A New Horizon: Closely-Held Business Entities In Divorce

Richard R. Orsinger
richard@ondafamilylaw.com
http://www.orsinger.com

Orsinger, Nelson, Downing
& Anderson, L.L.P.

San Antonio Office:
Tower Life Building, 26th Floor
San Antonio, Texas 78205
(210) 225-5567
http://www.orsinger.com

Dallas Office:
5950 Sherry Lane, Suite 800
Dallas, Texas 75225
(214) 273-2400

Frisco Office:
2600 Network Blvd., Ste. 200
Frisco, Texas 75034
Tel: (972) 963-5459

Advanced Family Law Course 2023
August 9, 2022
San Antonio, Texas

*****

Richard's 40th consecutive year presenting at the
State Bar of Texas' Advanced Family Law Course

*****

© 2023
Richard R. Orsinger
All Rights Reserved

Table of Contents

I. INTRODUCTION 1

II. TYPES OF ENTITIES. 2
A. PROPRIETORSHIP 2
1. Ownership Interest 2
2. Assets 2
3. Liabilities. 2
4. Distributions. 2
B. CORPORATION. 2
1. It Is An Entity. 2
2. Ownership Interest. 3
3. Assets. 3
Author's Note. 3
Practice Tip 4
Tax Tip. 4
4. Liabilities. 4
5. Claims Against Corporation. 5
6. Distributions to Owners. 5
7. Transfers of Shares. 5
8. Close Corporation. 6
9. Duties Owed by Officers and Directors to the Corporation and to Sharholders 6
C. PARTNERSHIP.. 6
1. Is it an Entity? Yes and No. 6
2. Governing Texas Statutes. 7
Historical Note 7
Practice Tip 7
3. Ownership Interest 7
Settlement Tip 8
4. Assets 8
5. Liabilities 9
6. Payment of Claims 9
7. Capital Account 9
Litigation Tip 10
Litigation Tip 10
8. Distributions to Partners 10
Tax Tip 11
9. Transfer of a Partnership Interest. 11
Litigation Tip 11
Litigation Tip: 11
10. Partners' Duties to the Partnership and Other Partners 12
D. LIMITED PARTNERSHIPS 12
1. Ownership Interest. 12
Litigation Tip 12
2. Assets 13

3. Liabilities . . . 13
4. Payment of Claims. . . . 13
5. Distributions to Partners . . . 13
6. Partners' Duties to the Limted Partnership and Other Partners . . . 13
E. LIMITED LIABILITY COMPANIES. . . . 13
1. Is an LLC an Entity: Yes and No. . . . 13
2. Membership Interest. . . . 14
3. Assets. . . . 14
4. Liabilities. . . . 14
5. Payment of Claims. . . . 15
6. Distributions to Members. . . . 15
7. Transfers of Membership Interests. . . . 15
8. Members' and Managers' Duties to the LLC Other Members . . . 15
F. PROFESSIONAL ENTITIES . . . 15
1. Is it an Entity? . . . 16
2. Membership Interest. . . . 16
3. Assets. . . . 16
4. Liabilities. . . . 16
5. Payment of Claims. . . . 16
6. Distributions to Members. . . . 16
7. Transfers of Membership Interests. . . . 16

III. BASIC ENTITY TAX PRINCIPLES.. . . . 16
A. SOLE PROPRIETORSHIP. . . . 17
Tax Tip . . . 17
Forensic Tip: . . . 17
B. PARTNERSHIP AND LLC CLASSIFIED AS A PARTNERSHIP FOR TAX PURPOSES . . . 17
Practice Tip . . . 18
1. Distributions from a Partnership . . . 18
Non-Cash Assets . . . 18
Hot Assets. . . . 18
Disguised Sales. . . . 18
2. Exceptions for Distributions . . . 18
3. Losses from a Partnership . . . 19
4. Tax Basis . . . 19
Inside and Outside Basis . . . 19
5. Contributed Property . . . 19
6. Tax Upon Sale or Exchange of a Partnership Interest . . . 19
a. Payments for Unrealized Receivables and Inventory Items–"Hot" Assets. . . . 19
7. Tax Upon Liquidation. . . . 20
C. CORPORATIONS AND ENTITIES ELECTING TO BE TAXED AS A CORPORATION. . . . 20
1. Electing to be Taxed as a Corporation. . . . 20
2. Estimated Tax Payment Requirements . . . 21
3. Capital Contributions . . . 21
4. Section 351 Transfers . . . 21

5. Distributions . . . 21
6. Tax Effects of Distributions . . . 22
7. Nondividend Distributions . . . 22
8. Constructive Dividends . . . 23
9. Earnings and Profits . . . 23
Litigation Tip . . . 23
D. S CORPORATIONS. . . . 23
1. Filing Requirements. . . . 24
2. Schedule K-1, Shareholder's Share of Income, Deductions, Credits, etc.. . . . 24
3. Comparison of C Corporation and S Corporation. . . . 24
a. C Corporations . . . 24
1. Taxation . . . 24
2. Dividends . . . 24
3. Ordinary Losses . . . 24
4. Capital Gains . . . 24
5. Capital Losses . . . 24
b. C Corporation Carryovers . . . 24
c. S Corporations. . . . 25
1. Taxation . . . 25
2. Dividends . . . 25
3. Ordinary Losses . . . 25
4. Capital Gains . . . 25
5. Capital Losses . . . 25
4. Shareholder Tax Basis in S Corporation Stock.. . . . 25
5. Distributions from an S Corporation.. . . . 26

IV. REIMBURSEMENT CLAIMS INVOLVING ENTITIES. . . . 26
A. THE GENERAL RULE OF REIMBURSEMENT. . . . 26
B. FOR CONTRIBUTIONS OF CAPITAL AND TRANSFERS INTO AN ENTITY. . . . 26
C. FOR ENHANCEMENT DUE TO COMMUNITY EFFORT. . . . 27
1. *Jensen* Reimbursement. . . . 27
2. Family Code Reimbursement. . . . 27
3. The Pattern Jury Charge. . . . 28
4. What Offsetting Benefits are Considered? . . . 29
5. Is Amount of Enhancement a Cap? . . . 29
6. Cases. . . . 29
Litigation Tip . . . 30

V. PIERCING THE CORPORATE VEIL . . . 30
1. Disregarding Formalities. . . . 31
2. Actual Fraud. . . . 31
3. Direct Personal Benefit. . . . 31
4. Constructive Fraud. . . . 31
5. Reverse Piercing. . . . 32
6. LLCs. . . . 32
7. Limited Partnerships. . . . 33
8. Single Business Enterprise Theory. . . . 33

9. The Internal Affairs Doctrine. 33

VI. VALUATION OF BUSINESS 34

VII. TRANSFER RESTRICTIONS/BUY-SELL PROVISIONS. 35
A. STATUTORY RESTRICTIONS 35
B. PRIVATE RESTRICTIONS AND BUY-SELL AGREEMENTS. 35
C. TAX ASPECTS 35
Litigation Tip 36

VIII. DIVIDING ENTITIES UPON DIVORCE. 36
A. OPTIONS FOR THE COURT IN THE PROPERTY DIVISION.. 36
1. Leaving or Making the Spouses Co-Owners of the Entity. 36
a. Transfer Restrictions. 36
b. Problems with Co-Ownership, Now and Later. 37
Litigation Tip--Control 37
c. Phantom Income. 37
d. Capital Calls.. 37
e. Ongoing Fiduciary Duties. 38
2. Award The Entity to One Spouse. 38
3. Sell the Entity and Divide the Proceeds. 39
4. Transfering Assets From Inside Entity to a Spouse. 39
5. Subdivide the Entity and Award Part to Each Spouse. 40
6. Liquidation Over Time. 40

IX. TAX ASPECTS OF THE PROPERTY DIVISION. 41
A. INTERNAL REVENUE CODE § 1041. 41
B. TAX ASPECTS OF ACQUISITION, REDEMPTION, OR LIQUIDATION. 41
C. THE ASSIGNMENT OF INCOME DOCTRINE. 42

X. FORMAL AND INFORMAL FIDUCIARY RELATIONSHIPS; NON-FIDUCIARY RELATIONSHIPS. 42
A. FORMAL FIDUCIARY RELATIONSHIPS. 42
1. Agent → Principal. 43
2. Trustee → Beneficiary. 43
3. Attorney → Client. 43
4. Corporate Directors/Officers/Managers → Company, Owners, Creditors. 43
5. General Partnerships. 43
6. Limited Partnerships. 43
7. Joint Venturers. 44
8. Limited Liability Companies. 44
9. Executive Rights Over Mineral Interests. 44
10. Spouses. 44
11. Parent → Child. 44
B. INFORMAL FIDUCIARY RELATIONSHIPS. 44
1. Moral, Social, Domestic, or Merely Personal Relationships. 46
2. The Relationship Must Pre-Exist the Transaction. 46

3. No Informal Duty Is Owed By Corporate Directors to Shareholders.. 46
C. ARM'S-LENGTH TRANSACTIONS. 46
1. No Fiduciary Duty. 46

XI. DEFINING FIDUCIARY DUTIES. 47
A. HISTORICAL STANDARDS OF FIDUCIARY DUTY. 47
B. TEXAS PATTERN JURY CHARGE. 48
C. DUTY OF OBEDIENCE.. 48
D. DUTY OF LOYALTY.. 48
E. DUTY OF CARE 48
1. Ordinary Care. 48
2. Prudent Investor Standard of Care. 49
3. The Business Judgment Rule. 49
F. DUTY OF GOOD FAITH. 49
G. DUTY TO DISCLOSE 50
H. PROHIBITION AGAINST SELF-DEALING 51
I. CONFLICT OF LAWS. 51

XII. DUTIES AFFECTED BY THE NATURE OF THE RELATIONSHIP 52
A. GENERALIZED DUTIES.. 52
B. AGENT-PRINCIPAL. 52
C. BUSINESS ENTITIES 52
1. For-Profit Corporations 52
a. Directors.. 52
b. Officers.. 53
c. Contracts with Directors and Officers. 53
d. Duties to Owners. 54
e. Duty of Obedience. 54
f. Duty of Care.. 54
Owed to the Company. 54
Owed to Third Parties. 54
g. Duty of Loyalty. 54
h. Reliance on Others.. 55
i. Duties to Creditors.. 55
j. Duties to Third Parties. 56
2. Nonprofit Corporations.. 57
3. Closely-Held Corporations. 57
4. General Partnerships.. 57
Duty of Loyalty 57
Duty of Care 58
Obligation of Good Faith 58
Breach of Partnership Agreement or Statutory Duty 58
Expulsion of a Partner. 58
5. Limited Partnerships.. 58
6. Joint Ventures.. 59
7. Limited Liability Companies. 59
8. Majority Owners.. 60

D. SPOUSES.. 60
1. The Existence of a Fiduciary Duty. 61
Ends Upon Filing Divorce and Hiring Independent Professionals. 62
Ends Upon Granting of Divorce. 62
2. The Duty to Disclose. 63
3. The Fairness Standard.. 63
4. Duty Regarding Community Property. 63
5. Fiduciary Fraud or Fraud on the Community. 64
Litigation Tip 65
E. THE DUTY TO DISCLOSE. 65

XIII. ALTERING DUTIES BY AGREEMENT. 66
A. CORPORATIONS. 66
B. PARTNERSHIPS.. 66
C. LIMITED LIABILITY COMPANIES. 66
D. EXPRESS TRUSTS.. 67

XIV. DERIVATIVE ACTIONS. 68
Parting Shot 69

A New Horizon: Closely-Held Business Entities In Divorce

by

Richard R. Orsinger
Board Certified in Family Law
& Civil Appellate Law by the
Texas Board of Legal Specialization

I. INTRODUCTION. This Article examines legal, tax, and practical issues to consider when handling a Texas divorce that involves closely-held businesses entities. One approach to covering this topic would be to dive right into claims that can be brought in a divorce involving business entities. Litigation is one way to resolve issues, but it is often not the best way. Especially where the estate of the parties involves entities that are not subject to the divorce court's power to divide the community estate, the best and sometimes only feasible route to part the ways is to utilize different features of the businesses themselves to divide the wealth. Recognizing the opportunities that are presented in a divorce involving business entities requires the advocate to consider the intersection of entity law, tax law, marital property law, divorce law, and fiduciary law. Like a tour through a zoo, this Article moves from animal to animal, examining the features of the creatures, and different ways these features can be used to divide business interests in a divorce.

A divorce involving closely-held business entities will involve income tax issues. These tax issues must be considered in making the property division, because the division of wealth before taxes are considered can substantially differ from the division of wealth after taxes have their effect. The discussion of tax principles included in this Article originated with an article published at the State Bar of Texas' 2016 Advanced Family Law Course, co-authored by Richard Orsinger, Patrice Ferguson, and Bryan Polk.[1] Citations to that article are indicated "OFP p. __," and a link to the article is included in the end notes below. Because the income tax issues arising in connection with dividing closely-held businesses in divorce can be complex, it is wise to engage a CPA, or business lawyer, or tax practitioner, to assist you in dealing with tax issues.

In some divorces, whether by design or by happenstance, we find that assets such as homes, cars, investments, real estate, IRA's, 401(k)s, etc., are not held in individual names. Instead they are owned by entities that are community property. When this occurs, the divorce court's broad powers to divide the community estate in a manner that the court deems just and right is hemmed in and sometimes even eliminated, replaced by the complexities of common law principles and statutes governing the entities in question. Matters can be further complicated if the entity was created under the laws of another state, requiring that disputes over "internal affairs" be governed by the laws of that state. One or both spouses may be shareholders, partners, limited partners, or members of these entities, and often one spouse and not the other has management authority over the entity, as officer, general partner, or manager. So too with spouses being co-trustees or co-beneficiaries of an express trust. These arrangement give rise to a bewildering array of fiduciary duties that go beyond the fiduciary duty owed by spouses to each other, and they present many opportunities to assert claims

between spouses for breach of fiduciary duty. In some estates, what used to be a battle fought using familiar family law concepts has become a battle fought using elements of entity and fiduciary law, of Texas, of Delaware, of South Dakota, and other states. This Article takes a close look at the fiduciary duties that arise in different business entities, and in different relationships. In cases like this we may find that we have entered a brave new world of divorce, under the laws that govern entities, not under the familiar family law principles.

II. TYPES OF ENTITIES. From a legal perspective, there are four kinds of businesses: sole proprietorship, corporation, partnership, and LLC. From a tax perspective, there are three kinds of businesses: sole proprietorship, corporation, partnership.

A. PROPRIETORSHIP. A sole proprietorship is not an entity for legal or tax purposes. The income is taxed to the owner, and is reported on Schedule C of the owner's personal tax return, IRS Form 1040.

1. Ownership Interest. There is no ownership interest in a "sole proprietorship," because there is no entity to own.

2. Assets. A sole-proprietorship can have both tangible and intangible assets. It can also have business goodwill, distinct from the personal goodwill of the owner-spouse, that relates to trade name, customer relations, supplier relations, advertising, location, and workforce-in-place, etc. The assets are owned by the proprietor, or perhaps are leased or on loan from third parties. When the proprietor is married, the assets are presumptively community property.

3. Liabilities. The liabilities of a sole-proprietorship are usually liabilities of the business proprietor, and for a married proprietor they are debts of the community estate. The proprietor-spouse's non-exempt separate property, and his/her non-exempt sole management community property, and non-exempt joint management community property, are subject to collection for contractual debts. If the non-proprietor spouse is closely associated with the business, s/he could become personally liable for the businesses debts. This occurred in *Cockerham v. Cockerham*, 527 S.W.2d 162 (Tex. 1975), where the husband advanced capital for the wife's business, and let the wife sign his name to checks used to pay debts of the business, and once referred to the business's debts as "my debts," resulting in him being held personally liable for the wife's debts.

4. Distributions. Since the cash and other assets are typically owned by the proprietor-spouse, a sole-proprietorship cannot make distributions to owners. Any profits of the business belong to the proprietor.

B. CORPORATION.

1. It Is An Entity. A corporation is an entity for legal purposes. Corporate assets belong to the corporation. All corporate debts are debts of the corporation. The shareholders do not own corporate assets, and they are ordinarily not liable for corporate debts. However, shareholders can become liable for corporate debts by personally guaranteeing them or under the doctrine of piercing the corporate veil.

A corporation is an entity for tax purposes. A corporation is taxed either as a C Corporation or an

S Corporation. A C Corporation is treated as a separate taxable entity for all tax purposes. It is taxed on its earnings and profits ("E&P"). When a corporation distributes its E&P to shareholders, it gets no tax deduction to offset taxable income. The shareholders are taxed on profits distributed, at the dividend tax rate, currently either 15% or 20%. This results in double-taxation of the same profits, albeit at different tax rates. C Corporation stock is a capital asset of the shareholder, and it is subject to capital gain tax when it is sold or redeemed.

An S Corporation for tax purposes is treated in some ways as an entity and in some ways not. For example, an S Corporation's profits and losses are reported on the shareholder's personal tax returns, and are taxed to the shareholders and not the corporation. Profits are taxed only once: there is no double taxation as with a C Corporation. However, an S Corporation is treated as an entity for other purposes. For example, when shares in an S Corporation are sold or redeemed, the shareholder has disposed of a capital asset and a capital gain or loss is recognized for tax purposes.

2. Ownership Interest. A corporation is a legally-recognized entity distinct from its owner/shareholders. If a spouse owns shares of stock in a corporation, those shares may be community property to be divided (or considered) in a Texas divorce.

Except for certain licensed professions, there is no Texas law prohibiting the award of community property corporate shares to the non-shareholding spouse. The corporation's organizational paperwork, or agreements between shareholders, may impose restrictions on the transfer of shares, or may give the corporation or other shareholders an option or obligation to purchase the shares upon the happening of certain events, including death of a shareholder or the award of shares to the shareholder's spouse in a divorce. See Section VII below.

3. Assets. Because a corporation has a separate legal identity from the shareholders, all assets of a corporation belong to the corporation and not the shareholders. *Legrand-Brock v. Brock*, 246 S.W.3d 318, 322 (Tex. App.--Beaumont 2008, pet. denied), citing *Bryan v. Sturgis Nat'l Bank*, 40 Tex. Civ. App. 307, 90 S.W. 704, 705 (Tex. Civ. App. 1905, writ ref'd) ("The accumulated earnings or surplus funds of a corporation constitute a part of its assets, and belong to the corporation, and not to the stockholders, until they have been declared and set apart as dividends"); *Thomas v. Thomas* 738 S.W.2d 342, 343 (Tex. App.--Houston 14th Dist. 1987, writ denied) ("It is well established that, unless the corporation is a spouse's alter ego, ... a court upon divorce may award only shares of stock, and not corporate assets.). See Section V below, regarding piercing the corporate veil.

> **Author's Note**: The *Marshall* case says that a spouse cannot use the doctrine of mutation to follow the separate property character of an asset into and back out of a partnership. *Marshall v. Marshall*, 735 S.W.2d 587, 594 (Tex. App--Dallas 1987, writ ref'd n.r.e.) ("Woody apparently relies on the rule that mutations of separate property remain separate if properly traced. Norris, 260 S.W.2d at 679. However, a withdrawal from a partnership capital account is not a return of capital in the sense that it may be characterized as a mutation of a partner's separate property contribution to the partnership and thereby remain separate. Such characterization is contrary to the UPA and implies that the partner retains an ownership interest in his capital contribution. He does not; he partnership entity becomes the owner, and the partner's contribution becomes partnership property which cannot be characterized as either separate or community property of the individual partners.... Thus, there can be no mutation of

> a partner's separate contribution; that rule is inapplicable in determining the characterization of a partnership distribution from a partner's capital account."). *Accord*, *Lifshutz v. Lifshutz*, 199 S.W.3d 9, 27 (Tex. App.-San Antonio 2006, pet. denied) ("'[W]hen an individual partner contributes property into a partnership, the partner loses individual interest in the property and, since the partnership itself is the new owner, the property can no longer be classified as separate or community.' ... Accordingly, since partnership property does not retain a separate character, distributions from the partnership are considered community property, regardless of whether the distribution is of income or of an asset." (Quoting TEXAS PRACTICE: MARITAL PROPERTY AND HOMESTEADS § 4.10 (1993), and citing *Marshall*).

Texas Business Organizations Code ("TBOC") § 10.251 provides that a domestic entity "may transfer and convey by sale, lease, assignment, or other method an interest in property of the entity, including real property." The transfer may include goodwill, and may be "on any terms and conditions and for any consideration, which may consist wholly or partly of money or other property . . . ." TBOC § 10.251(a)(2). Unless provided by other Texas statute, a person acquiring property from an entity "may not be held responsible or liable for a liability or obligation of the transferring domestic entity that is not expressly assumed by the person." TBOC § 10.254(b). A corporation may pledge or mortgage any of its assets. TBOC § 10.251(b).

> **Practice Tip:** A corporate asset that often appears in the general ledger and balance sheet of closely-held businesses is a "loans to shareholders" account; sometimes the debt is reflected in a series of promissory notes. When the corporation is separate property, occasionally the owner-spouse "loans" money to himself, rather than paying the funds out as compensation for the owner's labor or making distributions of profits, which would be community property. These loans may be attacked as being disguised compensation.

> **Tax Tip:** If the IRS spots loans to the shareholder, the loans may be taxed to the owner as dividends received if interest is not paid (or accrued and reported as income) and no bone fide plan of repayment exists. If the other spouse contests the legitimacy of such "loans" and the Court ignores the community liability for such loans, an income tax will be owed on the amount of the loans that are treated as income to the shareholder. That leads to the question of whether the loans should be recast as dividends or compensation, which have different tax rates, and compensation is deductible by the corporation, but dividends are not.

4. Liabilities. One of the signature features of a corporation is that shareholders are not liable for corporate debts. However, shareholders of a Texas corporation can be held liable for corporate debts under the equitable (and partially statutory) doctrine of "piercing the corporate veil." See Section V of this Article. Shareholders are personally contractually liable for corporate debts that they personally guarantee, and are personally liable for any tortious wrongs they are personally held responsible for.

A corporation can owe money to its owners, sometimes reflected in a "loans from shareholders" account reflected in the business's general ledger or in the balance sheet, and sometimes reflected in promissory notes. Shareholders can put money into a corporation either by making contributions of capital or by loaning money to the corporation. In a closely-held business, often times the parties dispense with the formalities of a promissory note and instead maintain a running balance in the general ledger of advancements to the company and repayments made by the company. Although

informally documented, these loans are nonetheless real (unless they are disguised compensation or disguised distributions of profits).

5. Claims Against Corporation. Like any other "person," a corporation can be found liable in contract, tort, or fiduciary law, and is subject to claims in equity (rescission and restitution, unjust enrichment, constructive trust, etc.). A spouse can assert such claims in a divorce. However, claims of fraud on the community are not tort claims, and the spouse cannot recover actual or exemplary damages. *Schlueter v. Schlueter*, 975 S.W.2d 584, 588-89 (Tex. 1998). Furthermore, a spouse cannot recover against a third party for participating in fraud on the community if the wrongful-acting spouse retained the community property. *Chu v. Hong*, 249 S.W.3d 441, 446 (Tex. 2008) ("[i]f one spouse retains the fruits from defrauding the community estate, it is hard to see how the estate as a whole has been damaged, not to mention why someone else should pay for it"). However, "if a third party steals community property, surely either spouse or both can seek recovery in tort for it." *Id.* The equitable remedy of constructive trust is available to recover community property unjustly in the hands of a third party. *Barnett v. Barnett*, 67 S.W.3d 107, 112 (Tex. 2001) (wife has a remedy to impose a constructive trust on one half of the proceeds of the community property life insurance policy that passed to husband's mother upon husband's death). A constructive trust can be imposed by a court on assets held by a corporation that in equity should be community property. A corporation can also be sued in a divorce for a reverse-piercing claim. See Section V below.

6. Distributions to Owners. Corporations can pay salary, bonuses, and other forms of compensation and deferred compensation to owners. Corporations can reimburse business-related expenses of shareholders and can pay debt owed to shareholders. Corporations can also distribute profits or capital to owners in the form of dividends, return of capital, or in partial or total liquidation. The decision to do such things normally rests with the corporation's board of directors TBOC § 21.401(a), and should be reflected in board resolutions. Accounting entries should reflect the nature of such transactions. The tax treatment of these transfers varies, depending on the type of distribution. See Section III of this Article.

With closely-held corporations, sometimes the proper corporate paperwork that would differentiate a past distribution as a repayment of debt, distribution of profits, return of capital, or partial or total liquidation, is insufficient or even non-existent. Sometimes, under the scrutiny of forensic CPAs in the divorce, it will appear that the corporation's accountants incorrectly "booked" a transaction in the accounting records, and that can create fact issues to be resolved in the divorce. In handling a divorce, the forensic CPAs and the corporate lawyer and corporate CPA must be attuned to the way past distributions were characterized, and can be recharacterized, and they must choose carefully, document properly, and report changes in the type of distributions correctly to the IRS. Because some of these categories are affected by the corporation's historical profits and losses, and distributions, past events can affect the tax treatment given to distributions from the corporation that are changed in the resolution of a divorce.

7. Transfers of Shares. The TBOC does not prohibit the transfer of shares to non-owners, except for certain licensed professions (like law, medicine, dentistry, veterinary medicine, etc.). See Section VII of this Article. However, the corporation's organizational paperwork, or agreements between shareholders, can restrict the transfer of shares, or can provide the optional right to buy shares before or when they would otherwise be transferred to non-shareholders. See Section VII of this Article. Shares are normally transferred by executing an assignment and delivering the share certificate to

the transferee, and the transfer is supposed to be reflected in the corporate records, especially the stock transfer ledger. The common practice is to retire the old shares and to reissue the same shares under a new certificate number in the name of the new shareholder. If shares are redeemed by the corporation, they are transferred from the shareholder to the corporation, after which the corporation either retains the shares as unissued shares, or cancels the shares which causes the shares to cease to be issued.

The tax treatment of different kinds of corporate distributions to shareholders is discussed in Section III of this Article.

8. Close Corporation. A "close corporation" is different from a "closely held corporation." A closely held corporation is "a corporation that has: (1) fewer than 35 shareholders; and (2) no shares listed on a national securities exchange or regularly quoted in an over-the-counter market by one or more members of a national securities association." TBOC § 21.563. A "close corporation," on the other hand, is a corporation that is formed under Chapter 21, Subchapter O, of the TBOC. The Texas Secretary of State says this: "A close corporation is any domestic for-profit corporation or professional corporation that states in its certificate of formation that 'this corporation is a close corporation' The statement can be included in a corporation's initial certificate of formation, or it can be added later by filing a certificate of amendment. A close corporation may be managed according to a shareholders' agreement instead of by a board of directors or bylaws. Frequently, shareholders in close corporations agree to limit the conditions under which shares may be transferred or sold, apportion profits and losses in a specific manner, or set terms and conditions for share ownership or management positions."

9. Duties Owed by Officers and Directors to the Corporation and to Sharholders. The duties owed by officers and directors to the corporation and to shareholders are heavily impacted by statutory law. See Section XII.C.1, 2, & 3 below. Where the corporation was originally incorporated in another state, the laws governing "internal affairs," including fiduciary duties, are the laws of the state of incorporation. See Section V.9 below.

C. PARTNERSHIP.

1. Is it an Entity? Yes and No.

<u>For Legal Purposes</u>. Under Texas law, a partnership is an entity for legal purposes. All partnership assets belong to the entity. As for liabilities, however, a general partnership is not like an entity. In a general partnership, the partnership and all of the partners are liable for partnership debts. In a limited partnership, the partnership and the general partners are liable for partnership debts, but limited partners are not.

<u>For Tax Purposes</u>. Under U.S. tax law, in some ways a partnership is an entity and in some ways it's not. For example, a partnership's profits and losses are reported by the partnership on a partnership tax return filed with the IRS but they are reported by and taxed to the partners. The partnership reports its profits, losses, and distributions on a Form K-1 sent to each partner. Each partner reports his/her share of the partnership's profits or losses on Schedule E of his/her personal tax return. When a partner's interest is sold or liquidated, the transaction is treated as a capital gain or loss of that partner. Tax law distinguishes "inside" from "outside" tax basis. Inside tax basis is the partnership's

tax basis in partnership assets. Outside tax basis is the partners' tax basis in their partnership interests. Capital gains can be recognized both inside and outside the partnership.

2. Governing Texas Statutes. Texas partnerships are governed by Chapter 151, 152 and 154 of the TBOC. These chapters are largely default provisions that apply if the partnership agreement does not provide otherwise. See TBOC § 152.002.[2] Partners have great flexibility in designing their rights and responsibilities, compared to the more rigid corporate form, which is hemmed in by mandatory statutory requirements. Because the partnership agreement controls most issues, and since partnership agreements vary from case to case, determining rights, powers, and duties under a partnership agreement is often a matter of contract interpretation. *See Driveway Austin GP, LLC v. Turbo Partners*, 409 S.W.3d 197, 202-03 (Tex. App–Amarillo 2013, judgm't vacated w.r.m.) (extent to which partnership agreement allowed amendment by majority vote was a question of determining the intent of the parties).

Under the TBOC, a partnership is "an association of two or more persons to carry on a business for profit as owners." TBOC §152.051. A general partnership can be formed by the oral or written agreement of two or more individuals. See TBOC §151.001(5). There is no required formality for creating a partnership. See TBOC § 1.002(22) (a general partnership is not a filing entity). Partnerships can be formed between human beings, or between entities, or a mix, including a partnership between partnerships. The ownership percentages of partners affects distributions of profits, distributions of capital, and preferential entitlement to distributions, during the life of the partnership and on dissolution ("winding up").

> **Historical Note:** Partnerships date back to the *societas* of Roman law, some 2,000 years ago, but what is considered to be the world's first officially-chartered corporation, the East India Company, did not arise until 1600 A.D.[3] Partnerships are created by private agreement, while corporations are a creature of the state. Partnerships are altogether different animals.

> **Practice Tip:** Since there is no registration or other required formality for establishing a general partnership, two or more persons (including spouses) who have associated with each other to carry on a business for profit as owners have created a partnership, whether they realize it or not. See TBOC § 152.051. Every "sole" proprietorship has the potential to be a partnership if there is more than one participant in the business. With some restaurants and stores, both spouses are involved in running the business. Each spouse in such a divorce should evaluate who gains or loses if the business is a sole proprietorship or a partnership.

3. Ownership Interest. Although not originally true, Texas legislation has made it clear that "[a] partnership is an entity distinct from its partners." TBOC §152.101. A partnership is owned by its partners. Each partner owns a "partnership interest" which "is personal property for all purposes." TBOC §154.001(a). The partnership interest "may be community property under applicable law." TBOC §154.001(b). However, the right to participate in management cannot be community property. TBOC § 152.203(a). There are usually two types of ownership interests in a partnership: a "capital interest" and a "profits interest." A "capital interest" entitles the partner to receive both a share of future profits and losses, and payments upon withdrawal from the partnership or distributions upon partial or total liquidation ("winding up") of the partnership. *See Central State, Southeast and Southwest Areas Pension Fund, v. Creative Development Co.*, 232 F.3d 406, 425 (Dennis, J., dissenting); Alan J. Tarr, *Tax Planning for Domestic & Foreign Partnerships, LLCs,*

Joint Ventures & Other Strategic Alliances, Tax Law and Estate Planning Course Handbook Series p. 19 (Practicing Law Institute, 2007) [available on Westlaw at 747 PLI/Tax 9]. A "profits interest" entitles the partner to receive a share of earnings and profits, but no right to payment upon withdrawal or winding up. Mark Winfield Brennan, *The Receipt of a Profits Interest in a Partnership as a Taxable Event After Campbell and Mark IV*, 57 MO. L. REV. 273, 276 (1992). One partner can have both a capital interest and a profits interest and the percentage of each does not have to be the same. TBOC § 54.101 permits a written partnership agreement to "establish or provide for the future creation of additional classes or groups of one or more partners that have certain express relative rights, powers, and duties, including voting rights." Classes or groups can be established either at start up or when the class is later created. *Id.* at § 54.101(a). Classes established later can be given rights, powers, or duties that are senior to previously-existing classes. *Id.* at § 154.101(b).

An essential feature of being a general partner is the right to withdraw from the partnership, TBOC 152.501(b)(1), and receive fair value for the partnership interest. TBOC § 152.602. Shareholders in corporations ordinarily have no such right.

> **Settlement Tip:** TBOC §154.104 provides that a partnership agreement "may provide rights to any person, including a person who is not a party to the partnership agreement, to the extent provided by the partnership agreement." This ability could be used in settling some divorce cases, if the partnership agreement can be amended, typically requiring the consent of all partners.

If a spouse's partnership interest is community property, it can be awarded to the other spouse upon divorce (except for certain licensed professions). However, under TBOC Section 152.406, the non-partner spouse can receive in this manner only a "transferee's interest" in the partnership. A transferee's interest entitles the transferee to receive (but not require) distributions from the partnership, and to receive the transferee's share upon winding up of the partnership. TBOC § 152.404. The transferee does not have a right to participate in the management or conduct of the partnership business. TBOC § 152.402(3). A transferee is not obligated to make capital contributions to the partnership, so the obligation to meet capital calls remains with the transferor, even after a divorce. See TBOC § 152.404.

Under current law, a general partner is not required to make a capital contribution in order to own a partnership interest. TBOC § 153.151(c)(1). Nowadays, many times the general partner has no capital interest and no profits interest in the partnership.

4. Assets. Under TBOC §154.001, "[a] partner is not a co-owner of partnership property." Under TBOC §154.002, "[a] partner does not have an interest that can be transferred, voluntarily or involuntarily, in partnership property." These provisions are the essence of a partnership being an entity distinct from its owners. Thus, partnership assets cannot be awarded by a divorce court to the non-partner spouse. This has long been the law of Texas. *See McKnight v. McKnight*, 5423 S.W.2d 863 (Tex. 1976). A partnership may convey its assets, subject to any restrictions contained in the partnership agreement, and may pledge or mortgage any of its assets. TBOC § 10.251(a) & (b). So a divorce settlement could involve the partnership transferring assets to a partner's spouse. Doing so raises income tax issues. See Section IX.B.

5. Liabilities. For general partnerships, "all partners are jointly and severally liable for all obligations of the partnership unless otherwise: (1) agreed by the claimant; or (2) provided by law." TBOC §152.303. Thus, a partnership does not afford entity-like protection to general partners against partnership debt. A partner admitted to a partnership after its inception does not have personal liability for a partnership obligation that arose before her admission to the partnership, or that relates to an event occurring before admission, or that arises after admission under a contract or commitment made before admission. TBOC §152.304(b). If a general partner is married, the partner-spouse's non-exempt separate property, non-exempt sole management community property, and non-exempt joint management community property, can be taken by contract creditors. If the liability is tortious, the other spouse's non-exempt sole management community property can also be taken. See Tex. Fam. Code § 3.202. TBOC §152.308 subsection (a) provides that, on application by a judgment creditor of a partner or of any other owner of a partnership interest, a court having jurisdiction may charge the partnership interest of the judgment debtor to satisfy the judgment. Subsection (b) provides that, to the extent that the partnership interest is charged in the manner provided by subsection (a), the judgment creditor has only the right to receive any distribution to which the judgment debtor would otherwise be entitled in respect of the partnership interest. Subsection (c) provides that a charging order constitutes a lien on the judgment debtor's partnership interest. The charging order lien may not be foreclosed on under this code or any other law. Subsection (d) provides that the entry of a charging order is the exclusive remedy by which a judgment creditor of a partner or of any other owner of a partnership interest may satisfy a judgment out of the judgment debtor's partnership interest.

6. Payment of Claims. Like any other "person," a partnership can be held liable in contract, in tort, in fiduciary law, and is subject to claims in equity (unjust enrichment, constructive trust, etc.).

7. Capital Account. In dealing with partnership issues in a divorce it is necessary to understand the role of a partner's "capital account." The capital accounts of partners in a Texas partnership are maintained in accordance with TBOC Section 152.202, which provides:

> Sec. 152.202. Credits of and Charges to Partner.
>
> (a) Each partner is credited with an amount equal to:
>
> > (1) the cash and the value of property the partner contributes to a partnership; and
> > (2) the partner's share of the partnership's profits.
>
> (b) Each partner is charged with an amount equal to:
>
> > (1) the cash and the value of other property distributed by the partnership to the partner; and
> > (2) the partner's share of the partnership's losses.
>
> (c) Each partner is entitled to be credited with an equal share of the partnership's profits and is chargeable with a share of the partnership's capital or operating losses in proportion to the partner's share of the profits.

Stated in simpler terms, a partner's capital account reflects the cumulative total of four things:

(i) capital contributed by the partner, plus
(ii) the partner's share of profits; less
(iii) distributions to the partner; less
(iv) the partner's share of losses.

This rule on capital accounts is one of the many that apply to both general partnerships and limited partnerships. TBOC § 153.003.

The capital account is in effect a running total of the net of past contributions, profits, distributions, and losses. A partner's capital account is a way to measure the partner's claim on partnership assets upon withdrawal or dissolution.

Upon winding up a partnership, any capital accounts that are out-of-balance with a partner's capital ownership percentage must be brought into balance before liquidating distributions are made in proportion to capital percentages. That is, if one partner's capital account is higher than her percentage capital interest and another partner's capital account is lower than her percentage capital interest, the partner whose capital account is lower must forego distributions or even put money back into the partnership until her capital account is brought into parity with her capital interest, and the partner whose capital is higher than her percentage capital interest will disproportionately receive distributions that reduce her capital account until her capital account is brought into parity with her percentage capital interest.

> **Litigation Tip.** The capital account feature of partnership accounting means that a partner's claim on partnership assets is not just a function of her capital interest; it is a function of her capital interest as adjusted by her capital account. This adjustment should be considered when valuing a spouse's partnership interest for purposes of divorce.

In a sense, a capital account lower than the partner's capital interest is a "loan" from the partnership that must repaid no later than winding up, and a capital account that is higher than the partner's capital interest is a loan to the partnership that must be repaid no later than winding up. While each partnership agreement is different, many partnership agreements do not provide that a partner's capital account must be brought into balance with her capital interest at any time prior to winding up. Thus, if the partnership agreement allows it, a partner can take more than her share of money out of a partnership simply by taking distributions that reduce her capital account below her proportionate capital interest.

> **Litigation Tip.** If community property is contributed to a separate property partnership, a reimbursement claim arises. See Section IV below. The evidence of capital contributions during marriage may be reflected in the partnership's accounting records in the owners' equity section of the balance sheet.

An article with an in-depth analysis of capital contributions to partnerships is Cliff Ernst, *Planning, Drafting and Implementing Capital Call Provisions,* Univ. of Texas School of Law's Partnerships, Limited Partnerships and LLCs, pp. 23-37 (July 2009).[4]

8. Distributions to Partners. Partnerships can pay debts owed to partners, or reimburse partners' expenses, make distributions of profits, make distributions of capital, and have a partial or total

liquidation. TBOC §154.203(a) says that a partner cannot require a distribution from the partnership in any form other than cash, unless the partnership agreement so provides. Nor can the partnership force a partner to take, as a distribution in kind, a greater portion than his percentage share of a non-cash asset. TBOC §154.203(b).

> **Tax Tip:** Partnership income flows through to the partners' tax returns. So a partner can owe income tax on partnership income that has not been distributed. This is sometimes called "phantom income." See Section VIII.A.1.c. below.

In certain situations, distributions to partners can create tax liability. This topic is discussed in Sections VIII.A.4 and IX.B below.

9. Transfer of a Partnership Interest. "A partner may transfer all or part of the partner's partnership interest." TBOC §152.401. "After the transfer, the transferor continues to have the rights and duties of a partner other than the interest transferred." TBOC §152.403. "A transferee of a partner's partnership interest is entitled to receive, to the extent transferred, distributions to which the transferor otherwise would be entitled." TBOC §152.404(a). The transferee is also entitled to receive "the net amount otherwise distributable to the transferor" upon winding up of the partnership, to the extent transferred. TBOC §152.404(b). The transferee assumes no partnership liabilities as a result of the transfer, unless the transferee becomes a partner. TBOC §152.404(c). The transferee can, "for a proper purpose," require "reasonable information or an account of a partnership transaction and make reasonable inspection of the partnership books." TBOC §152.404(d). If the partnership is winding up, the transferee can require an accounting. TBOC §152.404(d). The partnership does not have to give effect to a transferee's rights until it receives notice of the transfer. TBOC §152.404(e). TBOC §152.406 provides that, "on the divorce of a partner, the partner's spouse, to the extent of the spouse's partnership interest, if any, is a transferee of the partnership interest."

> **Litigation Tip:** The partnership agreement can be amended to provide for a transferee-ex-spouse to receive more information about partnership business, if the conditions for amending the partnership agreement can be met (i.e., with consent of the other partners).

> TBOC Section 152.405 very importantly says:

> A partnership is not required to give effect to a transfer prohibited by a partnership agreement.

TBOC §152.406(c) says that "[t]his chapter does not impair an agreement for the purchase or sale of a partnership interest at any time, including the death or divorce of an owner of the partnership interest."

> **Litigation Tip:** A spouse receiving a transferee's interest can be admitted as a partner, if the conditions for admitting a new partner are met. Becoming a general partner entails personal liability for some past and all future partnership obligations. See Section II.C.5 above. Admission as a limited partner avoids personal liability for partnership debts. See Section II.D below.

The TBOC authorizes transfer restrictions and buy-sell agreements for partnership interests,

including mechanisms that are triggered by divorce. See the discussion of restrictions and buy-sell agreements in Section VII below.

As noted above, a transferee is not liable for capital calls. If the transferor does not make the capital contribution required of the transferee's interest, the transferee's interest is subject to the penalties contained in the partnership agreement, including dilution of the transferee's ownership percentage. See TBOC § 153.202. See also Cliff Ernst, *Planning, Drafting and Implementing Capital Call Provisions*, Univ. of Texas School of Law's Partnerships, Limited Partnerships and LLCs, pp. 23-37 (July 2009). In a divorce settlement, the transferee may want to include a penalty provision if the transferor's failure to make a required capital call harms the transferee.

10. Partners' Duties to the Partnership and Other Partners. The duties owed by partners in a general partnership to the partnership and to other partners is discussed in Section XII.C.4 below.

D. LIMITED PARTNERSHIPS. In Texas, limited partnerships have the essential features of general partnerships, except that: (i) registration with the Secretary of State is necessary to trigger the limited liability feature of the partnership into existence; (ii) limited partners have ownership with limited management rights; and (iii) the liability of limited partners is restricted to their ownership interest in the business. Limited partnerships are governed by Chapter 153 of the TBOC, and provisions governing both general partnerships and limited partnerships are contained in Chapter 154 of the TBOC. A limited partnership must have a general partner and at least one limited partner. If there are at least three partners, the same persons or entities can own both a general partner interest and a limited partnership interest. A limited partnership is a "filing entity" under TBOC § 1.002(22), meaning that it is created by filing a certificate of formation under TBOC § 3.001. Note that a limited partnership formed by agreement of the partners that does not file a certificate of formation is a general partnership.

1. Ownership Interest. TBOC §152.101 says that "[a] partnership is an entity distinct from its partners." A partnership is owned by its partners. Each partner owns a "partnership interest" which "is personal property for all purposes." TBOC §154.001(a). A partnership interest gives the partner both rights and liabilities. In a limited partnership, the partnership interests are divided between general partner interests and limited partner interests. The general partner may or may not have an capital or profits interest in the partnership, and the general partner always has managerial rights, subject to restrictions in the partnership agreement and a few restrictions in the TBOC. The limited partner interests have ownership with limited management rights, that can include veto power over certain major decisions. See TBOC § 153.103. A limited partnership interest "may be community property under applicable law." TBOC §154.001(b).

A limited partner may withdraw as limited partner "only at the time or on the occurrence of an event specified in the written partnership agreement. The withdrawal of the partner must be made in accordance with that agreement." TBOC § 153.110. Limitations on the right of limited partners to withdraw can be a significant restriction on the rights of limited partners as compared to general partners. Upon withdrawal, the limited partner is entitled to receive "fair value" within a reasonable time. TBOC § 153.111.

> **Litigation Tip:** "Fair value" is understood to be the value without considering adjustments to value for control or lack of control or lack of marketability. TBOC § 10.362(b) (defining "fair

value" in connection with dissenters' rights).

2. Assets. As with general partnerships, the assets of a limited partnership are owned by the partnership, not by the partners. TBOC §§ 154.001 & 154.002.

3. Liabilities. The general partner of a limited partnership is liable for all partnership debts and liabilities. *Asshauer v. Wells Fargo Foothill*, 263 S.W.3d 468, 474 (Tex. App.–Dallas 2008, pet. denied). A limited partner is not liable for partnership debts. TBOC § 153.102. Even if a certificate of limited partnership was not filed under pre-TBOC law, or a certificate of formation was not filed under TBOC § 3.001, the limitation of liability of limited partners is effective as against parties with actual notice that the partnership was a limited partnership. *See Apcar Inv. Partners VI, Ltd. v. Gaus*, 161 S.W.3d 137, 141 (Tex. App.--Eastland 2005, no pet.).

However, if a limited partner participates in the control of the businesses, she may subject herself to liability like a general partner. TBOC § 153.102(a). That rule applies even if the limited partner manages the partnership through a general partner that is an entity. *Delaney v. Fid. Lease Ltd.*, 526 S.W.2d 543, 545 (Tex. 1975) ("the personal liability, which attaches to a limited partner when 'he takes part in the control and management of the business', cannot be evaded merely by acting through a corporation").

Using the doctrine of piercing the "corporate" veil to make limited partners liable for partnership debts has been rejected by both Texas and Federal courts. See Section V below.

4. Payment of Claims. Like a general partnership, a limited partnership can be held liable in contract, in tort, and under fiduciary law, and is subject to claims in equity (unjust enrichment, constructive trust, etc.).

5. Distributions to Partners. Limited partnerships can pay debts owed to partners, and reimburse partners' expenses, and make distributions of profits, distribution of capital, and liquidating distributions. TBOC §154.203(a) says that a partner cannot require a distribution from the partnership in any form other than cash, unless the partnership agreement so provides. Nor can the partnership force a partner to take, as a distribution in kind, a greater portion than his percentage share of a non-cash asset. TBOC §154.203(b). The tax treatment of different kinds of limited partnership distributions are discussed in Sections III.B.1 and VIII.A.4 below.

6. Partners' Duties to the Limted Partnership and Other Partners. The duties owed by partners in a limited partnership to the partnership and to other partners is discussed in Section XII.C.5 below.

E. LIMITED LIABILITY COMPANIES.

1. Is an LLC an Entity: Yes and No. An LLC is an entity for legal purposes. The LLC owns its assets and the members are not liable for LLC debts, except for personal guarantees and piercing the entity veil. The LLC can elect to be taxed like a C Corporation or like an S Corporation. When a membership interest in an LLC is sold, it is recognized as a capital gain or loss of the seller for tax purposes.

2. Membership Interest. An LLC is an entity. The owners of an LLC are called "members," and they own membership interests. The company agreement can label membership interests as "shares," "units" or some other name. The rules governing the ownership and operation of the LLC are contained in a "company agreement." TBOC §§ 101.001(1) & 101.052.

Texas is one of twenty-one jurisdictions that allow one LLC to have members of different "series." See TBOC § 101.601, subch. M. A series is a sort of subpart of the LLC, but each series is completely distinct from other series. Each series has its own membership interests, assets, liabilities, and management rights. See TBOC § 101.502 (assets); § 101.606 (liabilities); § 101.608 (management); § 101.613 (distributions). See Philip D. Weller, *Transactions in Series LLCs*, State Bar of Texas Advanced Real Estate Law Course ch. 4 (2014). To date, the IRS has recognized the series (pl.) as distinct from one another for tax purposes, for example requiring a separate taxpayer I.D. number for each series.

Under TBOC § 101.106, a member's interest in an LLC may be community property, but a member's right to participate in management and conduct of the business is not community property. Under TBOC § 101.1115, on divorce of a member, the member's spouse is, "to the extent of the spouse's membership interest, if any, . . . an assignee of the membership interest." Under TBOC § 101.110, an assignee is "entitled, to the extent assigned, to the same rights and powers granted or provided to a member of the company by the company agreement" or the TBOC. The assignee is similarly bound to the same restrictions and obligations imposed on members by the company agreement or the TBOC, and is liable for obligations owed by the assignor to the LLC, except for obligations that cannot be ascertained from the company agreement and of which the assignee had no knowledge when s/he became a member. TBOC § 101.110(b). The assignee is liable for the assignor's obligations to make contributions to the company, except for obligations that cannot be discerned from the company agreement and of which the assignee had no knowledge. TBOC § 101.110(a)(3). This differs from transferees of a partnership interest, who are not liable for any obligation to contribute capital to the partnership (capital calls). See TBOC § 152.404. The assignor of the interest is entitled to continue to exercise all rights and powers not assigned, until the assignee becomes a member. TBOC § 101.111(a). The assignor is not released by the assignment from liability to the company. TBOC § 101.111(b).

3. Assets. The assets of an LLC belong to the LLC, or to the particular series of the LLC, and not to the members. TBOC § 101.106(b). See TBOC § 101.112(f) (a creditor of a member has no right to exercise legal or equitable remedies against the assets of the LLC). *Touponse v. Touponse*, No. 02-20-00285-CV (Tex. App.--Fort Worth July 1, 2021, no pet.) (mem. op.) ("A limited-liability company is a separate legal entity, and property owned by such a company is neither the community property nor the separate property of its members. Tex. Bus. Org. Code Ann. § 101.106(a)-(a-1)…").

4. Liabilities. Under TBOC § 101.113, a member of an LLC can be named a party to a lawsuit by or against the LLC only as to the member's right against or obligations owed to the LLC. The liabilities of an LLC are liabilities of the LLC itself, and not its members; members and managers cannot be held liable unless the company agreement specifically provides otherwise. TBOC § 101.114; *Sanchez v. Mulvaney*, 274 S.W.3d 708, 712 (Tex. App.–San Antonio 2008, no pet.) (members are not liable for LLC debts). In a series LLC, the liabilities of one series are distinct from the liabilities of other series, unless the credit arrangements provide otherwise. The liabilities of a series are not liabilities of the LLC itself, unless the credit arrangements provide otherwise. The

series LLC concept is relatively new and has not generated much case law, but corporate lawyers are hoping that the bankruptcy of one series of an LLC will not involve other series or the LLC itself, under the doctrine of "substantive consolidation."

As for personal liabilities of a member, the member's interest in the LLC is subject to a charging order to pay a judgment creditor. TBOC § 101.112. This gives the judgment creditor a right to "receive any distribution to which the judgment debtor would otherwise be entitled in respect of the membership interest." A charging order is the sole method of collecting a liability from a member's LLC interest. TBOC § 101.112(d). So a creditor cannot foreclose on a member's interest and offer it for sale, like it could with corporate shares.

5. Payment of Claims. Like any other "person," an LLC can be liable in contract, in tort, under fiduciary law, and is subject to claims in equity (unjust enrichment, constructive trust, etc.). See the discussion in Section III.E.4 above. The same can be said of each series of a series LLC.

6. Distributions to Members. Profits and losses of an LLC must be allocated on the basis of contributions made by each member, using agreed values. TBOC § 101.201. The member is entitled only to cash distributions, regardless of the form of contribution to the LLC. TBOC § 101.202. Distributions from the LLC must be made according to the agreed value of each member's contribution to the company. A member cannot require interim distributions. TBOC § 101.204. A member "who validly exercises the member's right to withdraw from the company granted under the company agreement,' is entitled to receive, within a reasonable time after the date of withdrawal, the "fair value of the member's interest in the company as determined as of the date of withdrawal." TBOC § 101.205. Distributions cannot be made if the LLC would have a negative net worth, as measured by the terms of TBOC § 101.206.

7. Transfers of Membership Interests. Membership interests in an LLC (or series) can be freely transferred, subject to any transfer restrictions or buy-sell agreements that apply. If a spouse's membership interest is community property, it can be divided and awarded in a divorce as the parties or the court sees fit, subject to any transfer restrictions and buy-sell provisions. However, the non-member spouse can receive only an assignee's interest. See Section II.E.2 above.

8. Members' and Managers' Duties to the LLC Other Members. The duties owed by LLC members to the LLC and to other members are discussed in Section XII.C.7 below.

F. PROFESSIONAL ENTITIES. Under Title 7 of the TBOC, Section 301.033, "'Professional entity' means a professional association, professional corporation, or professional limited liability company."

A professional association ("PA") is an association, distinguished from either a partnership or a corporation, formed under Title 7 of the TBOC to provide professional services by doctor of medicine, doctor of osteopathy, doctor of podiatry, dentist, chiropractor, optometrist, therapeutic optometrist, veterinarian, or licensed mental health professional. TBOC § 301.003(2). TBOC Section 302.001 provides that PAs are subject to statutes relating to for-profit corporations, set out in TBOC ch. 20 and 21.

A professional corporation ("PC") is formed under Title 7 for the purpose of providing a

professional service, other than the practice of medicine by physicians, surgeons, or other doctors of medicine, that by law a corporation governed by Title 2 is prohibited from rendering. TBOC § 301.003(3). TBOC Section 303.001 provides that PAs are subject to TBOC ch. 20 and 21.

A professional limited liability company ("PLLC") means a limited liability company formed for the purpose of providing a professional service and governed as a professional entity under Title 7. TBOC § 301.003(6). PLLCs are subject to TBOC Title 3, Limited Liability Companies.

1. Is it an Entity?A professional entity is an entity for legal purposes. For tax purposes, the entity is treated under the rules that apply to the type of entity.

2. Membership Interest. TBOC §1.002(53)(E) defines a member of a professional association as "a person who has membership rights in the professional association under its governing documents." A member must be a "professional individual," which is a person licensed to perform the same professional service as is rendered by the professional entity. TBOC § 301.003(5). Only an "authorized person" can own an interest in a professional entity. TBOC § 301.007(a). An "authorized person" with regard to a PA is a "professional individual"; an "authorized person" with regard to a PC or PLLC can be either a professional individual or a professional organization. TBOC § 301.004. Thus, only individuals can own PA's while individuals and professional entities can own a PC or PLLC. If a non-authorized person succeeds to an ownership interest in a professional entity, that person must "promptly relinquish the person's financial interest in the entity." TBOC § 301.008(c).

The members of a professional entity own "shares" in the entity. TBOC § 1.002(80).

3. Assets. In accordance with entity law applying to the underlying entity, the assets of a professional entity belong to the entity and not to the owners.

4. Liabilities. Relying in entity law applying to the underlying entity, generally speaking the liabilities of a professional entity are liabilities of the entity and not of the members.

5. Payment of Claims. A professional entity can be held liable in contract, in tort, in fiduciary law, and is subject to claims in equity. TBOC Section 301.010 provides that a professional entity is jointly and severally liable for the negligence or malfeasance of an owner, manager, or agent committed in providing a professional service for the entity or in the course of employment.

6. Distributions to Members. The rules governing distributions are determined by the type of entity: PCs and PAs are like corporations; PLLCs are like LLCs; and

7. Transfers of Membership Interests. The rules governing transfers are determined by the type of entity: PCs and PAs are like corporations; PLLC are like LLCs. However, only "authorized persons" can own an interest in a professional entity. If a non-authorized person succeeds to an ownership interest in a professional entity, that person must "promptly relinquish the person's financial interest in the entity." TBOC § 301.008(c).

III. BASIC ENTITY TAX PRINCIPLES. Tax-related issues can be as important as legal issues when it comes to dividing business entities upon divorce. This very important section of the Article

discusses basic principles of taxation of entities, and complications that can be encountered in dividing entities in a divorce. If you encounter issues involving a business in a divorce, you should involve a tax advisor to be sure that you are aware of the tax effects of the property division.

A. SOLE PROPRIETORSHIP. Because a sole proprietorship is not a legal entity, all the income and expenses from a sole proprietorship are reported on Schedule C of the business owner's Form 1040 U.S. Individual Income Tax Return. There is no tax impact related to contributions to or distributions from a sole proprietorship from or to its owner per se. The tax effects relate to the individual assets and liabilities themselves.

> **Tax Tip**: If both spouses are involved in running an unincorporated business together, they may meet the definition of a partnership under Texas law and if so, they would report income or losses on Form 1065 and not Schedule C. However, whether an unincorporated business is treated as an entity separate from its owners for federal tax purposes is a matter of federal tax law, not state law. See Revenue Procedure 2002-69.

Revenue Procedure 2002-69 says:

> The Treasury Department and the Internal Revenue Service have become aware that taxpayers are unsure of the classification for an entity that is owned solely by a husband and wife as community property under the laws of a state, a foreign country, or a possession of the United States. To alleviate this uncertainty and in the interest of administrative simplicity, this revenue procedure provides that the Internal Revenue Service will respect a taxpayer's treatment of these entities as either disregarded entities or partnerships.

Ordinarily, a domestic entity with two or more owners is classified as a partnership for federal tax purposes unless it elects or is required to be treated as an association taxable as a corporation. If spouses in a community property state choose to treat a community property business as an entity disregarded for tax purposes, there will be no entity tax return. The business activity will instead be reported on Schedule C of the spouses' individual tax return Form 1040.

> **Forensic Tip:** Schedule C of a Form 1040 reflects income and expenses and net profit or loss, but not a balance sheet of assets and liabilities. However, Line 35 reflects beginning and ending inventory. In some businesses, the inventory may be a large component of the value of tangible assets.

B. PARTNERSHIP AND LLC CLASSIFIED AS A PARTNERSHIP FOR TAX PURPOSES. A partnership is a "pass-through entity" for tax purposes. Income or loss is passed through to partners on a Form K-1, and each partner reports her share of income and losses on their individual tax returns. Thus, although an entity taxed as a partnership files a tax return it pays no taxes. It is the partners and not the partnership who pay the income tax on partnership income.

Net income or loss is allocated among the partners according to the partnership agreement, generally but not always in proportion to the partners' profits interests. Income or loss that is passed through to a partner is referred to as the partner's "distributive share." Each partner pays the tax on his/her distributive share of income in the year earned. When a partnership distributes cash or property to

a partner, the transaction is generally not taxable, subject to exceptions.

A partnership's business income, deductions, credits, gains, and losses resulting from partnership operations are reported on Form 1065, U.S. Return of Partnership Income. The partnership tax return Form 1065 includes a separate Schedule K-1 for each partner, which reports the partner's distributive share of income and other separately stated items. The partnership is required to furnish a copy of Schedule K-1 to each partner by March 15 or, if the deadline is extended, September 15.

An individual partner reports ordinary income from the Schedule K-1 on Schedule E of his/her Form 1040 U.S. Individual Income Tax Return. Other items of income or loss are reported on the appropriate forms or schedules.

> **Practice Tip:** In a divorce, always obtain the pass-through entity tax returns and the owner-spouse's Schedules K-1. This information will help not only in identifying and valuing ownership interests, but also can provide important information that can affect the decision of whether to continue co-ownership after the divorce. Disregarded entities will have no tax return.

1. Distributions from a Partnership. Partners generally are taxed when the income is received by the partnership (if the partnership utilizes the cash method of accounting) or earned by the partnership (if the partnership utilizes the accrual method of accounting). A distribution of cash or property from a partnership to its partners generally does not affect the tax liability of the partners, though taxation can occur if the distribution is a guaranteed payment, a distribution made in exchange for a partner's capital interest, or the distribution is in excess of the partner's tax basis in the partnership interest.

> **Non-Cash Assets**. Different issues arise when the distribution is a non-cash asset. A partner's tax basis in non-cash property distributed to the partner is the partnership's adjusted tax basis in the property immediately before the distribution, limited to the partner's adjusted tax basis in the partnership. Internal Revenue Code ("IRC") § 732(a). If money and property are distributed together, the money reduces the partner's adjusted tax basis before the property is considered. The partner's holding period for the property includes the partnership's holding period plus any holding period of the partner who contributed the property to the partnership. See OFP p. 11.

> **Hot Assets.** "Hot assets" are unrealized receivables of the partnership, or inventory items of the partnership. Under IRC § 751, hot assets distributed from a partnership are not taxed as capital gains, subject to certain exceptions.

> **Disguised Sales.** A "disguised sale" under IRC § 707(a) occurs when a partner contributes real estate or non-cash personal property with a value exceeding the partner's tax basis in the property, and the partner receives consideration other than a partnership interest.

2. Exceptions for Distributions. A partner recognizes a gain or loss on a distribution from a partnership when the partnership distributes non-cash property with:

a. a disproportionate distribution of Section 751 ("hot") assets;
b. a distribution of contributed property to which Section 704(c)(1)(B) applies (Section

704(c)(1)(B) applies when property is contributed by a partner and the property is subsequently distributed by the partnership to another partner within seven years of the original contribution);

c. a distribution subsequent to a contribution of appreciated property to which Section 737 applies;
d. a distribution of marketable securities under Section 731(c); or
e. a distribution that is part of a disguised sale transaction under Section 707(a).

A partner's gain on distribution is considered to be a gain from the sale or exchange of a partnership interest, which is generally a capital gain, except to the extent the partnership has "hot assets," like unrealized receivables or inventory. IRC § 731(a). If the holding period for the partnership interest is one year or less, the gain is a short-term capital gain; if held longer than one year, the gain is a long-term capital gain. IRC § 1222. See OFP pp. 11-12.

3. Losses from a Partnership. A partner's distributive share of losses can be deducted by a partner up to the partner's adjusted tax basis in the partnership. The adjusted tax basis in the partnership generally includes the partner's pro rata share of partnership liabilities. A partner's adjusted tax basis cannot go below zero. Deducting losses in excess of adjusted tax basis is not allowed. Other rules limiting a partner's losses include the at-risk and passive activity loss rules. See OFP p. 12.

4. Tax Basis. A partner's initial tax basis in a partnership is generally the cash contributed, plus the adjusted tax basis of property contributed, plus any taxable income to the partner from the contributed property, plus any liabilities the partner assumes when becoming a partner, and less any liabilities the partnership assumes from the partner. Any liabilities assumed by the partnership are treated as a distribution of money to the contributing partner. IRC § 752(b). Each of the other partners' tax basis is increased by his/her proportionate share of the liability assumed. See OFP p. 12.

Inside and Outside Basis. Federal tax law refers to "inside" and "outside" basis. "Outside basis" is the tax basis in the partner's tax basis in her interest in the partnership. "Inside basis" refers to a partnership's tax basis in its assets. IRS Publication 541 discusses outside basis. A clear explanation of inside and outside basis in partnership tax law is contained in the IRS Practice Unit on *Partner's Outside Basis*, LB&I Transaction Unit (6-10-2021).[5]

5. Contributed Property. Generally, no gain or loss is recognized by the partner or partnership when a partner contributes property to the partnership in exchange for an interest in the partnership. IRC § 721(a). See OFP p. 12.

6. Tax Upon Sale or Exchange of a Partnership Interest.[6] When a partner sells her partnership interest, the tax approach is to recognize the entity aspect and not the aggregate aspect of partnership. The event is a sale of capital asset, and the sale or exchange of partnership interest usually results in capital gain or loss. However, certain exceptions exist. Gain or loss is the difference between the amount realized and the adjusted tax basis of the partner's interest in the partnership outside basis). If the selling partner is relieved of any partnership liabilities, that partner must include the liability relief as part of the amount realized for his or her interest. See IRS Publication 541.

a. Payments for Unrealized Receivables and Inventory Items–"Hot" Assets. If a partner

receives money or property in exchange for any part of a partnership interest, the amount attributable to his or her share of the partnership's unrealized receivables or inventory items results in ordinary income or loss. This amount is treated as if it were received for the sale or exchange of property that is not a capital asset.

This treatment applies to the unrealized receivables part of payments to a retiring partner or successor-in-interest of a deceased partner only if that part is not treated as paid in exchange for partnership property.

The income or loss realized by a partner upon the sale or exchange of her interest in unrealized receivables and inventory items is the amount that would have been allocated to the partner if the partnership had sold all of its property for cash at fair market value, in a fully taxable transaction, immediately prior to the partner's transfer of interest in the partnership. Any gain or loss recognized that is attributable to the unrealized receivables and inventory items will be ordinary gain or loss. See OFP p. 13.

7. Tax Upon Liquidation. In a liquidation, the partnership's outside basis is allocated first to money, and then to other property which is usually a carryover basis from the partnership's inside basis. *See* LB&I Transaction Unit Primary UIL Code 731.00-00 on *Liquidating Distributions of a Partner's Outside Basis* (7-8-2023).[7]

C. CORPORATIONS AND ENTITIES ELECTING TO BE TAXED AS A CORPORATION. A C Corporation is a taxable entity for Federal income tax purposes. It is subject to double taxation: once at the corporate level at corporate tax rates, then again on the shareholder's tax returns upon distribution of dividends. Dividend income is taxable to recipients beginning at a 15% rate, rising to 20% for individuals whose taxable income exceeds $415,050 (for single taxpayers). An eligible C Corporation may make an S Corporation election to avoid paying tax at the corporate level. The income of an S Corporation is passed through to the shareholders' personal tax returns.

Every corporation must file an annual tax return, which is generally a Form 1120 U.S. Corporation Income Tax Return. The tax return due date for a C Corporation is the 15th day of the fourth month following the close of its tax year.

Unlike partnerships, a C Corporation is taxed on its income. A C Corporation carries on a trade or business, realizes net income or loss, pays income taxes, and distributes profits to shareholders. C Corporation income has double taxation: the income of the corporation is taxed to the corporation when it is earned, and it is taxed again to shareholders when the profits are distributed to them in the form of dividends. No deduction is allowed to the corporation for dividends paid to shareholders.

1. Electing to be Taxed as a Corporation. An LLC or other entity that files a Form 8832 Entity Classification Election to be taxed as a corporation, is able to make an S election. All members must be an eligible shareholder to own S Corporation stock. An LLC that is eligible to elect S status and timely files a Form 2553 electing S status is considered to have made the election to be taxed as a corporation. A Form 8832 does not have to be filed if an S election is properly filed.

2. Estimated Tax Payment Requirements. A C Corporation's estimated income tax must be deposited quarterly or an underpayment penalty will apply. Exception: no underpayment penalty is assessed if the tax owed is less than $500. Different estimated tax payment rules may apply based on the level of taxable income generated by the corporation.

3. Capital Contributions. There is no gain or loss to the corporation when it issues stock in exchange for cash or property. IRC § 1032. There is no recognition of gain or loss by shareholders when contributing *cash* in exchange for stock. Recognition of gain or loss may occur when a shareholder contributes *property* in exchange for stock. When property is transferred to a corporation in exchange for stock, the property is deemed to have been sold to the corporation at fair market value. If services are performed in exchange for stock, the fair market value of the service is taxable compensation. Any amount included in income is the shareholder's tax basis. The tax basis of property contributed by a non-shareholder is zero. Any cash contributed by a non-shareholder reduces the corporation's tax basis in assets held inside the corporation. Capital contributions made to a corporation after start-up are called "additional paid-in capital."

4. Section 351 Transfers. Ordinarily, when a person transfers property to a corporation in exchange for shares in the corporation, the contributing person recognizes a capital gain (or loss) on the property transferred. However, an IRC § 351 transfer is generally not taxable. In a Section 351 transfer, no gain or loss is recognized if one or more persons transfer cash or property to a corporation solely in exchange for stock if the person or persons control the corporation immediately after the exchange. Control is owning at least 80% of the voting stock and 80% of all other classes stock. Under Section 351, the corporation receives the transferor's tax basis in the property received.

Section 351 does not apply to: 1) property transferred to an investment company, 2) a transfer of property in a bankruptcy in exchange for stock used to pay creditors, or 3) stock received in exchange for the corporation's debt or for accrued interest on the corporation's debt that occurred while the transferor held the debt.

The holding period for an asset received in a Section 351 transfer includes the time the asset was held by the transferor. The shareholder's holding period for the stock received in a Section 351 transaction includes the period that the shareholder held the property before the exchange. IRC § 1223.

If a shareholder contributes property subject to liabilities in a Section 351 exchange, the shareholder's basis in the stock received is reduced by the amount of liability relief. IRC § 358. If liabilities exceed the shareholder's adjusted tax basis in the property transferred, gain is recognized on the excess and the shareholder's tax basis in the stock is zero. However, liability relief is not included in the computation if payment of the liability gives rise to a deduction. IRC § 357(c)(3).

5. Distributions. When a C Corporation distributes cash or property to a shareholder, the type of distribution determines the tax treatment. Distributions from a corporation to a shareholder are generally transferred in one of the following forms: wages, salary, bonuses, deferred compensation, fringe benefits, dividends, distributions of capital, loans, rent payments, or royalties. In certain situations, the IRS may attempt to reclassify the distribution as a dividend to the shareholder.

Distributions paid to shareholders from earnings and profits (E&P) are generally considered taxable dividends. If non-cash property is distributed, the shareholder is taxed on the fair market value of the property less any liabilities assumed by the shareholder in connection with the distribution. Distributions in excess of E&P are considered to be a nontaxable return of capital. However, any return of capital in excess of the shareholder's adjusted tax basis in his/her stock is treated as a gain from the sale or exchange of property. IRC § 301(c)(3)(A).

6. Tax Effects of Distributions.

a. No gain or loss is recognized by corporation when cash is distributed to shareholder.

b. If a C Corporation distributes appreciated property to a shareholder (other than the corporation's stock or securities), the corporation must recognize a gain as if the corporation sold the property at fair market value. IRC § 311(b). For purposes of distributions, fair market value is the greater of the actual fair market value or the amount of liabilities assumed by the shareholder in connection with the transaction. The rule also applies to a distribution of property in satisfaction of a declared dollar dividend.

c. There is no loss recognition by the corporation on the distribution of property to a shareholder unless the corporation is undergoing a complete liquidation. See OFP p. 16.

d. Distributions of cash or property will reduce the corporation's E&P. Distributions of cash or property do not affect the corporation's taxable income. Distributions of appreciated property increase E&P by the amount of appreciation and decrease E&P by the fair market value of the distribution.

7. Nondividend Distributions.

a. Form 5452, Corporate Report of Nondividend Distributions, must be filed when nondividend distributions are made to shareholders, which includes distributions that are fully or partially nontaxable because the distribution exceeds the corporation's E&P. Form 5452 does not need to be filed for distributions of tax-free stock dividends or distributions exchanged for stock in corporate liquidations or redemptions of corporate stock.

b. A distribution of stock or right to acquire stock in a corporation is not a taxable distribution to the stockholder unless it is one of the following IRC § 305(b) conditions apply:

1) distribution in lieu of money or other property,
2) disproportionate distribution,
3) distribution with respect to preferred stock,
4) distribution of certain convertible preferred stock (there are exceptions), or
5) distribution of common and preferred stock resulting in the receipt of preferred stock by some common shareholders and receipt of common stock by other common shareholders.

The above-listed distributions will be a taxable dividend only to the extent that the corporation has E&P. OFP pp. 16-17.

8. Constructive Dividends.

a. If a C Corporation with E&P makes a distribution to a shareholder and classifies the distribution as something other than a taxable dividend, and the IRS reviews it, the IRS will likely reclassify the distribution as a constructive dividend, especially for closely-held corporations. Inadequate records and lack of substantiation by the closely-held corporation may lead to a tax controversy with the IRS.

b. Constructive dividends may result from the following types of transactions:

1) Unreasonable compensation paid to a shareholder.
2) Payment of rent to a shareholder in excess of fair market value.
3) Personal use of corporate property (auto, airplane, other property depreciated by the corporation [such as home furnishings or artwork], and entertainment facilities).
4) Interest on loans owed by the corporation to shareholders if the loans are not bona fide or the debts are excessive in relation to equity.
5) A loan owed by the shareholder to the corporation, which may be shown as a receivable due from shareholder on the books and records of the corporation.
6) Sale of property to a corporation if the sales price is greater than the fair market value of the property.
7) Expenses classified as personal expenses (auto, travel, and entertainment).
8) Shareholder purchase of property from the corporation at a price lower than its fair market value.

OFP p. 17.

9. Earnings and Profits. Corporate E&P is not the same as taxable income. E&P determines taxation of corporate distributions to shareholders. Taxable distributions of a corporation are deemed to come first from current E&P and then from accumulated prior-year E&P, and then from paid-in capital. IRC § 316(a).

> **Litigation Tip:** This tax rule can be used in characterizing distributions from a separate property corporation. Distributions of current earnings and retained earnings could be classified as community property, while distributions of paid-in capital could be classified as separate property, under the exhaustion method of tracing.

Distributions in excess of E&P are nontaxable to the shareholder to the extent of the shareholder's tax basis in the stock. Distributions in excess of E&P that exceed the shareholder's stock basis are taxable as a capital gain. IRC § 30(c).

D. S CORPORATIONS. "S Corporations" get their name from Subchapter S of Chapter 1 of the Internal Revenue Code. To be an S Corporation, the entity must meet the following requirements (among others): (i) it must be a domestic corporation (or entity taxable as a corporation); (ii) with not more than 75 shareholders who are individuals (excluding nonresident aliens or their spouse), estates or certain trusts; and (iii) have not more than one class of stock.[8] All shareholders must sign the election for Subchapter S treatment (IRS Form 2553). See OFP p. 17.

The election of S Corporation status is usually based on the desire to pass through earnings to shareholders but retain the protection afforded under state law for the corporate form of business. Distributions from a C Corporation are usually in the form of dividends that are taxable as income to the shareholders. Tax treatment of S Corporation distributions depends on whether the S Corporation has accumulated earnings and profits ("E&P"). See IRC §§1368 and 301. An S Corporation typically will not have accumulated E&P unless it was previously a C Corporation or it acquired another corporation with accumulated earnings and profits. BNA Tax Management Portfolios, Dividends-Cash and Property A-8, Volume 764 (2nd ed. 2001). See IRC §1368 for taxation scheme. If the S Corporation has accumulated E&P–or if the S Corporation has no E&P–see ordering rules for distributions discussed in OFP p. 20.

1. Filing Requirements. An S Corporation must file a Form 1120S U.S. Income Tax Return for an S Corporation by the 15th day of the third month following the close of its tax year or date of dissolution (March 15 for calendar-year S Corporations).

2. Schedule K-1, Shareholder's Share of Income, Deductions, Credits, etc. Income and deductions of an S Corporation are "passed through" to shareholders on Schedule K-1 (Form 1120S). S Corporation items are generally allocated to shareholders on a per-share, per-day basis. IRC §1377(a)(1). Certain income and deductions are separately stated on Schedule K and K-1, as the taxation and limitations for the separately stated items may be different than ordinary income and deductions.

3. Comparison of C Corporation and S Corporation. Qualifying corporations can elect to be taxed as an S Corporation. Generally, an S Corporation will not pay a corporate level tax on net income passed through to shareholders. S Corporations avoid the double taxation problem associated with C Corporations

a. C Corporations. C Corporations are a tax-paying entity.

1. Taxation. Double taxation: income is taxed at the corporate level and dividends to shareholders are taxed at the shareholder level.

2. Dividends. Dividends are generally taxed to the individual shareholder at the same rate as long-term capital gains (0%, 15%, or 20%).

3. Ordinary Losses. Corporate losses are deducted only at the corporate level, including net operating loss carrybacks and carryforwards.

4. Capital Gains. Corporate capital gains are taxed at the same rates as ordinary income.

5. Capital Losses. Capital losses are deductible only to the extent of capital gains. Net capital losses are carried back three years and forward five years.

b. C Corporation Carryovers. No carryforward, and no carryback arising for a taxable year for which a corporation is a C Corporation, may be carried to a taxable year for which such corporation is an S Corporation. IRC § 1371(b)(1). However, capital losses and net operating losses may carry over from a C Corporation to an S Corporation for purposes of calculating the built-in gains tax.

c. S Corporations. S Corporations are a pass-through entity similar to a partnership. Rules for S Corporation shareholders are often similar to the rules affecting partners in a partnership.

1. Taxation. Income and losses are passed through to shareholders. No corporate level tax.

2. Dividends. Dividends are ignored for tax purposes, to the extent that the S Corporation has accumulated earnings and profits ("AEP"). Earnings are passed through to the shareholder and taxed as ordinary income, regardless of whether dividends are paid.

3. Ordinary Losses. Losses are passed through to shareholders. Losses are deductible up to the shareholder's tax basis in S Corporation stock and loans to the S Corporation.

4. Capital Gains. Capital gains are passed through to shareholder and eligible for capital gain tax rates for individuals.

5. Capital Losses. Capital losses are passed through to shareholder. Capital losses can reduce capital gains and are deductible but limited on the shareholder's individual return.

4. Shareholder Tax Basis in S Corporation Stock.

a. A shareholder's tax basis in S Corporation stock includes the purchase price paid for the stock, plus capital contributions, plus or minus the adjustments under IRC § 1367, which include:

Increases
+ Separately stated income, including tax-exempt income.
+ Non-separately stated income.
+ Depletion in excess of the basis in the property.

Decreases
– Distributions of cash or property to shareholders.
– Separately stated losses and deductions.
– Non-separately stated losses.
– Nondeductible corporation expenses.
– Depletion to the extent it does not exceed the basis in the property.

b. A shareholder's tax basis may not go below zero. Any reduction to basis below zero will be suspended until the tax basis is reestablished. Losses from the S Corporation are allowed to the shareholder only to the extent of the shareholder's tax basis in the stock. Losses may be further limited under the "at risk" rules and passive activity loss rules.

c. Unlike partnerships, the liabilities inside an S Corporation do not increase a shareholder's tax basis. However, direct bona fide loans a shareholder makes to an S Corporation create additional tax basis for purposes of determining the shareholder's limit on losses. IRC § 1366(d)(1).

d. If a C Corporation makes an S election, the shareholder's tax basis in stock in the C Corporation stock becomes the beginning stock basis in the S Corporation stock.

5. Distributions from an S Corporation. The taxability of distributions by an S Corporation to its owners is a complicated subject. For more on this topic, see OFP, p. 20.

IV. REIMBURSEMENT CLAIMS INVOLVING ENTITIES.

A. THE GENERAL RULE OF REIMBURSEMENT. An equitable right to reimbursement "arises when the funds or assets of one estate are used to benefit and enhance another estate without itself receiving some benefit." *Vallone v. Vallone*, 644 S.W.2d 455, 459 (Tex. 1982). The 88th Legislature recently amended Section 3.402 of the Family Code, describing reimbursement as follows: "A claim for reimbursement exists when one or both spouses use property of one marital estate to confer on the property of another marital estate a benefit which, if not repaid, would result in unjust enrichment to the benefited estate." The State Bar of Texas Pattern Jury Charges (Family & Probate 2022 ed.) (published before the recent Family Code amendments) PJC 204.1 gives the following instruction regarding reimbursement that could apply to closely-held entities [italics represents replaceable terms]:

> * * *
>
> A claim for reimbursement arises when the property of one estate is used to benefit the property of another estate without the first estate itself receiving an equal benefit in return.
>
> * * *
>
> QUESTION 1
>
> Did *Estate A* confer a benefit on *Estate B*?
>
> *Estate A* conferred a benefit on *Estate B* if-
>
> *[Insert applicable instruction(s).]*
>
> 1. the property of *Estate A* was used to pay a debt, liability, or expense that in equity and good conscience should have been paid from the property of *Estate B*; or
>
> 2. the property of *Estate A* was used to make capital improvements on the real property of *Estate B*, and the improvements resulted in an enhancement in the value of *Estate B*'s real property; or
>
> 3. one or both spouses used community property, time, toil, talent, or effort to enhance the value of *Estate B*'s property.

B. FOR CONTRIBUTIONS OF CAPITAL AND TRANSFERS INTO AN ENTITY. When a spouse transfers community property assets to a business entity in which the spouse owns a separate property interest with no corresponding benefit to the community estate, it fits the description in PJC 204.1, that the property of one estate was used to benefit the property of another

estate without the first estate itself receiving an equal benefit in return. This principle was recognized in *Lifshutz v. Lifshutz*, 199 S.W.3d 9, 27 (Tex. App.--San Antonio 2006, pet. denied), where the contribution of a community property asset to a separate property entity gave rise to a claim for reimbursement. PJC 204.1, Question 2, says that the claim is the value of the benefit "measured at the time of trial." This measure of the claim is not suited for capital contributions or assets transferred to an entity, because the value of the contribution ordinarily cannot be measured once the money or asset is put to use in the business, or expended in operating the business. A more suitable measure of the claim is the amount of money contributed or the fair market value of the asset contributed on the date it was contributed. See *Mason v. Mason*, No. 03-17-00546-CV (Tex. App.–Austin May 3, 2019, no pet.): "Like reimbursement claims for uncompensated time and effort expended to the benefit of stock belonging to another marital estate, a reimbursement claim for funds expended to the benefit of a membership interest belonging to a separate estate may be measured by the cost of the contribution to the community estate." Where community money is used to pay a debt of the separate property business, the ordinary rule of reimbursement for paying separate debt would apply.

C. FOR ENHANCEMENT DUE TO COMMUNITY EFFORT. An increase in the value of a separate property business "resulting from fortuitous circumstances and unrelated to an expenditure of community effort will not entitle the community estate to reimbursement." *Harris v. Harris*, 765 S.W.2d 798, 805 (Tex. App.--Houston [14th Dist.] 1989, writ denied). However, the community estate has a claim for reimbursement for uncompensated or undercompensated time, toil and talent expended by a spouse for the benefit and enhancement of his or her separate property interests, beyond that reasonably necessary to manage and preserve the separate asset. *Id*. at 805. *Jensen v. Jensen*, 665 S.W.2d 107 (Tex. 1984); Tex. Fam. Code § 3.402(a).

1. *Jensen* Reimbursement. The claim for reimbursement to the community estate for community efforts that increase the value of a separate property business entity was established in *Jensen v. Jensen*, 665 S.W.2d 107, 109 (Tex. 1984). The Court wrote:

> A consideration of the writings of various scholars in this field, the treatment of the issue by our sister community property states, and the constitutional, statutory and case law of Texas leads to the conclusion that the reimbursement theory more nearly affords justice to both the community and separate estates. This theory requires adoption of the rule 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.

2. Family Code Reimbursement. In 1999, the Texas Legislature introduced its own conception of reimbursement into Texas law. The portion relating to closely-held businesses says:

> Sec. 3.402. CLAIM FOR REIMBURSEMENT; OFFSETS.
>
> (a) For purposes of this subchapter, a claim for reimbursement includes:
>
> (1) * * *;

(2) inadequate compensation for the time, toil, talent, and effort of a spouse by a business entity under the control and direction of that spouse ....

The statute also includes as reimbursable expenditures paying down debt and paying for capital improvements, which could apply to separate property business entities. The statute also recognizes the offset of benefits flowing to the contributing estate.

Notice that the statutory condition for reimbursement for undercompensation is "a business entity under the control and direction of that spouse." The *Jensen* case did not impose this condition. The 88th Legislature amended Family Code Section 3.402(c)(3) to recognize reimbursement when "one or both spouses used time, toil, talent, or effort to enhance the value of property of a spouse's separate estate beyond that which was reasonably necessary to manage and preserve the spouse's separate property, and for which the community marital estate did not receive adequate compensation."

Whether statute-based reimbursement replaced the common law reimbursement has never been definitively resolved. The author believes that the best argument is that these two schemes co-exist as alternatives.

3. The Pattern Jury Charge.

PJC 204.1 continues:

If you answered "Yes" to Question 1, then answer Question 2. Otherwise, do not answer Question 2.

QUESTION 2

What is the value of the benefit *Estate A* conferred on *Estate* B, measured at the time of trial?

[Insert applicable instruction(s).]

1. If the benefit conferred on *Estate B* resulted from the use of Estate A's property to pay a *debt, liability, or expense* that in equity and good conscience should have been paid from the property of *Estate B*, then the value of the benefit conferred is measured by the amount of the *debt, liability, or expense* Estate A paid.

2. If the benefit conferred on the property of *Estate B* resulted from the use of Estate A's property to make capital improvements on the real property of *Estate B*, then the value of the benefit conferred is measured by the enhancement in the value of *Estate B*'s real property that resulted from the capital improvements.

3. If the benefit conferred on *Estate B* resulted from the use of community property, time, toil, talent, or effort, then the value of the benefit conferred is measured by the time, toil, talent, or effort other than that reasonably necessary to manage and preserve *Estate B*'s property.

4. What Offsetting Benefits are Considered? In *Jensen*, the Supreme Court said that in determining whether the owning spouse was undercompensated, you must determine the value of the time, toil and talent expended by the owner/spouse, and subtract from that compensation paid to him/her for such time, toil and talent, in the form of salary, bonuses, dividends, and other fringe benefits. *Jensen v. Jensen*, 665 S.W.2d 107, 110 (Tex. 1984). One 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. That raises the question of whether something the community is otherwise entitled to receive (to-wit: income from separate property) is a proper offset to a reimbursement claim. In determining undercompensation, the court in *Trawick v. Trawick*, 671 S.W.2d 105, 109 (Tex. App.–El Paso 1984, no writ) (an estate case), said to exclude rental income received from the business for use of the husband's separate property real estate as an offsetting benefit, since the community owned that rental income independently from the husband's labors. The court also said that money paid to wife should not be considered, unless her employment was a sham and she performed no labor. The Trawick court also said to exclude expense account reimbursements to husband, except to the extent they exceeded his true out-of-pocket expenses. The 88th Legislature recently adopted Texas Family Code Section 3.402(g) which provides: "(g) A claim for reimbursement of a marital estate by one spouse may be offset by the value of any related benefit that the other spouse proves that the conferring estate received from the benefited estate, including: … (2) income received by the conferring estate from the property of the benefited estate …." Although the family law bar needs time to reach a consensus on this new legislation, the Legislature seems to have adopted the view that any benefit received is an offsetting benefit – even where the community estate is receiving a benefit it already owns.

5. Is Amount of Enhancement a Cap? The court in *Trawick v. Trawwick*, 671 S.W.2d 105, 108-9 (Tex. App.– El Paso 1984, no writ) (an estate case), suggested but did not hold that the amount of enhancement in the separate property business could be a cap on the amount of reimbursement that can be recovered for undercompensation of the spouse's labors. If it is a cap, a claim for undercompensation could be asserted against the business as a claim for quantum meruit or even constructive or actual fraud. There may be a statute of limitations bar on such claims.

6. Cases. A *Jensen* reimbursement claim against a husband's interest in a law partnership was rejected in *Harris v. Harris*, 765 S.W.2d 798 (Tex. App.--Houston [14th Dist.] 1989, writ denied), based on the husband's uncontradicted testimony that the enhancement in issue was not attributable to his labors. There seems to be no reason to treat partnerships any differently from corporations, when it comes to a *Jensen*-like reimbursement claim.

In *Holloway v. Holloway*, 671 S.W.2d 51, 58 (Tex. App.--Dallas 1983, writ dism'd), although it was established that the value of husband's separate property corporations rose from $ 1,000 to $ 30 million, and $ 3,000 to $ 60 million, as a result of his labors during marriage, the wife waived her reimbursement claim by failing to secure a jury finding regarding the value of his time contributed to the businesses.

A claim for back wages should be distinguished from reimbursement for undercompensation. A claim for back wages is a claim against the entity, not a claim against the owning spouse's separate estate. *Halamka v. Halamka*, 799 S.W.2d 351, 354-55 (Tex. App.--Texarkana 1990, no writ). As noted above, there may be a limitations bar on a claim against the business.

Litigation Tip: Note that under TBOC Section 152.203(c), "[a] partner is not entitled to receive compensation for services performed for a partnership other than reasonable compensation for services rendered in winding up the business of the partnership." This may affect a reimbursement claim for undercompensation relating to a separate property partnership.

V. PIERCING THE CORPORATE VEIL. "The corporate form normally insulates shareholders, officers, and directors from liability for corporate obligations; but when these individuals abuse the corporate privilege, courts will disregard the corporate fiction and hold them individually liable." *Castleberry v. Branscum*, 721 S.W.2d 270, 271 (Tex. 1986). One basis for disregarding the corporate entity is the equitable doctrine of "alter ego." "Alter ego applies when there is such unity between corporation and individual that the separateness of the corporation has ceased and holding only the corporation liable would result in injustice." *Id.* at 272. Alter ego is just one of several grounds to pierce the corporate veil. As noted in *Castleberry*: "[m]any Texas cases have blurred the distinction between alter ego and the other bases for disregarding the corporate fiction and treated alter ego as a synonym for the entire doctrine of disregarding the corporate fiction.... However, . . . alter ego is only one of the bases for disregarding the corporate fiction ...." *Id.* at 272. To quote *Castleberry* further: "We disregard the corporate fiction, even though 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." *Id.* at 271. Continuing from *Castleberry*:

> Specifically, we disregard the corporate fiction:
>
> (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 resorted to as a means of evading an existing legal obligation;
> (4) where the corporate fiction is employed to achieve or perpetrate monopoly;
> (5) where the corporate fiction is used to circumvent a statute; and
> (6) where the corporate fiction is relied upon as a protection of crime or to justify wrong.

Id. at 272. [Footnotes omitted.]

There is also a justice component. "Where a corporate entity is owned or controlled by an individual who operates the company in a manner indistinguishable from his personal affairs and in a manner calculated to mislead those dealing with him to their detriment, the corporate fiction may be disregarded in order to prevent injustice." *Mancorp, Inc. v. Culpepper*, 802 S.W.2d 226, 229 (Tex. 1990) (internal quotations omitted).

However, the Supreme Court did not have the last word. In reaction to *Castleberry*, in 1989 the Legislature enacted Tex. Bus Corp. Act § 2.21, expanded in 1993, eliminating constructive fraud as a basis to enforce a contractual obligation of the entity against shareholders (subject to an exception), and eliminating piercing for any type of claim based upon the failure to observe corporate formalities. The statute allows piercing "if the obligee demonstrates that the holder, beneficial owner, subscriber, or affiliate caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud on the obligee primarily for the direct personal

benefit of the holder, beneficial owner, subscriber, or affiliate." The effect of this statute is two-fold. First, shareholders cannot be held liable for a corporation's *contractual* liabilities based on piercing the corporate veil, absent actual fraud. Second, the failure to observe corporate formalities is not a ground for making shareholders liable to corporate creditors for any type of claims. However, the statute recognizes piercing for contact claims where "the obligee demonstrates that the holder, beneficial owner, subscriber, or affiliate caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud on the obligee primarily for the direct personal benefit of the holder, beneficial owner, subscriber, or affiliate." In effect, contract claimants can pierce if they can prove actual fraud. Thus, *Castleberry*'s reliance on constructive fraud for piercing was undone as to contract claims, but contract claimants can still pierce for claims based on actual fraud, and tort claimants can continue to rely on actual or constructive fraud. Fiduciary claims are not expressly addressed in the statute. Presumably breach of fiduciary claims would be treated like tort claims, especially where they arise by operation of law or from an informal fiduciary duty.

Jury instructions and questions for piercing the corporate veil are set out at TEXAS PATTERN JURY CHARGES (BUSINESS, CONSUMER, INSURANCE, & EMPLOYMENT 2022) ch. 108.

An informative article on the subject of piercing the entity veil is Elizabeth S. Miller, *The Limits of Limited Liability: Veil Piercing and Other Bases of Personal Liability of Owners, Governing Persons, and Agents of Texas Business Entities*, State Bar of Texas 19th ANNUAL CHOICE, GOVERNANCE & ACQUISITION OF ENTITIES (May 21, 2021).[9]

1. Disregarding Formalities. TBOC § 21.223 eliminates failure to observe corporate formalities as a ground for piercing the corporate veil.

2. Actual Fraud. The term "actual fraud" is not defined in TBOC § 21.223. In *Castleberry* the Supreme Court described actual fraud as "involv[ing] dishonesty or purpose or intent to deceive." *Id.* at 273. The fraud must relate to the transaction in issue. *Viajes Gerpa, S.A. v. Fazeli*, 522 S.W.3d 524, 533-35 (Tex. App.--Houston [14th Dist.] 2016, pet. denied) (an alter ego case). In *Stover v. ADM Milling Co.*, No. 05-17-00778-CV (Tex. App.–Dallas Dec. 28, 2018, pet. denied) (memo. op.), the court said: "In the context of piercing the corporate veil, ... actual fraud is not equivalent to the tort of fraud").

3. Direct Personal Benefit. A shareholder can be held liable for a corporate contractual obligation if s/he "caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud on the obligee primarily for the direct personal benefit of the holder." TBOC § 21.233(b). In *Hong v. Harvey*, 551 S.W.3d 875, 887 (Tex. App.–Houston [14th Dist.] 2018, no pet.) (finding no direct personal benefit), the court said: "In cases in which the direct personal benefit showing has been met, evidence showed that funds derived from the corporation's allegedly fraudulent conduct were pocketed by or diverted to the individual defendant.... In contrast, evidence showing that fraudulently procured funds were used to satisfy a corporation's financial obligations cuts against the notion that the fraud was perpetrated primarily for the direct personal benefit of an individual."

4. Constructive Fraud. TBOC § 21.233 eliminated constructive fraud as a ground to pierce the corporate veil based on *contract claims*, not tort claims or breach of fiduciary duty claims. Unfortunately, the PJC for Business litigation does not directly address piercing the corporate veil for constructive fraud. The TEXAS PATTERN JURY CHARGES (FAMILY LAW & PROBATE 2022) PJC

205.2 does offer a fraud instruction that includes constructive fraud: "'Fraud' is the breach of some legal or equitable duty that, irrespective of moral guilt, the law declares fraudulent because of its tendency to deceive others, to violate confidence, or to injure public interests." The Committee said that the instruction is based on *Castleberry*, 721 S.W.2d at 273.

5. Reverse Piercing. Texas law also recognizes the remedy of "reverse piercing." As explained in *Chao v. Occupational Safety & Health Review Comm'n*, 401 F.3d 355, 364 (5th Cir. 2005):

> In the typical corporate veil piercing scenario, the corporate veil is pierced such that individual shareholders can be held liable for corporate acts. . . . Here, the purpose of piercing the corporate veils . . . would be to hold the corporations liable for the acts of their individual shareholder . . . Therefore, this case presents a "reverse corporate veil piercing" situation. . . . This slight variation is of no consequence, however, because the end result under both views is the same– "two separate entities merge into one for liability purposes." . . . If alter ego is shown, courts reverse pierce the corporate veil to treat the individual and the corporation as "one and the same."

As a creditor's claim, piercing the corporate veil permits a third party to impose liability on shareholders, thereby ignoring the existence of the corporation as an entity separate from its owners. In a divorce situation, a spouse is aiming to get the court to ignore the existence of the corporation as an entity separate and apart from its owners, with the result that the assets that belong to the corporation are now considered to be assets owned by the shareholders (likely the opposing spouse). This is called "reverse piercing." TBOC § 21.233 is phrased in terms of when a shareholder can and cannot be held liable for corporation's debts and obligations. It therefore has no impact on a reverse-piecing claim. Reverse piercing in a divorce was discussed in *Boyo v. Boyo*, 196 S.W.3d 409, 419-20 (Tex. App.--Beaumont 2006, no pet.) ("Reverse piercing is sometimes used to characterize as part of a community estate what would otherwise be a corporate asset.... In the context of a divorce, the evidence must show not only that there is unity of the corporation and the spouse, but also that the spouse's improper use of the corporation has damaged the community estate, and the loss cannot be remedied by reimbursement."); *Lifshutz v. Lifshutz*, 61 S.W.3d 511, 516-18 (Tex. App.--San Antonio 2001, pet. denied) ("Thus to properly pierce in a divorce case, the trial court must find something more than mere dominance of the corporation by the spouse. 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." [Footnotes omitted]); *Zisblatt v. Zisblatt*, 693 S.W.2d 944, 952 (Tex. App.--Fort Worth 1985, writ dism'd). In *Southwest Livestock & Trucking Co. v. Dooley*, 884 S.W.2d 805, 810 (Tex. App.–San Antonio 1994, writ denied), the appellate court refused the wife's effort to apply the doctrine of piercing the corporate veil where the wife had unclean hands because she participated in and benefitted from the very acts upon which she based her piercing claim. A family-law oriented article on reverse piercing is Diana S. Friedman & Andrew J. Anderson, *Division of Closely-Held Business Interests*, pp. 3-7 STATE BAR OF TEXAS NEW FONTIERS IN MARITAL PROPERTY COURSE (2005).

6. LLCs. TBOC § 101.002 extends the protection of TBOC § 21.223 to LLCs and their members, owners, etc. In *Walden v. Walden*, No. 03-09-00576-CV (Tex. App.--Austin March 16, 2012, pet. denied), the appellate court applied the standards for piercing the entity veil to an LLC. *Accord*,

McCarthy v. Wani Venture, A.S., 251 S.W.3d 573, 591 (Tex. App.--Houston [1st Dist.] 2007, pet. denied) (allowing piercing of LLC veil, saying "Texas courts and other jurisdictions, have applied to LLCs the same state law principles for piercing the corporate veil that they have applied to corporations"). Note that the TBOC provision does not protect against reverse-piercing claims such as would be asserted in a divorce. For background, see Natalie Smeltzer, *Piercing the Veil of a Texas Limited Liability Company: How Limited is Member Liability?*, 61 S.M.U. L. REV. 1663 (2008). The history of piercing the veil of an LLC is discussed in *Shook v. Welder*, 368 S.W.3d 604 (Tex. App.–Austin 2012, pet. denied).

7. Limited Partnerships. "Texas courts have uniformly declined to apply the alter-ego theory to pierce a limited partnership's 'veil' to impose the entity's liabilities on a limited partner. The need for any equitable veil-piercing doctrine is fundamentally dubious as applied to the liabilities of a limited partnership. Unlike a person doing business with a corporation, a person doing business with a limited partnership always has recourse against any general partner in the same manner as partners are liable for the liabilities of a partnership without limited Partners." *Peterson Group, Inc. v. PLTQ Lotus Group*, 417 S.W.3d 46, 56 (Tex. App.--Houston [1st Dist.] 2013, pet. denied) (footnote omitted). In the divorce context, the appellate court in *Lifshutz v. Lifshutz*, 61 S.W.3d 511, 518 (Tex. App.--San Antonio 2001, pet. denied), held that the doctrine of piercing the veil did not apply to partnerships. *See Pinebrook Properties, Ltd. v. Brookhaven Lake Property Owners Association*, 77 S.W.3d 487 (Tex. App.--Texarkana 2002, pet. denied) ("The theory of alter ego, or piercing the corporate veil, is inapplicable to partnerships").

8. Single Business Enterprise Theory. Under the "single business enterprise" doctrine, when separate corporations are not operated as separate entities, but instead integrate their resources to achieve a common business purpose, each constituent corporation can be held liable for the debts incurred in pursuit of that business purpose. *Paramount Petroleum Corp. v. Taylor Rental Ctr.*, 712 S.W.2d 534, 536 (Tex. App.--Houston [14th Dist.] 1986, writ ref'd n.r.e.); *Hideca Petroleum Corp. v. Tampimex Oil Int', Ltd.*, 740 S.W.2d 838, 844 (Tex. App.--Houston [1st Dist.] 1987, no writ). The single business enterprise doctrine was rejected in *SSP Partners v. Gladstrong Inv.(USA)*, 275 SW 3d 444, 456 (Tex. 2008), as an alternative route to piercing the corporate veil.

9. The Internal Affairs Doctrine. Under TBOC §§ 1.101 & 1.102, the law that governs the formation and internal affairs of an entity is the law of the state where the business was organized. However, Sections 1.101 and 1.102 apply only when the formation occurs when the certificate of formation or similar instrument is filed. TBOC §§ 1.101 & 1.102. Where the entity is not formed by a filing instrument (i.e., a partnership or joint venture), the law governing formation and internal affairs is the law of the entity's jurisdiction of formation. TBOC § 1.103. TBOC § 1.105 defines internal affairs as including the "rights, powers, and duties of its governing authority, governing persons, officers, owners, and members" and "matters relating to its membership or ownership interests." This so-called "internal affairs doctrine" is held to apply to duties owed by corporate directors, officers, managers, to the corporation (but not usually to its owners). In any business entity relationship, a central question is which state's law to apply when an entity is organized in one state but conducts business in another state. In *Phillips v. Carlton Energy Group, LLC*, 475 S.W.3d 265 (Tex. 2015), by agreement of the parties the Texas Supreme Court applied Nevada law on piercing the corporate veil to a corporation incorporated in Nevada.

VI. VALUATION OF BUSINESS. The issues surrounding business valuation are so broad that they must be covered in a separate article. An article you can review is Orsinger, Business Valuations: Effective Presentation of Complex Issues, for the 2021 Advance Family Law Course, along with the related PowerPoint presentation.[10]

Here some matters to keep in mind regarding business valuation in a divorce:

- There are different concepts of "value" that can come into play in a divorce valuation. There is fair market value, fair value, investment value, intrinsic or fundamental value, going-concern value, liquidation value, book value, value to the owner, etc. There are important differences in these concepts of value, and the advocate must consider which concept of value to pursue in a particular divorce.

- The value of a business in a divorce is the value as of the date of trial, but parties usually agree to a "valuation date" prior to trial, typically after the most recent quarter's financial results have been reported. The two business valuators should use the same valuation date, so you are comparing apples to apples and not apples to oranges.

- There are three valuation approaches: the market approach, the income approach, and the asset-based approach. Each of those approaches has sub-parts. If your divorce practice recurrently involves dividing businesses, you should take the time to understand these approaches. Business valuators sometime press the limit on their approaches. Your expert can tell you what the pressure points are, but cross-examination can be a cat-and-mouse game and the best cross-examination occurs when the lawyer understands business valuation principles, and when they are being stretched or circumvented.

- The value of a business enterprise is made up of the value of its tangible assets (such as equipment, inventory, and the like) and the value attributable to its identifiable intangible assets (such as contractual rights, trade secrets, leases, employment agreements, covenants not to compete, intellectual property, etc.). But a business can have a value in excess of the value of its tangible assets and identifiable intangible assets, and that excess value is called "goodwill."

- The value of "goodwill" is generally arrived at by taking the value based on the income approach or market approach and subtracting the value of all tangible and identifiable intangible assets. The difference is "goodwill," which is the value attributable to other qualities of the business, such as location, workforce-in-place, relationships with suppliers and customers, brand identity, celebrity endorsements, standing of the owner in the community, minority-ownership, advertising campaigns, vanity appeal (like sports teams), and many other intangible aspects of the business that make it profitable or valuable.

- In a Texas divorce, personal goodwill of the owner is not a community property asset, *Nail v. Nail*, 486 S.W.2d 761 (Tex. 1972), so personal goodwill must be excluded when valuing a business in a divorce. Post-divorce profits that are a return on the spouse's future labors also must be excluded from calculating the value of the community estate's interest in the business.

- The gate-keeping role of trial judges in assessing the data and methodology of an expert under *Daubert* and *Robinson* and Tex. R. Evid 705 applies to business valuation experts. Since

business valuation is not a science, an articulation of the standard of admissibility can be taken from *Gammill v. Jack Williams Chevrolet, Inc.*, 972 S.W.2d 713, 725-26 (Tex. 1998): "We conclude that whether an expert's testimony is based on 'scientific, technical or other specialized knowledge,' *Daubert* and Rule 702 demand that the district court evaluate the methods, analysis, and principles relied upon in reaching the opinion. The court should ensure that the [*726] opinion comports with applicable professional standards outside the courtroom and that it 'will have a reliable basis in the knowledge and experience of [the] discipline.'" There are business-valuation organizations that have published professional standards, and there is case law and there are books and articles that are a source for professional standards outside the courtroom. These can be articulated by your expert.

- Buy-sell agreements can affect the division of the community estate's interest in a business. Texas courts of appeals are not unified on what the impact can be, such as whether a formula in a buy-sell agreement is binding on valuation in a divorce. However, there is more certainty where a buy-sell agreement provides that, if a non-owning spouse ends up with an interest in the entity after divorce, then the entity or other owners may be able to acquire that interest at a set price, or based on an appraisal, or at a price determined in some other manner. In that instance, the agreement will prevail after the divorce property division is implemented.

- There can be many different tax consequences resulting from a division of a business in a divorce. They can be very complex, as other Sections of this Article demonstrate. In dividing a business in a divorce, it is the *after-tax* value, not just the fair market value, that should drive the decision-making

VII. TRANSFER RESTRICTIONS/BUY-SELL PROVISIONS.

A. STATUTORY RESTRICTIONS. There are no TBOC prohibitions against transferring an ownership interest in a business entity to a spouse in a divorce, except for licensed professions like law or medicine. However, the TBOC Section 152.406 provides that a spouse of a partner can receive only a transferee's interest in the partnership, which entitles the transferee to receive (but not require) future distributions, and gives limited access to financial information and no management rights. The same rule applies to an interest in an LLC transferred to the member's spouse in a divorce. TBOC § 101.1115.

B. PRIVATE RESTRICTIONS AND BUY-SELL AGREEMENTS. Entities and their owners can create restrictions on transfer of ownership interests. Owners also can enter into buy-sell agreements that give the entity or other owners an option to purchase an interest in the business in the event that the owner's spouse acquires an ownership interest through the divorce. The buy-sell terms are sometimes nothing more than a right of first refusal to buy the ownership interest on the same terms offered by a third party. In other instances the buy-sell agreement sets a price ($__/share), or a formula (book value, or 3 times book value), or a method of determining the price (a business valuation by 1, 2 or 3 appraisers).

C. TAX ASPECTS. From a tax standpoint, if a buy-sell option to purchase is exercised by a spouse, IRC § 1041 will keep the transaction from being taxed. If other owners exercise an option to purchase, it is not clear whether IRC § 1041 applies. If the entity exercises an option to purchase, the Treasury Regs. under IRC § 1041 allow the spouses to choose to tax the transaction as a capital

gain to the departing spouse or a constructive dividend to the remaining spouse. If they do not choose, § 1041 protection depends on whether the entity assumed an obligation of the remaining spouse to buy-out the departing spouse. See Section IX below.

Litigation Tip: Don't leave the tax treatment for later resolution. Negotiate the tax treatment at the time of divorce.

VIII. DIVIDING ENTITIES UPON DIVORCE. This Section of the Article discusses issues to consider in dividing a closely-held business interest in a divorce.

A. OPTIONS FOR THE COURT IN THE PROPERTY DIVISION. Six options for the parties or the divorce court are discussed below.

1. Leaving or Making the Spouses Co-Owners of the Entity. If the spouses are already named co-owners of the business, the divorce court can leave them as co-owners. If ownership is in the name of one spouse alone, awarding the non-named spouse an ownership interest in the business can encounter problems, but they may be surmountable.

a. Transfer Restrictions. There are no prohibitions in the TBOC against transferring an ownership interest in a business entity to a spouse in a divorce, except for licensed professions (law, medicine, etc.). However, under the TBOC, the spouse of an LLC member or a partner can receive only an assignee's or transferee's interest in the LLC or partnership, which entitles the transferee to receive her share of future distributions, but affords only limited access to financial information and no management rights, and no right to force distributions. TBOC § 101.1115 (LLC) & § 152.406 (partnership).

Entities can restrict the transfer of ownership interests in their governing documents. Additionally, owners can enter into a buy-sell agreement giving the entity and non-transferring owners the option to purchase the departing spouse's interest. These buy-sell agreements usually are one of the following:

- a right-of-first-refusal to buy the interest on the same terms offered by a third party;
- a set figure (like $___ per share);
- a formula (e.g., book value plus % of net receivables but not goodwill);
- fair market value or fair value (determined by agreement, court, or arbitration);
- averaged appraised value (1, 2, or 3 appraisers).

Where the buy-sell provision is triggered upon divorce only when the non-owning spouse receives an ownership interest in the business, the parties or court can trigger or avoid triggering the buy-sell option by transferring or not transferring an ownership interest to the non-owning spouse. To avoid the trigger while still having co-ownership, the owner spouse would have to make a transfer that is approved in the buy-sell agreement (like a transfer into trust for the benefit of a spouse prior to divorce), or the owning spouse can be named as trustee to hold the non-owning spouse's share in trust for her benefit. If a trust relationship is used, the divorce settlement can let the law of express trusts define the fiduciary obligations of the owner-spouse, or specific fiduciary duties can be negotiated between the husband and the wife and put in writing.

b. Problems with Co-Ownership, Now and Later. Leaving the ex-spouses as co-owners avoids the need to value the business as part of the divorce, but it can create problems after the divorce. If ex-spouses have equal control, an impasse can develop that may trigger litigation or require a court-appointed receiver. If one ex-spouse has exclusive control, there can be actual or perceived minority oppression leading to a suit for an accounting, breach of fiduciary duty, breach of contract, fraud or constructive fraud, conversion, fraudulent transfer, conspiracy, unjust enrichment, or quantum meruit. Under *Ritchie v. Rupe*, 443 S.W.3d 856, 882, 885 (Tex. 2014), there is no claim under Texas law for minority oppression. It may be difficult to establish an informal fiduciary duty owed by the controlling ex-spouse to the non-controlling ex-spouse, in light of the termination of the spousal fiduciary duty by virtue of the divorce. See Section XII.D.1 below. Even the controlling ex-spouse can dislike having to deal with an unhappy minority owner causing trouble. If there are other owners, splitting the community property interest may cause both ex-spouses to lose voting control, or one ex-spouse can turn against the other ex-spouse and join other minority owners in a voting block to create a new majority. Disagreements can arise when the business is eventually being sold, as to allocation of sale proceeds between ex-spouses, including the amount paid for one ex-spouse's covenant not to compete versus price per share.

> **Litigation Tip--Control:** Assume that H owns 1% GP interest in partnership as separate property and a 99% limited partner interest as community property. The court awards a 49.5% limited partner community property interest to each spouse. What problems can that create?
>
> > Answer: W received a non-controlling minority interest that is likely worth less than H's controlling minority interest. If W wants to appeal the property division as an abuse of discretion, she faces the problem that, if the only value determined at trial was the limited partnership entity as a whole, then the value of her 49.5% interest without control cannot be ascertained by the appellate court. So she has no way to show the appellate court the disparate value between what H received (a minority interest with control) and what she received (a minority interest without control). After divorce, ex-H can double his salary, or ex-H can suspend distribution of profits, creating a problem for ex-W over "phantom income," where she has to report 49.5% of partnership income even if she receives no money from the partnership to pay her tax liability. Her only effective recourse at that point is a derivative action suit or a suit for breach of fiduciary duty. The divorce court could create such a fiduciary duty in the decree of divorce. The court could probably also require in the divorce decree that the H cause the entity to distribute enough money to pay the tax on the "phantom income" (unless there are other partners whose rights might be affected).

c. Phantom Income. If the entity is a pass-through entity for tax purposes, it is important that the non-controlling but co-owning spouse not be required to pay income tax on phantom income without receiving money from the entity to pay towards that tax. The non-controlling spouse cannot avoid the obligation to report tax, but the entity could guarantee to distribute enough money to pay the tax on pass-through income. Or an entity can elect to be taxed as a C Corporation (IRS Form 8832), where the owners are taxed only on income that is distributed. Or a pass-through entity can be converted to a C Corporation.

d. Capital Calls. Under TBOC § 153.254, an assignee of a limited partner interest is not liable to fulfill capital calls unless the assignee becomes a limited partner. If the assignee spouse does not have the wherewithal to meet future capital calls, the capable spouse can advance the money for the

capital call subject to later repayment, or the advancement of capital calls can dilute ownership in favor of the ex-spouse covering the call. An assignee of a member interest in an LLC is obligated to pay capital calls if that duty can be discerned from the company agreement or if the assignee has knowledge of the duty. See Section II.E.2 above.

e. Ongoing Fiduciary Duties. Fiduciary law is a domain that involves the interface of statutory law, case law, and contractual agreement. See Sections XI and XII.C below. In resolving a divorce with an ongoing business relationship between spouses, it is preferable to reach agreement on how to define or describe post-divorce fiduciary duties, rather than leaving the parties to the uncertainties that exist if the duties are defined by statutes and case law.

2. Award The Entity to One Spouse. The spouses or the divorce court can award the business to one spouse and award offsetting cash or property, or a promissory note or judgment, to the other spouse. This requires the entity to be valued. Because Internal Revenue Code § 1041 precludes the recognition of gain upon a transfer between spouses incident to divorce (see Section IX.A below), the capital gain tax and costs of sale upon ultimate sale of the business will fall entirely on the spouse who receives the business in the divorce. Thus, the net-after-closing-costs and net-after-tax analysis may cause a spouse to be unwilling to take the business unless an adjustment is made for the present value of projected future costs of taxes upon sale and costs of sale.

If there are not enough other money/assets to offset half the value of the business, then the buying spouse will have to make payments over time to the selling spouse. This creates a debtor/creditor relationship between ex-spouses, with its attendant risks. An interest rate needs to be determined, and it should be (but often is not) commensurate with risk of non-collection, which would be higher than the prime lending rate and perhaps even higher than the prevailing commercial loan rate. Risk is increased, and a further upward adjustment of the interest rate would be warranted, if there is no collateral for the obligation or if the selling spouse has to take a second lien position behind other creditors as to some or all of the business's assets. There is also the sometimes thorny question of whether the debt should be reflected by a promissory note or a judgment. A promissory note in default must be reduced to judgment before it becomes enforceable, although it may be susceptible to a motion for summary judgment. A judgment can be enforced directly, without an intervening lawsuit. Enforcement procedures on the judgment can be suspended while payments are kept current and collateral is not compromised. Some business owners, however, may believe that the ability to get credit, suppliers, customers, etc. is impaired more by a judgment than by a promissory note. Then there is the issue of collateral or security for the debt, including an entity guarantee of the personal debt, the perfecting of liens and security interests, and liens in non-business assets. Also to be considered is the availability of a Texas Family Code ch. 9 post-divorce enforcement proceeding, and non-dischargeability in bankruptcy (as a domestic support obligation under 11 U.S.C. § 101(14a) or non-dischargeable debt under § 523(a)(15)). In an agreed-upon property division, the terms of sale can include an earn-out provision based on performance of the business after the divorce, and an earn-out can sometimes be used to circumvent a valuation dispute. There is no case law on whether a court can include an earn-out provision in a contested divorce decree. Earn-outs must be carefully crafted so that the metrics are not susceptible to manipulation by the business owner (for example, use gross revenue rather than net profit, or prohibit raising salaries or declaring bonuses as a way to reduce profits). And the departing spouse needs to have the ability to verify that the business is reporting information accurately. The Court must consider the effect of

transfer restriction or buy-sell agreement if both spouses are owners at the time of divorce and the transfer of one spouse's ownership interest to the other spouse will trigger a buy-sell agreement.

3. Sell the Entity and Divide the Proceeds. The spouses can agree or the divorce court can order that the business be sold. *In re Marriage of A.W.E. & D.M.F.N.*, No. 05-19-01303-CV (Tex. App.–Dallas March 4, 2021, no pet.) (mem. op.) ("To the extent Wife argues Texas law does not allow the trial court in the divorce decree to order the sale of a community asset, Wife is mistaken. The trial court in a divorce proceeding has authority to order the sale of a community asset the court determines is not subject to partition in kind.") Selling the business avoids having to value the business in the divorce, since the sales price is by definition Fair Market Value (willing buyer/willing seller). However, dissension between the ex-spouses can scare off legitimate buyers, leaving only "vultures" looking for a bargain. If a receiver is appointed, it adds to the costs of sale. The receiver may reduce the price for a quick sale for cash, when a longer period of marketing or more strenuous negotiations might lead to a higher sales price or better terms of sale, including earnout payments. Sale of a partial interest is not feasible if there are other owners, or if there are transfer or buy-sell restrictions (unless the entity or the other owners agree to buy out the departing spouse). Neither spouse can be required to sign a covenant not to compete, *Ulmer v. Ulmer*, 717 S.W.2d 665 (Tex. App.–Texarkana 1986, no writ), which will chase off buyers or depress the sale price. If a covenant not to compete will be signed by one or both spouses, how much of the sale proceeds will be allocated to each covenant? Will the spouse be able to keep the amount paid for the covenant as his/her separate property? How does it affect the division of the sale proceeds if one or both spouses are required to work for the business for a period of time after the sale? If the ex-spouses disagree on these issues, what court has jurisdiction to can decide the question, if the parties do not agree at the time of divorce to arbitrate such disputes?

4. Transfering Assets From Inside Entity to a Spouse. Texas law is clear: assets of an entity do not belong to the owners of the entity. The spouses can agree to use cash or assets inside the entity to redeem the departing spouse's interest in the business. Doing so requires the consent of the entity, or reverse-piercing of the entity veil, or imposing a resulting or constructive trust to remove assets from the entity. The redemption will be taxed either as a dividend to the remaining spouse or capital gain to the departing spouse. See Sections VII.C and IX.B below. There are also so-called "Hot Assets" inside an S Corporation or partnership that can be taxed at ordinary tax rates if they are distributed. See Section III.B.1 above.

If the entity veil is pierced generally, the assets acquired by the business during marriage become owned by the spouses and are subject to division absent tracing of separate property. If the entity veil is pierced only as to one or a few assets acquired during marriage, then those assets become marital property to the extent of the spouse's ownership interest in the business. To pierce, does the entity have to be joined as a party? "Yes," if an asset is going to be pulled out of the entity and into the marital estate. But if the design is to seek a finding of alter ego for purposes of the divorce, but leave the assets intact, and just award offsetting assets or a money judgment to the other spouse, ownership of the entity's assets are not put in jeopardy so (probably) the entity need not be a party.

What do you do about a spouse retaining earnings inside a separate property entity? Retained earnings inside an entity are not marital property; they belong to the entity. *Thomas v. Thomas*, 738 S.W.2d 342, 344 (Tex. App.--Houston [1st Dist.] 1987, writ denied). When a spouse is allegedly bottling up earnings so that they do not become community property upon distribution, does the

other spouse have a remedy? There is no case law on this point, and there are arguments pro and con. In the Author's experience, family lawyers sometimes allege fraud, constructive fraud, and breach of fiduciary duty, and see where that leads. Another angle is to ask whether the owner-spouse contributed community labor that enhanced the value of the separate property entity, and if so, whether the community estate was adequately compensated. If not, a claim for reimbursement for under-compensation arises. Tex. Fam. Code § 3.402(a)(2); *Jensen v. Jensen*, 665 S.W.2d 107 (Tex. 1984). Also, the Court can also take these circumstances into consideration in making a disproportionate division of the community estate.

5. Subdivide the Entity and Award Part to Each Spouse. The parties can subdivide an entity and award a portion to each spouse. (A divorce court would not have this power absent consent or reverse-piercing). An entity can be converted to one or more C Corporations, S Corporations, LLCs, or partnerships, with component parts awarded to each spouse. A corporation can have a spin-off, split-off, or split-up. In Texas, a merger can be a joinder of two or more corporations. It can also be a "divisive merger," where a corporation is split into two or more corporations. TBOC §1.002(55)(A). A divisive merger is the opposite of traditional merger; instead one entity divides into multiple entities; the dividing entity is not required to terminate, and may be one of surviving entities; assets and liabilities of the dividing entity are allocated among new entities formed; a divisive merger is NOT considered to be an assignment or transfer under Texas or Delaware state law; may be used to avoid transfer restrictions; this requires filings with Secretary of State; and may trigger tax issues.

6. Liquidation Over Time. If the business assets consist of long-term investments, such as a land developer with a number of properties waiting to be reached by outward city growth, or a homebuilder with a number of subdivision lots to build on, or a landlord with a number of commercial or residential properties held for rent, or an individual investor with several or many pieces of real estate held for resale, and the decision is made to liquidate the investments incident to divorce over a period of time, one option is to create a liquidating trust designed to complete projects and sell the investments in a orderly way. The key is to find a trustee whom both ex-spouse parties can trust. One of the ex-spouses could serve as trustee, if there is complete transparency in the process and some degree of consent to transactions required by the other spouse. The next question of importance is the terms of the trust. The trustee must have enough flexibility to be able to maximize the proceeds from liquidation, but not so much flexibility as to encourage skullduggery. It might be difficult to find a person willing to serve as trustee for ex-spouses who may be disposed to see themselves as having conflicting interests. There is some ability to include in the trust agreement terms that alter the trustee's fiduciary duties from what they would otherwise be under the Texas Trust Act and the common law. See Sections XIII.D below. A possible work-around is to provide that the trustee will make significant decisions only with the agreement of the ex-spouse beneficiaries, and absent agreement designating another person as an arbitrator to resolve disagreements by binding arbitration with no right to overturn arbitration awards in trial or appellate courts. The arbitrator has no fiduciary duties to either spouse, and can therefore assume the role of final decision-maker without exposing himself or herself to the risk of being sued by an ex-spouse.

If one or more projects is in the development or construction phase, practicality demands that the managing spouse remain in control to finish the project(s). The best solution may be to put ownership of the project(s) into a newly-created LLC with negotiated terms of the fiduciary duties that the managing ex-spouse will owe to the other ex-spouse. See Section XIII.C below.

IX. TAX ASPECTS OF THE PROPERTY DIVISION. While the tax aspects of a divorce are not always complicated, they can be more complicated when the divorce involves business entities.

1. IRC § 1041 eliminates a capital gain tax where one spouse conveys an interest in the business to the other spouse for money or other property, incident to divorce.

2. However, if the spouses want to use *money or other assets inside the entity* to buy out one spouse's interest in the business, it will require a distribution from the entity and that distribution is subject to income tax. Treasury Regulation 26 CFR § 1.1041-2(c) permits the spouses to agree that a redemption or liquidation will be taxed either to the "departing spouse" as a capital gain or loss, or to the "remaining spouse" as a constructive dividend. The tax rates on a dividend or a capital gain are the same, but a capital gain tax is levied on the amount paid after subtracting the departing spouse's tax basis in the entity, whereas a dividend tax is levied on 100% of the amount paid. Moreover, a capital gain can be reported on an installment basis over a period of months or years, which may lower the overall tax paid.

3. In a redemption or partial liquidation, a tax at ordinary tax rates (up to 39.6%) can be triggered if the entity owns "hot assets." Hot assets include unrealized receivables, inventory, mineral leasehold interests for which intangible drilling and investment costs were deducted, and property subject to depreciation recapture. Hot assets can increase the tax that will be triggered upon a redemption or liquidation.

4. Under the "assignment of income" doctrine, income is taxed to the person whose efforts earned it, even if the right to receive the income is assigned to someone else. A lawyer or doctor spouse who assigns part of the accounts receivables to the other spouse will have to pay the tax on that income when it is received by the other spouse. IRC § 1041 does not protect against this. See Section IX.C below.

A. INTERNAL REVENUE CODE § 1041. Internal Revenue Code (IRC) Section 1041 precludes capital-gain-tax recognition for interspousal transfers, including transfers incident to divorce. IRC § 1041 does not recognize a capital gain where a spouse conveys an interest in property to the other spouse incident to divorce (within one year of cessation of marriage or related to cessation; presumed unrelated if more than six years after divorce). However, if the spouses want to use entity money or property to redeem a spouse's interest in the entity, it will require a distribution of that property from the entity, and that distribution is subject to income taxation. Section 1041 does not apply where one spouse is a non-resident non-citizen.

B. TAX ASPECTS OF ACQUISITION, REDEMPTION, OR LIQUIDATION. If one spouse acquires the other spouse's interest incident to divorce, IRC § 1041 precludes capital gain recognition. The existing tax basis is carried forward. If the entity acquires the interest, it is a redemption, and the Treasury Regs. under IRC § 1041 permit the spouses to choose between a capital gain to the departing spouse or a constructive dividend to the remaining spouse. A capital gain tax is levied on the amount paid to the departing spouse after subtracting the departing spouse's tax basis in the entity; a dividend tax is levied on 100% of the amount distributed. A capital gain can be reported on an installment basis over a period of months or years, while a dividend must be reported in the year in which it was paid. It can be complicated if you don't make a § 1041 election. If the spouses do not elect, then whether IRC § 1041 applies depends on whether the entity assumed

an obligation of the remaining spouse to buy-out the departing spouse. If other owners acquire the departing spouse's interest, it is not clear whether IRC § 1041 protects against capital gain recognition.

C. THE ASSIGNMENT OF INCOME DOCTRINE. The Assignment of Income Doctrine announced in *Lucas v. Earle*, 281 U.S. 111 (1930), provides that income from personal services is taxed to the party who performed the services, regardless of who receives the income. In *Helvering v. Horst*, 311 U.S. 112, 116 (1940), the U.S. Supreme Court said that a taxpayer generally may not escape taxation by voluntarily assigning his or her unreceived income. In *Kochansky v. Commissioner*, 92 F.3d 957 (9th Cir. 1996), a contingent fee earned by a lawyer in a community property state, half of which was awarded to his spouse in the divorce, was taxable entirely to the lawyer. In *Meisner v. United States* (1998), 133 F.3d 654 (8th Cir. 1998), the appellate court held that a divorcing husband's assignment to the wife of royalties relating to music of *The Eagles* was not taxable to the husband after the divorce "[b]ecause there is no evidence of retained control over Jennifer's rights by Randall and because this transfer of rights occurred pursuant to a divorce...." Rev. Rul. 2002-22 recognized that Section 1041 exempts vested nonstatutory stock options from the Assignment of Income Doctrine. However, the ruling does not apply to unvested stock options or options that are subject to substantial contingencies at the time of transfer. The take-away is to allocate the tax burden explicitly in the settlement agreement or decree, to avoid guesswork, and back that up with a contractual indemnification in the event the tax does not fall where the parties agreed for it to fall. That leads to a question of whose tax rate to apply in determining the tax on the income when received, and whether the assignee trusts the assignor to pay over the net income, or the assignor trusts the assignee to pay the tax on the income received by the assignee.

X. FORMAL AND INFORMAL FIDUCIARY RELATIONSHIPS; NON-FIDUCIARY RELATIONSHIPS. In a divorce involving a closely-held business, sometimes breach of fiduciary duty claims are made. Fiduciary duties will also be an issue if the ex-spouses will remain in business together after divorce, or if the process of liquidating a business or investments extends over time.

Business transactions can be divided into three categories: formal fiduciary, informal fiduciary, and arm's-length. The duties vary with the type of transaction. Formal and informal fiduciaries have duties that depend on the type of fiduciary relationship. Most arm's-length transactions are without special duties, but criminal laws and general tort duties apply.

A. FORMAL FIDUCIARY RELATIONSHIPS. There are different articulations of who is a formal fiduciary under Texas law. The Texas Supreme Court has listed attorney-client, principal-agent, partners, and joint venturers, as relationships that give rise to a formal fiduciary relationship as a matter of law. *Insurance Co. of N. Am. v. Morris*, 981 S.W.2d 667, 674 (Tex. 1998); *Texas Bank & Trust Co. v. Moore*, 595 S.W.2d 502, 507 (Tex. 1980). Texas Penal Code § 32.43, Commercial Bribery, lists as fiduciaries (A) an agent or employee, (B) a trustee, guardian, administrator, executor, conservator, receiver, or similar fiduciary, (C) a lawyer, physician, accountant, appraiser, or other professional advisor, or (D) an officer, director, partner, manager, or other participant in the direction of the affairs of a corporation or association. Texas Penal Code § 32.45(a)(1), Misapplication of Fiduciary Property, lists as fiduciaries a trustee, guardian, administrator, executors, executor, conservator, and receiver. In the Code of Ethics and Minimum Standards for Guardianship Services,[11] promulgated by the Texas Supreme Court on June 24, 2016, the term "fiduciary" is defined as "[a]n individual, agency, or organization that has agreed to undertake for

another a special obligation of trust and confidence, having the duty to act primarily for another's benefit and subject to the standard of care imposed by law or contract." The rules regarding business-related fiduciary relationships are discussed below.

1. Agent → Principal. "Under the common law of most jurisdictions, including Texas, agency is also a special relationship that gives rise to a fiduciary duty." *Johnson v. Brewer & Pritchard, P.C.*, 73 S.W.3d 193, 200 (Tex. 2002). See Section II.B below.

2. Trustee → Beneficiary. The trustee-beneficiary relationship is the epitome of a fiduciary relationships. The duties of a trustee are impacted by statutory standards and prohibitions, as well as common law principles, and the terms of the trust agreement.

3. Attorney → Client. The attorney-client relationship is on both of the Texas Penal Code's listings of formal fiduciary relationships. In *Archer v. Griffith*, 390 S.W.2d 735, 739 (Tex. 1964), the Supreme Court said: "the relation between an attorney and his client is highly fiduciary in nature, and their dealings with each other are subject to the same scrutiny, intendments and imputations as a transaction between an ordinary trustee and his cestui que trust."

4. Corporate Directors/Officers/Managers → Company, Owners, Creditors. "Corporate officers and directors are fiduciaries, and the consequences of their acts a such are determinable under the facts in each case." *Int'l Bankers Life Inc. co. v. Holloway*, 368 S.W.2d 567, 576 (Tex. 1963). This articulation of duties points to no specific standards. The Texas Supreme Court decisions and Texas business statutes are a patchwork, and a coherent statement of the duties of corporate directors and officers under Texas law exists mainly in a robust body of comprehensive Texas continuing legal education articles that sometimes fall back on Delaware law and Delaware court decisions to fill gaps in the Texas patchwork. See Section XII.C below.

In June of 2022, the Supreme Court decided *Matter of Estate of Poe*, 648 S.W.3d 277 (Tex. 2022), which involved an alleged informal fiduciary duty from a corporate director to a shareholder in the context of managing a family corporation. The Supreme Court made important statements about formal and informal fiduciary duties in the corporate context, and rejected the existence of an informal fiduciary duty owed by corporate directors to corporate shareholders, saying that directors' controlling duty is the fiduciary duty owed to the corporation.

5. General Partnerships. In *Bohatch v. Butler & Binion*, 977 S.W.2d 543, 545 (Tex. 1998), the Court wrote: "We have long recognized as a matter of common law that '[t]he relationship between ... partners ... is fiduciary in character, and imposes upon all the participants the obligation of loyalty to the joint concern and of the utmost good faith, fairness, and honesty in their dealings with each other with respect to matters pertaining to the enterprise.'" See Section XII.C.4 below.

6. Limited Partnerships. In *Crenshaw v. Swenson*, 611 S.W.2d 886, 890 (Tex. App.--Austin 1980, writ ref'd n.r.e), the court said that the general partner of a limited partnership has the same fiduciary duties as a trustee owes to the trust beneficiaries. Ordinarily a limited partner's lack of decision-making authority curtails its fiduciary duties to the partnership and other partners. Professor Elizabeth S. Miller, *Fiduciary Duties, Exculpation, and Indemnification in Texas Business Organizations*, 13th ANNUAL ADVANCED BUSINESS LAW ch. 7, p. 1 (2020) ("Miller 2020"). p. 39. However, if a limited partner exercises control over the operation of the business, a fiduciary-like duty arises. *CBIF Limited Partnership v. TGI Friday's*

Inc., No. 05-15-00157-CV, *19 (Tex. App.--Dallas Dec. 5, 2016, pet. denied) (memo. op.); *Strebel v. Wimberly*, 371 S.W.3d 267, 281 (Tex. App.--Houston [1st Dist.] 2012, pet. denied); *Daniels v. Empty Eye, Inc.*, 368 S.W.3d 743, 750-51 (Tex. App.--Houston [14th Dist.] 2012, pet. denied). The duty of loyalty may apply to limited partners. See TBOC § 152.205. See Section XII.C.5 below.

7. Joint Venturers. Joint venturers owe each other the fiduciary duties of partners. *CBIF Ltd. v. TGI Friday's, Inc.* No. 05-15-00157-CV (Tex. App.--Dallas Dec. 5, 2016, pet. denied) (memo. op.) See Section XII.C.6 below.

8. Limited Liability Companies. The TBOC does not attribute formal fiduciary obligations to managers and members of LLCs. The case law has turned mostly on the existence of informal fiduciary relationships. See Section XII.C.7 below.

9. Executive Rights Over Mineral Interests. Under Texas law, the holder of the executive right over the mineral interests of other royalty owners owes a duty of utmost good faith to the other owners. *Manges v. Guerra*, 673 S.W.2d 180, 183-84 (Tex. 1984). The duty is a fiduciary duty. *Id.* However, unlike the agent in a principal-agent relationship, or the trustee of an express trust, the holder of executive rights does not have to put the other royalty owners' interests before his own. Instead, this fiduciary duty requires the holder of the executive right to acquire for the non-executive every benefit that he exacts for himself in leasing the property. *Id.*

10. Spouses. Texas has long recognized that the marital relationship entails fiduciary obligations between spouses. See Section XII.D below.

11. Parent → Child. "[P]arents generally stand in the role of fiduciaries toward their minor children." *S.V. v. R.V.*, 933 S.W.2d 1, 8 (Tex. 1996). Neither the Texas Family Code nor other statutes spell out the fiduciary obligations of parent to child. The standards of principal and agent would readily apply, but the common law duties of an express trustee might be a source of authority. *Id.*

B. INFORMAL FIDUCIARY RELATIONSHIPS. In *Crim Truck & Tractor Co. v. Navistar Intern. Transportation Corp.*, 823 SW 2d 591, 594 (Tex. 1992), the Supreme Court wrote:

> We have also recognized that certain informal relationships may give rise to a fiduciary duty. *See*, *e.g.*, *MacDonald v. Follett*, 142 Tex. 616, 180 S.W.2d 334 (1944). Such informal fiduciary relationships have also been termed "confidential relationships" and may arise "where one person trusts in and relies upon another, whether the relation is a moral, social, domestic or merely personal one". *Fitz-Gerald v. Hull*, 150 Tex. 39, 237 S.W.2d 256, 261 (1951). Because not every relationship involving a high degree of trust and confidence rises to the stature of a formal fiduciary relationship, the law recognizes the existence of confidential relationships in those cases "in which influence has been acquired and abused, in which confidence has been reposed and betrayed". *Texas Bank & Trust Co. v. Moore*, 595 S.W.2d 502, 507 (Tex. 1980). The existence of a confidential relationship is usually a question of fact. *See MacDonald*, 142 Tex. at 623, 180 S.W.2d at 339; *Schiller v. Lick*, 150 Tex. 363, 240 S.W.2d 997, 1000 (1951). Although we recognize that the existence of a confidential relationship is ordinarily a question of fact, when the issue is one of no evidence, it becomes a question of law. *See Thigpen v. Locke*, 363 S.W.2d 247, 253 (Tex. 1962).

> In *Mills v. Gray*, 147 Tex. 33, 210 S.W.2d 985 (Tex. 1948), and *Fitz-Gerald v. Hull*, 150 Tex. 39, 237 S.W.2d 256 (Tex. 1951), the Supreme Court recognized that confidential relationships may arise not only from the technical fiduciary relationships such as attorney-client, trustee-cestui que trust, partner and partner, etc. – which as a matter of law are relationships of trust and confidence–but may arise informally from "moral, social, domestic or purely personal" relationships. 54 Am. Jur. 173, § 225, "Trusts". The existence of the fiduciary relationship is to be determined from the actualities of the relationship between the persons involved.

In *Texas Bank and Trust Co. v. Moore*, 595 S.W.2d 502, 508 (Tex. 1980), the Court said: "In resolving the problem of the existence or not of a fiduciary relationship this Court has severely scrutinized transactions between parties where trust and confidence is reposed by one, and personal profit is gained by another.... The problem is one of equity and the circumstances out of which a fiduciary relationship will be said to arise are not subject to hard and fast lines." (Citations omitted.)

As for the criminal law perspective, in *Showery v. State*, 678 S.W.2d 103, 107 (Tex. App.--El Paso 1984, pet. ref'd), the court wrote:

> While the legal profession's frequent handling of fiduciary matters leads to an initial impression that the term is solely within the province of our own profession, we must not overlook the fact that we have no monopoly on the English language. "Fiduciary" and "fiduciary relation" have a common meaning to be found in lay dictionaries. See: Webster's Third New International Dictionary (1971 ed.). Such lay definitions are consistent with [Penal Code Section 32.45] subsection (a)(1)(B) and subject to common understanding. The consistent elements, applicable to the statute and this case, are holding or dealing with the property of another with a duty of trust toward the beneficiary.

There are a number of criminal cases describing what constitutes an informal "fiduciary capacity" for purposes of criminal law. A list is given in *Berry v. State*, 424 S.W.3d, 579, 585 n. 7 (Tex. Crim. App. 2013): "*Fuelberg v. State*, 410 S.W.3d 498, 502 (Tex. App.--Austin 2013) (defendant was general manager of non-profit utility cooperative who funneled cooperative's funds to his brother and a friend); *Anderson v. State*, 322 S.W.3d 401, 406-07 (Tex. App.--Houston [14th Dist.] 2010, pet. ref'd) (defendant was investment manager who received funds for sole purpose of investing funds in limited partnership but instead spent funds on personal legal fees and a car); *Head v. State*, 299 S.W.3d 414, 433 (Tex. App.--Houston [14th Dist.] 2009, pet. ref'd) (defendant was financial adviser and protector of elderly woman's two trusts who took personal and business loans from complainant's funds without her knowledge); *Tyler v. State*, 137 S.W.3d 261, 264-66 (Tex. App.--Houston [1st Dist.] 2004, no pet.) (defendant was acting in 'fiduciary capacity' when she agreed to help manage elderly relative's financial assets and then withdrew funds from complainant's bank account without authorization); *Huett v. State*, 970 S.W.2d 119, 124-25 (Tex. App.--Dallas 1998, no pet.) (defendant used investors' money on personal expenditures unrelated to oil-lease business including house and car payments, clothing, and grocery expenses); *Starnes v. State*, 929 S.W.2d 135, 137-38 (Tex. App.--Fort Worth 1996, pet. ref'd) (defendant was hired by volunteer fire department to run charity bingo games and misappropriated money from organization); *Dwyer v. State*, 836 S.W.2d 700, 702 (Tex. App.--El Paso 1992, pet. ref'd) (defendant was accountant who received customers' payments for purpose of forwarding them to utility company but instead applied them to his own personal and business expenses); *Showery v. State*, 678 S.W.2d 103, 106 (Tex. App.--El Paso 1984, pet. ref'd) (defendant was physician who received insurance-company overpayments on patient's behalf and then failed to forward payments to patient).

1. Moral, Social, Domestic, or Merely Personal Relationships. What constitutes a "moral" relationship was not explained in the *Crim Truck* case. Perhaps a spiritual advisor has a "moral" relationship with his/her parishioner. A "social" relationship presumably means a long-standing non-business relationship. As to "domestic," the fiduciary duty between spouses is discussed in Section XII.D below. Other family relationships can support a finding of an informal fiduciary duty or confidential relationship. *See Texas Bank & Trust Co. v. Moore*, 595 S.W.2d 502 (Tex. 1980) (saying that the aunt-and-nephew relationship, by itself, did not establish a fiduciary relationship). "A family relationship, while it is considered as a factor, does not by itself establish a fiduciary relationship." *Kirkpatrick v. Cusick*, No. 13-13-00149-CV, * 4 (Tex. App.--Corpus Christi Dec. 19, 2013, pet. denied) (memo. op.).

2. The Relationship Must Pre-Exist the Transaction. "[W]hile a fiduciary or confidential relationship may arise from the circumstances of a particular case, to impose such a relationship in a business transaction, the relationship must exist prior to, and apart from, the agreement made the basis of the suit." in *Schlumberger Technology Corp. v. Swanson*, 959 S.W.2d 171, 177 (Tex. 1997).

3. No Informal Duty Is Owed By Corporate Directors to Shareholders. In *Matter of the Estate of Poe*, 648 S.W.3d 277, 288-89 (Tex. 2022), the Supreme Court ruled out the existence of a fiduciary duty owed by corporate directors to corporate shareholders, holding that such a duty was incompatible with the directors' statute-based duties owed to the corporation.

C. ARM'S-LENGTH TRANSACTIONS.

1. No Fiduciary Duty. In *Berry v. State*, 424 S.W.3d 579 (Tex. Crim. App. 2014), the Texas Court of Criminal Appeals wrote:

> [W]e observe that the civil courts of Texas have generally held that everyday arms-length business transactions, including contracts to sell goods and services, do not give rise to a fiduciary relationship between the parties. *See Crim Truck & Tractor Co. v. Navistar Int'l Transp. Corp.*, 823 S.W.2d 591, 594 (Tex. 1992), superseded by statute on other grounds ("The fact that one businessman trusts another, and relies upon his promise to perform a contract, does not rise to a confidential relationship."). That is because in everyday business dealings, it is assumed that the parties interact for their mutual benefit, and, therefore, a party is not expected to act solely for the benefit of the other party to the contract. *See Schlumberger Tech. Corp. v. Swanson*, 959 S.W.2d 171, 177 (Tex. 1997) (declining to impose fiduciary relationship in contractual situation because "all contracting parties presumably contract for their mutual benefit"). To impose a fiduciary relationship in ordinary business dealings would run contrary to the principle that a fiduciary is obligated to act for the primary benefit of the other party.

While in an arm's-length transaction each party is permitted to pursue his own interests without regard to the interests of the other party, there are limits on allowable behavior. In an arm's-length transaction a party cannot intentionally misrepresent a material fact in order to procure an agreement. Nor can a party make a promise to perform while secretly harboring the intention to not perform. If a party negligently misrepresents facts relied upon by the other party s/he can be held liable for the tort of negligent misrepresentation.

The Supreme Court wrote: "In an arm's-length transaction the defrauded party must exercise ordinary care for the protection of his own interests and is charged with knowledge of all facts which would have

been discovered by a reasonably prudent person similarly situated. And a failure to exercise reasonable diligence is not excused by mere confidence in the honesty and integrity of the other party." *Courseview, Inc. v. Phillips Petroleum Co.*, 312 S.W.2d 197, 205 (Tex. 1957) (involving notice of when the statute of limitations began to run).

Business transactions are normally viewed as being arm's-length; however, when a business transaction occurs in the context of a formal or informal fiduciary relationship, fiduciary duties arise. In *Thigpen v. Locke*, 363 S.W.2d 247, 253 (Tex. 1962), the Supreme Court wrote:

> [I]n this case there is not such evidence of justifiable trust and confidence as will create a fiduciary relationship. We may assume that respondents did trust Mr. Thigpen; they have testified so time and time again, but mere subjective trust alone is not enough to transform arms-length dealing into a fiduciary relationship so as to avoid the statute of frauds. Businessmen generally do trust one another, and their dealings are frequently characterized by cordiality of the kind testified to here. If we should permit respondents to set aside their conveyances on such slender evidence, the security of contracts and conveyances in this state would be seriously jeopardized.

In *Thigpen v. Locke,* Chief Justice Calvert, joined by Justice Ruel Walker and Justice Zollie Steakley (three great Justices of the Texas Supreme Court),[12] wrote in dissent about the standard for when a fiduciary duty arises in a business transaction, saying:

> One of the best statements of a rule of measurement which I have found is in *Collins v. Nelson*, 193 Wash. 334, 75 P.2d 570, 574, as follows:
>
> > To establish a fiduciary relationship upon the violation of which fraud is sought to be based, there must be something more than mere friendly relations or confidence in another's honesty and integrity. There must be something in the particular circumstances which approximates a business agency, a professional relationship, or a family tie, something which itself impels or induces the trusting party to relax the care and vigilance which he otherwise should, and ordinarily would, exercise.

Id. 254-55 (Calvert, C.J., dissenting).

XI. DEFINING FIDUCIARY DUTIES.

A. HISTORICAL STANDARDS OF FIDUCIARY DUTY. Justice Benjamin Cardozo described the fiduciary duty of co-venturers in *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545 (1928), as requiring "something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor most sensitive, is then the standard of behavior." This description is famous, partly due to Cardozo's enduring stature as a renowned jurist and important legal author,[13] and partly due to the piquancy of his comment. The Texas Supreme Court similarly said in *Johnson v. Peckham*, 132 Tex. 148, 120 S.W.2d 786, 788 (1938): "When persons enter into fiduciary relations each consents, as a matter of law, to have his conduct towards the other measured by the standards of the finer loyalties exacted by courts of equity. That is a sound rule and should not be whittled down by exceptions." In the decades since Cardozo wrote, the stringency of his description of a fiduciary duty has devolved into a variety of standards that fall below his ideal. In the business-entity context, and even in formal fiduciary relationships like trustees of an

express trust and partners in a partnership, legislatures and courts have articulated a variety of duties and exceptions.

B. TEXAS PATTERN JURY CHARGE. The State Bar of Texas PATTERN JURY CHARGES (BUSINESS, CONSUMER, INSURANCE & EMPLOYMENT 2022) PJC 104.2 describes the duties of a fiduciary under the common law. The liability question asks: (1) was the transaction fair and equitable to the beneficiary?;(2) did the fiduciary make reasonable use of the confidence placed in him?; (3) did the fiduciary act in the utmost good faith and exercise the most scrupulous honesty toward the beneficiary?; (4) did the fiduciary place the beneficiary's interest before his own and not use the advantage of his position to gain any benefit for himself at the expense of the beneficiary?; <u>and</u> (5) did the fiduciary fully disclose all important information to the beneficiary concerning the transaction? The questions are submitted in one broad form question, and the fiduciary has the burden of proof to secure a "yes" answer.

Where the fiduciary duties are specified by statute or agreement, PJC 104.4 asks whether the fiduciary complied with "all of the following duties," and says to list duties alleged to have been breached and the standard of care using language from the applicable statute or agreement, or both, and common law duties.

C. DUTY OF OBEDIENCE. The duty of obedience was articulated in *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 719 (5th Cir. 1984): "The duty of obedience requires a director to avoid committing ultra vires acts, i.e., acts beyond the scope of the powers of a corporation as defined by its charter or the laws of the state of incorporation. *Ubelaker* at 782. An ultra vires act, negligent or not, may be voidable under Texas law, but the director is not personally liable for it unless the action in question is also illegal. *Staacke v. Routledge*, 111 Tex. 489, 241 S.W. 994 (1922); *Sutton v. Reagan & Gee*, 405 S.W.2d 828 (Tex.Civ.App.--San Antonio 1966, writ ref'd n.r.e.); see also Tex. Bus. Corp. Act Ann. art. 2.04 (Vernon 1980). An illegal act in this context is one in violation of a specific statute, malum in se, malum prohibitum, or against public policy. *Staacke v. Routledge*, 241 S.W. at 998-99." *Gearhart* was cited for this point by the Texas Supreme Court in *Matter of the Estate of Poe*, 648 S.W.3d 277, 287 (Tex. 2022).

D. DUTY OF LOYALTY. The duty of loyalty is specified for agents, corporate directors and officers, partners, and trustees of express trusts. For an agent, "[u]nless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency." *Johnson v. Brewer & Pritchard, PC*, 73 S.W.3d 193, 200 (Tex. 2002). For a partner, the duty of loyalty includes: accounting to and holding for the partnership property, profit, or benefit derived by the partner, refraining from dealing with the partnership on behalf of a person who has an interest adverse to the partnership; and refraining from competing or dealing with the partnership in a manner adverse to the partnership. TBOC § 152.205.

E. DUTY OF CARE. If Texas law applies (see Section XI.I below), the duty of care is specified by statute for trustees of express trusts, corporate directors and officers, and partners.

1. Ordinary Care. The "reasonably prudent person" standard is another way of describing the standard of care for ordinary negligence. *See Missouri-Kansas-Texas Railroad Co. v. McFerrin*, 291 S. W.2d 931, 936 (Tex. 1956) ("we apply the objective common-law test of the reasonably prudent man" in a motor vehicle accident case); *Snow v. Bond*, 438 S.W.2d 549, 550-51 (Tex 1969) (asking "what a reasonable and prudent doctor would have done under the same or similar circumstances" in a medical malpractice case). For trustees, the duty of care is "the use of the skill and prudence which an ordinary capable and

careful person will use in the conduct of his own affairs." *InterFirst Bank Dallas, NA v. Risser*, 739 SW 2d 882, 888 (Tex. App.–Texarkana 1987, writ dism'd by agr.). The duty of care of directors and officers of a corporation is the amount of care an ordinarily careful and prudent person would use in similar circumstances. *Gearhart Indus., Inc. v. Smith Intern., Inc.*, 741 F.2d 707, 720 (5th Cir. 1984). A partner's duty of care is to act with the care that an ordinarily prudent person would exercise in similar circumstances. TBOC § 152.206.

2. Prudent Investor Standard of Care. Texas Property Code § 117.003 provides that a trustee investing and managing trust assets must comply with the Prudent Investor Rule. Section 117.004(a) sets out the Rule: "A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution." In *Goughnour v. Patterson*, No. 12-17-00234-CV (Tex. App.--Tyler March 5, 2019, pet. denied) (memo. op.), the court surprisingly held that a claim that a trustee violated the statutory standard of care (the Prudent Investor Rule) equates to a claim for breach of fiduciary duty, and thus the four-year limitation period applies to this claim.

3. The Business Judgment Rule. "The business judgment rule in Texas generally protects corporate officers and directors, who owe fiduciary duties to the corporation, from liability for acts that are within the honest exercise of their business judgment and discretion." *Sneed v. Webre*, 465 S.W.3d 169, 173 (Tex. 2015). In *Gearhart Industries, Inc. v. Smith International*, 741 F.2d 707, 723 n. 9 (5th Cir. 1984), the court said "[t]he business judgment rule is a defense to the duty of care. As such, the Texas business judgment rule precludes judicial interference with the business judgment of directors absent a showing of fraud or an ultra vires act. If such a showing is not made, then the good or bad faith of the directors is irrelevant." [Author's Comment: under this standard, ordinary negligence or even gross negligence is not enough to impose liability.] The Supreme Court of Delaware, in *Corwin v. KKR Financial Holdings LLC.* 125 A.3d 304, 313-14 (Del. 2015), said:

> [T]he core rationale of the business judgment rule ... is that judges are poorly positioned to evaluate the wisdom of business decisions and there is little utility to having them second-guess the determination of impartial decision-makers with more information (in the case of directors) or an actual economic stake in the outcome (in the case of informed, disinterested stockholders). In circumstances, therefore, where the stockholders have had the voluntary choice to accept or reject a transaction, the business judgment rule standard of review is the presumptively correct one and best facilitates wealth creation through the corporate form.

In *In re Estate of Poe*, 591 S.W.3d 607, 641 (Tex. App.--El Paso 2019, *reversed on other grounds*, 648 S.W.3d 277 (Tex. 2023), the court held that the burden to overcome the Business Judgment Rule was on the plaintiff and not the defendant.

F. DUTY OF GOOD FAITH. Under Texas law, a trustee of an express trust has a duty of good faith. "The trustee shall administer the trust in good faith according to its terms and this subtitle [i.e., Texas Trust Code, subtitle B]." Tex. Prop. Code § 113.051. A trustee must exercise a discretionary power in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries." Tex. Prop. Code § 113.029(a). If a trustee with full discretion to distribute the principal of a trust may distribute principal to the trustee of a second trust, but that discretion must be exercised "in good faith, in accordance with the terms and purposes of the trust, and in the interests of the beneficiaries." Tex. Prop. Code § 112.072(e).

Under Texas law, a partner is required to discharge his duties to the partnership and other partners in good faith and in a manner that the partner reasonably believes to be in the best interest of the partnership. TBOC § 152.204(b). [Author's Comment: This reasonable belief standard is a mixed subjective and objective standard.] This is not described as a duty, but rather as general standard of conduct or obligation. Additionally, TBOC § 152.204(c) says that "[a] partner does not violate a duty or obligation under this chapter or under the partnership agreement merely because the partner's conduct furthers the partner's own interest." And to make things even clearer, TBOC § 1252.204(d) says that "[a] partner, in the partner's capacity as partner, is not a trustee and is not held to the standards of a trustee."

In *Lee v. Lee*, 47 S.W.2d 767, 794-95 (Tex. App.--Houston [14th Dist.] 2001, pet. denied), the court found that different meanings had been applied to the term "good faith" in connection with a transaction under the U.C.C., official immunity, or a whistleblower action. A fiduciary acts in good faith when he or she: (1) subjectively believes his or her defense is viable, and (2) acts reasonably in light of existing law. *Id*.

In the case of *Market Street Associates LP v. Frey*, 941 F.2d 588, 595 (7th Cir. 1991), the court described the duty of good faith and fair dealing in contracts as being "halfway between a fiduciary duty (the duty of utmost good faith) and the duty merely to refrain from active fraud." The court continued: "The office of the doctrine of good faith is to forbid the kinds of opportunistic behavior that a mutually dependent, cooperative relationship might enable in the absence of rule." *Id*. at 595. The duty of good faith appears in TBOC § 7.001 (corporate fiduciary duties), and Tex. Prop. Code § 13.051 (general duty of trustees to administer trust in good faith). A clause in a trust document, saying that a person who brings a court action against the trustee forfeits his interest in the trust, is not enforceable if the person proves just cause for bringing the suit and that the action was brought and maintained in good faith. Tex. Prop. Code § 112.038.

G. DUTY TO DISCLOSE. "As a general rule, a failure to disclose information does not constitute fraud unless there is a duty to disclose." *Bradford v. Vento*, 48 S.W.2d 749, 755 (Tex. 2000). "Generally, no duty of disclosure arises without evidence of a confidential or fiduciary relationship." *Ins. Co. of N. Am. v. Morris*, 981 S.W.2d 667, 674 (Tex. 1998). However, a duty to disclose has been recognized: (i) in a formal or informal fiduciary relationship; (ii) when a partial disclosure leads to a duty to fully disclose; (iii) when new information causes an earlier disclosure to become misleading or untrue; (iv) when a partial disclosure conveys a false impression; (v) in connection with estoppel by silence; and (vi) when a person "by force of circumstances is under a duty to another to speak." *A. R. Clark Investment Co. v. Green*, 375 S.W.2d 425, 435 (Tex. 1964) (involving estoppel by silence). "[W]here there is a duty to speak, silence may be as misleading as a positive misrepresentation of existing facts.... There is an analogy to the rule considered by us in considerable depth, and with approval, in *Champlin Oil & Refining Co. v. Chastain*, 403 S.W.2d 376 (Tex. 1965), that an estoppel may arise as effectually from silence, where there is a duty to speak, as from words spoken." *Smith v. National Resort Communities, Inc.*, 585 S.W.2d 655, 658 (Tex. 1979). The duty of disclosure in business transactions is examined in Deborah A. DeMott, *Do You Have The Right to Remain Silent: Duties of Disclosure in Business Transactions*, 19 DELAWARE J. OF BUS. LAW 65 (1994).

In *Huie v. DeShazo*, 922 S.W.2d 920, 923 (Tex. 1996), the Court said: "[t]rustees and executors owe beneficiaries "a fiduciary duty of full disclosure of all material facts known to them that might affect [the beneficiaries'] rights.'"

H. PROHIBITION AGAINST SELF-DEALING. The Federal Deposit Insurance Corporation's (FDIC) Trust Examination Manual defines self-dealing in these terms: "Self-dealing always involves a conflict of interest, but not all conflicts of interest involve self-dealing. Self-dealing occurs when a fiduciary is a party to a transaction with itself or its affiliates." FDIC Trust Examination Manual[14] § 8.B. The Manual quotes the U.S. Supreme Court in *Michoud v. Girod*, 45 U.S. 503, 555 (1846):

> The general rule stands upon our great moral obligation to refrain from placing ourselves in relations which ordinarily excite a conflict between self-interest and integrity.... It therefore prohibits a party from purchasing on his own account that which his duty or trust requires him to sell on account of another, and from purchasing on account of another that which he sells on his own account. In effect, he is not allowed to unite the two opposite characters of buyer and seller, because his interests, when he is the seller or buyer on his own account, are directly conflicting with those of the person on whose account he buys or sells.

Self-dealing by a fiduciary is frowned upon in all areas of fiduciary law. Fiduciaries are entitled to receive reasonable compensation for their services, and perhaps even compensation for risks undertaken, but they are not allowed to take advantage of their fiduciary position to profit at the expense or to the detriment of the beneficiary. When a fiduciary benefits from a transaction with the beneficiary, there is a presumption of fraud and the fiduciary must prove that the transaction was fair to the beneficiary. *See Archer v. Griffith*, 390 S.W.2d 735 (Tex. 1965); *accord*, *Stephens County Museum, Inc. v. Swenson*, 517 S.W.2d 257, 739 (Tex. 1974) ("Under such conditions, equity indulges the presumption of unfairness and invalidity, and requires proof at the hand of the party claiming validity and benefits of the transaction that it is fair and reasonable"). In the trust context, "[s]elf-dealing means the trustee used the advantage of its position to gain any benefit for the trustee, other than reasonable compensation, or any benefit for any third person, firm, corporation, or entity, at the expense of the trust and its beneficiaries." *Grizzle v. Texas Commerce Bank, NA*, 38 SW 3d 265, 281 (Tex. App.–Dallas 2001), *rev' in part on other grounds*, 96 S.W.3d 240 (Tex. 2002); *InterFirst Bank Dallas, N.A. v. Risser*, 739 S.W.2d 882, 888 (Tex. App.--Texarkana 1987, no writ) (containing an in depth discussion of self-dealing). The Texas Trust Code § 114.001 provides that "[t]he trustee is accountable to a beneficiary for the trust property and for any profit made by the trustee through or arising out of the administration of the trust, even though the profit does not result from a breach of trust...." (The statute goes on to say that this standard does not apply to compensation under the trust agreement or an agreement signed by all beneficiaries.)

I. CONFLICT OF LAWS. Disregarding the Internal Affairs Doctrine, as to other claims, Texas courts apply the law of the state with the most significant relationship to the case. See RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 6(2) (1971). *Gutierrez v. Collins*, 583 S.W.2d 312 (Tex. 1979) (as to torts); *Duncan v. Cessna Aircraft Co.*, 665 S.W.2d 414, 421 (Tex. 1984) (as to all types of claims). In *Longview Energy Co. v. The Huff Energy Fund, LP*, 533 S.W.3d. 866 (Tex. 2017), in a breach of fiduciary duty suit by a corporation against two directors, the Court applied the law of Delaware to substantive issues and the law of Texas to procedural issues. *Id.* at 872. The Court applied the law of Delaware to the remedy of constructive trust. *Id.* at 873. Texas recognizes choice-of-law clauses in agreements. *DeSantis v. Wackenhut Corp.*, 793 SW 2d 670, 678-84 (Tex. 1990) (recognizing the validity of choice-of-law clauses at stated in RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187, but applying the public-policy exception to covenants not to compete). Courts apply the law of the forum to procedural matters. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 122 (1971). Conflict of laws issue can arise in a fiduciary framework. Apart from the most-significant relationship doctrine that prevails in Texas courts, special considerations arise in the business context. In a divorce involving a closely-held business,

sometimes breach of fiduciary duty claims can be made. Fiduciary duties will also be an issue if the ex-spouses will remain in business together after divorce, or in the process of liquidating a business or investments over time. The case of *Touponse v. Touponse*, No. 02-20-00285-CV, * (Tex. App.--Fort Worth July 1, 2021, no pet.) (mem. op.), is a reminder that it is necessary to prove up the law of another state or else it will be presumed that the sister-state's law is identical to Texas law.

XII. DUTIES AFFECTED BY THE NATURE OF THE RELATIONSHIP.

A. GENERALIZED DUTIES. In all relationships, there is a duty not to commit a criminal offense, and not to intentionally harm, and not to be reckless or grossly-negligent, and not to be negligent. Texas does not recognize a general legal duty to avoid negligently inflicting mental anguish without physical injury. *Boyles v. Kerr*, 855 S.W.2d 593, 597 (Tex. 1993).

B. AGENT-PRINCIPAL. An agent is duty-bound, unless otherwise agreed, to "act solely for the benefit of the principal in all matters connected with his agency." In *Johnson v. Brewer & Pritchard, P.C.*, 73 S.W.3d 193, 200 (Tex. 2002), the Court quoted the RESTATEMENT (SECOND) OF AGENCY cmt a (1958): "Among the agent's fiduciary duties to the principal is the duty to account for profits arising out of the employment, the duty not to act as, or on account of, an adverse party without the principal's consent, the duty not to compete with the principal on his own account or for another in matters relating to the subject matter of the agency, and the duty to deal fairly with the principal in all transactions between them." The Court indicated that an agent has a duty not to divert an opportunity from the principal in a way that the agent or an entity controlled by the agent profits or benefits in some way. *Id*. at 200. In *Vogt v. Warnock*, 107 S.W.3d 778, 782 (Tex. App.--El Paso 2003, pet. denied), the court held that a power of attorney automatically creates an agency relationship along with its fiduciary duties, even if the power of attorney is not exercised. *Accord*, *Jordan v. Lyles*, 455 S.W.3d 785, 792 (Tex. App.--Tyler 2015, no pet.); through or arising out of the administration of the trust, even though the profit does not result from a breach of trust...."

C. BUSINESS ENTITIES. Texas law surrounding business entities has developed special fiduciary duties that are described using standards borrowed from other areas of law.

1. For-Profit Corporations. "Corporate officers and directors are fiduciaries, and the consequences of their acts as such are determinable under the facts in each case." *Int'l Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 576 (Tex. 1963). Corporate directors, officers, and managers owe these fiduciary duties to the corporation, sometimes its shareholders, and only rarely to its creditors. Directors, officers, and managers of publicly-traded companies also have a duty of disclosure to the public, and a duty not to profit from "insider information." In *Matter of the Estate of Poe*, 648 S.W.3d 277, 288-89 (Tex. 2022), the Supreme Court held that directors cannot have an *informal* fiduciary obligation to shareholders, as that inherently conflicts with their formal fiduciary duties to the corporation.

a. Directors. TBOC § 22.221(a) says that a corporate director must "discharge the director's duties, including duties as a committee member, in good faith [a subjective standard], with ordinary care [an objective standard], and in a manner the director reasonably [objective] believes [subjective] to be in the best interest of the corporation. Section 22.221(b) says that "[f]or a director to be liable for actions or inactions, the complainant must show that the director (i) did not act in good faith, <u>and</u> (ii) did not use ordinary care, <u>and</u> (iii) did not act in a manner that the director reasonably believed to be in the best interest of the corporation." (Underline added.) [Authors' Comment: Because the proposition is

conjunctive, to be liable for damages the director must breach all three duties at the same time.] "Good faith" is not defined in the TBOC. Good faith is a subjective standard. "Ordinary care" is an objective standard, the familiar tort standard of ordinary prudence under similar circumstances. "Reasonable belief" of best interest is a mixed standard: "belief" is a subjective assessment of what was in the mind of the director, but the reasonableness of this belief is an objective standard of ordinary care. Section 22.223 says that "[a] director of a corporation is not considered to have the duties of a trustee of a trust with respect to the corporation or with respect to property held or administered by the corporation, including property subject to restrictions imposed by the donor or transferor of the property." [Authors' Comment: The trustee of an express trust is required to put the beneficiary's interest before his own. How this differs from the "duty of loyalty" owed by corporate directors is a complicated question.] Under Section 22.224 the board of directors can delegate investment authority, and if it does so "[t]he board of directors is not liable for an action taken or not taken by an advisor under this section if the board acted in good faith [subjective] and with ordinary care [objective] in selecting the advisor." [Authors' Comment: the board must meet both the subjective and objective standards for the exception to apply.] Section 22.225(a) flatly prohibits a corporation from making a loan to a director. Under Section 22.225(b), any director who votes for such a loan, or any officer who participates in making the loan, is liable to the corporation for the amount of the loan. In *Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014), the Court said that directors must make decision about declaring dividends "in compliance with the formal fiduciary duties that they, as officers or directors, owe to the corporation, and thus to the shareholders collectively." In *Matter of the Estate of Poe*, 648 S.W.3d 277, 288-89 (Tex. 2022), negated a fiduciary duty owed to shareholders.

b. Officers. The TBOC does not directly describe an officer's duties to the corporation. However, TBOC § 22.235, Officer Liability, limits the liability of officers for acts or omissions that are otherwise actionable (presumably this means intentional, grossly negligent, or negligent wrongs). Under Section 22.235, an officer is not liable to the corporation or other person unless his/her conduct (i) was not exercised in good faith [a subjective standard], **and** (ii) was not exercised with ordinary care [an objective standard], **and** (iii) was not exercised in a manner the officer reasonably [objective] believes [subjective] to be in the best interest of the corporation. [Author's Comment: Because the negative proposition is stated conjunctively, an officer is exonerated if any one or more of the three conditions are not met.] We can infer from this statute that officers have a duty of good faith and ordinary care, and must reasonably believe that their actions are in the best interest of the corporation, but they are liable only when an act or omission breaches all three duties. Thus, bad faith alone will not support liability, nor will negligence alone. A belief that an action or inaction is in the corporation's best interest will negate liability as long as that belief is reasonable. [Author's Comment: this third prong is a mixture of objective (i.e., reasonableness) and subjective (i.e., belief) standards.]

c. Contracts with Directors and Officers. "Contracts between a corporation and its officers and directors are not void but are voidable for unfairness and fraud with the burden upon the fiduciary of proving fairness." *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 576 (Tex. 1963). TBOC § 22.230 governs contracts between directors, officers, members of a corporation or its affiliates. Such contracts are valid if (i) the material facts about the relationship or interest and the contract or transaction are disclosed to or known by the board of directors, or a committee or members, and a majority of *disinterested* directors, committee members, or members vote to approve the contract in the exercise of good faith and ordinary care, **or** the contract or transaction is fair to the corporation when it was authorized. [Author's Comment: note that "fairness" is a fiduciary standard.] "[I]nterestedness or disinterestedness does not turn on any technical form of legal status; it is a substantial fact question." *Allen v. Wilkerson*, 396 S.W.2d 493, 501 (Tex. Civ. App.-- Austin 1965, writ ref'd n.r.e.). "An officer or

director is considered ‘interested’ if he or she (1) makes a personal profit from a transaction by dealing with the corporation or usurps a corporate opportunity, (2) buys or sells assets of a corporation, (3) transacts business in his or her officer’s or director’s capacity with a second corporation of which he or she is also an officer or director or is significantly financially associated, or (4) transacts corporate business in his or her officer’s or director’s capacity with a family member.” *Loy v. Harter*, 128 S.W.3d 397, 407-08 (Tex. App.--Texarkana 2004, pet. denied).

d. Duties to Owners. The fiduciary duties of corporate directors, officers, and managers are owed to the corporation. In *Matter of the Estate of Poe*, 648 S.W.3d 277, 288-89 (Tex. 2022), the Texas Supreme Court held that corporate directors cannot owe a fiduciary duty to shareholders.

e. Duty of Obedience. Baylor Law School Professor Elizabeth S. Miller writes that corporate directors owe a “duty of obedience” which she says forbids ultra vires acts. Miller, *Fiduciary Duties, Exculpation, and Indemnification in Texas Business Organizations*, State Bar of Texas 13th ANNUAL ADVANCED REAL ESTATE STRATEGIES COURTS, ch. 4, p. 1 (2019) (“Miller 2019"). *Accord*, *In re the Estate of Poe*, 648 S.W.3d 277, 288-89 (Tex. 2022); *Gearhart Industries, Inc. v. Smith International*, 741 F.2d 707, 719 (5th Cir. 1984) (“[t]he duty of obedience requires a director to avoid committing ultra vires acts, i.e., acts beyond the scope of the powers of a corporation as defined by its charter or the laws of the state of incorporation”).

f. Duty of Care. Corporate directors and others owe a duty of care to the corporation. But in some instances a generalized duty of care is owed to third parties.

Owed to the Company. In *Hoggett v. Brown*, 971 S.W.2d 472, 488 (Tex. App.–Houston [14th Dist.] 1997, pet. denied), the court said: “[a] director’s fiduciary duty runs only to the corporation, not to individual shareholders or even to a majority of the shareholders.” *Accord*, *Somers v. Crane*, 295 S.W.3d 5, 11 (Tex. App.--Houston [1st Dist.] 2009, pet. denied) (citing cases that so hold). See *In re the Estate of Poe*, 648 S.W.3d at 288-89.

Owed to Third Parties. “ As a general rule, the actions of a corporate agent on behalf of the corporation are deemed the corporation’s acts.” *Holloway v. Skinner*, 898 S.W.2d 793, 795 (Tex. 1995). “[A]n officer or director may not be held liable in damages for inducing the corporation to violate a contractual obligation, provided that the officer or director acts in good faith and believes that what he does is for the best interest of the corporation.” *Maxey v. Citizen’s Nat’l Bank*, 507 S.W.2d 722, 726 (Tex. 1974). “A corporate officer or agent can be liable to others, including other company employees, for his or her own negligence. However, individual liability arises only when the officer or agent owes an independent duty of reasonable care to the injured party apart from the employer’s duty.” *Leitch v. Hornsby*, 935 S.W.2d 114, 117 (Tex. 1996).

g. Duty of Loyalty. “The duty of loyalty dictates that a corporate officer or director must act in good faith and must not allow the individual’s personal interest to prevail over the interest of the corporation.” *Loy v. Harter*, 128 S.W.3d 397, 408 (Tex. App.--Texarkana 2004, pet. denied). However, TBOC § 22.223 says that a director does not have the duties of the trustee of a trust. In *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 577 (Tex. 1963), the Court said this about corporate opportunities: “A corporate fiduciary is under obligation not to usurp corporate opportunities for personal gain, and equity will hold him accountable to the corporation for his profits if he does so. Transactions in which a corporate fiduciary derives personal profit, either in dealing with the corporation or its property, or in

matters of corporate interest, are subject to the closest examination and the form of the transaction will give way to the substance of what actually has been brought about." [Author's Comment: question whether the remedy for diversion of a corporate opportunity is disgorgement or damages, or both.] "When a corporate officer or director diverts assets of the corporation to his own use, he breaches a fiduciary duty of loyalty to the corporation. In such a case, a court in equity may find the officer or director holds the usurped property as a constructive trustee for the corporation." *Sw. Livestock & Trucking Co. v. Dooley*, 884 S.W.2d 805, 809 (Tex. App.--San Antonio 1994, writ denied).

h. Reliance on Others. TBOC § 3.105 says that "[i]n discharging a duty or exercising a power, an officer of a domestic entity may, in good faith and ordinary care, rely on information, opinions, reports, or statements, including financial statements and other financial data, concerning the entity or another person and prepared or presented by: (1) another officer or an employee of the entity; (2) legal counsel; (3) a certified public accountant; (4) an investment banker; or (5) a person who the officer reasonably believes possesses professional expertise in the matter."

i. Duties to Creditors. The Texas Uniform Fraudulent Transfers Act ("TUFTA") permits creditors of a business to have a court nullify transfers by the debtor that are made with the "actual intent" to hinder, delay, or defraud any creditor of the debtor, or collection of a creditor's claims, or which occur when the company is insolvent or is made insolvent by the transfer. Tex. Bus. & Comm. Code § 24.005. Bankruptcy law gives similar power to the trustee in bankruptcy. 11 U.S.C. § 548. Under these statutes, the remedy is against the transferee, except when the transferee took in good faith and for a reasonably equivalent value. Tex. Bus. & Com. Code § 24.009(a); 11 U.S.C. § 435(c) (third party protected only to the extent of value given).

When do a business's directors and officers have a duty to creditors of the company that can subject them to personal liability? In *Conway v. Bonner*, 100 F.2d 786, 787 (5th Cir. 1939), the court said that officers and directors of a Texas corporation owe fiduciary duties only to their corporation and not its creditors "so long as it continues to be a going concern, conducting its business in the ordinary way, without some positive act of insolvency." The court cited five Texas Court of Civil Appeals cases in support. *Conway v. Bonner* did not address a corporation that is insolvent. In *Carrieri v. Jobs.com*, 393 F.3d 508, 534 n. 24 (5th Cir. 2004), the court said in dicta: "[o]fficers and directors that are aware that the corporation is insolvent, or within the 'zone of insolvency' ... have expanded fiduciary duties to include the creditors of the corporation." Several bankruptcy judges and a Federal District Judge applying Texas law have declined to apply *Carrieri*. In *Fagan v. La Gloria Oil & Gas. Co.*, 494 S.W.2d 624, 628 (Tex. Civ. App.--Houston [14th Dist.] 1973, no writ), the court said: "It is a basic rule of law that officers and directors of a corporation owe to it duties of care and loyalty. They stand in a fiduciary relationship to the corporation. Such duties, however, are owed to the corporation and not to creditors of the corporation." However, the court went on to describe the "trust fund doctrine":

> when a corporation (1) becomes insolvent and (2) ceases doing business, then the assets of the corporation become a trust fund for the benefit, primarily, of its creditors. The officers and directors hold the corporate assets in trust for the corporate creditors. They are placed in a fiduciary relation to and owe a fiduciary duty to the creditors. That duty obliges them to administer the corporate assets for the benefit of the creditors and to ratably distribute them. The breach of that duty gives rise to a cause of action against the officers and directors which can be prosecuted directly by the creditors.

Id. at 628. TBOC § 21.303 provides that a "a corporation may not make a distribution ... if the corporation would be insolvent after the distribution," except pursuant to winding up and termination pursuant to TBOC ch. 11. TBOC § 22.226(a) provides:

> In addition to any other liability imposed by law on the directors of a corporation, the directors who vote for or assent to a distribution of assets other than in payment of the corporation's debts, when the corporation is insolvent or when distribution would render the corporation insolvent, or during the liquidation of the corporation, without the payment and discharge of or making adequate provisions for any known debt, obligation, or liability of the corporation, are jointly and severally liable to the corporation for the value of the assets distributed, to the extent that the debt, obligation, or liability is not paid and discharged.

Section 22.226(b) provides that a director is not liable under Section 22.226(a) if (i) s/he relied in good faith and with ordinary care on an investment advisor's opinion, or (ii) in good faith [a subjective standard] and with ordinary care [an objective standard] considered the assets of the corporation to be at least equal to their book value; or (iii) relied in good faith [subjective] and with ordinary care [objective] on financial statements of, or other information concerning, a guarantor of corporate debt. Section 22.226(b) provides that a director is not liable under Section 22.226(a) "if, in the exercise of ordinary care [objective], the director acted in good faith [subjective] and in reliance on the written opinion of an attorney for the corporation." Under Section 22.229, a director held liable under Section 22.226 is entitled to contribution from persons who accepted or received the improper distribution.

Thus, under the older Texas case law if the corporation is insolvent and has ceased to do business, the directors owe a fiduciary duty directly to creditors. Creditors can sue directors directly for breach of this fiduciary duty. Under Section 22.226 the fiduciary duty is owed to the corporation, so the creditors must bring a derivative action to recover any money.

A choice-of-law issue can arise where the corporation was organized under the law of one state but is sued by creditors in another state. Are the claims of creditors against the directors and officers governed by (i) the law of the state of organization, or (ii) the law of the forum state, or (iii) the law of the state with the most significant relationship? In the *Longview Energy* case mentioned in Section XI.I above, the Texas Supreme Court applied the Delaware law of constructive trusts to a lawsuit by a corporation against its directors. The Internal Affairs Doctrine may not (should not?) apply to creditors' claims against the corporation, allowing the court to apply forum law or the law of the state with the most significant relationship or, if a loan document contains a choice-of-law clause, the law of the chosen state.

j. Duties to Third Parties. In *Holloway v. Skinner*, 898 S.W.2d 793, 795 (Tex. 1995) (involving a claim of tortious interference with contract), the Court said: "[c]orporations, by their very nature, cannot function without human agents. As a general rule, the actions of a corporate agent on behalf of the corporation are deemed the corporation's acts...." However, cases say that a corporate officer or agent can be liable to others, including other company employees, for his or her own negligence. However, individual liability arises only when the officer or agent owes an independent duty of reasonable care to the injured party apart from the employer's duty." *Leitch v. Hornsby*, 935 S.W.2d 114, 117 (Tex. 1996). A corporate agent who knowingly participates in a tortious or fraudulent act may be held individually liable to third persons even though he performed the act as an agent of the corporation. *Northwest Cattle Feeders, LLC v. O'Connell*, No. 02-17-00361-CV (Tex. App.--Fort Worth, June 14, 2018, pet. denied)

(memo. op.); *Nwokedi v. Unlimited Restoration Specialists, Inc.*, 428 S.W.3d 191, 201 (Tex. App.--Houston [1st Dist.] 2014, pet. denied).

2. Nonprofit Corporations. Nonprofit corporations have no owners, but directors, officers, and managers nonetheless owe fiduciary duties to the corporation. Texas Property Code § 114.003(c) ("A person, other than a beneficiary, who holds a power to direct with respect to a charitable trust is presumptively a fiduciary required to act in good faith with regard to the purposes of the trust and the interests of the beneficiaries").

3. Closely-Held Corporations. A closely-held corporation is defined for purposes of derivative actions as a corporation with fewer than 35 shareholders with no shares traded on a national securities exchange. TBOC § 21.563. In *Cardiac Perfusion Servs., Inc. v. Hughes*, 436 S.W.3d 790, 791 n. 1 (Tex. 2014), the Court wrote: "this Court has never recognized a formal fiduciary duty between a majority and minority shareholder in a closely held corporation." Some Texas courts of appeals have held that no formal fiduciary relationship exists between majority and minority shareholders of closely-held corporations. *Vejara v. Levoir Int'l L.L.C.*, No. 04-11-00595-CV, *3 (Tex. App.--San Antonio Oct. 31, 2012, pet. denied) (memo. op.); *Allen v. Devon Energy Holdings, L.L.C.*, 367 S.W.3d 355, 391 (Tex. App.--Houston [1st dist.] 2012, pet. dism'd by agreement) (opinion not withdrawn). However, informal fiduciary relationships can arise between shareholders. *Flanary v. Mills*, 150 S.W.3d 785, 794 (Tex. App.--Austin 2004, pet. denied). In *Herring Bancorp, Inc. v. Mikkelsen*, 529 S.W.3d 216, 227 (Tex. App.--Amarillo 2017, pet. denied), the court said: "Even in the context of disproportionate ownership interests, the vast majority of intermediate appellate courts of this State have declined to recognize a broad formal fiduciary relationship between majority and minority shareholders that applies as a matter of law to every transaction between them."

4. General Partnerships. The common law duties owed by a partner to other partners have been articulated in cases stretching over many decades. "The relationship between ... partners ... is fiduciary in character, and imposes upon all the participants the obligation of loyalty to the joint concern and of the utmost good faith, fairness, and honesty in their dealings with each other with respect to matters pertaining to the enterprise." *Fitz-Gerald v. Hull*, 237 S.W.2d 256, 264 (Tex. 1951).

However, the Legislature has laid a statutory framework over the common law fiduciary duties of partners. Texas Business Organizations Code § 152.204(a) describes the duties that a partner owes to the partnership and other partners as the duty of loyalty and the duty of care. Section 152.204(b) says that a partner must discharge his duties to the partnership and other partners in good faith and in a manner that the partner believes to be in the best interest of the partnership. [Author's Comment: The belief need not be objectively reasonable.] Under Section 152.204(c), a partner does not violate a duty "because the partner's conduct furthers the partner's own interest." Section 152.204(d) says that "[a] partner, in the partner's capacity as a partner, is not a trustee and is not held to the standards of a trustee."

Duty of Loyalty

Under TBOC § 152.205, a partner's duty of loyalty includes (i) accounting to the partnership and holding for the partnership any property, profit, or benefit derived by the partner in the conduct of partnership business or from use of partnership property, (ii) refraining from dealing with the partnership on behalf of a person who has an interest adverse to the partnership; and (iii) refraining from competing or dealing with the partnership in a manner adverse to the partnership. [Author's Comment: TBOC § 152.002(b)(2)

prohibits partnership agreements from eliminating the duty of loyalty, except for permitting certain types or categories of activities if the permissions are not “manifestly unreasonable.”]

Duty of Care

TBOC § 152.206(a) defines the partner’s duty of care as that degree of care that an ordinarily prudent person would exercise in similar circumstances (i.e., an objective negligence standard). Section 152.206(b) says that an error in judgment does not alone breach the duty of care. [Author’s Comment: the culpability must be negligence or higher.] Section 152.206(c) says that a partner is presumed to satisfy the duty of care if the partner acts on an informed basis and in good faith and in a manner the partner reasonably believes to be in the best interest of the partnership. [Author’s Comment: meeting this Section 152.206(c) standard puts the burden of proof on the complaining party, where it already was by virtue of ordinary civil litigation rules, but without the reversal of the burden of proof characteristic of fiduciary litigation]

Under Section 152.002(b)(3), partners cannot eliminate the duty of care but they can agree on the standards by which the performance of the duty of care is to be measured, if the standards are not “manifestly unreasonable.” Given that the nature of a duty is normally a judge question and not a jury question, we might expect that the “manifestly unreasonable” determination is for the court to decide, not the jury.

Obligation of Good Faith

Under TBOC § 152.204(b), a partner must exercise her rights and powers in conducting partnership business in good faith. The statute calls this an “obligation,” not a “duty,” in contrast to the two specified duties of loyalty and care. Section 152.002(b)(4). Good faith is nonetheless an obligation encompassing all actions of a partner in conducting partnership business, and it is thus tantamount to an all-encompassing legal duty. Section 152.002(b)(4) provides that the partners cannot eliminate the obligation of good faith, but they can determine the standards by which the performance of this obligation is measured if the standards are not “manifestly unreasonable.”

Breach of Partnership Agreement or Statutory Duty

Under TBOC § 152.210, a partner is liable to the partnership and other partners for a breach of the partnership agreement or a breach of duty under Chapter 152 that harms the partnership or other partners. [Author’s Comment: this is a statutory basis for partnership law liability that exists independently of contract law, tort law, and common law fiduciary standards.]

Expulsion of a Partner

The fiduciary duty between partners does not extend to the decision to expel a partner. *Bohatch v. Butler & Binion*, 977 S.W.2d at 545 (“partners have no obligation to remain partners”).

5. Limited Partnerships. The general partner of a limited partnership owes partnership fiduciary duties to the limited partners. TBOC§ 153.152 (a)(2). *Hughes v. St. David’s Support Corp.*, 944 S.W.2d 423 (Tex. App.--Austin 1997, writ denied); *McLendon v. McLendon*, 862 S.W.2d 662 (Tex. App.--Dallas 1993, writ denied). Limited partners do not have fiduciary duties by virtue of being limited partners.

Strebel v. Wimberly, 371 S.W.3d 267 (Tex. App.--Houston [1st Dist.] 2012, pet. denied); *AON Props. Inc. v. Riveraine Corp.*, No. 14-96-00229-CV, *23 (Tex. App.--Houston [14th Dist.] Jan. 14, 1999, no pet.) (unpublished); *Crawford v. Ancira*, No. 04-96-00078-CV (Tex. App.--San Antonio April 30, 1997, no writ) (unpublished).

TBOC § 153.004 provides that a limited partnership agreement cannot eliminate the partners' right to inspect the books and records.

6. Joint Ventures. In *CBIF Ltd. v. TGI Friday's, Inc.* No. 05-15-00157-CV (Tex. App.--Dallas Dec. 5, 2016, pet. denied) (memo. op.), the parties had a written joint venture agreement. The court applied partnership standards saying that "[t]he relationship between partners is fiduciary in character, and imposes on all the participants the obligation of loyalty to the joint concern and of the utmost good faith, fairness, and honesty in their dealings with each other with respect to matters pertaining to the enterprise." *Id*. at *16. [Author's Comment: the standard of "utmost good faith, fairness and honesty" must be tempered by the description of the duty of loyalty between partners expressed in TBOC § 152.205.]

A joint venture is proved by four elements: (1) a community of interest; (2) an agreement to share profits; (3) an agreement to share losses; and (4) a mutual right of control or management of the enterprise. *Ayco Dev. Corp. v. G.E.T. Serv. Co.*, 616 S.W.2d 184, 186 (Tex. 1981); *Coastal Plains Development Corp. v. Micrea, Inc.*, 572 S.W.2d 285, 287 (Tex. 1978). All elements are essential. *Brazosport Bank of Tex. v. Oak Park Townhomes*, 889 S.W.2d 676, 683 (Tex. App.--Houston [14th Dist.] 1994, writ denied). Thus, persons involved in a business undertaking later found to be a joint venture might learn after the fact that they owed fiduciary duties that they did not specifically agree upon or realize at the time of the events in question.

In *Coplin v. State*, 585 S.W.2d 734 (Tex. Crim. App. 1979), the Court wrote:

> A joint venture, while it is similar to a partnership, differs in that it is limited to a single transaction rather than an ongoing business. 33 Tex.Jur.2d 289, Joint Adventures, Section 3 (1962). However, just as with a partnership,
>
>> "[t]he parties bear a fiduciary relation one to another, and are bound to the same degree of good faith as that which is required in case of a partnership." 33 Tex. Jur.2d 294, Joint Adventures, Section 6.
>
> In its discussion of the fiduciary duty owed by partners to each other, Texas Jurisprudence observes that the existence of a fiduciary relationship "is especially true in favor of a partner who is ignorant of the details of the business as against one who has been entrusted and charged therewith as an expert, and whose advice and good faith have been relied on." 44 Tex. Jur. 2d 376, Partnership, Section 50 (1963).

7. Limited Liability Companies. The TBOC does not state fiduciary duties inside an LLC. In *Bazan v. Munoz*, 444 S.W.3d 110 (Tex. App.--San Antonio 2014, no pet.), the court held that no formal fiduciary duty was owed by majority owners to minority owners of an LLC. However the jury found an informal fiduciary relationship on the facts. In *Guevara v. Lackner*, 447 S.W.3d 566 (Tex. App.--Corpus Christi--Edinburg 2014, no pet.), the court wrote that one member's status as co-member of an LLC did not give rise to a fiduciary relationship, but that an informal fiduciary relationship could have arisen from the fact

that the defendants were named in the company agreement as managers, and that they had extensive knowledge of operations while the plaintiff did not. In *Macias v. Gomez*, No. 13-14-00017-CV (Tex. App.--Corpus Christi--Edinburg Dec. 29, 2015, no pet.) (memo. op.), the court held that members of an LLC did not have a formal fiduciary relationship with each other. However, *Allen v. Devon Energy Holdings, L.L.C.*, 367S.W.3d 355, 395-98 (Tex. App.–Houston [1st Dist'] 2012, pet. granted, judgm't vacated w.r.m.), held that while a fiduciary relationship did not exist as a matter of law, on the facts of the case a majority owner and sole manager of an LLC owed a "formal" fiduciary duty to a minority member with regard to the redemption of the minority member's ownership interest because of the majority owner/member's degree of control over the LLC. [Author's Comment: the appellate court called the fiduciary duty a "formal" one, when it really met the criteria of an "informal" fiduciary duty.] In *Siddiquiv. Fancy Bites, LLC*, 504 S.W.3d 349 (Tex. App.--Houston [14th Dist.]2016, pet. denied), the court refused to allow an informal fiduciary relationship between members of an LLC unless the relationship existed before the LLC was created.

In *Vejara v. Levoir Int'l L.L.C.*, No. 04-11-00595-CV, *3 (Tex. App.--San Antonio Oct. 31, 2012, pet. denied) (memo. op.), a minority owner of an LLC was found to have had an informal fiduciary duty to the majority owner because the minority owner exercised created the company, signed the leases, held keys to vehicles, and had exclusive access to stored inventory. In *Angel v. Tauch* (*In re Chiron Equities, LLC*), 552 B.R. 674 (Bankr. S.D. Tex. 2016), the court found that a manager/minority member owed the LLC, but not the other member, fiduciary duties.

8. Majority Owners. The majority owners of a corporation owe no formal fiduciary duties to minority shareholders. In *Willis v. Donnelly*, 199 SW 3d 262, 277 (Tex. 2006), the Supreme Court said: "The only conceivable basis for a fiduciary relationship in this case would be a duty owed by a majority shareholder to a minority shareholder. Assuming without deciding that such a relationship can give rise to a general fiduciary duty, we decline to recognize the existence of such a duty on this record." However, in *Vejara v. Levoir Int'l L.L.C.*, No. 04-11-00595-CV, *3 (Tex. App.--San Antonio Oct. 31, 2012, pet. denied), the court found that the majority shareholder of a closely-held corporation had an informal fiduciary duty to the minority shareholders due to his "operating control" and "intimate knowledge" of the company's daily affairs. *Id*. at 5.

D. SPOUSES. Spouses have fiduciary duties to each other. Speaking generally, the fiduciary obligation arises from the inherent trust between spouses, but a fiduciary duty also emanates from a position of exclusive control over sole management community property. The most frequently-litigated fiduciary duty is the duty of a spouse who manages or disposes of the other spouses's undivided one-half ownership interest in community property. Additionally, courts have applied fiduciary standards to transactions between spouses. Occasionally the fiduciary obligation arises from one spouse's acting as the other spouse's financial advisor or legal representative.

In *Wiley and Co. v. Prince*, 21 Tex. 637, *3 (1858), Chief Justice Hemphill wrote:

> There is no relation in which more influence, more dominion can be exercised by one person over another than that exercised by the husband over the wife. They are separate in this state as to property, but in other respects the legal existence, the powers of the wife, are merged in the husband, and his conduct in obtaining gifts or suretyships from her property should therefore be watched with the most scrupulous attention.

Under the law at the time that Chief Justice Hemphill wrote, the spouses each *owned* one-half of the community property assets, but the husband had *exclusive control* over *all* community property. This control over the property of another is a classic trustee-beneficiary relationship. While the last of the wife's disabilities of coverture were finally extinguished by the Texas Marital Property Act of 1967, the Family Code has carried forward the legal notion of a spouse's "sole management, control, and disposition" over certain categories of community property. See Tex. Fam. Code ch.3, subch. B. The managing spouse's control over the other spouse's one-half community property interest in a community property asset justifies a fiduciary duty. And control is a factor when one spouse is dealing with property, separate or community, that is the homestead of both spouses. See Tex. Fam. Code § 5.001 (neither spouse can convey or encumber an interest in the homestead without the joinder of the other spouse, subject to the exceptions in Chapter 5 or "other rules of law"). In *Miller v. Miller*, 700 S.W.2d 941, 945-46 (Tex. App.–Dallas 1985, writ ref'd n.r.e.), the court affirmed the jury's finding that a confidential relationship existed between ex-spouses relative to community property stock that was not divided in the divorce. The court also upheld the jury's finding that a shareholder's agreement which the ex-husband induced the ex-wife to sign before the divorce was not fair, and therefor invalid. The appellate court noted that "authorities are divided on the question of whether an officer and director of a corporation has a general fiduciary duty to disclose to a stockholder his knowledge of information affecting the value of the stock before purchasing it from the stockholder. Some courts have followed the so-called "majority rule" that a director or officer does not stand in a fiduciary relation to a stockholder in respect to his stock and, therefore, has the same right as any other stockholder to trade freely in the corporation's stock." *Id.* at 945-46. The appellate court found, however, that the application of fiduciary standards was warranted by the "special-facts" exception to the so-called "majority rule," "imposing on the officer or director a limited fiduciary duty to disclose any knowledge of special matters relating to the corporate business— e.g., merger, assured sale, etc.—that may affect the value of the stock." *Id.* at 946. We must think through how this reasoning is impacted by the decision in *Matter of Estate of Poe*, 648 S.W.3d 277 (Tex. 2022), holding that officers and directors of a corporation do not owe a fiduciary duty to individual shareholders. In the *Miller* case, the corporate officer was engaged in a personal transaction with a shareholder who was his spouse at the time of signing, and withheld pertinent information, which is very different from general policy considered in *Poe*.

1. The Existence of a Fiduciary Duty. Many court of appeals cases agree that a marriage relationship creates a fiduciary duty between spouses. *Knight v. Knight*, 301 S.W.3d 723, 731 (Tex. App.--Houston [14th Dist.] 2009, no pet.) ("A fiduciary duty exists between a husband and a wife as to the community property controlled by each spouse"); *Smith v. Deneve*, 285 S.W.3d 904, 911 (Tex. App.--Dallas 2009, no pet.) (saying, in dicta, "[t]he marital relationship is a fiduciary one"); *Solares v. Solares*, 232 S.W.3d 873, 881 (Tex. App.--Dallas 2007, no pet.) ("A fiduciary duty exists between spouses"); *Miller v. Ludeman*, 150 S.W.3d 592, 597 (Tex. App.–Austin 2004, pet. denied) ("Husbands and wives generally owe a fiduciary duty to one another"); *Hubbard v. Shankle*, 138 S.W.3d 474, 483 (Tex. App.--Fort Worth 2004, pet. denied) ("the relationship between a husband and wife is ordinarily a fiduciary relationship");" *Toles v. Toles*, 113 S.W.3d 899, 916 (Tex. App.--Dallas 2003, no pet.) ("A fiduciary duty exists between spouses"); *Connell v. Connell*, 889 S.W.2d 534 (Tex. App.--San Antonio 1994, writ denied) ("It is established law that the relationship between a husband and wife is a fiduciary relationship, and the spouses are bound by that fiduciary duty in dealing with the community estate"); *Buckner v. Buckner*, 815 S.W.2d 877, 880 (Tex. App.--Tyler 1991, no writ). ("It has long been recognized in Texas that a confidential relationship does exist between a husband and his wife."); *Daniel v. Daniel*, 779 S.W.2d 110, 115 (Tex. App.--Houston [1st Dist.] 1989, no writ) ("Because of the confidential relationship between a husband and a wife, courts have imposed the same duties of good faith and fair dealing on spouses as

required of partners and other fiduciaries"); *Bohn v. Bohn*, 455 S.W.2d 401, 406 (Tex. Civ. App.--Houston [1st Dist.] 1970, writ dism'd) ("a confidential relationship exists between husband and wife has been recognized in Texas"). In *Daniel v. Daniel*, 779 S.W.2d 110, 115 (Tex. App.--Houston [1st Dist.] 1989, no writ), the court said that, "[b]ecause of the confidential relationship between a husband and a wife, courts have imposed the same duties of good faith and fair dealing on spouses as required of partners and other fiduciaries."

<u>Ends Upon Filing Divorce and Hiring Independent Professionals.</u> Several Texas appellate courts have said that the fiduciary relationship between spouses ends at the start of a contested divorce in which the spouses each hire independent attorneys or financial advisors. *Bass v. Bass*, 790 S.W.2d 113, 119 (Tex. App.--Fort Worth 1990, no writ) ("Although marriage may bring about a fiduciary relationship ..., such a relationship clearly does not continue when a husband and wife hire numerous independent professional counsel to represent them respectively in a contested divorce proceeding"); *Parker v. Parker*, 897 S.W.2d 918, 924 (Tex. App.--Fort Worth 1995, writ denied) ("While marriage may bring about a fiduciary relationship, such a relationship terminates in a contested divorce when a husband and wife each have independent attorneys and financial advisers"); *Boyd v. Boyd*, 67 S.W.3d 398, 405 (Tex. App.--Fort Worth 2002, no pet.) ("The fiduciary duty arising from the marriage relationship does not continue when a husband and wife each hire independent professional counsel to represent them in a contested divorce proceeding"); *Toles v. Toles*, 113 S.W.3d 899, 916 (Tex. App.--Dallas 2003, no pet.) ("A fiduciary duty exists between spouses.... However, that relationship terminates in a contested divorce when a husband and wife each have independent attorneys."); *Ricks v. Ricks*, 169 S.W.3d 523, 526 (Tex. App.–Dallas 2005, no pet.) ("The fiduciary duty arising from the marital relationship ceases in a contested divorce when the husband and wife each hire independent attorneys to represent them"); *Boaz v. Boaz*, 221 S.W.3d 126, 133 (Tex. App.--Houston [1st Dist.] 2006, non pet.) ("adverse parties who have retained professional counsel, including husbands and wives in a suit for divorce, do not owe fiduciary duties to one another"). The Austin Court of Appeals, however, in *Sheshunoff v. Sheshunoff*, 172 S.W.3d 686, 701 n. 21 (Tex. App.--Austin 2005, pet. denied), rejected a categorical rule that hiring separate counsel in a divorce always eliminates fiduciary obligations. It makes sense that the duty of disclosure that exists between spouses would be supplanted, at least to some extent if not entirely, by the discovery rules of procedure that govern the disclosure of information in a lawsuit. However, if the relationship giving rise to a fiduciary obligation between spouses exists independent of the marriage, like a partnership relationship or an agency relationship, one would think that those duties are not altered by the filing of a divorce. And in instances where a spouse convinces the other spouse to enter into a settlement unbeknownst to his or her attorneys, the rule might not apply.

<u>Ends Upon Granting of Divorce.</u> Several cases sensibly hold that the fiduciary duty between spouses ends upon the granting of a divorce. *Grossnickle v. Grossnickle*, 935 S.W.2d 830, 846 (Tex. App.--Texarkana 1996, writ denied) (no fiduciary duty after divorce); *In re Marriage of Notash*, 118 S.W.3d 868, 872 (Tex. App.--Texarkana 2003, no pet.) ("The fiduciary duty between husband and wife terminates on divorce"); *Camacho v. Montes*, 2006 WL 2660744, *3 (Tex. App.--Amarillo 2006, no pet.) (mem. op.) ("The formal fiduciary relationship between Frances and Delfino as husband and wife terminated on their divorce"); *Solares v. Solares*, 232 S.W.3d 873, 881 (Tex. App.--Dallas 2007, no pet.) ("in a contested divorce where each spouse is independently represented by counsel, the fiduciary relationship terminates"); *Robbins v. Robbins*, 550 S.W.3d 846 (Tex. App.--Ft. Worth, 2018, no pet.) (ex-wife failed to prove a fiduciary duty owed to her by her ex-husband with regard to the sale of their former marital residence). However, Texas Family Code Section 9.001 creates a post-divorce fiduciary duty with regard to a former spouse who receives property awarded in the decree of divorce to the other spouse.

2. The Duty to Disclose. Several cases identify a spouse's duty to disclose. In *Buckner v. Buckner*, 815 S.W.2d 877, 880 (Tex. App.--Tyler 1991, no writ), the court said: "The husband must disclose the material facts within his knowledge and the legal consequences flowing from them to his wife." In *Izzo v. Izzo*, 2010 WL1930179, *7 (Tex. App.--Austin 2010, pet. denied) (memo. op.), the Court said: "The fiduciary duty between spouses extends to a duty to disclose material information in business transactions"). According to one decision, the duty to disclose does not extend to personal behavior. In *Freeman v. Freeman*, No. 03-97-00626-CV, *5 (Tex. App.--Austin Dec. 3, 1998, pet. denied), hiding the fact that a child born into marriage was not the husband's child was held not to breach a fiduciary duty.

3. The Fairness Standard. In *Bohn v. Bohn*, 455 S.W.2d 401, 406 (Tex. Civ. App.–Houston [1st Dist.] 1970, writ dism'd), the court said, in connection with an interspousal transfer, that the spouse who received the property had the burden of "affirmatively showing that he acted in good faith, and that the gift was voluntarily and understandingly made." In *Matthews v. Matthews*, 725 S.W.2d 275, 279 (Tex. App.–Houston [1st Dist.] 1986, writ ref'd n.r.e.), which involved the enforceability of a post-marital partition agreement, the Court said: "Appellant and appellee, as husband and wife, owed each other special fiduciary duties. . . . The fiduciary relationship requires that appellant demonstrate the basic fairness of the transaction."

4. Duty Regarding Community Property. Although every community asset is owned one-half by each spouse, the Texas Family Code gives sole management and control to a spouse over community property that would have belonged to the spouse if single when acquired (like wages, dividend income on stock in his/her name, etc.). Tex. Fam. Code § 3.102. This creates a tension between two interests, as described in *Givens v. Girard Life Ins. Co. of Am.*, 480 S.W.2d 421, 427-28 (Tex. Civ. App.--Dallas 1972, writ ref 'd n.r.e.):

> Reconciliation of the managerial power of one spouse with the interest of the other spouse as equal owner is a problem inherent in the concept of management by one spouse of marital property owned in common. This concept has come down to us from the laws of Spain and Mexico, and is carried forward in the statutes above mentioned without substantial change, except that the managerial powers of the husband have been restricted and those of the wife have been extended with respect to classes of property not now before us.
>
> Our review of the authorities reveals that the husband's power to make gifts of community property has always been limited, though the limits have never been clearly defined.

In the context of claims for misappropriation of community property, a spouse may sue either for intentional fraud, or constructive fraud, or both. Actual or intentional fraud exists when a spouse transfers community property with the intent to deprive the other spouse of his or her interest in the property. For actual fraud, the burden of proving fraudulent intent is on the claimant, and the question of whether the conveyance was "fair" is not an issue. *See Jean v. Tyson-Jean*, 118 S.W.3d 1, 9 (Tex. App.--Houston [14th Dist.] 2003, pet. denied) (distinguishing actual fraud from constructive fraud); *In re Soza*, 542 F.3d 1060, 1072 (5th Cir. 2008) (distinguishing actual from constructive fraud in Texas law). See Tex. Fam. Code § 6.707 (transfers of property or debts incurring during pendency of divorce are void with respect to the other spouse "if the transfer was made or the debt incurred with the intent to injure the rights of the other spouse").

Constructive fraud does not depend upon the state of mind (or scienter) of the acting spouse. Constructive fraud is constructive because fraudulent intent is attributed by operation of law to the acting spouse, based on the circumstances, without regard to his/her actual motivation.

THE TEXAS PATTERN JURY CHARGES (FAMILY & PROBATE 2022) distinguishes the two types of fraud in this manner:

PJC 206.1 Confidence and Trust Relationship between Spouses

> A relationship of confidence and trust exists between a husband and wife with regard to that portion of the community property that each controls. This relationship requires that the spouses use the utmost good faith and frankness in their dealings with each other.
>
> Because of the nature of the spousal relationship, conduct of a spouse affecting the property rights of the other spouse may be fraudulent even though identical conduct would not be fraudulent as between nonspouses.

PJC 206.2A Actual Fraud by Spouse against Community Estate—Instruction

> A spouse commits fraud if *that spouse transfers community property or expends community funds for the primary purpose of depriving the other spouse of the use and enjoyment of the assets involved in the transaction*. Such fraud involves dishonesty of purpose or intent to deceive.

PJC 206.4A Constructive Fraud by Spouse against Community Estate—Instruction

> *A spouse may make moderate gifts, transfers, or expenditures of community property for just causes to a third party. However, a gift, transfer, or expenditure of community property that is capricious, excessive, or arbitrary is unfair to the other spouse. Factors to be considered in determining the fairness of a gift, transfer, or expenditure are—*
>
> 1. *The relationship between the spouse making the gift, transfer, or expenditure and the recipient.*
>
> 2. *Whether there were any special circumstances tending to justify the gift, transfer, or expenditure.*
>
> 3. *Whether the community funds used for the gift, transfer, or expenditure were reasonable in proportion to the community estate remaining.*

See Justice Ann Crawford McClure and John F. Nichols, Sr., *Fraud, Fiduciaries, and Family Law*, 43 TEX. TECH. L. REV. 1081 (2011).

5. Fiduciary Fraud or Fraud on the Community. A number of cases hold that a claim for breach of fiduciary duty in handling community property is really a claim for fraud on the community to be compensation through the property division upon divorce. *Schlueter v. Schlueter*, 975 SW 2d 584, 589 (Tex. 1998) ("there is no independent tort cause of action for wrongful disposition by a spouse of

community assets"); *In re Marriage of Moore*, 890 S.W.2d 821, 827 (Tex. App.--Amarillo 1994, no writ): "The breach of a legal or equitable duty which violates this fiduciary relationship existing between spouses is termed 'fraud on the community,' a judicially created concept based on the theory of constructive fraud. *Jackson v. Smith*, 703 S.W.2d 791, 795 (Tex. App.--Dallas 1985, no writ). Any such conduct in the marital relationship is termed fraud on the community because, although not actually fraudulent, it has all the consequences and legal effects of actual fraud in that such conduct tends to deceive the other spouse or violate confidences that exist as a result of the marriage.

> **Litigation Tip:** In an estate that involves spouses who are officers, directors, partners, managers, agent-in-fact, or trustee for the other spouse, the fiduciary obligation that is breached does not spring from the marriage relationship but rather from the relations as officer, director, partner, manager, agent, or trustee-beneficiary. The charge to the jury would set out the fiduciary duties arising from that relationship, which are independent from but co-exist with the duties that spouses owe to each other. If the recovery is to the community estate, then the breach of fiduciary duty claim is part of the property division in the divorce. If the recovery is to an entity, or to a trust, or to a spouse's separate estate, it would not be fraud on the community per se, and should be compensated by actual damages along with exemplary damages. However, a recovery is to the entity raises the issue of whether the claims must be brought as a derivative action, and not an action of the spouse individually. See Section XIV below.

E. THE DUTY TO DISCLOSE. "As a general rule, a failure to disclose information does not constitute fraud unless there is a duty to disclose." *Bradford v. Vento*, 48 S.W.2d 749, 755 (Tex. 2000). "Generally, no duty of disclosure arises without evidence of a confidential or fiduciary relationship." *Ins. Co. of N. Am. v. Morris*, 981 S.W.2d 667, 674 (Tex. 1998). A duty to disclose has been recognized: (i) in a formal or informal fiduciary relationship; (ii) when a partial disclosure leads to a duty to fully disclose; (iii) when new information causes an earlier disclosure to become misleading or untrue; (iv) when a partial disclosure conveys a false impression; (v) in connection with estoppel by silence; and (vi) when a person "by force of circumstances is under a duty to another to speak." *A. R. Clark Investment Co. v. Green*, 375 S.W.2d 425, 435 (Tex. 1964) (involving estoppel by silence). A recent case seems to expand the scope of the duty to disclose. In *Bombardier Aero. Corp. v. Spep Aircraft Holdings, LLC*, 572 S.W.3d 213, 219-220 (Tex. 2019), the Court said:

> Fraud by non-disclosure, a subcategory of fraud, occurs when a party has a duty to disclose certain information and fails to disclose it. *Schlumberger Tech. Corp. v. Swanson*, 959 S.W.2d 171, 181 (Tex. 1997). To establish fraud by non-disclosure, the plaintiff must show: (1) the defendant deliberately failed to disclose material facts; (2) the defendant had a duty to disclose such facts to the plaintiff; (3) the plaintiff was ignorant of the facts and did not have an equal opportunity to discover them; (4) the defendant intended the plaintiff to act or refrain from acting based on the non-disclosure; and (5) the plaintiff relied on the non-disclosure, which resulted in injury.... In general, there is no duty to disclose without evidence of a confidential or fiduciary relationship.... There may also be a duty to disclose when the defendant: (1) discovered new information that made its earlier representation untrue or misleading; (2) made a partial disclosure that created a false impression; or (3) voluntarily disclosed some information, creating a duty to disclose the whole truth.

"[W]here there is a duty to speak, silence may be as misleading as a positive misrepresentation of existing facts.... There is an analogy to the rule considered by us in considerable depth, and with approval, in

Champlin Oil & Refining Co. v. Chastain, 403 S.W.2d 376 (Tex. 1965), that an estoppel may arise as effectually from silence, where there is a duty to speak, as from words spoken." *Smith v. National Resort Communities, Inc.*, 585 S.W.2d 655, 658 (Tex. 1979).

W. Page Keeton, in *Fraud--Concealment and Non-Disclosure*, 15 TEX. L. REV. 132-33, (1936), advocated that a reasonable man standard be applied to non-disclosure of information in a transaction. The duty of disclosure in business transactions is examined in Deborah A. DeMott, *Do You Have The Right to Remain Silent: Duties of Disclosure in Business Transactions*. 19 DELAWARE J. OF BUS. LAW 65 (1994).

XIII. ALTERING DUTIES BY AGREEMENT. There is broad flexibility for parties in Texas to alter and sometimes waive what would otherwise be applicable fiduciary duties.

A. CORPORATIONS. TBOC § 7.001 (a), (b) & (c) generally permit domestic entities other than a partnership or LLC to waive in the certificate of formation liability of a governing person to the entity or its owners for acts or omissions as a governing person. However, the entity cannot eliminate or limit the duty of loyalty, or waive a claim for an act or omission "not in good faith" that breaches a duty to the entity or involves misconduct or a knowing violation of the law, or from which the individual "received an improper benefit," or an action for liability that is prescribed by statute. TBOC § 7.001(c).

B. PARTNERSHIPS. TBOC § 7.001(d) permits a general partnership agreement to limit or eliminate the liability of a "governing person" to the partnership or its partners except for a breach of loyalty or a claim for an act or omission "not in good faith" that breaches a duty to the entity or involves misconduct or a knowing violation of the law, or from which the individual "received an improper benefit," or an action where liability is prescribed by statute. TBOC § 7.001(c) & (d). TBOC § 152.002 provides that "a partnership agreement governs the relations of the partners and between the partners and the partnership," except as provided in Subsection (b). Subsection (b) provides that a partnership agreement or the partners may not: (1) unreasonably restrict a partner's right of access to books and records under Section 152.212; (2) eliminate the duty of loyalty under Section 152.205, except that the partners by agreement may identify specific types of activities or categories of activities that do not violate the duty of loyalty if the types or categories are not manifestly unreasonable; (3) eliminate the duty of care under Section 152.206, except that the partners by agreement may determine the standards by which the performance of the obligation is to be measured if the standards are not manifestly unreasonable; (4) eliminate the obligation of good faith under Section 152.204(b), except that the partners by agreement may determine the standards by which the performance of the obligation is to be measured if the standards are not manifestly unreasonable; (5) vary the power to withdraw as a partner under Section 152.501(b)(1), (7), or (8), except for the requirement that notice be in writing; (6) vary the right to expel a partner by a court in an event specified by Section 152.501(b)(5); (7) restrict rights of a third party under Chapter 152 or other partnership provisions, except for a limitation on an individual partner's liability in a limited liability partnership as provided by this chapter; (8) select a governing law not permitted under Sections 1.103 and 1.002(43)(C); or various deviations from the provisions of Chapters 1, 2, 3, 4, 5, 10, 11 and 12, other than certain exceptions, unless the provision says in the governing documents that it can be waived and further specifies the person(s) entitled to approve a modification or the vote or other method to approve modification. TBOC § 152.002(c) & (d).

C. LIMITED LIABILITY COMPANIES. The liability of a governing person may be limited or eliminated in a limited liability company by its certificate of formation or company agreement as to monetary damages for an act or omission by the person in the person's capacity as a governing person,

except that liability cannot be limited or eliminated for breach of loyalty to the organization or its owners or member, or an action not in good faith that constitutes a breach of duty of the person to the organization; or involves intentional misconduct or a knowing violation of law. TBOC § 7.001(d)(3). However, TBOC § 101.401 allows "[t]he company agreement of a limited liability company [to] expand or restrict any duties, including fiduciary duties, and related liabilities that a member, manager, officer, or other person has to the company or to a member or manager of the company."

D. EXPRESS TRUSTS. The trust agreement for an express trust can impose or relieve or alter duties of the trustee. Texas Property Code § 114.007(c) provides that a settlor can include in the terms of the trust provisions expressly "1) relieving the trustee from a duty or restriction imposed by this subtitle or by common law; or (2) directing or permitting the trustee to do or not to do an action that would otherwise violate a duty or restriction imposed by this subtitle or by common law." However, the trust agreement cannot relieve a trustee of "a breach of trust committed: (A) in bad faith; (B) intentionally; or (C) with reckless indifference to the interest of a beneficiary"; nor can it relieve the trustee from "any profit derived by the trustee from a breach of trust." Tex. Prop. Code § 114.007(a). If an exculpatory clause is inserted in a trust "as a result of an abuse by the trustee of a fiduciary duty to or confidential relationship with the settlor," it is ineffective. Tex. Prop. Code § 114.007(b).

"[T]he settlor can reduce or waive the prudent man standard of care by specific language in the trust instrument." G. Bogert & G. Bogert, LAW OF TRUSTS AND TRUSTEES § 541, p. 172 (rev. 2d ed. 1993); see also RESTATEMENT (SECOND) OF TRUSTS §174, Comment d (1957) ("By the terms of the trust the requirement of care and skill may be relaxed or modified").

In *Texas Commerce Bank v. Grizzle*, 96 S.W.3d 240, 249 (Tex. 2002), the Court ruled that Texas Property Code § 113.059 "allows an exculpatory clause to relieve a corporate trustee from liability for self-dealing defined as misapplying or mishandling trust funds, including failing to promptly reinvest trust monies, unless those activities violate the prohibitions in §§113.052 [loans to trustee] and 113.053 [sales to insiders]." The Legislature repealed Section 113.059 in 2005, and in 2005 amended Section 111.0035 to preclude a trust agreement from limiting the trustee's duty to (i) provide an accounting upon request by the beneficiary of an irrevocable trust; (ii) to "act in good faith and in accordance with the purposes of the trust," or (iii) eliminating a common law duty to keep the beneficiary of a trust who is 25 years old or older informed about his/her right to distributions from the trust.

Texas Property Code § 114.007 provides:

> (a) A term of a trust relieving a trustee of liability for breach of trust is unenforceable to the extent that the term relieves a trustee of liability for:
>
> > (1) a breach of trust committed:
> >
> > > (A) in bad faith;
> > > (B) intentionally; or
> > > (C) with reckless indifference to the interest of a beneficiary; or
> >
> > (2) any profit derived by the trustee from a breach of trust.

> (b) A term in a trust instrument relieving the trustee of liability for a breach of trust is ineffective to the extent that the term is inserted in the trust instrument as a result of an abuse by the trustee of a fiduciary duty to or confidential relationship with the settlor.
>
> (c) This section applies only to a term of a trust that may otherwise relieve a trustee from liability for a breach of trust. Except as provided in Section 111.0035, this section does not prohibit the settlor, by the terms of the trust, from expressly:
>
> > (1) relieving the trustee from a duty or restriction imposed by this subtitle or by common law; or
> >
> > (2) directing or permitting the trustee to do or not to do an action that would otherwise violate a duty or restriction imposed by this subtitle or by common law.

In *Neuhaus v. Richards*, 846 S.W.2d 70, 74-75 (Tex. App.--Corpus Christi 1992), judgm't set aside w.r.m.), 871 S.W.2d 182 (Tex. 1994), the court acknowledged that "[t]he settlor may within the trust instrument relieve the trustee of certain duties, restrictions, responsibilities, and liabilities imposed on him by statute. … Thus, if the language of the trust instrument unambiguously expresses the intent of the settlor, the instrument itself confers the trustee's powers and neither the trustee nor the courts may alter those powers. However, exculpatory clauses are strictly construed, and the trustee is relieved of liability only to the extent that the trust instrument clearly provides that he shall be excused."

In *Martin v. Martin*, 363 S.W.3d 221, 223-24 (Tex. App.--Texarkana 2012, pet. granted, judgm't vacated w.r.m.), the court, faced with a trust agreement that relieved the trustee of the duty of loyalty, said "We hold that statutory provisions impose certain duties on the trustee that cannot be waived."

In *Goughnour v. Patterson*, No. 12-17-00234-CV (Tex. App.--Tyler 2019, pet. denied) (memo op.), the court enforced an exculpatory clause when there was no evidence of gross negligence or willful breach of trust.

XIV. DERIVATIVE ACTIONS. In *Wingate v. Hajdik*, 795 S.W.2d 717, 719 (Tex. 1990). the Court said: "Ordinarily, the cause of action for injury to the property of a corporation, or the impairment or destruction of its business, is vested in the corporation, as distinguished from its stockholders, even though it may result indirectly in loss of earnings to the stockholders. Generally, the individual stockholders have no separate and independent right of action for injuries suffered by the corporation which merely result in the depreciation of the value of their stock. This rule is based on the principle that where such an injury occurs each shareholder suffers relatively in proportion to the number of shares he owns, and each will be made whole if the corporation obtains restitution or compensation from the wrongdoer. Such action must be brought by the corporation, not alone to avoid a multiplicity of suits by the various stockholders and to bar a subsequent suit by the corporation, but in order that the damages so recovered may be available for the payment of the corporation's creditors, and for proportional distributions to the stockholders as dividends, or for such other purposes as the directors may lawfully determine." [Citations omitted.] Where the claim belongs to the corporation, and the corporate managers will not pursue the claim, shareholders can seek to do so by bringing a derivative proceeding. Shareholder derivative proceedings are governed by TBOC §§ 21.551 et seq. These statutory provisions include a requirement to make demand on the corporation, discovery limited to independence and disinterestedness, good faith, and reasonableness, and dismissal if the court finds that the corporate managers decide in good

faith, after reasonable inquiry, that continuing the proceeding is not in the best interest of the corporation. However, procedural barriers are relaxed for closely-held corporations. TBOC § 21.563.

Parting Shot. The Author was involved in a divorce where both spouses were partners in a partnership where the partnership agreement contained an arbitration provision that disputes between the partners had to be arbitrated. The District Judge referred the issue of the value of the partnership to arbitration. Mandamus petitions to the Court of Appeals and then the Supreme Court were rejected without opinion. The case did not generate any legal precedents, but be "ready to ride and spread the alarm," as Henry Wadsworth Longfellow penned long ago.

ENDNOTES

1. <https://www.orsinger.com/s/Dividing-Ownership-Interest>.

2. TBOC § 152.002(a) provides: “Except as provided in Subsection (b), a partnership agreement governs the relations of the partners and between the partners and the partnership. To the extent that the partnership agreement does not otherwise provide, this chapter and the other partnership provisions govern the relationship of the partners and between the partners and the partnership.”

3. The first-self organized corporation that has come to light was a mill company in Tolouse, France, which formally constituted itself in 1372, with by-laws, recorded capital contributions, and shares. See Germain Sicard, *The Origins of Corporations* (Yale University Press, 2015).

4. Cliff Ernst, *Planning, Drafting and Implementing Capital Call Provisions* <http://www.gdhm.com/images/pdf/ce-planning-drafting-implementing-capital-call-provisions.pdf>.

5. Called UIL Code 705.00-00, *Determination of Basis of Partnership Interest* <https://www.irs.gov/pub/irs-utl/partners-outside-basis.pdf> [7-8-2023].

6. IRS Publication 541.

7. *Liquidating Distributions of a Partner's Outside Basis* <https://www.irs.gov/pub/irs-utl/liquidating_distributions_partner.pdf> [7-8-2023].

8.Leslie H. Loffman & Sanford C. Presant, *Choice of Entity–Business and Tax Considerations*, Tax Law and Estate Planning Course Handbook Series (2007) [available on Westlaw at 743 PLI/Tax 575], p. 609.

9. Miller, *The Limits of Limited Liability: Veil Piercing and Other Bases of Personal Liability of Owners, Governing Persons, and Agents of Texas Business Entities*, <https://www.baylor.edu/content/services/document.php/117969.pdf> [7-8-2023].

10. <https://www.orsinger.com/s/Business-Valuations-Effective-Presentation-of-Complex-Issues>; https://www.orsinger.com/s/_20210714-308-pm-PPT-Business-Valuations-Effective-Presentation-of-Complex-Issues.pdf>.

11. *Code of Ethics and Minimum Standards for Guardianship Services* <https://www.txcourts.gov/media/1455557/code-of-ethics-minimum-standards-2022.pdf> [7-8-2023].

12. Robert W. Calvert was born in Tennessee, the son of a sharecropper. His father died and his mother placed him in an orphanage in Texas where he grew to maturity. He graduated from the University of Texas Law School in 1931. He was a district attorney, a state representative, and Speaker of the Texas House of Representatives. He was elected to the Supreme Court in 1961, then served as Chief Justice from 1961 until 1972. Ruel Walker was born in Texas, graduated from UT Law, and served on the Texas Supreme Court from 1954 until 1976. Zollie Steakley was born in Texas, graduated from UT Law, served as Secretary of State, and joined the Supreme Court in 1961 to fill Robert Calvert’s empty associate justice seat, where he served through 1980.

13. Benjamin N. Cardozo’s series of lectures, published as THE NATURE OF THE JUDICIAL PROCESS (Yale University Press, 1921), is exceptionally clear legal writing.

14. *FDIC, Trust Examination Manual* <https://www.fdic.gov/regulations/examinations/trustmanual/index.html> [7-8-2023].