Cathy C. Hunt

Divorce:

Diaper mogul's divorce is reason to change your plan

In 2000, Tereson Dupuy, started an online patented cloth pocket baby diaper business called FuzziBunz. She later appeared on the television show "Shark Tank" to promote her invention. Despite having over $23 million in sales, the sharks didn't bite, noting that Dupuy was an impediment to the company's profitability. Dupuy, appearing on the show's podcast, agreed that she was burnt out after 12 years of "killing it" and six years of post divorce settlement fallout. What happened to Dupuy is not uncommon among striving entrepreneurs.

Starting a business is life consuming on all levels. It requires living with uncertainty and often working in some capacity seven days a week. For owners that are married the stakes are higher. Often, the marriage and the business become like contenders, each competing for a valued piece of the business owner's time. Perseverance, persistence and determination mark the traits of entrepreneurs who successfully find their market and outlast their learning curve. However, the division of attention between work and family can cause a marriage to unravel.

Risk management for any company should include strategic planning in the event that a founder gets divorced. Making thoughtful and considered decisions on ownership, income distribution and buyback provisions in happier times will save money, aggravation and possibly the business itself should a divorce occur.

If you're not careful in developing your business plan, you could find yourself in business with your soon to be ex or floating a loan to buy out your spouse's shares in the business. That's what happened to Dupuy, who launched her company early in her marriage. When her marriage dissolved, the company had to borrow a reported $2 million to buy the husband's interest, and Dupuy's husband was actually awarded control of the company on a temporary basis according to *Entrepreneur* magazine. Payments on that kind of debt would significantly reduce cash flow and negatively affect a company's borrowing power. Hindsight is 20/20, and if Dupuy had it to do over again, it is likely she would develop a business plan that would protect the company in the event of divorce.

Making thoughtful and considered decisions on ownership, income distribution and buyback provisions in happier times will save money, aggravation and possibly the business itself should a divorce occur.

Too often owners of closely held companies don't follow corporate formalities, especially when it comes to naming owners and creating a custom operating agreement. They give ownership to a spouse who really is not involved in the business creating income and tax consequences, and he or she has no operating agreement or one that is very generic. This casual approach to corporate governance is almost always a problem when business owners divorce.

Here are six strategies to consider as a matter of strategic planning to prevent the disruption to business if a founder divorces.

CUSTOMIZE YOUR AGREEMENT

It is important to have corporate documents formally prepared and customized. It is not sufficient to download an agreement from the internet or have a lawyer prepare a stock agreement that is not personalized for the business. The following things are critical to a company's operating agreement:

- Have a lawyer draft the company's operating agreement and understand what it says.
- Identify ownership, management and income issues related to married business owners, and determine who will run the company and what the other spouse will do for income if there is a separation or divorce.
- Review and/or update your agreement annually.
- Hold meetings, and vote consistent with what your agreement provides.

• For business owners who are married but not in business with their spouse, the agreement should provide for the right, but not the duty, of the company to buy back shares in the event of a separation or divorce.

FIRE YOUR SPOUSE

Business owners often name a nonparticipating spouse as an owner for tax reasons or to gain other advantages such as having a woman-owned business. However, it creates a myriad of problems, including management and control issues if marital problems ensue. The right to buy, sell, borrow or sign checks becomes problematic if a spouse grabs control based on their right as an owner, especially if they have never worked in the business. Frequently, income allocated to a non-participating spouse is never actually paid to the spouse or it is deposited into a joint account. However, a spouse with an ownership interest has a right to be paid consistent with other owners. If they make a demand for payment, the finances of the business and the family have to be restructured. This is especially difficult during a time where spouses have a high degree of distrust and a diminished ability to agree. Gratuitous ownership should be avoided. If there are real reasons for naming a spouse as an owner it is important at the outset to address issues of management, control and income allocation in the event of divorce or separation.

MAINTAIN ACCURATE RECORDS

Owners in closely held businesses are notoriously bad at following corporate formalities and maintaining good records. As long as there are no problems, it doesn't really seem to matter. However, when there is a dispute between owners, especially ones that are married, poor record keeping and informal accounting routinely leads to suspicion and accusations of wrongdoing. Common concerns include:

• "Loans" to shareholders for which there are no promissory notes or payments

• Income reported on the books that is inconsistent with the lifestyle of the divorcing owner(s), which may indicate unreported cash being taken out of the business

• Payment of personal expenses through the business that are not reported as income

• Financial statements that are puffed up for borrowing purposes but later minimized when an owner is getting divorce

• Appraisals of the business for purposes of marketing the company for sale that are downplayed as a real indication of value in a divorce case

GET A PROFESSIONAL VALUATION

The biggest mistake you can make is to get your business valued by someone who is not properly qualified. Your CPA can assist an appraiser, but your CPA should not value your business. FuzziBunz was valued in Dupuy's divorce based on a projection of 10 years of future growth rather than current revenue, according to *Entrepreneur* magazine. Dupuy wishes she had challenged FuzziBunz's valuation, as it took her years to pay her husband for his interest. Business valuation is a highly specialized area, and only the most-qualified expert should be retained to value the business.

SIGN A PRENUP OR POSTNUP

While your relationship is still on solid ground, you may greatly increase your odds of surviving a divorce with your business intact by entering into a prenuptial or a postnuptial agreement.

Before marriage, parties can enter into a premarital agreement that will provide for the distribution of property and terms regarding spousal support. This is often recommended when one spouse is an owner in a family business or other closely held entity where such interest is intended to stay within the immediate family or the existing shareholders.

A postnuptial agreement is a contract between spouses entered into after marriage that outlines the distribution of financial assets and debts in the event of divorce. Entering into such an agreement may help calm concerns about splitting assets in the event of divorce and may promote harmony in the marriage by reducing tension and fighting associated with financial differences.

CREATE A BUY-SELL AGREEMENT

A buy-sell agreement provides a mechanism for repurchasing shares should any owner's status change, as is the case in a divorce. The agreement might limit a nonowner spouse's ability to acquire ownership, or give the company or other partners the right but not the obligation to buy at a predetermined price in the event of divorce.

Any of these strategies would have been a lifesaver for Dupuy, especially a postnuptial or buy-sell agreement. If she had been able to establish terms regarding the business in the event of a divorce, she would have saved countless hours in litigation, legal expenses and disruption to her business through the process. The tale of FuzziBunz is a cautionary tale and underscores the old adage that an ounce of prevention is worth a pound of cure.

CATHY C. HUNT is a senior partner with Gailor, Hunt, Jenkins, Davis and Taylor PLLC. She dedicates her practice to the representation of high-net-worth business owners going through divorce. Formerly, she practiced corporate law with Womble, Carlyle, Sandridge and Rice in North Carolina and McGuire, Woods, Battle and Booth in Northern Virginia. Her corporate-law experience provides her with the expertise that is necessary to understand complex equitable distribution cases, especially those involving business valuation issues. Her peers have recognized her as a member of North Carolina's Legal Elite in family law. She also has been named as one of North Carolina's Top Lawyers in that practice area. She welcomes any follow up questions and can be reached at chunt@ghdivorcelawyers.com.