

BUSINESS ISSUES IN THE CONTEXT OF DIVORCE

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THE THREE TYPES OF ENTITIES

CORPORATION (LEGAL)

- A corporation is an entity distinct from its owners.
- Assets belong to the corporation, not the shareholders.
- The Corporation is liable for its debts; shareholders and officers are not (absent a personal guarantee or piercing the corporate veil).
- In a divorce there can be “reverse piercing.”
- Corporate shares are subject to turnover and sale to pay shareholder’s debt.
- Stock transfer restrictions and buy-sell agreements can prohibit or condition stock transfers.

LIMITED LIABILITY COMPANY (LEGAL)

- An LLC is an entity distinct from its members and managers.
- Assets belong to the LLC, not its members; members are not liable for LLC debts (absent personal guarantee or piercing).
- A member's interest is not subject to foreclosure or turnover; member's creditor must seek a charging order.
- When a member's interest is sold, the member recognizes a capital gain or loss.

PARTNERSHIP (LEGAL)

- A partnership is an entity distinct from its partners.
- Partnership assets belong to the partnership, not the partners.
- A general partnership and its partners are individually liable for partnership debts.
- In a limited partnership, the partnership and its general partner are liable for partnership debts, but not limited partners.
- Partnership creditors cannot pierce the partnership veil; *Peterson Grp. V. PLTQ Lotus Grp.* (2013); *Asshauer v. Wells Fargo Foothill* (2008); *Pinebrook Props., Ltd. v. Brookhaven Lake Prop. Owners Ass'n* (2004). But these were not reverse-piercing cases.
- A partnership interest is not subject to turnover; a partner's creditors must seek a charging order.

DIVIDING ENTITIES UPON DIVORCE

CHOICES

1. Leave the spouses as co-owners of the entity.
2. Sell the entity and divide the proceeds.
3. Award the entity to one spouse and offsetting cash or property to the other spouse, or give the departing spouse a promissory note or money judgment.
4. Transfer cash or property from inside the entity to the departing spouse in liquidation of her interest (requires the consent of the entity, reverse-piercing, or imposing a resulting or constructive trust).
5. Subdivide the entity and award part to each spouse (requires consent).
6. Dissolve the entity and divide its assets (requires consent, grounds for winding up).

LEAVING SPOUSES AS CO-OWNERS

- Avoids the need to value the business, but it can create problems **post-divorce**.
- If ex-spouses have equal control, an **impasse** can develop that may trigger lawsuits or require a court-appointed receiver.
- If one spouse has exclusive control, there can be actual or perceived minority oppression leading to a suit for breach of fiduciary duty.
- 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 join other minority owners in a voting block.

SUBDIVIDING THE ENTITY

- The entity can be converted to one or more C Corps, S Corps, LLC's, 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)

DIVISIVE MERGERS

- Reverse of traditional merger; one entity divides into multiple entities
- Dividing entity is not required to terminate, and can be one of surviving entities
- Assets and liabilities of dividing entity are allocated among new entities formed
- NOT considered an assignment or transfer under Texas or Delaware state law
- May avoid transfer restrictions
- Required filings with Sec'y of State; possible tax issues

SELLING THE ENTITY

- Avoids having to value the business in the divorce, since the sales price establishes Fair Market Value.
- Dissension between the ex-spouses can scare off legitimate buyers, leaving only “vultures” looking for a bargain.
- Events surrounding selling process can generate litigation.
- If a receiver is appointed, it adds to the costs of sale.
- Sale of a partial interest is not feasible if there are other owners or transfer or buy-sell restrictions (unless the entity or the other owners buy out the departing spouse).

SELLING THE ENTITY

- If the terms of sale are determined by a receiver, she 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.
- Neither spouse can be required to sign a covenant not to compete, which will chase off buyers or depress the sales price.
- If a covenant will be signed, how much of the sale proceeds will be allocated to the covenant? Is that separate property?

AWARDING ENTITY TO ONE SPOUSE, WITH OFFSETTING PROPERTY OR JUDGMENT

- Requires the entity to be valued; capital gain and costs of sale will fall on the remaining spouse upon eventual sale.
- If not enough other money/assets to offset, then payments over time are required; need interest rate commensurate with risk.
- Creates a debtor/creditor relationship: issues include promissory note vs. judgment, security for the debt, perfecting liens, post-divorce enforcement, and dischargeability in bankruptcy.
- Agreement on earn-out can avoid valuation dispute; can the court order this?
- Effect of transfer restriction or buy-sell agreement.
- For partnership, can transfer only a transferee's interest (absent consent by other partners).

AWARDING ENTITY ASSETS

- The TBOC is clear: assets of an entity do not belong to the owners of the entity.
- A court cannot award individual assets of an entity to either spouse absent consent of the entity, reverse-piercing, or imposing a resulting or constructive trust.
- If the entity veil is reverse-pierced, asset(s) become owned by the spouses and can be community property.
- You can pierce without taking assets away from the entity.
- What to do about excess retained earnings?

FIDUCIARY DUTIES

MARITAL FIDUCIARY DUTIES ARE UNIQUE

- The *Texas Family Code* does not say that a marriage creates a fiduciary relationship.
- The fiduciary relationship between spouses is recognized in multiple court of appeals opinions.
- This case law is reflected in the SBOT's Pattern Jury Charge (Family & Probate).
- Does fiduciary duty end when divorce is filed and parties "lawyer up"?
- Several cases say that fiduciary duty ends upon divorce. But TFC §9.011(b) creates fid. obligation for subsequently-received property awarded to the other spouse in the divorce decree.

RECONCILING MANAGEMENT RIGHTS AND OWNERSHIP

- *Givens v. Girard Life Ins. Co. of Am.* – A problem inherent in the concept of sole management community property is the need to reconcile the ownership interest and managerial power of one spouse with the ownership interest of the other spouse.
- *Greco v. Greco* – Although a spouse has the right to dispose of community property under his or her control, he may not dispose of his spouse's interest in community funds if actual or constructive fraud exists.
- *Knight v. Knight* – a fiduciary duty exists between a husband and a wife as to the community property controlled by each spouse.

FRAUD ON THE COMMUNITY IS NOT A TORT

- *Schlueter v. Schlueter* (Tex. 1998) – “Because a wronged spouse has an adequate remedy for fraud on the community through the ‘just and right’ property division upon divorce, we hold that there is no independent tort cause of action between spouses for damages to the community estate.” *Id.* at 585.

“[A] claim of fraud on the community is a means to an end, either to recover specific property wrongfully conveyed, ... or ... to obtain a greater share of the community estate upon divorce, in order to compensate the wronged spouse for his or her lost interest in the community estate.” *Id.* at 588.

“Because of our holding in the present case that there is no independent tort cause of action for wrongful disposition by a spouse of community assets, the wronged spouse may not recover punitive damages from the other spouse.” *Id.* at 589.

ACTUAL FRAUD ON THE COMMUNITY

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 206.2B Actual Fraud by Spouse against Community Estate—Questions

QUESTION 1

Did SPOUSE A commit fraud with respect to the community-property rights of SPOUSE B?

Answer “Yes” or “No.”

Answer: _____

If you have answered Question 1 “Yes,” then answer Question 2. Otherwise, do not answer Question 2.

QUESTION 2

State in dollars the value, if any, by which the community estate of Party A and Party B was depleted as a result of the fraud of Party A.

Answer: \$ _____

CONSTRUCTIVE FRAUD ON THE COMMUNITY

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.

PJC 206.4B Constructive Fraud by Spouse against Community Estate—Questions

QUESTION 1

Was the transfer made by SPOUSE A to THIRD PARTY fair?

Answer “Yes” or “No.”

Answer: _____

If you have answered Question 1 “No,” then answer Question 2. Otherwise, do not answer Question 2.

QUESTION 2

State in dollars the value, if any, by which the community estate of SPOUSE A and SPOUSE B was depleted as a result of the transfer made by SPOUSE A to THIRD PARTY.

Answer: \$ _____

RECONSTITUTING THE COMMUNITY ESTATE

Fam. Code § 7.009 provides:

- (a) In this section, “reconstituted estate” means the total value of the community estate that would exist if an actual or constructive fraud on the community had not occurred.
- (b) If the trier of fact determines that a spouse has committed actual or constructive fraud on the community, the court shall:
 - (1) calculate the value by which the community estate was depleted as a result of the fraud on the community and calculate the amount of the reconstituted estate; and
 - (2) divide the value of the reconstituted estate between the parties in a manner the court deems just and right.
- (c) In making a just and right division of the reconstituted estate under Section 7.001, the court may grant any legal or equitable relief necessary to accomplish a just and right division, including:
 - (1) awarding to the wronged spouse an appropriate share of the community estate remaining after the actual or constructive fraud on the community;
 - (2) awarding a money judgment in favor of the wronged spouse against the spouse who committed the actual or constructive fraud on the community; or
 - (3) awarding to the wronged spouse both a money judgment and an appropriate share of the community estate.

FIDUCIARY DUTY REGARDING COMMUNITY PROPERTY

- Sole and joint management community property can be expended however the controlling spouse wishes, as long as it doesn't constitute a fraud on the other spouse.
- “Fraud on the community” has unique standards. In a divorce you must first seek remedy through the property division and “reconstituting” the community estate; only if inadequate can you sue third parties.
- Taking or conveying the other spouse's separate property is actionable by normal standards of theft, conversion, fraud, constructive fraud, etc.

INFORMAL FIDUCIARY RELATIONSHIPS

- “[W]here one person trusts in and relies upon another, whether the relation is a moral, social, domestic, or merely personal one.” *Fitz-Gerald v. Hull* (Tex. 1951).
- 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* (1980).
- “A relationship of trust and confidence.” PJC 104.1
- “[T]he existence of a confidential relationship is ordinarily a question of fact.” *MacDonald v. Follett* (Tex. 1944).
- Requires fact finding that a fiduciary or confidential relationship exists.

OTHER SOURCES OF DUTIES BETWEEN SPOUSES

- Agent/Principal
- Trustee/Beneficiary
- Attorney/Client
- Financial Manager/Other Spouse
- Manager/Owner of business
- Partner/Partner
- Duty to fully disclose material facts (arising from partial disclosure, original disclosure no longer accurate, induced reliance)

HYPOTHETICAL NO. I: “THE HARBOR” SPOUSAL CO-OWNERSHIP OF PRIVATE COMPANY

- Husband and Wife: 50-50 Co-Owners of The Harbor, Inc. - owns three hotels
- Wife suspects Husband has siphoned off funds for other business he owns, which provides liquor to restaurants and hotels, including The Harbor.
- Wife has filed divorce: she wants the following relief:
 - One-half of the value of The Harbor, Inc.;
 - Actual and punitive damages from husband for fraud and breach of fiduciary duty; and
 - Forfeiture to her of Husband's liquor supply business

Questions:

1. Can Wife recover the relief she is requesting?
2. Can Wife force a sale of The Harbor, Inc.?
3. Difference if LLC or partnership instead of Inc.?

HYPOTHETICAL NO. 2: **“GOLDEN EGGS”: MINORITY INTEREST HELD BY SPOUSES IN PRIVATE COMPANIES**

- Husband and Wife own 30% of stock in corporation called Golden Goose (“Goose”)
- Goose owns valuable NFT’s (non-fungible token), and spousal 30% interest may be worth \$5 million or more
- In divorce action, Husband wants to retain the 30% ownership interest in Goose, but he lacks the assets to pay Wife for the value of her half of the spousal interest in Goose
- Husband and Wife believe that the officers/directors of Goose have breached their fiduciary duties, and would like to pursue claims against them on a contingent fee basis

Questions:

1. What type of claims do spouses have against Goose’s officers/directors?
2. What is involved in pursuing a shareholder derivative claim against Goose’s officers/directors?
3. What options exist for Husband to structure payment for value of Wife’s interest in Goose?

HYPOTHETICAL NO. 3

“GORDON GEKKO”: IMPACT OF PERSONAL GOODWILL ON THE VALUATION OF PRIVATE COMPANY IN DIVORCE

- Husband is sole owner of Pied Piper (“PP”), an LLC that provides investment advice to family offices and hedge funds. PP has 7-8 employees who assist in providing investment services/advice.
- Husband owns valuable investments in private companies, but contends these investments are separate property, but he has invested community property in these private companies.
- Husband files for divorce and wants to keep sole ownership of PP, along with all of his other investments.
- Wife believes Husband used assets from marital estate to purchase investments. Wife wants to receive 50% of the value of PP, as well as 50% of the value of Husband’s other investments.

Questions:

1. How does personal goodwill factor into the value of a privately-held company?
2. Who has burden to prove investments in Husband’s name are separate property, and how is that done?
3. What claims does Wife have for Husband’s misuse of community property to fund investments?

SUING THIRD PARTIES

SUING THIRD-PARTIES FOR FRAUD ON THE COMMUNITY

Chu v. Hong (Tex. 2008) – “Hong notes correctly that in *Schlueter* we did not decide whether torts against the community estate could be alleged against a third-party. As a general matter, they clearly can; if a third party steals community property, surely either spouse or both can seek recovery in tort for it.

But the question presented here is a narrower one: whether a third party can be held liable in tort when community property is taken by one of the spouses. We answered that question in the negative in *Cohrs v. Scott*. There, a divorcing wife settled all her property claims against her husband, and then sought damages against a third party for helping her husband transfer two cars to a mistress. This Court held that “the fraud having been initiated and carried out mainly by the husband, [the wife] must look primarily to him and his property to right the wrong.”

For several reasons, we believe that remains the proper rule. ...

Finally, the jury found that Chu knowingly participated, aided, or assisted Gyu in breaching his fiduciary duty to his former wife. Assuming such a claim exists and is somehow different from a conspiracy to breach his fiduciary duty, it too is excluded by *Schlueter* for the reasons noted above.” *Id.* at 445-47.

SUING THIRD-PARTIES FOR FRAUD ON THE COMMUNITY

Chu v. Hong – “We hold the courts below erred in allowing one spouse to recover damages without first recovering the community property from the spouse who took it.” *Id.* at 443.

“[I]f one spouse can enlarge the community estate by suing the other’s relatives, many acrimonious divorce cases will undoubtedly become more so. That may be necessary when relatives have community property in their hands; but when they do not, little is gained by adding third parties if the property can be restored through orders between the former spouses. . . . *Schlueter* requires Hong to seek restitution from her own husband before seeking it from someone else’s lawyer.” *Id.* at 446.

Barnett v. Barnett (Tex. 2001) (not a divorce) – H replaced W with his mother as beneficiary of a community property life insurance policy. H died, and the policy proceeds were paid to the mother. W sued H’s mother for fraud on the community.

Under Texas law, Marleen Barnett has a cause of action for fraud on the community. Neither Dora nor any of the other defendants challenged the court of appeals’ holding that a fraud on the community occurred in this case. Marleen’s state-law remedy is to impose a constructive trust on one half of the proceeds of the Prudential policy that insured the life of her estranged husband.

PJC 206.5A FRAUD ACTION AGAINST NONSPOUSE PARTY—INSTRUCTION

“A person commits fraud if that person participates with a spouse in a transfer of community property 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 206.5B FRAUD ACTION AGAINST NONSPOUSE PARTY—QUESTIONS

Question 1

Did *NONSPOUSE PARTY* commit fraud with respect to the *community-property* rights of *SPOUSE B*?

Answer “Yes” or “No.”

Answer: _____

If you have answered Question 1 “Yes,” then answer Question 2. Otherwise, do not answer Question 2.

Question 2

What sum of money, if paid now in cash, would fairly and reasonably compensate the *community estate* for the damages, if any, resulting from *NON-SPOUSE PARTY*’s fraud?

Answer in dollars.

Answer: \$ _____”

THANK YOU!