

Valuation and Division of Business Assets in Divorce

by Raiford D. Palmer

Introduction. This article is designed to inform corporate and transactional attorneys of the effects of divorce on client-owned businesses. This article specifically provides information regarding the assessment and division of business assets generally, and consideration of

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buy-sell, shareholder, and operating agreements by domestic relations courts. The article also provides suggested methods to limit liability and control the valuation and division of business assets in the divorce context. Specific methods of business valuation are not addressed here, as well as details regarding valuation of specific assets such as stock options, as other authors have thoroughly examined those topics.¹

Divorce proceedings in Illinois are governed by the Illinois Marriage and Dissolution of Marriage Act (“IMDMA”).² Pursuant to the IMDMA, the court will ascertain what property owned by divorcing parties is marital or non-marital, and determine an equitable distribution of marital

property and debt. Where the ownership of a business is involved, the divorce court will determine whether the business interest is marital or non-marital, and ascertain the value of the business interest. If the business is awarded to one spouse, the court may award other property to the other spouse as an offset. The purpose of this article is to provide a basic guide to the law of valuing and dividing business interests in divorce cases, and what steps may be taken to limit liability and protect ownership of a business.

Valuation of Business Assets – Buy-Sell Agreement not Necessarily Binding. With respect to valuation and division of business assets, the central question is: What evidence will the court use in determining value and what can the court do with the business assets? Many practitioners may be under the impression that drafting a shareholder agreement or buy-sell agreement which provides a specific valuation approach will be sufficient to protect the business owner’s interest in a divorce proceeding. That is not necessarily the case, however.

A divorce court generally will assess the value of parties’ marital assets and debt, and then order transfers of property and debt to equitably divide the marital property. Generally, where one or both parties owns an interest in a business, the court can consider evidence of the value of those



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interests presented by experts and (depending on the circumstances) ignore the formulas, restrictions, and requirements of a buy-sell or shareholders agreement. Similarly, the court can order transfer of business assets and stock to a non-owner spouse.

IMDMA Regarding Marital and Non-Marital Property. The divorce court will first determine whether property is marital or non-marital, and therefore whether it is subject to equitable division. The IMDMA sets forth the framework for dividing property in divorce, stating as follows:

(a) For purposes of this Act, “marital property” means all property acquired by either spouse subsequent to the marriage, except the following, which is known as “non marital property”:

- (1) property acquired by gift, legacy or descent;
- (2) property acquired in exchange for property acquired before the marriage or in exchange for property acquired

by gift, legacy or descent;

(3) property acquired by a spouse after a judgment of legal separation;

(4) property excluded by valid agreement of the parties;

(5) any judgment or property obtained by judgment awarded to a spouse from the other spouse;

(6) property acquired before the marriage;

(7) the increase in value of property acquired by a method listed in paragraphs (1) through (6) of this subsection, irrespective of whether the increase results from a contribution of marital property, non marital property, the personal effort of a spouse, or otherwise, subject to the right of reimbursement provided in subsection (c) of this Section; and

(8) income from property acquired by a method listed in paragraphs (1) through (7) of this subsection if the income is not attributable to the personal effort of a spouse.

(b)(1) For purposes of distribution of property pursuant to this Section, all property acquired by either spouse after the marriage and before a judgment of dissolution of marriage or declaration of invalidity of marriage, including non marital property transferred into some form of co ownership between the spouses, is presumed to be marital property, regardless of whether title is held individually or by the spouses in some form of co ownership such as joint tenancy, tenancy in common, tenancy by the entirety, or community property. The presumption of marital property is overcome by a showing that the property was acquired by a method listed in

subsection (a) of this Section.³

Property acquired during the marriage (including a business ownership interest) is presumed to be marital⁴. Even if the non-owner spouse had no ownership interest or involvement in a business established during marriage, the spouse is entitled to an equitable share. This obviously may result in disruption of the business and in some cases the non-owner spouse may become an owner of the business. If a business was formed prior to a marriage, the gain in value in the ownership interest which accrued by personal effort of the owner spouse during the marriage is deemed marital property subject to equitable division⁵. Also, discrete, distinguishable assets acquired by a nonmarital business during marriage may be considered marital property.⁶ Furthermore, a non-owner spouse may be entitled to a right of reimbursement for contributions made toward a nonmarital business during the marriage.⁷ Stock options are presumed to be marital property if awarded to the owner spouse during the marriage.⁸ Retained earnings (in an entity where the owner-spouse does not have control) are nonmarital property.⁹

Division of Business Assets by Divorce Courts – Finality is Favored. Illinois courts try to avoid making divorcing spouses partners in business. They prefer to find a way to offset the value of the business interest by awarding other assets to the non-owner spouse. In a case awarding a family farm to the wife (and not dividing the ownership of the farm into equal shares), the Second District Appellate Court stated, “Both finality to avoid continued need for court intervention and division of the property to avoid

ongoing association between the parties are goals to be considered in apportioning such marital assets.”¹⁰ The Court also noted, “An ongoing business association between former spouses, such as would have been required in the management of the farm property, is disadvantageous.”¹¹ When the property at issue is a small business and the parties have shown that they cannot work together, courts have held that it is better to award the business solely to one party or the other.¹² However, Illinois courts have divided the ownership interest in a business between spouses. This can potentially make the non-owner spouse a minority owner without a say in management and no ready market for the ownership interest. Alternatively, ex-spouses could wind up as partners in the business.

Valuation of Business by the Divorce Court. The divorce court has wide latitude in determining the value of a business. The appellate court in Illinois will not overturn a trial court valuation of a business if it is within the range testified to by the parties’ experts.¹³ The First District Appellate Court stated, “The appraisal of a closely held corporation is as much an art as it is a science. There are simply no precise rules for fairly evaluating such businesses in the dissolution context. Despite the fact that closely held corporations may be without established market value, they may, nevertheless, possess an ascertainable value with respect to the division of marital property.”¹⁴ The divorce court should consider all evidence relevant to the value of a business, including the economic outlook and capitalization of future earnings.¹⁵

To determine the value of a business in a divorce matter, the

court must consider (1) fixed assets, (2) other assets, including accounts receivable, (3) the goodwill in the business, and (4) business-related liabilities.¹⁶ Enterprise goodwill such as the goodwill of a corporation is a marital asset subject to inclusion in the value of a business.¹⁷ However, personal goodwill like that created by a dentist in a small dental practice is nonmarital property.¹⁸

Divorce Court may not be Bound to Follow Buy-Sell Agreements for Value or Distribution Restrictions of Business Interests. Illinois courts have ignored buy-sell agreement restrictions in order to do equity between divorcing parties. The trial court in a divorce was not required to use a law firm's compensation and buy-sell agreement when valuing the husband's shares in a law firm.¹⁹ In that case, the court considered the testimony of an expert called by the non-owner spouse and refused to consider the terms of the buy/sell agreement as evidence of value.²⁰ A divorce court was also not bound to use a stock redemption agreement as determinative of value for a closely held marketing business.²¹ Similarly, in *Marriage of Devick*, the trial court set aside restrictions on the transfer of stock where the non-owner spouse was awarded stock as part of a dissolution judgment and the non-owner spouse was not a party to the agreement placing the restrictions on the stock.²² The *Devick* reviewing court held that restrictions only apply to voluntary transfers and not transfers by operation of law; however, the case involved stock held in joint tenancy by the spouses and may be limited to those facts.²³ Courts in other jurisdictions have also disregarded

buy-sell agreements as being determinative of value.²⁴

In many jurisdictions, buy-sell valuation provisions and restrictions on transfer are relevant to determination of value, but are only factors to be considered together with other evidence.²⁵ This appears to be the case in Illinois. Naturally, the business owner wants to preserve the valuation approach set forth in the buy-sell,

“The trial court in a divorce was not required to use a law firm’s compensation and buy-sell agreement when valuing the husband’s shares in a law firm.”¹⁹”

option agreement, or shareholder agreement, and minimize the risk that a divorce court will cast them aside in determining the value of and allocation of business interests in divorce.

Potential Solutions – Premarital Agreements. Perhaps most obvious, a prenuptial agreement is a useful tool to prevent problems related to valuation and allocation of business interests in divorce. The Illinois Uniform Premarital Agreement Act allows parties to determine the ultimate disposition of property in divorce with a written agreement signed by both parties.²⁶ The agreement is enforceable without consideration.²⁷ Generally, courts will uphold premarital agreements so long as they are entered into voluntarily, are not unconscionable when made, and the parties had a fair and reasonable disclosure of the financial conditions of the other party (or waived their rights to more complete disclosure).²⁸ Premarital agreements may

determine the disposition of business interests in divorce. 750 ILCS 10/4 provides in pertinent part, as follows:

Sec. 4. Content. (a) Parties to a premarital agreement may contract with respect to: (1) the rights and obligations of each of the parties in any of the property of either or both of them whenever and wherever acquired or located; (2) the right to buy, sell, use, transfer, exchange, abandon, lease, consume, expend, assign, create a security interest in, mortgage, encumber, dispose of, or otherwise manage and control property; (3) the disposition of property upon separation, marital dissolution, death, or the occurrence or nonoccurrence of any other event;

Illinois courts have upheld premarital agreements comports with the statute. In one case, the Appellate Court noted that the husband fully disclosed the extent of his substantial assets to the wife prior to execution of the premarital agreement and the wife admitted she was not coerced into executing the agreement.²⁹ Courts in Illinois have also upheld premarital agreements created before the effective date of the statute on January 1, 1990.³⁰

Potential Solutions – a Carefully Drafted Postmarital Agreement with Consideration. Postmarital (or postnuptial) agreements can be equally effective in either avoiding transfer of any business interests to a non-owner spouse, or in controlling the valuation of the business interests in the event of divorce.³¹ Postmarital agreements, similar to premarital agreements, are binding if they comply with basic contract law. Postmarital agreements have been considered

binding by Illinois courts.³² Postmarital agreements must include all of the elements of a binding contract, including an offer, acceptance, and consideration, and the agreements must not be unconscionable.³³ Note that consideration for a postmarital agreement cannot solely be a promise to remain married where divorce is not pending or threatened.³⁴ Adequate consideration may be the mutual release of property rights between the parties³⁵. The primary weakness for postnuptial agreements appears to be that a divorce court can find the agreements unconscionable and unenforceable if the court finds that one party was under duress at the time of executing the postnuptial agreement. Illinois courts define "duress" as "oppression, undue influence, or taking unfair advantage of

another's stress to the point where that person is deprived of the exercise of free will."³⁶ However, the party trying to defeat a postnuptial agreement under a duress theory must prove by clear and convincing evidence that they were "bereft of the quality of mind essential to the making of a contract."³⁷

Potential Solutions – A Buy-Sell Including the Non-Owner Spouse. Clearly Illinois courts have set aside shareholder's agreements in valuing and apportioning business interests in divorce in the past. However, shareholder's agreements might yet be useful in controlling or restricting transfers of ownership to a spouse, and may be considered by a divorce court to determine the value of business interests. To bind a party to the terms of this type of agreement in the divorce context it

appears that the non-owner spouse must execute the agreement, and the agreement must comport with the requirements of postnuptial agreements. The court in *Devick* indicated that a key factor in avoiding the stock transfer restrictions for the non-owner spouse was that she was not a party to the agreements requiring the restrictions on transfer.³⁸ At least one court in another jurisdiction held the terms of buy-sell agreements to be binding on a non-owner spouse where the non-owner spouse executed the agreement.³⁹ The court in that case specifically held that the trial court erred in failing to order repurchase of stock from the non-owner spouse pursuant to the buy-sell agreement.⁴⁰ However, one court in Washington held that even where a spouse executed a buy-sell agreement, the terms were not binding upon that spouse in



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divorce because the non-owner spouse was not informed about the business and had no participation in it.⁴¹

Conclusion. Illinois domestic relations courts may freely divide business assets in divorce, and may often consider a wide range of values from expert witnesses in determining property distributions. Therefore it may be wise for the business attorney to recommend premarital agreements, postmarital agreements, and carefully drafted buy-sell agreements to clients to help control the outcome of a potential divorce case.

The best practice for business attorneys, where a prenuptial agreement does not exist or is not an option, appears to be preparation of a post-nuptial agreement with valid consideration, or to include the non-owner spouse in any shareholders agreement, operating agreement, or similar document. According to the case law, any post-nuptial agreement or business agreement such as a buy-sell must provide the non-owner spouse with all the basic requirements of contract, including offer, acceptance, and consideration. Furthermore, the non-owner spouse must receive full disclosure of the financial information for the business, and should be represented by counsel. Finally, the non-owner spouse should indicate in writing contemporaneously with the execution of the agreement that the agreement is fair, not unconscionable, and that the non-owner spouse was not coerced into executing the agreement.

As has been shown, divorce courts in Illinois may consider or disregard valuation formulas and restrictions on transfer for ownership in business buy-sell,

shareholder, and operating agreements. Courts may value a business using a method that completely departs from that set forth in a contract entered into by the business owner spouse. However, if the business owner spouse has a properly prepared premarital agreement, postmarital agreement, or buy-sell agreement following postnuptial principles, it is more likely that the valuation and/or distribution of business assets can be controlled with an outcome more favorable for the business owner.■

¹ Hon. Michael R. Galasso, "Business Valuations in Domestic Relations", *DCBA Brief*, Jan. 1992; Hon. Rodney W. Equi, "Stock Options: A Little Understood Marital Asset", *DCBA Brief*, Nov. 1996; H. Joseph Gitlin, *Gitlin on Divorce*, Sec. 8-13(e)(1), (Lexis Nexis, 2007); Gunnar J. Gitlin, *Business Valuations*, Ch. 5, *Illinois Family Law Series*, Vol. IV, (Illinois Institute for Continuing Legal Education 2006).

² 750 ILCS 5 *et seq.*

³ 750 ILCS 5/503

⁴ 750 ILCS 5/503(b)(1), *In re Marriage of Schneider*, 343 Ill.App.3d 628, 634, 798 N.E.2d 1242, 1247 (2nd Dist. 2003), *rev'd on other grounds*, 214 Ill.2d 152, 824 N.E.2d 177.

⁵ 750 ILCS 5/503(7)

⁶ *In re Marriage of Perlmutter*, 225 Ill.App.3d 362, 374-5, 587 N.E.2d 609, 616-7 (2nd Dist. 1992).

⁷ 750 ILCS 5/503(c)(2). See also *In re Marriage of Bowlby*, 338 Ill.App.3d 720, 727, 789 N.E.2d 366, 372 (5th Dist. 2003).

⁸ 750 ILCS 5/503(b)(3) states: "For purposes of distribution of property under this Section, all stock options granted to either spouse after the marriage and before a judgment of dissolution of marriage or declaration of invalidity of marriage, whether vested or nonvested or whether their value is ascertainable, are presumed to be marital property." For a complete examination of this subject, see Michael W. Kalcheim, "Apportioning Stock Options at Divorce: A Detailed Guide" 91 IBJ 454 (Sep. 2003)

⁹ *In re Marriage of Joynt*, 375 Ill.App.3d 817, 819 874 N.E.2d 916, 918 (3rd Dist. 2007). See also Michael W. Kalcheim, "Are a Closely Held Corporation's

Retained Earnings Fair Game for a Divorcing Spouse?" 95 IBJ 30 (Jan. 2007) for a pre-Joynt in-depth analysis of this topic.

¹⁰ *In re Marriage of Moll*, 232 Ill.App.3d 746, 754, 597 N.E.2d 1230, 1235-36 (2nd Dist. 1992) (citing *In re Marriage of Banach* (1986), 140 Ill.App.3d 327, 331, 489 N.E.2d 363; *In re Marriage of Hellwig*, 100 Ill.App.3d at 459, 426 N.E.2d 1087)

¹¹ *In re Marriage of Moll*, 232 Ill.App.3d 746, 757, 597 N.E.2d 1230, 1237 (2nd Dist. 1992) (citing *In re Marriage of Hellwig*, 100 Ill.App.3d at 459-60, 426 N.E.2d 1087.) See also *In re Marriage of Blackstone*, 288 Ill.App.3d 905, 911, 681 N.E.2d 72, 76 (1st Dist. 1997) (IMDMA generally seeks to sever economic ties between parties).

¹² *In re Marriage of Thomas*, 239 Ill.App.3d 992, 996, 608 N.E.2d 585, 588 (3rd Dist. 1993).

¹³ *In re Marriage of Olson*, 223 Ill.App.3d 636, 646, 585 N.E.2d 1082, 1089 (1992).

¹⁴ *In re Marriage of Blackstone*, 288 Ill.App.3d 905, 913, 681 N.E.2d 72, 78 (1st Dist. 1997)

¹⁵ *In re Marriage of Olson*, 223 Ill.App.3d 636, 646, 585 N.E.2d 1082, 1089 (1992).

¹⁶ *In re Marriage of Feldman*, 199 Ill.App.3d 1002, 557 N.E.2d 1004 (2nd Dist. 1990), citing *In re Marriage of Rubinstein* (1986), 145 Ill.App.3d 31, 36, 99 Ill.Dec. 212, 495 N.E.2d 659.

¹⁷ *In re Marriage of Schneider*, 214 Ill.2d 152, 167-8, 824 N.E.2d 177, 185-6 (Ill. 2005).

¹⁸ *In re Marriage of Talty*, 166 Ill.2d 232, 239-40, 652 N.E.2d 330, 334 (Ill. 1995). See also *In re Marriage of Schneider*, holding that personal goodwill was a nonmarital asset in a professional dental practice, 214 Ill.2d 152, 167-8, 824 N.E.2d 177, 185-6 (Ill. 2005).

¹⁹ *In re Marriage of Gunn*, 233 Ill.App.3d 165, 182-4, 598 N.E.2d 1013, 1025-6. (5th Dist. 1992).

²⁰ *Id.*

²¹ *In re Marriage of Olsher*, 78 Ill.App.3d 627, 635-6, 397 N.E.2d 488, 494-5 (1st Dist. 1979). The *Olsher* Court noted that since the value of a closely held business fluctuates with the performance of the business, that the redemption agreement stock price formula had little probative value. The Appellate Court remanded the case to the trial court for determination of the value of the business, as the trial court abused its discretion in determining that the stock had "no value" due to testimony

from one party that the stock was in a closely held corporation and thus had no recognized market value.

²² *In re Marriage of Devick*, 315 Ill.App.3d 908, 735 N.E.2d 153, 156 (2nd Dist. 2000).

²³ *Id.*

²⁴ See *In re Marriage of Lyon*, 439 N.W.2d 18, 20 (Minn. 1989) citing *In re Marriage of Rogers*, 296 N.W.2d 849, 852 (Minn. 1980) and *In re Marriage of Suther*, 28 Wash.App. 838, 845, 627 P.2d 110, 113-4 (Wash. App. 1981). (Importantly, in *Suther*, the trial court found that the non-owner spouse signed the buy-sell agreement, but had no actual knowledge of the operations of the business and no role in the business at the time she executed the agreement).

²⁵ *In re Marriage of Overbey*, 2007 WL 1733214, *5, 139 Wash.App. 1017, (Wash.App. Div. 1, 2007), citing *In re Marriage of Suther*, *Id.* See also *In re Marriage of Barton*, 281 Ga. 565, 639 S.E.2d 481 (Ga. 2007), *In re Marriage of Moffatt*, 279 N.W.2d 15, 18 (Iowa 1979), *In re marriage of Bossermann*, 9 Va.App. 1, 384 S.E.2d 104, 108 (Va.App. 1989). *In re Marriage of Amodio*, 70 N.Y.2d 5, 7-8, 516 N.Y.S.2d 923, 924, 509 N.E.2d 936, 937 (N.Y., 1987), *In re Marriage of Bowen*, 96 N.J. 36, 47-49, 473 A.2d 73, 79 (N.J.,

1984)

²⁶ 750 ILCS 10/1 *et seq.*

²⁷ 750 ILCS 10/3

²⁸ 750 ILCS 10/7

²⁹ *In re Marriage of Barnes*, 324 Ill.App.3d 514, 519-21, 755 N.E.2d 522, 526-27. (4th Dist. 2001)

³⁰ *In re Marriage of Drag*, 326 Ill.App.3d 1051, 1055, 762 N.E.2d 1111, 1115 (3rd Dist. 2002).

³¹ For more detail on this topic, See Laura Caldwell, "Postnuptial Agreements in Illinois" 88 IBJ 473 (Aug. 2001).

³² *Estate of Brosseau*, 176 Ill.App.3d 450, 451, 531 N.E.2d 158, 159 (3rd Dist. 1988)

³³ *In re Marriage of Tabassum and Younis*, — N.E.2d —, 377 Ill.App.3d 761, 2007 WL 4336101, *7 (2nd Dist. 2007).

³⁴ *Id.*, at 8, citing *In re Marriage of Bratton*, 136 S.W.3d 595, 603 (Tenn.2004) (parties were not having marital problems when they entered postnuptial agreement, it was not a reconciliation agreement, and wife's promise to stay married not consideration), and *In re Marriage of Whitmore*, 8 A.D.3d 371, 372, 778 N.Y.S.2d 73, 75 (N.Y.App.2004) (continuing marriage not sufficient consideration for postnuptial agreement in which wife released claims on husband's property).

³⁵ *Id.*, at 7.

³⁶ *Id.*

³⁷ *Id.*

³⁸ *In re Marriage of Devick*, 315 Ill.App.3d 908, 735 N.E.2d 153, 156 (2nd Dist. 2000).

³⁹ *In re Marriage of Kelley*, 959 So.2d 109, 112-13 (Ala.Civ.App. 2006)

⁴⁰ *Id.*

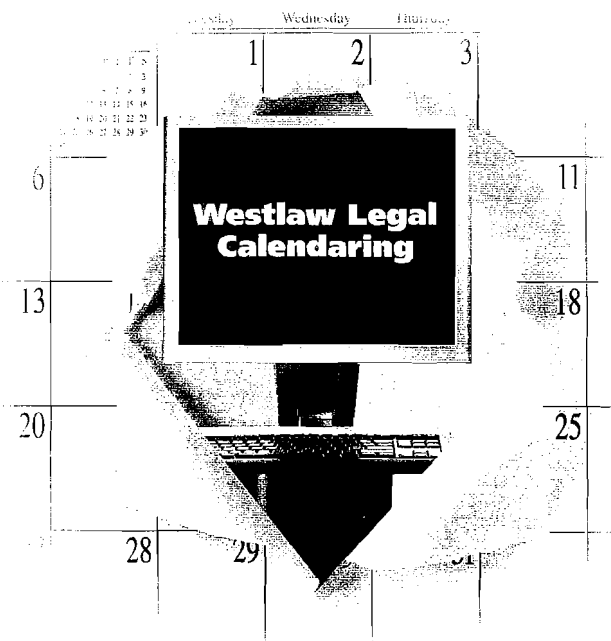
⁴¹ *In re Marriage of Suther*, 28 Wash.App. at 845, 627 P.2d at 113-4.

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