

PUGET SOUND Business Journal

Business Leaders Get It.

FEBRUARY 23-MARCH 1, 2007

Divorce and business

Avoid the financial pitfalls when a marriage crumbles

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When the owners of a business decide to divorce, there's one BIG question lurking in the split.

What's going to happen to the business?

Puget Sound area family law attorneys say it is rare that a business is sold or shuttered because of a divorce among owners because it rarely, makes financial sense to do so. Still, divorce can have negative impacts on the business owner's attendance and attention to the business, health care costs and the business's productivity and financial health.

Some attorneys offer that a little preventive medicine can go a long way toward protecting a business from taking a big financial hit because of a divorce.

To be sure, couples typically don't enter marriages or businesses assuming either would be ripped apart by divorce. Still, with the national divorce rate estimated as high as 50 percent, it happens.

Remedies for a company with divorcing owners depend on the type of business involved, says Sands McKinley, managing partner of Seattle's McKinley Irvin, which specializes in complicated family law cases. But the biggest key, he says, is to get a family law attorney as early as possible, when a divorce first appears to be looming on the horizon.

"There are business planning decisions that can be made," he says, that can ease the effects of the split down the road.

Some businesses are able to carry on relatively unscathed by a divorce. Seattle family law attorney Steve Hemmat recalls a former case in which a dentist's practice was given a valuation for the divorce, and it

amounted to about one-third of the couple's total assets.

The dentist gave up his share of the couple's house and part of his 401 (k) to get clear title to his business, and it maintained cash flow.

"It's easier for a sole proprietor to protect their businesses than it is when there are two or more owners in the company," says McKinley. "Sole proprietors have no fiduciary duties to partners or shareholders."

But they still have to plan ahead if divorce is forth-coming. For instance, if a sole proprietor sees a divorce ahead and is planning to merge his company with another, the best bet is to hold off until the divorce is final, says McKinley.

"I'm not talking about being dishonest," he says. "I'm talking about the timing for implementation of certain plans, similarly to how one makes decisions when tax planning."

When partners are involved, there should be ownership agreements in place, adds McKinley, so that spouses can claim only a community property interest in the value of the divorcing owner's shares but not ownership of the shares. That can keep spouses from becoming partners in the business as a result of a divorce. However, he adds, the spouses must agree to such terms after running them by their own lawyers.

Having the foresight to keep a business unscathed from a divorce, however, isn't always at the top of a business owner's mind.

"People running a business are not planning for divorce," says Gordon Wilcox, Seattle-based family law attorney. "They're trying to make the business profitable. It would be a lousy business plan to have a divorce reserve."

COUPLES COUNSELING

Family law attorney Sands McKinley suggests these ways to divorce-proof a business:

1. Hire a family law attorney sooner rather than later. Lining up the experts needed for your case a year or more before filing for divorce will make for a smoother split.

2. In the event of a divorce, make sure shareholders' agreements are drafted. Otherwise the spouse of a partner may suddenly become a new partner in the company, a scenario that existing partners may not want.

3. If you own a business before marriage, sign a prenuptial agreement to keep the business your separate property after marriage, or,

4. If you don't have a prenuptial agreement, make sure not to co-mingle your business interests with community property interests.

5. Be mindful of business plans if divorce is in your future. So, if you're thinking about merging with another company, which would increase the value of your ownership, you might want to put it off until your divorce is final.

8. Watch cash flow and spending when a spouse has access to business accounts and credit. Sometimes the spouse will use company cash for personal use, or run up company credit debt prior to a divorce.

7. Be aware of the effects of stress. Try to minimize any of your actions that could be affected by stress, distractions and emotional exhaustion. They can hurt the company during a divorce.

And for employees going through a divorce:

8. Don't expect a divorcing employee to perform at 100 percent. If the employee is in a key position, they may work better on light duty to ensure the company isn't harmed by a stressed, distracted and emotionally exhausted employee.

9. Managers should be compassionate but clear on expectations of divorcing employees, to maintain performance according to company needs.

10. Provide employees with information and resources that can help them. This includes counseling referrals, tips on how to hire an attorney and suggestions on how to work effectively while coping with personal problems.

—MARK LARSON

DIVORCE: *Separate business and personal assets*

Still, they can draft a shareholders' agreement declaring share values of the company and how much each spouse owns, says Wilcox. But the problem with that, he quickly notes, is that it isn't legally binding. In a divorce proceeding in court, a judge can overrule such an agreement when deciding how to equitably split up a couple's pooled assets.

And, notes attorney Hemmat, if one spouse quickly persuades the other to sign a release of ownership of a business assets, that too can be overruled in court if it is determined there was psychological abuse by one of the parties.

But attorney McKinley says that if a business ownership is formally defined contractually, it introduces contract law into the case and strengthens the argument in court of who owns what part of the business.

If a person owns a business prior to marriage, for instance, he recommends the signing of a prenuptial agreement that identifies the business as a separate property. McKinley notes, however, that if such a business pre-nup is signed a month or two before a wedding, a judge may rule that the close proximity to the wedding date put undue pressure on the spouse to sign, and nix the agreement.

An alternate method is to keep the business's accounting strictly separate from other assets in the marriage so it can be documented as such.

When a divorce hits a family owned business, Wilcox says, each case has its own distinct set of facts that determine the businesses' fate in a divorce.

And family law attorneys are typically hired to document those facts.

First, the husband or wife considered most critical to the business has to be identified and agreed upon. And that's usually very clear, says Wilcox. "It's very rare that both people claim to be the key person in the business."

That person will likely be awarded the business in a divorce, but many more steps lie ahead. The business has to be valued. When the divorcing couples have their own valuations done by third parties, Wilcox says, they typically come up with numbers that are close. But that's if a business has only one set of books and everything's on the up and up.

Disputes sometimes pop up, and with complicated bookkeeping, says attorney Hemmat, getting to an agreed-upon valuation of the business may be a tall order.

"It's tricky, no doubt about it," he says, especially if there's mistrust between the divorcing partners. And that is as likely as not.

Attorney McKinley says he's seen spouses of business owners take advantage of access to company accounts and credit, taking company cash for personal use, or running up credit in the months leading up to a divorce.

"It's definitely a more difficult case to manage if people are being untoward or dishonest during the process," he says. "It's nightmarish for the client who is trying to do the right thing, both in terms of stress and expense."

Once the spouse running the business is determined and total assets are figured,

there are two basic scenarios: cases in which the business is the couple's biggest asset, and those in which the business is a fraction of the couple's total assets.

In the former case, says Wilcox, "What you wind up with is a business problem." That's because the business then must come up with the cash to settle with the other spouse. And in these cases, the business typically doesn't have enough income to support both partners separately.

But in such cases, says Wilcox, selling the business to settle the divorce is rare. Typically, settlement payments are agreed to that will allow the business to continue. Attorney McKinley says spouse settlement payments are usually one of two arrangements: a large chunk of cash paid initially, followed by a series of payments, or a set number of payments over a specified period. He rarely sees the payouts done with the help of a lender.

Attorney Hemmat says selling or dissolving the business usually isn't a good idea because it leaves one of the divorced parties without an income. "That's not good if you have children or other maintenance needs," he says.

Beyond that, adds Hemmat, "Mom and pop businesses are only as good as the mom or pop who runs them, so selling the business should probably be the last resort in most cases."

But it could be necessary in a case in which the business makes up 70 percent of the couple's total assets, he says, and one spouse wants a 50-50 split.

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