Small Business Issues in a Texas Divorce

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Who are we?

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Basic rules about property division in Texas divorce

Identification

Characterization

Valuation

Division

Starting the divorce process

- Who do you represent? Be cautious about representing both the spouse and the business entity, especially if the entity is community property or co-owned by the spouses to avoid a conflict of interest developing.
- Filing divorce pleadings
- Standing Orders – what they prevent, what they allow
  - Reasonable business activities
  - Business entity as a party
- Temporary restraining orders (non-standard orders under civil rules)
- Confidentiality orders
  - Confidentiality of information
  - Protected business secrets
  - Sealing the file

Temporary orders upon filing of divorce

Supporting the spouse who physically leaves the business – temporary support orders

What if both spouses stay in the business – operating agreements and rules

Receivership – at the time of divorce, either spouse may apply to the court for a receiver to run the business during the divorce and for an auditor to be appointed. An appointed receiver decides the money to be paid to each spouse and whether either or both will be allowed to work in the business.

Issues regarding operating during divorce

What if jointly run the business?

What if one party is more involved?

Preserve ability of business to operate during divorce

Identification of marital assets

What is the asset?

- Entity theory
  - Business entity separate from the individual, own interest in the entity, not the individual assets of the entity
  - Applies to corporations and partnerships, no sole proprietorships
- What is subject to divorce
  - Tangible v. intangible assets
  - Goodwill

Characterization Issues

Community v. separate property

- Texas Constitution definitions

Inception of title doctrine

Texas Business Organizations Code

Effective 2006, replaces all other codes as of 1/1/2010

Corporation – formed by filing of articles of incorporation with the Texas Secretary of State

Partnership – formed by agreement of two or more people to be partners regardless of formal documentation unless formal documentation states a specific formation date.

Corporation

<u>Treatment of earned by undistributed income</u>: where corporate stock is the separate property of a spouse, undistributed earnings remain corporate property and only become marital property subject to characterization when distributed. Thomas v. Thomas, 738 S.W.2d 342 (Tex. App. – Houston [1st Dist.] 1987, writ denied).

<u>Liquidation</u>: Upon liquidation of a corporate entity, all distributions are deemed to be an exchange for the stock in liquidation and held to be a mutation of the stock for purposes of characterization. Legrand-Brock v. Brock, 246 S.W3.d 318 (Tex. App. – Beaumont 2008, pet. denied). So, if the corporate stock is separate property, then a complete liquidation results in the assets distributed maintaining the separate property character.

Alter Ego/Reverse Piercing the Corporate Veil: The corporate fiction may be disregarded when the corporate form has been used as part of a basically unfair device to achieve an inequitable result. Castleberry v. Branscum, 721 S.W.3d 270 (Tex. 1986). The corporate fiction may be disregarded: (1) when the fiction is used as a means of perpetuating fraud (but see TBOC 21.223); (2) where a corporation is organized and operated as a mere tool or business conduit of another corporation; (3) where the corporate fiction is employed to achieve or perpetrate monopoly; (5) where the corporate fiction is used to circumvent a statute; and (6) where the corporate fiction is relied upon as a protection of crime or to justify a wrong.

TBOC 21.223(b) requires a finding of actual fraud and not merely constructive fraud. See S. Union Co. v. City of Edinburg, 129 S.W.3d 74 (Tex. 2003).

Reverse piercing in the family law context

Reverse piercing: Unlike traditional piercing in which the stockholder is held liable for debts of the corporation, reverse piercing in the divorce context allows the trial court to move assets out of the corporation and divide the between spouses as part of the shareholder's community estate. 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. Zisblatt v. Zisblatt, 693 S.W.2d 944 (Tex. App. – Fort Wroth, 1985, writ dismd).

Two prong test for reverse piercing: There must be unity between the separate property corporation and the spouse such that the separateness of the corporation has ceased to exist; and the spouse's improper use of the corporation damaged the community estate beyond what might be remedied by a claim for reimbursement. Lifshutz v. Lifshutz, 61 S.W.3d 511 (Tex. App. – San Antonio 2001, pet denied). The court cannot reimburse a spouse from the community if the community itself is not harmed and/or if the harm can be remedied by reimbursement.

Where the other spouse participates in the fraudulent activities of a corporation, the unclean hands doctrine prevents reverse piercing. Southwest Livestock Trucking Co. v. Dooley, 884 S.W.2d 895 (Tex. App. – San Antonio 1994, writ denied).

Partnerships

Nonliquidating partnership distributions, regardless of the partner's interest, are community property. Harris v. Harris, 765 S.W.3d 798 (Tex. App. – Houston [14^{th} Dist.] 1989, writ denied).

Partnerships are not subject to piercing. Pinebrook Properties Ltd. v. Brookhaven Lake Prop. Owners Ass'n, 77 S.W.3d 487 (Tex. App. – Texarkana 2002, pet. denied). Alter ego is inapplicable with regard to a partnership because there is no veil that needs piercing, even when dealing with a limited partner, because the general partner is always liable for the debts and obligations of a partnership to third parties. So, an injured party may always seek restitution and recovery from the general partnership.

Limited Liability Company

LLC is a hybrid of a corporation and partnership.

The corporate veil of an LLC may be pierced. Gonzalez v. Lehtinen, 2008 WL 668600 (Tex. App. – Corpus Christi 2008, no pet. hist.); McCarthy v. Wani Venture, A.S., 251 S.W.3d 573 (Tex. App. – Houston [1st Dist.] 2007, pet. denied). But note, there are no family law cases that address reverse piercing with respect to an LLC.

Professional Corporations and Professional Associations

A Professional Corporation (PC) is a Texas corporation owned and managed by licensed professionals (not medical doctors). The ownership interest may not be transferred to one who is not a professional.

A Professional Association (PA) is the entity for medical doctors.

Alter ego and piercing apply to PC and PA.

Non corporate entities

Can alter ego or corporate piercing apply to noncorporate entities?

Trust created for purposes of defrauding creditors or other persons is illegal and may be disregarded upon a finding of alter ego when such trust was created with the intention of preventing another party from reaching property in the trust. In re Marriage of Dick, 15 Cal. App. 4^{th} 144 (1993).

Sole proprietorships

A sole proprietorship is defined as a business in which one person owns all the assets, owes all the liabilities, and operates in his or her personal capacity.

One of the most important features of a sole proprietorship is that it is not an independent legal entity. The sole proprietor and the sole proprietorship are one and the same person. The assets and liabilities of the sole proprietorship belong to the operator directly. Bush v. Bush, 336 S.W.3d 722 (Tex. App. – Houston [1st Dist.] 2010, no pet.).

There is no alter ego concept regarding sole proprietorships because the entity is already the alter ego of the person.

Tangible assets of the sole proprietorship are subject to traditional characterization rules – presumption of community property and tracing. Intangible assets, such as personal goodwill are not divisible. A sole proprietorship may have commercial goodwill. Finch v. Finch, 825 S.W.2d 218 (Tex. App. – Houston [1st Dist.] 1992, no writ).

Marital property rules for sole proprietorships

The profits of a sole proprietorship are presumptively community property, subject to tracing as a mutation of separate property. Yaklin v. Glusing, Sharpe & Krueger, 875 S.W.2d 380 (Tex. App. – Corpus Christi 1994, no writ).

An equitable reimbursement claim may be made for commingled separate and community profits earned from the operation of a sole proprietorship. Hartman v. Hartman, 253 S.W.2d 480 (Tex. Civ. App. – Austin 1952, no writ).

Inception of title of a sole proprietorship does not "carry forward" through its reformation as a business entity. Allen v. Allen, 704 S.W.2d 600 (Tex. App. – Fort Worth 1986, no writ). In other words, incorporating a sole proprietorship during marriage does not maintain the separate property character of the sole proprietorship.

4 types of property rights to a sole proprietorship

(1) The ownership interest in the business;

(2) the tangible assets used by the business, such as inventory and equipment;

(3) the intangible assets used by the business, such as contract and intellectual property rights, and personal goodwill; and

(4) the intangible asset of commercial goodwill associated with the business.

A sole proprietorship created during a marriage can never ben separate property.

The commercial goodwill of a sole proprietorship attaches to the business and is divisible upon divorce if the ownership interest in the business is also divisible (follows the character of the business).

Valuation of business entity -- goodwill

Do not include the value of personal goodwill but do include the value of commercial goodwill. Nail v. Nail, 486 S.W.2d 761 (Tex. 1972); Geesbreght v. Geesbreght, 570 S.W.2d 427 (Tex. Civ. App. – Fort Worth 1978, writ dismd). The reputation and good name of the spouse who owns the business might go away if he sold his interest, but the general reputation and business goodwill of the company would still be an asset of value to a prospective buyer.

Two prong test to determine business goodwill: First, goodwill must be determined to exist independently of the personal ability of the professional spouse. Second, if such goodwill is found to exist, then it must be determined that goodwill has commercial value in which the community estate is entitled to a share. Finn v. Finn, 658 S.W.2d 735 (Tex. App. – Dallas 1983, writ ref'd. n.r.e.). However, if the business is one-person professional corporation conducting a business in that person's name, then it will be hard to find there is goodwill independent of the owner. Hirsch v. Hirsch, 770 S.W.2d 924 (Tex. App. – El Paso 1989, no writ).

Valuation of the business entity – minority interest and marketability

The total value of the company has to be discounted if the spouse owns a minority interest in the company and also discounted for lack of marketability. These discounts can significantly reduce the value of a company. Ritchie v. Rupe III 1995, 339 S.W.3d 275 (Tex. App. – Dallas 2011), reversed on other grounds 443 S.W.3d 856 (Tex. 2014).

Valuation of the business entity – buy-sell agreement

A buy-sell agreement can effect or even determine the value of an interest in a business. Here, part of the corporate documents contain an agreement that fixes the buy-back price if the shareholder dies, quits, is fired, or is divorced. Mandell v. Mandell, 310 S.W.3d 531 (Tex. App. – Fort Worth 2010, no pet.). But, the value may go beyond the buy-sell agreement and include the intrinsic value of the property interest to the owner (i.e., the value to the owner of being able to drive a new car, have health insurance paid for, have company-financed life insurance policy, to belong to a country club, and other financial benefits).

Valuation of the business entity – non-compete agreement

In valuing a business entity in the divorce context, the court must assume the spouse who owns all or part of the business is leaving the business and taking his personal professional reputation with him. If the owner agrees to sign a non-compete agreement, the practice will likely be sold for a higher price. Rathmell v. Morrison, 732 S.W.2d 6 (Tex. App. – Houston [14^{th} Dist.] 1987, no writ).

If there is an existing non-compete agreement, the valuation should take into account the value of the non-compete to a prospective buyer. Collins v. Collins, 904 S.W.2d 792 (Tex. App. – Houston [1^{st} Dist.] 1995, writ denied). If there is no non-compete, then the valuation assumes the spouse is free to compete if she sells.

A trial court cannot order a covenant not to compete provisions as part of a divorce. Ulmer v. Ulmer, 717 S.W.2d 665 (Tex. App. – Texarkana 1968, no writ).

Methods for valuation

Asset approach: tangible assets are appraised and reflected at market value, then liabilities are subtracted to arrive at the adjusted book value.

Income approach: estimates the amount of income that will be generated by the business in the future and then decides how much an investor would invest for a reasonable rate of return to obtain that stream of income. Here the earnings of the business are capitalized at a rate to arrive at the fair market value of the corporation. Morgan v. Morgan, 657 S.W.2d 484(Tex. App. – Houston [1st Dist.] 1983, writ dism'd).

Market approach: looks at recent sales of same or similar companies.

Valuation of a sole proprietorship

The value of a sole proprietorship is the fair market value, or assets minus liabilities. However, the sole proprietorship owns no tangible or intangible assets, but only commercial goodwill like workforce-in-place and the name of the business.

Expert witness for valuation

CPA licensed by the State of Texas with experience in valuing businesses.

Credentials in business valuations:

- National Association of Certified Valuation Analysts (NACVA) has certifying programs Accredited Valuation Analyst (AVA), Certified Valuation Analyst (CVA), or Certified Financial Forensic Analyst (CFFA).
- American Society of Appraisers (ASA) has certifying programs Accredited Member (AM), Accredited Senior Appraiser (ASA), and Fellow of the American Society of Appraisers (FASA).
- Institute of Business Appraisers (IBA) is the oldest professional society devoted to the appraisal of closely-held businesses and has certifying programs Accredited by IBA (AIBA), Certified Business Appraiser (CBA), Master Certified Business Appraiser (MCBA), and Business Valuator Accredited for Litigation (BVAL).

Division of business entity

Usually awarded to one party at value

Receivership – if can’t award to one party, may be ordered sold/liquidated

Co-ownership after divorce

PC/PA cannot be awarded to spouse who is not professional

Post Divorce Issues

Ongoing operating agreements – what if the spouses choose to remain business owners after they divorce?

Securing pay-off judgments against business entity – if an equalization judgment is utilized to reach a just and right division, can the judgment be secured against the corporate stock or partnership interest?

Redrafting corporate documents if one spouse leaves the corporation after divorce where the two spouses co-owned the entity prior to divorce.

Resources:

Enos, G., Business Valuation, www.divorcereality.com 2011.

Conner, C., King, H., Miskel, E., Business Succession Planning: Protecting Business in Divorce, Essentials of Business Law, State Bar of Texas 2010.

Orsinger, S., The Intangible Assets of a Non-Existent Entity: Sole Proprietorships & Goodwill in a Texas Divorce 35th Annual Marriage Dissolution Institute, State Bar of Texas 2012.

Goranson, T., Pingenot, A., A Modest Primer on Business Ownership, Divorce, and the Courts, New Frontiers in Marital Property 2011.