VALUATION, CHARACTERIZATION AND DIVISION OF UNUSUAL ASSETS

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"Mental Health Professionals and the Legal System Including Ethical Issues," American Academy of Matrimonial Lawyers, Chicago, Illinois, November, 1998

"Relocation: Moving Forward, or Moving Backward?," American Academy of Matrimonial Lawyers Annual Conference, Chicago, Illinois, November, 1996

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"Pretrial and Trial Strategies for the Complex Property Case", New Frontiers in Marital Property Law, Santa Fe, New Mexico, October 2000.

"Strategic Use of Law Beyond the Family Code", New Frontiers in Marital Property Law, San Diego, California, October 1999.

"Fiduciary Duties of Spouses, Effective Use of the Remedy of the Constructive Trust, Recoveries for Violations of these Duties, and Issues Presented When Spouses are Under Multiple and/or Conflicting Duties," New Frontiers in Marital Property Law, Santa Fe, New Mexico, October, 1998.

"Dealing With Special Problems Relevant to Evaluation & Division of Professional Practices," Second Annual New Frontiers in Marital Property Law, San Diego, California, October, 1997

ADVANCED FAMILY LAW:

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"Breach of Fiduciary Duty and Nonphysical Tort Claims," Annual Advanced Family Law Course, San Antonio, Texas, August, 1998;

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"Piercing Claims of Immunity in Family Law Litigation," Advanced Family Law Course, San Antonio, Texas, 1994;

"Piercing Claims of Immunity in Family Law Litigation," Advanced Family Law Course, San Antonio, Texas, 1994;

"Getting and Characterizing Punitive Damages in Family Law Litigation," Advanced Family Law Course, San Antonio, Texas, August 1994.

ADVANCED CIVIL APPELLATE

"Trends in Preservation of Error (At Trial, Charge, and Post Verdict)", 13th Annual Advanced Civil Appellate Practice Course, State Bar of Texas, Austin, Texas, October 1999.

MARRIAGE DISSOLUTION

"Valuing and Dividing the Community Business, Marriage Dissolution Seminar, Corpus Christi, Texas, May 2001.

"Bill of Review", 23rd Annual Marriage Dissolution Seminar, Fort Worth, Texas, May 2000.

"Sex and Lies: A Daubert Challenge, Techniques for Presenting the Child's Testimony to the Trial Court in a Child Abuse Case, 23rd Annual Marriage Dissolution Seminar, Fort Worth, Texas, May 2000.

"Appellate Tips: Judges Panel",23rd Annual Marriage Dissolution Seminar, Fort Worth, Texas, May 2000.

"Litigating Marital Agreements: "You can't always get what you want....",22nd Annual Marriage Dissolution Institute, San Antonio, Texas, May 1999.

"Handling the Divorce Involving a Medical Practice," Marriage Dissolution Conference, Austin, Texas, May, 1998;

"Scratches on the Heart: Non-Physical Tort Claims," Marriage Dissolution Conference, Dallas Texas, May, 1997;

"The Effective Use of the New Conservator Rights Responsibilities and Duties in a Custody Case," Marriage Dissolution Conference, South Padre Island, Texas, 1994;

TEXAS ACADEMY OF FAMILY LAW SPECIALISTS

"Presenting the Child's Perspective: Techniques for Presenting the Child's Preference of Conservator to the Trial Court", Texas Academy of Family Law Specialists, Las Vegas, Nevada, February 2000.

TEXAS TRIAL LAWYERS ASSOCIATION

"Conflicts Between Personal Injury and Family Law," Texas Trial Lawyers Association, Austin, Texas, February 1999.

"How Much Is Your Law Practice Worth? Valuing Personal Injury Law Practices for Purposes of Divorce," Texas Trial Lawyers Association, Dynamic Advocacy Seminar, Whitefish Montana, July, 1998;

"Discussion of Texas Supreme Court Cases Involving Tort Claims of Emotional Distress," joint meeting of Travis County Trial Lawyers and Travis County Women's Bar, Austin, Texas, 1994;

UNIVERSITY OF TEXAS COURSES

"Interaction of Probate Court and Family Law," Family Law on the Front Lines, Galveston, Texas, April 2001

STATE BAR OF TEXAS COURSES

"Bottom Line Appellate Issues," Ultimate Trial Notebook: Family Law, New Orleans, Louisiana, December 2000

"Playing By the Rules," Winning Techniques in Family Law Litigation: Mastering the Challenge, Houston, Texas, December 1998

"Emerging Issues in Custody Litigation," 1997 State Bar of Texas Legal Assistant Division Advanced Family Law Seminar, Austin, Texas, March, 1997;

"Changes in Texas Family Law," The College of the State Bar of Texas, Austin, Texas, 1994;

"The Social Worker: Learning from Your Expert What to Ask,"The Ultimate Trial Notebook - Family Law, State Bar of Texas, Austin, Texas 1994.

"Sharpening Negotiating Skills - Your Key to Success," State Bar of Texas, Women's Law Section, Austin, Texas, 1990;

"Mothers Without Custody" San Francisco, California, 1987;

"Child Abuse - The Quiet Crime," State Bar of Texas, San Antonio, Texas, 1985; and

"Post Divorce, Modification of Conservatorship and Support Orders" in Divorce 1984: Division of Property and Decisions on Children, El Paso, Texas 1984

ASSOCIATION OF FAMILY AND CONCILIATION COURTS

"Parental Relocation Disputes: An Interdisciplinary Approach to Resolution," Second World Congress on Family Law and the Rights of Children and Youth with the 1997 Annual Conference of the Association of Family and Conciliation Courts, San Francisco, California, June, 1997;

"Gender Issues in Domestic Torts," Association of Family and Conciliation Courts, Montreal, Canada, May 1995;

SPEAKER/AUTHOR VARIOUS COURSES

Summary of the 1999 amendments to the Texas Family Code", Legal Assistant U, San Antonio, Texas, September 1999.

"Domestic Tort Liability and Characterization of Damages," First Annual Texas Marital Property Institute, Austin, Texas, October, 1997;

"Trying Jury Cases Under the Amendments to the Texas Family Code and the New Texas Pattern Jury Charge," Travis County Family Law Section Meeting, April 1996;

"What Attorneys Expect from an Appraiser in a Divorce Situation," American Society of Appraisers, Austin, Texas, November 1995;

"Complex Family Law Litigation, Interspousal Tort Claims," Texas College of Advanced Judicial Studies, 1993;

"Changes in the Family Code," Travis County Family Law Section Meeting, Austin, Texas, 1993;

Travis County Bar Association Third Annual Jury Selection Seminar, Family Law Voir Dire Demonstration, 1993;

"Issues Particular to the Appeal of Family Law Cases in Texas" Civil Appellate Seminar, Austin, Texas, April, 1994;

Travis County Bar Association Second Annual Jury Selection Seminar, Family Law Voir Dire Demonstration, 1992;

Travis County Domestic Relations Division - Child Custody Litigation, 1990;

"Child Custody Litigation," Tarrant County Bar Association, Fort Worth, Texas, 1990;

VARIOUS PUBLICATIONS

"Overview of the New Uniform Child Custody Jurisdiction Enforcement Act", The Newsletter of the American Academy of Matrimonial Lawyers," Winter 2000

"Targeted by the Opposing Party; The Tort of Negligent Misrepresentation Applied to Divorce Lawyers", Texas Lawyer, December 1999.

"Relocation: Moving Forward or Moving Backward?", 15 Journal of American Academy of Matrimonial Lawyers 701, 2Spring 1999

"The Fiduciary Duty Between Spouses, A Look at "Fraud on the Community", Texas Lawyer, October, 1998;

"Torts in Texas the New Frontier" Texas Trial Lawyers Forum, 1992;

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VALUATION, CHARACTERIZATION AND DIVISION OF UNUSUAL ASSETS

I. STOCK OPTIONS, PHANTOM STOCK AND GOLDEN HANDCUFFS

A. Stock Options

1. In General

A "stock option" is the right to buy a designated stock (termed a "call" option), or to sell a stock (termed a "put" option), at anytime within a specified period at a determinable price, if the holder of the option chooses. *See, In re Marriage of Short*, 435, 859 P.2d 636, 641 (Wash.Ct. App. 1993), *aff'd in part, rev'd in part on other grounds,* 890 P.2d 12 (Wash. 1995) (a "stock option" is the right to buy a designated stock at a particular price for a specified period of time); *see also*, Internal Revenue Code §1234(a) (an employee stock option is a contractual right to purchase stock on or before a specified date at a predetermined price). There are two classifications of options: (1) statutory or qualified options, those granted under and governed by specific Internal Revenue Code sections; and (2) nonstatutory or nonqualified options, those governed under the more general I.R.C. principles of compensation and recognition of income. *Wendt v. Wendt*, No. FA96 0149562 S, 1998 WL 161165, *116 (Conn.Super., March 31, 1998), *aff'd,* 59 Conn.App. 656, 658, 757 A.2d 1225, 1230 (Conn.App.Ct. 2000).

When the option holder has the absolute right to exercise the purchase right at any time by paying the purchase price, the option is vested and matured. *See, e.g., Everett v. Everett*, 195 Mich.App. 50, 489 N.W.2d 111, 113 (1992). If the option cannot be exercised until some future date, and then only contingent upon a future event, such as the employee remaining an employee, the option is "unvested." *See, Id.* Whether the options are granted to provide compensation for past or present services, or whether they are used to provide incentive for continued employment, such options usually expire with termination of the employment.

One Washington state appellate court has characterized an "option" to purchase any kind of property as "a bilateral contract, under which the grantor is obligated to sell at a fixed price within a certain time, but under which the grantee has the choice of buying or not buying for that same price." *Short,* 71 Wash.App. at 439, 859 P.2d at 643. Thus, an option gives the grantee a right of election to exercise a "privilege." *Id*.

To the Internal Revenue Service, an employee stock option is a form of "deferred compensation." *See*, *Short*, 71 Wash.App. at 435, 859 P.2d at 641-642. In effect, the employee accepts the employer's promise to pay in the future, rather than a current cash payment, and, if the employer's stock option plan has been carefully drawn so that it is accepted as a "non-qualified" plan by I.R.S., the employer need not fund the plan, as would otherwise ordinarily be required by ERISA. *Id*.

Typically, stock options vest over time, for example, 20% per year, in which case the employee must remain with the company for 5 years to vest 100% of the options. The grant of a stock option does not equate to ownership of stock, which is acquired at the time the options "vest." The employee's cost of the stock options is set by the company in the form of a stated exercise price. The employee pays for the stock at the time the stock options are exercised. Generally, as mentioned, if an employee leaves the company prior to the stock options vesting, the unvested stock options are lost.

The value of stock options is the difference between the employee's cost of the stock options and the price the stock can be sold. Therefore, if the value of the company's stock does not increase, the stock received pursuant to exercising the vested stock options may have little or no value. There is no guarantee that stock options will have value or that the employee will actually exercise vested stock.

As stated in *Rice v. Montgomery,* 104 Ohio App.3d 776, 663 N.E.2d 389, 392 (Ohio Ct. App. 1995):

> the true value of the stock option to its owner is the potential for appreciation in stock price without investment risk. If the stock price were to drop, the owner of the option simply would not exercise it, because he could instead buy the stock more cheaply on the market. As stated by Treas. Reg. 1.83-

7(b)(3), the value of this type of stock option is risk-free appreciation.

2. Stock-Based Compensation Plans

a. Incentive Stock Option Plan

Under an incentive stock option plan (ISO), a company grants a right to a key employee to buy the company's stock during a stated period of time at a price equal to, or based on, its per share value. Such a plan can be designed to restrict the stock purchased so that the key employee receiving the stock can only sell it to the company, and only upon his termination of employment – at a price equal to the value of such stock at the time of the sale.

If the key employee exercises an ISO at a time when the value of the stock exceeds the purchase price, he or she will receive an immediate benefit in the form of a bargain purchase. If the stock's value continues to rise, he or she will receive further benefit – since the employee can sell the stock to the company on the termination of employment at a price that takes into account the further increased value.

In order for an option to qualify as an ISO, the option must satisfy a number of requirements set forth in Section 422 of the Internal Revenue Code. Each ISO must be granted in connection with the optionee's employment, under a plan that details both (1) the aggregate number of shares that may be issued upon the exercise of the ISO and (2) the employees (or class of employees) who are eligible to receive the ISO. In addition, an ISO may only be granted with an exercise term of 10 years or less, and the exercise price may not be less than the fair market value.

When these requirements are satisfied, the ISO issuance constitutes a nontaxable event for federal income tax purposes. The company granting the ISO receives no deduction either on the date the ISO is granted or on the date the ISO is exercised. Similarly, no amount is generally included in taxable income by the optionee on either date.

However, the potential for income recognition exists on the date of exercise for an ISO. This is because the difference between the value of the stock received on the exercise of the option and the option price constitutes an item of tax preference for purposes of the alternative minimum tax.

Absent income recognition by the optionee under applicable alternative minimum tax rules, gain or loss will be recognized by the employee receiving an ISO only upon his or her sale of the stock. The amount of gain or loss will equal the difference between (1) the sum realized on the sale of the stock and (2) the sum of any amount paid for the option (presumably zero), plus the amount paid for the stock upon the exercise of the option.

An ISO must be granted pursuant to a plan that is approved by the sponsoring company's shareholders within 12 months before or after the adoption of the plan. The approval by the shareholders of a stock option plan must comply with all applicable provisions of the corporate charter, bylaws, and the laws of the state of incorporation.

b. Nonqualified Stock Option Plan

Like ISOs, nonqualified stock options (NSOs) are contractual rights to buy stock from the issuer at a specified price. Unlike ISOs, an NSO grant is not restricted to employees and they are not required to meet specific tax requirements.

Accordingly, a good deal of flexibility is available in designing NSOs. For example, the price of NSOs need not bear any relationship to the price of the stock being optioned, nor must NSOs be exercised within any particular time frame.

Whether the granting of an NSO constitutes a taxable event depends principally on whether the NSO has a "readily ascertainable fair market value" at the time it is granted. Because NSOs are normally nontransferable and are not immediately exercisable in full, they generally do not have an ascertainable fair market value. For this reason, the exercise of an NSO will generally constitute a taxable event.

The amount that will be included in income by the NSO recipient will be the excess of (l) the fair market value of the stock over (2) the sum of any amount paid for the NSO (presumably zero), plus the amount paid for stock. The amount taken into income by the individual will be characterized as ordinary income. The company granting the NSO

will generally be entitled to a tax-deduction equal to the amount that is included in the individual's income

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If the optionee continues to hold the stock after exercise, and he or she eventually sells the stock for a gain, the additional tax due on the gain will be taxed at the capital gains rate. It will be applied to the difference in value from the date of exercise to the date of sale.

c. Restricted Stock Plan

Under a restricted stock plan, an employee is generally granted shares of stock that are subject to: (1) a substantial risk of forfeiture, and (2) transfer restrictions that lapse only if he or she remains in the employ of the company for a specified period. If the employee terminates employment prior to the expiration of the restriction period, then he or she forfeits the shares to the company.

If the employee remains employed by the company until the end of the restriction period, then the forfeiture provision will lapse and the employee will own the stock. A restricted stock plan may also provide that the employee (1) can only sell the stock to the company, and (2) will have to sell the stock to the company when his or her employment terminates.

Internal Revenue Code Section 83(a) provides that an employee receiving stock under such a plan will realize no income for federal income tax purposes at the time of the grant (unless he or she files an election pursuant to Section 83(b)). Rather, the employee will realize income when the restriction or forfeiture provision lapses in an amount equal to the then value per share multiplied by the applicable number of shares. The company issuing the shares will be entitled to a deduction equal to the amount taken into income by the employee (to the extent that the amount constitutes reasonable compensation). Upon the employee's sale of the shares to the company, the employee will also realize income or loss.

d. Stock Appreciation Rights Plan

A stock appreciation rights plan (SAR) is another method of management compensation. An SAR plan operates in a manner similar to that of a phantom stock plan, and has similar tax characteristics. However, in contrast to distributions from a phantom stock plan, distributions from an employee's SAR account are based only on the increase, if any, in the value per share between the date of the award and the date of distribution. While SAR plans use a maturity date as an automatic time for distribution, others allow a employee to choose – within a prescribed period – the timing of the distributions from his or her account.

e. Stock Bonus Plan

Under a stock bonus plan, an employee bonus is contingent upon the issuing company's earnings exceeding a stated level for a specified period. Bonuses under the plan may be contingent on the financial or earnings performance of the company. A stock bonus plan allows a company great flexibility in compensating key employees. For instance, such a plan can provide that if earnings rise above a certain minimum level, the bonus amounts will also increase, thus providing the company employees an incentive to maximize earnings.

The bonuses may be paid in the form of the company's stock or cash, or both. A stock bonus plan can provide that the stock received under the plan can only be sold to the company, and/or must be sold to the company when employment terminates, at a price equal to the value per share at the time of transfer.

An employee receiving shares under a stock bonus plan realizes no taxable income at the time he or she is awarded bonus credits. When the amount of the stock bonus is paid, then the employee will realize ordinary income in an amount equal to the value per share multiplied by the number of shares he or she receives, plus the amount of any cash received.

The company awarding the bonus credits is entitled to a deduction equal to such amount (to the extent it constitutes reasonable compensation). When the employee sells the stock to the company, he or she realizes income or loss, as the case may be.

3. Characterization of Stock Options

a. Seminal California Decisions

Until fairly recently, there was little Texas case law on the issue of characterizing and dividing stock options. Consequently, Texas attorneys faced with the task of characterizing and dividing stock options were required to rely on case law from other jurisdictions, in particular, two seminal California cases, *In re Marriage of Hug*, 154 Cal. App. 3d 780, 201 Cal. Rptr. 676 (1984), and *In re Marriage of Nelson*, 177 Cal. App. 3d 150, 222 Cal. Rptr. 790 (1986).

In *Hug*, which involved both vested and unvested employee stock options, the California Court of Appeals upheld the application of a time-rule formula to determine what percentage of the employee-spouse's stock options (including options granted before the parties' separation), constituted community property. The appellate court emphasized that trial courts have broad discretion to select an equitable method to allocate community and separate property interests. The trial court applied, and the appellate court upheld, the following formula: (*months married during employment*) divided by (*months from date of employment to date options may be exercised*) times (*number of stock options granted*) equals (*number of stock options that are community property*).

It has been stated that *Hug* is both the "earliest case regarding allocation of stock options based on past, present, and/or future service" and the "most widely cited case in the country dealing with stock options in a dissolution of a marriage." *Wendt*, 1998 WL 161165 at *157.

In *Nelson,* the California Court of Appeals essentially followed the reasoning expressed earlier in *Hug*, but differed on the method of valuing options. In *Nelson*, the trial court held that stock options granted and exercisable before the parties separated were wholly community property, options granted before the parties separated but not exercisable until after they separated were partly community property and partly the separate property of the husband (designated "intermediate options"), and options granted after the parties separated were wholly the husband's separate property. To determine the proper apportionment of the intermediate stock options, the trial court used (and the appellate court upheld) a formula, the numerator of which was the number of months from the date of the grant of each block of options to the date of the couple's separation, and the denominator of which was the period from the date of each grant to the date of its exercisability.

Both the *Hug* and *Nelson* formulas are similar to the calculation for retirement benefits utilized by the Texas Supreme Court in *Berry v. Berry*, 647 S.W.2d 945 (Tex. 1983). The *Hug* formula calculates the community portion of the stock options based on the ratio of time from the date of employment to date of vesting, compared to the time married during employment to the date of divorce. The *Nelson* formula calculates the community portion of the stock options based on the ratio of the time from the date of the grant to the date of vesting, compared to the time married, beginning with the date of the grant to the date of divorce.

Following *Hug*, a coverture factor has emerged nationally as a mechanism for apportioning between spouses the benefit or value of unvested stock options, retirement plans or other benefits that were earned partially during and partially after the marriage. *Wendt*, 59 Conn.App. at 666, 757 A.2d at 1234, *citing*, *Short,* 125 Wash.2d 865, 872, 890 P.2d 12. According to *Hug* and its far-flung progeny, a coverture factor is a flexible concept, and no single rule or formula is applicable to every dissolution case involving employee stock options. *Wendt*, 59 Conn.App. at 667, 757 A.2d at 1234, *citing*, *Hug,* 154 Cal.App.3d 780, 792, 201 Cal.Rptr. 676 .

b. Other State Decisions

A minority of State courts holds that options granted during the marriage are entirely marital property. *See, e.g.*, *Green v. Green,* 64 Md.App. 122, 136, 494 A.2d 721 (1985); *In re Marriage of Chen,* 142 Wis.2d 7, 12, 416 N.W.2d 661 (1987);

Smith v. Smith, 682 S.W.2d 834, 837 (Mo.Ct.App.1984) (a stock option is earned when the contract for the stock option is signed, and thus, even though continued employment was required by the husband after the divorce trial to exercise many of the options, all the options were characterized as marital property).

Another minority holds that unvested or unexercisable options are not marital property. *See, e.g.*, *Hann v. Hann,* 655 N.E.2d 566 (Ind.App. 1995) (stock options not exercisable at time of dissolution are not marital property); *Hall v. Hall,* 88 N.C.App. 297, 363 S.E.2d 189 (1987) (unvested stock options granted to an employee which are not exercisable as of the date of separation, and which may be lost as a result of events occurring thereafter, are the separate property of the spouse for whom they may vest, depending upon the circumstances, at some time in the future); *Ettinger v. Ettinger,* 637 P.2d 63 (Okla. 1981).

According to the majority position, however, whether options should be considered part of the marital estate depends on the reason (or reasons) for which they were given. *Baccanti v. Morton*, No. SJC-08442, 2001 WL 901999, at *6 (Mass. April 5, 2001)*, citing, Hug*, 154 Cal.App.3d at 784, 201 Cal.Rptr. 676 ("since the purposes underlying stock options differ, reference to the facts of each particular case must be made to reveal the features and implications of a particular employee stock option"). The majority position reflects that practical reality that options may be given to an employee as compensation for past services (*e.g.*, a project already completed), present services (*e.g.*, accepting employment with the company), future services (*e.g.*, remaining with the company or work to be performed in the future), or a combination thereof. *See, Baccanti*, 2001 WL 901999, at *6 (the Supreme Court of Massachusetts adopted the majority rule, focusing on the parties' respective contributions in acquiring the asset, rather than on the date that the options were granted).

The Supreme Courts of several other states as well have adopted the majority rule. *See, e.g., Bornemann v. Bornemann,* 245 Conn. 508, 5254, 752 A.2d 978 (Conn. 1998) (the Supreme Court of Connecticut observed that "the majority approach that apportions unvested stock options between marital and nonmarital property according to when the options were earned provides the most appropriate method of classification..."); *Davidson v. Davidson,* 254 Neb. 656, 663, 578 N.W.2d 848 (1998) (adopting the majority position in which the court looks to whether and to what extent the unvested options were granted for past, present, or future services, and then determines what percentage thereof was earned during the marriage and what percentage was earned prior to the marriage and/or subsequent to its dissolution); *In re Marriage of Miller*, 915 P.2d 1314, 1319 (Co. 1996) ("...we conclude that to the extent an employee stock option is granted in consideration of past services, the option may constitute marital property when granted....[o]n the other hand, an employee stock option granted in consideration of future services does not constitute marital property until the employee has performed those future services").

In adopting the majority position with respect to the future efforts issue, the Supreme Court of Washington stated:

> To determine how unvested employee stock options are characterized...a trial court must first ascertain whether the stock options were granted to compensate the employee for past, present, or future employment services. This involves a specific fact finding inquiry in every case to evaluate the circumstances surrounding the grant of the employee stock options. Unvested employee stock options granted during marriage for present employment services...are acquired when granted. Unvested employee stock options granted for future employment services are acquired over time as the stock options vest.

Short, 125 Wash. at 873, 890 P.2d at 16.

Many state lower courts have adopted the majority position as well. *See e.g., Batra v. Batra,* 135 Idaho 388, 17 P.3d 889, 893 (Idaho Ct.App. 2001); *Hansel v. Hansel*, 779 So.2d 939, 948-949 (La.Ct.App. 2000), *writ denied*, No. 2001-0279, 2001 WL 401388 (La. April 12, 2001), *reconsideration denied*, No. 2001-0176, 2001 WL 401384 (La. May 25, 2001), *Hansel*, 779 So.2d at 945 (because the trial court found that the stock options granted to the husband served a dual purpose of rewarding him for past service and as an incentive for future performance, the trial court properly ruled that the options should be pro-rated based on the amount of time between the grant date and the vesting date that took place during the community); *In re Marriage of Fatora*, No. CV95-10406, 95-30727, 1998 WL 91883, *7 (Del.Fam.Ct., July 10, 1998) (whether options are community or marital property depends upon the purpose for which they were awarded and not the dates upon which they were granted and vested, other than to the extent that the latter is indicative of the former, and thus the trial court property applied a "time rule" to the division of stock options earned in part during marriage); *DeJesus v. DeJesus,* 90 N.Y.2d 643, 648, 665 N.Y.S.2d 36, 687 N.E.2d 1319 (1997); *Garcia v. Mayer,* 122 N.M. 57, 60-61, 920 P.2d 522 (Ct.App.1996) ("[t]he purpose of awarding options to employees may differ from company to company and may even change from time to time within a single company"); *Salstrom v. Salstrom,* 404 N.W.2d 848, 851 (Minn.Ct.App.1987) (employee stock options granted to one spouse prior to the dissolution of marriage, yet scheduled to vest after the dissolution of marriage, should have been apportioned to reflect their marital and nonmarital aspects).

c. Developments in Texas Law

While *Hug* and *Nelson* were handed down approximately 15 years ago, the courts in Texas have been slow to address the question of the character and value of stock options. Within the last several years, however, Texas appellate courts have issued a number of reported opinions dealing with the characterization of stock options. Consequently, it does not appear that Texas attorneys will be required to continue to rely upon the decisions in *Hug* and *Nelson*. Instead, attorneys can now turn to Texas law to address these matters. As reflected below, however, the issues concerning the character and valuation of stock options are far from settled in Texas.

As commentators have noted, the developing body of Texas authority on the characterization and division of stock options in divorce has uniformly applied the inception of title rule, but none of the reported cases has involved pre-marriage grants of options, nor have any of the courts involved been presented with evidence that the court found sufficient to indicate that the options were granted in consideration of future services. *See,* Warren Cole and Brenda Keen Schwartz, *Tophats, Handshakes and Handcuffs*: *Identifying and Dividing the Different Executive Compensation Plans*, p. 24, 27th ANNUAL ADVANCED FAMILY LAW COURSE (2001) [hereinafter "Cole and Schwartz"].

(1) *Myklebust v. Myklebust*

In *Myklebust v. Myklebust*, 605 S.W.2d 397, 397 (Tex.Civ.App.–Houston [14th Dist.] 1980), *rev'd on other grounds*, 615 S.W.2d 187 (Tex. 1981), the ex-wife appealed the grant of summary judgment against her in a post-divorce enforcement action in which she alleged that the former husband had concealed the existence of valuable stock options received in the course of this employment during marriage. Without further [any] analysis, the Houston Fourteenth Court of Appeals stated that "[t]he options were earned during coverture, and thus were community property." *Id.* It would appear that, in 1980, the complexities of stock options, at least in the context of community property law, had not yet reared its ugly head.

(2) *Marriage of Joiner*

In *Matter of Marriage of Joiner*, 755 S.W.2d 496, 498 (Tex.App.–Amarillo 1988), *on reh'g*, 766 S.W.2d 263 (Tex.App.–Amarillo 1988, no writ), the Amarillo Court of Appeals considered the proper characterization and division of the husband's stock plan. Under the terms of the husband's plan, a 20% interest in the employee's

account vested after six years of service, *i.e.*, after the first fiscal year of participation in the plan, and a 20% interest vested each year thereafter until the tenth year of service, *i.e.*, the fifth fiscal year of participation in the plan, when the account became 100% vested. Prior to marriage, the husband had worked six and one-half years for his employer. *Id.*

On appeal of the parties divorce decree, the appellate court distinguished the husband's stock plan from military retirement or pension plans under which benefits are earned by reason of years of service, on the grounds that the husband's stock plan provided that benefits were not earned during the five-year period of employment required for participation in the plan, but rather provided that an employee first acquired a vested interest in the benefits of the plan at the end of the sixth fiscal year of employment. *Id.* at 698. Thus, according to the Amarillo Court of Appeals, the initial five-year employment period only generated a mere expectancy which, by not fixing any benefit in any sums at any future date, was not a property interest to which property laws apply. *Id.* Since the character of property as separate or community is fixed at the very time of acquisition, the appellate court continued, the crucial time for determining the character of interests in and benefits of the plan was the time when the vested interests were acquired. *Id.*

Thus, held the Amarillo Court of Appeals, a 20% interest in the benefits of the husband's plan was acquired and vested at the end of the husband's sixth year of employment (prior to marriage), and a similar 20% interest was acquired and vested on each year thereafter for four more years, at which time the plan account was fully vested. *Id.* Because the initial 20% interest was acquired and vested while the husband was a single man, it was his separate property, and the remaining 80% was acquired and vested during the marriage, and thus was community property. *Id.* In *Joiner,* then, the appellate court adopted and advocated a time rule formula to determine the community's interest in a profit-sharing stock plan.

On rehearing, the wife contended that the inception of title doctrine–*i.e.,* the character of property interests in the plan as separate or community is fixed at the time the vested interests are acquired–was not applicable to situations involving retirement or pension benefits. 766 S.W.2d 263. Rejecting the wife's argument, and re-affirming that the inception of title doctrine was applicable to the husband's stock plan, the Amarillo Court of Appeals noted that its focus was on the characterization of the separate property-community property interests in the husband's plan, which was relevant to the trial court's decision in dividing the community estate in a manner deemed just and right. *Id.* The appellate court stated that it did not measure the monetary value of the interests, a matter to be proved in the trial court, nor prejudge an apportionment of the value of the community interest, a matter reserved to the discretion of the trial court. *Id.* at 263-264. The Amarillo court also stated that its decision did prevent a party from offering proof that under the peculiarities of the plan–*i.e.*, the amount of annual contributions being dependent upon the company's profits and the husband's salary, as well as upon the performance of the stock purchased with the contributions–there was an increase in the value of the husband's separate property interest which was attributable to his employment during marriage, giving the community an interest in the increased value which was subject to division by the trial court. *Id.* at 264.

(3) *Demler v. Demler*

In *Demler v. Demler,* 836 S.W.2d 696, 699 (Tex. App.–Dallas 1992, no writ), the Dallas Court of Appeals recognized that stock options earned during the marriage ***may*** constitute community property subject to a "just and right" division upon divorce. For such proposition, the Fifth Court of Appeals cited none other than *Myklebust*. Since the husband testified that the options at issue had been awarded to him during marriage, the Dallas appellate court held that the trial court erred in failing to divide the options. *Id.*

Demler is of little guidance in determining how to handle the division of stock options. It is unclear in *Demler* whether the options were vested or unvested. Moreover, it is not apparent what authority, if any, was offered to the trial court on the

issues of characterization and allocation of the options.

(4) *Bodin v. Bodin*

In *Bodin v. Bodin,* 955 S.W.2d 380 (Tex.App.–San Antonio 1997, no writ) the appellate court affirmed the property division awarding the wife an interest in unvested stock options holding that "the unvested options constitute a contingent interest in property and are a community asset subject to consideration along with other property in the disposition of the parties estate." In *Bodin,* the husband argued that because the stock options were unvested, could not be exercised at the time of divorce, and were contingent on his continued employment after the divorce, they constituted his separate property. In rejecting the husband's argument, the appellate court compared the unvested options to unvested retirement benefits in *Cearly v. Cearly,* 544 S.W.2d 661 (Tex. 1976), and found that the options were community property. Citing *In re Marriage of Hug,* 154 Cal. App.3d 780, 201 Cal. Rptr. 676, (1984), as well as a multitude of cases from other jurisdictions, the court indicated that the conclusion that the options were community property was supported by the decisions of the majority of courts that have considered the question.

While the *Bodin* case answers the question as to whether unvested stock options are property subject to division by the trial court in a divorce, like *Demler,* it provides little insight into how the options should be apportioned, *i.e.,* for example, whether a time apportionment formula is appropriate.

(5) *Charriere v. Charriere*

In *Charriere v. Charriere*, 7 S.W.3d 217, 218 (Tex.App.–Dallas 1999, no writ), the wife was granted options to purchase 80,000 shares of stock at $2.50 a share. *Id.* According to the stock option agreement, the options were "exercisable [at] any time"; however, the stock was subject to various transfer restrictions that prohibited the wife from selling it without the company's consent. *Id.* The transfer restrictions lapsed gradually over time (at the rate of ten percent per year) and, as a result, acted as an incentive for the wife to remain employed with the company. *Id.* Further, under the agreement, if the wife terminated her employment with the company, two things would happen: (1) she would have three months from the date of her termination to purchase any options that were no longer subject to the transfer restrictions; and (2) her option to purchase those shares still subject to the transfer restrictions would terminate immediately. *Id.* at n. 2. If the wife had previously exercised her option to purchase any shares still subject to the transfer restrictions, the company had the right to "repurchase all or any portion" of those options at the wife's cost. *Id.*

When, some years later, the husband sued for divorce, 64,000 shares remained subject to the transfer restrictions. *Id.* Following a trial on the merits, the trial court (1) determined that the wife's options to purchase the shares were community property, and (2) divided them equally between the husband and wife. *Id.* The wife appealed the award of one-half of the 64,000 stock options on the grounds that (1) the options could not be classified as community property; and (2) their value, if any, was dependent on her post-divorce activity (*i.e.*, employment with the company). *Id.* On appeal, the Dallas Court of Appeals affirmed the trial court's finding that all 64,000 stock options belonged to the community estate, as well as its award of half of the options to the husband. *Id.*

The Fifth Court of Appeals begin its analysis by noting that in *Demler,* 836 S.W.2d at 699, it had held that stock options earned during marriage may be community property subject to a "just and right" division upon divorce, but noted further that, in *Demler*, it was not faced with the precise issue presented in *Charriere*, *i.e.,* whether stock options that depend for their value, at least in part, on one spouse's post-divorce employment are still community assets. 7 S.W.3d at 219.

The option agreement provided that the options granted to the wife were exercisable any time after the grant date and before the "option termination date," and thus were exercisable during the marriage. *Id*. at 220. In addition, once the wife exercised her option, she enjoyed "ownership of the

shares," including the right to vote the shares and receive dividends. *Id.* According to the Dallas Court of Appeals, therefore, the optioned shares were available for purchase during the marriage, and, once purchased, included potentially valuable rights. *Id.*

The appellate court concluded that the options, which were acquired and exercisable during marriage, were community property subject to division as part of the parties' community estate, and that the wife presented no clear and convincing evidence to the contrary. *Id.* The Fifth Court of Appeals reached such conclusion even though the wife, to the extent the value of the options was dependent on her post-divorce employment, effectively controlled the value of those options to the husband (she could terminate her employment and effectively deprive him–and herself–of any value those options would have had over time). *Id.* at n. 6. However, stated the appellate court, the fact that the value associated with some or all of the options could be forfeited by the occurrence of certain contingencies (the wife's termination of employment with the company) did not divest the options of their status as community property. *Id*.

To the Dallas Court of Appeals, there was "no question" that the community owned the stock options at the time of the divorce. *Id.* at 220. The appellate court cited *Bodin* as support for its position, noting that, like the options in *Bodin,* the options in *Charriere* were received during the marriage and their value was, in large part, contingent on post-divorce employment. *Id.* at 220-221. However, unlike the options in *Bodin*–and persuasive to the Fifth Court of Appeals–the options in *Charriere* were completely exercisable during the marriage. *Id.* at 221.

The Dallas appellate court necessarily rejected the wife's argument that classifying the options as community property was improper because the options had no value apart from her post-divorce personal services (due to the "admittedly"onerous transfer restrictions). *Id.* Although the wife analogized the options to "professional goodwill" and "professional degrees," in that their "value" depends upon post-divorce efforts (an analogy the appellate court rejected by remarking that options are "fundamentally different" from goodwill or degrees, which were intangible property), *Id.* at n. 7, she cited no authority, and the Fifth Court of Appeals found none, for the proposition that the characterization of property as either community or separate is somehow dependent on the value of the property at the time of divorce. *Id*. at 221. Rather, according to the Dallas appellate court, in Texas, property is characterized as "separate" or "community" based on the time title to the property is acquired. *Id.* To hold otherwise would require trial courts to engage in some type of "value analysis" when classifying property as either "community" or "separate," and such an approach, unsupported by any legal authority, in the view of the Dallas Court of Appeals, would unnecessarily complicate the already difficult determination of the proper characterization of options. *Id.* at n. 8.

The appellate court also rejected the wife's suggestion that it analogize the stock options to retirement benefits and, as with retirement benefits, allocate them proportionally between the parties on a "time rule" basis because, unlike retirement benefits, the stock options were not benefits earned over the entire period of the wife's employment, but had already been earned. *Id.* at 221-222. Since the value of the options was fixed and could not be changed except by market forces, the Dallas appellate court concluded that (1) the options were distinguishable from retirement benefits, and (2) treating them the same would therefore be improper. *Id*.

(6) *Kline v. Kline*

In *Kline v. Kline,* 17 S.W.3d 445, 446 (Tex.App.–Houston [1st Dist.] 2000, pet. denied), the Houston First Court of Appeals affirmed the trial court's determination that unvested stock options were community property. The appellant argued on appeal that the trial court had divested him of his separate property because the right to receive the unvested options was conditioned upon the appellant's continued employment post-divorce. *Id.*

The appellant conceded that if stock options are awarded in consideration for past services, the

options are community property and are subject to being divided upon divorce. *Id*. The appellant argued, however, that if options are awarded as an incentive for continuing employment, the options are separate property. *Id*.

Relying on the opinion of the San Antonio Court of Appeals in *Bodin,* the First Court of Appeals held that the although the stock options were contingent on the husband's continued employment, the options were a community asset subject to division by the trial court. *Id*. at 446-447.

The appellant in *Kline* attempted to distinguish *Bodin* on the grounds that at trial he presented uncontroverted expert testimony that the options had not been granted for past services. *Id*. at 446. In addressing such argument, the Houston appellate court noted that, in the absence of findings of fact and conclusions of law, the fact that the recitals in the stock agreements themselves reflected that the option were given for past service was sufficient to support the trial court's judgment. *Id*. at 447.

4. Valuation

Courts across the country have used a variety of methods to value employee stock options. *Davidson v. Davidson*, 254 Neb. 656, 668, 578 N.W.2d 848, 858 (Neb. 1998). One state appellate court has summed up the difficulties in valuing stock options as follows:

> Quantifying the value of a stock option at the time of its grant is a complex task, subject to the vagaries of market forecast and compounded by the fact that no ready market can exist for nontransferable stock options. The IRS resolves the difficulty of valuing a nontransferable stock option by waiting until the option is exercised, at which time there is a recognition of income equal to the difference between the option price and the fair market value of the stock at the time of the exercise. At the moment that the income is recognized, a fair market value can be assigned to the stock option.

Montgomery, 104 Ohio App.3d 776, 663 N.E.2d at 392. Moreover, the Supreme Court of Pennsylvania recently stated:

> We agree with [the lower courts] that it is impossible to ascribe a meaningful value to the unvested stock options, primarily because it is absolutely impossible to predict with reliability what any stock will be worth on any future date. Ascription of a value to a stock option before it vests is impermissibly speculative.

Fisher v. Fisher, 769 A.2d 1165, 1169 (Pa. 2001).

It has been opined that estimates of option values are a species of "soft information" that is derived from sources such as the specific terms of a plan (including when and for how long options are exercisable), historical information concerning the volatility of the securities that will be authorized to be optioned, and debatable assumptions about the future. *See, Lewis v. Vogelstein*, 699 A.2d 327, 336 (Del.Ch. 1997).

Note that, In 2001, the Texas Legislature enacted §6.711 of the Family Code, which provides that in a suit for dissolution of a marriage in which the court has rendered a judgment dividing the estate of the parties, on request by a party, the court shall state in writing its findings of fact and conclusions of law concerning: (1) the characterization of each party's assets, liabilities, claims, and offsets on which disputed evidence has been presented; and (2) the value or amount of the community estate's assets, liabilities, claims, and offsets on which disputed evidence has been presented. Section 6.711 takes effect September 1, 2001, and applies to a suit for dissolution of a marriage pending on that date or filed on or after that date. Thus, the new amendment to the Family Code apparently will require, if either party so

requests, that the trial court value employee stock options, despite the difficulties in doing so.

Although the valuation issue is difficult, and although there are a number of methodologies by which values can be assigned to options, three general approaches stand out, and a fourth is sometimes possible.

a. Intrinsic Value

An option's intrinsic value is obtained by subtracting the exercise price from current market price of publicly traded stock and multiplying that by the number of shares of the stock option. *Wendt*, 1998 WL 161165 at *192*; see also*, G. Daniel Jones and Melvyn Frumkes, *Dividing Stock Options*, p. 4, AMERICAN ACADEMY OF MATRIMONIAL LAWYERS MARCH MEETING (2001) [hereinafter "Jones and Frumkes"] (intrinsic value represents the difference between the current stock price and its strike, or exercise, price). However, according to Judge Tierney in *Wendt*, the intrinsic valuation method does not take into account two factors: (1) risk of investment, and (2) volatility of the stock price. 1998 WL 161165 at *192. To the illustrate such weakness in the intrinsic value method, Judge Tierney proposed in *Wendt* the following scenario:

> If a stock option grant was given at a $50 per share rate on December 1, 1995, and the stock price on October 1, 1997 was $50, that stock would have zero intrinsic value. Inherent in stock options is the right to be able to acquire that stock at sometime in the future, presumably when its price had increased. If that same stock had an ability to grow and it was exercisable on December 1, 1999, no doubt that stock option would have some market value on October 1, 1997 even though it had no intrinsic value as of October 1, 1997.

Id. As a result, Judge Tierney concluded that intrinsic value is an inadequate method of evaluating stock options in a marital context. *Id*.; *see also*, Jones and Frumkes, p. 4 (intrinsic value is "[n]ot generally accepted"); *Fisher,* 769 A.2d at 1171 (Newman, J., concurring) ("[t]he majority appears to believe that the intrinsic value method is too speculative, and I agree").

Despite articulated reservations–"[i]t appears that...the intrinsic value...is [not] useful to obtain a value of employment issued unvested stock options in a marital setting, *Wendt*, 1998 WL 161165 at *199–he ultimately used it in the case. *See, Wendt,* 757 A.2d 1232, at n. 3. Moreover, intrinsic value has been used by other courts in divorce settings. *See*, Geoffrey S. Poll, *Tax Traps/Tax Tricks and the Complex Property Case*, sec. 4, NEW FRONTIERS IN MARITAL PROPERTY LAW (2000) [hereinafter "Poll"], *citing*, *Richardson v. Richardson,* 280 Ark. 498, 659 S.W.2d 510 (1983) (awarding amounts to the spouse with respect to unexercised stocks options based on their intrinsic value); *Smith,* 682 S.W.2d at 836-37 (containing a calculation of the value of vested and unvested stock options based on the intrinsic value method).

b. Discount to Present Value

Another possible valuation methodology for options is termed "discount to present value." *See, Wendt*, 1998 WL 161165 at *192. In the discount to present value method, the intrinsic value of the option is determined, then various discounts, *i.e.*, risk of forfeiture, lack of marketability, and tax consequences, are applied to the intrinsic value in order to obtain the present value. *See, Id*. at *193.

Judge Tierney's opinion in *Wendt* recites that discount to present value method was used in an unpublished New York decision, *Evans v. Synder*, 207 N.Y.L.J. 21, April 15, 1992 (N.Y. Sup.Ct. 1st Dept 1992), which was affirmed without opinion, 197 A.2d 389, 603 N.Y.S.2d 740 (1993). Judge Tierney also states that, although the trial court in *Evans* set forth in detail the discount to present value calculations (which had reduced the stock's intrinsic value of $3,837,500.00 to a present value

of $1,654,730.00), the trial court did not actually compute and divide the present value of the restricted stock issue, but rather awarded the wife "a portion of the stock at the time a transfer is possible." *Wendt*, 1998 WL 161165 at *193. Judge Tierney ultimately concluded that "[t]he present value/discount method appears to be a viable method of valuing unvested stock options and/or restricted stocks if there is sufficient supporting data to justify the use of the various discounts." *Id*. at *199 (although, as already mentioned, Judge Tierney himself employed the intrinsic value method in *Wendt*).

In *Hansel*, 779 So.2d at 948-949, the trial court did not error by finding that discount to present value method advocated by the husband more fairly and accurately established a present value of unvested stock options than did the Black-Scholes model [discussed below] advocated by a the wife. Further, the trial court did not error by applying a 23% discount to restricted stock owned by the parties, rather than the lesser discount of 10% argued by the wife. *Id*. at 949.

c. Black-Scholes Option Pricing Model

There are several sophisticated methods which are used to determine the exact value of a particular stock option. *Wendt*, 1998 WL 161165 at *193. The most generally accepted mathematical (theoretical) model used to value options is termed the "Black-Scholes Model," named after its creators, who first published the methodology in 1973. Jones and Frumkes, p. 3. The model is "complicated," and its "imposing algebra" requires six inputs of data, most often done by computer. *Id.* In fact, of the Black-Scholes Model, Judge Tierney comments:

> It appears to a layman to be one of the most complicated formulas ever devised by mankind. It is hardly useful for a court to consider with a simple calculator on the bench. It would require expert computation.

Wendt, 1998 WL 161165 at *195.

The Black-Scholes Model relates the value of an option to six factors: (1) exercise or strike price; (2) current stock price; (3) the dividend yield for the particular stock; (4) the time to expiration; (4) the current risk free market rate of return; and (6) the future volatility (standard deviation) of the particular stock. Jones and Frumkes, p. 3; *see also*, *Wendt*, 59 Conn.App. at 663, 757 A.2d at 1223, n. 4, *citing*, *Snyder v. Commissioner,* 93 T.C. 529, 540, 1989 WL 129656 (1989) (the Black-Scholes method of valuation "is a complex formula which reflects the interrelationship of the fair market value of the stock to be purchased, the exercise price of the option, the amount of dividends to be paid on the stock over the life of the option, the 'risk-free' rate of return at the time the option is granted, the volatility of the stock to be purchased, and the term of the option").

However, the Black-Scholes model makes a number of assumptions that are not relevant to placing a value on nonvested stock options in a marital setting: (1) the value of the option has nothing to do with expectancies about the future price of the underlying stock (a purchaser of an option would not buy that option merely because of a belief that the price of the stock will rise), (2) there must be a known market for the asset, and (3) there must be prior history of the trading price for both the underlying stock and the option being evaluated. *Wendt*, 1998 WL 161165 at *196. In *Wendt*, Judge Tierney concluded: "[t]he Black-Scholes model is not an appropriate method of evaluating employment issued unvested stock options in a marital setting." *Id*. at *197.

Judge Tierney's observations notwithstanding, the Black-Scholes Model has been applied in divorce cases. In *Davidson*, 254 Neb. at 669, 578 N.W.2d at 858, the Supreme Court of Nebraska held that the trial court did not abuse its discretion by applying the Black-Scholes Model to value the husband's employee stock options, where the husband's own accountants used the method, the wife's expert used the method, and the company used the method for it proxy statement.

On the other hand, the trial court in *Chammah v. Chammah*, No. FA 95145944S, 1997

WL 414404 at *6 (Conn.Super., July 11, 1997) stated:

> The court finds that the Black-Scholes method was created in 1973 for the purpose of evaluating stock options traded on the public market. The Black-Scholes method involves various components. Involved in the formula are the analysis of dividends, the volatility of stock and the lack of a known market for these "contingent resources." The Black-Scholes method also has a number of variations. No one Black-Scholes formula exists. The Black-Scholes method does not appear to be an accurate method for evaluating employment issued stock options in a marital context."

In *Fisher,* 769 A.2d at 1172, Justice Newman wrote a concurring opinion in which he stated:

> I have discussed discounting to present value and the Black Scholes model simply to illustrate that there are alternatives to the unacceptably speculative intrinsic value method employed by [the wife's] expert in this case....I reiterate that if parties provide the trial court with expert testimony that cogently sets forth how a present value can be assigned to stock options, it is within the court's discretion to accept that testimony and order immediate distribution of the marital assets.

All this said, it should be recognized that several inherent problems plague the Black-Scholes model in determining employee stock option values. Cole and Schwartz, at p. 28. For example, it was developed for European-style options, which are exercisable only at their expiration date with no vesting and transferability restrictions, whereas almost all U.S. employee stock options can be exercised at any time after vesting (usually by year seven or eight) and are rarely transferable. *Id*. In addition, employee stock options can almost never be sold or traded, unlike publicly traded options. *Id*. Finally, and most importantly, the Black-Scholes model attempts to predict future price volatility based on the stock's past performance over a specified period. *Id*.

d. Market Value

Options to purchase or sell shares of major public corporations are freely traded on public stock markets, but, in the case of a Texas divorce, nontransferable stock options generally will be involved, which only the owner or the owner's estate can exercise.

However, even options from smaller companies are sometimes traded on a market. As a result, the "market comparable approach" as one court has termed it, bases the value of stock options on their worth in a secondary market' such options, known as warrants, are publicly traded and bring a price distinct from the value of the underlying stock. *Banning v. Banning*, No. 95 CA 79, 1996 WL 354930, at *6 (Ohio.App., June 28, 1996). The market comparable approach uses the price of publicly traded stock options from the same company as of the date of the trial or divorce, but although the market approach is a good measure of the value, the necessary information is rarely available and, therefore, such method is not often used. *Id*.

5. Division

In *Callahan v. Callahan*, 361 A.2d 561, 563 (N.J. Super.Ct.Ch.Div. 1976), the New Jersey Superior Court observed:

> [t]he more perplexing problem facing the court is determining the manner of distribution, recognizing the restrictions of the plan and considering [the husband's] argument that conversion of the

> options requires an expenditure on his part.

Indeed, the division of stock options can be perplexing, particularly when the options are non-transferable. *Banning*, 1996 WL 354930 at *6. It has been observed that courts generally presume that valuing options is necessary to make sure that one party does not get more than his or her fair share of the marital property, but valuation is often unnecessary, since the court can ensure that the parties do not get more than their fair share by how it distributes the options. *Id*. at *8.

a. In Kind

One commentator suggested a few years back that perhaps the "easiest" out for a trial court dividing stock options was a division in kind. Brenda Keen Schwartz, *Executive Compensation*, p. 22, 25th ANNUAL ADVANCED FAMILY LAW COURSE (1999). This year, however, that same commentator joined another to caution that,

> [a]lthough at first blush, dividing employee benefits "in kind" might appear less risky than evaluating the asset and making an offsetting award of other assets, it is critical that the attorney recognize the myriad complexities of the particular benefit being divided.... Due to the fact there are infinite variations of stock option grants and other executive compensation plans, it is impossible to provide hard and fast detailed methodology for division that would be appropriate in all cases.

Cole and Schwartz, at p. 28.

These same commentators have noted that an "un-QDRO" might be appropriate to divide stock options. *Id*. Even though most stock options are not ERISA based "qualified" plans, and so in general a QDRO is not available as a tool for division, and most options are non-transferable, some companies have adopted nonetheless rules affecting these plans under which the administrator may accept and honor a "domestic relations order," so long as the order contains the same information and otherwise meets the standards of the qualified plan. *Id*.

In *Fisher*, 769 A.2d at 1169, the Supreme Court of Pennsylvania considered whether to distribute the husband's unvested options according to the parties' martial proportions. The Pennsylvania Supreme Court noted that such an approach would alleviate the troublesome necessity of valuing the options, but determined that the immediate distribution of the options was not possible because the husband's options were nontransferable, indivisible, had to be exercised while the husband remained in the employ of his employer, and would expire upon his death. *Id*. at 1169-1170.

b. Offset

The trial court might award all the options of whatever nature to one party, and award the other party a cash offset or an offset of other property, if such assets are available. In *Wendt*, 59 Conn.App. at 655, 757 A.2d at 1234, the Connecticut appellate court affirmed Judge Tierney's award to the wife of cash offsets of $1,017,000.00 and $1,700,000.00 for unvested and vested options, respectively, which were awarded in their entirety to the husband.

In *Fisher,* 769 A.2d at 1169, the Supreme Court of Pennsylvania discussed what it termed the "immediate offset" distribution method, in which a present value would be assigned to the options and then such value would be divided in accordance with each party's marital proportion determined appropriate to effectuate economic justice. Although the "immediate offset" method had the commendable quality of finality, because it made a final disposition at the time of distribution, and did not need to take account of future fluctuations in stock prices or other contingencies which may affect the value on the dates when the stock options might be exercised, the method required that the value of the options be known. *Id*. Because, as mentioned above, the Pennsylvania Supreme Court had already determined that no value for unvested stock options

can be established without unjustifiable assumptions which render the value impermissibly speculative, the "immediate offset" approach was not a viable one. *Id.*

c. If, As and When

Many Texas commentators espouse the "if, as, and when" method of division. For example, according to several:

> Thus, it seems the best solution for drafting purposes would be the use of an appropriate apportionment formula applied to the stock, if as and when available for purchase. The non-employee spouse would be required to advance the funds for his or her share of the stock to be purchased by the employee spouse serving in the capacity of constructive trustee. The failure to advance the purchase price would result in the forfeiture of his or her share of the option.

See, J. Lindsey Short, Scott T. Cook, Milton Frankfort, Kenneth D. Fuller, and Brenda Keen Schwartz, *Complex Executive Compensation Plans*, p. 15, NEW FRONTIERS IN MARITAL PROPERTY LAW (1997) [hereinafter "Short, *et. al.*"]; *see also*, Jones and Frumkes, at p. 11 (the if, as and when method is generally fair to both spouses, especially in light of the market decline in 2000, which has resulted in many options once "in the money" being "underwater"; waiting for the options, which are held in a constructive trust, to regain their value will be equitable result for both parties); *see also,* Poll, at section 4 (the options can be exercised on an if, as and when basis with the non-employee spouse having control over the timing of the options' exercise, the options being maintained in a constructive situation with the employee spouse acting as trustee); *see also and cf., Banning*, 1996 WL 354930 at *7 (the options had value even though they were "underwater" at the time of trial).

In *Baccanti*, 2001 WL 901999, at *9 (citations omitted), the Supreme Court of Massachusetts stated:

> Although a present division of assets is generally preferable, if present valuation is uncertain or impractical, as it often will be with unvested stock options, the better practice is to order that any future recovery or payment be divided, if and when received, according to a formula fixed in the property assignment....We leave it to the judge's discretion to determine in each case whether a present value can be assigned to the options or whether it is more practical and equitable to divide the proceeds (stock or cash derived from the sale of the stock) if and when the options vest and are exercised.

Such "wait and see" methods have been praised because they avoid coercing the option-holder into exercising the options at a time that he or she would not have chosen to do so, and because they assign equally the risk that the exercise of the options may not be profitable and the benefit if they are lucrative; such arrangements, however, are not perfect. *Banning*, 1996 WL 354930 at *7. One negative aspect of such methods is that they do not totally split all of the property to allow the parties a clean break to start their new lives, and, in fact, require that the parties maintain some contact after they are divorced. *Id.*

With respect to the constructive trust approach, in *Callahan*, 142 N.J. Super. at 330-331, 361 A.2d at 564, the wife was awarded 25% of each of the husband's options; the court ordered the husband to act as trustee for the wife. Further, the husband was to exercise the wife's share of the options only at her direction, the wife was required to supply the husband with the funds necessary to make the purchase, and the husband was ordered to pledge the stock at the wife's request should she wish to utilize it to finance her purchase. 142 N.J. Super. at 331, 361 A.2d at 564; *see also, Banning*,

1996 WL 354930 at *6 (some courts give the spouse benefitting from the constructive trust the right to choose if and when his or her portion of the stock options will be exercised; to do so, the court orders the option holding spouse to only exercise the other spouse's options at his or her direction, while the receiving spouse must provide the option-holding spouse with the necessary funds to exercise the options and to cover any taxes) Once exercised, the husband in *Callahan* was to hold the stock in trust for the wife. *Callahan*, 142 N.J. Super. at 331, 361 A.2d at 564.

The trial court in *Callahan* also ordered that, following the exercise of the option, the wife could require the husband to transfer the stock held in trust to her, or sell it on the market and turn over the proceeds, with two restrictions: (1) the wife could not order a transfer of the stock to her, or a sale of the stock, within six months of its acquisition, so as not to violate the Securities and Exchange Commission's "insider trading" rules, and (2) if the transfer of the trust stock to the wife, or a sale on the market for her benefit, resulted in tax liability to the husband, the wife was to hold the husband harmless from such liability. 142 N.J. Super. at 331, 361 A.2d at 564.

It should be noted that some constructive trust arrangements have been particularly criticized as creating a relationship tantamount to a partnership, because they require some communication and cooperation between the parties after they are divorced, which one or both of the parties may not desire. *Banning*, 1996 WL 354930 at *7.

As a drafting matter, agreements (or decrees) should address several issues: (1) which options are marital and which are not; (2) whether the non-employee spouse can direct the owner to exercise and/or sell the options after vesting but before expiration; (3) the determination and allocation of tax consequences; and (4) when and how the net proceeds will be collected and distributed. Jones and Frumkes, at pp. 11-12.

d. Tax Consequences

Callahan raises the issue of the tax consequences involved in the division of stock options. Tax consequences can be astronomical in today's economic market. For example, in *Hansel*, 779 So.2d at 944, the trial court disallowed tax consequences because it found the amount of taxes to be speculative. On appeal, the Louisiana appellate court found that the rate of taxation was no more speculative than the value of the stock options themselves, and stated that recognizing the speculative value of a stock option, but refusing to recognize the speculative rate of taxation on the value of those options, was simply inequitable. *Id*. Accordingly, held the appellate court, the trial court erred in failing to consider the income taxes that must be paid when the stock options are exercised. *Id*. By so holding, the Louisiana appellate court saved the husband over $5 million. *Id*. at 946.

B. Phantom Stock

1. In General

Under a "phantom stock" plan, hypothetical shares of a company's stock are allocated by book entry to the account of an employee. No actual cash or shares of stock are set aside by the company to fund future distributions.

If the employee remains with the company until the end of the restriction period, then the phantom shares are converted into actual shares or cash, or both. Again, the company may use a restriction period to prevent any employee leaving within a set period of years from receiving any stock or cash.

To the extent that the phantom shares are distributed in cash, they are valued using the existing value per share of the company's stock. Shares distributed to an employee may be restricted so that they may be sold only to the company, and/or must be sold to the company when the employee's employment terminates.

An employee receiving a phantom stock grant realizes no taxable income at the time of the award. The employee is taxed at ordinary income tax rates when distributions are made from the

phantom stock account. If shares are later sold to the company, the employee will realize income or loss, as the case may be, with capital gains tax being payable on any income so realized.

2. Characterization

The inception of title rule should apply to a phantom stock agreement. For example, in *In re Marriage of Leisner*, 219 Ill.App.3d 752, 579 N.E.2d 1091, 162 Ill.Dec. 277 (Ill.Ct.App. 1991), the husband received over $400,000.00 pursuant to a phantom stock agreement with his employer executed during marriage. The agreement stated that the employer found it "desirable to encourage and reward [the husband] in a manner that will stimulate his active interest in the development and financial success of the Company and strengthen his desire to remain with the Company." 219 Ill.App.3d at 754, 579 N.E.2d at 1092, 162 Ill.Dec. at 278. The agreement further provided that if employer-business was not sold by a particular date, the husband was to receive a promissory note from it for an amount equal to the value of 20 shares of its common stock (hence the term "phantom stock agreement"), plus "a sum...equal to the amount of cash which the husband would have received on account of [any cash dividends upon the common stock of the company which would have been declared and paid prior to the date of sale of the company]...had he been the owner of...[such 20 shares]." 219 Ill.App.3d at 755, 579 N.E.2d at 1092, 162 Ill.Dec. at 278.

In essence, the trial court found that the agreement had been executed during marriage, and the therefore all proceeds thereof were marital property, a decision upheld by the appellate court on appeal. 219 Ill.App.3d at 759, 579 N.E.2d at 1095, 162 Ill.Dec. at 281. The result would be much the same under Texas law.

3. Valuation

In *Liesner*, 579 N.E.2d at 1099, the husband argued that the trial court, in determining that all the proceeds from the phantom stock plan were marital property, failed to consider that he had already paid $105,000.00 in taxes on the proceeds and still owed another $20,000.00. The appellate court noted that, under Illinois law, the trial court was not obligated, when ***valuing*** an asset, to deduct from that value the amount of taxes which were paid on it; rather, the trial court was required to consider the tax consequences of the property ***division***. *Id*.

4. Division

There are no reported cases discussing the division of phantom stock in a divorce. Presumably, such stock will be divided under the settled principles of Texas law, as discussed hereinabove.

C. Golden Handcuffs

Essentially, "golden handcuffs" are a benefit package, often involving stock options, designed to ensure that an employee remains with the employer. *See*, *e.g.*, *In re Marriage of Harrison*, 179 Cal.App.3d 1216, 1227, 225 Cal.Rptr. 234, 240 (Cal.Ct.App. 1986), *review denied* (July 9, 1986) (the court was satisfied that the option represented "golden handcuffs" to assure the husband would stay with the company); *cf., Wendt,* 59 Conn.App. at 668, 757 A.2d at 1235 (where the trial court found that unvested shares were granted partially for present, but largely for future services, the options could not be categorized solely as "golden handcuffs").

As stated by the trial court in *Wendt*, 1998 WL 161165 at *158:

> Stock options for future compensation can include: specific language to that effect in the grant documents, long term retention of key executives, increasing the executive's incentives and efforts, providing security for the executive and "golden handcuffs."
>
> This type of option for future compensation is granted to insure the employee's continued employment and future productivity. The valued employee is offered an incentive to remain

> with the company because if he is no longer with the company the "golden handcuff" option terminates with no payment to the employee. These incentive stock options, awarded now, but for labor to be expended in the future, beyond the date of dissolution are not divisible. Evidence of the future nature of the option is usually found in the language of the option grant or employment agreement.

It should be immediately noted that *Charriere* deals with classic "golden handcuff," *i.e.,* options that are presently "vested," but the underlying subject stock of which is onerously restricted. Recall that in *Charriere*, the Dallas Court of Appeals held that such options were entirely community property. The California case of *Harrison* suggests, at the very least, that the Dallas Court of Appeals' approach to such "golden handcuffs" is not the only approach available.

In *Harrsion*, the husband was awarded, during the marriage, nonqualified options to company stock, fully exercisable on the day of the grant. 179 Cal.App.3d at 1224, 225 Cal.Rptr. at 238. However, any stock issued was subject to restrictions providing for forfeiture to the corporation if the employee were terminated for cause or were to leave voluntarily without corporate consent. Such forfeiture provisions lapsed in 20 percent increments, starting two years after the stock was issued, and did not apply if the employee died, was terminated without cause, or left corporate employment voluntarily with corporate consent. *Id.* The trial court applied a "*Hug*" time apportionment formula referring to the time the options were granted until the time the restrictions to the subject stock lapsed. 179 Cal.App.3d at 1223, 225 Cal.Rptr. at 237.

On appeal, the California appellate court noted that since the stock was subject to restrictions, it was not "vested," but that the options, on the other hand, were vested. 179 Cal.App.3d at 1225, 225 Cal.Rptr. at 238. For this reason, the trial court's formula referring to the vesting dates of the options was wrong, although harmlessly wrong, since the formula could be–and was–modified to refer to the date upon which the restrictions on the stock issued pursuant to the options were removed. *Id*. After such modification, the California affirmed the trial court's application of the *Hug* time apportionment formula, finding that the options were indeed "golden handcuffs," and specifically noting that there was no evidence to indicate the stock options were a factor in initially attracting the husband to the company, or that they were granted as deferred compensation for past services. 179 Cal.App.3d at 1227, 225 Cal.Rptr. at 240. Rather, based on the record, the California appellate court concluded that the stock options reflected the husband's time, skill and effort beginning on the date the options were granted. *Id.* Ultimately, the use of the time frame regarding the lapsing of the stock restrictions properly diluted the wife's share of the property to account for the post-divorce efforts of the husband. *See*, Short, *et. al.*, at p. 12.

The result in *Harrison* should be compared to that in *Miller*, 915 P.2d 1314. In *Miller*, the husband's employer granted the husband 2,500 shares of restricted stock, which was to vest over five years. *Id*. at 1315. During the restriction period, the husband could not transfer or pledge his interest in the stock shares, but retained all other rights associated with ownership of the stock shares, including the rights to vote the stock and to receive cash dividends; further, the restrictions affected his right to retain all or portions of the restricted stock shares in the event of the termination of the his employment prior to the expiration of the restriction period, his retirement, total and permanent disability, or death. *Id.*

With respect to such restricted shares, the Colorado Supreme Court noted that the employer could not unilaterally repudiate the husband's right to retain the stock, and that he had indeed received the shares, not simply a conditional right to receive

the shares. *Id*. at 1319. Because the husband had already earned the right to receive the restricted shares, they represented a form of deferred compensation, and thus constituted marital property. *Id*. at 1319-1320. According the Colorado Supreme Court, that the husband's full enjoyment of the benefit was conditioned on his remaining an employee affected the present value of the restricted stock shares, not their marital nature. *Id*. at 1320.

In contrast, the Supreme Court of Nebraska held in *Davidson*, 254 Neb. at 664-665, 578 N.W.2d at 856, that restricted "retention shares" should be treated like stock options, and subject to a time-apportionment rule (acknowledging but disagreeing with *Miller*).

Interestingly, or "inexplicably," in the words of the California appellate court, the wife in *Harrison* presented no evidence on the value of the options themselves; rather, she focused on the value of the stock controlled by the husband. 179 Cal.App.3d at 1225, 225 Cal.Rptr. at 239. The appellate court noted that options are regularly bought and sold on listed exchanges, and conjectured that some day there would be a case in which one spouse would emphasize the value of the vested option while the other spouse would argue the value of the restricted stock issued pursuant to that option, thereby highlighting the element of post-separation efforts. *Id*. at n. 2.

Further, according the California appellate court, the trial court in *Harrison* properly applied the time apportionment formula to "the gain on the stock option plan after the costs of the purchase of the stock by [the husband] and any taxes paid thereon are repaid to [the husband]." 179 Cal.App.3d at 1223, 225 Cal.Rptr. at 237, at n. 1. In doing so, the trial court used an effective tax rate of 61% to determine the federal and state income tax impact on the net gain apportioned between the parties, which was also upheld by the appellate court. 179 Cal.App.3d at 1227, 225 Cal.Rptr. at 240.

II. INTELLECTUAL PROPERTY

Few reported appellate opinions, from Texas or any other jurisdiction, address the issue of intellectual property in the context of a divorce. As a result, the present discussion relies heavily on three previously published articles: Thomas P. Goranson and K. Dennise Garcia, *Intellectual Property in Divorce - Oxymoron or Not?*, 22ND ADVANCED FAMILY LAW COURSE (1999) [hereinafter "Goranson and Garcia"]; Robert S. Hoffman and Melissa Longin, *Intellectual Property: Is it Property? When?,* ADVANCED FAMILY LAW COURSE (2000) [hereinafter "Hoffman and Longin"]; and David Henry and Richard Orsinger, *Intellectual Property*, UNIVERSITY OF TEXAS SCHOOL OF LAW FIRST ANNUAL TEXAS MARITAL PROPERTY INSTITUTE (1997) [hereinafter "Henry and Orsinger"]. Moreover, although the present article is expressly limited to one form of intellectual property, patents, the legal principles addressed are usually applicable to other intellectual properties, such as copyrights and trademarks.

A. In General

1. Definition of Intellectual Property

Intellectual property "...refers to those products of an individual's intellectual processes protected under copyright, patent, or trademark law." 2 VALUATION & DISTRIBUTION OF MARITAL PROPERTY, §23.07 (Matthew Bender 1997) [hereinafter "2 VALUATION]; s*ee also*, Henry and Orsinger, p. 1 ("Patents, copyrights and trademarks are often referred to collectively as 'intellectual property.' Intellectual property is the set of legal rights to an expressed name or idea. It is property that results from the fruits of mental labor").

Intellectual property is "intangible property." In *Day v. Day*, 896 S.W.2d 373, 376 (Tex.App.–Amarillo 1995, no writ), the Amarillo Court of Appeals stated that "general intangibles...[are] a bundle of rights such as those inherent in a franchise, a chose in action, a copyright, or an annuity"; *see also*, Goldberg, VALUATION OF DIVORCE ASSETS, §12.6, p. 314 (West 1984) (trademarks, copyrights and the

like are actually intangible property which has no intrinsic or marketable value, but are merely the representation or evidence of value).

2. Preemption

Federal intellectual property laws reflect the declared federal policy that science should be promoted. Hoffman and Longin, p. 4, *citing*, U.S. Const. art. I, §8, cl. 8 (Patent and Copyright Clause). In other words, federal intellectual property laws encourage the creation and development of works deemed beneficial to the American public. 2 VALUATION, §23.07[3][a]. Thus, very simply put, federal preemption turns on whether state law–for the purposes of the present discussion, state marital property laws–have the effect of discouraging the creation of intellectual properties. *Id*.

Until recently, there has been no consensus, either judicial or academic, as to the proper resolution of preemption questions in the context of intellectual property and state marital property laws. Hoffman and Longin, pp. 4-5. However, just over a year ago, the United States Fifth Circuit decided a copyright case which may effect the analysis of federal preemption in the context of patents and state marital property laws. *Rodrigue v. Rodrigue*, 218 F.3d 432 (5th Cir. 2000), *cert. denied*, 121 S.Ct. 1127 (2001), concerned a husband who was a very successful and prolific painter, the creator of the series of "blue dog" paintings for which he had become famous, and who had obtained copyrights for many of his paintings.

In *Rodrigue v. Rodrigue*, 55 F.Supp.2d 534, 541 (E.D. La 1999), the lower federal district court held that the 1976 Copyright Act implicitly preempted Louisiana state marital property law. The district found that because, under the Act, a copyright vests in the author at the time of creation, the copyright therefore represented the author's separate property. *Id*. Further, the federal district court found that the implicit conflict between the Copyright Act and Louisiana community property law to be irreconcilable, since to deem copyrights to be community property would risk damage to the Copyright Act's goals of predictability and certainty of ownership. *Id*. at 547. Ultimately, the district court invited Congress to visit the issue, suggesting that harmony between the federal and state statutory systems might be achieved if the author was given the sole right to control and manage the copyright, while the non-author spouse was given a share in the benefits of the copyright, such as royalties. *Id*. at 546.

On appeal, the Fifth Circuit reversed the lower federal district court, and found that the Copyright Act did not preempt Louisiana law, remanding the case for a determination, among other things, of which copyrights were subject to the rules of Louisiana's community property laws. The crux of the Fifth Circuit's rationale derived from its analysis of the Copyright Act's specific protection of five particular rights: (1) reproduction; (2) adaptation; (3) publication; (4) performance; and (5) display. 218 F.3d at 435. According to the Fifth Circuit, "...none of these rights expressly or implicitly include the exclusive right to enjoy income or any of the other economic benefits produced or derived from copyrights." *Id*. Thus, the Fifth Circuit adopted the lower district court's idea that the author could retain control and management of the copyright, while the non-author spouse could share in the economic benefits of the copyright. *Id.* at 434; *see also, In re Marriage of Worth*, 195 Cal.App.3d 768, 241 Cal.Rptr. 135 (1987) (marital community has an interest in a copyright).

B. Patents

1. In General

A "patent" is a grant of right to exclude others from making, using or selling one's invention; a patent includes right to license others to make, use or sell the invention. BLACK'S LAW DICTIONARY (6th Ed.). Under federal law, a patent secures for an inventor the exclusive right to make, use, and sell an invention for a term of years. *See, e.g.,* 35 U.S.C.A. §154.

As several commentators have noted, a patent is a valuable right because the holder can elect to keep the actual protected work as his or her

monopoly, license the rights to a third party, or sell the patent. *See,* Hoffman and Longin, p. 3. Thus, in general terms, the purpose of a patent is to grant to the owner the exclusive rights over the fruits of his or her mental labors. 2 VALUATION, §23.07.

2. Preemption

Rodrigue raises interesting questions with regard to patents. Under federal law, a patent gives the owner the right "to exclude others from making, using or selling the invention throughout the United States" for a term of years. *See,* 35 U.S.C. §154(a). Additionally, 35 U.S.C. §154(d) provides for the "provisional right" of obtaining a "reasonable royalty" from any person who, in essence, infringes upon a patent. Because the right granted by a patent is the right to exclude others from commercial exploitation of the invention, it follows logically that the patent-holder is the only one who may make, use or sell the invention. Henry and Orsinger, p. 2.

Accordingly, it might be argued that the right to exclude others from selling an invention means that the federal statute explicitly–or at least implicitly–addresses, and guarantees to the patent-holder, the right to the economic benefits of the invention. If so, under the analysis of *Rodrigue*, federal law might preempt state law that would otherwise hold that a particular patent is community property. In other words, it might be argued that the patent laws, as opposed to the copyright laws, appear to contemplate that the holder of the patent is entitled to enjoy the fruits of his or her mental labors.

3. Characterization

Whether a patent, copyright, trade mark or other intangible is separate or community property has not been well analyzed in Texas. Goranson and Garcia, p. 4. Because of the nature of patents, characterization is a fuzzy issue. For example, each of the various types of intellectual properties, *i.e,* patents, copyrights, trademarks, has its own system for determining when the property interest actually "vests" pursuant to federal law. 2 VALUATION, §23.07. The various "vesting" dates are at least pertinent to the Texas inception of title rule.

There are, essentially, four stages in the "life on an invention" and its corresponding patent: (1) the invention, in which the inventor has embellished his or her basic idea or concept with sufficient detail to make and use an embodiment of the idea; (2) research into patentability; (3) the patent application; and (4) the grant of the patent. Henry and Orsinger, pp. 29-30, *citing,* 2 VALUATION, §23.07[2]. A valid patent does not require actual reduction to use; rather, a patent may issue if the inventor has supplied sufficient information to enable a person reasonably skilled in the relevant field to make and use an embodiment of the invention without undue experimentation. Henry and Orsinger, p. 30.

As a matter of federal law, the date a patent is issued is the date the inventor has exclusive rights to the invention. Hoffman and Longin, p. 14, *citing*, *Woodbridge v. United States*, 263 U.S. 50 (1923). However, 35 U.S.C. §101 provides that whoever "invents or discovers any new and useful process, machine...may a obtain a patent therefor...." Thus, it has been argued that, a person's entitlement to patent protection is the result of the act of invention, not the application for or the grant of a patent. Henry and Orsinger, p. 30. Recall that, under Texas law, inception of title occurs when a party first has a right of claim to the property by virtue of which title is finally vested. *See*, *Strong v. Garret,* 148 Tex. 265, 271, 224 S.W.2d 471, 474 (1949).

Further, ownership of the invention and ownership of the patent may well be logically separable. Does such entitlement constitute, under Texas law, "inception of title," or does it simply pertain to who, between competing inventors, may obtain the patent? Commentators have suggested, and cogently so, that the act of invention constitutes inception of title. *See generally*, Henry and Orsinger, p. 30-31; *In re Marriage of Crivello*, No. 43707-1-I, 2000 WL 1668014, at *6 (Wash.Ct.App. 2000) (the patent was community property, even though the husband testified that he developed the idea for the invention prior to marriage, when the patent application was made during the marriage

and the patent was issued during the marriage). The question is, as a matter of Texas law, unanswered.

Mr. Orsinger and Mr. Henry have also posed the following pertinent questions:

> If an inventor marries after an act of invention but before the patent is issued, can it be argued that there was, prior to the marriage, an inception of title in whatever property rights can be owned with respect to an invention (a patent directed to that invention)? Similar questions can be asked as to work occurring during marriage that leads to a patent after divorce. And when discovery occurs during marriage based on years of investigation prior to marriage, is some time apportionment approach or value-contributed apportionment approach fitting?

Henry and Orsinger, p 31. Note that, in response to the last question posed above, in *Dunn v. Dunn*, 802 P.2d 1314, 1318-1319 (Utah App. 1990), the inventor-spouse's argument, that the development of instruments patented during the marriage was the result of twenty-six years of education and training, most of which predated the parties' marriage, failed utterly to carry the day: the patent was held a marital asset.

As mentioned, reported Texas cases concerning patents in the domestic context are few and far between. In *Rose v. Hatten*, 417 S.W.2d 456 (Tex.Civ.App.–Houston 1967, no writ), the factual recitation in the reported appellate opinion mentions that the trial court had found that a patent was community property, but the issue was not taken up on appeal. Hoffman and Longin report that there is case law from other jurisdictions that supports both the proposition that intellectual property acquired during a marriage is community property, as well the contrary proposition that federal law prohibits intellectual property acquired during the marriage from being divided upon divorce. Hoffman and Longin, pp. 11-12; *see also*, *Id*. at n. 18 and n. 19 n (lists of cases, pro and con).

4. Valuation

a. In General

There are no reported Texas cases addressing the valuation of a patent in the context of a divorce. Commentators have stated that, in general, the value of intellectual property derives from the income produced by the property, which involves projections of future income streams, applicable discount rates, and other accounting concerns. Henry and Orsinger, p. 36.

In their article *Valuation Problems of Unique Assets*, SHOW ME THE MONEY, p. 32 (American Academy of Matrimonial Lawyers Mid-Winter Meeting, 1998) [hereinafter "Kinser and Kolenberg"], Katherine Kinser and Katherine A Kolenberg list three "important factors" to consider when valuing a patent:

1. The estimate annual income attributable to the patent or application;

   (a) Does a history of earnings exist? If an earnings history exists, is the history of earnings indicative of future earnings?

   (b) If an earnings history does not exist, consideration should be given to elements of value including studies of the industry, market surveys and analysis, needs by industry, opinions of industry experts, and any other relevant factors;

2. The interest rate at the valuation date; and

3. The most reasonable speculative capitalization rate, taking into consideration the following risk factors: remaining "legal" life, economic life, competitive products or changes in industry needs.

In the end, the valuation of a patent is a difficult matter. Most reported cases have skirted the actual valuation issue and awarded the non-

inventor or non-author spouse a percentage of future profits. Hoffman and Longin, p. 15, n. 22, *citing*, *In the Matter of the Marriage of Monslow*, 990 P.2d 249 (Kan.Ct.App. 1995), *aff'd*, 259 Kan. 412, 912 P.2d 735 (Kan. 1996) (the wife was awarded 40% of the future income from the husband's patent); *In re Heinze*, 257 Ill.App.3d 782, 631 N.E.2d 728, 197 Ill.Dec. 506 (Ill.App.Ct. 1994) (the husband was awarded 25% of the wife's book royalties).

In *Monslow*, 259 Kan. 428, 912 P.2d 746, the husband argued that the interest in his patents was not subject to division because it had no current value. In response, the Kansas Supreme Court stated:

> There would not seem to be, however, an insurmountable obstacle to achieving equitable distribution of property without ascertaining a current dollar value. The trial court may formulate an award based on percentages and base the percentages on allocations between individual and marital interests.

259 Kan. 428-429, 912 P.2d 746.

b. Market Value

It should be recalled that, in Texas, there are four grades of evidence which may be produced to prove value: (1) market value; (2) intrinsic value; (3) cost of replacement; and (4) value to the owner. *See, Taylor County v. Olds*, 67 S.W.2d 1102, 1105 (Tex.Civ.App.–Eastland 1934, writ dism'd). Furthermore, *Taylor County* creates a loose "hierarchy"of value, *i.e*., "market value" is the best indicator of value. *Id*. at 1104.

Goranson and Garcia have stated: "...there is such a thing a patent dealer, that is, someone whose business it is to sell, or offer for sale, patent rights." Goranson and Garcia, p. 7. In other words, in the world of patents, there appears to be an existing market for the sale and purchase of, at least, some patents. If there is a such a market, then market value, under *Taylor Count*, is the best indicator of the value of a patent.

Texas courts have recognized three general approaches to determining market value: (1) the market data (or comparable sales) approach; (2) the cost approach; and (3) the income (or income-capitalization, or discounting, approach. *Travis Cent. Appraisal Dist. v. FM Properties Operating Co.*, 947 S.W.2d 724, 730 (Tex.App.–Austin 1997, pet. denied). The three different approaches are not different definitions of market value, but rather are simply different ways of arriving at an estimate of what a willing buyer would pay a willing seller. *Id*.

c. Patent Infringement Cases

While, as already discussed, there are no reported Texas cases directly on point that deal with the valuation of intellectual property rights in a divorce setting, courts across the country have had to deal with the issue of valuation in the context of patent infringement claims. Goranson and Garcia, p. 6. In an infringement case, in order to recover lost profits, and not merely a reasonable royalty, the patent holder must advance affirmative proof of the demand for his patented product in the marketplace, the absence of acceptable noninfringing substitutes, and that he had production and marketing capacity to meet the demand. *Id*., *citing*, *Milgo Electronic Corp. v. United Business Communications , Inc*. 623 F.2d 645 (10th Cir.1980), *cert. denied,* 449 U.S. 1066 (1980). Further, each infringement case is controlled by its own facts; if, however, actual value cannot be ascertained by a reasonable apportionment of profits and damages, a reasonable royalty can be determined by considering the nature of invention, its utility and advantages. Goranson and Garcia, p. 6, *citing*, *Elrick Rim Co. v. Cheek,* 195 F. Supp. 496 (D.C. Cal. 1961).

In Texas, the actual application to intellectual property of the three approaches to determining market value, *i.e*., (1) market data, (2) cost, and (3) income, has occurred in infringement cases, and not in divorce cases. Hoffman and Longin, pp. 16-17. In the context of intellectual

property, problems exist, however, with each such valuation approach .

For example, in terms of a copyright, the cost approach, *i.e*., a typical investor will not pay more than the cost to purchase or produce a substitute property, at best provides only a minimum floor for valuation, since an investor can't produce (because of copyright laws) a substitute property; thus, the cost approach does not provide a particularly accurate appraisal of the copyright. *Id*. at 16.

With respect to the market approach, again in the context of copyrights, in which there is an active market for licensing and royalties, copyright owners are compensated in a number of different manners, thus making difficult the identification of a consistent "unit of comparison." *Id*., *citing*, Robert F. Reilly & Robert P. Schweichs, *Valuing Intangible Assets*, p. 327 (1999). Recall that, for "comparable sales" to be an accurate indicator of value, the compared sales must actually be "comparable." *See, e.g*., Edwin J. (Ted) Terry, Jimmy Vaught, Karl E. Hays, James W. LaRue, and J. Kenneth Huff, Jr., *Professional Partings: Valuing Medical/Legal Professional Practices*, pp. 16-17 ("Sales: Comparable and Otherwise") 27th ANNUAL ADVANCED FAMILY LAW COURSE (2001).

Finally, with respect to the income approach, it must be noted that the life of a copyright lasts considerably longer than the "useful life" of the product. Hoffman and Longin, p. 16, *citing*, Reilly & Schweichs, p. 328. Patents, in contrast to copyrights, are limited in "life," but the underlying invention, even without the exclusive rights associated with a patent, may well produce income after the patent period has expired. Additionally, the present value of future royalties may prove too speculative an analysis for a Texas trial court to consider, especially if such expected future royalties depend in part, or in full, on the continuing efforts of owner-spouse, now divorced [this issue is discussed in more detail immediately below]. Goranson and Garcia, p. 7.

In the end, there is no magic formula for determining the value of a patent. *Id*. at p. 5. Certainly, Texas case law provides little or no guidance, and is something very near a *tabula rasa* on the matter.

d. Future Efforts

Commentators have opined that, in the valuation process, "[c]omplications arise if a spouse is required to invest post-divorce labor or money into keeping the asset productive...." Henry and Orsinger, p. 36. Other commentators have observed that "...an interesting and perplexing valuation scenario can play out if post divorce efforts are necessary to generate future royalties." Hoffman and Longin, p. 17. Kinser and Kolenberg state that, in a patent valuation, "...the earnings considered must be solely those attributable to the patent, and not those earnings attributable to such things as personal service, managerial skill, tangible assets, and marketing procedures." Kinser and Kolenberg, pp. 32-33.

As has already been mentioned in the earlier treatment of stock options, in Texas, the fruits of post-divorce efforts are usually considered the separate property of the producer. However, as also already discussed, in the context of stock options, litigants arguments that "future efforts" represent separate property have not fared well among Texas appellate courts. *See, e.g., Charriere,* 7 S.W.3d at 221; *cf*., *Hazard v. Hazard*, 833 S.W.2d 911 (Tenn.App. 1991) (a medical tool kit created by the husband had value divisible upon divorce, even though the kit required further refinement in order to be marketable; it was therefore not error to award the wife 20% of the post-divorce income resulting from the sale of the kit).

On the other hand, as is discussed below with respect to royalties, several courts of other states have recognized that the resulting value of required post-divorce efforts of the producing spouse should not be awarded to the non-producing spouse.

It has been argued that the value of future book royalties could be directly linked to the post-

divorce work of the author spouse, *i.e*., the higher the visibility of the author spouse (in terms of speeches, television appearances, etc.), the better chance the royalties related to the book will be higher. Goranson and Garcia, p. 6. Suggestions as to the precise mechanism for such valuation of post-divorce efforts are less easily imagined. *See*, *Id*.

It has also been noted that, with respect to copyrights, a publisher normally will insist on post-publication activity by the author spouse. *Id*. Accordingly, publishers might be a source of statistical information justifying an attempt at proving and quantifying the benefit that such post-divorce efforts generate. *Id*. at pp. 5-6. Post-divorce efforts by, for instance, an author-spouse, might well implicate notions of personal goodwill (although the Authors are aware of no reported case to that effect). *See*, *Id*. at p. 6.

e. Tips

It has been strongly suggested that the Texas practitioner involved in the valuation of any intellectual property hire an expert. Goranson and Garcia, p. 7. With respect to such expert, a Daubert challenge should be anticipated. *Id*. at p. 5.

Additionally, as a discovery matter, inquiries should be made as to any prior litigation that has occurred concerning the intellectual property, since such litigation might reveal pertinent authorities or relevant evidence as to value. *Id*. at p. 6; *cf., Fawer, Brian, Hardy & Zatzkis v. Howes*, 639 So.2d 329, 335, (La.Ct.App.1994), *writ ref'd*, 644 So.2d 653 (1994) (the ex-husband alleged in a separate lawsuit that the original patents issued during the marriage were either worthless or nonexistent).

5. Division

No reported Texas case addresses the exact mechanics of dividing an intellectual property right. Recall that many courts have simply awarded the spouses percentage interests in future income. *See, Monslow*, 990 P.2d 249 (the wife was awarded 40% of the future income from the husband's patent); *Heinze*, 631 N.E.2d 728 (the husband was awarded 25% of the wife's book royalties). However, when dividing future royalties (as often occurs), it is important that the future costs related to the royalty be addressed, including the future costs or efforts of either spouse that may be required to make the royalty interest more profitable. *Cf*., *Howes v. Howes,* 637 So.2d 1282, 1285 (La.App. 4 Cir. 1994) (as a co-owner of the patent, the wife was liable for her share of attorneys' fees related to the preservation and maintenance of the patent' as well as those related to an infringement action); *Allen v. Allen*, 601 P.2d 760 (Okla.App.1979) (the trial court erred in awarding the wife a one-half interest in patents obtained by the husband during marriage, without also requiring that the wife assist in payments for debts created in efforts to exploit the patents).

The Kansas Supreme Court has held that

> [t]o the extent that future [patent] benefits might not be materialize, the remedy should be to divided the future benefits, if, as, and when they become payable, and not to hold that the entire patent...is not divisible.

Monslow, 912 P.2d 735.

Actual "division" of a patent may create problems. Several commentators have recognized that the value associated with copyrights and patents necessarily originates in the exclusivity of the rights involved; thus, if both the husband and the wife possess an interest in the patent or copyright, they are both free to license the patent or copyright without the consent of the other, and, as a practical matter, such potentialities may significantly reduce the value of the right (since neither holds an exclusive right). *See*, Henry and Orsinger, p. 37; Goranson and Garcia, p. 7; *see also*, *Sullivan v. Rule*, No. 81-1217-MA (U.S. Dist.Ct.Mass. 1981) [available on Lexis] (the parties agreed that they would divide the husband's patent, but that he would be the exclusive agent for licensing the invention; the husband's later federal suit, to prevent the former wife from using the patented processes to manufacture and sell competing

products was dismissed on the grounds that such suit was a state action, not a federal action).

Another possible alternative is division of the value of the intellectual property right, as opposed to the actual right. This approach is fairly simple if there is enough property to offset the right, and if the spouses can agree on who should get which assets. In this manner, intellectual property rights would be treated like all other assets in a divorce. *See generally*, Goranson and Garcia, p. 7.

The following language was used by one trial court to divide a patent:

> IT IS ORDERED, ADJUDGED, AND DECREED...[that the wife] has a one-half undivided interest in a multiple-lumen catheter device known as the "Howes Venous Catheter Device" U.S. Patent Number 4072146 or any variation thereof as defined by Section 1(c) in License Agreement between [the husband] and Arrow International, Inc. dated April 15, 1982.
>
> IT IS FURTHER ORDERED, ADJUDGED AND DECREED that a permanent injunction be and hereby is issued herein, restraining and prohibiting Arrow International, Inc. from making any further payments to [the husband] or to anyone designated by [the husband] to receive payments under the terms of the License Agreement concerning Patent Number 4072146, or any successor thereof, unless said payments are made one-half directly and by separate check to [the wife] and one-half directly and by separate check to [the husband].

Howes v. Howes, 518 So.2d 1147, 1148 (La App. 4th Cir.), *writ denied*, 523 So.2d 232 (La. 1988).

In any event, the division of intellectual property is a complicated, touchy issue. Great caution on the lawyer's part is advised. *See*, *Id.*

C. Royalties

1. In General: License v. Assignment

In terms of a patent, a license allows a person to use the patent for a limited period of time, while an assignment is the transfer of all rights to the property. *Dunbar v. Baylor College of Medicine*, 984 S.W.2d 338, 342, at n. 10 (Tex.App.–Houston [1st Dist.]1998, no pet.), *citing*, BLACK'S LAW DICTIONARY 109, 829 (5th ed. 1979). A patentee or his assigns may assign either "(1) the whole patent comprising the exclusive right to make, use, and vend the invention throughout the United States; or (2) an undivided part or share of that exclusive right; or (3) the exclusive right under the patent within and throughout a specified part of the United States." *Waterman v. Mackenzie*, 138 U.S. 252, 260-261 (1891). An assignment divests the inventor of his rights as though the invention were a chattel [and] he [or she] is bound to leave the assignee free to deal with the invention as he wills. *Jones v. Cooper Industries, Inc*., 938 S.W.2d 118, 123 (Tex.App–Houston [14th Dist] 1996, writ denied), *cert. denied*, 522 U.S. 1112 (1998). If, on the other hand, the patentee desires to reserve rights in the patents, he or she can license the patent to a third party, in which case, as the licensor, the patentee retains ownership but allows the licensee use of the patent. *See*, *Rite-Hite Corp. v. Kelley Co.*, 56 F.3d 1538, 1552 (Fed. Cir.), *cert. denied*, 516 U.S. 867 (1995).

A royalty on a patent is consideration for the sale of the patent and is subject to the law of contracts. *Jones*, 938 S.W.2d at 124; *see also, Dunbar*, 984 S.W.2d at 340 (the assignment stated that, in return for all rights to the invention, the inventor would receive either royalty payments, or, if the assignee entered into an agreement with a third-party corporation to develop the invention, the inventor would receive stock in such corporation in exchange for the release of her royalty payments).

2. Characterization

Not surprisingly, the Authors have located no reported case that specifically addresses the issue of the proper characterization of royalties from patents. In *Bell v. Moores*, 832 S.W.2d 749 (Tex.App.–Houston [14th Dist.] 1992, writ denied), two former wives brought an action against their former husbands' employer to recover royalties the employer had allegedly agreed to pay the former husbands. Under their employment agreement, the former husbands were to receive a salary plus a one-third royalty of the gross sales for all software they authored for their employer. *Id*. at 751. The opinion does not discuss the nature of the agreement between the employers and the former husbands, or intellectual property law. In the opinion, however, the Houston appellate court stated that, during the marriage, the royalties allegedly due one of the husbands were community property under his sole management and control. *Id*. at 753.

Henry and Orsinger have questioned whether the Texas rule, that royalties from separate property mineral interests remain separate property, should be applied to royalties from intellectual properties. Henry and Orsinger, p. 37. The answer is probably no. In *Jones*, 938 S.W.2d at 122, the Houston Fourteenth Court of Appeals rejected the proposition that principles of real property should apply to patents, noting that, under federal law, patents"have the attributes of personal property." *See also,* 35 U.S.C. §261. Consequently, stated the Houston appellate court, a right to collect royalties after an assignment of a patent is not "akin" to a royalty interest in a mineral estate. *Jones*, 938 S.W.2d at 122.

Henry and Orsinger have also raised the issue of whether income from the pre-marital licensing of intellectual property received during the marriage is separate or community in nature. Henry and Orsinger, p. 37. One response to such query would be the settled Texas rule that income from separate property, absent an agreement between the parties, is community property. *See, e.g., Lipsey v. Lipsey*, 983 S.W.2d 345, 350 (Tex.App.–Fort Worth 1998, no pet.).

Further, *Heinze*, 631 N.E.2d 728, illustrates the contract implications involved in the characterization of royalty payments. In *Heinze,* during the marriage, the author-wife had written several books, and had signed royalty contracts. Upon the parties' divorce, the wife argued that future sales of the books would be enhanced by her post-divorce efforts, *i.e*., her participation in workshops and giving speeches. In rejecting the wife's arguments, the appellate court stated:

> ...the contract right to the future book royalties for the four books was acquired during the marriage. Consequently, similar to pension rights, the future book royalties are the fruit of the shared enterprise of marriage and should be divided as marital property.

Id. at 731. Nonetheless, the appellate court acknowledged that the wife's post-divorce speeches, seminars, and workshops contributed to her book sales and resulting royalty payments, as did the wife's continuing to write additional books, so that it was appropriate to award her 75% of the post-divorce royalty income. *Id*.

Similarly, in *Morey v. Morey*, No. 01-A-01-9506-CV-00243, 1995 WL 739565 (Tenn.App. Dec. 15, 1995), royalties were treated as contract rights. In *Morey*, the husband had assigned all copyright and ownership rights to a book he had authored to his employer, in exchange for royalty payments. *Id*. at *1-*2. Upon divorce, the husband argued that, since he didn't own the copyright (his work had been "for hire"), post-divorce royalties would constitute his separate property. *Id*. at *3. The appellate court disagreed, stating:

> In the present case, the ownership of the copyright to the book produced by [the husband] is immaterial. The material fact is that, by his labors during marriage, [the husband] acquired a contract right to a percentage of the profits on al future sales of the book. This right was vested during marriage,

> and is therefore just as much a part of the marital estate as is a salary....The only difference is that the amount depends upon the volume of sales of the book.

Id. However, the appellate court added that "[a]ny part of the future royalty payments attributable to such future efforts [of the husband, post-divorce] should not be included in the marital estate." *Id*. The appellate did not say exactly how such a determination might be made, leaving the matter to the trial court.

The Fifth Circuits' decision in *Rodrigue* raises a rather disturbing "post-divorce efforts" issue in the context of art. In *Rodrigue*, the husband-artist had copyrighted certain of his "characters", in particular, his very popular "blue dog." In remanding the case, the Fifth Circuit instructed the lower federal district court to determine, among other things, the wife's economic rights in the post-divorce works by the husband termed "derivative" of his copyrighted works. 218 F.3d at 443. The effect of the Fifth Circuit's ruling is to give the wife an interest in post-divorce works of art produced by the husband, simply because he uses in such post-divorce creations a theme, or "character," that he copyrighted during the marriage. In the opinion of these Authors, the Fifth Circuit's decision ignores the realities of artistic creation, and decidedly provides a disincentive for the husband in *Rodrigue* to continue producing "blue dog" works of art.

3. Valuation

Of course, royalties received during marriage are easily determinable. Royalties to be received post-divorce are another matter altogether. However, it is unlikely that valuation will be a contested issue, since the trial court can simply–and usually does–award a percentage of the royalties to each spouse, rather in the manner of pension benefits "if, as and when" received.

4. Division

Royalties to be received can be divided by percentage between the parties. *See, e.g.*, *Cathcart v. Robison, Lyle, Belaustegui, & Robb*, 106 Nev. 477, 478, 795 P.2d 986, 986 (Nev. 1990) (*per curiam*) (the wife was awarded one-half of the monthly royalty income for the duration of a patent owned by the husband on a prosthetic hip device); *cf*., *Snyder v. Synder*, No. 99-G-2230, 2000 WL 1876614, at *8 (Ohio Ct.App.2000) (the trial court's award of a business that owned the patent included the royalties generated by the patent).

Note again, the willingness of certain appellate courts in jurisdictions other than Texas to attempt to segregate out the value attributable to the post-divorce efforts of the involved spouse, as evidenced in *Morey* and *Heinze.*

III. REAL PROPERTY

A. Time-shares

1. Characterization

The inception of title rule will apply to an interest in a time-share condominium. *See, e.g., Beard v. Beard*, No. 10-98-357-CV, 2001 WL 392260, at *17 (Tex.App.–Waco, April 18, 2001, reh'g overruled) (the husband's condominium, purchased prior to marriage, was his separate property).

2. Valuation

Time-shares are bought and sold on the "open market." Thus, there will be an established market value for such interests, which can be determined by reference to "comparable sales."

3. Division

There appear to be no reported Texas cases discussing the division, pursuant to divorce, of an interest in a time-share condominium. However, it would seem logical to assume that the trial court could divide the interest "in kind," provided the parties' time allotment for the property was sufficiently large (*i.e*., one week for her, one week for him). Otherwise, an interest in a time-share could be awarded to one party, or sold and the

proceeds divided pursuant to an agreement or by an order of the trial court.

B. Undivided Interests

1. In General

The co-ownership of separate, undivided interests in land is a cotenancy. *Cecola v. Ruley*, 12 S.W.3d 848, 853 (Tex.App.–Texarkana 2000, no pet.); *see also*, *Dierschke v. Central Nat'l Branch of First Nat'l Bank at Lubbock*, 876 S.W.2d 377, 379 (Tex.App.–Austin 1994, no writ) ("[a]n undivided possessory interest in property is a tenancy in common"). In Texas, such a situation frequently results when spouses co-own separate property. *Id.*; *see also*, *Cockerham v. Cockerham*, 527 S.W.2d 162, 167 (Tex. 1975) (a tenancy in common was created when the husband owned an undivided fifty percent interest in land as his separate property, and the remaining fifty percent interest in the land was owned by the community estate); *Nesmith v. Berger,* No. 03-00-00686-CV, 2001 WL 893668, at *1 (Tex.App.-Austin, August 9, 2001, no pet. history) (by a written agreement, the wife "bought in" to the marital residence, which had theretofore been the husband's separate property, after which the husband, as grantor, conveyed to himself and to the wife undivided interests in the property).

Parties are often awarded undivided interests in divorce decrees. *See, e.g., Rittgers v. Rittgers*, 802 S.W.2d 109, 110 (Tex.App.–Corpus Christi 1990, writ denied) (the final decree of divorce awarded each party a one-half interest in real property).

Cotenants have the right to possess and to use the entirety of the property, although neither has the right to possess or use any particular portion to the exclusion of the other. *Cecola,* 12 S.W.3d at 853.

A joint gift to a husband and wife is not community property; rather, each gets a one-half undivided separate interest in the gift. *Roosth v. Roosth*, 889 S.W.2d 445, 457 (Tex.App.–Houston [14th Dist.] 1994, writ den'd). In contrast, a deed from a third party in the names of both husband and wife raises a presumption that the property is community rather than jointly-held separate property. *Dakan v. Dakan*, 125 Tex. 305, 83 S.W.2d 620, 626 (1935); *Dutton v. Dutton*, 18 S.W.3d 849, 852 (Tex.App.–Eastland 2000, pet. denied) (there was nothing in the deed to the spouses to indicate that the transaction was a gift, so the presumption of community property applied).

Under general Texas property law, however, where a deed names more than one grantee [not spouses], and the interest of each grantee is not stated, a rebuttable presumption arises that each of the grantees is vested with title to an equal undivided interest in the property. *Zephyr v. Zephyr*, 679 S.W.2d 553, 556 (Tex.App.–Houston [14th Dist.] 1984, writ ref'd n.r.e.). Such presumption can be rebutted by showing that the grantees did not furnish the consideration in equal shares. *Id.*

A cotenancy may be terminated by partition into severalty. *See*, *Condra v. Grogan Mfg. Co.*, 228 S.W.2d 588, 597 (Tex.Civ.App.–Beaumont 1949), *aff'd*, 149 Tex. 380, 233 S.W.2d 565 (1950). Partition does not confer title; rather, it dissolves the cotenancy, and the person receiving a specific share of property holds the same to the exclusion of the other cotenant who previously had equal possessory rights. *Garza v. Cavazos*, 148 Tex. 138, 221 S.W.2d 549, 552 (1949).

A cotenant may compel a partition of jointly-owned real property; in such a situation, the trial court must determine each owner's share or interest, including all questions of law or equity which may arise and affect title to the realty. *Rittgers*, 802 S.W.2d at 113. Should the trial court determine that a fair and equitable division of the realty cannot be made, the court must order a sale of the indivisible property and divide the proceeds among the cotenants according to their respective interests. *Id.* at 113-114.

2. Characterization

a. Inception of Title

The inception of title rule applies to undivided interests in real property. *See, e.g.*, *Cockerham,* 527 S.W.2d at 167 (it was undisputed that the husband owned an undivided one-half interest in identifiable real property prior to marriage).

In *In re Marriage of Murray*, 15 S.W.3d 202, 204 (Tex.App.–Texarkana 2000, no pet.), the parties acquired real property before marriage, the warranty deed listed both parties as grantees, and the future wife paid $500.00 in earnest money and a $23,497.09 down payment for the property with her separate property funds; both parties, however, signed the purchase money note for the remaining amount of the purchase. Relying on the inception of title doctrine, the wife argued that she was the sole owner of the property, because the title originated when she paid the earnest money with her separate property funds. *Id*. at 205.

The Texarkana Court of Appeals considered the wife's argument "misguided," noting that the inception of title doctrine determined the character of property as either separate or community, but that Texas courts look beyond the inception of title doctrine to determine "ownership." *Id*. Since the evidence conclusively established that the property was separate property–because title originated before marriage–the issue became who owned such separate property, and therefore the Texarkana appellate court turned to general Texas property law. *Id*.

The Texarkana Court of Appeals first stated that, because the deed to the property named both parties as grantees, they were each presumptively vested with title to an undivided one-half interest in the property. *Id*. For the wife to establish more than a one-half interest in the property, she had the burden to prove that she contributed a greater amount of the purchase price (her ownership would then be proportional to the amount she contributed toward the total purchase price). *Id*. at 205-206. However, the vendor's lien was in the names of both parties, and both parties paid the note on the lien; thus, there was no evidence that the wife contributed all of the consideration for the purchase price, and the trial court erred in finding that the property was her sole and separate property. *Id*. at 206.

b. Tracing

Traditional tracing principles also apply to undivided interests in land. *See, e.g.*, *Cockerham*, 527 S.W.2d at 167 (since the evidence showed that the husband put up the undivided one-half of the 320-acre tract he owned prior to marriage as partial consideration for the purchase of the entire tract [as part of a partition suit by the owners ultimately conducted to obtain a loan on the property], such undivided one-half interest remained his separate property; *Whorrall v. Whorrall*, 691 S.W.2d 32, 34-35 (Tex.App.–Austin 1985, writ dism'd) (the trial court properly found that the wife's separate estate owned an undivided interest in the marital residence where she showed that she contributed separate funds toward the purchase–made just before the parties' marriage–of the house); *Clay v. Clay*, 550 S.W.2d 730, 734 (Tex.Civ.App.–Houston [1st Dist.] 1977, no writ) (a portion of the separate property awarded to the wife consisted of her undivided one-half interest in the residence given to her by the husband during their marriage).

3. Valuation

There is little, if any, reported case law in the divorce context on the valuation of undivided interests in real property.

In the area of estate taxation, the IRS has taken the position that undivided interests in real property are susceptible to partition. Thus, the value of an undivided interest in real property will be determined usually by valuing the whole property, then assigning a proportionate value to the undivided interest, and then applying some discount for lack of marketability. Typically, if a tract of land in easily partitioned, the discount will be small; if partition is difficult, the discount will be larger.

The proportionate valuation of undivided interests in real property has been used in at least one reported Texas case. In *State v. Lynch*, 390 S.W.2d 335, 337-338 (Tex.Civ.App.–Waco 1965, no writ), a condemnation case, the value of a 1/6

undivided interest in real property was determined, essentially, by taking 1/6 of the value of the entire tract.

Valuation issues surrounding undivided interests in real property can also be avoided, since, among other things, unvalued, undivided interests can simply be awarded to a party or parties. *See, e.g., Tate v. Tate*, No. 08-99-00006-CV, 2000 WL 1060537, at *6 (Tex.App.-El Paso, Aug. 3, 2000, no pet.) (in the divorce decree, each party was awarded an 50% undivided interest in real property that was labeled by the trial court as "unvalued"); *cf., Cecola*, 12 S.W.3d at 854 (there was evidence that the land could be divided into tracts of equal value).

4. Division

Undivided interests in real property may be divided, in kind, or sold and the proceeds divided, like any interest in real property. For example, in *Mogford v. Mogford*, 616 S.W.2d 936 (Tex.Civ.App.–San Antonio 1981, writ ref'd n.r.e.), the husband owned as his separate property an undivided interest in 320 acres of land, and the remaining undivided interest was owned as community property by the husband and his wife. Upon divorce, the trial court ordered a sale of the property and awarded the husband all of the proceeds from the sale of his undivided separate property interest and one-half of the proceeds from the sale of the undivided community property interest. *Id*. at 945. On appeal, the San Antonio Court of Appeals affirmed, holding the trial court had the power to partition the property either in kind or, finding no equitable manner by which to partition in kind, by sale, and that the trial court's action simply changed the form of the husband's separate property from realty to personalty, rather than divested him of his separate property. *Id*.

Parties can transfer undivided interests in real property, even separate property interests. *See, e.g., Simpson v. Simpson*, 387 S.W.2d 717, 719 (Tex.Civ.App.–Eastland 1965, no writ) (there was no reason why the husband could not convey or agree to convey his separate property undivided interest in the real property to his wife as a part of their settlement; the trial court simply ratified and confirmed the action of the parties in so dividing the property).

In *Halamka v. Halamka*, 799 S.W.2d 351, 353 (Tex.App.–Texarkana 1990, no writ), shortly before they married, and while the husband-to-be was still married to his previous wife, the parties purchased a house and twenty-four acres in the future wife's name. Upon the parties' eventual divorce, the trial court found that the parties' had purchased the home "jointly." *Id*.

On appeal, the wife complained of the trial court's finding that the separate property jointly purchased prior to marriage had to be sold because it could not be partitioned in kind. *Id.* The Texarkana Court of Appeals upheld the partition, finding that, although a partition of separate property was not, strictly speaking, a part of a divorce action, the trial court could [and did] divide the property in a [separate] partition proceeding, under the general laws pertaining to partition suits between co-tenants, not under the laws applicable to a divorce action. *Id.* at 353-354. Thus, applying Texas partition law, the trial court properly determined that the house and twenty-four acres were incapable of partition in kind and that equity required an immediate partition by sale through a receiver appointed by the court. *Id*. at 354.

IV. LIVESTOCK

A. Bull Semen

The Authors have located no reported Texas case discussing bull semen as a marital asset. However, in *Hight v. Dublin Veterinary Clinic*, 22 S.W.3d 614, 617 (Tex.App.–Eastland 2000, pet. denied), a wrongful goat-death case, the plaintiffs alleged that they had placed their Boer goat, Pancho–who later died–at a breeding facility "...for the purpose of standing him at stud, collecting, storing and selling his semen." Invariably, when goats appear, bulls are not far behind.

Bull semen is used for artificial insemination procedures, or "AI." There is, accordingly, a bull semen industry, at least of sorts. The information presented herein concerning the

bull semen "industry" derives from interviews with two Texans who own and operate businesses in the industry. The first is Mr. Brad Cardwell, of Elgin Breeding Service, Inc., in Elgin, Texas. Elgin Breeding Service is a "one stop shop," which provides both semen and embryo collection and warehousing services. The second is Mr. Carl Rugg, who is the owner of Bovine Elite, Inc., in College Station, Texas. In contrast to Elgin Breeding Service, Bovine Elite provides semen and embryo warehousing services, but is not otherwise concerned with production. Mr. Rugg is a broker, in effect.

The Authors gratefully appreciate the time and Texas friendly of both Mr. Cardwell and Mr. Rugg. If a question should arise concerning bull semen or embryos, particularly valuation questions, these two gentlemen would be very good resources for the Texas practitioner. Mr. Cardwell can be reached at 512-285-2019; Mr. Rugg at 979-693-0388. Another valuable resource is the article by Brenda Keen Schwartz and Susan D. Strickland, *Issues of Post-Divorce Disposition of Unique Items of Personal Property and Necessary Ancillary Instruments*, MARRIAGE DISSOLUTION INSTITUTE (1998), in which the Authors provide a fairly exhaustive list of cattle associations, as well as horse and other animal associations.

Bull semen is collected at a production/collection center, such as Elgin Breeding Service. The semen is then stored in what is called a "straw," which is the current standard packaging method. Each straw contains one-quarter to one-half mil of diluted bull semen (diluted with an "extender" that extends not only the volume of the semen, but the length of its viability as well). As a general rule, one straw is considered a "dose," good for one impregnation.

The straws are stored in liquid nitrogen, and, properly stored, the bull semen will keep indefinitely. Storage is usually handled by warehousing operations, such as Elgin Breeding Service or Bovine Elite. The stored semen may be on consignment, in which case the owners of the bull still own the semen, while the warehouse markets it (Elgin Breeding Service). Or, the warehousing operation may purchase semen and hold it as its own inventory, which it then sells in the marketplace (Bovine Elite). The larger warehousing operations store millions of straws of bull semen.

According to Mr. Rugg, the idea behind artificial insemination is the genetic improvement of the particular breed involved. Simply put, better genetics means better cattle means better beef means better money. Mr. Cardwell gave the example of introducing domestic red angus genetics into Central American or South American herds: the resulting stock will be lighter in color than if black angus lines had been introduced, and accordingly will tolerate the hot tropical climates better than darker stock.

Foreign countries are a huge factor in the bull semen industry. Brazil, for example, according to Mr. Cardwell, is the world's largest "user" of bull semen, but Central American and Carribean counties are also significant players. Interestingly, in Texas, many commercial breeders do not use artificial insemination, but rather continue on in the traditional manner with horses and fences rather than with veterinarians and delivery devices.

1. Characterization

a. Inception of Title

It might be argued that bull semen is something like oil: both are taken out of something and put into something else, where, the thinking goes, the social and financial utility of the situation is much improved. With respect to oil and gas interests, the general rule is that royalties paid for oil and gas produced from the separate property of a spouse are payment for the extraction or waste of the separate estate, and, therefore, remain that spouse's separate property. *See*, *e.g.*, *Norris v. Vaughan*, 260 S.W.2d 676, 679 (Tex. 1953).

On the other hand, it might well be replied that bull semen is not like oil, which is subject to extraction or waste, but is more like potato chips, of which more can always be made. Thus, the waste or extraction rationale under *Norris* and its progeny

would not apply to bull semen. This riveting issue is, as yet, unresolved by Texas courts.

If the bull semen is collected during marriage, it will in all probability be considered community property, particularly since, as is discussed hereinbelow, the offspring born during marriage to even separate property cattle are community property.

b. Tracing

Given that, once collected, bull semen is stored in straws, which are individually identified and labeled, tracing should not normally be a problem encountered by a Texas practitioner so fortunate to be involved in a bull semen case.

2. Valuation

An active market–indeed, an entire industry–exists for bull semen. Under the loose "hierarchy" of value established by *Taylor County v. Olds*, 67 S.W.2d 1102, 1105 (Tex.Civ.App.–Eastland 1934, writ dism'd), "market value" is therefore is best grade of evidence for the value of bull semen. S*ee also and cf.*, *Wendlandt v. Wendlandt*, 596 S.W.2d 323, 235 (Tex.Civ.App.–Houston [1st Dist.] 1980, no writ) (the concept of market value assumes an existing, established market).

Texas courts have recognized three general approaches to determining market value: (1) the market data (or comparable sales) approach; (2) the cost approach; and (3) the income (or income-capitalization approach. *Travis Cent. Appraisal Dist. v. FM Properties Operating Co.*, 947 S.W.2d 724, 730 (Tex.App.–Austin 1997, pet. denied) (the income approach is not applicable). However, when using a valuation methodology based on "comparable sales," great care must be taken to make certain that the "comparable sales" are indeed comparable, and there are several issues surrounding bull semen that must be considered.

The price, or value, of bull semen is the result of supply and demand. A number of factors may affect supply. First, it should be noted that sometimes one particular bull will be in very high demand, because of its perceived "look," *i.e.*, genetics, or productivity. However, the semen supply of that particular bull may be affected if the bull sustains an injury, or for some other reason loses procreative abilities; the value of that bull's semen may well be affected thereby. Likewise, if a prize sire dies, his stored semen may become drastically more valuable.

As for demand, the popularity of breeds waxes and wanes. The influence of foreign demand, as already mentioned, affects market value within particular breeds. Foreign influence is aptly described as high volume, low price. The demand for beef as a food staple is also relevant, as the current market climate in Europe after the various health scares relating to the consumption of cow, mad or otherwise, amply illustrates.

Clearly, the semen of a once popular sire, that is now languishing on the shelf, and has been for some time, is not as valuable as it once was, its historical value, as established by previous sales, notwithstanding. Indeed, in such a situation, Mr. Rugg proposes that such bull's semen is worth only what it cost to produce and collect.

According to both Mr. Rugg and Mr. Cardwell, bull semen may be valued from as little as one dollar per straw, to as much as thousands of dollars per straw. Typically, the average straw may be worth $15-$30 dollars. One bull may easily produce for storage 1000 straws of semen. Mr. Cardwell reported an instance of a single bull producing 60,000 straws of semen. Thus, in any given divorce case in which bull semen is an issue, the prudent Texas practitioner would do well to keep in mind that there might be gold in them thar straws.

Proper valuation will best be accomplished through experts. Some companies, like Bovine Elite, maintain internal pricing lists for their stored semen inventory. If the semen in issue in a divorce appears on such a list, then perhaps such pricing would be determinative of valuation. However, in the likely event that the bull in issue does not appear on any such industry or business list, both Mr.

Cardwell and Mr. Rugg agree that there are so many factors that affect the current market value of bull semen that expert assistance is all but required.

3. Division

Typically, according to Mr. Rugg, the spouse who will continue the ranch or breeding operations post-divorce will be awarded the bull semen. It would appear, however, that such division need not necessarily occur, particularly where the spouses have "their" semen warehoused with a broker on consignment. In such case, the semen on hand at the time of the divorce could be awarded to either spouse, regardless of which spouse continued in the business, or even could be split in kind between the spouses.

If the semen can be sold, the proceeds can be split in kind between the spouses according to an agreement between the parties, or pursuant to the trial court's discretion.

B. Rare Animals - Breeding Stock

1. Characterization

a. Inception of Title

The inception of title rule applies to livestock. *See, e.g., Gutierrez v. Gutierrez*, 791 S.W.2d 659, 665 (Tex.App.–San Antonio 1990, no writ) (70 head of cattle owned by the husband prior to his marriage was his separate property herd).

b. Offspring

Texas law is settled that the offspring born to livestock during the marriage, even if the parents are the separate property of one spouse, become community property. *Gutierrez*, 791 S.W.2d at 664-665 (cattle); *see also*, *Blum v. Light*, 81 Tex. 414, 16 S.W. 1090, 1092 (1891) (cattle); *Bobbitt v. Bass*, 713 S.W.2d 217, 220 (Tex.App.–El Paso 1986, writ dism'd) (the increase of separate property cattle is community property); *Smoak v. Smoak*, 525 S.W.2d 888 890, n. 1 (Tex.Civ.App.–Texarkana 1975, writ dism'd) (cattle); *Amarillo Nat'l Bank v. Liston*, 464 S.W.2d 395, 406 (Tex.Civ.App.–Amarillo 1970, writ ref'd n.r.e.) (cattle); *see also, generally*, *Wagnon v. Wagnon*, 16 S.W.2d 366 (Tex.Civ.App.–Austin 1929, writ ref'd) (cattle).

c. Tracing

With respect to livestock, tracing has been a real issue in several reported Texas cases. As a general rule, of course, property possessed by either spouse during or on dissolution of marriage is presumed to be community property. Tex.Fam.Code Ann. §3.003(a). (Vernon Supp. 1998). A party can overcome the community presumption by tracing the assets on hand back to the original separate estate, but this burden is not discharged when the assets on hand have been so commingled as to defy resegregation and identification. *See e.g., Estate of Hanau v. Hanau*, 730 S.W.2d 663, 667 (Tex. 1987).

In *Gutierrez*, 791 S.W.2d at 664, for example, the husband had at least 70 cows before marriage, but, after marriage, his herd had increased to some 150 head. The San Antonio Court of Appeals held that the trial court properly characterized, upon divorce, the entire herd as community property, since the calves born to the separate property cattle, all community in character, were commingled with the original herd, and the appellate court could find nothing in the record to indicate that the offspring were segregated from the husband's original herd. *Id*. at 665. In *Gutierrez*, the San Antonio Court of Appeals seemed to suggest that the husband was required to "segregate" his separate property cattle from the community cattle, which, as a practical matter, could be quite onerous, if not impossible in a traditional cattle operation.

Nonetheless, other reported Texas cases have also considered the "commingling" issue significant in livestock cases. In *Smoak*, 525 S.W.2d at 890, at the time of marriage, the husband owned, as separate property, fifty head of cattle; at the time of trial the couple had approximately seventy-five head of cattle, twenty-five admittedly community property, being born after the parties' marriage. Ultimately, all the cattle on hand at the time of the trial were presumed to be community property. *Id*. According to the Texarkana Court of Appeals, the

record did not show that any of the original cattle were still on hand at trial, or the time any of the then-existing herd had been acquired. *Id*. There was no contention that the parties owned the identical cattle (which had been purchased more than twenty-five years prior to trial), or offspring therefrom, and the husband did not trace the proceeds of sale of his separate cattle to reinvestment in any specific cattle in parties' possession at the time of the divorce. *Id*. Thus, held the Texarkana appellate court, the evidence supported a conclusion that production and sale of cattle was on a commercial basis and that the original fifty head of cattle and proceeds from the sale thereof were commingled with community assets of like nature. *Id.*

The treatment of the commercial "stock" in *Smoak* should be compared to cases such as *Schmidt v. Huppman*, 11 S.W. 175, 176 (Tex. 1889), *Blumer v. Kallison*, 297 S.W.2d 898, 902-903 (Tex.Civ.App.–San Antonio 1956, writ ref'd n.r.e.), and *Schecter v. Schecter*, 579 S.W.2d 502, 505-506 (Tex.Civ.App.–Dallas 1978, no writ), in which it was held that a business owner accomplishes adequate tracing by simply detailing the value of the business inventory (or "stock") at the date of the marriage, and the value of the inventory at the date of divorce. The burden on the owner of livestock appears to be much greater than that placed upon the owner of business inventory. Whether such distinction is justifiable is problematic. *See and cf., Bobbitt*, 713 S.W.2d at 220 (although there was evidence of, as well as a jury finding that, there was ***no net increase*** in the value of the separate property livestock during the marriage, such finding did not establish that the parties' possessed no community property) (emphasis added); *Bowling v. Bowling*, 373 S.W.2d 829, 831 (Tex.Civ.App.–Houston 1963, no writ) (in which the Houston appellate court determined that the trial court justifiably treated the parties' cattle as community property, where, among other things, there had been a sale of some of the husband's original cattle during the marriage, others had been purchased, and some had calved, so that different cattle were on hand at the time of the divorce).

2. Valuation

As with most assets, the valuation of livestock is generally, but not always, a battle between experts.

In *Gutierrez*, 791 S.W.2d at 666, the husband complained on appeal that the trial court's money award to the wife for her interest in the community cattle on hand at the time of divorce was unsupported by the evidence. The San Antonio Court of Appeals noted that an expert witness gave testimony of the value of the steers, bulls, calves, and heifers based on photographs in evidence. *Id*. The husband attacked such evidence because it dealt with gross numbers and average weights and prices, and did not proceed animal by animal, but the San Antonio appellate court rejected his argument, stating that the husband cited no authority, and the appellate court could find none, that would require such animal by animal evidence. *Id*.

In re Marriage of Taylor, 992 S.W.2d 616 (Tex.App.–Texarkana 1999, no pet.) illustrates two additional general valuation principles specifically applicable to livestock. In *Taylor*, the husband argued, and the Texarkana Court of Appeals agreed, that the wife's testimony that the parties' cattle was worth in the "neighborhood of $14,000.00 to $15,000.00" did not support the trial court's valuation of $20,000.00. *Id*. at 621.

First, it should be noted that lay opinion may establish the value of livestock. *See, Laprade v. Laprade*, 784 S.W.2d 490, 492 (Tex.App.–Fort Worth 1990, writ denied) (the wife's testimony as to the value of the community was admissible and supported the trial court's valuation); *Hochheim Prairie Farm Mut. Ins. v. Burnett*, 698 S.W.2d 271, 276 (Tex.App.–Fort Worth 1985, no writ) (homeowner was allowed to testify concerning the value of his house damaged by fire, when the owner had owned rent houses before, knew the market value of the house, had listed it for sale before the fire, had knowledge of the construction and decor of the house, and had personally inspected the house after the fire).

However, although the finder of fact is not required to accept the opinions of the experts on either side of the controversy [or lay opinion for that

matter], it must find the value to be somewhere in the range between the high and low values offered in evidence. *See also, Grossnickle v. Grossnickle,* 935 S.W.2d 830, 842 (Tex.App.–Texarkana 1996, writ denied) (as the fact finder, the trial court had a right to decide between the figures offered by the wife's expert and by the husband's expert as to the valuation of the parties' cattle herd); *Salinas v. Rafati*, 948 S.W.2d 286, 289 (Tex. 1997).(no evidence supported jury's finding that a medical partnership's value was $4,284,000, when the expert testimony placed the value of the partnership at between $756,821 and $2,940,000).

Grossnickle highlights an important issue for livestock valuators. In a footnote, the Texarkana Court of Appeals noted that the wife did not complain on appeal of the trial court's inconsistency in using the market value at the time of the trial on the property division, which occurred two years after the divorce, but in using the size of the herd at the time of the divorce, in that she was penalized by valuating the herd based on the loss in market value after the divorce, but not credited with any calving that may have occurred to increase the herd after the divorce. 935 S.W.2d at 842 at n.7. The Texarkana appellate court stated that, for the sake of consistency, the higher value of the herd as it existed at the time of the divorce should have been used, or alternatively, if the court was to use the value two years later, then it should have considered the entire herd as it existed on that date. *Id*.

Grossnickle thus reminds the livestock valuator to consider the value of unborn, but, expected, calves. *Id*.

3. Division

Livestock can be divided in kind. Practicalities often call for the award of the entire herd to one spouse, with an offsetting monetary award to the other spouse. *See, e.g., Gutierrez*, 791 S.W.2d at 665 (the trial court awarded the wife one-half of the value of the community's herd).

V. PERSONAL INJURY PRACTICE

A. Entity Theory: Form of the Practice

A personal injury practice will be conducted in one of several "forms." The "form" of the particular personal injury practice is one of the first determinations to be made in any divorce, since typically the form of the practice will affect characterization, valuation, and division issues.

1. Corporation

A corporation is a legal fiction and can act only through its agents. *Maryland Ins. Co. v. Head Indus. Coatings and Servs., Inc*., 906 S.W.2d 218, 233 (Tex.App.–Texarkana 1995), *rev'd on other grounds*, 938 S.W.2d 27 (Tex. 1996); *In re Marriage of Morris*, 12 S.W.3d 877, 885 (Tex.App.–Texarkana 2000, no pet.) (a corporation is a separate legal entity that normally insulates its owners or shareholders from personal liability). Ownership of a corporation is evidenced by stock; an individual owns stock in a corporation (thereby an interest in the corporation), while the corporation owns the actual corporate assets. Thus, upon divorce, the trial court can award only shares of stock, and not corporate assets. *See, e.g.,Thomas v. Thomas*, 738 S.W.2d 342, 343 (Tex.App.–Houston [1st Dist.] 1987, writ denied).

The general rule as to the non-divisibility (upon divorce) of corporate assets holds true unless the corporation is a spouse's alter ego. *See, e.g., Siefkas v. Siefkas*, 902 S.W.2d 72, 79 (Tex.App.– El Paso 1995, no writ).

a. C-Corp

A "C-corp" is a regular corporation. Corporate income is taxed at the corporate level; dividends paid to the shareholders are then taxed (a second time) at the shareholder level.

b. S-Corp

An "S-corp" is a corporation in which the shareholders have elected "Subchapter S" status, in which corporate income is treated as personal income of the shareholders (like a partnership) for federal income tax purposes; an S-corp does not pay federal income taxes. *See, Id*.; *Suburban Utility*

Corp. v. Public Utility Commission, 652 S.W.2d 358, 363 (Tex. 1983) (under Subchapter S, a corporation may elect a tax status which protects the earnings and profits of the corporation from conventional corporate tax rates).

c. Closely Held Corporation

A "closely held" corporation is a corporation which is owned by a small number of shareholders, often related. *See, e.g., DeBord v. Circle Y of Yoakum, Inc*., 951 S.W.2d 127, 131 (Tex.App.–Corpus Christi 1997), *rev'd on juris. grounds sub nom*., *Stary v. DeBord*, 967 S.W.2d 352 (Tex. 1998) (in a closely held corporation, a small number of shareholders operate more as partners than in strict compliance with the corporate form); *see also, Dixie Pipe Sales, Inc. v. Perry*, 834 S.W.2d 491, 492 (Tex.App.–Houston [14th Dist.], 1992, writ denied) (the corporation was a closely held corporation, primarily held by members of one family and their spouses).

d. Professional Corporation

The Texas Professional Corporation Act, Tex.Rev.Civ.Stat. art. 1528e, authorizes the formation of a "Professional Corporation." A professional corporation ("P.C.") means a corporation organized under the Act for the sole and specific purpose of rendering professional service, and which has as its shareholders only individuals who themselves are duly licensed or otherwise duly authorized within Texas to render the same professional service as the corporation. Tex.Rev.Civ.Stat. art. 1528e, Sec. 3(b).

The Act contemplates that professionals such as architects, attorneys, certified public accountants, dentists, public accountants, and veterinarians will form professional corporations. Tex.Rev.Civ.Stat. art. 1528e, §3(a).

Physicians, surgeons and other doctors of medicine are specifically excluded from the operation of this Act since there are established precedents allowing them to associate for the practice of medicine in joint stock companies. *Id*.

2. Partnership

a. In General

A partnership is an association of two or more persons to carry on as co-owners of a business for profit. Tex.Rev.Civ.Stat. art. 6132b §6. The essential elements of a partnership are (1) an agreement to share profits and losses, (2) a mutual right of control, and (3) a community of interest in the partnership. *MacMorran v. Wood*, 960 S.W.2d 891, 897 (Tex.App.–El Paso 1997, writ denied). Mere joint ownership of property does not create a partnership. *See, e.g*., *Nesmith*, 2001 WL 893668, at *5-*6 (the untitled buy-in agreement, stating, "[t]his is to document the partnership agreement between [the husband] and [the wife] regarding their joint ownership of the residence...," did not meet the requirements of establishing a partnership, since Tex.Rev.Civ.Stat. art. 6132b-2.03(b) specifically lists joint ownership of property as a circumstance that does not indicate the creation of a partnership

b. Statutory Provisions Relevant to Characterization and Valuation

A Texas partnership will involve either (1) the Texas Uniform Partnership Act (TUPA) or (2) the Texas Revised Partnership Act. *See, Salinas*, 948 S.W.2d at 289.

The Texas Revised Partnership Act became effective in Texas on January 1, 1994; the older statutory scheme, the Texas Uniform Partnership Act, did not expire until January 1, 1999. *Hawthorne v. Guenther*, 917 S.W.2d 924, 934, n. 2 (Tex.App.–Beaumont 1996, writ denied). Until January 1, 1999, the older statutory scheme (TUPA) continued to apply to partnerships formed prior to January 1, 1994, except for those pre-1994 partnerships that expressly elected to have the new law applied. *Id.*

In pertinent part, the Texas Uniform Partnership Act provides:

> A partner's interest in the partnership is his share of the

> profits and surplus, and the same is personal property for all purposes.

Tex.Rev.Civ.Stat. art. 6132b, Sec. 26.

The Texas Uniform Partnership Act also provides:

> (1) a partner's rights in specific partnership property are not community property;
>
> (2) a partner's interest in the partnership may be community property; and
>
> (3) a partner's rights to participate in the management is not community property.

Tex.Rev.Civ.Stat. art. 6132b, Sec. 28-A.

On the other hand, the Texas Revised Partnership Act, provides, in pertinent part:

> "Partnership interest" means a partner's interest in a partnership, including the partner's share of profits and losses or similar items, and the right to receive distributions. A partnership interest does not include a partner's right to participate in management.

Tex.Rev.Civ.Stat. art. 6132b-1.01(13).

> Partnership property is not property of the partners. Neither a partner nor a partner's spouse has an interest in partnership property.

Tex.Rev.Civ.Stat. art. 6132b-2.04.

> A partner's partnership interest is personal property for all purposes. A partner's partnership interest may be community property under applicable law.

Tex.Rev.Civ.Stat. art. 6132b-5.02(a).

The Comment of the 1993 Bar Committee to Art. 6132b-5.02 states, in pertinent part:

> Subsection (a) states...[a] partner's partnership interest does not include the partner's right to participate in management of the partnership. It follows that a partner's right to participate in management is not community property, the same as in TUPA [Texas Uniform Partnership Act] §28-A(3).

Comment, Tex.Rev.Civ.Stat. art. 6132b-5.02.

The Texas Revised Partnership Act also provides:

> On the divorce of a partner, the partner's spouse, to the extent of the spouse's partnership interest, shall be regarded for purposes of this Act as a transferee of the partnership interest from the partner.

Tex.Rev.Civ.Stat. art. 6132b-5.04(a). According to the Texas Revised Partnership Act, a transfer of a partner's partnership interest is permissible, in whole or in part. Tex.Rev.Civ.Stat. art. 6132b-5.03(a)(1). As against the other partners or the partnership, however, a transfer does not entitle the transferee, during the continuance of the partnership, to participate in the management or conduct of the partnership business. Tex.Rev.Civ.Stat. art. 6132b-5.03(a)(4). Ultimately, a transferee of a partner's partnership interest is entitled to receive, to the extent transferred, distributions to which the transferor otherwise would be entitled. Tex.Rev.Civ.Stat. art. 6132b-5.03(b). After a transfer, the transferor continues to have the rights and duties of a partner other than the interest transferred, and, until the transferee becomes a partner, the transferee does not have liability as a partner solely as a result of the transfer. *Id*.

c. Effect of the Aggregate Theory

With the passage of the Uniform Partnership Act in 1961, Texas discarded the aggregate theory of partnership and adopted the entity theory. *Marshall v. Marshall*, 735 S.W.2d 587, 593-594 (Tex.App.–Dallas 1987, writ ref'd n.r.e.). Under the entity theory, the individual assets are owned by the partnership, and not by the individual partners. *Harris v. Harris*, 765 S.W.2d 798, 802 (Tex.App.–Houston [14th Dist] 1989, writ denied). Consequently, partnership property can be characterized neither as community nor separate. *Marshall*, 735 S.W.2d at 594. The only partnership property right possessed by a partner which is subject to a community or separate property characterization is the partner's interest in the partnership. *McKnight v. McKnight*, 543 S.W.2d 863, 867-868 (Tex. 1976); *Farley v. Farley*, 930 S.W.2d 208, 213 (Tex.App.–Eastland 1996, no writ) (the rights of a divorcing spouse can attach only to the partner"s interest in the partnership, and not specific partnership property). Thus, characterization and valuation issues turn on the partner's ***interest*** in the partnership.

d. Partnership Agreement

A Texas partnership may also involve a partnership agreement. *See, Salinas*, 948 S.W.2d at 289. A partnership agreement, under the law of contracts, governs the rights of the partners. *See, e.g., Dobson v. Dobson,* 594 S.W.2d 177, 180 (Tex.Civ.App.–Houston [1st Dist.] 1980, writ ref'd n.r.e.). However, only when a partnership agreement is silent as to particular issues do the statutory provisions of Texas law come into play. *See, McLendon v. McLendon*, 862 S.W.2d 662, 676 (Tex.App.–Dallas 1993, writ denied); *see also*, Tex.Rev.Civ.Stat. art. 6132b-1.03(a).

3. Sole Proprietorship

In a sole proprietorship, an individual owns the business and its assets outright. A sole proprietorship is distinguishable from partnership or corporate entities in which ownership interests are held by the partners or shareholders of the entity, and the entity owns the assets.

B. Characterization

1. Corporation

a. Inception of Title

The separate or community nature of shares of stock is fixed by operation of law, *i.e.*, the inception of title rule, upon the existent facts. *In re Marriage of York*, 613 S.W.2d 764 769 (Tex.Civ.App.–Amarillo 1981, writ ref'd w.o.j.), *citing, Hilley v. Hilley*, 342 S.W.2d 565, 568 (Tex. 1961); *see also, Allen*, 704 S.W.2d at 604; *Harris v. Harris*, 765 S.W.2d 798, 801 (Tex.App.–Houston [14th Dist] 1989, writ denied)(stating that *Allen* applies the inception of title rule to the incorporation of a business). Because a corporation does not exist until the issuance of a certificate of incorporation, and there can be no title to a corporation until it actually exists, the inception of title doctrine can only be applied to a corporation as of the date of incorporation. *Allen*, 704 S.W.2d at 604.

The approach of Texas courts in determining the separate or community character of a corporation formed during a marriage has been to require the parties to clearly trace the separate and community property assets that were contributed during the formation of the corporation. *Id*., *citing*, *Vallone v. Vallone*, 644 S.W.2d 455, 457 (Tex. 1982). Corporations organized during marriage and capitalized entirely with the traceable separate property of one spouse are characterized as the separate property of that spouse. *Allen*, 704 S.W.2d at 604; *see also, Hunt v. Hunt*, 952 S.W.2d 564, 567 (Tex.App.–Eastland 1997, no writ) (corporation funded after marriage, but entirely with separate property helicopters owned by the husband – not with community property or by means of incurring community debts – was the separate property of the husband); *Holloway v. Holloway*, 671 S.W.2d 51, 56-57 (Tex.App.–Dallas 1983, writ dism'd) (although organized and capitalized during the marriage, the corporation was initially capitalized with the proceeds of a loan from a lender who had agreed to look only to the separate property of the

husband for repayment, and was therefore the husband's separate property).

Under the inception of title rule, an interest in a corporation owned prior to marriage is the separate property of the owner-spouse. *See, Horlock v. Horlock*, 533 S.W.2d 52, 60 (Tex.Civ.App.–Houston [14th Dist.] 1975, writ dism'd); *see also*, *Hilliard v. Hilliard*, 725 S.W.2d 722, 723 (Tex.App.–Dallas 1985, no writ) (it was evident that the corporate stock was separate property since it was acquired before marriage).

It is not uncommon for the initial capital contribution or stock purchase to be based upon services rendered. If such services are rendered during the marriage, the stock will be community property. If such services are rendered before the marriage, the stock will be separate property. Thus, the specific services rendered in exchange for stock must be identified and traced either to work performed prior to the marriage, or to work performed after the marriage.

b. Tracing

Tracing involves establishing the separate origin of property through evidence showing the time and means by which the spouse originally obtained possession of the property. *Hilliard*, 725 S.W.2d at 723. Separate property will retain its character through a series of exchanges so long as the party asserting separate ownership can overcome the presumption of community property by tracing the assets on hand during the marriage back to property that, because of its time and manner of acquisition, is separate in character. *See, e.g., Cockerham*, 527 S.W.2d at 167.

In order to establish the separate character of corporate stock, a party's duty to trace extends no farther than to prove that his or her separate property was exchanged for a certain percentage of the capital stock and to show that the stock has been held by the party since the time of issuance. *Vallone v. Vallone*, 618 S.W.2d 820, 822-823 (Tex.Civ.App.–Houston [1st Dist.] 1981), *rev'd on other grounds,* 644 S.W.2d 455, 460 (Tex. 1982).

[The tracing examples presented hereinbelow in the present discussion on corporations are applicable, by analogy, to partnerships as well.]

(1) Purchase Funds

Tracing is adequate when the funds for the purchase of stock are shown to be drawn from a separate account. *See, Trawick v. Trawick*, 671 S.W.2d 105, 112 (Tex.App.–El Paso 1984, no writ).

(2) Marital Agreement

An ownership interest in a corporation may become separate property by virtue of a marital agreement, as may any profits, dividends, interest, or proceeds which accrue therefrom. *See*, *Dewey v. Dewey*, 745 S.W.2d 514, 517 (Tex.App.–Corpus Christi 1988, writ denied); *Williams v. Williams*, 720 S.W.2d 246, 249-50 (Tex.App.–Houston [14th Dist.] 1986, no writ).

(3) Chain of Events

Satisfactory tracing may also be accomplished by establishing the "chain of events" leading from the separate property asset to the subsequent acquisition of the stock in question, particularly if it can be shown that no other transactions occurred on the day or days in question, which would plant the seeds of doubt upon the possible source of the funds used to acquire the disputed stocks. *See*, *Hanau*, 730 S.W.2d at 667 (in a proceeding involving the distribution of property of the testator, who bequeathed his separate property to his children of a prior marriage, and his portion of the parties' community property to his wife, stock was properly traced to the testator's separate property, when the stock sale and purchase transaction were in an account in the testator's own name, in which community assets had not been commingled, and over which the wife had no power, and the stock in question was acquired on the same day and for about the same price as the sale of other stock which was testator's separate property); *see also*, *Fazakerly v. Fazakerly*, 996 S.W.2d 260, 266-267 (Tex.App.–Eastland 1999, pet. denied) (the boards of directors of two separate property corporations of the wife established two new

companies by resolution, transferred the assets to them, and approved resolutions whereby the wife would buy 60,000 shares of stock in each new company for the total sum of $2,000, after which stock certificates for each new company were issued only in the wife's name; although the wife could not produce a cancelled check for the $2,000 she paid for the stock of the new companies, it was shown that no community funds were used for such purchase, the wife had substantial separate property cash at the time, and a subsequent offer to buy all the companies was made to the wife alone, thus establishing the new companies were the wife's separate property).

(4) Merger

Under the longstanding Texas rule that mutations and changes in the character of property do not affect the property's nature as separate or community, corporate stock acquired as a result of a merger of a separate property corporation with another corporations is–as a matter of law–separate property. *Horlock*, 533 S.W.2d at 60.

(5) Gift

Property acquired during marriage by gift is separate property. Tex.Fam.Code §3.001. For a court to find the existence of a gift, there must be proof of donative intent, delivery, and acceptance; a gift of stock further requires that there be relinquishment of dominion and control by the owner. *Gannon v. Baker*, 830 S.W.2d 706, 710 (Tex.App.–Houston [1st Dist.] 1992, writ denied).

Stock acquired by gift is separate property. *Powell v. Powell*, 822 S.W.2d 181, 183 (Tex.App.–Houston [1st Dist.] 1991, writ denied) (shares of stock owned by the wife were the wife's separate property, acquired by gift from husband, when there was testimony that the husband intended to give such shares before marriage as a wedding present, and that a second gift was made after the marriage as a conditional gift to protect such shares from the husband's former wife's judgment, and that the husband did not try to rescind the conditional gift after the resolution of disputes with his creditors); *Rusk v. Rusk*, 5 S.W.3d 299, 303-305 (Tex.App.–Houston [14th Dist.] 1999, pet. denied) (when the only evidence that consideration existed for the transfer of corporate stock from the father to his son (the husband) was the share certificate's pre-printed recitation, stating, "[f]or value received...," and other than such unsupported fictional recital, there was no testimonial evidence or any other kind of documentary evidence, such as the corporate books, checks or receipts, that demonstrated in any fashion actual consideration, the presumption of a gift between the parent and child was not overcome, and the stock was the husband's separate property, even though the actual delivery of the stock certificate occurred a few weeks after the marriage; the record showed that all indicia of ownership followed the inception of the business five years before the parties' marriage, at which time the husband's "right or claim" to the stock originated); *cf*., *Massey v. Massey*, 807 S.W.2d 391, 405 (Tex.App.–Houston [1st Dist.] 1991), *writ denied*, 867 S.W.2d 766 (Tex. 1993) (*per curiam*) (parol evidence was not admissible in a divorce action to establish that 157 shares of bank stock and two tracts of land were gifts to the husband's separate estate; copies of deeds and a $180,000 promissory note reflected the terms of the transactions by which the husband had acquired such property, and which, under the express language of the unambiguous documents – reciting consideration and transfers of the property during the marriage – were bargained-for exchanges).

(6) Stock Swap

Stock acquired through a stock swap for separate property stock retains its separate property character. *Farish v. Farish*, 982 S.W.2d 623, 629 (Tex.App.–Houston [1st Dist.] 1998, no pet.) (when the husband testified that the trustee's of a testamentary agreed to exchange 12,606 shares of one stock for 8,000 shares of the husband's separate property stock, and the husband produced three stock certificates, one for his separate property stock, one for the stock of the trust (with the word "canceled" hand-written across it), and one in his name for the swapped 12,606 shares, such uncontroverted evidence established, as a matter of law, the separate character of the 12,606 shares).

(7) Stock Split

Stock acquired in a stock split of existing separate property stock remains separate in character. *Harris*, 765 S.W.2d at 803; *see also*, *Halbert v. Halbert* 794 S.W.2d 535, 536 (Tex.App.–Tyler 1990, no writ) (the uncontroverted evidence showed that at least 9,904 of the 11,904 shares issued to the husband resulted from a stock split, and thus were his separate property).

(8) Mutation Upon Dissolution

A mutation resulting from an exchange of separate property corporate stock for cash or other assets upon dissolution of the corporation will remain separate property. *Hilliard*, 725 S.W.2d at 723 (because husband did not provide the trial court with sufficient evidence that the house was a mutation of the husband's separate property stock upon a corporate dissolution, the presumption of community property was not rebutted and the house was community property).

(9) Goodwill From Predecessor Sole Proprietorship

There must be evidence of the value of the goodwill of a predecessor sole proprietorship (belonging to spouse) allegedly used to capitalize a successor corporation, or else it is impossible to trace the portion of the corporation created with the alleged separate property. *Allen*, 704 S.W.2d at 604-605 (while it was clear that the corporation took over the activities of wife's sole proprietorship, and continued to do business in the same location, with the same employees and with the same clientele, there was no evidence presented concerning the value of the goodwill contributed by the wife at the time of incorporation).

c. Retained earnings

The retained earnings of a corporation are the property of the corporation until distributed. *Cleaver v. Cleaver,* 935 S.W.2d 491, 494 (Tex.App.–Tyler 1996, no writ); *see also, Thomas*, 738 S.W.2d at 344 (courts in community property states have unanimously held that corporate earnings remain corporate property until distributed and, therefore, are not divisible on divorce); *Snider v. Snider*, 613 S.W.2d 8, 12 (Tex.App.–Dallas 1981, no writ) (prior to the actual declaration of a dividend, all the accumulation of surplus in the corporation merely enhanced the value of the shares held by the husband as his separate property and the community had no claim thereto). Corporate management may invest company earnings in corporate assets rather than distributing those earnings to shareholders. *Cleaver*, 935 S.W.2d at 495; *see also, Fain v. Fain*, 93 S.W.2d 1226, 1229 (Tex.Civ.App.–Fort Worth 1936, writ dism'd). Further, until distributed to shareholders by the corporation, income on the company's retained earnings are neither the community nor separate property of the shareholder-spouses, but are simply corporate earnings, an asset of business. *Cleaver*, 935 S.W.2d at 494.

The retained earnings of a Subchapter S corporation, the stock of which is the separate property of one spouse, are not marital property subject to division in a divorce action, but rather are a corporate asset even though the community estate may pay federal income tax on such retained earnings during the marriage. *Thomas*, 738 S.W.2d at 344.

d. Professional Corporation

For characterization purposes, a professional corporation is simply a corporation, and will be characterized in exactly the same manner as any other corporation.

2. Partnership

a. Inception of Title

An interest in a partnership, owned prior to marriage, is the separate property of the owner-spouse. *See, In re Marriage of Higley*, 575 S.W.2d 432, 434 (Tex.Civ.App.–Amarillo 1978, no writ); *see also*, *Harris*, 765 S.W.2d 798, 802-803.

In contrast, an interest in a partnership, acquired during the marriage, is (presumptively) community property. *York v. York*, 678 S.W.2d 110,

112 (Tex.App.–El Paso 1984, writ ref'd n.r.e.) (evidence, including documents establishing that the partnership gas well started producing prior to the divorce, that the partnership agreement signed by the divorced husband and other parties recited that the partnership would be deemed to have been created prior to the divorce, and the partnership tax return showing that the husband joined the partnership prior to divorce, was sufficient to establish that the husband was a partner in the partnership prior to the date of divorce, and therefore, the partnership interest was community property); *Lumpkins v. Lumpkins*, 519 S.W.2d 491, 494 (Tex.Civ.App.–Austin 1975, writ ref'd n.r.e.) (Phillips, J., dissenting) (an interest in a partnership is property, and such interest acquired during marriage is community property subject to division by the court).

b. Tracing

Mutations of a separate property partnership interest remains separate property. *Harris*, 765 S.W.2d at 802 (while the value of the husband's separate property partnership fluctuated during the marriage, there was no evidence that any "additional" interest was acquired); *cf*., *Marshall*, 735 S.W.2d at 594 (there can be no mutation of a partner's separate property capital contribution because the partner's contribution becomes partnership property which cannot be characterized as either separate or community property of the individual partners).

c. Undistributed Partnership Income

Under the entity theory of partnership, undistributed partnership income retained in the partnership is neither the community nor the separate property of any individual partner, but rather remains partnership property, non-divisible upon divorce. *Cleaver*, 935 S.W.2d at 494.

It should be noted that, in his dissenting opinion in *Thomas*, 738 S.W.2d at 348, Justice Bass cited *Grost v. Grost*, 561 S.W.2d 223, 229 (Tex.Civ.App.–Tyler 1977, writ dism'd) for the proposition that the undistributed income of separate property partnerships is treated in Texas as community property. Justice Bass, however, miscited *Grost*. There is no indication whatsoever in *Grost* that the partnership in issue was ever claimed to be separate property; rather, the facts of the case, as recited in the opinion, strongly suggest that the partnership was community property. Indeed, the word "separate" does not even appear in the Tyler appellate court's discussion of the partnership issues in *Grost*. *See*, 561 S.W.2d at 229-230. Appropriately, therefore, the Tyler Court of Appeals' opinion in *Cleaver* does not even allude to *Grost*.

In *Grost*, Justice Bass also cited *Norris*, 260 S.W.2d at 681, for the proposition that Texas courts consistently hold that the portion of the partnership interest that consists of profits accumulated during a marriage, whether or not distributed, is community property. However, as recognized in *Marshall*, 735 S.W.2d at 594-595, the adoption in Texas of the Uniform Partnership Act in 1961 effectively overruled *Norris* on the issue of the proper treatment of undistributed partnership income.

3. Sole Proprietorship

Under the inception of title rule, the assets of a sole proprietorship will be presumptively community property if acquired during the marriage and, therefore, subject to division by the court. *See*, *e.g*., *Butler v. Butler,* 975 S.W.2d 765, 768 (Tex.App.–Corpus Christi 1998, no pet.) (the sole proprietorship's furniture, fixtures, machinery, equipment, inventory, cash, accounts, goods, supplies, and all personal property used in connection with the operation of the business, were acquired during the marriage and were therefore community property).

In contrast, the value of the inventory or stock of a business owned before marriage retains upon divorce its character as the separate property of the owner spouse, and adequate tracing may be accomplished by detailing both the value of the inventory at the date of the marriage and the value of the inventory at the date of divorce. *Schmidt*, 11 S.W. at 176. In such a situation, the Texas Supreme Court stated:

> While the specific articles that made up the original stock had been sold, and their places supplied by others from time to time as the exigencies of the business required, the property was in fact the same, a stock of merchandise, and we think that there was not such a change in the property as would divest it of its separate character, to the extent of the goods owned by appellant at the time of the marriage.

Id. at 176.

The rule in *Schmidt* has been followed in other Texas cases. For example, in *Blumer*, 297 S.W.2d at 902-903, the wife held a one-fourth interest in a mercantile business, whose books were kept during the marriage so as to identify and keep separate the profits as distinguished from the capital of the business, with the intention to distinguish the community property from separate property, the San Antonio appellate court held that the interest of the wife was properly regarded as an interest in a business, as well as an interest in the stock of merchandise, and there was no commingling of properties or funds that would prevent identification of separate property of wife at her death). In *Schecter*, 579 S.W.2d at 505-506, the Dallas Court of Appeals followed *Schmidt*, and held that the wife sufficiently traced the inventory of her business, even though she did not trace the specific items of inventory from the beginning of the marriage to its end.

C. Valuation

1. Goodwill: Theory and Practice

"Goodwill" may well constitute one of the more valuable assets of a professional practice, including a personal injury practice.

a. Definition

In Texas, "goodwill" has been defined as the advantage or benefits acquired by a business beyond the value of its capital stock, accumulated funds and property, because of the general public patronage and encouragement which it receives from constant and habitual customers on account of its position, or common celebrity, or reputation for skill, or influence, or punctuality, or from accidental circumstances or necessities, or even from ancient partialities or prejudices. *Peat Marwick Main & Co. v. Haass,* 818 S.W2d 381, 389 (Tex. 1991), *citing, Taormina v. Culicchia*, 355 S.W.2d 569, 573 (Tex.Civ.App.–El Paso 1962, writ ref'd n.r.e.); *see also, Salinas,* 948 S.W.2d at 290 (the probability that customers would resort to the old place of business may be deemed a valuable right).

Goodwill is property and, although intangible, is an integral part of a business, the same as its physical assets. *Finn v. Finn*, 658 S.W.2d 735, 749 (Tex.App.–Dallas 1983, writ ref'd n.r.e.) (Stewart, J., dissenting).

As a property right, goodwill may be sold or transferred. *Allen v. Allen*, 704 S.W.2d 600, 604-605 (Tex.App.–Fort Worth 1986, no writ). Indeed, the goodwill of a business can be transferred apart from any of its tangible assets. *Airflow Houston, Inc. v. Theriot*, 849 S.W.2d 928, 933 (Tex.App.–Houston [1st Dist.] 1993, no writ).

b. Types of Goodwill

Goodwill may attach to a business, or to a person. *See, Nail v. Nail,* 486 S.W.2d 761, 764 (Tex. 1972). Accordingly, two distinct types of goodwill are identifiable: (1) "professional goodwill" (also referred to as "personal" goodwill); and (2) "practice goodwill" (also referred to as "enterprise" or "business" or "commercial" goodwill). Additionally, a hybrid form of goodwill may exist, in which personal and commercial goodwill are "mixed."

(1) Professional Goodwill

"Professional goodwill" is conceptually distinct from goodwill associated with a trade or a business. *Guzman v. Guzman*, 827 S.W.2d 445, 447 (Tex.App.–Corpus Christi 1992, writ denied). Professional goodwill is based on an individual's reputation, experience, training, and ability. *See,*

e.g., Salinas, 948 S.W.2d at 286 (the distinction has been drawn that professional goodwill is not so much fixed or as localized as the goodwill of a trade, and attaches to the person of the professional man or woman as a result of confidence in his or her skill and ability). Such qualities are personal to the individual and are probably impossible to separate from the business, making the associated value difficult to transfer. The implication here is that if the professional left his or her current practice and entered another practice, his or her clients would follow. Thus, unless the professional's individual traits can be transferred to a buyer, there is no value to such individual's goodwill for the purposes of division in a divorce.

Incidentally, it should be noted that a person need not be a "professional," like a lawyer or a doctor, in order to develop "professional" goodwill: personality, social contacts, and specialized knowledge of the problems and solutions peculiar to a particular business create, on the part of clients or customers, confidence in the person's skill and ability, *i.e.,* "professional" goodwill." *See, Rathmell v. Morrison,* 732 S.W.2d 6, 18 (Tex.App.–Houston [14th Dist.] 1987, no writ) (key man in several insurance companies possessed professional goodwill).

In Texas, professional goodwill does not possess value, or constitute an asset separate and apart from the person of the professional, or from the professional's ability to practice the profession; it is extinguished in the event of death, or retirement, or disablement, or upon the sale of the practice or loss of clients. *Nail*, 486 S.W.2d at 764; *see also, Smith v. Smith,* 836 S.W.2d 688, 690 (Tex.App.–Houston [1st Dist.] 1992, no writ). Professional goodwill is not divisible upon divorce in Texas.

(2) Practice Goodwill

Practice (or commercial) goodwill refers to an entity's reputation and its ability, as an institution, to attract and hold business, even with a change of ownership. *See, e.g., Peat Marwick Main & Co.,* 818 S.W2d at 389. The key to practice or commercial goodwill is whether customers of the entity will stay with the entity upon the change of ownership. Practice goodwill in Texas is often divisible upon divorce.

(3) "Mixed" Professional and Practice Goodwill

Professional and practice goodwill may be "mixed." In other words, a particular individual may accrue professional goodwill, and the business with which the individual is associated may also accrue practice goodwill, a fact Texas courts have repeatedly recognized. *See, e.g., Keith v. Keith,* 763 S.W.2d 950, 952 (Tex.App.–Fort Worth 1989, no writ) (father-son partnership); s*ee also, Welder v. Green*, 985 S.W.2d 170, 178 (Tex.App.–Corpus Christi 1998, pet. denied) (accounting partnership); *Eikenhorst v. Eikenhorst,* 746 S.W.2d 882, 888 (Tex.App.–Houston [1st Dist.] 1988, no writ) (medical partnership); *Rathmell,* 732 S.W.2d at 18 (despite the importance of the owner, the "key man," his insurance companies were not a "one man show" and had goodwill separate and apart from him); *Finn,* 658 S.W.2d at 741 (law firm).

In *Geesbreght v. Geesbreght,* 570 S.W.2d 427, 435-436 (Tex.Civ.App.–Fort Worth 1975, writ dism'd), the Fort Worth Court of Appeals held that a large medical practice corporation could have practice goodwill associated with its name separate from the individual doctors who actually provided the medical services, and discussed such "mixed"goodwill as follows:

> "Goodwill" is sometimes difficult to define. In a personal service enterprise, such as that of a professional person or firm, there is a difference in what it means as applied to "John Doe" and as applied to "The Doe Corporation" or "The Doe Company." If "John Doe" builds up a reputation for service it is personal to him. If "The Doe Company" builds up a reputation for service there may be a change in personnel performing the service upon a sale of its business, but the sale of such

> business naturally involves the right to continue in business as "The Doe Company." The "goodwill" built up by the company would continue for a time and would last while the new management, performing the same personal services, would at least have the opportunity to justify confidence in such management while it is attempted to retain the "goodwill" of customer clients of the former operators....the name of the business is a company name as distinguished from the name of an individual. Therein does it have value, plus the value of the opportunity to justify confidence in the new management by the customer/clients of the predecessor owner(s).

With each level of organizational complexity in a professional practice, the segregation of professional goodwill from practice goodwill becomes more difficult. If, for instance, an established, well-known individual lawyer incorporates under a business name, adds associates and partners, and expands into multiple offices, almost invariably the lawyer will have created commercial goodwill in addition to his or her own professional goodwill.

c. The Existence of Goodwill: Evidentiary Factors

The existence of goodwill is question of fact. *Guzman,* 827 S.W.2d at 447; *Simpson v. Simpson,* 679 S.W.2d 39, 41 (Tex.App.–Dallas 1984, no writ). In determining whether a trade or business possesses commercial goodwill separate and apart from an associated professional, Texas courts consistently look to several evidentiary factors.

(1) The business name is different from the individual's.

Texas courts have been careful to distinguish partnerships that have a generally recognized name, thus prompting patrons to do business with any person or firm using that name, from partnerships the names of which are not generally recognized, composed of, for example, the names of the former (possibly deceased) partners. *See, Welder*, 985 S.W.2d at 179.

When the name of a business is a company name, as distinguished from the name of an individual professional, the business will possess valuable goodwill, in that (a) its reputation for service would survive even a change in management while the new management had an opportunity to presently justify customers' former confidence in the old management, and (b) the existing goodwill presented an opportunity for the new management to enter into the identical field of operations. *Geesbreght,* 570 S.W.2d at 435-436; *see also, Finn,* 658 S.W.2d at 741 (legal professional corporation conducted business under names of founding partners and not current senior partners); *cf., Welder*, 985 S.W.2d at 179 (the accounting partnership had changed its name at various times upon prior dissolutions, and thus there was no goodwill for the continued use of an established, well-recognized name).

On the other hand, as is often the case with a solo professional practice, when the business is a one person professional corporation conducting business in that person's name, any associated goodwill will probably be personal. *Hirsch v. Hirsch,* 770 S.W.2d 924, 927 (Tex.App.–El Paso 1989, no writ).

In general, of course, a well-established business name, in and of itself, generates commercial goodwill. *See, e.g., Rice v. Angell*, 73 Tex. 350, 11 S.W. 338, 340 (1889) (goodwill will survive the dissolution of a partnership when it is attached to a well established name, such as "The Galveston Insurance Agency"); *see also, Pemelton v. Pemelton*, 809 S.W.2d 642, 665 (Tex.App.–Corpus Christi 1991), *rev'd on other grounds, sub nom.*, *Heggen v. Pemelton*, 836 S.W.2d 145 (Tex. 1992) (recognizing the goodwill

value of the name "Pemelton Farm and Ranch/Rio Rico Farms").

(2) The business employs many employees.

A business that employs competent employees, who handle day-to-day business affairs, will likely possess goodwill apart from the personal goodwill of the owner, even if the owner is a critical "key man" in the business. *See, Rathmell,* 732 S.W.2d at 18; *see also, Geesbreght,* 570 S.W.2d at 435 (10 full-time employees, and 50-100 part-time employees); *Finch v. Finch,* 825 S.W.2d 218, 224-225 (Tex.App.–Houston [1st Dist.] 1992, no writ) (business goodwill existed because the owner employed men to work on cars at his shop, and did not personally perform all of the work on the vehicles; thus, had the owner retired, died, or been disabled, the goodwill would not have been extinguished, since persons other than the owner performed some of the work at the shop)*; Finn,* 658 S.W.2d at 741 (law firm had over forty partners and over forty associates).

(3) The business contracts with customers.

A business that contracts directly with customers, as opposed to the principals contracting with customers, accrues goodwill apart from the goodwill of the principals. *Eikenhorst,* 746 S.W.2d at 888; *cf., Simpson,* 679 S.W.2d at 41 (contracts with customers did not even mention corporation, but instead recited names of owners); *see also and cf., Salinas,* 948 S.W.2d at 292 (because hospital would only agree to contract with an individual physician, even though the contracting physician shared the benefits of the contract with his partners, the contract was personal to the contracting physician and was not a partnership asset).

(4) The business supplies competitive prices and services.

Competitive pricing and product selection also create goodwill in a business, regardless of the personal goodwill attached to a principal. *Rathmell,* 732 S.W.2d at 18. Competitive pricing and products are seldom features of a personal injury practice. although competitive [or distinctly non-competitive] contingent fee rates could feasibly figure into the goodwill analysis.

(5) The business serves many customers.

A business that serves many customers, particularly in the absence of direct participation by the principal or principals of the business, creates goodwill with those customers apart from the personal goodwill attached to the principal(s). *See, Geesbreght,* 570 S.W.2d at 435; *Eikenhorst,* 746 S.W.2d at 888 (medical partnership provided radiological services to four hospitals).

(6) The business has an established location.

A business with an established location, such as the "corner store," may have commercial goodwill simply by virtue of such location. *See, e.g., Rice*, 11 S.W. at 340; *see also, Nail*, 486 S.W.2d at 763 (goodwill can exist as an incident of a continuing business having locality or name); *Taormina,* 355 S.W.2d at 573-74 (goodwill could exist when former partners continued their business, among other things, in the same place and with the same name).

d. The Divisibility of Goodwill: *Finn's* Two-Pronged Test

In Texas, only goodwill that exists separate and apart from an individual's personal skills, abilities, and reputation is divisible upon divorce. *Rathmell*, 732 S.W.2d at 17. In *Finn,* the Dallas Court of Appeals enunciated the two-pronged test, acknowledged by Texas courts as determinative, for whether goodwill is divisible upon divorce: (1) the goodwill must exist independently of the personal goodwill of the professional; and (2) such goodwill must have a commercial value in which the community is entitled to share. *Finn*, 658 S.W.2d at 740. Put another way, goodwill in a professional business is not considered part of the community estate unless it exists independently of the professional spouse's skills, and the community estate is otherwise entitled to share in the asset. *Guzman*, 827 S.W.2d at 447.

e. Goodwill and Future Earnings

The Texas Supreme Court has held that, to the extent that a valuation of a dissolved partnership was based on the goodwill attributable to the personal skills and talents of the former partners – *i.e.*, the ability of the partnership to produce income in the future – the valuation improperly took into account intangibles that were not partnership assets. *Salinas*, 948 S.W.2d at 289-290. An attempt to harness the future earning capacity of a former partner would allow another partner to recover a share of the former partner's ability to generate income under the guise of goodwill, an impermissible result under Texas law. *Id.* at 291. Similarly, Texas law does not permit a spouse to share, post-divorce, in the future earnings of the other spouse. *See, e.g., Berry v. Berry,* 647 S.W.2d 945, 947 (Tex. 1983); *Licata v. Licata*, 11 S.W.3d 269, 278 (Tex.App–Houston [14th Dist.] 1999, pet. denied) ('[w]e recognize a spouse is not entitled to a percentage of his or her spouse's future income"); *Butler,* 975 S.W.2d at 768 (wife has no interest in the husband's post-divorce earnings); *Rathmell*, 732 S.W.2d at 18 (post-divorce time, toil and talent of a business owner must be excluded by the trial court when determining the value placed on a business).

Expert testimony concerning the value of a sole proprietorship, based solely on the owner-spouse's future earning capacity, is not admissible to establish the value of the business, because the valuation is based upon matters personal to the spouse. *Smith,* 836 S.W.2d. at 692.

f. Goodwill: Evidentiary and Procedural Considerations

(1) Proof

Since the existence of goodwill is question of fact, the trial lawyer must develop sufficient facts to support his or her position, whether for or against the existence of divisible goodwill in any particular case.

Critical elements of the proof should include evidence that personal goodwill existed (or didn't) and the amount of such personal goodwill. *See, e.g., Welder*, 985 S.W.2d at 179. In *Welder*, after a partnership dissolution, one partner continued the business at the same location used prior to the breakup, and, on appeal, the Corpus Christi Court of Appeals acknowledged that such fact might create goodwill value. *Id*. at 179. However, while the record was replete with references to valuation practices employed by accountants in determining goodwill, and there was evidence of how the various precursor partnerships had determined the value owed to a departing partner or due from new partners buying their way into the partnership, there was no evidence of clients who had remained with the one partner, or of their value, based solely on the partner's continued use of the old location, and so there was not even a scintilla of evidence showing or tending to show that any goodwill attached to his business was attributable to its location. *Id*.; *see also*, *Parker v. Parker*, 897 S.W.2d 918, 933 (Tex.App.–Fort Worth 1995, no writ) (husband failed to sufficiently brief point of error so that appellate court could determine whether the trial court considered the two types of goodwill in determining the value of the corporations).

(2) Findings of Fact

It is also important that the trial court's findings of fact and conclusions of law indicate whether the trial court considered goodwill in the valuation of any business for the purposes of dividing the marital estate. *See, Finch*, 825 S.W.2d at 224*; Parker*, 897 S.W.2d at 933.

As already mentioned, the Texas Legislature recently enacted §6.711 of the Family Code, which will require valuation findings for assets the value of which the parties contest. A request for findings of fact and conclusions of law under §6.711 must conform to the Texas Rules of Civil Procedure. And, as also already discussed, §6.711 takes effect September 1, 2001, and applies to a suit for dissolution of a marriage pending on that date or filed on or after that date.

Prior to September 1, 2001, Texas lawyers are faced with conflicting opinions out of the courts of appeals regarding valuation findings. Over the years, there has been substantial Texas authority holding that the trial court is not required to make

specific valuation findings in divorces. *See, e.g.*, *Lettieri v. Lettieri*, 654 S.W.2d 554, 557 (Tex.App.–Fort Worth 1983, writ dism'd) (the trial court is not required to set out its theories or the legal basis upon which it grounded the division of property; *Finch v. Finch*, 825 S.W.2d 218, 221 (Tex.App.–Houston [1st Dist.] 1992, no writ) (the value of specific property is not an ultimate issue, and therefore need not be set out in findings of fact); *see also*, *Wallace v. Wallace*, 623 S.W.2d 723, 725 (Tex.App.–Houston [1st Dist.] 1992, no writ). *Lettiere, Finch,* and *Wallace* are based upon the general rule that a Texas trial court must make findings on each material issue raised by the pleadings and evidence, but not on evidentiary issues; findings are required only when they relate to ultimate or controlling issues. *See, e.g.*, *Roberts v. Roberts*, 999 S.W.2d 424, 434 (Tex.App.–El Paso 1999, no pet.).

Certain other Texas appellate courts, however, have taken a contrary position and have held that findings are necessary in valuation cases. The El Paso Court of Appeals has been in the forefront of the fray. *See, e.g., Roberts v. Roberts,* 999 S.W.2d 424, 435 (Tex.App.–El Paso 1999, no pet.) ("[b]ecause we believe that an appellant cannot demonstrate that a trial court abused its discretion in making a just and right division of the community estate without being able to quantify the size of the community pie or just how large a slice each spouse was served, we conclude that an appellant is entitled to findings on characterization and valuation when error is preserved"); *see also*, *Joseph v. Joseph*, 731 S.W.2d 597, 598 (Tex.App.–Houston [14th Dist.] 1987, no writ) (the trial court's failure to file findings placed the appellant in an unjust and harmful position of guessing at the valuation methods used when attacking the property division, requiring that the case be reversed and remanded for a new trial).

In *Morris*, 12 S.W.3d at 886, the Texarkana Court of Appeals found that the trial court's valuation of a $180,000.00 cash award to the wife was a controlling issue that had a direct effect on the judgment. Moreover, stated the Texarkana appellate court, without specific findings as to what values were considered in arriving at that sum, there was no way to know if the court awarded half the fair market value of a particular property, or if the court was simply reimbursing the wife for her time, toil, and labor in enhancing the value of husband's separate property, and, if so, in what amounts. *Id.* According to the Texarkana Court of Appeals, such findings were necessary to give the husband adequate information for the preparation of his appeal. *Id.*

(3) Exclusion Procedure

The Texas practitioner should also be aware of the proper procedure to exclude expert testimony regarding valuation on the grounds of incorrectly valuing *divisible* goodwill. The expert witness should be taken on voir dire, and asked whether he or she can put a value on the business entity that does not include personal or professional goodwill; if the expert cannot do so, his or her testimony should be excluded upon proper motion. *See, Hirsch,* 770 S.W.2d at 927; *see also, Smith,* 836 S.W.2d. at 690 (the expert's appraisal was not admissible because the expert had failed to exclude the husband's personal goodwill from his evaluation).

2. Goodwill and the Sole Proprietorship

a. *Nail* and Its Progeny

The leading Texas case regarding the valuation of the goodwill of a professional practice operated in the form of a sole proprietorship is probably *Nail,* 486 S.W.2d 761. The husband was an ophthalmologist who had been operating as a sole proprietor for about fifteen years. In the party's eventual divorce, the trial court found:

> [t]hat the value of the assets of the medical practice of [the husband] is $131,759.64, including all fixtures, furniture, equipments, and the value of the goodwill that has accrued thereto during the marriage....That the approximate value of [the husband's] office equipment and office furniture is $735.47.

Id. at 762.

On appeal, the Texas Supreme Court deduced that the trial court had valued the goodwill of the husband's medical practice at $131,024.17 ($131,759.64 - $735.47). The Texas Supreme Court then held:

> ...it cannot be said that the accrued goodwill in the medical practice of [the husband] was an earned or vested property right at the time of the divorce or that it qualifies as property subject to division by decree of the court. It did not possess or constitute an asset separate and apart from his person, or from his individual ability to practice his profession. It would be extinguished in an event of his death, or retirement, or disablement as well as in the event of the sale of his practice or the loss of his patients, whatever the cause....That it would have value in the future, is no more than an expectancy wholly dependent upon the continuation of existing circumstances.

Id. at 764 (citations omitted). The Texas Supreme Court expressly left open in *Nail* the question of whether goodwill could be considered in evaluating a professional partnership or corporation, and also said that it was "not concerned with goodwill as an asset incident to the sale of a professional practice." *Id.* at 764. However, as will be discussed below, in *Salinas*, the Texas Supreme Court apparently answered the question of the application of *Nail* to professional partnerships and corporations in the affirmative.

In *Austin v. Austin*, 619 S.W.2d 290 (Tex.Civ.App.–Austin 1981, no writ), the Austin Court of Appeals considered the valuation of a solo professional practice of a certified public accountant. Following *Nail*, the Austin appellate court stated:

> The goodwill of an ongoing non-corporate, professional practice is not the type of property that is divisible as community property in a divorce proceeding....Once a professional practice is sold, the goodwill is no longer attached to the person of the professional man or woman. The seller's actions will no longer have significant effect on the goodwill. The value of the goodwill is fixed and it is now property that may be divided as community property.

Id. at 292 (citations omitted); s*ee also, Guzman,* 827 S.W.2d at 448 (goodwill, if any, of the solo CPA firm did not exist independently from the husband); *Hirsch,* 770 S.W.2d at 927 (no evidence that goodwill existed apart from the personal abilities of the husband, a solo lawyer).

Nail does not establish an absolute rule. *Salinas,* 948 S.W.2d at 291. Thus, whether a sole proprietorship has goodwill should be a business-by-business determination. The existence of goodwill, after all, is a question of fact. Since goodwill is oftentimes the most valuable asset in a service-oriented business, *Nail* must not deter the effort to place goodwill among the business' assets in the valuation process. *Nail* should be limited to cases in which the goodwill of the sole proprietorship is totally indistinguishable from the sole proprietor. If goodwill exists separate and apart from the person of the sole proprietor, its value should be considered.

b. How Not to Value a Sole Proprietorship

In *Smith,* 836 S.W.2d. 688, the husband was a licensed, certified respiratory therapist and operated his business as a sole proprietorship. No independent income tax returns were filed for the business; business income was reported on Schedule C of the parties' joint income tax return.

At the trial of the divorce, both the wife and the husband testified that, in 1988, the husband told the wife that if anything happened to him, she

should sell the business to another individual for $72,000, to be paid over a period of three years, or let an employee run it for one-half of the profits. *Id.* at 691.

The wife also called an accounting expert to provide the court with a valuation of the husband's business. The expert reviewed three years of their personal income tax returns and financial records. To arrive at the valuation for the business, the expert determined the income from the business for four years, from which he subtracted the tax liability to reach that year's after tax income. He then added the after tax income for the four years, and divided that figure by four, to arrive at an average after-tax income of $68,846. Finally, the expert multiplied the average after tax income by a factor of 9.818 (the present value of an annuity of $1 for 20 years at 8% return) to calculate the present value of the business at $675,930. The expert explained his assumptions for the formula: he assumed the husband was 40 years old and would work until he is 60, and that 8% was a conservative rate of return. The expert described his method as an estimate of the present value of average annual earnings on an annuity basis. The expert testified that he was not familiar with the husband's type of business and did not have any comparable sales of similar businesses. He said he did not interview the husband, did not inspect the facilities, and did not see the equipment. In determining the value of the business, he said he assumed the assets were not of any consequence and the entire value of the business was based on the earning capacity of the husband. The expert admitted on cross-examination that his valuation was merely an evaluation of the income generated by the husband. *Id.* at 690-691.

The trial court valued the husband's business, excluding goodwill, at $100,000. *Id.* at 690.

On appeal, the Houston First Court of Appeals held that the wife's expert presented only evidence of the husband's personal future earning capacity, as opposed to the value of the business. *Id.* at 692. His testimony was based on matters personal to the husband (his life expectancy; the amount earned in past years projected over his work lifetime), and did not include any consideration of the business (its assets, receivables, or comparable sales of similar businesses). *Id.* Since a spouse is not entitled to a percentage of his or her spouse's future income, but rather is only entitled to a division of property that the community owns at the time of the divorce, the Houston appellate court held that the only admissible evidence of value of the business was the parties' identical testimony that the husband valued it at $72,000 in 1988. *Id.* Consequently, such evidence was both legally and factually insufficient to support the trial court's finding of a valuation of $100,000. *Id.*

3. Goodwill and the Closely Held or Professional Corporation

a. Valuation v. Characterization

As will be discussed, as an intangible asset, goodwill can accrue to an individual involved with a corporation, or it can accrue to the corporation itself. *See, Geesbreght,* 570 S.W.2d at 435-436. In either case, it is not an asset over which a Texas trial court has jurisdiction to divide upon divorce. If the goodwill belongs to the individual, it is personal, and cannot be divided. *Nail*, 486 S.W.2d at 764. If the goodwill belongs to the corporation, it is a corporate asset, and cannot be divided by a trial court. *Thomas*, 738 S.W.2d at 343. With regard to the corporation, goodwill – if it exists – enhances the value of the corporation, and thus the value of the corporate stock. *See*, *Geesbreght,* 570 S.W.2d at 435 (the value of the stock of Dr. Geesbreght's corporation was enhanced by goodwill separate and apart from the person of Dr. Geesbreght). Accordingly, the commercial goodwill of a corporation is more accurately considered a factor in the ***valuation*** of the corporation and any interest therein, rather than a factor in the ***characterization*** of the corporation and its stock. *Cf., Hirsch,* 770 S.W.2d at 927 (it has become relatively clear that goodwill is not to be included or considered ***when placing a value*** on a professional corporation unless it can be determined first, that the goodwill exists independently of the personal ability of the professional person, and second, that if such goodwill does exist, it has a commercial value in which the community estate is entitled to share)

(emphasis added). In other words, with regards to goodwill in a corporate context, the characterization issue is limited to the identification and segregation of personal and commercial goodwill; beyond that determination, the existence of commercial goodwill affects only the valuation of the corporate entity.

b. *Geesbreght* and its progeny

Goodwill in a professional corporation which exists independently of a professional's personal skills may be subject to division. *Guzman*, 827 S.W.2d at 447.

The leading Texas case with regard to the valuation of the goodwill of a professional practice operated as a closely held corporation is *Geesbreght*, 570 S.W.2d 427, mentioned earlier. In 1975, the husband and his partner, both doctors, formed a professional corporation, which, ultimately, supplied hospital emergency room services by other physicians in its employ to hospitals at eight different locations, and was grossing more than $1 million annually.

In 1976, the husband filed for divorce, and the value of his interest in the professional corporation was contested. After a trial before the court, the trial court found that the $16,000 book value of the husband's 500 shares of stock to be the value of the stock for purposes of the parties' property division. The wife appealed, contending the trial court erred in not considering the goodwill of the professional corporation.

After distinguishing the circumstances present in *Nail* from those of the husband, the Fort Worth Court of Appeals in *Geesbreght* held that the value of the corporate stock was enhanced by goodwill separate and apart from the person of the husband. *Id.* at 435.

In *Rathmell*, 732 S.W.2d 6, the Houston Fourteenth Court of Appeals expanded upon the traditional concept of professional goodwill in a corporation. In 1975, after more than twenty years of marriage, the husband and wife entered into a property settlement agreement, approved by the court and incorporated in the parties' divorce decree, which awarded to the husband the Rathmell companies, insurance agencies in which the husband was the key man.

In 1977, the husband sold the Rathmell companies for substantially more than the value represented to the wife in their prior settlement negotiations. The wife filed a bill of review alleging, among other things, that the husband had misrepresented the value of the Rathmell companies. After a trial before the court, the trial court made a fact finding that the value of the Rathmell companies was $4,857,000 on the date of the parties' divorce.

The Houston Fourteenth Court of Appeals reversed the trial court and remanded the case for a new trial. *Id.* at 20. The Houston appellate court compared the personal goodwill of the husband with the professionals in *Nail, Geesbreght*, and *Finn*:

> [The husband] is not a lawyer or a doctor, as were the professionals in *Nail, Geesbreght,* and *Finn*. Nevertheless, it is clear that appellant did develop professional goodwill as the term is used in *Nail*....Several witnesses testified that the key to financial success of the Rathmell companies was [the husband's] personality, social contact, and specialized knowledge of the problems and solutions peculiar to insuring businesses and associations. Personality and social contacts are important in business because they help "get a foot in the door." Specialized knowledge is needed to get customers the right kind of insurance for a good price. It is undisputed that [the husband] was the major "producer" in the companies, meaning he brought in most of the customers. The goodwill that arose because of these attributes in [the husband] attached as a result of confidence in

> his skill and ability, and did not possess value or constitute an asset separate and apart from [the husband's] person or his individual ability to practice his profession, and would be extinguished if he died, or retired, or was disabled.

Id. at 18.

The husband argued that all goodwill associated with his companies was his professional goodwill. *Id.* However, the Houston appellate court did not agree, but rather found that his companies were not a "one man show." *Id.* Thus, the Rathmell companies also had goodwill separate and apart from the husband. *Id.*

Hirsch, 770 S.W.2d 924, sheds additional light upon the valuation of goodwill in a professional corporation. In *Hirsch,* the husband had practiced law since the mid-1960's and had formed a professional corporation in 1976. The wife filed for divorce, and the value of the incorporated one-person law practice was at issue. In the ensuing jury trial, the wife's expert testified that the law practice had a present value of $444,774, arriving at that figure by multiplying a 5-year average of the law practice's annual gross receipts by 1.5. The jury charge submitted by the trial court did not instruct the jury to exclude the husband's personal goodwill from the valuation of the professional corporation. The husband appealed, claiming, among other things, that the trial court improperly permitted the jury to consider his personal goodwill.

The El Paso Court of Appeals reversed the judgment of the trial court. *Id.* at 928. In its holding, the Court cited *Nail* and *Geesbreght,* but focused primarily on the two-pronged test established by *Finn*:

> ...it has become relatively clear that goodwill is not to be included or considered when placing a value on a professional corporation unless it can be determined first, that the goodwill exists independently of the personal ability of the professional person, and second, that if such goodwill does exist, it has a commercial value in which the community estate is entitled to share....Where the entity is a one person professional corporation conducting business in that person's name, it would be difficult to get past the first prong of the test. In this case, there is no evidence that goodwill existed independently of the personal ability of [the husband].

Id. at 927.

4. Goodwill and the Partnership

a. Valuation v. Characterization

While the personal goodwill of a partner is not divisible upon divorce, the commercial goodwill of a partnership belongs to the partnership, and, as a partnership asset, cannot be divided by a Texas trial court upon divorce. *See, Nail*, 486 S.W.2d at 764.

b. *Finn* and its progeny

There may be goodwill in a professional partnership that is separate from the skills or attributes of an individual partner, just as a mercantile partnership can have goodwill beyond the individual contributions or the partners. *Welder*, 985 S.W.2d at 178. Recall that, in *Salinas*, the Texas Supreme Court stated: "***[t]o the extent*** that the valuation of the dissolved [professional] partnership was based on the goodwill attributable to the personal skills and talents of the former partners, it improperly took into account intangibles that were not partnership assets." *Salinas,* 948 S.W.2d at 290 (emphasis added). Thus, there may be *divisible* practice goodwill in a professional partnership, as well as non-divisible professional goodwill.

Many Texas practitioners believe that the leading case regarding the valuation incident to divorce of the goodwill of a professional practice

operated in the form of a partnership is *Finn,* 658 S.W.2d 735. During the parties' entire twenty year marriage, the husband practiced law with a prominent Dallas law firm, of which he was a senior partner.

Under the terms of the firm's partnership agreement, if the husband died or withdrew from the partnership, he was only entitled to (1) the amount contributed in his capital account, (2) any earned income which had not been distributed, and (3) his interest in the firm's reserve account less 10% of his proportionate share in the accounts receivable for client's disbursement. The agreement did not provide for compensation for accrued goodwill to a partner who ceased to practice law with the firm, nor did it provide any mechanism to realize the value of the firm's goodwill.

The trial court instructed the jury to exclude the goodwill of the law firm and its future earning capacity from the valuation of the community interest in the husband's law practice. On appeal, the wife contended that the trial court's instruction was erroneous.

Applying its new two-pronged test, *i.e.*, (1) the goodwill must exist independently of the personal goodwill of the professional and (2) such goodwill must have a commercial value in which the community is entitled to share, the majority of the Dallas appellate court found that the restrictions in the husband's partnership agreement deprived him of any legal entitlement to the value of the firm's goodwill. *Id.* The *Finn* majority opinion is premised directly on the fact that the partnership agreement provided no recovery for goodwill on the husband's death or withdrawal from the professional practice. According to the majority, the husband could not realize the value of the firm's goodwill and therefore it had no commercial value. *Id.* at 740. Thus, the goodwill attributable to the husband's partnership interest was not divisible upon divorce. *Id* at 741.

It should be noted that the *Finn* opinion was the result of an *en banc* rehearing (11 Justices sitting) with 4 of the Justices joining the majority, 2 concurring, and 5 joining in the dissent.

In a well-reasoned concurring opinion, Justice Annette Stewart strongly disagreed with the *Finn* majority opinion:

> The partnership agreement does not control the value of the individual partnership interests. The asset being divided is the husband's interest in the partnership as a going business, not his contractual death benefits or withdrawal rights. The formula in the partnership agreement may represent the present value of the husband's interest, but it should not preclude a consideration of other facts. The value of the husband's interest should be based on the present value of the partnership entity as a going business, which would include consideration of partnership goodwill, if any. Goodwill is property and, although intangible, it is an integral part of a business, the same as its physical assets.

Id. at 749 (Citations omitted).

Further, Justice Stewart asserted that the *Finn* majority was concerned with "future contingencies," but noted that, under Texas law, the assets of a community estate are valued as of the time of dissolution of the marriage. *Id.* Consequently, argued Justice Stewart, there was no valid reason to exclude a professional partnership interest from the basic rule as to valuation at the time of dissolution, when the partner, whose interest was being valued, intended to continue as a member of the firm. *Id.* at 741-742.

The Texas Supreme Court's refusal to find reversible error in the *Finn* decision may *not* have been an implicit approval of the opinion of the Dallas Court of Appeals on partnership goodwill. The Court of Appeals reversed the trial court, but on grounds unrelated to the question of partnership goodwill. Thus, it is at least arguable that the *Finn* opinion on partnership goodwill was *dicta*.

Fairly recently, the San Antonio Court of Appeals stated that, in *Salinas*, 948 S.W.2d at 291, the Texas Supreme Court recognized that goodwill may exist in a professional partnership that *must* be considered in dividing a community estate upon divorce. *See*, *Southwest Texas Pathology Associates, L.L.P. v. Roosth*, 27 S.W.3d 204, 209 (Tex.App.–San Antonio 2000, pet. dism'd) (emphasis added). However, in *Salinas*, the Texas Supreme Court actually stated: "[n]evertheless, there may be goodwill in a professional partnership that is separate from the skills or attributes of an individual member." *Salinas,* 948 S.W.2d at 291, *citing*, *Nail*, 486 S.W.2d at 764. Thus, contrary to the implication of the San Antonio appellate court in *Southwest Texas Pathology*, in *Salinas*, the Texas Supreme Court did not address the issue of the *divisibility*, under *Finn*, of partnership goodwill, but rather only the existence of potentially divisible commercial goodwill. Even so, the San Antonio appellate court's misstatement notwithstanding, it is true that there may be goodwill in a professional partnership that must be considered upon divorce, as the Texas Supreme Court implicitly (but not explicitly) recognized in *Salinas*.

5. Common Problems in Valuing a Personal Injury Practice

Personal injury law practices are, perhaps, the hardest type of law practice to value. The primary problem with these practices surrounds the client files and the nature of the contingency fee contract. Because personal injury cases are handled on contingency fees, there are no readily ascertainable "accounts receivable." In some instances, there will be no recovery for the client, and therefore no fee to be received by the firm. Certain cases may realize a much better return by settlement or judgment than expected, while other cases may realize less. Frequently, even the attorneys involved are not able to accurately assess the likelihood of recovery, or the eventual amount.

There is a whole host of problems with the valuation of personal injury cases. The final determination in these valuations will often come down to the role of the trial expert. Such expert, based upon his or her own experience in handling cases of the sort being valued, must determine from the available information the actual value of the case. Such value can vary widely, depending upon a number of factors, including the identity of the law firm that is handling the case and the manner in which the client's case is being prepared. Thus, a case may ultimately be worth more than $100,000.00 in the hands of one firm, but less than $100,000.00 in the hands of another.

Further, the personal trial expert, in valuing the individual files, must project the amount of additional work necessary to complete the case–and the manner in which individual attorneys manage their cases varies widely. The number of depositions, the amount and form of investigation performed, and typical pre-trial preparation, are idiosyncratic to particular firms, as well as to particular lawyers within each firm. For example, in complex cases, some firms will conduct "mini trials," or other studies, to determine the type of jury most favorable to the case. Substantial work by independent expert witnesses may be required, or models may need to be built. A case once estimated to be 50% complete at the time of valuation may well later turn out to have been only 20% complete.

Obviously, when valuing a personal injury practice's "client files" to determine the value of the practice, a number of practical and ethical issues develop.

a. Percentage of Completion

Because in a personal injury practice there are no "accounts receivable" at any given time, there is no means to obtain a current "snapshot" of the value of client files. Additional work by the firm will usually be necessary to finalize most cases and to achieve therein a quantifiable recovery.

When a case first comes into the office, before any work is done on it, there is some chance that the case is worth little to nothing. By the time a demand letter is sent, and work has been underway, however, the case has some value, but not as much as a case that is already in trial or settlement talks, or subsequent to trial on appeal.

Any estimate of value for any case will be affected by the amount of work yet to be done. It is therefore necessary to determine the "stage" of each client file at the time of the valuation.

Generally, a percentage of completion formula is applied that takes into account the estimated final value of the case and multiplies that number by the estimated stage of completion. For example, if the case is valued at $100,000.00, and is 60% complete, then the value assigned to that case will be $60,000.00.

b. Inception of Title

Questions regarding the "inception of title" of individual personal injury cases being valued may (or should) often arise.

In a personal injury case, does title arise when the case is "signed up," and the injured person becomes a client of the firm? Or does the attorney have "title" when the funds in settlement funds are ascertained to be a sum certain, or when the judgment is actually collected? Arguably, until money is collected, the firm or attorney has no more than an expectancy interest. The question, however, is unsettled in Texas.

c. Referral Fees

(1) Fees Paid Out

Each case valuation must also take into account whether there is an agreement to pay a referral fee to another attorney or firm. In such cases, the value of the case will be reduced by the amount of the fee to be paid.

For example, in the case discussed above and valued, because of the "stage" at which it stood, at $60,000.00, if a referral agreement exists, calling for a 33 1/3% fee, then the real value to the firm will be about $40,000.00.

(2) Fees Paid In

The valuation of the entire firm must include the amount of fees that may be recovered from other law firms on cases that were referred "out" from the firm being valued (which may generate later referral fees for the firm). There are quite a few obstacles in placing values on such fees, however, particularly since the pertinent files are generally outside the firm, held by another firm or by lawyers who are not members of the firm being valued. When a case has been referred out, and there are no written referral fee agreements, placing a value on the eventual fees to be recovered by the firm may encounter, among other things, "inception of title" problems.

d. Structured Settlements

Structured settlements also involve potential problems with the inception of title doctrine, as well as with terms of the applicable contingency fee agreements. Often, when a personal injury case is resolved by means of a structured settlement, the attorney's fees percentage will be paid up front in a lump sum. In such cases, it is easy to determine the value of that particular client file. In other instances, however, there may be valuation problems if the contingency fees are also structured.

One commentator has suggested that a Texas court will most likely date the inception of the title to the fee back to the contract with the client, comparing the case to a winning lotto ticket. *See*, Larry H. Schwartz, *Handling the Divorce Involving a Law Practice*, p. A-6, MARRIAGE DISSOLUTION INSTITUTE (1998). If the lotto ticket is purchased during the marriage, it is presumptively community property. Schwartz, at A-6. If the parties later divorce, and the lotto ticket wins, then "inception of title" arose at the time the ticket was purchased. *Id*. Mr. Schwartz also observes that most lotto winnings are paid out over time, but the entitlement still dates back to the purchase of the ticket. *Id*.

These Authors agree, in general terms, with the lotto ticket analogy on contingency fee cases. However, it should also be noted that structured settlements are somewhat distinguishable from other contingency fee cases. If a case with a structured settlement has already settled, the amount of the

settlement, and consequently the associated attorneys' fees, are readily ascertainable. Title should vest once the structured settlement is signed since the right to receive the funds is contractual, and not merely an expectancy.

e. Advanced Expenses and Costs

In most personal injury cases, the law firm will advance expenses and associated costs, *i.e.*, "fund" the lawsuit. The contract with the client frequently provides for the payment of such expenses and costs out of the client's percentage of any future recovery. Clearly, some attorneys are better able to predict the likelihood of a successful recovery than others. In valuing the client files, the valuation expert will need to be cautious and mindful as to whether the firm has advanced more costs and expenses than they can expect to recover in any given matter, or as a whole. Additionally, the expert will need to predict whether, in any particular case, additional costs and expenses will need to be advanced for a successful recovery, and the approximate amount of those costs and expenses. Such a prediction is necessary to arrive at a "net value" of the individual client file.

f. Partners' or Shareholders' Percentage Interests

Once the individual cases are valued, the attorney spouse's percentage of ownership interest will also need to be determined. If the attorney spouse has the same percentage ownership interest in recoveries already received but not yet disbursed, or expected to be received in the future, then the percentage can be applied across the board. However, in many cases the interest will change from one point in time to another, or from one case to another. In such instances, the percentage interest must be applied on a case-by-case basis. Further, the percentage interest may be subject to change due to some future event (such as promotion within the partnership).

g. Shelf Life of Cases

The "shelf life," or amount of time a case has been pending, will also affect the value of the client file. Some attorneys are more aggressive than others, and actively work their cases on the assumption that they will receive a higher recovery if they "strike while the iron is hot." Others tend to allow their cases to languish and often become dormant, which results in a lack of interest by the defendants, adjusters, and insurers. In order to determine the pattern of the firm being valued, the expert witness will need to look at the history of similar cases within the firm.

Equally, the "type" of personal injury cases within the firm will also be important. It is, for example, typical for a complex class action toxic tort case to take far longer to finalize than a rear end automobile collision with little damages.

6. Problems with Discovery and Personal Injury Practices

A competent, thorough valuation of the community estate's interest in a law firm, particularly when the firm has contingent fee contracts with clients, requires analysis of the firm's records, both financial and regarding the contingent fee cases. If the law firm is a partnership, the contingent fee files are an asset of the partnership. *Bader v. Cox,* 701 S.W.2d 677, 682 (Tex.App.–Dallas 1985, writ ref'd n.r.e.). If the firm is a corporation, the corporation owns the file. *See, Thomas*, 738 S.W.2d at 343. In such situations, of course, the community owns an interest in the partnership or in the corporation, and not in specific partnership or corporate assets, but an accurate valuation of the partnership or corporation still necessarily entails a valuation of the partnership or corporate assets, including contingency fee cases. Not surprisingly, efforts to discover a law firm's files, however, often encounter objections that such information is protected by the attorney-client privilege and work product exemption.

One reported Texas appellate court case, *Enos v. Baker* 751 S.W.2d 946, 949-950 (Tex.App.–Houston [14th Dist.] 1988, no writ) held that a trial judge's order for an attorney to produce "an inventory of any evaluation or demand that has been made on behalf of any client," and "all active client files," constituted an abuse of discretion

because (1) the active client files of law firm were protected by the attorney-client privilege and (2) the law firm's evaluations and demands made on behalf of clients were protected as attorney work product. Even though the lawyer-husband admitted that the true value of the law firm resided in the value in the firm's cases, the Houston appellate court believed that any evaluation based on the probable outcome of personal injury and workers' compensation suits in various stages of the litigation process would be little more than conjecture. *Id.* at 949. Further, the Houston Fourteenth Court of Appeals stated that the need of each client for privacy, guaranteed to them at the time any communication is made, is of greater importance than marital economics and convenience. *Id.*

Other courts disagree, and in the opinion of these Authors, their arguments are more persuasive, and more effectively take into account current trends in discovery and family law. Unfortunately, however, the need to obtain the information from the family lawyer's perspective often entails additional work on the part of the law practice that is being valued, and therefore taps the resources of such practice's personnel.

In *Finn,* 658 S.W.2d 735, the Dallas Court of Appeals considered a similar issue. The wife contended that the trial court improperly denied discovery of the balance sheets, profit and loss statements, and records reflecting salaries and disbursements to senior partners of her husband's law firm (the trial court granted discovery of the firm's partnership agreement and retirement plan and of the husband's K-1 schedules, which provided annual summaries of the husband's share of the firm's assets and earnings). *Id.* at 742.

The Dallas appellate court held that the denial of discovery deprived the wife of access to material information needed to effectively cross-examine the husband's valuation experts and to allow her experts all the information they required to accurately calculate the value of the husband's interest in the firm (the wife's experts were not required to rely on secondary data in determining and presenting to the court her estimate of the value of the community interest in the firm). *Id.* at 744. Further, the denial of discovery was material not only because it denied the wife information needed to adequately present her case to the court, but also because it deprived the trial court of sufficient evidence on which to base a valuation of the community interest in the law firm. *Id.*

The Dallas Court of Appeals recognized the need to protect the confidentiality of the records of the husband's law practice, but stated that such need did not constitute an absolute bar to discovery because the trial court may order an *in camera* inspection of the documents to protect confidential client records. *Id.* at 746. In conclusion, the court observed:

> The husband's interest in the firm was a major asset of the community estate. Lack of this discovery left the trial court's valuation of this asset without proper support in the evidence. Since this interest is the largest item of the community estate, and its value was the principal contested issue at the trial with respect to the division of the property of the parties, we conclude that without a proper valuation the trial court could not properly exercise its discretion in making a "just and right" division within [former] section 3.63 of the Texas Family Code.

Id.

Similarly, in *Fanning v. Fanning*, 841 S.W.2d 949, 951 (Tex.App.–Waco 1992, no writ), a child support action, the Waco appellate court held that the blanket denial of discovery of financial records of husband's law firm was an abuse of discretion. Although the Waco Court of Appeals acknowledged the need to protect the confidentiality of the records of the law practice, it found that such a need was not an absolute bar to discovery, because the trial court could order an *in camera* inspection of the documents to protect confidential client records. *Id*.

In *Turner v. Montgomery*, 836 S.W.2d 848, 851 (Tex.App.–Houston [1st Dist.] 1992, no writ), the Houston First Court of Appeals observed that the following two discovery requests, with respect to the husband's law firm, did not seek "unquestionably" privileged communications between attorney and client:

> (32) [w]ith regard to the cases which the law firm of Barnes and Turner currently has pending, please produce the following: Barnes and Turner attorney fee contracts; all settlement records (letters, agreements, statements); all final orders, judgments, non-suits, or dismissals; any structured settlement letters, statements, or agreements, trust accounts, notes or promises to pay Sylvester Turner or any firms with which he is or was associated...;
>
> (39) [w]ith regard to the cases which the law firm of Barnes and Turner currently has pending, please produce copies of all documents relating to any funds, from any source, which may be received by you individually or by any other party.

The Houston appellate court then stated that the mere possibility that a document might be partly privileged will not justify its total exclusion. *Id.; cf., Methodist Home v. Marshall,* 830 S.W.2d 220, 231 (Tex.App.–Dallas 1992, no writ) (the attorney-client privilege protects confidential communications, not information). Thus, although the Houston First Court of Appeals ultimately ruled in favor of the wife on grounds that the husband waived his right to assert that the requested information was protected by the attorney-client privilege, the court's reasoning supports the positions of *Finn* and *Fanning, i.e.,* that privileged materials can be protected during a divorce while at the same the time the compelling need to properly value a law firm may be satisfied as well.

Discovery may take several forms. By way of example, it is time consuming, but not impossible, to obtain some information on a specific attorney's client files by reviewing discovery responses from the case that have been filed with the court. However, such information will be available only when a lawsuit has been actually filed. The information would also be limited to those cases in which written discovery has been conducted and responses have been made part of the public record.

There are also some sources of information that may be less confidential than others, even though the information is in the attorney's client files. However, Texas courts have not been uniform in their decision as to which information will always be made available.

7. Ethical Considerations

a. Privileges

Clients have privileges which must be fully protected at all times. Rule 503 of the Texas Rules of Evidence sets forth the Lawyer-Client Privilege and provides, in pertinent part, as follows:

> (b)(1) A client has a privilege to refuse to disclose and to prevent any other person from disclosing confidential communications made for the purpose of facilitating the rendition of professional legal services to the client:
>
> (A) between the client or a representative of the client and the client's lawyer or a representative of the lawyers;
>
> (B) between the lawyer and the lawyer's representative;
>
> (C) by the client or a representative of the client, or the client's lawyer or a representative of the lawyer, to a lawyer or a representative of a lawyer representing another party

in a pending action and concerning a matter of common interest therein;

> (D) between representatives of the client or between the client and a representative of the client; or
>
> (E) among lawyers and their representatives representing the same client.

Tex.R.Evid. 503(b). The exceptions to the Lawyer-Client Privilege are found in Rule 503(d). There is no privilege under Rule 503 for the following: (1) furtherance of crime or fraud; (2) claimants through same deceased client; (3) breach of duty by a lawyer or client; (4) document attested by a lawyer; and (5) joint clients. Tex.R.Evid. 503(d).

The Texas Rules of Civil Procedure further provide that certain matters are not discoverable. discovery of certain matters. Rule 192.5, for example, entitled "Work Product," provides, in pertinent part:

> (1) core work product–the work product of an attorney or an attorney's representative that contains the attorney's or the attorney's representative's mental impressions, opinions, conclusions, or legal theories–is not discoverable; and
>
> (2) any other work product is discoverable only upon a showing that the party seeking discovery has substantial need of the materials in the preparation of the party's case and that the party is unable without undue hardship to obtain the substantial equivalent of the material by other means.

Tex.R.Civ.P. 192.5(1); Tex.R.Civ.P. 192.5(2).

It should also be noted that an attorney may employ an accountant for the client's benefit in order for communications from the client to qualify for the attorney-client privilege. *Parker v. Carnahan*, 772 S.W.2d 151, 157 (Tex.App.–Texarkana 1989, writ denied). However, mere employment of the accountant does not make the accountant an agent of the attorney; rather, basic principles of agency law are applicable, and such agency is to be determined on the basis of the attorney's control of the work done by the accountant. *Id.*; *see also*, *Lone Star Partners v. NationsBank Corp.*, 893 S.W.2d 593, 600 (Tex.App.–Texarkana 1994, writ denied) (absent evidence of control, merely engaging an accountant does not make the accountant an agent of the employer).

b. Confidentiality

Paramount in all cases is the concept of confidentiality. An attorney's clients are entitled to the confidentiality privilege afforded by the attorney/client relationship. The privilege belongs to the client, rather than to the attorney, and cannot be disturbed because of disputes the attorney may have either in his or her personal life or in the life of another member of the law firm. A client should not have the additional burden, over and above the problems which led the client to seek legal counsel and representation in the first place, of worrying about whether the personal disputes of the attorney may result in the client's confidential information being disclosed to a third party.

Diametrically opposed to the client's right of protection and confidentiality is the non-attorney spouse's right of access to information necessary to value his or her interest in a community property asset in the context of a divorce.

Rule 1.05 of the Rules of Professional Conduct sets out the standards regarding confidential information. Comment 1 to Rule 1.05 expresses the theory and policy behind the client's right to an expectation of confidentiality:

> Both the fiduciary relationship existing between the lawyer and the client and the proper functioning of the legal system require the preservation by the lawyer of

> confidential information of one who has employed or sought to employ the lawyer. Free discussion should prevail between the lawyer and client in order for the lawyer to be fully informed and for the client to obtain the full benefit of the legal system. The ethical obligation of the lawyer to protect the confidential information of the client not only facilitates the proper representation of the client, but also encourages potential clients to seek early legal assistance.

Rule 1.05(a) defines "confidential information" as both "privileged information" and "unprivileged client information." It further provides that "privileged information" is that information which is protected by Rule 503 of the Rules of Evidence. Although Rule 503 lists exceptions to the privilege, those exceptions are limited. The exceptions to Rule 1.05 of the Rules of Professional Conduct are also limited.

> (c) A lawyer may reveal confidential information:
>
> (1) When the lawyer has been expressly authorized to do so in order to carry out the representation.
>
> (2) When the client consents after consultation.
>
> (3) To the client, the client's representatives, or the members, associates, and employees of the lawyer's firm, except as otherwise instructed by the client.
>
> (4) When the lawyer has reason to believe it is necessary to do so in order to comply with a court order, a Texas Disciplinary Rule of Professional Conduct or other law.
>
> (5) To the extent reasonably necessary to enforce a claim or establish a defense on behalf of the lawyer in a controversy between the lawyer and the client.
>
> (6) To establish a defense to a criminal charge, civil claim or disciplinary complaint against the lawyer or lawyer's associates based upon conduct involving the client or the representation of the client.
>
> (7) When the lawyer has reason to believe it is necessary to do so in order to prevent the client from committing a criminal or fraudulent act.
>
> (8) To the extent revelation reasonably appears necessary to rectify the consequences of a client's criminal or fraudulent act in the commission of which the lawyer's services had been used.

Clearly, there is no exception provided for the disclosure of such information in the attorney's own divorce, or in the divorce litigation of an attorney's partner. One commentator has argued that Rule 1.05(c)(4) (disclosure permissible to comply with a court order) provides a means by which the disclosure of such information may be permitted to comply with court orders related to the attorney's divorce, provided additional precautions are taken. Schwartz, at A-11.

c. Precautions to Protect Confidentiality

Although burdensome to the office personnel of the personal injury attorney, substantial controls can be put into place in order to protect the confidential information in the attorney's client files. These precautions take several forms. Most precautions are directed at removing the client's identifying information, such as name, age, social security and driver's license numbers from documents. Other precautions may also be taken, such as removing facts that are unnecessary to the

valuation of the client's claim. Clearly, a confidentiality agreement would also be required to protect any inadvertently disclosed information.

On the issue of confidentiality agreements, it cannot be overemphasized that, whenever proprietary information from a legal practice is disclosed to opposing parties–either voluntarily or through discovery–confidentiality agreements must be put into place. The Authors know of one case in which proprietary information from a medical practice was voluntarily released to the opposing party, for purposes of the opposing party's valuation of the medical practice, but without an concurrent confidentiality agreement. The opposing party promptly, and broadly, disseminated the information to the competitors of the medical practice, resulting in an unnecessary, and altogether avoidable, mess. The bottom line is: court orders or carefully drafted agreements are required whenever sensitive proprietary information of a professional practice is disclosed to outside parties.

D. Division

1. In General

In making a "just and right" division of the community estate, the trial court should first decide whether the parties' community property is subject to partition in kind. *Hailey v. Hailey*, 331 S.W.2d 299, 303 (Tex. 1960). In determining if property is subject to division in kind, the trial court should consider the nature and type of particular property involved and the relative conditions, circumstances, capabilities and experience of the parties. *Walston v. Walston*, 971 S.W.2d 687, 693 (Tex.App.–Waco 1998, pet. denied). These factors are also considered when the trial court must decide whether to divide community property by awarding a money judgment to one party and community assets to the other party, instead of dividing the community property in kind. *Finch*, 825 S.W.2d at 224.

Normally, a business is not subject to division in kind. Frequently, the business is operated by one spouse, or by one spouse and that spouse's partners or associates, and the assets of the business will be more valuable in the hands of that spouse than in the hand's of the other, as many reported Texas cases recognize. *See, e.g., Hanson v. Hanson*, 672 S.W.2d 274, 278 (Tex.App.–Houston [14th Dist.] 1984, writ dism'd w.o.j.) (it was permissible for the trial court to recognize that the assets of the husband's professional medical corporation were of no particular benefit to wife and of much greater value under the control of husband, and it would have been impractical for the trial court to have granted the wife an interest in the husband's retirement plan or keogh plan, since to do so would have imposed a serious hardship on the husband had he been forced to liquidate his retirement plans); *Goren v. Goren*, 531 S.W.2d 897, 900 (Tex.Civ.App.–Houston [1st Dist.] 1975, writ dismissed) (the trial court could take cognizance of the fact that the assets of the husband's medical practice were of no particular benefit to the wife, and were of much greater value in the hands of the husband; further, any disposition of such assets, whether by partition or sale, would have adversely affected the husband's practice and thus his earning capability); *Dorfman v. Dorfman*, 457 S.W.2d 417, 423 (Tex.Civ.App.–Texarkana 1970, no writ) (leaving the operation of business projects in the husband's hands, because of his knowledge and experience in the business, appeared reasonable and preferable to placing such operations in the wife's relatively inexperienced management).

Further, a community business is not normally subject to division in kind because to do so would leave the divorcing spouses in the difficult position of remaining "partners" with each other, a situation not usually to be envied. In *Earthman's, Inc. v. Earthman*, 526 S.W.2d 192, 196 (Tex.Civ.App.–Houston [1st Dist.] 1975, no writ), for instance, the wife was awarded a 21% ownership of the closely held corporation owned and controlled by the husband and his sons. When the wife sought to have the shares transferred into her name, the corporation took the position that share transfer restrictions which gave the corporation or other shareholders a first right purchase the shares became effective upon the transfer incident to the divorce. *Id*. at 198. The wife was forced to sue. *Id*.

As a result, when there is a community business involved, the trial court will usually award the business to one spouse, and equalize the division of the community estate for the other spouse with other community assets or a money judgment.

However, as might be expected, trial courts do sometimes do the unexpected, and appellate courts sometimes delight in the unexpected. For example, in *Braswell v. Braswell*, 476 S.W.2d 444, 445 (Tex.Civ.App.–Waco 1972, writ dism'd), the parties' most valuable asset was the (almost complete) ownership of a closely-held corporation; a small number of shares was owned by an employee of the corporation. The trial court awarded each party one-half of the shares they owned. *Id*.

On appeal, the wife asserted that the trial court abused its discretion by dividing in kind the shares of stock owned by the parties, rather than ordering a sale of the stock and an equal division of the proceeds. *Id*. at 447. In support of her position on appeal, the wife argued that, because the employee would always vote his shares in accord with the husband, she was thereby "locked in" as a minority stockholder, no cash dividends had been paid by the corporation for many years, and thus she could not anticipate any future income from her stock investment, she was "unable to liquidate her minority interest, and that she was "subject to the whim and caprice of an obviously disgruntled ex-husband who refuses to sell the business yet possesses the control to operate it for his own benefit." *Id*.

The wife's seemingly cogent arguments notwithstanding, the Waco Court of Appeals disagreed, finding her assertions unsupported by the record. *Id*. The Waco appellate court noted that the jury found that the shares of stock allotted to the wife had a present cash market value of $3,775,896, and therefore assumed that she could liquidate her interest in the corporation if she chose to do so. *Id*. Despite the corporation's dividend history (or lack thereof), the Waco Court of Appeals did not believe that the record raised a presumption that the corporation, acting through its dominant officer and stockholders, would not regularly declare and pay reasonable dividends, adding that, if the corporation should improperly refuse to do so, then any minority stockholder had his or her legal remedy. *Id*. Finally, the Waco appellate court stated that "the mere fact that stock in a closely-held corporation is divided in kind between the husband and wife in such a way that the husband, who is president and general manager of the corporation, might retain the control of the corporation does not, alone, constitute an inequitable division." *Id*. at 448.

Similarly, in *Beard*, 2001 WL 392260, at *25, the wife argued that the court abused its discretion by failing to award the parties each a one-half undivided interest in the shares of bank stock they purchased during their marriage and appoint a trustee to make distributions, pay the debt secured by the stock, and hold the stock in trust until the parties mutually agree to a disposition of all or part of the shares. However, the Waco Court of Appeals held that the trial court's refusal to award each of the parties an undivided one-half interest in their shares of bank stock, and appoint a trustee to hold these shares, was neither arbitrary nor unreasonable, even though the husband could ally his shares with those of his father's in such a manner that they could arrange for a sale of these banks under terms that the buyer not purchase wife's shares and not pay dividends on her shares; the evidence showed that (1) no prospective buyers had emerged for either of the small-town banks in the past twenty years and none were anticipated in the foreseeable future; (2) the husband's father had never been known to treat minority shareholders unfairly; and (3) placing the parties' bank stock in trust would unduly complicate their ownership interests). *Id*.; *see also, Matter of Marriage of Trujillo*, 580 S.W.2d 873, 875 (Tex.Civ.App.–Texarkana 1979, no writ) (despite misgivings of the Texarkana appellate court – *i.e.,* "[w]hile this court does not think it is wise to award undivided interests in a going business between parties who are already antagonistic, we cannot say that such action constitutes an abuse of discretion" – the trial court's award to the wife of an undivided one-third interest in a restaurant upheld, with the prudent caveat that, if the husband was dissatisfied, he could petition the court for a partition of the property, which in all likelihood would require the

business to be sold and the net proceeds to be divided between the parties according to their interests).

2. Equalizing Money Judgment

a. Security

A trial court should provide security for money judgments which are granted to achieve an equitable division of a community estate, unless there is some compelling reason to do otherwise. *Hanson*, 672 S.W.2d at 279. The party granted the money judgment thus will be protected from uncertainties such as bankruptcy, concealment, and waste of assets, which could work to deprive the party of his share of the community estate. *Id.* Nonetheless, the failure to provide security for a cash judgment awarded in division of a community estate does not necessarily constitute an abuse of discretion. *Id*.

b. Terms of the Judgment

A trial court should set the term for payment of the cash judgment for as short a period as possible without imposing a serious hardship on the party responsible to pay the judgment. *Hanson*, 672 S.W.2d at 279 (six year payout unreasonable); *Collins*, 904 S.W.2d at 804 (there was no evidence to support the need for a 12-year pay-out, or the husband's capacity for paying in a shorter period of time). Requiring payment within the shortest possible time minimizes two disadvantages of judgments with pay back terms: (1) while a party's judgment is outstanding, the party is deprived of the right of control and disposition of his or her full share of the estate; and (2) when a trial court sets an unduly long term for payment, with an award of interest at a fixed rate, the party granted the judgment will usually end up being under or over compensated for the delay in payment due to the fluctuation of interest rates. *Hanson*, 672 S.W.2d 279.

The trial court should also set the judgment in accordance with the current post-judgment interest statute. *See, Collins*, 904 S.W.2d at 804; Tex.Fin.Code §304.003.

3. Receivership

In *Hailey*, 331 S.W.2d at 303, the Texas Supreme Court held that if community property is not subject to partition in kind, the trial court can appoint a receiver and order so much of the property as is incapable of partition to be sold and the proceeds divided between the parties in such portions as, in the discretion of the court, may be a just, fair and equitable partition, having in mind the rights of the parties and the children. Tex.Fam.Code §7.001 grants a trial court broad authority to divide marital property in a manner it deems just and right upon the dissolution of marriage, and such broad authority sometimes includes the power to enlist the aid of a receiver to effectuate the trial court's orders and judgments. *Rusk*, 5 S.W.3d at 306-307 (Tex.App.–Houston [14th Dist.] 1999, pet. denied). The appointment of a receiver is an equitable action, left to the sound discretion of the trial court. *Vannerson v. Vannerson*, 857 S.W.2d 659, 673 (Tex.App.–Houston [1st Dist.] 1993, writ denied).

However, receivership is an extraordinarily harsh remedy and one that courts are particularly loathe to utilize. *Rusk*, 5 S.W.3d at 306. In fact, judicial seizure and court management of any asset should be a last resort. *Id.*

Rusk has possibly created something of controversy. In *Rusk*, the husband argued that the trial court erred in appointing a receiver without first meeting the mandatory statutory requirement of showing that the property was in jeopardy of being lost, removed, or materially injured, relying, in part, on Tex.Civ.Prac.& Rem..Code §64.001. *Rusk*, 5 S.W.3d at 306. In other words, the husband argued, and the majority in *Rusk* agreed, that §64.001 of the Civil Practice and Remedies Code governs the appointment of receivers in marriage dissolution cases. *See, Id*. at 313 (Fowler, J., dissenting).

But, as the dissent in *Rusk* points out, when third parties or companies do not have an interest in the property subject to a receivership, Texas courts have not applied the receivership rules contained in §64.001 to marriage dissolution cases; rather, Texas

courts have held that §7.001 of the Family Code governs. *Id.*; *see also, Vannerson*, 857 S.W.2d at 673 (holding that §64.001 of the Civil Practice and Remedies Code does not govern the appointment of a receiver over property when it is divided upon divorce; instead, the predecessor of Texas Family Code §7.001 controls);*Young v Young*, 765 S.W.2d 440, 444 (Tex.App.–Dallas, 1988, no writ) (holding that §64.001 does not govern the appointment of a receiver over property when it is divided upon divorce, but rather §7.001 of the Texas Family Code); *North Side Bank v. Wachendorfer*, 585 S.W.2d 789, 792 (Tex.Civ.App.–Houston [1st Dist.] 1979, no writ) (holding that under the statutes governing family courts, a family court has broad power to appoint a receiver where it is necessary, but that this power is limited by §64.001 of the Civil Practice and Remedies Code when a receiver is sought by the owner of marital property against a third party creditor).

4. Problems Dividing a Professional Corporation

For purposes of divorce, the problem with a professional legal corporation is that the shares representing ownership are transferable only to persons duly licensed or authorized to perform the same type of professional service as that for which the corporation was organized. Tex.Rev.Civ.Stat. art. 1528e, §12. In other words, a trial court may not divide the shares of a professional legal corporation in kind between an attorney-spouse and a non-attorney spouse. As discussed above, *Eikenhorst* specifically addressed the analogous difficulty involved in dividing a professional medical association, whose requirements and non-transfer provisions are essentially identical to those of a professional legal corporation. *See*, Tex.Rev.Civ.Stat. art. 1528f, §2(b) and §10.

The Authors have located no reported Texas that addresses such difficulties in the specific context of a professional corporation.

218 F.3d 432
2000 Copr.L.Dec. P 28,115, 55 U.S.P.Q.2d 1321
(Cite as: 218 F.3d 432)

United States Court of Appeals,
Fifth Circuit.

George G. RODRIGUE, Jr. and Richard Steiner, Plaintiffs-Appellees,
v.
Veronica Hidalgo RODRIGUE, Defendant-Appellant.

No. 99-30334.

July 7, 2000.
As Revised Aug. 18, 2000.

Husband who had copyrighted his paintings sued former wife, seeking determination that paintings were not part of community property regime. The United States District Court for the Eastern District of Louisiana, Mary Ann Vial Lemmon, J., 55 F.Supp.2d 534, granted summary judgment for husband, and wife appealed. The Court of Appeals, Wiener, Circuit Judge, held that author- spouse in whom copyright vests maintains exclusive managerial control of copyright but, under Louisiana law, economic benefits of copyrighted work belong to the community while it exists and to former spouses in indivision thereafter.

Reversed and remanded with instructions.

West Headnotes

[1] Husband and Wife k249(2.1)
205k249(2.1)

[1] Husband and Wife k265
205k265

[1] Husband and Wife k272(1)
205k272(1)

Author-spouse in whom copyright vests maintains exclusive managerial control of copyright but, under Louisiana law, economic benefits of copyrighted work belong to the community while it exists and to former spouses in indivision thereafter. 17 U.S.C.A. §§ 106, 201(a); LSA-C.C. arts. 2346, 2351.

[2] Property k7
315k7

Under Louisiana law, full ownership of property comprises three separate sub-bundles: (1) "usus," the right to use or possess, i.e., hold, occupy, and utilize the property; (2) "abusus," the right to abuse or alienate, i.e., transfer, lease, and encumber the property, and (3) "fructus," the right to the fruits, i.e., to receive and enjoy earnings, profits, rents, and revenues produced by or derived from the property.

[3] Copyrights and Intellectual Property k1
99k1

[3] Copyrights and Intellectual Property k41(1)
99k41(1)

Under Louisiana law, copyright is a "movable." LSA-C.C. art. 475.

[4] Husband and Wife k247
205k247

[4] States k18.29

360k18.29

Federal copyright law does not preempt Louisiana community property law to extent of denying entitlement of non-author spouse to undivided one-half interest in economic benefits of copyrighted works created by author during existence of community, and of derivatives of such works following its termination; copyright law does not occupy entire "field" and thereby totally eclipse all state marital property law, nor would designating copyrights community property to extent of economic benefit derived therefrom do substantial damage to important federal interests. U.S.C.A. Const. Art. 6, cl. 2; 17 U.S.C.A. § 301; LSA-C.C. arts. 2346, 2351.

[5] Husband and Wife k247
205k247

[5] States k18.28
360k18.28

State family and family-property law must do major damage to clear and substantial federal interests before Supremacy Clause will demand that state law be overridden. U.S.C.A. Const. Art. 6, cl. 2.

[6] Husband and Wife k247
205k247

[6] States k18.29
360k18.29

Louisiana's general rule of equal management of community property is pre- empted vis a vis copyrights and by Louisiana Civil Code provision for exclusive management of movables registered or issued in name of one spouse. U.S.C.A. Const. Art. 6, cl. 2; 17 U.S.C.A. § 301; LSA-C.C. arts. 2346, 2351.

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Appeal from the United States District Court for the Eastern District of Louisiana.

Before GARWOOD, WIENER and DENNIS, Circuit Judges.

WIENER, Circuit Judge:

Our task in this appeal, before us under Federal Rule of Civil Procedure 54(b), is to sort out and reconcile the respective rights and obligations of authors under federal copyright law and their spouses under Louisiana community property law when those two legal regimes intersect. Defendant-Appellant Veronica Hidalgo Rodrigue ("Veronica") asks us to reverse the district court's ruling that, by virtue of copyright law, her ex-husband, Plaintiff-Appellee George Godfrey Rodrigue, Jr. ("George"), holds *all* ownership rights in intellectual property that he created during the parties' marriage, to the exclusion of any rights she might otherwise have in those creations by virtue of community property law. Agreeing with Veronica, we reverse and remand with instructions.

I.
Facts and Proceedings

George and Veronica were married in Louisiana in 1967 and were divorced there in

1993. In the absence of an election by them to have any other marital property regime apply, the Rodrigues' Louisiana marriage effected the "legal regime" of matrimonial property, [FN1] establishing between them a community of acquets and gains, commonly referred to simply as the community. [FN2]

FN1. La. Civ.Code art. 2334.

FN2. La. Civ.Code art. 2327.

During the marriage, George became a widely acclaimed, highly successful, and very prolific painter. He created numerous paintings both during the existence of the community and after its termination, a number of which depicted a stylized and easily recognizable image of a blue dog. Modeled after the family pet, Tiffany, the first blue dog painting was created in 1984. George obtained certificates of copyright for some but not all of his paintings.

Divorce terminated the community that had existed between Veronica and George throughout their marriage. [FN3] As a general proposition, the Louisiana Civil Code provides that, on termination of the community, the property formerly belonging to it becomes subject to the provisions governing***434** co-ownership [FN4]: "Each spouse owns an undivided one-half interest in former community property and its fruits and products" [FN5] until partition. [FN6]

FN3. La. Civ.Code art. 2356.

FN4. La. Civ.Code art. 2369.1.

FN5. La. Civ.Code art. 2369.2.

FN6. La. Civ.Code art. 2369.8.

Following the dissolution of his marriage with Veronica, George and co- Plaintiff-Appellee Richard Steiner, George's former business associate, filed this action in federal court seeking a declaration that George is the sole owner of intellectual property rights in all the paintings, particularly the blue dog image. They also sought to enjoin Veronica from (1) seeking a declaration of her co-ownership of those works, (2) making image transfers, and (3) suing for copyright infringement. Veronica filed a counterclaim in an effort to obtain a declaration that she owns an undivided one-half interest in (1) all intellectual property rights (including, but not limited to, the blue dog) generated during the existence of the community and (2) all post-community artworks that are "derivative" of that intellectual property. Veronica also sought an accounting for her half-interest in the proceeds of post-community use of those copyrights and derivatives.

After the parties filed cross-motions for summary judgment, the district court granted George's, grounding its decision in federal copyright preemption of state community property law. Veronica filed a motion for reconsideration which the court did not address, entering instead an order dismissing all of her claims. Veronica filed a second motion for reconsideration which the court granted to the extent that the previous order purported to resolve all claims of all parties. The court certified the preemption issue for immediate appeal pursuant to Rule 54(b) and stayed the remaining issues.

In a scholarly and thorough analysis, the district court concluded that, as a matter of *conflict* preemption, subjecting copyrights on works of the author-spouse to Louisiana community property law would damage federal interests in national uniformity and efficient exchange of copyrights. The court

held that, as a result of this conflict, the state marital property law is preempted and cannot appertain. The court also considered 17 U.S.C. § 301, the express preemption provision of the federal Copyright Act of 1976 ("the Copyright Act" or "the Act") but concluded that it did not apply because Louisiana's community property law does not purport to provide rights "equivalent" to those specified by the Act. And the court rejected Veronica's "transfer" argument that, even though § 201(a) of the Copyright Act specifies that a copyright "vests initially" in the author at the time of creation of the work, it is transferred to the community by operation of law immediately following such initial vesting.

In concluding that federal law preempts state law in this instance, the district court voiced particular concern about the practicability of copyright co-management by spouses. Still, in describing problems associated with co-management, the court flagged a possible solution: The author-spouse could retain and exercise sole management and control of the copyright without depriving the non author-spouse of the "more tangible benefits." Instead of so holding, however, the court demurred to Congress to decide whether to adopt that approach.

We are convinced that the district court visualized the correct method for reconciling the apparent conflict, but we disagree about the need for a congressional fix. We therefore adopt the approach considered but rejected by that court, and we reverse.

II.
Analysis

We review the grant of summary judgment *de novo,* applying the same standards ***435** as the district court. [FN7]

FN7. *Gardes Directional Drilling v. U.S. Turnkey Exploration Co.,* 98 F.3d 860, 864 (5th Cir.1996).

George contends that provisions of both the Copyright Act [FN8] and the U.S. Constitution [FN9] preempt state community property law, preventing his copyrighted artistic works from ever having become property of the community that was created by his marriage to Veronica and thereby exempting his copyrights from division and partition of the community after divorce. Section 201(a) of the Act specifies that a "[c]opyright in a work protected under this title vests initially in the author or authors of the work." In facial contrast, Louisiana Civil Code article 2338 declares that "property acquired during the existence of the legal regime through the effort, skill, or industry of either spouse" is community property. George insists that federal law, which specifies that the copyrights in the blue dog and other images "vest [ ] initially" in him as the "author," cannot be harmonized with state law, which would hold those self-same copyrights to have been community property and to belong now to the two former spouses in indivision. He argues that, because, under the Supremacy Clause, state law is preempted to the extent that it conflicts with federal law, his copyrights are immune from Louisiana community property law.

FN8. 17 U.S.C. § 101 *et seq.*

FN9. Art. I, § 8, cl. 8 ("The Congress shall have power ... [t]o promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries.")

[1] We do not disagree with George's general premise; we do disagree, though, with his expansive view of the scope of the conflict between copyright law and community property law, and thus with the extent of the preemptive effect of such conflict. We are satisfied that the conclusion we reach today--that an author-spouse in whom a copyright vests maintains exclusive managerial control of the copyright but that the economic benefits of the copyrighted work belong to the community while it exists and to the former spouses in indivision thereafter--is consistent with both federal copyright law and Louisiana community property law and is reconcilable under both.

We begin by delineating the precise scope of the language of § 201(a) [FN10] on which George bases his sweeping preemption theory. This subsection pertains only to "copyright," which, by the Act's own definition at § 106, is a finite bundle of but five fundamental rights, being the exclusive rights of reproduction, adaptation, publication, performance, and display. [FN11] Notably, none of these rights either expressly or implicitly include the exclusive right to enjoy income or any of the other economic benefits produced by or derived from copyrights.

> FN10. 17 U.S.C. § 201(a) provides: "Initial Ownership.--Copyright in a work protected under this title vests initially in the author or authors of the work. The authors of a joint work are co-owners of copyright in the work."
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> FN11. 17 U.S.C. § 106; H.R.Rep. No. 94-1476 at 61 (1976), *reprinted in* 1976 U.S.C.C.A.N. 5659, 5674.

Section 201(a) specifies that the copyright "vests" in the author. Except in its title, [FN12] this subsection never uses the words "own" or "ownership," and the Act does not speak of ownership per se or globally, but only in the sense of the five ***436** exclusive attributes listed in § 106. "To vest" means to give an immediate, fixed right of present or future enjoyment; to accrue to; to be fixed; to take effect. [FN13] " 'To own' means to have a good legal title; to hold as property; to have a legal or rightful title to; to have; to possess." [FN14] When analyzed in the framework of the Act's inclusion of only five express attributes of ownership while omitting, *inter alia,* the attribute of enjoyment of economic benefits, Congress's reference to immediate vesting of the copyright, and not to vesting of ownership, supports the more limited construction advocated by Veronica. We agree with her insistence that, in and of itself, "vesting" of the copyright and its five (and five only) statutorily delineated attributes in one spouse does not preclude classification of other attributes of ownership of a copyright as community property. Moreover, by its very title, § 201(a) addresses only *initial*--not *permanent*--vesting of the copyright in the author. And, even though the author's copyright arises at the moment of creation of the work, [FN15] the Act explicitly allows for subsequent vesting in non- authors, either jointly with the author or subsequent to him by virtue of transfer of all or lesser portions of the copyright. [FN16]

> FN12. "The title of an act cannot control its words, but may furnish some aid in showing what was in the mind of the legislature." *Holy Trinity Church v. United States,* 143 U.S. 457, 462, 12 S.Ct. 511, 513, 36 L.Ed. 226 (1892). "While the title of an act will not limit the plain meaning of the text, it may be of aid in resolving ambiguity." *Maguire v. Commissioner,* 313 U.S. 1, 9, 61 S.Ct. 789, 794, 85 L.Ed. 1149 (1941)

(citations omitted). We perceive no ambiguity here.

FN13. BLACK'S LAW DICTIONARY 1563 (6th ed.1990). We note in passing that the use of "vest" in statutes commonly has a temporal connotation, indicating the time at which an interest in property accrues to its rightful holder, rather than a substantive denotation of the nature or scope of the ownership of such an interest in property.

FN14. BLACK'S LAW DICTIONARY 1105 (6th ed.1990).

FN15. 17 U.S.C. § 302(a); 1 MELVILLE B. NIMMER & DAVID NIMMER, NIMMER ON COPYRIGHT , § 5.05(B)(1), at 5-59 (1998) [hereinafter NIMMER ON COPYRIGHT].

FN16. 17 U.S.C. § 201(a), (d); *see Worth v. Worth,* 195 Cal.App.3d 768, 777, 241 Cal.Rptr. 135 (1987) (noting that Act "provides only that the copyright 'vests initially in the author'; and nothing is found in the Act which either precludes the acquisition of a community property interest by a spouse, or which is otherwise inconsistent with community property law").

True, the copyright "vests initially" in the "*author,*" and the "author" is the "originator," the "maker," the person to whom a work "owes its origin." [FN17] We do not question that George is the sole "author" of the copyrights here at issue. Neither do we mean to suggest that Veronica's co- ownership interests arise from co-authorship. We do conclude, though, that the language of § 201(a), providing that a bundle of but five specific rights, those listed in § 106, "vests initially" in the author, does not ineluctably conflict with any provision of Louisiana matrimonial property law that would recognize that Veronica does have an economic interest in George's copyrights.

FN17. *Community for Creative Non-Violence v. Reid,* 490 U.S. 730, 737, 109 S.Ct. 2166, 104 L.Ed.2d 811 (1989) ("As a general rule, the author is the party who actually creates the work, that is, the person who translates an idea into a fixed, tangible expression entitled to copyright protection."); *Burrow-Giles Lithographic Co. v. Sarony,* 111 U.S. 53, 57-58, 4 S.Ct. 279, 28 L.Ed. 349 (1884) ("An author in that sense is 'he to whom anything owes its origin; originator; maker; one who completes a work of science or literature.' ").

[2] As a useful framework for understanding the Louisiana Civil Code provisions on which our holding ultimately rests, we begin with general concepts of Louisiana property law. In the Civil Law, the bundle of rights that together constitutes full ownership [FN18] of property comprises ***437** three separate sub-bundles: (1) *usus*--the right to use or possess, i.e., hold, occupy, and utilize the property; (2) *abusus*--the right to abuse or alienate, i.e., transfer, lease, and encumber the property, and (3) *fructus*--the right to the fruits, i.e., to receive and enjoy the earnings, profits, rents, and revenues produced by or derived from the property. [FN19] In Louisiana, those three facets of ownership may be allocated in various combinations among different persons, with each having less than full ownership. [FN20] For example, the owner of a legal usufruct ("usufructuary") has the right

to use the property burdened with the usufruct (*usus*) and to enjoy the fruits of that property (*fructus*), but does not have the right to alienate the property (*abusus*); that right belongs to the naked owner, albeit subject to the usufruct. [FN21]

> FN18. Both the terms "full ownership" and "perfect ownership" appear in the Civil Code articles and in Louisiana case law (at least one case also uses the term "complete ownership") and are used roughly interchangeably. We use the term "full ownership" here to connote ownership of all three sub-bundles that together constitute the bundle of all ownership rights in property. *See* La. Civ.Code 477 (providing that the "owner" of a thing may use, enjoy, and dispose of it); Andrew L. Gates III, *Partition of Land and Mineral Rights,* 43 LA. L.REV. 1119, 1129 (1983) ("[P]erfect, or full, ownership consists of the right to use, the right to enjoy, and the right to dispose of the property."); *see also* La. Civ.Code art. 478 cmt. b ("Under this revision ownership is no longer distinguished into perfect and imperfect ownership.").
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> FN19. *See Giroir v. Dumesnil,* 248 La. 1037, 184 So.2d 1, 6 (1966).
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> FN20. *Campbell v. Pasternack Holding Co.,* 625 So.2d 477, 480-81 (La.1993).
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> FN21. *Id.* at 484 n. 13; *In re Stein,* 508 So.2d 1377, 1380 (La.1987); *see also* La. Civ.Code arts. 538, 539.

When the property in question is a copyright, allocation of these attributes of ownership within the community property framework, according to the rule we announce today, produces a division similar to usufruct but different in combination: The author-spouse alone holds the elements of *usus* and *abusus*--a combination that comprises the exclusive rights to possess, use, transfer, alienate, and encumber the copyright as he sees fit--free of any management, consent, or participation of the non-author spouse. [FN22] Obviously, § 106's "five fundamental rights" of reproduction, adaptation, publication, performance, and display are includable harmoniously in the conjointment of *usus* and *abusus* in the author-spouse. But the community during its existence (and the former spouses or other successors after its termination) holds the element of *fructus,* i.e., the right to receive and enjoy the economic benefits produced by or derived from the copyright. [FN23] The exclusive right of the author-spouse to the *abusus* of the copyright, like that of the naked owner of property burdened by a usufruct, is nevertheless subject to the continuing *fructus* rights of the community so long as the copyright remains vested in the author-spouse, unless partition should modify the situation.

> FN22. We leave for another day the question whether the author- spouse, in exercising his exclusive rights to exploit and alienate the copyright both during the existence of the community and after its dissolution, has some agency or fiduciary-like duty to the non-author spouse, such as the duty to act in good faith and not in a manner contrary to her interests, akin to the obligation of a usufructuary to serve as a "prudent administrator" of the usufruct and to "faithfully fulfill" his obligations toward the naked owner, *see, e.g.,* La. Civ.Code art. 571, or to the duty of a mineral lessee to act as a "reasonably prudent administrator,"

even though not a fiduciary to his lessor. *See, e.g.,* La.Rev.Stat. § 31:122.

For reasons that are not apparent to us, neither party has invited us to consider Civil Code article 2369.3, which imposes an affirmative duty on a spouse "to preserve and to manage prudently former community property under his control" and makes him "answerable for any damage caused by his fault, default, or neglect." As we do not reach this issue, we merely flag this Civil Code article and note its congruity with the exclusive management approach to copyrights under community property law that we adopt today. *See also* KATHERINE SHAW SPAHT & LEE HARGRAVE, LOUISIANA CIVIL LAW TREATISE, MATRIMONIAL ESTATES § 7.20, at 436-37 (1997) (comparing former spouse's duty under § 2369.3 to usufructuary's duty as "prudent administrator").

FN23. *See* La. Civ.Code art. 551 (defining kinds of fruits: "Civil fruits are revenues derived from a thing by operation of law or by reason of a juridical act, such as rentals, interest, and certain corporate distributions."); La. Civ.Code art. 2339 ("The natural and civil fruits of the separate property of a spouse ... are community property...."). Note that, because the author enjoys the attribute of *fructus* jointly with the non-author spouse, the author does not acquire a full ownership of the copyright through the civilian doctrine of confusion. *See* La. Civ.Code art. 622.

With those general Civil Law property concepts in mind, we turn next to the Civil ***438** Code's articles on marital property. In broadest form, the Code embodies the concept of "equal management" of property belonging to the community: Each spouse, acting alone, has the right to manage, control, or dispose of community property. [FN24] If this general principle were to be applied across the board to copyrights created by one spouse in community, however, an irreconcilable conflict with the author-spouse's five exclusive § 106 rights of reproduction, adaptation, publication, performance, and display would result. In apparent recognition that such conflicts would likely occur in connection with "movables issued or registered in" the name of one of the spouses, [FN25] the Civil Code specifies, as an exception to equal management, that such spouse alone has exclusive management rights (the combination of *usus* and *abusus*) but preserves for the spouses jointly the right to enjoy the benefits (the *fructus*) of such property. We conclude that copyrights come within the category of exceptional movables contemplated by such provisions. [FN26]

FN24. La. Civ.Code art. 2346.

FN25. La. Civ.Code art. 2351.

FN26. We are cognizant of (and do not necessarily disapprove) the "transfer" approach of the California court in *Worth,* holding that, under § 201(a), the copyright "vests initially" in the author-spouse at the time of creation, and thereafter, according to § 201(d), is automatically transferred "by operation of [state community property] law," to the matrimonial community. *Worth v. Worth,* 195 Cal.App.3d 768, 774, 241 Cal.Rptr. 135 (1987). Our approach is consistent yet analytically distinct; the author-spouse alone (at the time of

> creation and at all times thereafter, absent voluntary transfer of the copyright) is vested with the § 106 five exclusive "fundamental rights"; those rights are never automatically transferred to the community. The *fruits* of the copyright, nevertheless, are community property at the "very instant" they are acquired. *See Beatty v. Vining,* 147 So.2d 37, 43 (La.App.1962).

Numerous examples of exclusive management of community property and shared enjoyment of those assets exist: A paycheck issued by the employer in the name of the employee-spouse alone can be cashed, deposited, or otherwise negotiated only by that spouse; yet, the proceeds of the paycheck, representing earnings of one spouse in community, belong to the community. Likewise, a motor vehicle purchased with community funds but titled in the name of one spouse alone can be sold, leased, or encumbered only by the named spouse [FN27]; yet the proceeds of any such disposition belong to the community. And when, during the existence of the community, one spouse joins an existing partnership or joins in the formation of a new one, the partner-spouse has the exclusive right to participate in the partnership and to manage, alienate, or encumber that interest; yet the economic benefits--and liabilities--flowing from the partnership belong to the community. [FN28]

> FN27. *See* La. Civ.Code art. 2351.

> FN28. La. Civ.Code art. 2352.

[3] In concluding that copyrights should be treated the same as paychecks, cars, and partnership interests, we rely initially on Louisiana Civil Code article 2351 which proclaims that "[a] spouse has the exclusive right to manage, alienate, encumber, or lease movables issued or registered in his name as provided by law." This right of exclusive management of those kinds of movables is not coterminous with the community but continues as long as the copyright is vested in the author-spouse, even after partition of the property formerly belonging to the community is complete. [FN29] Under Louisiana law a copyright ***439** is a "movable," [FN30] and under federal law a copyright is issued or registered in the name of the author-spouse. [FN31] In compatible combination, these two systems of law provide for the author-spouse's *exclusive management* of copyrights created during the existence of the community and thereafter until completion of the partition of the property of the former community, while at the same time ensuring that the non author-spouse is not deprived of his or her right to one-half of the economic benefits of the copyright.

> FN29. La. Civ.Code art. 2369.5 & cmt. a (creating exception to Civ.Code art. 2369.4). Civil Code article 2369.4 replaces the general rule of equal management that exists during the existence of the community with the rule that, on divorce, each spouse must obtain concurrence of the other to alienate, encumber, or lease former community property. But according to Civil Code article 2369.5, such concurrence is *not* required for community property managed *exclusively* by one spouse, even after divorce. This single-spouse management would continue after partition for as long as the copyright remains vested in the author-spouse, unless the situation is modified by the partition.

FN30. *See* La. Civ.Code art. 475 ("All things corporeal or incorporeal, that the law does not consider as immovables [e.g., tracts of land and their component parts, La. Civ.Code art. 462] are movables.").

FN31. 17 U.S.C. § 201(a).

[4] The *economic benefits* that flow from particular types of one-spouse assets, including but not limited to cars, paychecks, partnership interests-- and copyrights--can inure to the benefit of the community without doing violence to the legal results intended by the Louisiana Legislature or Congress in providing for vesting of title in one spouse only, results designed with third parties in mind, not spouses or other co-owners. In the context of these clearly established concepts and principles, we conclude that federal copyright law does not conflict with, and therefore does not preempt, Louisiana community property law to the extent of denying the entitlement of the non- author spouse (Veronica) to an undivided one-half interest in the economic benefits of the copyrighted works created by the author (George) during the existence of the community, and of the derivatives of such works following its termination.

In confirmation of this conclusion, we look first to the express preemption provision in the Act itself. When we do so we reach the same initial conclusion as did the district court, that the Act does not mandate the monolithic preemption of Louisiana community property law *in toto.* Section 301(a) of the Act states that "all legal or equitable rights that are equivalent to any of the exclusive rights within the general scope of copyright ... are governed exclusively by this title." For openers, "the general scope of copyright" is not broad enough to cover the entire body of marital property law; that is, copyright law does not occupy the entire "field" and thereby totally eclipse all state marital property law. [FN32] We do not understand George to quarrel with this basic premise.

FN32. *Compare* this with ERISA's total preemption of the field of retirement or health benefits in the private sector. *See, e.g., Boggs v. Boggs,* 520 U.S. 833, 117 S.Ct. 1754, 138 L.Ed.2d 45 (1997).

Indeed, the Copyright Act, in defining the scope of its own preemptive effect, expressly acknowledges that state law continues to operate unless there is a direct and irreconcilable clash between a state law right and an exclusive right under the Act with which such state law right is equivalent. Section 301(b) expresses that "[n]othing in [§ 301(a) of the Copyright Act] annuls or limits any rights or remedies under the common law or statutes of any State with respect to ... activities violating legal or equitable rights that are not equivalent to any of the exclusive rights within the general scope of copyright as specified by section 106." [FN33] To repeat, the only ownership rights that the Act grants exclusively to the author are the rights to (1) reproduce, (2) prepare derivative works, (3) distribute copies, (4) perform, and (5) display the work. [FN34] Among the entire "bundle" of rights comprising full ownership of property generally, the preemptive effect of federal copyright law extends only to this explicitly-enumerated, lesser- included quintet. As those five exclusive rights of the author conflict with Louisiana's general principle of equal management of community property, that principle cannot operate. Instead ***440** Civil Code article 2351's special exception for exclusive management by one spouse applies.

FN33. 17 U.S.C. § 301(b)(3).

FN34. 17 U.S.C. § 106.

Notably absent from the Copyright Act's exclusive sub-bundle of five rights is the right to enjoy the earnings and profits of the copyright. Nothing in the copyright law purports to prevent non-preempted rights from being enjoyed by the community during its existence or thereafter by the former spouses in community as co-owners of equal, undivided interests.

The § 301 preemption provision of the Copyright Act was intended to accomplish a "fundamental and significant change" in the existing state of the law, under which published works were governed by federal copyright law and unpublished works were governed by the common law of copyright. The new statute substituted a single, uniform system in place of the existing anachronistic and highly complicated dual system. That goal was accomplished in part by specifying a limited preemption which trumps only those common law or state law rights that are *equivalent* to federal copyright, [FN35] such as state laws that purport to grant copyright protection to particular works. We discern nothing in the Act's plain wording or legislative history to indicate that Congress--fully aware of the existence of community property laws in a number of states--had any intention of preempting that entire body of non- federal law as well. [FN36] Our conclusion is buttressed by the explicit clarification in § 301(b)(3), noted above, that the preemptive effect does not extend beyond the subject matter of the Act.

FN35. H.R.Rep. No. 94-1476 at 130-31 (1976), *reprinted in* 1976 U.S.C.C.A.N. 5659, 5746-47; *see also* NIMMER ON COPYRIGHT § 1.01(B)(1), at 1-11 (citing same and clarifying meaning of "equivalent" rights).

FN36. *See Brown v. Ames,* 201 F.3d 654, 661 (5th Cir.2000) (noting that case for federal preemption is particularly weak when Congress is aware of operation of state law and nevertheless stands by both concepts and tolerates whatever tension might exist between them).

[5] George nevertheless insists in the alternative that, even if § 301 preemption does not apply, "conflict preemption" does because designating copyrights as community property would do substantial damage to important federal interests. [FN37] In this argument, George fails (or refuses) to recognize the jurisprudential corollary that "[s]tate family and family- property law must do 'major damage' to 'clear and substantial' federal interests before the Supremacy Clause will demand that state law be overridden." [FN38] He attempts to bolster his conflict preemption argument by demonizing the Louisiana Civil Code doctrine of equal management: If copyrights were to be deemed community property, George contends, both he and Veronica would have the right, acting alone, to control, encumber, or dispose of the copyrights, which in turn would impair federal interests in uniformity and efficient exchange of rights to ensure predictability, [FN39] and in providing incentives to authors to create. [FN40] George argues that (1) copyrights will not be amenable to efficient or predictable exchange if spouses have equal rights to impair or dispose of such rights, possibly in conflicting manners, (2) predictability and uniformity will not be served if varying state laws are applied to copyright management issues, and (3) authors will have less incentive to create if they must share the fruits of their

creative works. His reliance on these three arguments is misplaced.

FN37. *Gade v. National Solid Wastes Management Assoc.,* 505 U.S. 88, 98, 112 S.Ct. 2374, 120 L.Ed.2d 73 (1992); *Hines v. Davidowitz,* 312 U.S. 52, 67, 61 S.Ct. 399, 85 L.Ed. 581 (1941) (state law is preempted if it "stands as an obstacle to the accomplishment of the full purposes and objectives of Congress").

FN38. *Hisquierdo v. Hisquierdo,* 439 U.S. 572, 581, 99 S.Ct. 802, 59 L.Ed.2d 1 (1979) (citing *United States v. Yazell,* 382 U.S. 341, 352, 86 S.Ct. 500, 15 L.Ed.2d 404 (1966)).

FN39. *See Brown,* 201 F.3d at 660 (citing legislative history).

FN40. *See Goldstein v. California,* 412 U.S. 546, 555, 93 S.Ct. 2303, 37 L.Ed.2d 163 (1973).

***441** [6] George's first contention is negated by our ready recognition today that the author-spouse has the exclusive right to manage and control the copyright, i.e., to deal with it in any manner that is not inconsistent with federal copyright law. This conclusion is supported by our acknowledgment that the general rule of equal management is pre-empted *vis a vis* copyrights and by Louisiana Civil Code article 2351's provision for the exclusive management of movables registered or issued in the name of one spouse. As equal management does not apply to copyrights, federal interests in predictability and efficiency are not impaired by it. A potential purchaser or licensee will still be able to obtain good "title" from the author-spouse alone free of interference from the other spouse. [FN41]

FN41. NIMMER ON COPYRIGHT § 6A.04, at 6A-26 to -27 (noting that solution for this "worst disorder" of "co-owner" spouses issuing rival grants of title to the copyrighted work would be to place sole management and control in author-spouse).

George's second contention does not persuade us that allowing differing state laws--in particular, community property laws that differ from state to state among the eight that presently have some version of such marital property regimes [FN42]--to apply just to the economic benefit derived from copyrights will somehow damage the federal interests in predictability and uniformity. Indeed, the Act itself subjects copyrights to varying state laws for other purposes. For example, copyrights are expressly transferrable by conveyance, [FN43] and such conventional transfers are governed by individual, *non-uniform* state contract laws; yet no significant obstruction of federal interests has occurred to prompt preemption. [FN44] In like manner, copyrights are expressly transferable by testamentary disposition or in intestacy, [FN45] either of which is likely to produce co-ownership of undivided interests in the copyright among the author's heirs or legatees. State law governs such death-related transfers and the resulting co-ownerships they produce, and does so routinely without impairing federal interests. [FN46] The litigation and management issues arising from contractual conveyance and post-mortem devolution of copyrights [FN47] has not resulted in obstruction of federal interests leading to preemption of state law, and we discern no reason why the community property result we decree today should fare differently.

FN42. *See* David Nimmer, *Copyright Ownership by the Marital Community: Evaluating* Worth, 26 UCLA L. REV.

383, 384 n. 4 (1988) (listing eight states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington) [hereinafter Nimmer, UCLA L. REV.].

FN43. 17 U.S.C. § 201(d)(1).

FN44. H.R.Rep. No. 94-1476, at 132 (1976), *reprinted in* 1976 U.S.C.C.A.N. 5659, 5748 ("Nothing in this bill derogates from the rights of parties to contract with each other and to sue for breaches of contracts....").

FN45. 17 U.S.C. § 201(d)(1).

FN46. *See* Nimmer, 26 UCLA L. REV., at 386-87 n. 13 (noting that proposition that inheritance of copyrights is governed by state laws is "to obvious to have spawned litigation").

FN47. In addition to permitting these two means of copyright transfer, the Act defines "transfer of copyright ownership" to include "assignment, mortgage, exclusive license, or any other conveyance, alienation, or hypothecation of a copyright." 17 U.S.C. § 101. Even though the Act explicitly prohibits involuntary transfers by any governmental body or other official or organization, 17 U.S.C. § 201(e), it specifies that "[t]raditional legal actions that may involve transfer of ownership, such as bankruptcy proceedings and mortgage foreclosures, are not within the scope of [the involuntary transfer] subsection." H.R.Rep. No. 94-1476, at 124 (1976), *reprinted in* 1976 U.S.C.C.A.N. 5659, 5739. These other types of transfer, like contractual conveyance and inheritance, are subject to varying state laws, yet Congress has not perceived any inherent obstruction of federal interests in such additional modes of alienation, and neither do we.

As for George's third contention--that community entitlement to the "fruits" of copyrights would lessen the author's incentive ***442** to create or exploit his works, thereby conflicting with the federal interest in encouraging authorship--we decline to assume globally that the commercial and economic interests of spouses *during* marriage are so at odds that one spouse would be disinclined to create copyrightable works merely because the economic benefits of his endeavors would inure to the benefit of their community rather than to his separate estate. As for a former spouse's lack of incentive *following* divorce, we perceive the presence of the proverbial stick and carrot. To mix metaphors, the carrot is the half-a-loaf incentive of the author to exploit pre-divorce copyrights to the best of his ability rather than shelve them and receive no benefit whatsoever; the stick is exemplified by the provision of the Louisiana Civil Code that specifies an affirmative duty "to manage prudently" former community property that remains under one spouse's exclusive control. [FN48] Indeed, that article imposes a higher duty on a spouse managing *former* community property than the Code otherwise imposes on that same spouse during the marriage [FN49] or on a third party co-owner who is not a former spouse. [FN50] "The reason for imposing a higher standard of care in managing former community property is that, after termination of the community property regime, the law no longer assumes that a spouse who has former community property under his control will act in the best interest of both spouses in managing it." [FN51] Although we need not and therefore

do not reach the question of specific management duties, we observe that this affirmative duty imposed by Louisiana law refutes George's argument regarding a former spouse's disincentive to exploit fully a copyright simply because the economic benefits are subject to community property laws. We are convinced that the duty imposed by Louisiana is consistent with--not contrary to--the federal interest in encouraging authorship and exploitation of copyrights, just as we are convinced that most if not all authors will continue to exploit their copyrights after termination of the community rather than cutting off their noses to spite their faces by letting copyrighted works languish.

FN48. *See supra* n. 22 (citing La. Civ.Code art. 2369.3).

FN49. La. Civ.Code art. 2354 (liable for "fraud or bad faith").

FN50. La. Civ.Code art. 799 (liable for damage "caused by his fault"); *see* La. Civ.Code art. 2369.3 cmt. a.

FN51. La. Civ.Code art. 2369.3 cmt. a; *see* Katherine Shaw Spaht, *Co-Ownership of Former Community Property: A Primer on the New Law,* 56 LA. L.REV. 677, 699 (1996).

III.
Conclusion

In the end, we disagree with the district court only to the extent that it held the conflict between Louisiana community property law and federal copyright law irreconcilable absent congressional intercession. We therefore reverse the court's grant of summary judgment declaring George alone to be the owner of the blue dog and other copyrights created during his marriage to Veronica. Accordingly, we remand this case, appealed pursuant to Rule 54(b), for entry of an appropriate ruling regarding Veronica's rights with respect to the copyrights and for consistent disposition of all remaining issues still pending before that court.

Specifically, we instruct the district court to determine on remand which copyrights are subject to the rules of community property law that we announce today, either directly as works created during the existence of the community of acquets and gains or derivatively as works created after the termination of the community but based on pre-divorce works. [FN52] Even ***443** though the parties briefed the issue of derivative works in the instant appeal, the district court has not yet ruled on it so that issue is not ripe for our consideration and disposition. In holding that George alone is the owner of all copyrights in the artistic works, the district court denied Veronica's cross-motion for a summary judgment declaring her economic interests in the copyrights, including determination of which post-divorce works were derivative of the artwork created during the marriage. That ruling, however, was not certified to be a final judgment ready for appeal under Rule 54(b). As we now hold that Veronica *does* have economic rights with respect to the copyrights at issue, the district court must determine on remand which works are derivative as well.

FN52. *See* 17 U.S.C. § 101 (defining "derivative work"), § 103(a) (providing that subject matter of copyright includes derivative works).

We further instruct the district court, following such determinations, to enter judgment recognizing Veronica's entitlement to an undivided one-half interest in the net economic benefits generated by or resulting

from copyrighted works created by George during the existence of the community and from any derivatives thereof. Such judgment also must recognize George's continued entitlement to the exclusive control and management of the five rights in such intellectual property specified in § 106, albeit subject to any duty that he might ultimately be held to owe Veronica to "manage prudently" all such copyrights and derivatives thereof under his control. [FN53]

> FN53. La. Civ.Code art. 2369.3. *Cf. supra* n.22.

We acknowledge that it is for the state court that has jurisdiction over judicial partition and settlement of the Rodrigue community to determine both the proper method for establishing the value of Veronica's share of these net economic benefits and the proper procedure for delivery of that share to her, whether that be, for example, by (1) an accounting based on the present value of the appraised fair market value of the fully exploited copyrights and derivatives during their expected lifetimes, (2) periodic accountings and payments to Veronica as the copyrights and derivatives are exploited and proceeds are derived from them, or (3) some other altogether different procedure. [FN54] It follows, of course, that Veronica may continue to pursue judicial partition of former community property in that forum.

> FN54. The court is required to apply the detailed rules in La.Rev.Stat. § 9:2801(4) in partitioning assets and liabilities formerly belonging to the community to ensure that each spouse receives property of equal net value.

Finally, in the interest of judicial economy, we reserve to this panel limited appellate jurisdiction over this case with respect to future appeals--if any-- from judgments rendered by the district court on remand in implementation of our instructions.

REVERSED and REMANDED WITH INSTRUCTIONS.