Equitably Distributing Business Values Post Pandemic

Michael Scheffer's article entitled "New York Risk of Loss After Coronavirus"[1] struck a marital chord that will likely reverberate through the courtroom doors of virtually every pending divorce case involving the valuation of an existing business or one that closed its doors due to the pandemic.

Unlike those cases where the New York Risk Act[2], or a carefully worded risk of loss contractual provision, governs the allocation of the risk of loss between a buyer and seller of real property, in divorce actions, the risk of loss between a husband and a wife over the value of a pandemic- affected business is too often placed squarely and unfairly on the owner spouse's shoulders, who is probably nine times out of ten the husband. Through no fault of their own, those small business owners who settled their divorce cases based on pre-coronavirus conditions and a then booming economy must seek to salvage what is left of a business that was already equitably distributed in part to the other spouse based upon an absurdly high value errantly opined at trial by a court-appointed expert .

Unfortunately, once a case is settled or decided, there is no going back in time to rectify an inequity caused by an optimistic valuation that a harsh reality transforms into a windfall for one spouse over the other. Perhaps this "take no prisoners" pandemic will finally convince the judiciary to reconsider its standard approach of awarding an equitable distribution to the non-owner spouse of a portion of a value set by an expert rather than being set by the actual earnings of the business after divorce. Indeed, as the law stands now, a non-owner spouse awarded twenty percent of a business valued at $5 million at trial just before the pandemic struck and thereby decimated the owner spouse's

business gets to keep the $1 million non-dischargeable and non-modifiable distribution, despite the fact that the owner spouse tragically lost his entire business to the pandemic[3].

When a spouse acquires or grows the value of a business during the marriage, the other spouse is entitled to seek an equitable distribution award of a percentage of the value or the appreciation of that business interest. Without going into the factors material to the Court's discretionary determination of the percentage of the value to award to the non-titled spouse, identifying on what date to value the business interest is often a vexing and seemingly arbitrary process. The rule of thumb, however, is to value a business as of the date the divorce is commenced where the spouse is actively involved in the operation the business and can be viewed as having a discernible impact on the financial success or failure of the business. On the other hand, those businesses that owe their value to market fluctuations rather than the active efforts of the owner spouse, are generally valued as the date of trial. The pragmatic reasons for the distinction between "active" and "passive" assets aside,[4] both are equally susceptible to changes in value triggered by an unfathomable and devastating event such as the coronavirus pandemic.

In all pending and undecided divorce cases involving the valuation of a business, the pandemic has all but guaranteed reconsideration of the value to be attributed to the business. That means some very complicated and potentially unreliable guesswork on valuation will ensue or, better yet, the advent of some new and innovative "earned out" business value distributions will become part of the valuation discussion. For divorce attorneys, business valuators, and judges alike, managing the economic chaos that necessarily lies ahead will require an open-minded and deft collaborative effort from all involved.

Although judges often find comfort in embracing the unchallenged valuation opinions rendered by so-called valuation experts, who, fortunately for them, cannot be later sued for their erroneous prognostications, opining a reliable valuation methodology that accurately predicts how the pandemic will affect the future profitability of a business is clearly not the province of the mere mortals that label themselves business valuators. That means judges will need to come up with creative ways to think outside the box to ensure both divorcing spouses a semblance of equity. To accomplish that goal, the court may have to conceive an equitable way to tie the value at trial to the real world actual future profitability of a business. If buyers of service businesses, such as accounting or financial analyst practices, reliant on client loyalty for their profitability, condition the ultimate purchase price on the revenue derived through client retention, why can't divorcing couples do the same?

Opining a value for virtually any small niche business, post-pandemic or not, is very difficult and too often imprecise. Not surprisingly, the entrepreneurial marketplace , where the participants all have skin in the game, has long acknowledged the futility of looking only at a company's historical financial information in determining the price to purchase a business in a world where the proverbial Black Swan event seems to be far more prevalent and where the client loyalty shown to the seller of a business may not be so successfully and seamlessly transitioned to a hypothetical buyer as originally expected.

If business values in the marketplace are almost always tied to future events to hedge against the unexpected, no reason exists why judges cannot do the same, provided the future business revenue is tied not to the other spouse's earning ability or personal goodwill[5], which is only material to an award of maintenance, but is instead tied to the

goodwill of the business as an enterprise. Assigning to the non-titled spouse a percentage of the profits of the business for the 3 to 5 year period that follows the parties' divorce is probably the most equitable distribution of the enterprise value of a business.

For the cynics out there, like in all commercial buy-sell transactions where the purchase price is "earned out" of the revenue generated after closing, the reactive "cooking the books" lament can be minimized through transparency, periodic audits, together with other typical disincentives and penalties. Certainly, no seasoned divorce attorney would accept anything less.

Yes, post-trial quarrels may unfold, just like in ordinary business buy-sell transactions. However, the alternative is far less desirable, i.e. an errant value that portends an inequity to one of the parties over the other. A valuation approach that ties the award to reality would also ensure that in the event of another pandemic, business owners will not be saddled with paying to former spouses any more than a percentage of what the business actually makes rather than a set portion of a speculative value attributed to his business by an expert with no skin in the game.

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[1] NYLJ April 10, 2020, p.4

[2] General Obligations Law §5-1311

[3] *Simken v. Blank*, 19 N.Y.3d 46 (2012) (where the Court of Appeals refused to reform a marital agreement where the husband's share of the marital estate turned out to be worthless due to the fact that Bernie Madoff had made off with his money); *Kojovic v. Goldman*, 35 A.D.3d 65 (1st Dept 2006) (where the Appellate Division refused to set aside the parties' agreement after the wife learned her husband received $18 million on the sale of stock that she had undervalued in reaching a settlement.

[4] *Heine v. Heine*, 176 AD2d 77 (1st Dept 1992).

[5] *See* Domestic Relations Law §236(B)(5)(d)(7) (which eliminated. a spouse's enhanced earning capacity or career enhancement as marital assets).