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Using Spousal Agreements for Asset Protection

By Alexander A. Bove, Jr. and Melissa Langa

It is well-settled law in all of our states that a husband and wife can contract with one another.[1] It's also well-settled that, in all states, future spouses can enter into a pre-marital contract, fixing their respective rights in separation, divorce or death.[2] Most states even allow spouses to enter into binding postnuptial agreements establishing the spouses' respective rights to property, or calling for property division.[3]

But although there is little question that all of these agreements can be binding on the respective spouses, it's not at all settled whether such agreements, particularly postnuptial agreements, are binding on third parties, that is to say the spouses' creditors.

We propose that spousal agreements made after the marriage vows have been taken and accompanied by an actual property division between the spouses pursuant to the agreement, at best could protect the transferred property from creditors of the transferor spouse, and at least could place substantial obstacles in the path of a creditor seeking to reach the property.

Indeed, we see such benefit and so little risk to the postnuptial agreement as an asset protection strategy that we recommend you consider it for all married couples.

Who's This For?

The situation we contemplate is a couple who has been married for a number of years (the more, the better) and acquired assets over time. Of course, there are many couples today in which both spouses more or less equally contribute to the marital estate financially. For them, a division or

attribution of assets is not much of a problem; a spousal agreement accompanied by a division of assets usually can be supported by evidence of actual financial contribution.

But it's also common that one spouse contributes more financially while the other contributes by meeting other family obligations. Such a situation raises the question: How does the spouse who has not contributed financially justify any legal right to the marital estate?

Courts dividing marital estates have repeatedly recognized each spouse's equitable rights to a share of the estate, typically based on the length of the marriage and each party's respective contribution to the marriage as a whole.[4] From this long-established case and statutory law, it seems reasonable, if not necessary, to conclude that each spouse's rights to the marital estate have accumulated and essentially vested during the marriage. Otherwise, one would have to conclude that there was no marital estate until dissolution of the marriage—a patently untenable conclusion.

Yet our courts and system of domestic law and their effect on the exposure of the marital estate to the creditors of one spouse completely contradict this reasoning. For instance, consider a couple married, say, 25 years, during which time they accumulated assets through the husband's lucrative career (made possible by the wife's contribution to other family obligations). Imagine that virtually all the assets are in the husband's name, as so often happens. In the event of a divorce, a court presumably would divide the marital estate in equitable fashion, ordering the husband to transfer a share of the marital estate to the wife. But now imagine that just before the divorce action, the husband is sued and a judgment is issued, resulting in an order that will consume all of the husband's assets. It's quite possible. And, yet, is it fair? Shouldn't the wife be able to claim that her share of the marital estate is exempt from the husband's creditors?

Unfortunately, although a few reported cases do make some reference to the fact that an arm's length property settlement in anticipation of divorce or separation may be supported by fair consideration,[5] we were unable to find any case that supports protection of assets in a pure postnuptial spousal agreement that divides the marital estate.

Nevertheless, it would seem that virtually every divorce or separation settlement recognizing a financially non-contributing spouse's rights to a share of the marital estate would seem to support the concept. And those states that recognize postnuptial agreements[6] lend further support to this argument.

Accordingly, we propose that spouses who negotiate at arms-length and enter into a postnuptial agreement (not in anticipation of divorce or separation but simply to fix their respective rights to property in their marital estate) and who actually divide the property pursuant to this agreement, should be able to protect such transfers against an attack by the transferror's creditors. We also believe that this argument generally should apply in both community property and non-community property states.

Air-tight

In the event that postnuptial agreements stand any chance of offering protection from creditors of the transferor spouse, they must comply with certain standards, including those required for enforceability of such agreements as between the spouses. For instance, each spouse should be represented by independent counsel. Each spouse should make a complete financial disclosure to the other. The agreement also should be fair and reasonable under the circumstances.

To lend further strength against creditors, not only should the agreement be recorded in the registry within the county where the spouses reside but also any transfers of real property pursuant to the agreement should be recorded.

Be aware: Making such a recording may not be as simple as it might seem. It is one thing if the spouses have property in joint names or in one of their names; then, all that's needed is a simple deed transferring title pursuant to the agreement. But it's quite another thing when one spouse's property is held in a limited liability company, partnership, corporation or nominee trust. Typical recording statutes and practices often do not seem to contemplate any recording other than an outright interest in real property.

Yet it is essential to record the postnuptial allocation of property to put third parties on notice. Accordingly, there *should* be no reason why the agreement and transfers pursuant to the agreement should not be recorded in the relevant registries. Problem is: registries show ownership in the entity and not in the transferor spouse. That's why it is important when drafting both the postnuptial agreement and the transfer documents that appropriate reference to the underlying realty be made—as well as complying with all the rules of a particular registry.

Loss of privacy is another consideration when recording. The whole point of recording is to give notice to third parties (that is to say, to give public notice) of transfers pursuant to an agreement. Such exposure may pose problems for some clients. First, recording a postnuptial

agreement may give the mistaken impression that a couple is having marital problems. Also, assets that once were private and unknown to creditors or potential creditors (because of the entity ownership) become public knowledge. These concerns must be weighed against the urgency of the situation and the benefit of placing in the creditor's path the substantial obstacles constructed of the recorded agreement and transfers.

For clients who don't want to lose privacy, the question arises, "Is there any benefit to an unrecorded spousal agreement?" The answer is an unequivocal "maybe." If the agreement meets all other requirements, we feel it certainly will be binding as between the spouses. But as to third party creditors, protection may depend on when the agreement and transfers took place vis a vis the creditor's claim, whether or not the agreement is recorded. If the parties rushed into an agreement motivated by the knowledge of the existence of the creditor's claim, or worse, after a formal claim, it may be difficult to successfully argue that the transfers were not fraudulent transfers, especially if they left the transferor (debtor) spouse insolvent. On the other hand, if the agreement and transfer took place when no claims were "pending, threatened, or expected," there is a likelihood that the transfers would withstand a future creditor's attack, even though unrecorded. In either event, remember that the burden is on the creditor to prove, at its own further expense and in a separate proceeding, that the transfers were fraudulent.

Of course, for the common argument attacking a transfer as fraudulent to be successful, it must be either that the transferee had no enforceable right to the property or that fair consideration did not accompany the transfer. We believe such arguments can be rendered inapplicable.

If we agree that each spouse's rights accrue and gradually vest during the course of the marriage, then at any given time the spouses can agree to formally acknowledge those then-existing rights and divide their property accordingly. And if the property is transferred in satisfaction of an *existing* legal interest in such property, the transfer may not be subject to a claim that it was a fraudulent transfer,[7] because it was merely a transfer of a share in property in which the transferor already possessed an interest, similar to the severance of a tenancy-in-common.

On the other hand, even if no technical legal interest was recognized, the transfer may be regarded as having been made for fair consideration, because the transferee spouse would be

relinquishing her or his pre-existing enforceable claim to a share of the marital estate in return for the transfer.

In either case, a creditor would have to overcome both arguments before being able to reach the transferred property.

Accordingly, such transfers pursuant to a postnuptial agreement may withstand an attack even by creditors whose claims existed at the time of the postnuptial transfer (although different rules may apply in the event of a bankruptcy proceeding).

Cost/Benefit Analysis

Considering that there is no prohibition against entering into a postnuptial agreement, we are faced with two questions: What is the harm in entering such an agreement? And what is the possible benefit?

What harm?

The worst possibility is that the transfer in the postnuptial agreement could be regarded as an intentional fraudulent transfer (that is to say, one made with actual intent to prejudice a creditor). In bankruptcy, such a finding can result in the court refusing to enter a discharge.

There is certainly no crime involved. Nor, at least in almost all states, is there any cause of action for making a fraudulent transfer either against the transferor or against the attorney who assisted.[8] In such cases, a creditor (through the court) has numerous remedies available, including a rescission of the transfer—but nothing more. And that would be the case even with an existing or perhaps imminently foreseeable creditor (at the time of the agreement).[9]

If the agreement and transfers are completed and a creditor turns up six months or a year later, the picture is completely different; the creditor would find it extremely difficult to upset the agreement and transfers if properly structured and carried out. Creditors who make their claim years later may find their claims timed-barred.[10]

What benefit?

The potential benefits of a postnuptial agreement appear to far outweigh the risks. First, it must be kept in mind that an action to recover transferred property that was allegedly the object of a fraudulent transfer is a separate action that typically follows a judgment (although in some cases

the claims can be filed concurrently even though requiring separate factual determinations and burdens of proof).

In other words, the creditor first would have to obtain a judgment against the transferor in order to be able to conduct discovery to locate the assets and reveal the transfers, and then sue again to prove in court that each transfer was fraudulent. If successful, only then could the creditor recover those assets found to have been fraudulently transferred. And whether a transfer is fraudulent as to a particular creditor is a factual issue, and in the contention at hand, the spouse would argue the validity of the postnuptial agreement and the accompanying issues of fair consideration and prior ownership of the assets. With the substantial amounts of time and litigation expense looming yet no assurance of success, most creditors would probably settle rather than risk total loss, which would happen if the court upheld the agreement and the validity of the transfers.

Taxes

Naturally, we must ask whether there will be any adverse tax results in transferring property pursuant to the settlement. With very limited exception, the answer is, "no." Insofar as a postnuptial agreement is concerned, the Internal Revenue Code provides that "no gain or loss shall be recognized as a transfer of property from an individual to … a spouse,"[11] and such transfers are not taxable gifts.[12]

And so we are left with this conclusion: Even though we could find no cases exactly on point as to cause and effect, there are cases holding that valid postnuptial agreements may be effective to protect assets from creditors of a transferor spouse.[13] There are no adverse tax consequences to the postnuptial agreement and related transfers. And the cost/potential benefit ratio is quite favorable. Indeed, the postnuptial property division agreement may well become a recommended and integral part of most couples' asset protection plan.

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[1] *Garrity v. Garrity*, 504 N.E.2d 617 (Mass. 1986)

[2] Duncan E. Osborne and Elizabeth M. Schurig, *Asset Protection: Domestic & International Law & Tactics* Section 13.18 *et.seq.* West Publishing (2009).

[3] Sean Hannon Williams, "Post Nuptial Agreements," 2007 *Wis. L. Rev.* 827 (2007)

[4] See e.g., Mass. Gen. Laws ch. 208 § 34 (2007)

[5] *In Re Pilavis*. 233 B.R.1 (Bamkr. D. Ma. 1999)

[6] Note 3, *supra.*

[7] *See for example*, Mass. Gen Law ch. 209 § 25.

[8] Uniform Fradulent Transfers Act Section § 4

[9] Alexander Bove "The Ethics of Asset Protection Planning – An Oxymoron?" 41st Annual Heckerling Institute on Estate Planning, University of Miami School of Law.

[10] UFTA Section § 9

[11] I.R.C. § 1041

[12] I.R.C. § 2523

[13] *Friedman v. Friedman*, 100 Cal. App. 4th 65, 122 Cal. Rptr. 2d 412 (2002)