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AVOIDING SEXUALLY TRANSMITTED DEBTS

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I. Background

This paper looks at how the debts of one spouse - whom I will shall refer to generically as "the husband" - can affect the assets of the other spouse - whom I shall call "the wife".[1] It does not matter much whether the spouses are married. Is the wife liable for the debt? How can that liability be defended? Can the bank pursue her assets? Can she assert priority over the husband's assets that would otherwise accrue to his creditors? How does divorce or separation affect this picture? What can be done to reduce each spouse's exposure to the debts of the other?

In some countries with community property systems - such as several American states - family law legislation allocates the family's entire property to

[1] I hereby apologize for the stereotyping inherent in these assumptions. However, I claim justification. Feminist theory enjoins the commentator from obscuring the plain fact that in most cases, it is the husband who incurs the debt but the wife who is prejudiced by his business failure or through marital breakdown. The importance placed by the Supreme Court of Canada on defeating the feminization of poverty justifies this convention.

payment of the husband's debts. In others, such as South Africa, the wife's property is automatically distributed to his creditors unless she can prove that she acquired her property through her own means. But in Canada,[2] and particularly in Ontario, we have a "separate property" system which allows each spouse, in theory, to own his or her separate property unaffected by the debts of the other spouse.

So it is possible for a husband and wife each to have his or her separate assets and separate debts that do not affect each other. But this is not the normal reality for cohabiting couples, who often share, at least, a jointly owned home with a mortgage on which each is liable. And this is usually only the beginning of their financial interconnection.

Here are some of the typical kinds of debts that fall into this category:

- guarantees and collateral mortgages of spousal debt, often a bank loan for the husband's business
- joint personal debts such as credit cards, personal lines of credit, car leases
- liability for "family loans" from the other spouse's parents
- liability for necessaries during cohabitation
- liability for necessaries for the children, even after cohabitation
- vulnerability of the matrimonial home to creditors

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[2] This discussion excludes Quebec, which has a mix of both separate and community property governed by the Civil Code.

The generic term "sexually transmitted debt" was coined over ten years ago in Australia. Originally it referred to the predicament of a financially unsophisticated wife who is unknowingly saddled with ruinous personal liabilities resulting from the failure of the husband's business. The concept has since been expanded to include debts between people in relationships governed by dependency and emotional bonds, as follows:[3]

> The key feature of sexually transmitted debt is the relationship of dependence and the emotional ties that dominate the transaction. These are often found, for example, in wife/husband, parent/child and de facto relationships. The dependent party in the relationship accepts responsibility for the other party's debt primarily because of that relationship. If the other party becomes unable or unwilling, for example, through bankruptcy or divorce, to meet the debt, the dependent party is liable for the debt. In that way, the debt is 'transmitted' to the dependent party. A useful generic definition of sexually transmitted debt is 'the transfer of responsibility for a debt incurred by a party to his/her partner in circumstances in which the fact of the relationship, as distinct from an appreciation of the reality of the responsibility for the debt, is the predominant factor in the partner accepting liability.

It is important to note that sexually transmitted debt, or "STD" for short, is not necessarily a bad thing or a 'disease'. There are many good reasons to integrate the family's finances and to share debts and assets. There are significant benefits, for example, to signing a guarantee for the other spouse's business, or placing a mortgage on the home to raise financing for that business. If the business succeeds, or generates the family's income, that is an efficient and essential use of the capital that would otherwise remain tied up in the home. Diversification of gender roles - the stay-at-home spouse versus the wage earner spouse - can be

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[3] Australian Law Reform Commission's Report, *Equality Before the Law: Women's Equality*, (1994) Report No. 69 Pt. II, para. 13.4

an effective way to deal with the stresses of financial necessity in our culture. Many spouses are quite willing, out of love, trust and a shared sense of hope and destiny, to tie their financial welfare to the judgment of the other spouse, and normally such trust is vindicated through the financial success of the family.

But a feminist critique of this phenomenon points out some disturbing aspects. Wives often lack the degree of advice or information that would allow them to make an informed choice. They can be vulnerable to cultural or gender values that limit their freedom to say "no". They may agree against their better judgment in order to maintain marital peace. Their choices are sometimes unknowing or unconscious. Finally, they may be subject to undue pressure, force, abuse, guilt or dependency, all of which limit or negate their freedom of choice. Here is how one noted academic put it:[4]

> Many of the married women seeking to resist enforcement of guarantees still conform to the profile graphically outlined in previous case law. In the business guarantee context guarantor wives face some strikingly similar problems time after time. These include: Limited business skills, knowledge and experience; Limited involvement in the husband's business affairs; Limited education levels, which in most cases do not include accounting, business or legal skills; Different cultural values; Marital problems; and Difficulty in understanding legal and business documents ... Several important qualitative reviews of the case law as well as empirical studies confirmed that the combination of economic inequality and emotional dependence in many marriages contributed to the vulnerability of married women sureties. The studies indicated that women were particularly vulnerable upon divorce and that the desire to keep the marriage on foot and avoid the adverse financial repercussion of its breakdown is an underlying imperative in the decisions of many women to undertake surety obligations which they are not necessarily comfortable with.
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> Despite the advances of women in society, these studies indicated that traditional gender roles were observed in the marriages of many of the women who were the victims of sexually transmitted debt. A disquietening feature in many

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[4] Janine Pascoe, *Women Who Guarantee Company Debts: Wife or Director*, 8 Deaking L. Rev. 13 (2003)

> of the marriages was that the women's disadvantaged educational and business backgrounds translated into a situation of financial dependency, thereby increasing their vulnerability to control and abuse ... While those cases provided evidence of physical and emotional abuse, economic dependency, minimal educational opportunities and broken work patterns, there were other cases in which educated women were also held to be vulnerable. A typical example was Mrs. Garcia, who was a professional woman experienced in business and in dealing with financiers. She was, however, subject to condescending and deprecatory remarks regarding her business skills by her husband and to subtle bullying tactics.

With this background, we can start to isolate the mechanisms that lead to an intermingling of spousal debts. This discussion will be focused on Ontario law. There are provincial variations that are covered in detail in my book, *Bankruptcy, Insolvency and Family Law (2nd Ed.).*

II. Spousal Liability by Operation of Law

In general, Canadian law treats each spouse as a separate personality in all matters. Liability for the debt's of one's spouse are assumed only if one has signed a formal guarantee or if one is independently liable for the debt by way of a promissory note, mortgage or the like.

There are exceptions to this general rule. First, Ontario's *Family Law Act* ("*FLA*"), s. 45(1), provides that each spouse has authority, until marriage breakdown, to render him- or herself and his or her spouse jointly and severally liable to a third party for necessities of life. This can include rent, appliances, food and utilities; the limits of the definition are not closed. This means that while the spouses are cohabiting, the husband can buy a refrigerator and, by giving his wife's name, can make her jointly liable to pay; in other words she can be sued for the debt.

Section 45(2) provides that both parents are liable, even after marriage breakdown, for debts relating to the provision of necessities for their children. For example, if the ex-husband does not pay the child's dental bill, the wife can be sued, even if she knew nothing of the dentist in question.

Corporate law can impose liability on a spouse as a result of business failure. This can occur if the spouse is a director or officer of a company, under numerous provincial and federal enactments. These liabilities include:

- employees' wage arrears for up to six months, and vacation pay for up to one year;
- income tax source deductions, CPP, UI and health insurance premiums and pension withholdings; and
- liability for dividends paid while the corporation was insolvent.

A wife who is a passive director of a family business, or who becomes a director through family law proceedings, may in the event of business insolvency not only lose the business but be saddled with significant personal liabilities for which serious penalties may be imposed.

Let us now look at direct debt remedies against the wife.

III. Spousal Liability by Contract

Spouses can incur joint liability through the careless use of credit cards. Hardly anyone remembers whether a card was taken out in joint names or not; no-one reads the fine print on the credit contracts for these cards. It is all too easy to be fixed with liability for the other spouses' purchases. Some newly separated spouses discover to their horror that they are on the hook for their spouse's debt because, in the distant past, they signed a joint credit card application. Our Court of Appeal recently upheld this in a case noted below.[5] The fact that a credit card statement is addressed solely to the husband, does not mean that the wife is not liable.

Spouses can be fixed with liability on agency principles. For example, if the wife owns the home but the husband signs the renovation contract, a court would have little difficulty in concluding that he was doing so as agent for the wife.

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[5] *Bank of Nova Scotia v. Baker*, (2004) O.J. No. 3065 (Ont. C.A., July 20 2004): Joint $25,000 credit line. The credit application had been signed by both spouses long before. It provided in the fine print that the bank was authorized to direct correspondence to only one of them, and to increase the credit line at any time. The original amount borrowed had long ago been paid off. The bank addressed all correspondence to the husband, effectively treating him as the sole customer, and increased the line to $30,000 without notice to the wife. The husband used up the entire credit line, and embezzled further funds from his employer and from the wife. The bank did not communicate with the wife until the credit line was in default; then the bank sued her for the full amount. Held: the documentation signed by the wife years before allowed the bank to do all this. The wife was liable for the full amount.

Spousal liability is often predicated on a guarantee or collateral mortgage of the other spouse's business debt. The basic premise of bank lending to individuals is that the bank will attempt to obtain as much security as it possibly can. Since the matrimonial home is often the only asset of significance held by a married couple, it is customary for banks to insist on collateral security against this asset. Alternatively, the bank may require guarantees from the spouses.

Courts are vigourous in attempting to protect the family from the consequences of business failure. One of the ways this is done is through the wide scope of defences to guarantee transactions. The doctrines of duress, unconscionability and undue influence have developed to protect the innocent spouse in this situation. The practice of requiring independent legal advice has evolved as an antidote to this judicial sympathy. Here are some of the basic defences in this area:

- **Unconscionability:** "The combination of the inequity of the parties to the task of protecting their respective interests, and the improvidence of the transaction on the part of the weaker of the two, justifies the court in setting aside the contract as unconscionable". The remedy requires proof of the improvidence of the transaction and a preying of one upon the other.

- **Undue Influence:** Where the wife has been unduly pressured by the husband to sign the guarantee, and the bank is either aware of this fact or ought to have had suspicions about it. The bank may have a duty to enquire even if it has no specific knowledge, although the presumption of undue influence may be rebutted on the facts.

- **Non est factum:** To establish non est factum ("it is not my document"), the wife must show: (i) the document was fundamentally different than what she thought she was signing; and (ii) the signing was not attributable to her carelessness, by not reading the document or by not taking steps to ascertain its nature. The recent judicial trend appears to be that the courts are reluctant to grant the defence of non est factum save for compelling circumstances". The onus lies on the wife to show the absence of negligence.

- **Independent legal advice:** It is now traditional for a bank to insist that a wife receive independent legal advice ("ILA") in connection with signing a guarantee or collateral mortgage. This is intended to ensure that she does not suffer from misrepresentation, duress, fraud or other circumstances that might invalidate her signature. This increases the cost of the loan by up to $300. Mere lack of independent legal advice ("ILA") does not invalidate a guarantee or mortgage in the absence of one of the above defences.

One can question whether ILA really helps anyone but the bank. Here are some of the problems that can occur:

- Referral from a professional colleague may lead the legal advisor to wish not to rock the boat;

- The bank may provide insufficient financial information to allow the advisor to sufficiently assess the risk;
- The advisor may realize that he or she will only be paid for the consultation if the wife signs the documents;
- The husband may be waiting in the lobby, creating pressure unknown to the advisor;[6]
- Cultural and gender conditioning cannot be overcome in a short meeting with a stranger.
- Common misconceptions in the meaning of legal terms such as "joint and several", "guarantor", or "revolving line of credit", can remain unclear due to passivity, shame, or poor communication skills.

Here is the conclusion of one author:[7]

> ILA is a "triumph of legal form over substance which is more likely to protect banks than guarantors ... Sureties, due to their lack of business experience, did not know the questions to ask ... Married sureties were particularly inclined to emphasize their perception at the time of signing that their marriage was for life, and that, as a result, they felt bound to support their spouse."

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[6] *Mraovic v. Mraovic*, (2003) M.J.# 457 (Man. Q.B.): A separation agreement made with ILA was set aside for duress where the husband was waiting in the solicitor's lobby, he pressured her (the solicitor did not know this), and the solicitor took too little time to explain; the agreement was unconscionable.

[7] B. Fehlberg, *Money and Marriage: Sexually Transmitted Debt in England*, 11 Int'l J. of Law, Policy and the Family 320 (1997)

IV. Enforcing the Debt Against the Matrimonial Home

If the bank's judgment lies only against one spouse, say the husband, how can it be enforced against the matrimonial home? Let us consider the various possibilities, depending on whether the home is owned solely by the wife, jointly, or by the husband alone. In this section, I shall presume that the spouses are happily cohabiting.

A. Home Owned Solely by the Wife

1. Creditors' Remedies Under Matrimonial Property Legislation?

If there is no breakdown of the relationship, Ontario's family law legislation gives the husband's creditors no right to a matrimonial home that is owned entirely by the wife.[8] As against the matrimonial home therefore, an unsecured debt

[8] For example, in *Blackman v. Davison* (1987), 12 B.C.L.R. (2d) 24, 64 C.B.R. (N.S.) 84 (C.A.), the husband's creditors attempted to claim, on his behalf, a one-half ownership interest in the wife's solely owned condominium under the division of property provisions of B.C.'s matrimonial property legislation. The spouses continued to live happily together and had done so for 41 years. Without a separation or other triggering event as between the spouses, the court refused allow the creditors to intervene. In *Clark Drummie and Co. v. Ryan* (1999), 70 D.L.R. (4th) 266, 209 N.B.R. (2d) 70 (N.B.C.A.), a law firm sought to enforce its $238,000 judgment, arising out of the fraud of one of its partners, against that partner's matrimonial home which had been held in the wife's name for several years before the fraud had commenced. The spouses were happily married. The New Brunswick Court of Appeal confirmed that creditors cannot utilize or claim under matrimonial property legislation unless, at least, the spouses' rights have already crystallized as between them in an application commenced by one of the spouses.

against the husband is generally enforceable only against the husband's interest in the home. If he is not on title, the creditors have no claim against the wife's home, even though the husband lives there and, perhaps, pays the mortgage and all carrying charges.

There are several devices that can nonetheless be utilized, at least in theory, to get at the home where it is not owned by the judgment debtor.

2. Trust

The bank can allege that the wife holds the home, or part of it, in trust for the husband. This argument can be asserted by a creditor or bankruptcy trustee. An example of this approach is found in *Morganti v. Strong*,[9] where the common-law wife had, while bankrupt, allegedly paid $33,000 toward the purchase price of a property acquired in her common-law husband's sole name. Her trustee[10] alleged that she held a trust interest which was subject to the creditors' claims. The Ontario Court of Appeal held that her trustee (or the creditors) were fully entitled to pursue the allegation that the husband held a part of the property on resulting trust for the wife.

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[9] (1999), 14 C.B.R. (4th) 127 (Ont. C.A.), varying (1998), 3 C.B.R. (4th) 145 (Ont. Gen. Div., Hoilett J.)

[10] Actually, the trustee's assignees under *BIA* s. 38.

It is extraordinarily difficult to prove a trust in these circumstances. The creditor must overcome the spouses' evidence that they never intended a trust relationship. Where the spouse continue to cohabit, this is unlikely in the extreme unless there is evidence of a fraudulent conveyance or other preferential act.

3. Mortgage payments as fraudulent conveyance

The creditor or trustee can argue, if the facts so demonstrate, that the husband paid all the mortgage payments on the home, including reduction of principal. If these payments were outside of the normal monthly mortgage amount, this could be characterized as contrary to the *Bankruptcy and Insolvency Act* ("*BIA*"), or as a fraudulent conveyance.[11] However, unless the test under those remedies can be met, the courts reject any adverse characterization flowing merely from paying the mortgage and carrying costs. The husband is entitled to support the family with his income.

4. Acquisition of Title as fraudulent conveyance or preference

The creditor or trustee can challenge the transaction under which the wife became sole owner of the home. If the home was recently transferred from joint names, or from the husband's name alone, the normal tests for challenging such a conveyance will apply. The transfer may constitute a fraudulent conveyance

[11] *Boyle's Trustee v. Boyle*, (1988) Scots Law Times 581 (Outer House): Husband's pre-bankruptcy paydown of mortgages on wife's solely owned home could be, when taken as a whole, part of a scheme to enrich wife at expense of creditors.

if the husband was insolvent or on the verge of insolvency and it was done with intent to defeat his creditors or give the wife an undue preference. In the event of bankruptcy, the transfer may be attacked under the *BIA* if it was done for no consideration within five years of the bankruptcy; or if the consideration was conspicuously inadequate and the conveyance was within one year of the bankruptcy.

In all of these remedies, the crucial questions are the good faith of the spouses and the value of the consideration. The essence of these remedies is the "smell test": does it smell right? The sense of smell is aided by the presence of various "badges of fraud" that, while rebuttable, suggest closer scrutiny. The existence of one or more of these suspicious elements will place the onus on the recipient to justify the transaction and corroborate any explanation. These so-called "badges of fraud" include:

- The grantor continues, after the transfer, to treat the property as his or her asset
- The transaction substantially denudes the grantor of all his or her property
- The secrecy of the transaction
- Unusual haste in closing the transaction
- No change in the possession or use of the property after the transaction.
- Lack of documentation

5. Special remedy for income tax arrears

The matrimonial home, even if it is owned by the wife alone, is vulnerable to the Tax Department if the husband owes income tax arrears. If he has transferred any property to the wife during the time that tax arrears remain unpaid, the tax authorities are entitled to recover that property to pay his taxes.[12] This means that if the husband had made all the mortgage payments during this period, the wife may have to refund any reduction of the mortgage principal that accrued to her benefit. If she amassed any savings or investments from money that he provided to her during this period, she may have to refund such amounts to pay his taxes. This remedy does not apply if the spouses are separated and the property is given to the wife under a separation agreement or court order.

B. Home Owned Jointly by the Spouses

There are several points to note here. First, if the home is jointly owned, the wife may assert ownership claims over the husband's half. This can be done under various equitable theories.

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[12] *Income Tax Act*, s. 160

1. Equitable Theories

- *Trust:* The wife may establish a trust entitlement that reduces or extinguishes the husband's interest in the home. This is more common where the husband is the sole owner, and will be discussed below.

- *Equity of Exoneration*: Where a mortgage has been placed against the matrimonial home for the sole or principal benefit of the bankrupt husband, the wife may require that his half share of the property account for the full amount of the mortgage.[13]

- *Equitable accounting*: Where joint property has been sold, and one party (the wife) has contributed more than a half share to the purchase or upkeep, the court may grant an allowance out of the proceeds.[14]

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13 *Slan v. Blumenfeld* (1997), 34 O.R. (3d) 713 (Gen. Div., Kitely J.): Wife with four young children, husband bankrupt; husband's unpaid solicitor attempts to realize on the husband's half interest in the matrimonial home; court finds an equity of exoneration in favour of wife, vests the husband's half interest in her.

14 *Goertz (Trustee of) v. Goertz* (1994), 26 C.B.R. (3d) 222 at 247-248 (Sask. Q.B.), ap. dis. (1995), 37 C.B.R. (3d) 1 (Sask. C.A.): "In this case, there being only two joint tenants, each is declared as having an undivided one-half interest. If Mrs. Goertz is of the view that she has contributed more than half of the costs of acquiring such lands or the cost of improving the same, or that she received less than one half of the net income and fruits of the land after payment of expenses, or that she has paid more than her share of the expenses pertaining to the land, I order that she may at anytime prior to December 1, 1994 apply to this Court for an allowance for such items and for an order directing the payment out of such allowance out of the proceeds from the sale of the lands to which the allowance pertains. I further order that should Mrs. Goertz apply for such an allowance, the trustee shall be at liberty to claim similar allowances on behalf of the bankrupt estate."

2. Forcing Sale of the Home

If these equitable theories are unavailable on the facts, the creditor or trustee will seek to force a sale of the jointly owned home. The court will normally require a sale unless to do so would cause "serious hardship" to the spouse and children. The "serious hardship" threshold is not very difficult to meet. For example, where there are several children under ten years old who were born in the matrimonial home, have made their friends in the area and are attending school there and have a degree of security in the present home and environment, exclusive possession has been ordered as against the trustee. The spouse may succeed in deferring sale until the youngest child completes its education. Lenient terms may also be granted.

C. Home Owned Solely by the Husband

Where the husband owns the home solely, the non-titled wife typically alleges a trust entitlement to half (or all) of the home. There are three key kinds of trusts.

1. Express Trusts

An express trust is usually written and formalized. Provided the creation of the trust is not in itself an attackable transaction (see discussion above), the trust is fully enforceable against creditors. It need not be registered. Express trusts can fail on numerous technical grounds, including the lack of any of the three certainties — certainty of intention to create a trust, certainty of the object or beneficiaries of the trust, and certainty of subject matter of the trust.

2. Resulting Trusts

A "purchase money" resulting trust arises when one spouse contributes money, or property, directly toward the acquisition or improvement of a specific property to a greater extent than is reflected by legal ownership. The spouse's contribution must be directly traceable into the property. There must be an intention or agreement that the donor spouse retain a beneficial interest in respect of his or her contribution. This intention may be express, implied, or presumed under a presumption of resulting trust. If the contribution is intended as a gift, either expressly or implicitly, or as a loan, no trust arises. The presumption of resulting trust between spouses assists in establishing the trust on the facts.

3. Constructive Trusts

A constructive trust may arise where the wife's contributions to the property are neither financial nor direct. It is the lack of a direct money contribution — traceability of property, in trust jargon — that usually distinguishes a constructive from a resulting trust. The other important distinction is that there is no need to establish intention, either presumed or implied. A constructive trust in the family law context is usually based on unjust enrichment, sometimes referred to as a remedial constructive trust, which is a modern Canadian legal development originating in the "farm wife" line of cases. Unlike the other kinds of trusts, which are established by the underlying facts and only "recognized" by the court, an unjust enrichment-based constructive trust is imposed, as a remedy, by the court. The key aspect of constructive trust claims is that unlike resulting or express trust claims, the interests of creditors must be considered before the constructive trust is imposed.[15]

V. Effect of Separation and Divorce

The ground rules change when family breakdown occurs. Creditors can no longer safely rely on "the law" when family need, human suffering and child welfare conflict with creditors' claims. This reminds me of the "widow" defence to summary judgment which a colleague of mine once observed, when the presiding judge refused to grant judgment against a recently widowed woman who had no defence whatever. He simply refused, out of sympathy for this woman, to apply

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[15] John Glover, *Bankruptcy and Constructive Trusts*, (1991) Australia Bus. L.R. 98, at p. 119: "The operation of the constructive trusts in insolvency has considerable intuitive appeal — vindication of the claimant's title to property wrongfully misappropriated by the bankrupt, or the bankrupt's being required to disgorge wrongfully acquired benefits. But the real question of justice in insolvency does not arise between the claimant and the bankrupt, where the equities are clear. It arises between the different classes of creditors of the bankrupt, where the equities are much more difficult to distinguish. The main "victims" of an expanded constructive trust are the trustee's unsecured creditors." The Supreme Court of Canada said in *Soulos v. Korkontzilas* (1997), 46 C.B.R. (3d) 1 (S.C.C.) at p. 17 C.B.R., "There must be no factors which would render imposition of a constructive trust unjust in all the circumstances of the case; e.g. the interests of intervening creditors must be protected."

the weight of the law. While the law is an abstraction in some sense, judges are real people who are susceptible, like all of us, to strong feelings of empathy.

The fact of separation has several legal effects on creditors' rights.

1. Transfers pursuant to Separation Agreements

If marriage breakdown occurs, the spouses may conclude a separation agreement which conveys the property to the wife alone, in consideration for a release of support and other claims. In many circumstances these agreements are upheld even if they occur on the eve of insolvency. While a property transfer between a married couple is a badge of fraud, this does not extend to transfers between divorced or separated couples where there is insufficient intimacy between them.[16] Where a release of support, and particularly child support, is put forward as consideration, courts are typically accepting. When the separation agreement is negotiated at arms length by matrimonial lawyers, and duly approved by a matrimonial court judge, it is very difficult to challenge.

The ground rules change when family breakdown occurs. Creditors can no longer safely rely on "the law" when family need, human suffering and child welfare conflict with creditors' claims. While law is an abstraction in some sense, judges are real people who are susceptible, like all of us, to strong feelings of

[16] One case took this point even further, stating that settlements made as part of matrimonial disputes are considered to have been made for good consideration: *MGM Grand Hotel Inc. v. Liu*, (1997) B.C.J. No. 2528 (B.C.S.C., Levine J., November 10 1997).

empathy. These emotions also have a legitimate jurisprudential basis since the 1994 Supreme Court of Canada decision in *Marzetti v. Marzetti.*[17] In *Marzetti*, a former husband who was in arrears under an order for spousal and child support, declared personal bankruptcy. Both his trustee, and the Alberta Director of Maintenance Enforcement, claimed to be entitled to his post-bankruptcy tax refund. The court had to decide who had priority to the money: the bankruptcy trustee, or the wife and children.

The Supreme Court unanimously ruled that the wife's support claim had priority over the trustee. The Supreme Court held that an income tax refund was essentially wages in another form, the priority of which fell within the *BIA* treatment of post-bankruptcy wages governed by a 'family needs' test. Moreover, the Supreme Court stated that as a matter of public policy, where family needs were at issue, it would rule on the side of caution and focus on an overriding concern for the support of families. Statutory interpretation, even in the debtor-creditor setting, should be guided by the public policy goal of helping to defeat the feminization of poverty associated with divorce. In other words, debtor-creditor law could be "bent" in certain circumstances to help the family.

There are other important policy issues at play that simply do not arise in respect of property transfers between non-separated spouses. For example, the

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[17] *Marzetti v. Marzetti*, (1994) 2 S.C.R. 765, 5 R.F.L. (4th) 1, 26 C.B.R. (3d) 161, 169 N.R. 161, 20 Alta. L.R. (3d) 1, (1994) 7 W.W.R. 623 (S.C.C.)

Divorce Act requires in many different respects that counsel and the court steer the spouses toward negotiated resolution of their conflict. Section 9(2) provides that,

> 9(2) It is the duty of every barrister, solicitor, lawyer or advocate who undertakes to act on behalf of a spouse in a divorce proceeding to discuss with the spouse the advisability of negotiating the matters that may be the subject of a support order or a custody order and to inform the spouse of the mediation facilities known to him or her that might be able to assist the spouses in negotiating those matters.

The Supreme Court of Canada has emphasized that this section clearly indicates Parliament's intention to promote negotiated settlement of all matters corollary to a divorce. The practice of "collaborative family law" is now in vogue across the country. Every family court has devoted massive resources to induce settlement of these cases, which otherwise clog the court system, ruin families through the cost of endless litigation, and prevent spouses and their children from moving on with their lives.

All this is to say that the usual rules do not apply when it comes to attacking these settlements. The bankruptcy courts are staffed by judges of the provincial superior court, who often have experience in matrimonial matters. These judges may well recall their days when they presided over cases where the goal of all parties, and the court, was to help the fractured family survive the pressures of poverty, debt, and simply not having enough money. In these cases, if the creditors can be beaten, so much the better. After all, the *Divorce Act* also requires that support orders should,

> 15.2(6) ... (c) relieve any economic hardship of the spouses arising from the breakdown of the marriage; and
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> (d) in so far as practicable, promote the economic self-sufficiency of each spouse within a reasonable period of time.

These cases are usually brokered by matrimonial lawyers who are paid, trained and educated to negotiate settlements. Setting aside a separation agreement may therefore implicate the integrity and professionalism of two lawyers along with the spouses. Where a court order effects or approves the transfer, the judge's integrity is also challenged, if only tangentially.

Separation agreements cannot be set aside antiseptically. While commercial contracts, if they are voided, normally result merely in a money transfer, matrimonial settlements can be set aside only at the cost of plunging a family back into crisis, even perhaps a fresh custody dispute. Poverty can loom in the backdrop of this remedy. Thus the clear intent of matrimonial policy, on many levels, will be violated if a matrimonial settlement is overturned.

For all of these reasons, it appears that the threshold is extraordinarily high to overturn a final matrimonial resolution, even one that incorporates suspicious or aggressive property transfers.

My rule of thumb for separation agreements made on the eve of one spouse's insolvency, is whether a judge would have approved the agreement if the circumstances had been fully disclosed in matrimonial court. If the family lawyers can certify that in their view, the compromise reached by the spouses would have received court approval by a judge in that jurisdiction, who was apprised of all the relevant facts (such as the looming debt crisis of one spouse), then the agreement is likely to stand up to subsequent challenge. This standard allows one to compare the impugned transfer, and the circumstances in which it was effected, with matrimonial cases where similar transfers were approved or specifically ordered by the matrimonial court. It allows one to base an assessment of the propriety of these transfers, on empirical evidence from matrimonial litigation.

If a matrimonial judge would have ordered the transfer, how can a bankruptcy judge determine that the transfer was a fraud? This also has the effect of focusing attention on process issues: Were the parties separately represented? Was the agreement effected through arms' length negotiations, evidenced by documentation? Was the recipient spouse merely following legal advice? Was she merely aggressively attempting to advance her own interests? These are process factors that the courts utilize as markers of good faith.

In one seminal case, for example,[18] the husband transferred his half interest in the matrimonial home to his wife some four months before his assignment in bankruptcy. The transfer was incorporated into Minutes of Settlement in the family law proceedings which had been outstanding for several years. The transfer was stated to represent, in part, an $80,000 lump sum payment on account of future child support at the rate of $1,000 per month. The wife was fully aware of the husband's financial difficulties, since the agreement contained a clause permitting either spouse to withdraw from the agreement if a bankruptcy lawyer advised that it was too risky. The trustee did not attack the transfer directly, but raised the issue at the husband's discharge hearing as grounds for imposing harsh conditions of

[18] *Rakus, Re* (1991), 3 C.B.R. (3d) 25 (Ont. Gen. Div.)

discharge. Austin J. accepted that the husband had been acting in good faith on the advice of his solicitor in effecting the transfer and, in effect, held that the transaction was bona fide.

2. Creditors are not bound by Separation Agreements

After separation, the spouses usually negotiate between them as to who will have responsibility for their shared or joint debts. For example, the husband will agree to pay off the credit cards and will agree to indemnify the wife if he does not do so. The important point to remember is that this agreement is not binding on the creditors. If both spouses are liable on the debt, the creditor can sue both or either of them. The creditor is not bound by a separation agreement that the creditor did not sign. The creditor can recover the money from the wife, who is then left to her matrimonial remedies against the husband. If the husband declares bankruptcy, she may be out of luck and may have to face the creditor alone.[19]

3. Lump Sum Support Priority

The Ontario *Creditors Relief Act* provides that support arrears take priority over any other unsecured judgment debt. In bankruptcy, the priority applies to support arrears owing under a separation agreement or court order made before

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[19] In some circumstances the wife may be able to obtain a support order against the husband requiring him to reimburse her for the debts that he ought to have paid.

the date of bankruptcy, and is limited in amount to any periodic arrears accruing in the one year period before the bankruptcy, plus any pre-bankruptcy lump sum.[20] The creation of lump sum support obligations (including, perhaps, cost orders) may significantly erode the creditors' ability to recover on their debts.

4. Creditor Priority over Matrimonial Property Division

In some early cases under Ontario's *Family Law Reform Act* (since repealed), the Ontario courts concluded that a wife's right to division of matrimonial property took priority over execution creditors' claims to the property interests of the husband. This conclusion was repudiated by the Supreme Court of Canada in *Maroukis v. Maroukis*,[21] where it was held that an execution creditor takes priority over the husband's property unless the wife has first obtained an order granting her proprietary rights (i.e. security or vesting) in the husband's property. This same reasoning applies to the bankruptcy context.

5. Speed

Matrimonial litigation, resulting from marriage breakdown, may lead to a court order vesting the matrimonial home, or other property, in the spouse's name alone. The order, according to its tenor, takes priority over subsequent writs of

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[20] *BIA* ss. 178(1)(b),(c), 121(4) and 136(1)(d.1)

[21] (1984) 2 S.C.R. 137, 12 D.L.R. (4th) 321, 41 R.F.L. (2d) 113, 54 N.R. 268, 34 R.P.R. 228 (S.C.C.)

execution or the rights of a subsequent trustee in bankruptcy. This can lead to a procedural race: who can obtain a judgment first, the wife or the creditor? The race is to the swiftest.

6. Trustee's Right to Claim Division of Property

Ontario courts have recognized that in certain circumstances, the husband's bankruptcy trustee acquires the right to sue the wife for equalization. This entitlement occurs if, at the time of the husband's bankruptcy, the spouses have separated and a claim for equalization of property has been commenced. If so, the trustee acquires the husband's right to prosecute and settle the claim, and the husband loses the right to do so. I have argued strongly against this interpretation in my book,[22] and recently the Senate Bankruptcy Review endorsed my proposal to legislatively reverse this rule.

VI. Creditor Proofing

I will end this paper with a brief discussion of creditor proofing techniques available to spouses.

[22] See R. Klotz, *Bankruptcy, Insolvency and Family Law, 2nd ed.* (Carswell, 2001, supplemented), Chapter 6.

A. Matrimonial Home

The Ontario *FLA* protects each spouse's rights in the matrimonial home regardless of legal title. The non-titled spouse's rights include a right of possession, a veto power over disposition or mortgage of the home, a right to notification of the exercise of creditors' remedies, and usually, in practical terms, the right on separation to an equal division of the equity in the matrimonial home. Thus the transfer to a spouse of one's interest in the matrimonial home can be effected with minimal vulnerability to the turmoil of a subsequent marital breakup. Provided the transfer is made without contravening any creditor protection legislation, the case law is quite clear that creditors cannot invoke the equalization principles of the *FLA* to make a vicarious claim on the debtor spouse's behalf.[23] Even marital separation, alone, does not grant creditors any further rights.

Conveying the house to the spouse is best done before any debts are incurred, when the intention is to order one's affairs rather than to defeat creditors. Such a transfer should be considered before embarking on a new business venture.

If financing for the business acquisition is to come from family or friends, it may be prudent to secure any such loans against the acquiror's matrimonial home, or alternatively against one spouse's interest in the home. If, say, the husband is acquiring a business in his own right, utilizing joint assets to do so (i.e. the family bank account, a collateral mortgage on the jointly owned family home, etc.), the wife

[23] See the discussion in section IV(A)(1) above.

may require that he sign a loan agreement, or an indemnity requiring him to indemnify her against any call on the collateral mortgage. In appropriate circumstances, this loan or indemnity agreement may be secured against his interest in the matrimonial home, or pursuant to a General Security Agreement or other security.[24]

The spouses should consider severing their joint tenancy in the matrimonial home, to ensure that at some later date, the entirety of the home does not fall into the hands of one spouse's creditors when the other, solvent, spouse dies. Of course, this also limits the possibility of a windfall to the solvent spouse if the insolvent spouse dies before any executions are registered on title. If this step is taken, both spouses will require wills.

B. High Risk Spouse vs. Low Risk Spouse

One of the objectives of creditor-proofing is to insulate one's spouse or family from the effects of a business failure. Thus, when times are good, both spouses increase their net worth. When business turn sour, only one spouse's assets will be in jeopardy.

Obviously, this is not always achievable. Lenders may require the personal guarantee of a spouse, or collateral security against the matrimonial home.

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[24] The propriety of securing the wife's "equity of exoneration" is confirmed in a number of English cases including *Hall v. Hall*, (1911) 1 Ch. 487, 80 L.J. Ch. 340, 104 L.T. 529; *A Debtor (Re) (No. 24 of 1971)*, (1976) 2 All E.R. 1010; *Pittortou (Re)*, (1985) 1 All E.R. 285 (Ch. D.)

Central to this goal, however, is the concept of the high risk spouse vs. the low risk spouse.

Let us assume, by way of illustration, that the husband is the entrepreneur who is purchasing or has acquired a new business, and the wife is securely employed in an unrelated field. The husband, as entrepreneur, is vulnerable, at least potentially, to business failure or litigation risk. The wife is not. The husband in this case is the high risk spouse. Any assets he accumulates will be vulnerable to his existing or future creditors. The wife is the low risk spouse. There is little likelihood that the assets she accumulates will be vulnerable to creditors or litigation attack. The planning objective is to ensure that to the extent permissible, the family's future savings and assets will accumulate in the hands of, and be held by, the low risk spouse; and, concomitantly, that liability and credit risks accrue only to the high risk spouse.

Thus, from a protective planning perspective, it makes no sense to have both spouses act as directors or officers of a corporation. This would needlessly expose the low risk spouse to directors liabilities in the event of business failure. If the low risk spouse is active in the business, her capacity should be as employee or consultant only.

From the same perspective, it may make no sense for the high risk spouse to own the shares of the corporation. Subject to allegations of fraud or piercing the corporate veil, share ownership does not attract liability, but allows for the accumulation of value. The low risk spouse can safely hold shares, unless there is any future likelihood of litigation into which the shareholder might be drawn.

Where the spouses' joint income exceeds their expenses, savings will result. Who should save? From a protective planning perspective, the answer is simple: the high risk spouse spends, the low risk spouse saves. Groceries, consumables, carrying costs, etc. are paid by the high risk spouse, while savings and investments are taken in the low risk spouse's name from money which accumulates in her private bank account into which only her salary is deposited.

The low risk spouse should consider, under her will and life insurance policies, whether to exclude the high risk spouse as a beneficiary. Depending on the degree of risk, it may be safer to benefit the children or others so as to ensure that, on the death of the low risk spouse, monies do not accrue to the high risk spouse at a time when he is insolvent. Of course, this may cause serious family problems if the child chosen to receive the bequest does not feel any moral obligation to support the surviving parent. The alternative is to establish, in the will, a discretionary testamentary trust which permits - but does not compel - the executor of the will (or other named trustee) to favour the surviving high risk spouse with discretionary funds.

Depending on the degree of sophistication and the amount of money involved, discretionary inter vivos trusts can also be established, whether in Canada or offshore in a climatically favoured tax haven. Such trusts may also serve tax planning objectives. They may be tailored for the high risk spouse's benefit (or the children) but so as not to be legally enforceable by her nor exigible by her creditors.[25] Some of the foreign jurisdictions afford significantly lower levels of creditor protective legislation which, in combination with blocking statutes against discovery and bank secrecy laws, render an attack against such trusts challenging, interminable or punitively expensive. This is tricky business which is fraught with legal and ethical perils.

C. RRSP's and RESP's

Most people invest their RRSP's with banks or brokerages. These investments are completely vulnerable to their creditors. But RRSP's can be creditor-protected under the *Insurance Act* if:

(a) They are held by or invested with an insurance company, in the form of an annuity; and

(b) The designated beneficiary on the RRSP annuity is a member of the protected family class, namely a married or common law spouse, child, grandchild, parent, or same-sex partner.

While the laws on RRSP exemption may be expanded legislatively in the next few years, for the time being this is the only expedient way to protect one's investment

[25] See, for example, *Mooney v. Orr* (1994), 33 C.P.C. (3d) 13 and 33 C.P.C. (3d) 31 (B.C.S.C.)

from one's own creditors. It is thus ideal for self-employed professionals who have no access to a pension plan.

Note that RESP's are not creditor-protected, even though they are in some sense held in trust for the children. The husband's creditor, for example, can recover the full value of the RESP if the husband is its sole owner, or half its value of the RESP is held jointly..

VII. Conclusion

Sexually transmitted debt is not necessarily bad. There is nothing wrong with financial integration of the family if this is done consensually and it leads to economic success. Problems arise only if this financial integration occurs without knowledge or consent, or for reasons which are structurally predisposed against the interests of women. Unfortunately, both of these factors are often present. In such cases, marital separation or the husband's business failure can lead to unexpected, unanticipated and extremely unpleasant outcomes. Knowledge, foresight and assertiveness are thus essential to limit these risks.

(**IMPORTANT NOTE**: Readers are cautioned that this paper should not be taken as legal advice. Legislation, and the relevant jurisprudence, changes frequently. This paper is a simplification of a complex field, and does not address provincial nuances and subtle issues that may have significant legal effect on a given case. Please consult a lawyer if you require legal advice on the topics discussed in this paper.)

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