VALUING AND DIVIDING THE COMMUNITY BUSINESS

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STATE BAR OF TEXAS
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Chapter 16

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EDUCATION:
University of Texas, B.A. in History, 1972
St. Mary's University, J.D., 1975

BOARD CERTIFIED BY THE TEXAS BOARD OF LEGAL SPECIALIZATION:
Board Certified Family Law - Texas Board of Legal Specialization 1981
Recertified in Family Law 1986, 1991, and 1996.

MEMBERSHIPS:
American Board of Trial Advocates
President-elect, American Academy of Matrimonial Lawyers - Texas Chapter
Fellow - American Academy of Matrimonial Lawyers
Fellow - International Academy of Matrimonial Lawyers
Texas Academy of Family Law Specialists
Member, Family Law Council
Charter member, Texas Family Law Foundation
American Bar Association - Family Law Section
State Bar of Texas - Family Law Section
Travis County Bar Association - Family Law Section
President, Travis County Family Law Advocates 1999 - 2000
Treasurer, Travis County Family Law Advocates - Political Action Committee
Texas Trial Lawyers Association

PROFESSIONAL ACTIVITIES AND HONORS:
Listed - The Best Lawyers in America - Family Law
Martindale-Hubbell - "AV" rating
Martingale-Hubbell Bar Register of Preeminent Lawyers

CONTINUING LEGAL EDUCATION (PLANNING AND ADMINISTRATION):
Course Director- Ultimate Trial Notebook Family Law-2000;
Course Director-American Academy of Matrimonial Lawyers, Texas Chapter, Survival Retreat-2001

Planning Committee for 1994, 2000, 2001 Advanced Family Law Seminar;
Planning Committee for 1998, 2001 New Frontiers in Marital Property Law Seminar;
Chair, Interdisciplinary Relations on Mental Health Committee- 1997, 1998, 1999, 2000 - American Academy of Matrimonial Lawyers;
Member of Newsletter Committee - American Academy of Matrimonial Lawyers;
Member of the Foundation of the American Academy of Matrimonial Lawyers;
Planning Committee Marriage Dissolution - 1998,1999,2000;
Chair, Texas Association of Family Law Specialists Legislative Oversight Committee - 1999;
Planning Committee for Intermediate Family Law Conference - 2000;
Nominating Committee - Family Law Council-2001;
Membership Committee-Family Law Council 2001;

CLE ACTIVITY:

INTERNATIONAL ACADEMY OF MATRIMONIAL LAWYERS

"Fiduciary Duties of Spouses and Non-Physical Torts", International Academy of Matrimonial Lawyers, Palm Beach, Florida, March 2000.

AMERICAN ACADEMY OF MATRIMONIAL LAWYERS

"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

NEW FRONTIER'S MARITAL PROPERTY LAW

"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:

"Representing the High Tech Entrepreneur: IPO's, Venture Capitalists and Beyond", 26th Annual Advanced Family Law Course, San Antonio, Texas, August 2000.

"The Appellate Process-the Good, the Bad, and the Ugly", 25th Annual Advanced Family Law Course, Dallas, Texas, August 1999.

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

"The Ab(use) of the Rules of Evidence and Privileges," Advanced Family Law Course, San Antonio, Texas, August, 1997;

"Reporting Child Abuse: Counterpoint - A Lawyer has a Duty to Report Child Abuse," State Bar of Texas Annual Meeting, Houston, Texas, June, 1997 and Advanced Family Law Course, San Antonio, Texas, August, 1997

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

"Representing the High Tech Entrepreneur: IPO's, Venture Capitalists and Beyond", 26th Annual Advanced Family Law Course, San Antonio, Texas, August 2000.

"Family Law Court v. Probate Court: What Every Family Lawyer Should Know", 26th Annual Advanced Family Law Course, San Antonio, Texas, August 2000.

"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.

"The Appellate Process-the Good, the Bad, and the Ugly", 25th Annual Advanced Family Law Course, Dallas, Texas, August 1999.

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

"Whose Kids are They, Anyway? Reporting Child Abuse: Counterpoint - A Lawyer has a Duty to Report Child Abuse," State Bar of Texas Annual Meeting, Houston, Texas, June, 1997 and Advanced Family Law Course, San Antonio, Texas, August, 1997

"The Ab(use) of the Rules of Evidence and Privileges," Advanced Family Law Course, San Antonio, Texas, August, 1997;
"Piercing Claims of Immunity in Family Law Litigation," Advanced Family Law Course, San Antonio, Texas, 1994;

MARRIAGE DISSOLUTION

"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.

"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;

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

"Appellate Tips: Judges Panel",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.

"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;

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;

STATE BAR OF TEXAS COURSES

"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;

"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

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

"Bottom Line Appellate Issues," Ultimate Trial Notebook: Family Law, New Orleans, Louisiana, December 2000.The Ultimate Trial Notebook - Family Law, 1994, State Bar of Texas, Austin, Texas, "The Social Worker: Learning from Your Expert What to Ask";

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;

"Infliction of Emotional Distress: No Justice in the Middle Ground" Texas Trial Lawyers Forum, 1992;

"Evaluation and Division of Professional Goodwill and Professional Degrees During Marriage" Texas Trial Lawyers Forum, 1985;

Co-Author with Dan Price, "Post Divorce, Modification of Conservatorship and Support Orders" in Divorce 1984: Division of Property and Decisions on Children, 1984;

Co-Author with Thomas Oakland, Ph.D.: Divorced Fathers, 1984

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PROFESSIONAL ACTIVITIES

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Board Certified, Civil Appellate Law (1988-present)
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Texas Board of Legal Specialization

LICENSED TO PRACTICE

The Supreme Court of Texas
The Supreme Court of the United States
The United States Courts of Appeals for the Fifth and Eighth Circuits
United States Federal District Court for the Western District of Texas

PROFESSIONAL MEMBERSHIPS & HONORS

Martindale-Hubbell - "AV" rating

Member, Association of Attorney-Mediators

Member, Planning Committee, Fifth, Sixth, Ninth, Tenth, Eleventh and Thirteenth Annual Advanced Civil Appellate Practice Courses (1991-92, 1995-97, 1999)

Member, Planning Committee, Family Law on the Front Lines (2001)

Member, Planning Committee, The Ultimate Trial Notebook - Family Law (2000)

Member, Planning Committee, University of Texas School of Law, First, Second and Third Annual Insurance Law Institutes (1996-98)

Member, Editorial Board, APPELLATE ADVOCATE, State Bar Appellate Practice & Advocacy Section 1994-97

Member, Council, State Bar Appellate Practice & Advocacy Section 1995-1998

Member, Task Force on Staff Diversity, Texas Commission on Judicial Efficiency 1995-96

Chair, Civil Appellate Law Section, Travis County Bar Association November 1991-1993, 1995-1997

Member, Travis County Bar Association Board of Directors November 1991-1993, 1995-1997

Member, Planning Committee, Primer for Handling Civil Appeals, Travis County Bar Association, Austin 1995, 1996

Staff Attorney, Hon. Jack Hightower, Justice The Supreme Court of Texas 1989-1995

EDUCATION

Baylor University School of Law J.D., *cum laude* 1980

University of Texas B.A. 1974

SELECTED LAW RELATED PUBLICATIONS & PRESENTATIONS

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

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

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

"Representing the High Tech Entrepreneur: IPO's, Venture Capitalists and Beyond", 26th Annual Advanced Family Law Course, San Antonio, Texas, August 2000.

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"Fiduciary Duties of Spouses and Non-Physical Torts", International Academy of Matrimonial Lawyers, Palm Beach, Florida, March 2000.

Internal Procedures in the Texas Supreme Court Revisited: The Impact of the Petition for Review and Other Changes, 31 TEX. TECH L. REV. 63 (2000)

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

"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.

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"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 Conflicting Fiduciary Duties," New Frontiers in Marital Property Law, Sante Fe, New Mexico October 1998

"Appeal of the Coverage Suit," Third Annual Insurance Law Institute (University of Texas School of Law, October 1998) (panelist/speaker and co-author);

"The New Appellate Rules -- At Last!" Eleventh Annual Advanced Civil Appellate Practice Course, Dallas September 1997 (speaker and author);

GUIDE TO THE NEW RULES OF APPELLATE PROCEDURE (State Bar of Texas 1997) (contributing author);

Motion Practice in the Texas Supreme Court, 59 TEX. B. J. 846 (October 1996)

"Factual and Legal Sufficiency in the Texas Supreme Court," Tenth Annual Advanced Civil Appellate Practice Course, Austin 1996 (co-author)

"Inside the Texas Supreme Court," Ninth Annual Advanced Civil Appellate Practice Course, San Antonio 1995 (moderator and author)

Internal Procedures in the Texas Supreme Court, 26 TEX. TECH L. REV. 935 (1995)

Jurisdiction in the Supreme Court of Texas: "Amount in Controversy", 7 APPELLATE ADVOC. 3 (May 1994) (co-author)

"Internal Procedures and Motion Practice in the Supreme Court," Seventh Annual Advanced Civil Appellate Practice Course, Austin 1993 (speaker and author)

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EDUCATION

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PROFESSIONAL ACTIVITIES

Board Certified, Family Law, 1996
Certified Mediator, 1994
Board Certified, Civil Appellate Law, 1993
Board Certified, Civil Trial Law, 1991

PROFESSIONAL AFFILIATIONS

Texas Academy of Family Law Specialists, Travis County Bar Association, Texas Bar Association, College of the State Bar, San Antonio Bar Association, San Antonio Family Law Association, Texas Bar Foundation

SELECTED LAW RELATED PUBLICATIONS & PRESENTATIONS

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

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

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

"Representing the High Tech Entrepreneur: IPO's, Venture Capitalists and Beyond", 26th Annual Advanced Family Law Course, San Antonio, Texas, August 2000.

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

Co-Author, "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.

Co-Author, "Fiduciary Duties of Spouses and Non-Physical Torts", International Academy of Matrimonial Lawyers, Palm Beach, Florida, March 2000.

Co-Author, "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.

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

Co-Author, "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.

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

Co-Author, "The Appellate Process-the Good, the Bad, and the Ugly", 25th Annual Advanced Family Law Course, Dallas, Texas, August 1999

Co-Author, "Malpractice", Advanced Family Law Course, State Bar of Texas, San Antonio, Texas, 1992.

Co-Author, “Malpractice, Advanced Family Law Course, State Bar of Texas, San Antonio, Texas, 1991.

Co-Author, “Expert Witnesses”, Advanced Family Law Course, State Bar of Texas, San Antonio, Texas, 1990.

Table of Contents

VALUING AND DIVIDING THE COMMUNITY BUSINESS

I. INTRODUCTION

Perhaps nowhere else do the complexities inherent in family law manifest themselves more poignantly than in the context of valuing and dividing a business in a divorce. The Texas family law practitioner who is faced, for example, with a community or family business in a divorce must be equal parts family lawyer and business lawyer, and he or she must always maintain the attitude not only of such a versatile professional, but of a prudent businessperson as well.

A community business is, of course, often the single most valuable asset in a marriage, especially in today's economy. Accordingly, this article addresses a variety of topics, from general basics to more technical issues, frequently associated with the challenging task of valuing and dividing a community business in a Texas divorce.

II. FORM OF THE COMMUNITY BUSINESS

The "form" of the community business is one of the first inquiries that must be made in a valuation. There are different issues at stake, depending on the form of the practice, including the issue of "commercial" or "practice" goodwill versus "personal" or "professional" goodwill," discussed below. There may be other issues as well, such as transfer agreements between partners, and the laws controlling ownership interests in professional corporations. All of these factors–and others–affect the value of the spouse's ownership interest in the community business.

A. 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 owners in the entity, and the entity owns the assets. Thus, in a sole proprietorship, the valuation of the owner's interest will include all of the assets, whereas in a partnership or a corporation, the valuation is of the partnership interest or the stock owned. In a sole proprietorship, the assets of the practice themselves likely will be community property if acquired during the marriage. Such assets are, therefore, subject to division by the court. *See*, *e.g.*, *Butler v. Butler*, 975 S.W.2d 765, 786 (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).

B. Partnership

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).

A partnership will be treated somewhat differently than a sole proprietorship. 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, a value must be placed on the partner's ***interest*** in the partnership, which may include the value of the partnership assets.

Tangible partnership assets include cash, accounts receivable, work in progress, tangible personalty and realty, etc. Intangible partnership assets include goodwill and going concern value (and should be accounted for in any valuation process).

It should be noted that one Texas appellate court has held that, 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 v. Cleaver*, 935 S.W.2d 491, 494 (Tex.App.–Tyler 1996, no writ).

A valuation of a partnership will involve either (1) the Texas Uniform Partnership Act (TUPA) or (2) the Texas Revised Partnership Act, as well as the (3) applicable partnership agreement. *See, Salinas v. Rafati*, 948 S.W.2d 286, 289 (Tex. 1997)

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 have expressly elected to have the new law applied. *Id.*

In pertinent part, the Texas Uniform Partnership Act provides:

> §26. Nature of Partner's Interest in the Partnership
>
> 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, §26.

> §28-A. Extent of Community Property Rights of a Partner's Spouse
>
> (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.
>
> (3) A partner's rights to participate in the management is not community property.

TEX.REV.CIV.STAT. art. 6132b, §28-A.

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(12).

> Personal Property. 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 in the Historical Notes to Article 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 §28-A(3).

The applicable 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).

C. 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. history) (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). In other words, the value of an individual's interest in a corporation is limited to the value of his or her stock, which may include the value of the corporation's tangible and intangible assets; however, the actual assets belong to the corporation and cannot be "partitioned" out of the corporation by a Texas trial court.

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).

1. 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.

The retained earnings of a C-corp are assets of the corporation, and are not divisible by a trial court upon divorce. *See, e.g., Thomas*, 738 S.W.2d at 344.

2. 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).

Earnings retained by a S-corp, and not distributed to shareholders, remain corporate assets and cannot be divided upon divorce. *Thomas*, 738 S.W.2d at 345.

3. 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).

4. 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*.

As with all corporations, the value of an individual's interest in a professional corporation is limited to the value of the stock, rather than the assets. However, it is still the value of the professional practice, including the assets owned by the corporation, that will help determine the value of the stock ownership interest at stake.

D. Franchise

In general, a franchise is an agreement between a franchiser – who owns, at the national or international level, the rights to a particular business, such as a Macdonald's or a Dairy Queen – and a franchisee – who obtains the right to operate the business at the local level, in accordance with the franchisor's standards. The franchisee may operate the business at the local level in any number of forms, *i.e.*, by means of a partnership or a corporation, etc.

Importantly, the franchise agreement may often contain restrictive provisions concerning the transfer of the franchise rights. Typically, the franchise is not freely transferable, at least not without the express approval of the franchisor. Thus, in any given situation involving a franchise, the franchise agreement should be examined for its effects on the transferability of the franchise, and thereby its effects, if any, on the value of the franchise.

II VALUATION THEORY

A. Introduction to the Valuation Process

In any divorce, valuation issues are resolved by an interplay between the parties lawyers, experts, and judges. With regard to the valuation and division of a community business upon divorce, into such mix must be added many complicated economic and accounting principles. Consequently, it may be prudent to keep in mind the following cynical explanation, offered by one unknown author:

> Experts are people who know a great deal about very little, and who go along learning more and more about less and less until they know practically everything about nothing.
>
> Lawyers, on the other hand, are people who know very little about many things, and who keep learning less and less about more and more until they know practically nothing about everything.
>
> Judges are people who start out knowing everything about everything, but end up knowing nothing about anything, due to their constant association with experts and lawyers.

See, Crum & Forster, Inc. v. Monsanto Co., 887 S.W.2d 103, 134 n. 26 (Tex.App.-Texarkana 1994, no writ).

Another potential wildcard in a business valuation case is the finder of fact. The fact finder is not required to accept the opinions of the experts on either side of the controversy, but can determine the value to be somewhere in the range between the high and low values offered in evidence. *InterFirst Bank Dallas, N.A. v. Risser,* 739 S.W.2d 882, 890 (Tex.App.-Texarkana 1987, no writ). The fact

finder's determination must fall between the high and low values offered in evidence because the jury must have an evidentiary basis for its findings. *Salinas*, 948 S.W.2d at 289 (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).

Ultimately, the valuation of a business is an estimate of what the business is worth. An estimate of value is based upon various assumptions, many of which will be discussed in this paper.

Generally, the valuation of a business looks toward the future earnings potential of the business. However, for purposes of divorce, valuation should be predicated upon historical data, since future earnings after divorce are not divisible by a Texas trial court. *See, e.g., Berry v. Berry*, 647 S.W.2d 945, 947 (Tex. 1983). Moreover, historical data is most often used and relied upon in valuing small closely held businesses and professional practices, particularly when the analyst acts in the capacity of an expert witness, because such data is based on fact and is not easily disputed.

It should also be noted that a "valuation" and an "appraisal" are two distinctly different animals. In a "valuation," the valuator seeks

> [t]o establish a value for an entire or partial interest in a closely held business or professional practice, taking into account both quantitative and qualitative tangible and intangible factors associated with the specific business being valued.

Black & Isom Associates, BUSINESS VALUATIONS: FUNDAMENTALS, TECHNIQUES & THEORY, Chapter Two - 1 (1995). On the other hand, in an "appraisal," the appraiser seeks

> [t]o establish the value of certain specific tangible assets, based upon special market knowledge, education, and vocational training possessed by the appraiser.

Id. at Chapter Two - 2. Accordingly, a "valuation" may utilize "appraisals" of specific tangible assets in the determination of the overall value of the business.

B. The Definition of "Value"

In the more particular context of a Texas divorce, according to TEXAS PATTERN JURY CHARGES - FAMILY, PJC 203.1 (2000), value is defined as:

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

The foregoing definition represents the yardstick by which *all evidence* must be measured in a divorce trial involving a valuation of any community business (actually, of any asset). But it must be emphasized that "fair market value" is not a singular figure valid for a variety of purposes; rather, every valuation must begin with an answer to the question: "value of what, to whom, and for what purpose?" Maxson, *Valuation of Closely Held Securities - Avoiding Common Pitfalls and Misconceptions,* VALUATION NOTES (Deloitte & Touche, June 1991), *quoted in* Brenda Keen Schwarz, *Complex Business Valuation Issues: Presentation and Impeachment*, EE-1, 22nd ANNUAL ADVANCED FAMILY LAW COURSE (1996).

One commentator has identified four basic tenets of valuation practice:

1. value is forward looking;
2. all value is the expectation of future performance;
3. the best indicator of future performance is usually the performance of the immediate past; and
4. historical accounting and other data are useful primarily as a road map to the future.

Robert James Cimasi, *Medical Practice Valuation and Transactions in a Changing Market*, p. 15, INSTITUTE OF CERTIFIED BUSINESS COUNSELORS 21ST ANNUAL MEETING.

C. The Measure of Value

Texas jurisprudence has produced several measures of value. These common law notions of value arise primarily from non-divorce situations and are difficult, at best, to reconcile. One seminal, instructive opinion with respect to the various measures of value is *Taylor County v. Olds*, 67 S.W.2d 1102 (Tex.Civ.App.–Eastland 1934, writ dism'd). *Taylor County,* an often cited condemnation case, establishes 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. *Id.* at

1105. Only certain of these "grades" of evidence establishing value are relevant to the valuation of a community business ("cost of replacement," for example, is an irrelevant concern in the valuation of a business).

Furthermore, *Taylor County* creates a loose "hierarchy"of value. Thus, a party offering evidence of value other than market value should lay a predicate therefor by a *prima facie* showing that there exists no market value at the time and place in question; if the party fails to do so, the opposing party has the right to object to the admission of any other evidence of value until such showing is made. *Id*. at 1104; *see also, Bryant v. Stohn,* 260 S.W.2d 77 (Tex.Civ.App.–Dallas 1952, writ ref'd n.r.e.).

However, in many instances involving the valuation of a community business, laying the predicate for establishing a measure of value that is not market based may be relatively easy, since there is no readily ascertainable market. However, over the past several years, there are more data bases reporting sales of closely held companies. Documented, bona fide bid and asked prices for closely held entities, for instance, rarely exist. *See, e.g.,* Schwarz at EE-3.

1. Market Value

a. Willing Buyer and Willing Seller

Market value has been defined by the Texas Supreme Court as:

> [t]he price the property will bring when offered for sale by one who desires to sell, is not obligated to sell, and is bought by one who desires to buy, but is under no necessity of buying.

City of Pearland v. Alexander, 483 S.W.2d 244, 247 (Tex. 1972).

According to the Internal Revenue Service, and the American Society of Appraisers, fair market value is:

> [t]he price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.

Rev. Rul. 59-60, 1959-1 C.B. 237; *see also,* BUSINESS VALUATION STANDARDS, *Definitions* (Am.Soc.Appraisers 1994). Clearly, *City of Pearland* and Rev.Rul. 59-60 articulate the classic definition of "fair market value." As a practical matter, however, whether the "classic" definition is of any use is far less clear.

For example, the valuation of a business, for the purposes of divorce, often *assumes* a hypothetical, as opposed to a specific, identified, "willing" buyer and seller. Further, in this hypothetical valuation, it must be *assumed* that "willing" means "willing to do anything in order to complete the sale"; in other words, it must be assumed that the "willing" seller has no actual participation in the negotiations culminating in an eventual sale of his or her business. However, *sellers do participate*: in actual arms-length sales transactions; covenants not to compete (often included in the overall consideration of an actual sale, and the value of which is "carved out" of the actual sales price), although usually demanded, are sometimes refused. Thus, the assumption of a "willing" buyer and seller often conflicts with the realities of a given valuation situation. Realistically, it simply *cannot* be assumed that a "willing" buyer will do *anything* to consummate a sale.

In the marketplace, "actual value" is most often the result of arms-length negotiated transactions. Yet, in most divorce valuations there has been no arms-length negotiated transaction. Further, there appear to be no reported Texas cases articulating the extent to which a seller must be "willing" to sell for the classic definition of value to be applicable. Is it defensible, either in theory or in practice, for a court to assume that any specific, identified seller will agree to a covenant not to compete, particularly if that seller has unequivocally expressed his unwillingness to do so?

An interesting example of the application of the "willing buyer and seller" standard occurred in *Morgan v. Morgan*, 657 S.W.2d 484, 487 (Tex.App.–Houston [1st Dist.] 1983, writ dism'd), in which the husband unsuccessfully argued that the trial court erred by placing an excessive valuation of $450,000 on the couple's business.

In its opinion, the Houston First Court of Appeals recounted that the wife's expert accountant testified that the income tax returns of the husband's company, which were prepared on a cash basis, were inadequate to give a "picture of the company's performance," since not all the essential information was contained therein. The accountant therefore also examined the accrual basis financial reports. The accountant then evaluated the earnings history and historical growth rate and explained the steps by which he capitalized the annual earnings on an after-tax basis. *Id.* Concluding that the business generated a pretax cash flow of $119,961 for 1981, the expert determined the after-tax cash flow by assuming an amount of $36,550 as compensation the husband would pay himself, and factoring in a 30% tax rate, a rate he termed conservative. *Id.* at 489. Finally, the expert chose a capitalization rate of 15% as a yield an investor in the current market would expect from his investment and divided the after-tax cash flow by 15% to arrive at a total of $567,000 as the fair market value of the property. *Id.*

The Houston appellate court noted that, while it was true that the accountant never specifically testified that he took the classic "fair market value" definition into consideration, it was

nonetheless "obvious" that the expert did consider the willing buyer/willing seller standard, since the whole purpose of his analysis by income capitalization was to arrive at the amount of money a willing investor would pay for the business. *Id.* In other words, the valuation of $567,000 was, in the expert's opinion, what a willing buyer would pay a willing seller in order to gain a 15% return on his investment. *Id.* Accordingly, the Houston appellate court found that the expert's opinion was well-supported and that there was sufficient evidence to support the trial court's ultimate valuation of $450,000. *Id.* at 490.

b. Sales: Comparable and Otherwise

The concept of market value assumes an existing, established market. *See, e.g., Wendlandt v. Wendlandt*, 596 S.W.2d 323, 235 (Tex.Civ.App.–Houston [1st Dist.] 1980, no writ). In theory, the marketplace is the most reliable indication of value. Therefore, in theory, sales of comparable closely held businesses or professional practices should be helpful in the determination of value.

But, as a practical matter, there is often little or no actual market for a closely held or other community business. Therefore, other measures of value must be utilized. *See, e.g., Religious of Sacred Heart of Texas v. City of Houston*, 836 S.W.2d 606, 615-616 (recognizing that when the most common method of determining market value – the market data approach – cannot be successfully utilized, resort to additional methods of determining market value is necessary); *InterFirst Bank Dallas, N.A.,* 739 S.W.2d at 890 n. 7 (when sales of stock had been infrequent, had consistently been in small blocks, and had been to buyers who were generally members of the controlling family, the expert witnesses properly sought other methods for arriving at a fair market value).

In actual practice, comparable sales present many difficulties in the valuation of an existing business. As expressed by several valuation experts:

> Useful comparative sales data are much harder to obtain for sales of businesses than for sales of real estate. The problem of obtaining comparative transaction data is greater for small businesses and professional practices than for large businesses.

Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs, VALUING SMALL BUSINESS AND PROFESSIONAL PRACTICES, 67 (2nd Ed. Irwin) [hereinafter referred to as "Pratt"]. If comparable sales of a small business are indeed discovered, the actual negotiated terms of the sales are usually not known. The demands for, as well as the offers and rejections of, such sales terms as covenants not to compete, long term payouts, and requirements for the seller to remain in the employ of the subject practice, are difficult to determine. The unique motivations of the particular buyers and sellers can be impossible to ascertain, yet they significantly affect fair market value.

Another significant problem with the use of comparable sales data for the valuation of a community business is the uniqueness of every business:

> Each parcel of real estate is also unique, of course; but the large number of variables, many of which are impossible to measure numerically, usually make the matter of comparability a greater problem when using comparable sales transaction data [for the sale of a small business] than when using comparative real estate transaction data.

Pratt, Reilly and Schweihs at 67-68. Simply put, if comparable sales are utilized in a valuation of a specific business, then the businesses sold must be truly comparable. In the jargon of valuation experts: if comparable sales data is utilized, the translations used to postulate value should be comparable in terms of (1) size of practice (volume); (2) location (urban vs. suburban vs. rural); and (3) time of the transaction. Robert L. Brown, Ed., VALUING PROFESSIONAL PRACTICES AND LICENSES: A GUIDE FOR THE MATRIMONIAL PRACTITIONER, §7.02[b][2] (1997 Supp. 2nd Edition).

With respect to the notion of "comparable sales," Shannon Pratt has pointed out that it is common, although erroneous, to think of "comparable" only in the sense of similar products. Shannon Pratt, *Business Valuation Body of Knowledge*, 127 (John Wiley 1998). However, according to Dr. Pratt, "comparable" actually refers to companies with similar risk characteristics, *e.g.,* similar supply and demand forces and other economic risk factors. *Id*. It is common, for instance, in the Tax Court to compare companies that have similar consumer brand recognition and distribution, even though the products of such companies may be different. *Id*.

Consequently, if "comparables" are to be used in a valuation, Dr. Pratt further notes that Revenue Ruling 59-60 advocates the use of the public companies that are the same or similar to the subject company, and that "similar" has been generally interpreted to allow wide latitude in guideline company selection, since the object is to identify companies with similar risk characteristics. *Id*. at 128.

Comparable or guideline company valuation methods are becoming increasingly common, because the data bases for obtaining the necessary "comparable" information about such companies is becoming increasingly broad and available.

2. Intrinsic Value

According to *Taylor County,* in the absence of market value, the next best evidence of value is intrinsic value. 67 S.W.2d at 1105*; Howell v. Bowden*, 368 S.W.2d 842, 848 (Tex.Civ.App.–Dallas 1963, writ ref'd n.r.e.). Thus, intrinsic value is considered a proper basis for valuation only when there is evidence that the property has no market value. *Whelan v. State*, 282 S.W.2d 378, 380 (Tex. 1955).

The term "intrinsic value" is often used interchangeably with the term "actual value." *See, e.g., Religious of Sacred Heart of Texas,* 836 S.W.2d at 616 ("[r]eal, actual or intrinsic value...). Intrinsic value has been defined as: "[t]he true, inherent and essential value of a thing, not depending upon accident, place or person, but the same everywhere and to everyone." *Rosenfield v. White*, 267 S.W.2d 596 (Tex.Civ.App.–Dallas 1954, writ ref'd n.r.e.). Intrinsic value is "[w]orth based upon such factors as costs, depreciation, present usefulness, past return on investment, etc...." *City of Austin v. Cannizzo*, 267 S.W.2d 808, 812 (Tex. 1954).

The concept of intrinsic value is less well-defined than market value. Consequently, intrinsic value is seldom utilized in business valuations. *See, e.g.*, Edwin J. (Ted) Terry, Kristin K. Proctor, Ken Huff, and James LaRue, *Dealing with Special Problems Relevant to Evaluation & Division of Professional Practices,* B-20, 22nd ANNUAL NEW FRONTIERS IN MARITAL PROPERTY LAW (1997) [hereinafter referred to as "Terry and Proctor"].

3. Value to the Owner

The concept of "value to the owner" appears to be very similar to what is often expressed as "going concern value." A "going concern" is "an operating business enterprise." BUSINESS VALUATION STANDARDS, *Definitions* (Am.Soc.Appraisers 1994). "Going concern value" is the intangible value of an enterprise that has the necessary work force, systems, procedures, operating assets, and organization structure in place. *See, Id.* A trained and assembled work force is a particularly valuable intangible asset for many businesses because of the significant "start-up" cost necessarily involved with developing a new work force.

"Value to the owner" has been recognized as a legitimate measure of value in the context of a divorce. In *Beavers v. Beavers,* 675 S.W.2d 296, 299 (Tex.App.–Dallas 1984, no writ), the community estate owned a one-third interest in the stock of a closely held corporation. The sale of the shares of stock was restricted by an agreement that they be offered first to the other shareholders at book value. Thus, it was acknowledged by all concerned that the market value of the stock was zero. Nevertheless, the trial court found the value of the community stock to be $170,000. The Dallas Court of Appeals affirmed the trial court's finding and held:

> [w]hile market value is usually the best evidence of the value of the personal property, in the absence of a market value, the actual value of the property to the owner may be shown.

Id. at 299.

It has been argued that the definition of value from *City of Pearland,* and further expanded by *Beavers*, opens the door to the introduction of all sorts of evidence bearing on the value of the ownership of a closely held business to the owner (provided that it has been established that no market value exists). *See,e.g.,* Terry and Proctor at B-25. For example, such evidence might include the value of being able, by virtue of ownership of stock in a closely held corporation:

- to earn a salary in excess of $100,000 per year;
- to drive a new automobile;
- to have health insurance paid for by the company;
- to have a company financed life insurance policy;
- to make trips at company expense;
- to have a company funded pension plan; and
- to belong to the country club at company expense, etc.

See, Id.

4. Book Value

There are two things that the Texas practitioner should know about book value. The first is the definition: book value means the sum of the asset accounts, net of depreciation and amortization, less the liability accounts, as shown on the entity's balance sheet. Pratt at 33. The second is that book value is entitled to little, if any, weight in determining the value of closely held corporate stock, or any other business. *See, e.g.,Bendalin v. Delgado*, 406 S.W.2d 897, 900-901 (Tex. 1966); *cf., Smallwood v. Singer*, 823 S.W.2d 319, 322, n. 2 (Tex.App.–Texarkana 1991, no writ) (in which the Texarkana Court of Appeals states that "t]he only case that we have found in any jurisdiction to suggest that book value of stock in a closely-held corporation is prima facie evidence of value is *Percy v. Percy*, 115 Ariz. 230, 564 P.2d 919, 920 (Ct. App. 1977)").

D. Summary of Valuation Methods

1. Adjusted Net Assets Method

The Adjusted Net Assets Method sets a "floor value" for determining total entity value, *i.e.,* the fair market value (not book value) of existing assets less related debt. There is no reason that the owner of a closely held business or professional practice would be willing to accept less than the net asset value of a business or professional practice. This method is used when the business or professional practice earnings are not sufficient to give rise to an intangible value, for example, when it would be better to incur the cost of starting up a competing business or professional practice rather than to purchase the existing business or professional practice. *See,* Terry and Proctor at B-16.

The Adjusted Net Assets Method is an asset based valuation approach and therefore does not address the operating earnings of a business. The Adjusted Net Assets Method may include going concern value.

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2. Capitalization of Earnings Method

An income based approach, the Capitalization of Earnings Method is used to value a business based on future or normalized current earnings of the business. This method assumes that all of the assets, tangible or intangible, are an indistinguishable part of the business, and does not attempt to separate the values of the tangible or intangible earnings of the business. This method is most commonly used when the tangible assets of the business are not a material component of the business. However, it should be noted that the proper use of the Excess Earnings Method, as described below, will yield a value very close to the Capitalization of Earnings Method, since the rate of return on tangible assets of a business that has very little tangible assets will result in an insignificant increase in the total value of the business. *See, Id.*

3. Excess Earnings Method

This method is an income and asset based method. The total value of a closely held business is the sum of the fair market values of net tangible and intangible assets. The value of intangible assets of a closely held business is determined by capitalizing earnings in excess of a reasonable return on the fair market value of the adjusted net assets of the business, after "reasonable owners compensation." In the case of a community business with very few tangible net assets, it should not be necessary to determine the rate of return on tangible assets since the calculated value would not differ materially from the Capitalization of Earnings Method.

Some business valuation experts discount the Excess Earnings Method in determining the value of a closely held business or professional practice. Specifically, business valuators often cite Revenue Ruling 68-609 for the proposition that "[t]he 'formula' approach may be used for determining the fair market value of intangible assets of a business only if there is no better basis therefor available." Realistically, a closely held business can be valued based upon asset based valuations, income based valuations, or a combination of income and asset based valuations, and sometimes based upon a comparable sales method. As discussed earlier, the current thought about "comparables" is that the guideline companies used in the valuation may be of much larger size than the subject company, provided both the subject company and the guideline company share the same or similar risk factors and revenue generators.

Morgan, 657 S.W.2d at 487, presents an example of the application of the Excess Earnings Method to a business valuation incident to divorce. The Excess Earnings Method has also been applied in at least one Texas partnership valuation case. *Taormina v. Culicchia*, 355 S.W.2d 569 (Tex.Civ. App.–El Paso 1962, no writ) involved a suit by a former partner to recover his proportionate share of the assets of a dissolved partnership. The former partner called an appraiser as an expert who testified that he had made an investigation of the partnership company, had observed its operations, and had examined its books. The expert testified that the partnership firm had goodwill, and fixed its value at the sum of $533,514.45. The expert testified that the method he used in determining the value of the partnership goodwill was based upon excess earnings (earnings in excess of eight percent to ten percent of the average tangible net assets or invested capital of the business), and where the net profits exceeded ten per cent of the tangible net assets or invested capital of a business, recognizable goodwill value existed. *Id.* at 574. The value of such goodwill, then, according to the expert, was computed on the basis of the amount by which the net earnings of the business exceed normal earnings in the same or similar business. *Id.* On appeal, the El Paso appellate court held that the trial court did not err in permitting the testimony of the expert witness to be considered by the jury. *Id.* at 575.

4. Discounted Earnings Method

Another income based approach, the Discounted Earnings Method, is based on future earnings. The ultimate value of the business is determined from the present value of future earnings plus the present value of the terminal value of the business. The present value of the terminal value represents the capitalization of terminal year earnings. This method generally should not be used in a divorce case since future earnings are not divisible in a dissolution of the marriage because they are post-divorce earnings and therefore are the separate property of the divorced professional or business owner. *See, Berry*, 647 S.W.2d at 947.

5. Rule of Thumb Methods

These are theoretical market derived comparisons and constitute a variation of the market comparison approach. These methods should be used only as a guidelines, or as "sanity checks,"

since there is usually limited knowledge about the actual transaction upon which the Rule of Thumb Method is based.

6. Market Based Methods

This method is based upon "comparable sales," or guideline companies, in a manner similar to real estate valuations. However, as already discussed, unlike real estate, there are very few, if any, "comparable sales" of closely held businesses. Furthermore, it is very difficult to compare sales of publicly traded stock to the stock of closely held businesses or professional practices unless there is sufficient information to correlate the subject company with the guideline companies based on similar risk and revenue factors.

Ultimately, utilization of market based methods to value a particular community business would be similar to a real estate appraiser valuing Austin, Texas, property based upon the selling price of Newport Beach, California, property. The two are simply not comparable. If the sales compared are not "comparable," or the identified guideline companies not sufficiently comparable, then the conclusions drawn from the comparison will be utterly unreliable.

E. Capitalization Rates

Perhaps the single most important factor in determining the ultimate value of a business is the "capitalization rate." A "capitalization rate" has been defined as "any divisor (usually expressed as a percentage) that is used to convert a stream of income into value." BUSINESS VALUATION STANDARDS, *Definitions* (Am.Soc.Appraisers 1994). "Capitalizing" is a mathematical procedure that converts a single flow of returns (income) into an indication of value. *See, e.g.,* Pratt at 164.

The mathematics of capitalization is simple: the return flow to be capitalized is divided by the capitalization rate. In other words,

$$PV = A/C$$

where:

PV = present value;

A = amount of return to be capitalized (usually dollars per year); and

C = capitalization rate.

Id. Thus, it becomes easy to see that the higher the capitalization rate, the lower the value, and vice versa.

Theoretically, the capitalization rate represents the "risk" factor in the mathematical calculation that produces an estimate of a business' value. In other words, the capitalization rate is an estimate of risk, utilized when comparing a proposed investment in relatively risk free investments, such as stocks, municipal bonds, CD's, etc. to a proposed investment in a closely held business or professional practice. *Cf., Morgan*, 657 S.W.2d at 489 (capitalization rate of 15% represented the yield an investor in the current market would expect from his investment). The capitalization rate is an important factor in evaluating the risk involved in a proposed investment in a closely held business because an investor could always put his or her money into a "safe" investment, for a "safe" return. Given the risk involved in small businesses, some factor must be included that addresses the issue of risk, and that factor is the capitalization rate.

To illustrate the significance of the capitalization rate in the valuation of a business, assume that a business generates $100,000 in income per year. If one party to a valuation believes that the business represents a serious "risk," that party might decide to use a capitalization rate of 25%, in consideration of the perceived high risk. Using a capitalization rate of 25%, the business would be worth $400,000.

On the other hand, if the other party to the valuation believes that the business is relatively risk free, then that party might decide to use a capitalization rate of 10%. Accordingly, with the 10% capitalization rate, the business would be worth $1,000,000. Hence, the contest between capitalization rates becomes the contest over the "actual" value of the business.

The difference between a "capitalization" rate and a "discount" rate is growth: subtracting growth from a discount rate equals a capitalization rate.

F. Goodwill

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*, 355 S.W.2d at 573; *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). According to the American Society of Appraisers, goodwill is:

> [t]hat intangible asset which arises as a result of name, reputation, customer patronage, location, products and similar

> factors that have not been separately identified and/or valued but which generate economic benefits.

BUSINESS VALUATION STANDARDS, *Definitions* (Am.Soc.Appraisers 1994).

1. Professional versus Practice Goodwill

Goodwill may attach to a business, or to a professional person. *See, Nail v. Nail,* 486 S.W.2d 761, 764 (Tex. 1972). Accordingly, two types of goodwill are identifiable: (1) "practice goodwill" (also referred to as "enterprise" or "business" or "commercial" goodwill); and "professional goodwill" (also referred to as "personal" 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). 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; *Smith v. Smith,* 836 S.W.2d 688, 690 (Tex.App.–Houston [1st Dist.] 1992, no writ).

Professional goodwill is based on an individual's reputation, experience, training, and ability. These qualities are personal to the individual and are perhaps impossible to separate from the business, making the associated value difficult to transfer. The implication here is that if the professional left his current practice and entered another practice, his clients would follow him. Thus, unless the professional's individual traits can be transferred to a buyer, there is no value to this individual's goodwill for the purposes of division in a divorce.

"Practice" (or commercial) goodwill, on the other hand, 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.

Professional and practice goodwill may be "mixed." In other words, a particular individual may accrue professional goodwill, and the business or partnership with which the individual is associated may also accrue goodwill. *See, e.g., Keith v. Keith,* 763 S.W.2d 950, 952 (Tex.App.–Fort Worth 1989, no writ). A large medical practice, for example, may offer an excellent example of such "mixed" professional and practice good will, and indeed, *Geesbreght v. Geesbreght,* 570 S.W.2d 427 (Tex.Civ.App.–Fort Worth 1975, writ dism'd), presents just such a case. In *Geesbreght,* 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 that work there. The appellate court discussed the "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).

Id. at 435-436.

Many Texas courts have recognized that business entities accrue goodwill apart from the personal or professional goodwill accrued by an important individual associated with the business. *See, e.g., Welder v. Green*, 985 S.W.2d 170, 178 (Tex.App.–Corpus Christi 1998, pet. denied) (accounting partnership); *Keith,* 763 S.W.2d at 952 (father-son partnership); *Eikenhorst v. Eikenhorst,* 746 S.W.2d 882, 888 (Tex.App.–Houston [1st Dist.] 1988, no writ) (medical partnership); *Rathmell v. Morrison,* 732 S.W.2d 6, 18 (Tex.App.–Houston [14th Dist.] 1987, no writ) (insurance company); *Finn v. Finn,* 658 S.W.2d 735, 741 (Tex.App.–Dallas 1983, writ ref'd n.r.e.) (law firm).

2. The Existence of Goodwill

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 possessed goodwill apart from an

associated professional, Texas courts have consistently looked to several evidentiary factors.

a. The business name is different from the individual's.

The Fort Worth Court of Appeals in *Geesbreght* held that when the name of the business is a company name, as distinguished from the name of an individual, the business possesses 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); *Hirsch v. Hirsch,* 770 S.W.2d 924, 927 (Tex.App.-El Paso 1989, no writ) (when entity is one person professional corporation conducting business in that person's name, any goodwill will probably be personal).

b. The business employs many employees.

In *Rathmell,* the Houston Fourteenth Court of Appeals found that, since none of the companies involved was a "one man show," and, in fact, each had several competent employees who handled day-to-day business affairs, goodwill existed in the companies apart from the personal goodwill of the owner, despite his importance to the business. *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 when owner employed some men to work on cars at his shop, and did not perform all of the work on the vehicles brought to his shop; thus, had the owner retired, died, or been disabled, the good will would not have been extinguished because persons other than the owner performed some of the work at the shop and fostered the good will toward the customers and so the good will of the business did not attach to the person of the owner)*; Finn,* 658 S.W.2d at 741 (law firm had over forty partners and over forty associates).

c. 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, 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).

d. 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.

e. 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).

3. 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.

From an accounting standpoint, *Finn's* two-pronged test represents the excess profits which are separate from the income of the individual professional.

4. 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. Dr. Nail was an ophthalmologist who had been operating as a sole proprietor for about fifteen years. His wife sued for divorce which was granted after a trial before the court. The trial court found:

> That 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.

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

> In any event, it cannot be said that the accrued goodwill in the medical practice of Dr. Nail 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 the question of whether goodwill could be considered in evaluating a professional partnership or corporation. *Id*. at 764. The Texas Supreme Court also said that it was "not concerned with goodwill as an asset incident to the sale of a professional practice." *Id.* at 764.

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 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. *See, e.g., Guzman,* 827 S.W.2d at 447. 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 is 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 the wife worked primarily as a homemaker. The husband did not operate his business as a corporation, but as a sole proprietorship under the business name of Respiratory Care Services. No income tax statements were filed for the business; the business income was reported on a profit and loss statement filed as part of the joint income tax return for the Smiths. The joint tax returns reported the husband as self-employed.

The trial court valued the husband's business, excluding goodwill, at $100,000, and found that an unequal property division in the wife's favor was appropriate because of a disparity of earning power and the admitted and fault of the unrepentant husband. *Id.* at 690.

At trial, both the wife and the husband testified that in 1988 he 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.

Also at trial, the wife 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 (he estimated the amount for 1989), from which he subtracted the tax liability to reach that year's after tax income (he estimated the amount for 1989). 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. 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 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.*

5. Goodwill and the Partnership

Valuation of a professional partnership presents many of the same problems as occur in the valuation of a sole proprietorship. It can be argued that such a practice is worth at least the professional spouse's percentage interest in the adjusted book value of the partnership, as has already been mentioned. Partnership assets include capital contributions, capital accounts, accounts receivable, work in progress, tangible personalty and realty, etc. But the goodwill of the partnership must also be accounted for in the valuation process.

The Texas Revised Partnership Act defines a partner's interest less restrictively than does the Texas Uniform Partnership Act, *i.e.*, a "partnership interest" is the partner's interest in the partnership, *including* the partner's share of profits and losses or similar items, and the right to receive distributions. Neither statutory framework specifically accounts for the possible value of goodwill. But, as an element of intangible value, goodwill should – in certain circumstances must – be taken into account in any comprehensive and competent partnership valuation analysis. *See, e.g., Austin*, 619 S.W.2d at 291 (when goodwill is not attached to the person of the professional man or woman, it is property that may be divided as community property).

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. The Finns were married more than twenty years. During the entire marriage, Mr. Finn practiced law with a prominent Dallas law firm. The law practice was structured as a partnership in which Mr. Finn had been a senior partner for over ten years.

Under the terms of the partnership agreement, if Mr. Finn 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 Mr. Finn's law practice. On appeal, Mrs. Finn 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 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 Mr. Finn's death or withdrawal from the professional practice. According to the majority, Mr. Finn 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 Mr. Finn'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 the assets of the community estate are valued as of the time of dissolution of the marriage. *Id.* As a result, 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*.

6. Goodwill and the Closely Held or Professional Corporation

Revenue Ruling 59-60 is probably the determinative authority for valuation of a closely held corporation. For instance, the Texarkana Court of Appeals noted in *InterFirst Bank Dallas, N.A.*, 739 S.W.2d at 891-892, that all of the expert valuation witnesses who testified except one (who was not familiar with it) recognized Revenue Ruling 59-60 as authoritative in evaluating closely held corporations; the Texarkana appellate court also noted, dryly, that the expert witnesses did not agree, however, as to how Revenue Ruling 59-60 would apply to the evaluation of the shares of the corporation at issue in the case.

Section 4.01 of Revenue Ruling 59-60, 1959-1 CB 237, sets forth eight relevant factors which should be considered as fundamental, but not all inclusive, for the evaluation of stock in closely held corporations or for stock of corporations for which the market quotations are either lacking or too scarce to be recognized:

> (a) the nature of the business and the history of the enterprise from its inception;
>
> (b) the economic outlook in general and the condition and outlook of the specific industry in particular;
>
> (c) the book value of the stock and the financial condition of the business;
>
> (d) the earning capacity of the company;
>
> (e) the dividend paying capacity;
>
> (f) whether or not the enterprise has good will or other intangible values;
>
> (g) sales of stock and the size of the block of the stock to be valued; and
>
> (h) the market price of stocks of corporations engaged in the same or similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

See, InterFirst Bank Dallas, N.A., 739 S.W.2d at 892.

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, Dr. Geesbreght and his partner formed a professional corporation. Upon incorporation, each doctor paid $500 and each received 500 shares of stock as the only shareholders. Ultimately, the corporation was supplying hospital emergency room services by other physicians in its employ at eight different locations, and was grossing more than $1 million annually.

In 1976, Dr. Geesbreght 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 Dr. Geesbreght's 500 shares of stock to be the value of the stock for purposes of the parties' property division. Mrs. Geesbreght 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 Dr. Geesbreght, the Fort Worth Court of Appeals held that the value of the stock was enhanced by goodwill separate and apart from the person of Dr. Geesbreght. *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 that was approved by the court and incorporated in the parties' divorce decree. Among the assets thereby awarded to the husband were two corporations. The Rathmell companies were 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 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.* The Rathmell companies specialized in providing insurance to large businesses and associations. 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 John 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 contended 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, according to the Houston appellate court, the 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.

7. The Impact of *Salinas v. Rafati*

In *Salinas*, upon dissolution of a professional partnership of radiologists, and the formation of a new partnership by two of the former

partners, the plaintiff (the third of the ex-partners) sued his former partners, alleging a breach of fiduciary duty and wrongful dissolution, and that he had not been fully paid for his share of the partnership. The issue before the jury was whether the one partner had been fully compensated for his interest in the partnership. Under the plaintiff's theory of the case, the future earning capacities of the former partners could be considered in valuing a professional partnership upon dissolution. *Id.* at 289.

In essence, then, the plaintiff argued that the value of the dissolved partnership should include the ability the partnership would have had to produce income in the future. *Id.* at 290. At trial, although the plaintiff's expert purported to remove any personal goodwill from his valuation of the partnership, he testified unequivocally that his valuation was based on what the two former partners could earn over time if they and their employees continued the practice of radiology in the same location and in the same manner as they had done in the past. *Id.*

However, the Texas Supreme Court noted that the plaintiff treated the partnership upon dissolution as if it were a salable, going concern, when by definition, the partnership ceased to exist after the period of time necessary to wind up outstanding matters. *Id.* Thus, according to the Texas Supreme Court, the value that the plaintiff attributed to the partnership was largely based on the talents and abilities of the individual physicians and their ability to generate income in the future. *Id.* Therefore, to the extent that the valuation of the dissolved partnership was based on the goodwill attributable to the personal skills and talents of the former partners, the Texas Supreme Court held that the valuation improperly took into account intangibles that were not partnership assets. *Id.* The Texas Supreme Court then stated that the plaintiff's attempt to harness the future earning capacity of the former partners highlighted the incongruity of a rule of law that would allow a partner to recover a share of a former partner's ability to generate income *under the guise of goodwill*. *Id.* at 291.

Salinas raises a number of important issues. For example, *Salinas* appears to extend the Texas Supreme Court's reasoning in *Nail* to partnerships and corporations (Justice Owen, writing for a unanimous court, commented favorable upon *Geesbreght*), two entities that had not been addressed earlier by the Texas Supreme Court. *See,* George P. Roach, *The Texas Supreme Court Revisits Professional Goodwill,* STATE BAR SECTION REPORT FAMILY LAW, Vol. 1998-1, p. 20 (Spring 1998); *see also, Salinas,* 948 S.W.2d at 291. Additionally, since a partner should not be able to recover a share of a former partner's ability to generate income under the guise of goodwill, *Salinas* stands for the proposition that the personal *professional goodwill of all the partners must be excluded* in valuing commercial goodwill. *See,* Roach at 21. Logically, then, *Salinas* appears to require that, in the valuation of the commercial goodwill of a corporation, the professional goodwill of shareholders must be excluded.

In a divorce case, "goodwill" is a tempting prize, capable of dramatically inflating the balance sheet of a professional spouse. As a result, it is not unusual to find a non-professional spouse attempting to "harness the future earning capacity" of the professional spouse under the "guise of goodwill." *Salinas* mandates that such an attempt should not be permitted to succeed.

8. Goodwill: Evidentiary and Procedural Considerations

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 personal goodwill. *See, e.g., Welder*, 985 S.W.2d at 179 (nowhere in the record did evidence exist that would permit the jury to distinguish between the value of goodwill associated with the individuals and the value of the goodwill associated with the partnership); *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).

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.

Further, the practitioner should 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.

G. Covenants Not to Compete

As discussed hereinabove, value attributable to the personal goodwill of a divorcing spouse must be excluded from the value of the business being evaluated. In *Rathmell,* 732 S.W.2d at 18, the husband requested the trial court to make findings of fact as to what portion, if any, of the value of the his companies was attributable to (a) his personal good

will, (b) the time, toil and talent he would expend following the divorce, and/or (c) his willingness not to compete with the companies. The trial court refused to make such findings and the Houston appellate court held that its refusal constituted error, since in finding the value of the Rathmell companies the trial court should have excluded value attributable to the factors listed. *Id.*

As a result, *Rathmell* is authority for the proposition that a covenant not to compete should be excluded from the valuation of a business entity, on the grounds that it represents "personal goodwill," and thus cannot be divided by the trial court. Further, one commentator has noted that *Rathmell* "spawned" former 5 TEX. PATTERN JURY CHARGES, PJC 203 (1989) (amended), which provided, in pertinent part:

> You are to determine the present value *of the ownership interest in the business* as if the party participating in it will no longer continue to do so and will be free to compete directly with it.

Sam Bashara, *Complex Business Valuation Issues: Rathmell and the Covenant Not to Compete,* FF-6, 22nd ANNUAL ADVANCED FAMILY LAW COURSE (1996).

The Texas Pattern Jury Charges have since been amended and now do not include a specific charge regarding whether the jury can consider a covenant not to compete in valuing a business or professional practice. Consequently, the Texas Pattern Jury Charges appear to have taken a neutral position *vis-a-vis* the holding of *Rathmell* regarding the effect of a covenant not to compete on the valuation of a business. In fact, in the Comment to PJC 203.2, p. 54 (2000) (entitled "Factors to Be Excluded for Valuation of Business"), the Committee on Pattern Jury Charges - Family noted that "[i]n *Rathmell,* the court *suggested* that the jury be instructed, in connection with valuing the business, to disregard the personal goodwill of the spouse; the time, toil and talent of the spouse to be expended after the divorce; and the spouse's willingness not to compete with the business." (Emphasis added). As currently drafted, TEXAS PATTERN JURY CHARGES - FAMILY 203.2 (2000) now provides:

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

There has been a great deal of controversy among some practitioners as to the validity of *Rathmell*, and some argue that the jury charge must have questioned the vitality of *Rathmell* on the issue of the covenant not to compete. It has also been reported that arguments have been made that *Collins v. Collins,* 904 S.W.2d 792, 803 (Tex.App.–Houston [1st Dist.] 1995), *writ denied*, 923 S.W.2d 569 (1996) overruled, or modified, *Rathmell,* at least by implication. *See* BASHARA at FF-7.

In *Collins,* the trial court had instructed the jury according to former 5 TEX.PATTERN JURY CHARGES, PJC 203 (1989) (amended), as follows:

> The "present value" of an asset is its market value unless it has no market value.
>
> "Market value" is the price the asset will bring when it is offered for sale by one who desires to sell, but is not obligated to sell and is bought by one who desires to buy, but is under no obligation of buying.
>
> If an asset has no market value, its present value is the value of its ownership as determined from the evidence.
>
> You are to determine the present value of the ownership interest in the business as if the party participating in it will no longer continue to do so and will be free to compete directly with it.

Collins, 904 S.W.2d at 803.

The wife argued that the court's instruction destroyed the value of the three allegedly relevant non-competition agreements executed by the husband and that the agreements were assets of the husband's corporation and should be valued accordingly. *Id.* at 802-803. On appeal, the Houston First Court of Appeals held that the agreements were assets of the corporation, having been explicitly transferred to the corporation upon its formation. *Id.* at 803. Therefore, according to the appellate court, the corporation had an enforceable non-competition agreement signed by the husband (and another principal), and the jury should not have been instructed to disregard the agreement as having no value to the corporation. *Id*.

The Authors certainly believe that *Rathmell* is still good law. *Collins* is distinguishable from *Rathmell* because in *Collins* the husband had "surrendered" his rights to compete, and therefore no longer owned the "right to compete." *See,* Bashara at FF-7. In *Rathmell,* on the other hand, the husband had signed no express covenant to compete, and thus he was able to compete with a new owner of his business; in essence, he still owned the right

to compete. *See, Id.* In this manner, *Collins* and *Rathmell* are reconcilable. *See, Id.*

Furthermore, the proposition that a covenant not to compete may represent personal goodwill finds support in other areas of the law. For example, TEX.BUS.& COM.CODE ANN. §15.50 provides:

> Notwithstanding Section 15.05 of this code, a covenant not to compete is enforceable if it is ancillary to or part of an otherwise enforceable agreement at the time the agreement is made to the extent that it contains limitations as to time, geographical area, and scope of activity to be restrained that are reasonable and do not impose a greater restraint than is necessary to protect the goodwill or other business interest of the promised.

According to the Texas Supreme Court, legitimate, protectable interests include "business goodwill, trade secrets, and other confidential or proprietary information." *DeSantis v. Wackenhut Corp*., 793 S.W.2d 670, 782 (Tex. 1990), *cert. denied*, 498 U.S. 1048 (1991).

It is interesting to note that a trial court also cannot order a non-compete provision as a part of its decree of divorce. In *Ulmer v. Ulmer*, 717 S.W.2d 665, 666-667 (Tex.App.–Texarkana 1986, no writ) the decree of divorce contained the following permanent injunction:

> IT IS ORDERED AND DECREED that since ULMER JANITORIAL SERVICE, INC. has been awarded to CARRENE T. ULMER, as her sole and separate property that RUFUS E. ULMER be and is hereby enjoined and restrained from entering into like business in competition with CARRENE T. ULMER for a period of one year, within San Antonio, Bexar County, Texas; and that he will do nothing to take away or diminish the trade, business, or goodwill between the business and its customers.

The husband in *Ulmer* argued that the injunction deprived him of his separate property, *i.e.*, the right to engage in his chosen profession. *Id.* The Texarkana Court of Appeals held that "[a]n individual's ability to practice his professional does not qualify as property subject to division by decree of the court," relying on *Nail. Id.*

Thus, to assert that a covenant not to compete is considered an "inherent" part of any sale of a business, *i.e.,*that any willing buyer would naturally agree to a covenant not to compete, is contrary to the existing Texas case law on the issue. *See,* Terry and Proctor at 23; *but cf.,* Mike Hill, *Fair Market Value After PJC(5),* FAMILY LAW FORUM, Texas Academy of Family Law Specialists (January 1989) (covenant not to compete is inherent in the concept of a willing seller).

Occasionally, the contract for a sale of a business will specifically allocate a portion of the sales proceeds to "goodwill." This raises an interesting issue.

Conceptually, the allocated goodwill, if determined by the excess earnings generated by the physician, would indeed be personal goodwill, particularly if the excess earnings were generated entirely by the personal efforts of the physician. Assume that the sale is completed, and the owner gets his money. Soon thereafter, though, he files for divorce. The wife argues that the sales proceeds are all community property.

An argument can be made that the portion of the sales proceeds separately allocated for the covenant not to compete represents compensation for the owner's personal goodwill and willingness not to expend post-sale efforts competing with the buyer. Under *Rathmell,* the sales proceeds therefore would represent non-divisible, separate personal goodwill.

Thus, a prudent professional or key-man owner, who desires to protect his or her separate property, should be very careful to draft the sales contract to allocate portions of the total sales price not only to specific tangible assets, but to intangible assets as well, such as the covenant not to compete, personal goodwill, and commercial goodwill. Upon receipt of the sales proceeds, the prudent professional would then deposit the community portion into community accounts and the portions attributable to personal goodwill and the covenant not to compete into separate property accounts.

H. DISCOUNTS AND PREMIUMS

There are two "discounts" commonly encountered in the valuation of a closely held business: (1) the lack of marketability discount, and (2) the minority interest discount.

1. Lack of Marketability Discount

The concept of marketability deals with the liquidity of an interest, *i.e.,* how quickly and how certainly the interest can be converted to cash at the owner's discretion. Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs, VALUING A SMALL BUSINESS: THE ANALYSIS AND APPRAISAL OF Closely held COMPANIES, 528 (3rd Ed. Irwin 1996). The "lack of marketability" discount measures the diminution in value attributable to the lack of a ready market for a particular interest in property. *See, e.g., Ward v. Commissioner,* 87 T.C. 78, 106-107 (1986). The rationale underlying the lack of marketability discount is simple: any interest in a closely held business, subject to infrequent trading and therefore a lack of marketability, is less attractive to the

average investor than a similar interest which is traded publicly and to which the public has ready access. *See, Central Trust Co. v. United States,* 305 F.2d 292 (Ct. Cl. 1962). Essentially, the lack of marketability discount "equalizes" an interest in a closely held business with an interest in a publically traded business.

Despite the absence of a specific regulation or ruling, the Internal Revenue Service has conceded the propriety of the lack of marketability discount in many valuation cases. *See, e.g., Estate of O'Connell v. Commissioner*, 37 T.C.M. (CCH) 822 (1978). Consequently, the fair market value of a closely held business is calculated according to established valuation criteria, then discounted for its lack of marketability.

The lack of marketability discount may be simply a flat percentage of fair market value. *See, Id.* Alternatively, the discount can be accounted for by determining how much it would cost to create the missing marketability for the closely held business being evaluated. *Wallace v. United States,* 556 F. Supp. 904 (D. Mass. 1981).

There is no general rule regarding the size of the discount for lack of marketability, but generally it has ranged from 20% to 35%. *See, e.g., Estate of O'Connell v. Commissioner* (30%); *Wallace v. United States* (35%).

The Authors have located no Texas appellate case that specifically addresses the lack of marketability discount. In *InterFirst Bank Dallas, N.A.*, 739 S.W.2d at 892, the Texarkana Court of Appeals mentioned the fact that one of the defendant's experts applied a 25% discount for lack of marketability in valuing the shares of a closely held corporation, but made no comment upon the propriety of such a discount. It should be noted that the expert valued the stock at between $500 and $600 per share, *Id.* at 892-893, while the jury ultimately valued the stock at $1,548.79 per share. *Id.* at 890.

2. Minority Discount

By definition, a minority interest represents control of less than 50% of the shares of a corporation; in a partnership, it means less than 50% of the partnership interest. Courts have long recognized that the shares of stock of a corporation that represent a minority interest are usually worth less than a proportionate share of the value of the assets of the corporation. *See, e.g., Estate of Newhouse v. Commissioner*, 94 T.C. 103, 249 (1990); *Ward,* 87 T.C. at 106. The minority discount reflects a minority interest's lack of control over corporate policy and inability to direct the payment of dividends or compel the liquidation of the corporate assets. *Harwood v. Commissioner,* 82 T.C. 239, 267 (1984), *aff'd without published opinion,* 786 F.2d 1174 (9th Cir. 1986). Because the critical factor is lack of control, and lack of control may equally exist for a minority partner as for a minority shareholder, the minority discount applies in the valuation of partnership interests as well as interests in closely held corporations. *See, Moore v. Commissioner,* T.C. Memo 1991-546, 1991 WL 220426 at p. 7 (U.S. Tax Court 1991).

There is no general rule concerning the size of the allowable minority discount. The courts have consistently allowed a 20% to 35% discount for minority ownership. *Ward*, 87 T.C. 78 (33 1/3%); *Northern Trust Co. v. Commissioner*, 87 T.C. 349 (1986) (25%); *Henry J. Knott v. Commissioner,* 55 T.C.M. 424 (CCH 1988) (30% discount appropriate to reflect the illiquidity and lack of control inherent in the 50% limited partnership interest); *Moore,* 62 T.C. M. 1128 (court allowed a 35% discount from the underlying net asset value for a minority general partnership interest with certain restrictions on selling, withdrawing or assigning the partnership interest).

Although there is some overlap between the discount for a minority interest and the discount for lack of marketability, the discounts are conceptually distinct. *Estate of Newhouse,* 94 T.C. at 249; *Harwood,* 82 T.C. at 267. Nonetheless, courts have varied in their actual applications of the discounts to particular fact situations. Some courts combine the two "conceptually distinct" discounts into a single discount. For example, in *Estate of Newhouse,* 94 T.C. at 252*,* the Tax Court held that an estate acted properly in discounting a 44% interest in a closely held corporation 35% to reflect both lack of marketability and minority ownership.

However, it has been argued that such discounts are usually taken *consecutively*. *See,* Shannon Pratt, *Shannon Pratt's Business Valuation Update,* Vol. 3, No. 1, p. 2 (January 1997) (interview with Stacy Eastland) [hereinafter referred to as "Pratt's Update"]. Consecutive application of the discounts occurs as follows:

Net Asset Value:	$100
Minority Interest Discount - 30%:	-30
Publically Tradable Minority Value:	70
Marketability Discount - 40%:	-28
Net Minority Nonmarketable Value:	$42

See, Id.

A third approach taken by the courts is to add the discounts together. In *Barudin v. Commissioner,* No. 7156-94 (U.S. Tax Ct., August 26, 1996), the court added a 19% minority discount and a 26% marketability discount for a total discount of 45%. *See, Pratt* at 2 (Eastland interview); *see also, Whittemore v. Fitzpatrick*, 127 F.Supp. 710, 721-722 (D.Conn 1954) (combined a 50% lack of marketability discount with a 32%minority discount); *Lefrak v. Commissioner,* 66 T.C.M. 1297 (CCH 1993) (20% minority discount added to 10% lack of marketability discount).

Texas courts have rarely addressed the issue of the minority interest discount. In *Gannon v. Baker,* 830 S.W.2d 706, 708-709, (Tex.App.–Houston [1st Dist.] 1992, writ denied), the Houston First Court of Appeals recited that the value of a minority shareholder's stock had been discounted by 35%, due to the stock's minority position and lack of marketability, but did not otherwise comment or rule upon the propriety of the discount, either in theory or as applied. Similarly, in *InterFirst Bank Dallas, N.A.*, 739 S.W.2d at 894, the Texarkana Court of Appeals noted, without further explanation, that one of the plaintiffs' experts took the position that a minority interest should not be treated as a minority interest because it was the swing block and without it no one would have a majority interest and so the experts did not discount the stock as a minority block.

As with the lack of marketability discount, the Authors have located no Texas case that specifically addresses the minority discount as a part of the valuation of a business.

3. Family Limited Partnerships: The Current "Cutting Edge" for Discounts

Although outside the subject matter of the current paper, the estate planning tool of the family limited partnership has focused a great deal of attention on the issue of the applicability of various discounts in the valuation process. Consequently, the Texas divorce practitioner should probably pay some attention to the developing principles and law regarding the various discounts, as have been recently generated by estate planners in connection with family limited partnerships, particularly if the practitioner desires to minimize the value of his or her client's interest in a partnership or other closely held entity.

"Combining assets into a partnership investment is not a new idea, but has received increased emphasis over the past eight years or so as an entity for family investment management and estate planning." Curtis R. Kimball, "*Valuing Family Limited Partnership Interests for Estate Planning Purposes,"* 1, 20th ANNUAL WORKSHOP FOR HANDLING CLOSELY HELD BUSINESS INTERESTS IN ESTATES AND TRUSTS (October 1995). In the typical family limited partnership, family assets are transferred to the partnership. Then, (normally) the parents gift fractional interests in the partnership to other family members of different generations.

One of the advantages of the family limited partnership is that the fractional interests are minority interests for appraisal purposes, and therefore a timely series of gifts or sales of such interests under a fair market standard for estate planning purposes can reduce the overall value that is taxed in a generational shift of ownership within the family. *Id.* Equally, such fractional interests are readily discounted because of lack of marketability (limited partnership interests generally have no control over partnership affairs, and the economic benefits, if any, flowing to the limited partners are usually dependent upon the discretion of the general partner or partners). Studies of partnership interests indicate that the minority and lack of marketability discounts in the context of family limited partnerships result in effective discounts to net asset value of as small as 10%, but as large as 85%. *Id.*

Generally, a partner's interest in a limited partnership is worth much less than the partner's share of the partnership's "liquidation value" if that partner does not have the unilateral right to liquidate his or her interest. Pratt's Update at. 2 (Eastland interview). Tax case law indicates that both minority and lack of marketability discounts are applicable and that valuation methodologies will support substantial discounts compared to the liquidation value of the underlying assets, as much as 40% to 85%. *Id.*

4. Control Premiums

If the value of owning a minority interest must be discounted due to a lack of control, it makes sense that the value of owning a controlling interest also may be adjusted due to the presence of control. In fact, ownership of a controlling interest, *i.e.*, more than 50 percent of the voting stock, may be worth a "premium." As stated in Rev.Rul. 59-60 §4.02(g), 1959-1 C.B. 237:

> [t]he size of the block of stock itself is a relevant factor to be considered....[a]lthough it is true that a minority interest in an unlisted corporation's stock is more difficult to sell than a similar block of listed stock, it is equally true that control of a corporation, either actual or in effect, representing as it does an added element of value, may justify a higher value for a specific block of stock.

In *Estate of Salsbury v. Commissioner*, 34, T.C.M. 1441, 1451 (1975), the Tax Court stated:

> [t]he payment of a premium for control is based on the principle that the per share value of a minority interest is less than the per share value of a controlling interest.....[a] premium for control is generally expressed as the percentage by which the amount paid for a controlling block of stock exceeds the amount which would have otherwise been paid for the stock if sold as minority interests and is not based on a percentage of value of stock held by all or a particular class of minority stockholders.

The concept of the control premium was further clarified in *Estate of Chenoweth v.*

Commissioner, 88 T.C. 1577, 1581 (1987), when the Tax Court stated:

> [w]e would tend to agree that the sum of the parts cannot equal more than the whole, that is, the majority block together with the control premium, when added to the minority block of the company's stock with an appropriate discount for minority interest, should not equal more than the total 100 percent interest....

The Texarkana Court of Appeals tangentially addressed the issue of "control" in *Beavers,* 675 S.W.2d at 299, when it stated that in assigning values of closely held corporations in contested divorce actions, considerations given by the trial judge to company assets and to the realities of corporate control, such as a stock transfer restriction (which rendered the stock valueless), are appropriate. *Beavers,* 675 S.W.2d at 299.

I. Transfer Restrictions

Generally, the transfer of securities may be restricted. *See,* TEX.BUS. & COM.CODE art. 2.22B. In Texas, a restriction on the transfer or registration of securities of a corporation is valid if it reasonably:

> (1) obligates the holders of the restricted securities to offer to the corporation or to any other holders of securities of the corporation or to any other person or to any combination of the foregoing, a prior opportunity, to be exercised within a reasonable time, to acquire the restricted securities; or
>
> (2) obligates the corporation to the extent permitted by [the Business Corporation Act] or any holder of securities of the corporation or any other person, or any combination of the foregoing, to purchase the securities which are the subject of an agreement respecting the purchase and sale of the restricted securities; or
>
> (3) requires the corporation or the holders of any class of securities of the corporation to consent to any proposed transfer of the restricted securities or to approve the proposed transferee of the restricted securities for the purpose of preventing violations of federal or state laws; or
>
> (4) prohibits the transfer of the restricted securities to designated persons or classes of persons, and such designation is not manifestly unreasonable; or
>
> (5) maintains the status of the corporation as an electing small business corporation under Subchapter S of the United States Internal Revenue Code, maintains any other tax advantage to the corporation, or maintains the status of the corporation as a close corporation under Part Twelve of [the Business Corporation Act].

TEX.BUS. & COM.CODE art. 2.22D (footnote deleted).

According to the Internal Revenue Service, transfer restrictions may affect the value of a security:

> Where the option, or buy and sell agreement, is the result of voluntary action by the stockholders and is binding during the life as well as at the death of the stockholders, such agreement may or may not, depending on the circumstances of each case, fix the value for estate tax purposes. However such agreement is a factor to be considered, with other relevant factors, in determining fair market value.

Rev.Rul. 59-60, §8, 1959-1 CB 237.

Since the effect of transfer restrictions on value is fact-dependent, the results of the tax cases vary rather dramatically. Some courts hold that a restriction fixes the value of a security at a discount; on the other hand, at least one has held that a restriction actually increased the value of corporate securities. *See, generally,* Schwartz at EE-6; *see also, Estate of Hall v. Commissioner,* 92 T.C. 312 (1989) (as long as restrictions had a valid business purpose, the restrictions controlled the value of the stock for estate tax purposes); *cf., Luce v. U.S.,* 4 Cl. Ct. 212 (1983) (when the majority family stockholder testified that he would have a paid a premium to keep ownership of the securities in the family, the court held that a viable market existed for the security, and the restrictions enhanced the value thereof).

IV. VALUATION PRACTICE

A. Normalizing Income

In valuing a closely held business or professional practice, issues arise due to the owner's control. "Normalizing" the business' earnings represents one such inevitable issue. Close scrutiny must be given to the company's expenses, in order to unravel the sometimes muddled distinction between corporate and personal spending, *i.e.,* the

issue of "excessive compensation." *See,* Terry and Proctor at B-1.

Excessive compensation represents an owner's taking profits out of a closely held business or professional practice. Such compensation is the amount of compensation above that which would be ordinarily paid to a manager of the business or an associate in the professional practice. Excessive compensation often includes various perks that the company may be paying on the owner's behalf, such as auto expenses, club dues, personal use of corporate credit cards, telephone service, maid service (expenses related to the owner's residence), non-working employees (family members and significant others), bartered (noncash) items, and so forth. Some companies even have direct payment accounts with liquor stores, grocery stores, florists, and other merchants that may have been used for "personal" expenditures.

In the case of a business that is not closely held, the excess profits paid out as "excessive compensation" normally would be paid to outside shareholders as dividends. Thus, such excess profits, or "excessive compensation," is an element of the business or professional practice that results in the business having a greater value than the value of its tangible assets less the amount of its debt.

Through interviews with key people, review of financial documents and tax returns, and other forensic techniques, the expert can piece together a more realistic picture of the business' true income.

There are some valuation "experts" who believe that normalizing income is simply a matter of adjusting a company's financial statements to GAAP (generally accepted accounting principals) standards. Strictly speaking, such a view is not accurate. Normalizing income also has to do with adjustments relating to a potential purchaser, although such adjustments, under GAAP standards, may not necessarily be required. For example, a company's treatment of country club expenses may be done according to GAAP standards, yet, for the purposes of a potential sale, such treatment may need to be normalized, since the payment of country club expenses may well represent "excessive compensation," and thereby affect the value of the business.

B. Discovery and Valuation Experts

A trial to establish the value of a community business is likely to be a trial by expert. Since "creative" accounting and appraisal techniques appear to be the accepted professional norm, it is not uncommon to see expert appraisals differ by millions of dollars over the less liquid property interests such as closely held businesses. The growing tendency to produce "hired guns" in family law litigation has created an industry of appraisal experts whose quality and integrity is frighteningly uneven. Thus, it is important that family law attorneys have a system for discovering the raw data needed for business valuations, and that they be able to discuss that data intelligently once it surfaces in the valuator's written report or testimony.

For example, it is essential to understand the valuation techniques being used in the case. There are more than 25 commonly accepted valuation techniques *and they should not be mixed*. It is proper to apply two or more valuation techniques in the valuation of a single enterprise and then to compare or weigh the results. But the techniques themselves should not be mixed. The price earnings ratio technique should not be combined with a goodwill capitalization technique. The results will be grossly inaccurate. *It is therefore not surprising that many valuation experts combine techniques* in order to weigh the result in favor of their client. The impenetrable veneer of accounting and valuation jargon enables them to camouflage the distorted result. *See,* Terry and Proctor at B-35.

1. Written Report

Pursuant to TEX.R.CIV.P. 195.5, the opposing expert may be required to produce a timely written report. At the very least, then, the attorney will have something to attempt to understand, to discuss, and to attack.

2. Depose the Expert

The expert should be deposed concerning (at the minimum) the following topics:

1. College degrees, post graduate degrees, actual fields of study, history of seminars, attending or post college training programs;

2. Textbooks read or other industry literature which has created this witness's expertise assisted the witness in this particular area. Get the titles, authors, dates published and dates read. Find out the "who" and "what" they recognize as authoritative. It makes impeaching possible.

3. Determine (1) the nature of any preliminary study

in connection with this particular valuation; (2) each person the expert has interviewed (obtain and review the expert's notes from each interview).

4. Find out every assumption the witness has utilized or relied upon. Test each assumption to determine if the assumption is reasonable or speculative.

5. Get the history and details of the witness' publishings, teachings, or lecturing in the area of expertise and review them. If the attorney cannot personally review them, then they should have his or her own expert do it.

6. Determine how long the expert has made appraisals, what kinds of appraisals he or she has made, how many and when, and the employment history (all jobs including professional engagements) of the expert.

7. Inquire into memberships and affiliations with professional associations and the requirements for membership or affiliation.

8. Determine (1) the relationship of the expert with opposing counsel or with the opposing party; (2) when the expert was initially engaged and by whom; (3) the expert's fee arrangement.

9. Find out about the expert's history of testimony in other divorce cases, the names of the cases, the names of the judges in the court, the dates of testimony, the names of opposing experts and the amount and nature of differing appraisals, the final results, how much was the fee, and how was it determined.

10. Find out what the expert knows about the particular industry or type of case involved.

11. If the expert has determined that commercial goodwill exists, have the expert explain in detail exactly how reasonable compensation was calculated, *i.e.,* how were the excess earnings separate and distinct from the earnings generated by the physician or principal determined.

12. Examine closely the reasonableness of the ascertained value.

C. Documentary Evidence at Trial

The specific use to be made of a document will depend upon the attorney's overall trial strategy. Irrespective of valuation strategy, one should be most cautious in the utilization of documentary evidence and always consider whether or not the other side can turn such evidence to their own advantage. A classic example of this might be the introduction into evidence of a keyman life insurance policy, the proceeds of which are intended to be used for redemption of the stock of a deceased key man. The attorney representing the keyman in a divorce case might utilize the face amount of the policy to prove that the corporation would be worth a great deal less without the services of the employee. However, the spouse's attorney, for example, could argue that the value of the stock has been set by the amount of insurance provided for the redemption of the stock and such value could conceivably be considerably in excess of what the keyman spouse's attorney is contending. This is a particularly dangerous area for the keyman spouse's attorney since the value of the stock contemplates that the owner would no longer be a participant in

the corporation. This falls foursquare within the methodology to be utilized in this particular type litigation in arriving at the present value. *See, Rathmell,* 732 S.W.2d at 18.

The use of the documents, to a great extent will be dictated by whether or not the litigator is representing the business owner spouse, whose business is being valued – in which case a lower valuation is more favorable – or the other spouse who would prefer of course that the business be valued at a higher amount. Equally important to the litigator's decision to use documentary evidence is whether or not such documents are being utilized in the case in chief, *i.e.*, as evidence of value, or if they are being utilized as a source of cross-examination in an attempt to discredit the valuation evidence of the opposing party. Thus, the following comments should be considered as applicable to the appropriate context, *i.e.*, case in chief or cross-examination.

1. Original Purchase Documents

If there was a recent purchase of the asset involved, the purchase documents would be of considerable benefit.

On cross-examination, question whether or not the values set forth in the original purchase documents include anything other than actual purchase price. Examples of this could be such things as broker's commissions, or the satisfaction of other obligations between the buyer and the seller such as pre-existing debt that was not actually related to this particular transaction. A portion of the sales price may have been allocated specifically to goodwill or to a covenant not to compete. A full understanding of the relationship between the parties could possibly lead to additional matters to be covered on cross.

2. Minutes of the Board of Directors Meetings

Details such as stock purchases or exchanges of property for stock may be found in the minutes. It is self evident that any written record dealing with value could be evidence to be considered relative to value.

On cross-examination, there can be diverse reasons for assigning values to stock in corporate minutes, most of which have to do with tax planning. For instance, an attempt to make transactions totally tax free, or to provide an opportunity for a stepped up basis, both of which affect the tax consequences at the time of the transfer, can greatly influence values assigned to stock or assets exchanged for stock as reflected in the corporate records. The comments made here would be equally true for records of shareholders meetings and organizational meetings.

3. Corporate Balance Sheets, Profit and Loss Statements and Sales Forecasts

These records can likewise be beneficial as proof of value. Balance sheets, for instance, show such matters as long and short term debt, and quite often, will be part of an annual or periodic how-goes-it type approach to a business often accompanied by notes to the balance sheet reflecting either positive or negative comments which can be cross referenced with subsequent profit and loss statements as well as sales forecasts. Depending on valuation strategy, the argument can be made that the forecast are either reliable or unreliable, depending upon how they match.

On cross-examination, inquires should be made as to the purpose for creation of the balance sheet. Likewise, inquiry should be made into any adjustments, etc., which should be reflected in notes to the balance sheet. As to profit and loss statements, one should inquire into compensation to owners or upper level management personnel. These can drastically affect the profit picture. Likewise, hidden expenses for travel and entertainment, and other executive perks, will affect profits. This may also be a good place to look, whether on cross or direct, for items that can be utilized for proof of value of the stock to the individual owning it, should the attorney be taking the "no market value" approach.

4. Representation of Values to Third Parties

This is a particularly valuable asset to both sides in proving value. Into this category would fall loan documents, financing statements, probate records, (such as inventory and appraisements), gift and estate tax returns, and inventories filed in divorce cases or other third party litigation. These type documents would be particularly helpful if they are chronologically sequential, showing a consistent representation over a period of time in varying circumstances, which would show consistency of value or methodology for arriving at value.

On cross-examination, determination of the circumstances surrounding, and the purpose for, such representation of values to third parties is of paramount importance. The relationship of the third parties to the person making the representation is equally important. Such evidence can be attacked from the standpoint of the length of time since the representation, *i.e.*, is it stale information. Attempts should likewise be made to determine if, since the representations were made to third parties, there have been occasions when inquiry was made into the value and there was a failure to response to the inquiry with a statement of value.

5. Tax Returns, Buy-Sell Agreements, Partnership Agreements, and Stock Transfer Ledgers

Some of the things that might come to light that would bear on value in these type documents could be payments made for items such as non-compete agreements, which would show up on amortization schedules of corporations, previous

sales of stock, or explanations of purported tax free exchanges on an individual return, which might involve the stock in question or the tax treatment of various licenses, etc., on corporate or partnership tax returns. Buy-Sell Agreements have been addressed previously, but, again, they could be utilized as a starting point for proof of value, or for that matter, be utilized as proof of an impediment to value since stock value could be reduced by restrictions placed upon it due to the buy-sell agreement or a right of first refusal. Stock transfer ledgers often will show, and should show, the consideration given for the transfer of shares of stock. Partnership agreements likewise will often set forth formulas for the purchase of a partner's interest in the event of a partner leaving the partnership under various circumstances such as death, buy-out, divorce, leaving without an intent to compete, etc.

On cross-examination, corporate tax returns are particularly valuable if an income approach to valuation is being utilized. Ordinarily, some multiple of earnings will be utilized by the valuator in order to compute present value. Corporate tax returns will show such things as compensation of owners, travel and entertainment expenses, large expenditures that might be a one time expense item, sale of assets, insurance, etc. All of these are merely leads to follow in the cross-examination depending upon whether the return supports or is adverse to the attorney's trial strategy. Typically, valuators will use a multiple of EBIT, (earnings before interest and taxes). Therefore, if executive compensation is excessive, or large write offs have occurred that are not of a recurring nature, or travel and/or entertainment expenses are excessive, these are items that should be added back to the EBIT prior to applying the multiple.

Some of these items may seem minimal. However, if a multiple of four or five is being utilized, even small add backs tend to become significant. As to partnership tax returns, the same reasoning would hold. Bear in mind that partnership returns are merely information returns and that any undistributed income passes through and is picked up on the individual return of the parties. Again, unusual expense items that can be added back to increase the profit picture, or further expenses that could be deducted to decrease the profit picture, can have substantial impact when utilizing a multiple of earnings approach.

Buy-sell agreements are automatically suspect and should be subject to extensive inquiry on cross examination since they are usually negotiated with one eye on the tax collector and the other on out-of-pocket expenditures, particularly as to pay out provisions. Customarily, there are extended periods of payout which substantially reduce the value of the consideration paid. The matter of a buy-sell agreement in a partnership can be of critical importance, and, prior to conducting cross-examination on such matters, the cross-examiner should be intimately familiar with *Nail*, *Rathmell*, *Finn*, and *Geesbreght*.

Stock transfer ledgers customarily reflect how the managers of the corporation want transactions to appear, rather than of what they actually were. The cross-examiner should be particular interested in canceled stock certificates that have been re-issued. What often happens is that the stock certificates are initially issued in one form or the other in certain denominations and later the principals decide there was a more advantageous way to have done the transaction. The stock certificate are often canceled and re-issued in different forms and denominations. This can be of particular importance if the distribution of stock is critical to the value in cases in which a discount factor is being applied for minority interest.

6. Prior Litigation

These records can be a very good source of proof of value. For instance, if there has been prior litigation between partners or other third parties involving the value of particular assets such as accounts receivable, contracts, licenses, etc., these could all have direct bearing on the value of the asset involved in the current litigation.

On cross-examination, a complete understanding of the underlying facts of the previous litigation is absolutely essential to an effective examination of a witness utilizing prior litigation documents as proof of value. This is essential to understanding the motivation for the representations involved, and to determine if the present position being taken concerning value is consistent with that taken in the prior litigation. It is particularly important to remember to get ***all*** the exhibits introduced in the prior litigation. Even though the prior exhibits may not have worked in that litigation, they could prove of substantial benefit in the present litigation with different players and different circumstances.

7. Loan Applications and Financial Statements

These records will invariably reflect a very high or inflated value. Seldom does one preparing a financial statements or loan application try to make the value of assets listed appear less than what they actually are. One possible exception to this, however, might be a financial statement prepared for the Internal Revenue Service in an attempt to work a payout for delinquent taxes. It is reasonable to assume in such instances one would not desire to appear overly wealthy, while attempting to get a long term payout.

Cross-examination regarding these documents can consist of matters such as the reason for filing the financial statement, who prepared it, what was the basis for the values assigned, the date of the application or financial statement, and the general business conditions and outlook for the business at the time the financial statements were prepared.

8. Personal Property Tax Rendition Records

These records are often overlooked and are not available in all instances. Usually their availability is restricted to the larger metropolitan areas.

On cross-examination, the cross-examiner will generally attempt to impeach these records since most likely they will have been utilized by the low-side litigator in the case in chief. They are subject to the usual cross-examination strategy that persons rendering property for tax purposes are ordinarily going to attempt to minimize the tax bite by making a low rendition.

9. Business Interruption Insurance Policies and Underwriters Reports

These records can provide invaluable information to the litigator operating on a limited budget. This is particularly true for the litigator whose client has an interest in receiving a higher valuation. Invariably, underwriters and others selling this type of insurance will show tremendous income losses should the entity's business be interrupted. Otherwise, there would be no need to buy their insurance.

On cross-examination, point out that insurance salesmen typically sell more insurance that is actually needed, that insureds are urged to buy too much rather than too little insurance – particularly in light of the fact that the premiums are fairly low since they ordinarily have a kick-out period of 15, 20, 30 or 60 days before payments commence – that the premiums are deductible, and that the insurance is designed to protect against catastrophe, *i.e.*, some highly unlikely event, rather than day-to-day occurrences. Insurance of this type is typically sold based on gross income, rather than profit, since it is typically designed to cover fixed and ongoing expenses, rather than net profits.

10. Market Studies

These records can be of particular value to the litigator depending upon whether or not the outlook is overall good or bad. The content of the report itself would indicate its usefulness in a particular situation.

On cross-examination, the first thing to establish is the reason for the study, *i.e.*, is it to attract business, sell some service to the industry, etc. It should be established that many market studies conducted by trade associations or individuals can be designed and are often carried out for the sole purpose of helping to obtain financing or for promotional purposes. One final point to be considered on cross-examination is to make sure the study is applicable to the enterprise in question, *i.e.*, whether it is regional or national, short term or long term, etc. Coupled with the reasons for the study, the character of the study should enable an astute litigator to design an effective cross-examination.

11. Real Estate or Equipment Leases

These records can be of use to the litigator when and if they are keyed to revenues of the enterprise utilizing the real estate or equipment. Additionally, if there is a long term lease accompanied by a right of renewal or extension it will probably be at a higher rate. The argument can therefore be made that the unexpired term of the lease has value since it is below what the market is expected to be at the time of its expiration, if, in fact, there is a substantial period of time remaining the on term.

On cross-examination, one should bear in mind that, if the lease is keyed to revenues, particular attention should be given to whether or not it is net or gross revenues and to the definitions or methodology to be utilized in determining the net or gross. One can cast great doubt on lease documents if the applicable definitions are not very specific and tight in determining the lease payments.

12. Real Estate Tax Records

Historically, real estate renditions have been considerably below present market value. However, much more emphasis is now being given to tax roll renditions since state law now requires that all real estate be rendered at 100% of market.

On cross-examination, one must be aware that when real estate values are in a decreasing phase, it is more likely that the tax rolls will have the real estate in question over valued. The cross-examiner should establish this, or in the alternative, if he is on the opposite side, establish that, if it is over-valued, that the owner has known about the over-valuation for some time, and if he truly believed that it was over-valued, he would have taken steps to correct it. As a precautionary note, there are only certain times after a tax roll rendition during which an appeal of the rendition may be taken. It would be well for the cross-examiner to know these appeal windows prior to undertaking cross-examination.

13. Trade Association Brochures and Literature

These records are of particular benefit to the litigator on a short budget. If such literature supports the client's position, the argument is that people knowledgeable in the business, who are independent of the client, authored the records.

On cross-examination, the cross-examiner should establish that business associations are self serving, that for the greater part they only report things that will be favorable to their point of view, and that they will attempt to minimize any adverse information regarding the industry. Cross-examination should be made of the witness of any as to prognostications of future prospects, and particularly, concerning any long term projections. Detailed cross examination should be conducted as to the source and reliability of the date upon which such forecast is based.

14. Franchise Agreements

These may be good sources of value since quite often formulas are utilized for valuation purposes. Franchise agreements also often provide for two different scenarios of valuation, for instance, as an ongoing business or in liquidation.

On cross-examination, establish that even though these formulas are set forth, they are not always followed. The mere fact that there is a formula computing value is no guarantee that it will create a market. Point out in cross-examination that most franchisors require prior approval of any assignment of the franchise. Many of the franchise agreements have a right of first refusal prior to the sale of the franchise. Most will have been written several years before and therefore may not be applicable in the present economy in which gross revenues have not kept pace with the expense of doing business. A right of first refusal and a necessity for prior approval of an assignment can and does frequently affect the marketability of the franchise and ultimately its value.

15. Offers to Buy/Sell

Unaccepted offers to buy or sell are inadmissable. *Hanks v. Gulf, Colorado & Santa Fe Railway Co*., 320 S.W.2d 333, 336 (Tex. 1959); *Southwestern Bell Telephone v. Wilson* 768 S.W.2d 755, 762 (Corpus Christi 1988, writ denied). However, it does not hurt to try to get such evidence before the trier of fact, and if the other side is not on their toes, with a proper objection, such evidence can be admitted.

On cross-examination, offers are meaningless since they did not result in an ultimate sale. Therefore, they are not evidence of value. The circumstances regarding the offer to buy or sell may not have been at arms' length, or possibly they were an attempt by one owner to get out of an unpleasant business situation. This hardly qualifies as a willing buyer and a willing seller under no compulsion to buy or sell. Lastly, question whether the circumstances are now different than they were at the time the offer to buy or sell was made.

16. Record Replacement Insurance

This is an often overlooked valuation tool. As is often the case, in a corporate valuation situation, the largest value is going to be intangible value, whether it is called good will, on going business, blue sky, or something else. The value of the records replacement insurance is to prove either a high or low value for the records themselves, which are a tangible asset. This may either help or hurt the valuation situation depending on the client's position. Sorting out the hard assets and identifying the blue sky portion of the valuation is one of the favorite techniques of most valuation litigators. Thus, the litigator should be aware of these insurance policies and be prepared to utilize them either as a sword or a shield as the facts may dictate in the particular case. The same could hold true for casualty insurance policies on such things as equipment or improvements to real estate.

On cross-examination, establish that insurance is customarily for replacement value and is therefore different than a willing buyer and a willing seller situation. If it is being used against the client to prove a high value, then the litigator should bring out the fact that, just because it is insured for the amount in question, it does not necessarily mean that such amount is the market value. It also could be argued that the very reason for the insurance is that such records are not for sale on the open market and therefore are irreplaceable.

D. But You Don't Always Need A Hired Gun

In *Laprade v. Laprade*, 784 S.W.2d 490, 492 (Tex.App.–Fort Worth 1990, writ denied), the wife was asked her opinion concerning the current value of the community business. She answered, "I think it's in excess of $200,000." *Id*. On appeal, the husband contended that the trial court erred in permitting the wife, as part owner, to give her lay opinion concerning the value of the business, and that any finding by the court concerning the value of the business in reliance upon the wife's lay opinion was contrary to the admissible evidence in trial. *Id*.

The Fort Worth Court of Appeals, however, held the admission of the wife's testimony concerning the market value of the company was not an abuse of discretion by the trial court since the evidence showed there was a basis for the wife's knowledge of the value of the property. *Id*. Specifically, according to the Fort Worth appellate court, the evidence showed that the wife had knowledge of the business accounts receivable, ran the business for five years, and knew what was paid for each of their trucks, as well as the value of other smaller, similar businesses for sale. *Id*. Further, stated the Fort Worth Court of Appeals, if a witness has personal knowledge of facts from which an opinion is derived, a rational connection exists between the opinion and the facts; if the lay opinion is helpful, then it is within the court's discretion to allow the lay person to express an opinion on the value. *Id*. Thus, under TEX.R.CIV.EVID 701, the wife's testimony was admissible to establish the value of the business. *Id*.

Laprade remains the law in Texas on the admissibility of lay opinion testimony from an owner concerning the value of a business or other asset. *See, e.g., Ramex Const. Co. v. Tamcon Services Inc*., 29 S.W.3d 135, 138 (Tex.App.–Houston [14th Dist.] 2000, no pet. history) (it was error to exclude the testimony of the principal shareholder of a closely held corporation concerning the value of the corporation, when the shareholder held an accounting degree, had worked for the company for many years, was familiar with the accounts receivable and the company's books, and was the person who oversaw liquidation of the company's assets when it shut down); *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).

V. SPECIAL PROBLEMS IN VALUING AND DIVIDING THE COMMUNITY BUSINESS

A. Transfer Restrictions: Binding on Spouse?

Closely held corporations or partnerships will typically have bylaws or partnership agreements that restrict transferability of shares or interests. Many contain buy-out provisions. In the context of a divorce, an issue of immediate significance is whether such provisions will be applicable to the non-employee spouse. Interestingly, there is a paucity of case law in Texas on the issue, particularly with respect to effect of transfer restrictions, and/or buy-out provisions, on the non-employee spouse.

1. Family Law Context

In *Earthman's, Inc. v. Earthman*, 526 S.W.2d 192, 196 (Tex.Civ.App.–Houston [1st Dist.] 1975, no writ), 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. Not surprisingly, the wife sued. *Id*.

On appeal, the Houston First Court of Appeals noted that a provision which restricts a stockholder's right to sell or transfer his stock, particularly one which affords a prior right of purchase to the corporation or to another stockholder, is not looked upon with favor in the law and is strictly construed. *Id*. at 202; *see also, Docudata Records Management Servs., Inc. v. Wieser*, 966 S.W.2d 192, 198 (Tex.App.–Houston [1st Dist.] 1998, pet. denied) (sound corporate jurisprudence requires courts to narrowly construe rights of first refusal and other provisions that effectively restrict the free transfer of stock; to view otherwise would compromise the law's unfavorable estimation of such restrictive provisions). The Houston appellate court further noted that it had generally been held that such a restriction is inapplicable to a transfer occurring as a result of an involuntary sale, or by operation of law, unless by specific provision in the restriction it is made applicable. *Id*.

The First Court of Appeals next cited the Louisiana case of *Messersmith v. Messersmith*,, 86 So.2d 169 (La. 1956), in which it was contended that certain community owned stock should not be divided in kind, as decreed by the divorce court, and that the husband should be permitted to retain the stock and to pay his wife one-half its book value in accordance with a restrictive clause in the corporate charter requiring a stockholder, who wished to sell his stock, to first offer it to the other stockholders or officers of the corporation. *See,* 526 S.W.2d at 202. In *Messersmith*, the Louisiana Supreme Court determined that the restrictive provision of the charter could not prevent the recognition of the wife's share of ownership in the corporation, held that she was entitled to have delivered to her in kind the interest awarded to her under the divorce decree, and stated:

> The restriction in the charter cannot affect the status of the stock purchased during the existence of the community or the rights the wife may assert thereunder. Such a restriction cannot negative the wife's present interest as a co-owner, and as a co-owner in community she is clearly entitled to be recognized as such and obtain the exclusive management and control of her vested interest.

526 S.W.2d at 202, *quoting,* 86 So.2d at 173.

Accordingly, the Houston First Court of Appeals in *Earthman's Inc*. held that the restrictive provision should not be construed so as to preclude the wife's right to have her shares of ownership reflected on the books of the corporation and to have the stock certificates evidencing her ownership issued to her. 526 S.W.2d at 202; *see also, Consolidated Bearing and Supply Co., Inc. v. First Nat. Bank at Lubbock*, 720 S.W.2d 647, 650-651 (Tex.App.–Amarillo 1986, no writ) (*citing Earthman's* with approval).

2. Commercial Context

Article 2.22 of the Texas Business Corporation Act generally provides that stock transfer restrictions are enforceable against the holder of the restricted security or any successor or transferee of the holder, if such restrictions are reasonable and are conspicuously noted on the stock certificate.

In *Dixie Pipe Sales, Inc*, 834 S.W.2d at 492, upon the death of a shareholder, the corporation refused to transfer the stock to the beneficiaries under the will and opted instead to pay them the book value of the stock pursuant to a right of first refusal contained in the corporation's bylaws. The parties agreed that, under article 2.22 of the Texas Business Corporation Act, the restriction was valid, and thus the question was whether the corporation was entitled to the right of first refusal when the transfer was made by the will. *Id*. at 493.

The Houston appellate court stated that restrictions on the power of a corporate shareholder to transfer his or her shares of stock may validly be imposed in the charter or the bylaws of a corporation, provided such restraints are reasonable and not contrary to public policy. *Id.* According to the Fourteenth Court of Appeals, the reasonableness of such a restriction is ordinarily to be determined by applying the test of whether the provision is sufficiently necessary to the particular corporate enterprise to justify overruling the usual policy of the law in opposition to restraints on the alienability of personal property. *Id*.

The Houston appellate court also noted that article 2.22 specifically provided that a transfer restriction could be enforced against any successor or transferee of the holder. *Id.* Thus, the transfer restriction applied to a beneficiary under the will. *Id*. at 494.

In discussing whether the restriction was reasonable, the Houston Fourteenth Court of Appeals stated:

> The provision in [the corporation's] bylaws is not unreasonable, but is calculated instead to advance legitimate objectives of both the corporation and its individual stockholders, that is, to keep the stock in the family. Such a restriction is inherently more "reasonable" when applied to the stock of a corporation having only a few shareholders who are active in the business and members of the same family, than when imposed on the stock of a corporation that has many shareholders who are not only unrelated to one another, but who, ordinarily, do not participate actively in the day-to-day management of the corporation.

Id.

Certainly, under *Dixie Pipe Sales, Inc.*, it could be argued that a spouse, who is to receive stock of a closely held high tech company, is a "successor" or "transferee" of the employee spouse. Even if the transfer restriction does not contain a provision explicitly addressing divorce, then, *Earthman's Inc.* notwithstanding, the restriction may well apply to the non-employee spouse.

Other Texas cases in the area of commercial law generally support the enforceability of transfer restrictions. *See, e.g., Ling and Company v. Trinity Savings and Loan Ass'n,* 482 S.W.2d 841, 844 (Tex. 1972) (there was nothing "unusual or oppressive" in requiring a selling shareholder to notify and give an option to buy to more than twenty other shareholders); *Shindler v. Harris,* 673 S.W.2d 600, 609 (Tex.App.–Houston [1st Dist.] 1984, writ ref.'d n.r.e.) ("clear and unequivocal" forfeiture provision appearing in a written joint venture agreement upheld); *RGS, Cardox Recovery v. Dorchester Enhanced Recovery,* 700 S.W.2d 635, 639 (Tex.App.–Corpus Christi 1985, writ ref.'d n.r.e.) (requirement that no partnership action could be taken at a meeting unless 75% of voting members present and voting was upheld since the parties had a right to agree and contract to "whatever limitations upon themselves" they desired, however, "burdensome or awkward").

3. Enforceability against Non-Employee Spouse

Several issues pertain to the enforceability, against a non-employee spouse of transfer restrictions or buy-out provisions in corporate bylaws, stock purchase agreements, or partnership agreements.

a. Signature

First, it must be determined whether the non-employee spouse signed any document evidencing the restrictions. Further, the precise nature of the document signed must be ascertained. A simple signature at the end of the document containing the restrictions – as well as many other unrelated provisions – will probably not be as persuasive in supporting enforceability as will a more explicit, precise acknowledgment and waiver, such as, for example, the following provision:

> The undersigned spouse of the Purchaser [the employee spouse] has read and hereby approves the foregoing Stock Purchase Agreement. In consideration of the Company's granting the Purchaser the right to acquire the Purchased Shares in accordance with the terms of such Agreement, the undersigned spouse hereby agrees to be irrevocably bound by all the terms of the such Agreement, including (without limitation) the right of the Company (or its assignee) to purchase any Purchased Shares in which the Purchaser is not vested.

b. Legal Representation

As is the case with premarital or postmarital agreements, whether the non-employee spouse obtained, or was encouraged to obtain, legal representation regarding the effect of any agreements containing transfer restrictions or buy-out provisions may be an important issue.

c. Fairness of Agreement

Dixie Pipe Sales, Inc. addresses the issue of reasonableness. The reasonableness of an agreement may turn on whether it is fair, and several factors are implicated in such a determination. Perhaps the most important is how the stock is to be valued: fair market value will necessarily be more

reasonable than other indicia of value, such as book value. Further, the process whereby the value of the stock is to be determined is also important.

A buy-out agreement that provides that the remaining shareholders may buy out the selling shareholder at a predetermined price, for example, $1 per share, may be enforceable as between the shareholders. It may not be enforceable, however, against a spouse, particularly if the shares are worth far in excess of $1 per share.

A reasonable valuation method often used is to provide that, in the absence of agreement as to the value of the stock or interest in question, the parties will select an appraiser to determine the value; if the parties cannot agree on the selection of an appraiser, each selects his or her own, and the two appraisers then select a third who is charged with the determination. The allocation of the costs of the appraisal is significant as well.

d. Sophistication of Non-employee Spouse

The vice president of a bank will probably be held to a transfer restriction, to which he or she agreed, more readily than will a checker at a local grocery store.

B. The Effect of Buy-Sell Agreements

In today's increasingly sophisticated economic climate, partnerships and close-closely held corporations frequently have buy-sell agreements in place between partners and shareholders. Normally intended for the mutual protection of the partners or shareholders, and to promote the continuous, harmonious and successful management of the business (by allowing the surviving or remaining parties to maintain ownership and control of the business), a buy-sell agreement typically contains mutual covenants to buy and sell a shareholder's or partner's interest at death or if a shareholder wished to make an inter vivos sale his or her interest in the business. *See, e.g., Little v. X-Pert Corp*., 867 S.W.2d 15, 16 (Tex. 1993). Buy-sell agreements also typically require the interest or stock to be purchased at a particular price, often "fair market value," and provide a mechanism for determining such value.

In the context family law, there are two developments of significance. First, buy-sell agreements increasingly trigger upon the divorce of a partner or shareholder. Second, non-involved spouses are signing such agreements with increasing regularity. *See, e.g., Donahue v. Bowles, Troy, Donahue, Johnson, Inc*., 949 S.W.2d 746, 748 (Tex.App.–Dallas 1997, writ denied) (all company shareholders and their wives executed a buy-sell agreement, which required that, within ninety days of the termination of a shareholder's employment, that shareholder must sell his stock and the company must buy it).

If, for example, a buy-sell agreement provides that, upon the involved spouse's divorce, the business has a right to buy back, at a specified price, that spouse's interest in the business, and if the buy-sell agreement is enforceable against the non-involved spouse, then certainly the issues concerning the valuation of the interest (for purposes of divorce) have become decidedly simplified. Thus, the binding effect of buy-sell agreements is becoming more and more a concern for both parties and their lawyers in Texas.

There appear to be only two reported cases in Texas that, in the context a of divorce, specifically address the issue of the effect of a partnership agreement on the valuation of a partner's interest, *Finn*, 658 S.W.2d 735, and *Keith*, 763 S.W.2d 950, both of which have been discussed at some length previously in this paper, and, naturally, the two cases are at odds with each other.

In *Finn*, under the terms of the law firm's partnership agreement, if the husband died or withdrew, he was entitled only to (1) the amount contained in his capital account, (2) any earned income which had not been distributed, and (3) his interest in the firm's reserve account, less ten percent of his proportionate share in the accounts receivable for clients' disbursement. By a vote of three fourths of the senior partners, the husband could have been required to withdraw, and in that event he was entitled to the same compensation for his interest as provided for under the voluntary withdrawal provisions. The partnership agreement did not provide any compensation for accrued goodwill to a partner who ceased to practice law with the firm, nor did it provide any mechanism to realize the value of the firm's goodwill. 658 S.W.2d at 741-742. It is interesting to note that the opinion of the Dallas Court of Appeals in *Finn* does not mention that the partnership agreement contained buy-out provisions upon divorce, or that the wife signed the agreement. It is probably safe to assume – but this is just an assumption – that the partnership agreement contained no such provisions and that the wife did not sign it.

The Dallas appellate court majority held that the community estate was not entitled to a greater interest than that to which the husband was entitled in the firm's goodwill, and that the extent of the husband's interest was governed by the partnership agreement. *Id*. at 741. Justice Stewart, it will be recalled, specifically disagreed that the partnership agreement controlled the value of the individual partnership interests, arguing that the asset being divided was the husband's interest in the partnership as a going business, not his contractual death benefits or withdrawal rights. *Id*. at 749.

In *Keith,* 763 S.W.2d the (non-professional) husband asserted on appeal that trial court erred by failing to find the market value of a partnership, of which he was a partner, by applying the formula set forth in the partnership agreement, since his wife had signed the agreement, stating her approval of the agreement and her acceptance of its provisions, and agreeing to be bound by it. *Id*. at 953. The partnership agreement provided a method for

determining the value of the business in the event it was terminated due to the withdrawal, other act, or death of one of the partners. *Id*. The Fort Worth appellate court stated that it agreed with the concurring opinion of Justice Stewart in *Finn* to the effect that the formula set forth in the partnership agreement with respect to death or withdrawal of the partner was not necessarily determinative of the value of a spouse's interest in the ongoing partnership as of the time of divorce. *Id*.

It can be argued that the trend in Texas has been to acknowledge that Justice Stewart's dissent in *Finn* was the better position, as evidenced by *Keith*. That so few reported cases exist on this point – even though the issue raises its ugly head more frequently as times go on – seems revealing . Underlying Justice Stewart's argument is the hard question posed by the extreme case: what do you do when the buy-out agreement establishes a value demonstrably, and egregiously, below a fair and reasonable estimate of value? Regardless of one's personal position on the matter, *Keith* remains the last reported case on the issue, and that must mean something.

Conceptually, one problem with the majority position in *Finn* is that it seems to ignore what could be considered the two different purposes of the typical buy-out agreement: (1) to define the rights and duties of parties in times of turbulence and change; and (2) to provide incentive for loyalty (or put another way, disincentive for disloyalty). The incentive/disincentive aspect of buy-out agreements necessarily undervalues the interest. Thus, a problem may well exist in using the buy-out mechanism as the determinative indicator of value.

Moreover, it should be noted that, in *Beavers*, 675 S.W.2d at 299, the Dallas Court of Appeals did not hold that the wife was bound by the corporate buy-out provisions, but rather used an "actual" or "intrinsic" value roughly based on the corporation's underlying assets (as opposed to "book value," the value established in the corporate buy-out provisions), since the buy-out agreement rendered the shares in question valueless. The Dallas appellate court did not explain its rationale for avoiding the effect of the buy-out agreement, stating only that "...[i]n assigning values to closely held corporations in contested divorce actions, those considerations given here by the trial judge to company assets and to the realities of corporate control are appropriate." *Id.*

In the end, *Finn* survives. If the Dallas appellate court was correct in *Finn* when it stated that the community estate was not entitled to a greater interest than that to which the husband was entitled in the firm's goodwill, and that the extent of the husband's interest was governed by the partnership agreement, then a buy-sell agreement that defines the value of a business interest will limit the value of that interest that can be awarded pursuant to a divorce.

Additionally, it is also worthwhile to recall that in *Beavers*, 675 S.W.2d at 299, the Dallas Court of Appeals referred to the concept of "value to the owner," a notion which potentially opens the door to all sorts of proof regarding factors that may inflate the "value" of a business to an owner. In turn, this leads to Justice Stewart's conclusion in *Finn*, 658 S.W.2d at 749, that the husband's partnership agreement should not have precluded consideration of other "facts" in valuing the husband's interest in the law firm, a conclusion echoed by *Keith*. Thus, *Beavers* might well be used to undermine *Finn* under appropriate circumstances.

Accordingly, the prudent Texas practitioner confronted with a draconian buy-sell agreement would do well to think hard about the factors and considerations discussed hereinabove concerning the binding effect of transfer restrictions.

C. The Professional Association

By statute in Texas, any one or more persons duly licensed to practice a profession, including podiatry, under the laws of this state may form a professional association, as distinguished from either a partnership or a corporation, by associating themselves for the purpose of performing professional services and dividing the gains therefrom. TEX.REV.CIV.STAT. art. 1528f, §2(A) [as previously mentioned, physicians, surgeons and other doctors of medicine are specifically excluded from forming a professional corporation under the Texas Professional Corporation Act: *see,* TEX.REV.CIV.STAT. art. 1528e, §3(a)].

For purposes of divorce, the problem with a professional association is that the shares or other "units of ownership" are transferable only to persons licensed to perform the same type of professional service as that for which the professional association was formed. TEX.REV.CIV.STAT. art. 1528f, §10. In other words, a trial court may not divide, for example, the shares of a professional association in kind between a physician-spouse and a non-physician spouse. One reported Texas case has specifically addressed the difficulty involved in dividing a professional association.

In *Eikenhorst*, 746 S.W.2d at 887, the trial court awarded the non-physician wife cash from the corporate bank accounts of the husband's professional association. On appeal, the husband argued that the trial court's award was erroneous, analogizing to the well-settled rule that a trial court cannot award specific partnership property to a spouse, but rather can only award an interest in the partnership, citing the Texas Supreme Court case of *McKnight*, 543 S.W.2d at 868. *Id.*

However, the Houston First Court of Appeals distinguished *McKnight* on the grounds that (1) *McKnight* involved a partnership, with independent third party partners, and in *Eikenhorst* the trial court's award involved a corporation in

which the husband was the only shareholder, and (2) under TEX.REV.CIV.STAT. art. 1528f, §10, shares of professional associations are transferable only to persons who are licensed to practice the same type of profession for which the professional association was formed. *Eikenhorst*, 746 S.W.2d at 887. Thus, because the wife in *Eikenhorst* could not be awarded shares in the professional association in which she had a community interest, the Houston appellate court held that it was not improper for the trial court to award the wife her community interest from the cash assets of the professional medical association in which her physician husband was the sole shareholder. *Id.*

Does *Eikenhorst* apply to the medical professional association in which two or more physicians are involved? Most likely not. *Eikenhorst* presented relatively easy facts: in essence, the Houston First Court of Appeals held that the professional association was simply the physician-spouse's alter ego. Normally, unless a corporation is a spouse's alter ego, a trial court may only award a spouse's interest in the corporation, not specific corporate property. *See, e.g., Siefkas*, 902 S.W.2d at 79.

Thus, rather than divide the shares of a medical professional association in kind, the trial court may award the non-physician spouse a judgment for the value of her interest in the professional association. The issue then becomes how to secure the judgment. May the trial court create a trust arrangement in which a trustee holds the community's shares of the professional association in trust for the benefit of the non-physician spouse?

The answer should be no. Regardless of the identity of the trustee, the creation of a trust containing the community's shares of the professional association necessarily requires a transfer of the beneficial or equitable interest in the shares to the non-physician spouse. It is basic trust law that "for a trust to be a trust, the legal title of the [trust property] must immediately pass to the trustee, and beneficial or equitable interest to the beneficiaries." *Cutrer v. Cutrer,* 334 S.W.2d 599, 605 (Tex.Civ.App.-San Antonio 1960), *aff'd*, 345 S.W.2d 513 (Tex. 1961). In fact, the separation of the legal and equitable estates in the trust property is the basic hallmark of the trust entity. *Perfect Union Lodge No. 10, A.F. and A.M., of San Antonio v. Interfirst Bank of San Antonio, N.A.* 748 S.W.2d 218, 220 (Tex. 1988). Accordingly, a trust arrangement in which the shares of the professional association represent the trust *res* runs afoul of section 10 of the Texas Professional Association Act.

In order to secure an judgment resulting from the division of a professional association, the trial court must look to other assets owned by the parties. Under *Hirsch,* the trial court may be able to impose an equitable lien on the separate assets of the physician spouse. *Hirsch,* 770 S.W.2d at 928 (the trial court is vested with authority to affix a lien on the separate property of one spouse to secure the discharge of payments by the owner of that property to the other spouse, and the court's action in doing so does not result in a prohibited divestiture of separate property). However, the issue is unclear, in that on this point *Hirsch* may have been implicitly overruled by *Heggen v. Pemelton*, 836 S.W.2d 145 (Tex. 1992). *See, e.g., Arnold v. Eaton*, 910 S.W.2d 181, 184 (Tex.App.-Eastland 1995, no writ) (a trial court cannot impose an equitable lien on the separate property of a spouse).

D. *Jensen* Reimbursement Claims

According to the Texas Supreme Court, a right to reimbursement arises when the time, toil, and labor of the community estate are expended to enhance and benefit one spouse's separate estate, and the community is inadequately compensated for those contributions. *Jensen v. Jensen*, 665 S.W.2d 107, 109 (Tex. 1984); *see also*, *Vallone*, 644 S.W.2d at 459 (the right to reimbursement is only for the value of the time, toil and effort expended to enhance the separate estate other than that reasonably necessary to manage and preserve the separate estate, for which the community did not receive adequate compensation). In the context of a divorce involving one spouse's separate property business, reimbursement claims often arise – or should often arise. In such a situation, the parties, the attorneys, and the finder of fact are confronted with two primary considerations: (1) an increase in the value of separate property attributable to community effort; and (2) the under compensation of the community for that effort. *Trawick v. Trawick*, 671 S.W.2d 105, 108 (Tex.App.–El Paso 1984, no writ).

1. Reimbursement in General

Reimbursement is a court-created equitable doctrine intended to address inequities that can arise by the operations of the laws of property ownership. Richard R. Orsinger, *Reimbursement in the 21st Century*, Chapter 8, 1, 26th ANNUAL ADVANCED FAMILY LAW COURSE (2000). In *Vallone*, the Texas Supreme Court defined reimbursement in the following manner:

> The rule of reimbursement is purely an equitable one. It obtains when the community estate in some ways improves the separate estate of one of the spouses (or vice versa). The right of reimbursement is not an interest in property or an enforceable debt, per se, but an equitable right which arises upon the dissolution of the marriage through death, divorce, or annulment.

644 S.W.2d at 458-459 (citations omitted.). Reimbursement occurs most commonly from a

separate estate to the community estate, but also arises between separate estates, and between the community estate and a separate estate. *See, Dakan v. Dakan*, 125 Tex. 375, 83 S.W.2d 620, 627 (1935).

Under the equitable doctrine of reimbursement, a court of equity is bound to look at all the facts and circumstances and determine what is fair, just and equitable. *Penick v. Penick*, 783 S.W.2d 194, 197 (Tex. 1988). Several results flow logically from the equitable nature of reimbursement. First, it must be noted that reimbursement is not available as a matter of law, but lies in the discretion of the trial court. *Vallone*, 644 S.W.2d at 459. Thus, great latitude is given to the trial court in applying equitable principles to value a claim for reimbursement. *Penick*, 783 S.W.2d at 198. An equitable claim for reimbursement is not merely a balancing of the ledgers between competing marital estates. *See, Id.* Moreover, the discretion to be exercised in evaluating a claim for reimbursement is equally as broad as the discretion exercised in making a just and right division of the community estate. *Zieba v. Martin*, 928 S.W.2d 782, 789 (Tex.App.–Houston [14th Dist.] 1996, no writ).

Second, because of the equitable nature of reimbursement, offsetting benefits are always a factor to be considered by the trial court (regardless of the nature of the reimbursement claim). *Penick*, 783 S.W.2d at 197; *see also*, *Jensen*, 665 S.W.2d at 109 (the equitable nature of a claim for reimbursement allows for consideration of offsetting benefits). Consequently, the trier of fact should consider the benefits and detriments to each estate. *Zieba*, 928 S.W.2d at 789.

2. *Jensen*

Prior to marriage, Mr. Jensen acquired 48,455 shares in RLJ Printing Company. *Jensen*, 665 S.W.2d at 108. Also prior to the Jensen's marriage, RLJ acquired Newspaper Enterprises. *Id.* Mr. Jensen was the key man in the operation of RLJ, which was a holding company whose sole assets consisted of all of the stock of Newspaper Enterprises. *Id.* During the years of the parties' marriage, Mr. Jensen's compensation from RLJ, consisting of salary, bonuses and dividends, was $64,065.97 in 1976, $95,426.00 in 1977, $106,143.00 in 1978 and $115,000.00 in 1979. *Id.*

Upon the parties' divorce, the trial court ordered that the 48,455 shares of stock in RLJ Printing Company, acquired by Mr. Jensen four months prior to marriage, together with any increase in value in such stock which occurred during marriage (the value of the stock was not determined by the trial court), were the separate property of Mr. Jensen, and denied Mrs. Jensen any interest in the stock or its increased value. *Id.* Among other things, the trial court found that RLJ was not an alter ego of Mr. Jensen, that it had not been acquired in fraud of the rights of the community estate, that the salary, dividends, and bonuses paid to Mr. Jensen had been adequate and reasonable, that Mr. Jensen was the key man in the operation of RLJ, and that the successful operations of RLJ were primarily due to the time, toil and effort of Mr. Jensen. *Id.* The court of appeals reversed and remanded, holding that the community should be compensated for an enhancement in value of the stock because such appreciated value had been due primarily to the time, toil and effort of Mr. Jensen. *Id.*

On appeal, the Texas Supreme Court therefore considered, as a point of first impression, how to treat, upon divorce, corporate stock owned by a spouse before marriage but which increased in value during the marriage due, at least in part, to the time and effort of either or both spouses. *Id.* at 109. The Texas Supreme Court adopted the reimbursement rule that the community should be reimbursed for the value of the time and effort expended by either or both spouses to enhance the separate estate of either, other than that reasonably necessary to manage and preserve the separate estate, less the remuneration received for that time and effort in the form of salary, bonus, dividends and other fringe benefits, those items being community property when received. *Id.*

Accordingly, concluded the Texas Supreme Court, if the trial court's finding that Mr. Jensen had been adequately and reasonably compensated for his time and effort expended in enhancing the value of the RLJ shares could be sustained upon appellate review, Mrs. Jensen's right to reimbursement would be precluded because Mr. Jensen's compensation was community property. *Id.* at 109-110. However, the only evidence offered at trial to establish the reasonableness of Mr. Jensen's compensation was based primarily upon Mr. Jensen's stock ownership, and not upon the salary, bonuses and dividends received by the community due to his time, toil and effort. *Id.* at 110. Therefore, held the Texas Supreme Court, the trial court's finding that Mr. Jensen's compensation was reasonable was without adequate support, and without that finding of fact, there was no basis for the trial court's finding that the community was not entitled to receive the value of the appreciation in shares of RLJ Printing Company, Inc. that was due to the time, toil and effort of Mr. Jensen. *Id.*

In conclusion, the Texas Supreme Court remanded the cause, stating that, upon retrial, the burden of proving the reimbursement claim would be upon the claimant, Mrs. Jensen. *Id.* Moreover, any right to reimbursement could be only for the value of the time, toil and effort expended to enhance the separate estate other than that reasonably necessary to manage and preserve the separate estate, for which the community did not receive adequate compensation. *Id.* However, continued the Texas Supreme Court, if the right to reimbursement was proved upon retrial, a lien would not attach to Mr. Jensen's separate property shares, but rather, a money judgment could be awarded.

Thus, *Jensen's* reimbursement theory is that the community will be reimbursed for the value

of time and effort expended by either or both spouses to enhance the separate estate of either, other than that reasonably necessary to manage and preserve the separate estate, less the remuneration received for that time and effort in the form of salary, bonus, dividends, and other fringe benefits, those items being community property when received. *See, e.g.*, *Jones v. Jones*, 699 S.W.2d 583, 586 (Tex.App.–Texarkana 1985, no writ).

3. Issues Raised By *Jensen*

a. Pleading Requirements

Generally, reimbursement must be pled in order for it to be awarded. Orsinger at 3. For example, in *Vallone*, 644 S.W.2d at 459, the wife waived her reimbursement claim for the uncompensated time, toil and talent expended by her husband in enhancing the value of his separate estate because she requested reimbursement only for community funds ***expended*** on the husband's separate estate.

However, in *Jensen*, the wife, who had similarly failed to plead for reimbursement for the uncompensated time, toil and talent expended to enhance her husband's separate estate, obtained a remand, "in the interest of justice," in order to replead and prove reimbursement upon retrial. *See,* Orsinger at 3. Consequently, the Tyler Court of Appeals, in *Jones,* 699 S.W.2d at 586, remarked that *Vallone's* pleading specificity requirement was apparently no longer required. *Jones* and *Jensen* notwithstanding a reimbursement award not supported by any pleadings may – and probably will be – reversed. *See, e.g., Gay v. Gay*, 737 S.W.2d 94, 96 (Tex.App–El Paso 1997, writ denied).

Several Texas courts of appeals have held that defects in reimbursement pleadings may be waived if not brought to the trial court's attention in writing prior to the signing of the judgment. *See*, *Jones*, 699 S.W.2d at 586; *Hilton v. Hilton*, 678 S.W.2d 645 (Tex.App.–Houston [14th Dist.] 1984, no writ); *see also*, TEX.R.CIV.P. 90.

Reimbursement claims may also be tried by consent. *See, e.g., Smith v. Smith*, 715 S.W.2d 154, 156 (Tex.App.–Texarkana 1986, no writ) (the husband did not object to the absence of reimbursement pleadings, or to the evidence offered showing the improvements and enhancement to the value of his separate property by the community estate, and therefore the issue of reimbursement was tried by consent).

b. Burden of Proof

The party seeking reimbursement has the burden of proof. *Jensen*, 665 S.W.2d at 110. According to one commentator, whether a party seeking reimbursement has the burden to prove that such reimbursement exceeds offsetting benefits is less clear. *See,* Orsinger at 4.

c. Findings

It is critical for the party asserting a claim for reimbursement to secure a finding at trial in support of such claim. In *Holloway v. Holloway*, 671 S.W.2d 51, 58 (Tex.App.–Dallas 1983, writ dism'd), for instance, despite the facts that, because of his efforts, the husband's stock in one company had increased in value during the marriage from $1,000 to $30,000,000, and from $3,000 to $60,000,000 in another, the wife waived her reimbursement claim because she failed to carry her burden to plead, prove, and request jury findings on the value of the time and effort expended by the husband over and above the salaries, bonuses, and dividends received by the community estate. In the words of the Dallas Court of Appeals:

> Although the evidence may be undisputed that a major portion of the enhanced value was the result of [the husband's] managerial efforts, no special issue was submitted or requested that would have elicited a finding as to what amount of compensation would be proper or what portion of the enhanced value was attributable to [the husband's] efforts over and above the value of the salaries, bonuses, and dividends received. The amount of that claim in the present case is a question of fact which the trial court could not properly resolve without submitting it to the jury.

Id.

d. Time, Toil, Talent and Effort?

Simply put, time, toil and trouble are required. *See, e.g., Pearce v. Pearce*, 824 S.W.2d 195, 200 (Tex.App.–El Paso 1991, writ denied) (when time, toil, talent and effort have been expended for the betterment of a marital estate, it is clear that a spouse has the option of pursuing a claim for reimbursement). However, according to the Houston Fourteenth Court of Appeals, an increase in the value of a separate property in resulting from "fortuitous circumstances and unrelated to an expenditure of community effort" will not entitle the community estate to reimbursement. *Harris*, 765 S.W.2d at 805; *see also, Dawson-Austin v. Austin*, 920 S.W.2d 776, 788 (Tex.App.–Dallas 1996), *rev'd on other grounds*, 968 S.W.2d 319 (Tex. 1998) (the community estate is not entitled to reimbursement for increases in the value of separate property caused by market forces).

In *Fazakerly v. Fazakerly*, 996 S.W.2d 260, 262-263 (Tex.App.–Eastland 1999, writ denied), the father married a second wife, and began working in

his new wife's business, which had been faltering. After the father became involved, the business began to flourish. *Id.* The father left his daughter by another marriage a note, to be opened upon his death, stating that he thought he was responsible for the increased profits and vitality of his new wife's business, and that the daughter's lawyer should see the note. *Id*. at 263. Upon the father's death, the daughter read the note, and, of course, sued her step-mother, alleging that the community estate was entitled to reimbursement from the step-mother's estate for the efforts of the father. *Id*. At trial, the jury found that the reimbursement was inappropriate. *Id*.

On appeal, the Eastland Court of Appeals noted that a community estate cannot claim reimbursement for increases in the value of separate property caused by the market or general economy. *Id*. at 268. Because there was evidence that market factors had played a major role in the rejuvenation of the step-mother's business, and because there was evidence that the community had received in excess of $1 million in the form of wages, director fees, interest and dividends, and rental income from the step-mother's separate property business, the Eastland appellate court held that sufficient evidence supported the jury's finding that no reimbursement was due to the community estate. *Id.*

In *Gutierrez v. Gutierrez*, 791 S.W.2d 659, 665 (Tex.App.–San Antonio 1990, no writ), the wife assisted her husband with his separate property cattle herd by cooking meals for ranch hands, helping search for bulls to purchase, and helping feed and round up the cattle. However, as the San Antonio Court of Appeals noted, there was no evidence of the value of these services, or whether they exceeded what was necessary to maintain and preserve the herd. *Id.*

Consequently, the wife's proof failed because there was no indication that her efforts did more than was required to maintain the herd, nor was there evidence of the value of her uncompensated labor. *Id*. While mathematical certainty is not required, stated the San Antonio appellate court, there must be some proof of value. *Id*.

e. The Measure of Reimbursement (Time, Toil, Etc.)

As discussed, a right to reimbursement arises when community time, toil, and labor are utilized to benefit and enhance a spouse's separate estate, beyond that reasonably necessary for management and preservation, and for which the community did not receive adequate compensation. Under Texas law, the contributing spouse is not entitled to the enhanced value of the separate property, but only to the value of the uncompensated time and labor. *See, Jensen*, 665 S.W.2d at 109. The burden is squarely on the claimant to establish the value of the community time and labor expended on the spouse's separate property, over that which was reasonably necessary for management and preservation, and over the value of any compensation or benefit received by the community. *Rogers v. Rogers*, 754 S.W.2d 236, 239 (Tex.App.–Houston [1st Dist.] 1988, no writ). Thus, evidence must be presented establishing the value of the alleged uncompensated labor, and that any such labor was greater than any benefits received. *See, Id*.; *cf*., *Magill v. Magill*, 816 S.W.2d 530, 535 (Tex.App.–Houston [1st Dist.] 1991, writ denied (a claim for reimbursement for funds expended by one estate for improvements to another estate is to be measured by the enhanced value to the benefitted estate).

In his recent article on reimbursement, Richard Orsinger stated the rule for the measure of reimbursement in the following manner: "'[f]or the increase in value of a spouse's separate property ownership in a corporation due to the owning spouse's labor, we reimburse the cost (as measured by the value of the uncompensated community labor expended to enhance the corporation), but (possibly) limited by the amount of the spouse's interest in the business." Orsinger at 2

f. Identification/Calculation of Offsetting Benefits

Richard Orsinger has also posed the pertinent question: why should benefits from a separate property business, to which the community estate is entitled apart from any spouse's labor – *i.e.*, the dividends mentioned in *Jensen*, or other income from separate property interests – be considered as an "offset" to a claim for reimbursement? *See*, Orsinger at 11. In the words of Mr. Orsinger: "[o]ne wonders why dividends would be considered compensation for time, toil and talent, when dividends are distributions of profits to owners, even those owners who contribute no effort to the profits." *Id*.

Of course, the significant counter-argument can be made that, reimbursement being a purely equitable remedy, with no hard and fast "legal" rules, dividends are indeed a form of benefit received by the community estate. In the end, the identification and calculation of offsetting benefits – as well as the measure of "under compensation" – are areas not yet well demarcated in Texas law.

In *Trawick*, 671 S.W.2d at 109, the El Paso Court of Appeals addressed the issue of compensation to the community. The El Paso appellate court included as compensation to the community the owner-spouse's salary, life insurance premiums and club memberships paid by the business as well as the death benefits paid by the business when the owner-spouse died.

However, the El Paso Court of Appeals excluded several alleged "benefits" from its calculation of the actual compensation paid to the community estate: (1) rental income received from the business for its use of the owner-spouse's separate property, since such income had nothing to do with the efforts of the owner-spouse; (2) money

paid to the wife (the nonowner-spouse), unless her employment was a complete sham; and (3) the expense account of the owner-spouse, unless such expense payments exceeded the amount of his actual out-of-pocket expenses (since only in such a situation would the expense payments represent true compensation for services rendered). *Id*.

g. Ceiling To Reimbursement?

In *Trawick*, 671 S.W.2d at 108, the El Paso Court of Appeals also stated that, under *Jensen*, the enhanced value of the separate property stock is one of the factors to be considered by the fact finder in determining the value of the community time and effort. Consequently, the appropriate computation for reimbursement is to determine the discrepancy between the reasonable value of the effort expended and the actual compensation received, and then look to the enhanced value of the separate estate to satisfy that discrepancy. *Id*. The Eight Court of Appeals noted that

> [i]n given cases, the total enhanced value may equal or exceed the demonstrated right to reimbursement. We are not yet confronted with a question of right to reimbursement exceeding the enhanced value of a specific separate property asset and will not attempt to suggest the outcome of such a conflict.

Id. at 109. It has been suggested that *Trawick* indicates that the amount of enhancement of a separate property business is a limit to the amount of reimbursement available to the community for the under compensation of one spouse for his or her time, toil and talent. *See,* Orsinger at 11; *see also, Trawick*, 671 S.W.2d at 110 ("[a]rguments can be made both for and against the use of the enhanced value figure as a ceiling of recovery").

4. Specific Business Contexts

a. Retained Earnings of Subchapter S. Corporation

The retained earnings of 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. Richard Orsinger has cogently suggested that, in such a situation, the community estate may well have a reimbursement claim to the extent of the income taxes paid by the community on behalf of the separate property corporation. *See,* Orsinger at 14. Of course, it would be a different story if the income taxes were actually paid out of the separate property of the owner-spouse.

b. Retained Earnings of Partnership

As previously discussed, under the "entity" theory of partnership, undistributed partnership income is neither a community nor a separate asset of any individual partner, but rather constitutes a partnership asset, not divisible upon divorce. *Cleaver*, 935 S.W.2d at 494. As with a Subchapter S corporation, the federal income tax liability for undistributed partnership income might be paid by the community estate, since a partnership is a "pass through" entity for tax purposes. Thus, reimbursement might be an available remedy in such a situation.

c. Separate Property Corporate Distributions Exceed Profits

In *Brooks v. Brooks,* 612 S.W.2d 233, 236-237 (Tex.Civ.App.–Waco 1981, no writ), the trial court properly reimbursed the husband's separate property corporation for the amount, in excess of the total corporate earnings, that the parties had withdrawn from the corporation. As noted by the Waco Court of Appeals, the husband's corporation was the vehicle out of which came the money that paid not only the living expenses of the parties and the wife's two minor children by a former marriage, but also for the acquisition of the community property accumulated by the parties during the years of marriage. *Id*. at 237. The wife complained (and lost) on appeal about the reimbursement award, even though the parties not only withdrew from the corporation all the money it earned during the marriage, but an additional $48,020.88 from the corpus or capital structure of the corporation as well (all of which goes to show that many people really do believe that no good deed should go unpunished). *Id*.

5. Conclusion

Jensen claims are alive and well in Texas. Ultimately, a *Jensen* claim will probably hinge on the issue of reasonable compensation. For example, in the case of a separate property business – say, a car dealership – that pays the owner $3 million a year in salary and other benefits, but which also is growing a rapid rate, so that there is accumulated capital, is $3 million "reasonable compensation?" It is easy to perceive that different finders of fact may answer that question differently

Thus, to say that *Jensen* claims are alive and well is not to say that such claims are as straightforward and routine as one might want to believe, but they are clearly an important consideration in any divorce involving a community business, particularly a separate property community business.

E. Dirty Tricks

1. Hiding income

Believe it or not, people do attempt to hide money, and not just from the IRS. *See, e.g.*, *Underwood v. Underwood*, 902 S.W.2d 152, 154

(Tex.App.–Houston [1st Dist.] 1995, no writ) (in a SAPCR action, the former husband purposely hid his ownership interest and income from two business entities). More typically, however, income will be "lost" in a business, in the form of perks paid to owners, or expenses paid by the business (perhaps to fake vendors). Income can also be hidden by failing to convert work-in-progress to accounts receivable, and then not billing. Sometimes, income is simply stolen.

It must always be remembered that, in divorce cases, parties often subscribe to the firm conviction that "what's mine is mine, and what's yours is mine." Such an approach often allows – even justifies – the most peculiar ethical positions. Consequently, the prudent practitioner and his or her valuation experts will always investigate the income issue.

2. Inappropriate Valuation Methods

Not surprisingly, lawyers and their accountants often present estimates of value based upon utterly questionable, if not utterly preposterous, valuation methodologies, or based upon legitimate methodologies corrupted with subtle, but insupportable assumptions or assertions of fact. The Authors are aware of at least two such valuation "strategies" that have come across their desks in the past few years. Many others exist. The Authors are further aware that Texas trial judges sometimes "bite" on such offerings. The Texas practitioner must be constantly diligent to expose and extirpate impermissible valuations.

a. Harnessing Future Earnings

In many divorces, what exists in the way of divisible assets may not be nearly as attractive as what is going to exist in the future. As already discussed, a spouse's future earnings represent an alluring morsel in many cases.

However, Texas law simply does not permit a spouse to share, post-divorce, in the future earnings of the other spouse. Many Texas cases to that effect exist, and the Texas family law practitioner needs to know them. Among the more significant are: *Berry*, 647 S.W.2d at 947; *Licata v. Licata*, 11 S.W.3d 269, 278 (Tex.App–Houston [14th Dist.] 1999, no pet.) ('[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); *Smith*, 836 S.W.2d at 692 (valuation based on 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).

b. "Gross Receipts" v. "Profits"

Although it seems perhaps elementary to most people that income based valuations must be based upon earnings, and not gross receipts or revenue since profits represent gross income less expenses and other associated costs. As stated by one respected commentator:

> To a large extent, the profitability of a business is viewed as an indicator of value of an interest therein. Before a profit figure can be reached, all items of income and all expenses must be identified and analysed [sic].

Arnold J. Rutkin, *Valuation of a Closely Held Corporation, Small Business or Professional Practice*, VALUATION AND DISTRIBUTION OF MARITAL PROPERTY, Vol. 2, pp. 22-23 (Matthew Bender 1998).

The Austin Court of Appeals has specifically recognized the impropriety of a valuation methodology based upon "gross receipts." In *Travis Cent. Appraisal Dist. v. FM Properties Operating Co.*, 947 S.W.2d 724 (Tex.App.-Austin 1997, writ denied), one of the major issues was the proper valuation of multiple unimproved lots in a subdivision. The Austin appellate court stated that professional appraisers acknowledged that, although the "retail price" of individual lots should be considered in their valuation, direct and indirect development and marketing costs must also be considered in order to find true market value. *Id.* at 729. Further, according to the Third Court of Appeal, labeling "expected gross receipts as any kind of value estimate is highly misleading and should be avoided." *Id.* To illustrate the fundamental error of using gross receipts as an indicator of value, the Austin Court of Appeals also posed the following hypothetical:

> For example, imagine a company that is in the business of selling widgets. The company has on hand a stock of 100,000 widgets, which retail for $2 each. Thus, the company hopes to receive $200,000 in gross receipts from the sale of its widgets. Assume the evidence shows, however, that in all likelihood it will take one year to sell off this entire stock of widgets; during that year, the company will likely spend $25,000 to lease a widget store, $25,000 to staff the store with salespersons, $25,000 to advertise the widgets, and $25,000 to maintain the widgets in good condition while they are waiting to be sold. Thus, the company hopes, by the end of the year, to net $100,000 profit from its widget sales (less the original cost to buy the stock of widgets). What would a reasonable, willing buyer with full information pay for the entire inventory of widgets at the beginning of the year? No more than $100,000, possibly less. Yet

> the simplistic method of multiplying the number of widgets on hand (100,000) by the retail sales price of each ($2) would produce a "fair market value" of $200,000, even though no "willing buyer" would pay that much for the company's inventory as a unit.

Id. at 731-732.

Recently, the impropriety of "gross receipts" as a factor or basis in determining value has struck home, and, in many areas of country, central Texas included, has struck home hard. Over the past several years, it became rather the standard to value the new internet companies on the basis of anticipated gross revenues, since the companies had neither current nor historical earnings. As has been heavily reported in the national media, such companies were given grossly inflated values. Of course, for many of such companies, the expected revenues never materialized, and the result is a glut of bankruptcies and lawsuits – in other words, full employment for many attorneys.

3. Intentional Devaluation

In *In re Marriage of Parker*, 997 S.W.2d 833, 838 (Tex.App.–Texarkana 1999, pet. denied), the wife contended at trial that the husband had devalued his business assets through questionable business dealings with a long-time business associate. The trial court believed the wife, and awarded her $50,000 as a part of the just and right division of property. *Id*.

On appeal, the Texarkana Court of Appeals noted that the husband had started the business, of which he was the incorporator, sole investor, and sole shareholder, after the marriage with $139,000 in community assets. *Id*. at 838-839. Further, during the parties' pending divorce, on the same date the trial court conducted a hearing on a motion for temporary orders restraining the parties from disposing or encumbering any property, the husband signed a note and security agreement to his business associate for $1.2 million, for alleged cash advances over a period of time. *Id*. at 838. Of course, the husband testified that there were no contemporaneous writings to support the debt owed to the associate because the money had been loaned in a series of "handshake deals." *Id*. at 838-839.

Later, in a voluntary foreclosure resulting from the husband's default on the note (and conducted in the office of the husband's divorce attorney), the husband transferred the business to his associate. *Id*. at 839. A new company, of which the husband was just an employee, then took over the husband's business at the same location and showed over $2 million in sales in the first fifteen months. *Id*.

At trial, the wife argued that the husband could have made the payments on the outstanding note, and thereby avoided the foreclosure, but did nothing. *Id*. The husband denied that his transactions with his associate were an attempt to defeat any claim the wife may have had to any of the property. *Id*. Understandably, the Texarkana Court of Appeals found sufficient evidence to support the trial court's award of $50,000 to the wife. *Id*.

F. Fiduciary Duties Between Spouses

In certain circumstances, a spouse may find himself or herself confronted with conflicting but simultaneous fiduciary duties. Such a situation may arise when one spouse is a member of, or has an interest in, a business of one flavor or another. The involved spouse may owe duties to the business that conflict with duties he or she may the other spouse or the community. Although not necessarily a factor that directly affects valuation issues, a conflict between fiduciary duties might well constitute a consideration the trial court acknowledges in the exercise of its equitable powers, for example, concerning reimbursement claims.

1. In General

The relationship that exists between a husband and a wife has been held to create a fiduciary duty requiring the duty of utmost good faith. *In re Marriage of Moore*, 890 S.W.2d 821, 827 (Tex. App.–Amarillo 1994, no writ); *Matter of Marriage of DeVine*, 869 S.W.2d 415, 428 (Tex.App.–Amarillo 1993, writ denied).

2. Duration of Fiduciary Duty

Texas law is unclear as to the duration of the fiduciary duty between spouses. On the one hand, according to the Texarkana Court of Appeals, the fiduciary relationship between husband and wife terminates upon divorce. *Grossnickle v. Grossnickle,* 935 S.W.2d 830, 846 (Tex.App.–Texarkana 1996, writ denied). On the other, the Fort Worth Court of Appeals has stated that the fiduciary duty between husband and wife ceases to exists when a suit for divorce is filed and both sides are represented by counsel. *Parker v. Parker,* 897 S.W.2d 917, 924 (Tex.App.–Fort Worth 1995, writ denied).

In *Miller v. Miller*, 700 S.W.2d 941, 945 (Tex.App.–Dallas 1985, writ ref'd n.r.e.), the jury found, and the Dallas appellate court affirmed, that a husband and wife had a confidential relationship after the husband had filed for divorce. However, at the time during which the jury found the confidential relationship to exist, the wife apparently had not yet engaged the services of any professionals for the purposes of the pending divorce.

In *Bass v. Bass* 790 S.W.2d 113, 119 (Tex.App.–Fort Worth 1990, no writ), the Fort Worth Court of Appeals noted that the jury in *Miller found* a pre-divorce confidential relationship, and the reviewing appellate court in *Miller* considered the jury's finding supported by the evidence. In *Bass*, however, the Fort Worth appellate court expanded on *Miller* by stating that, under different factual circumstances, the opposite might well be true, *i.e.,* the evidence might not support a finding of a pre-divorce confidential relationship. *Id*. As a result, in *Bass,* the Fort Worth Court of Appeals considered such different factual circumstances to be present when the husband and wife each hired numerous independent professional counsel to represent them in the contested divorce proceeding. *Id*.

3. Fiduciary Duties as to Property

a. Sole Management Community Property

During marriage, each spouse has the sole management, control and disposition of the community property that he or she would have owned if single, including but not limited to (1) personal earnings; (2) revenue from separate property; (3) recoveries for personal injuries; and (4) the increase and mutations of, and the revenue from, all property subject to his or her sole management, control and disposition. TEX.FAM.CODE §3.102(a). This property is generally referred to as the "special community property" of a spouse.

In the ***absence of fraud upon the other spouse***, the managing spouse has the sole right of control and disposition of that spouse's special community property. *See, e.g., Kruegar v. Williams*, 359 S.W.2d 48, 50 (Tex. 1962). In other words, there is a fiduciary duty owed by one spouse to the other in the reasonable management and control of his or her special community property. *See, e.g., Carnes v. Meador*, 533 S.W.2d 365, 370 (Tex.Civ.App.–Dallas 1975, writ ref'd n.r.e.).

b. Community Property

Spouses are also burdened with reciprocal fiduciary duties in the management, control and disposition of community property. *See, e.g., Id.* Of course, spouses are free to make expenditures of community property, ***absent*** some deception or objection by the other spouse. *See, e.g., Pelzig v. Berkebile*, 931 S.W.2d 398, 400 (Tex.App.–Corpus Christi 1996, no writ).

4. Traditional Fiduciary Duties

a. Corporate Directors/Officers

Directors and officers of a corporation are fiduciaries and they owe a duty of loyalty to the corporation. *Poe v. Hutchins*, 737 S.W. 2d 574, 584 (Tex. App.–Dallas 1987, writ ref'd n.r.e.). Corporate fiduciaries may not usurp corporate opportunities for personal gain and transactions in which a corporate fiduciary receives personal profit are subject to the closest examination. *International Bankers Life Ins. Co. v. Holloway,* 368 S.W. 2d 567, 577 (Tex. 1963); *Poe*, 737 S.W. 2d at 584.

A director's fiduciary duty runs only to the corporation, not to individual shareholders or even to a majority of the shareholders. *Hoggett v. Brown*, 971 S.W.2d 472, 488 (Tex.App.–Houston [14th Dist.] 1997, pet. denied). Similarly, a co-shareholder in a closely held corporation does not as a matter of law owe a fiduciary duty to his co-shareholder. *Kaspar v. Thorne*, 755 S.W.2d 151, 155 (Tex.App.–Dallas 1988, no writ). Instead, whether such a duty exists depends on the circumstances. *Hoggett*, 971 S.W.2d at 488.

b. Partner/Partnership

For partnerships governed by the statutory scheme effective before January 1, 1994, *i.e.,* before the adoption in Texas of the Texas Uniform Partnership Act, partners owe fiduciary duties to the partnership and the other partners; in other words, partners must deal with each other honestly and fairly in conducting the partnership business. *See, e.g., McLendon v. McLendon,* 862 S.W. 2d 662, 676 (Tex. App.–Dallas 1993, writ denied). For partnerships governed by the statutory scheme effective since January 1, 1994, partners do not owe fiduciary duties to the partnership and the other partners, but owe a duty of "loyalty."

5. Examples: Conflicting Duties

a. Duty of Spouse and Attorney/Physician

The profession of one spouse may create multiple duties owed to the other spouse. For example, if one spouse is an attorney and giving legal advice, that spouse may owe a fiduciary duty to the other that arises from the attorney-client relationship as well as a fiduciary duty that arises from the marriage. These types of "dual duties" are more apt to increase the amount of care and good faith owed by one spouse to the other, rather than create a conflict of duties.

In *Vickery v. Vickery* (reported at *Vickery v. Vickery*, 999 S.W.2d 342, 357 (Tex. 1999)), for example, the Houston Court of Appeals found the husband's role as an attorney to be significant. The appellate court observed that "to the extent that [the husband] was advising [the wife] of the legal aspects of a transaction by which he would benefit, [he] assumed the 'high duty of an attorney to his client.'" *Id*., citing *Bohn v. Bohn*, 455 S.W.2d 401, 412 (Tex.Civ.App.–Houston [1st Dist.] 1970, writ dism'd). The duty breached may have been both

one of an attorney to a client, and a spouse to the other.

In a suit brought by the wife's wrongful death beneficiaries, the San Antonio Court of Appeals failed to find a physician husband liable for the wrongful death of his wife. *See, Rampel v. Wascher*, 845 S.W.2d 918 (Tex. App.–San Antonio 1993, writ denied). In *Rampel*, the wife died near her hot tub after consuming alcohol and pills she allegedly received from her husband, an osteopath.

The plaintiffs tried to assert that a physician-patient relationship existed between the spouses, and that as an osteopath, the husband owed a fiduciary duty to the wife. The evidence at the trial court established that the husband had treated the wife for stress and anxiety, and had prescribed medications for her, including tranquilizers a day or so before her death.

However, the jury failed to find that a physician-patient relationship existed on the night of the wife's death since the husband was not acting as her physician and did not see her take any medications. He testified that whatever medications she ingested were on her own, with no input from him. He also testified that he did not give her the medication she took that night, which had actually been prescribed by the husband to himself to relieve his back pain, rather than for the wife. *Id*. at 921.

The husband's experts testified that the physician-patient relationship did not exist 24 hours a day, and that when a wife has taken her doctor-husband's personal medicine, he did not "prescribe" the medication for the wife. Thus, the jury's finding that the husband was not acting as the wife's physician the night of her death was supported by the evidence. *Id.* at 922. Under different facts, however, a totally different result might occur.

However, it should also be noted that the San Antonio appellate court further held that spouses and other family members have no legal right of action against each other arising from the failure to take affirmative action to prevent injury. *Id.* at 925. The plaintiffs asserted that a family relationship is a special relationship that imposes a duty of care on the other family members, and that the trial court committed error by refusing to submit their requested instructions that the marital contract between husband and wife, as well as the family relationship, imposed a duty of ordinary care for the other. *Id.* at 924.

The plaintiffs "sought to establish that one spouse has a duty to intervene in the other's conduct to rescue him or her from taking foolish action." *Id.* However, the San Antonio appellate court distinguished misfeasance from nonfeasance, when the law is more reluctant to impose liability for failure to act than for acting carelessly, and declined to impose upon spouses and family members an affirmative legal duty to act, which would produce a right to bring an action for money damages. *Id.*

b. Duty Owed to Spouse vs. Duty Owed to a Professional Association

In other instances, there may be created multiple duties owed by a spouse to third parties that create conflict with duties owed to the other spouse.

For example, it is well established that, as a matter of law, a non-physician cannot own an interest in a professional medical association. TEX.REV.CIV.STAT. art.1528f, §10. What happens, then, if the physician spouse grants a security interest in the professional association (such as by signing a stock trust agreement or granting an irrevocable stock power to the non-physician spouse), thereby "conveying" an interest in the professional medical association to the non-physician? Has the physician violated Texas law pertaining to professional medical associations? Is the professional medical association automatically dissolved, rendering the spouse's security interest worthless? If the association has lost its status as a professional medical association by the physician's execution of security interests in favor or his non-physician spouse, has the physician breached a duty owed to the other members of the association?

The Authors believe the answers to those questions are "yes." Whether the physician's breach to his associates is "excused" when the physician acted only on the order of the Court in executing the documents pursuant to a written decree of divorce is less clear. Should the marital status or divorce of a member of a professional association or a corporate officer alter the duties that such a person owes to third parties who are "outsiders" to the marriage?

A physician may also have written agreements with his or her professional associates/partners that govern the manner in which the professional association business matters will be conducted. It is not uncommon for such an agreement to provide for a dissolution of the professional association or for a "buy out" of the partner's interest in the event one of the members wants to convey his or her interest in the association to another person, or may restrict such a transfer.

Other agreements may allocate the manner in which the ownership interest of the individual members should be valued in the event of a divorce. There is some question concerning whether such an agreement might be considered a breach of a duty owed to a spouse, in the event the Court should uphold the agreement. For example, in *Keith,* 763 S.W.2d at 952, the Fort Worth Court of Appeals held that a spouse was not bound by a partnership agreement between the husband and his son, when the agreement provided for a formula to determine the value of the business in the event it was terminated due to the withdrawal, other act, or death of one of the partners, and was signed by the wife. Is there any "breach of loyalty" from the husband to the son by virtue of the manner in which the court

valued the partnership? Probably not in this case, but one can see how the husband's duties owed to the spouse, his partner, and his son might run afoul of each other.

c. Duty of Corporate Director Officer and Duty as Spouse

One can imagine situations in which a spouse encounters conflicting duties owed as a result of serving as an officer or director of a corporation. For example, problems such as diversion of a community opportunity to a corporation or executing restrictions on stock transfers that could defraud the spouse.

6. Diversion of Community Opportunity

In *Holloway v. Holloway*, 671 S.W.2d 51, 59-60 (Tex.App.–Dallas 1983, no writ), the wife accused the husband, as manager of the community estate, of unjustly enriching his separate estate by diverting community funds into separate corporations. Specifically, the wife argued that the husband breached a fiduciary duty owed to the community estate by using separate funds to capitalize the corporations when there were adequate funds in the community estate. *Id.* at 59.

However, the Dallas Court of Appeals refused to agree with the wife, stating that in engaging in a new and speculative venture and borrowing funds for that purpose, a married entrepreneur may well consider whether the risk is one that should properly be undertaken by himself alone without jeopardizing the assets of the community estate. *Id.* If the venture turned out to be successful, as it did in *Holloway,* the Dallas appellate court determined that the husband could not be held guilty of breach of a fiduciary duty in the absence of evidence of an intent to defraud the wife. *Id.* at 59-60.

On the one hand, *Holloway* has been criticized as contrary to the basic principles of the community property system. *See,* Donald R. Smith, *Diversion of Community Opportunity,* ADVANCED FAMILY LAW COURSE (1986). On the other, it has been suggested that the theory of "diversion of community opportunity" is meritorious, and should be investigated by the practitioner in the proper case. Cheryl L. Wilson, *Breach of Fiduciary Duty,* M-7, 16th ANNUAL MARRIAGE DISSOLUTION INSTITUTE (1993). It should be noted, however, that there appears to be no reported Texas case recognizing the diversion of community property theory.

Even so, the concept of "diversion of community opportunity" might apply appropriately to a situation in which one spouse, involved in a separate property business, diverts or channels a business opportunity into the separate business, instead of into the community. Might a reimbursement claim then be in order?

G. The Availability (or Non-Availability) of Findings of Fact on Value

Findings of fact and conclusions of law reflect the factual and legal basis for the trial court's judgment after a non-jury trial; they are often utterly essential to a successful appeal. *See, generally,* Ann C. McClure, James A. Vaught, Edwin J. (Ted) Terry, Karl E. Hays, and James LaRue, *Bottom Line Appellate Issues: Post-Rendition Motions,* 21, ULTIMATE TRIAL NOTEBOOK: FAMILY LAW (December 2000). However, there is a developing debate among Texas courts of appeals concerning what findings are actually available in the divorce context, particularly with respect to valuation issues. In *Roberts v. Roberts*, 999 S.W.2d 424 (Tex.App.–El Paso 1999, no pet.), Justice Ann McClure of the Eighth Court of Appeals addressed the controversy in some detail.

According to Justice McClure, Texas courts of appeals are not consistent in their discussions of what findings are available to an appellant, particularly in a divorce context. *Id*. at 434. Certainly, the 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. *Id.*; *see also, Coke v. Coke*, 802 S.W.2d 270, 273 (Tex.App.–Dallas 1990, writ denied) (the trial court's findings of fact and conclusions of law sufficiently disposed of the subject matter, venue, jurisdiction, parties, and issues in the case, and thus, although they were not as complete as the father desired, they were dispositive of each of the ultimate controlling issues to be decided by the trial court).

In *Roberts*, Justice McClure also noted that special problems arise in divorce appeals. *Roberts,* 999 S.W.2d at 434. In a divorce case, for example, the ultimate issue concerning property is whether the marital estate was divided in a just and right manner. *Id.*; *see also, e.g., Rafferty v. Finstad*, 903 S.W.2d 374, 376 (Tex.App.–Houston [1st Dist.] 1995, writ denied) (in matters of property division, the ultimate or controlling issue is whether the division was just and right). However, argued Justice McClure, any question that can properly be submitted to a jury should be worthy of a finding by the judge in a bench trial. *Id*. Moreover, since jury findings as to both characterization of property and valuation are binding upon the trial court, findings should be available on characterization of property and value. *Id.*; *cf.*, *Jones v. Jones*, 699 S.W.2d 583 (Tex.App.–Texarkana 1985, no writ) (the Texarkana appellate court determined that it was the husband's burden to request additional findings of fact to establish the specific valuation of the various community property assets and liabilities used by the trial court, thereby assuming that the husband was entitled to obtain findings on the values of assets).

Justice McClure asserted in *Roberts* that if conflicting evidence introduced by the parties establishes a wide range of value, it would virtually

impossible to determine the overall fairness of the eventual property division without knowing what value the trial court assigned to the asset; indeed, there would be no way to determine that the court assigned a value within that range at all. *Roberts* 999 S.W.2d at 435. Further, if the trial court is not required to state what factors it considered in dividing the property, the appellant will be left in a posture of challenging the sufficiency of the evidence as to every conceivable factor which might have been considered, a process that unduly and unnecessarily complicates the appeal and burden may be virtually impossible to overcome. *Id.*

Thus, in *Roberts*, Justice McClure stated:

> [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.

Id. at 435; *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).

Recently, *In re Marriage of 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 concerning 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*.

Despite *Roberts*, *Joseph* and *Morris*, there is substantial Texas authority holding that the trial court is not required to make specific valuation findings in divorces, as acknowledged by Justice McClure in *Roberts*. *Roberts* 999 S.W.2d at 434. In *Lettieri v. Lettieri*, 654 S.W.2d 554, 557 (Tex.App.–Fort Worth 1983, writ dism'd), for example, the Fort Worth Court of Appeals - determined that the trial court is not required to set out its theories or the legal basis upon which it grounded the division of property. Similarly, the Houston First Court of Appeals has repeatedly held that the value of specific property is not an ultimate issue, and therefore need not be set out in findings of fact. *See, e.g., Finch*, 825 S.W.2d at 221; *see also, Wallace v. Wallace*, 623 S.W.2d 723, 725 (Tex.App.–Houston [1st Dist.] 1992, no writ); *Rafferty,* 903 S.W.2d at 379 (issues such as whether the husband conveyed certain items of property, the relative earning capacities of the parties, whether the wife invested her separate property in the community residence, or whether the husband was cruel, were issues which the trial court was entitled to consider, but which were merely evidentiary and would not have determined the ultimate, controlling issue of whether the partition was 'just and right').

It should be noted that one First Court of Appeals justice, who joined in the *Finch* opinion, has now changed her mind. In *Rafferty*, 903 S.W.2d at 379 (O'Connor, J, dissenting), Justice O'Connor wrote:

> I recognize we held in *Finch* that it is not necessary for the trial court to make specific findings in a divorce on the characterization and value of the property. Even though I was a member of that panel, I now believe that decision was wrong. In a case like this, with complicated complaints regarding the separate and community assets and claims of reimbursement, it is not possible to show error without specific findings. The trial court's scant findings are of no assistance to our review.

903 S.W.2d at 379 (Citations omitted).

VI. "DIVIDING"THE COMMUNITY BUSINESS

A. 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, 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. Recall the problems engendered in *Earthman's, Inc.*, 526 S.W.2d at 196, when the wife was awarded a 21% ownership of the closely held corporation owned and controlled by the husband and his sons. 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; *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).

Another example of the difficulty in dividing a "family" business occurred in *Butler*, 975 S.W.2d at 786. In *Butler*, the husband offered his counseling services under the business name, "Alvin Counseling Service," apparently operated as a sole proprietorship. *Id*. The trial court awarded the wife 50% of the business, "...including but not limited to all furniture, fixtures, machinery, equipment, inventory, cash, accounts, goods, and supplies; all personal property used in connection with the operation of such business; and any and all rights and privileges, past, present, or future, arising out of or in connection with the operation of such business." *Id*. The trial court explained that it intended its award to mean "whatever income that counseling service receives from any source, its 50% hers, as well as the liability." *Id*.

On appeal, the Corpus Christi Court of Appeals held that the husband's income through the business after his divorce was not property acquired during marriage, and therefore was not community

property in which the wife had an interest. *Id.* On the other hand, according to the Corpus Christi appellate court, the assets of the business were acquired during marriage, and therefore those assets were properly included in the community estate. *Id.* Because the trial court erred in mischaracterizing the husband's future earnings as community property, the Corpus Christi Court of appeals remanded the property division to the trial court for further proceedings consistent with its opinion. *Id.* at 770. It is, of course, unknown how the trial court treated the husband's business on remand, but it would seem clear that the wife would not be much interested in only the meager assets of the counseling business, as opposed to its future earnings.

B. Equalizing Money Judgment

1. 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.* However, 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.*

2. 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.

C. 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 v. Rusk*, 5 S.W.3d 299, 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 section 64.001 to marriage dissolution cases; rather, Texas courts have held that section 7.001 of the Family Code governs. *Id.*; *see also, Vannerson*, 857 S.W.2d at 673 (holding that section 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 section 64.001 does not govern the appointment of a receiver over property when it is divided upon divorce, but rather section 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 section 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).

VII. CONCLUSION

Frequently, a fair divorce involving a community business will require an accurate valuation of that business. This paper has attempted to present the underlying methodologies of responsible and accurate valuation techniques and principles in an intelligible fashion, in the hopes that the Texas practitioner may better achieve fair results in divorce litigation involving the community business.