ALM | LAW.COM

New Jersey Law Journal

What To Know When Representing a Business Owner in Divorce

By Tracy Julian and Matthew A. Smuro
January 22, 2024

A divorce where one or both parties are business owners involves unique and specific issues. Business entity interests are complex assets that require calculation of value for purposes of equitable distribution; and business income and perquisites impact party "needs" and "abilities to pay" for support purposes. In addition to those significant issues, there are a myriad of other concerns to address in these divorce cases.

Credit: yellowj/Adobe Stock

Need for a Business Valuation

Equitable distribution of assets is a multiphase process that includes: (1) identifying each asset owned by either party; (2) valuing each asset; and (3) allocating ownership interests and distributing each asset pursuant to the factors set forth in N.J.S.A. 2A:34-23.1. Thus, to properly allocate the value of a business between two divorcing spouses, the parties must first place an accurate value on the business interests.

Given the importance of the analysis, it is helpful to discuss the need for a business valuation at the outset of each business owner consultation. If they have done their homework, the educated business owner may already be aware that hiring a forensic accountant is in the cards. Still, the need for a formal, forensic business valuation is often a controversial topic with a business owner client. Commonly they will resist retaining an "expensive" expert for a variety of reasons. Namely, the cost; vulnerability in sharing confidential business information; and, sometimes, the owner's oft mistaken belief that the business has "no value." A non-owner spouse may believe that they are not entitled to the necessary business documents because they do not personally hold title to the entity. In addition, business owners will frequently explain that their bookkeeper or tax accountant has already completed the necessary work and may have even ascribed a value to the entity. These are misnomers to promptly dissuade the client from at the beginning of the representation.

In response to the reluctance, it is helpful to explain the equitable distribution process in detail with an emphasis on the need for accurate data. The client is entitled to a share of the business value and guessing at a value is contrary to their best interests. Further, even if the client insists upon committing to a value without expert advice, it is unlikely that their spouse's counsel will agree to an arbitrary figure. And certainly, in discovery, the court will require a forensic valuation and will compel the parties to cooperate. The fight against undertaking a forensic valuation is not a fight they will win.

Need for a Cash Flow Analysis

As a companion effort to a valuation, the parties will often retain the same expert to complete a "cash flow analysis." The accountant reviews the business records to ascertain the true income the owner spouse derives from the entity. It considers not only W-2, 1099 and K-1 income, but it also computes the value of the perquisites the party enjoys because of the ownership.

For purposes of calculating alimony under N.J.S.A. 2A:34-23, et seq., the lawyers calculate the cost to maintain the marital standard of living and consider the income available to each party to pay the monthly costs associated with maintaining that standard. At times, the business owner may demonstrate limited cash "income" on paper with shelter, transportation and personal expenses that exceed their "income" on a monthly basis. This is explained by the fact that the owner utilizes the business to pay personal expenses they would otherwise pay with their own funds (properly under the Internal Revenue Code or not). When the accountant identifies those payments in the business books, the accountant will "add back" the value of those expenses to the owner's "income" for purposes of calculating support obligations. On occasion, the value of these "add backs" will impact the overall business value if the funds used to pay the personal expenses should still be properly deposited in the business accounts.

Selecting an Accounting Expert

Selecting the forensic accountant to conduct the business valuation and the cash flow analysis is an important step. As noted, business owners commonly request to use the professionals they are accustomed to working with in their regular business operations including their tax accountants and bookkeepers. While these individuals can provide key information, documents and insight into the finances, it is essential to select a competent forensic accountant with education and experience in valuing businesses for litigation purposes.

The forensic accountant will prepare draft "schedules" that reflect the data and calculated value. As a next step, they may prepare a "report" to set forth their education and experience; explain their methodology; and recite the information they relied upon in reaching their conclusion. Counsel may depose the expert to test their calculations and the expert may be called upon to provide testimony at trial. Experienced forensic accountants will review and consider all the necessary financial data and be well prepared to explain and defend their calculations to the parties, attorneys, and the court. The process is rigorous, and the client will likely come to appreciate just how imperative it is to retain a quality expert. While the costs are not inconsequential, the money at stake will typically outweigh the expense. If there is a chance the end value will not justify the means, an ethical professional will warn of that possibility early on. Further, a quality forensic accountant can help to amicably settle a divorce litigation long before a trial because, in educating the parties as to the business value and true cash flow, they assist the parties in comprehending the realities of each of their cases and in predicting what a judge may decide concerning those issues at a trial.

It is common and can be advantageous for the parties to share a "joint expert." The joint expert works for neither party specifically and is instead retained by both parties together to conduct the analysis. In addition to being a cost-saving measure, the experienced joint expert will make both parties feel comfortable with the process and will engender trust by both sides to conduct a thorough analysis and offer unbiased conclusions. In the event either party disagrees with the joint expert's methods or findings, that party can reserve the right to then retain their own expert to challenge the findings of the joint expert.

Gathering the Business Books and Records

At the outset of the forensic accountant representation, the expert will provide the parties with a retainer agreement and a list of documents the expert requires. The list typically includes all categories of business financial documents such as: income tax returns; financial statements; detailed general ledger; bank, credit card and investment account statements; fixed asset schedules; year-end payroll reports and entity W-2s, 1009s and K-1s; declaration pages of insurance policies; formation documents; operating agreements; retirement or deferred compensation plans; and many others.

In a single member entity, it should be easy to provide the necessary documents. If the divorcing owner has partners, they may resist sharing the information for privacy or other reasons. In that case, the owner may lean on his/her statutory entitlement to the documents or counsel can serve a subpoena directly upon the business. Where privacy and confidentiality are at issue, the parties may enter into a confidentiality agreement or protective order to maintain the confidentiality of the information.

Distribution of the Business Value

Once the value of the business is defined (either by agreement or in a judgment of divorce after trial), the attorneys or court will have to establish a plan for the owner spouse to pay the non-owner spouse his or her fair share of the business. This is typically completed by providing the non-owner spouse with credit towards other marital assets (if other assets are available)—or with a buy-out over time. In the event of a buy-out, the parties must consider security to ensure the payments; and life insurance in the event the owner spouse passes away prior to meeting his obligation.

Other Issues

In addition to valuing the business and calculating cash flow, there are a series of additional issues unique to business owner divorce cases to consider. For example, if the business owns real property, the parties will need to retain an appraiser to ascertain the value of the commercial real property in addition to business value.

If one or both parties are business employees, they will need to address employment issues incident to the divorce. Will one or both parties remain as employees? If a party is leaving the employ, the parties will need to replace the income of the disassociated spouse. If the business paid for personal needs of the employee spouse (vehicle, cell phone, insurance, etc.), they need to address how those costs will be paid moving forward. It may prove helpful for the divorce attorney and client to consult with an employment attorney to identify all the employment issues and brainstorm remedies to address them.

Conclusion

The divorce of a business owner presents unique and challenging issues for divorce counsel and their clients. The parties should be prepared to hire competent and experienced counsel and experts to usher them through the process to ensure the parties address and resolve all the many unique issues at hand.

Tracy Julian *and* **Matthew A. Smuro** *are founding partners at Julian Smuro Law, a boutique family law firm representing clients throughout New Jersey. www.juliansmurolaw.com*