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Divvying up assets in divorce: In-kind distributions of stock may warrant valuation discounts

Divorce courts typically refrain from subtracting discounts for lack of control and marketability when divvying up marital estates that include private businesses. Instead, a spouse is generally entitled to the cash equivalent value of a pro rata share of the entire business.

But the Supreme Court of Rhode Island recently made a noteworthy exception in *McCulloch v. McCulloch*. Here, the court made an "in-kind" distribution of stock by awarding one spouse 25% minority interests in two privately held businesses that were controlled by her former husband. The appellate court determined that the trial court had erred by failing to value the businesses and by assigning the spouse disproportionate ownership percentages without considering differences in control and marketability.

No value consensus

The main assets of the McCulloch marital estate were two affiliated companies worth between $106 million and $126 million combined, according to the parties' valuation experts. The court appointed a third valuator to reconcile the valuation discrepancy.

The third appraiser couldn't arrive at a value opinion due to a pending merger with a Chinese supplier and extraordinary market changes. So the court decided to abstain from assigning a value to the businesses. Instead, it awarded the wife a 25% interest in each of the businesses. The husband retained a 75% interest in each business.

On appeal, the wife argued that receiving an in-kind distribution of stock is different from receiving its cash equivalent value. Cash can be used to buy other assets or pay off debts. But what can you do with a stock certificate — especially if your former spouse controls whether you receive dividends and you have no ready market in which to sell your stock?

In-kind distribution or cash equivalent value

The Rhode Island Supreme Court agreed that the in-kind distributions essentially put one spouse in the undesirable position of having no control over his or her investments and no avenue for selling them. The opinion states that it's both "appropriate" and "necessary" to include discounts for lack of control and marketability when a court awards unequal in-kind business interests to divorcing spouses.

These discounts wouldn't have been necessary if the wife had received cash (or another asset) for her interest in the businesses. Here, the cash equivalent value would have equaled the wife's pro rata share of the business before valuation discounts.

The appellate court remanded the case to the trial court to determine the value of the businesses and then to craft a more equitable asset distribution, based on that valuation.

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Lessons learned

In *McCulloch*, the appellate court didn't mandate a cash payout. Instead, the opinion states, "An assignment of stock in a closely held corporation, which makes one spouse a minority shareholder, is generally disfavored and should be avoided whenever possible." It's generally better for one spouse to buy out the other's business interest, rather than continue to co-own or co-manage after the divorce settles — particularly when the spouses will retain unequal ownership percentages.

The case also underscores the importance of coming up with a settlement plan outside of court, rather than being at the mercy of a judge. If left to the court's discretion, the parties may end up with an undesirable settlement arrangement.

Finally, it shows that reviewing any proposed divorce settlement agreement from the perspective of a hypothetical investor is advisable. It's important to consider the rights and liquidity each spouse receives with his or her retained assets.

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