



Splitsville

Divorce and the closely held business owner.

BY ERIN HOLLIS

For many business owners who are married to each other, 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 could spark substantial controversy and conflict. Further, without preparation and precaution, the consequences of divorce can have a devastating financial impact on a business. If either you or your business partners are contemplating divorce, or if divorce is imminent, consider the following.

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 with the following credentials:

- **Independent**—An attorney is your advocate whereas an appraiser is only an advocate of the business's value. Therefore, having your CPA or someone you know perform the business valuation is a big no-no. Opposing legal counsel can easily dispute the credibility and objec-

tivity of the business valuation report. Any appraiser with whom you already have an existing relationship and who knowingly accepts such an assignment is bordering on a violation of professional ethics.

- **Certified**—An individual may have an alphabet soup of letters after their 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.
- **Experienced**—It's not enough to hire an independent, certified appraiser. You must also hire one who has substantial valuation experience in your company's industry. Experience is critical and typically can make or break the validation of the appraiser's value opinion, especially if your company operates in a niche market. Further, your appraiser may be required to provide a verbal attestation of 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, an ownership percentage of 51 or more represents a controlling interest and is worth more than one that is of a non-controlling nature, or 50 percent or less. Depending on the particular state's caselaw, a valuation discount for minority ownership may apply. However, if ownership of the company is 50-50 between co-owner spouses, a non-controlling premise may not apply. In this case, the indi-

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vidual's 50 percent ownership may be recognized as a controlling interest due to the familial relationship of the parties involved.

State Caselaw. Your appraiser should be very familiar with the relevant state caselaw. Many states mandate that a particular standard of value be utilized valuing closely held stock or ownership for divorce purposes. For most IRS tax matters, 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 and might be referred to as "divorce value" or "marital estate value." The standard of value may also impact the court's allowance of valuation discounts, such as marketability and minority ownership discounts.

Further, the particular state caselaw may specify the separation of corporate goodwill and personal goodwill. This is particularly pertinent to professional service companies, such as engineering and accounting firms or healthcare 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 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 company has key person issues—meaning, the business could not sustain its current level of operations and financial performance without the significant participation of any one individual, such as the owner—then the value that individual brings to the company must be excluded from the value of the business *if* the state specifies the exclusion of personal goodwill from the value of the business.

Entity Structure and Taxation.

The entity structure of your 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. The taxation of business earnings is controversial because it may make a material difference in the value of your ownership interest.

How Will the Divorce Impact the Business?

Aside from the obvious emotional impact a divorce may have, the financial implications on your business can be overwhelming. Funding the marital settlement can place a financial burden on your business if you do not have sufficient personal liquidity. Supporting the settlement without interrupting business operations typically requires sufficient cash on hand, readily available liquid assets, or other type of funding such as a business loan.

Some common mistakes made by an owner facing divorce 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.

These tactics may have little effect on the business's value 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. Finally,

and most important, anomalies and extraordinary events may be "normalized," meaning the appraiser will recast the financials to reflect the normal course of business. Nevertheless, an appraiser can bring sanity to divorce business valuation situations. Therefore, don't make the mistake of choosing an inexperienced, unaccredited appraiser. A wrong choice could not only cost you unnecessary aggravation but also the payout of unnecessary money. **TBJ**



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