 at ¶ 22:10.10(2)(c); See contra *Royal Securities Corp. v. Montreal Trust Co.*, [1967] 1 O.R. 137, 1966 CarswellOnt 150 (H.C.J.) (where the Ontario High Court of Justice expressed a contrary view of the validity of a note secured by a trust indenture, stating that ss. 21(1) and 176(3) deal specifically with notes that may be non-negotiable or secured), *aff'd* [1967] 2 O.R. 200, 1967 CarswellOnt 97 (C.A.).

³³ *BEA, supra* note 4, s. 178.

³⁴ To "endorse" (or "indorse" in UK) means either to accept responsibility for paying an obligation memorialized by the instrument or to make the instrument payable to someone other than the payee. "Endorsement" of a note consists of the signature of the endorser and the delivery of the note to another party with the intention to pass on the property by doing so. This is discussed at greater length below under section 2.4.

³⁵ *BEA, supra* note 4, s. 186(2).

³⁶ As permitted by s. 179 of the *BEA*; See *supra* note 3.

³⁷ *BEA, supra* note 4, s. 179(2).

³⁸ M.C. Cullity, "Personal Liability of Trustees and Rights of Indemnification" (1996) 16 E.T.J. 115, cited in Suzana Popovic-Montag, "Revisiting a Trustee's Right to Indemnification" (2003) 50 E.T.R. (2d) 161 (WL).

considered and deliberate.³⁹ It has traditionally been held that a trustee usually incurs personal liability to the fullest extent when contracting with third parties in respect of a trust or estate.⁴⁰ The general rule is that a trustee is entitled to full indemnification out of the trust property for all costs, expenses and liabilities properly incurred in the administration of the trust.⁴¹ However, although a trustee may attempt to limit contractual liability to the value of the trust assets, or to the extent that a right of indemnity exists only against such assets, his or her ability to do so will depend upon the terms of the contract with the third party.⁴²

There must be some indication of a joint intention of the parties to limit the personal liability of the trustee. If a trustee covenants “as trustee and not otherwise” or “*qua* trustee only”,⁴³ there is a personal liability to pay, but only out of the assets of the trust or estate, and only to the extent of his or her assets for the duration in which he or she administers the estate.⁴⁴ In *Gordon v. Roebuck*⁴⁵ (“**Gordon**”), promissory notes containing the words “*in trust*” after the Trustee’s name on the signature page were found to be sufficient to indicate an intention to exclude personal liability.⁴⁶

2.4. Endorsement

The meaning of “endorse” is not defined in the *BEA*, but the term refers to either accepting responsibility for paying a promissory note or to make the instrument payable to someone other than the payee.⁴⁷ The term “endorsement” is defined in the *BEA* as “endorsement completed by delivery”,⁴⁸ which refers to the transfer of liability or benefit from one party to another completed by an exchange of possession.

Case law has discussed that the endorsement of a note consists of the signature of the endorser and the delivery of the note to another party with the intention to pass on the property

³⁹ Popovic-Montag, *ibid.*

⁴⁰ *Watling v. Lewis*, [1911] 1 Ch. 414 (Eng. Ch. Div.) at 423 [*Walting*].

⁴¹ *Goodman Estate v. Geffen*, [1991] 2 S.C.R. 353, 1991 CarswellAlta 91 at para. 75.

⁴² *Gant v. Hobbs*, [1912] 1 Ch. 717 (Eng. C.A.) at 728.

⁴³ Or, similarly, if an executor covenants “as executor”, and “as executor only”.

⁴⁴ Popovic-Montag, *supra* note 38, citing John Delatre Falconbridge, *Falconbridge on Mortgages*, 4th ed. (Agincourt, Ontario: Canada Law Book, 1977) at 428-9.

⁴⁵ *Gordon v. Roebuck*, 92 D.L.R. (4th) 670, 1992 CarswellOnt 1719 [*Gordon*].

⁴⁶ *Gordon*, *ibid.* at paras. 15-16.

⁴⁷ See e.g. Bryan A. Garner (ed.), *Black’s Law Dictionary*, 8th ed. (St. Paul, Minnesota: Thompson West, 2004) at 789, where “indorse” is defined as “either to accept responsibility for paying an obligation memorialized by the instrument or to make the instrument payable to someone other than the payee”.

⁴⁸ *BEA*, *supra* note 4, s. 2.

by doing so.⁴⁹ It has also been held that although a bill is usually endorsed by signing the back of it, an endorsement may be on any part of the note, including its face.⁵⁰

An endorsement must be completed by delivery, and the *BEA* lays out the endorser's liability as follows. By endorsing a note, the endorser:

(a) engages that on due presentment it shall be accepted and paid according to its tenor, and that if it is dishonoured he will compensate the holder or a subsequent endorser who is compelled to pay it, if the requisite proceedings on dishonour are duly taken;

(b) is precluded from denying to a holder in due course the genuineness and regularity in all respects of the drawer's signature and all previous endorsements; and

(c) is precluded from denying to his immediate or a subsequent endorsee that the bill was, at the time of his endorsement, a valid and subsisting bill, and that he had then a good title thereto.⁵¹

2.5. Holder in Due Course

Where a note has been transferred to a third party, it is generally accepted that the promisor should be held to the letter of his or her obligation and be prevented from setting up defences to undermine the apparently absolute nature of the obligation.⁵² Such a bearer is termed a "holder in due course", and is defined in the *BEA* as follows:

55. (1) A holder in due course is a holder who has taken a bill, complete and regular on the face of it, under the following conditions, namely,

(a) that he became the holder of it before it was overdue and without notice that it had been previously dishonoured, if such was the fact; and

⁴⁹ *McKenty v. Vanhorenback* (1911), 19 W.L.R. 184, 1911 CarswellMan 129, cited in John D. Gardner & Karen M. Gardner, *Sanagan's Encyclopedia of Words and Phrases Legal Maxims Canada*, 5th ed. (Toronto: Carswell, 2005) at E-42 [*Sanagan's*].

⁵⁰ *A. D. Gorrie Co., Ltd. v. Whitfield and Michaud* (1920), 58 D.L.R. 326, 1920 CarswellOnt 165, cited in *Sanagan's, ibid.*

⁵¹ *BEA, supra* note 4, s. 132(1).

⁵² *Federal Discount Corp. v. St. Pierre* (1962), 32 D.L.R. (2d) 86, 1962 CarswellOnt 146 at para. 24 (C.A.) [*Federal Discount*].

(b) that he took the bill in good faith and for value, and that at the time the bill was negotiated to him he had no notice of any defect in the title of the person who negotiated it.⁵³

Developed in merchant law, a “holder in due course” enjoys special privileges which a promisor does not. In *Federal Discount Corp. v. St. Pierre*⁵⁴ (“*Federal Discount*”) the Ontario Court of Appeal discussed this privileged position distinguishing the rights accruing to the holder in due course, of a promissory note from other contractual obligations:

The rights which accrue to a holder in due course of a bill of exchange are unique and distinguishable from the rights of an assignee of a contract which does not fall within the description of a bill of exchange. The assignee of a contract, unlike the holder in due course of a bill of exchange, takes subject to all the equities between the original parties, which have arisen prior to the date of notice of the assignment to the party sought to be charged.⁵⁵

However, in *Federal Discount* the Ontario Court of Appeal imposed limitations on this privilege to accommodate changes in modern society. The Court held that the relationship between the promisor (the maker of the note) and the transferee must be considered in assessing the legitimacy of a claim to be a holder in due course,⁵⁶ and where there is a “close connection” between them the endorser may be considered not to qualify as a holder in due course.

Subsequent case law indicates that courts will be weary of situations where a note has been exchanged between parties for the purpose of enabling the transferee bearer to avoid defences that would otherwise have been available to the promisor of the note. If a court finds this to be the situation it will apply the doctrine of “close connections” to disqualify the bearer as a holder in due course.⁵⁷

2.6. Defences

Defences, other than the doctrine of “close connection” articulated in *Federal Discount*, may include incapacity to incur contractual liability (such as by corporate actors without signing

⁵³ *BEA*, *supra* note 4, s. 55(1).

⁵⁴ *Federal Discount*, *supra* note 52.

⁵⁵ *Federal Discount*, *ibid.* at para. 22.

⁵⁶ *Federal Discount*, *ibid.* at paras. 26, 37-39.

⁵⁷ Crawford, *supra* note 1 at ¶ 23:50.30-23:50.40; Part V of the *BEA* was enacted partially to legislate the doctrine of close connection articulated in *Federal Discount*.

authority, minors and legal incompetents); forgery, fraud or illegality that renders the obligation void;⁵⁸ an ineffective delivery of the instrument (such as where it is blank or incomplete); material alteration of the instrument, and; discharge of the instrument by payment in due course, surrender, renunciation at or after maturity, or by cancellation.

In *Kirkham v. Kirkham Estate*⁵⁹ (“**Kirkham**”) the beneficiaries of an estate commenced an action against the estate, the deceased’s ex-wife and others, seeking to have a motor home (which was held by the ex-wife and the deceased jointly at the date of the deceased’s death) returned as property of the estate, and the estate trustee claimed against the ex-wife to enforce a promissory note, signed by her, in which she agreed to pay the deceased or his estate an amount before a certain date. The BC Supreme Court found that because the promissory note was made by the ex-wife for the benefit of the deceased, the beneficiaries did not have a right to enforce the note directly. The Court further rejected the beneficiaries’ allegations that the will made an inadequate provision of support, noting their intention to affect a wills variation that would result in the enforcement of the promissory note. The Court did recognise the argument of the executor of the estate who held the promissory note on behalf of the estate as payee of the note, but found in favour of the defendant on the basis that the contractual requirements had not been met.⁶⁰

The Court commented that promissory notes remain contractual obligations subject (with few exceptions) to all the normal defenses that may be raised on any action upon a contract. After analysing whether the requirements of a contract were present, the Court found that the defendant had not received any consideration for making the promissory note:

The testator realized that the defendant wanted only the house and had never wanted the motorhome. He clearly changed his will to leave her the house after full consideration that this had been their understanding from an early time in the relationship. He voluntarily altered the will on January 4th, 1992 to reflect this understanding. The defendant’s signature of the promissory note and the "Dear Brennetta" letter were expressions of her voluntary agreement to convert the motorhome to money and to pay it over to the estate. There is no evidence of a reciprocal undertaking or consideration for the promise to pay. The gratuitous promise of the

⁵⁸ *BEA*, *supra* note 4, s. 55(2).

⁵⁹ *Kirkham v. Kirkham Estate*, [1996] B.C.W.L.D. 1887, 1996 CarswellBC 1410 [*Kirkham*].

⁶⁰ *Kirkham*, *ibid.* at para. 16-17, 19, 23, 25.

defendant under the letter and the promissory note is unenforceable.⁶¹

The *Kirkham* decision illustrates the basic contractual requirement for consideration to be received in exchange for a promissory note. Where it can be demonstrated that consideration has not been received, this may constitute a defence for the promisor of the note.

2.7. TAX CONSIDERATIONS

Issues that arise for promissory notes in the tax context often come down to the interpretation of specific provisions of the applicable tax law. The *McLarty* case discussed above is a good illustration of this. It concerned subsection 66.1(6) of the *Income Tax Act*⁶² (“*ITA*”), which permits a deduction for Canadian exploration expenses to taxpayers who had made themselves absolutely liable. It was necessary for the Supreme Court of Canada to first determine that the obligation made by the taxpayer was absolute, and constituted a legitimate promissory note, in order for it to find that the provision applied.⁶³

The Canada Revenue Agency (“**CRA**”) has made statements on how promissory notes will be treated in the taxation of trusts. The CRA instructs that a promissory note should only be issued to a beneficiary by a trust as evidence of an amount payable where permitted by the trust indenture. While it is accepted that the note may be non-interest bearing, it must satisfy the requirement of being payable on demand without restriction. For reporting purposes, the promissory note should also be delivered to the beneficiary before the end of the year where the amount payable to the beneficiary is known. If it is not possible to determine the amount payable until after the end of the trust's taxation year, then the promissory note should be delivered to the beneficiary immediately.⁶⁴

One estate planning context where promissory notes are used is a post-mortem tax planning technique referred to as a “pipeline”. This structure typically aims to avoid double taxation by ensuring or preserving either dividend treatment or capital treatment to an estate in respect of the distribution of funds to an estate from a company owned by the deceased at death.

⁶¹ *Kirkham, ibid.* at para. 36; However the defendant reiterated her intention to return the motorhome regardless of her legal obligation, and the estate received it back in spite of the claim.

⁶² *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.).

⁶³ *McLarty, supra* note 29; See similarly *Canada v. Huanz and Danczkay Ltd.* (2000), 54 D.T.C. 6549 (F.C.A.).

⁶⁴ Canada Revenue Agency, Doc. 2012-0444891C6, “CTF Prairie Conference—trust payment to minor” (May 28, 2012).

This is done by distributing the property of a corporation to an estate or beneficiary as a creditor of the company, not as a shareholder.

The Tax Court of Canada recently discussed the use of such structures in *MacDonald v. The Queen*⁶⁵ (“*MacDonald*”) where it provided the following illustration of how a post-mortem pipeline will typically operate:

The estate transfers the shares of the company that were owned by the deceased at death (the “deceased’s company”) to [a newly formed] holding company. The consideration for the transfer is a note equal in value to the [fair market value] of the transferred shares, which does not trigger a capital gain given the estate’s high [adjusted cost base] in the shares of the deceased’s company. The deceased’s company pays a liquidating dividend to the holding company, which uses the funds to pay the note held by the estate. This avoids double tax: the retained earnings of the deceased’s company have only been taxed once, as a capital gain to the deceased in the year of death.⁶⁶

The CRA has approved of pipeline structures where the existing holding corporation (owned by a deceased person) will not be amalgamated with, or wound-up into, the new corporation until at least one year has elapsed, and no repayment of the promissory notes issued by the new corporation would be made until after the amalgamation or winding-up.⁶⁷ Violation of these conditions would result in administrative challenges pursuant to subsection 84(2) of the *ITA*. In *MacDonald* the Tax Court indicated that the CRA’s conditions are arbitrary, amounting to a “contrived smell test” unwarranted by the express language of that provision. The decision has been appealed and yet to be heard by the Federal Court of Appeal,⁶⁸ so it is not certain exactly how pipeline structures will continue to develop or be treated by the CRA in the future.

3. HOW AND WHEN TO CALL

A promissory note may be called either at the end of the term indicated in the note, or at a time decided by the bearer if it is a demand note. To be enforceable, a note must be duly

⁶⁵ *MacDonald v. The Queen*, 2012 TCC 123 [*MacDonald*].

⁶⁶ *MacDonald*, *ibid.* at para. 76.

⁶⁷ Canada Revenue Agency, Doc. 2011-0401811R3, “Post-Mortem Tax Planning” (2011).

⁶⁸ Tax Court of Canada, Current Appeals Docket, online: Canada <http://cas-ncr-nter03.cas-satj.gc.ca/tcc_docket/search_e.php>

presented for payment by the bearer to the promisor at the place specified in the note or at the promisor's place of business or residence.⁶⁹

Unless specifically waived,⁷⁰ the general rule is that the note must be presented for payment promptly on maturity or the promisor and endorsers will be discharged:

85. (1) A bill is duly presented for payment that is presented when the bill is

(a) not payable on demand, on the day it falls due; or

(b) payable on demand, within a reasonable time after its issue, in order to render the drawer liable, and within a reasonable time after its endorsement, in order to render the endorser liable.⁷¹

However, the *BEA* provides that failure to present a term promissory note on the day of maturity does not discharge the promisor, but does give him or her the right for a discretionary award of costs by the Court if an action for enforcement is initiated against him or her.⁷²

Where liability for a note has been endorsed, the note must be presented for payment at the place specified in the note in order to render the endorser of the note liable.⁷³ Otherwise, if no time for payment is specified in the note, it will be deemed payable on demand.⁷⁴

If on presentment a note is not accepted or can't be paid, it will be considered "dishonoured"⁷⁵ and an immediate right of recourse will accrue to the bearer of the note or holder in due course.⁷⁶

3.1. Reasonable Time

The definition of "reasonable time" is important for a demand note where liability has been endorsed. The *BEA* provides that the interpretation of what is reasonable is determined by

⁶⁹ *BEA*, *supra* note 4, ss. 84, 86, 87, 183.

⁷⁰ *BEA*, *ibid.*, ss. 33(b), 91(e).

⁷¹ *BEA*, *ibid.*, s. 85; See also s. 180.

⁷² *BEA*, *ibid.*, s. 183(2).

⁷³ *BEA*, *ibid.*, s. 184.

⁷⁴ *BEA*, *ibid.*, s. 22.

⁷⁵ *BEA*, *ibid.*, s. 94(1) a note may otherwise be dishonoured where presentment has been excused and the note is overdue and unpaid. The implications for dishonouring a note will change in the *BEA* according to whether notice was given or whether the dishonoured note was subsequently accepted. See *BEA*, ss. 36, 55, 71, 78-82, 95-125, 129, 132-135, 146, 152, 161.

⁷⁶ *BEA*, *ibid.*, s. 94(2).

the nature of the instrument and the usages of trade and the facts of the particular case.⁷⁷ However, there is little case law that illustrates the application of this principle. In the leading case *Cliff v. Devlin*⁷⁸ (“*Cliff*”), the New Brunswick County Court commented the following:

I think that the reason for the provision in s. 180 is that the endorser has a right to expect that he will not be prejudiced by undue delay, as he has an interest in knowing at an early date whether the maker will pay the note; otherwise a postponement, delay or neglect in making demand would extend unreasonably the period of the endorser's liability and increase the risk that the maker might not be able to pay the note when it is presented because of many reasons, such as loss of employment, or because he has lost or dissipated his assets by the time demand has been made. Hence the necessity for the provision in s. 181 requiring the assent of the endorser to deliver the note as a collateral or continuing security.⁷⁹

An endorser should not remain liable on the instrument for an unreasonable length of time unless the endorser assented to a continuing security. The promisor, however, does not receive benefit of the same qualification. If the note has been transferred and retained for an unreasonable time since issue before presentment, the *BEA* provides that in the hands of a holder in due course the note is not deemed to be overdue.⁸⁰ Furthermore, the *BEA* only refers to the time lapsed since issue, so in keeping with the *Cliff* decision, it would appear that the note will continue to be current until the evidence on its face is that a reasonable time has elapsed, the holder has made a demand or the imposition of a limitations period.⁸¹

4. LIMITATIONS

The current *Limitations Act, 2002* (Ontario)⁸² came into effect on January 1, 2004 consolidating numerous existing limitation periods under one statute. The former statute⁸³

⁷⁷ *BEA, ibid.*, s. 180(2).

⁷⁸ *Cliff v. Devlin*, [1953] 1 D.L.R. 627, 1952 CarswellNB 28 (County Ct.) [*Cliff*].

⁷⁹ *Cliff, ibid.* (statutory references are to *Bills of Exchange Act*, R.S.C. 1927, c. 16.).

⁸⁰ *BEA, supra* note 4, s. 182.

⁸¹ Crawford, *supra* note 1 at ¶ 35:60.30.

⁸² *Limitations Act, 2002*, S.O. 2002, c. 24, Sched. B.

⁸³ *Limitations Act*, R.S.O. 1990 c. L. 15.

imposed a six year limitation period on demand notes,⁸⁴ but the *Limitations Act, 2002* provides for a basic limitation period of two years subject to the doctrine of discoverability.⁸⁵

In *Hare v Hare*⁸⁶ (“**Hare**”) the Ontario Court of Appeal examined limitation periods in the context of demand obligations. In that case, the creditor made a loan to the debtor in 1997 and the debtor stopped making payments in 1998. In 2004, the creditor sent a demand letter that was subsequently refused. In 2005, when the creditor initiated an action, the issue before the court was to determine when the claim was discoverable.

The plaintiff argued that the claim was not discoverable until the demand letter had been sent and the payment refused, thus satisfying the new two year limitation period. The defendant argued that the claim was discovered when the promissory note was issued, meaning that the former six year limitation period would apply and the claim would be statute-barred.⁸⁷ The Court of Appeal found in favour of the defendant and held that the claim was discovered when the promissory note was issued.⁸⁸

The *Limitations Act, 2002* has subsequently been amended to address the issue raised in *Hare*. The newly added subsection 5(3) provides that “the day on which injury, loss or damage occurs in relation to a demand obligation is the first day on which there is a failure to perform the obligation, once a demand for the performance is made”. In *Bank of Nova Scotia v. Williamson*⁸⁹ (“**Williamson**”), the Ontario Court of Appeal commented the following about the added section:

This amendment demonstrates the intent of the legislature that for all demand obligations, a demand is a condition precedent for the commencement of the limitation period. The legislature may be taken to have recognized that this puts the creditor in the position to extend the limitation period by failing to make a prompt demand. However, it creates more certainty in establishing the commencement date for the limitation period. Although this new section does not affect this case, it affirms the law regarding third party demand guarantees.⁹⁰

⁸⁴ *Limitations Act, ibid.*, s. 45(1)(b).

⁸⁵ *Limitations Act, 2002, supra* note 83, ss. 4, 5.

⁸⁶ *Hare v Hare*, 2006 CarswellOnt 7859, 83 OR (3d) 766.

⁸⁷ See *Limitations Act, 2002, supra* note 83, s. 24(5).

⁸⁸ *Limitations Act, 2002, ibid.*, s. 50.

⁸⁹ *Bank of Nova Scotia v. Williamson*, 2009 ONCA 754, 2009 CarswellOnt 6633 at para. 19 [*Williamson*].

⁹⁰ *Williamson, supra* note 87 at para. 19.

4.1. Tolling Agreements

A tolling agreement is an agreement between parties to waive a right to make claim that litigation should be dismissed as statute-barred. Such agreements are often used to permit a party additional time to assess and determine the viability of its claims, or assess damages, without the necessity of filing an action. It may otherwise be used to permit a debtor further time to establish financing or other methods of repaying a debt without the creditor losing its ultimate right to sue for enforcement. In general, tolling agreements have been endorsed as being consistent with judicial economy.⁹¹

Subsection 22(1) of the *Limitations Act, 2002* expressly prohibits parties from contracting out of a statutory limitation period subject to specific exceptions provided for in the act:

22. (1) A limitation period under this Act applies despite any agreement to vary or exclude it, subject only to the exceptions in subsections (2) to (6).

(2) A limitation period under this Act may be varied or excluded by an agreement made before January 1, 2004.

(3) A limitation period under this Act, other than one established by section 15, may be suspended or extended by an agreement made on or after October 19, 2006.

(4) A limitation period established by section 15 may be suspended or extended by an agreement made on or after October 19, 2006, but only if the relevant claim has been discovered.

(5) The following exceptions apply only in respect of business agreements:

1. A limitation period under this Act, other than one established by section 15, may be varied or excluded by an agreement made on or after October 19, 2006.

2. A limitation period established by section 15 may be varied by an agreement made on or after October 19, 2006, except that it may be suspended or extended only in accordance with subsection (4).

(6) In this section,

⁹¹ “Recommendations for a New Limitations Act”, *Report of the Limitations Act Consultation Group* (Toronto: Ministry of the Attorney General, March 1991) at 46, cited in Graeme Mew, *The Law of Limitations*, 2d ed. (Toronto: LexisNexis Butterworths, 2004) at 26-27; See *Tolofson v. Jensen*, [1994] 3 S.C.R. 1022, 1994 CarswellBC 1 at para. 89.

“business agreement” means an agreement made by parties none of whom is a consumer as defined in the Consumer Protection Act, 2002; (“accord commercial”)

“vary” includes extend, shorten and suspend. (“modifier”).⁹²

To summarize, these exceptions depend on the nature of the parties and date of the agreement’s formation to determine the extent they may vary the limitation period. An agreement may be made to vary or exclude a limitation period with few restrictions as long as it was formed prior to January 1, 2006.⁹³ Otherwise, if the agreement was reached after October 19, 2006, the limitation period may only be suspended or extended for up to 15 years.⁹⁴ However, in the context of a business agreement (i.e. not involving a consumer) the parties may vary or exclude a limitation period for up to 15 years, or beyond 15 years if the relevant claim has been discovered by that point.⁹⁵

The tolling agreement must satisfy the usual formal requirements of a contract including consideration. Care must also be taken to evaluate the impact the tolling agreement may have on liability insurance, and the possibility that its wording may resuscitate claims for which the limitations period has already passed. The Ontario Court of Appeal recently discussed tolling agreements (or “forbearance agreements”) in *Hamilton (City) v. Metcalfe & Mansfield Capital Corp.*⁹⁶ (“**Hamilton**”) where it stated the following:

First, s. 22(1) requires a bilateral agreement between the parties to toll a limitation period. ... Second, a mere promise to forbear does not suspend a limitation period unless the promise is given in exchange for some consideration from the debtor.⁹⁷

Furthermore, the agreement between the parties must expressly state their intention to affect the limitation period.⁹⁸ In *Re Edwards*⁹⁹ (“**Edwards**”) the Ontario Superior Court of Justice held that the correspondence exchanged between an estate trustee and a credit union would only

⁹² *Limitations Act, 2002, supra note. 81, s. 22(2)-(6).*

⁹³ *Limitations Act, 2002, ibid., s. 22(2).*

⁹⁴ *Limitations Act, 2002, ibid., s. 22(3);* Pursuant to s. 15(2) the 15 year period begins the day on which the act or omission on which the claim is based took place.

⁹⁵ *Limitations Act, 2002, ibid., s. 22(5).*

⁹⁶ *Hamilton (City) v. Metcalfe & Mansfield Capital Corp.*, 2012 ONCA 156, 2012 CarswellOnt 2578 [*Hamilton*].

⁹⁷ *Hamilton, ibid.* at para. 80.

⁹⁸ *Penn-Co Construction Canada (2003) Ltd. v. Constance Lake First*, 2011 ONSC 5875, 2011 CarswellOnt 11617 at para. 56; *Edwards, Re*, 2010 ONSC 5718, 2010 CarswellOnt 7758 at para. 79 [*Edwards*].

⁹⁹ *Edwards, ibid.*

constitute a tolling agreement where a “clear and unambiguous request” has been made and “an equally clear and unambiguous affirmative response” had been received.¹⁰⁰

Finally, it should be kept in mind that tolling agreements pose the risk of precluding third party claims. In *HSBC Securities (Canada) Inc. v. Davies, Ward & Beck*¹⁰¹ (“*HSBC Securities*”) the Ontario Superior Court noted that while a tolling agreement may be made between parties to preserve the right to initiate an action beyond a limitations period, it does not preserve the right of the defendant to that action to initiate third party actions for contribution.¹⁰²

5. FRAUD AND UNDUE INFLUENCE

A significant concern over promissory notes in the estates context is the potential for unscrupulous parties to perpetuate fraud. The case *R. v. Saunders*¹⁰³ (“*Saunders*”) is an example of where an estate trustee, who was a lawyer, breached his fiduciary duty to the estate by using a promissory note to “borrow” estate funds. The lawyer had transferred money and GICs from the estate account for his personal use, and placed promissory notes in the estate file for the value taken. The Trial Judge disagreed with the trustee’s characterization of the appropriation of funds and convicted the trustee of theft.¹⁰⁴

On appeal, the Nova Scotia Court of Appeal rejected the trustee’s argument that the promissory notes demonstrated that he had no intent to deprive the estate or any beneficiary of the funds, and reiterated that a trustee’s fiduciary duty encompasses a duty of honesty and standard of utmost good faith. The Court endorsed the lower court findings that an executor who removes estate funds from an estate for his own purposes commits theft.¹⁰⁵

In *Hazen v. Wusyk Estate*¹⁰⁶ (“*Hazen*”), a beneficiary of an estate used a promissory note to repay the Public Trustee the amount he had misappropriated from his grandmother’s estate. He argued that the value of the promissory note should be deducted from the inheritance he

¹⁰⁰ *Edwards, ibid.* at para. 81; See also *Boeing Satellite Systems International Inc. v. Telesat Canada*, 2007 CarswellOnt 4519 at para. 7 (S.C.J.) (where the Court suggested that a consent order would suffice for s. 22(3)).

¹⁰¹ *HSBC Securities (Canada) Inc. v. Davies, Ward & Beck*, 68 O.R. (3d) 289, 2003 CarswellOnt 4639 (SCJ) [*HSBC Securities*], aff’d 249 D.L.R. (4th) 571, 2005 CarswellOnt 267 (CA) (on different grounds) (CA), appeal ref’d 345 N.R. 394, 2005 CarswellOnt 2737 (SCC).

¹⁰² *HSBC Securities, ibid.* at paras. 102-105.

¹⁰³ *R. v. Saunders*, 2001 NSCA 87, 2001 CarswellINS 176 [*Saunders NSCA*]; See also *Saunders v. Crouse Estate* (1999), 28 E.T.R. (2d) 136, 1999 CarswellINS 186 (C.A.).

¹⁰⁴ *R. v. Saunders* (2000), 189 N.S.R. (2d) 43, 2000 CarswellINS 386 at paras. 21, 24, 33 (S.C.).

¹⁰⁵ *Saunders NSCA, supra* note 104 at para. 5.

¹⁰⁶ *Hazen v. Wusyk Estate*, 2003 MBCA 3, 2003 CarswellMan 4 [*Hazen*].

would receive from his grandmother. To support this claim he produced a will that he claimed was his grandmother's last testament that only he had knowledge of. Noting the many inconsistencies with the will and the testimony given by the beneficiary in regard to its creation, the Manitoba Court of Appeal refused to probate the will presented by the beneficiary. The Court found that it was not a genuine document and commented that there was compelling evidence pointing towards the conclusion that undue influence had been exercised.¹⁰⁷

There are situations where claims of improper use of promissory notes are unfounded. An example of this is seen in *Deneve v. Kadachuk Estate*¹⁰⁸ ("**Deneve**") where family members sought to challenge the deceased's will. In that case, the testator sold his land to his brother's two daughters and received promissory notes for the purchase, bearing zero percent (0%) interest. The testator subsequently executed a new will that forgave the promissory notes and divided the remainder of his estate equally between three nieces (including the two who received the land transfer). After the testator passed away, relatives unhappy with the division of the estate sought to have the will proven in solemn form. They claimed that the testator had made the bequest under duress and undue influence. Initially, the chambers judge held that the objectors had failed to meet the burden of proof required to allege duress and undue influence and dismissed the allegations. This order was overturned on appeal to the Saskatchewan Queens Bench, but then restored by the Saskatchewan Court of Appeal.

In reciting the facts of the case, the Court of Appeal considered the affidavit evidence of the brother of the testator who owned the land. In his affidavit, he stated that it was their intention to give the property to his daughters and that they chose to use promissory notes after receiving legal and tax advice in order that the debt would subsequently be forgiven.¹⁰⁹ The testator's lawyer confirmed that the testator was of sound mind when he asked for the new will to be drafted, and similarly confirmed that it was the testator's intention to give his interest in the land to his nieces. The testator chose to use the promissory notes for tax reasons and believed that he would achieve the same result of leaving it to them in his will, by selling it to them and then forgiving their promissory note in the will.

¹⁰⁷ *Hazen, ibid.* at paras. 30, 35-36.

¹⁰⁸ *Deneve v. Kadachuk Estate*, 2007 SKCA 145, 2007 CarswellSask 720 [*Deneve*].

¹⁰⁹ *Deneve, ibid.* at para. 26.

6. CONCLUSION

Although the law concerning promissory notes has developed predominantly in the context of banking transactions this paper has illustrated various contexts where promissory notes have played a role in estates of trusts matters.

EXAMPLE DEMAND NOTE

May 9, 2013
\$1,000,000.00 (Cdn.)
Toronto, Ontario

To: **Craig Creditor**

FOR VALUE RECEIVED the undersigned promises to pay to or to the order of Craig Creditor (the "**Lender**") at 9213 Credit-Ville Road, Toronto, Ontario, Canada:

- (a) **forthwith after written demand by the Lender for payment, the principal sum of One Million Dollars (\$1,000,000.00) in lawful money of Canada; and**
- (b) **interest on such principal sum from the date hereof, and interest on overdue interest, both before and after demand, default and judgment and until actual payment in full, at the rate of 35 per cent per annum, calculated and payable monthly not in advance on the 9th day of each successive month, commencing on June 9th, 2013.**

The undersigned hereby waives protest, presentment and notice of dishonour.

The undersigned hereby agrees that all limitation periods established by the *Limitations Act, 2002* (Ontario) are hereby excluded and shall not apply to this note, other than the ultimate 15-year limitation period established by such statute. The undersigned also agrees that this note constitutes a "business agreement" as such term is defined by such statute.

Billy Borrower

By: _____
Name:
Title: