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USING A PRENUPTIAL AGREEMENT TO PROTECT THE SMALL BUSINESS

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ABSTRACT

A divorce or death in the small business owner's family can threaten loss of assets and/or control of the business. A prenuptial agreement can be used to control the distribution of assets upon divorce and/or death in order to preserve the assets of the business and retain ownership and control of the business. Small business consultants are in a unique position to discuss this matter with their clients and suggest a policy regarding prenuptial agreements. General requirements of prenuptial agreements and possibilities for use in the small business are discussed.

INTRODUCTION

An owner of a successful business nears retirement age and wishes to transfer ownership of the business to his adult children. He wants one main thing from the transfer: the guarantee of an income for life. But his children are all married, and he knows that in the event of one or more divorces among the children, the business he worked so hard to build could be destroyed in the litigation. What would happen to his income stream if the business were not protected?

Consider the real case of George Lavelle, president of Lavelle Co., a wholesaler and distributor of building materials. Although he knew it would cause hard feelings, he made transfer of stock in his company to his eleven children contingent on two things: the income stream for life and the signing of a post-nuptial agreement by all his eleven children and their spouses. Although they all eventually signed against the advice of a divorce attorney, hard feelings were one of the unavoidable results. (Livingston, 1997). Or were they?

If George had considered this problem much earlier, before any of his children were married, he could have created a policy that any future owner of the business must have a valid prenuptial agreement in existence which protects the owner's interest in the business from the claims of an in-law. Those who own a small business or are contemplating one, or are involved in a family-owned business, have much to lose in the event of divorce. Assets accumulated by the small business during the marriage, as well as increases in value in previously held assets, will be considered marital assets subject to division in the event of divorce. A lack of liquidity in the business may necessitate selling some or all of the business assets to pay the non-owner spouse his or her share of the marital assets. These and other considerations suggest that a prenuptial agreement, often called a premarital agreement, be contemplated by small business owners before marriage.

ROLE OF THE SMALL BUSINESS CONSULTANT

Small business consultants such as attorneys, accountants, and financial planners are in a unique position to suggest the use of premarital agreements to small business owners and perhaps a policy regarding their use. Small business owners with children who may become involved in the business may not have considered the impact of a child's later marriage and possible divorce. Even if they have considered the use of a premarital agreement, few are actually implemented because of the hard feelings and distrust many people have when confronted with the issue. (Livingston, 1997). Small business consultants can suggest the use of a premarital agreement as well as ways to minimize hard feelings associated with it.

The time to consider the impact of a new daughter-in-law or son-in-law is not when the engagement is announced, but long before when the discussion is not as likely to be viewed in a hostile manner. If the owners wish to preclude a future in-law from acquiring an interest in the business, the time to consider the manner of accomplishing this objective is well before any marriage is contemplated.

A business could adopt a policy that all owners are expected to have a valid premarital agreement with their spouses which precludes the spouse from obtaining an ownership interest in the business. A policy applied to all owners will reduce the likelihood that anyone could be singled out later, and encourage compliance with the policy.

GENERAL PRINCIPLES

Premarital agreements serve two purposes: to provide for the division of property upon divorce, and to provide for the distribution of property upon death. One agreement may provide for both situations. The idea that couples may provide for the distribution of property upon death in a premarital agreement has been long accepted by the courts. However until the 1970's, courts were reluctant to accept that couples could lawfully contemplate divorce before they were married and provide for a division of property in advance. (Brandt, 1997). This was founded on the belief that such agreements fostered divorce and were against public policy.

In reality, such agreements evidence the thoughtfulness of the couple before marriage and can provide for the early resolution of many issues, both financial and otherwise. Financial issues dominate most premarital agreements, and suggestions for the small business owner are discussed below.

However, there are other issues which the couple may choose to include in the agreement such as the religious faith and surname of future children. The understanding of the parties as to whether to have children at all may be addressed in the premarital agreement, although the enforceability of such a provision is doubtful. Premarital agreements have included such unusual matters as post-marital weight gain, pet custody, frequency of sex, and other day-to-day matters, most of which are probably unenforceable and not an appropriate use of the premarital agreement. (Garpstas & LeGalley, 1996; Hoffman, 1995).

Premarital agreements are a matter of state law, and each state may have its own particular requirements. Often these requirements are found in the case law, rather than statutory law. There is a Uniform Premarital Agreement Act [UPAA, (1987)], which has been adopted by about half of the states including Arizona, Arkansas, California, Connecticut, Delaware, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Maine, Montana, Nebraska, Nevada, New Jersey, New Mexico, North Carolina, North Dakota, Oregon, Rhode Island, South Dakota, Texas, Utah, and Virginia. (Brandt, 1997). The following discussion includes general principles found in many states and the UPAA, and recommendations to avoid common pitfalls.

Formalities

The premarital agreement must be in writing and signed by both parties. This is required under the Statute of Frauds and the UPAA. Witnessing and notarization are recommended but not generally required. Premarital agreements are generally not enforceable unless the parties do actually marry, except to the extent necessary to avoid an inequitable result.

Voluntary agreement

The premarital agreement must be voluntarily entered into by both parties. Duress and undue influence must be avoided. Duress is a threat that overcomes a party's free will. Undue influence is a pressure or coercion that can occur between parties in a confidential relationship with each other. Courts generally recognize that parties about to marry do not deal at arms' length with each other. "Unlike a party negotiating at arm's length, who generally will view any proposal with a degree of skepticism, a party to a premarital agreement is much less likely to critically examine representations made by the other party. The mutual trust between the parties raises an expectation that each party will act in the other's best interest. The closeness of this relationship, however, also renders it particularly susceptible to abuse. Parties to premarital agreements therefore are held to the highest degree of good faith, honesty, and candor in connection with the negotiation and execution of such agreements." ("In the Matter of the Estate of Beesley," 1994).

Undue influence can occur if one party suggests a premarital agreement at a time close to the wedding date and threatens to back out of the marriage unless the other party agrees. At this point, wedding invitations have been sent and all the arrangements made. One party may feel that the embarrassment and expense of calling off the wedding are too much to bear and agree to something to which he or she would not otherwise have agreed.

Those were the basic facts of *Lutgert v. Lutgert* (1976). The parties had known each other for quite some time, but were engaged for a period of four weeks before the wedding. Each had been married before and were middle-aged at the time of the marriage. The wedding occurred suddenly. The prospective groom suggested on a Monday that they be married on the following Thursday if they could book passage on the SS Constitution for an extended honeymoon. The prospective wife agreed. By Tuesday, the passage had been arranged and the parties spent the remainder of the day purchasing expensive wedding clothes for both of them, straightening out the passports, getting blood tests, making all the official arrangements, and inviting family and friends. On Wednesday, the wedding rings were sized and the license obtained. On Thursday, while the final sizing on the rings was being done at the jewelers, the groom pulled a premarital agreement out of his pocket and asked that the bride sign it.

She objected, and the groom arranged for her to speak to his attorneys on the telephone. The groom's attitude was that there would be no wedding unless the agreement was signed. The bride signed the agreement shortly after midnight at the airport immediately before they were married. The bride was certainly aware that the groom was quite a wealthy man and the subject of a premarital agreement had been discussed before between the parties. Nevertheless, the court found that the husband "sprang the agreement upon her and demanded its execution within twenty four hours of the wedding..." Therefore, the court found that the bride had not voluntarily signed the agreement and invalidated it. (Lutgert v. Lutgert, 1976)

On remarkably similar facts, the court in the *DeLorean* case did not invalidate the premarital agreement. (DeLorean v. DeLorean, 1986). Hours before the wedding, the groom presented the bride with a short premarital agreement that "... any and all property, income and earnings acquired by each before and after the marriage shall be the separate property of the person acquiring same, without any rights, title or control vesting in the other person." The groom persuaded an attorney friend of his to advise the bride, and he advised her not to sign the agreement. At the time, the groom was a senior executive with an automobile manufacturer, in his mid-forties, and 25 years older than the 23 year old bride.

Nevertheless, the court found the agreement voluntary under California law. "While it may have been embarrassing to cancel the wedding only a few hours before it was to take place, she certainly was not compelled to go through with the ceremony." Although the court did not invalidate the agreement, it is never wise to broach the subject of a premarital agreement close to the date of the wedding.

Full and fair disclosure or knowingly waiver of same

The best evidence that the parties knowingly entered into a premarital agreement is an itemized list of each party's assets included in the agreement itself. Each party can see what assets the other owns and may knowingly waive some or all claims to those assets. Iowa, Nevada, and New Jersey specifically require financial disclosure as an independent requirement for validity of a premarital agreement under their version of the UPAA. (Brandt, 1997).

In lieu of the itemized statement, the premarital agreement may include a statement that each party waives disclosure of the other's assets. Of course, this must be a voluntary waiver on the part of both, and evidence that each party had access to legal counsel and adequate time to contemplate the matter are important to later enforcement of the waiver. Lack of legal counsel by Amy Irving at the time she signed a premarital agreement on a scrap of paper with her fiancé, Steven Spielberg, caused the court to invalidate the premarital agreement. Spielberg then settled with Irving for $100 million after their four-year marriage. (McMenamin, 1996).

A third possibility is that the parties already know the assets of the other. The UPAA expressly includes this under its discussion on enforcement of the premarital agreement. The UPAA also provides that the party seeking to avoid the agreement has the burden of establishing that there was no full and fair disclosure or waiver. There may be a time limit on raising objections to the agreement. New York limits the time to six years from the date the agreement was signed. (McMenamin, 1996).

Agreement not unconscionable at the time of execution

Courts have traditionally had the power to decline enforcement of any agreement found to be unconscionable. Under the UPAA, the issue of unconscionability focuses only on the time of execution of the document, not at the time of enforcement. As such, the UPAA prohibits courts from taking into consideration any change of circumstances from the time of execution to the time of enforcement. Additionally, the UPAA couples the unconscionability issue with the issue on full and fair disclosure. Therefore, under the UPAA, a party can avoid enforcement only if the agreement was unconscionable at the time of execution <u>and</u> there was no full and fair disclosure or knowing waiver. The UPAA has been criticized because of this. (Ladden & Franco, 1990; Davis, 1988). North Dakota and Connecticut have adopted the UPAA, but retained the right of the court to refuse to enforce some or all of the agreement if it is unconscionable at the time of enforcement. (Brandt, 1997; Parley, 1995).

USE OF THE PREMARITAL AGREEMENT IN CONTEMPLATION OF DIVORCE

In the absence of a premarital agreement, assets acquired after the marriage are considered "marital assets" subject to division by the court. Some assets acquired during the marriage, particularly gifts and bequests made to only one party, are typically excluded from the definition of marital assets. While assets owned before the marriage are non-marital assets, increases in value due to appreciation and additions to investments during the marriage are marital assets.

For the small business owner, this means that the owner's assets in the business acquired after the marriage will be thrown into the hopper as part of the total marital assets to be divided. These assets can include inventory, business equipment, cash on hand, and accounts receivable. In order to keep the owner's interest in the business after the divorce, the owner-spouse may have to relinquish claims on substantially all the other marital assets. These can include an interest in the marital home, bank accounts, investments, automobiles, personal property, and the like. This can leave the owner-spouse with little other than the business after the divorce.

In some cases, the assets of the business on paper will exceed half the total assets of the marriage and force the owner-spouse to sell some or all of the business to pay the other spouse his or her share. Because of these possibilities, business owners should consider the following options.

<u>Complete waiver of rights in each other's assets</u>

Each party may completely waive the interest in the other's assets acquired during the marriage. This means that each party's earnings, additions to the business, investments, and such would remain each party's separate property. While this would protect the owner-spouse's interest in his or her business, the provision also cuts the other way. If the business were not particularly successful at the time of divorce, the owner-spouse would be prohibited from claiming any interest in the other spouse's assets.

<u>Partial waiver of rights in each other's assets</u>

A partial waiver of rights can involve each party waiving an interest in certain property held by the other. For example, if each party owned a business coming into the marriage, each could waive any interest in additions or increases in value in the other's respective business, but consider all other property acquired after the marriage as marital property subject to equitable division.

In a family business situation, the prospective in-law can be asked to waive any interest in the family business in the event of divorce. These agreements designate the family member's interest in the family business as separate, non-marital property, including any appreciation in the business' value. The business value is not included when determining the marital assets. (Sharfstein, 1998).

Another possibility involves lessening the percentage of interest one party acquires in the other's assets acquired after the marriage. For example, the typical division without a premarital agreement is one-half to each spouse. The parties could agree to a one-third share in the other's assets. This would mean that an owner-spouse could claim no more than one-third of an interest in investments, savings, and such, acquired and maintained by the other spouse during the marriage out of his or her employment. At the same time, the non-owner-spouse could similarly claim no more than one-third of an interest in the owner-spouse's business. This type of partial waiver reflects the fact that one spouse's employment often helps support the owner-spouse while getting a business started and growing.

A third possibility involves protecting a future income stream that arises out of work performed before the marriage. Persons who sell life, property, and casualty insurance receive residual income after the policy is sold. Similarly, persons involved in multilevel marketing businesses, such as Amway, Mary Kay Cosmetics, NuSkin, and the like, often receive bonuses based on the sales performance of their downline distributors. Some of these downline distributors may have been in place before the marriage, yet the income stream from these distributors will continue into the future. The parties involved in such a business may want to structure their agreement to exclude some or all of such income attributable to previous policyholders or distributors.

Satisfaction of marital rights out of nonbusiness assets

An agreement can provide that the spouses are not waiving their marital rights, but are choosing to indicate how each spouse's rights would be satisfied. This can protect the small business assets from being transferred to the non-owner-spouse. This can also prevent the non-owner-spouse from becoming an owner in the business. This is especially important in the closely-held business. However, the parties need to plan how the marital interest of the non-owner-spouse will be satisfied. There must be enough other marital assets to cover the spouse's one-half interest. The owner-spouse, if involved in a closely-held business with others, might consider executing a buy-sell agreement with the other owners to prohibit transfers to third parties such as a soon-to-be-former spouse. (Frunzi, 1990)

If the business involved is a family-owned business, the parents or other relatives of the couple may have a significant interest in the couple's premarital understanding. Parents often worry that a former son-in-law or daughter-in-law may acquire an interest in the business they have worked so hard to build. The fact that the couple enters into a premarital agreement does not protect the parents' interest fully because the couple can amend or revoke their own agreement after the marriage without anyone's knowledge or consent. Commentators suggest having the parents or other family members as signatories on the original premarital agreement with the requirement that they agree to any amendments or revocation. (Sharfstein, 1998; Frunzi, 1990) The parents' wills also may be used to control the couple by providing that the child's share in the family business is contingent on the existence of a binding premarital agreement at the time of distribution. (Frunzi, 1990)

USE OF THE PREMARITAL AGREEMENT IN CONTEMPLATION OF DEATH

Most states recognize a person's right to use a premarital agreement to limit one spouse's future legal interest in the estate of the other. Persons in their second or later marriage often have children from a former marriage to whom they would prefer to give the bulk of their estate, particularly a small business nurtured by the parents during their lifetimes.

In the absence of a premarital agreement, however, most state laws provide that a spouse be provided for in the event of death. This is accomplished through the law of intestate succession when a person dies without a valid will. Most states provide that a surviving spouse receive between one-third and all of the estate if the other spouse dies intestate. In the event a valid will is left without adequate provision for the surviving spouse, state law allows the spouse to take a statutory forced share of the estate, thereby diminishing all other bequests pro rata.

A premarital agreement can include a waiver of the right to a statutory forced share and require that each spouse make a will providing for the other in lieu of the statutory forced share. In the event that no valid will was executed by the time of the decedent's death, a court would enforce the premarital agreement as a contract to make a will. This could have a major impact on the surviving spouse. Instead of receiving a substantial part of the decedent's estate under the law of intestate succession, the surviving spouse may receive a small gift, or none at all.

In the event that a valid will and premarital agreement reflected the same understanding, the court would have two indications of the decedent's intent and enforce the terms. In the event the will and premarital agreement differed, the court would probably determine the decedent's intent based on which document was executed last. If the premarital agreement were executed first and a will executed later that provided for a greater gift to the spouse, the court would likely view the later will as the best indicator of the decedent's intent. If the will were executed first, the premarital agreement would likely be viewed as the better indicator. It is possible that the decedent forgot to change the will in accordance with the premarital agreement.

Retirement benefits

A premarital agreement should not be used to dispose of retirement benefits. The federal pension law precludes nonparticipant spouses from relinquishing survivor annuities before marriage. (ERISA, 1988) Although one court (In re Estate of Hopkins, 1991) has held that a premarital agreement validly waived rights under ERISA, the decision has been criticized as a misreading of the statute since only spouses can waive rights. (Rose, 1991) Since then, several courts have held that premarital agreements cannot waive spousal rights under ERISA. (Hurwitz v. Sher, 1992; Nellis v. Boeing Co., 1992; Zinn v. Donaldson, 1992; Howard v. Branham & Baker Coal Co., 1992; Featherston & Douthitt, 1997). Unless the nonparticipant spouse voluntarily relinquishes these rights after the marriage, the spouse will be protected.

ADDITIONAL CONSIDERATIONS

The following are additional considerations the parties and their attorneys should contemplate as part of drafting and executing the premarital agreement.

Use separate legal counsel and pay separately

The party desiring the premarital agreement should not recommend or pay for the other party's attorney's fees. This helps show that neither party misunderstood the effects of the agreement. If the party refuses to do so, include a statement in the premarital agreement that the opportunity for independent counsel was afforded and declined.

Consider the duration of the agreement

Most parties assume that the agreement will last for the duration of the marriage, and it should, if no other provision is made. The parties may want to consider a duration such as fifteen years. If a petition for divorce were filed within the fifteen year period, the agreement would be in force. If the petition were filed beyond that time, the agreement would have expired and the state law on divorce would apply. Parties may desire this result under the belief that after fifteen years, the marriage could be considered "long-term" and that both parties would have worked equally long in the marriage and be entitled to share equally in the division of assets.

Provide for full and fair disclosure

Itemize each party's assets and include this list in the agreement. Consider using separate certified public accountants to prepare each party's financial statements for attachment to the agreement.

Indicate which state's law should apply.

State laws vary quite a bit. What might suffice for full and fair disclosure in one state may not be enough in another. The parties may make the agreement in one state with advice from a local attorney and later move to another state.

Consider an escape clause to renegotiate if federal tax laws change.

If tax considerations are an important part of the premarital agreement, provisions were likely made on the basis of the then-applicable federal tax laws. In the event of a change in law in the future that would affect the tax liability of the parties, an escape clause allowing renegotiation under current law is advisable.

Consider arbitration instead of court enforcement.

Each party should consult his/her attorney about the availability of local arbitrators. If they are available, that option should be considered. It can be quicker and less expensive than paying both divorce attorneys to litigate the matter in court. (Guttman, 1996).

Execute the agreement ten or more days in advance of the wedding.

This helps avoid claims of duress at the time of execution.

Have the agreement witnessed and notarized.

Some states require this, and it helps establish that the parties recognized the formality of what they are doing.

Consider videotaping the final review of the document and signing.

The videotape will show each party and their respective attorneys going through the document clause by clause, explaining the impact of the document. It will also show the parties indicating their understanding and signing the agreement. This will help avoid claims that the parties did not appreciate the effect of the agreement.

CONCLUSION

Persons considering marriage, especially those involved in a small business, have many reasons for considering a premarital agreement. A clear premarital understanding of the financial agreement between the parties can go a long way toward encouraging mutual cooperation during the marriage and, if necessary, simplifying the arrangements at the time of divorce or death.

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