Presented:

8th Annual Family Law on the Front Lines Conference
Galveston, Texas

Helping Your Client Deal With Debt in Divorce

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The first half of this article is adapted from *Who Gets the Debts, Or Worse, I'm Gonna File For Bankruptcy* by Diana S. Friedman.

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Increasingly, clients are as concerned about the division of their debt in a divorce as they are the division of their assets. It is not uncommon to have a divorcing couple with much more debts than assets. Especially in the current economy, managing debts has become an all-too-real concern for clients and the lawyers that represent them. This article will review the law applicable to debts and their division in divorce and give practical ideas for helping clients address their debt issues.

I. The Law Regarding Debts & Division

A. Presumption of Community

A marital debt incurred prior to divorce is presumed to be a community debt. *Cockerham v. Cockerham*, 527 S.W.2d 162, 171 (Tex. 1975). If the non-acting spouse contends that the debt is the acting spouse's separate debt, then the non-acting spouse has the burden of overcoming the community presumption. *Pemelton v. Pemelton*, 836 S.W.2d 145 (Tex. 1992). When there is no evidence that the creditor agreed to look solely to the separate property of one of the spouses for repayment, it is presumed that the debt is community in nature. *Rush v. Montgomery Ward*, 757 S.W.2d 521 (Tex. App. – Houston [14th Dist.] 1989, writ denied). Therefore, if the promissory note uses specific language that the creditor agreed to look solely to the separate estate of the contracting spouse for satisfaction then it will be separate in nature. *Cockerham*, 527 S.W.2d at 171.

However, the analysis does not end with whether a debt is community or not. It is only the beginning. This is because that designation does not clarify which spouse is actually liable for the debt. In fact, in Texas it is possible that liability can even attach to community property. Tex. Fam. Code sec. 3.202; *State Farm Lloyds, Inc. V. Williams*, 791 S.W.2d 542 (Tex. App. – Dallas 1990, writ denied). After determining that the debt is a marital debt, the next step of the analysis is to determine who or what is liable.

B. Who is Liable?

Before one can decide who should be awarded the debt in a decree, it is important to determine who or what may be liable on the debt. Subchapter C of the Texas Family Code is entitled *Marital Property Liabilities*, and it outlines Texas' stance on spousal liability and the rules regarding marital property liability. Tex. Fam. Code sec. 3.201-3.202. Although Texas is a "community property" jurisdiction with regard to assets, this community property body of law does not define the liability for marital debts. *Id.* Instead, marital debt liability in Texas can make a spouse personally liable, or the property held and managed liable, or any combination of both. *Id.*

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1. Personal Spousal Liability

A non-acting spouse is personally liable for the act of her spouse only if (1) the spouse acts as an agent for the non-acting spouse; or (2) the acting spouse incurs a debt for necessities. Tex. Fam. Code sec. 3.201.

The mere fact that one is married does not necessarily create an agency relationship between the spouses. *See Missouri K.T.R. Co. v. Hamilton*, 314 S.W.2d 114, 118 (Tex. App. – Dallas1958, writ ref'd n.r.e.). However, this was not always so clear cut. The 1975 *Cockerham* case greatly harmed the understanding of the law regarding the liability of marital debts. *Cockerham v. Cockerham*, 527 S.W.2d 162 (Tex. 1975). Specifically, the *Cockerham* case held that both spouses were personally liable for the debts created by a business, which was primarily managed by only one of the spouses. *Id.* at 171. The holding and *dicta* stated that the debt was presumed to be joint (or community in nature) since it was presumed that community credit was utilized to obtain the goods. *Id.* This dramatically extended the liability of the non-acting spouse with regard to debts created during the marriage.

The Legislature soon responded to the confusing *Cockerham* case by revising the marital liability statutes to specifically state that the mere fact of marriage does not create agency or liability between the spouses. Tex. Fam. Code sec. 3.201(c). This remains the current state of the law. *Id.* Therefore, it is necessary to analyze the specific facts to your case, and not just rely on the marital union to create agency or liability.

Since marriage itself does not create agency, one must be informed as to how the courts find agency-based liability. "Agency" is defined as "a relationship between two persons, by agreement or otherwise, where one (the agent) may act on behalf of the other (the principal) and bind the principal by word and actions." Black's Law Dictionary 62 (6th ed. 1990); *see also Bhalli v. Methodist Hosp.*, 896 S.W.2d 207 (Tex. App. – Houston [1st Dist.] 1995, writ denied).

In determining agency-created personal liability, the law utilizes traditional agency-based theories. For example, the elements of a "joint enterprise" are (1) an agreement which is either express or implied among members of the group; (2) a common purpose; (3) a common pecuniary interest between the members with regard to that interest; and (4) an equal right to voice the direction of the enterprise. Black's Law Dictionary 838 (6th ed. 1990); *see also Shoemaker v. Estate of Whistler*, 513 S.W.2d 10, 15 (Tex. 1974). If these prongs are met, then there is generally an agency relationship, which in turn creates personal liability for the debt.

To find other agency relationships between spouses, a number of common legal theories have been applied to determine the non-acting spouse's liability. For example, joint enterprise, joint venture, *respondeat superior*, third-party beneficiary, and partnership theories have all been used to attach liability to the non-acting spouse. *See Wilkinson v. Stevison*, 514 S.W.2d 895 (Tex. 1974) (joint enterprise); *Rhea v. Williams*, 802 S.W.2d 118 (Tex. App. – Fort Worth 1991, writ ref'd n.r.e.) (joint venture); *Graham v. McCord*, 384 S.W.2d 897 (Tex. Civ. App. – San Antonio

1964, no writ) (*respondeat superior*); *Nationwide of Brian, Inc. v. Dyer*, 969 S.W.2d 518, 520 (Tex. App. – Austin 1998, no pet.) (third-party beneficiary).

As stated, a proponent for attaching liability to the non-acting spouse must prove the existence of an agency-type relationship. Therefore, the existence or absence of an agency relationship is a question of fact. *Little v. Clark*, 592 S.W.2d 61, 64 (Tex. App. – Houston [14th Dist.] 1990, no writ).

The second prong of section 3.201 allows personal liability to attach if the acting spouse was using credit to purchase "necessities". Clearly, this is also a question of fact as to whether the goods involved were "necessities". Nevertheless, necessities have generally been defined as goods which are "reasonable and proper" for the person in the non-acting spouse's "station of life". *See Crooks v. Aero Mayflower Transit Co.*, 363 S.W.2d 191 (Tex. Civ. App. – San Antonio 1962, writ ref'd n.r.e.); *Daggett v. Neiman Marcus Co.*, 348 S.W.2d 796, 799-800 (Tex. Civ. App. – Houston [1st Dist.] 1961, no writ).

Given this broad definition, it seems that a good advocate could make most items a necessity. For example, the courts have found that a piano and cosmetics are necessities. *Lee v. Hall Music Co.*, 355 S.W.2d 365 (Tex. 1931); *Gabel v. Blackburn Operating Corp.*, 442 S.W.2d 818 (Tex. Civ. App. – Amarillo 1969, no writ). Furthermore, the obvious such as food, clothing and shelter are also necessities. *Wadkins v. Dillingham*, 59 S.W.2d 1099, 1100 (Tex. Civ. App. – Austin 1933, no writ).

The premise behind necessities and the liability imposed on the non-acting spouse is based on the law that a spouse has a duty to support his or her minor child as well as the other spouse. Tex. Fam. Code sec. 2.501 and 151.001(a)(3). A spouse or parent that fails to discharge that duty of support is liable to any individual who provides necessities to those individuals. *Office of Attorney General v. Carter*, 977 S.W.2d 159, 160-61 (Tex. App. – Houston [14th Dist.] 1998, no writ).

2. Marital Property Liability

Property Liability is dramatically different from personal liability. Property liability creates an *in rem* burden against the property without regard to personal liability.

In order to determine if marital property is liable, the property needs to be classified based upon which spouse generally manages it. Texas law recognizes five distinct classifications. After categorizing, it can be determined whether the property is liable. Tex. Fam. Code sec. 3.202.

The five classifications are: (1) husband's sole management community property; (2) husband's separate property; (3) wife's sole management community property; (4) wife's separate property; and (5) spouse's joint management property. *Id.*

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A spouse's separate property is not subject to the liabilities of the other spouse unless both spouses are liable by other rules of law. *Id.* at 3.202(a). Each spouse has sole management, control and disposition over the community property that they would have owned if they were not married. *Id.* at 3.102. This generally includes revenue from separate property, personal earnings, monetary recoveries for personal injuries, and the increases, mutations and revenue from all property subject to that specific spouse's sole management. *Id.*

However, if the spouses comingle their respective sole managed community property, then the mixed or combined community property becomes subject to the joint management of the spouses. *Id.* at 3.102(b). Finally, joint managed property, or property managed equally by the spouses, is defined as all remaining property not designated as sole managed community property. *Id.* at 3.102(c). By labeling the management rights of the property in question, a practitioner is closer to determining what exposure his client has regarding the debt.

Specifically, spouses' property is liable as follows:

Separate Property of Spouse	1.	That spouse's non-tortious liabilities during marriage;
	2.	That spouse's premarital liabilities;
	3.	That spouse's tortious liabilities during marriage;
	4.	That spouse'

	5. 6. 7.	s federal tax liabilities; The joint liabilities of husband and wife; The liabilities incurred for the children and the other spouse's necessities; and, The liabilities incurred by the other spouse if acting as agent.
Property Solely Managed by Spouse	1.	That spouse's premarital

		liabilities;
	2.	That spouse's tortious and non-tortious liabilities during marriage;
	3.	The joint liabilities of husband and wife;
	4.	The liabilities incurred for the children and the other spouse's necessities;
	5.	The liabilities incurred by the other spouse if

	6.	acting as agent; and, Federal income taxes incurred by both spouses.
Jointly Managed Property Liability	1. 2. 3. 4.	Both spouses' premarital liabilities; Both spouses' tortious and non-tortious liabilities during marriage; All joint liabilities of husband and wife; and, Federal taxes incurred by the

	spouses .

Thus, in order for a creditor to attach assets, the creditor must prove either that the spouse is personally liable, in which case all the non-exempt assets of the spouse are subject to liability, or that the non-exempt asset is jointly managed community property (rather than the non-acting spouse's solely managed community property). Again, jointly managed community property is subject to all liabilities of either the acting or the non-acting spouse.

The practitioner is urged to carefully plan their argument after analyzing all of their client's goals. For example, in the *Nelson* case, the court founds that the wife was not personally liable for the husband's debt. *Nelson v. Citizens Bank & Trust Co.*, 881 S.W.2d 128 (Tex. App. – Houston [1st Dist.] 1994, no writ). However, since the asset the wife was attempting to protect was jointly managed, the item of property was able to be liquidated to satisfy the debt the wife had avoided.

If the interplay between personal liability is not carefully considered with regard to the property liability, it is possible that a client's objectives will not be met because the sought after property item could be liquidated, as in the *Nelson* case.

In conclusion, the practitioner first needs to determine whether the debt was incurred solely by one spouse, or jointly by both; and whether the debt was incurred during the marriage. After the identified debts are classified (as tortious or non-tortious) then the last step is to determine if the debt was subject to agency principles and/or incurred for necessities. At that time the practitioner will be able to determine if there is any liability stemming from section 3.202.

C. Borrowed Funds Liability

Borrowed money adds a different host of problems to awarding liability amongst spouses. Whether loaned funds are community or separate generally depends on the intention of the parties obtaining the loan. *See Coggin v. Coggin*, 204 S.W.2d 47 (Tex. Civ. App. – Amarillo 1947, no writ); *Esdall v. Esdall*, 240 S.W.2d 424 (Tex. Civ. App. – Eastland 1951, no writ).

If the money is borrowed for the benefit of a spouse's separate property, and the intention is that repayment will be from separate property, it will likely be characterized as separate property funds. This is true even if the other spouse pledged her separate property to be able to secure the loan. *Armstrong v. Turbeville*, 216 S.W. 1101 (Tex. Civ. App. – El Paso 1919, writ dism'd). While such a convoluted series of facts is not advisable, spouses have the general ability to contractually alter the statutory provisions for liability. For example, a spouse may agree with a creditor that only that spouse's separate property will be liable for repayment, or that only separate management community property will be looked to for repayment. Of course, the creditor would have to agree to limit their remedies during the pursuit of a bad debt – which

is unlikely. In such a situation, it is best to include in the loan document a recital that the creditor agrees to look to that spouse's sole and separate property for satisfaction of the debt.

D. Unsecured Debts Liability

Most credit cards are opened with an account agreement. From a contract law perspective, only the parties to the contract are bound to the terms of the agreement. Therefore, it is simple to determine who is contractually liable if one has a copy of the account agreement – which hardly ever happens in practice. If that is the case, the practitioner can utilize the credit report to determine if the spouse is contractually responsible, or just an authorized user. Arguably, if a spouse is designated as an authorized user then that may create agency as defined above. Alternatively, if the purchases were for necessities, liability could be present regardless of whether one was an authorized user or not.

Nevertheless, an authorized user should probably not seek to assume this unsecured liability in the decree. If this is done, the authorized user will have a difficult time in restricting the future access of the other spouse to that account. While an injunction may assist in protecting the authorized user, it would still be advisable to not seek responsibility for the payment of this debt. Alternatively, the spouse who is the primary card holder should (as soon as legally possible) revoke the authorized user status of the ex-spouse to avoid problems.

E. Division of Debts

The trial court is charged with the duty to make a "just and right" division of the marital estate. Tex. Fam. Code sec. 7.001. In order to make a just and right division, the court must award both the assets and debts. *See Taylor v. Taylor*, 680 S.W.2d 645 (Tex. App. – Beaumont 1984, writ ref'd n.r.e.). Specifically, the division must take into consideration the equities, the nature of the property, the debts secured by liens on the property awarded, and the ability for that specific spouse to manage and pay for the property that is encumbered. *Walker v. Walker*, 527 S.W.2d 200 (Tex. Civ. App. – Fort Worth 1975, no writ). While there is no steadfast rule as to the allocation of the debts, an abuse of discretion *could* occur if the court orders that one spouse pays the majority of the debt. *See Welch v. Welch*, 694 S.W.2d 374 (Tex. App. – Houston [14th dist.] 1985, no writ); *Cogging v. Cogging*, 738 S.W.2d 375 (Tex. App. – Corpus Christi 1987, no writ).

The trial courts generally enjoy great latitude as it is permissible to award the physical property to one spouse and make the other spouse pay the debt associated with that property. *Cogging*, 738 S.W.2d at 375. However, the trial court cannot modify the contractual obligations between either of the spouses as to the creditor. *Walker v. Walker*, 527 S.W.2d 200 (Tex. Civ. App. – Fort Worth 1975, no writ). In other words, the court can never diminish or limit the creditor's rights to proceed against either spouse, or both spouses, for payment of a community debt that was incurred prior to the decree. *Blake v. Amoco Fed. Credit Union*, 900 S.W.2d 108 (Tex. App. – Houston [14th Dist.] 1995, no writ).

After the decree is entered, the rights and liabilities of the spouses may be different than they were prior to the decree. For example, community property that has been awarded by the trial court remains subject to the demands of creditors. Therefore, if the former wife received property that would otherwise be liable to the claims of creditors, she would now be *personally* liable for the payment of the debts to the extent of the property she received. *Swinford v. Allied Finance Co.*, 424 S.W.2d 298 (Tex. Civ. App. – Dallas 9168, writ dism'd w.o.j.); cert. denied 393 U.S. 923 (1968).

It is important to characterize all of the debts in a divorce case and to determine what or who is actually liable for them. As a multifaceted analytical process, the practitioner should make sure the client's property division objectives are addressed and planned for both before and after the divorce is granted.

F. Agreements to Change Marital Property Liability

Marital and premarital agreements can be an effective way to change the character of the parties' property. Because of this ability to change the character of an asset, a creditor's ability to satisfy a debt with that property may be affected. By executing a partition and exchange agreement, the parties can create an estate in which no community property exists. This would shield the party's separate property from the claims of their spouse's creditors. If liabilities are incurred for necessaries or if any agency relationship was created then neither spouse can keep their separate property from such liability.

Keep in mind that a partition or exchange agreement is void if the intent was to defraud a pre-existing creditor. Tex. Fam. Code sec. 4.106(a).

In order to provide constructive notice of the agreement to a creditor, the partition or exchange agreement must be acknowledged and recorded in the deed records of the county in which the real property is located. Tex. Fam. Code sec. 4.106(b).

G. Creditor's Rights Unaffected by Divorce

It is important to keep in mind and to continue to remind clients that the divorce court only has the ability to impose on a party the responsibility for paying certain liabilities. The allocation of debts does not extinguish the liability of the non-acting spouse from such debts if he or she is personally liable on the debt. *Blake*, 900 S.W.2d at 108; *Stewart Title Co. v. Huddleston*, 598 S.W.2d 321, 323 (Tex. Civ. App. – San Antonio) writ ref'd *per curiam*, 608 S.W.2d 611 (Tex. 1980).

The trial court cannot diminish the rights of the creditors to take action against either or both spouses for obligations which were incurred during the marriage unless the creditor is a party to the divorce action, which is unlikely. Additionally, assets that could have been used to satisfy a creditor's claim prior to the divorce can still be reached by the creditor after the divorce. *Anderson v. Royce*, 624 S.W.2d 621, 623 (Tex. App. – Houston [14th Dist.] 1981, writ ref'd

n.r.e.); *Inwood Nat'l Bank of Dallas v. Hoppe*, 596 S.W.2d 183 (Tex. Civ. App. – Texarkana 1980, writ ref'd n.r.e.). The only recourse that a party has in such a situation is to institute a proceeding against the defaulting spouse. This demonstrates why it is so important to use the indemnification language in your decrees and property settlements.

A creditor's rights are unaffected even in the case of bankruptcy. When one spouse files for bankruptcy protection after the divorce there is nothing to limit the creditors from proceeding against the other spouse if that spouse is also liable. Divorce will to affect the rights of third party creditors. *K.B. v. N.B.*, 811 S.W.2d 634 (Tex. App. – San Antonio 1991, writ denied); *Rush*, 757 S.W.2d at 523.

H. Uniform Fraudulent Transfer Act

It is important to consider the effect of the Uniform Fraudulent Transfer Act when advising clients about property settlement agreements. If the transfer of assets in a property settlement agreement is found to have violated these provisions then the transfer will be set aside as to both pre-divorce and post-divorce creditors.

The constructive fraud section of the fraudulent transfer act is where practitioners need to be wary. Tex. Bus. Com. Code sec. 24.006(a). A fraudulent transfer is made when there has been an exchange for less than a reasonably equivalent value and the debtor was insolvent at the time of the transfer or became insolvent as a result of the transfer. Based on this, it is necessary to consider whether or not the other spouse's financial condition is solid before accepting an agreement in which your client accepts non-exempt assets in a property settlement agreement.

II. Practical Strategies

The lack of liquidity or cash flow is often as much of a problem encountered in divorce cases as is the division of debts. Without cash flow, it may be impossible to maintain obligations imposed under temporary orders or to obtain or keep the representation of an attorney. Some divorcing couples may have an estate with assets, such as a house, business, or retirement plan, that has value but no liquidity. Other situations may involve the need to decrease debt to avoid bankruptcy. Sometimes a lawyer serves in the role of financial counselor to make suggestions for strategies to decrease debt and/or increase liquidity in an estate.

A. Four Ways To Decrease Debt

Christy Adamcik Gammill, certified divorce financial analyst and financial consultant, suggest four ways to decrease debt and increase liquidity for a client during and after the divorce process. In prioritizing debts for payment, look at the interest rate of a debt versus the balance owed. Pay off the debts with the highest interest rate and smallest balance first. This provides a sense of accomplishment and retires particularly expensive debt.

1. <u>Decrease Debt Using Existing Assets</u>

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Using existing assets to decrease debt service is the preferred way to manage debt. Except for maintaining an emergency cash reserve, existing cash assets should be used to retire debts that have higher interest rates. It does not make sense to keep cash in an account earning, for example, 5% interest, when a credit card is charging 20% interest (or higher) for the borrowed money.

Using the equity in a house or retirement plan to retire debt each pose unique challenges and opportunities. The current problems in the mortgage industry have made qualification on mortgages much more difficult for most people. No longer will mortgage companies accept "stated income" as a method of qualification. Instead, they are requiring proof of ownership of a bank account for a sufficient length of time, at least three months proof of income, etc. This poses a particular problem for a spouse who did not work during the marriage and who wants to purchase a house after the divorce. One strategy to improve the chances of such a client qualifying for a mortgage would be to term "temporary spousal support" received by the spouse as "alimony" for purposes of proof of income.

Another existing asset that can be utilized to pay debts during or after divorce is a retirement plan. A qualified retirement plan, such as a 401K, can be accessed at the time of divorce to take a distribution without penalty. The client will still have to pay tax on the funds distributed, but federal law provides a specific exception to the penalty when the funds are distributed following a divorce. Keep in mind, however, that if the funds are rolled over from a 401K to an IRA, then a penalty will be assessed. Non-qualified plans, such as IRAs, fall under different rules and generally cannot be withdraw upon divorce without penalty.

2. Increase Income to Pay Debts

Practically speaking, one way to generate additional funds to retire debt is to increase the income stream available to pay towards the debt. For some clients, this may involve simply getting a job. Some clients have not had to work outside the home during the marriage, but find their situation changing as a result of divorce. The reality of getting a job may be hard to face, but necessary. For those clients who have employment, an examination of their current potential may show that they are not employed in a position that reaches the full potential of their earning capacity. So, finding a new position that simply pays better will assist in generating funds available to pay toward debt. Another alternative may be to take a second job and utilize those funds solely to pay toward debt. All of these options may have other hurdles within the client's life, such as making child care arrangements, but the short-term priority of retiring debt may outweigh those hurdles.

Another option is to look at the automatic deductions from the client's pay. Make sure the income taxes are set at an appropriate level, not too high or too low. Also, if the client is making contributions to a retirement plan, stop the contributions and use that money to pay down debt. If the client is eligible for social security retirement, make sure they have filed under the right plan to maximize the monthly benefit.

3. Decrease Outflow of Monthly Resources

Another strategy to create liquidity to use toward decreasing debts is to decrease the outflow of monthly resources. Suggest that the client cut back on all nonessential expenses such as cell phones, cable television, club memberships, lawn service, pool service, housecleaning service, internet service, eating out, convenience foods, gourmet coffee drinks, etc. Although our society places importance on some of these items, they are recent additions to our culture and certainly life will go on without them on a short-term basis while other priorities are met. For example, cancelling gym membership and lawn service provides the opportunity to get exercise by mowing the lawn and saving money in the process to pay toward debt.

The "Envelope System" is another way to help clients realize sources of unnecessary spending. This system involves putting all debit and credit cards someplace where they can only be accessed in an emergency, like frozen in a glass of water in the freezer. All essential bills are paid online directly or through checks. For all non-essential expenditures, the client develops a budget for monthly expenses and segregates those monthly budget items by envelopes. The cash amount of the monthly budget item is put into that item's envelope and only spent toward those items. This makes the amount of money spent on some items a harsh reality. Suggested categories include: groceries, hair/facials/makeup/manicures, clothes, wine/beer, cigarettes, gym/trainer/nutrition, gas/fuel, gifts for other people, eating out, etc.

4. Create More Debt

Another option is to borrow funds from a retirement account. This is like borrowing from yourself. Each plan will have its own rules and restrictions that must be followed. Although it may be preferable to maintaining debt service, keep in mind that any funds borrowed from a retirement plan are paid back using after tax dollars, which results in essentially a double taxation of those funds when they are eventually taken out at retirement.

The last resort to decreasing debt should be the creation of more debt. Credit card companies advertise low interest rates on transfer balances, hoping to encourage people to apply for new debt. This only serves to harm the person's long-term credit rating, even if it provides available credit or reduced interest rate in the short-term. This does nothing to solve the problem of the overall debt service and only prolongs the reality of the debt problem.

B. Moving Forward

Moving forward after divorce, a client should be encouraged to use strategies to prevent the creation of debt. Living within one's means is a simple, but effective way to prevent the creation of debt. Having emergency cash reserves available to take care of unplanned expenses is another solution. Accurate and honest budgeting can provide a realistic view of the cash flow necessary to prevent the build-up of debt. Any financial planner can assist a client in making these decisions and plans.