Friday, May 8, 2020

There has been considerable speculation that one consequence of the Coronavirus will be an increase in the divorce rate resulting from togetherness imposed by the quarantine that pushes marriages already on shaky ground over the brink. Whether divorces will increase in the future due to Covid-19 remains an open question, but what is certain is that a sizable number of future divorces will involve the transfer of a business ownership interest between spouses as part of the divorce. To address this situation, this post focuses on key business issues that arise when one spouse (the “Divesting Spouse”) transfers an ownership interest in a business to the other spouse (the “Recipient Spouse”) as part of a divorce settlement. Addressing these issues will help the Recipient Spouse continue to run the business successfully and also avoid future conflicts with the Divesting Spouse, as well as with future investors and potential buyers of the business.

1. Don’t Rely on Divorce Decree or Settlement Agreement to Document the Transfer of a Business Ownership Interest
Between Spouses

A divorce decree and settlement agreement will document the terms of the divorce and the division of property between spouses, but it is not a good idea to rely on the decree or the divorce settlement to memorialize the transfer of a business interest between spouses. There are a number of reasons for the Recipient Spouse to insist on securing a stock transfer agreement (or its equivalent), including the fact that the Recipient Spouse will likely be required to show the transfer document to third parties in the future, including banks or other lenders, new investors, company officers or managers, and potential future buyers. The Recipient Spouse will not want to show the decree or settlement agreement to these third parties, however, because they include private matters unrelated to the business. This will therefore require the Recipient Spouse to prepare a heavily redacted document for review by third parties. It is more efficient to simply require a transfer document to be signed that is limited solely to issues related to the business.

Another reason for the use of a transfer document is that it will include many provisions that are not normally part of a settlement agreement. The decree or settlement agreement will become a very lengthy document if it includes all of the provision that are traditionally set forth in a separate document that covers the transfer of a business interest.

2. Secure a Separate Release of the Divesting Spouse’s Claims Against the Business

After the business is transferred and the divorce becomes final, the Recipient Spouse will not want to defend claims that are brought by the Divesting Spouse against the business. This requires the Recipient Spouse to secure a broad release of claims against the business from the Divesting Spouse. This release of the business is separate from and in addition to the release that the Divesting Spouse provides to the Recipient Spouse, individually.

For example, if the Divesting Spouse was an officer, employee, director or manager of the company, the Divesting Spouse’s release needs to include a release of all employment claims, such as claims for unpaid wages/back pay, vacation time, unpaid expenses, and commissions. The release will also include the Divesting Spouse’s release all claims for wrongful termination, claims related to the distribution of any profits generated by the company and all other business related claims. The release will also confirm that the Divesting Spouse has resigned from all positions with the company and has no further right or authority to take any action for or make any statements on behalf of the company.

3. Confirm Broad Transfer of All Rights by Divesting Spouse

The provisions that confirm the transfer of ownership in the business by the Divesting Spouse need to be broadly described in the transfer agreement to include all rights, title and interest of every kind related in any way to the business. This includes all rights of the Divesting Spouse in any and all intellectual property of the company, such as company names, trademarks, trade secrets and patent rights. This is particularly important if the Divesting Spouse worked in the business, because
the Recipient Spouse does not want to be faced with a situation in the future where the Divesting Spouse later claims that he or she developed some software, designs or other intellectual property rights that are not owned by the business, and which are now being used by the Divesting Spouse in direct competition with the company.

4. Consider Requesting Divesting Spouse to Accept Restrictive Covenants

In a normal M&A transaction, a company buyer secures a set of restrictive covenants from the seller as part of the purchase agreement to prevent the seller from competing in any way with the company after the sale takes place. The buyer will require the seller to provide all of the following restrictive covenants that will last for two to five years: (i) a covenant not to compete, restricting any involvement by the Divesting Spouse — whether as an owner, employee, consultant, etc., — in a business that is competitive with the subject business for a reasonable period of time within a reasonable geographic area, (ii) an agreement not to interfere with the business’s relationship with its customers and vendors or to solicit customers, or attempt to persuade the business’s customers and vendors to cease doing business with the company, and (iii) an agreement not to hire or solicit the hiring of any of the employees of the business, or otherwise attempt to persuade any of the employees of the business to cease their employment relationship with the company.

If the Recipient Spouse is concerned that the Divesting Spouse may compete in business against the company after the divorce, the Recipient Spouse may want to request the Divesting Spouse to agree to accept some or all of these restrictions. The Divesting Spouse will not agree to accept these post-divorce restrictions, however, without a corresponding commitment from the Recipient Spouse to provide some amount of additional consideration in the divorce settlement.

5. Request Confidentiality Agreement from Divesting Spouse

Confidentiality agreements are similar to restrictive covenants in that they prevent the person who is subject to the agreement from taking actions that are harmful to the business. The confidentiality agreement is specific, however, in prohibiting the individual officer or employee from using or transferring any of the company’s confidential information or trade secrets. All of the company’s officers and employees are subject to a common law duty not to use or misuse any of the company’s confidential information, but a written confidentiality agreement makes this prohibition clearer on the use of confidential information and trade secrets.

If the Divesting Spouse has not already entered into a confidentiality agreement with the company, the Recipient Spouse will want to request the Divesting Spouse to accept and sign a confidentiality agreement to protect the company’s valuable confidential information and trade secrets. The Recipient Spouse wants to make sure that the company’s confidential information, technology and trade secrets are maintained in strict confidence.

6. Secure “Tail Coverage” of Divesting Spouse From D&O Carrier

If the company has a directors and officers liability insurance policy (a “D&O
Policy”) that provides protection for officers and directors from third party claims, these policies will generally remain for one or two years after the company’s officers and directors are no longer affiliated with the company. The Recipient Spouse will therefore want to secure “tail coverage” to provide continuing insurance coverage for claims made against the Divesting Spouse. In this regard, the Recipient Spouse may want to secure a tail policy will extend the D&O coverage over former officers and directors for a total period of five years.

The Recipient Spouse may feel like securing a tail policy that extends coverage for third party claims against the Divesting Spouse is unnecessary because it provides a benefit solely for the Divesting Spouse. In fact, a tail policy provides insurance protection that protects both the Recipient Spouse and the Divesting Spouse, and it is also a benefit to the company. If third party claim is made against the Divesting Spouse after the divorce related to the business, the Divesting Spouse will likely demand that the company indemnify him or her. If the D&O policy is still in place, however, the tail policy will enable the company tender a defense of the claim against the Divesting Spouse, because the D&O carrier will cover all of these legal defense costs. Fortunately, a tail policy that extends D&O coverage is often not too expensive to secure.

7. Specify Treatment of Future Tax Filings

Dealing with all of the tax issues involved in the transfer of the business is an extensive subject that goes beyond the scope of this post, and spouses engaging in the transfer of a business interest are strongly advised to consult with a tax advisor during their divorce. But there is one tax issue that the Recipient Spouse should consider addressing up front. Many businesses held in marriages are structured as pass through entities (i.e., LLC’s partnerships, Sub S corporations), which means that the owners pay the taxes on all profits that are generated by the company. As a result, in the year following the divorce, Recipient Spouse may be required to issue a K-1 to the Divesting Spouse based on the ownership interest held in the business by the Divesting Spouse during the year in which the divorce took place.

If the K-1 issued in the year after the divorce reflects any income that is apportioned to the Divesting Spouse, he or she may expect to receive a cash distribution from the company that is sufficient to cover the Divesting Spouse’s federal tax liability based on this income. If the company does not issue any distribution to the Divesting Spouse, that would create what is known as “phantom income” because the Divesting Spouse has to pay taxes on this income even though no distribution was issued by the Company. The issuance of phantom income to the Divesting Spouse is likely to provoke a heated dispute at that point.

The Recipient Spouse will therefore want to address in the divorce settlement how the future K-1 that will be issued to the Divesting Spouse will address any income generated by the business in the year of the divorce. If the Recipient Spouse is prepared to issue a distribution to the Divesting Spouse, that will take care of the issue. If the Recipient Spouse has no intention of authorizing the company to issue any distributions in the future to the Divesting Spouse, however, this issue will need to be dealt with by the Recipient Spouse in a manner that will not lead to a future legal dispute with the Divesting Spouse.
Conclusion

The transfer of ownership interests in business is common in divorce settlements. But if business issues related to the transfer of this type of interest are not considered at the time of the divorce, the parties may find themselves engaging in continuing disputes they did not anticipate. The Recipient Spouse, in particular, needs to take steps to ensure that the transfer takes place in a manner that allows the business to continue to run successfully, and to head off potential future conflicts with the Divesting Spouse and others after the divorce.

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