There's No Business Like Family Law Business

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I. INTRODUCTION

According to the U.S. Census released in December 2013, Texas added more than 387,000 residents between July 1, 2012, and July 1, 2013, and more than 1.3 million since April 1, 2010, significantly more than any other state. Another significant statistic is that small businesses, being those businesses with fewer than 500 employees, numbered 2.2 million in Texas in 2008. Of those, 391,010 were direct employers, accounting for 45.9% of private sector jobs in Texas and constituting 98.6% of the state's employers. Moreover, business ownership is becoming more inclusive in Texas. The number of women and minority owned businesses in 2007 exceeded 700,000, an increase of almost 50% over 2002.[1] Because small businesses are a significant element of Texas' economic landscape, family law practitioners frequently represent clients who own or have a community property interest in a small business.

Family law practitioners need to understand the nature of the various business forms and entities, as well as the issues relating to characterization of the business entities. The importance of understanding the type of business entity, when and how it was formed, and any mutations of that entity are significant considerations when dividing the estate of the parties and determining potential equitable claims against the entity. In addition, organizational documents, such as partnership agreements, bylaws, shareholder agreements and company agreements, may contain sale restrictions and buy-sell provisions (which sometimes have divorce-specific provisions) and may affect the rights and obligations of the spouses in the context of a divorce.

The involvement of a business law attorney and valuation experts early in the divorce process can significantly improve a family law attorney's ability to perform a proper analysis and provide competent and accurate representation for his or her client. The purpose of this article is to assist family law attorneys in understanding (1) business entities, (2) the Texas Business Organizations Code and its relation to the Family Code, (3) the effect of entity formation on marital property character, (4) valuation of business entities in the context of divorce and (5) reimbursement claims by one spouse against the separate property business of the other spouse.

[1] U.S. Small Business Administration, Office of Advocacy, Texas Small Business Profile (Feb. 2011).

II. GOVERNING LAW

A. Generally

The Texas Business Organizations Code ("TBOC") governs the following business entities:

1. Corporations;
2. Limited Liability Companies {"LLC");
3. General Partnerships;
4. Limited Partnerships ("LP"); and
5. Limited Liability Partnerships ("LLP").

In 2003, the Texas Legislature enacted TBOC to codify the Texas statutes relating to the above business entities, together with the Texas statutes governing the formation and operation of other for-profit and non-profit private sector entities.[2] Prior to its enactment, no less than ten individual statutes governed business entities in Texas. TBOC governs various formation, governance, operational and liability aspects of Texas business entities, their owners or interest holders, and their principals.

B. Prior Law

TBOC was enacted in 2003, effective January 1, 2006. As enacted, TBOC contained transition provisions that, generally speaking, provided for (1) TBOC to govern entities created or first registered on or after January 1, 2006; (2) TBOC to govern entities created or registered prior to January 1, 2006 upon their election to be governed by TBOC; and (3) TBOC to govern all entities, regardless of their date of creation or registration or their election, on and after January 1, 2010. The transition provisions are set forth in sections 400.001, et seq. of TBOC.

Except as expressly provided in TBOC, all of the provisions of TBOC govern acts, contracts or other transactions by an entity subject to TBOC or its managerial officials, owners or members that occur on or after the mandatory application date, and those acts, contracts or transactions that occurred prior to the mandatory application date are governed by prior law.[3]

Because TBOC became effective over four years ago, this article will generally address TBOC rather than prior law, although some specific issues relating

[2] Acts 2003, 78th Leg., ch. 182, Sec. 1, eff. Jan. 1, 2006.
[3] TBOC § 402.006.

to or arising from prior law or the transition to the TBOC may be addressed.

C. How TBOC is Structured

In a departure from the prior law, which had a patchwork of separate, self-contained statutes for specific entities, TBOC was organized in a "hub-and-spoke" format, which was designed to simplify and streamline the statutory framework.

The "hub" is found in Title 1 (General Provisions), and contains provisions that govern all domestic entities and foreign entities to the extent provided in Title 1.[4] The subchapters within Title 1 govern matters such as formation, governance, required filings and liability, among others. These are found in Chapters 1 through 12 of Title 1.

The "spokes" are found in other titles of TBOC and contain provisions that apply to specific entity types. Thus, a practitioner analyzing issues involving a particular type of entity should be familiar with both the "hub" provisions and any "spoke" provision applicable to that entity.

The spoke provisions that would typically come into play in the family law context include the following:

1. Title 2 (**Corporations**), Chapters 20 (the General Provisions sub-hub) and 21 (For-Profit Corporations);

2. Title 3 (**Limited Liability Companies**), Chapter 101 (same);

3. Title 4 (**Partnerships**), including Chapter 151 (the General Provisions sub-hub), Chapter 152 (General Partnerships), Chapter 153 (Limited Partnership) and Chapter 154 (Provisions Applicable to Both General and Limited Partnerships);

4. Title 5 (**Real Estate Investment Trusts**), Chapter 200 (same); and

5. Title 7 (**Professional Entities**), Chapters 301 (Provisions Relating to Professional Entities), 302 (Provisions relating to Professional Associations), 303 (Provisions relating to Professional Corporations) and Chapter 304 (Provisions Relating to Professional Limited Liability Companies).

[4] *See* TBOC § 1.106.

TBOC section 1.002 provides the following definitions:

1. "Corporation" means an entity governed as a corporation under Title 2 or 7. The term includes a for-profit corporation, nonprofit corporation, and a professional corporation.

2. "Limited liability company" means an entity governed as a limited liability company under Title 3 or 7. The term includes a professional limited liability company.

3. "General partnership" means a partnership governed as a general partnership under Chapter 152. The term includes a general partnership registered as a limited liability partnership.

4. "Limited partnership" means a partnership that is governed as a limited partnership under Title 4 and that has one or more general partners and one or more limited partners. The term includes a limited partnership registered as a limited liability limited partnership.

5. "Limited liability partnership" means a partnership governed as a limited liability partnership under Title 4.

Note that TBOC does not apply to sole proprietorships, also called "DBAs" because those businesses do not have a separate legal existence independent of their owners.

III. FORMATION

A. Introduction

TBOC governs the formation and internal affairs of entities that are formed by filing the certificate of formation with the Texas Secretary of State, as well as a non-filing entity if Texas law is the law of the entity's jurisdiction of formation.[5] If the entity is formed by filing a certification of formation or other similar document with a foreign governmental authority, the law of the state or other jurisdiction in which that foreign governmental entity is located governs the formation and internal affairs of the entity.[6] TBOC also provides that the law of the jurisdiction that governs an entity under the foregoing statutes also governs the liability of an owner, member,

[5] *See* TBOC 1.101, 1.103.
[6] *See* TBOC § 1.102.

or managerial official of the entity in such person's capacity as an owner, member or managerial official, including a debt of the entity for which the person is not otherwise liable by contract or under a provision of law other than TBOC.[7]

Entities that are formed by filing appropriate documents with the Texas Secretary of State are referred to as "filing entities." Filing entities under TBOC include domestic corporations, limited partnerships, limited liability companies, professional associations, cooperatives and real estate investment trusts.[8] Entities that do not require filings, such as domestic general partnerships and nonprofit associations, [9] are referred to a "non-filing entities."

Some types of entities have additional subcategories governed by special provisions that designate or restrict the types of business in which the owners engage and may limit the liability of the owners, and these typically require additional documents to be filed with the Texas Secretary of State. There are also subcategories of some entities, such as a close corporation or closely held corporation, which may play a role in how the entity is governed or valued, and other subcategories that will insulate the interest holders from liability for an entity traditionally not associated with limited liability (e.g., a general partnership registered as a limited liability partnership).

B. Filing Entities

Subject to other the provisions of TBOC, Section 3.001(a) provides that, in order to form a filing entity, a certificate of formation complying with Sections 3.003, 3.004 and 3.005 must be filed in accordance with the provisions of Chapter 4 of TBOC.[10] The certificate of formation must contain certain information prescribed in section 3.005. It must be signed by a person authorized to act on behalf of the to-be-formed entity and be delivered to the Secretary of State in person or by mail, courier, facsimile or electronic transmission, or any comparable form of delivery.[11] If the Secretary of State determines that the certificate of formation conforms to the code provisions applicable to the entity as well as the filing rules, and that all required fees have been paid, the Secretary of State is required to: (1) file the certificate of formation by accepting it into the Secretary of State's filing system and assigning it a date of filing; and (2) deliver a written acknowledgment of filing to the entity or its representative.[12]

The existence of the filing entity commences when the certificate of formation takes effect as provided by Chapter 4.[13] The certificate of formation also may specify a delayed effective date, however, in which case the certificate of formation would not take effect, and the existence would not begin, until the specified delayed effective date.[14] The requirements of the formation and of the determination of the existence of a non-filing entity are governed by the title of TBOC that applies to that specific entity.[15]

Except in certain cases involving action by the state to terminate an entity, an acknowledgment of the filing of a certificate of formation issued by the filing officer is conclusive evidence of: (1) the formation and existence of the filing entity; (2) the satisfaction of all conditions precedent to the formation of the filing entity; and (3) the authority of the filing entity to transact business in this state.[16]

The formation of filing entities under TBOC differs somewhat from prior law. Under the Texas Business Corporations Act ("TBCA"), a corporation was formed by filing articles of incorporation and paying the statutory fee.[17] Under Section 3.05(A), which was repealed effective September 1, 2003, the corporation was not permitted to transact or commence business until it received an initial capital contribution of $1,000.[18] Under the Texas Limited Liability Company Act ("TLLCA"), a limited liability company ("LLC") was formed by filing articles of organization and paying the required fees, and the entity's existence began upon the Secretary of State's issuance of the certificate of organization.[19] A limited partnership was formed under the Texas Revised Limited Partnership Act ("TRLPA") by entering into a partnership agreement and causing one or more partners, including all general partners, to execute and file a certificate of limited partnership with the Secretary of State, and the limited partnership was formed as of the time of filing

[7] *See* TBOC § 1.104.
[8] *See* TBOC § 1.002(22).
[9] See TBOC § 1.002(57).
[10] *See* TBOC § 3.001(a).
[11] *See* TBOC §§ 4.001(a)(1)-(2).
[12] *Id.* § 4.002(a)(1)-(2).
[13] *Id.* § 3.001(c).
[14] *See* TBOC § 4.052.
[15] TBOC 3.002.
[16] *Id.* § 3.001(d).
[17] TBCA § 3.03.
[18] TBCA § 3.05(A).
[19] *See* Tex. Rev. Civ. Stat. Ann. art. 1528n, art 3.03(A), 3.04(A).

the initial certificate of limited partnership with the Secretary of State or a later date stated in the certificate provided there was substantial compliance with the formation provisions.[20] TBOC's provisions regarding certificates of formation streamlined this process.

IV. BOOKS, RECORDS AND CERTIFICATES

A. Basic Record-Keeping Requirements

All filing entities are required to keep certain basic records as described in, and subject to the exceptions described in the hub section of TBOC.[21] These include: (1) books and records of accounts; (2) minutes of the proceedings of the owners, members or governing authority of the filing entity and their respective committees (although not required for limited partnerships or LLCs unless required by its governing documents); (3) a current record of the name and mailing address of each owner or member; (4) other books and records as required by the title of TBOC dealing with the specific entity types.[22] The records may be maintained in paper form or another form capable of being converted into paper form in a reasonable period of time.[23]

B. Inspection

TBOC permits a governing person of a filing entity other than a limited partnership to examine the entity's books and records maintained under section 3.151 and other books and records of the entity for a purpose reasonably related to the governing person's service as a governing person, and to seek court assistance if the access is denied.[24]

Each owner and member of a filing entity may also examine such books and records to the extent provided by the governing documents of the entity and the title of TBOC governing that entity.

C. Certificated or Uncertificated Ownership

The ownership interests in a domestic entity may be certificated or uncertificated, dependent on the entity type. For-profit corporations, real estate investment trusts and professional corporations must be certificated unless the governing documents or a resolution of the governing authority states otherwise.[25] For other domestic entities, the ownership interests are uncertificated unless TBOC or the governing documents state that the ownership interests are to be certificated.[26] TBOC outlines the requirements for the form and validity of ownership certificates in sections 3.202 through 3.204, and also requires, in section 3.205, that certain information be provided to holders of uncertificated ownership interests after issuing or transferring such an interest.[27] Such provisions do not apply, however, to limited liability companies or limited partnerships unless required by the governing documents.[28]

V. OVERVIEW OF FORMS OF BUSINESSES AND BUSINESS ENTITIES IN TEXAS

A. Sole Proprietorships

1. Generally

Although not an entity, the sole proprietorship is discussed because it is a common form under which an individual owns and operates a business. It consists of an individual conducting business as the sole owner of the business without the use of an entity structure. A sole proprietorship does not have a separate legal existence distinct from the operator of the business.[29] Having no independent legal existence, the business is also freely transferable. The assets and liabilities of the sole proprietorship belong to the operator directly.[30] A sole proprietorship in not required to file a separate income tax return and the business income is reported on the owner's IRS Form 1040 as Schedule C.

2. Formation and Organization Documents

No documents are required to form a sole proprietorship. In many cases, however, the individual (i.e., the sole proprietor), will do business under an assumed name. An assumed name certificate (commonly referred to as a DBA) is filed with the office of the county clerk in the county were a business premise is maintained, the Texas Secretary of State, or both. If no business premise is maintained, then an

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[20] *See* Tex. Rev. Civ. Stat. Ann. art. 6132a-1, § 2.01.
[21] *See* TBOC § 3.151.
[22] *See Id.*
[23] *Id.*
[24] *See* TBOC § 3.152.
[25] TBOC § 3.201(b).
[26] *Id.* § 3.201(c).
[27] *Id.* § 3.205.
[28] *See id.* § 3.201(d)-(e).
[29] *Ideal Lease Serv., Inc. v.* Amoco *Prod. Co., Inc.*, 662 S.W.2d 951, 952 (Tex. 1983).
[30] *CU Lloyd's of Tex. v. Hatfield*, 126 S.W.3d 679, 684 (Tex. App.—Houston [14th Dist.] 2004, pet. denied) (citing BLACK'S LAW DICTIONARY 1398 (7th ed.1999)).

assumed name certificate should be filed in all counties where business is conducted under the assumed name.

B. Corporations

1. Generally

Unlike a sole proprietorship, which does not have a separate existence as discussed above, a corporation is a distinct legal entity which comes into existence by charter from the state.[31] A corporation is, by default, a "C" Corporation. Businesses organized as a C corporation may have an unlimited number of owners, called "shareholders," and multiple ownership classes. Ownership interests in a C corporation are freely transferable unless restricted by articles of incorporation, bylaws, or shareholder agreements. C corporations report income each year on IRS Form 1120 and are required to pay income tax on the taxable income of the business. In most instances, the shareholders' income from the C corporation will be as wages and salary, reported by IRS Form W-2, or dividend distributions, reported by IRS Form 1099-DIV.

Corporation owners may elect to be taxed as an "S" Corporation. To qualify for S corporation status, the entity must meet the following requirements:

a. be a domestic corporation;
b. have only allowable shareholders:
   i. including individuals, certain trusts, and estates; and
   ii. may not include partnerships, corporations or non-resident alien shareholders
c. have no more than 100 shareholders;
d. have one class of stock;
e. not be an ineligible corporation (i.e., certain financial institutions, insurance companies, and domestic international sales corporations).

To be taxed as an S corporation, the entity and all of its equity owners must make a timely election on IRS Form 2553. Unlike C corporations, businesses electing S corporation status may have no more than 100 owners and may have only one ownership class. However, like C corporations, ownership interests in an S corporation are freely transferrable unless restricted by articles of incorporation, bylaws, or shareholder agreements. S corporations report income each year on IRS Form 1120S; however, the S corporations generally do not pay income tax on the ordinary business income of the business. Instead, the S corporation issues a Schedule K-1 to each shareholder reporting that shareholder's portion of the income (loss), deductions, credits, and other items. Because the income is not taxed at the entity level, an S corporation is called a flow-through or pass-through entity. If the shareholder is providing services for the business, the S corporation may also pay the shareholder wages and salary, reported by IRS Form W-2.

2. Formation and Organizational Documents

A corporation is a filing entity under TBOC. A corporation is created by the filing of a certificate of formation, and the existence commences when the certificate of formation takes effect.[32] The certificate can be amended or restated, but this requires adoption by the board of directors and in some cases adoption or approval by the shareholders.[33]

TBOC provides for the board of directors of a corporation to also adopt initial bylaws, which may contain provisions for the regulation and management of the affairs of the corporation that are consistent with law and the corporation's certificate of formation.[34] The board of directors may amend or repeal bylaws subject to certain restrictions, including where that power is reserved exclusively to the shareholders, or where, in amending, repealing or adopting a bylaw, the shareholders provide that the board of directors may not amend, repeal or readopt that bylaw.[35]

TBOC also permits, but does not require, that the shareholders enter into a shareholders' agreement.[36] A shareholders' agreement may cover a wide range of corporate management and structure issues. For example, it may restrict the discretion of the board of directors; eliminate the board of directors and permit management in whole or in part by one or more of its shareholders and other persons; establish the individuals who will serve as officers or directors of the corporation and set out their terms and manner of selection and removal or terms and conditions of employment; govern authorization or making of distributions; determine apportionment of profits and losses; govern voting; and govern other matters

[31] *E.g., Waddill v. Phi Gamma Delta Fraternity*, 114 S.W.3d 136, 141 (Tex. App.—Austin 2003, no pet.).

[32] TBOC 3.001(c).
[33] *See* TBOC §§ 21.052-56.
[34] *Id.* § 21.057(a)-(b).
[35] *Id.* § 21.057(c).
[36] *See id.* § 21.101.

relating to the exercise of corporate powers, management and the relationship among the shareholders, the directors and the corporation as if the corporation were a partnership or in a manner that would otherwise be appropriate only among partners and not contrary to public policy.[37] If the shareholders' agreement complies with TBOC, it is effective among the shareholders and between the shareholders and the corporation even if it is has terms that are inconsistent with TBOC.[38]

3. Issues Relating to Family Law

As stated above, the corporation's existence (inception of title) commences when the certificate of formation takes effect.[39] However, a shareholder does not have a vested property right resulting from the certificate of formation, including a provision in the certificate relating to the management, control, capital structure, dividend entitlement, purpose or duration of the corporation.[40] The shareholders' ownership interest is represented by shares. The corporation may issue the number of authorized shares stated in the corporations' certificate of formation and may dive the authorized shares into one or more classes and divide the classes into one or more series.[41] The shares may not be issued until the consideration has been paid or delivered as required in connection with the authorization of the shares, and when the consideration is paid or delivered: (1) the shares are considered to be issued; (2) the subscriber or other person entitled to receive the shares is a shareholder with respect to the shares; and (3) the shares are considered fully paid and non-assessable.[42] If the consideration consists, in whole or in part, of a contract for future services or benefits or a promissory note, the corporation may place the shares in escrow until the consideration is received by the corporation.[43] In the absence of fraud in the transaction, the judgment of the board of directors or the shareholder is conclusive in determining the value and sufficiency of the consideration received for the shares.[44]

[37] *Id.* § 21.101.
[38] *Id.* § 21.104.
[39] TBOC § 3.001(c).
[40] *See* TBOC § 21.051.
[41] TBOC §§ 21.151-52.
[42] *Id.* § 21.157(b).
[43] *See Id.* § 21.157(c).
[44] *Id.* § 21.162.

C. Limited Liability Companies

1. Generally

A limited liability company is considered a separate legal entity from its members.[45] The TBOC governs and, with narrow exceptions, limits the legal liability of a Texas limited liability company's members and the ability to sue the members.

Businesses organized as an LLC may have an unlimited number of owners, called "members," and as few as one owner, also known as a Single Member LLC." Multiple membership cases are permitted. Beneficial membership interest is freely transferable unless restricted by the LLC's article of organization or regulations. However, unless otherwise provided in the article of organization or regulations, the status of a member is not transferable without the consent of all members.

A Single Member LLC defaults to being disregarded for federal income tax purposes unless the LLC affirmatively makes an election on IRS Form 8832 to be taxed as a corporation. Thus, where the single member of the LLC is an individual, the result is that the LLC is treated as a proprietorship for federal income tax purposes, and the LLC's income is reported on the member's IRS Form 1040 at Schedule C or E. Where the singe member of the LLC is an entity, the result is that the LLC is treated as if it were a division of the owning entity for federal income tax purposes, and the LLC's income is reported on the owning entity's applicable federal income tax return. Where the single member LLC has elected to be taxed as a corporation, the LLC's income is reported on IRS Form 11200 or 1120S, as applicable.

A multiple member LLC defaults to being taxed as a partnership for federal tax purposes unless the LLC affirmatively makes an election on IRS Form 8832 to be taxed as a corporation. Where the multiple member LLC has elected to be taxed as a corporation, the LLC's income is reported on IRS Form 1120 or 1120S, as applicable. Where the multiple member LLC has not elected to be taxed as a corporation, the LLC's income is reported on IRS Form 1065.

[45] *See Geis v. Colina Del Rio, LP*, 362 S.W.3d 100, 109 (Tex. App.—San Antonio 2011, pet. denied) (recognizing limited liability company legally distinct from member); *Sanchez v. Mulvaney*, 274 S.W.3d 708, 712 (Tex. App.—San Antonio 2008, no pet.) (same).

2. Formation and Organizational Documents

Because a limited liability company is a filing entity,[46] the formation of the entity requires the filing of a certificate of formation in accordance with section 3.001 and Chapter 4 of TBOC. The supplemental provisions regarding the certificate of formation for a limited liability company state that, in addition to the basic information required under section 3.005, the certificate of formation must also state whether the company will or will not have managers, and the name and address of each initial manager and initial member, as applicable.[47]

TBOC provides for an LLC to have a company agreement, meaning any agreement, written or oral, of the members concerning the affairs or conduct of the business of an LLC.[48] The legislature specifically authorized single member LLCs in section 101.101(a) of TBOC, and while agreements typically involve more than one party, TBOC provides that a company agreement of a single-member LLC is not unenforceable because there is only one party to it.[49] Although the company agreement typically is a stand-alone document, TBOC permits term and provisions that would be contained in the company agreement to instead be included in the certificate of formation.[50]

The company agreement will govern the relationship among members, managers and officers of the company, assignees of membership interests and the company itself, as well as other internal affairs of the company.[51]

3. Issues Relating to Family Law

Like a corporation, an LLC's existence (inception of title) commences when the certificate of formation takes effect A membership interest in a limited liability company is personal property and may be community property under applicable law.[52] However, a member or an assignee of a membership interest does not have an interest in any specific property of the company.[53]

TBOC specifically sets forth the effect of divorce on a membership interest in an LLC, as follows:

> (a) For purposes of this code:
>
> (1) on the divorce of a member, the member's spouse, to the extent of the spouse's membership interest, if any, is an assignee of the membership interest;
>
> (2) on the death of a member, the member's surviving spouse, if any, and an heir, devisee, personal representative, or other successor of the member, to the extent of their respective membership interest, are assignees of the membership interest; and
>
> (3) on the death of a member's spouse, an heir, devisee, personal representative, or other successor of the spouse, other than the member, to the extent of their respective membership interest, if any, is an assignee of the membership interest.
>
> (b) This chapter does not impair an agreement for the purchase or sale of a membership interest at any time, including on the death or divorce of an owner of the membership interest.[54]

D. General Partnerships

1. Generally

Businesses organized as a general partnership may have an unlimited number of owners, but must have a minimum of two owners. Multiple ownership classes are permitted. Beneficial ownership is freely transferrable unless restricted by the partnership agreement. However, the status of a partnership is not transferrable without the consent of all partners.

Unless a general partnership affirmatively makes an election on IRS Form 8832 to be taxed as a corporation, it defaults to being taxed as a partnership for federal tax purposes. General partnerships report income each year on IRS Form 1065; however, general partnerships do no pay income tax on the ordinary business income of the business. Instead, the partnership issues a Schedule K-1 to each partner who then reports that partner's portion of the income (loss), deductions, credits, and other items. Because the income is not taxed at the entity level, a general partnership is called a flow-through or pass through

[46] TBOC § 1.002(22),
[47] See TBOC § 3.010.
[48] TBOC § 101.001.
[49] *Id.* § 101.001(a).
[50] TBOC § 101.051(a).
[51] TBOC § 101.052.
[52] TBOC § 101.106(a).
[53] Id. § 101.106(b).
[54] TBOC § 101.1115.

entity. If the partner is providing services for the business, the general partnership may also pay the partner wages and salary, as reported on IRS Form W-2. Where the general partnership has elected to be taxed as a corporation, the partnership income is reported on IRS Form1120 or 1120S, as applicable.

2. Formation and Organizational Documents

Unlike a corporation, a partnership may be created informally. Subject to certain exceptions, an "association of two or more persons to carry on a business for profit as owners" creates a partnership, regardless of whether the persons intend to create a partnership or the association is called a "partnership," "joint venture" or other name.[55] TBOC includes a list of factors indicating that persons have created a partnership, including: (a) receipt or right to receive a share of profits of the business; (b) expression of an intent to be partners in the business; (c) participation or right to participate in control of the business; (d) agreement to share, or sharing of, losses of the business or liability to third-parties for claims against the business; and (e) agreement to contribute, or contributing, money or property to the business.[56] The rules under the former Texas Revised Partnership Act and TBOC for determining partnership formation are substantially the same.[57]

A general partnership is not a filing entity.[58] Therefore, it need not file a certificate of formation, and its formation and existence is governed by the title of TBOC applicable to partnerships.[59]

Parties frequently prefer to utilize a written partnership agreement. The partnership may, however, be any agreement, written or oral, of the partners concerning the partnership.[60] The partnership agreement governs the relationship between the parties and the partnership, although there are provisions of TBOC that may not be varied by the agreement.[61] In the absence of provisions to the contrary, TBOC will govern.[62]

[55] TBOC § 152.051.
[56] Id. § 152.052.
[57] *See Ingram v. Deere*, 288 S.W.3d 886, 904 (Tex. 2009) (citing TBOC § 152.052 and Tex. Rev. Civ. Stat. art. 6132b–2.03).
[58] *See* TBOC § 1.002(22).
[59] *See Id.* § 3.002.
[60] TBOC § 151.001(5).
[61] TBOC 152.002(b).
[62] TBOC 152.002(a).

3. Issues Relating to Family Law

TBOC has adopted the entity theory for partners, recognizing that a partnership is an entity distinct from its partners.[63] TBOC expressly provides that partnership property is not property of the partners. A partner or a partner's spouse does not have an interest in partnership property.[64] A partner's right to participate in the management and conduct of the business is not community property.[65] With respect to both general and limited partnerships, a partner's partnership interest is personal property for all purposes and may be community property under applicable law, but a partner is not a co-owner of partnership property.[66]

TBOC specifies the effect of divorce on a partnership interest, and provides that upon the divorce of the partner, the partner's spouse, to the extent of the spouse's partnership interest, if any, is a transferee of the partnership interest.[67] TBOC does not, however, impair an agreement for the purchase or sale of a partnership interest at any time, including on the divorce of an owner of the partnership interest.[68]

E. Limited Partnerships

1. Generally

Businesses organized as a limited partnership may have an unlimited number of owners, but must have a minimum of two owners. Multiple ownership classes are permitted, but the limited partnership must have at least one general partner and one limited partner. Beneficial ownership interest is freely transferrable unless restricted by the limited partnership agreement. However, the status of a limited partner or general partner in a limited partnership is not transferable without the consent of all partners.

Unless a limited partnership affirmatively makes an election on IRS Form 8832 to be taxed as a corporation, it defaults to being taxed as a partnership for federal tax purposes. Limited partnerships report income each year on IRS Form 1065; however, limited partnerships do not pay income tax on the ordinary business income of the business. Instead, the

[63] TBOC § 152.056.
[64] TBOC § 152.101.
[65] TBOC § 152.203(a).
[66] TBOC § 154.001(a)-(c).
[67] TBOC § 152.406(a)(1).
[68] *Id.* § 152.406(c).

partnership issues a Schedule K-1 to each partner who then reports that partner's portion of the income (loss), deductions, credits, and other items. Because the income is not taxed at the entity level, a limited partnership is called a flow-through or pass through entity. If the partner is providing services for the business, the limited partnership may also pay the partner wages and salary, as reported by IRS Form W-2. Where the limited partnership has elected to be taxed as a corporation, the partnership income is reported on IRS Form 1120or 112S, as applicable.

2. Formation and Organizational Documents

Because a limited partnership is a filing entity,[69] the formation of the entity requires the filing of a certificate of formation in accordance with section 3.001 and chapter 4 of TBOC. The supplemental provisions regarding the certificate of formation for a limited partnership state that, in order to form a limited partnership, the partners must enter into a partnership agreement and file the certificate of formation.[70] Although TBOC provides that the partnership agreement means any agreement, written or oral, of the partners concerning a partnership,[71] the partners typically will create a written agreement of limited partnership outlining the rights and obligations of the general and limited partners and the governing provisions. Section 153.004 contains certain provisions that may not be waived or modified in the partnership agreement of the limited partnership.

A person acquiring a limited partnership interest becomes a limited partner on the later of (1) the date on which the limited partnership is formed, and (2) the date stated in the records of the limited partnership as the date on which the person becomes a limited partner or, if that date is not stated in those records, the date on which the person's admission is first reflected in the records of the limited partnership.[72]

The rules are slightly different for admission of general partners. After a limited partnership is formed, a general partner may be admitted in the manner provided in the partnership agreement or, if the limited partnership does not provide for the admission of general partners, with the written consent of all partners.[73] In addition, TBOC permits a written partnership agreement to provide that a person may be admitted as a general partner, including as the sole general partner, without (1) making a contribution to the limited partnership, (2) assuming an obligation to make a contribution to the limited partnership, or (3) acquiring a partnership interest in the partnership.[74]

2. Issues Relating to Family Law

With respect to both general and limited partnerships, a partner's partnership interest is personal property for all purposes and may be community property under applicable law, but a partner is not a co-owner of partnership property.

F. Limited Liability Partnerships

Businesses organized as a limited liability partnership may have an unlimited number of owners, but must have a minimum of two owners. Multiple ownership classes are permitted. Beneficial ownership interest is freely transferable unless restricted by the limited liability partnership agreement. However, the status of partner in a limited liability partnership is not transferable without the consent of all partners.

Unless a limited liability partnership affirmatively makes an election on IRS Form 8832 to be taxed as a corporation, it defaults to being taxed as a partnership for federal tax purposes. Limited liability partnerships report income each year on IRS Form 1065; however, limited liability partnerships do not pay income tax on ordinary business income of the business. Instead, the partnership issues a Schedule K-1 to each partner who then report that partner's portion of the income (loss), deductions, credits, and other items. Because the income is not taxed at the entity level, a limited liability partnership is called a flow-through or pass through entity. If the partner is providing services for the business, the limited liability partnership may also pay the partner wages and salary, as reported by IRS Form W-2. Where the limited liability partnership has elected to be taxed as a corporation, the partnership income is reported on IRS Form 1120 or 110S, as applicable.

G. Professional Entities

TBOC contains a number of provisions regarding professional entities. Chapters 301, 302 and 303 govern professional entities. In addition, TBOC permits doctors of medicine and doctors of osteopathy

[69] TBOC § 1.002(22)
[70] TBOC § 3.011.
[71] TBOC § 151.001
[72] TBOC § 153.101.
[73] TBOC § 153.151.
[74] *Id.* § 153.151(c) – (d).

licensed by the Texas State Board of Medical Examiners and persons licensed as podiatrists by the Texas State Board of Podiatric Medical Examiners to create partnerships jointly owned by those practitioners to perform a professional service that falls within their scope of practice.[75] Licensed physicians and physician assistances are also permitted to create a partnership to perform a professional service that falls within the scope of practice of those practitioners, although restrictions limit the assistants' right to act as general partners, participate in the management of the partnership and engage in other supervisory conduct.

A professional corporation, partnership or other entity has many characteristics of the underlying entity type, such as shareholders or limited or general partners, as the case may be. As examples, a professional association and a professional corporation have, with certain exceptions set forth in Chapters 303-303 of TBOC, the same powers, privileges, duties, restrictions and liabilities as a for-profit corporation.[76] However, the professional nature of the entity may affect both what may be considered in valuing the asset and how the spouse's asset should be allocated or divided.

As a practical matter, a professional entity that operates a medical practice or other practice requiring a license could not be awarded to a non-professional spouse without losing its ability to engage in business (or its value). TBOC expressly restricts the purpose of a professional entity to engaging in only one type of professional service, unless expressly authorized to perform more than one type of service, as well as services ancillary to that type of professional service.[77]

VI. MARITAL PROPERTY CHARACTER ISSUES WITH BUSINESS ENTITIES

A. Characterization of the Business Entity

In a divorce involving a business entity owned by one or more of the parties, it is important to first ascertain the character of that entity. Characterization of the entity may determine the necessity of a business valuation and may give rise to equitable claims against that business. To determine the character of a business interest, it is important to locate the certificate of formation on the Secretary of State's website to determine when and how the corporation was formed and then to review the agreements that govern the business owners' rights such as the bylaws and shareholder agreements.

1. Inception of Title

The date of initial incorporation is deemed to be the date of inception of title to the business – the time upon which a person first has a right to claim title to the property.[78] Although business entities formed during the marriage are presumed to be community property, this presumption can be overcome with clear and convincing evidence that the capital contribution was separate property or a mix of separate and community property.[79] Business entities formed before marriage are separate property and such characterization is not altered by any mutations or changes in the form of the property, including but not limited to the sale, substitution, or the exchange of the property.[80] "Separate property will retain its character through a series of exchanges so long as the party asserting separate property ownership can overcome the presumption of community property by tracing the assets on hand during the marriage back to the property that, because of its time and manner of acquisition, is separate in character."[81] Further, any increase in the value of the stock belonging to the separate estate of one spouse that is due to natural fluctuations in the market remain the separate property of that spouse.[82]

For example, in *Harris*, the Texas Appellate Court found that, although the husband executed a second partnership agreement and a contingent fee agreement with his law firm during the parties' marriage, said agreements did not dissolve and/or alter the interest he obtained in the partnership prior to the parties'

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[75] TBOC § 152.055(a).

[76] *See* TBOC §§ 2.108, 2.109.

[77] *See* TBOC § 2.004.

[78] *Camp v. Camp*, 972 S.W.2d 906, 908 n.1 (Tex.App.—Corpus Christi 1998, pet. denied); *Jensen v. Jensen*, 665 S.W.2d 107, 109 (Tex. 1984) (holding that shares of stock held by husband in his printing corporation prior to his marriage were his separate property, including any increases in value of the stock due to the successful operations of the corporation which occurred during the parties' marriage); *See e.g., Allen v. Allen*, 704 S.W.2d 600, 604 (Tex.App.—Fort Worth 1986, no writ).

[79] *Allen*, 704 S.W.2d at 604; *Vallone v. Vallone*, 644 S.W.2d 455, 457 (Tex. 1982).

[80] *Harris v. Harris, 765 S.W.2d 798, 802 (Tex.App.—Houston [14th Dist.] 1989, writ denied)*; *LeGrand-Brock v. Brock*, 246 S.W.3d 318, 321 (Tex.App.—Beaumont 2008, pet. denied); *see e.g.*, *Horlock v. Horlock*, 533 S.W.2d 52, 59-60 (Tex.Civ.App.—Houston [14th Dist.] 1975, writ dism'd); *Celso v. Celso*, 864 S.W.2d 652, 654 (Tex.App.—Tyler 1993, no writ).

[81] *Celso*, 864 S.W.2d at 654; *see also Cockerham v. Cockerham*, 527 S.W.2d 162, 167 (Tex. 1975).

[82] *Dillingham v. Dillingham*, 434 S.W.2d 459, 461-62 (Tex.Civ.App.—Fort Worth 1986, writ dism'd.).

marriage; therefore the interest remained the separate property of the husband.[83] In so finding, the Court noted that the wife had failed to present evidence that any "new" or "additional" interest in the partnership had been acquired during the parties' marriage to establish a community property interest in the partnership.[84] The agreements made by the husband with the partnership during the marriage only served to clarify and define husband's share and the manner of its distribution.[85] The fact that the value of husband's separate property interest may have increased during the parties' marriage did not change the nature of the interest for characterization purposes and any increases thereon remained the separate property of the husband, subject only to the right of reimbursement.[86]

Likewise, in *Legrand-Brock*, the Texas Appellate Court upheld the trial court's award of all cash distributions made to husband during the parties' marriage for the liquidation of his corporate stock to husband as his separate property.[87] In so holding, the Court found that all stock held by husband in the corporation was obtained prior to the parties' marriage, and retained their separate property character upon dissolution of the corporation.[88] The fact that the stock may have been sold, substituted, and/or exchanged did not alter the character of the property.[89]

2. Capital Contributions and Retained Earnings

A person owns only the business equity interest and therefore the individual property of a business entity is not subject to characterization and remains the property of the business.[90] Such property includes capital contributions and retained earnings and cannot be divided upon divorce.[91] The same rule applies even if the corporation has elected to file as a subchapter "S" corporation.[92]

For example, In *Thomas*, the Texas Court of Appeals reversed and remanded the trial court's decision to award the wife a share of the retained earnings of the husband's separate property corporation, holding that the retained earnings of the corporation were corporate assets and not marital property.[93] In so holding, the Appellate Court noted that corporate distributions are controlled by state law and that a shareholder in a Subchapter S corporation has no greater rights over corporate assets than a shareholder in any other corporation.[94] The Court further found that although the community estate had paid taxes on the S corporation, the community did not acquire an interest in the corporation simply by doing so.[95] Moreover, the Court found that the trial court did not have the authority to award wife a portion of dividends that were likely subject to future distribution by the corporation to the husband because the community estate did not have an interest in those distributions at the time of divorce.[96]

However, as further discussed below, corporate property, including retained earnings and capital contributions, can be characterized as community property if a spouse can show evidence that the company is essentially the "alter ego" of the other spouse and therefore the Court should "pierce the corporate veil" and characterize the corporation's property for division purposes.[97]

3. Partnerships

In a partnership, the spouse's ownership interest can be characterized as community property if the spouse acquired the interest during the parties' marriage.[98] Similar to a corporation, inception of title in a partnership occur on the date the partnership was created or upon a specific "triggering event" set out in the partnership agreement.[99] To determine when the partnership has actually been created, the family law practitioner should look at the nonexclusive list of factors outlined in Section 152.052 of the TBOC.

Distributions from partnerships follow the general characterization rules outlined in the Texas Family Code – i.e. profits distributed during marriage are community property while profits distributed before and after marriage are separate property.[100] Interestingly, the character of distributions from a partnership is not affected by the character of the

[83] *Harris*, 765 S.W.2d at 803.
[84] *Id*.
[85] *Id.* at 804.
[86] *Id*. at 803.
[87] *Legrand-Brock*, 246 S.W.3d at 324.
[88] *Id.* at 321.
[89] *Id*.
[90] *Thomas v. Thomas*, 738 S.W.2d 342, 343 (Tex.App.—Houston [1st Dist.] 1987, writ denied).
[91] *Id*.
[92] *Id*.
[93] *Id.* at 344.
[94] *Id.* at 343.
[95] *Id.* at 345.
[96] *Id.*
[97] *Young v. Young*, 168 S.W.3d 276, 281 (Tex.App.—Dallas 2005, no pet.)
[98] Tex. Bus. Orgs. Code §152.052
[99] *Harris*, 765 S.W.2d at 802-03.
[100] *Harris*, 765 S.W.2d at 802.

ownership interest.[101] The same holds true even if the distributions are made from a partnership's capital account.[102] However, if the distributions are made pursuant to a buyout of the partner's interest, then the character of those distributions retain the character of the partner's ownership interest, regardless of whether said distributions were made during the parties' marriage.[103]

Note, partnership property is not subject to division or characterization.[104] For purposes of this rule, a partner's capital contribution to the partnership becomes the property of the partnership, and therefore cannot be divided by the court upon dissolution of the marriage.[105] The same holds true for retained earnings of the partnership.[106]

4. Sole Proprietorship

All property of a sole proprietorship can be characterized as either separate or community property, and includes everything that makes up the business – i.e. furniture, inventory, cash, goods, supplies, etc.[107] As with a corporation, the character of a sole proprietorship is determined based on the inception of title rule.

If formed during marriage, the assets of the sole proprietorship will be community unless established as separate property through tracing.[108] This presumption, however, can be overcome with the careful drafting of a pre-marital or post-marital agreement.[109] As with other forms of property, a court may divide a sole proprietorship as long as and to the extent that the company is part of the community estate.

5. Goodwill

The character of goodwill depends on whether the goodwill being characterized is business goodwill or professional goodwill. Note, a company can have both business and personal goodwill.

a. Business (Commercial) Goodwill

By definition, business goodwill is the value of a business beyond its liquidation value.[110] Characterization of business goodwill depends on whether the goodwill was developed before or during marriage.[111] As expected, goodwill developed during marriage is characterized as community property and is therefore divisible upon dissolution of the marriage as long as the goodwill is (1) independent of the personal ability of the spouse, and (2) has commercial value in which the marital estate is entitled to share.[112] Problems in characterizing business goodwill arise when the business does not provide the working spouse with the means to realize the value of the goodwill, and the Courts are divided on whether business goodwill can even be characterized under such circumstances.[113]

b. Personal (Professional) Goodwill

Unlike business goodwill, personal goodwill cannot be characterized as separate or community property, as the goodwill attaches exclusively to the person rather than the ownership interest.[114] Therefore, personal goodwill terminates upon the professional's death, retirement, or disablement.[115] Personal goodwill is not considered property and cannot be divided upon dissolution of marriage.[116] Oftentimes, personal goodwill becomes an issue when the business entity in question is a law firm, medical practice, or accounting firm.

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[101] *Marshall v. Marshall*, 735 S.W.2d 587, 594 (Tex.App.—Dallas 1987, writ ref'd n.r.e.)

[102] *Id.*, at 594.

[103] *Harris*, 765 S.W.2d at 803.

[104] *McKnight v. McKnight*, 543 S.W.2d 863, 867–68 (Tex. 1976).

[105] *Lifshutz v. Lifshutz,* 199 S.W.3d 9, 26 (Tex. App.—San Antonio 2006, pet. denied)

[106] *Cleaver v. Cleaver*, 935 S.W.2d 491, 494 (Tex. App.—Tyler 1996, no writ)

[107] *Zeptner v. Zeptner*, 111 S.W.3d 727, 738 (Tex.App.—Fort Worth 2003, no pet.); *Butler v. Butler*, 975 S.W.2d 765, 768 (Tex.App.—Corpus Christi 1998, no pet.).

[108] *Butler v. Butler*, 975 S.W.2d 765, 768 (Tex. App.—Corpus Christi 1998, no pet.)

[109] *See Williams v. Williams*, 720 S.W.2d 246, 249 (Tex. App.—Houston [14th Dist.] 1986, no writ)

[110] *Finn v. Finn*, 658 S.W.2d 735, 742 n.3 (Tex.App.—Dallas 1983, writ ref'd n.r.e.)

[111] *Austin v. Austin*, 619 S.W.2d 290, 292 (Tex.App.—Austin 1981, no writ).

[112] *Geesbreght v. Geesbreght*, 570 S.W.2d 427, 436 (Tex.App.—Fort Worth 1978, writ dism'd); *Von Hohn v. Von Hohn*, 260 S.W.3d 631, 638 (Tex.App.—Tyler 2008, no pet.).

[113] *Compare Von Hohn*, 260 S.W.3d at 639-40 (business goodwill could be characterized since partnership agreement did not control valuation of goodwill and the triggering event had not yet occurred) *with Finn*, 658 S.W.2d at 742 (partnership agreement controlled valuation of goodwill and failed to provide a means for spouse to realize the value of the partnership's goodwill and therefore the business goodwill could not be characterized).

[114] *Von Hohn*, 260 S.W.3d at 638; *Guzman v. Guzman*, 827 S.W.2d 445, 447 (Tex.App.—Corpus Christi 1992) *writ denied*, 843 S.W.2d 486 (Tex. 1992)

[115] *Von Hohn*, 260 S.W.3d at 638.

[116] *Id*.

B. Characterizing the Individual Interest

Regardless of when a business entity was formed, an individual's interest in the entity is created through exchange of capital. Typically, this is expressed in entity documents as One Thousand Dollars (as required prior to TBOC), even though this may not have been the initial capital contribution. This presents many challenges for the family law practitioner in trying to characterize an entity formed during the parties' marriage, particularly with older companies which may have sloppy stock records and unreliable facts and evidence regarding the initial contribution of the owners. The prudent practitioner should therefore research the entity's stock certificates and stock ledger and gather evidence regarding the initial contribution in tracing the character of the business entity.

When determining the character of the initial business interest, the family law practitioner may encounter evidence of the following: (1) capitalization with funds from other companies; (2) additional interests; (3) redeemed interests; and (4) reissuing interests. The effect of each is discussed further below.

1. <u>Capitalization with Funds from Another Corporation</u>

Family law practitioners should be mindful of the character of the property used to capitalize a client's business which can affect the character of the client's ownership interest. Even if a corporation is formed during marriage, if the corporation is entirely capitalized with separate property, then the ownership interest is characterized as separate property.[117] On the other hand, if the business is formed with mixed funds – that is separate and community property funds – then the ownership interest is characterized in proportion to the amount each estate contributed.[118]

Multiple scenarios can occur when funds from one business create a second business entity. In such situations, family law attorneys must trace the contributed funds for all involved businesses in order to determine the character of the individual owner's interest in the corporation.

As further discussed below, the typical scenario is when a separate property company (Company A) makes a non-liquidating distribution to its owners and then that distribution is in turn used as the capital contribution to the formation of another company during marriage (Company B). Even through the distribution came from a separate property company, Company B is now community property because the non-liquidating distribution was community property.

2. <u>Acquiring Additional Interest in the Business Entity</u>

Characterizing the acquisition of additional interests in a business entity is relatively simple and straightforward, as the inception of title rule still applies. For example, if an owner has 250 shares in a business entity before marriage and then acquires an additional 100 shares during the parties' marriage with community funds, then the 250 initial shares would be the owner's separate property and the additional 100 shares would be community property and subject to division by the Court.

3. <u>Redemption of Business Interests</u>

Redemption of business interests occurs when an entity repurchases its own shares in exchange for consideration. The shares, which are now owned by the company, may be cancelled, retired, or held as treasury stock. Although the business interest holders will still own the same amount of shares, their ownership percentage will actually increase. Such an increase in the percentage of ownership has no effect on the character of the other business interest holders' existing shares. However, this result only applies when the entity, not the individual, redeems the shares.

Thus, for example, if husband uses community funds to redeem shares of other owners in husband's separate property corporation, those redeemed shares would be community property as opposed to separate property.

4. <u>Reissuance of Business Interests</u>

The reissuance of business interests by an entity typically occurs when a company wants to clean up its stock ledger. So long as additional shares are not being issued, canceling and reissuing shares is simply an administrative task – a mutation – having zero effect on the character of the individual's business interest.

C. Characterizing Distributions

As stated above, mutations of a business entity do not affect the character of that business, regardless of the number of changes in form.[119] Likewise, mutations of the distributions from a separate property business

[117] *Hunt v. Hunt*, 952 S.W.2d 564, 567 (Tex.App.—Eastland 1997, no writ).
[118] *Vallone*, 644 S.W.2d at 457.
[119] *Horlock*, 533 S.W.2d at 60.

do not affect the separate property character of those distributions. However, distributions can still change from separate to community property under certain scenarios, as discussed below.

1. Dividends

The character of a dividend depends on whether the dividend is cash or stock and whether it has actually been distributed. Cash dividends distributed by a business entity during marriage are considered community property regardless of whether the source was from a separate property stock.[120] The character of a stock dividend follows the character of the stock. Therefore a stock dividend from separate property stock is separate property, regardless of when it is distributed.[121]

For characterization purposes, cash dividends distributed during marriage are treated as income, but a corporation's earnings or surplus funds normally do not constitute a dividend while they are retained by the corporation.[122] A shareholder also may generally expect to share proportionately in the corporation's earnings, but the shareholder has no general expectation of receiving a dividend.[123] Under TBOC, the board of directors may authorize a distribution and the corporation may make a distribution, subject to Section 21.303, which places limitations on distributions.[124] Among other things, a corporation cannot make a distribution that violates the corporation's certificate of formation or that exceeds certain specified distribution limits.[125]

2. Stock Splits

Similar to a stock dividend, the character of a stock split follows the character of the stock.[126] A stock split from separate property stock is separate property, regardless of when it is distributed.[127]

3. Liquidating Distribution

Liquidating distributions are property or funds received in exchange from the sale or redemption of a business interest. A liquidating distribution from a separate property business is separate property.[128]

4. Non-Liquidating Distribution

Non-liquidating distributions from both profits and capital are characterized as community property when distributed during the marriage.[129] The Texas Appellate Court states in *Marshall* as follows:

> A withdrawal from a partnership capital account is not a return of capital in the sense that it may be characterized as a mutation of a partner's separate property contribution to the partnership and thereby remain separate. Such characterization is contrary to the UPA and implies that the partner retains an ownership interest in his capital contribution. He does not; the partnership entity becomes the owner, and the partner's contribution become partnership property which cannot be characterized as either separate or community property of the individual partners. Thus, there can be no mutation of a partner's separate contribution; that rule is inapplicable in determining the characterization of a partnership distribution from a partner's capital account.

a. Mineral Rights Owned by a Partnership

A particularly tricky area of partnership law that a family law practitioner may encounter while handling a divorce in Texas is a spouse's separate property interest in a partnership that holds oil and gas interests. In 1953 the Texas Supreme Court applied the aggregate theory of partnership in *Norris v. Vaughan* when it held that royalties from the separate property partnership's oil and gas interests were a spouse's separate property because oil and gas production is "an invasion of the assets comprising [a spouse's] separate estate.[130] In *Norris*, the husband acquired his interest in the separate partnership before the marriage. Id. Additionally, the partnership acquired its interest in the producing gas wells also prior to the husband and

[120] *Legrand-Brock*, 246 S.W.3d at 322.
[121] *Wohlenberg v. Wohlenberg*, 485 S.W.2d 342, 347 (Tex.Civ.App.—El Paso 1972, no writ)
[122] *See Legrand–Brock v. Brock*, 246 S.W.3d 318, 322-24 (Tex. App.—Beaumont 2008, pet. denied); *Fischer–Stoker v. Stoker,* 174 S.W.3d 272, 279 (Tex. App.—Houston [1st Dist.] 2005, pet. denied) ("[D]ividends paid on investments, whether the investments are separate property or not, are income under Texas law and generally community property.").
[123] *See Argo Data Res. Corp. v. Shagrithaya*, 380 S.W.3d 249, 270 (Tex. App.—Dallas 2012, pet. denied) (citing TBOC § 21.302).
[124] TBOC § 21.303.
[125] *See Id.*
[126] *Tirado v. Tirado*, 357 S.W.2d 468, 473 (Tex. Civ. App.—Texarkana 1962, writ dism'd).
[127] *Id.*
[128] *Harris*, 765 S.W.2d at 803; *LeGrand-Brock*, 246 S.W.3d at 321.
[129] *Harris*, 765 S.W.2d at 802; *Marshall v. Marshall*, 735 S.W.2d 587, 594 (Tex.App.—Dallas 1987, writ ref'd n.r.e.).
[130] *Norris v. Vaughan*, 260 S.W. 2d 676, 681 (1953).

wife's marriage. Id. The Court reasoned that "since the oil and gas in place are part of the corpus of the land," extracting and selling the oil and gas was simply a mutation of separate property.[131] Thus, proceeds from the sale of oil and gas production, the royalties, "are derived from the piecemeal sale of a separate asset, the corpus of the land, and remain separate property."[132]

In 1961 the Legislature passed the Texas Uniform Partnership Act, which overruled the aggregate theory applied in *Norris* and adopted the entity theory of partnership. Tex. Rev. Civ. Stat. art. 6132b, § 18(1)(a) & (f). The entity theory of partnership articulates that the individual partners themselves do not own the partnership property; the partnership itself owns the partnership property.[133]

In 1987, the husband in *Marshall* attempted to rely on Norris to prove that distributions (besides salary) from his separate property partnership were from his capital account and therefore his were separate property.[134] The husband argued that, as in Norris, his separate property partnership acquired all of its oil and gas leases before marriage making the oil and gas sale proceeds nothing more than a mutation of his separate property.[135] Disagreeing with the husband's argument, the Marshall Court reasoned the aggregate theory of partnership, which had underpinned the ruling in Norris, was rejected by the Uniform Partnership Act and the Texas Business Organization Code and replaced with the entity theory of partnership.[136]

As previously noted, the *Marshall* Court stated that a "withdrawal from a partnership capital account is not a return of capital in the sense that it may be characterized as a mutation of a partner's separate property contribution to the partnership and thereby remain separate. Such characterization is contrary to the UPA and implies that the partner retains ownership interest in his capital contribution. He does not; the partnership entity becomes the owner, and the partner's contribution becomes partnership property which cannot be characterized as either separate or community property of the individual partners."[137]

Texas Courts addressed this issue of partnership distributions again in *Lifshutz II*.[138] In that case, the husband's separate property company, Liberty Partnership, owned stock in a lumber company.[139] The partnership then distributed the stock as a non-liquidating distribution to the husband, and the husband immediately re-contributed the stock to Liberty Financial, the husband's separate property entity.[140] The wife relied on the Marshall case in her argument that the distribution of the lumber company stock was community property.[141] The husband argued that the distribution of stock was an asset distribution and not a distribution of income.[142] However, the court held "whether the distribution was of an asset or cash, the distribution was from the capital account to which Marshall states that the 'mutation of a partner's separate contribution does not apply.'"[143] The Court further held that because the partnership made a distribution to the husband during marriage, the distribution was community property and the community has a right of reimbursement for the value of the distribution because the husband used community property to enhance value of his separate property entity.[144]

The *Marshall* and *Lifshutz II* courts affirm that the rule of mutation does not apply to a partner's separate property capital contribution and thus placing mineral interests into a partnership will unfortunately likely change the proceeds from what had been separate property mineral interests, such as royalties, to community property. Similarly, undistributed income left in the partnership from the sale of the mineral interests is property of the partnership and not subject to a property characterization during a divorce. While it might be tempting for a client to refuse to distribute income from a separate property partnership during divorce to prevent that income from becoming separate property, a client should be cognizant that leaving undistributed income in a partnership may lead the opposing spouse to make a Jensen claim or a claim for fraud on the community.[145]

5. Distributions from Business Entities Held in Trust

Placing separate property business entities into trusts is a growing trend in estate planning. However, this estate planning technique can create headaches

[131] *Id.* at 679–80.
[132] *Id.*
[133] *Marshall*, 735 S.W.2d at 594.
[134] *Marshall*, 735 S.W.2d at 592.
[135] *Id.* at 593.
[136] *Id.* at 593–94, thus negating the basis for the *Norris* decision.
[137] *Id.* at 594.

[138] *Lifshutz v. Lifshutz*, 199 S.W.3d 9 (Tex. App.—San Antonio 2006, pet. denied) (*Lifshutz II*).
[139] *Id.* at 24.
[140] *Id.*
[141] *Id.* at 25.
[142] *Id.*
[143] *Id.* citing *Marshall* at 594.
[144] *Lifshutz II* at 26-27.
[145] *See infra* XIV. Reimbursement Claims.

when determining how to characterize income from those entities held in a trust during divorce.

Like undistributed income held in a partnership, undistributed trust income is considered the property of the trust, not community or separate, and thus may not be subject to characterization.[146] Characterizing *distributed* income from business entities held in a trust is much more difficult and depends on, among other factors, whether the beneficiary spouse has a present possessory right to the trust corpus.[147] If the beneficiary spouse has no present possessory right to the corpus, then income distributions from the trust would be considered separate property. The theory is that income distributed to a beneficiary spouse from a trust created by a third party is considered separate property because it is acquired as a gift, and the income constitutes part of that gift.[148]

What if the beneficiary spouse acquires a present possessory right to a portion of the trust corpus during the marriage? Some trusts provide that a beneficiary spouse is entitled to income from the corpus of the trust until the beneficiary reaches a certain age. After the beneficiary reaches that age, the trustee is directed to distribute a portion of the trust corpus each year until the corpus is exhausted. Courts have held that once the spouse has a right to receive the trust corpus, the income from the corpus becomes community property.[149]

In the *Long* decision, the husband's mother created a trust for her son. The trustee had discretion to distribute income from the trust to the son or to allow the trust income to accumulate in the trust. The son had the right to one-half of the trust corpus and to take control of the trust assets on his twenty fifth birthday, but he chose not to do so. The son married his wife when he was twenty, and they became involved a divorce action when he was twenty five. The husband elected not to take a distribution of the trust corpus and kept undistributed trust income in the trust. The Court held that son could not characterize undistributed trust income as his separate property simply because the son chose not to terminate the trust saying that, "the beneficiary in the case before us was entitled to a present possessory interest in one-half of the trust corpus and the income from that one-half."[150]

These scenarios beg the question of what can be done to protect separate property business entities held in a trust. Case law indicates that careful trust drafting is absolutely critical to parties who are using trusts to preserve the characterization of business entities and income from those entities. In the *Ridgell* case, the Court held, "the testamentary trusts granted to [wife] possessory interest in the net incomes of the trusts and expectancy interest in the trust corpuses, revealing, at least prima facie, that the trust incomes during the marriage are community property."[151] The Court further explained that the trust settlors' main concern was the welfare of the wife and her children, "but absent more, we find nothing in the instruments operating so as to preclude the trust income from becoming community property in the event of [the wife]'s marriage."[152] Thus if the trust language is silent on how to treat income from the trust corpus, the general rule is that income is separate property only if the beneficiary spouse does not have a present possessory right to the corpus of the trust.[153]

In fact, the drafting of trust language is so critical that it is possible to create a trust in which a beneficiary spouse is the trustee and has the right to the income and the corpus of a trust to extent necessary for health, education, support, and maintenance as the beneficiary spouse/trustee deems necessary while maintaining the separate property characterization of the income from the trust corpus.

In the *Sharma* case, the court held that trust income distributed to the beneficiary husband who was also the trustee of two trusts was actually his separate property.[154] The husband in *Sharma* was entitled to discretionary income, and he could invade the corpuses of the trusts if he deemed necessary for his health, support, and maintenance; however he never exercised his discretion to make distributions of the corpus to himself. The court held that,

> in the context of a distribution of trust income under an irrevocable trust during marriage, income distributions are community property only if the recipient has a present possessory right to part of the corpus, even if the recipient has chosen not

[146] *See Buckler v. Buckler*, 424 S.W.2d 514 (Tex. App.—Fort Worth 1967, writ dismissed).
[147] *Sharma v. Routh*, 302 S.W.3d 355 (Tex. App.--Houston [14th Dist.] 2009, no pet.).
[148] *See Wilmington Trust Co. v. U.S.*, 753 F.2d 1055 (Fed. Ct. 1985), *aff'g* 4 Cl. Ct. 6 (1983).
[149] *In re Marriage of Long*, 542 S.W.2d 712 (Tex. App.—Tyler 1996, no writ).
[150] *Id*. at 718.
[151] *Ridgell v. Ridgell*, 960 S.W.2d 144, 149 (Tex. App.—Texarkana 1976, no writ).
[152] *Id.*
[153] *See id*.
[154] *Sharma v. Routh*, 302 S.W.3d 355 (Tex. App.—Houston [14th Dist.] 2009, no pet.).

> to exercise that right, because the recipient's possessory right to access the corpus means that the recipient is effectively an owner of the trust corpus.[155]

The Court concluded that the husband did not have a "present possessory right" to the corpus of the trusts because the trusts were 1) irrevocable, 2) the trusts provided for mandatory income distributions, and 3) the beneficiary spouse's only potential right of access to one of the trust's corpus was for the health, support, and maintenance of the beneficiary spouse as needed to maintain the standing of living he enjoyed at the time of the grantor's death.[156] The only time the beneficiary spouse would have had a present possessory right to the corpus of the trust would be if the beneficiary spouse, as the trustee, had determined that a distribution of the trust corpus would have been necessary for his health, support, and maintenance. In this case, the Court found no evidence that the beneficiary spouse ever made a determination that such distributions were necessary or that he was ever entitled to receive such distributions.[157] Thus, the distributions made from the trust were the separate property of the beneficiary spouse.

Another case which illustrates the importance of a well-written trust document is the *Benavides* case. In *Benavides v. Mathis*, the Fourth Court of Appeals, held that income distributions to a beneficiary spouse were that spouse's separate property.[158] Long before the husband was married, his family created a trust for preservation and management of a very large mineral estate, and the husband received monthly payments of revenue from the trust.[159] The husband became incapacitated and a guardian was appointed for the husband and his estate. Roughly a year later, the wife asked that the guardian deliver to her one-half of the trust distributions under the theory that such distributions were community property.[160]

The wife also argued that the family trust was not irrevocable because it could be amended by agreement of three quarters of the beneficiaries.[161] Additionally, the wife asserted that her husband had a present, possessory right to the corpus of the trust because he could transfer his interest, receive a portion of the corpus at the discretion of the trustee, and he could receive all of his interest in the corpus at the termination of the trust.[162]

The *Benavides* court held that "minerals are part of the land; therefore, as a general rule, royalties are considered corpus."[163] However, in any given case, the question of whether royalties constitute the corpus of the estate or constitute income can be decided only by reference to the trust documents as a whole."[164] Because the family trust document clearly defined the royalties as revenue and not as part of the corpus, the court held that, "the fact that [husband] receives royalties and bonuses as revenue does not mean he has a present, possessory interest in the trust corpus."[165] This decision falls clearly in line with *Wilmington Trust*'s holding that if a beneficiary spouse does not have a present possessory right to the corpus of the trust as defined by the trust terms, then the income from that corpus is treated like a gift and thus the income is separate property of the beneficiary spouse. This also confirms that if a separate property business entity is placed into a trust to which a beneficiary spouse has no present possessory right, the income from those entities, including oil and gas entities, can be characterized as separate property so long as the trust document clearly defines income as part of the gift.

VII. BUSINESS MUTATIONS

Business entities consistently evolve to ensure they are afforded the most favorable tax and liability protection. This can often create challenges in divorce suits when trying to determine the character of a business entity.

For example, in *Lifshutz II*, Husband had two separate property companies: Separate Property Company A and Separate Property Company B (for simplicity's sake). Separate Property A held shares in a lumber company and transferred said shares to Separate Property Company B. While Husband contended that the transfer was part of a recapitalization with no distribution, the Court of Appeals held that the transfer constituted a non-liquidating distribution and therefore the resulting shares were community property. The crux on the decision rested on the fact that the corporate documents did not show this as a direct transfer but rather clearly showed that a distribution was made. Had the transaction been a direct transfer, then it would

[155] *Id*. at 364.
[156] *Id*.
[157] *Id*. at 365.
[158] *Benavides v. Mathis*, 2014 WL 1242512 (Tex. App.—San Antonio 2014, pet. denied).
[159] *Id*.
[160] *Id*.
[161] *Id*.
[162] *Id*.
[163] *Id*; *see also Mitchell v. Mitchell,* 244 S.W.2d 803, 807 (1951).
[164] *Benavides* at 7.
[165] *Id.* at 8.

have simply been a mutation of the original business interest and the shares would have remained the separate property of Husband.[166]

One of the most common types of mutations is the merger. Mergers are governed by Section 10.001 of the Texas Business Organizations Code (TBOC), which provides that the business entity must adopt and approve a plan of merger. Except as otherwise provided in the plan of merger, the merger takes effect upon the acceptance of the certificate of filing of the certificate of merger with the Secretary of State. Section 10.008(8) of the Texas Business Organizations Code provides that the Plan of Merger of a merging corporation shall govern how the ownership interest in the merged entity will result in the surviving entity.

Although the impact on marital property character by the merger of community and separate property businesses has not been fully explored in Texas courts, the *Horlock* case does provide some guidance for the family law practitioner when dealing with a merged corporation.

In *Horlock*, husband owned 800 shares in his separate property company before his marriage. That company merged with two other corporations during the marriage to form a new company. In addition to the assets of the separate property company, the separate property company contributed $200,000.00 to the merger. As a result, husband received 14,152 shares in the new company in exchange for is 800 shares in his separate property company. The Houston Court of Appeals held that stock held by husband before marriage in the separate property company that merged with two other corporations during the parties' marriage remained the separate property of the husband.[167] The Court noted that the shares received by the husband in the merger in exchange for the original shares were simply a mutation in the form of the original shares, and therefore retained the character of those original shares.[168]

VIII. INSULATION FROM LIABILITY AND PIERCING

A. Generally

1. Corporations

Under Section 21.223, a holder of shares is not liable to the corporation or its obliges with respect to any contractual obligation of the corporation or any matter relating to or arising from the obligation on the basis that the holder was the alter ego or on the basis of actual or constructive fraud, or other similar theory.[169]

There is a statutory exception, providing that subsection (a)(2) does not prevent or limit the liability of the holder if the obligee demonstrates that the holder caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud on the obligee primarily for the direct personal benefit of the holder.[170] Courts have narrowly applied this requirement in relation to both corporations and LLCs.[171]

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[166] *Lifshutz v. Lifshutz*, 199 S.W.2d 9, 24 (Tex.App.—San Antonio 2006, no pet.) (*Lifshutz II*).
[167] *Horlock*, 533 S.W.2d at 60.
[168] *Id*.

[169] *See* TBOC § 221.223(a)(2).
[170] *Id.* § 21.223(b).
[171] *See, e.g., Metroplex Mailing Services LLC v. RR Donnelley & Sons Co.*, 410 S.W.3d 889, 897-98 (Tex. App.—Dallas 2013, no pet.) (reversing judgment against sole member of LLC, finding that member's having used monies wired to the LLC as part of sale of equipment to pay off a personal loan and then shutting down the LLC's business might have been evidence of alter ego but no evidence that member had committed a fraud on the LLC's creditors or obtained a direct personal benefit from the closing of the company); *K-Solv, LP v. McDonald*, 01-11-00341-CV, 2013 WL 1928798 (Tex. App.—Houston [1st Dist.] May 9, 2013, no pet.) (affirming summary judgment for LLC members and rejecting plaintiff's assertion that by causing the LLC not to pay its debt to the plaintiff, the members were able to pay monies toward obligations personally guaranteed by them and IRS debts for which they were personally responsible, and further noting that even if payment of such obligations could constitute the kind of "direct personal benefit" required to hold the members liable, there was no evidence of a connection between those payments and the plaintiff's transaction with the LLC); *Shook v. Walden*, 368 S.W.3d 604, 622 (Tex. App.—Austin 2012, pet. denied) (evidence that defendant was the primary investor in the LLC, was one of only two members, and gave money he withdrew from LLC to his daughter was insufficient to raise a reasonable inference of perpetration of an actual fraud for his direct personal benefit); *Menetti v. Chavers*, 974 S.W.2d 168, 175 (Tex. App.—San Antonio 1998, no pet.) (reversing judgment imposing individual liability on shareholders for corporate obligation and stating that "[e]vidence that the [defendants] bought their groceries or paid their credit card bills from the corporate account is insufficient, because the fraud must relate to the transaction at issue, the contract between the [defendants] and the [plaintiffs]"); *Rutherford, Rutherford v. Atwood*, No. 01–00–00113–CV, 2003 WL 22053687, *4–5 (Tex. App.—Houston [1st Dist.] Aug. 29, 2003, no pet.) (mem. op.) (explaining that alleged direct personal benefit to corporate actor must relate to alleged fraudulent transaction to support vicarious liability).

Under Section 21.224, the liability of a shareholder for an obligation that is limited by Section 21.223 is exclusive and preempts any other liability imposed for that obligation under the common law or otherwise.[172] There is an exception to the preemption of liability where the shareholder expressly assumed, guaranteed or agreed to be personally liable to the obligee, or where the shareholder is otherwise liable under TBOC or other applicable statute.[173]

In addition to the foregoing general provisions, TBOC also provides that the existence of or performance under a shareholders' agreement authorized by TBOC is not a ground for imposing personal liability on a shareholder for an act or obligation of the corporation by disregarding the separate existence of the corporation or otherwise, even if the agreement treats the corporation as a partnership or in a manner that otherwise would be appropriate only among partners, results in the corporation receiving tax treatment as a partnership, or result in the failure to observe corporate formalities otherwise applicable to those matters governed by the shareholders' agreement.[174]

2. Limited Liability Companies

TBOC provides that an LLC member "may be named as a party in an action by or against the [LLC] only if the action is brought to enforce the member's right against or liability to the company."[175] In addition, "[e]xcept as and to the extent the company agreement specifically provides otherwise, a member or manager is not liable for a debt, obligation, or liability of a limited liability company, including a debt, obligation, or liability under a judgment, decree, or order of a court."[176]

LLC members are also insulated from liability in the same manner as corporate shareholders and subject to certain exceptions, as discussed above. Section 101.002 of TBOC provides that, subject to section 101.114, sections 21.223, 21.224, 21.225 and 21.226 of TBOC (governing corporate shareholders' liability for corporate debts) apply to an LLC and the LLC's members, owners, assignees, affiliates and subscribers.[177] In the LLC context, the references in these sections to "shares" includes "membership interests;" a reference to "holder," "owner" or shareholder" includes a "member;" and a reference to "corporation" includes a "limited liability company."[178]

The exceptions to limited liability are discussed below in the "piercing" section.

3. Partnerships and Limited Partnerships

With certain exceptions, general partnerships do not insulate partners from liability. Under TBOC, a partner of a general partnership is jointly and severally liable for all obligations of the partnership unless otherwise agreed by the claimant or provided by law, subject to certain exceptions for liabilities arising before the partner's admission to the partnership.[179]

Likewise, with certain exceptions, a general partner of a limited partnership has the liabilities of a partner in a general partnership without limited partners to persons other than the partnership and the other partners.[180]

The exceptions include a general partnership registered as a limited liability partnership pursuant to sections 152.801 et seq. of TBOC, in which case, except as provided by the partnership agreement, a partner will not be personally liable to any person, including a partner, directly or indirectly, for any obligation of the partnership incurred while the partnership is a limited liability partnership.[181] In addition, if a limited partnership is registered as a limited liability partnership, the general partners and limited partners enjoy the protections of section 152.801.[182]

TBOC provides substantively and significantly different protections to limited partners in a limited partnership. It provides that a limited partner is not liable for the obligation of a limited partnership unless: (1) the limited partner is also a general partner; or (2) in addition to the exercise of the limited partner's rights and powers as a limited partner, the limited partner participates in the control of the business.[183] Even then, it further provides that if the limited partner

[172] *Id.* § 21.224.
[173] *See Id.* at § 21.225.
[174] *Id.* § 21.107.
[175] *See* TBOC § 101.113.
[176] *Id.* § 101.114.
[177] TBOC § 101.002(a).
[178] *See id.* § 101.002(b).
[179] *See* TBOC § 152.304(a)&(b).
[180] *See* TBOC 153.152.
[181] TBOC § 152.801.
[182] *See* TBOC 153.353.
[183] TBOC 153.102(a)(1)-(2).

participates in the control of the business, "the limited partner is liable only to a person who transacts business with the limited partnership reasonably believing, based on the limited partner's conduct, that the limited partner is a general partner."[184] TBOC also contains an extensive list of activities that do not constitute participation in the business.[185]

B. Piercing the Corporate Veil

1. Generally

Spouses frequently assert alter ego claims in the divorce context in an effort to reach what would otherwise be characterized as the other spouse's separate property.

Under Texas law, alter ego is only one of several grounds for piercing the corporate veil.[186] In general, courts will "disregard the corporate fiction, even though corporate formalities have been observed and corporate and individual property have been kept separately, when the corporate form has been used as part of a basically unfair device to achieve an inequitable result."[187] *Castleberry* sets forth six grounds for piercing the corporate veil.

> (1) when the fiction is used as a means of perpetrating fraud;
>
> (2) where a corporation is organized and operated as a mere tool or business conduit of another corporation;
>
> (3) where the corporate fiction is resorted to as a means of evading an existing legal obligation;
>
> (4) where the corporate fiction is employed to achieve or perpetrate monopoly;
>
> (5) where the corporate fiction is used to circumvent a statute; and
>
> (6) where the corporate fiction is relied upon as a protection of crime or to justify wrong.[188]

Although *Castleberry* has been partially superseded by statute, *see* TBOC § 21.223(a), its list of piercing grounds has been reiterated by the Texas Supreme Court as its comprehensive review of the bases for imposing liability notwithstanding the corporate structure.[189] Alter ego in particular applies where there is such unity between the corporation and an individual that the separateness has ceased to exist and holding only the corporation liable would result in injustice.[190]

Piercing the corporate veil is not a cause of action, but is instead a means of imposing liability for an underlying cause of action.[191]

2. Piercing is an Equitable Doctrine

Piercing is an equitable doctrine, and Texas follows a flexible fact-specific focus which focuses on equity.[192] Each of the six grounds for piercing identified in *Castleberry* involves some type of wrongdoing, or in the words of *Castleberry*, injustice or inequity. "By 'injustice' and 'inequity' we do not mean a subjective perception of unfairness by an individual judge or juror; rather, these words are used in *Castleberry* as shorthand references for the kinds of abuse, specifically identified, that the corporate structure should not shield—fraud, evasion of existing obligations, circumvention of statutes, monopolization, criminal conduct, and the like."[193] Any other rule would seriously compromise a bedrock principle of corporate law, that a legitimate purpose for forming a corporation is to limit individual liability for the corporation's obligations. *Id.*

It is well established that the corporate fiction generally will not be disregarded absent exceptional circumstances.[194] Similar equitable principles apply to

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[184] *Id.* § 153.102(b).
[185] *Id.* § 153.103.
[186] *See, e.g., Castleberry v. Branscum*, 721 S.W.2d 270, 272 & n.3 (Tex. 1986).
[187] *Id.* at 271.
[188] *Id.*
[189] *See SSP Partners v. Gladstrong Investments (USA) Corp.*, 275 S.W.3d 444, 454 (Tex. 2008) (reciting the *Castleberry* grounds and rejecting the "single business enterprise" theory as a grounds for piercing the corporate veil).
[190] *Castleberry*, 721 S.W.2d at 272.
[191] *E.g., Wilson v. Davis*, 305 S.W.3d 57, 68 (Tex. App.—Houston 1st Dist. 2009, no pet.) (citing *Gallagher v. McClure Bintliff*, 740 S.W.2d 118, 119 (Tex. App.—Austin 1987, writ denied)).
[192] *Castleberry*, 721 S.W.2d at 273.
[193] *SSP Partners v. Gladstrong Invs. (USA) Corp.*, 275 S.W.3d 444, 455 (Tex. 2008).
[194] *See Lucas v. Tex. Indus., Inc.*, 696 S.W.2d 372, 374 (Tex. 1984).

both direct- and reverse-piercing, such as that the veil will be pierced only when necessary to prevent an injustice and in "exceptional circumstances."[195]

3. Limited Partnerships May Not be Subject to Piercing

A number of courts have found that veil piercing theories are inapplicable to limited partnerships.[196]

To the extent the limited partner's general partner is also a liability-limiting entity, however, that entity itself may be subject to veil piercing.[197]

IX. PIERCING THE CORPORATE VEIL IN THE DIVORCE CONTEXT

To disregard the corporate entity – "pierce the corporate veil" – Section 21.223 of the TBOC requires actual fraud or failure to maintain any corporate formalities. This allows the litigant to hold the shareholder liable for various corporate obligations. The spouse may attempt to accomplish this by showing that the corporation is actually the "alter ego" of the shareholder spouse through a process referred to as reverse piercing. In the family law context, the non-owner spouse is able to "reverse pierce" the corporation and deem corporate assets as community property and subject to division by the Court.

To reverse piece, the litigant must show the following: (1) the unity between the company and the spouse; and (2) harm to the community that would not be remedied by reimbursement.[198] In other words, if reimbursement can remedy the harm caused to the community, then the court will not reverse pierce the corporation. Notably, the complaining spouse cannot have "unclean hands" by participating in creating such a unity and then complaining about the same actions. Further, establishing both prongs is extremely fact intensive and is often misapplied by the courts.

Unity between a business entity and a spouse is most often found in instances where the spouse is the sole employee of the corporation and uses the separate property corporation as his or her own "personal piggy bank" to the detriment of the community estate. In such situations, the spouse often re-deposits all income into corporate accounts and uses said funds to pay separate property expenses and debts. This in turn reduces the funds available to the community. Other situations where unity has been found include placing the marital residence in the corporation's name, receiving salary which is not commensurate with the work that has been performed, and purchasing household furnishings in the name of the corporation.[199]

A. No Unity Found

Courts are oftentimes very reluctant to pierce the corporate veil and find unity between the shareholder spouse and the corporation. In *Goetz v. Goetz*, the Dallas Court of Appeals held that although the husband, as the sole shareholder and president of the company, made undocumented transfer between companies, no evidence was presented showing that such transfers were made for an improper purpose and therefore no unity existed between the corporation and the husband.[200] Likewise, in *Duke v. Duke*, the El Paso Court of Appeals found that no unity existed between husband and his corporation in spite of the fact that all stock was held in husband's name; husband controlled all aspects of the corporation; the incorporation was simply made for tax purposes; and husband used corporate funds to make four monthly alimony payments.[201]

B. Unity Found But No Harm

Although a court may find unity between the shareholder spouse and the corporation, the court may still decline to find that the corporation is the alter ego of the shareholder spouse if there was no harm done to

[195] *Wilson*, 305 S.W.3d at 70 (citing *Cappuccitti v. Gulf Indus. Prods., Inc.*, 222 S.W.3d 468, 481–82 (Tex. App.—Houston [1st Dist.] 2007, no pet.))

[196] *E.g., Seidler v. Morgan*, 277 S.W.3d 549, 558 n. 5 (Tex. App.—Texarkana 2009, pet. denied); *Pinebrook Props., Ltd. v. Brookhaven Lake Prop. Owners Ass'n*, 77 S.W.3d 487, 499 (Tex. App.—Texarkana 2002, pet. denied); *see also Peterson Grp., Inc. v. PLTQ Lotus Grp., L.P.*, 417 S.W.3d 46, 58 (Tex. App.—Houston 2013, pet. filed) (noting that Texas courts have uniformly declined to apply the alter-ego theory to pierce a limited partnership's veil to impose the entity's liabilities on a limited partner); *Lifshutz v. Lifshutz*, 61 S.W.3d 511 (Tex. App.—San Antonio 2001, pet. denied) (concluding that piercing was not appropriate for a partnership interest under the Texas Revised Partnership Act, based on the clear legislative intent as followed by the Texas Supreme Court to the effect that a partner's spouse has no community property right in partnership property).

[197] *Peterson*, 417 S.W.3d at n.5.

[198] *Lifshutz v. Lifshutz*, 61 S.W.3d 511, 517 (Tex. App.—San Antonio 2001, pet. denied) (*Lifshutz I*)

[199] *See e.g.*, *Young v. Young*, 168 S.W.3d 276, 281 (Tex.App.—Dallas 2005, no pet.); *see also Zisblatt v. Zisblatt*, 693 S.W.2d 944 (Tex. App.—Fort Worth 1985, writ dism'd).

[200] *Goetz v. Goetz*, 567 S.W.2d 892, 896 (Tex. Civ. App.—Dallas 1976, no writ).

[201] *Duke v. Duke*, 605 S.W.2d 408, 412 (Tex. Civ. App.—El Paso 1980, writ dism'd).

the community estate. Specifically, in *Marcum v. Marcum*, the First Court of Appeals of Houston found that no alter ego existed when, despite transfers of funds from the community to the company for payment of company expenses, the community estate was not harmed by wife's actions. Since husband failed to meet his burden of proving the second element to reverse pierce the corporation, the court could not reimburse the community for said funds.

Similarly, in *Lifshutz I*, the San Antonio Court of Appeals found that although unity existed between the partnership and husband's personal finances, the actions taken by husband actually enhanced the community estate. The Court further held that only corporations, and not partnerships, can be pierced because the TBOC specifically prohibits the award of partnership assets to the non-partner spouse in the event of a divorce.[202]

C. Unity and Harm Found Beyond Remedy

In *Spruill v. Spruill*, the El Paso Court of Appeals upheld the trial court's finding of unity and harm by the husband, awarding wife all of the husband's interest, if any, in his companies, the house, and all personal property in the home. The evidence showed that husband's company had paid for everything in the community estate, and the home, all cars, and furnishings were placed in the corporation's name. Reimbursement would not have made the community whole as all stock in husband's corporation was pledged to husband's friend pursuant to a promissory note upon which husband defaulted. Therefore, the only remedy available to the community was "reverse piercing" and awarding wife any assets of the company.[203]

Similarly, in *Zisblatt*, the Fort Worth Court of Appeals disregarded husband's company and reverse pierced the corporate veil, finding that the company was "nothing more than a series of account into which were deposited the majority of the commissions earned by husband over the course of the marriage."[204] By attempting to change the character of earned income to separate property (an asset of the corporation), the husband defrauded the community, and husband and the company could not be viewed as ever existing as separate entities. The result of husband's actions placed the community in a position where the only assets owned by the community were the clothes on the parties' backs.[205]

X. Potential Conceptual Problems with Piercing

Reverse piercing can present some difficult policy considerations.[206] In *Moore*, the Bankruptcy Court provided a fairly lengthy discussion of the history of reverse piercing and its development in the Texas courts and the Fifth Circuit, as was troubled by the theory's growing acceptance without thorough analysis of its support or precise contours:

> The court recites this history of Texas and Fifth Circuit jurisprudence regarding reverse corporate veil piercing because this court is troubled that the doctrine has evolved and become accepted into the mainstream, starkly during a time when the Texas Legislature is limiting the availability of traditional veil piercing, and without meaningful discussion of what, in substance, the doctrine does (and can potentially do). It is one thing to apply the reverse veil piercing doctrine in divorce property divisions, in the context of a small wholly-owned corporation (*e.g.*, so that a spouse might get a more equitable division of marital property—where significant value is in a corporation wholly-owned by the other spouse). It seems quite another thing to broadly apply it in commercial litigation contexts (*e.g.*, so that a creditor who loaned money to an individual, with only the legitimate expectation of being able to reach the individual's assets—including perhaps his stock in a corporation—is suddenly attempting to reach the *assets* of a corporation that might have its own significant creditors).[207]

The Moore court was clearly concerned with the effect of a reverse piercing on the rights of parties other than the shareholder owing the debt or obligation to the creditor invoking the theory. Ultimately, the Moore court stated:

> Thus, in the absence of any Texas Supreme Court case clearly adopting reverse veil piercing, and in the absence of Texas or Fifth Circuit authority that clearly defines the specific parameters for its use, this court will incorporate for the case at bar the views expressed by certain courts from other circuits—namely, that reverse veil piercing should

[202] *Lifshutz I*, 61 S.W.3d at 514-519.
[203] *Spruill v. Spruill*, 624 S.W.2d 694, 696-98 (Tex. App.—El Paso 1981, writ dism'd w.o.j.)
[204] *Zisblatt*, 693 S.W.2d at 958.
[205] *Id.* at 947.
[206] *See In re Moore*, 379 B.R. 284, 294–95, 296 (N.D. Tex. 2007); *Wilson*, 305 S.W.3d at 70.
[207] *Moore*, 379 B.R. at 294-95.

only be applied when it is clear that it will not prejudice non-culpable shareholders or other stakeholders (such as creditors) of a corporation. *See Stoebner v. Lingenfelter*, 115 F.3d 576, 579–580 (8th Cir. 1997) (indicating that Minnesota has only recognized the doctrine of reverse corporate piercing in very limited circumstances—namely, when no shareholder or creditor would be adversely affected); *Scholes v. Lehmann*, 56 F.3d 750, 758 (7th Cir. 1995) (indicating without citations that "[r]everse piercing is ordinarily possible only in one-man corporations, since if there is more than one shareholder the seizing of corporation's assets to pay a shareholder's debts would be wrong to the other shareholders. Even in one-man corporations it is a rarity because a simple transfer of the indebted shareholder's stock to his creditors will usually give them all they could get from seizing the assets directly."); *Cascade Energy & Metals Corp. v. Banks*, 896 F.2d at 1575 (analyzing Utah law, suggesting that the reverse piercing doctrine was "little recognized" and presents many problems—namely it bypasses normal judgment collection procedures whereby a judgment creditor can simply attach the judgment-debtor's shares in the corporation and not the corporation's assets; ultimately refusing to apply the doctrine in the absence of a clear statement from the Utah Supreme Court adopting it).

The approach herein suggested by this court (of only considering reverse veil piercing if the facts clearly show it will not prejudice nonculpable stakeholders) not only respects due process and established creditors' rights principles, but also gives proper deference to the will of the Texas Legislature—*i.e.*, to impose a measured use of alter ego doctrine.[208]

The *Moore* court attempted to balance the competing interests by requiring that there be an ownership interest between the individual and the corporation whose separateness was sought to be disregarded, following the general standards for application of alter ego (where the corporation is used as a mere tool or business conduit for another, considering the totality of circumstances, and considering whether applying reverse piercing would prejudice non-culpable shareholders or stakeholders (such as creditors) of the corporation.[209] The *Moore* court stated, however, that there was nothing in Texas law that per se prohibits reverse piercing when there are other equity owners. *Id.*

The *Moore* court referred to three Texas cases involving reverse piercing, including two divorce cases, *Dillingham v. Dillingham*, 434 S.W.2d 459 (Tex. App.—Fort Worth 1968, writ dism'd), in which the assets and earnings of a corporation were treated as though they were those of an individual spouse, but in which the court did not cite authorities, provide analysis or use the term "reverse piercing," and *Zisblatt v. Zisblatt*, 693 S.W.2d 944 (Tex. App.—Fort Worth 1985, writ dism'd), in which the court of appeals provided a discussion of alter ego but did not use the term reverse piercing. The *Moore* court did not cite to *Vallone v. Vallone*, 644 S.W.2d 455 (Tex. 1982), in which the Texas Supreme Court also did not use the term "reverse piercing," but nevertheless decided, without discussion, that alter ego could be used in the divorce context, stating that "Consideration of whether a corporation is an *alter ego* for purposes of determining whether assets held in the corporation's name should be treated as community property is an issue of fact from which the status of the property is determined."[210]

There may be other distinctions in how traditional veil piercing theories should be applied to reverse piercing. For example, at least one court has concluded that when the claim involves reverse piercing, the protections contained in the predecessor to section 21.223 of TBOC do not apply.[211]

[208] *Id.* at 295-96.
[209] *Id.* at 296.

[210] *Id.* at 458.
[211] *See Wilson v. Davis*, 305 S.W.3d 57, 68 (Tex. App.—Houston [1st Dist.] 2009, no pet.) (concluding that Tex. Bus. Corp. Act Ann. art. 2.21(2), (3) (Vernon 2003) (recodified eff. Jan. 1, 2006 at TBOC § 21.223) limited the use of alter ego and like theories when a claimant seeks to hold a shareholder liable for a corporate obligation, but does not apply where a party seeks to hold the corporation liable for a shareholder's tortious action under a reverse piercing theory).

XI. VALUATION OF THE BUSINESS ENTITY

After determining the character of the business entity, it is critical for the family law practitioner to begin the process of determining the value of the company for division purposes. Oftentimes, it is necessary to retain the services of a business valuation expert to value a closely-held business interest and determine whether any claims, such as reimbursement, can be made.

A. Standard of Value – Fair Market Value

In Texas, the standard of value considered in establishing the value of community property in divorce cases is Fair Market Value.[212] One can look to the International Glossary of Business Valuation Terms which defines Fair Market Value as follows:

> *The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.*

Similarly, the Texas Supreme Court has defined Fair Market Value in an almost identical manner in *City of Pearland v. Alexander*, 483 S.W.2d 244 (Tex. 1972), which forms the basis of Texas Pattern Jury Charge 203.1:

> *The value of an asset is its fair market value unless it has no fair market value.*
>
> *"Fair market value" means the amount that would be paid in cash by a willing buyer who desires to buy, but is not required to buy, to a willing seller who desires to sell, but is under no necessity of selling.*
>
> *If an asset has no fair market value, its value is the value of its current ownership as determined from the evidence.*
>
> *In valuing an asset to be received in the future, you are to find its present value as determined from the evidence.*

Oftentimes owners and partners will entire into buy-sell agreements which may specify a formula on which value is based; however, the requirement to utilize fair market value as the standard of value may override the buy-sell agreement, and the courts in many cases will still look to Texas Pattern Jury Charge 203.1 in defining the standard of value.

B. Valuation Approaches

There are three generally accepted approaches to valuing a business: (1) the asset approach, (2) the market approach, and (3) the income approach. Within each of these approaches are many acceptable valuation methods. It is generally expected that a thorough analysis will consider all valuation methods, but may utilize only those applicable to the facts and circumstances surrounding the engagement.

1. The Asset Approach

The asset approach, sometimes referred to as the "cost" approach, is a general way of determining the value of a business based on the value of the company's underlying assets net of liabilities. Each asset and liability of the business is valued separately and then totaled to produce the total value of the business. The asset approach is the most intuitive of the three approaches.

In general, only the tangible and certain intangible assets of the business are valued when using the asset approach. Theoretically, a business should be worth at least the fair market value of its tangible assets less liabilities, as that is the minimum value the owners would expect to receive on complete liquidation of the business. For going concern businesses, both tangible and intangible assets should be considered by the valuator in his or her analysis. As many businesses claim intangible assets that cannot be valued apart from the business, the asset approach generally should not be used alone as the conclusion of value for a going concern entity, but can establish a value floor.

2. The Market Approach

The market approach seeks to determine the value of a business by comparing the subject company to similar businesses or ownership interests that have been sold. This approach can be difficult to apply for small, closely-held businesses, as guideline and other market directed indicators are often scarce and reliable information can be difficult to obtain.

The guideline public company method is a

[212] *Ricks v. Ricks*, 169 S.W.3d 523, 527 (Tex. App. – Dallas [5th Dist.] 2005 no pet.).

method within the market approach in which the value of the subject company is determined by applying multiples (i.e., price-to-earnings) derived from the stock price of similar companies that are actively traded in a free and open market. In slight contrast, the market transaction method (also referred to as the merger and acquisition method) determines value based on pricing multiples derived from transactions involving significant interests in companies engaged in the same or similar lines of business. Valuators may also wish to consider any recent transactions involving the subject company where price was determined at arms-length.

3. The Income Approach

The income approach is a method to determine the value of a business by converting anticipated future economic benefits into a single present value. Free cash flow and earnings before interest, taxes, depreciation and amortization (EBITDA) are common examples of such economic benefits.

The two main methods used in the income approach are the capitalization of earnings method and the discounted cash flow method.

a. Capitalization of Earnings Method

The capitalization of earnings method arrives at a value by dividing the economic benefits received from a business over the course of a representative single period by a capitalization rate. The capitalization rate is calculated based on the required rate of return and expected long-term growth of the business. A business's required rate of return is the return an investor would expect to receive from an investment considering the relative risk of such an investment. When using the capitalization of earnings method, it is assumed the subject company's economic income will continue to grow or decline at a stable rate into perpetuity.

b. Discounted Cash Flow Method

The discounted cash flow method measures value by applying a discount rate to a series of future expected economic benefits. The discount rate represents the investor's required rate of return for an investment in the business (i.e., the return the investor expects to receive for money invested in the business given the relative risk of the business). The discounted cash flow method is used when a company is expected to exhibit changing growth rates in economic income. Economic income is projected for each year until a steady-state growth rate is achieved. At such time, the next year's economic income is capitalized to derive a terminal value of the business. The present value of the ongoing economic income and the present value of the terminal business value are then summed to determine total value.

There are several different methods to calculate a discount rate, including the weighted average cost of capital (WACC) and the build-up method.

4. Reconciliation of the Three Approaches

Different valuation approaches will often render different conclusions of value. As discussed earlier, the asset approach will typically yield the smallest conclusion of value because it generally fails to consider the value of intangible assets. In contrast, the market and income approaches which do consider intangible assets usually render higher valuations.

Additionally, a valuation expert might weigh the consideration given to each approach differently and, in some instances, may consider but not utilize one or more approaches in the valuation.

C. Adjustments to Financial Statements

It is often the case that the financial statements of a closely held entity reflect non-recurring expenses or non-operating expenses (or both) which benefit the owners and their families. Generally, the financial statements need to be adjusted to reflect the true amount of income available to the owners. Adjustments to the financial statements are based on subjective interpretations of complex data, and two valuation experts analyzing the same set of financial statements might conclude that different adjustments should be made.

1. Normalizing Adjustments

In valuations of both control and non-controlling interests, valuators should make normalizing adjustments to the financial statements to "convert" business income to economic income. Normalizing adjustments include correcting errors, removing non-business revenues and expenses, and adjusting non-recurring revenue and expense items to determine the true operating income of the subject company.

a. Non-Recurring Expenses

Non-recurring expenses can be buried in the financial statements and in many cases are only discovered through the expert's due diligence. Non-recurring expenses should be removed from the financial statements, as they are not expected to be incurred in the future under normal operating conditions and therefore do not affect value.

Examples of non-recurring expenses include: write-off of obsolete inventory, excessive legal expense due to a non-recurring legal matter, and excessive administration expense due to a switch in accounting systems.

b. Non-Operating Income and Expenses

In determining fair market value, the valuator should rely on income statements that reflect only income and expenses related to operating the business. As such, non-operating income and expenses, such as personal expenses, should be removed from the financial statements. This can be especially important when valuing closely-held companies owned by family members or related parties.

Valuators that do not adjust for personal expenses are under-valuing the community asset. In cases involving considerable personal expenses, one should be aware of potential income tax consequences.

Examples of personal expenses include:

- Personal property taxes;
- Expenses related to luxury items, such as sports cars, boats, and country clubs fees;
- Personal travel; and
- Salaries paid to non-working family members

2. <u>Control Adjustments</u>

An owner with a controlling interest in an entity generally operates the entity in the manner that is most beneficial to the owner individually, even though such a manner of operation may be an inefficient use of entity resources when considered from the perspective of other non-controlling owners or potential owners. Accordingly, there may be additional economic benefits available to willing buyers that are not reflected in the entity's financial statements because it is operated inefficiently.

The valuator should make appropriate adjustments to the financial statements to reflect the economic benefits available to a willing buyer as if the entity were operated in the most efficient manner. The valuator will generally look to comparable public companies operating in similar industries in considering efficient operation, as it is assumed that competition has driven surviving firms to operate as efficiently as possible.

a. Compensation Adjustments[213]

In many instances, it is not unusual for a controlling shareholder in a private company to take compensation greater than market rates for comparable services. Since a willing buyer might employ a manager to operate the business, it is appropriate to remove from the income statement the portion of the compensation which is higher than expected relative to the rest of the market.

There are many different sources available for compensation data, including:

- ERI (Economic Research Institute)
- MGMA (physician compensation)
- Altman Weil Publications (attorney compensation)
- Compensation research studies
- Vocational experts
- Trade associations
- Industry consultants / experts

b. Debt-to-Equity Ratio

When valuing a controlling interest and determining a capitalization or discount rate to employ in the income approach, the valuator should adjust the leverage of the subject company to a level that is equivalent to the estimated industry debt-to-equity level. The adjustment is based on the theory that a hypothetical buyer would restructure the subject company to operate at the optimal debt-to-equity ratio as reflected by the surviving firms in a competitive industry.

3. <u>Other Financial Adjustments</u>

In addition to normalizing and control adjustments, there are other financial adjustments which must be considered in determining the conclusion of value.

[213] Compensation adjustments can also be considered a normalizing adjustment.

a. Capital Expenditures

The cash flows analyzed in determining the value of the entity should be adjusted to reflect relevant capital expenditures normally incurred in the operation of the business. In some industries, such as natural resource exploration, ongoing capital expenditures can be significant and adjustments can have a substantial impact on value.

b. Fair Market Value of the Assets and Liabilities

In utilizing the asset approach to valuing a business (as discussed above), the valuator must adjust the balance sheet to reflect the fair market value of all assets and liabilities. Such adjustments include adjusting the value of real estate and marketable securities to reflect current fair market value, and adjusting accounts receivable for the collectability of debt.

c. Related Party Transactions

Adjustments for related party transactions can materially impact the conclusion of value and require careful review of the nature of the transaction.

Consider the business owner who holds a promissory note from the subject company. Is the owner likely to enforce the promissory note and seek to collect on the note if the business is unable to make payments in accordance with the terms of the note? In such situations, the valuator might convert debt held by the owner to equity for purposes of valuing the business. If the debt is converted to equity, the offsetting receivable held by the shareholder should not be included as a personal asset.

XII. THE EFFECT OF PERSONAL GOODWILL IN VALUING THE BUSINESS ENTITY

The Supreme Court of Texas has stated that, in valuing the practice of an unincorporated professional for purposes of divorce, the court cannot include the value of goodwill that has accrued to the individual and that is not separate and apart from that individual's person or that individual's ability to practice the profession.[214] As stated in Texas Pattern Jury Charge 203.2:

> *"Personal goodwill" is the goodwill that is attributable to an individual's skills, abilities, and reputation.*
>
> *In determining the value of PARTY A's medical practice, you are not to include the value of personal goodwill or the value of time and labor to be expended after the divorce. However, you may consider the commercial goodwill, if any, of the practice that is separate and apart from personal goodwill.*

The calculation of personal goodwill should start with a calculation of the value of the business' intangible assets. It is often the case that, for a going concern enterprise, the value of the entity will exceed the net value of tangible assets less liabilities. Under such circumstances, the difference between the total value of the business and the net value of the tangible assets is attributable to intangible assets (i.e., goodwill).

Intangible assets can include: assembled workforce, customer lists, patents, proprietary processes, phone number, business name, supplier and distributor relationships, and personal goodwill. Assigning value to each intangible asset is a qualitative process that could arguably be considered more art than science. Once the value of goodwill has been determined, it must be allocated appropriately among corporate goodwill and personal goodwill.

A. Single Owner Adjustment

In valuations of a single owner business, the likelihood is that the amount of personal goodwill will be high. However, a valuator cannot determine personal goodwill without also considering the other assets of the company, the industry, and the potential for a new owner to hire an industry expert that could provide a similar set of knowledge and skills as the current owner.

Within the context of a marital dissolution, it is not uncommon for owners of closely-held businesses to believe that their contribution to the business is solely unique and the business will certainly fail without them. They believe they are 100 percent of the intangible value. The burden is placed on the valuator to examine the value of the other intangible assets (discussed above) to estimate the amount of corporate goodwill which exists.

[214] *Nail v. Nail*, 486 S.W.2d 761, 764 (Tex. 1972).

B. Multiple Partners Adjustment

In some jurisdictions, the personal goodwill of all owners may be considered. The court ruled in *Salinas v. Rafiti*, 948 S.W.2d 286 (Tex. 1997), that goodwill attributable to individual partners is not an asset subject to division. Consequently, the personal goodwill of all owners of a business, and not just the owner spouse, may be excluded when determining the value of a community property business.

XII. CONTROL AND MARKETABILITY DISCOUNTS

For valuations of closely held entities for family law matters in Texas, the appropriate level of value is either (1) controlling, non-marketable or (2) non-controlling, non-marketable. The size of the ownership interest and the partnership/operating agreement will dictate whether the interest being valued is considered controlling or non-controlling. Depending on the valuation method used, the valuator may need to apply a discount for lack of control and/or a discount for lack of marketability, both of which decrease the initial conclusion of value.

A. Discount for Lack of Control

A minority interest holder does not have the ability to unilaterally control the operations of an entity, distribute cash to owners, or dispose of the entity's assets. Accordingly, a non-controlling interest is likely less valuable than a controlling interest, and a discount for such lack of control may be appropriate in determining the fair market value of the non-controlling interest.

B. Discount for Lack of Marketability

A discount for lack of marketability is based upon increase selling costs, (1) the lack of a ready market to sell or transfer ownership interests in closely-held businesses and (2) the possible restrictions that must be resolved by an owner prior to selling an ownership interest to an outside investor. In the public markets, one can sell shares of a publicly-traded company at any time at his or her discretion. There are significant differences, however, between an interest in a closely-held entity and publicly-traded securities. The owner of publicly-traded securities knows at all times the market value of his or her holdings and can sell those holdings for cash within a few working days. Such is not the case with respect to an interest in a privately held company. Clearly, an asset with a ready and available market is more valuable than an identical asset in an illiquid market. Therefore, a discount for lack of marketability may be applicable in valuing a closely-held entity.

Discounts for lack of marketability can be developed by reviewing empirical studies of restricted stock and pre-IPO stock, as well as court cases that establish appropriate guidelines. Most of the restricted stock studies identify median or average discounts in the range of 25 percent to 35 percent for prices of non-marketable shares relative to marketable shares that were otherwise deemed to be comparable.

In addition to the empirical data, the valuator might also perform an analysis of the factors which affect the marketability of an ownership interest in the entity. Such an analysis may entail an in-depth review of organizational documents which address the owner's ability to sell the ownership interest, any restrictions or requirements that limit the number of buyers, an understanding of the current marketplace, and the historical distributions paid to the owner of the interest.

C. Multiplicative vs. Additive

The application of the discount for lack of control and the discount for lack of marketability is always multiplicative, as opposed to additive.

XIII. BUY-SELL AGREEMENTS

Buy-sell agreements are becoming more prevalent among partners and shareholders in closely held entities. The impact of buy-sell agreements on the values of entities within the context of divorce is a topic that has been addressed in the courts and by various commentators.[215]

A. Overview

The purpose of a buy-sell agreement is to control the transfer of ownership within a closely held entity. The buy-sell agreement usually contains a formula or

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[215] See Buy / Sell Agreements, Kyle W. Sanders and Robert S. Slater, Advanced Family Law Drafting, December 2010, and Valuation of Business Interests, Current Theories, Practices and Case Law, Jack W. Marr, New Frontiers in Marital Property Law, October 2011 for two insightful articles on the subject of buy-sell agreements.

some other mechanism to determine the price at which an ownership interest will be exchanged. To the extent that the divorcing party was to sell his or her interest to a third party or back to the entity, then the buy-sell agreement would be triggered and the price at which the ownership interest is sold would be pre-determined based on the agreement. In a divorce, however, there is no actual transfer of ownership; rather, the "owning party" will generally continue to hold his or her ownership going forward. The challenge is in determining what kind of impact the buy-sell agreement has on the value of an ownership interest in a closely held entity that is not being sold or exchanged and for which the buy-sell agreement has not been triggered.

The impact of buy-sell agreements remains unsettled among the Courts of Appeals in Texas. Certain decisions seem to suggest that, unless a triggering event has occurred, the terms of a buy-sell agreement are but one of many factors to be considered by the Court in determining the fair market value of an ownership interest in a closely held entity. Other decisions, however, seem to indicate that the value specified in a buy-sell agreement is the only value for which an owner-spouse could exchange his or her interest, and such value is therefore the appropriate value for purposes of divorce. The key factors that seem to determine whether or not the terms of a buy-sell agreement are the appropriate measure of value are (1) the corporate form of the entity and (2) whether or not the buy-sell agreement specifically cites divorce as a triggering event.

B. Two Schools of Thought

1. <u>Buy-Sell Agreements are Merely One of Many Factors to be Considered in Determining the Value of a Closely Held Entity</u>

a. *Keith v. Keith*, 763 S.W.2d 950 (Tex. App.—Fort Worth 1989, no writ).

Keith involves a partnership interest in a chemical company. Husband entered into a partnership agreement during marriage which contained buy-sell provisions, and wife consented to the agreement in writing. The trial court determined the value of husband's partnership interest to be $262,400, which was inconsistent with the formula specified in the buy-sell provisions of the partnership agreement. Husband appealed the trial court's ruling.

The Court of Appeals agreed that the buy-sell provisions in the partnership agreement provided a valuation methodology in the event the partnership was terminated due to withdrawal, death, or other act of one of the partners. However, the Court Appeals also determined that because the partnership was not being terminated, the valuation methodology was not applicable. The Court in *Keith* held that the formula set forth in the buy-sell provisions in the partnership agreement is not necessarily determinative of the value of a spouse's interest in the partnership on divorce, and actually gave no weight to the buy-sell provisions because the triggering events had not occurred.

b. *Von Hohn v. Von Hohn*, 260 S.W.3d 631 (Tex. App.—Tyler 2008, no pet.).

Von Hohn involves husband's partnership interest in a law firm. The partnership agreement allotted each partner units of participation, assigned each partner an undivided profits account and capital account, and included a formula for calculating the value of a partner's interest in the partnership at death, retirement, withdrawal or expulsion from the firm. The partnership agreement contained no method for valuing the partnership interest in the event of divorce.

The trial court found that other methods of valuing husband's interest than those set forth in the partnership agreement could be considered in the event of a divorce proceeding. After a jury trial, the jury found that the value of husband's interest in the law firm was $4.5 million, subject to taxes.

Husband appealed and argued that the value of his interest in the law firm was determined by the partnership agreement, and that the community estate was not entitled to a greater interest than that to which he was entitled in the firm's commercial goodwill.

The Court of Appeals determined that while the formula in the partnership agreement may represent the value of husband's interest, it should not preclude the consideration of other factors. The Court found that the partnership agreement did not control the value of each individual partner's interests on divorce, and that the asset being divided was the partner's interest in the partnership as a going concern, not his contractual death benefits or withdrawal rights. Consequently, the value of the partner's interest should be based on the partnership as a going concern, which would include consideration of partnership goodwill.

Similar to *Keith*, the *Von Hohn* Court also concluded that since the partnership was not being terminated, the provision in the partnership agreement that determined the value of the business on death or withdrawal was not applicable. As husband was neither withdrawing nor had he died, none of the triggering events in the partnership agreement had occurred. Until such triggering events were to occur, the Court saw no legal reason to be limited to the formula in the partnership agreement when determining the value of the interest on divorce.

The findings in *Keith* and *Von Hohn* seem to suggest that, absent the occurrence of a triggering event, the buy-sell provisions should only be one factor considered in determining the fair market value of an interest in a going concern.

2. <u>Buy-Sell Agreements Control the Value of Ownership in a Closely Held Entity</u>

a. *Finn v. Finn*, 658 S.W.2d 735 (Tex. App.—Dallas 1983, writ ref'd n.r.e.).

Finn involves a partnership interest in a law firm. The parties in *Finn* were married twenty one years. During the entire marriage, husband worked for a Dallas law firm in which he was a partner. Wife argued that husband's partnership interest had goodwill apart from husband's personal goodwill that should be included in the valuation of husband's partnership interest. Husband argued that the goodwill was not a vested property right and noted that that the partnership agreement contained no provision for compensating a partner for the goodwill of the firm in the event of death or withdrawal. Husband further argued that, because there was no provision for such goodwill, the goodwill was merely an expectancy contingent on his continued participation in the firm.

The Dallas Court of Appeals determined that husband's law firm in *Finn* had goodwill independent of husband's professional ability, and it therefore needed to determine whether the goodwill had a commercial value in which the community estate was entitled to share.

The Dallas Court of Appeals decided that the goodwill was <u>not</u> a right to which the community estate was entitled to share. Husband's partnership interest was governed by a partnership agreement. The partnership agreement did not provide any compensation for accrued goodwill to a partner who ceased to practice law with the firm, nor did it provide a mechanism by which a partner could realize the value of the firm's goodwill. Citing the lack of any right of husband to realize the value of the firm's goodwill, the Dallas Court of Appeals held that in valuing a spouse's interest in a partnership it was not proper to consider the business' accrued goodwill or future earning capacity when placing a value of the community interest, as the buy-sell provisions in the partnership agreement did not provide any compensation for goodwill.

Although the Dallas Court of Appeals did not apply a buy-sell formula, the Court did give considerable weight to the restrictions attributable to the buy-sell agreement. It was determined that commercial goodwill existed, but was irrelevant because "the community estate is not entitled to a greater interest than that to which the husband is entitled in the firm's goodwill."

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

Mandell involves stock in a professional association with which husband entered an employment agreement and a stock purchase agreement during marriage. Husband and wife also signed a shareholders agreement which specifically addressed stock transfers in the event of divorce. Per the shareholders agreement, if a divorcing shareholder does not succeed to the former spouse's community interest in the shares, the former shareholder shall purchase all of the stock back from the former spouse within 180 days at $0.50 per share.

Wife's business appraiser valued husband's 22,000 shares at $794,300 under GAAP and $1,100,000 as a going concern. However, based on the above language in the shareholders' agreement, the trial court made a determination that husband's 22,000 shares were worth $11,000 and omitted all of wife's evidence as to the value of the shares.

Wife offered the testimony of a certified public accountant and chief financial officer of the association who testified that he did not know what the contractual $11,000 purchase price was based on, and that the book value of the association was $5 million in 2006. Husband owned 25 percent of the shares. Wife relied on the holdings in *Keith* and *Von Hohn* in support of her position that the formula in the shareholders' agreement should not be dispositive of the value of the shares.

The Court of Appeals held that the findings in *Keith* and *Von Hohn* were not applicable to the facts and circumstances specific to *Mandell* for two reasons: (1) the property being valued for purposes of divorce in those matters was not stock in a closely held corporation; rather, it was a spouse's interest in a partnership, and (2) the partnership agreements in *Keith*, and *Von Hohn* did not address the value of the ownership interest in the event of divorce, unlike the shareholders' agreement in *Mandell* which did specifically address divorce.

In summary, the findings of *Finn* and *Mandell* seem to indicate that buy-sell agreements control the value of the ownership interest in the closely held entity because the community estate should not be entitled to receive value for commercial goodwill of an ongoing entity which exceeds the value that the owner spouse could receive pursuant to the buy-sell agreement.

XIV. REIMBURSEMENT CLAIMS

Reimbursement is a concept that is deeply rooted in Texas case law and is also addressed in the Texas Family Code (see §§ 3.402, 3.406, 3.409, and 7.007). While the facts and circumstances giving rise to reimbursement claims are varied, the following discussion focuses on those claims that are commonly encountered in connection with entity ownership.

A. The Jensen Claim: Inadequate Compensation for Time, Toil, Talent and Effort

1. <u>Overview</u>

Jensen v. Jensen, 665 S.W.2d 107 (Tex. 1984) involved a husband who owned a separate property corporation which had increased in value during marriage. On divorce, wife claimed that the increase in the value corporation was due solely to the community time, toil, and talent that he expended on his corporation. Wife also asserted that the community estate had not been adequately compensated for Husband's efforts and was therefore entitled to a claim for reimbursement.

The Court determined in *Jensen* that inadequate compensation to the community estate for a spouse's time, toil, talent and effort to enhance the spouse's separate property resulted in a claim for reimbursement to the extent the contributing spouse's time, toil, talent and effort exceeded what was reasonably necessary to preserve and maintain his or her separate property.

Texas Family Code §3.402(a)(2) also addresses reimbursement claims for the inadequate compensation of time, toil, talent and effort:

> *A claim for reimbursement includes inadequate compensation for the time, toil, talent and effort of a spouse by a business entity under the control and direction of that spouse;*

Note that there are certain fundamental differences which exist between the Court's ruling in *Jensen* and Texas Family Code §3.402(a)(2):

- The *Jensen* decision seems to imply that the spouse's separate property business interest needs to have benefitted or been enhanced in order for a reimbursement claim to be made, while the statute does not address any benefit or enhancement;

- The *Jensen* decision suggests that a spouse is afforded the opportunity to contribute their time, toil and talent up to an extent necessary to maintain his or her separate asset, and that only time, toil and talent beyond that which is necessary to maintain the asset is subject to a reimbursement claim, while the statute does not appear to allow for a spouse to contribute their time, toil and talent to maintain their separate property asset;

- The statute seems to suggest that the business entity must be under the direction and control of the spouse in order for a reimbursement claim to be made, while the *Jensen* decision seems to have no such requirement.

2. <u>Elements of the Claim</u>

There appear to be four elements that need to be established in making a reimbursement claim as provided for in the *Jensen* decision:

a) The value of the separate property was enhanced by the time, toil, talent and effort of the owner spouse

The spouse asserting the claim must prove that the other spouse's separate estate was actually enhanced by the time, toil, talent and effort expended.[216] It might be necessary to retain a valuation expert to assist in demonstrating that the value of the separate property

[216] *Garza v. Garza*, 217 S.W.3d 538, 547 (Tex. App.—San Antonio 2006, no pet.).

entity has increased. It is important to note that a reimbursement claim under common law *Jensen* only exists to the extent that the value of the entity has increased as a result of the time, toil, talent and effort of the spouse. An increase in the value of a separate property business "resulting from fortuitous circumstances and unrelated to an expenditure of community effort will not entitle the community estate to reimbursement."[217] If the separate estate is proven to be enhanced by market forces, or sheer luck, during the marriage, there is no claim for reimbursement under common law.

b) The value of the time, toil, talent and effort expended

The spouse asserting the reimbursement claim must also establish the value of the time, toil, talent and effort expended to enhance the separate property entity. In *Garza*, the Court held that although wife was entitled to seek reimbursement under the inadequate compensation theory established in *Jensen*, her claim was denied because she put on no evidence of the value of the contribution. It may be necessary to employ the assistance of a vocational expert who is qualified to demonstrate what the compensation would have been for a person of similar skill, experience and education to put forth the same time, toil, talent and effort.

c) The amount of time, toil, talent and effort expended by the owner spouse exceeds that which is necessary to manage and preserve their separate estate

As stated above, the Court in *Jensen* determined that reimbursement was appropriate only as to the value of undercompensated time, toil, talent and effort which exceeded that *which was reasonably necessary to preserve and maintain* the separate estate. Consequently, it seems that the party seeking reimbursement must establish the value of the time, toil, talent and effort necessary to preserve and maintain the entity, and then deduct that value from the total value of time, toil, talent and effort actually expended in making his or her reimbursement claim. Clearly, one can anticipate certain challenges in establishing the amount of time, toil, talent and effort necessary to maintain the separate property asset, as well as the value of such time, toil, talent and effort.

[217] *Harris v. Harris*, 765 S.W.2d 798, 805 (Tex. App.—Houston (14th Dist.) 1989, writ denied).

d) The amount of remuneration (if any) received for the efforts expended

Any benefit actually received in the form of salary, wages, bonus, dividends, and distributions should be considered and deducted in calculating the amount of the claim. To the extent that the community estate actually receives adequate compensation for the time and effort expended, then no reimbursement claim exists.

3. <u>Unsettled Issues</u>

Although the concept of *Jensen* claims has existed in Texas Family Law for decades, the codification of the reimbursement statutes in the Texas Family Code have introduced unsettled and seemingly contradictory issues.

As noted above, the *Jensen* decision seems to imply that the spouse's separate property business interest needs to have benefitted or been enhanced in order for a reimbursement claim to be made. However, Texas Family Code §3.402(a)(2) does not explicitly state that any benefit or enhancement needs to have occurred in order for the reimbursement claim to be valid. At this time, it seems to be an unsettled issue as to what extent the separate property business entity must be enhanced in value in order for a reimbursement claim to be made.

Similarly, and also as noted above, the *Jensen* decision seems to imply that reimbursement only exists to the extent that a spouse contributes his or her time, toil, talent and effort over and above that which is reasonably necessary to manage and preserve his or her separate estate. Again, Texas Family code §3.402(a)(2) does not seem to limit the claim to only the amount of time, toil, talent and effort beyond that which is necessary to preserve and maintain the separate property entity. Consequently, at this time it seems to be unsettled as to whether the entire amount of time, toil and talent is subject to reimbursement, or only the amount above and beyond that which is reasonably necessary to manage and preserve the separate estate.

Further, the statute specifies that the business entity must be under the direction and control of the spouse who contributed the undercompensated time, toil, talent and effort. However, consider the hypothetical example of a spouse with a non-controlling, minority ownership interest in an entity that was her separate property and from which she received inadequate compensation for her time, toil, talent and effort contributed to the entity. Would there be no reimbursement claim available based on the statute, since the entity was not actually under her direction or control?

Additionally, the value of a *Jensen* reimbursement claim still seems to be an unsettled issue. Texas Family Code §3.402(d) states that "Reimbursement for funds expended by a marital estate for improvements to another marital estate shall be measured by the *enhancement in value* to the benefitted marital estate." The statute seems to directly contradict the Court in *Jensen*, which determined that the spouse seeking reimbursement is not entitled to the enhanced value of the separate property, but only to the value of the uncompensated time and labor.[218] At this time, the appropriate measure of the claim appears to be unsettled. Does the appropriate measure of value for the claim depend on whether or not the value of uncompensated time and labor is greater than or less than the enhanced value of the entity?

B. Contributions of CP Funds to SP Entity

Another situation giving rise to a reimbursement claim exists when community funds are contributed to an entity that is characterized as one spouse's separate property. The practitioner or an accounting expert can review entity tax returns, general ledgers, financial statements, and account statements to quantify funds contributed by the community estate to the entity and calculate the amount of the reimbursement claim.

To the extent that any funds contributed to the entity were actually *loaned*, as opposed to merely contributed with no requirement for repayment, then the community estate might actually have a claim on the receivable owed from the entity back to the individual instead of a reimbursement claim. In such situations, a claim on the receivable might actually be a preferable claim for the community estate, as a reimbursement claim is subject to equitable principles and could be offset.

Further, in the event that any additional ownership was received in the entity in exchange for contributions of community funds, then the entity would likely be mixed character and the community estate might have an ownership interest in the entity equal to the additional interest acquired, instead of a reimbursement claim. Similar to the reasons cited above, an ownership interest might be a preferable claim over reimbursement.

C. Income Tax Liabilities on Undistributed Income from SP Entities

Certain entities, including partnerships, limited liability companies, and corporations that elect to be taxed as Subchapter S corporations, are referred to as "pass through" entities because the entities are not taxed on their income; rather, the income is reported by the individual partners, members and shareholders, and the individuals pay taxes on their portion of income allocated to them. The income is taxed to the partners, members and shareholders' in the year it is reported, regardless of whether or not is has been distributed.

In situations in which one marital estate pays the tax liability attributable to undistributed income from a partnership or corporation owned by another marital estate, the contributing estate has a reimbursement claim against the benefitted estate which owns the partnership interest or shares of stock. It may be necessary in such matters to retain an accounting expert to assist in quantifying the reimbursement claim. Additionally, such a reimbursement claim can be offset with any benefit received by the contributing estate attributable to the entity (i.e., dividends or distributions in amounts sufficient to pay the tax liability).

D. Common Law Reimbursement Claims

The *Jensen* claim discussed above is only one type of claim for reimbursement. In 2009, the Texas Family Code was amended and the economic contribution model for reimbursement was repealed.[219] The statute now contains nine specific types of reimbursement claims available, Texas Family Code section 3.402(a)(1)–(9).[220] The statute includes the following types of reimbursement claims:

> (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;

[218] See also *Rogers v. Rogers*, 754 S.W.2d 236, 239 (Tex. App.—Houston (1st Dist.) 1988, no writ.).

[219] *See* Joan F. Jenkins & Susan E. Oehl, Reimbursement, Marriage Dissolution Institute, State Bar of Texas CLE, ch. 24, 1 (2012).

[220] *See also id.*

(3) the reduction of the principal amount of a debt secured by a lien on property owned before marriage, to the extent the debt existed at the time of marriage;

(4) the reduction of the principal amount of a debt secured by a lien on property received by a spouse by gift, devise, or descent during a marriage, to the extent the debt existed at the time the property was received;

(5) the reduction of the principal amount of that part of a debt, including a home equity loan:

(A) incurred during a marriage;
(B) secured by a lien on property; and
(C) incurred for the acquisition of, or for capital improvements to, property;

(6) the reduction of the principal amount of that part of a debt:

(A) incurred during a marriage;
(B) secured by a lien on property owned by a spouse;
(C) for which the creditor agreed to look for repayment solely to the separate marital estate of the spouse on whose property the lien attached; and
(D) incurred for the acquisition of, or for capital improvements to, property;

(7) the refinancing of the principal amount described by Subdivisions (3)-(6), to the extent the refinancing reduces that principal amount in a manner described by the applicable subdivision;

(8) capital improvements to property other than by incurring debt; and

(9) the reduction by the community property estate of an unsecured debt incurred by the separate estate of one of the spouses.[221]

With the new amendments to the Family Code, family law practitioners across Texas began to question if a common law claim for reimbursement still existed. The short answer is yes. An in-depth legal analysis of why common law reimbursement claims still exist is beyond the scope of this paper but in his paper, Reimbursement: Statutory and Common Law Recoveries, Michael P. Geary does an excellent job of providing a thorough legal explanation. Texas Bar CLE, New Frontiers in Marital Property Law, 1–2 (2010). The Legislature did not attempt to and codify every type of reimbursement claim with the 2009 amendments. Reimbursement claims not prohibited by the statute exist through a common law claim.

[221] Tex. Fam. Code § 3.402(a).

1. Examples of Common Law Reimbursement Claims.

While the focus of this paper is on business entities, the authors wanted to provide the reader with additional information regarding frequently encountered common law reimbursement claims. Various reimbursement claims existed at common law, but were not expressly codified in the statute or expressly prohibited by statute.[222] Below are a few examples of the reimbursement claims that still exist:[223]

a. Noncapital Improvements to Real Property.

Hailey v. Hailey, 176 S.W.3d 374, 385 (Tex. App.—Houston [1st Dist.] 2004, no pet.): The Court allowed reimbursement claims to the community estate for expenditures on the husband's separate property which included capital improvements such as a new roof and other noncapital improvements such as supplies, utilities and repairs to the husband's house. *See id.* When the Legislature repealed the economic contribution statutes, the repeal also removed the prohibition for the recovery of expenditures made for "ordinary maintenance and repair." Thus, under common law, a party may assert a reimbursement claim for noncapital improvements to real property.

[222] For other examples of common law reimbursement claims not expressly codified in the 2009 changes to the reimbursement statute *see* Joan F. Jenkins & Susan E. Oehl, *Reimbursement*, Marriage Dissolution Institute, State Bar of Texas CLE, ch. 24, 13 (2012). Coincidentally, the Legislature did codify what claims are nonreimbursable in Tex. Fam. Code § 3.409.

[223] For a more comprehensive discussion on available common law reimbursement claims including the affirmative defense of offset, *see* Michael P. Geary, *Reimbursement: Statutory and Common Law Recoveries*, New Frontiers in Marital Property Law, Texas Bar CLE 13 (2010); *see also* Joan F. Jenkins & Susan E. Oehl, *Reimbursement*, Marriage Dissolution Institute, State Bar of Texas CLE, ch. 24, 13 (2012).

b. Life Insurance Premiums.

McCurdy v. McCurdy, 372 S.W.2d 381, 384 (Tex. Civ. App.—Waco 1963, writ ref'd): A claim for reimbursement may arise when the community estate pays the premiums for a separate property life insurance policy. In McCurdy, the deceased husband had purchased the policies prior to marriage and named his estate as the beneficiary.[224] Community funds were expended during the marriage to pay the premium on the policies.[225] Based on the inception of title doctrine, the proceeds of the policies went to the estate of the deceased husband.[226] Therefore, the community estate was entitled to reimbursement for the total amount of the payments made and allowed the wife to recoup one-half of the payments made toward the policies.[227]

c. Use of One Marital Estate's Funds to Defend Litigation Regarding Another Marital Estate.

Farish v. Farish, 982 S.W.2d 623 (Tex. App.—Houston [1st Dist.] 1998, no pet.): This case opens the possibility that a court will consider one spouse's use of community funds to defend litigation regarding a different marital estate when determining a just and right division of the community estate. In Farish, the Court considered a reimbursement claim the wife asserted against her husband for approximately $30,000.00. The husband expended community funds on the litigation of the husband's child support obligation created with the husband's previous divorce. Although the Court did not award a dollar-for-dollar credit, the Court did consider this expenditure in making the property division.

d. Payment of Unsecured Debts.

In *Salinas v. Salinas*, 13-10-00279-CV, 2011 WL 3846545 (Tex. App.—Corpus Christi Aug. 30, 2011, pet. denied), the court awarded the wife $51,506.55 as a reimbursement for payment of "unsecured liabilities of the community estate" as she had expended separate property funds on the community estate.

e. Payment of ad valorem taxes.

A spouse may assert a reimbursement claim for community funds expended on the payment of ad valorem taxes on the separate property of the other spouse.[228] However, this claim may be offset by benefits received by the community estate from the spouse's separate property. In *Salinas*, the trial court found that $2,483.26 in community funds were spent during the marriage to pay taxes on the husband's real property.[229] "The trial court did not abuse its discretion by failing to reimburse the community estate for such tax payments because it was free to find that the community received offsetting benefits from the rents, royalties, and tax benefits received from Ernest's separate property."[230]

2. Measurement of Reimbursement Claims.

When it is established that one estate is entitled to a common law reimbursement claim, how does the court measure the value of the reimbursement? The Family Code states that "reimbursement for funds expended by a marital estate for improvements for another marital estate shall be measured by the enhancement in value to the benefited marital estate."[231] Is the enhancement in value measurement used only when one of the marital estates brings a statutory claim for reimbursement? Or should common law claims for reimbursement use the enhancement in value measurement as well?

Prior to the codification and amendments to the Family Code, courts long debated what method of measurement should apply to reimbursement claims. During that period, three methods were applied across the state:

a. **Cost of the Improvement** – The measure of the claim for reimbursement was the original cost of the improvement.[232]

b. **Enhanced Value of the Improvement** – The measure was the enhanced value of the property at the time of the dissolution of the marriage due to the improvement for which the community paid.[233]

c. **The Lesser of Cost or Enhanced Value** – The Supreme Court favored the lesser of the

[224] *Id.* at 383-84.
[225] *Id.*
[226] *Id.*
[227] *See id.* at 382–84.

[228] *See Hunt v. Hunt*, 952 S.W.2d 564, 569 (Tex. App.—Eastland 1997, no writ)

[229] *Id.*
[230] *Id.*
[231] Tex. Fam. Code § 3.402(d).
[232] *See Rice v. Rice*, 21 Tex. 58 (1858).
[233] *Clift v. Clift*, 72 Tex. 144, 10 S.W. 338 (1888).

> cost of the improvement or the enhanced value.[234]

Texas courts used enhancement in value as the measurement for reimbursement of funds expended on real property for years.[235] This principle was established through a series of cases, chiefly *Anderson v. Gilliland*[236] and *Penick v. Penick*.[237] In *Anderson*, the Court stated that "[t]he right of an estate to reimbursement from another estate is an equitable right and should be determined by equitable principles."[238] In *Penick*, the Court held that an equitable claim for reimbursement is not merely a balancing of the ledgers between the marital estates.[239] "The amount of reimbursement is not determined by the cost of improvements made, but by the enhancement in value of the estate improved by virtue of the improvements made by the other estate."[240] A court calculates enhancement in value, not by looking at the actual cost it took to make the improvements, but by taking the difference between the fair market value of the property before improvements and the fair market value of the property after improvements made during the marriage.[241] "The discretion to be exercised in evaluating a claim for reimbursement is equally as broad as that discretion subsequently exercised by the trial court in making a 'just and right' division of the community property."[242] Thus, rather than give a "dollar for dollar" reimbursement claim for community funds expended on the separate estate, the Court considered the benefits received by the community estate.[243]

Where real property is not involved, is the enhancement in value method really the most appropriate measure for reimbursement? If so, how should courts calculate enhancement in value when the property involved is not real property but is instead an interest in an entity partially acquired by use of money from one marital estate to benefit another marital estate? Two examples where this question may arise involve stock options and cash calls.

3. Stock Options: Separate Property Stock Options Exercised During the Marriage.

The Texas Family Code artfully sets out the ownership aspect of stock options acquired before and during marriage, but which have not necessarily fully vested by the date of marriage. The Code creates a formula to determine what portion of the stock options are separate property and what portions are community. This formula takes into account when the options vest and whether that time period happens before marriage, during the marriage or after the date of divorce. Section 3.007(d)–(e) sets forth the formula as follows:

> (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

[234] *See Dakan v. Dakan*, 83 S.W.2d 620 (Tex. 1935).
[235] For more case law on reimbursement to one marital estate for improvements to another marital estate *see* Michael P. Geary, *Reimbursement: Statutory and Common Law Recoveries*, New Frontiers in Marital Property Law, Texas Bar CLE 13 (2010).
[236] 684 S.W.2d 673, 675 (Tex. 1985).
[237] 783 S.W.2d 194, 197 (Tex. 1988).
[238] *Anderson*, 684 S.W.2d at 675 (citing *Dakan*, 83 S.W.2d 620).
[239] *Penick*, 783 S.W.2d at 198 (citing *Dakan*, 83 S.W.2d at 627).
[240] *Anderson v. Gilliland*, 684 S.W.2d 674, 675 (Tex.1985) (quoting *Lindsay v. Clayman*, 254 S.W.2d 777, 781 (1952)). *See also Cook v. Cook*, 693 S.W.2d 785, 786 (Tex. App.—Fort Worth 1985, no writ).
[241] *Vickery v. Vickery*, 999 S.W.2d 342, 371 (Tex.1999); *Anderson*, 684 S.W.2d at 675.
[242] *Penick*, 783 S.W.2d at 198 (citing *Dakan*, 83 S.W.2d at 627).
[243] *Id.*

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 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 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.

(e) The computation described by Subsection (d) applies to each component of the benefit requiring varying periods of employment before the grant could be exercised or the restriction removed.[244]

What the statute does not address is the situation when a spouse enters the marriage with a fully vested stock option but exercises the option during the marriage using community cash. Consider the following scenario:

> Company XYZ grants Stewart stock options in July 1999. The options become fully vested over a 10-year period. Stewart marries Sara in November 2010, after the stock options have fully vested. Stewart decides to exercise his stock options in January 2011, using money from Stewart and Sara's joint checking account which solely contains the parties' income, *just before he retires* from Company XYZ in February 2011. Stewart and Sara decide to divorce in 2014. What are Sara's rights to the stock purchased pursuant to the stock options?

In this situation, Stewart's stock options were fully vested when he entered the marriage. With the doctrine of inception-of-title governing,[245] Stewart's stock options were clearly his separate property. However, Stewart used community funds to exercise the stock options. The community estate does not receive an ownership of the purchased stock, but Sara may make a reimbursement claim.[246] Because this particular situation is not covered by the nine specific types of reimbursement claims set forth in the Family Code, one must look to case law to determine how to measure the reimbursement claim. Unfortunately, there is little to no case law on this particular issue.

Given the lack of statutory authority or specific case law, how do we measure the reimbursement claim under our scenario? Is enhancement of value truly the most equitable measure? Further, although a claimant is not required to establish the value with mathematical certainty, whether there is evidence available to establish enhanced value in this situation will depend in large part on the type of entity involved and the valuation standards generally applicable to the type of entity.

Let's add some facts to our scenario:

> The stock options allowed Stewart to purchase 1000 shares of Company XYZ stock at $5.00 a share. Stewart purchased the stock for $5,000.00 using community funds. Company XYZ did extremely well and the stock increased in value to $25.00 a share.

Based on this set of facts, could Sara assert that the enhanced value of the stock is $20,000? Is it equitable to allow a reimbursement claim based on this measure? Generally, an increase in the value of

[244] Tex. Fam. Code § 3.007(d)–(e).

[245] Tex. Fam. Code § 3.404(a). *See also Zagorski v. Zagorski*, 116 S.W.3d 309, 316–17 (Tex. App.—Houston [14th Dist.] 2003, pet. denied).

[246] Had Stewart remained employed by Company XYZ and the stock value increased during his employment with Company XYZ, Sara could potentially assert a *Jensen* claim. *See Jacobs v. Jacobs*, 669 S.W.2d 759, 762 (Tex. App.—Houston [14th Dist.] 1984) *aff'd in part, rev. in part*, 687 S.W.2d 731 (Tex. 1985). Sara would have the burden of pleading and proving that Stewart's time, talent, and labor enhanced the value of the stock of Company XYZ and that such time, talent, and labor was beyond the attention necessary for proper maintenance of Company XYZ, and that the community did not receive adequate compensation for such time, talent, and labor.

separate-property stock remains separate property.[247] Would the community estate be entitled to reimbursement of $20,000 even though the community only expended $5,000? What amount of the enhancement in value would be referable to market conditions and is it equitable to allow the community to benefit from the enhancement in value generated by market conditions?

What about this scenario:

> The stock options allowed Stewart to purchase 1000 shares of Company XYZ stock at $5.00 a share. Stewart purchased the stock for $5,000.00 using community funds. Company XYZ did extremely poor and by the time the parties divorced, the stock prices fell to $2.00 a share.

Technically, there is no enhancement in value. How do you measure the reimbursement claim? Can the value of the reimbursement claim ever exceed the total value of the property acquired? What if the purchase of the stock took Stewart from a minority owner to a majority owner in Company XYZ? How does one measure this enhancement in value?

4. Cash Calls: Using Community Funds to Maintain a Separate Property Investment

Another murky and unsettled area that attorneys may encounter during a complex divorce involves one spouse contributing community funds to a cash call made by a separate property partnership or company. A cash call, similar to a capital call, occurs when the managing member or members of a company decide that that company needs additional cash to function, and an entity agreement requires the owner to provide the requested cash.[248] The managing member(s) issue a cash call to the non-operating partners for a certain amount of money.[249] In order for the non-operating partner to keep his or her share of the company control, he or she must contribute the amount requested by the company to the cash call.[250]

Suppose a spouse owns an interest in the company before marriage; that company interest is of course separate property because spouse acquired the interest in the property before marriage.[251] After marriage, when the spouse contributes community funds to a cash call from the company, to how much of a reimbursement is the community estate entitled for the payment of these funds? How should a court measure such reimbursement claims? The Family Code does not enumerate this type of claim as one of the nine specific types of reimbursement claims in the 2009 amendments to the statute. Therefore, the practitioner must look to the common law for a claim for reimbursement.[252]

Unfortunately, there is very little case law discussing reimbursing one marital estate for payment made from another marital estate for a cash call. One of the only cases with similar issues was decided in 1975, long before the enactment of the first reimbursement statute in 2001, the 2009 statutory amendments and the change from the economic contribution model to the enhancement in value model.[253] As discussed in *Horlock*, Husband owned 800 shares of Student Housing, Inc. prior to marriage.[254] After marriage, Student Housing, Inc. merged with two other corporations to form Collegiate

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[247] *Smith v. Smith*, 22 S.W.3d 140, 150 (Tex. App.—Houston [14th Dist.] 2000, no pet.) (citing *Horlock v. Horlock*, 533 S.W.2d 52, 60 (Tex. 1975) and *Ridgell v. Ridgell*, 960 S.W.2d 144, 150 (Tex. App.—Corpus Christi 1997, no writ).

[248] Elizabeth S. Miller, *Practical Issues in Drafting Texas Limited Liability Company Agreements*, Tax Law 101, State Bar of Texas CLE, ch. 5, 5 (2012).

[249] *See* Cash Calls, SAP¸ available at http://help.sap.com/erp2005_ehp_04/helpdata/en/4b/ad4a3617fd11d28a360000e829fbbd/frameset.htm.

[250] *Id.* This author only found a handful of Texas CLE articles that mention cash calls. For more information on the subject *see* Joan F. Jenkins, *Liabilities: Personal and Property*, Advanced Family Law, Texas Bar CLE, ch. 30, 19 (2013); Elizabeth S. Miller, *Practical Issues in Drafting Texas Limited Liability Company Agreements,* Tax Law 101, Texas Bar CLE, ch. 5, 5 (2012); Elizabeth S. Miller, *Hot Topics in Partnerships and LLCs: A Survey of Recent Texas Partnership and LLC Cases*, Advanced Estate Planning Strategies Course, Texas Bar CLE, ch. 5.2, 5 (2011).

[251] *See Rusk v. Rusk*, 5 S.W.3d 299, 303 (Tex. App.—Houston [14th Dist.] 1999, pet. denied) ("The characterization of property as either 'community' or 'separate' is determined by the inception of title to the property. . . . Inception of title occurs when a party has first right of claim to the property by virtue of which title is finally vested.").

[252] See Joan F. Jenkins & Susan E. Oehl, *Reimbursement*, Marriage Dissolution Institute, State Bar of Texas CLE, ch. 24, 13 (2012) (discussing how the Legislature did not codify every potential claim for reimbursement).

[253] *See Horlock v. Horlock*, 533 S.W.2d 52 (Tex. Civ. App.—Houston [14th Dist.] 1975, writ dism'd w.o.j.); *see also supra* Part VII.

[254] *Horlock*, 533 S.W.2d at 59.

Services Corporation.[255] As a result of the merger, Husband owned 14,152 shares of Collegiate Services Corporation.[256] Prior to the merger, but after the parties were married, Husband contributed approximately $60,000 of separate and community funds to maintain the investment he made prior to marriage.[257] After the merger, Husband contributed an additional $40,000 to maintain his investment, bringing the total amount spent on maintaining his investment to $100,000.[258]

The Houston Court of Appeals held that the 14,152 shares of stock in Collegiate Services Corporation were Husband's separate property because he owned the shares prior to marriage and it was already long established that mutations in the character of the property do not affect the separate nature of the property.[259] In 1854, the Texas Supreme Court stated that "to maintain the character of separate property, it is not necessary that the property of either husband or wife should be preserved in specie, or in kind. It may undergo mutations and changes, and still remain separate property; and so long as it can be clearly and indisputably traced and identified, its distinctive character will remain."[260] Because the court determined the stocks were Husband's separate property, the court held that the community estate was entitled to a reimbursement of $100,000 from Husband's separate marital estate.[261] Without even discussing whether the enhancement in value method should be applied, the court determined that dollar-for-dollar reimbursement was the appropriate avenue for reimbursing the community for the funds Husband spent on maintaining his investment. Similarly, the Houston Court of Appeals again held that the community estate was entitled to reimbursement from Husband's separate estate for professional fees paid relating to the acquisition of his separate stock in *Jacobs v. Jacobs*.[262]

Horlock and *Jacobs* differ from other cases regarding reimbursement in that the Houston Court of Appeals decided that the actual cost of contribution was the appropriate reimbursement method as opposed to the enhancement in value to the property. Perhaps this is because the actual cost of contribution is the easiest and most sensible way to reimburse the community estate for contributing to a cash call or other investment in a business entity given the difficulty in determining the enhancement of value number. It makes sense to use the enhancement in value approach to reimburse a community estate for money expended to improve separate real property because the enhancement in value to the real property can be somewhat easily calculated.

As an example, suppose Wife has an interest in Partnership X before she and Husband are married. During the marriage, Partnership X demands a cash call of $10,000.00 and informs Wife that she must either pay the $10,000.00 or forfeit her investment in the partnership. Wife pays Partnership X the $10,000.00 out of community funds so that she may maintain her investment. Under the dollar-for-dollar theory applied in *Horlock*, the community estate would be entitled to $10,000.00 for reimbursement because Wife used community funds to maintain her separate property investment. How would a court apply the enhancement of value method to this scenario? What if Wife's cash call contribution did not increase her partnership interest and only allowed her to maintain her investment? Would not the value of enhancement be zero because nothing changed?

As you can see, enhancement in value may not be the most appropriate or most equitable measure of reimbursement when the claims involve a spouse using community funds to benefit his or her separate estate. Because reimbursement is based upon equitable principles, perhaps one of the former methods of reimbursement articulated in *Rice v. Rice* or *Dakan v. Dakan* is more appropriate in this situation.

[255] *Id.*
[256] *Id.*
[257] *Id.*
[258] *Id.*
[259] *Id*. at 60.
[260] *Rose v. Houston*, 11 Tex. 324, 326 (1854). *See also Harris v. Harris*, 765 S.W.2d 798, 803 (Tex. App.—Houston [14th Dist.] 1989, writ denied) ("As in the case of stock splits and increases, analogous to this situation involving 'units' of partnership, mutations and increases in separate property remain separate property.").
[261] *Horlock*, 533 S.W.2d at 60.
[262] 669 S.W.2d 759, 763 (Tex. App.—Houston [14th Dist.] 1984) *aff'd in part, rev. in part*, 687 S.W.2d 731 (Tex. 1985).