

A photograph of a modern office interior with large windows. Several people are seated around a long white table, working on laptops and papers. The office has a clean, professional look with a dark ceiling and large glass walls.

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Creative Solutions Dividing a Business in a Divorce

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Introduction



The world is changing but divorces go on. How can spouses deal with a business they can't value or divide? This article discusses methods of division, focusing on in-kind division and deferred buy-outs, because of the difficulty valuing businesses now, or finding liquidity for a buy-out. Holding company and nominee methods will be addressed, along with due diligence and tax problems.

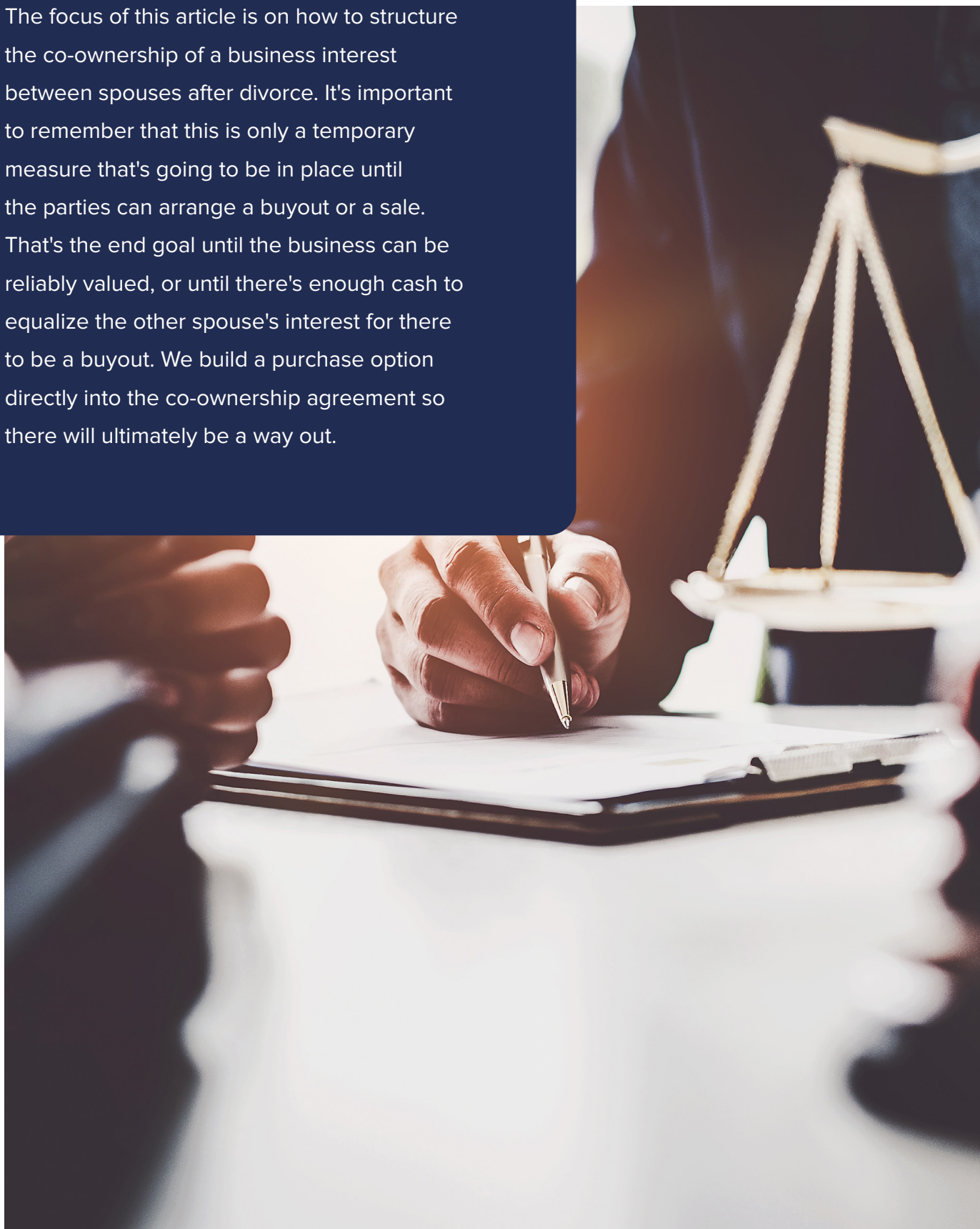
There are three options for how to deal with a business interest in divorce. A buyout, sale, or co-ownership.

Buyout is the preferred option because there's a clean break so the ex-spouses aren't in business together. But valuation is difficult in an uncertain economy. Equalization can also be difficult because, usually, a family business is the largest asset the couple has, so there may not be enough other assets to award to one spouse in exchange for the other spouse getting the business.

The second option is a sale. Many don't want to sell their business interest because they've been growing it and developing it for several years.

That leaves us with the third option, which is co-ownership. But it's fraught with danger.

The focus of this article is on how to structure the co-ownership of a business interest between spouses after divorce. It's important to remember that this is only a temporary measure that's going to be in place until the parties can arrange a buyout or a sale. That's the end goal until the business can be reliably valued, or until there's enough cash to equalize the other spouse's interest for there to be a buyout. We build a purchase option directly into the co-ownership agreement so there will ultimately be a way out.



Co-Ownership Overview

Co-ownership is not ideal, and should end when conditions improve. The end game will be a buy-out or sale. A purchase option can be built into the agreement.

A.

THE MOVING PARTS IN STRUCTURING

A CO-OWNERSHIP DEAL

The options for co-ownership must be explored to determine what is feasible. Due diligence is required to know whether the plan will work, the risks, and how to document the transaction. Compensation to the operator spouse must be considered, along with the interplay of that compensation and support orders. When a structure has been agreed upon, someone must draft the documents and ensure the transaction is tax efficient.



The Co-Ownership Conundrum

Overview

Exploring the Options

Due Diligence

Disclosures & Investigations

Limitations

Entity Structure

Management

Control & Compensation

The Agreement

Key Terms & Security

Taxes

IRC 1041

B.

OWNERSHIP VS.**MANAGEMENT**

Economic rights in an entity are proportional to the person's ownership interest. Distributions follow equity.

Management and control rights over an entity need not follow the ownership interest. A manager can have no interest in the entity. A spouse can cede the right to manage and control to the other spouse. Co-ownership by former spouses typically involves one manager.



In-Kind Approach

Equal division of community interest by creating a subordinate class of equity in the entity for the non-operator spouse, with reduced voting or management rights and protections of the non-operator spouse.

1
Spouse
50%

2
Spouse
50%

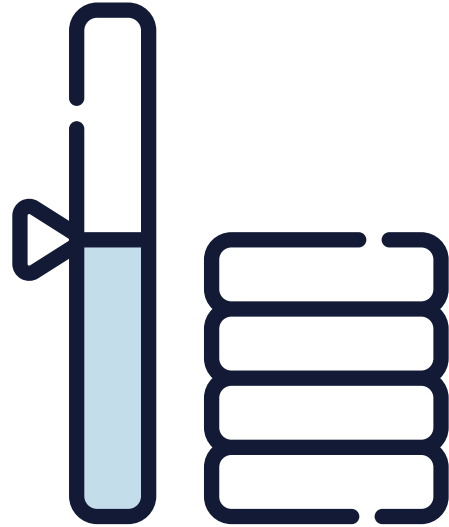
**Operating
Company**

Manager
Spouse 1

A.

LIMITATION ON IN-KIND DIVISION

If the entity is owned solely by the spouses, it is easy to accomplish an in-kind division. But when other owners exist, those third parties don't want new partners. The formation documents for the entity usually prohibit transfers or assignments to others without consent of all owners. We will have to find a work around if the third party owners do not consent. Although the court can order a spouse to do something, there are not a lot of options to overcome the resistance of third-party owners.



Successful businesses will usually have other owners, or a series of structures to hold assets or perform management services. It seems like the more money these businesses make, the more layers of entities they have. They may have management and control in one entity, and they may have ownership of particular assets in other entities, all wrapped up into another operating company. So, you can have multiple layers of entities, and we have to go through the operating agreements, or shareholder agreements, for each entity to understand what can be done, and not just assume the divorce court can just force solutions.

We have to work within the entity documents, and most have, as a standard provision, anti-assignment provisions. Provisions prohibiting the introduction of a new partner or owner without consent of the others.

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We have to work within the entity documents, and most have, as a standard provision, anti-assignment provisions. Provisions prohibiting the introduction of a new partner or owner without consent of the others.

That's going to be a problem we're going to have to contend with, and we're going to have to know whether these other owners are going to consent to it. Be aware of transfer restrictions that say a purported transfer allows the company to purchase the interest for a nominal sum.

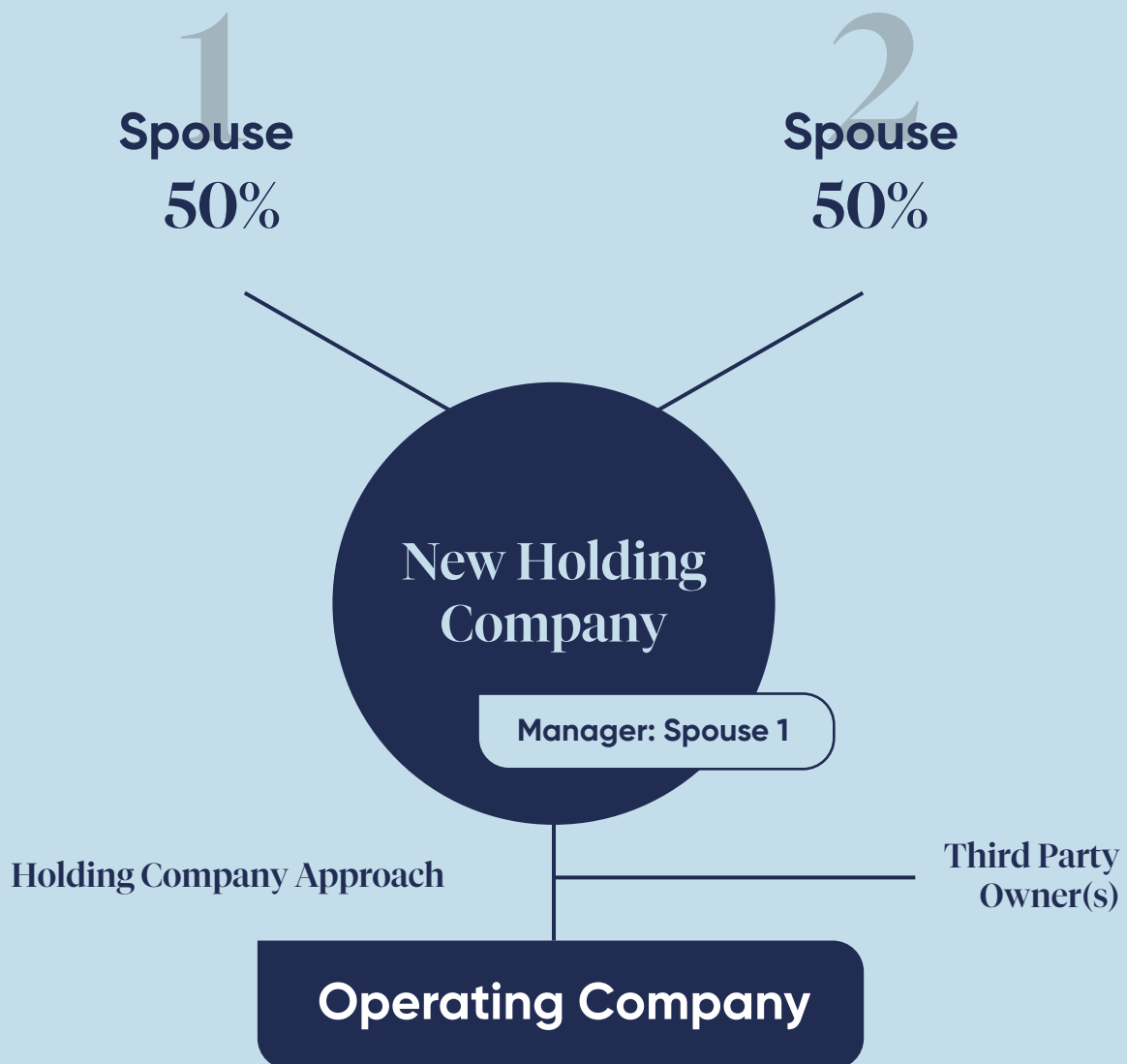
Negotiating with the other owners to allow the out-spouse to be an additional owner of record of the entity can be a long process. The other owners may not be open to bringing somebody in who's getting a divorce with their business partner. That just sounds like a bad idea. So, they will be resistant to it, and they will certainly want it documented. Who's going to pay for that? Who's going to pay for all those business lawyers to go through and redo all of these agreements? The business doesn't want to be involved in that. So, often it's "no, thank you."

If we can't convince the other owners to admit our client as a passive economic-only interest holder of the business, then we will have to look at how they will hold that economic-only interest without approval from the others. That leads us to consider the holding company or nominee approaches.



Holding Company Approach

New entity formed to hold spouses' interests, with management rights assigned to one of them.



A.

CHOICES FOR HOLDING COMPANY

We'll move now to the holding company approach. That means forming a new entity to hold the spouses' interest, and that holding company would be the member, shareholder, or partner of the existing entity that operates the business. So, let's consider the diagram. We've got the holding company in the middle that owns the interest in the operating company. Spouse One is the manager and each spouse has a 50% interest in the holding company.



This structure will probably need consent of the other owners because the interest of the spouses in the existing entity will be transferred to the holding company. The third party owners of the business should like this structure because Spouse One decides for the holding company (i.e., the same spouse controlling the spouses' interest in the business during marriage will continue to do so in this arrangement). The holding company protects the spouses because each owns a 50% direct ownership interest in the holding company. So, if either spouse were to face bankruptcy or credit or collection issues, the other spouse's interest would not be affected. So we like this as divorce lawyers too.

It's less offensive to the other owners of the operating company. Down at the bottom of the green diagram is the existing entity in which the spouses have a community or joint interest.

Before the split, one spouse was holding the member interest of both spouses, without one being on record as an owner. All we're proposing is to substitute Spouse One for the holding company as the owner of the spouses' interest. The holding company will have the same rights and responsibilities as Spouse One had, and Spouse One will continue to call the shots for the interest now held by the holding company.

Within the holding company, we can write all the protections and agreements we want about management of the holding company, compensation to the manager, fiduciary duties the spouses owe to each other, the purchase option, etc. The other owners need not see or be concerned about those details. It's a realistic alternative.

There are a bunch of choices for the structure of the holding company, and each option can have management rights separate from ownership rights.

01

A limited partnership is the classic business structure for this arrangement, where the general partner manages and the limited partners own.

02

Limited liability companies are easy to form. There's a managing member that controls, and the members who own their interests and don't control.

03

In a corporation, the spouses would each be shareholders, and then there would be a board of directors to govern. The spouses can agree who will be on the board of directors.

04

Or, you could create a trust, with the spouses as beneficiaries, and the trustee would have control. Some entity documents allow a transfer to trust.

B.

SOME ENTITIES CANNOT

HOLD OTHERS

There are limitations on what types of entities can hold ownership interests in other entities, so you got to watch out for that.



Say the spouses have a bunch of nursing homes, each set up as different entities. Some of those nursing homes own the real estate in which the homes were situated. Management of the nursing homes is conducted by a separate entity, and the intellectual property (e.g., trade name) is owned by yet another company. They also own a captive insurance company to provide coverage for claims against the nursing homes. There is a different mix of partners between the entities, and a different mix of LLCs and S corporations. Sound complex? This arrangement is to be expected in a successful operation. Because the business is so valuable, there may not be funds for a buy-out, so the spouses are stuck with co-owning their interest.

Wrapping up the spouses' interests in the entities into one holding company sounds tempting, but a holding company cannot hold all these things. There isn't one entity that can hold it all. The easy way to understand the limitation is that the IRS does not want a pass-through company holding another pass-through company. That may be an oversimplification of the rules, but helps sketch out the boundaries.

If we're using the holding company approach and we now want to create the H&W Holding Company, we have to select an entity type that can legally own the existing company(ies).

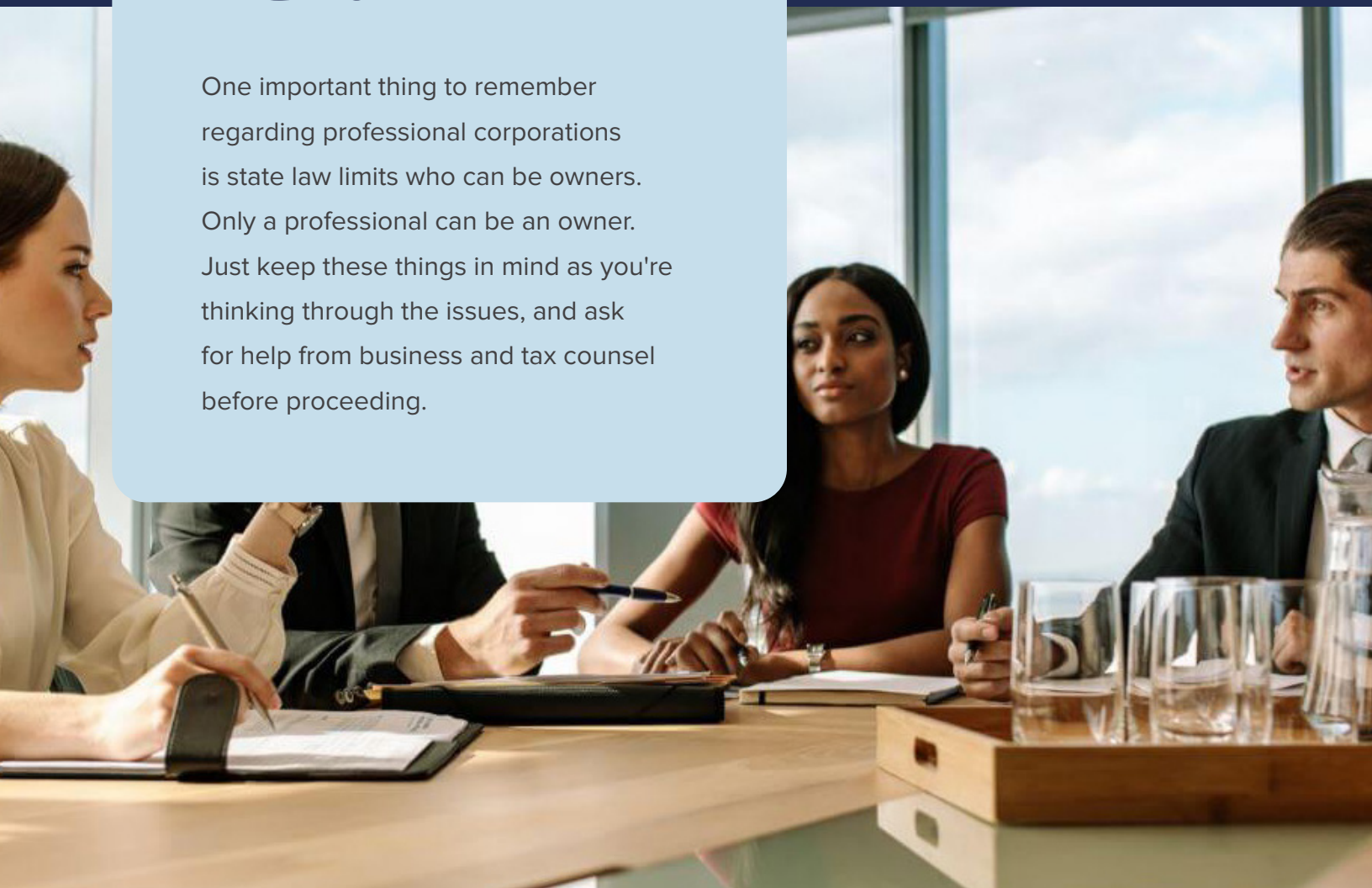
A pass-through entity, like a partnership, most LLCs, or a S Corporation, report taxes but do not pay taxes.

The entity files a tax return for information purposes, and the taxable income flows through directly to the owners, who pick up that income on a Schedule E to Form 1040. That type of entity can't be held by another pass-through entity.

We may need a C-Corporation, qualified sub-chapter S-trust, an electing small business trust, or maybe an irrevocable trust as the holding company, which will be difficult to form and administer. Business and tax counsel will be necessary.

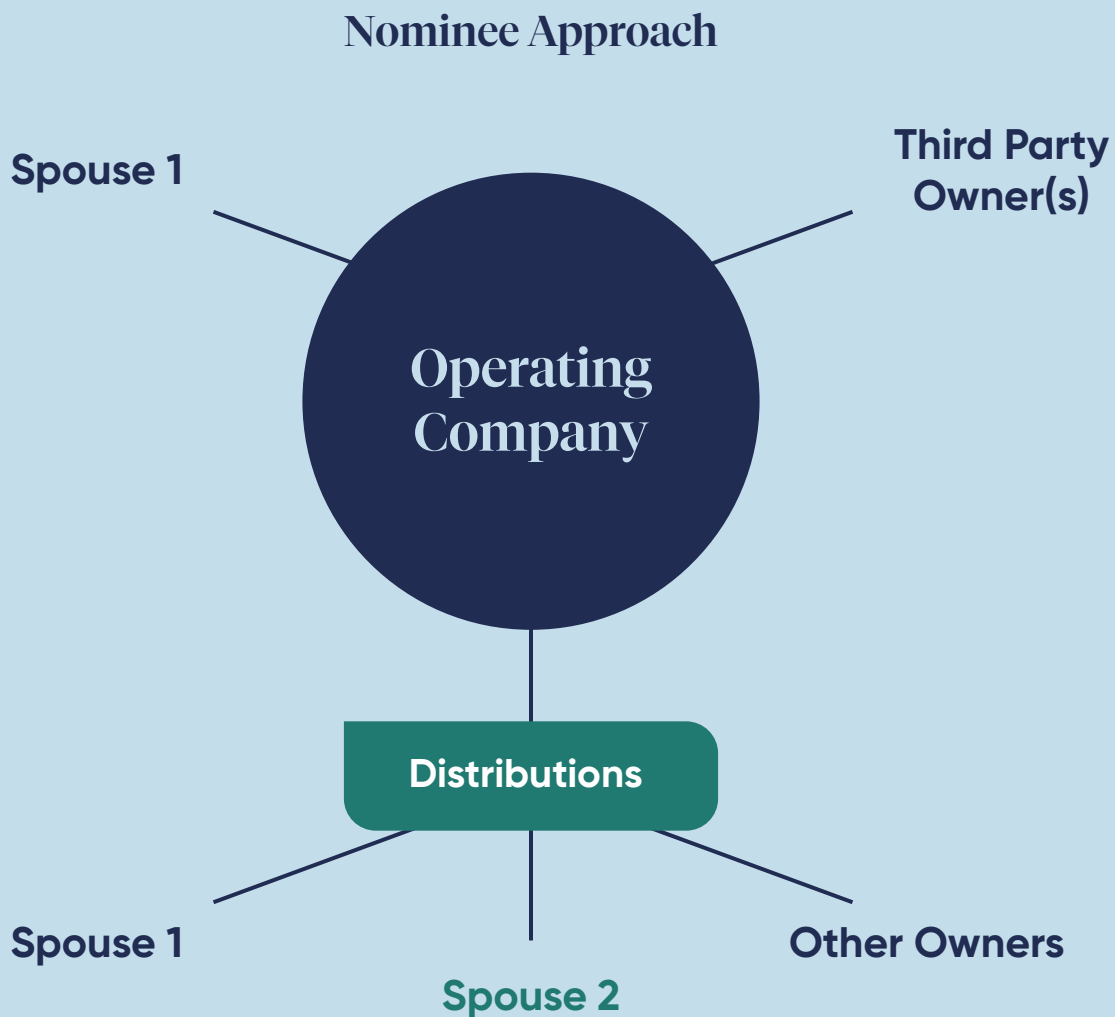
C. PROFESSIONAL ENTITIES

One important thing to remember regarding professional corporations is state law limits who can be owners. Only a professional can be an owner. Just keep these things in mind as you're thinking through the issues, and ask for help from business and tax counsel before proceeding.



Nominee Approach

Operator spouse continues to hold interest of both spouses, with accountability to distribute income.



A.

INSTRUCTING THE ENTITY TO DISTRIBUTE TO BOTH SPOUSES, OR**TRUSTING THE OPERATOR SPOUSE TO DO IT.**

Often, because of the issues we've just addressed, we are left with the nominee approach. This scares family law attorneys, because we prefer a clean break and don't want a situation where Spouse One continues to hold title to an interest on behalf of another. But it's simply the only way sometimes.



Spouse One will must account for, and turn over to, Spouse Two a share of any income derived from the interest in the business. Usually, this is the approach that we're unfortunately stuck with. In the diagram, Spouse One continues to hold title in the operating company with the third-party owners. When the company is getting ready to distribute income, Spouse One would instruct the company to pay out distributions per the spouses' agreement, to each spouse directly.

You may need consent of other owners because it's an assignment of Spouse One's entitlement to the income from the company. If the other owners agree, or the entity does not restrict such assignments, then the company can be instructed to pay Spouse Two his or her share of the income directly. If not, the company will continue to distribute to Spouse One, and we will have to rely on that spouse to turn over Spouse Two's share of income, as required by their agreement.

We don't like that. These parties have gone through a divorce. It's putting a lot of trust into Spouse One, and Spouse One may not wish to be in the role of collecting and paying over the money, out of fear of claims by Spouse Two of being cheated.

B.

USING NOMINEE

APPROACH PRE-TRIAL

The focus of this article is settlement options, but this approach can also work pretrial. Later, we will discuss the authority of the court to force situations like this, even when the Spouse One or the third parties don't agree, which can be requested as temporary measures or permanent solutions.

Divorces take a long time. It may be in a multi-year litigation. If we have a business throwing off a lot of money during the divorce, do we trust that Spouse One to receive the distributions, or do we want to ask for an order forcing the entity to distribute directly to our client? It may advantage Spouse One to divide income pretrial with his or her spouse, to reduce exposure to claims for support, or needs-based legal fees.



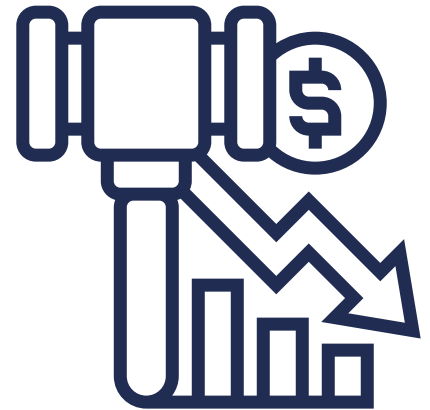
C.

BANKRUPTCY

RISK

A problem with the nominee approach is bankruptcy, because whenever a spouse holds an interest in his or her name, that person's creditors can go after that. We don't want our client's interests taken by the other spouse's creditors. Now, if they're a community creditor, maybe that's going to happen one way or the other. But if we can divide the interests and make our client the record owner of his or her own share, it provides protection.

The only way to do that is divide in-kind, but that may not be possible. The inherent risk of creditors in the nominee approach should be evaluated.



D.

ORDERS AGAINST

ENTITY

The court cannot change the entity agreement, and that's true even if you join the entity as a party to the divorce action. A good analogy is retirement plans. While we can divide benefits and direct payments, a court does not have the power to change the retirement plan. Same here. Whatever we will ask the court to do has to fit within the construct of this entity.



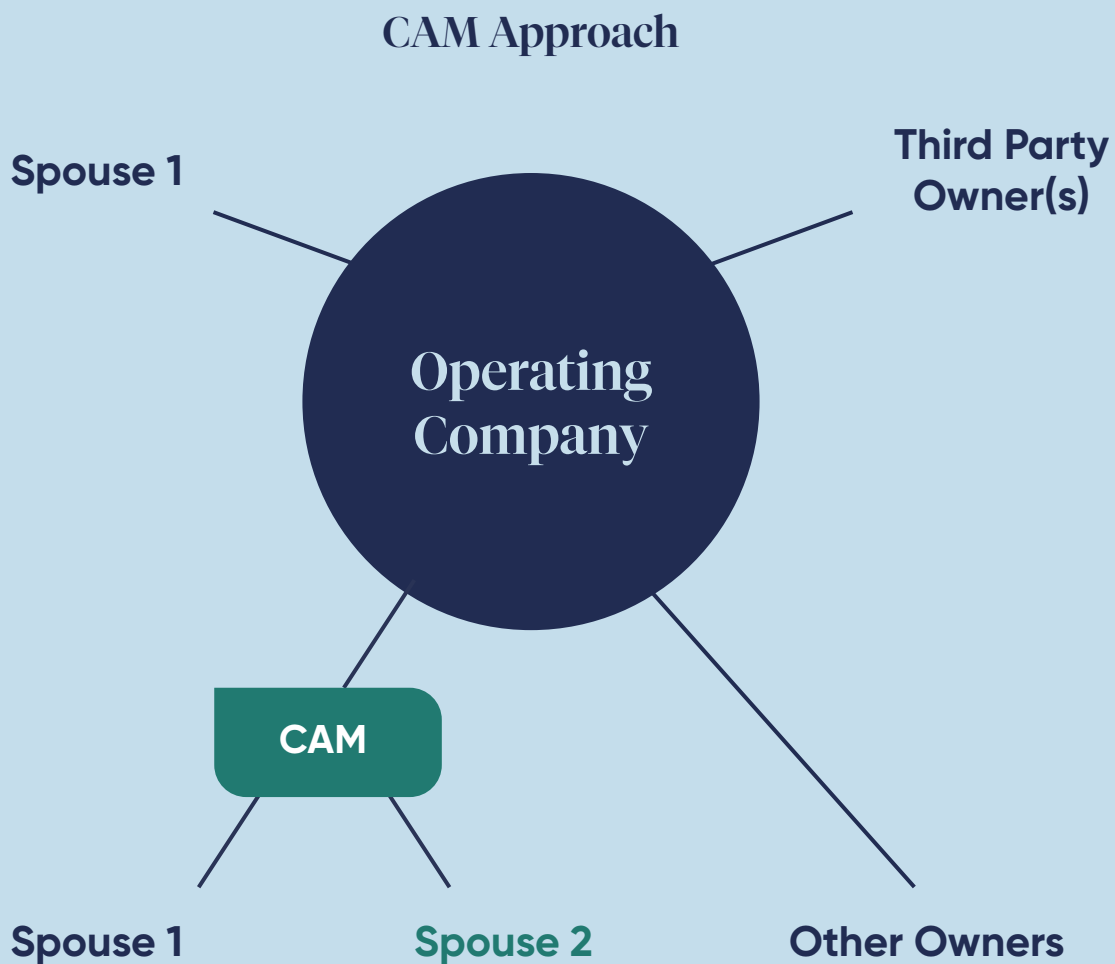
That's true even with the joinder. Courts have no authority to change the terms of an entity formation document, even when the company is joined as a party.

So, what can a court do? We know that orders can be made to protect the right to receive community income. Courts can make these orders, even without the third party being joined. California Family Code section 2045 allows the court to make injunctive orders against a third-party without a joinder in a dissolution proceeding, to protect the community interest. This is a good mechanism to get some quick relief without having to go through the joinder process, which can delay things. But section 2045 is limited to injunctive relief to prohibit transfers or other disposition of property, except in the usual course of business. We also have California Rule of Court, rule 5.18, which is broader than section 2045, because CRC 5.18 allows other relief besides just injunctive relief. That can be a useful tool.



Collection Account Management

This is like the nominee approach, but income is paid to a neutral party by the entity, to distribute per instructions. CAM is like an escrow, used in entertainment industry.



In film deals, multiple streams of revenues will come in that need to be distributed to rights holders. A collection account management (CAM) agreement facilitates those payments. The money is collected by a trusted person, like an escrow, then distributed.

We can adopt that process in divorce cases. The entity can be instructed to distribute money due to Spouse One to the CAM, who will then divide the funds between the spouses per their agreement.

The court may force this arrangement on the entity by filing a motion under section 2045 and rule 5.18, for relief against the entity, to compel them to make that payment attributable to the Spouse One's interest in the business to the CAM.

Use “if, as, and when” language in the order, which clarifies the entity is only required to pay money over to the CAM “if” the entity makes a distribution to its owners, the payment need be made only “when” the entity makes the distribution, and the form of the payment will be done “as” it makes it to the owners. That does not intrude on operating the business. It doesn't tell the business to make distributions. It just says that whenever you, in your discretion, make a distribution attributable to this spouse's interest, you shall instead pay it over here.

That's not intrusive. It is similar to a charging order, used in collecting judgments against the debtor, for funds due to that party from an entity.



Compensation



The next topic is compensation to the manager spouse during the period of co-ownership. In formulating this co-ownership, we are contemplating that one spouse is going to manage the entity on behalf of both spouses, and that manager may be compensated for his or her services post-separation, and so it's his or her separate property.

It is critical to deal with this upfront. You may need to get a reasonable compensation expert to opine or help you come up with what the reasonable comp should be. But it's critical to determine this up front with the co-ownership agreement, because otherwise, you are guaranteed to have a huge fight later, because the operator spouse will likely say, "Any income that was generated that came out of the business during this period was compensation for my services. There's nothing left over for distributions." You get nothing, whereas the out spouse will obviously argue the opposite.

The parties can agree on a fixed amount, like a salary, or you can have a formula which provides for an extra bonus amount based on the performance of the company, but it should be, like I said, agreed upon in advance in writing, and be crystal clear. Write into the agreement that operator spouse cannot change his or her compensation.

You don't want to have a situation where you've done this co-ownership agreement, you've fixed compensation, and then the operator spouse goes to the entity and says, «Hey, give me a raise.»

One way of addressing compensation issues provides Spouse Two a proxy vote on a decision that deals with Spouse One's compensation during the co-ownership period. It's important to think through all these different issues, because you're running in parallel between the co-ownership agreement and the entity operations, just to make sure everything is consistent, everything is on the same page, and there's not some kind of conflict or work around. It's going to end up prejudicing the out spouse.



Buy-Out and Support Interplay

As teased at the beginning of this article, co-ownership is meant to be temporary; it's a band aid solution. We're going to have an option to buy out the other spouse usually baked into this agreement. It might say at the end of three years, there'll be an option by Spouse One to purchase Spouse Two's interest for \$1 million. That could be exercised before then, or not. Or perhaps the buyout is required.

There could be installments along the way, and then by the end of three years, it's done and paid for. We contemplate that the business will spin off income that's over the reasonable compensation to Spouse One, and we will divide that excess income between the spouses for their ownership interests. Or, if you have this repurchase option baked in, part of the payments due Spouse One could be allocated to Spouse Two as installments on the buyout. That way, we know it's being funded, and there's not this gigantic balloon payment at the end.

There will be a support interplay. If we're setting salary at \$300,000 per year, we have to discuss whether support will be due on that salary.



Duties of Manager



The next question is, what are the duties of the manager spouse to the other spouse during this period of co-ownership? As we know, fiduciary duties of spouses apply to one another regarding community property, until the community property is divided, and that's under California Family Code section 1100, subdivision €. The question becomes under these co-ownership approaches, has there been a division of community property such to keep the fiduciary duty in place, or to have it terminated?

Ultimately, it doesn't matter because you can provide for a duty of care and loyalty by contract, for a fiduciary duty by contract. There are differences between the duty of care and the duty of loyalty.

The duty of loyalty is faithfulness to the purpose of the contract, not to lie, cheat, or steal from the other spouse, and there are probably some disclosure obligations built into that. The duty of care involves decision-making by the manager to act with ordinary care, on behalf of the entity. The manager will typically also be protected by the business judgment rule that protects decisions, made somewhat ordinary care, in the ordinary course of business.

Considerations we want to think about in coming up with the co-ownership agreement are, what kind of decisions can be made unilaterally by the manager spouse?

What kind of decisions require the consent of the out spouse? We should spell that out, just like any good partnership, business, or any other entity document would do, and the Uniform Partnership Act may be a place to look through, for how to kind of lay this all out in a co-ownership agreement.

Those decisions that can be made unilaterally, versus those that require consent. The other thing is that all contracts have an implied covenant of good faith and fair dealing built in. That's an added protection here as well. If the manager spouse is acting in bad faith, or frustrating the purpose of the contract, that can be actionable. We're going to move now to due diligence, which is actually something to consider at the very outset of all of this, but we've saved it for the end. It's critical to do your due diligence to make sure that everyone is going into this co-ownership structure with eyes wide open, knowing everything there is to know about the business and what could come up.



Due Diligence



Engage a business attorney early. We are family lawyers, not business lawyers. Most of this falls into business law, not family law. It's great to be able to issue spot to know these things exist, but you're going to want to engage a business counsel to do some of the heavy lifting on these items.



Request documents to verify the structure of the entity, its obligations, and your client's guarantees.



- > Articles of incorporation or organization
- > Employment agreement with owner spouse
- > Bylaws and minutes
- > Buy-sell agreements
- > Stock register
- > Financing agreements
- > Shareholder or operating agreement
- > Guarantees

C.

VOTING RIGHTS AND PRIVILEGES

There may be different classes of voting. Super control may be built in for one spouse, even though that party's ownership interest in the company wouldn't reflect that he or she could control the board.



- Are there different classes of voting rights?
- Who controls the board and appointments to the board?
- Is equity lost if an owner stops being a service provider?



Creditors



An important issue to know is who the creditors are, what's owed, and how is the debt secured. Are they secured through business property or other personal real estate? A lot of this will be obvious from the entity documents, like loan agreements, balance sheets, payments to creditors. Don't forget landlords, because leases for business premises may have a personal guarantee from an owner of the company. If a spouse has given a personal guarantee, this could have huge implications if a default occurs.

Tax authorities are also creditors, not just federal and state income tax, so it's important to look for unpaid sales tax and payroll taxes. These are significant, and the business attorney could assist in advising on those.

Some questions to ask:

- Who are they and what is owed?
- Security interests of others in business property
- Don't forget landlords and taxing authorities
- Personal guarantees or personal liability
- Check for covenants against transfer or assignment
- Claims or litigation involving company

Disclosures



The operating spouse should disclose any material facts or opportunities about the business. These can be stated as representations and warranties in the agreement.

- Any planned sale or other events expected?
- Other material facts relating to operation or continuity of business

Non-Compete



Consider an agreement from the bought-out spouse not to compete with the business. Even though that spouse did not operate the business, he or she may have enough knowledge to take customers, or market share from the spouse who paid for the business.

Security



Look at a QDRO to secure the buy-out payment against the spouse's retirement accounts. This is authorized by IRC 401(a)(13)(B), PLR 9234014 and PLR 200252093. The plan benefits awarded to the former spouse in the judgment can be pledged as security for that spouse's obligations under the judgment.

Taxes

IRC Section 1041 says no gain or loss is recognized on a transfer to a spouse, or former spouse, incident to divorce. We know it's incident to divorce if the transfer occurs within one year of the termination of marriage. It's presumed the transfer is presumed to be related to the cessation of divorce, if the transfer occurs within six years of divorce, and if the divorce instruments require the transfer.



With co-ownership, the parties will be partners beyond a year. There will hopefully be a buy-out by the sixth year, so IRC 1041 applies. The divorce instrument should spell out that the intent is to be covered under IRC 1041.

If the buy-out is beyond six years, there is a presumption that IRC Section 1041 does not apply, but you can still rebut the presumption by laying out the facts as to why it was impractical for the transfer to have occurred within the six years. There could be reasons, like liquidity or disputes with the other owners, as to why the transfer could not occur within 6 years.

Conclusion

That brings us to the end of the article. Most of this was corporate law, business law, and a little tax. Knowing these areas of law allows us to be creative and effective problem solvers for our clients.

