When business owners divorce: Proceed with caution in picking experts

When high net-worth business owners get divorced, the business is as much a party to the proceedings as the spouses. In fact, the business is often named as a party in the divorcing business owner's lawsuit because a court has no jurisdiction to order a business to do anything if the business is not a party. When a business is named as a party, the court has jurisdiction to order the business to do any number of things. The court might order the business to not engage in certain transactions, incur any additional financial liability, access or withdraw funds from certain bank accounts, or allow a nonparticipating spouse to work at or have access to the business.

When a business is named as a party in the divorcing business owner's lawsuit, or if the business receives a subpoena requiring the production of documents, electronic evidence or the testimony of someone from the business, it is necessary to engage corporate counsel and the business's accounting firm to assist, advise and, when necessary, defend against demands by a party that are unduly burdensome to the business. The costs incurred can be significant, and it is a time-consuming distraction for employees and the owner to comply with demands to produce documents or testify about the business while still meeting day-to-day responsibilities.

> **"The appraiser will request records going back at least five to seven years as part of the business valuation."**

When business owners get divorced they want to know:

• Will a court order me to own the company with my spouse who has not participated in running the business?

• Can the business redeem shares held by my nonparticipating spouse, and how will the amount be determined?

• Can the business redeem my shares pursuant to the shareholder or operating agreement's buyback provision? If so, what will be the price?

• Can I pay my nonparticipating spouse for his or her marital interest in the business, and how will the amount be determined?

• Will I have to remove my nonparticipating spouse's name from personal guarantees associated with the business?

• How will my business be valued, and how much will that cost?

• How much information, including sensitive financial and proprietary information, must my company disclose?

• What are the tax consequences if assets are transferred to my spouse?

Complexity requires experienced advice

There are many complex issues involved when a business owner gets divorced, including tax consequences, ownership transfer, continued operation of the business during the short and long term, the preservation and distribution of income and assets until the case is resolved, and the defense of any motion seeking to freeze the cash or hard assets of the business. The two most important steps a divorcing business owner must take are hiring a divorce lawyer whose personal practice is dedicated to cases involving business valuation and complex financial transactions and to retain a competent business-valuation appraiser who has experience in litigation. Typically, counsel for both spouses will independently hire an expert to value the business and, more often than not, the resulting values will be vastly different by as much as millions of dollars. It is imperative that the business owner retains an expert with proper credentials, who can produce an error-free report and testify in a way that will help explain complex issues, to ensure that the court accepts his or her opinion of the value of the business. This is a tall order to fill because few experts satisfy all three criteria. An attorney experienced in handing these cases can recommend competent and experienced valuation experts.

Penny-wise and pound-foolish

Competent divorce lawyers skilled in business-valuation issues are not inexpensive, nor are competent business appraisers. Hiring a certified public accountant or economist who does not have the necessary business-valuation and litigation training or experience may save money at the outset, but his or her value may ultimately cost tens of thousands of dollars more in the end. This usually occurs because the expert's opinion will be discredited in cross-examination and rejected by the court. The old adage "penny-wise and pound-foolish" applies here, and business owners must be careful not to compromise the entire case by hiring inexperienced counsel or appraisers.

Common missteps include hiring experts who:

- Lack appropriate credentials and experience to accurately appraise a business
- Fail to adhere to ethical and professional standards that govern business valuation
- Act as an advocate or "hired gun" and ultimately compromise their own opinion of value by showing bias and lack of independence
- Have no experience defending a business valuation in cross-examination
- Produce reports with typographical, grammatical and mathematical errors

An inaccurate business appraisal is detrimental to the divorcing spouse, but it also can affect the business and its other owners. The incorrect value will serve as precedent in negotiations over the sale of the company, the buyback of an owner's shares or in the valuation of another owner's interest if he or she gets divorced. All of these costly mistakes can be avoided. The best protection against the far-reaching effects of an incorrectly valued business in a divorce case is the right team of legal and financial advisers experienced in valuation and complex financial cases.

Inspection may expose company owners to risk

The business partners or shareholders should expect a thorough examination of its books and records if an owner is going through a divorce. The appraiser will request records going back at least five to seven years as part of the valuation. Even if the company is not being valued, lawyers and forensic accountants may examine its books and records to trace cash flow that may be available to the divorcing owner. This examination can spin off unexpected consequences for the business. Such intense scrutiny can pose a risk to businesses whose books do not reflect generally accepted accounting standards or, worst-case scenario, a failure to report taxable income. An examination of company books can reveal:

- Documented loans to shareholders for which there are no promissory notes or payments and which were not reported as income
- Income reported on the books that is inconsistent with the lifestyle of the divorcing owner, which may indicate unreported cash being taken out of the business
- Payment of personal expenses through the business that are not reported as income
- Financial statements that are "puffed up" for borrowing purposes but which may later be used against the business for valuation purposes
- Appraisals of the business for purposes of marketing the business for sale that can later be used as an indication of value in a divorce case.

Keep sensitive business information confidential

In addition to documents and information that disclose internal management of the business, other sensitive information may have to be shared. For example, the business will likely be required to produce detailed revenue, salary and benefit information. Although this information may have to be produced for purposes of the divorce case, business owners may wish to require that the divorcing owner, his or her spouse, consultants, accountants, lawyers and others with access to the information sign a confidentiality agreement. Such an agreement would require them not to disclose the information unless legally required. If the information is subpoenaed, the company's attorney may seek a protective order from the court, which may in turn order precautionary measures to keep the information confidential. The attorney also may wish to request that the court place the information under seal so that it is not available to third parties without the court's permission.

Divorce has caused many companies to dissolve because of the demands and costs incurred while dedicating resources to fulfill the requests of the opposing party. Experienced counsel can help manage the burden and protect the company from an unsupportable valuation that could bring problems down the road.

Cathy C. Hunt

Cathy C. Hunt is a senior partner with Raleigh-based Gailor, Hunt, Jenkins, Davis and Taylor PLLC. She dedicates her practice to the representation of high net-worth business owners going through divorce. Formerly, she practiced corporate law with Womble, Carlyle, Sandridge and Rice LLP in North Carolina and McGuire, Woods, Battle and Booth LLP in northern Virginia. Her corporate-law experience provides her with the expertise necessary to understand complex equitable-distribution cases, especially those involving business valuation issues. She has written about the impact of divorce on businesses and business owners for numerous business publications. She has been recognized by her peers as a member of *Business North Carolina's* Legal Elite in family law and also has been named one of North Carolina's Top Lawyers in the practice of family law.