Top Five Concerns Regarding Small Business Ownership and Divorce in Texas

By Michelle May O'Neil

When the parties to a divorce own a small business, a Texas divorce can have a deeper and more difficult effect. Not only are the emotions high due to the breakup of the relationship, but also one spouse or both spouses may be concerned about their future livelihood after the divorce because of the division of marital property and a small business.

<u>One: Type of business entity</u>

The first concern in addressing issues related to a small business in a divorce relates to the type of entity of the business. Is the business a corporation, partnership, or sole proprietorship? The rules of divorce differ depending on what type of entity is being divided.

<u>Two: Date of Formation</u>

The date a business was formed is the second step in evaluating the effect of divorce on a business. If the business was formed before the date of marriage, it is probably separate property such that the business or its value cannot be divided in the divorce as an asset of the marriage. If, on the other hand, the business began during the marriage, there will be a presumption that it is community property of both parties and subject to the divorce court's division. However, that presumption may be rebutted under certain circumstances if evidence exists showing the funds used for the initial formation came from one spouse's separate property.

<u>Three: Changes in Formation</u>

The third question regarding the evaluation of small businesses in divorce is a determination of whether there have been any changes in the formation of the business during the marriage. Even if the business is separate property at the time it was formed, it can be transformed into a community property asset if the business changed its entity type. For example, if one spouse owned a sole proprietorship before the marriage, but during the marriage, that spouse learned of the benefits of incorporation and incorporated during the marriage, the business may be transformed into a community property asset.

<u>Four: Operation of the Business During Divorce</u>

A very important issue to address regarding a small business during a divorce involves issues related to continued operation of the business while the divorce works through the process. This can be particularly problematic if both spouses were involved in the day-to-day activities of the business prior to the divorce being filed, but who cannot get along after the divorce is filed to co-operate the business. Under this type of circumstance, the divorce court may have to intervene and award one party or the other the right to operate the business within certain parameters. In extreme circumstances, the court may appoint an independent receiver to operate the business until the divorce can be concluded and the business awarded to one party or the other.

Five: Where do the customers come from?

For a court to determine the proper value of the business entity, the valuation expert must examine where the business' customers come from. If customers employ the business because of the reputation or abilities solely of the individual owner of the business who does the work, that intangible value is the "personal goodwill" of that individual and is not an asset that can be considered in the value of the business for division purposes. On the other hand, if the business gains customers due to the reputation of the entity itself, that intangible value is an asset of the business to be included in valuation.

Dealing with business entities in a divorce can be complex. Not only do the business issues relate to the division of property in the breakup, but the business entity may provide the crucial income that supports the family. This can create emotional frustrations and fears as the divorce process works through as well.