

**The Sale of Shareholder Interests in
Marital Dissolutions and Bankruptcy Concerns**
by
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A family business is very often one of the central assets to be divided in a marital dissolution. In the context of a divorce, one spouse will usually propose to buy-out the interest of the other spouse. Sometimes, this is accomplished by use of a promissory note. When drafting an agreement for the sale of a shareholder interest between divorcing spouses which is being financed by the promissory note, the parties must be careful to include provisions which protect the selling spouse/shareholder from losing the benefit of the value of his/her interest in the business.

There are two (2) bankruptcy issues which present themselves in connection with the buy-out of one marital shareholder by another through the use of a promissory note. The first is that any payment made for a year may be recovered by a Trustee in a Preference Action under 11 USC § 547. Because an unsecured note constitutes an antecedent debt, a Trustee may argue that any payments on the note to the former husband (an insider) for a period of one (1) year prior to the bankruptcy filing may be recovered by the estate. The second issue is that the debt represented by the note may be discharged completely or paid pursuant to a plan of reorganization unless the selling spouse can prove that it is non-dischargeable under 11 USC § 523.

BANKRUPTCY LAW

1. PREFERENCE ACTION UNDER 11 USC § 547

The preference provision allows the trustee to avoid a transfer of the debtor's property within either one year of the filing of a petition for bankruptcy protection (in the case of an insider) or made within 90 days of the filing. Therefore, a trustee may take back from creditors certain payments and transfers of the debtor's property. In order for a trustee to avoid a transfer, he/she must show six elements:

- a. A transfer of the property of the debtor;
- b. to or for the benefit of a creditor;
- c. for or on account of an antecedent debt;
- d. while the debtor was insolvent;
- e. within 90 days (or one year) preceding the petition; and
- f. enabling the creditor who received the transfer to receive a greater percentage of its claim than the creditor would have received had the transfer not been made and the creditor waited for its share in the bankruptcy proceeding.

A trustee is always entitled to a rebuttable presumption that a bankrupt was insolvent when a transfer was made. Therefore, it is always up to creditor to prove that when a particular

transfer was made, the debtor was not insolvent. However, a creditor may also defeat a preference action by showing that:

1. The payment was made in the ordinary course of the debtor's business and financial affairs; or
2. The payment was made on a purchase money security interest;

A. Ordinary Course of Business Defense

This defense requires that the creditor show a pattern of normal financial relations between itself and the debtor such that the payment does not appear outside the normal arrangement between the parties. The exception is narrowly drawn. Usually any payments made by a debtor after a **45 day** window after the debt was incurred looks suspect. In the case of an installment note on either a long term or short term debt, as long as payments are timely made, they qualify as "normal" financial relations and will not be subject to the trustee's avoidance powers. (*Union Bank v. Wolas*, 112 S. Ct. 527, 116 L. Ed. 2d 514 (1991)). However, if a note payment is late, then it is exposed to being taken back by a trustee.

B. Purchase Money Security Interests

Another exception to the trustee's power to avoid preferential transfers of the debtor's saves a PMSI. This is where the creditor lends the debtor new money to acquire property. This exception saves a security interest in a loan granted by a creditor which enables the creditor to purchase a specific property. In the case of buying stock through a marital settlement agreement, the way that this would work is that the Husband would sell the stock to wife, take back a note, and obtain a security interest in the stock only.

RECOMMENDATION TO AVOID PREFERENCE ACTION: In the MSA, the purchasing shareholder should make a representation that (1) at all times when a Note payment is made, the shareholder will be solvent, (2) the Note will be timely paid accordingly to the normal financial relationship between the parties as set forth in the Note, but will not be considered late until the selling shareholder issues a written notice of default, and (3) Note needs to be secured by a security interest in the stock of the corporation only so that it is considered a Purchase Money Security Interest Note.

2. NON-DISCHARGEABILITY OF DEBT UNDER 11 USC § 523.

Bankruptcy Code Section 727 provides that the "Court shall grant the debtor a discharge unless" one of ten exceptions are met. Because the Bankruptcy Court is a Court of equity, even if grounds for non-dischargeability are shown, the Court may still grant a discharge (to an individual only) where it is deemed appropriate. The Court is free to use its discretion liberally in all Section 523 matters.

- A. **Under Section 523(a)(2)(A)**, debts based on Fraud, false pretenses, false representations, or false financial statements are nondischargeable. Debts resulting from promises made without the present intent to perform may not be discharged (*In re Woosley*, 117 B.R. 524, 530-531 (9th Cir. 1990). False Pretenses or false representations may bar discharge where the bankrupt had actual knowledge of the falsity of a representation or reckless disregard for the truth. (*In re Pedrazzini*, 644 F.2d 756 (9th Cir. 1981).

Therefore, for purposes of an MSA, the purchasing spouse should be made to provide certain representations and covenants to the selling spouse in connection with the purchase of the corporate stock and his/her ability to (1) make timely make the quarterly installment payments and (2) intent to pay the Note in full. Further, the purchasing spouse should also be required to provide financial statements to selling spouse **prior** to the execution of the MSA which reflect his/her ability to pay the Note, and upon each installment payment.

- B. **Under Section 523(a)(2)(B)**, debts obtained by a statement in writing which is materially false and made with the intention to deceive the creditor and which the creditor reasonably relied, are non-dischargeable. (*In re Rodgers*, 115 B.R. 678 (Bankr. C.D. Cal. 1990).
- C. **Under Section 523(a)(4)**, debts obtained by fraud or defalcation of persons acting in a fiduciary capacity are non-dischargeable. The elements for non-dischargeability must be proved by a preponderance of the evidence. The creditor must prove that the debtor was acting in a fiduciary capacity and that the debtor committed a “defalcation”. (*In re Grabau*, 151 B.R. 235 (Bankr. N.D. Cal. 1993). “A defalcation is a failure of a party to account for money or property that has been entrusted to them.” *In re Baird*, 114 B.R. 198, 204 (Bankr. 9th Cir. 1990). A “fiduciary relationship” is one involving confidence, trust and good faith. Whether a person is a fiduciary for non-dischargeability purposes is a question of federal bankruptcy law rather than of state law, although state law may be relevant for determining whether a “trust” exists. *In re Lewis*, 97 F.3d 1182 (9th Cir. 1996).

For purposes of the MSA and the Note, both documents should contain a provision that the parties continue to be fiduciaries to each other, and to act in confidence, trust and good faith, until the Note is paid in full. Further, both the MSA and the Note should state that the selling spouse has “entrusted the corporate shares being sold.” The purchasing spouse should be required to provide a quarterly accounting for personal income and for the revenues of the corporation which would reflect that shares entrusted are not being wasted.

- D. **Under Section 523(a)(5)**, debts to a former spouse for alimony, maintenance or for support are not dischargeable. In order to prove a right to this exception, the spouse must prove that the obligation is actually in the nature of alimony or support and it must be in connection with a MSA, or other property settlement agreement or by order of the Court. Factors

considered are: whether the recipient spouse actually needed spousal support at the time of the divorce, the imbalance of the relative income, whether the obligation terminates on the death of a spouse, and the labels given to the payments by the parties. *In re Sternberg*, 85 F.3d 1400, 1408 (9th. Cir. 1996).

RECOMMENDATION TO QUALIFY FOR EXCEPTION TO DISCHARGE: To include extensive language in both the MSA and the Note which sets forth representations, warranties and covenants by the purchasing spouse to the selling shareholder about his/her financial ability to pay the Note. To require the purchasing spouse to produce personal and corporate financial statements to the selling spouse immediately prior to execution of the MSA. To provide that the selling spouse is “reasonably relying” on the representations and warranties of the purchasing spouse in selling the stock and receiving a promissory note for the purchase price. Both the MSA and the Note should state that the selling spouse has “entrusted the corporate shares being sold,” and that a “trust” exists over the shares until the promissory note is fully paid.

EXAMPLE REPS AND WARRANTIES LANGUAGE

1. Representation and Warranties

A. Wife represents, warrants and agrees that on the date that she delivers any quarterly Note payment to Husband, and for the duration of the period of time while the Note is outstanding, Wife shall be solvent and the Note shall be timely paid according to the normal financial terms and conditions set forth in the Note, and based on the normal financial relationship between the parties to the Note. Wife further represents, warrants and agrees, that any quarterly payment on the Note will not be considered “late” if Husband agrees in writing to the extension of time to make a specific quarterly payment.

2. Requirement to Deliver Financial Statements.

Prior to entering into this Agreement and as inducement to enter into the Note, and in making the covenants and promises contained in this Agreement, and as consideration for the Note, Wife has furnished to Husband her personal W-4 statements and tax return for the tax year since the date of separation, together with monthly wage deduction statements and personal balance sheet statements for tax year (hereinafter collectively referred to as the “Financial Statements”). The Financial Statements are unaudited but present accurately and fairly the financial position of Wife as of the indicated dates and for the indicated periods and have been prepared in accordance with generally accepted accounting principles consistently applied.

In making the covenants and promises contained in this Agreement, and as consideration for the Note, Wife has provided to Husband the balance sheet, profit and loss statement, a cash flow statement, a retained earnings statement, and corporate tax return for the corporation through the date of the MSA. The

Financial Statements are unaudited but present accurately and fairly the financial position of the corporation as of the indicated dates and for the indicated periods and have been prepared in accordance with generally accepted accounting principles consistently applied.

The Financial Statements of Company that have been delivered to Husband, (i) are in accordance with the books and records of Company which have been maintained in accordance with good business practice; (ii) have been prepared in conformity with GAAP; and (iii) fairly present the consolidated financial position of Company as of the dates presented therein and the results of operations, changes in financial positions or cash flows, as the case may be, for the periods presented therein. Neither Company has any contingent obligations, liability for taxes or other outstanding obligations which are material in the aggregate, except as disclosed in the Financial Statements.

Wife recognizes and acknowledges that in entering into this Agreement and the Note, Husband is expressly and reasonably relying on the Financial Statements provided by Wife as set forth herein.

3. Covenants.

A. Financial Statements. As long as the Debt on the Note, or part thereof, remains outstanding, Wife shall furnish to Husband the following:

1) Quarterly Financial Statements. With every quarterly installment payment made under the Note, Wife shall provide a copy of her own personal Financial Statements, and a copy of the Financial Statements of Company for such quarter and for the fiscal year to date, certified by Wife that said Financial Statements, and each of them, present fairly and accurately the financial condition of Wife and the Company. Each Company quarterly Financial Statement shall be prepared in accordance with GAAP consistently applied, subject to normal year end adjustments and except that no footnotes need be included with such Financial Statements.

2) Annual Financial Statements. Within Forty-five (45) days after the close of each fiscal year of Company, Wife shall produce and deliver to Husband a copy of the year end Financial Statements of Company for such year. Not later than June 1, Wife shall also provide to Husband a copy of her year end tax return.

B. Use of Proceeds. The proceeds of this Note shall be used to acquire the stock of the corporation named: _____, and for no other reason.

C. Representations and Warranties. The representations and warranties made by Wife shall be true and correct as of the date hereof in all

respects and shall be material to Husband's decision to sell the stock of the Company to Wife and to accept the Note as partial consideration for the stock. It shall be an immediate breach of this Note if Husband learns that any representation, warranty, or other statement (financial or otherwise) made or furnished by or on behalf of Wife to Husband in writing in connection with this Note or this Agreement, or made as an inducement to Husband to enter into this Agreement or Note shall be false, incorrect, incomplete or misleading in any material respect when made or furnished.

D. Trust and Fiduciary Relationship. As long as the Note remains unpaid, in whole or part, Wife covenants and agrees that at all times she shall act in confidence, trust and good faith towards Husband in the payment of the Note and with respect to the operation and management of the Company. In authorizing the transfer of ownership of the shares of stock of the Company on the corporate ledger from Husband to Wife pursuant to the terms of this Agreement, Husband has entrusted the shares of stock being sold to Wife by means of the Note. Accordingly, the parties hereto expressly agree that delivery by Husband to Wife of the shares of stock in the Company shall be in "trust" until the Note is fully paid. If Wife defaults in the payment of the Note, or any part thereof, Husband, at his sole election, shall be entitled to recover the shares of stock sold hereunder or make an immediate demand for full payment together with interest of the unpaid balance of the Note pursuant to the default provisions contained therein.

The information provided herein is not intended as legal advice and should not be acted upon. If you have additional questions about this subject matter or would like to consult with an attorney about this or related subject matters, please call Jennifer J. Hagan or James Hagan at The Hagan Law Firm (650) 322-8498.

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