When Family Business Owners Get Divorced

Valuation is important to the equitable distribution of your business

Key points

- The inclusion of a family business in your divorce proceedings can make things a bit more complicated
- Selling the business and splitting the assets, or one spouse buying out the other, are two options to consider
- When a buyout is involved, it requires a business appraisal as well as a strategy to fund the buyout

Navigating the emotional and financial challenges of a divorce can be daunting enough. But when a family business is part of the divorce proceedings, there are additional decisions to be made to determine the future of the business and the equitable distribution of its assets.

If only one spouse is involved in the business and will continue to operate it as such, then an appraisal of the business will be needed to determine its value for purposes of buying out the nonoperating spouse. When combined with the balance of the marital assets, this valuation can provide the basis for an equitable settlement.

However, when both spouses are involved in running the business, other factors need to be considered. Can you continue to work together for your mutual financial well-being and to preserve the business? If not, two choices remain: 1) Sell the business and split the proceeds, or 2) One spouse buys-out the other. As noted above, a buyout requires a business appraisal, as well as a strategy to fund the buyout. Seldom do businesses have sufficient cash available to fund the buyout, so the substitution of other marital assets may provide a better alternative to financing a sale.

Selecting a business appraiser

Business appraisers are retained in matrimonial matters through court appointment, jointly with consent of both you and your spouse, or privately retained with the help of your attorney. Each method has benefits and drawbacks. Privately retained professionals can assist in negotiations and advise on tax and accounting issues. Court-appointed and jointly retained experts must remain neutral and should not assist either side with negotiations or litigation.

Choosing the right business appraiser or valuation firm is an important decision. There are several business valuation designations that an individual can earn to signify basic knowledge in business appraisal. Organizations granting designations have their own accreditation requirements. In cases of unreported business income, the Certified in Financial Forensics (CFF) designation, offered through the American Institute of Certified Public Accountants (AICPA), has a focus on forensic analysis. The Accredited Senior Appraiser (ASA) and Accredited in Business Valuation (ABV) designations offered by the American Society of Appraisers and AICPA, respectively, are specific to valuation of closely held businesses. The Chartered Financial Analyst® (CFA®) designation is more geared to public company security analysis. Court experience is important as well. Look for one or more of these designations along with expert witness experience to select the most qualified appraiser.

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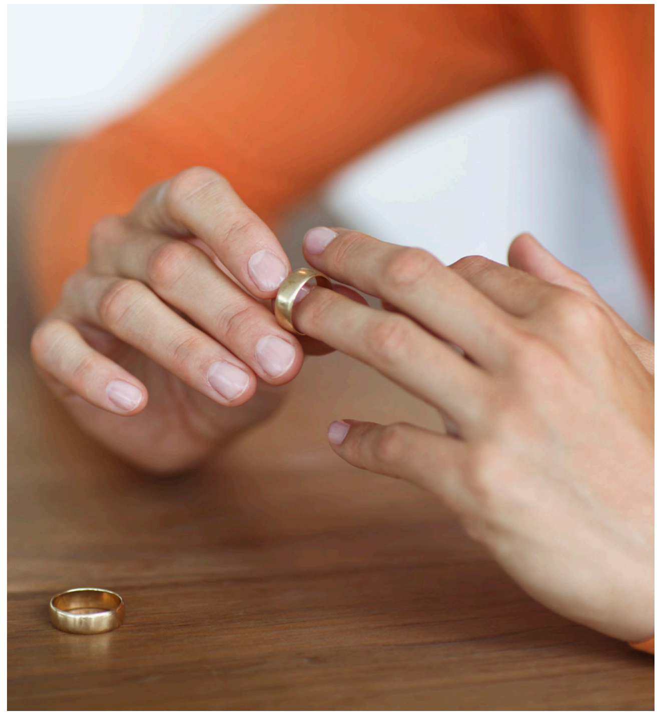
Selecting a business appraiser

There are several business valuation designations that an individual can earn that signify basic knowledge in business appraisal. Some designations include:

- Certified in Financial Forensics (CFF)
- Accredited Senior Appraiser (ASA)
- Accredited in Business Valuation (ABV)
- Chartered Financial Analyst® (CFA®)



Determining the value of the business

There are three approaches to determine the value of a business: the income approach; the market approach; and an asset-based approach. They are not mutually exclusive and a comprehensive analysis should consider each method and detail why it may or may not be appropriate given the circumstance. The income method requires the estimation of future income and conversion to value using a discount or capitalization rate appropriate given the level of risk of achieving expected returns. The market approach is based on the principle of substitution. Comparable private company sale transactions or stock prices of publicly traded companies can be used to capitalize the returns of the company being valued. The asset-based approach focuses on the balance sheet and deriving a value through the hypothetical sale of the assets.

A business appraiser may also take other factors into consideration including employment agreements, operating agreements, and shareholder agreements. Contracts between the shareholders often offer the best indication of the value of the subject interest. But, while binding parties to the agreement, the court is free to consider other factors when determining value in the context of divorce.

Shareholder loans and personal guarantees

Does your family business have shareholder loans on the balance sheet? Shareholder loans are personal assets includable in the marital estate, so they will need to be valued along with the family business. Shareholder loans are typically not worth their face value or unpaid balance. They are a contract to repay a debt in the future under specified terms. The amount and timing of the future payments as well as the current interest rate environment, strength of the borrower, and underlying collateral must all be taken into consideration before determining an estimated value. However, what if the shareholder loans are not really loans at all but capital contributions in disguise? There is considerable ambiguity regarding whether shareholder-level discounts are appropriate in business valuations prepared for divorce purposes across state lines. Therefore, the reclassification of shareholder debt as equity can result in discounts and the loss of marital asset value.

Many questions need to be answered when classifying shareholder notes as debt or equity. They include:

- Has the obligation been formalized in writing?
- Is repayment unconditional with a fixed repayment schedule and reasonable interest rate?
- Is the loan collateralized and does it include default provisions?

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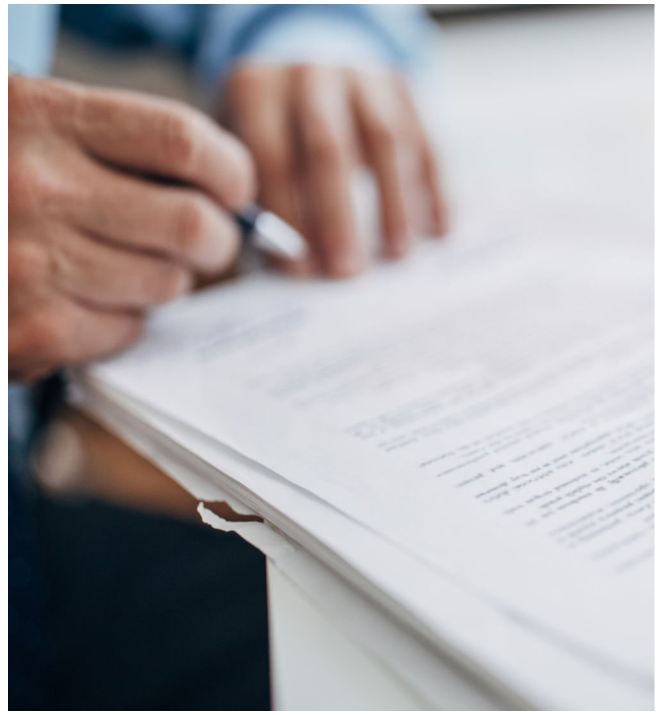
- Does the company generate sufficient cash flow to repay debt obligations?
- Are the shareholder loans subordinated to other sources of debt financing?

These factors are not exhaustive, and the absence of one or more consideration would not necessarily result in a reclassification, but help to determine the intent of the party making the loan.

Personal guarantees are more often than not required to obtain bank financing for small and mid-sized businesses. In some instances, debt is only extended because of the personal guarantee or pledge of personal assets. It's important to recognize what effect not having the personal guarantee and/or personal collateral would have when valuing the company. Typically, the higher the cost to borrow, the lower the value of the business. These are just a few of the many complicated issues your attorney and business appraiser will address on your behalf.



While the inclusion of a family business in your divorce proceedings can make things a bit more complicated, working closely with your advisors and business appraiser can help you make the most informed decisions as you embark on this new chapter of your life.

