Institute for Family Business

Marital Agreements and the Family Business

There is considerable uncertainty in the UK regarding the potential impact of marital breakdown on the family business. Owners who are either planning to marry, who are already married or who are separating face uncertainty in terms of the division of assets, and this can potentially have a knock on effect on the business.

For many family business owners their assets are made up in part or totally by shares inherited in a family company. Typically shares are in a private company and as such are not normally traded and therefore not easily saleable. Furthermore any liquidity call from shareholders will often have the effect of requiring the business to distribute cash. For many private firms this can have serious negative consequences on the ongoing strength of the company, possibly having negative effect on investment and employment.

To manage the associated risks many owners are keen to adopt strategies to minimise the impact of marital breakdown potentially rebounding on the family company. For this reason families are increasingly adopting an unofficial policy of requiring marrying family members to establish prenuptial agreements. These agreements typically will pay particular attention to the treatment of inherited assets that are brought into the marriage. The pre-nup will seek to exclude such assets from the shared pool of assets that would be divided in the event of separation, establishing a form of "firewall" in order to protect the business against a possible cash call.

The IFB would argue therefore that marital agreements should become binding documents to protect business continuity and employment, avoiding businesses being damaged by the fallout of broken marriages.

Background

For family businesses there are two strands to this policy area: marital property agreements and the recent attitude of the Courts to family businesses.

Prior to 2000, director spouses could be comforted with the knowledge that on divorce the Courts were reluctant to make any final order, which would have the effect of the business being sold. The landmark case of *White* in 2000 brought about a fundamental change in judicial treatment of a business. The Court expressed resoundingly the view that in certain cases the business should not be preserved - on the contrary that a sale might be required to finance the divorce settlement for the other spouse. A year later another 'family business on divorce' case. *N v N* afforded the husband three years to raise a third instalment to

complete the financial payment to the wife, the Court knowing that the net effect of this would cause the husband to either sell the business or seek some major financial restructuring.

Equality does not necessarily mean a simple 50 per cent split

In *P v P (Financial Relief: Illiquid Assets),* apart from the shares in the " family companies", the husband ended up with a " somewhat greater" share of the assets (£575,000) than the wife (£522,300), but some of his assets were not liquid. The shares in the companies were to be divided between the parties in order to achieve broad equality of assets, taking into account the fact that the husband had a greater proportion of illiquid assets in the division.

The liquidity of assets may not only be an important factor in determining (if only provisionally) an appropriate division, but also in determining the implementation of any order made. Thus in *R v R (Financial Relief: Company Valuation)* an important issue was not only the amount to be paid by the husband to the wife for her shares, but also the period over which payment was to be made. Coleridge J. said:

"The husband does need a breathing space, I find, to rebuild the company to its former strength. The wife should be paid out in full but in an orderly way so as not to destroy the goose, as it is sometimes described, that lays the golden egg. I do not think it will be in anybody's interests for the husband to be put under such pressure in relation to the payment to the wife that in fact the company ends up having to be put on the market. Experience shows that that very rarely produces the best price, particularly in circumstances where the industry realises that a sale has to proceed."

Sale of the company/breaking up the company

In *N v N (Financial Provision: Sale of Company)* Coleridge J. said that there was no doubt that if the case had been heard before *White v White,* the previous year, the court would have strained to prevent a disruption of the husband's business and professional activities except to the minimum necessary to meet the wife's needs:

"However, I think it must now be taken that those old taboos against selling the goose that lays the golden egg have largely been laid to rest; some would say not before time. Nowadays the goose may well have to go to market for sale, but if it is necessary to sell her it is essential that her condition be such that her egg laying abilities are damaged as little as

possible in the process. Otherwise there is a danger that the full value of the goose will not be achieved and the underlying basis of any order will turn out to be flawed."

In *N v N,* where liquidity was a problem, Coleridge J. considered that the husband should be required to face up to the necessary sale of the business, or his interest in it, which formed a significant part of his assets.

In some cases the family business, or an interest in it, may have been obtained by one spouse through inheritance or gift. Thus in *A v A* the wife had a little over 25 per cent of the shares in her family's company. While these had been acquired during the marriage, the major part of the holding had been given to her by her father. Charles J., after referring to the well-known passage from the speech of Lord Nicholls in *White v White* in relation to inherited property, concluded that the capital value of her holding could not be left completely out of account. The value of the shares to her as capital and income producing assets in the short, and the medium to long term, should be taken into account. Having regard to the source of the shares and the fact that they were shares in the wife's family company, the husband was right not to make a claim to the shares, or to argue that there should be a lump sum payment based on an equal division of the total value of all the assets. On the basis that a clean break was desired by the parties, Charles J. sought to achieve a fair distribution of the capital assets representing the matrimonial property apart from the shares, but bearing in mind, inter alia, that the wife retained the shares.

In *P v P* Baron J. said that the fact that the founder of the family business was the husband's father (with his brother) merited consideration, but it did not entitle the husband to a greater proportion of the assets, given the parties' actual needs. Moreover, it was the husband and his cousin who were really responsible for making the companies in the business "ultimately successful and valuable."

Marital Agreements, the Courts and policy

The starting point is the Matrimonial Causes Act 1973, the main statute governing matrimonial law. Section 25(1) provides that it is the duty of the court in deciding whether to exercise its powers to "have regard to all the circumstances of the case" .

Section 25(2) then sets out the checklist of factors to which the court shall have regard. Pre-nuptial agreements are not listed explicitly as a factor. The relevance of these agreements

has therefore been subject to judicial interpretation.

The courts have struggled over the years with the level of importance that they should attach to pre-nuptial agreements. The key constraint for the courts was summarised succinctly by Munby J. in the 2002 case of *X v Y (Y and Z Intervening),* where he stated:

"It remains the rule that any agreement or arrangement entered into by a husband and wife, whether before or during the marriage, which contemplates or provides for the separation of husband and wife at a future time is against public policy and void."

Up until the mid 1990s, the consensus of opinion was that such agreements were of very limited significance. However, during the next decade, there was a gradual but clear trend in the case law towards pre-nuptial agreements being generally considered as one of the circumstances of the case under s.25 and of giving them greater influence, if it is fair to do so.

However, the watershed was in 2003 with the decision in *K v K (Ancillary Relief: Prenuptial Agreement).* This was the first time in English law that an English pre-nuptial agreement had been, in part, upheld.

In this case, the wife had assets of about £1 million. The husband was worth at least £25 million. On discovering she was pregnant the wife pressed the husband to marry. Her father instigated the marriage before the baby's arrival, a pre-nuptial agreement being the carrot to persuade the husband to do so. The pre-nuptial agreement was signed the day before the marriage, both parties having taken legal advice. Full disclosure of the value of the husband's assets had not been made, although the wife was aware that the husband was very wealthy.

On divorce 14 months later, the High Court upheld the pre-nuptial agreement, as far as the wife's capital claims were concerned, but increased the housing provision (in trust) for the duration of the child's minority and ordered the husband to pay spousal maintenance (on which the pre-marital agreement had been silent). The Court also set out a helpful checklist of questions to which the Court should have regard when considering whether a pre-marital agreement would be influential in the discretionary exercise:

- Did the wife understand the agreement?
- Was the wife properly advised as to its terms?

• Did the husband put the wife under any pressure to sign it?

• Was there full disclosure?

• Was the wife under any other pressure?

• Did she willingly sign the agreement?

• Did the husband exploit a dominant position, financially or otherwise?

• Was the agreement entered into in the knowledge that there would be a child?

• Had any unforeseen circumstances arisen since the agreement was made, such as to make the agreement unjust to hold the parties to it?

• What does the agreement mean?

• Does the agreement preclude an order for periodical payments for the wife?

• Are there any grounds for concluding that injustice would be done by holding the parties to the agreement?

• Is the agreement one of the circumstances to be considered under s.25?

• Does the entry into this agreement constitute conduct which it would be inequitable to disregard?

The approach of the courts in subsequent cases was to follow the guidance offered in *K v K* and assess a pre-marital agreement as one of the circumstances of the case, subject to the court's overall discretion under s.25. It was generally accepted that, due to absent legislative intervention, this approach was about as far as the courts could, and would, go.

The next major development was the 2008 case of *Crossley v Crossley.* Both parties had been married before. The marriage was short and childless and there was substantial wealth on both sides. A pre-nuptial agreement was executed. Thorpe L.J. held that, on the facts of this (exceptional) case:

"[I]f ever there is to be a paradigm case in which the court will look to the pre-nuptial agreement as not simply one of the peripheral factors in the case but as a factor of magnetic importance it seems to me that this is just such a case."

The wife agreed to an order in the terms of the pre-nuptial agreement.

It was against this background that *MacLeod* and *Radmacher* came to be determined.

MacLeod

The MacLeods were wealthy Americans living and divorcing in the Isle of Man. They had executed a pre-nuptial agreement on their wedding day in Florida. They subsequently had five children. The pre-nuptial agreement was reviewed twice during the marriage, latterly in 2002 when it was considered possible, if not probable, that they would separate. A post-nuptial agreement was executed confirming the 1994 agreement but making amendments in the wife's favour. No specific provision was made for the children. The husband implemented the revised agreement. On their separation about a year later, the husband asked the Manx courts to uphold the agreement, although he accepted that provision should be made for the children (and indeed offered such provision). The husband (but not the wife) appealed again to the Privy Council in November 2008 on the issue of the enforceability of the 2002 agreement. The Privy Council held that an agreement entered into by parties *after* their marriage had the capacity to be binding if it regulated financial matters during the marriage (or in the event of a possible future separation) and it fulfilled normal contractual principles.

If those conditions are satisfied, then the agreement is a “maintenance agreement” falling within the Matrimonial Causes Act 1973 ss.34 to 36. It is therefore susceptible to variation by the courts only in limited circumstances, primarily in the case where circumstances have changed since the agreement was made such that the agreement is rendered manifestly unjust, or if inadequate provision was made for any children.

The MacLeods' 2002 agreement was held to have been validly made. Variation of this “maintenance agreement” was unwarranted, except to make proper provision for the children. Mrs MacLeod's personal entitlement under the 2002 agreement was restricted, even though it was less generous than that which the Board may have ordered independently.

The Privy Council was at pains to stress that it was *not* reversing the long-standing principle that pre-nuptial agreements are contrary to public policy and are thus not binding contractually. The Board considered that there was a significant difference between an agreement providing for a present state of affairs which has developed between a married couple and an agreement made before the parties have committed themselves to marriage.

This decision provides a departure from the previous judicial focus on pre-nuptial

agreements and reveals a hitherto unknown interpretation of “maintenance agreement” under the Matrimonial Causes Act 1973 ss.34 to 36 (legislation that had lain largely ignored by the legal profession for many years). The profession reacted to the judgment immediately by focusing on whether a (previously unenforceable) pre-nuptial agreement could in fact be rendered valid by conversion after marriage to a post-nuptial agreement.

The decision in *MacLeod* was revisited a few months later by the Court of Appeal in *Radmacher.*

Radmacher v Granatino

Ms Radmacher (German) and Mr Granatino (French) married in London in November 1998, having executed a pre-nuptial agreement in August 1998. They had two children. Ms Radmacher came from a very wealthy family and had significant assets before meeting Mr Granatino. At her request, on their engagement, they immediately discussed terms for a pre-nuptial agreement. The agreement was drafted in German by the Radmacher family notary. A clause in the draft agreement disclosing their respective financial positions was deleted at the wife's instigation. Financial disclosure was not exchanged.

Although the husband had seen the draft contract in German, he had not seen a translation. The notary explained the main provisions to both parties in English (without a verbatim translation) and the contract was executed in his presence. The key provisions of the contract were as follows:

• neither party would have any interest in any property brought into the marriage by the other;

• any resources accrued by either party during the marriage would remain theirs alone;

• both during and after the marriage, neither party would have any claim on the property and/or income of the other, even in the case of extreme hardship; and

• in the event of either party's death during the marriage, the survivor would have no rights against the deceased's estate except as provided for under German law.

Both parties also waived their claims for any maintenance on divorce.

The parties separated in October 2006.

First instance decision

In the High Court, Baron J. was clear that the old common law rule prevailed and that a pre-nuptial agreement could not be enforced contractually.

She gave weight to the fact that the agreement would be valid and enforceable in both Germany and France and that, whilst these foreign elements of the agreement were not determinative or ultimately fully decisive, they were definitely relevant as they were essential features to discount (if not extinguish) Mr Granatino's claim. The agreement was flawed from an English perspective and the husband's agreement was therefore tainted as:

• he received no independent legal advice about the ramifications of the deal;

• the agreement deprived him of all his claims, even in real need;

• he did not know what his future wife was worth;

• there had been no negotiations; and

• two children had been born during the marriage.

That said, in assessing his needs, Baron J. took account of all the circumstances of the case and considered that his award should be circumscribed to reflect the fact that he had accepted the terms of the contract. She addressed his claims on a classic needs-based approach and awarded him a lump sum of £5.56 million (comprising £2.5 million for a house, £700,000 towards his debts, £25,000 for a car and £2.335 million as a whole-life sum) together with funds for the purchase of a home near the children for the purposes of contact with them and child maintenance.

Court of Appeal

Ms Radmacher appealed on the basis that the pre-nuptial agreement had not been given sufficient weight in the High Court's decision.

There was much discussion by the Appeal Judges as to the development of the law relating to pre-nuptial agreements. Particular emphasis was placed on the fact that England is becoming increasingly isolated from other European jurisdictions as regards the enforceability of agreements freely entered into. Furthermore, it was becoming increasingly unrealistic to recognise the rule that pre-nuptial agreements are void and not to move with the times and recognise the rights of adults to enter into agreements governing their "future financial relationship … in an age when marriage is not generally regarded as a sacrament and divorce is a statistical commonplace".

The Court of Appeal also highlighted the inconsistencies arising from *MacLeod* -where the Privy Council had rejected the old common law public policy objections to *post* -nuptial contracts, whilst still retaining a separate public policy rule preserving objections to *pre* -nuptial contracts- while acknowledging that courts can take them into account on divorce, sometimes decisively. The Court of Appeal suggested that the only real difficulty in relation to the validity of pre-nuptial contracts is that they remain subject to the ultimate discretion of the court under s.25. As there remains this ultimate safeguard, any public policy objections are surely irrelevant. The Court of Appeal stressed that "a presumption of dispositiveness of any nuptial contract" remains inconsistent with the existing law under s.25, but that such a presumption "has much to recommend it", subject of course to appropriate safeguards being in place.

On addressing the first instance decision, the Court of Appeal held that Baron J. had erred in not giving decisive weight to the pre-nuptial agreement under the s.25 exercise, given that the parties were French and German nationals and that the pre-marital agreement was both standard practice and enforceable in both jurisdictions.

The Court also disagreed with Baron J.'s reliance on the parties' failure to comply with what had hitherto been seen as prerequisites for a pre-nuptial agreement, as set out in *K v K.* Given that Mr Granatino was a man of the world, had been given ample opportunity to take legal advice (and had not done so), was fully aware that Ms Radmacher came from a rich family and had himself chosen not to be involved in negotiations, he could not subsequently plead that the contract was unfair. It would take a more serious defect to remove the necessary basis of consent.

The Court of Appeal therefore substituted the first instance order by limiting the duration of Mr Granatino's award to the years of his parenting responsibility for the children, in much the same way as a claim under the Children Act 1989 Sch.1. The £2.5 million for a house was to be held on trust for his exclusive occupation while his parenting duties subsisted and the capitalised maintenance award of £2.335 million was to be reformulated to cater only for his needs as a homemaker for the children, rather than as a spousal award for life.

International comparisons

Notwithstanding a still prevailing negative attitude towards premarital agreements, today

there is an increasing tolerance towards them. A remarkably widespread contractual freedom to negotiate away from the default rules on the financial consequences of divorce can be found in the USA and in Germany. These countries are unusual in that German law as well as the law in the vast majority of US states not only allows for modifications of the matrimonial property regime but also has a long-standing tradition of enforcing premarital contracts on post-marital maintenance.[i] In contrast, in most European jurisdictions premarital agreements on maintenance in the event of an eventual divorce are not legally binding. In Italian and Dutch law, a waiver of alimony (*assegno di divorzio* and *alimentatie*, respectively) in a premarital contract is generally unenforceable. French judges determine the *prestation compensatoire*, the post-marital compensation payment, regardless of any premarital agreement. According to Art. 140 par. 1 Swiss Code of Civil Law, a premarital agreement as to the consequences of divorce becomes legally valid only when a court has approved it. Rather unclear is the dimension of contractual freedom in Spain where premarital agreements that regulate financial consequences of divorce are a relatively new phenomenon. Yet, it seems to be the case that a waiver of the *pension compensatoria* will generally not be enforced as far as the payment serves the function of post-marital maintenance To be sure, in both the USA and Germany, premarital agreements are subject to judicial review, and courts regularly deem them void if they find a lack of procedural or substantive fairness, if they perceive detrimental effects on third parties (particularly common children), or if a waiver of rights makes one party eligible for public assistance. However, as a matter of principle, future spouses enjoy considerable freedom to regulate property division and post-marital spousal support according to their individual preferences.

In Germany the law developed with some room for contractual flexibility in marriage as far back as the Middle Ages. The legal change with respect to premarital agreements shows that initially the law was hostile towards such agreements since they were regarded as conflicting with a social demand that the law should lend moral and physical force to the sanctity and stability of marriage. Ultimately, however, a contrarian social demand for private autonomy and contractual freedom prevailed.

Conclusion

It is the IFB's view that the public policy presumption against the binding nature of pre-marital agreements should be balanced against the public interest in fostering enterprise. It is clear from *White* that the Courts will no longer strive to keep the business intact in the event of a divorce. It is also clear from the string of cases that this is a problem of a magnitude that merits further action.

Recommendation: the IFB recommends that marital agreements should be legally binding

GG, May 20th 2010

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[i] Binding premarital agreements on the financial consequences of divorce, including spousal maintenance, were also introduced in Australia in December 2000 (see Fehlberg and Smyth, 2002: 127; Luhn, 2008: 173-232). Moreover, the Canadian Family Law Act expressly recognises in Part IV the validity of premarital contracts on support obligations (see Hovius, 2005: 889-90). Only few European jurisdictions grant a comparable degree of freedom of contract, eg Austrian law (Roth, 2002: 70; Zankl, 2005: section 80 annot. 6) and Greek law (Koutsouradis, 2002: 25, 2005: 313). See for an overview on maintenance agreements in European jurisdictions, Boele-Woelki et al (2003: 461-95).