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The Top 10 Reasons 21st-Century Couples Should Consider a Prenuptial Agreement

by Burton A. Mitchell and Elaine M. Leichter

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Spouses are not mere roommates. They are *partners*, with each individual assuming obligations to support the other during their marriage and with each being entitled to certain marital property rights, depending upon their circumstances and where they live.

Maybe Everyone Needs a Prenuptial Agreement

Since the various state law marital property systems can wreak havoc on rights that a couple might think they acquired in property during their marriage, and since the mix of state laws is so confusing – then, unless the couple is going to live in the same jurisdiction throughout their marriage, should every couple with individually accumulated assets prior to marriage consider a prenuptial agreement?

Not necessarily.

State marital property rules should be adequate for couples starting out with few assets or liabilities and who will build wealth together. If the couple has accumulated significant wealth and must change their domicile, they can consider a postnuptial agreement. (No short-cuts allowed, however – each spouse *must* have independent representation.)

Here are ten excellent reasons for a couple contemplating marriage to consider a prenuptial agreement when one or both of them bring substantial separate property to their future marriage.

Segregate Inherited Wealth

It is the nature of inherited wealth that the senior generations, be they alive or dead, are third parties in the marital relationship. A prenuptial agreement will draw boundaries around, and set ground rules regarding, the couple's use of inherited wealth. Two goals to be accomplished with these prenuptial agreements are as follows:

REASON 1. *Avoid diluting control of inherited wealth.*

The primary goal here is to have effective segregation of the inherited funds. Commentators have claimed that this can be accomplished with trust arrangements. As California lawyers, we believe that no trust can be relied upon to protect an inheritance. Inherited property held in an irrevocable discretionary trust is presumed to be available for support (if the heir is the ***supported*** spouse). A pattern of past distributions will be presumed to continue, for the purposes of calculating spousal support (if the heir is the ***supporting*** spouse). An inherited interest in a family business may not retain its separate property character if the beneficiary actively manages the business and is not adequately compensated for those efforts. A prenuptial agreement is the appropriate tool for the job.

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The Effect of Marriage on Property Rights

Marital property laws vary widely.

Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin are community-property states, in which spouses are generally treated as full economic partners. (Alaska adopted a form of community property law in 1998.)

Community property wealth derived during the marriage is owned jointly in equal, present, undivided interests. Each spouse owns or controls the disposition of 50 percent of the marital community upon divorce or death. Beyond these fundamentals, state-by-state variations are significant.

The remaining states are common-law jurisdictions. Each spouse owns what he or she earns or receives. The non-earning

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REASON 2. *Keep a family business that will be managed by the new spouse in the family.*
In this example, the inherited business interest is simultaneously a quintessential marital asset (the business maintained/built up by the working spouse/heir during the marriage) and an inherited asset. Expect the court to give preference to the "marital asset" character over the "inherited asset" character. In California, the intangible value of the business attributable to the spouse/heir's efforts during the marriage can become the dominant factor in the value of the business over the course of the marriage. The only way to ensure that the underlying equity value or voting control of the family business remains the heir's separate property is with a prenuptial agreement.

Maintain Specific Separate Wealth

Reasons Three and Four are variations on the "Inherited Wealth" theme. The different relationship that the owner has with his or her property tends to change the dynamics of the negotiation of the prenuptial agreement.

REASON 3: *Maintain control of specific separate property assets; manage expectations.*
In this case, the separate property coming into the marriage can be anything – an investment property/project, a portfolio, even a residence. The spouses' respective words, conduct and unspoken assumptions can create confusion. A prenuptial agreement can avoid ambiguities regarding the character of these separate property assets over the passage of time. Opportunities for expensive-to-litigate he-said/she-said arguments can also be foreclosed. For example, the non-owner fiancé may expend personal skill and effort in the management of an asset owned by the other fiancé and may expect to become a co-owner of the asset after the marriage (based upon premarital and post-marital efforts). The owner fiancé may view his or her beloved as generously having given of his or her time with no expectation of becoming a co-owner. The owner fiancé may view the separate property asset as something that he or she must preserve at all costs, or he or she may be possessed of a self-confidence that allows him or her to be more generous. Prenuptial agreement negotiations will help to uncover miscommunications that the fiancés may not even realize exist and may provide them an opportunity to sort out these issues.

REASON 4: *Maintain separate property ownership of a business; limit marital property to compensation paid to the owner spouse during the marriage.*
In this case, the owner fiancé is an entrepreneur, professional, artist or entertainer. The couple wishes to have marital property from earnings without risking the entrepreneur's ownership and control of the business. The owner spouse is directly responsible for the existence of the business (either alone or in partnership with a co-owner). His or her efforts have everything to do with the success of the business. The prenuptial agreement allocates reasonable compensation to marital property. Equity in the business and all income, gains, appreciation, distributions, etc., from the business remain separate property. All control over the business interest remains with the entrepreneur. When the entrepreneur effectively sets his or her compensation, an objective measure may be needed as a surrogate for "reasonable compensation" to avoid crafting a prenuptial agreement that is unenforceable for lack of a meaningful promise. When the entrepreneur is an entertainer or artist, it is essential to control how marital property rights may attach to the entrepreneur's residuals, intellectual property rights, and even physical objects such as master recordings, manuscripts, artworks, etc.

REASON 5: *Both fiancés are wealthy.*
For the purposes of this discussion, the source of the wealth is not the issue. Each fiancé is economically independent and is expected to remain so. Neither needs marital property. A prenuptial agreement can prevent marital property law (whether common-law or community property law) from complicating their economic relationship. The prenuptial agreement should also establish conventions that will reduce accounting burdens that can arise in a "no community/marital property" agreement (especially if there is no family office or neither spouse has a separate business manager). Incidentally, the prenuptial agreement negotiations should uncover whether the parties are being honest about their financial circumstances and whether they both belong in this category.

REASON 6. *Creditor protection.*
What if one member of the couple is engaged in a high-risk business? Or has substantial premarital debt? Both of these are good reasons for a prenuptial agreement.

If one member of the couple is in a high-risk business, a prenuptial agreement may allocate certain funds to one spouse for conservative investing as separate property while allocating *Continued on Page 4*

Property Rights *continued from page 1*

spouse is entitled to support, but does not control property earned or accumulated by the other spouse. In the event of divorce, the court makes an equitable division of marital assets. Upon the death of the owner spouse, the surviving spouse is generally entitled to a minimum (elective) share of the owner spouse's estate.

Common-law marital assets can be transformed into "quasi-community property" if a couple moves to certain community property jurisdictions. This generally comes as a nasty surprise to the spouse whose name is reflected as the sole owner of the assets.

Keep in mind that couples planning to bring substantial common-law marital property to any community property state (especially California, Louisiana, Washington and Wisconsin) are advised to seek the advice of estate planning counsel prior to their move. A discussion of specific state marital property rules is beyond the scope of this short article. Local estate planning and/or family law counsel should be consulted regarding specific property rights and obligations or entitlements relating to spousal and child support. ■

Stress Test Your Life Insurance

by Gordon A. Schaller and Scott A. Harshman

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The life insurance industry has utilized technology over the last 30 years to create new hybrid financial/life insurance products. Life insurance can be an efficient tool to provide liquidity for a family, business, charity or to fund estate taxes. Most people who purchase life insurance rely on their financial advisor to design the product to meet their objectives with a high degree of certainty. Universal life and variable universal life are two such products which have substantially replaced whole life as the sales leaders. Volatile financial markets and negative returns have highlighted a major design risk in variable universal life - negative investment returns, coupled with increasing mortality costs as insureds age, can force a policy into a death spiral from which it may not recover. As discussed below, Monte Carlo analysis can be used to measure the likelihood of policy failure - at the inception of the policy or anytime during its life.

Universal life products seem simple: pay premiums into the policy, and after sales and term insurance charges and some other expense items, the balance of the premium goes into a "cash value" account which earns a current rate of return (crediting rate) declared by the insurance company. However, the long-term ability of a universal life policy to remain effective past life expectancy to the actual date of death depends on the ultimate balance of these credits and debits. When crediting rates were high (12-14 percent in the 1980s), although not guaranteed, this seemed obvious. By the 1990's the actual crediting rate had declined to seven to eight percent. This highlighted the fact that "premiums" calculated by computerized insurance illustration systems were not guaranteed - only the underlying minimum crediting rate (usually four percent) was guaranteed.

As interest rates continued to decline and the stock market began its bull run in the 1990s, variable universal life became the next "big thing" in life insurance. As with universal policies, variable universal life allowed the owner to choose a "premium," and also allowed the owner to direct the investment of the net cash value. This created an opportunity to capitalize on surging equity returns.

The "rising tide lifts all ships" stock market obscured an important technical issue in variable life. Negative investment returns and significant volatility, combined with increasing mortality costs at older ages, can create a fast-acting, negative domino effect on the sustainability of variable life policies. Subsequent positive investment performance - even if robust - seldom repairs this problem.

Statistical analysis can help determine the probability that a variable universal life policy will fulfill the client's expectations. Conventional insurance policy illustrations require use of constant performance assumptions. Since this never occurs, the illustration is compared with a random application of actual, volatile monthly returns of the last 50 or more years (a "Monte Carlo" analysis). The analysis is done 1000 separate times producing a certain number of randomly calculated hypothetical illustrations in which the policy sustains to age 100; the remaining number do not sustain to age 100. Suppose the result was 450 successful and 550 unsuccessful outcomes. A 45% chance that the policy will pay the death benefit as expected is never acceptable. Reversing this approach can determine the required "premium" either when the policy is acquired, or while it is in force, to achieve the desired success ratio.

When properly designed and managed, life insurance is unique in its ability to deliver cash just when it is needed. However, much confusion exists about the difference between guaranteed, contractual policy provisions and the appearance of a substantially more aggressive policy illustration. Each policy alternative must be analyzed in comparison with the policy owner's "insurance style," including his or her risk tolerance, timeframe, and basic asset allocation. Once a policy is acquired, it is critical to review the performance and sustainability of that policy regularly with a financial advisor. Stress testing your policy will provide a realistic picture of a policy's condition and determine whether financial remediation is in order. ■

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certain assets to the other spouse, as separate property, for the high-risk business.

In the case of one person bringing substantial debt to the marriage, the best interests of the family as a whole are often served by sheltering the marital assets from that person's debts. This is particularly important in California, where community property assets can be reached by the creditors of either spouse for debts arising ***before or during*** the marriage. A future spouse who brings substantial premarital obligations to the marriage can undermine the creation of a net community property estate. A prenuptial agreement can limit the debtor spouse's creditors to his/her separate property assets and earnings while allowing the non-debtor spouse to accumulate savings.

Spouses cannot transfer marital assets in hindrance of creditors. In a community property state, this can create difficulties if one spouse has creditor problems, because both spouses have a present and equal undivided interest in the community property. Before the couple is married, while there is no marital property estate, they should be able to arrange their affairs as they wish. However, if significant creditor concerns exist, appropriate counsel should be consulted so that the best course of action can be taken for each individual and for the family as a whole.

Families with More Than One Domicile

REASON 7. *A multi-jurisdictional family.* Some couples know before they get married that their work or family circumstances will expose them to multiple jurisdictions. This is common among families with transnational business interests and domiciles in more than one country. For example, imagine a man from a common-law jurisdiction in the U.S. (Country A) who is working abroad in Country B and proposes to a woman with dual citizenship in Country C. The wedding is planned to take place in California, where neither fiancé has ever lived, but where the future husband says they are "definitely" moving, although he does not know when, exactly. Should he and his fiancé have a California prenuptial agreement? Will the agreement be effective in Country B if they divorce before moving? Can each fiancé select a preferred court or jurisdiction (i.e., "forum shop") if they split up, regardless of whether the individual's actual country of domicile at that time was Country B, Country C or the U.S. (Country A)? What happens if one of the spouses dies and more than one jurisdiction claims the deceased spouse as a domiciliary for estate tax purposes?

If substantial premarital assets or high incomes are involved, the couple should have a prenuptial agreement.

While a prenuptial agreement can never provide a guarantee, it may provide another expression of the deceased spouse's intent if two states are claiming the domicile of a decedent. In a forum-shopping battle, a prenuptial agreement may be helpful; however, the result will turn upon the weight that the foreign jurisdiction gives the prenuptial agreement and how the foreign court construes its provisions. A couple that knows there will be exposure to multiple jurisdictions should discuss a potential prenuptial agreement with estate planning and family law counsel in each of the jurisdictions most likely to touch their lives. One unfriendly jurisdiction does not negate the value of a prenuptial agreement. At the same time, the parties should understand the limits of enforceability and the potential for forum shopping.

Considerations for Second (or Subsequent) Marriages

Second marriages often come with "baggage." While the new spouse should not bear the sins of the first spouse, the scars left by a failed marriage are too often the basis for a prenuptial agreement. It is best to forge ahead and keep a positive frame of mind. The reasons for a prenuptial agreement before a second marriage are compelling.

REASON 8. *Address the needs of a blended family.*

Unique co-ownership issues.

Even if the couple is married "until death do us part," the marriage will eventually end, usually leaving one survivor. For a family that has significant assets, the survivor should consider a prenuptial agreement if he or she remarries. The survivor is probably a beneficiary and/or trustee of one or more trusts funded with the first spouse's assets. The surviving spouse has his or her own separate property and a beneficial interest in some or all of the deceased spouse's assets. Ordinarily, we do not think about how to manage the former spouse's assets when they may risk being commingled with the current spouse's respective separate property and the marital property.

The marital residence (which is often a central asset in the negotiation of a prenuptial agreement) is illustrative. The residence may be co-owned by the survivor (through a "survivor's trust") and a "decedent's trust," and possibly a "marital trust." The assets of the decedent's trust and marital trust are probably earmarked for eventual distribution to the children of the first marriage. Even if the survivor wishes to convert the residence to community property or make it a marital asset, he or she has no right to do that with the interest(s) in the residence owned by the decedent's trust and/or marital trust. If nothing else, negotiating the prenuptial agreement will force the new couple to address these unique co-ownership issues. The deceased spouse may have been the wealthier spouse. A prenuptial agreement cannot change that; however, the facts should come to light during the negotiations on the prenuptial agreement.

Special issues for young families.

If the first spouses divorced with young families, the issues are complex and dynamic. For example: (1) One or both of the new spouses could be paying spousal support and child support; (2) The second marriage could cause one of the spouses to cease to qualify for spousal support; (3) Children of one or both parties may live with, and may be supported by, the nonparent spouse. If so, which payments should be subject to reimbursement and which should presumptively be gifts? The new spouses will be melding assets that each received in marital settlements from their prior marriages. All of these—and a host of others—are reasons that the new couple needs a prenuptial agreement to arrange their financial and property affairs.

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REASON 9. *Lay the foundation for successful relationships by providing security for a new spouse and managing the expectations of adult stepchildren.*

Provide security for a new spouse of a retired/nonworking wealthy spouse.

The proponent of a prenuptial agreement usually is the wealthier fiancé.

However, when the wealthy spouse is retired and the less wealthy spouse must take early retirement for the sake of the marriage, the person who actually may need the prenuptial agreement is the less wealthy spouse. The new spouse's prospects to rejoin the workforce if the marriage ends in divorce will be limited, but the marriage will probably not have gone on long enough to result in a reasonable amount of spousal support (absent a negotiated amount under a prenuptial agreement). No meaningful marital property will accumulate (especially in a community property state where measuring community property is a matter of arithmetic). Neither spouse is working, and they probably enjoy an expensive lifestyle. In this case, a prenuptial agreement can provide for the security of the less wealthy spouse.

Manage adult stepchild/stepparent conflicts.

A prenuptial agreement can also be used to manage conflicts between adult stepchildren and the new stepparents. The wealthy fiancé often cannot bear the thought of the stepchildren inheriting from him or her through the new spouse. The children of the wealthy fiancé often cannot bear the thought that the "evil stepparent" (who may be their contemporary) has hoodwinked their parent and is brazenly making off with their birthright. While these issues can be addressed in the estate plan, backing up the estate plan with a prenuptial agreement can prevent future overreaching by either side.

Considerations for Ultra-High-Net-Worth Individuals

REASON 10. *Income support mitigation.*

An ultra-high-net-worth or ultra-high-income individual who marries will probably have a prenuptial agreement for at least one of the other reasons listed above. However, another reason is to provide an alternative to the unreasonably high support amounts that could be calculated by computer software used by the court to estimate support in a divorce scenario. The prenuptial agreement can cap spousal support or can provide a pre-negotiated marital property settlement in lieu of spousal support.

Although a prenuptial agreement cannot restrict the jurisdiction of the family court to rule on matters affecting child custody and support, the prenuptial agreement can include an acknowledgment by the parties that the wealthier fiancé's income is anticipated to exceed the amount necessary to support the expected marital lifestyle by an extraordinary amount. The parties can agree that measuring the child support award based upon the supporting party's income would be damaging to the well-being of their minor children. The prenuptial agreement can recommend, instead, that a potential future award of child support should be limited to the amounts needed to maintain the marital lifestyle enjoyed by the family prior to the breakdown of the marriage.

Be Patient

Recognize that negotiating a prenuptial agreement, even in the best of circumstances, will evoke strong emotions. (This is a good time for the couple not to be living together.) If discussions break down or seem to reach an impasse, as they often do, it is almost always temporary. The parties should give each other the benefit of the doubt, take a break, and resume discussions when they have had time to consider each other's positions.

Prenuptial Agreement—Yes or No?

A marital property agreement is imposed upon every couple, regardless of whether they have a prenuptial agreement. It is the one that's written for them by the laws of the state in which they marry and is amended by laws of the state in which they may live during their marriage. This seems to work for "happily ever after" couples who start with nothing and build their lives together —"until death do they part." For everyone else, the marital property rules created by state law could probably use some tweaking, but at what cost, emotionally and financially?

> Recognize that negotiating a prenuptial agreement will evoke strong emotions.

A custom-drafted prenuptial agreement should be created only if it can help the couple solidify the partnership that they must develop in order for their marriage to succeed. This requires the parties to be as fair, honest and understanding with one another as they can be. It also requires the expertise of attorneys on both sides of the table who understand family law, estate planning and relevant tax issues, who will encourage their respective clients to consider various possible outcomes (positive and negative) and who will work cooperatively to create an agreement that works for both parties. ■

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The Top 10 Reasons Couples Should Consider a Prenuptial Agreement

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