

Protecting your family business and/or investments against the consequences of divorce

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If you are an entrepreneur or your family has a family business, you may be well-advised to consider having a pre-nuptial or post-nuptial agreement. Some people think of pre-nups as documents only for royalty or film stars. This is far from the case. Pre- and post-nups are now integral tools in wealth preservation for many families (whatever the scale) in seeking to ring-fence assets brought into or inherited during a marriage, from claims on divorce.

For those entrepreneurs and family business owners whose spouse (or a spouse of the generation below) has been involved in their business, the issue of ongoing participation after separation and divorce requires very careful consideration. For many, it is trite to say that even if the former spouse may have made a valued contribution to the success of the business or taken an active role in its creation and day to day running, their continued participation after marriage breakdown is simply not viable. For some, the concern is that continued participation gives continued access to financial information which going forwards, they would prefer to remain private. For others, financial necessity and business functionality may mean that their active involvement is simply no longer practical.

The family business model can reap benefits for both the business and the family. Taking protective steps to ensure that business entities remain as intact as possible and mitigate against the damage in the unfortunate event of divorce or separation is a vital component of business and succession planning.

Damage limitation to the family business if divorce occurs: the hurdles

Frequently, divorcing parties assume that any interest the other spouse has in the business will be automatically transferred to them on divorce. This is not an inevitable outcome. A family business is not regarded as sacrosanct within the divorce arena, and some deconstruction, or finance raising may well be required to meet a spouse's financial needs. Whilst the English Family Court will have regard to the interests of third parties (such as other shareholders or trust beneficiaries), this factor will not preclude a Judge from making such orders as may be necessary to achieve a fair outcome between the divorcing spouses.

The divorce court operates very differently from the commercial court. It has wide ranging powers to divide the property of a divorcing couple fairly, with reference to three principles: the parties' and any children's financial needs; compensation for relationship-generated economic disadvantage; and the equitable sharing of the wealth built up during the course of the marriage (the marital assets), which can include business interests or growth in value during the marriage of a pre-existing business, as well as assets held in trust.

The English Family Court can make an order for a transfer of shares in the business from say a wife to a husband; it can make an order for a business to be partitioned and for each spouse to retain a part; the sale of shares; for a business to be sold (in part or in whole); or order one spouse to make a lump sum payment to the other which can only be achieved by using the business or its assets as collateral. The court's powers are wide ranging. The final outcome will depend on a variety of considerations including the nature, age, and liquidity of the business, the extent of reliance of the divorcing couple on the existing business as a future source of income, the parties' respective needs referable to the length and standard of living enjoyed during the marriage and a host of other statutory factors applied by the English Family Court to achieve a tailor-made outcome for each and every case.

In contested family court proceedings, the court will look, where possible, to achieve a fair division of the copper-bottomed assets on the one hand and the illiquid and risk-laden assets on the other. However, as this may simply not be practical in many family business situations, it is open to the divorcing couple to reach their own agreement (whether for example, directly between themselves, through mediation or negotiation through lawyers outside of or parallel to court process, with one spouse keeping their business interests intact) even though this may result in the other spouse receiving a larger share of the (non-business) matrimonial assets. This inevitably brings valuation and liquidity issues into play.

The English Family Court will generally respect, to varying degrees, the fact that the business may have been set up by one spouse, or previous generations of their family, prior to the marriage and accept that assets brought into the marriage should not be shared on divorce in the same way as assets built up during the marriage. Where these include business interests, this will often involve the need for retrospective valuation (if there is no contemporaneous value available) at the time of marriage as well as valuation at the time of marital breakdown.

Generally speaking, the increase in value during the marriage resulting from the active management of business by a spouse, will fall into the category of marital assets to be divided on divorce. It may make some adjustment, to reflect latent value of the business potential at the start of the marriage. Passive growth in value during the marriage may be discounted in this exercise.

Continued participation of both spouses in the business post-divorce can be an option

The court is unlikely to impose this outcome (as it is counter-intuitive to the court's objective of severing financial ties between spouses), unless for example there is a foreseeable value realisation event in the pipeline (eg sale or IPO). However, there is nothing to stop the separating couple from agreeing to continue together in business. Competing interests and conflict frequently make this unviable, unless there is no other option as a result of liquidity issues or commercial and strategic risk considerations. A precondition is that the parties remain willing and able to continue to work together, in which case, certain safeguards may be put in place which facilitate a continuing business relationship. For example a husband may retain a share in the family business with the proviso that he take a backseat role and that voting rights are vested in the wife, who has been actively involved in running the business throughout the marriage.

Damage limitation if divorce occurs – the protections

The efficacy of the pre-nuptial or post-nuptial agreement in protecting the family business

If you are an entrepreneur or your family has a family business, you may be well-advised to consider entering into a pre-nuptial or post-nuptial agreement. Some people think of pre-nups as documents only for royalty or film stars. This is far from the case. Pre- and post-nups are now integral tools in wealth preservation for many families (whatever the scale) in seeking to ring-fence assets brought into, or inherited during, a marriage from claims on divorce. Developments in case law demonstrate that the English Family Court will respect the autonomy of individuals by giving effect to such agreements if they are freely entered into by each party, with a full appreciation of the implications (which means they have each received independent legal advice and disclosed their assets to the other), unless in the circumstances prevailing it would not be fair to hold them to the terms. Therefore, whilst the English Family Court's jurisdiction to intervene and make orders on divorce cannot be extinguished by a pre- or post-nup, the burden will be on the spouse seeking to get out of the agreement to demonstrate that they should not be held to its terms.

Pre-nuptial and post-nuptial agreements can record a couple's preferred arrangements regarding the separation of property in the unfortunate event of divorce and this can be crucial when planning for future contingencies in the family business. Such agreements can dis-apply the 'sharing principle', thereby protecting particular assets from division, including pre-acquired business and trust interests and their growth in value during the marriage. This was aptly demonstrated in a recent reported case in which a divorcing spouse was successful in protecting his family business (co-owned with his brother) as a direct result of having entered into a pre-nuptial agreement.

No agreement is permitted to cause prejudice to the reasonable requirements of a child of the marriage, nor can it overreach the basic needs of the spouse, otherwise it would readily be open to challenge on the ground of unfairness.

Pre-nuptial agreements can also provide much needed privacy as those cases are less likely to be fought out in court. The last decade has seen expansion of media access to family courts, with more cases being heard in public and many reported without anonymity. Pre-nups can include terms of agreement that require the parties to mediate or arbitrate in the event of future dispute away from the prying eyes of the prurient press thus preserving confidentiality of the family and its financial interests.

So, where one party has a share in a family business or other business or trust interests which he/she wants to protect from potential claims in the event of future divorce, it is fundamentally important to consider the protection which a pre-nup or post-nup may provide and its impact on any subsequent divorce.

Structural corporate considerations designed to strengthen the family business against the consequences of divorce

Phantom agreements

If pre-emption rights prevent a spouse from being given an interest in a family business or other business interests, a phantom agreement may be entered into pursuant to which any value deriving from a share in a business is split.

A phantom agreement gives a spouse a financial interest equivalent to holding shares albeit that this will have different tax considerations. The backstop protection of an unfair prejudice claim does not exist with a phantom agreement. It therefore requires careful drafting to avoid a spouse side-stepping his or her payment obligations – a spouse's rights will only be as strong as the express provisions set out in the phantom agreement itself.

In any phantom agreement, consideration needs to be given as to how to deal with different kinds of exit eg a rollover into a purchasing company's shares, earn outs and escrow (for claims under the share purchase agreement/tax covenant). The tax position of a spouse's interest under any phantom agreement and the tax position of the spouse holding the shares or other business interests also need careful consideration. Care should also be taken to ensure the agreement is enforceable if the business owning spouse is planning on leaving the UK and/or some or all of the business interests are overseas.

Compulsory transfer provisions

Compulsory transfer provisions in the articles of association or a shareholders' agreement may have the effect of deterring some courts from making share transfer orders on divorce due to concerns about subsequent implementation or enforcement, but these provisions would not prevent the court from making such orders or finding an alternative solution in its quest for fairness (for example by making orders against the

individual spouse) which may have the effect of that spouse requiring assistance from family shareholders or trustees to enable compliance. In any event, a compulsory transfer of a spouse's shares may not always be in the best interests of the other spouse (who is to remain in the business) and his or her family. The permitted transfer provisions in the articles of association or a shareholders' agreement in a family company or to which other business interests are subject, may be drafted to require that shares be passed down to the issue of a senior family member or ancestor and thereby prevent transfer away from the original bloodline by a divorcing spouse.

If the former spouse's shareholding is a minority shareholding, the family may be comfortable with them retaining their shares for their lifetime and receiving dividends, but having no board representation rights and no other meaningful rights to veto how the company is run. Although a minority shareholder in an English company will have the right not to be unfairly prejudiced, subject to any rights of veto provided for in the family company's articles of association or shareholders' agreement (or documents governing other business interests), they would not otherwise have any meaningful right to interfere in the management of the company.

If compulsory transfer provisions on divorce are to be included in a family company's articles of association or shareholders' agreement, thought should be given as to how the share transfer value should be determined along with a mechanism for valuation process if not agreed. For example, should the value be a fair value assuming the business is a going concern with no discount for minority? Should a minority discount be applied, or should a low value be ascribed to the shares as might be the case for an employee who is a 'bad leaver'? In the event of dispute on value, the English Family Court will usually require independent expert valuation.

A penal valuation provision may result, for practical company purposes, in a transfer of value to the remaining family members, who would usually have the right to acquire the shares by way of 'pre-emption'. However, that may not be the same value as the value which court attributes to those shares when dividing up the marital assets between the spouses.

A planned outcome

Ensuring that all bases are covered from the outset from a corporate and matrimonial perspective is key. This may be achieved by putting in place structural safeguards such as pre-emption rights, compulsory transfer provisions or phantom agreements, and/or by signing a pre-nuptial or post-nuptial agreement. Or it may simply be achieved by entrepreneurs and family business members being fully appraised of the legal landscape. This in itself, will inform sensible commercial and structural wealth preservation decision-making.

Notes:

In this document, we have used the terms 'husband' and 'wife', recognising of course, that the roles in the business and the home may be interchangeable.

Facts and circumstances vary markedly from case to case, and the information, comments and opinions contained in this document are for the general information of the reader and are not intended to be relied upon in relation to any particular circumstances. For applications of the law to specific situations, the reader should seek legal advice.

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