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Spousal Claims Against the Business

PROFESSIONAL OPINION

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You founded the business or you have taken a family business to the next level. This required vision, creativity, tenacity, stamina, self-education, hard work and personal and family sacrifice. You may have thought that once you achieved a certain level of success and stability, you might worry less. Of course, part of you knows that in a business there is no pinnacle of stability and that the business constantly requires vigilant adaptation and continued growth. However, now your thoughts also turn to the preservation and protection of the business. Among the threats potentially facing the business are claims by your spouse, or spouses of your children or partners in the business. With a divorce rate of approximately 50%, the threat to the business is a reality that the business owner should address.

There are two primary scenarios. First, is death of a business owner, death of his or her business partner, or death of his or her child, or other beneficiary who may inherit the business. The second scenario is divorce of the business owner, business partner or business owner's child, or other beneficiary. Under New York law, and similar laws under other states, a spouse is entitled to onethird (1/3) of the net estate of a deceased spouse, including the business and the proceeds from the sale of any business. In the event of divorce, a spouse of the business owner, of a business partner, or of a child or other beneficiary, may be entitled to a portion of the business or a portion of its value, as part of the division of the assets of the couple. The value of the business may be a factor in determining maintenance or other support obligations. Generally, gifted and inherited assets are considered "separate property" and not "marital property." Generally, only marital assets are subject to division in the event of divorce. However, the distinction often is not clear. As an example, a business that is developed by the founder while the founder was married likely will be considered marital property. Even if the business is gifted or inherited, the appreciation in value of the business, and income generated, during the marriage may be considered marital property. Thirdly, as part of the business succession plan, in order to provide retirement benefits or value to the senior owner, the child or successor owner may be deemed to have purchased the business, rather than to have received the business as a gift, in which event the business would be considered marital property and subject to equitable division.

The threat in these situations is not merely that the business owner, business partner and child may lose value to a spouse with claims to the business through death or divorce, but also the healthy continuation of the business itself may be jeopardized by the disruptive and intrusive effect of investigation into the business. In both the death and divorce scenarios, the business will be subject to appraisal, and the consequent scrutiny and due diligence required in the appraisal process by both the appraiser of the business owner, his or her estate, or the business partner or business owner's child, but also by the appraiser of the claiming spouse. This process may involve protracted litigation, with the attendant costs and lost opportunities during the investigation and litigation process.

The key to avoiding or minimizing such disruption and loss of value lies in comprehensive and targeted planning well prior to death or divorce. There are various solutions that can be developed to meet your objectives. First, a thoughtful, wellcrafted buy-sell agreement is critical. The agreement can provide that owners of the business may transfer ownership interests only to a specifically defined class, such as children, business partners, or those working in the business, and that all other transfers are void subject to a right of first refusal process. The buy-sell agreement can further establish valuation guidelines directing use of discounts for lack of marketability, lack of control and other discounts to reduce the value of the business to a realistic value considering the circumstances of the untimely and catastrophic event triggering the valuation and buy-out. The purchase price determined by the buy-sell agreement does not need to value the business as though it were being sold to a synergistic buyer who appreciates the projected opportunities of the business and continued employment or consulting of the business owner. The buy-sell price can be based on historical financial statements and further consider the loss of the business owner, as the key driver of business initiatives. A buy-sell agreement can also provide that the price is payable on a long-term installment basis at the minimum interest rate allowed by the IRS, subordinated to existing and future debt of the business. The installment payment structure may further drive down value. The discounted valuation and subordinated installment payout should be considered commercially reasonable as the buy-sell agreement addresses events that can harm the business itself and provides a mechanism for the continuation of the business which might otherwise fail.

Another solution is for the family business owner to transfer the business or proceeds of the business in trust, either at his or her death or during lifetime, rather than provide for an outright transfer to a child. For example, a business owner can provide that the business assets or the proceeds of the business will be held in trust for his or her child for life, so that these assets will not be considered part of the child's estate in the event of death or part of the child's assets in the event of divorce. This solution may also provide other benefits such as creditor protection, as well as generation-skipping transfer opportunities to avoid estate tax at the child's level

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upon the child's death. Trusts can provide the child with all the financial benefits of the trust assets, as well as certain authority and power over the ultimate distribution of the trust at the child's death, while protecting the assets from the claims of spouses and other creditors.

Thirdly, prenuptial and post-nuptial agreements are common in these situations. Business owners may very well request their children to sign prenuptial or post-nuptial agreements in order to ensure that the family business is protected. The child and his or her fiancée or spouse will each need separate counsel, and must provide full disclosure of finances to each other, to support enforceability of the agreement. Although introducing these concepts in a marriage can be uncomfortable, it can be done in a thoughtful and constructive way that may well be a relief to those involved, set appropriate expectations and avoid conflict down the road.

Another solution often overlooked in the context of a new marriage and potential future divorce is for the business owner to obtain a baseline appraisal of the business from a reputable appraiser. If there are issues later about whether or not the appreciation in the business is a marital asset, a baseline appraisal can establish the value immediately prior to the marriage.

Focused planning is the key. Simply put, planning is the development of creative solutions tailored to the business owner's financial circumstances, family situation and objectives. ■

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