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When Divorce Strikes: What Family-Run Businesses Should Know

Nicholas Fairbank, 18 December 2019

When almost 90 per cent of UK-based businesses are owned by families it is obvious that divorce is a big deal, not only for the owners themselves but employees, other beneficial owners, suppliers and business partners. This article considers how to address divorce from a business control viewpoint.

A high percentage of UK business are run by families – a point that people may forget with so much media attention on large listed corporations and coverage of the ups and downs of their stock prices. With a family-run firm there are specific challenges, such as what is involved when owners want to pass on control. What also happens if there is a divorce or other disruption? Millions of jobs and business connections can be put at risk.

This article, by Nicholas Fairbank, a barrister at the practice 4PB, takes a close look at the details. The editors here are pleased to share these insights and invite readers to respond. The usual editorial disclaimers apply. Email tom.burroughes@wealthbriefing.com and jackie.bennion@clearviewpublishing.com

According to the Institute for Family Business, the number of family run companies in the UK increased by one million between 2010 and 2018. In fact, in 2018, 88 per cent of all UK businesses were family run. There are a few explanations for this rise, one being an increased awareness of the benefits that these company set ups can offer, from legacy planning to tax benefits. However, things can turn bittersweet when the future of the company and its employees become the subject of a couple's divorce.

The reality is that any family business of any significance will be relevant in divorce proceedings and will be taken into account by the court, either purely as an income generator or as a capital asset or both. That does not mean that it will automatically be split up – quite the opposite. Courts are generally loathe to reduce what might be the goose that lays the golden eggs for the couple to no more than a pile of rubble and sale of a business - the alternative to retaining it - which would bring about just such an end.

Most commonly, a family business will typically be run primarily or exclusively by one of the spouses. However, it can often be the case that the other spouse's name is on the title - an arrangement commonly used to extract money in a more tax-efficient manner, and possibly also to provide the less-involved spouse with a modicum of security and rights of access to documents, decisions, and bank accounts. In such cases, it is generally relatively straightforward to transfer ownership of the business to the spouse who has been responsible (either wholly or largely) for the running of the company. The transfer of shares can be ordered from one spouse to the other and commonly entrepreneur's relief will be available to mitigate capital gains tax.

The court tries to have a clear line regarding family businesses embroiled in a divorce; this is to steer the couple towards a clean break (s.25A MCA 1973). To avoid the human emotions involved in ex-spouses remaining in constant contact to co-operate over the running of a family business, the likely result is that one party will retain the business and be ordered to compensate the other spouse by paying either (a) capital or (b) maintenance or both, particularly if there is insufficient capital for the recipient spouse to live on to a fair standard without maintenance.

However, the court might not be able to take such a clear-cut view if the business is genuinely jointly operated. In such cases, often both parties will be keen to remain active in the company. Having regard to the steer towards a clean break, the courts will generally seek to allocate the business to one party. Ordinarily this would require resignation from directorship and any employment together with a transfer of shares to the party retaining the business. If this is not possible, for example because there is insufficient capital fairly to compensate the exiting spouse, then that spouse might retain a shareholding and retain rights to dividends, usually a minority shareholding so that the spouse intended to retain ownership also has control of the business. In such circumstances, there might also be a protective spousal maintenance order so that, for example, the business is not restructured by the spouse retaining control in order either to reduce dividend pay-outs (perhaps increasing his or her own salary in compensation) or to create separate share classes which might be utilised to deprive the minority shareholding spouse of his or her income.

If both spouses must remain in operation of the company, for example because they each have specialist skills not easily replicated by a replacement employee, there might be a time-limited buy-out option with a default sale so that either party can opt to assume control for a price determined by the court.

An authority

The case of Wells v Wells [2002] 2 FLR 97 is authority for the proposition that risk should be fairly allocated between spouses. A business is a risky asset compared with, say, the family home, and even more so compared with cash in an account. It is also inherently illiquid. This is often deployed as an argument for both spouses retaining shares in a company post-separation, so each stands to benefit from an uplift in the fortune of the company post-separation. In practice, courts tend to be against such an approach as the post-separation efforts of one spouse alone do not fall to be shared with the other under the law as it currently stands, so any such wealth would not fall to be distributed either equally or according to shareholdings. Put another way, the thought of one's ex-spouse benefiting from one's post-separation endeavour could well act as a disincentive to hard work, something ultimately not to the benefit of the company.

For example, in one case in which I acted the husband and wife worked in the same interior design company. The husband was the designer and was described by the court as the "creative genius". The wife did the marketing. There was a real issue over the extent of the wife's involvement in the company and, whilst the judge accepted that she was involved in the company as she had described, the decision was to transfer ownership of the business from their joint names over to the husband alone. This was because the two could not continue to work together in the business. One of them had to go. The court found that the husband was irreplaceable; without him, the company simply could not function. The marketing function undertaken by the wife could realistically be undertaken by an employee. She was therefore removed from the company by the court. However, she received suitable financial compensation by way of capital and maintenance.

Ultimately the court must think laterally in many business cases and a creative solution may be required. Unless there is a very good post-separation working relationship between the parties, which is inherently unlikely to be the case particularly if the case becomes contested, allocation to one spouse is the likely outcome with suitable capital compensation afforded. This is why specialist advice is nearly always required whenever a family business is involved.

Things can be more straightforward if one party wants a sale of the business and the other wishes to retain it. Then the question will be: can the outgoing spouse be suitably compensated from the available resources? This can often turn on the question of liquidity of the business, particularly if there are not sufficient resources available outside it to provide fair compensation. To answer this question, it is usually necessary to instruct an expert accountant not only to value the business but also to objectively assess liquidity. Whilst the accountant will not be able to second-guess genuine business decisions, his or her expert evidence is typically accepted by the court if properly reasoned.

The alternative to a sale is transfer from joint names into the sole name of one spouse. This is by far the simpler scenario in principle and is referred to above. However, the result can sometimes be difficult to achieve in practice, even if it is what both parties seek. Again, questions of liquidity arise, particularly if there are insufficient resources outside of the business to afford true separation.

Indeed, the most emotionally tricky situation arises when one spouse wants to introduce their new partner into the business arrangement, which won't be an issue if the other party is leaving the business. However, problems arise if both parties have sought to continue operating the business together. In short, given that it is generally not advisable to have both parties remain jointly running the (ex-)family business, having a new partner join is only likely to inflame the situation; it is usually unlikely to be in the business's best interests. If both ex-spouses retain genuine control then one could foresee board-level arguments and potentially even conflicting decisions taken one after the other regarding the partner-employee. To be discouraged.