

WHAT EVERY BUSINESS ATTORNEY NEEDS TO KNOW ABOUT FAMILY LAW

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CHAPTERS 1.1



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- State Bar of Texas, 1993
- Texas Supreme Court, 1993
- U.S. Supreme Court, 1998
- Board Certified in Family Law by Texas Board of Legal Specialization, 2000
- Collaborative Lawyer

AWARDS * RECOGNITION

- "Best Lawyers in America" since 2011
- Listed in *Texas Super Lawyers*®, *Texas Monthly Magazine*, 2003 – 2014
- Top Fifty Female Attorneys in Texas, 2005
- Listed in *Texas Super Lawyers*®, *Texas Monthly Magazine*, Top 100 *Super Lawyers*® in Dallas/Fort Worth, 2005
- *D Magazine* Best Women Lawyers (2010)
- Martindale-Hubbell AV® Peer Review Rated
- Best CLE Article of 2007, State Bar of Texas, Family Law Section

PERSONAL

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PROFESSIONAL & CLE ACTIVITIES

- Advanced Family Law Co-Course Director 2014
- Past President, Texas Academy of Family Law Specialists (Director 2002-2005) (Member since 2000)
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- Member, State Bar of Texas Family Law Council Legislative Committee (2009 to present)
- Past Chair of Section 14, State Bar of Texas Grievance Committee (panel member since 2008)

- Delegate, Family Law Council of Community Property States (2002 - 2005)
- Member, State Bar of Texas, Texas Family Law Practice Manual Form Book Committee contributing author since 1998
- Fellow, American Academy of Matrimonial Lawyers, 2006 to present
- TAFLS Trial Institute 2008 Course Director
- New Frontiers, State Bar of Texas Course Director 2008
- Editor, TAFLS Newsletter, "Family Law Forum" (2002 - 2005)
- Member, State Bar of Texas Family Law Council, (2005-2010)
- Member, Collaborative Law Institute of Texas and of Denton County
- Member, Denton, Tarrant, Collin & Dallas County Bar Associations
- Member, College of the State Bar of Texas
- Member, Texas Family Law Foundation
- Member, State Bar of Texas, Family Law Section

PUBLICATIONS

- Author, *Protecting Your Assets from a Texas Divorce*, 2010
- Author, *Texas Annotated Family Code* (LexisNexis-Matthew Bender, 2005 Edition and all Editions to present)
- Co-Author, SBOT, Texas Family Law Council Checklist Committee for "Checklist" Publication, Volumes I and II
- 2013 AFLC: "Things You May not Know but Should About Private Retirement Plans and Deferred Compensation"
- 2013 NCJFCJ Judicial Institute Family Law: "Retirement Plan Division and Orders"
- 2013 Small Business Seminar: "What Every Business Attorney Needs To Know About Family Law"
- 2013 Institute for Paralegal Education: "QDROs: The Great Unknown"
- 2013AFL Drafting: "Drafting QDROs for Retirement Division, Child Support and Alimony"
- 2012 AFLC: "Tricky Retirement Issues"
- 2012 TX College for Judicial Studies: "Legislative Update: Spousal Torts"
- 2012 Marriage Dissolution Course: "Breach of Fiduciary Duty by Fraud..."
- 2012 Texas Center for the Judiciary 2012 Winter Conference: "Spousal Maintenance and Fraud on the Community"
- 2011 TAPS: "Additional Causes of Action"
- 2011 AFL Drafting Course: "Drafting QDROs for Retirement Benefit Division, Child Support, and Alimony"
- 2011 AFLC: "Spousal Maintenance Overhaul"
- 2011 Marriage Dissolution: "Causes of Action in Family Law"
- 2011 Family Law on the Frontlines: "2011 Legislative Update"
- 2011 Small Business Seminar: "What Every Business Attorney Needs To Know About Family Law"
- 2010 Small Business Seminar: "Succession in Business Planning: Protecting Business Before Divorce"
- 2010 AFL Drafting Course: "Retirement Benefits and Drafting QDROs"
- 2010 AFLC: "Agreements Between Counsel and Parties: Rule 11, MSA's and Other Settlement Agreements"
- 2010 UTCLE: "Additional Causes of Action in Divorce"
- 2009 Small Business Seminar: "Succession in Business Planning: Protecting Business Before Divorce"
- 2009 Trial of a Fiduciary Litigation Case: "Pleadings, Pre-Trial Procedures, and Dispositive Motions"

- 2009 Ultimate Trial Notebook: “Ultimate Judge’s Notebook”
- 2009 AFLC: “The Latest Causes of Action in Family Law”
- 2009 AFLC: “Exploring Employment Plans and Benefits, and Drafting QDROs”
- 2008 AFLC: “How to Calculate, Prove & Present Financial Issues”
- 2008 AFLC: “New or Developing Causes of Action in the 21st Century in Family Law: Including Fiduciary Litigation
- 2008 Marriage Dissolution Institute “Retirement Benefits”
- 2008 Small Business Seminar “Mixing Love and Business”
- 2007 AFLC: Moderator of Retirement Workshop: “What Every Lawyer Should Know About Dividing and Drawing Orders Which Divide Qualified Retirement Plans”
- 2007 Marriage Dissolution Course: “Employee Benefits – QDROs”
- 2007 & 2006 Small Business Seminar: “Avoiding Divorce Disasters”
- 2006 AFLC: “What Every Lawyer Should Know About Dividing and Drawing Orders Which Divide Qualified Retirement Plans”
- 2006 AFLC: “Some of that Retirement is Mine: The Current State of Qualified Retirement Plans (Defined Contribution & Defined Benefit)”
- 2006 Marriage Dissolution Course: “Drafting QDROs”
- 2006 TAFLS Trial Institute: “Litigating the Case: Children’s Issues”
- 2005 AFLC: “Avoiding the Equal Property Division: When Equitable Doesn’t Mean Equal”
- 2005 Family Law Council of Community Property States: “Economic Contribution and Reimbursement”
- 2004 AFLC: “Retirement: QDROs for Defined Benefit and Contribution Qualified Plans under ERISA”
- 2004 TAFLS Trial Institute: “Twenty-Five Essential Factors When Drafting or Reviewing QDROs”
- 2004 Family Law Council of Community Property States: “Business Valuation”
- 2003 Family Law Practice Seminar, University of Houston: “Retirement: QDROs for Qualified Plans under ERISA (including using QDROs for Child Support)”
- 2003 AFLC: “Retirement: QDROs for Qualified Plans under ERISA (including using QDROs for Child Support)”
- 2002 AFLC: “ERISA Retirement Plans: An Analysis of the New Texas Family Law Practice Manual QDRO Forms and QDRO Drafting Tips”
- 2001 AFLC: “Handling ERISA Retirement Plans: An Overview and Explanation of the Texas Family Law Practice Manual QDRO Forms and Drafting tips for Alternative Clauses”
- 2000 AFLC: “Retirement Plans: What to Do When No QDRO is Honored”
- 1999 Family Law Practice Seminar, University of Houston Law Center: “QDROs and Retirement Benefits”
- 1999 AFLC: Expert Witness Workshop
- 1998 AFLC: "Retirement Overview and a Walk Through the QDRO"
- 1998 Family Law Practice Seminar, University of Houston: "QDROs: What You Don't Know Can Hurt You"
- 1997 AFLC: "Retirement, Pensions and that Ugly Word...QDROs"
- 1996 Distinctive Lifestyles of Northeast Tarrant County: “New Alimony Law in Texas Adds Protection”, March/April 1996 edition
- 1995 AFLC: "QDROs and Checklists"

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Professional Activities

Director, Officer & President, Tarrant County Bar Association 2003-2010
Director, Officer & President, Tarrant County Family Law Bar Association 1998-2003
Director/Officer & President, Texas Academy of Family Law Specialists, 2003 to 2012
Member and Officer, Family Law Council, State Bar of Texas, 2004 to Present (currently Chair Elect)
Fellow, American Academy of Matrimonial Lawyers, 2005 to Present
Member/Fellow, College of the State Bar of Texas, 1999 to Present
Member, Tarrant County Young Lawyers Association, 1996 to 2002
Associate Member, Barrister & Officer, Eldon B. Mahon Inn of Court, 1997-98, 2001-2005, 2007-2008, 2010 to 2011.
Senior Counsel, American College of Barristers, 2001 to Present
Member and/or Chairperson, Fee Arbitration Committee, Tarrant County Bar Association, 2001 to 2005
Member, State Bar of Texas, Family Law Section Checklist Committee, 2002-2003, Amicus Committee, 2004-2008, Parenting Plan Committee 2005-2006, Membership Committee 2005-2009, Legislative Committee 2010-2011, Awards and Scholarships Committee 2010-2011, Budget & Finance Committee 2010-2011, Publications Committee 2010-2011, Section History Committee 2010-2011, Mentoring Committee 2010-2011
Fellow, Texas Bar Foundation 2002 to Present
Lifetime Fellow, Texas Family Law Bar Foundation 2004 to Present
Fellow, Tarrant County Bar Foundation 2004 to Present

Awards/Recognition

Friend of the Inn for outstanding contributions to Eldon B. Mahon Inn of Court, 2002
President's Certification of Outstanding Achievement from Tarrant Co. Bar Assoc., 2003
Texas Super Lawyer, Texas Monthly Magazine 2003 to Present
Who's Who in Executives and Professionals 2003
Top Attorneys featured in *Fort Worth, Texas Magazine* 2003 to Present
Top Fifty Female Attorneys in Texas, Texas Monthly Magazine 2004 to Present
Top Fifty Female Super Lawyers, Texas Monthly Magazine 2006 to Present
Top 100 Lawyers in Dallas Fort Worth, Texas Monthly Magazine 2006 to Present
The Best Lawyers In America 2007 to present
Top Women Lawyers, D Magazine, 2010

Law Related Seminar Publications & Participation

Author, *An Attorney Ad Litem Is Really A Lawyer*, Attorney Ad Litem Training Seminar 1997.
Author, *Trial Preparation & Planning*, "Nuts & Bolts" Protective Order Seminar 1997.
Author, *Challenging Characterization Issues: Characterizing Trusts, Employee Stock Options, Workman's Compensation Claims, And Intellectual Property*, Advanced Family Law Course 1997.
Author, *Some Changes In The Texas Family Code*, Blackstone Seminar 1998.

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Board Certified, Family Law — Texas Board of Legal Specialization
Super Lawyers Rising Star, 2012, 2013, 2014
Young Lawyer of the Year, 2010-2011, Collin County Young Lawyers Association
2010 Leadership Class, Dallas Association of Young Lawyers
Life Fellow, Dallas Association of Young Lawyers Foundation

RECENT PUBLICATIONS AND SPEECHES

SAPCR Overview – Presumptions, Burdens, Statutes, and Case Law, Advanced Family Law Course, State Bar of Texas (2014).
The Trial of a Family Law Jury Case, Advanced Family Law Course, State Bar of Texas (2014) (with John Nichols).
Social Media, Wiretapping, and Intercepted Evidence, Advanced Criminal Law Course, State Bar of Texas (2014).
Pro Bono Divorce Clinic, Dallas Volunteer Attorney Program (2014).
Real-World Evidence Traps, Texas A&M Law Clinic (2014).
Authenticating Social Media – Admissibility, 2014 Spring Judicial Education Session, Texas Assoc. of Counties, March 2014. PowerPoint
Handling Special Property Division Issues, Advanced Family Law Practice for Paralegals: Handling Financial Issues at a Higher Level, HalfMoon Education, February 2014.
Financial Issues and Same-Sex Marriage after U.S. v. Windsor, Advanced Family Law Practice for Paralegals: Handling Financial Issues at a Higher Level, HalfMoon Education, February 2014.
Illegal Evidence: Wiretapping, Hacking, and Data Interception Laws, Sex, Drugs & Surveillance Course, State Bar of Texas (2014).
Authenticating Social Media – Admissibility, Fall Judicial Education Session, Texas Judicial Academy (2013).
Property Issues in Divorce, How to do a Pro Bono Divorce, Texas Young Lawyers Association (2013).

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Director, Harvard Club of Dallas
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The Mental Health Privilege in Divorce and Custody Cases, Journal of the American Academy of Matrimonial Lawyers, Vol. 25, No. 2 (2013), co-author.
What Every Business Attorney Needs to Know About Family Law, Essentials of Business Law, State Bar of Texas (2013), co-author.
Representing Yourself in a Divorce, a Guide from the Dallas Bar Association, Dallas Volunteer Attorney Program (2013), co-author.
Electronic Evidence Cases Every Family Lawyer Should Know, Dallas County Bar Association, Dallas County Family Law Bench Bar (2013), co-author.
Social Media Evidentiary Issues, 2013 Winter Regional Conferences, Texas Center for the Judiciary (2013).
Non-Parent Custody, Dallas Volunteer Attorney Program, Dallas Bar Association, (2012).
Preparing Marital Settlement Agreements, Texas Family Law Practice for Paralegals, (2012).
Evidence Traps - Recordings, Intercepted Communications, and Other Illegal Evidence, Arlington Bar Association (2012).
Inventories and Internet Resources, Advanced Family Law Course, State Bar of Texas (2012) (with Rick Robertson and Reggie Hirsch).
Electronic Evidence, Texas Bar College Summer School, State Bar of Texas (2012).
Family Law Legislative and Case Update, Collin County Bench Bar Conference (2012), co-author.
Standing, for the Not-So-Nuclear Family, Innovations – Breaking Boundaries in Custody Litigation, The University of Texas School of Law CLE (2012), co-author.

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WHAT EVERY BUSINESS ATTORNEY NEEDS TO KNOW ABOUT FAMILY LAW

I. INTRODUCTION

This paper will help you advise business owners about the impacts of divorce and family law upon businesses. This is important not only for the business owner who may be facing divorce, but for his business partners as well, who may find themselves and their interests affected by the divorce litigation. With an understanding of how Texas divorce law impacts businesses, business agreements can be drafted to shield the business and its other owners from the impact of one owner's marriage and divorce.

II. COMMUNITY OR SEPARATE PROPERTY

One of the most important foundational issues for a business owner in divorce is how a court will characterize the spouses' property. This is critical since only community property may be divided by a divorce court.

A. Marital Estates

In general, the marital estates include Husband's separate estate, Wife's separate estate, and the community estate.¹

All property existing at the time of divorce is presumed by the court to be community property.² Separate property can include property owned before marriage or property acquired during marriage by gift, devise, or descent.³

If a spouse can prove that specific property is separate property, then the divorce court may not award that property to the other spouse.⁴ However, a divorce court has some powers to place liens on separate property to secure the claims of a spouse in a divorce case.⁵

It is important to be clear on what property is actually owned by a spouse. Since a partnership or corporation is a separate legal entity, partnership or corporation property is not subject to division in a divorce, but the spouse's shares or the partnership interest itself may be. For example, a corporation's earnings or surplus funds are not community property

income so long as they are retained by the corporation and not yet distributed to the shareholders.⁶

B. Inception of Title Doctrine

The inception of title doctrine holds that property is characterized as "separate" or "community" when a party first has the right of claim to the property, by virtue of which title is finally vested.⁷

Inception of title can begin before a spouse formally acquires title to an asset. For example, the character of a piece of real property is determined when the owner signs the earnest money contract, not when the closing actually occurs.⁸ So, if a spouse signs a contract to purchase a house before marriage, and the closing occurs after marriage, the doctrine of inception of title would make that house separate property.

The existence of a corporation or LLC commences when the filing of the certificate of formation takes effect.⁹ However, a spouse's ownership interest and property right in the corporation is comprised of the stock shares. A spouse's inception of title in the entity begins when the spouse acquires her shares. For example, if a spouse owned 200 shares before the marriage, and she acquired an additional 100 shares during the marriage, the first 200 shares would be her separate property, while the 100 shares acquired during marriage would ordinarily be community property, unless she could prove she acquired them by gift or inheritance.

To use a business example, consider a spouse who owned a sole proprietorship prior to marriage and incorporated it after marriage, continuing to operate from the same location and using the same business name. If the consideration provided to the corporation in exchange for stock was \$1,000.00, the owner will have to trace that initial \$1,000.00 to her separate property funds in order for the corporation to be considered her separate property, even though the name, location, asset assemblage, etc. remained intact from the proprietorship. If the business owner could prove that the tangible equipment, receivables, inventory, etc. of the proprietorship were contributed as consideration, she may have the ability to prove that the ownership interest in the corporation is

¹ TEX. FAM. CODE §3.001 – 3.003.

² Tex. Fam. Code § 3.003(a).

³ Tex. Fam. Code § 3.001.

⁴ See, e.g., *Cameron v. Cameron*, 641 S.W.2d 210, 213-14 (Tex. 1982).

⁵ Tex. Fam. Code § 3.406.

⁶ *Thomas v. Thomas*, 738 S.W.2d 342, 244 (Tex. App. – Houston [1st Dist.] 1987 writ denied) (retained earnings are a corporate asset); *Bryan v. Sturgis Nat'l Bank*, 90 S.W. 704, 705 (Tex. Civ. App. 1905 writ ref'd).

⁷ *Boyd v. Boyd*, 131 S.W.3d 605, 612 (Tex.App.-Fort Worth 2004, no pet.); *Smith v. Smith*, 22 S.W.3d 140, 145 (Tex.App.-Houston [14th Dist.] 2000, no pet.).

⁸ *Carter v. Carter*, 736 S.W.2d 775, 779 (Tex.App.—Houston [14th Dist.] 1987, no writ).

⁹ Tex. Bus. Orgs. § 3.001(c).

separate (or at least have a claim against the corporation for the separate value provided).

C. Clear and Convincing Evidence

The spouse claiming separate property has the burden of tracing it by clear and convincing evidence.¹⁰ Clear and convincing evidence is defined as that “measure or degree of proof that will produce in the mind of the trier of fact a firm belief or conviction as to the truth of the allegations sought to be established.”¹¹ This burden of proof falls somewhere between the preponderance standard of civil proceedings and the reasonable doubt standard of criminal proceedings. While the proof must weigh heavier than merely the greater weight of the credible evidence, there is no requirement that the evidence be unequivocal or undisputed.¹²

D. Mutation

Generally, the character of property is not altered by the sale, substitution, or exchange of the property; separate property that merely undergoes mutations or changes in the form remains separate property.¹³

In the context of family law, the term “mutation” is generally defined as a change in the form of separate property, which does not always alter the character of the property as separate.¹⁴ For example, if separate property funds are used to purchase a vehicle during marriage, the vehicle will still be separate property. However, mutations may make it difficult to overcome the community property presumption and prove the existence of separate property by clear and convincing evidence.

If a business entity was formed during marriage and the capital contribution was made from separate property, the owner spouse should argue that the interest acquired in the business was a “mutation” of that spouse’s separate property, and thus the business remains separate property.

The characterization of distributions from a separate property business can be an extremely complex and fact-dependent issue.

- **Example: Dividends.** Stock dividends are considered a mutation of the original stock, and retain the same character as the original stock.¹⁵ Cash dividends, however, are considered income, and cash dividends from separate property are community property.¹⁶ A distribution by a corporation to its shareholders may constitute a dividend in law even though it is not formally designated a dividend by the board of directors.¹⁷
- **Example: Liquidating Distributions.** Unlike a cash dividend, a liquidating distribution is a mutation of the underlying property, and retains the same character as the property. For example, when a spouse owns separate property stock in a dissolving corporation and receives distributions of liquidated assets, the distributions remain the stockholder’s separate property.¹⁸ Distributions received in exchange for the cancellation of stock upon the corporation’s dissolution retain the character of the stock.¹⁹
- **Example: Non-Liquidating Distributions.** Many practitioners believe that, since partnership property is owned by the entity not the partners, any non-liquidating distribution from a partnership must therefore be income and be community property. For example, if a separate-property partnership owns a piece of real estate, sells the real property, distributes the proceeds to the partners, but does not cease operating, there can be an extremely difficult battle upon divorce as to whether that distribution is separate or

¹⁰ Tex. Fam. Code § 3.003(b).

¹¹ TEX. FAM. CODE §101.007; *Transp. Ins. Co. v. Moriel*, 879 S.W.2d 10, 31 (Tex.1994); *See Estate of Hanau v. Hanau*, 730 S.W.2d 663, 667 (Tex.1987) (citing *Tarver v. Tarver*, 394 S.W.2d 780, 783 (Tex.1965)).

¹² *Boyd v. Boyd*, 131 S.W.3d 605 (Tex.App.-Fort Worth Mar 11, 2004) citing *In re G.M.*, 596 S.W.2d 846, 847 (Tex.1980); *State v. Addington*, 588 S.W.2d 569, 570 (Tex.1979); *In re D.T.*, 34 S.W.3d 625, 630 (Tex.App.-Fort Worth 2000, pet. denied) (op. on reh’g).

¹³ *Harris v. Harris*, 765 S.W.2d 798, 802 (Tex. App.—Houston [14th Dist.] 1989, writ denied).

¹⁴ *Norris v. Vaughan*, 152 Tex. 491, 496-97, 260 S.W.2d 676, 679 (1953).

¹⁵ *Tirado v. Tirado*, 357 S.W.2d 468, 473 (Tex. Civ.App.—Texarkana 1962, writ dismissed).

¹⁶ *Bakken v. Bakken*, 503 S.W.2d 315, 317 Tex. App. – Dallas 1973, no writ).

¹⁷ *Ramo, Inc. v. English*, 500 S.W.2d 461, 465 (Tex. 1973); *see also Morony v. Morony*, 286 S.W.167, 169-170 (Tex. Comm’n App. 1929, judgment adopted).

¹⁸ *Legrand-Brock v. Brock*, 246 S.W.3d 318, 321 (Tex. App.-Beaumont 2008, pet. denied) citing *Fuhrman v. Fuhrman*, 302 S.W.2d 205, 212 (Tex. App. –El Paso 1957, writ dismissed); *see also Wells v. Hiskett*, 288 S.W.2d 257, 265 (Tex. App. – Texarkana 1956, writ refused n.r.e.).

¹⁹ *Legrand-Brock v. Brock*, 246 S.W.3d 318, 321 (Tex. App.-Beaumont 2008, pet. denied) citing *Wells v. Hiskett*, 288 S.W.2d 257, 265 (Tex.Civ.App.-Texarkana 1956, writ refused n.r.e.).

community property. Cases including *Marshall*²⁰ and *Lifshutz*²¹ are often thought to support the principle that any non-liquidating distribution must be considered community property. However, a close reading of the cases can support the view that that was not the holding at all, or that the cases are limited to their facts. For more discussion of this extremely thorny and important area of family law, see James M. Wingate, *Transactions Involving Corporations and Partnerships: Characterization and Reimbursement Issues*, Adv. Fam. Law Course, State Bar of Texas (2013).

E. Tracing

Separate property can be traced throughout mutations by following an admissible paper trail from the time the spouse acquired the initial asset to the date of divorce.²² When tracing separate property, it is not enough to show that separate funds could have been the source of a subsequent transfer of funds.²³ Moreover, as a general rule, mere testimony that property was purchased with separate funds, without any tracing of the funds, is insufficient to rebut the community presumption.²⁴ Any doubt as to the character of property is resolved in favor of the community estate.²⁵

Application of characterization rules to business entities can become quite complicated. A business that is formed before a marriage may be the separate property of a spouse, but investment of community property in the business, or investment of time, toil, and effort during a marriage can lead to claims by the community estate against the separate property business.²⁶ As another example, if a business is created during the marriage with an investment of

separate property but also a loan, then the community estate may own an interest in the business.

Example: Husband sells stock in a corporation owned prior to marriage and simultaneously forms a new corporation that requires the contribution of \$1,000. Upon his divorce, Husband may be unable to prove that the specific dollars from the sale of the separate property corporation were used to acquire the stock of the newly formed corporation. In many instances, where individuals involved in a divorce assert a separate property claim upon the ownership interest of a closely held business, evidence of the initial consideration does not exist and perhaps stock certificates were never issued. These circumstances will cause significant amounts of additional work to prove up a separate property claim and may even render it impossible. Therefore, as soon as a business owner suspects divorce may be on the horizon, he should begin organizing and preserving all documentation about the formation of the business entity.

III. REIMBURSEMENT CLAIMS

Money moving between the community estate and the separate estate of either spouse can give rise to a complex divorce claim called “reimbursement.” For example, when community property funds are spent to improve one spouse’s separate property, that spouse may be obligated to reimburse the community estate out of his or her separate property at the time of divorce. A reimbursement claim is not a dollar-for-dollar accounting, but rather an equitable claim subject to offsets.²⁷ The claim is measured by the enhancement in value to the benefited estate.²⁸

Reimbursement has long existed as an equitable claim at common law. It has also been incorporated into the Texas Family Code. Statutory reimbursement claims include:²⁹

- 1) payment by one marital estate of the unsecured liabilities of another marital estate;
- 2) inadequate compensation for the time, toil, talent, and effort of a spouse by a business entity under the control and direction of that spouse;
- 3) the reduction of the principal amount of a debt secured by a lien on property owned before marriage, to the extent the debt existed at the time of marriage;

²⁰ *Marshall v. Marshall*, 735 S.W.2d 587 (Tex. App.—Dallas 1987, writ ref’d n.r.e.).

²¹ *Lifshutz v. Lifshutz*, 199 S.W.3d 9 (Tex. App.—San Antonio 2006, pet. denied)

²² *Ganesan v. Vallabhaneni*, 96 S.W.3d 345, 354 (Tex.App.-Austin 2002, pet. denied).

²³ *Latham v. Allison*, 560 S.W.2d 481, 484 (Tex.Civ.App.- Fort Worth 1977, writ ref’d n.r.e.).

²⁴ *Boyd v. Boyd*, 131 S.W.3d 605, 612 (Tex.App.-Fort Worth 2004, no pet.); *Zagorski v. Zagorski*, 116 S.W.3d 309, 316 (Tex.App.-Houston [14th Dist.] 2003, pet. denied) (op. on reh’g); *Bahr v. Kohr*, 980 S.W.2d 723, 728 (Tex.App.-San Antonio 1998, no pet.); *McElwee v. McElwee*, 911 S.W.2d 182, 188 (Tex.App.- Houston [1st Dist.] 1995, writ denied).

²⁵ *Akin v. Akin*, 649 S.W.2d 700, 703 (Tex.App.-Fort Worth 1983, writ ref’d n.r.e.).

²⁶ See, e.g., *Jensen v. Jensen*, 665 S.W.2d 107 (Tex. 1984).

²⁷ TEX. FAM. CODE § 3.402(b).

²⁸ TEX. FAM. CODE § 3.402(d).

²⁹ TEX. FAM. CODE § 3.402(a).

- 4) the reduction of the principal amount of a debt secured by a lien on property received by a spouse by gift, devise, or descent during a marriage, to the extent the debt existed at the time the property was received;
- 5) the reduction of the principal amount of that part of a debt, including a home equity loan:
 - a) incurred during a marriage;
 - b) secured by a lien on property; and
 - c) incurred for the acquisition of, or for capital improvements to, property;
- 6) the reduction of the principal amount of that part of a debt:
 - a) incurred during a marriage;
 - b) secured by a lien on property owned by a spouse;
 - c) for which the creditor agreed to look for repayment solely to the separate marital estate of the spouse on whose property the lien attached; and
 - d) incurred for the acquisition of, or for capital improvements to, property;
- 7) the refinancing of the principal amount described by Subdivisions (3)-(6), to the extent the refinancing reduces that principal amount in a manner described by the applicable subdivision;
- 8) capital improvements to property other than by incurring debt; and
- 9) the reduction by the community property estate of an unsecured debt incurred by the separate estate of one of the spouses.

Because reimbursement claims existed at common law, a court held the statutory list to be a non-exhaustive list.³⁰ Even if a claim doesn't fit precisely into one of the listed types of reimbursement claims, a party can still plead a claim under equity and the common law. However, certain potential claims for reimbursement have been removed by statute. A divorce court may not recognize a marital estate's claim for reimbursement for:

- a) the payment of child support, alimony, or spousal maintenance;
- b) the living expenses of a spouse or child of a spouse;
- c) contributions of property of a nominal value;

- d) the payment of a liability of a nominal amount; or
- e) a student loan owed by a spouse.³¹

A. Reimbursement Example

Many small businesses must rely on debt financing for working capital and capital expenditures. Typically, lenders will require some form of personal guaranty from the owner of the business to help secure the debt, since many small businesses are lacking in asset base. By executing a personal guaranty that is not limited to the separate estate of the guarantor, the business owner puts the community estate at risk in order to benefit the business. Therefore, the community may have a claim against the assets of a separate property business interest obtained with the guaranteed debt or even against the ownership interest itself.

Alternatively, separate property collateral may be offered as security for the debt of the community property business interest, giving a spouse's separate estate a claim against the community estate. The question becomes how to value such a claim, especially if the business entity services the debt and the guaranty was never relied upon by the lender. Is it limited to the amount of the debt that was guaranteed, or is it zero if the guaranty is essentially on a "stand-by" status? The facts and circumstances of the case are often the most important factor in making these determinations.

Another claim for reimbursement against a closely held business can arise as a result of the entity's status for federal income tax purposes. Partnerships, Limited Liability Companies, and S Corporations generally do not pay an entity-level tax. Rather, the net taxable income flows through directly to the shareholder's personal income tax return and tax is paid on the shareholder's share of the taxable income by the shareholder. Assume that in a given year, a separate property S corporation "passes through" \$100,000 of taxable income to the personal income tax return of Husband and Wife and the parties pay income tax at an effective rate of 25%. Therefore tax of \$25,000 is paid on that income. Assume further that the S corporation has limited cash and cannot make a distribution to the shareholders to pay the tax on that income, so it is (in tax parlance) "phantom income." If the community pays the tax, a claim for reimbursement may be generated in favor of the community estate against the separate estate of the S corporation owner. This same logic can work the other way as well. Assume the S Corporation generates losses that flow through and offset the tax liability on community income. Does that generate a

³⁰ *Nelson v. Nelson*, 193 S.W.3d 624, 632 (Tex.App.-Eastland 2006, no pet.)

³¹ TEX. FAM. CODE § 3.409.

claim on behalf of the separate estate? It should be understood that the current earnings of “pass through” entities typically are not marital property until actually distributed, and they would tend to be community at the time of distribution. If those distributions get reinvested in the entity for additional ownership interests, then the additional ownership interests would tend to be community.

B. *Jensen* Claim

Another type of reimbursement claim is created when the business owner has not taken full compensation for the actual time, toil, and effort he or she has expended to further the business. This forgone compensation (e.g. compensation for personal services or distributions of profit from the business) would have been community property income, and a spouse can bring a claim for it in a divorce. This type of claim is referred to as a *Jensen* claim, after its namesake case,³² and can be beneficial to a community estate when one spouse has valuable separate property.

For a *Jensen* claim to be successful, the spouse owning the separate property business must have direction and control over the business entity. He or she must be able to set his or her compensation, and control the timing and amount of other items of compensation, such as corporate dividends. A *Jensen* claim involves four prongs:

- 1) the value of the effort put forth by the business owner;
- 2) the increase in the value of the separate property as a result of the time and effort so expended;
- 3) the value of the business owner’s effort that would have been reasonably necessary to preserve and manage the separate property; and
- 4) the actual compensation received by the business owner.³³

If the owner of the separate property business interest is not paid full compensation but instead reinvests it into the business, the community may assert a reimbursement claim for the enhanced value of the separate property business interest. The claim will be limited to the second prong and will be measured by the value of the effort provided less the compensation received.

If the community was adequately compensated for the time spent to merely preserve the separate property and the increase in value was fortuitous, then a *Jensen* claim may be inapplicable. However, if the

increase in value was due to the sustained effort of the business owner but the community was compensated only for a “caretaker’s” level of effort, then the community may have a reimbursement claim for the amount of the enhanced value less the caretaker’s salary.

C. *Jensen* Example

Husband owns a separate property company. His salary remained constant at about \$50,000 per year for fifteen years, but the sales and profitability grew steadily until the company was grossing almost \$2 million annually. The lifestyle of Husband and Wife was modest. Additionally, the Husband owned the corporate facility and leased it to his corporation for an amount of rent that was under-market. The corporation (and the Husband) was aging at the time of divorce and was starting to scale back activities. Husband had no heir to pass the business along to and had no expansion plans. However, the corporation had accumulated almost \$1 million in cash. A portion of the cash resulted from the enhanced value due to the underpayment of salary and underpayment of rent. Both of these would have been community property income if distributed. A *Jensen* claim was computed and presented successfully at mediation for the amount of underpaid rent and salary, less the income taxes that would have been paid on that compensation. In that case, enforcing the *Jensen* claim was easier due to the excess cash retained inside the corporation.

A *Jensen* claim is extremely disruptive to a business in a divorce. The discovery, forensic accounting, tracing, and other litigation activities necessarily consume a lot of effort and the business itself may be joined as a party. Failing to avoid this potential divorce disaster could be devastating to the business owner. Therefore, don’t forget the existence of the *Jensen* claim when advising a business owner on how to structure compensation.

D. Usurpation of Opportunity

Business lawyers are familiar with the cause of action for “usurpation of corporate opportunity.” No direct parallel exists in family law. However, because spouses generally owe one another a fiduciary duty,³⁴ a divorce lawyer can assert a claim when a spouse made an investment using his or her separate estate and did not offer the opportunity to the community estate. It is possible for the community to assert reimbursement claims for “fraud on the community”

³² *Jensen v. Jensen*, 665 S.W.2d 107 (Tex. 1984).

³³ *Id.*

³⁴ *Loaiza v. Loaiza*, 130 S.W.3d 894 (Tex.App.-Fort Worth Mar 11, 2004), rehearing overruled (Apr 29, 2004) citing *Zieba v. Martin*, 928 S.W.2d 782, 789 (Tex.App.-Houston [14th Dist.] 1996, no writ) (op. on reh’g); *In re Marriage of Moore*, 890 S.W.2d 821, 827 (Tex.App.-Amarillo 1994, no writ).

against a separate estate in such an instance.³⁵ Forming a business venture with a spouse's separate money, rather than community money, can be seen as diverting an opportunity of the community. On the flip side, the use of community property money for a risky venture can also invite trouble in the form of a waste claim. Navigating these waters is tricky, and it is helpful to seek the advice of an experienced family law practitioner to avoid trouble.

IV. FIDUCIARY DUTY AND FRAUD ON THE COMMUNITY

A fiduciary relationship exists between husband and wife as to that community property controlled by each spouse.³⁶ Each spouse owns a one-half interest in all community funds regardless of which spouse has management and control.³⁷ Although a spouse has the right to dispose of community property under his or her control, he or she may not dispose of the spouse's interest in community funds if actual or constructive fraud exists.³⁸ A presumption of constructive fraud arises when a spouse unfairly disposes of the other spouse's one-half interest in community property.³⁹ The burden of proof is on the disposing spouse or the person to whom the property was transferred to prove the fairness of the transaction.⁴⁰

Constructive fraud is the breach of a legal or equitable duty which the law declares fraudulent because it violates a fiduciary relationship.⁴¹ Constructive fraud does not require the intent to defraud, instead it is an equitable doctrine employed by courts to rectify an injury resulting from the breach of a fiduciary relationship.⁴² A breach of the fiduciary relationship existing between spouses is termed "fraud on the community," a judicially created concept based

on the theory of constructive fraud.⁴³ Although not actually fraudulent, the conduct has the consequences and legal effects of actual fraud in that it tends to deceive the other spouse or violate confidences that exist as a result of the marriage.⁴⁴

In determining if a presumption of constructive fraud exists, the court will look at whether the community funds transferred were in reasonable proportion to the remaining community assets.⁴⁵ In considering a claim of constructive fraud, the court may consider three factors:

- 1) the size of the gift in relation to the total size of the community estate;
- 2) the adequacy of the remaining estate; and
- 3) the relationship of the donor to the donee.⁴⁶

If a spouse commits actual or constructive fraud by transferring community property, the other spouse may have claims against that spouse and the party to whom the funds were conveyed.⁴⁷ Without specific proof of fraudulent intent, Texas courts have set aside gifts of community funds as a constructive fraud on the other spouse if the gift is capricious, excessive or arbitrary.⁴⁸

Because a wronged spouse has an adequate remedy for fraud on the community through the just and right property division upon divorce, there is no independent tort cause of action between spouses for damages to the community estate.⁴⁹ If the spouse has depleted the community estate such that a disproportionate division will not make the wronged spouse whole, the court can reconstitute a theoretical estate that includes the transferred property, perform a disproportionate division of the reconstituted estate, and award the wronged spouse a judgment against the other spouse.⁵⁰

The fiduciary duty arising from the marriage relationship does not continue when a husband and

³⁵ *Loaiza* at 921 citing *Zieba*, 928 S.W.2d at 789; *Moore*, 890 S.W.2d at 827 and citing *Zieba*, 928 S.W.2d at 789; *Moore*, 890 S.W.2d at 827.

³⁶ *Brownson v. New*, 259 S.W.2d 277, 281 (Tex.Civ.App.—San Antonio 1953, writ dismissed).

³⁷ *Carnes v. Meador*, 533 S.W.2d 365, 371 (Tex.Civ.App.—Dallas 1975, writ refused n.r.e.).

³⁸ *Carnes v. Meador*, 533 S.W.2d 365, 370 (Tex.Civ.App.—Dallas 1975, writ refused n.r.e.).

³⁹ *Reaney v. Reaney*, 505 S.W.2d 338, 340 (Tex.Civ.App.—Dallas 1974, no writ).

⁴⁰ *Murphy v. Metropolitan Life Insurance Co.*, 498 S.W.2d 278, 282 (Tex.Civ.App.—Houston [14th Dist.] 1973, writ refused n.r.e.); *Davis v. Prudential Insurance Company of America*, 331 F.2d 346 (5th Cir. 1964).

⁴¹ *Archer v. Griffith*, 390 S.W.2d 735, 740 (Tex. 1964).

⁴² *Id.*

⁴³ *Zieba v. Martin*, 928 S.W.2d 782, 789 (Tex.App.—Houston [14th Dist.] 1996, no writ).

⁴⁴ *Id.*

⁴⁵ *Carnes v. Meador*, 533 S.W.2d 365, 371 (Tex.Civ.App.—Dallas 1975, writ refused n.r.e.).

⁴⁶ *Horlock v. Horlock*, 533 S.W.2d 52, 55 (Tex. Civ.App.—Houston [14th Dist.] 1976, writ dismissed w.o.j.).

⁴⁷ *Carnes v. Meador*, 533 S.W.2d 365, 371 (Tex.Civ.App.—Dallas 1975, writ refused n.r.e.).

⁴⁸ *Givens v. Girard Life Insurance Co.*, 480 S.W.2d 421 (Tex.Civ.App.—Dallas 1972, writ refused n.r.e.).

⁴⁹ *Schlueter v. Schlueter*, 975 S.W.2d 584, 585 (Tex. 1998).

⁵⁰ Tex. Fam. Code § 7.009.

wife each hire independent professional counsel to represent them in a contested divorce proceeding.⁵¹

V. VALUATION

The valuation of a closely-held business entity upon divorce is often the most important issue in the case, and the practitioner should understand basic business appraisal issues in the context of divorce. Valuation issues are also important when considering milestones in the business entity's life, such as admission of new owners, redemption of current owners, acquisition of new business entities, or sale to another entity. Each time the business is valued for any purpose, that value may be referenced in a later divorce.

A. The Valuation Process

The standard of value in divorce is "fair market value," or what a hypothetical, willing seller who is in possession of all available information will take for the business interest in an arms-length transaction from a buyer with the exact same attributes.

As with real estate appraisals, the three general approaches for a business appraisal are the income, asset and market approaches:

1. Income Approach

The income approach consists of determining a normalized economic benefit available to a hypothetical investor (not necessarily an employee-owner) and determining the market value of that income stream by choosing an appropriate risk-based rate of return. A difficulty in this approach is determining what a normalized return for the subject business is. The credibility of the testifying expert is key with this approach because of the number of assumptions and adjustments that go into the final value.

2. Asset Approach

The asset approach measures the assets currently used or owned by the business and may require each individual asset to be valued. The business appraiser may be faced with the need to appraise hard assets, such as machinery, equipment, or real estate. In such a case, a separate appraiser with specific expertise and qualifications may have to be found.

3. Market Approach

The market approach consists of determining what similar businesses have sold for in the private market or how the public securities market values

similar companies. For small or closely-held businesses, it can be difficult to find comparable transactions.

4. Key Factors in Business Appraisals

Key factors to consider in the appraisal of a business have been outlined succinctly by the Internal Revenue Service in forty-year old Revenue Ruling 59-60:

- a) The nature of the business and the history of the enterprise from inception;
- b) The current economic outlook in general and the condition and outlook of the particular industry in general;
- c) The book value of the stock and the financial condition of the business;
- d) The earning capacity of the company;
- e) The dividend paying capacity of the company;
- f) Whether or not the enterprise has goodwill or other intangible value;
- g) Sales of the stock and the size of the block of stock to be valued;
- h) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over the counter.

5. Example

A fairly recent case dealt with business valuation issues in divorce.⁵² At trial, Wife's expert valued husband's medical practice at \$780,000. Husband's expert testified that the fair market value was \$359,000. Husband testified that the value of the practice should be no more than \$150,000. The court made a disproportionate division in favor of wife, based on her expert's value. Husband appealed, complaining of deficiencies in the expert's valuation, including her failure to compare Husband's rural medical practice to other rural practices in central Texas; her failure to visit Husband's medical practice, interview his staff, or examine his equipment; her erroneous classification of his practice as a "specialty medical practice," instead of a "general physician" office; and, most importantly, her failure to consider or factor in the losses and expenses of the imaging center. On appeal, the court stated two important holdings:

- a) The trial court is the sole judge of the witnesses' credibility and the weight to be

⁵¹ *Boyd v. Boyd*, 67 S.W.3d 398, 405 (Tex.App.-Fort Worth 2002, no pet.); *Parker v. Parker*, 897 S.W.2d 918, 924 (Tex.App.-Fort Worth 1995, writ denied).

⁵² *Gupta v. Gupta*, No. 03-09-00018-CV, 2010 WL 2540487 (Tex.App.—Austin 2010, no pet. h.) (mem. op.).

given their testimony. Therefore, the trial court was free to accept or reject the testimony of each expert in whole or in part and to resolve any inconsistencies in the testimony.

- b) In a divorce proceeding, the ultimate and controlling issue is whether the trial court divided the property in a "just and right manner" pursuant to the family code. How the trial court valued specific property is not an ultimate issue. One who complains of the way the trial court divided the community property must be able to show from the evidence in the record that the *overall division* is so unjust and unfair as to constitute an abuse of discretion.

B. Intangible Assets and Goodwill

Most closely-held businesses do not have any provision in their financial statements to capture the intangible value that they possess. However, the value of intangible assets must be calculated for a divorce valuation. Intangible assets can generally be placed in one of two categories.

1. Specifically Identifiable

The first category of intangible assets includes specifically-identifiable intangible assets such as patents, trademarks, trade names or trade dress, secret processes, formulas, etc. This category of intangible assets includes those that can be severed from the business and sold as a separate bundle of rights. Occasionally, a business may have the cost of the assets recorded, but the asset is often not carried at its current value.

2. Goodwill

The other category of intangible is generally known as "goodwill." Goodwill has been defined as:

[t]he advantage or benefit which is acquired by an establishment beyond the mere value of the capital stock, funds or property employed therein, in consequence of the general public patronage and encouragement which it receives from the constant and habitual customers on account of its local position, or common celebrity, or reputation for skill, or influence, or punctuality, or from other accidental circumstances or necessities, or even from ancient partialities or prejudices.⁵³

In other words, it is the intangible reputation of the business that allows it to get or retain customers in a unique way.

In divorce cases, there is a further distinction between "personal" goodwill and "professional" / "commercial" goodwill. Personal goodwill arises out of a party's personal or professional ability and reputation, and it relates to that party's future income. It is considered separate property in divorce, and should not be included in the valuation of a business for divorce purposes. Indicators of the value of personal goodwill include covenants not to compete, key man life insurance policies, and perhaps excess compensation.

Professional or commercial goodwill is not dependent on the personal qualities of the spouse, and so it is divisible upon divorce.

An example illustrating the difference would be to compare a McDonalds franchise, which gets customers regardless of the identity of an individual owner, and a solo law practice, which gets customers almost entirely based on the owner's personal skill and reputation.

Goodwill in a professional business is not considered part of the marital estate unless it exists independently of the professional's skills, and the estate is otherwise entitled to share in the asset.⁵⁴ There is a two-pronged test to determine whether the goodwill attached to a professional practice is subject to division upon divorce.⁵⁵ First, goodwill must be determined to exist independently of the personal ability of the professional spouse. Second, if such goodwill is found to exist, then it must be determined whether that goodwill has a commercial value in which the community estate is entitled to share.

When appraising a business for the purpose of divorce, the appraiser must be prepared to identify any goodwill of the company, and then allocate it between personal and commercial goodwill.

A unique feature of divorce valuations is that the valuation cannot assume a non-compete agreement. The business has to be valued as if the current owner could open an office next door and compete.

VI. EMPLOYEE SPOUSE

Commonly, both spouses work in the business and earn their living exclusively from the business. It would be unusual for them to want to continue to work together following the divorce. Because at least one spouse will have to find new employment during

⁵⁴ *Guzman v. Guzman*, 827 S.W.2d 445, 447 (Tex.App.—Corpus Christi 1992, writ denied); *Hirsch v. Hirsch*, 770 S.W.2d 924, 927 (Tex.App.—El Paso 1989, no writ).

⁵⁵ *Finn v. Finn*, 658 S.W.2d 735, 740-41 (Tex. App.—Dallas 1983, writ ref'd nre.).

⁵³ *Peat Marwick Main & Co. v. Haass*, 818 S.W.2d 381, 389 (Tex. 1991).

or after the divorce, this arrangement can cause unique problems in trying to resolve the divorce.

A. Supporting the Spouse Who Physically Leaves the Business

When a divorce ensues, one spouse usually wants to leave the business because it can be difficult to work together during such a stressful and emotional time. The spouse who leaves the business will need to maintain his or her income. An attorney should advise a client that the divorce court will likely try to ensure that the spouse leaving the business will be allowed to continue receiving comparable support during the divorce process.

B. Both Spouses Stay in the Business

If both spouses are crucial to the business's function, it may be possible for both spouses to continue to work in the business, but this is generally not advisable. With so much conflict and emotion, the workplace can become quite dysfunctional and non-productive in a short time, with both spouses present. Indeed, it is not unheard of for one spouse to intentionally drive the business into the ground for no other reason than the sheer emotional anger that often accompanies a divorce.

C. Receivership

Whether both spouses work in a business, the business attorney should advise the client that, at the time of divorce, either party can apply to the court for a receiver to run the business during the divorce or for an auditor to be appointed. In a civil case, there are legal requirements for the appointment of a receiver, but in a divorce case, the appointment of a receiver is entirely within the court's discretion. An appointed receiver will decide the money to be paid to each spouse and whether either or both will be allowed to work in the business. If an auditor is appointed, the business attorney should advise her client that the auditor will audit the business books. The spouse continuing to run the business should therefore always run the business honestly and in a legitimate manner.

D. (Often Undeclared) Cash

Last, the accounting of "cash" is always an issue when divorce ensues. If the spouses have previously used cash from the business, this will become an issue at the time of divorce. The spouse who is leaving the business or who is not involved in the business will want their "fair share" of the cash on a temporary basis and at the final division.

In the context of undeclared cash, business owners need to make sure their lifestyle does not contradict their stated income when they make arguments to a divorce court. For example, business owners will sometimes assert that the declared income

on their tax return is all they have to live on, in order to avoid providing support. Most divorce lawyers are experienced in challenging such claims by simply showing that the parties' lifestyle well exceeds the income declared on tax returns. If your client's mortgage payment exceeds his income, he or she will have some explaining to do.

VII. TEMPORARY SUPPORT

In the world of a civil litigator, temporary injunctions may be rare and difficult to obtain. In family law, temporary orders are commonly issued by a divorce court to provide interim relief for the spouses during the pendency of a divorce.⁵⁶ These interim orders can maintain the family, protect the community estate, and provide for the welfare of a financially-dependent spouse while the divorce is pending. The amount of support is determined based upon inability of the applicant to pay for his or her necessities during the pendency of the suit, and the ability of the other spouse to pay. Temporary support is not a property right, and is only meant to pay for necessary expenses--not to equalize the standard of living for each party pending a final division or to be an interim division of the property. Upon final division of property in divorce, the equities of the parties and final adjustments for any amount of temporary support paid may be taken into consideration in making a just and right division of the marital estate.⁵⁷

VIII. CHOICE OF ENTITY

A. Introduction

There are extreme differences in how partnership property, the shares of a corporation, or a sole proprietorship are divided in divorce. Divorce should always be a consideration when advising a client on the choice of entity. For example, partnership property belongs to the partnership. The only property that can be divided between the parties in a divorce is the partnership interest itself. Therefore, under the current state of the law, the money and assets in a partnership will remain in the partnership upon divorce. Further a corporation is protected by the corporate shell, which generally can only be pierced in extreme circumstances. In the context of divorce, this is referred to as "reverse piercing." The least protected is the sole-proprietorship, the value of which is fully-divisible in divorce.

⁵⁶ TEX. FAM. CODE §6.502.

⁵⁷ *Herschberg v. Herschberg*, 994 S.W.2d 273 (Tex.App.-Corpus Christi 1999, no pet.).

B. Partnerships

A partnership interest may be community property under the rules of characterization.⁵⁸ However, partnership property is owned by the partnership entity and not the individual partners.⁵⁹ Thus, neither spouse nor the community estate has a direct interest in partnership property.⁶⁰ Although no partner owns specific partnership property, each owns an undivided interest in partnership property.⁶¹ The partnership interest itself is the only partnership-related property that can be characterized as separate or community and divided in a divorce.⁶²

A partner's rights to participate in the management and business of the partnership are personal to the partner and thus are not community property.⁶³

Importantly, distributions of a partner's share of profits and surplus (income) are community property even if the partner's partnership interest is separate property.⁶⁴ Therefore, if a spouse contributes separate property to a partnership and receives distributions, that spouse has effectively converted the separate-property contribution into community property income. Until distributed, however, partnership earnings are partnership property and thus not subject to characterization as community or separate property.⁶⁵

Upon divorce, the spouse of the partner is regarded for purposes of the TEXAS REVISED PARTNERSHIP ACT as a "transferee" of the partnership

interest.⁶⁶ Though a spouse's partnership interest may be community property, actual division of the partnership interest upon divorce is often avoided by divorce courts, who possess considerable discretion in dividing the community estate.⁶⁷ Thus, a partnership interest that is community property is usually awarded to the partner spouse and other community property is awarded to the non-partner spouse to achieve a fair and equitable division.⁶⁸

The transfer of a partnership interest does not itself require a winding up of the partnership.⁶⁹ A person who is a transferee of a partnership interest is entitled:

- 1) to receive, to the extent of the interest transferred, distributions to which the transferor would otherwise be entitled,
- 2) to require reasonable information on account of partnership transactions,
- 3) to make reasonable inspection of the partnership books for any proper purpose, and
- 4) in a winding up, to receive, to the extent transferred, the net amount otherwise distributable to the transferor.⁷⁰

However, a transferee is not entitled to participate in the management or conduct of the partnership business.⁷¹

C. Limited Liability Company (LLC)

A membership interest in a limited liability company can be community property.⁷² However, as with partnerships, LLC property is owned by the entity and not the members – therefore, property of the company is not separate or community, and a

⁵⁸ VERNON'S ANN. CIV. ST. art. 6132b-5.02(a); V.T.C.A., BUS. ORG. CODE § 154.001(a) and (b).

⁵⁹ VERNONS ANN. CIV. ST. (TUPA) ART. 6132b §5.01.

⁶⁰ VERNONS ANN. CIV. ST. (TUPA) ART. 6132b §2.04.

⁶¹ *Biggs v. First Nat. Bank of Lubbock*, 808 S.W.2d 232 (Tex. App. – El Paso 1991, writ denied).

⁶² See *McKnight v. McKnight*, 543 S.W.2d 863 (Tex.1976); *Lifshutz v. Lifshutz*, 61 S.W.3d 511 (Tex.App.--San Antonio 2001, pet. denied); *Cleaver v. Cleaver*, 935 S.W.2d 491 (Tex.App.--Tyler 1996, no writ); *Harris v. Harris*, 765 S.W.2d 798 (Tex.App.--Houston [14th Dist.] 1989, writ denied); *Marshall v. Marshall*, 735 S.W.2d 587 (Tex.App.--Dallas 1987, writ ref'd n.r.e.).

⁶³ VERNON'S ANN. CIV. ST. art. 6132b-4.01(d). V.T.C.A., BUS. ORG. CODE § 152.203(a).

⁶⁴ See *Harris v. Harris*, 765 S.W.2d 798 (Tex.App.--Houston [14th Dist.] 1989, writ denied); *Marshall v. Marshall*, 735 S.W.2d 587 (Tex.App.-- Dallas 1987, writ ref'd n.r.e.).

⁶⁵ *Cleaver v. Cleaver*, 935 S.W.2d 491 (Tex.App.--Tyler 1996, no writ).

⁶⁶ VERNON'S ANN. CIV. ST. art. 6132b-5.04(a), (b), and (c).

⁶⁷ V.T.C.A., Family Code § 7.001.

⁶⁸ See, e.g., *Gaines v. Gaines*, 519 S.W.2d 694 (Tex.App.-- Houston [1st Dist.] 1975, writ ref'd n.r.e.); *Cortez v. Corsi*, 513 S.W.2d 648 (Tex.App.--Corpus Christi 1974, writ ref'd n.r.e.); cf. *Bell v. Bell*, 513 S.W.2d 20 (Tex.1974); V.T.C.A., BUS. ORG. CODE § 152.406(a)(1), (2), and (3).

⁶⁹ VERNON'S ANN CIV. ST. art. 6132b-5.03(a)(3); V.T.C.A., BUS. ORG. CODE § 152.402(2).

⁷⁰ VERNON'S ANN. CIV. ST. art. 6132b-5.03(b), (c).

⁷¹ VERNON'S ANN. CIV. ST. art. 6132b-5.03(a)(4); V.T.C.A., BUS. ORG. CODE § 152.402(3).

⁷² Tex. Bus. Orgs. § 101.106(a-1).

spouse cannot have a direct ownership interest in company property.⁷³

In a divorce, a non-owner spouse cannot become a member of the LLC solely by reason of the divorce. The membership interest is divisible as part of the community estate, but the non-owner spouse becomes an “assignee” of the interest, not a member.⁷⁴ An assignee only becomes a member on the approval of all the company’s members.⁷⁵

An assignee is not entitled to participate in the management and affairs of the company, become a member of the company, or exercise any rights of a member of the company.⁷⁶ An assignee of a membership interest in a limited liability company is also not liable as a member of the company.⁷⁷ A person who is assigned a membership interest in a limited liability company is entitled to:

- 1) receive any allocation of income, gain, loss, deduction, credit, or a similar item that the assignor is entitled to receive to the extent the allocation of the item is assigned;
- 2) receive any distribution the assignor is entitled to receive to the extent the distribution is assigned;
- 3) require, for any proper purpose, reasonable information or a reasonable account of the transactions of the company; and
- 4) make, for any proper purpose, reasonable inspections of the books and records of the company.⁷⁸

Since the assignee lacks control, an assignee can be in the position of incurring tax liabilities relating to the LLC without receiving any income from the LLC.

D. Corporate Alter Ego

The doctrine of alter ego, in a traditional business context, allows the trial court to set aside the corporate structure of a company, or “pierce the corporate veil,” to hold individual shareholders liable for corporate debt.⁷⁹ Traditionally, alter ego has two elements:

- 1) “such unity between corporation and individual that the separateness of the corporation has ceased,” and
- 2) a finding that “holding only the corporation liable would result in injustice.”⁸⁰

Piercing the corporate veil in a divorce case allows the divorce court to characterize assets in a spouse’s corporation as community property corporate assets that would otherwise be the separate property of one spouse.⁸¹ Alter ego and piercing is an equitable remedy separate and apart from the rule of reimbursement, discussed above, under which the community estate may be entitled to compensation for the time, talent, and toil of a spouse spent enhancing the value of a separate property corporation.

E. Reverse Piercing

Unlike traditional piercing in which the stockholder is held liable for debts of the corporation, piercing in the divorce context allows the trial court to move assets out of the corporation and divide them between spouses as part of the shareholder’s community estate.⁸² This is sometimes referred to as “reverse piercing.”

To properly pierce the corporate structure in a divorce case, the trial court must find something more than mere dominance of the corporation by the spouse.⁸³ At minimum, a finding of alter ego sufficient to justify piercing in the divorce context requires the trial court to find:

- 1) unity between the separate property corporation and the spouse such that the separateness of the corporation has ceased to exist, and
- 2) the spouse’s improper use of the corporation damaged the community estate beyond that which might be remedied by a claim for reimbursement.⁸⁴

Veil piercing theories do not apply to limited partnerships. The 2013 *Peterson* case held that Texas courts have uniformly declined to apply the alter-ego theory to pierce a limited partnership’s veil to impose

⁷³ See Tex. Bus. Orgs. § 101.106(b).

⁷⁴ See Tex. Bus. Orgs. § 101.1115(a)(1).

⁷⁵ Tex. Bus. Orgs. § 101.109(b).

⁷⁶ Tex. Bus. Orgs. § 101.108(b)(2).

⁷⁷ Tex. Bus. Orgs. § 101.109(c).

⁷⁸ Tex. Bus. Orgs. § 101.109(a).

⁷⁹ *Lifshutz v. Lifshutz*, 61 S.W.3d 511 (Tex.App.-San Antonio Jul 25, 2001), rehearing overruled (Aug 29, 2001), review denied (Dec 13, 2001), rehearing of petition for review denied (Jan 31, 2002) citing *Castleberry v. Branscum*, 721 S.W.2d 270, 271-72 (Tex.1986).

⁸⁰ *Id.* at 516 citing *Castleberry* at 272.

⁸¹ *Id.* citing *Zisblatt v. Zisblatt*, 693 S.W.2d 944, 949 (Tex.App.-Fort Worth 1985, writ dismissed); accord *Vallone v. Vallone*, 644 S.W.2d 455, 458 (Tex.1982).

⁸² *Id.* citing *Zisblatt* at 955.

⁸³ *Id.* citing *Goetz v. Goetz*, 567 S.W.2d 892, 896 (Tex.App.-Dallas 1976, no writ).

⁸⁴ *Id.*

the entity's liabilities on a limited partner.⁸⁵); The well-known *Lifshutz* case also concluded that piercing was not appropriate for a partnership interest under the Texas Revised Partnership Act, based on the clear legislative intent as followed by the Texas Supreme Court to the effect that a partner's spouse has no community property right in partnership property.⁸⁶

F. Change of Entity - Example

A 2010 Texas Supreme Court case was primarily a breach of contract case, but it does illustrate several of the issues involved with dividing a business interest in divorce.⁸⁷ Husband agreed to pay Wife \$22 million in a divorce settlement. As collateral, husband pledged 70% of the outstanding shares in two of his corporations. Husband and Wife entered into a security agreement giving Wife a security interest in husband's stock including all replacements, additions, and substitutions. For tax purposes, Husband later converted each corporation to a limited partnership and exchanged the corporate shares for units of the limited partnership. Wife sued Husband, arguing that his cancellation of the shares was a material breach that accelerated the remaining debt payments. The supreme court held that whether a party breached a contract was a question of law for the court when the facts were conclusively established. The court held that, although the corporate shares ceased to exist, because Wife's security agreement gave her a collateral interest in substitutions, Husband's actions had not destroyed her collateral. The court held that Husband had not breached the agreement as a matter of law.

IX. TAXES

A. Introduction

The tax effect of a property division is explicitly a factor the court may consider in dividing property upon divorce.⁸⁸ When dividing the marital estate, the divorce court may consider whether a specific asset will be subject to taxation and when such tax must be paid.⁸⁹

B. Analysis of Tax Effects

The family code allows the court to consider tax consequences, but does not require the court to do so. Attorneys can make arguments based on:

- 1) the nature of the tax (e.g. capital gain, tax on ordinary income, additional tax imposed as a result of early withdrawal);
- 2) the tax rate to be applied (e.g., future tax rates anticipated at retirement or the tax rates on the date of divorce);
- 3) whether the court is entitled to use tax rate assumptions based upon expert testimony that differ from current rates;
- 4) when the tax will be imposed;
- 5) in light of graduated tax rates, what assumptions should the court make with respect to the recipient's income at the time the asset is "realized";
- 6) whether the timing of tax consequences should be taken into consideration in the circumstance where one spouse may need to access and use funds much sooner than the other spouse.

An attorney should be aware of these arguments, and more, when requesting the court take into account the tax effects of a particular property division.

It is imperative to have an expert calculate the tax implications. For example, consider a loan from a defined contribution retirement plan—if an employee defaults on the loan, the unpaid amounts are treated as a distribution to the employee in the year of default and are taxed at the defaulting employee's rate at the time of the distribution. This is important to address if the divorce may cause one spouse to default on such a loan.

Family law practitioners generally agree that the court would probably not be required to make specific findings with respect to the tax consequences it uses in rendering a decision. The tax consequences are another factor which the court may consider in making a just and right division of the community estate.

C. Joint Liability

Another tax issue that can affect small business owners in divorce is one spouse's liability for the other's personal or business tax filings. Although a divorce court can apportion responsibility for tax liabilities between spouses, this does not bind the IRS. If the IRS uncovers a past tax liability from when the parties were married, it can go after either spouse for satisfaction of the arrearage. A spouse can always attempt to recover monies they paid for debts awarded to their ex, especially if the divorce decree was agreed and may be enforced as a contract, but that option is only as good as the former spouse's ability to pay. If the IRS is unable to recover from that spouse, the wronged spouse may be without remedy as well.

This can be an important consideration if a lawyer represents the non-business-owner spouse who

⁸⁵ *Peterson Grp., Inc. v. PLTQ Lotus Grp., L.P.*, 417 S.W.3d46, 58 (Tex. App.—Houston 2013, pet. filed).

⁸⁶ *Lifshutz v. Lifshutz*, 61 S.W.3d 511 (Tex. App.—San Antonio 2001, pet. denied).

⁸⁷ *Grohman v. Kahlig*, 318 S.W.3d 882 (Tex. 2010).

⁸⁸ V.T.C.A., Family Code § 7.008.

⁸⁹ *Id.*

thinks there might be tax liabilities flowing from a business the other spouse owns.

X. PRE- OR POST-MARITAL CONTRACTS

One of the clearest ways to protect a business is to set out the rights of the spouses in a marital contract. A pre- or post-marital contract can override the normal rules of a divorce. It is vital for a business attorney to have knowledge of the existence and scope of marital contracts, since such contracts affect the character of the property addressed by the contract, including a business entity or even funds used to capitalize a business entity. The Legislature has decided that public policy favors the enforcement of premarital and marital agreements.⁹⁰ Such agreements are presumed to be enforceable, and the party challenging the agreement has the burden to prove that the agreement is unenforceable.⁹¹

It is important to remember that, in Texas, one lawyer may not ethically represent two opposing parties. Similarly, when drafting a marital agreement, one lawyer cannot represent both parties. It is important that a lawyer, in drafting a marital agreement, not lead the other party to believe that the lawyer represents his or her interests too. This can potentially be grounds for challenging the agreement.⁹²

A. Pre-Marital Agreements

The UNIFORM PREMARITAL AGREEMENT ACT⁹³ contained within the TEXAS FAMILY CODE provides some of the items upon which parties to a premarital contract may agree. Premarital contracts, if done correctly, can be an excellent method to avoid potential divorce disasters for small businesses. The agreements can govern:

- 1) The rights and obligations of each of the parties in any of the property of either or both of them whenever and wherever acquired or located;
- 2) The right to buy, sell, use, transfer, exchange, abandon, lease, consume, expend, assign, create a security interest in, mortgage, encumber, dispose of, or otherwise manage a controlled property;

⁹⁰ See *Beck v. Beck*, 814 S.W.2d 745, 749 (Tex. 1991).

⁹¹ *Marsh v. Marsh*, 949 S.W.2d 734, 739 (Tex.App.-Houston [14th Dist.] 1997, no writ).

⁹² The following case contains many problems leading to a challenge to the enforceability of a premarital agreement: *Moore v. Moore*, No. 05-10-00498-CV (Tex.App.—Dallas Jul. 3, 2012).

⁹³ TEX. FAM. CODE Chapter 4, Subchapter A.

- 3) The disposition of property on separation, marital dissolution, death, or the occurrence or non-occurrence of any other event;
4. The modification or elimination of spousal support;
- 5) The making of a will, trust, or other arrangement to carry out the provisions of the agreement;
- 6) The ownership rights in and disposition of the death benefit from a life insurance policy;
- 7) The choice of law governing the construction of the agreement; and
- 8) Any other matter including their personal rights and obligations, not in violation of public policy or a statute imposing a criminal penalty.⁹⁴

A premarital agreement may address income from a business, ownership of the business, increases in value, property that is retained within the business or distributed from the business, as well as the time, effort, and money that the owner spouse has put into the business. For example, a divorcing spouse may allege a reimbursement claim – that community property funds were spent on the business, and therefore a debt was created to the community. Such reimbursement claims can be a headache for a business if the business has to comply with invasive discovery requests or if the business itself becomes a party to the divorce. Such reimbursement claims can be defined or eliminated entirely by a marital agreement.

The drafting of these agreements has become a highly technical and specialized skill, and the agreements are enforceable only if prepared in the proper manner and under the proper circumstances.⁹⁵ Since there can be huge exposure if the agreement is found unenforceable or legally deficient, it is important to have any relevant agreements examined by an experienced family law attorney as soon as possible.

B. Post-Marital Agreements

If a business already exists, and owner spouses are already part of the picture, then post-marital agreements can be used to define the rights and obligations of owners' spouses. The TEXAS FAMILY CODE allows parties to enter into three types of post-marital agreements:⁹⁶

⁹⁴ TEX. FAM. CODE §4.003(a).

⁹⁵ TEX. FAM. CODE §4.006.

⁹⁶ TEX. FAM. CODE Chapter 4, Subchapter B.

1. Partition and Exchange Agreements

Spouses may partition or exchange between themselves all or part of their community property, including interests in a small business. Property or a property interest transferred to a spouse by a partition or exchange agreement is that spouse's separate property. The partition and exchange agreement may additionally provide that future earnings and income arising from the property also remain the separate property of the owning spouse.⁹⁷ A postmarital agreement may be used to define a spouse's rights to the shares of a business, the income from a business, funds used to capitalize a business, as well as ownership or voting of shares post-divorce.

2. Agreements Concerning Income from Separate Property

Many spouses do not realize that income from separate property, including a separate property business, is community property.⁹⁸ As a result, businesses can become involved in divorce litigation over business income, especially if a spouse alleges that income was not properly distributed from the business during the marriage. A post-marital agreement concerning income from separate property can be an excellent way to avoid this potential divorce disaster.⁹⁹

This agreement must be in writing and signed by both parties¹⁰⁰, and may be unenforceable if certain circumstances are proven.¹⁰¹ An equivalent term may also be incorporated into a pre-marital agreement.

3. Agreement to Convert to Community Property

Agreements to convert separate property to community property also exist, though they are rare.¹⁰² This type of agreement is also sometimes referred to as a "transmutation agreement." Although consideration is not a requirement,¹⁰³ certain formalities specific to this type of agreement are required.¹⁰⁴

Merely transferring separate property into joint names or the other spouse's name is not sufficient to

convert it to community property.¹⁰⁵ It might instead be construed as a gift to that spouse as his or her own separate property.¹⁰⁶

All three types of post-marital agreements involve detailed analysis of whether they comply with specific statutory requirements. It is important that any such agreement be examined by an attorney familiar with marital contracts.

4. Complex Estate Planning

Business owners often invest in thorough and complex tax and estate planning, but neglect to do detailed divorce-planning. An estate plan, for tax purposes, may involve post-marital agreements. If the agreement is not prepared by a family law specialist, there can be devastating effects in the event of a divorce. Although an agreement may benefit a couple for tax purposes, it is important for any attorney representing a business owner to consider the consequences in the event of a divorce. Specifically, transferring ownership of property between the parties, trusts, partnerships, etc., can have the unwanted effect of transforming separate property into community property, or creating a discovery and forensic accounting nightmare at the time of divorce.

C. Buy-Sell Agreements

A company's buy-sell agreement or shareholder agreement can help business owners at the time of a divorce. These agreements define the procedure for any change of ownership, and they can specify what happens upon divorce. Most business owners do not want to continue in business with an owner's former spouse after a divorce. A buy-sell agreement or shareholder agreement can prevent the ownership interest from being awarded to the non-owner spouse in a divorce. For example, an agreement can give the original owners a right of first refusal to purchase the interest before it can be transferred to a spouse. The agreement can also specify how that price is determined.

A recent Texas case upheld a buy-sell agreement pricing Husband's business interest at \$11,000 when the fair market value was calculated by Wife's expert to be between \$800,000 and \$1,100,000.¹⁰⁷ During the marriage, Husband entered into a business association. The association required Husband and Wife to sign a shareholder's agreement that stated that, in the event of a divorce, the shareholder shall purchase all of his

⁹⁷ TEX. FAM. CODE §4.102.

⁹⁸ *Lucy v. Lucy*, 162 S.W.3d 770, 776 (Tex.App.-El Paso Apr 12, 2005) citing *See* TEX.FAM.CODE ANN. § 3.002 (Vernon 1998); *In re Marriage of Louis*, 911 S.W.2d 495, 497 (Tex.App.-Texarkana 1995, no writ).

⁹⁹ TEX. FAM. CODE §4.103.

¹⁰⁰ TEX. FAM. CODE §4.104.

¹⁰¹ TEX. FAM. CODE §4.105(a)(1).

¹⁰² TEX. FAM. CODE §4.202.

¹⁰³ TEX. FAM. CODE §4.203(a)(2).

¹⁰⁴ TEX. FAM. CODE §4.203(a)(1)(A)-(C).

¹⁰⁵ TEX. FAM. CODE §4.203(b).

¹⁰⁶ TEX. FAM. CODE §3.001(2); and see *In re Marriage of Thurmond*, 888 S.W.2d 269, 275 (Tex.App.--Amarillo 1994, writ denied).

¹⁰⁷ *Mandell v. Mandell*, 310 S.W.3d 531 (Tex.App.--Fort Worth 2010, pet. denied).

stock back from his former spouse at \$0.50 per share within 180 days. In the divorce trial, Wife tried to introduce expert testimony of the value of Husband's stock. The trial court sustained Husband's objection to this testimony, based on its ruling that the shareholder's agreement governed the value of the stock. The trial court divided the community property based on a valuation of \$11,000. Wife appealed, stating that the shareholder's agreement did not establish the fair market value of husband's interest as a going concern. The appellate court acknowledged that community property is generally valued according to fair market value, but held that such valuation is not appropriate when a community estate owns shares in a closely-held corporation that restricts sales of shares to stockholders by agreement. The court held that the only community asset was the stock itself, at the restricted price, not the association as a going concern.

XI. COMMON LAW MARRIAGE.

In contrast to marital contracts, which create welcome certainty, there is a doctrine lurking in Texas law that can potentially cause serious uncertainty for a small business.

You assume that you would know if your client were married. However, marriage is not always so obvious in Texas. Indeed, your client may not even be aware that he or she may be considered married under Texas law. Just as people can find themselves in a business partnership without formal paperwork, so can couples find that they are considered married, even without a certificate.

In Texas, an "informal" or "common law" marriage is defined by statute and can be proven in two ways:

- 1) by recorded written declaration of the spouses, or
- 2) an agreement by the spouses to be married, combined with cohabitation and a representation to others that they are married.¹⁰⁸

A common-law marriage must be dissolved by the same formal divorce process as a ceremonial marriage. Therefore, if a client's romantic partner alleges that the couple is actually common-law married, it can have significant effects on a small business.

A. Written Declaration

The written declaration, assuming it's in proper statutory form and recorded with the county clerk,

¹⁰⁸ TEX. FAM. CODE §§ 2.401, 2.402, and 2.404.

obviously speaks for itself.¹⁰⁹ It is likely your client would be aware of this type of marriage. The second type of informal marriage has the potential to cause the most problems for a business.

B. Informal Marriage

An informal marriage can exist where a man and woman agreed to be married and after the agreement they lived together as husband and wife and represented to others that they were married.¹¹⁰

The agreement to be married encompasses an express or implied intention on the part of both parties to have a present, immediate and permanent marital relationship, and can be proven by circumstantial evidence.¹¹¹

Cohabitation is living together, privately or publicly, although public cohabitation is stronger evidence of this element. There is often a popular misunderstanding that a couple can be common-law married just by living together for a certain number of years, or that a couple cannot be common-law married unless they have lived together a certain length of time. Cohabitation is determined on a case-by-case basis, and there is no bright line test for how long two people have to live together to satisfy this element.¹¹² Guidance from case law has taught us that cohabitation may be proven by moving your clothes or personal effects into a common room or apartment, giving that residence as your residence address, purchasing a home together, purchasing insurance together, or purchasing anything together as "husband and wife" (which also falls into the "holding out" category addressed below).¹¹³ Being a frequent overnight guest, or storing personal property at someone else's home is, by itself, generally not enough.¹¹⁴ Although the act of sexual intercourse is not included in the strict legal definition of "cohabitation", its presence or absence will be influential.¹¹⁵

¹⁰⁹ TEX. FAM. CODE §§ 2.402 and 2.404.

¹¹⁰ TEX. FAM. CODE § 2.401(a)(2).

¹¹¹ *Russell v. Russell*, 865 S.W.2d 629, 933 (Tex 1993); *Flores v. Flores*, 847 S.W.2d 648, 650 (Tex.App. – Waco 1993, writ denied); *Faglie v. Williams*, 569 S.W.2d 557, 565 (Tex.App. – Austin 1978, writ ref'd n.r.e.).

¹¹² *Omodele v. Adams*, No. 14-01-00999-CV (Tex.App.—Houston [14th], 2003, no pet.) (memo. op.).

¹¹³ *Id.*

¹¹⁴ *Allen v. Allen*, 966 S.W.2d 658, 661 (Tex.App.—San Antonio 1998, pet. denied).

¹¹⁵ There has been one case where the couple was found not to have been common law married because they slept in separate beds. *De Shazo v. Christian*, 191 S.W.2d 495, 496-97 (Tex.App.—Amarillo 1945, writ ref'd n.r.e.).

Representation of the “marriage” to others, or what divorce lawyers refer to as a “holding out” is the area where most litigation ensues over the existence of an informal marriage. Like cohabitation, holding out may be shown by conduct or circumstances. The “holding out” behavior should be intended as a communication to others, not merely intimate behavior in general.¹¹⁶ Although secrecy is inconsistent with holding out, spoken words are not necessary to fulfill the “holding out” requirement.¹¹⁷ Examples of holding out include referring to or addressing each other as “husband” or “wife” (although doing this occasionally, by itself, has been found not to be enough), acknowledging children of the parties as legitimate, joining in conveyances as spouses, and signing your tax return as “married.”¹¹⁸

C. Dissolving an Informal Marriage

Once an informal marriage is found to exist, it is treated exactly the same as a ceremonial marriage.¹¹⁹ Like ceremonial marriage, an informal marriage can only be dissolved by divorce. However, any suit for dissolution of an informal marriage must be filed within two years after the physical separation of the parties, or there is a rebuttable presumption that the parties did not enter into an agreement to be married (and thus did not satisfy all the elements of informal marriage).¹²⁰

D. Challenging an Informal Marriage

An informal marriage should be challenged immediately in the client’s initial pleadings in the divorce to avoid waiver. The existence of an informal marriage may additionally be challenged by requesting a declaratory or summary judgment that no marriage exists. The existence of the marriage should be adjudicated immediately in order to avoid interim orders from the divorce court, including temporary spousal support and temporary injunctions relating to property. Unfortunately, case law indicates that the loss of this initial challenge cannot be challenged on appeal until after the divorce itself is final.

¹¹⁶ *Mills v. Mest*, 94 S.W.3d 72, 75 (Tex. App. – Houston [14th Dist] 2002, pet. denied).

¹¹⁷ *Ex parte Threat*, 333 S.W.2d 361, 364-5 (Tex. 1960); *Lee v. Lee*, 981 S.W.2d 903, 906 (Tex.App. – Houston [1st Dist.] 1998, no pet.).

¹¹⁸ *Estate of Claveria v. Claveria*, 615 S.W.2d 164, 166 (Tex. 1981); *Owens v. Owens*, 398 S.W.2d 425 (Tex.Civ.App.-Beaumont Dec 30, 1965)

¹¹⁹ *Villegas v. Griffin Industries*, 975 S.W.3d 745, 750 (Tex.App. – Corpus Christi 1998, pet. denied).

¹²⁰ TEX. FAM. CODE §2.401(b).

E. Dealing with an Unwanted Informal Marriage

From an ethics perspective, a client who thinks he or she might be married should be fully advised of the ramifications of divorce on a spouse’s interest in his or her small business entity (as addressed elsewhere in this paper). The attorney representing the owner of a small business entity must therefore be well aware of his client’s marital status and should be wary of the ramifications of divorce. Simply ask sufficient questions to elicit information that will help you determine the potential existence of an informal marriage. If necessary, send your business client to a divorce lawyer (or, if you represent both of them, to separate divorce lawyers) to evaluate the potential existence of an informal marriage.

F. General Partnership as Alternative to Marriage

The recent *Leighton*¹²¹ case provides an interesting analysis of how an unmarried romantic partner can allege that he or she was also a business partner and is therefore entitled to share in another person’s property. In the *Leighton* case, Paul and Elizabeth had a personal relationship, lived together, filed joint tax returns, and purchased property as husband and wife. Elizabeth believed they were common-law married. When the personal relationship fell apart, Elizabeth filed for divorce. Paul counterclaimed that there was no marriage. As it turns out, there was no record of Elizabeth’s divorce from her previous husband, so she could not proceed with the divorce suit against Paul. The parties non-suited the case. Elizabeth continued working in Paul’s business after the nonsuited divorce. Eventually, more disputes arose, and Elizabeth sued, claiming that she and Paul had formed a general partnership and requesting that the court wind up the partnership business and divide the partnership assets. The facts in the case present additional complexity, so the case is recommended-reading for any practitioner facing this issue.

Importantly, if an attorney is advising an unmarried client who is involved in a long-term relationship with a person who is involved in the client’s business, the attorney should advise the client to sign a cohabitation agreement specifying the extent of each party’s interest in the other’s property.

¹²¹ *Leighton v. Rebeles*, 399 S.W.3d 721 (Tex. App.-Dallas 2013, no pet.).

XII. COLLABORATIVE LAW

The issues facing a court in dividing a closely-held business are numerous and complex, while the time available to the court is short, and its tools blunt. Collaborative law can be especially useful in negotiating the resolution of a business divorce.

In collaborative law, the divorcing spouses agree to withdraw the divorce process from the court's control. Instead, they agree to a confidential process with open information sharing. The process is typically a series of meetings with the spouses' attorneys, together with a neutral financial professional and a neutral mental health professional. Through collaborative divorce, the divorcing spouses come up with negotiated solutions for dividing their assets. One benefit is that the spouse keeping the business may agree to secure payments to the other spouse by revising the governing documents or creating new agreements in a way that a court does not have the power to order. This has the potential to create much more satisfying solutions for the business, since the couple can decide themselves how to restructure financial and business arrangements.

If the spouses are unable to come to a mutual agreement through collaborative law, and they decide to withdraw from the process, they must find new attorneys and start over in litigation. This costly penalty will often keep the parties at the negotiation table, but it is a potential consequence the practitioner must be aware of.

XIII. ARBITRATION

Texas arbitration laws apply to divorce cases as well. Parties can agree to arbitrate a suit for dissolution of a marriage¹²² or a suit affecting the parent-child relationship.¹²³

In the *Pettus*¹²⁴ case, the husband and wife jointly owned a closely-held corporation. During the divorce, they became deadlocked and agreed to temporary orders specifying procedures for managing the business functions and for arbitrating disputes. The parties continued to have repeated conflict over both the substantive issues of managing the company as well as the procedural issues relating to the several arbitrations. There were several arbitrations and the trial court vacated some of the arbitration awards. The case is an important read for any attorney dealing with business issues and arbitration in the context of a divorce case.

¹²² Tex. Fam. Code § 6.601.

¹²³ Tex. Fam. Code § 153.0071.

¹²⁴ *Pettus v. Pettus*, 237 S.W.3d 405 (Tex.App.-Fort Worth 2007 pet. denied).

XIV. REPRESENTING YOUR SMALL BUSINESS CLIENT IN THE DIVORCE

Representing your small business client in his or her divorce is ill-advised. There is a high potential for a conflict of interest if you have ever advised the other spouse with respect to the business. Additionally, because of the various duties, including fiduciary duties, a business owner owes to the community estate as well as his or her spouse, you might find yourself a witness with regard to the business entity creation, funding, and structure.

A. Conflict of Interest

A lawyer shall not represent a person if the representation of that person:

- 1) involves a substantially related matter in which that person's interests are materially and directly adverse to the interests of another client of the lawyer or the lawyer's firm; or
- 2) reasonably appears to be or become adversely limited by the lawyer's or law firm's responsibilities to another client or to a third person or by the lawyer's or law firm's own interests.¹²⁵

Hence, if you or your law firm have been assisting the spouses together in developing and administratively caring for a business entity that is the subject matter of a divorce between which the two spouses are now adverse, then, it is certainly conceivable that such business entity might become the "substantially related matter" defined by statute.¹²⁶

If you think that there is reduced potential for conflict (for example, if you have never met the other spouse, if the business entity was formed prior to the marriage, if the other spouse has no legal interest, or there is a legally binding agreement signed by both spouses), make certain that you obtain full disclosure and consent.¹²⁷

If you find yourself in the unenviable position of discovering a conflict exists after you've already become involved in the divorce representation, you must withdraw immediately in order to protect yourself.¹²⁸ Do not hand the case over to another member of your firm, as Texas disciplinary rules do

¹²⁵ Texas Disciplinary Rules of Professional Conduct, Rule 1.06.

¹²⁶ *Id.*

¹²⁷ *Id.*

¹²⁸ *Id.*

not permit forming a “Chinese wall” in these instances.¹²⁹

B. Lawyer as a Witness

Another problem for the lawyer that provides advice regarding the business is that you may ultimately become a witness in the divorce. An attorney is not permitted to continue to represent a client before a tribunal if that attorney may be a witness on a contested issue.¹³⁰ Your knowledge of the various transactions surrounding the formation of the business entity may become an issue if the character of the business entity is contested. If the non-managing spouse accuses the managing spouse of devaluing the business intentionally in anticipation of divorce (marital fraud), you may be required to testify about previous valuations. Further, if the opposing spouse is attempting to pierce or reverse-pierce the corporate veil, you may be called to testify about the legitimacy of the corporate structure. Those are just a few examples of the fact scenarios that might cause you to end up on the witness stand, thus excluding you from representing either spouse in the divorce. Even worse, what if your testimony will hurt your client (for example, if he is running all of his personal expenses through a corporation and would be subject to having those expenses imputed to him for purposes of interim support)?

C. Attorney Liability

In the recent *Byrd*¹³¹ case, the husband sued the wife’s attorneys for improperly preparing a title transfer document following a divorce case. The husband accused the wife’s lawyers of fraud, conspiracy, and aiding and abetting. Although the wife’s attorneys prevailed on a motion for summary judgment at the trial court, the appellate court overturned the summary judgment and remanded for trial. The basis for the claims against the wife’s attorneys was that, in preparing a bill of sale for an airplane, the attorneys listed the wife as the manager of one of the parties’ entities. The husband alleged that she was never a manager of the entity, and the result of the improperly-executed bill of sale was to unlawfully shift tax liability from the wife to the entity. Attorneys in Texas normally have qualified immunity for actions taken in the course of representing their clients. However, because an attorney’s fraud would be outside the scope of representing the client, qualified immunity may not

apply. A petition for review by the Texas Supreme Court has been filed but not decided as of the writing of this paper.

D. It’s Harder Than It Looks

If you are not experienced in handling complex divorces, and your small business client’s divorce involves any contested issues regarding the valuation and division of a business entity, it is best to let a divorce lawyer experienced in such matters handle the case. With the complex interplay of all of the considerations discussed in this paper, why in the world would you want to risk providing such representation?

XV. CONCLUSION

We hope that we have enlightened you as to some of the basics of family law as they apply to your representation of the small business owner, and how to better advise your small business client in preparation for a potential divorce. Family law is a complex and specialized field of practice. Many traps and pitfalls can be avoided for clients who are small business owners by your knowledge of family law.

¹²⁹ *Id.*

¹³⁰ Texas Disciplinary Rules of Professional Conduct, Rule 3.08.

¹³¹ *Byrd v. Vick, Carney & Smith LLP*, 409 S.W.3d 772 (Tex. App.-Fort Worth 2013, pet. filed).