

Bank of Mum and Dad: The treatment of loans from friends and family members on divorce

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23 Feb 2022



A recent court decision (reported as P and Q) from the lead judge for the London Financial Remedies Court has provided invaluable guidance on the treatment of loans from friends and family members within financial remedy proceedings on divorce.

According to a recent survey conducted by Legal & General, in 2020 gifts from parents, grandparents, friends and relatives accounted for more than 50% of house purchases among under-35s. It is reasonable to expect that figure has increased over the last two years with the impact of the pandemic and Brexit on many jobs. In the family court arena, it is continued experience that legal fees are funded by parents or other family members, often in the way of a loan. Some going through a divorce have their short-term needs met by a family member pending the financial settlement.

It is perhaps therefore no surprise that deciding how to treat such funds advanced by friends and family members on divorce is becoming an increasingly common task for the courts. It is also probably understandable this issue is often so emotive for those involved, whether they are the person who has advanced or received the funds, or indeed siblings who see parents helping out with the risk of no recovery. Very often the family courts simply treat as so-called 'soft loans' with no expectation of any repayment. This has caused much anger and financial distress within families.

As the judgment in P and Q records, the first question for the court is whether the sums advanced should be regarded as gifts or loans. For an advance of money to be a gift there must be an intention to give. Often it is relatively easy to show that there was no such intention to gift the sums advanced and that the funds advanced were instead intended to be by way of a loan. However, there is a very simple answer. Record it in writing. A simple bank transfer from a family member is not evidence of either a gift or a loan and therefore may be treated as a gift.

But as the judgement also concisely explains, in the family court that is not the end of the matter because even if found to be a loan, the treatment can depend on the '*hardness*' or '*softness*' of the loan. This treatment is described in the judgment as being an elusive topic to nail down, but one that arises in many cases. This is our continued experience in our many cases, national and international.

The judgment goes on to distil the following principles to be applied:

- If the court is satisfied that a contractually binding loan obligation exists between one party to the marriage and a third party, and not an outright unconditional gift, the court may need to consider whether it should be treated as a '*hard*' debt which goes on the asset schedule as a liability which needs to be repaid, or a '*soft*' debt which may be excluded from the asset schedule altogether.
- There is no hard and fast rule in relation to whether a loan will be treated as '*hard*' or '*soft*' and a wide range of circumstances can be taken into account when making this determination.

- A common feature of the analysis is whether it is likely that in reality the obligation will be enforced. This is one of the reasons why the court will often treat loans from family members as 'soft' because in reality, it may be unlikely that they would bring enforcement proceedings in the same way as a commercial lender would if repayment was not made. For example, in the particular case the family member had lent £150,000 but had explicitly said that if it wasn't repaid, she would not commence proceedings but would simply rearrange the provision of her will so the other family members did not lose out. Where it is not explicit, the family court will often expect this to be the case. This is another reason why it is best to put it in writing, to overcome this expectation.
- Factors which may point towards a loan being treated as 'hard' include:
 - the fact it is an obligation to a finance company
 - the terms of the obligation have the feel of a normal commercial arrangements
 - the obligation arises out of a written document
 - there is a written demand for payment or threat of litigation
 - there has been no delay in enforcing the obligation and the amount of money is such that it would be less likely to waive the obligation

All of this points to the preparation of a proper, legally binding document and we recommend our clients and family members to have one and we can prepare.

- Factors which may point towards the loan being treated as 'soft' include:
 - if the obligation is with a friend or family member with whom the debtor remains on good terms
 - the obligation arose informally, and the terms of the obligation do not have the feel of a normal commercial arrangement
 - there has been no written demand for payment
 - there has been a delay in enforcing the obligation and
 - the amount of money is such that it would be more likely for the creditor to waive the obligation. Most family members will not expect their loan to be treated as a soft loan.

This is further reason of the importance of recording in careful documentation.

On the facts of the case the judge found (as happens in so many cases) that the loans should be treated as soft. One of the main factors the court took into account when reaching this decision, included that it was unlikely the loans would ever be enforced if repayment was not made.

As with many things in life, prevention is often better than cure. Steps which are taken after the event – particularly once there are difficulties in the marriage, divorce proceedings have been issued or lawyers have become involved – are often set aside or added back as happened in P and Q. But there are some steps which can be taken, particularly at an early stage, which can increase the proposes of such loans being taken into account.

One particular area in which loans from friends and family members often arise is the payment of legal fees. Although there are some disadvantages, most notably the interest rates which can attach to them, it may be worth considering potentially borrowing by way of a litigation loan. This can increase the chances of the loan being taken into account in the proceedings which may outweigh the downside of incurring the interest which will come with a commercial loan.

If you would like to discuss the way in which loans from friends or family members may be treated upon divorce – whether on a preliminary basis by way of advanced planning or if you find yourself facing this situation at the moment – or to prepare a loan document with a family member, please do not hesitate to contact us using the details below.

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© February 2022

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