

**BUSINESS SUCCESSION PLANNING:
PROTECTING BUSINESS IN DIVORCE**

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CHAPTER 3



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EDUCATION

J.D. Southern Methodist
University 1993
B.S., *Summa Cum Laude*
Texas Woman's University &
Candidate for M.S., Marriage
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LICENSURE * CERTIFICATION

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
Certified Mediator &
Credentialed-Advanced
Mediator (TMCA)
Collaborative Lawyer

AWARDS * RECOGNITION

Best CLE Article of 2007, State
Bar of Texas, Family Law
Section
Listed in *Texas Super Lawyers®*,
Texas Monthly Magazine,
2003, 2004, 2005, 2006,
2007, 2008, 2009 and 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)
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PERSONAL

Charla Bradshaw Conner was
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Terry Bradshaw.

PROFESSIONAL & CLE ACTIVITIES

Member, State Bar of Texas Family Law Council, since April, 2005;
Committee Chair of Awards Committee; Legislative Committee
Chair, Section 14, State Bar of Texas Grievance Committee (since 2008)
Officer, Texas Academy of Family Law Specialists (since September 2005)
(Director 2002-2005) (Member since 2000)
Delegate, Family Law Council of Community Property States (2002 - 2005)
Member, State Bar of Texas, Texas Family Law Practice Manual Form Book
Committee since 1998
Fellow, American Academy of Matrimonial Lawyers, 2006 to present
TAFLS Trial Institute 2008 Course Director
New Frontiers, Course Director 2008
Editor, TAFLS Newsletter, "Family Law Forum" (2002 - 2005)
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, *Texas Annotated Family Code* (LexisNexis-Matthew
Bender, 2005 Edition, 2007 Edition, 2008 Edition)
Co-Author, SBOT, Texas Family Law Council Checklist Committee for
"Checklist" Publication, Volumes I and II
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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Education/License

B.A., Texas Christian University, 1987
J.D., Texas Tech University School of Law, 1995
Board Certified – Family Law, Texas Board of Legal Specialization, December of 2000
Re-Certified – Family Law, Texas Board of Legal Specialization, December of 2005

Professional Activities

President, Tarrant County Bar Association 2008-2009
President, Tarrant County Family Law Bar Association 2001-2002
Director/Officer/President, Tarrant County Bar Association 2003 to Present
Director/Officer/President, Tarrant County Family Law Bar Association, 1998 to 2003
Director & Officer, Texas Academy of Family Law Specialists, 2003 to Present
Member, 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
Senior Counsel, American College of Barristers, 2001 to Present
Member/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 2005-2008.
Fellow, Texas Bar Foundation 2002 to Present
Fellow, Texas Family Law Bar Foundation 2004 to Present
Fellow, Tarrant County Bar Foundation 2004 to Present
Fellow, American Academy of Matrimonial Lawyers, 2005 to Present
Council Member, Family Law Council, State Bar of Texas, 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, 2004 & 2005
Top Fifty Female Attorneys in Texas, Texas Monthly Magazine 2004 to 2008
Top Fifty Female Super Lawyers, Texas Monthly Magazine 2006 to present
Top 100 Lawyers in Dallas Fort Worth, Texas Monthly Magazine 2006 to 2008
The Best Lawyers In America 2007 to present

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.
Author/Speaker, *Uncontested Divorce Outline*, Pro Bono Family Law Seminar 1998.
Author, *Factors Affecting Property Division & Alimony*, Family Law Basics From the Bench, Tarrant County Bar Association Brown Bag Seminar 1998.
Speaker, *Practice Tips On Procedures At The Courthouse and Communicating With Court Personnel*, Advanced Family Law Trial Skills Seminar 1998.
Author, *The Potential Effect of The New Texas Family Law Legislation Regarding Proportional Ownership, Equitable Interests, Division Under Special Circumstances, & A Look At New Legislative Provisions For Transmutation*

Agreements, Advanced Family Law Course 1999.

Speaker, *Recent Cases in Child Support, Possession & Access*, 1999 Annual TADRO Conference 1999.

Speaker, *Filing Pleadings, Obtaining Settings, and Interacting With Court Coordinators and Clerks*, Family Law Trial Skills Seminar, West Texas Legal Services PAI Program, 1999.

Author, *Discovery In Property Cases Under The New Rules*, Advanced Family Law Course 1999.

Author/Speaker, *Drafting Family Law Pleadings: It's Almost All In The Manual*, "Nuts & Bolts" Family Law & Advanced Trial Law Trial Skills 2000.

Author, *Deciding When You Need A Jury & Conducting Voir Dire*, "Nuts & Bolts" Family Law & Advanced Trial Law Trial Skills 2000.

Author/Speaker, *Proper Drafting and Filing of Pleadings*, 26th Annual Advanced Family Law Course, Boot Camp 2000.

Author, *Discovery Gotta Haves: Essential Ideas for Discovery in Property and SAPCR's*, Marriage Dissolution Institute 2001.

Author, *Discovery*, Advanced Family Law Trial Skills, West Texas Legal Services PAI Program 2001.

Author/Trainer, "Proper Drafting and Filing of Pleadings", "Nuts & Bolts" Family Law Seminar, West Texas Legal Services PAI Program 2001.

Trainer, "Why Lawyers Lie", "Nuts & Bolts" Family Law Seminar, West Texas Legal Services PAI Program 2001.

Presenter, *Winning Trial Techniques in Property Cases*, Texas Academy of Family Law Specialists Annual Trial Institute 2002.

Author/Trainer, "Proper Drafting and Filing of Pleadings", 2002 Family Law Seminar, West Texas Legal Services PAI Program.

Trainer, "Why Lawyers Lie", 2002 Family Law Seminar, West Texas Legal Services PAI Program.

Author/Speaker, *Discovery & Mediation*, 28th Annual Advanced Family Law Course, Family Law Boot Camp 2002.

Panel Member, *Use and Abuse of Legal Assistants*, 28th Annual Advanced Family Law Course 2002.

Speaker, *Use and Abuse of Legal Assistants*, Panhandle Family Law Bar Association November Luncheon, 2002.

Author/Speaker, *Drafting Trial Documents With An Eye Toward Winning*, Advanced Family Law Drafting Course 2002.

Author/Speaker, *Discovery: Tools, Techniques & Timebombs*, Texas Academy of Family Law Specialists Annual Trial Institute 2003.

Author/Player, *Associate Judge Do's & Don't's*, Tarrant County Family Law Bar Association 2003.

Author/Speaker, *Evaluating A Custody Case*, 26th Annual Marriage Dissolution Institute 2003.

Co-Director, Family Law Boot Camp, 29th Annual Advanced Family Law Seminar 2003.

Author, *Discovery in Hard Places*, 29th Annual Advanced Family Law Seminar 2003.

Speaker, *Practicing Law For Fun & Profit*, 29th Annual Advanced Family Law Seminar 2003.

Author/Speaker, *Internet Searches for Financial & Personal Information Useful in Family Law Litigation*, Texas Academy of Family Law Specialists Annual Trial Institute 2004.

Moderator, Effective Courtroom Advocacy, Tarrant County Bench Bar Seminar 2004

Author/Speaker, *Internet Investigation of Personal Information & Assets*, Marriage Dissolution Institute 2004.

Director, Family Law Boot Camp, State Bar of Texas Annual Meeting 2004.

Author/Speaker, *Drafting 101, Basic Drafting of Pleadings*, Family Law Boot Camp, State Bar of Texas Annual Meeting 2004.

Author/Speaker, *Investigation of Personal Information & Assets*, Tarrant County Family Law Bar Association, Summer Bar Seminar 2004.

Author/Speaker, *Investigation of Personal Information & Assets*, State Bar College "Summer School" 2004.

Author, *The Life of a Grievance & The New Disciplinary Rules, What You Don't Know Can Hurt You*, 30th Annual Advanced Family Law Seminar 2004.

Director, Family Law Boot Camp, 30th Annual Advanced Family Law Seminar 2004.

Author/Speaker, *Drafting 101, Basic Drafting of Pleadings*, Family Law Boot Camp, 30th Annual Advanced Family Law Seminar 2004.

Author/Speaker, *Investigation of Personal Information & Assets*, Legal Assistant's University 2004

Author, *Advanced CYA For The Family Law Attorney*, Family Law Ultimate Trial Notebook 2004

Author/Speaker, *Divorce Planning*, Representing Small Business 2004

Assistant Director, Texas Academy of Family Law Specialists Annual Trial Institute 2005

Instructor, *Marital Property*, The People's Law School, Fort Worth 2005

Author/Speaker, *Marital Property 101*, State Bar of Texas Spring Training, Fort Worth 2005

Author/Speaker, *Effective Use of Psychologists and Psychiatrists*, 28th Annual Marriage Dissolution Institute 2005.

Panelist/Moderator, Evidence and Discovery Workshop, 30th Annual Advanced Family Law Seminar, Dallas 2005

Author/Speaker, *Internet Investigation of Personal Information and Assets*, Tarrant County Bar Association September 2005 Luncheon.

Director, Texas Academy of Family Law Specialists Trial Institute 2006, Reno, Nevada

Author/Speaker, *Avoiding Divorce Disasters*, Representing Small Businesses, Dallas March 23-24, 2006
Panelist/Author, 29th Annual Marriage Dissolution Institute Bootcamp – Practical Aspects of Enhancing Your Practice, *How To Lose A Paralegal In 10 Days, or Keep One for 10 Years*, April 19, 2006, Austin.
Moderator, 29th Annual Marriage Dissolution Institute, *Electronic Evidence*, April 20-21, 2006, Austin.
Speaker, *Being A Family Law Attorney*, Tarrant County Bench-Bar, April 27, 2006, The Woodlands.
Speaker, *Ethics: Evidence, Discovery and Witnesses*, Tarrant County Bar Association Brown Bag Luncheon, June 23, 2006, Fort Worth.
Author/Speaker, *21st Century Issues Dealing with Nontraditional Relationships*, 31st Annual Advanced Family Law Seminar, August 14-17, 2006, San Antonio.
Speaker, UTCLE Parenting Plan Conference, *Effective Strategies For Reaching Parenting Plan Agreements*, October 13, 2006.
Speaker, LexisNexis CLE, Learning to Make the Texas Family Code Work for You, *Navigating the Family Code*, October 20, 2006.
Speaker, LexisNexis CLE, Learning to Make the Texas Family Code Work for You, *Helpful Appellate References*, October 20, 2006.
Moderator, Texas Academy of Family Law Specialists Trial Institute 2007, Sante Fe, New Mexico, Electronic Evidence Panel.
Moderator, 30th Annual Marriage Dissolution Institute, *Electronic Evidence*, May 10-11, 2007, El Paso.
Co-Speaker, *Interesting Appellate Cases*, Tarrant County Family Law Bar Luncheon, May 22, 2007.
Speaker/Author, UTCLE Family Law on the Front Lines, *Appellate Tips for Family Law Attorneys*, Galveston, Texas June 28-29, 2007.
Speaker/Author, *Evidence, Keeping in In and Keeping it Out*, 32nd Annual Advanced Family Law Seminar, San Antonio.
Speaker, *Appellate Considerations*, Texas Academy of Family Law Specialists Trial Institute 2008, Sante Fe, New Mexico.
Speaker, UTCLE 8th Annual Family Law on the Front Lines, *Justice Behind Closed Doors: Protecting the Record, Your Client and Yourself In Chambers*, Galveston, Texas June 19-20, 2008.
Speaker/Author, SBOT Advanced Family Law Drafting, *Discovery*, Austin, Texas, December 3-4, 2008.
Speaker/Author, UTCLE Parent-Child Relationships: *Critical Thinking for Critical Issues, Discovery and Evidence, A Primer for Family Law Attorneys*, Austin, Texas, January 29-30, 2009.
Speaker/Author, SBOT Representing Small Business, *Protecting Business Before Divorce: What Every Business Lawyer Must Know About Family Law*, Dallas, Texas, March 26-27, 2009.
Speaker, UTCLE, 9th Annual Family Law on the Front Lines, *Electronic Evidence and Discovery*, San Antonio, June 18-19, 2009.
Director, 35th Annual Advanced Family Law Seminar, Dallas, Texas, August 3-7, 2009.
Speaker/Author, SBOT The Ultimate Trial Notebook: Family Law, *Effective Use of Prior Testimony*, San Antonio, December 3-4, 2009.
Speaker/Author, UTCLE 2010 Parent-Child Relationships: Critical Thinking for Critical Issues, *Discovery and Evidentiary Issues in Substance Abuse Scenarios*, Austin, Texas January 28, 29, 2010.

Law Related Periodical/Magazine Publications

Author, "Beating Out The Big Firms", *Texas Lawyer*, Vol. 18, No. 21, July 29, 2002.
Interviewed/Quoted "Divorce 101", *Fort Worth Magazine*, July 2003 edition.
Author, "Basic Internet Searches for Persons and Assets", *The College Bulletin, News for Members of the College of the State Bar of Texas*, Summer 2006

Law Related Books

Co-Author, *Texas Family Law: Direct & Cross Examination, Suggested Questions, Ideas & Outlines*, Heather King, Bruce Beverly & Syd Beckman (Imprimatur Press 2000).
Co-Author, *Texas Family Law: Direct & Cross Examination, Suggested Questions, Ideas & Outlines, A Focus on Children*, Heather King, Bruce Beverly & Syd Beckman (Imprimatur Press 2002).
Co-Author, *Texas Family Law: Direct & Cross Examination, Suggested Questions, Ideas & Outlines, A Focus on Property*, Heather King, Bruce Beverly, Syd Beckman & Randal Wilhite (Imprimatur Press 2004).
Co-Annotator for *Lexis Texas Annotated Family Code 2007-Present*.
Co-Author, *Protecting Your Assets From A Texas Divorce 2nd Ed.* (PSG Books 2009).

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BIOGRAPHICAL INFORMATION

EDUCATION

J.D., Harvard Law School
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LEGAL EXPERIENCE

Admissions: Texas; United States District Court, Eastern District of Texas

Koons, Fuller, Vanden Eykel & Robertson, P.C., Plano, TX.
Associate, Sept. 2009 – present

- Family law, including divorce and custody issues.
- Trained in mediation, arbitration, and collaborative law.
- Certified attorney ad litem.

Thompson & Knight LLP, Dallas, TX.
Associate, Sept. 2008 – Aug. 2009

- Practice areas included environmental and intellectual property litigation
- Federal practice included defending several patent infringement cases, notably obtaining a judgment as a matter of law for a defendant in a jury trial in the Eastern District of Texas.
- State court cases have included easement, tax foreclosure, and eminent domain issues.

MEMBERSHIPS

- College of the State Bar of Texas
- Pro Bono College of the State Bar of Texas
- Bar associations: Texas, Dallas, Plano, Collin County

PUBLICATIONS

Co-Author of:

- *Top 10 Things Every Woman (And Her Husband) Should Know Before Filing For Divorce*, The Advocate, Vol. 49 (2009).
- *Effective Use of Prior Testimony*, State Bar of Texas, Ultimate Trial Notebook: Family Law (2009).
- *Ultimate Judge's Notebook*, Ultimate Trial Notebook: Family Law, State Bar of Texas (2009).
- *Annual Survey of Texas Law, Environmental Law*, 62 SMU L. Rev. 1119 (2009).
- *Venezuelan Oil Seizure: Not a License to Steal*, Industry Today, June 5, 2009.
- *Arbitration of Venezuelan Oil Contracts: A Losing Strategy?*, 4 Tex. J. Oil, Gas & Energy L. 55 (2008).

COMMUNITY PROJECTS

Designed a financial skills curriculum and taught workshops at:

- New Friends New Life, for at-risk women.
- Central Dallas Ministries/TRAC, for foster teens.
- Turner Twelve, for teens in public housing.

TABLE OF CONTENTS

I.	INTRODUCTION	1
II.	PRE AND POST MARRIAGE CONTRACTS	1
	A. Pre-Marital Agreements	1
	B. Post-Marital Agreements.....	2
	1. Partition and Exchange Agreements	2
	2. Agreements Concerning Income from Separate Property	2
	3. Agreement to Convert to Community Property	3
	C. Buy/Sell Agreements	3
III.	INFORMAL MARRIAGE	3
	A. Written Declaration	3
	B. Agreement to Be Married.....	4
	C. Cohabitation.....	4
	D. Holding Out.....	4
	E. Dissolving an Informal Marriage	4
	F. Challenging an Informal Marriage	4
	G. Dealing with an Unwanted Informal Marriage	5
IV.	CHARACTERIZATION	5
	A. Marital Estate	6
	B. Burden is Clear and Convincing Evidence	6
	C. Inception of Title Doctrine.....	6
	D. Mutation	7
V.	CLAIMS OF AND AGAINST THE MARITAL ESTATES	7
	A. Economic Contribution and Reimbursement	7
	1. Economic Contribution	7
	2. Reimbursement.....	8
	B. Example of Application to Small Business	8
	C. Jensen Claim	8
	1. Example of <i>Jensen</i> Claim.....	9
VI.	FIDUCIARY DUTY	9
	A. Introduction.....	9
	B. Fraud/Fiduciary Duty	10
VII.	VALUATION	12
	A. The Valuation Process.....	12
	1. Business Appraisals in a Divorce Context	12
	B. Goodwill Issues.....	13
	1. Intangible Assets	13
	2. Illustration of Measuring Goodwill.....	14
VIII.	SPOUSE AS AN EMPLOYEE.....	15
	A. Supporting the Spouse Who Physically Leaves the Business	15
	B. Both Spouses Stay in the Business.....	15
	C. Receivership.....	15
	D. (Often Undeclared) Cash.....	15
IX.	TEMPORARY SUPPORT	15

X.	CHOICE OF ENTITY	16
A.	Introduction	16
B.	Partnership Property	16
1.	Partnership Property Belongs to the Partnership	16
2.	Participation in Management of Partnership	16
3.	Partnership Interest	16
4.	Transferees	16
C.	Corporate Alter Ego	17
D.	Reverse Piercing	17
XI.	TAX EFFECT	17
A.	Introduction	17
B.	Analysis of Tax Effects	18
C.	Joint Liability	18
XII.	COLLABORATIVE LAW	18
XIII.	REPRESENTING YOUR SMALL BUSINESS CLIENT IN THE DIVORCE	18
A.	Don't Do It!	18
1.	Conflict of Interest	18
2.	Lawyer as a Witness	19
3.	It's Harder Than It Looks	20
XIV.	CONCLUSION	20
EXHIBIT A		
Summary of New Developments in the Law – 2009		21

BUSINESS PLANNING: BUSINESS IN DIVORCE

SUCCESSION PROTECTING BUSINESS IN DIVORCE

I. INTRODUCTION

This article is designed to inform lawyers who represent small business owners about the potential issues lurking in the context of divorce, so that the business owner can better protect a business during a divorce.

A business is often a spouse's largest and most important asset. A business owner will want to protect the business during a divorce, keeping his or her interest in the business intact, if possible. Divorce can present significant issues for a business owner, and can be devastating to the business itself. In order to protect small businesses and their owners in divorce, it is very important for a small business lawyer to inform the client about the basics of characterization and valuation of the small business, fiduciary duties related to the business, marital fraud, common law marriage, and choice of entity, to name a few. Some pitfalls that will be discussed are whether the mere formation of a business has possibly violated the fiduciary duty to a spouse, whether a client even realizes that they are married, whether a client is knowledgeable about what is separate property and community property, whether that client's actions as related to the business entity may affect the potential outcome of property division in a divorce, and whether any of this has been modified by a pre-marital or post-marital agreement. The attorney representing a small business owner should be knowledgeable about the basic tenets of divorce. We hope this article gives you ideas and insights to protect your client (and yourself) when representing a small business owner.

II. PRE AND POST MARRIAGE CONTRACTS

The first thing for a divorcing business owner to consider is the existence or effect of any marital contracts. 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.

One complication is that spouses can create post-marital contracts for estate planning purposes, without realizing that they have a vital effect on whether property is considered community or separate property in a divorce.

A. Pre-Marital Agreements

The UNIFORM PREMARITAL AGREEMENT ACT¹ 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;
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.²

A premarital agreement may also address the issue of increases in the value of a closely-held business owned by one spouse prior to marriage. Commonly litigated divorce claims like reimbursement or economic contribution (in cases filed prior to September 1, 2009³) may have been defined or eliminated by the agreement. Such agreements can provide that all increases in value of a party's separate property stock due to the time, toil and effort expended by that person in the running of his or her business remain the

¹ TEX. FAM. CODE Chapter 4, Subchapter A.

² TEX. FAM. CODE §4.003(a).

³ The statutory claim of economic contribution that was previously contained in the TEXAS FAMILY CODE was repealed during the last Legislative session. However, the statute still applies to divorces filed prior to September 1, 2009. Due to the back log in larger counties, it is likely there are thousands of divorces still pending to which this statute, although repealed, still applies.

separate property of that party. A reimbursement claim may be defined, similar to liquidated damages, in terms of a fixed percentage of the increase in stock. The agreement could also include a provision that the owner spouse will receive a certain minimum salary for such spouse's time, toil and efforts and that the salary will be community property and, therefore, benefit the community estate.⁴ Reimbursement and compensation for the personal services of the non-owner spouse (as they relate to the small business) may be addressed explicitly in the pre-marital agreement as well.

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.⁵ 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 attorney⁶ as soon as possible.

B. Post-Marital Agreements

Post-Marital Agreements can be another source of certainty for divorcing business owners. The TEXAS FAMILY CODE allows parties to enter into three types of marital agreements:⁷

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

⁴ Cameron, Hoffman, Ytterberg, *Marital and Premarital Agreements*, 39 Baylor L. Rev. 1095 (Fall 1987).

⁵ TEX. FAM. CODE §4.006.

“A premarital agreement is not enforceable if the party against whom enforcement is requested proves that:

(1) the party did not sign the agreement voluntarily; or

(2) the agreement was unconscionable when it was signed and, before signing the agreement, that party:

(A) was not provided a fair and reasonable disclosure of the property or financial obligations of the other party;

(B) did not voluntarily and expressly waive, in writing, any right to disclosure of the property or financial obligations of the other party beyond the disclosure provided; and

(C) did not have, or reasonably could not have had, adequate knowledge of the property or financial obligations of the other party...”

⁶ Estate and probate specialists are also often well versed in the proper drafting of pre and post-marital agreements.

⁷ TEX. FAM. CODE Chapter 4, Subchapter B.

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.⁸ This can be a useful shortcut through litigation for a business owner in 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.⁹ As a result, the business owner mistakenly assumes that all income from his or her separate property business is safe from division upon divorce. A post-marital agreement concerning income from separate property can be an excellent way to avoid this potential divorce disaster.¹⁰

This agreement must be in writing and signed by both parties¹¹, and may be unenforceable if certain circumstances are proven.¹² An equivalent term may also be incorporated into a pre-marital agreement.

⁸ TEX. FAM. CODE §4.102.

⁹ *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).

¹⁰ TEX. FAM. CODE §4.103.

¹¹ TEX. FAM. CODE §4.104.

¹² TEX. FAM. CODE §4.105(a)(1).

A partition or exchange agreement is not enforceable if the party against whom enforcement is requested proves that:

(1) the party did not sign the agreement voluntarily; or

(2) the agreement was unconscionable when it was signed and, before execution of the agreement, that party:

(A) was not provided a fair and reasonable disclosure of the property or financial obligations of the other party;

(B) did not voluntarily and expressly waive, in writing, any right to disclosure of the property or financial obligations of the other party beyond the disclosure provided; and

(C) did not have, or reasonably could not have had, adequate knowledge of the property or financial obligations of the other party

3. Agreement to Convert to Community Property

Agreements to convert separate property to community property also exist.¹³ This type of agreement is also sometimes referred to as a “transmutation agreement.” Although consideration is not a requirement¹⁴, certain formalities specific to this type of agreement are required.¹⁵ Merely transferring separate property into the other spouse’s name is not sufficient to convert it to community property.¹⁶ It might instead be construed as a gift to that spouse as separate property.¹⁷

Even if your client presents you with an agreement that seems to result in devastating complications for his or her business, there are still ways to challenge the agreement’s enforceability. The transmutation agreement has statutory requirements for enforceability, including specific required warnings.¹⁸

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.

C. Buy/Sell Agreements

Another type of agreement that can provide some certainty to a business owner in divorce is a company’s buy/sell agreement or shareholder agreement. These agreements define the procedure for any change of ownership, including divorce. Most business owners are resistant to any ownership interest being transferred outside of the initial core group of investors. A buy/sell agreement gives the owners in the original group rights of first refusal to purchase the interest if it could be

transferred to someone, like a divorcing spouse, who is not well known to the ownership group. Such an agreement can boost the other owners’ confidence that a co-owner’s spouse will likely be awarded other property in lieu of ownership in the business.

III. INFORMAL MARRIAGE

In contrast to marital contracts, which create welcomed 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. The type of marriage being discussed in this section is not the obvious marriage resulting from a ceremony, cake and honeymoon, but rather the type of marriage that may be found based on the actions of a couple.

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.¹⁹ The divorce process is the same, whether a couple was formally or informally married. Therefore, if a client’s romantic partner alleges that the couple is actually married, it can have significant effects on a small business.

A common-law marriage can lead to a finding that capital invested in or property used by the business will now be considered community property. It can also create a fiduciary duty between the informally-married spouses. The spouse alleging the informal marriage can review prior business dealings for any breach of fiduciary duty. For example, it is a breach of fiduciary duty to hide assets from the other spouse or to divert community funds to a third party without the other spouse’s knowledge. The attorney that formed a business could find himself a witness on these issues in a divorce between the parties. The informal spouse’s divorce attorney may also allege alter ego and attempt to pierce the corporate veil to recover assets in the divorce.

A. Written Declaration

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

¹³ TEX. FAM. CODE §4.202.

¹⁴ TEX. FAM. CODE §4.203(a)(2).

¹⁵ TEX. FAM. CODE §4.203(a)(1)(A)-(C).

An agreement to convert separate property to community property:

(1) must be in writing and:

(A) be signed by the spouses;

(B) identify the property being converted; and

(C) specify that the property is being converted to the spouses’ community property.

¹⁶ TEX. FAM. CODE §4.203(b).

¹⁷ 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). The taking of title in both names does not change the result of tracing, but creates a presumption of a gift of one half of the separate property.

¹⁸ TEX. FAM. CODE §4.205.

¹⁹ TEX. FAM. CODE §§2.401(a)(1)-(2), 2.402 and 2.404.

obviously speaks for itself.²⁰ It's likely your client would be aware of this type of marriage, although on occasion a person will sign these declarations for emergency purposes (such as obtaining health care insurance for sick paramour) without realizing the true effect. The second type of informal marriage has the potential to cause the most problems for a business.

B. Agreement to Be Married

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.²¹

C. Cohabitation

Cohabitation is living together, privately or publicly, although public cohabitation is stronger evidence of this element. Cohabitation is determined on a case by case basis, and there is no bright line test for how long two people would have to live together to satisfy this element.²² 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).²³ Being a frequent overnight guest, or storing personal property at someone else's home is, by itself, generally not enough.²⁴ Although the act of sexual intercourse is not included in the strict legal definition of "cohabitation", its presence or absence could be influential.²⁵

D. Holding Out

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.²⁶ Although secrecy is inconsistent with holding out, spoken words are not necessary to fulfill the "holding out" requirement.²⁷ 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."²⁸

E. Dissolving an Informal Marriage

Once an informal marriage is found to exist, it is treated exactly the same as a ceremonial marriage.²⁹ 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).³⁰

F. 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 is final.

²⁰ TEX. FAM. CODE §§2.402 and 2.404.

²¹ *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.).

²² *Omodele v. Adams*, No. 14-01-00999-CV (Tex.App.—Houston [14th], 2003, no pet, Memorandum Opinion).

²³ *Id.*

²⁴ *Allen v. Allen*, 966 S.W.2d 658, 661 (Tex.App.—San Antonio 1998, pet. denied).

²⁵ There as 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.).

²⁶ *Mills v. Mest*, 94 S.W.3d 72, 75 (Tex. App. – Houston [14th Dist] 2002, pet. denied).

²⁷ *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.).

²⁸ *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)

²⁹ *Villegas v. Griffin Industries*, 975 S.W.3d 745, 750 (Tex.App. – Corpus Christi 1998, pet. denied).

³⁰ TEX. FAM. CODE §2.401(b).

G. 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.³¹ 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.

IV. CHARACTERIZATION

One of the most important issues for a small business owner facing divorce is how a court will characterize the spouses' property. This is critical since only community property is subject to division by a divorce court. Property that is proven separate by the proper evidentiary standard cannot be divested, although such property in a divorce that was on file prior to September 1, 2009 can potentially be subject to mandatory liens created upon the division of the marital estate.³²

Application of characterization rules to business entities can become quite complicated. For example, a business that is formed before a marriage is the separate property of a spouse (based upon the rule of inception of title discussed below), but property used during the marriage to capitalize the business can create complications. Investing community property in a separate property business can create claims between the marital estates.

Characterization also depends on the ownership of business property. For example, since a partnership is a separate legal entity, partnership property is not subject to division, but a spouse's partnership interest may be.

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.³³ 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.³⁴ Distributions received in exchange for the cancellation of stock upon the corporation's dissolution retain the character of the stock.³⁵

On the other hand, cash dividends from stock are treated like income and, when distributed during the marriage, are characterized as community property.³⁶ 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.³⁷ However, the corporation's earnings or surplus funds normally do not constitute a dividend as long as they are retained by the corporation.³⁸ If evidence of distributions is uncontroverted, the issue of characterization is a matter of law for the Court to decide.³⁹

³⁴ *LeGrand-Brock v. Brock*, 2005 WL 2578944, at *1 (Tex. App. – Waco Oct. 12, 2005, no pet) citing *Fuhrman v. Fuhrman*, 302 S.W.2d 205, 212 (Tex. App. – El Paso 1957, writ dismissed) (holding that stock received in liquidation of a corporation in which husband owned separate stock was husband's separate property); see also *Wells v. Hiskett*, 288 S.W.2d 257, 265 (Tex. App. – Texarkana 1956, writ refused n.r.e.) (holding that because stockholder received a liquidating distribution in the form of an oil and gas lease in consideration of the cancellation of the stock held in a dissolving corporation, the lease remained the stockholder's separate property as a matter of law).

³⁵ *LeGrand-Brock v. Brock*, 2005 WL 2578944, at *1 citing *Wells*, 288 S.W.2d at 265.

³⁶ *LeGrand-Brock v. Brock*, 2005 WL 2578944, at *1 citing *Bakken v. Bakken*, 503 S.W.2d 315, 317 Tex. App. – Dallas 1973, no writ).

³⁷ *LeGrand-Brock v. Brock*, 2005 WL 2578944, at *1 citing *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) (explaining that a corporation does not have to formally declare a dividend when it sets apart funds for distribution to its shareholders because it has the legal effect of a declared dividend).

³⁸ *LeGrand-Brock v. Brock*, 2005 WL 2578944, at *1 citing *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 refused) (“The accumulated earnings or surplus funds of a corporation constitute a part of its assets, and belong to the corporation, and not to the stockholders, until they have been declared and set apart as dividends).

³⁹ *Pace v. Pace*, 160 S.W.3d 706, 712 (Tex. App. – Dallas 2005, pet denied) (uncontroverted evidence showed house was purchased with wife's separate fund); *Harris*, 765

³¹ If the attorney represents both husband and wife in the business venture, a potential conflict problem may arise, as addressed below.

³² Note, the particular statute referred to as economic contribution that provides for the aforementioned liens by one estate has been repealed but still applies to cases filed prior to September 1, 2009.

³³ *Harris v. Harris*, 765 S.W.2d 798, 802 (Tex. App.—Houston [14th Dist.] 1989, writ denied).

A. Marital Estate

In general, the marital estate is defined to include Husband's separate estate, Wife's separate estate, and community property.⁴⁰ However, Texas law presumes the entire marital estate to be community property unless separate property is proven by the required evidentiary standard.⁴¹

B. Burden is Clear and Convincing Evidence

The spouse asserting the existence of a separate estate (or a claim between a separate and community estate⁴²) carries the burden of persuasion by clear and convincing evidence.⁴³ 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."⁴⁴ 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.⁴⁵ Meeting this burden is accomplished through tracing admissible documentary evidence.

In essence, the characterization of the asset is shown by an admissible paper trail beginning at the time of the acquisition of the asset and continuing to the date of divorce, which fully demonstrates that the property is separate property based upon the date of inception of title or the characterization of the funds used to purchase the asset.⁴⁶ When tracing separate property, it is not enough to show that separate funds could have been the source of a subsequent transfer of

funds.⁴⁷ 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.⁴⁸ Any doubt as to the character of property should be resolved in favor of the community estate.⁴⁹ Further, if the community wishes to make a claim upon a separate estate of a spouse, it must do so with the lesser burden of preponderance of the evidence, defined as the greater weight and degree of credible testimony.⁵⁰

C. 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.⁵¹ The vesting of the right of claim often is proved by showing that consideration was provided in exchange for the right so acquired.

For example, consider a spouse who owned a sole proprietorship prior to marriage and incorporated it subsequent to 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

S.W.2d at 802-3 (undisputed evidence showed husband received partnership interest in prior divorce).

⁴⁰ TEX. FAM. CODE §3.001 – 3.003.

⁴¹ TEX. FAM. CODE §3.003.

⁴² *Jensen v. Jensen*, 665 S.W.2d 107 (Tex. Feb 29, 1984); TEX. FAM. CODE Chapter 3, Subchapter E.

⁴³ TEX. FAM. CODE §3.003(b).

⁴⁴ *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); TEX. FAM. CODE §101.007.

⁴⁵ *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).

⁴⁶ *Ganesan v. Vallabhaneni*, 96 S.W.3d 345, 354 (Tex.App.-Austin 2002, pet. denied).

⁴⁷ *Latham v. Allison*, 560 S.W.2d 481, 484 (Tex.Civ.App.- Fort Worth 1977, writ ref'd n.r.e.).

⁴⁸ *Boyd* at 612 citing *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).

⁴⁹ *Akin v. Akin*, 649 S.W.2d 700, 703 (Tex.App.-Fort Worth 1983, writ ref'd n.r.e.).

⁵⁰ *Compton v. Elliott*, 126 Tex. 232, 88 S.W.2d 91, 95 (1935); *Allen v. State*, 786 S.W.2d 738, 741 (Tex.App.-Fort Worth 1989) (op. on reh'g), *pet.dism'd*, 841 S.W.2d 7 (Tex.Crim.App.1992); *Hill v. State*, 721 S.W.2d 953, 954-55 (Tex.App.-Tyler 1986, no pet.); *Davenport v. Cabell's, Inc.*, 239 S.W.2d 833, 835 (Tex.Civ.App.-Texarkana 1951, no writ).

⁵¹ *Boyd* at 612 citing *Smith v. Smith*, 22 S.W.3d 140, 145 (Tex.App.-Houston [14th Dist.] 2000, no pet.) (op. on reh'g).

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

D. Mutation

In the context of family law, the term “mutation” is generally defined as a change to the form of separate property, which does not always alter the character of the property as separate.⁵² For example, if separate property funds are used to purchase a vehicle during marriage, the vehicle will still be separate property. However, if a mutation goes so far as to make it difficult to distinguish the separate character of the property, it may be difficult or impossible to overcome the community property presumption. In that case, the originally separate property may become community property.

If a business entity was formed during marriage and the contribution to capital was made from a separate property account, the owner spouse should argue that the interest acquired was a “mutation” of the separate property funds, and thus remains separate property. However, questions could arise as to why the community estate did not have the opportunity to make the investment. While there is no statutory or equitable claim for “Diversion of Community Opportunity,” spouses generally have a fiduciary duty to the community estate.⁵³ It is possible for the community to assert a claim for fraud against a separate estate in such an instance.⁵⁴

In another hypothetical, Husband sells stock in a corporation owned prior to marriage and simultaneously forms a new corporation that requires

⁵² *Norris v. Vaughan*, 152 Tex. 491, 496-97, 260 S.W.2d 676, 679 (1953).

⁵³ *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). (A fiduciary duty exists between a husband and a wife regarding the community property controlled by each spouse).

⁵⁴ *Loaiza* at 921 citing *Zieba*, 928 S.W.2d at 789; *Moore*, 890 S.W.2d at 827 (“Fraud on the community” is a judicially created concept based on the theory of constructive fraud and is applied when there is a breach of a legal or equitable duty, which violates this fiduciary relationship existing between spouses) and citing *Zieba*, 928 S.W.2d at 789; *Moore*, 890 S.W.2d at 827.)Although not actually fraudulent, any such conduct in the marital relationship is termed fraud on the community because it has all the consequences and legal effects of actual fraud since the conduct tends to deceive the other spouse or violates marital confidences.).

the contribution of \$1,000 of money or business done. Upon his divorce, Husband may be unable to prove that the specific funds from the sale of the separate property corporation were used to provide the consideration 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.

V. CLAIMS OF AND AGAINST THE MARITAL ESTATES

Ownership interests in a closely held business can be subject to claims by the separate and community estates, commonly referred to as claims of “economic contribution” or “statutory reimbursement” (if the case was filed prior to September 1, 2009), and common law reimbursement. Though they may at first appear simple, they become much more complicated when applied to business transactions and the complex dealings therein.

A. Economic Contribution and Reimbursement

While conceptually economic contribution and reimbursement seem similar, there are key differences between the two. Economic contribution was created entirely by statute which was repealed during the most recent Legislative session (thus applying to cases filed prior to September 1, 2009) while reimbursement is based on a common law claim. Inasmuch as there are still thousands of cases pending to which economic reimbursement may apply, we will address the issue here with the caveat that it does not apply to cases filed after September 1, 2009. Economic contribution concerns the sharing between estates of any enhanced value which the contributing estate helped create, not limited to the amount of the actual contributions. Reimbursement is concerned only with the repayment of the exact amounts advanced.⁵⁵

1. Economic Contribution

As stated above, since the economic contribution statutes were repealed by the Legislature in 2009, such claims do not apply to divorces filed after September 1, 2009.

⁵⁵ 33 TXPRAC § 10.25.

Economic contribution attempted to distribute the increased value of property owned by one marital estate that had been enhanced by a contribution from another estate. It required that one estate have made either payment on a secured debt of another estate or a capital improvement to another estate.⁵⁶ A mathematical formula was used to determine the allocation of the enhanced value between the contributing and benefited estates.⁵⁷ For a divorce filed prior to the repeal of economic contribution, the practitioner must be aware that specific statutory circumstances must exist in order to have a claim for economic contribution.⁵⁸

2. Reimbursement

A statutory reimbursement claim now includes many of the grounds from the former economic contribution claim. A reimbursement claim includes:⁵⁹

- (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) Reductions of the principal amount of certain debts;
- (4) Refinancing of the principal amount of certain debts, to the extent the refinancing reduces the principal amount in specified ways; and
- (5) Capital improvements to property other than by incurring debt;

The amount to be reimbursed is measured by the value of items above, offset by the value of any benefits received, including use and enjoyment.⁶⁰

B. Example of Application to Small Business

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 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 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.

C. Jensen Claim

Another type of reimbursement claim that can face a divorcing business owner results when the owner of a separate property business has not taken full compensation for the actual time, toil, and effort he or she has expended in the furtherance of the business. This forgone compensation (e.g. compensation for

⁵⁶ Former TEX. FAM. CODE § 3.402 (prior to 2009).

⁵⁷ Former TEX. FAM. CODE § 3.403 (prior to 2009).

⁵⁸ Former TEX. FAM. CODE § 3.402 (prior to 2009).

⁵⁹ TEX. FAM. CODE § 3.402(a).

⁶⁰ TEX. FAM. CODE § 3.402(c).

personal services or distributions of profit from the business) would have been community property, and a spouse can bring a claim on behalf of the community in a divorce. This type of claim is referred to as a *Jensen* claim, after its namesake, and can be beneficial to a community estate when the marital estate is heavily loaded with separate value.⁶¹

For a *Jensen* claim to be successful, the spouse owning the separate property business interest must have direction and control over the business entity, i.e., 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.⁶²

If the owner of the separate property business interest is not paid out full compensation and 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 merely 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 be due a reimbursement for the amount of the enhanced value less the caretaker's salary.

1. Example of Jensen Claim

This example involves an industrial services company that was clearly the separate property of the Husband. The owner's 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 \$2MM 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 reduce or scale back activities. Husband had no heir to pass the business along to and had no expansion plans. However, the corporation had accumulated almost \$1MM in cash, a portion of which represented the enhanced value due to the underpayment of salary and underpayment of rent, both of which would have been community in nature. 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, arguing for the *Jensen* claim was made easier by the existence of the cash hoard built up inside the corporation.

Failing to avoid this potential divorce disaster could be devastating to the party attempting to duck a claim of economic contribution or common law or statutory reimbursement. Therefore, the practitioner should keep this issue in mind when advising the owner of a separate property business on the owner's compensation structure.

VI. FIDUCIARY DUTY

A. Introduction

The concept of "fraud" takes on many forms in the divorce context. A divorcing business owner should be informed of the potential claims for fraud in divorce. Fraud can include a spouse forming a business entity so as to "leave" the other spouse or the community estate out of the business. 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.

One of the largest areas of concern is whether a spouse who forms a partnership (which is not divisible by the court) breaches a fiduciary duty to the other spouse. We have seen many cases where a spouse takes the lion's share of the community estate and places it in a partnership (of which the other spouse is not a partner and therefore to the exclusion of the other spouse) where it is not subject to division upon divorce.

The small business attorney can also be subject to liability. It is our advice that the business attorney be very careful in formulating the business and in advising the client whether separate or community funds should be used. It is a good idea to be clear in

⁶¹ *Jensen v. Jensen*, 665 S.W.2d 107 (Tex. Feb 29, 1984).

⁶² *Id.*

your contract regarding whether you are representing the husband, the wife or both. If you represent both spouses, you need to proceed with caution in advising about funding and expenditures as to separate and community property, and as to the fiduciary duty the spouses have to each other. You do not want to invite a claim against yourself by one of the spouses claiming that you defrauded that spouse out of their separate estate or the community estate.

B. Fraud/Fiduciary Duty

Justice Ann McClure's concurrence in *Sprick v. Sprick*, 25 S.W.3d 7 (Tex.App.—El Paso 1999, pet. denied) is the most excellent explanation on the concept of fraud and is quoted in full as follows:

“Creative and inventive theories of recovery abound for economic torts committed against the community estate. These range from waste, depletion of assets, the community opportunity doctrine and its inverse partner, the community jeopardy doctrine [FN3] to the generic tort of fraud, which encompasses a number of varieties such as breach of fiduciary duty, fraudulent conveyance, excessive gifts to children, and community funds expended on paramours, just to name a few. The intermediate courts have not been consistent in their determination of whether an independent economic tort is actionable between spouses for damages to the community estate. It now appears that the Supreme Court has not been entirely consistent either.

“[FN3] The community opportunity doctrine derives from the corporate opportunity doctrine and stands for the proposition that a spouse has an obligation to maximize the community estate by taking advantage of an opportunity to invest in a lucrative venture using community, rather than separate, funds. The community jeopardy doctrine operates in the reverse and suggests that a spouse also has an obligation to protect the community estate from risky pursuits by investing separate, rather than community, funds. As might be expected, whether an investment is potentially lucrative or risky is easier to discern in hindsight and is ordinarily fact specific.

Fraud in the divorce context, as in other civil litigation, may be actual or constructive. Actual fraud is predicated upon the intent to

deceive. The elements are: (1) that a material representation was made; (2) that it was false; (3) that when the speaker made it, he knew it was false or made it recklessly without any knowledge of the truth and as a positive assertion; (4) that he made it with the intention that it should be acted upon by the party; (5) that the party acted in reliance upon it; and (6) that he suffered thereby.⁶³

“[C]onstructive fraud is the breach of some legal or equitable duty which, irrespective of moral guilt, the law declares fraudulent because of its tendency to deceive others, to violate confidence, or to injure public interests.”⁶⁴ In other words, intent is irrelevant. Because of the confidential relationship between a husband and wife, the marital partnership is fiduciary in nature.⁶⁵ A breach of this fiduciary duty is frequently termed a “fraud on the community.”⁶⁶ Generally speaking, the allegation is one of constructive rather than actual fraud: Any such conduct in the marital relationship is termed fraud on the community because, although not actually fraudulent, it has all the consequences and legal effects of actual fraud in that such conduct tends to deceive the other spouse or violate confidences that exist as a result of the marriage.⁶⁷

“Constructive fraud includes actions of one spouse in unfairly disposing of or encumbering the other spouse's interest in community property or unfairly incurring community indebtedness without the other spouse's knowledge or consent.⁶⁸ In the absence of fraud, a spouse has the right to control and dispose of community property subject to his sole management.⁶⁹ Although

⁶³ *Stone v. Lawyers Title Insurance Corp.*, 554 S.W.2d 183, 185 (Tex.1977).

⁶⁴ *Archer v. Griffith*, 390 S.W.2d 735, 740 (Tex.1964).

⁶⁵ *Matthews v. Matthews*, 725 S.W.2d 275, 279 (Tex.App.—Houston [1st Dist.] 1986, writ ref'd n.r.e.).

⁶⁶ *In Re. Marriage of Moore*, 890 S.W.2d 821, 827 (Tex.App.—Amarillo 1994, no writ).

⁶⁷ *Id.* at 827.

⁶⁸ *Massey v. Massey*, 807 S.W.2d 391, 402 (Tex.App.—Houston [1st Dist.] 1991), writ denied, 867 S.W.2d 766 (Tex.1993).

⁶⁹ *Id.* at 401, citing *Mazique v. Mazique*, 742 S.W.2d 805, 807 (Tex.App.—Houston [1st Dist.] 1987, no writ).

the managing spouse need not obtain approval or consent for dispositions made of special community property, the fiduciary relationship between husband and wife requires that a spouse's disposition of special community property be "fair" to the other spouse.⁷⁰ The managing spouse carries the burden of establishing that the disposition of property was fair.⁷¹

"FN4. During marriage, each spouse has the sole management, control, and disposition of the community property that the spouse would have owned if single, including personal earnings, revenue from separate property, recoveries for personal injury, and the increase and mutations of, and the revenue from, all property subject to the spouse's sole management, control, and disposition.⁷² Community property subject to a spouse's sole management and control is sometimes referred to as "special community property," particularly in older case law. All other community property is subject to the joint management, control and disposition of the spouses unless the spouses provide otherwise by power of attorney in writing or other agreement.⁷³

"The Supreme Court has recently reiterated that Texas recognizes the concept of fraud on the community, which it has defined as a wrong committed by one spouse which may be considered by the trial court in its division of the community estate and which may justify a disproportionate division.⁷⁴ It is not, however, an independent tort giving rise to a cause of action between spouses.⁷⁵ Nor may it give rise to a recovery for punitive damages, inasmuch as "recovery of punitive damages requires a finding of an independent

tort with accompanying actual damages."⁷⁶ Instead, the claim of fraud on the community is a means to an end, seeking either to recover specific assets wrongfully conveyed or to obtain a greater share of the community estate upon divorce as compensation for the loss of community property.⁷⁷ Where the economic tort depletes the community estate so as to leave insufficient property available to the wronged spouse, the courts may impose a money judgment in order to achieve an equitable division.⁷⁸ The money judgment serves to recoup the value of the wronged spouse's share of the estate which has been lost through the fraud.⁷⁹ "Because the amount of the judgment is directly referable to a specific value of lost community property, it will never exceed the total value of the community estate."⁸⁰ On the heels of *Schlueter*, the Court was presented with some rather egregious facts in *Vickery v. Vickery*, 999 S.W.2d 342 (Tex.1999)(J. Hecht, dissenting). The underlying court of appeals' opinion was unpublished. The Supreme Court denied the petition for review, with Justice Hecht dissenting from the denial in a published opinion which incorporates as an appendix both the intermediate court's opinion on the merits and Justice Andell's dissent from that court's denial of rehearing en banc. At issue was Mrs. Vickery's recovery in a bill of review proceeding. The jury found Mr. Vickery, himself an attorney, liable for fraud and breach of fiduciary duty and assessed Mrs. Vickery's damages at \$6.7 million for loss of marital property and \$1.3 million for mental anguish, together with \$1 million in punitive damages. The jury also found that Mrs. Vickery's attorney breached her fiduciary duty, resulting in damages of \$100,000 in lost marital property and \$350,000 in mental anguish damages.

⁷⁰ *Massey*, 807 S.W.2d at 402, citing *Horlock v. Horlock*, 533 S.W.2d 52, 55 (Tex.Civ.App.--Houston [14th Dist.] 1975, writ dismissed).

⁷¹ *Id.*

⁷² TEX. FAM. CODE § 3.102(a).

⁷³ TEX. FAM. CODE § 3.102(c).

⁷⁴ *Schlueter v. Schlueter*, 975 S.W.2d 584, 588 (Tex.1998).

⁷⁵ *Id.* at 586.

⁷⁶ *Schlueter*, 975 S.W.2d at 589, quoting *Twin City Fire Ins. Co. v. Davis*, 904 S.W.2d 663, 665 (Tex.1995)

⁷⁷ *Schlueter*, 975 S.W.2d at 588, quoting *Belz v. Belz*, 667 S.W.2d 240, 247 (Tex.App.--Dallas 1984, writ refused n.r.e.).

⁷⁸ *Schlueter*, 975 S.W.2d at 588, citing *Murff v. Murff*, 615 S.W.2d 696, 699 (Tex.1981).

⁷⁹ *Schlueter*, 975 S.W.2d at 588, citing *Mazique v. Mazique*, 742 S.W.2d 805, 808 (Tex.App.--Houston [1st Dist.] 1987, no writ).

⁸⁰ *Schlueter*, 975 S.W.2d at 588.

As Justice Hecht notes in his dissent, “[a]pplying *Schlueter* would require that the actual and punitive damages awarded Mrs. Vickery against her former husband be reversed and the case remanded to the district court to reconsider what division of the community is just and right. The district court may consider Mr. Vickery’s ‘dishonesty of purpose or intent to deceive’ and ‘the heightened culpability of actual fraud’ as found by the jury.” The fact that the Supreme Court, by denying review, allowed the actual and punitive damages to stand gives me some concern as to what the current state of the law is for economic torts committed against the community estate.^{81c}

In determining the division of community property, the court may consider proof of one spouse’s dishonesty or intent to deceive, constituting actual fraud, regarding the community assets,⁸² and may also consider evidence of one spouse’s constructive fraud in transactions involving community property, taking into account⁸³:

- a. the size of the property disposed of in relation to the total size of the community property,
- b. the adequacy of the remaining estate to support the other spouse, and
- c. the relationship of the parties involved in the transaction.

Unfairly disposing of the other spouse’s community property results in a presumption of constructive fraud.⁸⁴ However, the mere fact that a community property business venture lost money because of the acts of one spouse, even if it ended in bankruptcy, does not constitute fraud.⁸⁵ Additionally, the trial court may

⁸¹ *Id.* at 14.

⁸² *Schleuter v. Schleuter*, 975 S.W.2d 584 (Tex. 1998).

⁸³ *Massey v. Massey*, 807 S.W.2d 391 (Tex. App.—Houston [1st Dist.] 1991, writ denied).

⁸⁴ *Connell v. Connell*, 889 S.W.2d 534 (Tex. App. — San Antonio 1994, writ denied).

⁸⁵ *Id.*; see also *Andrews v. Andrews*, 677 S.W.2d 171 (Tex. App. — Austin 1984, no writ) (a spouse’s good faith, but unwise, investment of community funds resulting in losses to the community estate does not justify an unequal distribution of the remaining community property upon divorce).

take into account a spouse’s dissipation of the estate or concealment of assets.⁸⁶

VII. VALUATION

The valuation of the closely held business entity upon divorce is often the most important issue in a divorce, 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. Every time you state the value of the business for any purpose, you create a precedent of value for a divorce court to use later on.

A. The Valuation Process

The valuation process generally consists of the following steps: 1) Gaining an understanding of the business being appraised; 2) Determining the nature, extent, and value of the net assets of the business; 3) Determining the key economic drivers of the business and the return to investors that the business can produce, and determining if that return is enough to justify the existence of any “goodwill” or intangible value; and 4) Communicating the results of the appraisal.

1. Business Appraisals in a Divorce Context

Following are some key points to remember regarding business appraisals for divorce:

a. Fair Market Value

The standard of value 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.

b. Approaches for Business Appraisals

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

⁸⁶ See *Massey v. Massey*, 807 S.W.2d 391 (Tex. App.—Houston [1st Dist.] 1991, writ denied) (based on jury verdict that husband committed constructive fraud, trial court was entitled to award wife equalization for property depleted unfairly from community estate); *Reaney v. Reaney*, 505 S.W.2d 338, 340 (Tex.Civ.App.—Dallas 1974, no writ) (court took into account the husband’s dissipation of approximately \$53,000 of community assets when dividing the estate); *Pride v. Pride*, 318 S.W.2d 715, 718 (Tex.Civ.App.—Dallas 1958, no writ) (trial court rendered a money judgment against the husband for the wife’s share of \$3,000 he concealed).

asset and market approaches and the methods utilized within each of those 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 value of that income stream into perpetuity by risking it with an appropriate rate of return (principle of “anticipation”). The difficulty in this approach is determining what a normalized, investor return for the subject business is. A widely used benefit stream that is used for this purpose is “net cash flow to equity.” This benefit stream measures the amount of benefit available to the equity-holders of the business and consists of net income, increased by non-cash charges, adjusted for the changes in working capital, decreased by anticipated capital expenditures, and decreased by anticipated payments on long term debt (if any). The “understandability” factor and the multitude of calculations in this approach may make its use problematic in a litigation setting.

(2) Asset Approach

The asset approach contemplates the cost of duplicating the assemblage of assets that is currently utilized by the business operation (principle of “duplication”) and may require that a value be placed on each individual asset. For example, the face amount of accounts receivable may have to be reduced for uncollectable accounts. The business appraiser may be faced with the need to appraise hard assets, such as machinery, equipment, or real estate. In such a case, an individual with specific expertise and qualifications may have to be found to perform this component of the job.

(3) Market Approach

The market approach consists of determining what similarly situated businesses are being sold for in the private market or how the public securities market values similar companies (principle of “substitution”). The difficulty inherent in this approach is finding comparable transactions.

c. 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:

- (1) The nature of the business and the history of the enterprise from inception;

- (2) The current economic outlook in general and the condition and outlook of the particular industry in general;
- (3) The book value of the stock and the financial condition of the business;
- (4) The earning capacity of the company;
- (5) The dividend paying capacity of the company;
- (6) Whether or not the enterprise has goodwill or other intangible value;
- (7) Sales of the stock and the size of the block of stock to be valued;
- (8) 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.

Consideration of each of these factors is essential in the business appraisal process.

B. Goodwill Issues

In the business appraisal process, the desired result from the business appraiser is an opinion of the fair market value of the business enterprise. This encompasses the assets typically transferred in a sale transaction. In an asset sale, items transferred generally do not include cash, trade receivables, prepaid expenses, real estate, and non-operating assets not essential to the business (country club memberships, hunting lodges, investments of excess cash, etc.). In a stock sale, almost everything is transferred, other than excess or non-operating assets. In both asset and stock sales, however, the intangible value of the business that is generated by the assets in place is typically transferred—that is often the point of buying the business in the first place.

1. Intangible Assets

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

a. 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.

b. Goodwill

The other category of intangible is generally known as “goodwill.” Goodwill can be defined in several ways. One definition is the ability of a business concern to continue to receive patronage after a change in ownership, and the value represented by that ability. Another definition is the value represented by returns on the net assets of the business in excess of those normally expected.

(1) Personal Goodwill

The success of many small and closely-held businesses is inextricably linked to the efforts, skill, reputation, and ability of the owner-employee, especially professional practices. Therefore, the excess returns of the business may be possible only due to the efforts of the owner or his reputation and customer contacts. When this attribute exists, the component of the goodwill associated with the owner is referred to as “personal goodwill.” Personal goodwill is generally not marital property subject to division. This is because the personal goodwill is typically maintained by the daily efforts of the owner and will continue to have to be maintained by those efforts subsequent to the divorce.

Indicators of the value of personal goodwill include covenants not to compete, key man life insurance policies, and perhaps excess compensation. However, these are only indicators or guidelines assisting in the measurement of personal goodwill.

(2) Overall Goodwill -- Personal and Commercial Goodwill Combined

The overall goodwill of the business will consist of the personal goodwill of the owner and the “institutional” or commercial goodwill of the business itself. For example, consider two business entities that are being appraised. Each owns three restaurants in a large metropolitan area. The first entity operates three franchised restaurants, and the second operates an independently owned, exclusive French restaurant and is also the executive chef. The owner of the first entity utilizes three managers, who supervise the operations of each restaurant. The owner of the second entity is personally known by her customers, who patronize the restaurant for her fine cooking. If both entities possess goodwill as part of their business enterprise value, the commercial goodwill of the first entity will most likely be higher as a percentage of the total than the second entity.

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. For goodwill to be part of divisible value in a Texas divorce, it should be shown to exist independently of the professional ability

of the owner-employee spouse and if so, the goodwill must be shown to have commercially-available (saleable) value. Texas juries have been instructed that the jury must find the fair market value of the business as if the current owner was out of the business and free to compete with it. In other words, the business should be appraised as if the owner of the business is going to literally walk across the street, open a competing business, and maintain access to his customer’s names and numbers.

In the case of the two restaurant entities discussed above, the buyer of the first entity may not be as concerned about the ability of the owner to compete as in the first situation. The customers of the first entity are probably patronizing it due to the brand name and loyalty created by advertising. The customers of the second entity are patronizing it due to the skills, talent and reputation of the owner/chef.

2. Illustration of Measuring Goodwill

The following example demonstrates the measurement of business enterprise value and goodwill in a hypothetical appraisal situation. This is a very simplified example and is presented to demonstrate the concepts of business enterprise value and the measurement of intangible asset value.

Market Approach	
Annual Revenue of Subject	\$5,000,000
Price to Revenue Multiple Observed	30%
Intermediate Value Metric	\$1,500,000
Add: Cash and AR	\$500,000
Fair Market Value	\$2,000,000

Synthesis of value favoring the Market Approach	\$1,944,400
Adjusted Net Assets of Business	\$1,000,000
Implied Intangible	\$944,400
Value of Patent	\$100,000
Value of Trade Name	\$50,000
Total Specific Intangibles	\$150,000
Goodwill	\$794,400
Personal Goodwill	\$400,000
Commercial Goodwill	\$394,400
Total Goodwill	\$794,400

In this case, the commercial goodwill could be measured by the amount of lost profits that the current owner would experience if he or she had to open a competing business (represented by the lowered profitability during the startup period) and the commercial goodwill would be measured indirectly based on the difference between the personal goodwill identified and the total goodwill of the business. The specific intangibles would be valued by reference to the cost of a comparable intangible or the present value of the royalties the company would earn from licensing the intangible asset.

VIII. SPOUSE AS AN EMPLOYEE

It is not unusual for both spouses to work together in the business. If the business is the separate property of one spouse, refer also to the discussion above regarding statutory and common-law reimbursement. Whether the business is community property or one spouse's separate property, if both spouses work in the business and bring home an income, this scenario poses interesting and complex problems in a divorce.

A. Supporting the Spouse Who Physically Leaves the Business

When a divorce ensues, one spouse usually leaves the business because it can be difficult to work together during such a stressful and emotional time. Regardless, the spouse who leaves the business usually wants to maintain his or her income flow. One of the first issues in a divorce case is the issue of temporary support from one spouse to the other, discussed more extensively in the next section. An attorney should advise a client that if a divorce ensues, the spouse leaving the business will likely be allowed to continue receiving comparable support during the divorce process. There can even be an argument that the spouse should receive more income, if the spouse had previously been under-compensated for his or her work at the business.

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 and/or for an auditor to be appointed. An appointed receiver decides 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.

IX. TEMPORARY SUPPORT

Temporary orders are orders commonly issued by a divorce court to provide interim relief for the spouses during the pendency of a divorce.⁸⁷ 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

⁸⁷ TEX. FAM. CODE §6.502.

may be taken into consideration in making a just and right division of the marital estate.⁸⁸

X. 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. In some instances, the property belongs to the business itself and is not divisible (for example, under the entity theory or corporate shell). Additionally, the character of the capital funding may dovetail into the choice of entity.

For example, partnership property belongs to the partnership, with the exception of the partnership interest, which may be characterized as community property. Therefore, under the current state of the law, a lion's share of the monies in a partnership will remain in the partnership upon divorce, assuming the partnership is not dissolved. 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, with the exception of personal goodwill, is fully-divisible in divorce.

B. Partnership Property⁸⁹

1. Partnership Property Belongs to the Partnership

As all small business attorneys already know, partnership property is owned by the partnership entity and not the individual partners.⁹⁰ Thus, with few exceptions, neither spouse has an interest in partnership property.⁹¹

Although no partner owns specific partnership property, each owns a specific interest in such

property.⁹² Therefore, a partner/spouse's partnership interest may be community property under the rules of characterization.⁹³

2. Participation in Management of Partnership

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.⁹⁴

3. Partnership Interest

Therefore, the partnership interest is the only partnership-related property that needs to be characterized as separate or community.⁹⁵

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.⁹⁶ 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.⁹⁷

4. Transferees

Upon divorce, the spouse of the partner is regarded for purposes of the TEXAS REVISED PARTNERSHIP ACT as a "transferee" of the partnership interest.⁹⁸ Though a spouse's partnership interest may be community property, actual division of the

⁸⁸ *Herschberg v. Herschberg*, 994 S.W.2d 273 (Tex.App.-Corpus Christi May 20, 1999), rehearing overruled (Jul 01, 1999)

⁸⁹ The TEXAS BUSINESS ORGANIZATIONS CODE governs a domestic general partnership formed on or after January 1, 2006. The TEXAS REVISED PARTNERSHIP ACT continues to govern a domestic general partnership formed prior to January 1, 2006 until January 1, 2010, unless the general partnership makes an election (as provided by Section 402.003 of the Business Organizations Code) to be governed by the Business Organizations Code prior to January 1, 2010. 19 TXPRAC § 9.3 provided a majority of the information used in this section.

⁹⁰ VERNONS ANN. CIV. ST. (TUPA) ART. 6132b §5.01.

⁹¹ VERNONS ANN. CIV. ST. (TUPA) ART. 6132b §2.04.

⁹² *Biggs v. First Nat. Bank of Lubbock*, 808 S.W.2d 232 (Tex. App. – El Paso 1991, writ denied).

⁹³ VERNON'S ANN. CIV. ST. art. 6132b-5.02(a); V.T.C.A., BUS. ORG. CODE § 154.001(a) and (b).

⁹⁴ VERNON'S ANN. CIV. ST. art. 6132b-4.01(d). V.T.C.A., BUS. ORG. CODE § 152.203(a).

⁹⁵ 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.).

⁹⁶ 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.).

⁹⁷ *Cleaver v. Cleaver*, 935 S.W.2d 491 (Tex.App.--Tyler 1996, no writ).

⁹⁸ VERNON'S ANN. CIV. ST. art. 6132b-5.04(a), (b), and (c).

partnership interest upon divorce is often avoided by divorce courts, who possess considerable discretion in dividing the community estate.⁹⁹ 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.¹⁰⁰

The transfer of a partnership interest does not itself require a winding up of the partnership.¹⁰¹ 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.¹⁰² However, a transferee is not entitled to participate in the management or conduct of the partnership business.¹⁰³

C. 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.¹⁰⁴ 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.”¹⁰⁵

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.¹⁰⁶ 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.

D. 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.¹⁰⁷ 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.¹⁰⁸ 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.¹⁰⁹

XI. TAX EFFECT

A. Introduction

The tax effect of a property division is explicitly a factor the court may consider in dividing property upon divorce.¹¹⁰ 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.¹¹¹

⁹⁹ V.T.C.A., Family Code § 7.001.

¹⁰⁰ 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).

¹⁰¹ VERNON’S ANN CIV. ST. art. 6132b-5.03(a)(3); V.T.C.A., BUS. ORG. CODE § 152.402(2).

¹⁰² VERNON’S ANN. CIV. ST. art. 6132b-5.03(b), (c).

¹⁰³ VERNON’S ANN. CIV. ST. art. 6132b-5.03(a)(4); V.T.C.A., BUS. ORG. CODE § 152.402(3).

¹⁰⁴ *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).

¹⁰⁵ *Id.* at 516 citing *Castleberry* at 272.

¹⁰⁶ *Id.* citing *Zisblatt v. Zisblatt*, 693 S.W.2d 944, 949 (Tex.App.-Fort Worth 1985, writ dismiss’d); accord *Vallone v. Vallone*, 644 S.W.2d 455, 458 (Tex.1982) (alter ego is issue of fact from which the status of property as community or separate is determined).

¹⁰⁷ *Id.* citing *Zisblatt* at 955.

¹⁰⁸ *Id.* citing *Goetz v. Goetz*, 567 S.W.2d 892, 896 (Tex.App.-Dallas 1976, no writ) (wife not entitled to award of separate property corporate assets even though husband was sole shareholder and committed some improprieties, where husband’s improper use of corporation did not damage community estate).

¹⁰⁹ *Id.*

¹¹⁰ V.T.C.A., Family Code § 7.008.

¹¹¹ *Id.*

B. Analysis of Tax Effects

The family code allows the court to consider tax consequences, but does not require the court to do so. This can lead to complexity in applying the provision. For example, attorneys can make arguments based on: (1) the nature of the tax to be considered (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 in a defined contribution 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, using the divorce decree as a contract, but the contract is only as good as the former spouse's ability to pay. If the IRS wasn't able 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 thinks

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

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. There is a new trend in divorce law, called collaborative law, that can potentially help small business owners in a 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. 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. REPRESENTING YOUR SMALL BUSINESS CLIENT IN THE DIVORCE

A. Don't Do It!

Representing your small business client in his or her divorce is ill-advised. There is a high potential for conflict of interest if you have ever advised the other spouse with respect to the business. Additionally, because of the various 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.

1. Conflict of Interest

Remember, 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.¹¹² 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.¹¹³

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.¹¹⁴

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.¹¹⁵ Do not hand the case over to another member of your firm, as Texas disciplinary rules do not permit forming a "Chinese wall" in these instances.¹¹⁶

2. 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. 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.¹¹⁷ Even worse, if you know that 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)? You cannot represent the client in those instances, unless the client consents,¹¹⁸ nor can you throw the matter to another lawyer in your firm, without written authority from the client.¹¹⁹

¹¹⁷ (a) A lawyer shall not accept or continue employment as an advocate before a tribunal in a contemplated or pending adjudicatory proceeding if the lawyer knows or believes that the lawyer is or may be a witness necessary to establish an essential fact on behalf of the lawyer's client, unless:

(1) the testimony relates to an uncontested issue;

(2) the testimony will relate solely to a matter of formality and there is no reason to believe that substantial evidence will be offered in opposition to the testimony;

(3) the testimony relates to the nature and value of legal services rendered in the case;

(4) the lawyer is a party to the action and is appearing pro se; or

(5) the lawyer has promptly notified opposing counsel that the lawyer expects to testify in the matter and disqualification of the lawyer would work substantial hardship on the client.

V.T.C.A., GOVT. CODE T. 2, Subt. G App. A, Art. 10, §9 Rule 3.08.

¹¹⁸ *Id.* stating "A lawyer shall not continue as an advocate in a pending adjudicatory proceeding if the lawyer believes that the lawyer will be compelled to furnish testimony that will be substantially adverse to the lawyer's client, unless the client consents after full disclosure."

¹¹⁹ *Id.* stating "Without the client's informed consent, a lawyer may not act as advocate in an adjudicatory proceeding in which another lawyer in the lawyer's firm is prohibited by paragraphs (a) or (b) from serving as advocate. If the lawyer to be called as a witness could not also serve as an advocate under this Rule, that lawyer shall not take an active role before the tribunal in the presentation of the matter."

¹¹² V.T.C.A., GOVT. CODE T. 2, Subt. G App. A, Art. 10 §9 Rule 106.

¹¹³ *Id.*

¹¹⁴ *Id.* stating "A lawyer may represent a client in the circumstances described in (b) if: (1) the lawyer reasonably believes the representation of each client will not be materially affected; and (2) each affected or potentially affected client consents to such representation after full disclosure of the existence, nature, implications, and possible adverse consequences of the common representation and the advantages involved, if any."

¹¹⁵ *Id.* stating "If a lawyer has accepted representation in violation of this Rule, or if multiple representation properly accepted becomes improper under this Rule, the lawyer shall promptly withdraw from one or more representations to the extent necessary for any remaining representation not to be in violation of these Rules."

¹¹⁶ *Id.* stating "If a lawyer would be prohibited by this Rule from engaging in particular conduct, no other lawyer while a member or associated with that lawyer's firm may engage in that conduct."

3. It's Harder Than It Looks

Finally, 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?

XIV. 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 who is undergoing a 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.

Exhibit A

Summary of New Developments in the Law – 2009

A. Relevant Legislative Changes:

1. Employee Stock

§ 3.007(a), (b), & (f). Interest In Certain Employee Benefits – REPEALED

~~(a) A spouse who is a participant in a defined benefit retirement plan has a separate property interest in the monthly accrued benefit the spouse had a right to receive on normal retirement age, as defined by the plan, as of the date of marriage, regardless of whether the benefit had vested.~~

~~(b) The community property interest in a defined benefit plan shall be determined as if the spouse began to participate in the plan on the date of marriage and ended that participation on the date of dissolution or termination of the marriage, regardless of whether the benefit had vested.~~

~~(f) The characterization of the marital property interest in an option or restricted stock described by Subsection (d) must be recalculated if, after the initial division of the option or stock, the vesting occurs on a date earlier than the vesting date stated in the original grant of the option or stock. The recalculation required by this subsection must adjust for the shortened vesting period and applies to options and stock granted before and during the marriage.~~

Source: SB 866

Effective Date: 9/1/09

§ 3.007(d). Interest In Certain Employee Benefits - AMENDED

(d) A spouse who is a participant in an employer-provided stock option plan or an employer-provided restricted stock plan has a separate property interest in the options or restricted stock granted to the spouse under the plan as follows:

- (1) if the option or stock was granted to the spouse before marriage but required continued employment during marriage before the grant could be exercised or the restriction removed, the spouse's separate property interest is equal to the fraction of the option or restricted stock in which:
 - (a) the numerator is the sum of:
 - (i) the period from the date the option or stock was granted until the date of marriage; and
 - (ii) if the option or stock also required continued employment following the date of dissolution of the marriage before the grant could be exercised or the restriction removed, the period from the date of dissolution of the marriage until the date the grant could be exercised or the restriction removed; and
 - (b) the denominator is the period from the date the option or stock was granted until the date the grant could be exercised or the restriction removed; and
- (2) if the option or stock was granted to the spouse during the marriage but required continued employment following the date of dissolution of the [after] marriage before the grant could be exercised or the restriction removed, the spouse's separate property interest is equal to the fraction of the option or restricted stock in which:
 - (a) the numerator is the period from the date of dissolution [or termination] of the marriage until the date the grant could be exercised or the restriction removed; and
 - (b) the denominator is the period from the date the option or stock was granted until the date the grant could be exercised or the restriction removed.

Source: SB 866

Effective Date: 9/1/09- applies to suit for dissolution pending in TC on or filed on or after 9/1/09

2. Economic Contribution and Reimbursement

§ 3.401(1-3). Definitions– REPEALED

- (1) ~~“Claim for economic contribution” means a claim made under this subchapter.~~
 (2) ~~“Economic contribution” means the contribution to a marital estate described by Section 3.402.~~
 (3) ~~“Equity” means, with respect to specific property owned by one or more marital estates, the amount computed by subtracting from the fair market value of the property as of a specific date the amount of a lawful lien specific to the property on that same date.~~

Source: SB 866

Effective Date: applies to suits for dissolution filed on or after 9/1/09

§ 3.402(a-e). Claim For Reimbursement; Offsets ~~{Economic Contribution}~~ – AMENDED

- (a) For purposes of this subchapter, a claim for reimbursement includes:
- (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) [“economic contribution” is the dollar amount of:
 - ~~[(4)]~~ 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;
 - ~~(4) [(2)]~~ 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) [(3)]~~ 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) [(4)]~~ 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) [(5)]~~ the refinancing of the principal amount described by Subdivisions ~~(3)-(6) [(1)-(4)]~~, to the extent the refinancing reduces that principal amount in a manner described by the applicable [appropriate] subdivision; ~~[and]~~
 - ~~(8) [(6)]~~ 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.~~
- (b) The court shall resolve a claim for reimbursement by using equitable principles, including the principle that claims for reimbursement may be offset against each other if the court determines it to be appropriate.
- (c) Benefits for the use and enjoyment of property may be offset against a claim for reimbursement for expenditures to benefit a marital estate, except that the separate estate of a spouse may not claim an offset for use and enjoyment of a primary or secondary residence owned wholly or partly by the separate estate against contributions made by the community estate to the separate estate.
- (d) Reimbursement for funds expended by a marital estate for improvements to another marital estate shall be measured by the enhancement in value to the benefited marital estate.
- (e) The party seeking an offset to a claim for reimbursement has the burden of proof with respect to the offset
~~[“Economic contribution” does not include the dollar amount of:~~
~~[(1) expenditures for ordinary maintenance and repair or for taxes, interest, or insurance; or~~
~~[(2) the contribution by a spouse of time, toil, talent, or effort during the marriage].~~

Source: SB 866

Effective Date: applies to suits for dissolution filed on or after 9/1/09

§ 3.403. Claim Based On Economic Contribution – REPEALED

- (a) ~~A marital estate that makes an economic contribution to property owned by another marital estate has a claim for economic contribution with respect to the benefited estate.~~
- (b) ~~The amount of the claim under this section is equal to the product of:~~
- ~~(1) the equity in the benefited property on the date of dissolution of the marriage, the death of a spouse, or disposition of the property; multiplied by~~
 - ~~(2) a fraction of which:~~
 - ~~(A) the numerator is the economic contribution to the property owned by the benefited marital estate by the contributing marital estate; and~~
 - ~~(B) the denominator is an amount equal to the sum of:~~
 - ~~(i) the economic contribution to the property owned by the benefited marital estate by the contributing marital estate; and~~
 - ~~(ii) the contribution by the benefited estate to the equity in the property owned by the benefited estate.~~
- ~~(b 1) The amount of the contribution by the benefited marital estate under Subsection (b)(2)(B)(ii) is measured by determining:~~
- ~~(1) if the benefited estate is the community property estate:~~
 - ~~(A) the net equity of the community property estate in the property owned by the community property estate as of the date of the first economic contribution to that property by the contributing separate property estate; and~~
 - ~~(B) any additional economic contribution to the equity in the property owned by the community property estate made by the benefited community property estate after the date described by Subdivision (A);~~
 - ~~or~~
 - ~~(2) if the benefited estate is the separate property estate of a spouse:~~
 - ~~(A) the net equity of the separate property estate in the property owned by the separate property estate as of the date of the first economic contribution to that property by the contributing community property estate or the separate property estate of the other spouse; and~~
 - ~~(B) any additional contribution to the equity in the property owned by the separate property estate made by the benefited separate property estate after the date described by Subdivision (A).~~
- ~~(c) The amount of a claim under this section may be less than the total of the economic contributions made by the contributing estate, but may not cause the contributing estate to owe funds to the benefited estate.~~
- ~~(d) The amount of a claim under this section may not exceed the equity in the property on the date of dissolution of the marriage, the death of a spouse, or disposition of the property.~~
- ~~(e) The use and enjoyment of property during a marriage for which a claim for economic contribution to the property exists does not create a claim of an offsetting benefit against the claim.~~

Source: SB 866

Effective Date: 9/1/09

§ 3.404(b). Application Of Inception Of Title Rule; Ownership Interest Not Created - AMENDED

(b) A ~~[The]~~ claim for reimbursement ~~[economic contribution created]~~ under this subchapter does not create an ownership interest in property, but does create a claim against the property of the benefited estate by the contributing estate. The claim matures on dissolution of the marriage or the death of either spouse.

Source: SB 866

Effective Date: applies to suits for dissolution filed on or after 9/1/09

§ 3.406(a-b). Equitable Lien - AMENDED

(a) On dissolution of a marriage, the court may ~~[shall]~~ impose an equitable lien on the property of a benefited marital estate to secure a claim for reimbursement against ~~[economic contribution in]~~ that property by a contributing ~~[another]~~ marital estate.

(b) On the death of a spouse, a court may ~~[shall]~~, on application for a claim for reimbursement ~~[of economic contribution]~~ brought by the surviving spouse, the personal representative of the estate of the deceased spouse, or any other person interested in the estate, as defined by Section 3, Texas Probate Code, impose an equitable lien on the property of a benefited marital estate to secure a claim for reimbursement against that property ~~[economic contribution]~~ by a contributing marital estate.

Source: SB 866

Effective Date: applies to suits for dissolution filed on or after 9/1/09

§ 3.406(c). Equitable Lien - REPEALED

~~(c) Subject to homestead restrictions, an equitable lien under this section may be imposed on the entirety of a spouse's property in the marital estate and is not limited to the item of property that benefited from an economic contribution.~~

Source: SB 866

Effective Date: 9/1/09

§ 3.407. Offsetting Claims – REPEALED

~~The court shall offset a claim for one marital estate's economic contribution in a specific asset of a second marital estate against the second marital estate's claim for economic contribution in a specific asset of the first marital estate.~~

Source: SB 866

Effective Date: 9/1/09

§ 3.408. Claim For Reimbursement– REPEALED

~~(a) A claim for economic contribution does not abrogate another claim for reimbursement in a factual circumstance not covered by this subchapter. In the case of a conflict between a claim for economic contribution under this subchapter and a claim for reimbursement, the claim for economic contribution, if proven, prevails.~~

~~(b) A claim for reimbursement includes:~~

- ~~(1) payment by one marital estate of the unsecured liabilities of another marital estate; and~~
- ~~(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.~~

~~(c) The court shall resolve a claim for reimbursement by using equitable principles, including the principle that claims for reimbursement may be offset against each other if the court determines it to be appropriate.~~

~~(d) Benefits for the use and enjoyment of property may be offset against a claim for reimbursement for expenditures to benefit a marital estate on property that does not involve a claim for economic contribution to the property.~~

~~(e) The party seeking an offset to a claim for reimbursement has the burden of proof with respect to the offset.~~

Source: SB 866

Effective Date: 9/1/09

§ 3.410. Effect Of Marital Property Agreements - AMENDED

A premarital or marital property agreement, whether executed before, on, or after September 1, 2009 [1999], that satisfies the requirements of Chapter 4 is effective to waive, release, assign, or partition a claim for economic contribution, reimbursement, or both, under this subchapter to the same extent the agreement would have been effective to waive, release, assign, or partition a claim for economic contribution, reimbursement, or both under the law as it existed immediately before September 1, 2009 [1999], unless the agreement provides otherwise.

Source: SB 866

Effective Date: 9/1/09

§ 7.007. Disposition Of Claim For [ECONOMIC CONTRIBUTION OR CLAIM FOR] Reimbursement – AMENDED

~~[(a) In a decree of divorce or annulment, the court shall determine the rights of both spouses in a claim for economic contribution as provided by Subchapter E, Chapter 3, and in a manner that the court considers just and right, having due regard for the rights of each party and any children of the marriage, shall:~~

~~[(1) order a division of a claim for economic contribution of the community marital estate to the separate marital estate of one of the spouses;~~

~~[(2) order that a claim for an economic contribution by one separate marital estate of a spouse to the community marital estate of the spouses be awarded to the owner of the contributing separate marital estate; and~~

~~[(3) order that a claim for economic contribution of one separate marital estate in the separate marital estate of the other spouse be awarded to the owner of the contributing marital estate.~~

[(b)] In a decree of divorce or annulment, the court shall determine the rights of both spouses in a claim for reimbursement as provided by Subchapter E, Chapter 3, and shall apply equitable principles to:

(1) determine whether to recognize the claim after taking into account all the relative circumstances of the spouses; and

(2) order a division of the claim for reimbursement, if appropriate, in a manner that the court considers just and right, having due regard for the rights of each party and any children of the marriage.

Source: SB 866

Effective Date: applies to claims made on or after 9/1/09

B. Relevant Caselaw:

Wright v. Wright, 280 S.W.3d 901 (Tex.App.—Eastland 2009, no pet.).

Wife filed for divorce. Three days after the filing, Husband transferred 49% of the shares in the spouses' jointly-owned company to an employee for no consideration. On the same day, Husband had the bylaws restated to remove Wife as a director and to leave himself as the sole director. All claims were settled in mediation except Wife's claim that the stock transfer was fraud on the community. At trial, the court awarded Wife a \$318,500 judgment against Husband for his fraud on the community.

On appeal, the court held that a fiduciary duty exists between spouses regarding the community property each controls. The breach of this duty is termed "fraud on the community," a judicially created concept based on the theory of constructive fraud. "Fraud on the community" and "constructive fraud" are essentially the same tort. A presumption of constructive fraud arises when one spouse disposes of the other spouse's one-half interest in community property without the other's knowledge or consent. Husband had the burden of proof to establish that the transfer of the stock was not unfair to the rights of Wife. Second, the court stated that, although in a traditional fraud cause of action, a plaintiff must show six traditional elements, as between spouses, the six elements need not be shown. A spouse commits actual fraud if he or she transfers community property or expends community funds for the primary purpose of depriving the other spouse of the use and enjoyment of the assets involved in the transaction. Actual fraud between spouses involves dishonesty of purpose or intent to deceive. Third, the court held that, even though the stock was subject to Husband's management and control, as a director, Wife was entitled to participate in a decision of such magnitude.

Abuzaid v. Abuzaid, No. 05-08-00876-CV (Tex.App.—Dallas July 24, 2009, no pet.) (mem. op.).

Husband and Wife entered into a partition and exchange agreement of their partnership, with Husband paying Wife \$200,000 for the business. Wife later claimed Husband breached the agreement, filed a breach of contract claim, and took a default judgment against Husband for one-half of the partnership. She then filed suit for an accounting and division and dissolution of partnership assets. When Husband failed to appear, the court wound up the partnership.

On appeal, Husband argued that a court cannot wind up a partnership when no evidence of partnership assets or debts was presented. The appellate court held that for partners to properly use judicial methods to wind up a partnership, they must file and request it, then put on proof of the value of the partnership and its debts so that creditors may properly be paid before distribution of the excess value.