DIVORCE

AND THE OWNER OF THE CLOSELY HELD

BUSINESS

By Erin D. Hollis

According to the U.S. Census Bureau, among individuals younger than age 45, approximately 50 percent of first marriages for men and between 44 and 52 percent of first marriages for women end in divorce. The likelihood of a divorce is lowest for men and women age 60, of whom 36 percent of men and 32 percent of women may divorce from their first marriage by the end of their lives. Business owners, of course, are not excluded from these daunting statistics.

It is highly recommended that you have a business valuation performed by an appraiser who is independent, certified and experienced.

For many married business owners the business is both the most valuable and most illiquid asset in the marital estate. Therefore, it is reasonable to assume that if owners divorce, the business will be an asset that will spark substantial controversy and conflict between the divorcing parties. Further, without preparation and precaution, the consequences of divorce can have a devastating financial impact on your client's business. If either your client or your client's business partners are contemplating divorce or if divorce is imminent, you should consider these three very important questions:

1. Who should perform the business valuation?

2. What is to be valued?

3. How will the divorce impact the business?

Who Should Perform the Business Valuation?

If the business is to be included in the dissolution of the marital estate, it is highly recommended that you have a business valuation performed by an appraiser who is independent, certified and experienced.

An attorney is an advocate for the client, whereas an appraiser is only an advocate of the value of the business. Therefore, having your client's CPA or another individual with whom the client already has an existing personal or professional relationship perform the business valuation is a big no-no. Opposing counsel for the non-owner spouse can easily dispute the credibility and objectivity of the business-valuation report. Not only that, any appraiser with whom the client has an existing relationship and who knowingly accepts such an assignment is risking a violation of professional ethics.

An individual may have an alphabet soup of letters after his or her name, but at least one set of those letters should be from a recognized professional, business-valuation organization. Many courts have disallowed valuations performed by uncertified individuals. Hiring an uncertified appraiser not only wastes your time but your money as well.

Aside from the obvious emotional impact a divorce may have on your client, the financial implications for your client's business can be overwhelming and more than anticipated.

Unfortunately, it's not enough to hire an independent, certified appraiser. You must hire one who has substantial valuation experience in your client's company's industry. Experience is critical and typically can make or break the validation of the appraiser's value opinion, especially if the client's company operates in a niche market. Further, your appraiser may be required to provide a verbal attestation to the value opinion in court.

What is to be Valued?

Level of ownership — the amount or percentage of ownership to be valued — will guide your appraiser in the valuation analysis and application of the appropriate valuation methodology. Typically a 51 percent or more business-ownership represents a controlling interest and is worth more than a non-controlling interest of 50 percent or less. Depending on the particular state case law, a valuation discount for minority ownership may apply. However, if the ownership of the company is 50-50 between co-owner spouses, a non-controlling premise may not apply. In this case the individual 50-percent ownership may be recognized as a controlling interest due to the familial relationship of the parties involved.

Your appraiser should be very familiar with the relevant state case law. Many states

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mandate that a particular standard of value be used in valuing closely held stock or ownership for divorce purposes. For most tax matters concerning the Internal Revenue Service, the standard of value is fair market value, i.e., hypothetical willing buyer and seller. However, for divorce purposes the standard may not be fair market value. The value might be referred to as "divorce value" or "marital-estate value." The mandated standard of value may also impact the court's allowance of valuation discounts, such as marketability and minority-ownership discounts. Further, the particular state case law may specify the separation of corporate goodwill and personal goodwill. This is particularly pertinent to professional-service companies, such as engineering and accounting firms and health care practices.

Corporate goodwill is the goodwill of the business. It is a transferable asset and is included in the valuation of the enterprise. Personal goodwill is goodwill that adheres to an individual. It is not transferable and consists of the personal attributes of an owner, including personal relationships, skill, personal reputation and various other factors. The existence of personal goodwill may indicate dependence on a key person.

If your client's company has key-person issues — meaning that the business could not sustain its current level of operations and financial performance without the significant participation of a particular individual, such as the owner — the value that individual brings to the company must be excluded from the value of the business if the particular state specifies the exclusion of personal goodwill from the value of the business.

The entity structure of your client's company is also relevant. A hotly contested topic in business valuation is the tax-affecting advantages and disadvantages of C corporations versus those of pass-through entities such as S corporations and limited liability companies (LLCs). Although there are different schools of thought on the issue, the taxation of business earnings is controversial because it may make a material difference in the value of your client's ownership interest. If your client's company is taxed as an S corporation, your appraiser may use the SEAM (S Corporation Economic Adjustment Model), for example, to ascertain the effect the income tax treatment of the pass-through entity has on the value of the client's pro rata ownership.

How Will the Divorce Impact the Business?

Aside from the obvious emotional impact a divorce may have on your client, the financial implications for your client's business can be overwhelming and more than anticipated.

As mentioned above, the business may be the largest asset in the marital estate as well as the most illiquid. However, funding the marital settlement can place a financial burden on the business if your client does not have sufficient personal liquidity. Supporting the settlement without interrupting business operations typically requires sufficient cash on hand, readily available liquid assets or another type of funding vehicle such as a business loan.

Some common mistakes a business owner who is facing a divorce may make in relationship to the business are:

- Running personal or non-business-related expenses through the business;
- Blatantly neglecting operations;
- Selling off or destroying business-owned assets;
- Dramatically depleting profits or cash on hand; and
- Ceasing operations.

Oddly enough, these tactics may have zero to little effect on the value of the business, and it is recommended that owners avoid extraordinary actions or business decisions outside the company's day-to-day operations. First, the court and opposing counsel will probably be savvy enough to recognize the actions of possible self-inflicted sabotage. Second, the court will typically specify a valuation date, which could be the date of separation or another specified date, and the value of the business may be based on historical operations up to that date. Last and most important, anomalies and extraordinary events may be "normalized," meaning that the appraiser will recast the financials to reflect the normal course of business.

An appraiser can bring sanity to business-valuation in divorce situations. Therefore, as legal counsel to a business owner, don't make the mistake of choosing an inexperienced, unaccredited appraiser. A wrong choice could not only cost your client unnecessary aggravation but the unnecessary payout of funds.

Although it may seem a bit pessimistic to suggest planning for divorce, the consequences of not planning for any untimely life event, whether divorce, disability or death, can have a devastating financial impact on your client's business. Regular business valuations allow you proactively to care for the viability of your client's business investment and therefore anticipate an untimely event requiring immediate liquidity. However, if planning isn't an option and the unexpected event is already upon your client or his or her business partner, be smart in your selection of an appraiser. A business owner who is contemplating marital dissolution should always seek, with his or her legal counsel, advice to determine the scope of the valuation engagement and the necessary course of action. Due to variances in the appraisal process by state and in company and personal circumstances, the business appraiser should work closely with counsel in defining the focus for the valuation process. Not doing so may waste precious time and money. ⚖

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