BUSINESS VALUATIONS

Determining A Company's Worth During Divorce

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A successful company may be the most valuable asset of a business owner and his or her spouse. Its exact worth becomes a focus as various life stages unfold—including divorce.

Crain's Custom Media turned to four Chicago-based family lawyers to learn about business valuations as they pertain to divorce proceedings, and what entrepreneurs and their spouses should know about the process.

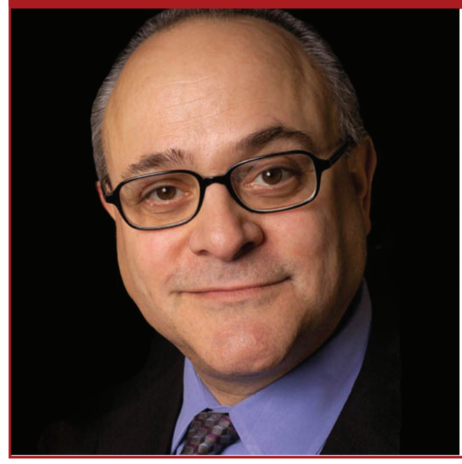
Brian Blitz is a principal of Berger Schatz, one of the nation's largest law firms dedicated exclusively to matrimonial law, representing high-profile and high-net-worth clients and their spouses. He is a fellow of the American Academy of Matrimonial Lawyers and a member of the Sports Law Association. Since 2013, he has been included in *The Best Lawyers in America* for the practice of family law, and is consistently named to the *Illinois Super Lawyers* list of Rising Stars and the *Leading Lawyers Network*. At age 33, he was selected by the *Chicago Daily Law Bulletin* as one of 40 Illinois Attorneys Under Forty to Watch. Committed to community service, he serves as a director of the Rolfe Foundation, a pancreatic cancer research organization, and supports organizations serving Chicago-area youth—recently as a coach and sponsor at NBA player Shawn Marion's annual North Chicago basketball camps.

Dean S. Dussias is a founding partner of Dussias Skallas Wittenberg Koenigsberger LLP, an integrated family and business law practice with offices in Chicago, Deerfield, Oak Brook and Tinley Park. He's practiced family law for more than 25 years, representing entrepreneurs, executives, professional athletes and other prominent clients in high-profile and financially complicated cases. He helps clients negotiate when possible, but is prepared to litigate when necessary. Because his goal is to solve disputes in a rational and cost-effective manner, he often recommends alternatives to costly court proceedings, such as mediation and collaborative divorces. He's a fellow and past president of the Illinois chapter of the American Academy of Matrimonial Lawyers. His honors include selection as one of *Illinois' Super Lawyers* (2008-2017), *Leading Lawyers* and *Best Lawyers in America*. In 2002, he was selected by the *Chicago Daily Law Bulletin* as one of 40 Illinois Attorneys Under Forty to Watch.

Jeffery M. Leving is president of the Law Offices of Jeffery M. Leving, Ltd., a Chicago firm that concentrates on matrimonial and family law. He's been named one of America's Best Lawyers by Forbes Radio and is part of the peer-recommended *Leading Lawyers Network*. He co-authored the Illinois Joint Custody Law, Illinois Virtual Visitation, Right to DNA Testing Notice, and Unlawful Visitation or Parenting Time Interference Laws. In 2000, he helped reunite 6-year-old Elián González with his father in Cuba. He's authored several books, including *Fathers' Rights*, *Divorce Wars* and *How to Be a Good Divorced Dad*. In 2013, President Barack Obama awarded him the National Lifetime Call to Service Award. The Illinois House of Representatives honored him in 2012 by adopting a resolution "for his work in safeguarding the rights of fathers and protecting the welfare of children and families in this State."

Anita Ventrelli is a senior partner at Schiller DuCanto & Fleck LLP, a family law firm with offices in Chicago, Lake Forest and Wheaton. She represents professionals, athletes, executives, entrepreneurs and those who value their wealth, lifestyle and well-being. She prides herself on giving each client an honest assessment of how the process will work for him or her, and educating them on available options. Since 1997, she's been a fellow of the American Academy of Matrimonial Lawyers. In 2003, the *Chicago Daily Law Bulletin* named her one of 40 Illinois Attorneys Under Forty to Watch. Since 2005, she's been recognized as an *Illinois Super Lawyer*; she's also been included in the *Leading Lawyers Network* and the *Best Lawyers in America*. She leads the faculty of the American Bar Association/ National Institute of Trial Advocacy Family Law Trial Advocacy Institute, where she presents on business valuation and sits in the ABA House of Delegates.

SELECTING AN EXPERT



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JEFFERY M. LEVING,
LAW OFFICES OF JEFFERY M. LEVING, LTD.

What role does a business valuation play in a divorce proceeding?

Dean Dussias: It's a vital piece of evidence that aids the presiding judge in dividing the marital value of the business, ultimately influencing the final decision on how assets will be divided in the divorce. A thorough, accurate valuation, calculated by a qualified business valuation expert, guides the divorce attorney's work. Understanding the true value of the business informs the legal strategy for most effectively preserving it.

Anita Ventrelli: It can also play a role in disputes over earnings and cash flows that relate to spousal maintenance and child support. Under the child support statute that became effective July 1, personal expenses paid through a business require adjustments to gross income.

Brian Blitz: If one spouse owns and operates a business, either partially or entirely, it's more likely than not that the spouse will "buy out" the other spouse's marital interest in the business.

Jeffery Leving: A business valuation may likely uncover hidden assets that otherwise would go undetected, financially crippling the uninformed spouse. Determining the true value of a business is critical to safeguarding a client's financial future. There's no room for error here.

What are some steps involved in a business valuation?

BB: The first step is to determine if a business may have value that would be relevant to a divorce proceeding. Is the business interest marital or non-marital? Does the business have value beyond personal goodwill? Assuming it has, interviewing and selecting an expert is the next important step. An expert will generally then assist in the discovery process, as it relates to obtaining information and documents required to develop the valuation. The expert may visit the business and interview other business owners and management; oftentimes the business's CFO and/or accountant are key players in providing critical insight and data. Lastly, the divorce attorney must track every step of the valuation process, to make sure that the client's interests are protected and that the ultimate valuation report accomplishes the client's goals in the divorce.

JL: Other important steps include a forensic analysis of the income stream of the business and the expenses that the business pays; and understanding and applying the nuances in Illinois—for example: personal good will. An expert business evaluator who correctly takes those steps will provide a keen insight into the issues, the business, and the industry, which the attorney can use in attacking and discrediting the adverse party's flawed business valuation.

How should a business owner go about selecting a valuation expert?

DD: Typically, a family lawyer will have a working relationship with a few experts who might be suitable for the business in question. For example, some are excellent in examining and understanding medical practices, but might not be as experienced with manufacturing concerns. If the business owner had previously worked with a business valuation firm and was satisfied with their work, they can also consider them again. It's good practice, however, to check with an attorney on this decision.

AV: The owner and counsel should meet the valuator to decide whether they will be good at explaining complicated concepts to the court in easy-to-understand language, and whether the expert will be good at analyzing and helping figure out the problems with the other side's valuation. Looking at a prior report for writing style is a good way to start. The best experts are unbiased, so an owner shouldn't compromise quality by using the company accountant or a relative, although those individuals can still be information sources for the expert. Make sure there are no court opinions that criticize the expert, or any cases where a court decided that the expert wasn't qualified to give an opinion.

JL: I worked on a very complicated case utilizing Bruce L. Richman from Mazars as a business evaluator and found him to be exceptionally bright, skilled and ethical. It's critical that the valuation expert is well trained in the fields of business valuations and forensic accounting, and that the expert has correctly conducted business valuations in divorce cases. The expert should have significant experience testifying in court in divorce cases, as he or she may be aggressively cross-examined.

BB: It is critical for a business owner to let his or her divorce lawyer guide the valuation process. While valuations may have already been performed internally for various reasons, such as to obtain financing or to negotiate buy/sell agreements, valuations and valuation experts used for other purposes, while instructive, are rarely suitable for divorce purposes. I recently handled a case where an opposing expert lacked experience valuing the kind of business my client owned, which was a software company that also provided online services to its clients. Our own expert, whom we selected based on his experience in divorce cases, as well as having performed several recent valuations of similar companies, became the only expert the court relied upon, which worked out quite well for our client.

CHALLENGING BUSINESS TYPES

"Any business where earnings fluctuate or grow irregularly, or where there have been extraordinary events in the recent past that make predicting future cash flows more difficult, present greater challenges."

ANITA VENTRELLI, SCHILLER DUCANTO & FLECK LLP

Are certain types of businesses more challenging to value?

AV: Any business where earnings fluctuate or grow irregularly, or where there have been extraordinary events in the recent past that make predicting future cash flows more difficult, present greater challenges. Businesses structured differently than those commonly found in a particular market also make valuation more difficult.

JL: Cash-based businesses are more challenging to value; however, if you have a business valuation expert who's a forensic accountant, the expert should know how to dig into the records to obtain the true value of a cash-based business. Businesses that have offices and do business internationally require a special type of evaluation process and resources. New, high-growth businesses require a specialized expert. With these businesses, the expert must predict what the income stream will be when there's not much of a track record to analyze. The expert will need to obtain a thorough understanding of the industry and the owner's true expectations for the future.

BB: Sometimes it's not the business itself but the business owner that presents the greatest valuation challenge. If an owner decides to be uncooperative in granting the valuation expert the data and access needed, this creates unnecessary obstacles that can delay the final report, add extra costs and force the lawyers to pursue litigation to get the valuation done.

How are intangible assets, such as customer lists and intellectual property, valued?

BB: We deal with intellectual property like any other business asset. Trade secrets and customer lists can be especially difficult to value. Specifically, customer lists may only be indicative of personal good will, which Illinois courts don't recognize as having value in divorce. For example, a commercial real estate brokerage company may have a long list of clients, but if the owner is the one person primarily responsible for maintaining those relationships, then once the business is "sold" (in the hypothetical sale that is used to determine fair market value), it is assumed that the owner will no longer be in the business—in which case the customer/client list may have little to no value. It will be part of the expert's task to determine to what extent customer lists or similar intangibles represent "assets" of the business with potential sale value, as opposed to the personal talents, connections or expertise of the owner.

DD: What valuation experts call "goodwill" we might call "the secret sauce." Sometimes the owner of a business—and a magical combination of his or her contacts, knowledge and personality—is so essential to its success that it's difficult to imagine the business succeeding, or even existing, without the owner. But it's important to remember that the "secret sauce" is only one ingredient of the hamburger. Depending on the type of business, its income sustainability—with or without the business owner—and other factors will determine if the goodwill is truly personal or whether it can be seen as "enterprise" goodwill; that is, belonging to the business itself versus the owner personally. If the business really cannot survive and thrive without the business owner,

DIVIDING THE VALUE

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BRIAN BLITZ, BERGER SCHATZ

then typically that "personal goodwill" component of the company will be deemed to be personal, as opposed to belonging to the enterprise. The value of this goodwill will need to be valued and, in most cases, subtracted from the marital portion of the value.

AV: Intangible assets consisting of intellectual property use economic analysis not unlike that applied to businesses themselves to assess earnings over time. Customer lists use methods that take the expectation of repeat patronage and the life of the list into account. In other words, they can present the issue of a valuation within a valuation.

How should a business owner expect to divide the value of the business with a nonworking spouse in the event of a divorce?

JL: A common scenario is where the business owner is awarded the business, and the non-working spouse is awarded other marital assets, such as the marital home, cash and investment accounts. However, these matters must be evaluated on a case-by-case basis. I represented a business owner in a very difficult trial in which the court awarded my client the business and the home, and jailed the adverse party. The opposing counsel must have been very disappointed with the judge's decision. I was surprised she didn't appeal the court's decision.

DD: The homemakers' contribution and its ascribed value can vary significantly on a case-by-case basis. For example, the spouse who raised five children, attended every business dinner, and sacrificed his or her own education and employment for the benefit of the business-owning spouse over 25 years may be judged to have made an equal contribution to the business and its value. On the other hand, the "country club" spouse who outsourced childrearing to three nannies and who rarely participated in work events might have a much smaller contribution attributed to his or her efforts.

AV: A business owner should not expect that a divorce will result in owning and operating the business with a former spouse. Judges favor separation of spouses in businesses even when both are owners unless they demonstrate the ability and the willingness to continue in business together after divorce.

BB: Intelligent and creative solutions are paramount. For example, one spouse can "buy out" the other spouse's marital share of the business–but unless the spouse has the cash or assets to finance the buy-out, this may require several years to complete. The other spouse may also demand sufficient security for the sale price, to protect against death or default. In the end, these transactions are really no different than other business sale contracts, in the sense that the two spouses may agree to a wide array of financing possibilities.

Is a valuation needed if a business is non-marital?

JL: Absolutely. Illinois is an "equitable state," where the courts are required to divide the parties' marital assets, as well as liabilities, equitably. The valuation of a non-marital business can be the key in determining what is an equitable division of the marital assets. Once a value is placed on the non-marital business, the value of that asset is considered by the court in equitably dividing the marital assets.

AV: While it might seem counterintuitive to value something that must be allocated to only one person, courts must consider the value of one person's non-marital property in deciding how to allocate the marital property between the spouses.

DD: What is "just" or "equitable" varies from case to case. In a hypothetical scenario where the marital estate consists of $1 million but one of the spouses also owns a pre-marital business valued at $10 million, the court could take that into consideration and award the non-business owning spouse a significantly larger amount of the marital property. If the parties can stipulate the value of the non-marital business, then a business valuation may not be necessary; but in my experience, both sides would be prudent to secure one.

EXAMINING A NON-MARITAL BUSINESS

"If the parties can stipulate the value of the non-marital business, then a business valuation may not be necessary; but in my experience, both sides would be prudent to secure one."

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DUSSIAS SKALLAS WITTENBERG KOENIGSBERGER LLP

What advice do you have for a business owner contemplating divorce who wants to protect his or her ownership interests?

DD: Once a divorce is filed, a court will have authority to preserve the status quo and safeguard the marital estate. Transactions will be scrutinized, and even conducting day-to-day business might be difficult. Generally speaking, if a business owner is contemplating or is on the precipice of a divorce, it's good practice to obtain and prepare an organized file with all business documents, records, returns, statements, ledgers, etc. for at least the past three years, since the spouse's attorney or other retained experts will be requesting them. The sooner this is done the better. It will reduce fees and costs and minimize the delay associated with discovery, thus enabling the business owner to return to normal operations more quickly.

BB: A business owner contemplating divorce should be meticulous about maintaining records showing when and how each business interest was acquired. Corporate minutes, stock certificates, bank records, receipts, notes and gift tax returns may be essential in proving ownership and characterizing the ownership as marital or non-marital. Also, if the owner has not observed corporate formalities, he or she should start by maintaining separate business and personal accounts, formalizing corporate roles and duties, and recording and reporting expenses. Finally, if a sale of the business is in the foreseeable future and that owner/spouse is strongly considering divorce, the timing of the sale should be discussed with legal counsel. Finalizing the divorce before the sale of the business could be advantageous to a business owner. In the divorce, the spouse's minority interest may be steeply discounted for lack of marketability and lack of control, which could allow the business-owning spouse to buy out the other spouse's share for far less than what the actual sales proceeds may bring. Here too, obtaining timely and smart legal advice is key.

AV: Business owners who want to protect their ownership interests should protect their credibility. If they inherit a business or receive it by gift during the marriage, they should not style the transaction as a purchase. Purchases during a marriage with marital funds are marital, which means sharing value while businesses received by gift or inheritance during marriage can be protected as non-marital. If an owner works in the business, the owner should be paid a fair salary for the work done because under-compensation can expose a non-marital business to claims for reimbursement to the marriage. Whether the owner receives a salary or distributions, courts consider income from all sources when awarding support. Finally, owners should not have people on the payroll who don't work in the company; it makes it easy for the other side to suggest the owner is not honest. Bottom line, if an owner thinks about implementing a strategy that they would not employ for any reason apart from a divorce, the owner should get counsel to be sure it will achieve the goal, because changes before or during a divorce always draw scrutiny.

JL: If done correctly, a post-nuptial agreement can be a valuable tool. A properly drafted post-nuptial agreement should establish that an existing or future business is non-marital; that compensation for the owner and management is reasonable; that there's a plan of succession of ownership in the event of divorce; that all appreciation is non-marital; and the business's value for purposes of divorce. Problems that can occur in the absence of a post-nuptial agreement include proving the non-marital status of an existing or future business; how profits, distributions and retained earnings are treated; and expansion of the business and increase in value during the marriage. Finally, if a business is non-marital, it should not be gifted to a spouse, as this could cause an owner to lose all or part of the business that might not have been otherwise lost.