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— Franks & Zalev - This Week in Family Law

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Meeting Our Contractual Obligation of Good Faith in Contract Performance by Telling You the Latest on the Duty of Good Faith in Contract Performance

Bhatnagar v. Cresco Labs Inc., [2022 CarswellOnt 3886](#) (S.C.J.) — Kimmel J.

As is clear from the style of cause, this is not a family law case. However, readers may recall that last year, we reported on two recent Supreme Court of Canada decisions — *C.M. Callow Inc. v. Zollinger*, [2020 CarswellOnt 18468](#) (S.C.C.) and *Wastech Services Ltd. v. Greater Vancouver Sewerage and Drainage District*, [2021 CarswellBC 265](#) (S.C.C.) — about the breadth and limits of the duty of good faith in contract. (See the 2021-03 (January 25, 2021) and 2021-07 (February 22, 2021) editions of *TWFL*.)

We also suggested that nowhere might the notion of good faith in contract performance be more important than in a domestic contract, especially a separation agreement, and courts seem to agree. See, for example, *Lopatowski v. Lopatowski* ([2018](#)), [3 R.F.L. \(8th\) 411](#) (Ont. S.C.J.) and *Wiebe v. Treissman*, [2017 CarswellBC 2359](#) (S.C.).

In a nutshell, these decisions, along with the Supreme Court's previous decisions in *Dynamic Transport Ltd. v. O.K. Detailing Ltd.*, [1978 CarswellAlta 298](#) (S.C.C.); *Bhasin v. Hrynew*, [2014 CarswellAlta 2046](#) (S.C.C.); and *Churchill Falls (Labrador) Corp. v. Hydro-Québec*, [2018 CarswellQue 9514](#) (S.C.C.), stand for the proposition that good faith contractual performance is a general organizing principle of Canadian common law, and that parties to a contract are under a duty to act honestly in the performance of their contractual obligations. This includes the obligation to perform the contract honestly, to exercise any contractual discretion reasonably (meaning relating to the underlying intentions of the discretion), and to co-operate to fulfil the objects of the contract. And to violate these principles — which we add cannot be waived — results in a breach of contract which attracts the usual contract remedies — damages, specific performance, etc.

Bhatnagar deals with the tension between, on the one hand, freedom to contract and, on the other, the duty of good faith.

The facts of *Bhatnagar* are not terribly important for our purposes, which is fortunate because the facts are very complicated, and we're not that smart. To materially oversimplify the case, the matter involved a share purchase agreement. The vendors were entitled to additional payments if the purchasers reached certain revenue targets. The vendors argued that the purchasers breached their duty of good faith by preventing the vendors from reaching those revenue targets.

In concluding that the purchasers had breached the duty of good faith, Justice Kimmel offered a handy summary of the principles of good faith in contract performance:

1. There is a duty of honest and reasonable contractual performance, including the obligation to not lie and the obligation to correct any factual misapprehensions on the part of the other about the contract. Parties have a duty to "speak up" or make disclosure to correct a misapprehension under which the other party is operating in respect of a matter that is directly linked to the performance of the contract. Even where there is no intention to mislead, a party breaches the duty of good faith by not correcting previously represented facts. However, this does not require a party to forego the advantages allocated to them in the contract or to safeguard the interest of the other contracting party. Nor does a contracting party have to explain to the other the *impact* upon them of any changed facts; that is for them to determine on their own.
2. There is a duty to act reasonably in the exercise of any contractual discretion such that the exercise of discretion must be connected to the purposes underlying the discretion. Parties must exercise their contractual obligations honestly and reasonably, not capriciously or arbitrarily.
3. There is a duty to cooperate in good faith to achieve the objects of the contract.
4. In considering whether there has been a breach of the duty of good faith, the Court must consider what the parties actually contemplated in the contract. Absent misrepresentation, a party cannot agree to a term and then later argue "good faith" to avoid the very term that was agreed to.
5. "Good faith" will not rewrite a contract or fill in missing terms.

Given that parties to domestic contracts are often not on the best of terms, as most domestic contracts are at least to some extent "forward-looking", and as such contracts are sometimes negotiated hurriedly at the courtroom door, it is easy to see how these duties might come into play in the family law context.

Justice Kimmel further noted that the duty of good faith is not meant to be a shortcut to, or to make up for insufficient evidence about, a claim for damages for misrepresentation. Negligent or fraudulent misrepresentation are different animals, especially in a contract including an "entire agreement" clause. The duty of good faith and honest performance of contractual obligations is not a way around the requirements for proving such a claim in contract.

And, finally, her Honour made the important point that a breach of the duty of good faith in and of itself does not give rise to damages. A breach of the duty of good faith gives rise to a claim for breach of contract, and that claim will require evidence to prove causation and damages.

With Great Appellate Power Comes Great Access to Justice Responsibility

Ward v. Murphy (2022), 72 R.F.L. (8th) 255 (N.S. C.A.) — Van den Eynden, Scanlan and Beaton JJ.A.

Ward v. Murphy is an important decision from the Nova Scotia Court of Appeal about the attribution of corporate pre-tax income under the *Child Support Guidelines* (the "*Guidelines*"). But as discussed further below, it is also yet another opportunity to give some serious thought to the important principle of proportionality in family law.

The parties in *Ward* had a young son together. In 2017, Justice Gregan heard the mother's initial claim for child support. As the father's disclosure was seriously lacking, Justice Gregan had to do the best he could with the available information, and ultimately concluded that the father should be imputed with an income of \$120,000 a year. This was based on \$60,000 a year of imputed income from employment and EI benefits, and \$60,000 a year for expenses the father had unreasonably deducted from his income (plus the gross-up on those expenses). This resulted in Table child support of **\$994** a month based on the child support Tables that were in effect at that time.

In 2018, the father commenced a variation application. He argued that he had never actually earned \$120,000 a year, and he asked that his child support payments be reduced in accordance with the income he reported on his income tax returns, which

was significantly less than \$120,000 a year. This was not a great way for the father to frame his case given that, as we discussed in our comment on *Janiten v. Moran* (2019), 32 R.F.L. (8th) 280 (Alta. C.A.) in the 2020-04 (February 3, 2020) edition of *TWFL*:

. . . to allow a party to ignore their disclosure obligations and then claim a material change by producing them would eviscerate the financial disclosure process: *Gray v. Rizzi* (2016), 74 R.F.L. (7th) 272 (Ont. C.A.). Remedying one's own default cannot constitute a material change in circumstances and cannot ground a material change in circumstances. Where a party is imputed with income on account of non-disclosure, *Trang v. Trang* (2013), 29 R.F.L. (7th) 364 (Ont. S.C.J.) offers the court a way to deal with the matter: **assume the original order is correct; consider why income was imputed and the basis for the imputed income; and then consider whether those circumstances have changed.** [See also *Power v. Power* (2015), 67 R.F.L. (7th) 138 (N.S. S.C.); *Ruffolo v. David* (2016), 75 R.F.L. (7th) 16 (Ont. Div. Ct.); *Gray v. Rizzi, supra*] [**emphasis added**]

At first glance, it certainly did not appear that anything material had changed since the initial hearing before Justice Gregan in 2017. The father was still qualified as a mechanic, carpenter, and scaffolder. He still relied on EI benefits to supplement his income. He still owned various rental properties that generated additional income for him, although he now owned 10 rental properties instead of the eight he owned at the time of the hearing in 2017.

The trial judge, however, determined that while Justice Gregan had treated the income from the father's rental properties as personal income, the evidence showed that, at all material times, the rental income had actually been earned by a company that was solely owned and controlled by the father. This, according to the trial judge, constituted a material change in circumstances that gave the Court jurisdiction to review the child support arrangements going back to October 2018.

Although the issue of whether there had been a material change was not raised by either party in the Court of Appeal, it is not at all clear to us how the father's disclosure of the fact that he was receiving rental income through a company instead of personally constituted a material change in circumstances. The father had every opportunity to explain his financial circumstances at the initial hearing before Justice Gregan, and his recent revelation that he owned his various rental properties through a corporation instead of personally was hardly a sufficient basis to allow him to re-litigate almost the entire case — especially given s. 18 of the *Guidelines* and the ability to impute pre-tax corporate income.

In any event, having found a material change, the trial judge proceeded to re-calculate the father's actual income for support purposes going back to 2018. Although the father had only reported earning an average of \$43,000 (rounded) in annual employment income on his personal income tax returns, the trial judge was not persuaded there was any basis to depart from Justice Gregan's finding from 2017 that the father was intentionally underemployed and should be imputed with \$60,000 a year in employment income pursuant to s. 19(1)(a) of the *Guidelines*.

The trial judge then went on to examine the father's company's pre-tax income, and the personal expenses that the company was paying for the father's benefit. As the company had lost money in 2018 and 2020, and had only earned a nominal profit in 2019, the trial judge basically decided to ignore the company's profits and losses. Instead, she added the approximate \$31,000 to \$33,000 (rounded) a year in personal expenses that she found the company had paid for the father's benefit directly to the father's income, along with a 23% gross-up. This resulted in slightly more than \$40,000 a year being added to the father's income for support purposes in each of 2018, 2019, and 2020, and resulted in the father having a total income for support purposes of \$101,000 in 2018, \$103,000 in 2019, and \$104,000 in 2020 (rounded).

In other words, the trial judge's Order reduced the father's child support payments from **\$994** a month, to **\$862** a month in child support in 2018, **\$876** a month in 2019, and **\$883** a month in 2020 and 2021.

In reaching this conclusion, the trial judge relied primarily on s. 18 of the *Guidelines*, but also noted that "if that is not the correct approach, I would impute the same amounts to [the father] under s. 19(1)(g) on the basis that he 'unreasonably deducted' these same amounts."

The trial judge also ordered that the father would require leave of the court to commence any further proceedings with respect to child support as she was persuaded the combination of the history of his litigation with the mother and his actions during the hearing justified the imposition of a leave requirement going forward.

The father appealed the trial judge's decision to the Nova Scotia Court of Appeal on numerous grounds. Most of the grounds of appeal, including his attack on the trial judge's order requiring him to obtain leave before commencing a further child support proceeding, were dismissed. But the interesting one for our purposes — and that resulted in a 2-1 split decision — was that the trial judge erred in law in how she dealt with the income from the father's company and the expenses that it had paid for his benefit.

In writing for the majority, Justice Van den Eynden agreed with the father. She found that the trial judge had misapplied s. 18 of the *Guidelines*, which for ease of reference states as follows:

Shareholder, director or officer

18(1) Where a parent is a shareholder, director or officer of a corporation and the court is of the opinion that the amount of the parent's annual income as determined under Section 16 does not fairly reflect all the money available to the parent for the payment of child support, the court may consider the situations described in Section 17 **and determine the parent's annual income to include**

- (a) **all or part of the pre-tax income of the corporation**, and of any corporation that is related to that corporation, for the most recent taxation year; or
- (b) an amount commensurate with the services that the parent provides to the corporation, provided that the amount does not exceed the corporation's pre-tax income.

Adjustment to corporation's pre-tax income

18(2) In determining the pre-tax income of a corporation for the purposes of subsection (1), **all amounts paid by the corporation as salaries, wages or management fees, or other payments or benefits, to or on behalf of persons with whom the corporation does not deal at arm's length must be added to the pre-tax income**, unless the parent establishes that the payments were reasonable in the circumstances. [emphasis added]

As previously noted, the trial judge effectively ignored the father's company's pre-tax income and losses. However, based on the wording of s. 18 of the *Guidelines*, which makes it clear that the court should *first* consider whether expenses should be added back to a corporation's pre-tax income, and *then* whether all or part of the adjusted pre-tax income should be attributed to a parent's income for support purposes, this was a clear error of law. As noted by the majority:

[117] I now turn to the s. 18 analysis, which the judge used to determine whether pre-tax corporate income should be attributed to [the father] for the purpose of determining his child support obligations. **Section 18 allows a judge to lift the corporate veil if satisfied income under s. 16 (the payor's Line 150 income) does not fairly reflect all income available for child support purposes.** This is particularly important in the case of a sole shareholder (as is the case here) because that shareholder has the ability to control the income of the corporation.

[118] As noted, on this record the judge was correct to resort to s. 18 as the preferred path. However, **the judge erred in principle because she completely by-passed, without any explanation, critical steps under s. 18.** Specifically, **she did not turn her mind to what the company's actual pre-tax income was after adjusting for certain expenses.** Since she did not do this, she did not turn her mind to what portion of the pre-tax income might be available for attribution. . . . [emphasis added]

The majority also found that the trial judge's reference to s. 19(1)(g) of the *Guidelines* as an alternative basis for justifying her conclusion did not fix the problem:

[134] The judge's reference to s. 19(1)(g) does not rectify her error in principle. I say that because **a fundamentally flawed analysis is not saved by merely saying the same incorrect amounts would be imputed under another mechanism, in this case s. 19(1)(g), without some justification.**

[135] **Had the judge correctly conducted the analysis she undertook pursuant to s. 18, she could not have arrived at the same amounts. The company did not have pre-tax income to attribute in the amounts the judge added directly to [the father's] personal income.** In fact, the disparity in pre-tax income, but for one year, is stark. There is no indication in the record or the judge's decision that she turned her mind to this quandary. **Had the judge been alive to her error and had she provided some justification for attributing income well beyond what the company's pre-tax income was, I might be persuaded otherwise. She did not and I could not identify any plausible justification on this record.** [emphasis added]

After adding back the expenses the trial judge found were personal in nature to the company's pre-tax income, the majority found that, at most, there was only \$15,000 of pre-tax income available to be attributed to the father in 2018, \$42,500 in 2019, and \$7,000 in 2020 (rounded). Accordingly, even if it was appropriate to attribute *all* of the company's pre-tax income to the father, his income for support purposes would have totalled, at most, \$75,000 in 2018, \$102,500 in 2019, and \$67,000 in 2020 (rounded).

Unfortunately for the parties, as the trial judge did not make the necessary findings of fact about whether the company's pre-tax income was available for child support purposes, the majority sent the matter back for a re-hearing before a different judge (unless the parties agreed otherwise). And, in the meantime, the majority ordered the father to pay the mother **\$512** a month in child support based on an income of \$60,000 a year. It also provided the following list of principles for judges to consider in future cases when dealing with corporate income under ss. 18 and 19 of the *Guidelines*:

[151] Section 18 was implemented for the purpose of making some (or all depending on the circumstances) of a corporation's pre-tax income available for the purpose of calculating child support. In my view, **when the record is conducive, judges should prefer s. 18 and its rigorous analysis in situations where a court wants to add back expenses deducted from corporate income, which could conceivably fall under s. 18 or s. 19(1)(g).** Otherwise, as this case makes clear, in circumstances where a company has a legitimate pre-tax net loss before adding back any expenses, there is a valid fairness argument for using s. 18 versus s. 19 because the results may be materially different.

[152] In my view, **s. 19 should be utilized in such circumstances where a payor is a controlling shareholder or operator of a corporation and there is insufficient evidence available to use s. 18** (which is not the case here). This approach gives meaning to the legislature's intent of differentiating s. 18 from s. 19. If trial judges default to use s. 19 in all circumstances, s. 18 would become meaningless. And as illustrated, the distinction on when to use s. 18 versus s. 19 becomes important when the amount attributed or imputed under each provision differs materially (as it does in this case).

[153] In short, a s. 18 analysis should not be shied away from when its use is appropriate. Here are some general, non-exhaustive, considerations that may assist in deciding whether income should be attributed under s. 18:

- Attribution of pre-tax corporate income to a payor pursuant to s. 18(1)(a) is a factual exercise, undertaken by a judge on a case-by-case basis.
- **A judge is not required to add any pre-tax corporate income to a payor's income. The *Guidelines* merely allow for a judge to do so.**
- The reasonableness of a deduction is a discretionary determination; however, the objective is to ensure the allocation of pre-tax corporate income between business and family purposes is fair. **At the end of the day, one should not interfere with reasonable economic decisions needed to meet corporate sustainability.**

- The **onus rests on the shareholder parent to establish that pre-tax income of the corporation is not available for support purposes**. This means the parent, who is typically the payor, **must lead evidence** that the pre-tax corporate income is not available for support purposes because it will jeopardize the capacity of the corporation to meet its financial obligations.
- When deciding the amount of pre-tax corporate income to attribute to the payor, consideration should be given to:
 - What is the nature of the business?
 - Is there a business reason for retaining earnings?
 - What is the historical practice for retaining earnings?
 - What degree of corporate control does the payor exercise?
 - Is there only one principal shareholder or other bona fide arm's length shareholders involved?
 - Depreciation;
 - Possible economic downturns;
 - Return on invested capital; and
 - If the corporation, after adding back expenses to the pre-tax corporate income, has an overall negative pre-tax income (also known as a loss), no amount of pre-tax corporate income can be attributed to the payor's income. (As illustrated above, this was not relevant in this case.) [**emphasis** added; *emphasis* in original]

Justice Beaton, on the other hand, would have dismissed the father's appeal on the s. 18 issue. Although Justice Beaton agreed with the majority that the trial judge did not apply s. 18 correctly, she was nevertheless satisfied the same result could be achieved under s. 19 of the *Guidelines*, which gives trial judges broad discretion to impute income in appropriate circumstances:

[77] It can easily be said the judge's overall rationale in calculating [the father's] income for support purposes, regardless of which section of the *Guidelines* she applied, was made clear in her reasons, and was grounded in the evidence she accepted. **Had she treated the "add-back" amounts by conducting only a s. 19 analysis to recognize the benefits conferred on [the father], rather than using s. 18(2) to address those same benefits, I am satisfied the judge would ultimately have ended up in the same place** — ascribing to [the father] additional annual income, in an amount reflecting expenses assumed by his company from which he directly benefitted despite the absence of any equivalent cash transfer. The judge said as much when she stated her alternate intention to employ s. 19. Doing so was within her purview.

[78] The judge was clearly cognizant the finances of his company were super-imposed on [the father's] income. While she did not, strictly speaking, complete the exercise in s. 18, the judge nonetheless arrived at a set of conclusions about [the father's] income that, practically speaking, took her decision and the parties to an outcome supported by the evidence. **I am not persuaded the effect of the judge's lapse in this case, occurring as it did despite her correct recitation of the law, amounts to an error that requires this court's intervention. Nor does it, in the end, unduly prejudice [the father].** While the judge's decision adopts an approach to s. 19 to which my colleagues object, in the end her reasons permit a clear understanding of the analysis she used to reach her conclusions. As I alluded to earlier, **the exercise of imputing income is inherently not one of precision. However, the judge did much more than "guesstimate" in arriving at final numbers she was satisfied were a reasonable representation of [the father's] income in each year assessed.** [emphasis added]

In our view, the majority's analysis under s. 18 of the *Guidelines* is, from a *technical* standpoint, certainly correct. Section 18 provides a clear formula for attributing corporate pre-tax income to a person's income for support purposes. While it permits a court to add back various expenses to a company's pre-tax income, it does *not* give the court authority to go beyond that. If a company does not actually have any pre-tax income even after adding back any personal expenses and applying any necessary gross-ups, then there is nothing to attribute for support purposes. [This is perhaps an oversimplification given the disagreement between various provincial courts of appeal as to whether the "Limited Rule" from *Bear v. Thompson* (2014), 52 R.F.L. (7th) 257 (Sask. C.A.), or the "Unlimited Rule" from *Mason v. Mason* (2014), 47 R.F.L. (7th) 173 (Ont. S.C.J.), rev'd (2016), 83 R.F.L. (7th) 1 (Ont. C.A.) applies. In a nutshell, the "Limited Rule" suggests that no pre-tax income can be attributed if there was no pre-tax income in the most current year. The "Unlimited Rule" suggests that, through a combination of ss. 17 and 18 of the *Guidelines*, pre-tax corporate income can be imputed in a year even if there was no pre-tax corporate income in the immediate preceding year.]

That being said, on the particular facts of this case, we much prefer Justice Beaton's more holistic approach to the situation over the majority's more technical approach. The father in this case had a history of non-disclosure, and had already been imputed with income on the basis that he was intentionally underemployed. There was also no question that the father had been writing off tens of thousands of dollars in personal expenses as business expenses through his company.

While the trial judge did the best she could to determine what the father was actually earning and capable of earning, anyone who has been involved in disputes over how much income to impute for intentional underemployment and/or whether a particular expense is personal, knows that these issues elude mathematical precision. Accordingly, we agree with Justice Beaton's decision to point out that the trial judge had not properly completed the necessary analysis under s. 18 of the *Guidelines*, but to ultimately conclude that the income figures that the trial judge arrived at were reasonable enough in the circumstances, bearing in mind that s. 19 gives the court broad discretion to impute income in appropriate circumstances.

We also think that the majority's decision to remit the matter for a re-hearing instead of deciding the matter on the existing record was problematic.

The *Guidelines* specifically state in s. 1 that their objectives include, among other things, "to reduce conflict and tension between parents by making the calculation of child support orders more objective", and "to improve the efficiency of the legal process by giving courts and parents guidance in setting the levels of child support orders and encouraging settlement". Sending this matter back for yet another hearing is, in our view, wholly inconsistent with these objectives.

Requiring the parties to have yet another court hearing to finalize their child support arrangements was, in our view, unnecessary given the nature of the issues, and the amounts of money that were actually in dispute. The end cannot possibly justify the means.

The initial decision from 2017, where the father failed to comply with his disclosure obligations, required him to pay the mother just under **\$1,000** a month in child support. The trial judge's decision to give him a second chance during the course of a 6-day variation proceeding in 2021 nominally reduced his child support payments to approximately **\$875** a month. The majority's decision reduced the child support payments to just over **\$500** a month, but left it open to the mother to seek additional support at the rehearing. Whatever amount of child support ultimately turns out to be "right" at the re-hearing, the difference cannot possibly justify requiring the parties (particularly the mother who appears to simply be trying to get the father to comply with his child support obligations), to spend even more time and money trying to bring an end to what ought to have been a straightforward child support case.

Respectfully, an order for a re-hearing in these circumstances was unfair to the parties (particularly the mother) who were left without finality despite already having gone through a 6-day trial and an appeal, and inconsistent with the Supreme Court of Canada's exhortation in *Hryniak v. Mauldin*, 2014 CarswellOnt 640 (S.C.C.) for courts to ensure that "[t]he balance between procedure and access struck by our justice system must come to reflect modern reality and recognize that new models of adjudication can be fair and just", and its warning that "when court costs and delays become too great, people look for alternatives or simply give up on justice."

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