

Securing the Equalizing Payment – When It Seemed That It Couldn't Be Done!

- Robert E. Blevans, AAML
- Ronald S. Granberg, AAML

AAML Annual Meeting – November 2-5, 2016 Renaissance Hotel, Chicago, IL
Joslin Davis, 2016 AAML President

VALUE SERVICE REWARD

AMERICAN ACADEMY
AAML
OF MATRIMONIAL LAWYERS

What are we usually thinking about when we think about security?

- Black's Law Dictionary's definition of security:
 - **SECURITY.** Protection; assurance; indemnification. The term is usually applied to an obligation, pledge, mortgage, deposit, lien, etc., given by a debtor in order to make sure the payment or performance of his debt, by furnishing the creditor with a resource to be used in case of failure in the principal obligation.

What are we usually thinking about when we think about security?

- Webster's Third New International Dictionary definition of security:
 - The quality or state of being secure as in freedom from danger.

Facts —

- Ira and Olive have agreed in principle that:
 - Coastal Trucking Company is 100% marital property
 - Coastal has a net worth of \$18,000,000

Additional Facts —

- Coastal will be awarded to Ira
- Ira will owe Olive a \$9M equalizing payment:
 - \$1M paid at signing
 - \$8M paid pursuant to an adequately-secured promissory note

But what about Big Bank?

- The parties agreed Coastal's net value is \$18,000,000 because, while Coastal is worth \$40,000,000, it owes \$22,000,000 in secured loans to Big Bank

THE PROBLEM – the terms of Big Bank’s loans permit Big Bank to declare acceleration/default if:

- Borrower permits a junior lien as to business assets
- Borrower agrees to an equalizing payment in a Marital Settlement Agreement
- A Court enters a Divorce Judgment that includes an equalizing payment

The “option-option” is an alternative to “traditional” security when existing lenders refuse to cooperate.

The major components of the “Option – Option” are:

- Don’t transfer Olive’s interest in Coastal to Ira
- Create the option for Ira to purchase Olive’s interest in Coastal
- Define the rules for short-term co-ownership
- Retain judicial jurisdiction to enforce option or sell Coastal if option not exercised

Don't transfer Olive's interest in Coastal to Ira

- be specific that Coastal remains un-divided marital property, which is important for fiduciary duties for maintaining family court's jurisdiction over Coastal

Structure the option for Ira to purchase Olive's interest in Coastal

- Re-structure the \$9,000,000 equalizing payment into an option:
- Re-structure the \$1,000,000 down payment as a non-refundable initial option fee
- Re-structure the \$8,000,000 balance as the only means to exercise the option
- Re-structure what would have been interest payments on the equalizing payment into periodic non-refundable option fee payments that do not reduce the option price (this can be structured as spousal support)
- Provide that a non-cured default in selected Marital Settlement Agreement obligations terminates the option
- If the option is not exercised within the time specified, order the business interest sold and the proceeds divided
- Note: no matter what the sale price is, Ira guarantees that Olive will receive the greater of: a) \$9,000,000 or b) 50% of the sale price. This protects all of from a decrease in the value of the business while under Ira's management.

Define the rules for short-term co-ownership

- Designate Ira as the operating spouse
- Require specific reporting and documentation as “agreed-to compliance” with Ira’s fiduciary obligation
- Allocate 100% of Coastal’s profits to Ira for his post-separation efforts, provided certain payments (option fees or spousal support payments) are timely made
- Require Ira to report and pay tax on Coastal’s profits

A Practical Note: Mirror Big Bank!

- Big Bank's reporting requirements
- Think about it – how can Ira complain about agreeing to provide all of what he already agreed to provide Big Bank?
- Big Bank's definition of default
- Again, how can Ira complain about agreeing to default provisions to Olive he already provided Big Bank?

Important Note: you don't want Ira/Coastal to be in default to Big Bank without also being in default to Olive!

The Family Court to retain jurisdiction over the following issues to enforce the option agreement or sell Coastal and divide the proceeds:

- Enforce the exercise of the option by payment of the option price
- Enforce the terms of the judgment provisions governing the co-ownership period
- If the option is not exercised within the time specified, order the business interest sold and the proceeds divided

Tax treatment of any option fee

- Tax treatment of any option fee as between spouses
 - To Ira -- More or less elective (tax deductible support / maintenance or not tax deductible under IRC Section 1041)
 - To Olive-- More or less elective (taxable income as support / maintenance or tax-free under IRC Section 1041)

Tax treatment of the option price.

- because of the tax treatments described above, it may be advantageous to pay the “disguised interest payments” as spousal support rather than as additional option fees



CAUTIONARY NOTE: this is not your first choice. Your earlier choices are:

- Cash
- First-position security interest
- Second-position security interest

Bonus Point One

- When creating a traditional security interest, beware of the bankruptcy court (See *Farrey v. Sanderfoot* (1991) 500 U.S. 291, 300-301, 111 S.Ct. 1825, 1830-1831.)

Bonus Point Two

- Why not use a “mini option-option to create a conditional release of claims?

Bonus Point Three

- the recorded negative pledge agreement for real estate
- puts buyers and lenders on notice – may prevent bona fide purchase or bona fide lender status
- doesn't trigger Big Bank's "no junior lien" default rights (see materials)

Bonus Point Four

- Beware of taking a security interest in C Corporation stock, as opposed to the underlying business assets
- Problem: tax liability associated with retained earnings
- Possible solution: require an election to S Corporation status (under traditional security or the option-option)