Family Law Newsletter
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Advance Preparation Helps to Minimize Future Risks to Business Owners in a Divorce

Plain and simple: a divorce can wreak havoc on a closely-held business. If a spouse acquires a business interest during the marriage, that interest will likely be characterized as a marital asset subject to equitable distribution at the time of the dissolution. If proper planning has not occurred, this turn of events - which would likely include the divorce court awarding the interest in the business to one of the spouses - can have a negative and costsly impact on *all* of the other shareholders or partners, not limited only to the person getting a divorce.

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To help avoid these problems, the interest-holder can execute clear and complete business planning agreements which anticipate such life events and set forth in specific detail how the business will be owned and managed upon their occurrence. In this way, the owners can be pro-active - rather than reactive - in times of turmoil.

These agreements are generally referred to as "shareholder," "operating," or "partnership" agreements, depending upon whether the business entity is a corporation, an LLC or a partnership. The purpose of these agreements is to formally establish plans and procedures which will be implemented upon certain triggering circumstances - such as an interest-holder being involved in a divorce - to ensure that the entity can continue to thrive in the midst of uncertainty. Too often, owners of businesses are so busy and focused on making their businesses successful that they either do not consider these agreements, or they put them off to be thought about another day. If you are a business owner and do not have this type of agreement in place, getting one done should be at the very top of your "to do" list.

In general, such agreements declare the rights, obligations, and expectations of the owners. With specific reference to the possible future divorce of one of the owners, the agreement can spell out the procedures for buying and/or selling ownership interests in the entity, can specify voting procedures that owners must follow, and may impose restrictions on an owner's right to sell or transfer his or her interest, with a particular focus on the ability of an ex-spouse of an owner to have any ownership interest in the business. If one of the shareholder/owners is involved in a divorce and, as a result, the corporation is required to incur costs, these agreements can specify how these costs can be be allocated (*i.e.* against the divorcing owner's income or interests) to prevent the other shareholders from being adversely impacted.

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Indeed, the potential dissolution of a marriage may be explicitly stated as one of the "involuntary transfers," which are usually included in the "buy-out" provisions of the agreement. Often, a separate provision in the agreement specifically devoted to divorce is also included, and a stand-alone "buy-sell" agreement may also be executed which should provide for a mechanism for the business or the other shareholders to purchase the interest to prevent third-parties from being involved in or creating havoc within the business.

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Congratulations to Future Associate Sarah Miruzzi

Congratulations to Future Schiller DuCanto & Fleck Associate, Sarah Miruzzi, on passing the bar exam!

The Characterization of Retained Earnings in a Non-Marital Subchapter S-Corporation

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In high net worth divorce cases, practitioners and their clients are almost always faced with asset characterization issues. When it comes to a client's closely held business interest, the characterization issue becomes more complex than characterizing more common assets, such as real estate or investment accounts. Due to the relatively favorable tax considerations, one of the most common organizational structures is the Subchapter-S Corporation ("Sub-S"). An issue may arise when a spouse owns an interest in a Sub-S that is non-marital in nature, but during the marriage the entity accrues profits as retained earnings. Litigants are often perplexed when the ownership interest itself may be deemed non-marital (even garnering a formal stipulation to that effect), but the retained earnings are subject to attack by the opposing spouse. Recent case law provides a general framework for the considerations when attacking or defending a spouse's Sub-S retained earnings.

Back to Basics: A Primer on Subchapter-S Corporations.

A Sub-S is a pass-through entity for taxation purposes because the corporation's profits are not subject to income taxes at the corporate level, but rather flow through to its shareholders' personal tax returns on a pro rata basis. However, not all of a shareholder's taxable profits are actually received by them in cash. For a variety of reasons that are unique from company to company, shareholders may elect to leave all or a portion of their taxable profits in the company, which are called retained earnings. A common reason companies elect to do this is because closely held businesses require working capital to sustain operations the same way a family household requires funds to keep the lights on and water running.

The IMDMA's Treatment of Income and Property Characterization.

Section 503 of the Illinois Marriage and Dissolution of Marriage Act ("IMDMA") presumes all property acquired after the marriage to be marital property, while carving out certain exceptions for a spouse's non-marital property including, for example, property acquired before the marriage, and any increase in value of a spouse's non-marital property, whether attributable to a spouse's personal efforts or the contribution of marital property. (1)

Traditional case law interpreting Sections 504 and 505 of the IMDMA, addressing maintenance and child support, respectively, treats a spouse's income as marital property. (2) The interplay between these provisions is a cause of frustration for divorcing Sub-S shareholder spouses and an illustration of the fact-sensitive analysis and attention to detail required of their lawyers. How a corporation or shareholder treats its retained earnings presents the following consideration for divorcing shareholders: are the company's retained earnings the non-marital property of the spouse owning the Sub-S or marital property as accrued income?

A Look to the Case Law: The Devil is in the Details.

The answer to the question of how the retained earnings should be characterized requires a fact-sensitive determination. The overarching principle on the characterization of retained earnings is that the earnings remain a corporation's property until severed from the other corporate assets and distributed to shareholders. (3) A handful of Illinois cases detail the instructive factors for consideration: (i) the nature and percentage of a shareholder's ownership interest; (ii) the shareholder's ability to declare distributions; (iii) whether the corporation retains earnings to pay business expenses; (iv) how a shareholder's taxes are paid on profits; and (v) the reasonableness of the shareholder's income for services rendered. (4)

Two cases are particularly instructive on this issue. In I*n re Marriage of Joynt*, the Appellate Court held that the husband's share of corporate retained earnings were his non-marital property. In reaching its conclusion, the Court found that the husband owned a non-marital, minority, 33% interest a Sub-S; that the husband lacked the authority to unilaterally declare distributions; that the corporation's retained earnings were previously used to pay business expenses; that the shareholders' compensation was reasonable; and that the taxes on shareholder profits were paid by year-end distributions. Analyzing and expounding on similar factors as the *Joynt* Court, the opposite result was reached in *In re Marriage of Lundahl*. In *Lundahl*, the Husband was the sole shareholder of his non-marital Sub-S. He had the authority to unilaterally declare distributions, the company did not retain earnings to pay business expenses, and the taxes on the husband's profits were paid by the husband. The *Joynt* and *Lundahl* Courts' analyses turned on the issue of each shareholder's level of control (this is not necessarily restricted to majority ownership).

While not overly-belabored by the *Joynt* and *Lundahl* Courts, the reasonableness of a shareholder-spouse's compensation, through expert testimony for example, relative to the market for similar employment should not be lost upon litigants and their attorneys when crafting their arguments as to the characterization of Sub-S retained earnings. (5) Logically, if there is competent evidence that a shareholder is under-compensated in their particular market and has high retained earnings in a non-marital Sub-S, the argument that the retained earnings are excessive (typically to the detriment of the marital estate) follows; the inverse equally applies.

In the aggregate, these cases make clear that when attacking the retained earnings of a non-marital Sub-S or defending against such a claim, the facts are your friend and the devil is in the details.

(1)750 ILCS 5/503 (a)(6) –(7) (2015).

(2)*In re Marriage of Phillips,* 229 Ill.App.3d 809, 817 (2nd Dist. 1992).

(3)*In re Marriage of Joynt,* 375 IllApp3d 817, 821 (3rd Dist. 2007); *In re Marriage of Lundahl*, 396 Ill.App.3d 495, 501 (1st Dist. 2009); and *In re Marriage of Steel*, 2011 IL App (2d) 080974, ¶63.

(4)*Id.*

(5)*See In re Marriage of Steele*, 2011 IL App (2d) 080974 (touching briefly on this point).

Advance Preparation Helps to Minimize Future Risks to Business Owners in a Divorce *(Continued from cover)*

Once the buy-sell provisions are agreed upon and executed, they will be triggered when an interest-holder becomes involved in a divorce. The buy-sell agreement will then provide in detail how the transfer of an ownership interest in the business will take place. Because ownership interests in a closely-held business often are not liquid, the buy-sell agreement generally establishes a market for the sale and/or purchase of those interests by implementing a procedure to determine the price and terms for its sale or purchase. In addition, the agreement usually includes provisions which prevent an owner from transferring and/or selling any ownership interests to third-parties without the prior written consent of the other owners, limits the ownership of any interest in the business to a specifically-stated group, and allows the business and/or the other owners to exercise the right-of-first-refusal to purchase the ownership interest from the ex-spouse of a current owner. Some agreements also include a provision which, upon the occurrence of the triggering event, automatically converts that specific ownership interest into one which is non-voting.

Finally, some agreements also contain a provision which requires all owners who are planning to marry - or to remarry - to execute a separate premarital agreement with his or her spouse-to-be. The premarital agreement, in turn, would require that the owner's future spouse waive any ownership interest in the business or state how his or her interest will be dealt with in the event of a divorce. This provides an added layer of protection.

In the absence of a crystal ball, no one can predict what the future holds. However, powerful tools are available to assist the business owner in planning for possible future life events, including divorce. Taking the time to carefully consider these issues prior to their occurrence and putting a detailed plan in place helps to minimize the possible risks and to provide some peace of mind to all who share an ownership interest in the entity.

Financial Considerations in Divorce: Preliminary Considerations When Valuing a Business in Divorce Cases

Type of Business and Industry

Whether you or your spouse owns a business as you approach or are embedded in a divorce, there is a possibility that the business may have to undergo a valuation to determine its marital or non-marital value. Before approaching the valuation process, business owners or spouses of business owners will want to carefully consider the type of business, as well as its industry, when selecting a valuator and beginning the process. Is the business a closely held business or publicly traded? What unique traits does the business itself or industry have? What particular niche allows the business to survive or thrive within its industry? What types of relationships have been built to sustain the business over time? Has the business or any similar companies been sold in the recent past? Does the industry typically see a lot of turnover in ownership or transfers of interests? These and many other key questions should be considered and answered prior to beginning the process to allow the business valuator to explore every possible factor that could affect the value of the business.

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Your Spouse's or Your Role Within the Business

Generally speaking, your role within the business, or your spouse's role if your spouse is the primary business owner or operator, could be a key component of the business value or play a large role in the valuation and divorce process. If you and/or your spouse assume a significant role in seeking and maintaining client relationships or bringing in clientele, there may be a component of personal goodwill in the business. Generally speaking, the term "goodwill" refers to the intangible value of a company over and above its assets, the value in the business identity which keeps clients coming through the door. In Illinois, divorce courts generally distinguish between personal goodwill and enterprise goodwill. Personal goodwill is attributable to a single person, which usually becomes an issue when attributable to the spouse who owns the business. Enterprise goodwill is the additional value attributable to the company overall or as a whole. In Illinois, personal goodwill generally has no value for purposes of arriving at a value for a marital or non-marital asset, whereas enterprise goodwill has value. If you or your spouse is a necessary component to the procurement of clientele and sustainability of the business, this could negatively affect the ultimate value of the business.

A spouse's role within a business could also affect access to information about the business. Business owners approaching a divorce will want to think about protecting access to business information that could be leaked to competitors or clients. Spouses of business owners will want to put some thought into how difficult it may be to timely obtain necessary information about the business. To prevent disclosure of sensitive information and to try to protect against abusive discovery practices, a protective order can frequently be obtained from the Court.

Finally, what should happen if both spouses share an equal interest in or equal roles within the business? Courts in Illinois tend to frown upon situations in which spouses both maintain ownership interests and/or continue to work together in a family business following the divorce, because the continued financial entanglement creates opportunity for additional issues to arise. If one of the spouses will relinquish his or her ownership interest in the business many questions arise regarding the future business operations. Who will continue to own or operate the business? What affect might loss of a key contributing spouse have on the value of the business? Logistically, will any training or consulting be required by one spouse as the business is being valued and a spouse's interest or duties are ultimately assumed by the other spouse? Will any new employees need to be hired and/or trained with the loss of a spouse, and how, if at all, could that affect costs, cash flow, and/or the value of the business as a whole?

Other Difficult Decisions to Make

A full blown valuation of a business in a divorce can cost each spouse tens of thousands of dollars depending on the size of the business, the amount of information to be analyzed and considered, the difficulty in seeking and obtaining information, and whether depositions and trial testimony of the business valuators become necessary. It is important that parties going through a divorce carefully consider the costs associated with valuing business interests and complete a cost-benefit analysis prior to commencing a business valuation.

The valuation process can also be extensive. A business valuator may analyze hundreds, if not thousands, of pages of documents to arrive at an opinion. Most valuators have extensive accounting backgrounds, so they are familiar with accounting and tax rules and issues. When deciding on the scope and depth of an analysis or valuation, a party will want to consider whether analysis of the business records and information will uncover issues relative to income, business versus personal expenses, or other issues that might raise red flags to the Internal Revenue Service or other entities. A divorcing party will want to consider whether any civil or criminal liability might arise for either spouse when information is carefully analyzed.

Finally, many closely held companies involve family members of one or both parties. When considering whether to undertake a valuation or address family business issues during a divorce, parties will want to consult their attorneys, valuators, and any other possible professionals to ascertain the full impact of business-related decisions during and following the divorce.

These are only a few preliminary considerations for divorcing parties who may face business valuation issues, and this article is by no means meant to be exhaustive. Many considerations do not even involve black letter legal rules or accounting principles. Either spouse preparing to partake in the valuation of a business interest during a divorce will have a considerable amount of skin in the game and should be as involved as possible as the process unfolds.

IN THE NEWS

Michele M. Jochner is being honored at the Women's Bar Association of Illinois' 2015 Top Women Lawyers in Leadership Awards on November 5, 2015. She will also will be a panelist at the WBAI's Young Lawyers Section on "Strategizing From the Start: Shaping Your Practice Early On" on October 29, 2015. Michele is also now a Member of the Advisory Board for the Schiller DuCanto & Fleck Family Law Center, DePaul University College of Law.

Anita M. Ventrelli will be a faculty member for the October 2015 AICPA Expert Witness Workshop on business valuation on October 2, 2015. Anita will also will be a speaker on the program: "Sure-Fire Techniques in Cross Examining the Financial Expert " at the Inaugural Fall Financial Issues Seminar of the Arizona Chapter of the American Academy of Matrimonial Lawyers/Arizona State CPA Seminar on October 22, 2015. Anita will be a speaker on the program: "Sure-Fire Techniques in Cross Examining the Financial Expert " at the Inaugural Fall Financial Issues Seminar of the Arizona Chapter of the American Academy of Matrimonial Lawyers/Arizona State CPA Seminar on October 22, 2015. She will also will be a speaker on the program: "For Love OR Money -- High Income Child Support" at the Annual Meeting Conference of the American Academy of Matrimonial Lawyers on November 5, 2015.

Jason N.Sposeep is presenting for the IICLE for the Family Law Webcast on October 23: Working Effectively with Expert Witnesses. He also spoke at the Collaborative Law Institute of Illinois' Basic Interdisciplinary Collaborative Practice Training on September 19, 2015.

Gregory Maksimuk was profiled regarding his new position as Kane County Bar Association President for the Chicago Daily Law Bulletin.

Brian A. Schrodeder was interviewed on ARD German TV regarding his frozen embryos case.

Meighan A. Harmon spoke at the annual Notre Dame Estate Planning Conference on the subject of "Nuptial Agreements" on September 18, 2015 and to the Chicago Estate Planning Counsel on October 1, 2015 regarding the recent Amendments to the Parentage Act and Probate Act.

Kimberly A. Cook was selected the 2015 / 2016 Chair of the Domestic Relations Committee for the Chicago Bar Association.

Timothy M. Daw, Co-Editor / Brittany A. Heitz, Co-Editor / Justine E. Long, Layout/Design

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