

**MIXING LOVE & BUSINESS:
WHAT EVERY BUSINESS LAWYER
MUST KNOW ABOUT FAMILY LAW**

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EDUCATION/LICENSE

J.D. Southern Methodist University School of Law, 1993
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State Bar of Texas, since 1993
Texas Supreme Court, since 1993
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Board Certified in Family Law by Texas Board of Legal Specialization Since 2000
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PROFESSIONAL ACTIVITIES AND PUBLICATIONS

Council Member, State Bar of Texas Family Law Council – April, 2005 to present
Officer, Texas Academy of Family Law Specialists Treasurer (September 2005 to present)
Director, Texas Academy of Family Law Specialists, 2002 to present
Editor, Texas Academy of Family Law Specialists Newsletter Editor of the “Family Law Forum” (2002 - 2005)
Delegate, Family Law Council of Community Property States Symposium (2002 - 2005)
Member, State Bar of Texas, Texas Family Law Council Checklist Committee for “Checklist” Publication Volumes I and II (1997, 1998, 1999)
Member, State Bar of Texas, Texas Family Law Practice Manual Form Book Committee (1998, 2001, 2002)
Member, State Bar of Texas, Texas Family Law Practice Manual Form Book Committee contributing author (2002 to present)
Member, State Bar of Texas, Planning Committees: Advanced Family Law Course, New Frontier’s
Fellow, American Academy of Matrimonial Lawyers, 2006 to present
Officer, Director, Member, Texas Academy of Family Law Specialists, 2000 to present
Member, Collaborative Law Institute of Texas
Member, Denton County Bar Association
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Member, College of the State Bar of Texas
Member, Texas Family Law Foundation
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AWARDS/RECOGNITION

Texas Super Lawyer, Texas Monthly Magazine, 2003, 2004, and 2005
Top Fifty Female Attorneys in Texas, Texas Monthly Magazine, 2005

LAW RELATED SEMINAR PUBLICATIONS & PARTICIPATION

- 2006 Marriage Dissolution Course: “Drafting QDROs”
- 2006 TAFLS Trial Institute: “Litigating the Case: Children’s Issues”
- 2005 Advanced Family Law Course: “Avoiding the Equal Property Division: When Equitable Doesn’t Mean Equal”
- 2005 Family Law Council of Community Property States: “Economic Contribution and Reimbursement”
- 2004 Advanced Family Law Course: “Retirement: QDROs for Defined Benefit and Contribution Qualified Plans under ERISA”
- 2004 TAFLS Trial Institute: “Twenty-Five Essential Factors When Drafting or Reviewing QDROs”
- 2004 Family Law Council of Community Property States: “Business Valuation”
- 2003 Family Law Practice Seminar, University of Houston Law Center: “Retirement: QDROs for Qualified Plans under ERISA (including using QDROs for Child Support)”
- 2003 Advanced Family Law Course: “Retirement: QDROs for Qualified Plans under ERISA (including using QDROs for Child Support)”
- 2002 Advanced Family Law Course: “ERISA Retirement Plans: An Analysis of the New Texas Family Law Practice Manual QDRO Forms and QDRO Drafting Tips”
- 2001 Advanced Family Law Course: “Handling ERISA Retirement Plans: An Overview and Explanation of the Texas Family Law Practice Manual QDRO Forms and Drafting tips for Alternative Clauses”
- 2000 Advanced Family Law Course: “Retirement Plans: What to Do When No QDRO is Honored”
- 1999 Family Law Practice Seminar, University of Houston Law Center: “QDROs and Retirement Benefits”
- 1999 Advanced Family Law Course: Expert Witness Workshop

- 1998 Advanced Family Law Course: "Retirement Overview and a Walk Through the QDRO"
- 1998 Family Law Practice Seminar, University of Houston Law Center: "QDROs What You Don't Know Can Hurt You"
- 1997 Advanced Family Law Course: "Retirement, Pensions and that Ugly Word...QDROs"
- 1996 Distinctive Lifestyles of Northeast Tarrant County: "New Alimony Law in Texas Adds Protection", March/April 1996 edition
- 1995 Advanced Family Law Course: "QDROs and Checklists"

CIVIC ACTIVITIES AND AFFILIATIONS

Officer, Texas Paint Horse Club, Recording Secretary and Youth Director

Director, Texas World Youth Team for the American Paint Horse Association World Paint Horse Show for 2003 to present

Mayor Pro Tem for City of Westlake (May, 1997 - May, 1999)

Chairman, Planning & Zoning Committee for City of Westlake (1995-1997)

Member, Impact Fee Committee, City of Westlake (1996)

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Board Certified – Family Law, Texas Board of Legal Specialization, December of 2000
Re-Certified – Family Law, Texas Board of Legal Specialization, December of 2005

Professional Activities

Director/Officer, Tarrant County Family Law Bar Association, 1998 to 2003
Member, College of the State Bar of Texas, 1999 to Present
Member, Tarrant County Bar Association, 1996 to Present
Member, Tarrant County Young Lawyers Association, 1996 to 2002
Associate Member, Barrister & Officer, Eldon B. Mahon Inn of Court, 1997-98, 2001-2005, 2007-2008
Senior Counsel, American College of Barristers, 2001 to Present
Member/Chairperson, Fee Arbitration Committee, Tarrant County Bar Association, 2001 to 2005
President, Tarrant County Family Law Bar Association, 2002
Member, State Bar of Texas, Family Law Section Checklist Committee, 2002-2003
Member, State Bar of Texas, Family Law Section Amicus Committee, 2004-2006
Member, State Bar of Texas, Family Law Section Parenting Plan Committee 2005-2006
Chairperson, State Bar of Texas, Family Law Section Membership Committee 2005-2008
Director, Tarrant County Bar Association, 2003 to 2005
Officer, Tarrant County Bar Association, 2005 to Present
Incoming President Tarrant County Bar Association 2008
Director & Officer, Texas Academy of Family Law Specialists, 2003 to Present
Fellow, Texas Bar Foundation 2002 to Present
Council Member, Family Law Council, State Bar of Texas, 2004 to Present
Member, Texas Family Law Bar Foundation 2004 to Present
Fellow, Tarrant County Bar Foundation 2004 to Present
Fellow, American Academy of Matrimonial Lawyers, 2005 to Present

Awards/Recognition

Friend of the Inn for outstanding contributions to Eldon B. Mahon Inn of Court, 2002
President's Certification of Outstanding Achievement from Tarrant Co. Bar Assoc., 2003
Texas Super Lawyer, Texas Monthly Magazine 2003, 2004, 2005, 2006 & 2007.
Who's Who in Executives and Professionals 2003
Top Attorneys 2003 featured in *Fort Worth, Texas Magazine* 2003, 2004 & 2005
Top Fifty Female Attorneys in Texas, Texas Monthly Magazine 2004 & 2005
Top Fifty Female Super Lawyers, Texas Monthly Magazine 2006 & 2007
Top 100 Lawyers in Dallas Fort Worth, Texas Monthly Magazine 2006 & 2007
The Best Lawyers In America 2007-2008

Law Related Seminar Publications & Participation

- Author, *An Attorney Ad Litem Is Really A Lawyer*, Attorney Ad Litem Training Seminar 1997.
- Author, *Trial Preparation & Planning*, "Nuts & Bolts" Protective Order Seminar 1997.

- Author, *Challenging Characterization Issues: Characterizing Trusts, Employee Stock Options, Workman's Compensation Claims, And Intellectual Property*, Advanced Family Law Course 1997.
- Author, *Some Changes In The Texas Family Code*, Blackstone Seminar 1998.
- Author/Speaker, *Uncontested Divorce Outline*, Pro Bono Family Law Seminar 1998.
- Author, *Factors Affecting Property Division & Alimony*, Family Law Basics From the Bench, Tarrant County Bar Association Brown Bag Seminar 1998.
- Speaker, *Practice Tips On Procedures At The Courthouse and Communicating With Court Personnel*, Advanced Family Law Trial Skills Seminar 1998.
- Author, *The Potential Effect of The New Texas Family Law Legislation Regarding Proportional Ownership, Equitable Interests, Division Under Special Circumstances, & A Look At New Legislative Provisions For Transmutation Agreements*, Advanced Family Law Course 1999.
- Speaker, *Recent Cases in Child Support, Possession & Access*, 1999 Annual TADRO Conference 1999.
- Speaker, *Filing Pleadings, Obtaining Settings, and Interacting With Court Coordinators and Clerks*, Family Law Trial Skills Seminar, West Texas Legal Services PAI Program, 1999.
- Author, *Discovery In Property Cases Under The New Rules*, Advanced Family Law Course 1999.
- Author/Speaker, *Drafting Family Law Pleadings: It's Almost All In The Manual*, "Nuts & Bolts" Family Law & Advanced Trial Law Trial Skills 2000.
- Author, *Deciding When You Need A Jury & Conducting Voir Dire*, "Nuts & Bolts" Family Law & Advanced Trial Law Trial Skills 2000.
- Author/Speaker, *Proper Drafting and Filing of Pleadings*, 26th Annual Advanced Family Law Course, Boot Camp 2000.
- Author, *Discovery Gotta Haves: Essential Ideas for Discovery in Property and SAPCR's*, Marriage Dissolution Institute 2001.
- Author, *Discovery*, Advanced Family Law Trial Skills, West Texas Legal Services PAI Program 2001.
- Author/Trainer, "Proper Drafting and Filing of Pleadings", "Nuts & Bolts" Family Law Seminar, West Texas Legal Services PAI Program 2001.
- Trainer, "Why Lawyers Lie", "Nuts & Bolts" Family Law Seminar, West Texas Legal Services PAI Program 2001.
- Presenter, *Winning Trial Techniques in Property Cases*, Texas Academy of Family Law Specialists Annual Trial Institute 2002.
- Author/Trainer, "Proper Drafting and Filing of Pleadings", 2002 Family Law Seminar, West Texas Legal Services PAI Program.
- Trainer, "Why Lawyers Lie", 2002 Family Law Seminar, West Texas Legal Services PAI Program.
- Author/Speaker, *Discovery & Mediation*, 28th Annual Advanced Family Law Course, Family Law Boot Camp 2002.
- Panel Member, *Use and Abuse of Legal Assistants*, 28th Annual Advanced Family Law Course 2002.
- Speaker, *Use and Abuse of Legal Assistants*, Panhandle Family Law Bar Association November Luncheon, 2002.
- Author/Speaker, *Drafting Trial Documents With An Eye Toward Winning*, Advanced Family Law Drafting Course 2002.
- Author/Speaker, *Discovery: Tools, Techniques & Timebombs*, Texas Academy of Family Law Specialists Annual Trial Institute 2003.
- Author/Player, *Associate Judge Do's & Don't's*, Tarrant County Family Law Bar Association 2003.
- Author/Speaker, *Evaluating A Custody Case*, 26th Annual Marriage Dissolution Institute 2003.
- Co-Director, Family Law Boot Camp, 29th Annual Advanced Family Law Seminar 2003.
- Author, *Discovery in Hard Places*, 29th Annual Advanced Family Law Seminar 2003.
- Speaker, *Practicing Law For Fun & Profit*, 29th Annual Advanced Family Law Seminar 2003.
- Author/Speaker, *Internet Searches for Financial & Personal Information Useful in Family Law Litigation*, Texas Academy of Family Law Specialists Annual Trial Institute 2004.
- Moderator, *Effective Courtroom Advocacy*, Tarrant County Bench Bar Seminar 2004
- Author/Speaker, *Internet Investigation of Personal Information & Assets*, Marriage Dissolution Institute 2004.
- Director, Family Law Boot Camp, State Bar of Texas Annual Meeting 2004.
- Author/Speaker, *Drafting 101, Basic Drafting of Pleadings*, Family Law Boot Camp, State Bar of Texas Annual Meeting 2004.
- Author/Speaker, *Investigation of Personal Information & Assets*, Tarrant County Family Law Bar Association,

Summer Bar Seminar 2004.

- Author/Speaker, *Investigation of Personal Information & Assets*, State Bar College “Summer School” 2004.
- Author, *The Life of a Grievance & The New Disciplinary Rules, What You Don’t Know Can Hurt You*, 30th Annual Advanced Family Law Seminar 2004.
- Director, Family Law Boot Camp, 30th Annual Advanced Family Law Seminar 2004.
- Author/Speaker, *Drafting 101, Basic Drafting of Pleadings*, Family Law Boot Camp, 30th Annual Advanced Family Law Seminar 2004.
- Author/Speaker, *Investigation of Personal Information & Assets*, Legal Assistant’s University 2004
- Author, *Advanced CYA For The Family Law Attorney*, Family Law Ultimate Trial Notebook 2004
- Author/Speaker, *Divorce Planning*, Representing Small Business 2004
- Assistant Director, Texas Academy of Family Law Specialists Annual Trial Institute 2005
- Instructor, *Marital Property*, The People’s Law School, Fort Worth 2005
- Author/Speaker, *Marital Property 101*, State Bar of Texas Spring Training, Fort Worth 2005
- Author/Speaker, *Effective Use of Psychologists and Psychiatrists*, 28th Annual Marriage Dissolution Institute 2005.
- Panelist/Moderator, Evidence and Discovery Workshop, 30th Annual Advanced Family Law Seminar, Dallas 2005
- Author/Speaker, *Internet Investigation of Personal Information and Assets*, Tarrant County Bar Association September 2005 Luncheon.
- Director, Texas Academy of Family Law Specialists Trial Institute 2006, Reno, Nevada
- Author/Speaker, *Avoiding Divorce Disasters*, Representing Small Businesses, Dallas March 23-24, 2006
- Panelist/Author, 29th Annual Marriage Dissolution Institute Bootcamp – Practical Aspects of Enhancing Your Practice, *How To Lose A Paralegal In 10 Days, or Keep One for 10 Years*, April 19, 2006, Austin.
- Moderator, 29th Annual Marriage Dissolution Institute, *Electronic Evidence*, April 20-21, 2006, Austin.
- Speaker, *Being A Family Law Attorney*, Tarrant County Bench-Bar, April 27, 2006, The Woodlands.
- Speaker, *Ethics: Evidence, Discovery and Witnesses*, Tarrant County Bar Association Brown Bag Luncheon, June 23, 2006, Fort Worth.
- Author/Speaker, *21st Century Issues Dealing with Nontraditional Relationships*, 31st Annual Advanced Family Law Seminar, August 14-17, 2006, San Antonio.
- Speaker, UT CLE Parenting Plan Conference, *Effective Strategies For Reaching Parenting Plan Agreements*, October 13, 2006.
- Speaker, LexisNexis CLE, Learning to Make the Texas Family Code Work for You, *Navigating the Family Code*, October 20, 2006.
- Speaker, LexisNexis CLE, Learning to Make the Texas Family Code Work for You, *Helpful Appellate References*, October 20, 2006.
- Moderator, Texas Academy of Family Law Specialists Trial Institute 2007, Sante Fe, New Mexico, Electronic Evidence Panel.
- Moderator, 30th Annual Marriage Dissolution Institute, *Electronic Evidence*, May 10-11, 2007, El Paso.
- Co-Speaker, *Interesting Appellate Cases*, Tarrant County Family Law Bar Luncheon, May 22, 2007.
- Speaker/Author, UT CLE Family Law on the Front Lines, *Appellate Tips for Family Law Attorneys*, Galveston, Texas June 28-29, 2007.
- Speaker/Author, *Evidence, Keeping in In and Keeping it Out*, 32nd Annual Advanced Family Law Seminar, San Antonio.
- Speaker, *Appellate Considerations*, Texas Academy of Family Law Specialists Trial Institute 2008, Sante Fe, New Mexico.

Law Related Periodical/Magazine Publications

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

Law Related Books

- Author, *Texas Family Law: Direct & Cross Examination, Suggested Questions, Ideas & Outlines*, Heather King,

Bruce Beverly & Syd Beckman (Imprimatur Press 2000).

- Author, *Texas Family Law: Direct & Cross Examination, Suggested Questions, Ideas & Outlines, A Focus on Children*, Heather King, Bruce Beverly & Syd Beckman (Imprimatur Press 2002).
- Author, *Texas Family Law: Direct & Cross Examination, Suggested Questions, Ideas & Outlines, A Focus on Property*, Heather King, Bruce Beverly, Syd Beckman & Randal Wilhite (Imprimatur Press 2004).
- Annotator for *Lexis Texas Annotated Family Code 2007-2008*.

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MIXING LOVE & BUSINESS: WHAT EVERY BUSINESS LAWYER MUST KNOW ABOUT FAMILY LAW¹

I. INTRODUCTION

This article is designed to inform lawyers who represent small business owners about the issues lurking in the context of family law, and the basics of important areas of family law as such areas relate to small business entities, so that divorce disasters may be avoided. In forming a new business for clients, it is very important to inform the client about the basics of characterization and valuation of the small business, fiduciary duties related to the business, marital fraud, common law marriage, and choice of entity, to name a few. Some pitfalls that will be discussed are whether the mere formation of a business could possibly violate the fiduciary duty to a spouse, whether a client really knows whether they are married, whether a client is knowledgeable about what is their separate property and community property, whether that client's actions as related to the business entity may affect the potential outcome of property division in a divorce, and whether that potential be modified by a pre-marital or post-marital agreement. Another key area is when a spouse is employed by the business or owns part of the business, and how that plays out in a divorce context. These are just some examples of areas where the attorney representing the small business owner should be knowledgeable about the basic areas of family law. We hope this article gives you ideas and insights to protect yourself and your client when representing the small business owner.

II. IS YOUR CLIENT MARRIED AND WHY YOU NEED TO KNOW.

In Texas, an "informal" or "common law" marriage is statutorily defined and can be proven by recorded written declaration of the spouses, or an agreement by the spouses to be married, combined with certain behaviors, such as cohabitation and a representation to others that they are married.²

Why is this important to the business lawyer? The primary reason you need to know if you client is married is to determine whether the parties have marital property in the form of separate or community property, so that the attorney forming and/or representing the business is aware of what property is being used to capitalize the business. This is important

because a spouse cannot use the other spouse's separate property, even if they are managing the property, without the other spouses permission, as this would be a breach of the fiduciary duty in the marital relationship. A spouse can use the community property without the permission of the other spouse. However, the same fiduciary duty applies. The lawyer forming the business should inform the client that it is safest for the other spouse to have knowledge of the formation and capitalization of the business.

It is a breach of fiduciary duty to hide assets from the other spouse and/or to divert community funds to a third party without the other spouse's knowledge. The attorney forming the business could find himself as a witness in the case of a divorce between the parties on these issues. With this being said, you can see why it is vital to determine who your client is because if a divorce attorney for either party uses the theory of alter ego and/or piercing the corporate veil, the party who formed the business is held responsible.

It is also very important to pinpoint who your client is and whether you can safely represent him or her without conflict.

A. Written Declaration

The written declaration, assuming it's in proper statutory form and recorded with the county clerk, obviously speaks for itself.³

B. Agreement to Be Married

The agreement to be married encompasses an express or implied intention on the part of both parties to have a present, immediate and permanent marital relationship, and can be proven by circumstantial evidence.⁴

C. Cohabitation

Cohabitation is living together, privately or publicly (although public cohabitation is greater evidence of the existence of this prong of the statutory requirement, as opposed to he said, she said). Cohabitation is determined on a case by case basis, and there is no bright line test for how long two people would have to live together to actually be cohabitating within this definition.⁵ Guidance from case law has taught us that cohabitation may be proven by moving your clothes or personal effects into a common room or

¹ The authors give special acknowledgment to Bryan Rice, C.P.A. for his contributions early on to this article which has been revised numerous times over the years but still contains his valuable input.

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

³ TEX. FAM. CODE §§2.402 and 2.404.

⁴ *Russell v. Russell*, 865 S.W.2d 629, 933 (Tex 1993); *Flores v. Flores*, 847 S.W.2d 648, 650 (Tex.App. – Waco 1993, writ denied); *Faglie v. Williams*, 569 S.W.2d 557, 565 (Tex.App. – Austin 1978, writ ref'd n.r.e.).

⁵ *Omodele v. Adams*, No. 14-01-00999-CV (Tex.App.—Houston [14th], 2003, no pet, Memorandum Opinion).

apartment, giving that residence as your residence address, purchasing a home together, purchasing insurance together, or purchasing *anything* together as “husband and wife” (which also falls into the “holding out” category addressed below).⁶ Being a frequent overnight guest, or storing personal property at someone else’s home is, by itself, generally not enough.⁷ Although the actual act of sexual intercourse is not referred to in the strict legal definition of “cohabitation”, the inferences are obviously there.⁸

D. Holding Out

Representation of the “marriage” to others, or what divorce lawyers refer to as a “holding out” is the area where most litigation ensues over the existence of an informal marriage. Like cohabitation, holding out may be shown by conduct and/or circumstances. The behavior of holding out is intended to be a communication to others, not just intimate behavior in general.⁹ Although secrecy is inconsistent with holding out, spoken words are not necessary to fulfill the “holding out” requirement.¹⁰ Examples of holding out generated by case law include referring to or addressing each other as “husband” and/or “wife” (although doing this occasionally, by itself, has been found not to be enough), acknowledging children of the parties as legitimate, joining in conveyances as spouses, and signing your tax return as “married.”¹¹

E. Dissolving an Informal Marriage

Like ceremonial marriage, an informal marriage can only be dissolved by divorce, and once the marriage is found to exist, is treated in every context (including in consideration of the small business entity) exactly the same as the ceremonial marriage, with one exception.¹² The suit for dissolution of an informal marriage (a/k/a petition for divorce) must be filed

within two years of the date of the physical separation of the parties, or there is a rebuttable presumption that the parties did not enter into an agreement to be married (thus not satisfying all of the prongs of an informal marriage).¹³

F. Challenging the Informal Marriage

In order to avoid waiver problems, the informal marriage should be challenged immediately within the client’s initial pleadings in the divorce. It may additionally be challenged via request for declaratory judgment (that a marriage does not exist) or request for summary judgment. Obviously, if your client is the one challenging the marriage, the existence or lack thereof of said marriage should be adjudicated immediately in order to avoid interim orders related to the divorce (particularly temporary support and temporary use of property). Unfortunately, case law indicates that the loss of this initial challenge cannot be challenged on appeal until after the divorce itself is final.

G. How to Avoid an Unwanted Informal Marriage

From an ethics perspective, a client who is married (or thinks he or she might be married per above) should be fully advised of the ramifications of divorce on a spouse’s interest in his or her small business entity (as addressed elsewhere in this paper). The attorney representing the owner of a small business entity must therefore be well aware of his client’s marital status (or potential marital status as time passes), and should be weary of the ramifications of divorce.¹⁴ Simply ask sufficient questions to elicit information that will help you determine the potential existence of an informal marriage, or send your client to a divorce lawyer (or, if you represent both of them, to separate divorce lawyers) to evaluate the potential existence of the marriage.

III. DOES YOUR CLIENT HAVE A PRE OR POST MARRIAGE CONTRACT?

A pre or post marital contract is used to stop the creation of community property or to convert community property into separate property. It would take a contract called a transmutation agreement for a spouse to convert their separate property to community property. The existence of these contracts is vital to know since they affect the character of the property or funds being used to capitalize as being separate or community. In addition, often times spouses will create these agreements after marriage for estate

⁶ *Id.*

⁷ *Allen v. Allen*, 966 S.W.2d 658, 661 (Tex.App.—San Antonio 1998, pet. denied).

⁸ There as been one case where the couple was found not to have been common law married because they slept in separate beds. *De Shazo v. Christian*, 191 S.W.2d 495, 496-97 (Tex.App.—Amarillo 1945, writ ref’d n.r.e.).

⁹ *Mills v. Mest*, 94 S.W.3d 72, 75 (Tex. App. – Houston [14th Dist] 2002, pet. denied).

¹⁰ *Ex parte Threat*, 333 S.W.2d 361, 364-5 (Tex. 1960); *Lee v. Lee*, 981 S.W.2d 903, 906 (Tex.App. – Houston [1st Dist.] 1998, no pet.).

¹¹ *Estate of Claveria v. Claveria*, 615 S.W.2d 164, 166 (Tex. 1981); *Owens v. Owens*, 398 S.W.2d 425 (Tex.Civ.App.-Beaumont Dec 30, 1965)

¹² *Villegas v. Griffin Industries*, 975 S.W.3d 745, 750 (Tex.App. – Corpus Christi 1998, pet. denied).

¹³ TEX. FAM. CODE §2.401(b).

¹⁴ If the attorney represents both husband and wife in the business venture, a potential conflict problem may arise, as addressed below.

planning purposes not realizing that these agreements have a vital effect in the case of divorce as to whether the property is community or separate property.

A. Pre-Marital Agreements

The UNIFORM PREMARITAL AGREEMENT ACT¹⁵ contained within the TEXAS FAMILY CODE provides some of the items upon which parties to a premarital contract may agree. This is an excellent method, if done correctly, to avoid potential divorce disasters, including those involving small business entities. Matters that can be contracted include:

1. The rights and obligations of each of the parties in any of the property of either or both of them whenever and wherever acquired or located;
2. The right to buy, sell, use, transfer, exchange, abandon, lease, consume, expend, assign, create a security interest in, mortgage, encumber, dispose of, or otherwise manage a controlled property;
3. The disposition of property on separation, marital dissolution, death, or the occurrence or non-occurrence of any other event;
4. The modification or elimination of spousal support;
5. The making of a will, trust, or other arrangement to carry out the provisions of the agreement;
6. The ownership rights in and disposition of the death benefit from a life insurance policy;
7. The choice of law governing the construction of the agreement; and
8. Any other matter including their personal rights and obligations, not in violation of public policy or a statute imposing a criminal penalty.¹⁶

1. Pre-Marital Agreements for the Closely Held Business

Depending on the circumstances, a premarital agreement may have to address the issue of increases in value of a closely held business owned by one spouse prior to marriage. If the spouse is concerned that, in the event of divorce, the other spouse will obtain some interest in the business or be entitled to reimbursement or economic contribution, a provision should be included, depending upon the desires of the parties, that all increases in value of a party's separate property stock due to the time, toil and effort expended by that person in the running of his or her business shall remain the separate property of that party. The

issue of reimbursement may be waived or addressed by setting it in terms of a fixed percentage of the increase in stock. The agreement could also include a provision that the owner spouse will receive a certain minimum salary for such spouse's time, toil and efforts and that the salary will be community property and, therefore, benefit the community estate.¹⁷ Reimbursement and compensation for personal services (as they relate to the small business) may be addressed in the pre-marital agreement as well.

The drafting of these agreements has become a highly technical and specialized skill, and the agreements are enforceable only if prepared in the proper manner and under the proper circumstances, requiring the inclusion of certain provisions to ensure enforceability.¹⁸ Unless you are experienced in drafting these agreements and knowledgeable of all of the legal requirements, do not attempt to do this on your own, as you could be risking huge exposure down the road if the agreement is found unenforceable or otherwise legally deficient.

B. Post-Marital Agreements

Post-Marital Agreements are another way of avoiding potential divorce disasters relating to small business entities in the context of divorce. The TEXAS FAMILY CODE allows parties to enter into three types of marital agreements:¹⁹

1. Partition and Exchange Agreements

Spouses may partition or exchange between themselves all or part of their community property, then existing or to be acquired, as the spouses may desire. This includes interest in the small business. Property or a property interest transferred to a spouse

¹⁷ Cameron, Hoffman, Ytterberg, *Marital and Premarital Agreements*, 39 Baylor L. Rev. 1095 (Fall 1987).

¹⁸ TEX. FAM. CODE §4.006.

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

- (1) the party did not sign the agreement voluntarily; or
- (2) the agreement was unconscionable when it was signed and, before signing the agreement, that party:
 - (A) was not provided a fair and reasonable disclosure of the property or financial obligations of the other party;

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

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

¹⁹ TEX. FAM. CODE Chapter 4, Subchapter B.

¹⁵ TEX. FAM. CODE Chapter 4, Subchapter A.

¹⁶ TEX. FAM. CODE §4.003(a).

by a partition or exchange agreement becomes that spouse's separate property. The partition or exchange of property includes future earnings and income arising from the property as the separate property of the owning spouse unless the spouses agree in a record that the future earnings and income will be community property after the partition or exchange.²⁰ This is an excellent method of avoiding litigation over business entity characterization in the context of divorce.

2. Agreements Concerning Income from Sep-arate Property

Many spouses do not realize that income from separate property, including a separate property business, is community property.²¹ As a result, the spouse/business owner wrongly assumes that all income from that spouse's separate property business is safe from division upon divorce. An excellent way to avoid this potential divorce disaster is through an agreement concerning income from separate property wherein spouses may agree that the income or property arising from the separate property that is then owned by one of them, or that may thereafter be acquired, shall be the separate property of the owner.²² This agreement must be in writing and signed by both parties²³, and may be unenforceable if certain circumstances are proven.²⁴ Yet, all the more reason to make certain that the agreement is drafted within the statutory requirements by a well-qualified attorney.

²⁰ TEX. FAM. CODE §4.102.

²¹ *Lucy v. Lucy*, 162 S.W.3d 770, 776 (Tex.App.-El Paso Apr 12, 2005) citing *See* TEX.FAM.CODE ANN. § 3.002 (Vernon 1998); *In re Marriage of Louis*, 911 S.W.2d 495, 497 (Tex.App.-Texarkana 1995, no writ).

²² TEX. FAM. CODE §4.103.

²³ TEX. FAM. CODE §4.104.

²⁴ TEX. FAM. CODE §4.105(a)(1).

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

- (1) the party did not sign the agreement voluntarily; or
- (2) the agreement was unconscionable when it was signed and, before execution of the agreement, that party:
 - (A) was not provided a fair and reasonable disclosure of the property or financial obligations of the other party;
 - (B) did not voluntarily and expressly waive, in writing, any right to disclosure of the property or financial obligations of the other party beyond the disclosure provided; and
 - (C) did not have, or reasonably could not have had, adequate knowledge of the property or financial obligations of the other party

This type of agreement may also be incorporated into a pre-marital agreement (and should be included if your client is the owner of a small business entity incepted prior to the date of marriage).

3. Agreement to Convert to Community Property

Spouses may agree that all or part of the separate property owned by either or both spouses is converted to community property.²⁵ This type of agreement is also sometimes referred to as a “transmutation agreement.” Like other types of marital agreements, there are certain formalities specific to this type of agreement.²⁶ Consideration is not a requirement.²⁷ These formalities must be met, as merely transferring the property into the other spouses name will not support a conversion to community property²⁸, but might rather support the creation of a gift to that spouse that becomes that spouse's separate property.²⁹ The transmutation agreement must contain specific language required by statute³⁰, and has statutory requirements for enforceability.³¹

²⁵ TEX. FAM. CODE §4.202.

²⁶ TEX. FAM. CODE §4.203(a)(1)(A)-(C).

An agreement to convert separate property to community property:

- (1) must be in writing and:
 - (A) be signed by the spouses;
 - (B) identify the property being converted; and
 - (C) specify that the property is being converted to the spouses' community property.

²⁷ TEX. FAM. CODE §4.203(2).

²⁸ TEX. FAM. CODE §4.203(b).

²⁹ TEX. FAM. CODE §3.001(2); and see *In re Marriage of Thurmond*, 888 S.W.2d 269, 275 (Tex.App.--Amarillo 1994, writ denied). The taking of title in both names does not change the result of tracing, but creates a presumption of a gift of one half of the separate property.

³⁰ TEX. FAM. CODE §4.205(b). An agreement that contains the following statement, or substantially similar words, prominently displayed in bold-faced type, capital letters, or underlined, is rebuttably presumed to provide a fair and reasonable disclosure of the legal effect of converting property to community property:

"THIS INSTRUMENT CHANGES SEPARATE PROPERTY TO COMMUNITY PROPERTY. THIS MAY HAVE ADVERSE CONSEQUENCES DURING MARRIAGE AND ON TERMINATION OF THE MARRIAGE BY DEATH OR DIVORCE. FOR EXAMPLE:

"EXPOSURE TO CREDITORS. IF YOU SIGN THIS AGREEMENT, ALL OR PART OF THE SEPARATE PROPERTY BEING CONVERTED TO COMMUNITY

IV. CHARACTERIZATION

One of the penultimate issues in family law is characterization. It is of the most extreme import because only community property is subject to division upon divorce. Property that is proven separate by the proper evidentiary standard, on the other hand, is not subject to divestiture upon divorce but can be subject to mandatory liens created upon the division of the marital estate.³²

Application of characterization to business entities and related business matters can become quite

PROPERTY MAY BECOME SUBJECT TO THE LIABILITIES OF YOUR SPOUSE. IF YOU DO NOT SIGN THIS AGREEMENT, YOUR SEPARATE PROPERTY IS GENERALLY NOT SUBJECT TO THE LIABILITIES OF YOUR SPOUSE UNLESS YOU ARE PERSONALLY LIABLE UNDER ANOTHER RULE OF LAW.

"LOSS OF MANAGEMENT RIGHTS. IF YOU SIGN THIS AGREEMENT, ALL OR PART OF THE SEPARATE PROPERTY BEING CONVERTED TO COMMUNITY PROPERTY MAY BECOME SUBJECT TO EITHER THE JOINT MANAGEMENT, CONTROL, AND DISPOSITION OF YOU AND YOUR SPOUSE OR THE SOLE MANAGEMENT, CONTROL, AND DISPOSITION OF YOUR SPOUSE ALONE. IN THAT EVENT, YOU WILL LOSE YOUR MANAGEMENT RIGHTS OVER THE PROPERTY. IF YOU DO NOT SIGN THIS AGREEMENT, YOU WILL GENERALLY RETAIN THOSE RIGHTS."

"LOSS OF PROPERTY OWNERSHIP. IF YOU SIGN THIS AGREEMENT AND YOUR MARRIAGE IS SUBSEQUENTLY TERMINATED BY THE DEATH OF EITHER SPOUSE OR BY DIVORCE, ALL OR PART OF THE SEPARATE PROPERTY BEING CONVERTED TO COMMUNITY PROPERTY MAY BECOME THE SOLE PROPERTY OF YOUR SPOUSE OR YOUR SPOUSE'S HEIRS. IF YOU DO NOT SIGN THIS AGREEMENT, YOU GENERALLY CANNOT BE DEPRIVED OF OWNERSHIP OF YOUR SEPARATE PROPERTY ON TERMINATION OF YOUR MARRIAGE, WHETHER BY DEATH OR DIVORCE."

³¹ TEX. FAM. CODE §4.205(a).

An agreement to convert property to community property under this subchapter is not enforceable if the spouse against whom enforcement is sought proves that the spouse did not:

- (1) execute the agreement voluntarily; or
- (2) receive a fair and reasonable disclosure of the legal effect of converting the property to community property.

³² Note, the particular statute that provide for the aforementioned liens by one estate to the other is currently being considered for repeal and/or revision that would make such liens discretionary (as opposed to mandatory as stated in the current statute.

complicated. For example, a business that is formed during a marriage is community property but the property used to capitalize the business can create complications in the character of the property within the business and can create claims back and forth between the marital estates. Further, if there is the creation of a partnership then the partnership owns the property in the partnership, and only the spouse's partnership interest is subject to division. A business that is formed before marriage is separate property, however when community property is used for the business after the marriage, claims are created between the separate estate of the spouse who owned the business and the community estate.

Generally, the character of property is not altered by the sale, substitution, or exchange of the property; separate property that merely undergoes mutations or changes in the form remains separate property.³³ For example, when a spouse owns separate property stock in a dissolving corporation and receives distributions of liquidated assets, the distributions remain the stockholder's separate property.³⁴ Distributions received in exchange for the cancellation of stock upon the corporation's dissolution retain the character of the stock.³⁵

On the other hand, cash dividends from stock are treated like income, and when distributed during the marriage are community property.³⁶ A distribution by a corporation to its shareholders may constitute a dividend in law even though it is not formally designated a dividend by the board of directors.³⁷

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

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

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

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

³⁷ *LeGrand-Brock v. Brock*, 2005 WL 2578944, at *1 citing *Ramo, Inc. v. English*, 500 S.W.2d 461, 465 (Tex. 1973); see also *Morony v. Morony*, 286 S.W.167, 169-170 (Tex. Comm'n App. 1929, judgment adopted) (explaining that a corporation does not have to formally declare a

However, the corporation's earnings or surplus funds normally do not constitute a dividend while they are retained by the corporation.³⁸ Ultimately, The characterization of distributions based on uncontroverted evidence is a matter of law for the Court to decide.³⁹

A. Marital Estate

In general, the marital estate is defined as community property, Husband's separate estate, and Wife's separate estate.⁴⁰ However, the entire marital estate is initially presumptively characterized as community property until such time as the separate estate is proven by the required evidentiary standard.⁴¹

B. Burden is Clear and Convincing Evidence

The spouse asserting the existence of a separate estate (or a claim by a separate estate upon the community estate, some form of contribution made by the separate estate to the community and vice versa⁴²) carries the burden of persuasion by clear and convincing evidence.⁴³ Clear and convincing evidence is defined as that "measure or degree of proof that will produce in the mind of the trier of fact a firm belief or conviction as to the truth of the allegations sought to be established."⁴⁴ This burden of proof falls between the preponderance standard of civil proceedings and the reasonable doubt standard of criminal proceedings.

dividend when it sets apart funds for distribution to its shareholders because it has the legal effect of a declared dividend).

³⁸ *LeGrand-Brock v. Brock*, 2005 WL 2578944, at *1 citing *Thomas v. Thomas*, 738 S.W.2d 342, 244 (Tex. App. – Houston [1st Dist.] 1987 writ denied) (retained earnings are a corporate asset); *Bryan v. Sturgis Nat'l Bank*, 90 S.W. 704, 705 (Tex. Civ. App. 1905 writ ref'd) ("The accumulated earnings or surplus funds of a corporation constitute a part of its assets, and belong to the corporation, and not to the stockholders, until they have been declared and set apart as dividends).

³⁹ *Pace v. Pace*, 160 S.W.3d 706, 712 (Tex. App. – Dallas 2005, pet denied) (uncontroverted evidence showed house was purchased with wife's separate fund); *Harris*, 765 S.W.2d at 802-3 (undisputed evidence showed husband received partnership interest in prior divorce).

⁴⁰ TEX. FAM. CODE §3.001 – 3.003.

⁴¹ TEX. FAM. CODE §3.003.

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

⁴³ TEX. FAM. CODE §3.003(b).

⁴⁴ *Transp. Ins. Co. v. Moriel*, 879 S.W.2d 10, 31 (Tex.1994); *See Estate of Hanau v. Hanau*, 730 S.W.2d 663, 667 (Tex.1987) (citing *Tarver v. Tarver*, 394 S.W.2d 780, 783 (Tex.1965); TEX. FAM. CODE §101.007.

While the proof must weigh heavier than merely the greater weight of the credible evidence, there is no requirement that the evidence be unequivocal or undisputed.⁴⁵ Meeting this burden is accomplished through tracing admissible documentary evidence, of which there are many types and definitions beyond the scope of the subject matter of this presentation.

In essence, the characterization of the asset is shown by an admissible paper trail beginning at the time of the acquisition of the asset and continuing to the date of divorce, which tracing clearly shows that the property is separate property based upon the date of inception of title and/or the characterization of the funds used to purchase the asset.⁴⁶ When tracing separate property, it is not enough to show that separate funds could have been the source of a subsequent deposit of funds.⁴⁷ Moreover, as a general rule, mere testimony that property was purchased with separate funds, without any tracing of the funds, is insufficient to rebut the community presumption.⁴⁸ Any doubt as to the character of property should be resolved in favor of the community estate.⁴⁹ On the other hand, if the community wishes to make a claim upon a separate estate of a spouse, it must do so with a lesser burden of persuasion referred to as a preponderance of the evidence.⁵⁰

⁴⁵ *Boyd v. Boyd*, 131 S.W.3d 605 (Tex.App.-Fort Worth Mar 11, 2004) citing *In re G.M.*, 596 S.W.2d 846, 847 (Tex.1980); *State v. Addington*, 588 S.W.2d 569, 570 (Tex.1979); *In re D.T.*, 34 S.W.3d 625, 630 (Tex.App.-Fort Worth 2000, pet. denied) (op. on reh'g).

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

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

⁴⁸ *Boyd* at 612 citing *Zagorski v. Zagorski*, 116 S.W.3d 309, 316 (Tex.App.-Houston [14th Dist.] 2003, pet. denied) (op. on reh'g); *Bahr v. Kohr*, 980 S.W.2d 723, 728 (Tex.App.-San Antonio 1998, no pet.); *McElwee v. McElwee*, 911 S.W.2d 182, 188 (Tex.App.- Houston [1st Dist.] 1995, writ denied).

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

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

C. Inception of Title Doctrine

The inception of title doctrine holds that title to property is vested when a party first has right of claim to the property by virtue of when title is finally vested.⁵¹ The vesting of the right of claim often is proved by showing that consideration was provided in exchange for the right so acquired. Therefore, in relevant example, if the articles of incorporation for a newly-formed corporate entity or the partnership agreement for a partnership require the contribution of a sum certain of money or other consideration, the practitioner should advise the business owner to make the required contribution as specified in the agreement. Such contribution should be easily mapped back to a specific source of funds or assets in accordance with the intent of the founder of the business.

For example, assume a spouse owns a sole proprietorship prior to marriage that rents its equipment and incorporates it subsequent to marriage, continuing to operate from the same location and using the same business name. If the consideration provided to the corporation in exchange for the stock is \$1,000.00, the owner of the corporation will have to prove that the \$1,000.00 came from her separate property funds in order for the corporation to be considered her separate property, even though the name, location, asset assemblage, etc. remained intact from the proprietorship. If the business owner could prove that the tangible equipment, receivables, inventory, etc. of the proprietorship were contributed as consideration, she may have the ability to prove that the ownership interest in the corporation is separate (or at least have a claim against the corporation for the separate value provided).

D. Mutation

In the context of family law, the term “mutation” is generally defined as a change to the form of separate property, which change does not always alter the character of the property as separate.⁵² However, a mutation that goes so far as to make it difficult to distinguish the separate property character of the separate property may make it difficult, if not impossible, to overcome the community property presumption, thus cause the originally separate property to become community.

If the business entity is formed during the marriage and the contribution to capital is made from an account that is separate property, the ownership interest acquired may be a “mutation” of the separate

property funds. However, questions could arise as to why the community estate did not have the opportunity to make the investment. While there is not a statutory or equitable claim for “Diversion of Community Opportunity,” spouses generally have a fiduciary duty to the community estate.⁵³ It is possible for the community to assert a claim for fraud against a separate estate in such an instance.⁵⁴

For example, if Husband sells the stock of a corporation that was owned prior to marriage for a substantial amount of cash and simultaneously with the sale of the old corporation, he forms a new corporation that requires the contribution of \$1,000 of money or business done. Upon his divorce, Husband was unable to prove that funds from the sale of the separate property corporation were used to provide the consideration to acquire the stock of the newly formed corporation. This illustrates what occurs in many instances, where individuals involved in a divorce assert a separate property claim upon the ownership interest of a closely held business, but when evidence to support the claim is sought, evidence of the initial consideration does not exist and perhaps even the stock certificate(s) have not even been issued. These circumstances will cause significant amounts of additional work to prove up a separate property claim and make the job much more difficult. Therefore, as an attorney representing a small business owner, it is incumbent upon the practitioner to consider and discuss with the client the possibility of “divorce planning”, that is performing the transaction in such a way as to assure the separate property characterization of the business remains intact, thus avoiding another divorce disaster.

⁵³ *Loaiza v. Loaiza*, 130 S.W.3d 894 (Tex.App.-Fort Worth Mar 11, 2004), rehearing overruled (Apr 29, 2004) citing *Zieba v. Martin*, 928 S.W.2d 782, 789 (Tex.App.-Houston [14th Dist.] 1996, no writ) (op. on reh'g); *In re Marriage of Moore*, 890 S.W.2d 821, 827 (Tex.App.-Amarillo 1994, no writ). (A fiduciary duty exists between a husband and a wife regarding the community property controlled by each spouse).

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

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

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

V. CLAIMS OF AND AGAINST THE MARITAL ESTATES

Ownership interests in a closely held business are subject to various types of claims by the respective components of the marital estate that the practitioner should be aware of when structuring business formation transactions and advising the owner of such interests. In a statutory context, these claims are commonly referred to as claims of “economic contribution” and “statutory reimbursement” and appear simple as defined below, but become much more complicated when applied to business transactions and the complex dealings therein.

1. Economic Contribution and Reimbursement

There is a difference between economic contribution and reimbursement. Economic contribution concerns sharing between estates any enhanced value which the contributing estate helped create. Often the contributing estate will have a claim to and be entitled to more than just the dollar amount of funds contributed. Reimbursement is concerned only with the pay back (or reimbursement) of the exact dollars advanced.⁵⁵

a. Economic Contribution

Economic contribution concerns itself with sharing in the enhanced value of property because of the contribution the contributing estate made in behalf of the benefited estate. It requires a payment on 1) a secured debt of, or 2) a capital improvement to the benefited estate. A mathematical formula is used to determine the allocation of the enhanced value between the contributing and benefited estates.⁵⁶ One of the following circumstances must exist in order to have a claim for economic contribution⁵⁷:

- (1) One marital estate reduces the principal amount of a debt secured by a lien on the property of another estate, whether the benefited estate was owned before marriage or was acquired as separate property during the marriage by gift, devise or descent.
- (2) One estate reduces the principal amount of debt secured by a lien, incurred during marriage, including a home equity loan, and the funds used as a result of the secured debt were for capital improvements to the benefited estate.

- (3) One estate reduces the principal amount of debt secured by a lien on the property of the benefited estate in instances where the secured creditor agreed to look solely to the benefited separate estate of the spouse in whose property the lien attached and the debt was incurred for the acquisition or improvement to that secured property.
- (4) The refinancing of debt secured by a lien in any of the circumstances listed above, to the extent that the refinancing reduced the principal amount of the debt.
- (5) Capital improvements were made to property other than by incurring debt.⁵⁸

b. Reimbursement

Reimbursement applies if the funds advanced by the contributing estate were not for payment of secured debt or for capital improvements to the benefited estate.⁵⁹ A reimbursement claim includes:

- (1) Payment by one marital estate of the unsecured liabilities of another marital estate; and
- (2) Inadequate compensation for the time, toil, talent, and effort of a spouse by a business entity under the control and direction of that spouse.⁶⁰ The amount to be reimbursed is measured by the value of the time, toil and talent expended, less the value of any compensation that has been received by the community such as salary, bonuses or other benefits.⁶¹

2. Example of Application to Small Business

Many small businesses must rely on debt financing to obtain working capital and financing for capital expenditures. Typically, lenders will require some form of personal guaranty from the owner of the business to help secure the debt, since many small businesses are lacking in asset base. If the business owner executes such a personal guaranty, he or she is putting the community estate at risk to assist the business, if the guaranty is not limited to the separate estate of the guarantor. Therefore, the community may have a claim against the assets of a separate property business interest that were obtained with the guaranteed debt or against the ownership interest itself.

Alternatively, separate property collateral may be offered as security for the debt of the community

⁵⁵ 33 TXPRAC §10.25.

⁵⁶ *Id.*

⁵⁷ As already footnoted above, the economic contribution statute is currently being considered for revision and/or repeal.

⁵⁸ *Id.* citing TEX. FAM. CODE §3.402.

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ *Id.* citing TEX. FAM. CODE §3.408.

property business interest. The question becomes how to quantify such a claim, especially if the business entity services the debt and the guaranty never has to be relied upon by the lender. Is it limited to the amount of the debt that was guaranteed, or is it zero if the guaranty is essentially on a “stand-by” status? The facts and circumstances of the case are often the most important factor in making these determinations.

Another claim for reimbursement against a closely held business can arise as a result of the entity’s status for federal income tax purposes. Partnerships, Limited Liability Companies, and S Corporations generally do not pay an entity-level tax. Rather, the net taxable income flows through directly to the shareholder’s personal income tax return and tax is paid on the shareholder’s share of the taxable income by the shareholder. Assume that in a given year, a separate property S corporation “passes through” \$100,000 of taxable income to the personal income tax return of Husband and Wife and the parties pay income tax at an effective rate of 25%. Therefore tax of \$25,000 is paid on that income. Assume further that the S corporation has limited cash and cannot make a distribution to the shareholders to pay the tax on that income, so it is (in tax parlance) “phantom income.” If the community pays the tax, a claim for reimbursement may be generated in favor of the community estate against the separate estate of the S corporation owner. This same logic can work the other way as well. Assume the S Corporation generates losses that flow through and offset the tax liability on community income. Does that generate a claim on behalf of the separate estate? It should be understood that the current earnings of “pass through” entities typically are not marital property until actually distributed, and they would tend to be community at the time of distribution. If those distributions get reinvested in the entity for additional ownership interests, then the additional ownership interests would tend to be community.

3. Jensen Claim

Another type of reimbursement claim results when the owner of a separate property business is not adequately compensated for the time, toil, and effort he or she expends in the furtherance of the business. The compensation not received would have been community (i.e. compensation for personal services and/or distributions of profit from the business). This type of claim is referred to after its name’s sake as a Jensen claim and can be beneficial to a community estate that is part of a marital estate that is heavily loaded with separate value.⁶²

⁶² *Jensen v. Jensen*, 665 S.W.2d 107 (Tex. Feb 29, 1984).

A *Jensen* claim involves four prongs:

- 1) the value of the effort set forth by the business owner;
- 2) the increase in the value of the separate property as a result of the time and effort so expended;
- 3) the value of the business owner’s effort that would have been reasonably necessary to preserve and manage the separate property; and
- 4) the actual compensation received by the business owner.⁶³

If the owner of the separate property business interest turns his or her back on this compensation and instead reinvests it into the business (thereby enhancing the value of the business), the community may assert a reimbursement claim for the enhanced value of the separate property business interest. The claim will be limited to the second prong and will be measured by the value of the effort provided less the compensation received.

If the community was adequately compensated for the time spent to merely preserve the separate property and the increase in value was merely fortuitous, then a *Jensen* claim may be inapplicable. However, if the increase in value was due to the sustained effort of the business owner but the community was compensated only for a “caretaker’s” level of effort, then the community may be due a reimbursement for the amount of the enhanced value less the caretaker’s salary.

It should be noted that in order to successfully assert a *Jensen* claim, the spouse owning the separate property business interest must have direction and control over the business entity, i.e., he or she must be able to set his or her compensation, and control the timing and amount of other items of compensation, such as corporate dividends.

a. Example of *Jensen* Claim

This example involves an industrial services company that was clearly the separate property of the Husband. The owner’s salary remained constant at about \$50M per year for fifteen years, but the sales and profitability grew steadily until the company was grossing almost \$2MM annually. The lifestyle of Husband and Wife was modest. Additionally, the Husband owned the corporate facility and leased it to his corporation for an amount of rent that was under-market. The corporation (and the Husband) was aging at the time of divorce and was starting to reduce or scale back activities. Husband had no heir to pass the

⁶³ *Id.*

business along to and had no expansion plans. However, the corporation had accumulated almost \$1MM in cash, a portion of which represented the enhanced value due to the underpayment of salary and underpayment of rent, both of which would have been community in nature. A *Jensen* claim was computed and presented successfully at mediation for the amount of underpaid rent and salary, less the income taxes that would have been paid on that compensation. In that case, arguing for the *Jensen* claim was made easier by the existence of the cash hoard built up inside the corporation.

Failing to avoid this potential divorce disaster could be devastating to the party attempting to duck a claim of economic contribution or common or statutory reimbursement. Therefore, the practitioner should keep the possibility of this type of issue arising in a divorce in mind when advising the owner of a separate property business concerning the owner's compensation structure. Note that these issues may also be avoided via a properly prepared and enforceable pre-marital agreement.

VI. FIDUCIARY DUTY

A. Introduction

The concept of "fraud" takes on many forms in the divorce context and a spouse may commit fraud in many forms. A spouse must be very careful in selecting and forming the business entity so as to not "leave" the other spouse, and/or the community estate, out of the business. A spouse must also avoid forming a business venture with their separate money rather than community money, which can be seen as diverting an opportunity of the community. However, on the flip side the use of community property money for a risky venture can invite trouble in this area.

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

It is our advice that the business attorney be very careful in formulating the business and in advising the client whether separate and/or community funds should be used. It is a good idea to be clear in your contract regarding whether you are representing the husband, the wife or both. If you represent both spouses, you need to proceed with caution in advising about funding and expenditures as to separate and community property, and as to the fiduciary duty the spouses have to each other. You do not want to invite a claim against yourself by one of the spouses claiming that

you defrauded that spouse out of their separate estate or the community estate.

B. Fraud/Fiduciary Duty

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

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

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

Fraud in the divorce context, as in other civil litigation, may be actual or constructive. Actual fraud is predicated upon the intent to deceive. The elements are: (1) that a material representation was made; (2) that it was false; (3) that when the speaker made it, he knew it was false or made it recklessly without any knowledge of the truth and as a positive assertion; (4) that he made it with the intention that it should be acted upon by

the party; (5) that the party acted in reliance upon it; and (6) that he suffered thereby.⁶⁴ "[C]onstructive fraud is the breach of some legal or equitable duty which, irrespective of moral guilt, the law declares fraudulent because of its tendency to deceive others, to violate confidence, or to injure public interests."⁶⁵ In other words, intent is irrelevant. Because of the confidential relationship between a husband and wife, the marital partnership is fiduciary in nature.⁶⁶ A breach of this fiduciary duty is frequently termed a "fraud on the community."⁶⁷ Generally speaking, the allegation is one of constructive rather than actual fraud: Any such conduct in the marital relationship is termed fraud on the community because, although not actually fraudulent, it has all the consequences and legal effects of actual fraud in that such conduct tends to deceive the other spouse or violate confidences that exist as a result of the marriage.⁶⁸

"Constructive fraud includes actions of one spouse in unfairly disposing of or encumbering the other spouse's interest in community property or unfairly incurring community indebtedness without the other spouse's knowledge or consent.⁶⁹ In the absence of fraud, a spouse has the right to control and dispose of community property subject to his sole management.⁷⁰ Although the managing spouse need not obtain approval or consent for dispositions made of special community property, the fiduciary relationship between husband and wife requires that a spouse's disposition of special community property be "fair" to the other

spouse.⁷¹ The managing spouse carries the burden of establishing that the disposition of property was fair.⁷²

"FN4. During marriage, each spouse has the sole management, control, and disposition of the community property that the spouse would have owned if single, including personal earnings, revenue from separate property, recoveries for personal injury, and the increase and mutations of, and the revenue from, all property subject to the spouse's sole management, control, and disposition.⁷³ Community property subject to a spouse's sole management and control is sometimes referred to as "special community property," particularly in older case law. All other community property is subject to the joint management, control and disposition of the spouses unless the spouses provide otherwise by power of attorney in writing or other agreement.⁷⁴

"The Supreme Court has recently reiterated that Texas recognizes the concept of fraud on the community, which it has defined as a wrong committed by one spouse which may be considered by the trial court in its division of the community estate and which may justify a disproportionate division.⁷⁵ It is not, however, an independent tort giving rise to a cause of action between spouses.⁷⁶ Nor may it give rise to a recovery for punitive damages, inasmuch as "recovery of punitive damages requires a finding of an independent tort with accompanying actual damages."⁷⁷ Instead, the claim of fraud on the community is a means to an end, seeking either to recover specific assets wrongfully conveyed or to obtain a greater share of the community estate upon divorce as compensation for the

⁶⁴ *Stone v. Lawyers Title Insurance Corp.*, 554 S.W.2d 183, 185 (Tex.1977).

⁶⁵ *Archer v. Griffith*, 390 S.W.2d 735, 740 (Tex.1964).

⁶⁶ *Matthews v. Matthews*, 725 S.W.2d 275, 279 (Tex.App.--Houston [1st Dist.] 1986, writ ref'd n.r.e.).

⁶⁷ *In Re. Marriage of Moore*, 890 S.W.2d 821, 827 (Tex.App.--Amarillo 1994, no writ).

⁶⁸ *Id.* at 827.

⁶⁹ *Massey v. Massey*, 807 S.W.2d 391, 402 (Tex.App.--Houston [1st Dist.] 1991), writ denied, 867 S.W.2d 766 (Tex.1993).

⁷⁰ *Id.* at 401, citing *Mazique v. Mazique*, 742 S.W.2d 805, 807 (Tex.App.--Houston [1st Dist.] 1987, no writ).

⁷¹ *Massey*, 807 S.W.2d at 402, citing *Horlock v. Horlock*, 533 S.W.2d 52, 55 (Tex.Civ.App.--Houston [14th Dist.] 1975, writ dismissed).

⁷² *Id.*

⁷³ TEX. FAM. CODE § 3.102(a).

⁷⁴ TEX. FAM. CODE § 3.102(c).

⁷⁵ *Schlueter v. Schlueter*, 975 S.W.2d 584, 588 (Tex.1998).

⁷⁶ *Id.* at 586.

⁷⁷ *Schlueter*, 975 S.W.2d at 589, quoting *Twin City Fire Ins. Co. v. Davis*, 904 S.W.2d 663, 665 (Tex.1995)

loss of community property.⁷⁸ Where the economic tort depletes the community estate so as to leave insufficient property available to the wronged spouse, the courts may impose a money judgment in order to achieve an equitable division.⁷⁹ The money judgment serves to recoup the value of the wronged spouse's share of the estate which has been lost through the fraud.⁸⁰ "Because the amount of the judgment is directly referable to a specific value of lost community property, it will never exceed the total value of the community estate."⁸¹ On the heels of *Schlueter*, the Court was presented with some rather egregious facts in *Vickery v. Vickery*, 999 S.W.2d 342 (Tex.1999)(J. Hecht, dissenting). The underlying court of appeals' opinion was unpublished. The Supreme Court denied the petition for review, with Justice Hecht dissenting from the denial in a published opinion which incorporates as an appendix both the intermediate court's opinion on the merits and Justice Andell's dissent from that court's denial of rehearing en banc. At issue was Mrs. Vickery's recovery in a bill of review proceeding. The jury found Mr. Vickery, himself an attorney, liable for fraud and breach of fiduciary duty and assessed Mrs. Vickery's damages at \$6.7 million for loss of marital property and \$1.3 million for mental anguish, together with \$1 million in punitive damages. The jury also found that Mrs. Vickery's attorney breached her fiduciary duty, resulting in damages of \$100,000 in lost marital property and \$350,000 in mental anguish damages.

As Justice Hecht notes in his dissent, "[a]pplying *Schlueter* would require that the actual and punitive damages awarded Mrs. Vickery against her former husband be reversed and the case remanded to the district court to reconsider what division of the community is just and right. The district court may consider Mr. Vickery's 'dishonesty

of purpose or intent to deceive' and 'the heightened culpability of actual fraud' as found by the jury." The fact that the Supreme Court, by denying review, allowed the actual and punitive damages to stand gives me some concern as to what the current state of the law is for economic torts committed against the community estate."⁸²

In determining the division of community property, the court may consider proof of one spouse's dishonesty or intent to deceive, constituting actual fraud, regarding the community assets, *Schleuter v. Schleuter*, 975 S.W.2d 584 (Tex. 1998), and may also consider evidence of one spouse's constructive fraud in transactions involving community property, taking into account *Massey v. Massey*, 807 S.W.2d 391 (Tex. App.—Houston [1st Dist.] 1991, writ denied):

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

Unfairly disposing of the other spouse's community property results in a presumption of constructive fraud.⁸³ However, the mere fact that a community property business venture lost money because of the acts of one spouse, even if it ended in bankruptcy, does not constitute fraud.⁸⁴ Additionally, the trial court may take into account a spouse's dissipation of the estate.⁸⁵

⁸² Id. at 14.

⁸³ *Connell v. Connell*, 889 S.W.2d 534 (Tex. App. – San Antonio 1994, writ denied).

⁸⁴ *Id.*; see also *Andrews v. Andrews*, 677 S.W.2d 171 (Tex. App. – Austin 1984, no writ) (a spouse's good faith, but unwise, investment of community funds resulting in losses to the community estate does not justify an unequal distribution of the remaining community property upon divorce).

⁸⁵ See *Massey v. Massey*, 807 S.W.2d 391 (Tex. App.—Houston [1st Dist.] 1991, writ denied) (based on jury verdict that husband committed constructive fraud, trial court was entitled to award wife equalization for property depleted unfairly from community estate); *Reaney v. Reaney*, 505 S.W.2d 338, 340 (Tex.Civ.App.—Dallas 1974, no writ) (court took into account the husband's dissipation of approximately \$53,000 of community assets when dividing the estate); *Pride v. Pride*, 318 S.W.2d 715, 718 (Tex.Civ.App.—Dallas 1958, no writ) (trial court rendered a

⁷⁸ *Schlueter*, 975 S.W.2d at 588, quoting *Belz v. Belz*, 667 S.W.2d 240, 247 (Tex.App.—Dallas 1984, writ ref'd n.r.e.).

⁷⁹ *Schlueter*, 975 S.W.2d at 588, citing *Murff v. Murff*, 615 S.W.2d 696, 699 (Tex.1981).

⁸⁰ *Schlueter*, 975 S.W.2d at 588, citing *Mazique v. Mazique*, 742 S.W.2d 805, 808 (Tex.App.—Houston [1st Dist.] 1987, no writ).

⁸¹ *Schlueter*, 975 S.W.2d at 588.

VII. VALUATION

The valuation of the closely held business entity upon divorce is often the most important issue in a divorce, and the practitioner should understand basic business appraisal issues in the context of divorce. Valuation issues are also important when considering milestones in the business entity's life, such as admission of new owners, redemption of current owners, acquisition of new business entities or sale to another entity.

Why is this important to the business attorney? Every time you state the value of the business for whatever purpose, you are creating a precedent of value for the divorce court to use later on.

Many small businesses must rely on debt financing to obtain working capital and financing for capital expenditures. Typically, lenders will require some form of personal guaranty from the owner of the business to help secure the debt if the assets in the business are lacking. If a spouse executes such a personal guaranty, that spouse is subjecting the community estate to risk for the benefit of the business therefore if the lender did not agree to look solely to the separate estate of the borrowing spouse then the lender can look to the assets of the community estate to satisfy the debt. Therefore, the community may have a claim against the assets of a separate property business interest that were obtained with the guaranteed debt of a spouse wherein the spouse did not agree that the lender would look solely to the separate property of the borrowing spouse. Alternatively, separate property collateral may be used to secure a debt of the community property business interest. The question becomes how to quantify such a claim, especially if the community property business entity services the debt and the guaranty never has to be relied upon by the lender.

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

money judgment against the husband for the wife's share of \$3,000 he concealed).

pays the tax, a claim for reimbursement may be generated in favor of the community estate against the separate estate of the S corporation owner. This same logic can work the other way as well. Assume the S Corporation generates losses that flow through and offset the tax liability on community income. Does that generate a claim on behalf of the separate estate? It should be understood that the current earnings of "pass through" entities typically are not marital property until actually distributed, and they would tend to be community at the time of distribution. If those distributions get reinvested in the entity for additional ownership interests, then the additional ownership interests would tend to be community.

A. The Valuation Process

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

1. Business Appraisals in a Divorce Context

Following are some key points to remember regarding business appraisals in the divorce context:

a. Fair Market Value

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

b. Approaches for Business Appraisals

As with real estate appraisals, the three general approaches for a business appraisal are the income, asset and market approaches and the methods utilized within each of those approaches.

(1) Income Approach

The income approach consists of determining a normalized economic benefit available to a hypothetical investor (not necessarily an employee-owner) and determining the value of that income stream into perpetuity by risking it with an appropriate rate of return (principle of "anticipation"). The difficulty in this approach is determining what a normalized, investor return for the subject business is. A widely used benefit stream that is used for this purpose is "net cash flow to equity." This benefit stream measures the amount of benefit available to the equity-holders of the business and consists of net

income, increased by non-cash charges, adjusted for the changes in working capital, decreased by anticipated capital expenditures, and decreased by anticipated payments on long term debt (if any). The “understandability” factor and the multitude of calculations in this approach may make its use problematic in a litigation setting.

(2) Asset Approach

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

(3) Market Approach

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

c. Key Factors in Business Appraisals

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

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

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

B. Goodwill Issues

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

1. Intangible Assets

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

a. Specifically Identifiable

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

b. Goodwill

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

(1) Personal Goodwill

The success of many small and closely-held businesses is inextricably linked to the efforts, skill, reputation, and ability of the owner-employee, especially when considering the value of a professional practice. Therefore, the excess returns of the business may be possible only due to the efforts of the owner or his reputation and customer contacts. When this attribute exists, the component of the goodwill associated with the owner is referred to as “personal

goodwill.” Personal goodwill is generally understood to not be marital property subject to division. This is because the personal goodwill is typically maintained by the daily efforts of the owner and will continue to have to be maintained by those efforts subsequent to the divorce. Indicators of the value of personal goodwill include covenants not to compete, key man life insurance policies, and perhaps excess compensation. However, these are only indicators and guidelines that assist in the measurement of personal goodwill.

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

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

When appraising a business for purpose of divorce, the appraiser must be prepared to identify any goodwill of the company, and then allocate it between personal and commercial goodwill. For goodwill to be part of divisible value in a Texas divorce, it should be shown to exist independently of the professional ability of the owner-employee spouse and if so, the goodwill must be shown to have commercially-available (saleable) value. Texas juries have been instructed that the jury must find the fair market value of the business as if the current owner was out of the business and free to compete with it. In other words, the business should be appraised as if the owner of the business is going to literally walk across the street, open a competing business, and will have his customer’s names and numbers available to him or her.

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

2. Illustration of Measuring Goodwill

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

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

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

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

VIII.SPOUSE AS AN EMPLOYEE

It is not unusual for both spouses to work together in the business. If the business is one spouse’s separate property, see the discussion hereinabove regarding statutory and commonly law reimbursement and

economic contribution. Whether the business is community property or one spouse's separate property, if both spouses work in the business and bring home an income, this scenario can pose some interesting and complex problems if the couple divorces.

A. Supporting the Spouse Who Physically Leaves the Business

When a divorce ensues, one spouse usually leaves the business because, obviously, the spouses don't want to be around each other during this stressful and emotional time, not to mention that loss of trust. Regardless, the spouse who physically leaves the business usually wants to keep his or her income flow. One of the first issues in a divorce case is the issue of temporary support from one spouse to the other, discussed more extensively in the next section. The attorney should advise the client that if a divorce ensues, the spouse leaving the business will more than likely be allowed to continue receiving comparable support (or even more, if the spouse was under-compensated for work at the business) during the divorce process.

B. Both Spouse Stay in the Business

If both spouses are crucial to the business's function, it may be possible for both spouses to continue to work in the business, but this is not advisable for obvious reasons. There is so much conflict and emotion that ensues with divorce that the workplace can become quite dysfunctional and non-productive in a short time, with both spouses present. Indeed, it is not unheard of for one spouse to intentionally drive the business into the ground for no other reason than the sheer emotional anger that often accompanies a divorce (the type of anger that causes a person to commit acts which the person should know will hurt not only the other spouse, but the acting spouse).

C. Receivership

Further, whether both spouses work in a business, the business attorney should advise the client that at the time of divorce, either party can apply to the court for a receiver to run the business during the divorce and/or for an auditor to be appointed. If an auditor is appointed, the business attorney should have advised their client that the auditor will audit the business "books" therefore the spouse running the business should always run the business honestly and in a legitimate manner. An appointed receiver is in charge of the money to be paid to each spouse and whether either or both will be allowed to work in the business.

D. (Often Undeclared) Cash

Last, the accounting of "cash" is always an issue when divorce ensues. If the spouses operate from cash

from the business, this will be an issue at time of divorce. The spouse who is leaving the business or who is not involved in the business will want their "fair share" of the cash on a temporary basis and at the final division.

And in the context of undeclared cash, those business owners who think they can actually assert the income on their tax return as what they live on (and claim poverty when asked to provide support), need to start looking at their lifestyle before they go into divorce court. Most divorce lawyers are experienced in challenging these claims in the form of simply showing that the parties' lifestyle well exceeded the income on the tax returns. If your client's mortgage payment exceeds his income, he or she will have some explaining to do.

IX. TEMPORARY SUPPORT

Temporary orders are a type of order commonly issued by a divorce court to provide interim relief for the spouses during the pendency of a divorce.⁸⁶ These interim orders are not only a means of maintenance of the family, but also of protecting the community estate, as well as the welfare of a financially dependent spouse, while the divorce is pending. The amount of support is determined based upon considerations of both the degree to which the applicant is destitute of means to pay for his or her necessities during the pendency of the suit, and the ability of the other spouse to pay. Although temporary support is not a property right, and is only meant to pay for necessary expenses (not as an interim division of the property or to equalize the standard of living for each party pending a final division), upon final division of property in divorce, the equities of the parties and final adjustments for any amount of temporary support may be taken into consideration in making a just and right division of the marital estate.⁸⁷

X. CHOICE OF ENTITY

A. Introduction

Why should you discuss the possibility of a divorce with your small business client when discussing the choice of entity? Primarily because there are extreme differences in how partnership property, the shares of a corporation, or a sole proprietorship are divided in the case of a divorce. In some instances the property belongs to the business itself and is not divisible. Does your client prefer it this way or not? And, depending on the character of

⁸⁶ TEX. FAM. CODE §6.502.

⁸⁷ *Herschberg v. Herschberg*, 994 S.W.2d 273 (Tex.App.-Corpus Christi May 20, 1999), rehearing overruled (Jul 01, 1999)

the capital funding will also dovetail into the choice of entity for all the reasons discussed herein.

Divorce should be a primary consideration when advising a client on the choice of entity. For example, as discussed elsewhere herein above partnership property belongs to the partnership, with the exception of the partnership interest, also discussed herein above, which may be characterized as community property. Therefore, under the current state of the law, a lion's share of the monies in a partnership will remain in the partnership upon divorce, assuming the partnership is not dissolved. Further a corporation is protected by the corporate shell, which generally can only be pierced in extreme circumstances in the context of divorce, which is referred to as reverse piercing. The least troublesome is the sole-proprietorship, the value of which (with the exception of personal goodwill discussed fully herein above), is taken into full consideration when dividing the marital estate.

B. Partnership Property⁸⁸

1. Partnership Property Belongs to Partnership

As all small business attorneys already know, partnership property is owned by the partnership entity and not the individual partners.⁸⁹ Thus, partnership property is not the property of the partners, and (in the context of a divorce) neither spouse has an interest in partnership property.⁹⁰ In other words, no partner owns specific partnership property, but each owns a specific interest of each property.⁹¹ Therefore, a partner/spouse's partnership interest may be community property under the rules of characterization.⁹²

2. Participation in Management of Partnership

On the other hand, a partner's rights to participate in the management and business of the partnership are

personal to the partner and thus are not community property nor subject to such characterization.⁹³

3. Partnership Interest

Therefore, the partnership interest is the only partnership-related property that may be characterized as separate or community.⁹⁴ Distributions of a partner's share of profits and surplus (income) are community property even if the partner's partnership interest is separate property.⁹⁵ Hence, significantly, the contribution of separate property to a partnership may transform what would be received as a spouse's separate property into community property. Until distributed, however, partnership earnings are partnership property and thus not subject to characterization as community or separate property.⁹⁶

4. Transferees

Upon divorce, the spouse of the partner is regarded for purposes of the TEXAS REVISED PARTNERSHIP ACT as "transferees" of the partnership interest.⁹⁷ Though a partner's partnership interest may be community property, division of the partnership interest upon divorce is often avoided by the exercise of the large amount of discretion possessed by courts to divide the community estate.⁹⁸ Thus, a partnership interest that is community property is usually awarded to the partner spouse and other community property is awarded to the non-partner spouse to achieve a fair and equitable division.⁹⁹

⁸⁸ The TEXAS BUSINESS ORGANIZATIONS CODE governs a domestic general partnership formed on or after January 1, 2006. The TEXAS REVISED PARTNERSHIP ACT continues to govern a domestic general partnership formed prior to January 1, 2006 until January 1, 2010, unless the general partnership makes an election (as provided by Section 402.003 of the Business Organizations Code) to be governed by the Business Organizations Code prior to January 1, 2010. 19 TXPRAC § 9.3 provided a majority of the information used in this section.

⁸⁹ VERNONS ANN. CIV. ST. (TUPA) ART. 6132b §5.01.

⁹⁰ VERNONS ANN. CIV. ST. (TUPA) ART. 6132b §2.04.

⁹¹ *Biggs v. First Nat. Bank of Lubbock*, 808 S.W.2d 232 (Tex. App. – El Paso 1991, writ denied).

⁹² VERNON'S ANN. CIV. ST. art. 6132b-5.02(a); V.T.C.A., BUS. ORG. CODE § 154.001(a) and (b).

⁹³ VERNON'S ANN. CIV. ST. art. 6132b-4.01(d). V.T.C.A., BUS. ORG. CODE § 152.203(a).

⁹⁴ See *McKnight v. McKnight*, 543 S.W.2d 863 (Tex.1976); *Lifshutz v. Lifshutz*, 61 S.W.3d 511 (Tex.App.--San Antonio 2001, pet. denied); *Cleaver v. Cleaver*, 935 S.W.2d 491 (Tex.App.--Tyler 1996, no writ); *Harris v. Harris*, 765 S.W.2d 798 (Tex.App.--Houston [14th Dist.] 1989, writ denied); *Marshall v. Marshall*, 735 S.W.2d 587 (Tex.App.--Dallas 1987, writ ref'd n.r.e.).

⁹⁵ See *Harris v. Harris*, 765 S.W.2d 798 (Tex.App.--Houston [14th Dist.] 1989, writ denied); *Marshall v. Marshall*, 735 S.W.2d 587 (Tex.App.-- Dallas 1987, writ ref'd n.r.e.).

⁹⁶ *Cleaver v. Cleaver*, 935 S.W.2d 491 (Tex.App.--Tyler 1996, no writ).

⁹⁷ VERNON'S ANN. CIV. ST. art. 6132b-5.04(a), (b), and (c).

⁹⁸ V.T.C.A., Family Code § 7.001.

⁹⁹ See, e.g., *Gaines v. Gaines*, 519 S.W.2d 694 (Tex.App.-- Houston [1st Dist.] 1975, writ ref'd n.r.e.); *Cortez v. Corsi*, 513 S.W.2d 648 (Tex.App.--Corpus Christi 1974, writ ref'd n.r.e.); cf. *Bell v. Bell*, 513 S.W.2d 20 (Tex.1974); V.T.C.A., BUS. ORG. CODE § 152.406(a)(1), (2), and (3).

The transfer of a partnership interest does not itself require a winding up of the partnership.¹⁰⁰ A person who is a transferee of a partnership interest is entitled (1) to receive, to the extent of the interest transferred, distributions to which the transferor would otherwise be entitled, (2) to require reasonable information on account of partnership transactions, (3) to make reasonable inspection of the partnership books for any proper purpose, and (4) in a winding up, to receive, to the extent transferred, the net amount otherwise distributable to the transferor.¹⁰¹ However, a transferee is not entitled to participate in the management or conduct of the partnership business.¹⁰²

C. Corporate Alter Ego

The doctrine of alter ego, in a traditional business context, allows the trial court to set aside the corporate structure of a company, or "pierce the corporate veil," to hold individual shareholders liable for corporate debt.¹⁰³ Traditionally, alter ego has two elements: (1) "such unity between corporation and individual that the separateness of the corporation has ceased," and (2) a finding that "holding only the corporation liable would result in injustice."¹⁰⁴

Piercing the corporate veil in a divorce case allows the divorce court to characterize as community property corporate assets that would otherwise be the separate property of one spouse.¹⁰⁵ Alter ego and piercing is an equitable remedy separate and apart from the rule of reimbursement, discussed above, under which the community estate may be entitled to compensation for the time, talent, and toil of a spouse spent enhancing the value of a separate property corporation. Obviously, understanding how a corporate veil can be pierced in a divorce context is they key to properly advising your small business owner client to assure that his or her behaviors do not

result in factual circumstances that would support piercing the veil.

D. Reverse Piercing

Unlike traditional piercing in which the stockholder is held liable for debts of the corporation, piercing in the divorce context allows the trial court to move assets out of the corporation and divide them between spouses as part of the shareholder's community estate.¹⁰⁶ This is sometimes referred to as "Reverse Piercing."

To properly pierce in a divorce case, the trial court must find something more than mere dominance of the corporation by the spouse.¹⁰⁷ At the least, a finding of alter ego sufficient to justify piercing in the divorce context requires the trial court to find: (1) unity between the separate property corporation and the spouse such that the separateness of the corporation has ceased to exist, and (2) the spouse's improper use of the corporation damaged the community estate beyond that which might be remedied by a claim for reimbursement.¹⁰⁸ Thus, to assure that your small business owner is not subject to a potential pierce, you must advise your client against any behaviors that might otherwise create a unity between the business and the community estate.

XII. TAX EFFECT

1. Introduction

Although tax effect has generally always been open for argument before the trier of fact, the business attorneys needs to be aware that the tax effect of the division of an asset is now statutorily defined as being a part of the consideration of the division.

2. Applicable Law

§ 7.008. Consideration of Taxes

In ordering the division of the estate of the parties to a suit for dissolution of a marriage, the court *may* consider:

(1) whether a specific asset will be subject to taxation; and

¹⁰⁰ VERNON'S ANN CIV. ST. art. 6132b-5.03(a)(3); V.T.C.A., BUS. ORG. CODE § 152.402(2).

¹⁰¹ VERNON'S ANN. CIV. ST. art. 6132b-5.03(b), (c).

¹⁰² VERNON'S ANN. CIV. ST. art. 6132b-5.03(a)(4); V.T.C.A., BUS. ORG. CODE § 152.402(3).

¹⁰³ *Lifshutz v. Lifshutz*, 61 S.W.3d 511 (Tex.App.-San Antonio Jul 25, 2001), rehearing overruled (Aug 29, 2001), review denied (Dec 13, 2001), rehearing of petition for review denied (Jan 31, 2002) citing *Castleberry v. Branscum*, 721 S.W.2d 270, 271-72 (Tex.1986).

¹⁰⁴ *Id.* at 516 citing *Castleberry* at 272.

¹⁰⁵ *Id.* citing *Zisblatt v. Zisblatt*, 693 S.W.2d 944, 949 (Tex.App.-Fort Worth 1985, writ dismissed); accord *Vallone v. Vallone*, 644 S.W.2d 455, 458 (Tex.1982) (alter ego is issue of fact from which the status of property as community or separate is determined).

¹⁰⁶ *Id.* citing *Zisblatt* at 955.

¹⁰⁷ *Id.* citing *Goetz v. Goetz*, 567 S.W.2d 892, 896 (Tex.App.-Dallas 1976, no writ) (wife not entitled to award of separate property corporate assets even though husband was sole shareholder and committed some improprieties, where husband's improper use of corporation did not damage community estate).

¹⁰⁸ *Id.*

(2) if the asset will be subject to taxation, when the tax will be required to be paid. [emphasis added]

HISTORY: Stats. 2005 79th Leg. Sess., Ch. 168 (H.B. 203), § 1, effective Sept. 1, 2005.

NOTES: Stats. 2005, 79th Leg. Sess., Ch. 168 (H.B. 203), § 2, provides: "The change in law made by this Act applies to a suit for dissolution of a marriage pending before a trial court on or filed on or after the effective date of this Act."

3. Use of New Tax Statute

Some courts have often considered tax consequences stemming from the division of community property however other courts have held that tax consequences may not be considered in the division of a marital estate. This statute seems to codify case law that allows the court to consider tax consequences, but does not require the court to do so.

The new statute is not without complexity in its application. For example, what is the nature of the tax to be considered (e.g. capital gain, tax on ordinary income, additional tax imposed as a result of early withdrawal)? What is the tax rate to be applied—future tax rates (e.g. anticipated rate at retirement) or the tax rates on date of divorce? Is the court entitled to use tax rate assumptions that differ from current rates if the assumptions are based upon expert testimony? When will the tax be imposed? In light of graduated tax rates, must the court assume that a spouse's income will be the same at the time the asset is "realized" as it is at the time of divorce? If not, what assumptions must/should the court make with respect to the recipient's income at the time the asset is "realized"? Should the timing of tax consequences be taken into consideration in the circumstance where one spouse may need to utilize funds to meet that spouse's needs where the other spouse may be a higher wage earner so the tax consequences may not occur until much later than the other spouse? These are all issues surrounding the application of the new statute.

Must the court make specific findings with respect to the tax consequences it uses in rendering a decision? The author and other colleagues agree "probably not" and that the tax consequences are another factor which the court must consider in making a just and right division of the community estate.

It will be imperative to have a CPA calculate the tax implications. In addition, think about a loan in a defined contribution plan—if an employee defaults on the loan, the unpaid amounts are treated as a distribution to the employee in the year of default and are taxed at the defaulting employee's rate at the time of the distribution. What about the employee in a cash

flow problem? What rate would be used if a default is likely, or planned?

XII. REPRESENTING YOUR SMALL BUSINESS CLIENT IN THE DIVORCE

A. Don't Do It!

Representing your small business client in their divorce is ill-advised. There is the high potential for conflict of interest because the attorney's representation of the client in relation to the small business as to each spouse's separate property and their community property. Additionally, you might find yourself a witness with regard to the business entity development and structure.

1. Conflict of Interest

Remember, a lawyer shall not represent a person if the representation of that person: (1) involves a substantially related matter in which that person's interests are materially and directly adverse to the interests of another client of the lawyer or the lawyer's firm; or (2) reasonably appears to be or become adversely limited by the lawyer's or law firm's responsibilities to another client or to a third person or by the lawyer's or law firm's own interests.¹⁰⁹ Hence, if you or your law firm have been assisting the spouses together in developing and administratively caring for a business entity that is the subject matter of a divorce between which the two spouses are now adverse, then, it is certainly conceivable that such business entity might become the "substantially related matter" defined by statute.¹¹⁰

If you are able to somehow clear away in your mind any potential for conflict (for example, if you have never met the other spouse and/or if the business entity was formed prior to the marriage and/or if the other spouse has no legal interest in the business entity due to inception of title or a legally binding agreement signed by both spouses), make certain that you obtain full disclosure and consent.¹¹¹

If you find yourself in the unenviable position of discovering a conflict exists after you've already gotten yourself involved in the divorce representation, you must withdraw from representation immediately in

¹⁰⁹ V.T.C.A., GOVT. CODE T. 2, Subt. G App. A, Art. 10 §9 Rule 106.

¹¹⁰ *Id.*

¹¹¹ *Id.* stating "A lawyer may represent a client in the circumstances described in (b) if: (1) the lawyer reasonably believes the representation of each client will not be materially affected; and (2) each affected or potentially affected client consents to such representation after full disclosure of the existence, nature, implications, and possible adverse consequences of the common representation and the advantages involved, if any."

order to protect yourself.¹¹² Do not hand the case over to another member of your firm, as the applicable disciplinary rule provides no option of forming a Chinese wall in these instances.¹¹³

2. Lawyer as a Witness

Another problem is that you may ultimately become a witness in the divorce. This is so because your knowledge of the various transactions surrounding the formation of the business entity, which transactions may become an issue if the character of the business entity is contested; or, if the non-managing spouse accuses the managing spouse of devaluing the business intentionally in anticipation of divorce (marital fraud); or, if the opposing spouse is attempting to pierce the corporate veil (reverse piercing). Those are just a few examples of the fact scenarios that might cause you to end up on the witness stand, thus obviously excluding you from representation of either client in the divorce.¹¹⁴ Even worse, what if you know that your testimony will hurt your client (for example if he is running all of his personal expenses through a corporation which will now subject him to having those expenses imputed

upon him for purposes of interim support)? You cannot represent the client in those instances, unless the client consents¹¹⁵, nor can you throw the matter to another lawyer in your firm, without written authority from the client.¹¹⁶

3. It's Harder Than It Looks

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

XIII.CONCLUSION

We hope that we have enlightened you as to the basics of family law as they apply to your representation of the small business owner, and how to avoid potential divorce disasters. Many traps and pitfalls for clients who are small business owners can be avoided by your knowledge of family law.

¹¹² *Id.* stating “If a lawyer has accepted representation in violation of this Rule, or if multiple representation properly accepted becomes improper under this Rule, the lawyer shall promptly withdraw from one or more representations to the extent necessary for any remaining representation not to be in violation of these Rules.

¹¹³ *Id.* stating “If a lawyer would be prohibited by this Rule from engaging in particular conduct, no other lawyer while a member or associated with that lawyer's firm may engage in that conduct.”

¹¹⁴ (a) A lawyer shall not accept or continue employment as an advocate before a tribunal in a contemplated or pending adjudicatory proceeding if the lawyer knows or believes that the lawyer is or may be a witness necessary to establish an essential fact on behalf of the lawyer's client, unless:

- (1) the testimony relates to an uncontested issue;
- (2) the testimony will relate solely to a matter of formality and there is no reason to believe that substantial evidence will be offered in opposition to the testimony;
- (3) the testimony relates to the nature and value of legal services rendered in the case;
- (4) the lawyer is a party to the action and is appearing pro se; or
- (5) the lawyer has promptly notified opposing counsel that the lawyer expects to testify in the matter and disqualification of the lawyer would work substantial hardship on the client.

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

¹¹⁵ *Id.* stating “A lawyer shall not continue as an advocate in a pending adjudicatory proceeding if the lawyer believes that the lawyer will be compelled to furnish testimony that will be substantially adverse to the lawyer's client, unless the client consents after full disclosure.”

¹¹⁶ *Id.* stating “Without the client's informed consent, a lawyer may not act as advocate in an adjudicatory proceeding in which another lawyer in the lawyer's firm is prohibited by paragraphs (a) or (b) from serving as advocate. If the lawyer to be called as a witness could not also serve as an advocate under this Rule, that lawyer shall not take an active role before the tribunal in the presentation of the matter.”