McCourt Divorce Shines A Light on Asset Protection

By Jacob Stein

Asset protection has significantly gained in prominence over the past few years. The declining fortunes of real estate developers and investors facing personal guarantee calls, coupled with business owners teetering on the verge of bankruptcy, resulted in a boom for this industry.

Asset protection deals with structuring asset and business ownership to make it either impossible, or at least very expensive and difficult, for a litigant or a creditor to reach the assets of a debtor. The goal of asset protection is similar to bankruptcy, and the two practice areas go hand-in-hand. When a debtor has none to few assets, the bankruptcy route is preferable. When the debtor has significant assets, asset protection may be the way to go.

There is no "magic bullet" in asset protection planning. Many structures are available to practitioners, with their use determined by aggressiveness of the creditor, timing, types of assets that need to be protected, and how far the debtor is willing to go to shield his assets.

A common asset protection fact pattern may look something like this. Husband owns a sports franchise. The franchise borrows money to employ an overweight and overpaid player, and the husband signs a personal guarantee for the benefit of the lender. If the lender someday calls the guarantee, all of the husband's assets are reachable by the lender (once they obtain a judgment against the husband). Any assets owned by husband and his spouse as community property are deemed 100 percent owned by the husband (it is a coextensive ownership interest), and reachable by the lender.

The husband and wife enter into a type of a postnuptial agreement known as a transmutation agreement. California Family Code allows spouses to enter into these agreements and transmute community property assets into separate property assets, and vice versa. In our example, the transmutation agreement provides that the spouses will no longer have community property assets. The sports franchise becomes the separate property of the husband and real estate holdings, bank accounts and shoes the separate property of the wife. Now, if the husband is sued by the lender for defaulting on the guarantee, he no longer owns real estate, bank accounts or shoes, and these assets are not-reachable by the lender.

If you have turned on your television at any time during the past several weeks, the above example should be familiar. This is exactly what Frank and Jamie McCourt did to protect their assets from the creditors of the Los Angeles Dodgers franchise.

Associated Press

Los Angeles Dodgers owner and chairman Frank McCourt and his wife Jamie McCourt after a Dodgers baseball game on Sept. 25, 2008. Former Dodger CEO Jamie McCourt is arguing in divorce proceedings that she's entitled to a stake in the team.

As their divorce proceeding have demonstrated, with sufficient greed, animosity and an overwhelming desire to enrich family lawyers, transmutation agreements may be challenged by a party to the agreement. But can these agreements withstand the attack of a third-party creditor, like a lender?

They can, if properly structured and drafted. From a structuring standpoint, the transmutation agreement should divide community property assets equally between the two spouses (this is simply good practice, there is no such legal requirement). This helps to negate a fraudulent transfer attack (the transfer is now in exchange for fair market value), and this also allows for a fair treatment of both spouses.

Equal division usually does not mean taking each asset and giving each spouse 50 percent in the asset. One usually picks and chooses which asset will go to which spouse. This allows the practitioner to cherry pick, taking into account creditor exposure of each spouse, and the ease or difficulty of a creditor attaching certain assets.

The downside of allocating different assets to each spouse is that they may appreciate in value at a different rate. As the McCourt divorce demonstrates, the Los Angeles Dodgers may appreciate in value faster than real estate. (Would Jamie McCourt have challenged the transmutation agreement if the divorce took place three years ago when real estate prices were much higher?)

For drafting purposes, transmutation agreements must contain full disclosure of assets and their values, may transmute the character of assets acquired later, have to be in writing, and must be recorded if they relate to real estate. It is possible to record an abstract of the agreement to prevent disclosure of personal property to the public.

Transmutation agreements have certain tax implications. For income tax purposes, if spouses file a joint return, then characterization of property as community or separate is irrelevant, as all income is aggregated. However, if spouses file a separate return, then each spouse must report his or her one-half share of community income, and his or her separate income. Because transmutation agreements change the nature of the property (including earnings and other income), they have the greatest income tax impact on separate tax returns.

On a spouse's death, one-half of the community property belongs to the surviving spouse, and the other half belongs to the decedent. If the property has appreciated in value during the time that it was held, the entire property will receive a stepped-up basis equal to its fair market value on the date of the deceased spouse's death, if the decedent's half of the property was included in his or her estate. The surviving spouse will receive a stepped-up basis in his or her half of the property, and will therefore have a smaller gain on disposition of that property.

Thus, while transmutation agreements are generally desirable from an asset protection standpoint, they may have adverse tax consequences, because of the loss of one-half of basis step up. By carefully coordinating the transmutation agreement with the spouses' will or trust, many of the adverse tax consequences can be minimized or eliminated. For example, if the spouses' residence is the separate property of the surviving spouse, then while the residence will not receive a step-up in basis, up to $250,000 of gain will be sheltered on the sale of the residence.

In the current economic climate a transmutation agreement may be a beneficial tax planning tool, as it will help spouses avoid a basis step-down on assets that have depreciated in value.

The practitioner should also keep in mind that spouses may enter into a transmutation agreement at any time during marriage. Accordingly, while the spouses work, operate a business, develop real estate or engage in any other activity that exposes them to risk, they may benefit from a transmutation agreement. When the spouses retire or sell their high-risk assets and risks dissipate, the spouses can enter into another transmutation agreement and convert their separate property back to community. This will also regain the basis step up on death.

In practice transmutation agreements prove themselves to be a formidable defense against creditor claims. While one of the spouses may challenge the validity of the agreement, a creditor may not, they are not a party to the agreement. As with all other asset protection planning, for maximum protection and effectiveness, one should try to plan early before there are existing creditor claims.

Jacob Stein is an asset protection attorney in the Los Angeles-based law firm Klueger & Stein. He is a frequent author and lecturer on this subject. He can be reached at Jacob@lataxlawyers.com.

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