THE MONEY PAGES

Protecting family loans against divorce or separation

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A loan from a family member or parent can help younger couples get onto the property ladder, pay for a wedding or support them financially in many other ways. But what happens to the repayments if the couple divorce or separate? Barrister, Clarissa Wigoder, explains

It is not uncommon for newlyweds to borrow money from parents and other family members, either to raise funds for a deposit on a first home, or to meet other significant capital expenditure during the course of a marriage.

Borrowing from a family member may be more accessible and affordable than seeking a loan from a formal lender, and can therefore be an attractive option where there are family members willing to give a helping hand.

However, it is important for those family members to consider in advance how to formalise the loan, to make sure that they will still get their money back if the marriage breaks down before the loan has been repaid.

Once financial remedy proceedings are issued, both spouses have to declare to the court all of their assets, liabilities and income. It is a relatively straightforward principle that the court has to know the size of the cake before they can start to cut it.

However, not all liabilities are treated equally. The court distinguishes, for the purpose of financial remedy proceedings, between the broad categories of "hard loans" and "soft loans". This is not a distinction made explicit in the statute, and so there is not a clear definition of the terms – there is a large degree of judicial discretion.

What is a hard loan?

Put simply, a "hard loan" must be repaid in the immediate future, or the lender is likely to take legal action.

A classic example of a “hard loan” is a mortgage from a bank, secured against the family home.

A mortgage must be repaid as a matter of priority upon the sale of the home, and so the sum owing will be deducted from the equity of that property in determining the available equity for distribution between the spouses.

What is a soft loan?

By contrast, a “soft loan” is one that is not required to be repaid straight away, or in some cases, at all. The loan may not have a specified repayment date, or require the payment of any interest. Loans from family members often fall within this category.

Repayment of a “soft loan” is considered at the discretion of the recipient and so will usually not be prioritised as part of a divorce settlement.

The loaned funds are unlikely to be earmarked for repayment; instead, the available assets will first be distributed to meeting the divorcing spouses’ needs.

How does a court decide if a family loan is ‘hard’ or ‘soft’?

It is for the party asserting the existence of the liability to prove it. The court will consider all the evidence – which may include narrative statements and oral evidence from the lender and the recipient, and any documentation evidencing the agreement at the time it was entered into – and determine whether the transfer of funds was a “hard loan”, a “soft loan”, or a simple gift.

The court will also look at the impact on the lender if the loan is not repaid, and whether the spouses’ needs can both still be met if it is.

So if you are thinking of loaning a large sum of money to a family member, how can you maximise the likelihood that the loan will be repaid in the event of divorce?

How to secure a familial loan

1. **Draw up a contract**

At the time of the lending, the loan should be formalised in a professionally drafted loan agreement.

This agreement should clearly set out the amount of money loaned, the parties to the loan (who the money is lent by, and to whom), the purpose of the loan, and the parties’ intentions as to how, when and on what terms, the loan should be repaid.

2. **Charge interest**

While it is not strictly necessary to charge interest on the loan this is a clear way of establishing that the loan is a genuine commercial agreement rather than simply a gift.

Although do watch out – any interest payments received are taxable income and must be declared to HMRC.

3. **Set a repayment date**

It is strongly advised that the loan agreement should specify either a repayment schedule (for example, regular monthly payments) or provide for the sum to be repaid on a specific date or upon the happening of a particular event.

That event can be the settlement of financial remedy proceedings. It is a good idea to put in place a repayment schedule – if there is a track record of repayments being made prior to divorce proceedings, this is a good indication to the court that repayments are genuinely expected and required.

The agreement should also stipulate the consequences of failure to repay – for example, a punitive interest rate.

4. **Register it**

Any loan agreement can be executed as a deed. If an agreement is contained in a deed, then consideration is not required, so this may be a good route if you decide not to charge interest.

While this does not guarantee that the loan will be recognised as a hard loan, it does go some way to formalising the agreement, and demonstrating your intention that it be upheld. Professional advice should be sought as to the drafting and execution of the document as a deed.

If the loan is used to fund the purchase of a property, the loan should be registered at the Land Registry as a legal charge secured against the property.

With a legal charge against the property, as with a mortgage from a bank, the loan must be repaid on the sale of the property. This is the single most effective way of ensuring that your loan is protected in the event of a divorce.

5. **Keep records**

Any transfers of money under the terms of the agreement – whether the initial advance or any repayments – should be done in such a way that records can be kept and later produced. A bank transfer is the easiest way of doing this. Cash payments should be avoided.

In short, while there is no way to guarantee that a divorce settlement will provide for repayment of a loan – the court retains an absolute discretion as to how the spouses' assets are to be distributed – if you follow these tips, you are much more likely to be able to prove the loan to be a genuine one if the issue ever arises!

Whilst it may feel awkward to suggest these formalities when a family member has come to you for financial help, having an open conversation and putting in place the right formalities at the start can save expensive and emotionally fraught litigation down the line.

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