DIVISION OF CLOSELY HELD BUSINESS INTERESTS

DIANA S. FRIEDMAN
ANDREW J. ANDERSON
Diana S. Friedman, P.C.
2301 Cedar Springs Road
Suite 330
Dallas, Texas 75201

State Bar of Texas
NEW FRONTIERS IN MARITAL PROPERTY LAW
October 20-21, 2005
Scottsdale, AZ

CHAPTER 4.1

TABLE OF CONTENTS

I. INTRODUCTION ... 1

II. GENERAL CHARACTERIZATION OF THE ENTITY ... 1
A. Basic Rules ... 1
B. General Characterization Rules For Corporations ... 1
1. Inception Of Title Before Marriage ... 1
2. Capital Contributions If Made During Marriage—Trace It ... 1
3. Gift, Devise Or Descent Is Separate Property ... 2
4. Separate Property Remains Separate Property Upon Dissolution ... 2
5. Marital Property Agreements May Alter Characterization Analysis ... 2
C. General Characterization Rules For Partnerships--Generally The Same As Corporations ... 2
D. Characterization of Sole Proprietorship ... 2
E. Property Undistributed By The Entity Cannot Be Characterized By The Divorce Court ... 2
1. Entity Theory for Corporations ... 2
2. Entity Theory for Partnerships ... 3
3. One Major Exception To Entity Theory ... 3

III. CHALLENGING THE VALIDITY OF A CLOSELY HELD SEPARATE PROPERTY ENTITY ... 3
A. Alter Ego Defined ... 3
B. Factual Elements Needed To Disregard The Corporate Fiction ... 4
C. Reverse Pierce Defined And Requirements In Divorce Cases ... 4
D. Was There Harm Caused By Misuse of Corporate Entity? ... 4
E. Calculation of Relief ... 6
F. Alter Ego And The Reverse Pierce In A Partnership? ... 6
G. Practical Considerations If A Reverse Pierce Is Possible ... 6
1. Representing the Non-Owner Spouse ... 6
2. Representing the Owner Spouse ... 6

IV. DISTRIBUTIONS AND LIQUIDATIONS ... 7
A. Undistributed Entity Property Is Not Property of the Marital Estate ... 7
B. What Are Distributions And Dividends? ... 7
1. Dividend Defined ... 7
2. Distributions Defined ... 7
3. How Dividends and Distributions Are Paid ... 7
4. Types and Characterization ... 7
C. Accounting Issues ... 8
D. Tax Issues ... 8
1. C Corporations ... 8
2. S Corporations ... 8
3. Partnerships ... 9
E. Redemptions ... 9
1. Defined And When Used ... 9
2. Tax Issues Redeeming Stock ... 9
3. Who Pays Uncle Sam After A 1041 Transfer? ... 10
F. Liquidations ... 10

V. TRANSFER RESTRICTIONS ... 11
A. Transfer Restrictions On Closely-Held Texas Entities ... 11
1. Controlling Entity Documents As Possible Vehicles For Predicting Division Upon Divorce ... 11
2. The Binding Effect Of Buy-Sell Agreements And Other Controlling Documents ... 13

VI. CONCLUSION ... 16

VII. ACKNOWLEDGMENT ... 16

DIVISION OF CLOSELY HELD BUSINESS INTERESTS

I. INTRODUCTION

Ownership of closely held entities can create difficult issues during divorce. This article explores the basic characterization of these entities, alter ego (and the reverse pierce), as well as restrictions on transferring ownership of these entities to a spouse.

II. GENERAL CHARACTERIZATION OF THE ENTITY

A. Basic Rules

The Texas Constitution defines separate property as all property of a spouse owned or claimed before marriage, or property acquired during the marriage by gift, devise, or descent. TEX. CONST. art. XVI, §15. Community property is defined as all property, other than separate property, which is acquired by either spouse during the marriage. TEX. FAM. CODE ANN. §3.002 (Vernon 1997); *see also* Arnold v. Leonard, 273 S.W. 799 (Tex. 1925). In Texas law, there is a presumption that all property acquired during the marriage is community property, and subject to a just and right division. TEX. FAM. CODE ANN. §3.003(a) & §7.001 (Vernon 1997). This presumption, in favor of community property, can only be rebutted by clear and convincing evidence. TEX. FAM. CODE ANN. 3.003(b) (Vernon 1997); *see also* Evans v. Evans, 14 S.W.3d 343, 346 (Tex. App.—Houston [14th Dist.] 2000, no pet).

B. General Characterization Rules For Corporations

1. Inception Of Title Before Marriage

One way to determine if marital property is separate or community is to analyze it from the inception of title. Parnell v. Parnell, 811 S.W.2d 267, 269 (Tex. App.—Houston [14th Dist.] 1991, no writ). Inception of title is defined as when a spouse first has the right of claim to the property by virtue of the title being finally vested in the property. Strong v. Garrett, 148 Tex. 265, 271, 224 S.W.2d 471, 474 (1949).

Texas courts have held that a corporation does not exist until there is an issuance of a Certificate of Incorporation from the Secretary of State. Allen v. Allen, 704 S.W.2d 600, 604 (Tex. App.—Fort Worth 1986, no writ). Therefore, the inception of title doctrine can only be applied to a corporation after the corporation is created. Id. Therefore, if a spouse receives interest or stock ownership prior to the marriage, the inception of title doctrine would characterize those specific stock certificates as the separate property of the owner spouse. Horlock v. Horlock, 533 S.W.2d 52, 60 (Tex. Civ. App.—Houston [14th Dist.] 1975, writ dism'd); *see also*, Hillard v. Hillard, 725 S.W.2d 722, 23 (Tex. App.—Dallas 1985, no writ).

2. Capital Contributions If Made During Marriage—Trace It

If the owner spouse invests more capital in exchange for new shares of stock in the corporation, the new shares are presumed to be community property. TEX. FAM. CODE ANN. §3.003 (Vernon 1997). This presumption may be overcome if the owner spouse can trace by clear and convincing evidence that the funds used to purchase the new stock originated from an account wherein only the owner spouse's separate property was kept. *See* Norris v. Vaughan, 260 S.W.2d 676 (Tex. 1953). Under Texas law, separate property retains its separate property characterization through a series of exchanges so long as the owner spouse can trace the separate property assets through each exchange. *See* Cockerham v. Cockerham, 527 S.W.2d 162, 167 (Tex. 1975).

Therefore, in order to establish the separate character of the specific stock in question, the owner spouse has a duty to trace by clear and convincing evidence that her separate property (generally cash) was exchanged for a certain amount of stock, which has been held by the owner spouse since it was issued. Vallone v. Vallone, 618 S.W.2d 820, 822-23, (Tex. Civ. App.—Houston [1st Dist] 1981), *rev'd on other grounds*, 644 S.W.2d 455, 460 (Tex. 1982). The owner spouse's tracing will generally be sufficient if she can prove that the funds came from her separately held account which was not commingled with community property during the marriage. Trawick v. Trawick, 671 S.W.2d 105, 112 (Tex. App.—El Paso 1984, no writ). If the owner spouse proves this then the purchased stock will remain her separate property.

Generally, separate property retains its characterization and remains unaltered by the sale, mutation, exchange or substation of that separate property. Gleich v. Bongio, 128 Tex. 606, 99 S.W.2d 881 (1937). Further, separate property interests in business entities retain their characterization even upon liquidation or dissolution of the entity during marriage. *See* Marshall v. Marshall, 735 S.W.2d 587 (Tex. App.—Dallas 1987, writ ref'd n.r.e.). For example, if a corporation buys another business entity which a spouse owns separate property shares of, then as a matter of law, the stock acquired as a result of the merger will remain the separate property of the owner spouse. Horlock v. Horlock, 533 S.W.2d 52 (Tex. Civ. App.—Houston [1st Dist.] 1976, writ dism'd). This is true even if the merger took place during the marriage. Horlock, 533 S.W.2d at 60. Furthermore, when separate property stock is swapped or exchanged during the marriage, it continues to retain its separate property characterization. Farish v. Farish, 982 S.W.2d 623, 629 (Tex. App.—Houston [1st Dist.]

1998, no pet.). A final example of separate property retaining its characterization would be when new stock is received due to a split of separate property stock. Halbert v. Halbert, 794 S.W.2d 535, 536 (Tex. App.—Tyler 1990, no writ).

3. Gift, Devise Or Descent Is Separate Property

Property which is acquired during the marriage by a spouse through gift, devise or descent is that spouse's separate property. TEX. FAM. CODE ANN. §3.001 (Vernon 1997). However, a joint gift to both spouses is not community property, but instead each spouse obtains a one-half undivided separate property interest in the gift. Dutton v. Dutton, 18 S.W.3d 849, 852 (Tex. App.—Eastland 2000, pet. denied). In order for a court to find the existence of a gift, there must be proof of donative intent, delivery, and acceptance. Powell v. Powell, 822 S.W.2d 181, 183 (Tex. App.—Houston [1st Dist.] 1991, writ denied). During the inquiry, courts specifically analyze whether there was a relinquishment of dominion and control by the donor. Gannon v. Baker, 830 S.W.2d 706, 710 (Tex. App.—Houston [1st Dist.] 1992, writ denied). Finally, once stock is proved to be actually gifted to the spouse, it becomes that spouse's separate property. Powell, 822 S.W.2d at 183; Rusk v. Rusk, 5 S.W.3d 299, 303-305 (Tex. App.—Houston [14th Dist.] 1999, pet. denied).

4. Separate Property Remains Separate Property Upon Dissolution

When a separate property entity is liquidated during the marriage, all separate property assets remain the separate property of the owner spouse. Hillard v. Hillard, 725 S.W.2d 722, 723 (Tex. App.—Dallas 1985 no writ). This is true so long as the owner spouse can rebut the community property presumption by showing that the money received was for the dissolution of the separate property entity. Hillard, 725 S.W.2d at 723.

5. Marital Property Agreements May Alter Characterization Analysis

The practitioner needs to inquire as to the existence of a marital property agreement and/or premarital agreement. If the agreement is valid, it may change the characterization of the entity and/or the stock held. Further, the practitioner should also inquire into the existence of any agreements used in forming the entity to see if there is a specific provision that could alter the characterization analysis.

C. General Characterization Rules For Partnerships--Generally The Same As Corporations

Like corporations, partnerships can also be characterized with the inception of title theory. *See* In the Marriage of Higley, 575 S.W.2d 432 (Tex. Civ. App.—Amarillo 1978, no writ). However, any partnership entered into during the agreement falls prey to the presumption that all property is presumed to be community property. TEX. FAM. CODE ANN. §3.003(a) (Vernon 1997); Lumpkins v. Lumpkins, 519 S.W.2d 491, 494 (Tex. Civ. App.—Austin 1975, writ ref'd n.r.e.)(Justice Phillips dissenting); York v. York, 678 S.W.2d 110, 112 (Tex. App.—El Paso 1984, writ ref'd n.r.e.).

Generally, other tracing concepts applicable to corporations have been successfully applied to partnerships. For example, the rule that mutations of separate property remain the separate property of the owner spouse, also apply to partnerships. *See* Harris v. Harris, 765 S.W.2d 798, 802-03 (Tex. App.—Houston [1st Dist.] 1989, writ denied). However, the practitioner must scrutinize the facts to determine if any additional interests in the partnership were received by the owner spouse during the marriage. If there were newly acquired interests, they could presumably be community in nature.

D. Characterization of Sole Proprietorship

A sole proprietorship, or a business venture that has not been incorporated, would presumptively be community property if created during the marriage. Butler v. Butler, 975 S.W.2d 765, 68 (Tex. App.—Corpus Christi 1998, no pet.). However, the value of inventory or stock of the sole proprietorship if owned prior to the marriage would retain its separate property characterization if adequately traced. Schmidt v. Huppman, 73 Tex. 112, 11 S.W. 175, 176 (Tex. 1889); Schecter v. Schecter, 579 S.W.2d 502, 505 (Tex. Civ. App.—Dallas 1978, no writ).

E. Property Undistributed By The Entity Cannot Be Characterized By The Divorce Court

1. Entity Theory for Corporations

The family practitioner should not lose sight that property held by the corporation is the property of that specific entity and it is not the owner spouse's property. In other words, one should not attempt to characterize property held solely by the corporation, which has not been distributed to the owner. Therefore, undistributed corporate earnings remain that corporation's property until they are distributed. Snider v. Snider, 613 S.W.2d 8, 12 (Tex. App.—Dallas 1981, no writ); Cleaver v. Cleaver, 935 S.W.2d 491, 494 (Tex. App.—Tyler 1996, no writ). In fact, this rule is so engrained in Texas jurisprudence that the only way specific corporate assets may be awarded to the non-owner spouse is if that spouse proves an alter ego theory, which is more fully discussed below. *See* Siefkas v. Siefkas, 902 S.W.2d 72, 79 (Tex. App.—El Paso 1995, no writ).

2. Entity Theory for Partnerships

Generally, Texas partnerships are considered an entity like corporations. This was not always the case as Texas originally subscribed to the aggregate theory, but now the entity theory for partnerships is Texas law. Marshall v. Marshall, 735 S.W.2d 587 (Tex. App.—Dallas 1987, writ ref'd n.r.e.). Therefore, the only property that is subject to being characterized is that partner's specific ownership interest in the partnership and not the specific undistributed property or income owned by the partnership. McKnight v. McKinght, 543 S.W.2d 863 (Tex. 1976); Farley v. Farley, 930 S.W.2d 208 (Tex. App.—Eastland 1996, no writ). Therefore, a trial court may not award specific partnership assets to the non-owner spouse in the event of a divorce. Instead, the trial court may only award to a non-owner spouse the interest in the partnership held by the owner spouse. Lifshutz v. Lifshutz, 61 S.W.3d 511, 518 (Tex. App.—San Antonio 2001, pet. denied). Further, as discussed below, alter ego theories have been unsuccessful due to this premise. Id.

3. One Major Exception To Entity Theory

There is one major exception to the general rule that specific property owned by the corporation is not subject to characterization or award by the trial court. This exception is if the court finds that the corporation was the alter-ego of the owner spouse, and a reverse pierce is necessary to protect the community estate. Siefkas v. Siefkas, 902 S.W.2d 72, 79 (Tex. App.—El Paso 1995, no writ). Which is discussed in greater detail below.

III. CHALLENGING THE VALIDITY OF A CLOSELY HELD SEPARATE PROPERTY ENTITY

A. Alter Ego Defined

There are many different theories for the practitioner to utilize in attempting to obtain benefits from an opponent's separate property business. Specifically, practitioners have used the economic contribution theory[1] (which has been recently revised in the Texas Family Code), fraud, breach of fiduciary duties, waste, alter ego and reimbursement claims (such as defined in *Jensen*[2] and its progeny). The full discussion of all of these topics could only be adequately covered in several volumes. Therefore, this article will only explore alter ego, and the reverse pierce theory, in the context of family law.

Alter ego is an equitable claim that was first created in corporate law. *Ballantine,* CORPORATIONS §123 at 294 (1946). In corporate law, the alter ego theory was used to enforce an obligation of the entity by holding shareholders personally liable for that contractual obligation. *Hamilton,* CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES, 6th Ed. pg. 256 (1998). It commonly led to the "piercing of the corporate veil" because the court held the shareholders personally liable for the entity's obligation. Id. This equitable theory was used to defeat the purpose of incorporating which was to avoid personal liability as to the corporation's obligations. Id. Since the liability flowed from the corporation to the individual shareholder, the corporate protections, or veil was pierced. Id.

Alter ego became traditionally known as unity between the individual and the corporation such that the separateness of the corporation had ceased to exist. *Ballantine,* CORPORATIONS §123 at 294 (1946). Unfortunately, many jurisdictions have blended alter ego and other claims for disregarding the corporate entity which has led to a massive expansion of the definition of "alter ego." *See* William B. Roberts, Inc. v. McDrilling Corp., 579 S.W.2d 335 (Tex. Civ. App.—Corpus Christi 1997, writ n're). According to the Texas Supreme Court in Castleberry, evidence of alter ego is based on the totality of circumstances from all dealings of the corporation with the owner. Castleberry v. Branscum, 721 S.W.2d 270, 271 (Tex. 1986). The Castleberry factors included: (1) to what degree the corporate formalities were followed;[3] (2) whether corporate and individual property have been kept separately; (3) the amount of ownership and control the owner maintained over the corporation; and (4) whether the corporation had been used for personal purposes. Castleberry v. Branscum, 721 S.W.2d 270, 271 (Tex. 1986)(*quoting* Lucas v. Texas Industries, Inc., 696 S.W.2d 372, 374 (Tex. 1984)).

Finally, to prevail with an alter ego theory, the non-owner spouse must not have taken part in the disregarding of the corporate entity, nor should the non-owner have been personally enriched at the determinant of other stockholders. *See* Southwest Livestock Trucking Co. v. Dooley, 884 S.W.2d 805

---

[1] TEX. FAM. CODE ANN. §3.401 -- §3.403 (Vernon 2001).

[2] Jensen v. Jensen, 665 S.W.2d 107 (Tex. 1984).

[3] Castleberry was "overturned" (or more correctly fine-tuned) by the Texas Legislature with the enactments of the TEX. BUS. CORP. ACT Art. 2.21§ (A)(3). This statute provided that a shareholder shall not be held liable for any obligation if the corporation fails to observe any corporate formality. TEX. BUS. CORP. ACT Art. 2.21(A)(3) (Vernon 1989). Further, the Texas Supreme Court's ruling was also altered in that actual fraud was necessary to prevail on an alter ego theory based on contract claims. Sims v. Western Waste Indus., 918 S.W.2d 682, 684 (Tex. App.—Beaumont 1996, writ denied). While academically Castleberry is overturned, it is arguable (and probable) that the enactment by the Legislature does not apply to tort claims or claims involving a reverse pierce which is the form commonly used in divorce cases.

(Tex. App.—San Antonio 1994, writ denied). This makes sense when one recalls that the alter ego theory is based in equity.

B. Factual Elements Needed To Disregard The Corporate Fiction

Alter ego has substantially evolved from its roots in corporate law. One of the major cases that helped to quantify and develop alter ego was the Castleberry case, as mentioned above.[4] According to the Castleberry court, a court can utilize six primary factual elements in determining whether it should disregard the corporate fiction. This is true even if the corporate formalities have been observed, and the entity's property was not commingled with the owner's individual property. Castleberry, 721 S.W.2d. at 272. The reason behind this theory is to avoid allowing the corporate form to foster an inequitable result. Id. While not all of these fact types may be present, they give the practitioner an idea of what is necessary. The elements are as follows:

1. When the fiction is used as a means of perpetrating fraud;
2. Where a corporation is organized and operated as a mere tool or business conduit of another corporation;
3. Where the corporate fiction is used as a means of evading an existing legal obligation;
4. Where the corporate fiction is employed to achieve or perpetuate a monopoly;
5. Where the corporate fiction is used to circumvent a statute; and
6. Where the corporate fiction is relied upon for protection against a crime or to justify a wrong. Castleberry v. Branscum, 721 S.W.2d 270, 272 (Tex. 1986).

Based on the above Castleberry case, alter ego is only one method for a court to disregard the corporate fiction. Id. Therefore, it becomes clear that "alter ego" is not a synonym for the entire doctrine of disregarding the corporate fiction. Id.

C. Reverse Pierce Defined And Requirements In Divorce Cases

Initially, in the corporate context, a reverse pierce required a finding that the owner's alter ego of the corporation was used to avoid preexisting personal liabilities. Zahra Spiritual Trust v. U.S., 910 F.d. 240, 244 (5th Cir. 1990). Since the owner's assets were in the corporation, they were exempt from collection by the holders of defaulted personal guarantees. Therefore, taking those exempt assets out of the corporation to satisfy the personal guarantees was the only equitable solution.

In some circumstances, the principles of alter ego and piercing the corporate veil have been applied to divorce cases in what is described as a "reverse piercing." *Ballantine,* CORPORATIONS §123 at 294 (1946); Lifshutz v. Lifshutz, 61 S.W.3d 511, 516-17 (Tex. App.—San Antonio 2001, pet. denied)(applying reverse pierce to divorce case). In a divorce case, piercing the corporate veil allows the court to characterize the corporate assets as community, when in reality the corporate assets belong to the corporation which is the separate property of the owner spouse. Since all of the assets of the corporation are now available for a just and right division, the court has "reverse pierced" the entity's protections. While family practitioners traditionally refer to the process as "alter ego," the correct term for the process of having a court artificially hold the separate property entity as community is a "reverse pierce." A finding of alter ego is only the first step in the process of proving a reverse pierce.

The actual reverse piercing theory allows the trial court to move assets out of the corporation and divide them between the spouses as part of the shareholder's community estate. This theory of relief is only viable if the court finds that: (1) the unity between the separate property corporation and the spouse is such that the separateness of the corporation has ceased to exist; and (2) the owner spouse's improper use of the corporation has damaged the community estate beyond that which might be remedied by a claim for reimbursement. Vallone v. Vallone, 644 S.W.2d 455, 58 (Tex. 1982). Therefore, it appears that these are currently the elements necessary to obtain a reverse pierce in a marital dissolution case. Zisblatt v. Zisblatt, 693 S.W.2d 944 (Tex. App.—Fort Worth 1985, writ dismissed); Young v. Young, 168 S.W.3d 276 (Tex. App.—Dallas 2005, n.w.h.).

D. Was There Harm Caused By Misuse of Corporate Entity?

The final step in the analysis is to prove that harm was caused to the community estate. This last prong has offered many specific interpretation problems since this theory of recovery was taken from corporate law. Specifically, harm caused to a commercial entity, is

---

[4] It should be noted that the Texas Supreme Court held in 1986, "we disregard the corporate fiction, even when corporate formalities have been observed and corporate and individual property have been kept separately, when the corporate form has been used as part of a basically unfair device to achieve an inequitable result." Castleberry v. Branscum, 721 S.W.2d 270, 271 (Tex. 1986)(*emphasis added*);(*referring to* Bell Oil & Gas v. Allied Chem. Corp., 431 S.W.2d 336, 340 (Tex. 1968)). To-date, it appears that the unfair device sub-theory has never been applied in a family law case.

generally different then harm caused to the martial estate in a divorce case. Generally, harm caused in the commercial arena is that the corporation has been undercapitalized. *See* Roy E. Thomas Const. Co. v. Arbs, 692 S.W.2d 926 (Tex. Civ. App.—Fort Worth 1985, no writ). Whereas, in the family arena generally the separate property corporation has been overcapitalized. However, with an increasing amount of case law coming from our divorce courts, the theory as applied to martial property is starting to become more certain.

One of the more recent martial property cases which has helped to quantify the type of harm necessary is the Lifshutz case. Lifshutz v. Lifshutz, 61 S.W.3d 511 (Tex. App.—San Antonio 2001, pet. denied). In the Lifshutz case, the Court of Appeals stated that the harm to the community estate must be more then what could be remedied by a claim for reimbursement. Again, the reverse pierce is tied to an equity analysis:

> [T]o properly pierce in a divorce case, the trial court must find something more than mere dominance of the corporation by the spouse.[3] At the least, a finding of alter ego sufficient to justify piercing in the divorce context requires the trial court to find: (1) unity between the separate property corporation and the spouse such that the separateness of the corporation has ceased to exist, and **(2)** ***the spouse's improper use of the corporation damaged the community estate beyond that which might be remedied by a claim for reimbursement.***
>
> Footnote 3. *See* Goetz v. Goetz, 567 S.W.2d 892, 896 (Tex. App.—Dallas 1976, no writ) (***wife not entitled to award of separate property corporate assets even though husband was sole shareholder and committed some improprieties, where husband's improper use of corporation did not damage community estate***). In the case before this court, the trial court held the proponent of alter ego need not show intent or fraud, only that an inequitable result will occur if piercing is not applied. We hold this statement is overbroad and misleading. It may be true the evidence need not show intent to defraud, but the inequity that justifies "reverse piercing" in a divorce case must stem from an improper transfer of community assets to the corporation. Lifshutz, 61 S.W.3d at 517 *(emphasis added).*

In the Spruill case, the El Paso Court of Appeals found sufficient harm to make a finding of alter ego. Spruill v. Spruill, 624 S.W.2d 696 (Tex. Civ. App.—El Paso 1981, writ dism'd). The husband in that case paid all of the family bills out of the separate property corporation of which he owned 48%. However, prior to divorce the business took an unexpected "downturn" and the husband signed many promissory notes (secured by his 48% ownership in the corporation) to the only other shareholder. Soon the community estate lost the house, cars, and every other conceivable community asset, due to the "downturn" in business. Nevertheless, the husband was still retained by the corporation as the president of the company. At this time, the other shareholder now owned all of the stock that was pledged when the husband defaulted on the loans. At the time of the divorce, the court had no community property to divide, and so the court awarded the wife all of the husband's shares of the corporation (if any were still in existence).[5] Clearly, this case illustrates the possible extent of harm necessary in a reverse pierce case. However, other cases may help the practitioner further define the harm necessary.

In the Zisblatt divorce case, the court again found an alter ego and allowed a reverse pierce. Zisblatt v. Zisblatt, 693 S.W.2d 944 (Tex. App.—Fort Worth 1985, writ dism'd). The harm that was perpetrated against the martial estate was that Mrs. Zisblatt basically owned nothing, and Mr. Zisblatt had placed every community asset (including all of his salary) into his separate property corporation. Since all the assets were placed within the corporation, the community estate was severely harmed. The court used an alter ego theory to make the marital property division more equitable. While the case is somewhat conclusory, this is another example of the harm necessary.

In the most recent case in Texas dealing with the alter ego theory, the Dallas Court of Appeals found that the husband caused harm to the community estate. Young v. Young, 168 S.W.3d 276 (Tex. App.—Dallas 2005, n.w.h.).[6] Specifically, the husband left all of his income in the corporate account, paid daycare (for a child from a prior marriage) and other expenses (such as car and house payments) from the corporate

---

[5] Interestingly, one might have argued that instead of awarding the interest in the corporation, the court should award specific corporate property. However, it is possible that the court could not do so because the husband no longer owned any corporate stock, or possibly the corporation was not joined as a third party to the divorce action.

[6] It should be noted that this case as currently drafted (it is presently subject to revision at the time this paper was written), did not include any facts for whether the husband was the only shareholder.

accounts. Id. Further, even though the husband and wife purchased a house together, it was placed in the corporation's name. The court specifically held that the corporation was the alter ego of the husband, and that a reverse pierce was necessary for the purpose of an equitable distribution.

E. Calculation of Relief

After piercing the corporate veil, there are three distinct ways for calculating and obtaining relief. First, the court could calculate the cash flow of the business. This theory analyzes whether the corporation is able to pay dividends, and if so how much should be paid. This method has difficulties in that dividends (as discussed below) come in all forms and can be contingent on many things. Further, just because the corporation has the money to pay dividends does not necessarily mean that it needs to be forced to pay them. This could be especially true if there are innocent shareholders involved.

The second way to calculate relief is by determining how much the value of the corporation has been enhanced. This is done by analyzing the capital gains of the owner spouse's share in the corporation. This theory requires the court to calculate both the beginning and the end value of the corporation as to the owner spouse's shares. This is a fruitful battleground for experts. Obviously, this theory requires ample speculation and uncertainty.

Another possible theory of calculating relief is to review each piece of tangible property owned by the corporation to see if it has increased in value. Since the reverse pierce has been perfected, the corporation does not legally exist. Thus, it may be possible to argue that the relief should be in the amount of all increases in that property from the date of marriage. A possible hybrid of this theory (or middle ground for a court unwilling to pierce too far) would be to analyze what property clearly would have been community if it was not placed in the corporation. *See* Zisblatt v. Zisblatt, 693 S.W.2d 944 (Tex. App.—Fort Worth 1985, writ dism'd). This may include the owner-spouse's earnings, homes bought by the corporation, etc. In those situations, it may be possible that the specific item should be awarded to the non-owner spouse. Finally, even if the property would not have been community, the non-owner spouse may want to be awarded the actual piece of property from the corporation such as a car, tractor, or computer.

Again, this area is filled with speculation and it will probably boil down to a battle of the experts over arguments much akin to valuation disputes. The difficult part about a reverse pierce case is that a practitioner cannot be certain as to what will actually be obtained if one is successful. This makes it exceedingly difficult for the practitioner to advise his client how hard to actually pursue this type of claim.

F. Alter Ego And The Reverse Pierce In A Partnership?

At least one Texas case has stopped a trial court from applying the reverse pierce theory to a separate property partnership. Lifshutz v. Lifshutz, 61 S.W.3d 511, 518 (Tex. App.—San Antonio 2001, pet. denied). Specifically, that court relied upon the "legislative intent" that a non-owner spouse has no community property right in partnership property. Id. However, this holding is somewhat conclusory in nature in that no specific rationale was given as to why partnerships cannot be pierced. Id. This is especially true now since corporate formalities (as explained above) are not necessary in some circumstances. The authors believe that the application of the reverse pierce to partnerships has not fully been litigated, or explained by the appellate courts.

G. Practical Considerations If A Reverse Pierce Is Possible

1. Representing the Non-Owner Spouse

As soon as you discover that you have a possible reverse pierce case, you will discover that there is a plethora of work necessary for you to even assert your claim. First, you will want to file an amended pleading bringing in the business entity as a third party. Lifshutz, 61 S.W.3d 511; 11 WILLIAM V. DORSANEO III, TEXAS LITIGATION GUIDE §165.100 (Feb. 2005)(form for joining of third parties entities and pleading alter ego). Texas Rules of Civil Procedure 37 through 41, will also be of interest to the practitioner as there are specific timelines for joining third parities. The practitioner should also consider propounding discovery, including depositions, to develop your theory. It is prudent to also retain an expert witness so that you can understand all of the transactions in question and any tax consequences. Finally, do not forget the possible use of summary judgments to narrow the issues of alter ego and the reverse pierce. TEX. R. CIV. P. 166a.

2. Representing the Owner Spouse

If an alter ego or reverse pierce theory has been asserted against your client, remember to scrutinize the third-party joinder rules and recommend a corporate attorney for your client's business entity. TEX. R. CIV. P. 37 – 41. Further, it may be possible to use a no-evidence summary judgment against the non-owner spouse to prove to the court that the discovery in the case has provided no evidence of alter ego. TEX. R. CIV. P. 166a. Finally, consider using Texas Rule of Civil Procedure 143 to force the non-owner spouse seeking relief to give security for the costs. This along with a request for sanctions and/or attorney fees may dissuade the opposing side from pursuing this theory. TEX. R. CIV. P. 13.

IV. DISTRIBUTIONS AND LIQUIDATIONS

A. Undistributed Entity Property Is Not Property of the Marital Estate

The term "distributions" denotes compensation paid to the entity's owners. At the time the owner receives the compensation, it becomes an asset that the courts need to award in a just and right division. As stated above, courts have long held that *undistributed* income from a business entity is neither community, nor separate property, as the income is still considered to be an asset of the business entity. Thomas v. Thomas, 738 S.W.2d 342 (Tex. App.--Houston [1st Dist.] 1987, writ denied)(discussing retained earnings of Subchapter S Corporations); Snider v. Snider, 613 S.W.2d 8 (Tex. Civ. App. -- Dallas 1981, no writ)(accumulations of surplus are not subject to community claims); Marshall v. Marshall, 735 S.W.2d 587 (Tex. App. -- Dallas 1987, writ ref'd n.r.e)(holding partnership property was owned by the partnership and not the individual partners). Therefore, since no marital estate has realized the (undistributed) property of the entity, it cannot be divided in the divorce case absent alter ego and a reverse pierce. However, when distributions are paid by the entity, then the martial estates realize the distribution and that specific property is now ripe for the characterization.

B. What Are Distributions And Dividends?

Generally, earnings of spouses, employee benefits, retirement accounts, life insurance premiums paid by the employer, disability benefits, and workers compensation are presumed to be community property. Herring v. Blakeley, 385 S.W.2d 843 (Tex. 1965). However, other forms of compensation, or disbursements, received by a spouse from a separate property entity are more difficult to characterize. These disbursements will be discussed in more depth below. Nevertheless, the first step in analyzing the characterization of a disbursement is to know the characterization of the entity that made the disbursement.

1. Dividend Defined

The main purpose of a corporation is to make profits for the owners and to pay them to the owners. Patton v. Nicholas, 154 Tex. 385, 279 S.W.2d 848, 855 (1955). The dividend is the vehicle for achieving this purpose. Interestingly, "dividend" is not defined in the Business Corporation Act. However, it is generally understood to be a distribution to shareholders of their respective portions of the corporate profits, or the return on their investment in the corporation. BLACK'S LAW DICTIONARY 478 (6th ed. 1990). Dividends are generally paid by corporations and not by partnerships. Further, assuming the corporation is actually keeping good accounting records, dividends should be reflected on the entity's accounting ledgers which will be discussed below. If good records are kept, this information can be used to calculate relief in a reverse pierce case as well as helping to ascertain the actual value of the interest owned by the owner spouse.

2. Distributions Defined

Unlike "dividend", the Business Corporation Act has defined "distribution."

> Distribution means a transfer of money or other property (except its own shares or rights to acquire its own shares), or issuance of indebtedness, by a corporation to its shareholders in the form of: (a) a dividend on any class or series of the corporation's outstanding shares; (b) a purchase, redemption, or other acquisition by the corporation, directly or indirectly, of any of its own shares; or (c) a payment by the corporation in liquidation of all or a portion of its assets. TEX. BUS. CORP. ACT, art. 1.02 §A(13) (Vernon 1997).

Further, due to the specific language of the Code, partnerships cannot make distributions.

3. How Dividends and Distributions Are Paid

Owner's rights to a dividend arise through a declaration of the dividend by the board of directors. Usually, the board of directors authorizes and sets a date for the payment as a part of its action declaring the dividend. After the creation of the dividend, or the right for the owners to receive the dividend, a debtor/creditor relationship between the entity and the owner(s). *See* Keller v. Keller, 135 Tex. 260, 141 S.W.2d 308, 311 (1940).

4. Types and Characterization

Dividends also can take many different forms. For example, the entity could distribute cash dividends, dividends of the entity's property, dividends of additional shares of stock, and/or liquidation dividends (created when the entity decides to reduce its operations or completely withdraw from the marketplace). *Philip E. Fess and Carl S. Warren*, ACCOUNTING PRINCIPLES pg. 569-70 (14th ed. 1193).

Generally, cash dividends or income generated by the owner spouse's shares is characterized as community property. Bakken v. Bakken, 503 S.W.2d 315 (Tex. Civ. App. -- Dallas 1973, no writ). This is true even if the business entity is the separate property of the owner spouse. Whereas, stock dividends, stock splits, and new stock from a merger based on separate stock holdings are characterized as (keeping their) separate property characterization. Horlock v. Horlock, 533 S.W.2d 52 (Tex. Civ. App. -- Houston

[14th Dist.] 1976, writ dism'd w.o.j.); Wohlenberg v. Wohlenberg, 485 S.W.2d 342 (Tex. Civ. App.—El Paso 1972, no writ); Tirado v. Tirado, 357 S.W.2d 468, 473 (Tex. Civ. App.—Texarkana 1962, writ dism'd). Finally, liquidating cash dividends also retain their separate property characterization if the business interest was separate. Horlock v. Horlock, 533 S.W.2d 52 (Tex. Civ. App.—Houston [14th Dist.] 1976, writ dism'd w.o.j.).

C. Accounting Issues

To fully recognize a dividend when one is made, the inquiring practitioner should look at the corporate books. For accounting purposes, dividends are recorded with a credit to the account representing the item distributed to the shareholder, along with a corresponding debit. *Philip E. Fess and Carl S. Warren*, ACCOUNTING PRINCIPLES pg. 570 (14th ed. 1993). For example, if a dividend was paid from cash there would be a credit to the "cash account" and a debit to the "retained earnings" account on the corporation's balance sheet. Id.

There are three important dates regarding the accounting of dividends. First, the "date of the declaration," which is when the dividend was actually declared by the board of directors. Id. On this date, the entity's balance sheet reflects a liability, as this date is when the liability was incurred by the entity. Id. The second noteworthy date is the "date of the recording." This is defined as when the entity determines who owns what portion of the entity so that the dividend can be properly paid. Id. No accounting entries are made at this time. Id. The final date is the "date of payment" which is when the dividend is actually paid to the owners. Id. In situations where the entity disburses cash or property dividends, the declaration date is vital because generally contractual liability is established on the date when the dividend is "declared." Id.

Dates of reference are different for stock dividends. Specifically, in the case of stock dividends, the important date is when the stock dividends *are actually paid*, as the entity could always change their position and decide not issue the stock dividends. Id. In other words, the owner does not really realize a stock dividend until it is actually in his hands.

D. Tax Issues

Accounting principles when combined with tax law may assist the practitioner in interpreting when there is actually a dividend. The Internal Revenue Service defines a "dividend" as a distribution out of either the corporation's current or accumulated earnings and/or profits. I.R.C. §316. Any person or entity that receives dividends will typically receive a 1099-Div or a Schedule K-1 form evidencing it. *Philip E. Fess and Carl S. Warren*, ACCOUNTING PRINCIPLES pg. 571 (14th ed. 1993). The treatment of the receipt of income depends on the amount of the corporation's earnings and/or profits. Id. If the distribution is equal to or less then the corporate earnings or profits it is a "dividend" which means it is treated as ordinary income to the owner. I.R.C. §316 & §301(c)(1). However, to the extent the pro rata amount received by the owner exceeds the entity's profits and earnings, it is treated as a return of capital. I.R.C. §301(c)(2). As a return of capital, it would have the tax effect of reducing the stockholder's basis in the entity. Id. For any additional amounts (exceeding the basis of the owner), the excess is treated as a capital gain. I.R.C. §301(c)(3)(A).

Basically, the tax treatment depends on how the distributions are made, and it is important to analyze the corporate books and witnesses to see the intent. Further, it may be advisable to retain an accountant and/or tax expert to assist you. This is especially true if you are contemplating receiving distributions as part of a settlement agreement as the tax liability may outweigh any benefits for your client.

1. C Corporations

Under the Tax Code, gross income generally does not include the amount of a stock distribution. I.R.C. §305(a). This is because when a corporation distributes a pro rata dividend of common stock, the respective positions of the owners have not changed as there has not been an increase in the owner's economic wealth. BNA Tax Management Portfolios, *Stock Rights and Stock Dividends* §305 and §306, Volume 765 (2nd Ed. 2004). Nevertheless, stock dividends in some instances can be taxable. For example, if the distribution is at the election of any of the owners, and is payable in stock or property, then it should be taxed as the owner's gross income. I.R.C. §305(b)(1). Further, if there are distributions which result in some owners receiving property, as well as an increase in the proportionate interest of other owners, then it should also be taxed as gross income. I.R.C. §305(b)(2). Another example of a distribution being taxed as gross income is if the distribution resulted in common stock to some owners and preferred stock to others. I.R.C. §305(b)(3).

2. S Corporations

It should be noted, that tax treatment of corporations that have elected to be taxed under Subchapter S of the Internal Revenue Code are taxed differently. I.R.C. §1361. Specifically, their tax treatment depends on whether the corporation has accumulated earnings and profits. I.R.C. §301 and §1368. However, such an entity will generally not have accumulated earnings and profits unless it was previously taxed as a C corporation, and the corporation is in the year of transition. I.R.C. §1368.

This is because the S corporation is taxed like a partnership. Further, it is common that the corporation will have distributed all earnings and profits to the owners. Thus, these entities do not generally carry forward any accumulated earnings and/or profits.

3. Partnerships

Generally, partnerships have "pass through" taxation. In other words, the partners report their allotment of the partnerships income, gains, losses, deductions and credits to the government. I.R.C. §701. This is true whether the partner receives a distribution from the partnership or not. I.R.C. §702. If a distribution is made, it is generally treated as a tax-free return of capital, which in turn reduces the partners' basis in the partnership interest. The rationale for this is that the partner had previously been taxed on the amounts contributed to the partnership.

E. Redemptions

1. Defined And When Used

According to the Internal Revenue Code, a redemption of stock is a corporation's acquisition of its own stock from an owner in exchange for property other than the redeeming corporation's stock. I.R.C. §317(b). It does not matter if the stock that is redeemed was cancelled, retired, or held as treasury stock. Id.

To exercise a redemption, the board of directors must first review the controlling documents of the corporation along with all applicable federal and state laws. Tax Management Portfolios – *REDEMPTIONS*, 767 2nd p. A-4 (2002). If the restrictions are violated, directors, officers, as well as the shareholders who have redeemed their interests, may be liable to all third parties harmed. Donahue v. Rodd Electrotype Co., 328 N.E.2d 505 (Mass. 1975).

Generally, redemptions in the family law arena are used to help a cash poor owner spouse buy-out the non-owner spouse. By redeeming stocks to the corporation, the owner spouse can obtain the necessary funds to pay contractual alimony and/or pay off any amount owed to the non-owner spouse.

2. Tax Issues Redeeming Stock

If the practitioner's client wishes to redeem stocks in the settlement of their divorce, they would be well advised to hire a tax expert. If prudent planning is not done, the redemption proceeds could be horribly taxed. While this section is not intended to make you a tax expert, it will allow you to spot issues and ask good questions to the expert(s) you have retained so that in stitching up the deal no money is "lost."

Be sure to always consult with a tax expert on tax issues. Section 1041 of the Internal Revenue Code is specifically designed to allow spouses to assign gains and losses amongst themselves. When deciding the allocation, the spouses need to remember what tax bracket they are, or will be in, after the divorce. Section 1041(a) states that, "no gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of)—(1) a spouse, or (2) a former spouse, but only if the transfer is incident to the divorce." Instead, the transfer is treated as a gift, but that the transferee has the transferor's adjusted basis. I.R.C. §1041(b). Generally, the term "incident to divorce" is defined if the transfer happens within one year after the date on which the marriage ceases, or is related to the cessation of the marriage. 1041 (c). While it seems that Section 1041 is solely applicable to transfers between spouses, three opportunities exist where there is the potential for a transfer to a third party. REG. §1.1041-1T(c) Q&A-9. They are as follows: (1) the transfer to the third party must be required in a divorce or separation agreement; (2) the transfer must be pursuant to the written request of the other spouse or the former spouse; and (3) the transferor spouse must receive written ratification (conforming to tax law) of the transfer to the third party from the other spouse. Id. In these three situations, the transfer of the property will be treated as being made directly to the non-transferring spouse and that spouse will be treated as immediately transferring the property to the third party. Id. The transfer from the non-transferring spouse to the third party qualifies for a non-recognition of gain and should not be taxed. Id.

Section 1041 mandates that no gain or loss be recognized on a property transfer between spouses or incident to divorce. The transfer instead is to be treated as a gift, with the transferee taking the transferor's basis. I.R.C. §1041(a)(b). Of course, the significance of Section 1041 extends well beyond the divorce tax arena. It applies not only to transfers "incident to divorce" but also to any transfer of property between spouses, whether in the form of a gift, or a sale or exchange at arms length. TEMP. REG. SEC. 1.1041-1T(a), Q&A-2. Section 1041 reflects a Congressional policy that transfers between spouses are transfers within a single economic unit and should not be taxed. This policy has been extended to encompass transfers incident to divorce as well as part of an effort to keep tax laws "as unintrusive as possible with respect to relations between spouses." H.R. Rep. 98-432, 98th Cong., 2d Sess., p. 1941.

Notwithstanding the effort by Congress, tax laws still intrude on relations between divorcing spouses and their attorneys. Property transfers incident to divorce may be nontaxable, but they carry with them significant tax consequences. For example, since neither gain nor loss is recognized, and the transferor's basis carries over to the transferee, the parties effectively determine who bears the future tax burden in appreciated property and the future tax benefit of

property with a value less than its basis when they divide their property. An illustration of this concept is if there are two items of property each worth $1,000.00, but if one spouse has a basis of only $100.00, and the other has a basis of $2,000.00, the tax liabilities are potentially very different. This further troubles the practitioner who probably has a dispute regarding the valuation of the stock in the first place, and now it is coupled with potential problems with valuing the basis within each asset.

3. Who Pays Uncle Sam After A 1041 Transfer?

Generally, a stock dividend is a nontaxable event as to the recipient shareholders because the shareholder has not realized anything of value as a result of the distribution. I.R.C. §305(a). Specifically, no corporate assets are distributed, and the shareholder's percentage of interest in the entity does not change. Therefore, the shareholder's stock basis is allocated to the dividend shares and the shares held by the investor before the dividend distribution. Remember, that a stock dividend is not equivalent to a cash dividend because when a stock dividend is paid the entity's earnings per share decrease proportionately to the percentage increase in common stock. Therefore, the price of each share of stock decreases proportionally. This rule seems fairly straight forward until the non-owner spouse wants her share based on the buy-sell agreement which itself may be vague.

Revenue Ruling 69-608 proposes a test called the "primary and unconditional obligation" to be used to determine the taxable income in a situation where the transfer is made with a third party. The reason for the "primary and unconditional obligation" test is to determine if a shareholder had an obligation to purchase the other shareholders interest in the entity. Generally, case law has looked at several facts to determine how the tax law should be applied. As with the other areas of law covered in this paper, the tax courts seem to have a problem with consistency in the application of the test outlined in Revenue Ruling 69-608.

Revenue Ruling 69-608 explains a nuance of Section 301 in the Internal Revenue Code. Specifically, it addresses situations when closely held corporations enter into agreements to provide for the disposition of the stock in the case of resignation, death, or incapacity of one or more of the shareholders. According to the Ruling, these agreements are reciprocated among the owners, but sometimes these agreements are even assigned to the corporation by the remaining shareholder and the corporation actually redeems stock from them. Under the test, a redemption of stock owned by one shareholder sometimes results in a constructive distribution to another shareholder if that shareholder had the primary and unconditional obligation to purchase the shares. However, cases dealing with this issues yielded a wide variety of rulings regarding who were taxed and how much.

On January 13, 2003, the rules were changed to allow the shareholders to use agreements as to how the tax liability would be allocated with regard to the stock redemptions. REG. §1.1041-2(c). In order for the agreement to qualify, it must be in a divorce or separation agreement, and be in writing. Further, the writing must state that (1) for federal income tax purposes the spouses intend to treat the stock redemption as either a redemption distribution to the transferor spouse, or a constructive distribution to the non-transferor spouse; and (2) the agreement must specifically state that it supercedes any other agreement regarding the purchase, sale, redemption, or other disposition of the stock. REG. §1.1041-2(c). However, the divorce instrument must be effective. Specifically, the written agreement must be executed by both parties prior to the date on which the transferor spouse (when treated as a redemption distribution under REG. §1.1041-2(c)(1)) or the non-transferor spouse (when treated as a receiving constructive distribution under REG. §1.1041-2(c)(2)) timely file their tax return for the year of the redemption. REG. §1.1041-2(c)(3). In no event can it be filed later then the date the return is due (including all applicable extensions). Id.

While this type of taxation appears to be extremely problematic, it is not in the short term. Specifically, for redemptions made from 2003 through 2008, the effect of the new regulation is essentially moot because of the change in the maximum tax rates for dividends and long-term capital gains. Currently, both long-term capital gains and ordinary income are taxed at a maximum rate of 15%. Thus, potentially adverse tax consequences of a disproportionate tax liability are not an issue—currently. However, Congress has legislated that this will expire in 2008, so these issues may be important in the near future. Nevertheless, the family law practitioner should always consult with a tax expert prior to settling a case dealing with the redemption of stocks.

F. Liquidations

There are two types of liquidations. A partial liquidation occurs when only some of the corporation's assets are redistributed to its owners. BLACK'S LAW DICTIONARY 931 (6th ed. 1990). The distribution is generally pro rata, and the corporation continues to do business. Id. A complete liquidation occurs when all of the corporation's assets are redistributed to the owners. Id. As stated above, if the business interest that is liquidated is characterized as separate property, then the liquidated cash dividends are also separate property. Horlock v. Horlock, 533 S.W.2d 52, 60 (Tex. Civ. App.—Houston [14th Dist.] 1975, writ dism'd).

V. TRANSFER RESTRICTIONS

Corporations and partnerships often have buy-sell agreements in place between the shareholders or partners. These agreements help to outline the procedure for an owner to sell his percentage without detrimentally affecting the operations of the business during the sell. In short, it provides certainty to the business. Generally, these agreements set a price certain for the ownership interest which is to be conveyed. Further, buy-sell agreements also help the retiring owner create a market for his portion of the business (as generally the agreements require that the remaining partners or shareholders purchase the terminating owner's interest). *See* Little v. X-Pert Corp., 867 S.W.2d 15 (Tex. 1993).

It was not long until family courts used these agreements to help ascertain the value of the closely held business upon divorce.[7] Soon corporate drafters determined that another way to use buy-sell agreements was to draft provisions to protect the business when an owner spouse was in a divorce action. The purpose of this was to provide certainty to the future operations of the business. Specifically, the business would benefit from a relatively seamless transition, and the other owners would have an idea of how the transition would take place. The case law that developed around the buy-sell agreements with regard to division of the marital property continues to evolve. Thus, the practitioner would be well advised to review the most recent decisions to determine how the courts will interpret this area of the law.

A. Transfer Restrictions On Closely-Held Texas Entities

Unlike corporations, partnerships have a statute regarding the transfer of ownership upon the death or divorce of a partner. According to Section 152.406(a) of the TEXAS BUSINESS ORGANIZATIONS CODE and Article 6132b-5.04(a) of the TEXAS REVISED PARTNERSHIP ACT, upon the divorce of a partner, the partner's spouse shall be regarded as a transferee of the interest to the extent of the owner partner.[8]

Under Texas law, the transfer of stock and interests can be restricted. TEX. BUS. CORP. ACT, art §2.22(C) (Vernon 2003); TEX. BUS. ORG. §21.223 -- §21.226 (Vernon 2003)(*effective January 1, 2006*). Specifically, the law provides that stock transfer restrictions are lawful if they are reasonable and conspicuously noted on the security. Id. Therefore, closely held businesses often have restrictions placed on stocks as well as within their controlling documents to take advantage of these benefits. This is true even though restrictions are generally disfavored as it inhibits alienability of personal property. Nevertheless, the courts will strictly adhere to the exact share restrictions, provided they do not violate public policy. Dixie Pipe Sales, Inc. v. Perry, 834 S.W.2d 491, 493-94 (Tex. App.—Houston [14th Dist.] 1992, writ denied).

1. Controlling Entity Documents As Possible Vehicles For Predicting Division Upon Divorce

(a) Restrictions On Stock Transfers—Family Law Style

While Texas is generally considered a trendsetting state in family law, the restrictions of stock in a family law context has been infrequently litigated, at least in appellate courts. The landmark case dealing with stock transfers in a family context is the 1975 Earthman case. Earthman's Inc. v. Earthman, 526 S.W.2d 192 (Tex. Civ. App.—Houston [1st Dist] 1975, no writ).

In the Earthman case, a former wife who had been awarded shares of stock in a divorce action brought a post-divorce civil case against her former husband, members of his family, as well as three family corporations. She was seeking to recover actual and punitive damages from the alleged conversion of stock which had been awarded to her. The wife claimed that when she tried to have her shares transferred into her name the corporations refused. Therefore, according to the wife, the corporations wrongfully exercised dominion and/or control over the stock and this was inconsistent with the wife's rights. The wife's action was couched as a conversion tort claim.

The corporate defendants responded citing numerous conditions precedent, which needed to be fulfilled prior to the stock being transferred. Most of these conditions dealt with presenting the specific certificates to the corporation. Id. at 196. However, the real dispute was that the stocks could not be transferred because "Earthman's Inc., or its stockholders intended to exercise an option to purchase the stock (awarded to wife) under a provision of the company's articles of incorporation." Id. Specifically, the corporation relied upon the articles of incorporation of the company which appeared to force the

---

[7] While buy-sell agreements are increasingly used to *value* the owner spouse's interest in the entity, their use in that capacity is outside the scope of this paper.

[8] Partnership rules changed with the enactment of the TEXAS REVISED PARTNERSHIP ACT, which took effect on September 1, 1997. In the recent past, one needed to review the TEXAS REVISED LIMITED PARTNERSHIP ACT, the TEXAS UNIFORM PARTNERSHIP ACT, and the TEXAS REVISED PARTNERSHIP ACT. However, starting January 1, 2006, attorneys will now only need to review the BUSINESS ORGANIZATIONS CODE which will have all of the three prior partnership codes organized in one code.

shareholder to offer the shares for sale prior to "selling, assigning or transferring" them.[9] Id.

After several weeks in a jury trial, the trial court entered a judgment (on the verdict) in favor of the wife. The defendant corporation and the husband's family members appealed. In upholding the trial court, the appellate court stated, 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." Earthman's Inc., 526 S.W.2d at 202, *citing* Casteel v. Gunning, 402 S.W.2d 529 (Tex. Civ. App.—El Paso 1966, writ ref'd n.r.e.); *see also*, Gulf States Abrasive Manufacturing, Inc. v. Oertel, 489 S.W.2d 184 (Tex. Civ. App.—Houston [1st Dist.] 1972, writ ref'd n.r.e.). Since there was no Texas law on point, the appellate court citied a Louisiana case:

> [W]e are of the opinion that the restrictive provision in question should not be construed so as to preclude [wife her] 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 . . . [w]e hold that the trial court properly determined that this provision did not afford to the corporation the right or option to purchase the shares . . so awarded to [the wife]. Id.

The Louisiana case cited by the appellate court reasoned that the restrictive provision of the articles of incorporation could not prevent the recognition of the wife's share of ownership in the corporation. Id. at 202. Therefore, the wife was entitled to have the stock in kind. Id. Interestingly, the appellate court then reversed the trial court's ruling regarding damages. Id. Nevertheless, it was clear that the failure to transfer stock by a corporation could be conversion, a tort from which corporate officers who instigated or participated in the refusal could be held liable. Id.

Unfortunately, for the present-day practitioner this case is somewhat vague in that the appellate case did not develop reasons why it was correct to award the stock to the wife. However, it is clear that during the litigation the restrictive clauses in the articles of incorporation were litigated. Interestingly, it is not clear from the facts just how the divorce court ended up characterizing the corporations or the stock. Even with these "problems" with the case, it seems that at least one other appellate court has cited this opinion as authority. *See* Consolidated Bearing and Supply Co. v. First National Bank at Lubbock, 720 S.W.2d 647 (Tex. App.—Amarillo 1986, no writ).

(b) Restrictions On Stock—Non-Family Law

The Dixie Pipe Sales, Inc., court was more willing to enforce restrictions on stock. Dixie Pipe Sales, Inc. v. Perry, 834 S.W.2d 491 (Tex. App.—Houston [14th Dist.] 1992, writ denied). This case has been included so that the practitioner can see both arguments regarding stock restrictions. The practitioner can then prepare the facts of their case to utilize either the corporate or the family law analysis.

In another case from the Houston Court of Appeals, the court had the opportunity to analyze whether a corporation was entitled to a right of first refusal on the transfer of stock in the context of a testamentary transfer. Dixie Pipe Sales, Inc. 834 S.W.2d 491. In Dixie Pipe Sales, the corporation filed for a declaratory judgment action alleging it had the right to purchase stock devised to the defendant. The trial court heard evidence that Dixie Pipe was a closely held corporation owned primarily by the Beeley family and their spouses. Id. at 492. When the corporation was formed, Mr. Raymond Beeley and his wife received 4,000 shares of stock which was characterized by the court as community property. Id. Ms. Raymond Beeley, in her will left her residuary estate to a trustee for the benefit of her husband. This bequeath included her portion of the sock in Dixie Pipe. After the death of both Mr. and Ms. Raymond Beeley, the shares were distributed to Ms. Raymond Beeley's niece and nephew. Id. When the niece and nephew requested that the stock be transferred in their names, Dixie Pipe refused. Instead, Dixie Pipe offered to buy them out and immediately issuing checks in the

---

[9] The exact language of the articles of incorporation: "The shares of stock of the corporation are to be held by each shareholder upon the condition that he will not sell, assign, transfer, pledge, or in any way dispose of or encumber any of such shares without first offering (in writing, mailed to the Corporation's office) the same for sale to the Corporation which shell have the right to purchase all or any portion of such shares within 60 days from the date of the offer . . . If for any reason the corporation does not purchase any shares of stock which it has the right to purchase under any provision of this Article, the remaining shareholders of the Corporation so electing shall have the right to purchase all or any portion of such shares (prorate, according to their stock ownership, or as they may otherwise agree) within 10 days following the end of the time during which the Corporation had the right to purchase such shares under this Article. The price for purchase of shares of stock under any provision of this Article shall be the book value of such shares as at the close of the month preceding the date of the offer . . . such book value to be determined by the certified public accountants serving the Corporation at such time, in accordance with the accounting practices followed in preparing the most recent annual financial statement to the Corporation. Such purchase price shall be paid in case and the balance may be paid in no more than four equal annual installments with interest at the rate of 6% per annum."

amount of the book value of the stock, as authorized by the stock purchase agreement.[10] Id. The recipients of the stock declined to negotiate the checks, and instead insisted upon having the stocks transferred to them. Id. at 493.

On appeal, the parties agreed that under the (then existing) TEXAS BUSINESS CORPORATION ACT article 2.22, the restrictions were valid. Therefore, the real issue was whether Dixie Pipe was entitled to the right of first refusal when the transfer was made by a will. Id. The appellate court held that the right of first refusal was permissible as the specific statute allowed it to be enforced against any successor or transferee. Id. at 493. The appellate court further stated that the test was whether the provision was sufficiently necessary to the particular corporate enterprise to justify overruling the usual policy of the law which generally opposes the restraints on the alienability. Id. After weighing the results, the court held that the company was entitled to put these restrictions on the corporate stock.

(c) Competing Theories, Now What!

The Dixie Pipe and Earthman cases both dealt with closely held corporations in the context of transfers that were not friendly. If the practitioner finds himself in a situation such as this it seems advisable to better ones odds by possibly planning what judge hears the case. Specifically, in larger counties, if one was against the transfer of the stock it may be advisable not to file in the original family law court, but instead possibly file a conversion action in the civil courts. Alternatively, if the practitioner represented the spouse with the newly received stock, it might be advisable to file in the original family court (that made the martial property division) under the theory of a declaratory judgment. The claim would be for the family law court to declare the rights and duties of the respective parties according to the divorce decree. However, the corporation would have needed to have been a party to the family law case. In simple terms, it could be possible to creatively plead your case and pick a court that may be more favorable to your requested relief.

Since the case law is not entirely clear, it would also probably be advisable for you to prepare your client for the possibility of an appeal. In fact, your appeal might just be the case that brings clarity to this issue for future installments of this paper.

2. The Binding Effect Of Buy-Sell Agreements And Other Controlling Documents

One thing that is clear is that a buy-sell agreement (or arguably any substantive change to any documents outlining the rights and duties of the owners) probably need to be ratified by the non-owner spouse. However, there are other considerations for the owner spouse and the corporation to consider if this is their objective.

(a) Signature

After discovery has provided the appropriate entity documents, the practitioner needs to review them to determine what substantive rights the documents change or modify, if the non-owner spouse executed them, if both sides were represented by lawyers, and whether the agreement was fair. After obtaining and understanding the documents, they should then be reviewed to see who signed them and (if possible) under what the conditions they were executed.

As alluded to above, the courts have held that the non-owner spouse's signature is an important consideration as to whether that spouse is bound to the terms of that agreement. Keith v. Keith, 763 S.W.2d 950, 952 (Tex. App.—Fort Worth 1989, no writ)(court makes reference that non-owner spouse signed partnership agreement); In re Taylor, 67 S.W.3d 530, 531 (Tex. App.—Waco 2002, no writ).

In fact, one court has held that the non-owner spouse was not bound to the terms of the arbitration provision in a partnership agreement for a professional entity since the non-owner spouse did not review and sign the agreement. Southwest Texas Pathology Associates, L.L.P. v. Roosth, 27 S.W.3d 204, 208 (Tex. App.—San Antonio 2001, writ dism'd w.o.j.). However, this holding is not entirely illustrative. In this case, the wife did not rely on or seek to enforce any provisions of the partnership agreements. Instead, she asserted that the other doctors and the partnership

[10] The stock purchase agreement provided: "No shares of the common stock of the corporation (in this Article VI referred to as "Stock"), or any interest in Stock, shall be transferable or transferred or sold or otherwise disposed of, except as hereinafter provided in this Article VI. Each holder of Stock (in this Article VI referred to as "stockholder"), shall not sell, assign, transfer, pledge, encumber or in any way dispose of, except to any administrator or executor or legal representatives of any deceased stock holder, any Stock that may now or hereafter be owned by him, nor shall any such Stock be transferable except as provided in Section 2 hereof. Section 2. Notice. Each stockholder prior to the disposition of any Stock shall give written notice by post-paid registered mail, which shall be effective on the day it is received by the corporation at its principle office. [I]n said notice [each stockholder] shall offer to sell and transfer such shares to the corporation and, subject only to the prior right of the corporation to acquire any of such shares, to its stockholders or such of them as may elect to purchase, severally or collectively, any of such shares (i) at a price per share equal to the cash price or consideration per hare specified in such notice, or (ii) in the event that no consideration is to be received by the stockholder for such share, the value per share of such shares as determined by Section 4 hereof." Dixie Pipe Sales, Inc. v. Perry, 834 S.W.2d 491, 493 (Tex. App.—Houston [14th Dist.] 1992, writ denied).

itself amended the partnership agreements to expel her husband from the partnership in an effort to impair the community estate. Specifically, if the husband was not a partner it would harm the wife's claims for alimony and child support. Id. Therefore, the wife claimed that they conspired to breach fiduciary duties and commit fraud. Since the wife was not trying to enforce the partnership agreement, the arbitration agreement analysis was not necessary. Id.

After determining that the non-owner spouse has signed the document, the family law practitioner needs to see what the non-owner spouse has specifically acknowledged. This is done by slowly dissecting and analyzing the document. For example, the practitioner may ask while reading the agreement: What type of provisions were included in the agreement? Were they merely restriction provisions or did they include other day-to-day matters of the entity? Did the document state that it was binding and irrevocable? Is the document binding on agents and representatives?

Currently, there are no cases regarding the exact language of a generally accepted acknowledgement. Many practitioners try to use case law from marital agreements (requiring specific language to make it binding) or contract law (having less stringent requirements) depending on the client's objectives. However, the practitioner needs to utilize caution as premarital agreements currently enjoy significant protection with regard to their validity from the statutes in the Family Code. Nevertheless, there are other areas where case law has been developed which may yield insight as to the enforceability of these agreements.

(b) Is The Value In The Agreement Fair?

Unconscionability should always come to mind when reviewing any agreement. Whether the agreement is fair or completely outlandish is always a critical point of the analysis. This issue becomes particularly important in the valuation of the interests of the entity. While most entity agreements define the value of the interest in the terms of "fair market value" or even "book value" an arguably better practice is to provide a specific formula and draft that into the agreement. For example, if the agreement sets a standardized calculation of how to calculate the value of the stock it may be appropriate especially if it has been utilized in the past. However, it could always be argued that what is fair to the owner spouse may not be fair to the non-owner spouse. This is particularly true in the instance where the owner spouse is a professional. Upon his withdrawal, the owner spouse obtains a reduced value for his interest in the entity since he is allowed to take patients away from the entity. Whereas, the non-owner spouse would have no use for the patients, but she would want to receive the fair value of interest.

This issue has been posed to several courts and the opinions are conflicting as in many areas of the law. In Keith, the trial court found that the method outlined in the agreement should not be utilized in the divorce case. Keith v. Keith, 763 S.W.2d 950 (Tex. App.—Fort Worth 1989, no writ). Specifically, the court found that the partnership agreement set out a valuation of the partner's interests upon "withdrawal, other act, or death of partner, and partnership was not being terminated." Keith, 763 S.W.2d at 953. According to the court, the partnership agreement entered into between the owners, "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 court went on to hold that since the partnership is not being terminated, "we do not find [that] this provision of the agreement has any applicability to the matter before the trial court." Id.

In finding that the formula had no applicability, the court also rejected that the formula offered the high-water mark in that the interest in the entity could not have been worth more then the number yielded by the formula. This argument originally was made in Finn which was an *en banc* case. Finn v. Finn, 658 S.W.2d 735 (Tex. App.—Dallas 1983, writ ref'd n.r.e.)(*en banc*). The Finn case is a notorious partnership goodwill case out of the Dallas Court of Appeals. Specifically, the arguments utilized in Finn were that the community estate should not be entitled to a greater interest than that which the owner spouse would be entitled to upon his death or withdrawal. Id. at 953.

Instead, the Keith court adopted Justice Annette Stewart's concurring opinion in Finn which held that the "death or withdrawal of a partner is not necessarily determinative of the value of a spouse's interest in the ongoing partnership as of the time of divorce." Keith, 763 S.W.2d at 953, *referring to* Finn v. Finn, 658 S.W.2d 735 (Tex. App.—Dallas 1983, writ ref'd n.r.e.)(*en banc*). The Keith case teaches that in some courts the agreement should specifically state that it can be used in a divorce type situation.

The R.V.K. case is almost in direct contradiction to the Keith case. R.V.K. v. L.L.K., 103 S.W.3d 612 (Tex. App.—San Antonio 2003, *en banc*). Specifically, the R.V.K. case was an *en banc* ruling from the San Antonio Court of Appeals that held that in determining market value of stock, trial courts should take into account buy-sell agreement restrictions on the marketability of the stock. Id.

The San Antonio Court of Appeals found that even though there was no "operative event" to trigger the provisions in the agreement, the agreement *should* be considered to determine the value of the stock. Id. at 618. The court further reasoned that since the record establishes that the fair market value of the corporation

would not exceed the value placed on the stock (through the use of the formula in the agreement) that there was no error since fair market value standard is generally used in valuation of assets in a divorce matter. Id. at 619. It should be noted that this court merely stated that the formula in the agreement should be considered. Interestingly, the appellate court did not state that it was the only factor to be considered.

While the authors' believe that the better analysis is to at least consider the provisions of an agreement, the analysis is truly fact dependent. Until this is resolved, the practitioner will have to develop her case to include both rationales and incorporate them into her theme in trying the case. However, it may be advisable for the practitioner to secure a pretrial ruling about whether the buy-sell and other significant agreements are going to be binding. This may help to proceed in a more focused manner if the court is willing to oblige. Nevertheless, make sure to protect the record by formally offering evidence to perfect your appeal if the court holds that the evidence is not admissible.

To determine the fairness of the value, the agreement may even require that an appraiser be retained to calculate the value based on a number of criteria at the time the controversy starts. The appraiser could analyze the profit and loss statements, capital infusion from the owners in recent years, potential for profit along with any other item that the owners thought was important in the valuation of their business. The agreement may even name a specific firm to perform the value, and that the parties are bound to their number. As seen from the discussion above, if the value in the agreement is not fair, it is yet another (equity) ground to bring before the court to try to obtain a favorable ruling for the non-owner spouse.[11]

(c) The Sophistication Level Of The Non-Owner Spouse

As evidenced above, sometimes an agreement is deemed fair to one person, but not another. This is particularly true if one of the parties is not as sophisticated as the other party. In those circumstances, the courts may be more willing to hold that the agreement is binding upon a non-owner spouse who is a certified public accountant as opposed to one that is a stay-at-home mother with no formal education. As is typical, there are a variety of levels of sophistication. What one court finds persuasive may not be persuasive to the next court.

Again, there are not many cases dealing with this point directly, but as suggested (and cautioned) above a good source of analogous cases are ones dealing with the enforceability of premarital agreements. In these cases, the courts look to whether the parties have experience with specific types of agreements. For example, courts have held that if the spouse has had sufficient experience with trading stocks and business activities, or they have experience reading complex contracts that those spouses would be hard pressed to argue they were not sophisticated enough to understand the agreement. *See* Marsh v. Marsh, 949 S.W.2d 734, 743 (Tex. App.—Houston [14th Dist.] 1997, no writ)(spouses educated and routinely conducted complex business transactions); Williams v. Williams, 720 S.W.2d 246, 248-49 (Tex. App.—Houston [14th Dist.] 1986, no writ). Other courts have looked at formal education, such as if the parties were lawyers or accountants. *See* Fanning v. Fanning, 828 S.W.2d 135, 139 (Tex. App.—Waco 1992), rev'd on other grounds, 847 S.W.2d 225 (Tex. 1993); Daniel v. Daniel, 779 S.W.2d 110, 115 (Tex. App.—Houston [1st Dist.] 1989, no writ).

(d) Was The Non-Owner Spouse Represented By An Attorney?

Another avenue of investigation is whether the non-owner spouse was represented by counsel. Again, there is a void of cases on point, but the execution of martial property agreements and premarital agreements are often used by analogy.

In the past, in the context of marital property agreements, courts have looked at a variety of factors to analyze whether the non-owner spouse actually consented to the agreement. For example, if a spouse was not represented by an attorney, the courts inquired into whether that spouse acknowledged and understood that they were free to consult with an attorney. *See* Marsh v. Marsh, 949 S.W.2d 734, 743 (Tex. App.—Houston [14th Dist.] 1997, no pet)(spouse acknowledge that an attorney and an accountant were offered prior to signing); Salder v. Salder, 765 S.W.2d 806, 808 (Tex. App.—Houston [14th Dist.] 1989, *rev'd on other grounds*, 765 S.W.2d 886 (Tex. 1989)(court inquired whether spouse took document to review and whether informed to hire own attorney).

(e) How Transfer Restrictions On Business Interests Effects Value

Being in Texas, we are lucky. Not only are our appellate courts not sure of whether buy-sell agreements are to be used in valuing the transfer of business interests, the Internal Revenue Service also puts in their two cents regarding transfer restrictions.

---

[11] The authors suggest that the reader consult some valuation guides as this is an immense topic and a full discussion of valuation is outside the scope of this paper. For more assistance, see Arnold J. Rutkin's *Valuation of a Closely Held Corporation, Small Business or Professional Practice,* VALUATION AND DISTRIBUTION OF MARITAL PROPERTY, (Matthew Bender 1998).

Specifically, according to the Internal Revenue Service's Revenue Ruling 59-60:

> [W]here 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 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.

Again, the practitioner is facing another area which is fact dependent. As such, the tax cases, (much like the Texas cases), are inconsistent. Some courts have held that a restriction fixes the value of a security, yet another court has found that the restriction actually increased the value of the security. For example, in the Luce case, one of the majority stockholders testified that he would actually have paid more to keep the ownership of his closely held business in the family and the court obliged this testimony with its holding concurring. Luce v. U.S., 4 Cl. Ct. 212 (1983). On the other hand, in the Hall case, that court found that as long as the stock restrictions had a business purpose that was valid, that those restrictions controlled the value of the stock for tax purposes. Estate of Hall v. Commissioner, 92 T.C. 312 (1989).

The practitioner seeking assistance from these analogous cases will find no relief. It seems that the federal courts are much the same turmoil. Nevertheless, these cases will be of assistance as persuasive authority as we argue before Texas courts for our clients.

VI. CONCLUSION

Many division issues surrounding closely held entities are not fully resolved legally. Therefore, it provides an ample arena for creative solutions and innovative approaches. However, it is a very fact specific aspect of the law and it requires that the practitioner have a commanding knowledge of the case and a broad understanding of business and accounting issues.

VII. ACKNOWLEDGMENT

The authors wish to acknowledge the resources available on this topic including: *Sophisticated Corporate Structures*, written by Randall Wilhite, Patrice Ferguson, Robert Piro, William Rucker and Cynthia Nguyen, presented at "New Frontiers in Martial Property" in October 2004; *Valuation of Professional Practices: Medical and Legal*, written by Edwin Terry, Karl Hays, Andrea Foltz, James Larue and J. Kenneth Huff, and presented at "29th Annual Advanced Family Law Course" in August 2003; *Getting Ready for the New Texas Business Organizations Code*, written by Daryl Robertson and presented at "Second Annual Advanced Business Law Course" in October 2004; *Claims Against Entities Owned by the Parties*, written by Cheryl Wilson, presented at the "31st Annual Advanced Family Law Course" in August 2005; and *Tax Issues – Significant Income Tax Developments*, written by Patrice Ferguson, presented at "29th Annual Advanced Family Law Course" in August 2003.