The Intangible Assets of a Non-Existent Entity: Sole Proprietorships & Goodwill in a Texas Divorce

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35th Annual Marriage Dissolution Institute
April 26-27, 2012
Dallas, Texas

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  Marriage Dissolution Institute, Galveston, 2008
  http://goo.gl/ZXkfy

• Effect of Choice of Entities: How Organizational Law, Accounting, and Tax Law for Entities Affect Marital Property Law
  Co-authored with Richard Orsinger & Patrice Ferguson
  http://goo.gl/f4aNR

• Trusts, Family Law, & the Contract-Property Dichotomy
  Authored, Co-presented with Harold C. Zuflacht
  Marriage Dissolution Institute, Fort Worth, 2009
  http://goo.gl/d3CVE

• Property Puzzles: 30 Characterization Rules, Explanations & Examples
  Co-authored with Richard Orsinger & Scott Downing
  Family Law on the Front Lines, San Antonio, 2009
  Advanced Family Law Course, Dallas, 2009
  http://goo.gl/xZHao

• Family Law Legislative Update
  Co-presented with Katherine Kinser, JoAl Cannon Sheridan, & Charlie Hodges
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• Practicing Family Law in a Depressed Economy - Part I: Your Law Practice and Your Clients
  Co-authored and co-presented with Richard Orsinger
  Advanced Family Law Course, Dallas, 2009
  http://goo.gl/SN4gL

• Valuation: Approaches, Assets, and Authority
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• Dealing with Business Entities
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  Advanced Family Law Course, San Antonio, 2011
  http://goo.gl/p62HR

• Discovery and Authentication of Electronically Stored Information
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Modern Family Law is a melting pot for legal principles derived from diverse fields, melding them together and attempting to harmonize the various rules that governed them in their original incarnations.

One example seen with increasing frequency in Texas divorces is the concept of personal and commercial goodwill as intangible assets of a spouse’s sole proprietorship. The law for sole proprietorships in the divorce context has, for the most part, developed independently from the law for more formal business entities like corporations and partnerships, of which goodwill is a part. Only recently have the special rules applying to sole proprietorships been thoroughly mixed with the those applying to goodwill, and a set of fundamental principles derived.

This paper focuses on how those principles have been developed, and where they stand today. Section I addresses the essential characteristics of sole proprietorships, and how they differ from other common business entities. Section II addresses the history of the two different types of goodwill, and how those concepts typically arise in a divorce. Finally, Section III addresses what happens when these two fields are combined.

I

Sole Proprietorships

A. Essence

The sole proprietorship is the simplest form of business. Its creation requires none of the formalities of traditional business entities such as a corporation or partnership, no particular governance structure is required, and its internal affairs are not prescribed by law.1 In its essence, the sole proprietorship is the oldest form of business, with a history stretching back past time immemorial.

However, the very concerns that originally led to the innovations of the corporation and partnership—insulation and protection from liability and risk—arose from the inadequacies of the sole proprietorship business form. Because the business and its owner are legally indistinguishable, the owner is entitled to all of the business’ assets, but is also personally liable for all of its debts.

Nevertheless, the sole proprietorship remains, by far, the most common form of business in the United States,2 and is the form many start-ups take before their viability in the marketplace is proven.3

B. Property

A sole proprietorship is defined as a business in which one person owns all the assets, owes all the liabilities, and operates in his or her personal capacity.4

One of the most important features of a sole proprietorship is that it is not an independent legal entity. A sole proprietorship does not have a separate legal existence distinct from the operator of the business.5 Texas law regards the sole proprietor and the sole proprietorship as one and the same person.6 “The assets and liabilities of the sole proprietorship belong to the operator directly.”7

C. Taxation

The income and losses for a sole proprietorship are reported on Schedule C of the owner’s personal income tax return. The owner must also pay self-employment taxes, and must pre-pay estimated taxes on a quarterly basis. For taxation purposes, a sole proprietor is like an

1 The rules and regulations of the Texas Business Organizations Code govern all business entities except sole proprietorships. In one sense, a sole proprietorship is a catch-all business form, the default when an enterprise does not fulfill the criteria for any of the entities covered by the TBOC.


3 eBay and Kinko’s are among the long list of notable business entities that began as sole proprietorships.


independent contractor who owns the business they work for. The sole proprietorship itself is not a taxable entity, and is not subject to the Texas franchise tax.

D. Alter Ego

In a traditional business context, the doctrine of alter ego allows the trial court to set aside the corporate structure of a company, or “pierce the corporate veil,” to hold individual shareholders liable for corporate debt. An entity is an alter ego if there is “such unity between corporation and individual that the separateness of the corporation has ceased,” and if “holding only the corporation liable [for the corporate debt] would result in injustice.” Traditionally, courts pierce the corporate structure to hold an individual officer, director, or stockholder liable for the debts of the corporation only where “it appears that the individuals are using the corporate entity as a sham to perpetrate a fraud, to avoid personal liability, avoid the effect of a statute, or in a few other exceptional situations.”

In the divorce context, piercing the corporate veil allows the divorce court to “go the other way” and characterize as community property corporate assets that would otherwise be the separate property of one spouse. Unlike traditional piercing in which the stockholder is held liable for debts of the corporation, piercing in a divorce case allows the trial court to move assets out of the corporation and divide them between spouses as part of the shareholder’s community estate.

Legally, the alter ego doctrine has no application to sole proprietorships—the business already is the alter ego of the owner, and there is no “separateness” that could be breached. Likewise, there is no veil to pierce to invade entity property or satisfy entity debt—the business itself has no assets or liabilities.

For those reasons, the alter ego doctrine can be understood as a court treating an independent business entity as if it were a sole proprietorship when the manager of the entity disregards the corporate form to a nefarious end.

A. Definitions

The Fort Worth Court of Appeals has judiciously—but demurely—observed that goodwill is “sometimes difficult to define.” Several of the different definitions of goodwill revolve around a central theme of the value associated with an established customer base:

Goodwill is...

- The probability (or expectancy) that old customers will resort to the old place.
- The favor which the management of a business wins from the public.
- The favorable consideration shown by the purchasing public to goods or services known to emanate from a particular source.
- The total of all the imponderable qualities that attract customers to the business.
- What brings patronage to a business.
- The expectancy of continued patronage, for whatever reason.
- The reasonable expectancy of preference in the race of competition.

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9 _Id._ (citing _Castleberry_, 721 S.W.2d at 272).
10 _Id._ (citing _Zisblatt v. Zisblatt_, 693 S.W.2d 944, 950 (Tex. App.—Fort Worth 1985, writ dism’d)).
11 _Id._ (citing _Zisblatt_, 693 S.W.2d at 952, and _Vallone v. Vallone_, 644 S.W.2d 455, 458 (Tex. 1982)).
12 _Id._ (citing _Zisblatt_, 693 S.W.2d at 955).
14 _Richard S. Miller & Sons, Inc. v. United States_, 537 F.2d 446, 450-51 (Ct. Cl. 1976).
17 _Id._
19 _Grace Bros., Inc. v. Commissioner_, 173 F.2d 170, 175-76 (9th Cir., 1949).
20 _Boe v. Commissioner_, 307 F.2d 339, 343 (9th Cir. 1962), aff’d, 35 T.C. 720 (1961).
21 _Dodge Bros., Inc v. United States_, 118 F.2d 95, 101 (4th Cir. 1941).
The ongoing expectation that customers would utilize [a company’s] services in the future.\(^{22}\)

The preexisting business relationship founded upon a continuous course of dealing that can be expected to continue indefinitely.\(^{23}\)

Note the recurring concept of an expectation due to customer loyalty that arises in nearly all of these definitions. This expectation is the essence of the economic value of goodwill.

Justice Story provided a thorough definition of this value associated with an established customer base:

[Goodwill is] the advantage or benefit, which is acquired by an establishment, beyond the mere value of the capital, stock, funds, or property employed therein, in consequence of the general public patronage and encouragement, which it receives from constant or habitual customers, on account of its local position, or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances or necessities, or even from ancient partialities or prejudices.\(^24\)

The United States Supreme Court later refined this definition, describing goodwill as “that element of value which inheres in the fixed and favorable consideration of customers, arising from an established and well-known and well-conducted business.”\(^{25}\)

The Internal Revenue Services’ famous Revenue Ruling 59-60—the definitive authority on the standards, approaches, and premises of business valuation—also addresses goodwill:

In the final analysis, goodwill is based upon earning capacity. The presence of goodwill and its value, therefore, rests upon the excess of net earnings over and above a fair return on the net tangible assets. While the element of goodwill may be based primarily on earnings, such factors as the prestige and renown of the business, the ownership of a trade or brand name, and a record of successful operation over a prolonged period in a particular locality, also may furnish support for the inclusion of intangible value...The enterprise has a value as an entity. Whatever intangible value there is, which is supportable by the facts, may be measured by the amount by which the appraised value of the tangible assets exceeds the net book value of such assets.\(^{26}\)

The concept of goodwill is itself subdivided into “personal”\(^{27}\) goodwill and “commercial”\(^{28}\) goodwill.\(^{29}\)

This distinction between personal and commercial goodwill is extremely important in the divorce context, and both types must be identified and valued.

1. Personal Goodwill

Personal goodwill is goodwill that “attaches to the person of the professional man or woman as a result of confidence in his or her skill and ability.”\(^{30}\) It is “attributable to an individual’s skills, knowledge, efforts, training, or reputation in making a business successful.”\(^{31}\)

Personal goodwill “would be extinguished in the event of the professional’s death, retirement, or disablement.”\(^{32}\)

2. Commercial Goodwill

Commercial goodwill is whatever is left over. It is what exists in a business “separate and apart from the professional’s personal ability and reputation.”\(^{33}\)

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\(^{27}\) Also referred to as “individual” goodwill.

\(^{28}\) Also referred to as “enterprise,” “corporate,” or “group” goodwill.

\(^{29}\) **BEWARE:** The term “professional goodwill” is ambiguously used to refer to either personal or commercial goodwill.

\(^{30}\) Salinas v. Rafati, 948 S.W.2d 286, 291 (Tex. 1997) (citing Nail v. Nail, 486 S.W.2d 761, 763 (Tex. 1972)).


\(^{32}\) Keith v. Keith, 763 S.W.2d 950, 952 (Tex.App.–Fort Worth 1989, no writ).

B. Valuation

Goodwill is a component of the value of a business under all three of the prevailing approaches to valuation: market data, asset, and income.

Consider the following diagram:

\[
1 = 2 + 3 = (4 + 5) + (6 + 7) = (4 + 5) + (6 + (8 + 9))
\]

Based on the method described in Revenue Ruling 59-60:

The total value of the assets of a business (1) is a combination of the value of the tangible assets (2) and intangible assets (3). Tangible assets include things actually owned by the business, such as inventory (4) and equipment (5), and their value can be easily appraised. Intangible assets include the business’ contract rights and intellectual property rights (6), which can be valued by calculating their rate of return.

Goodwill (7) is also an intangible asset, and can be calculated as the amount remaining after the estimated rate of return on all tangible assets and intangible assets such as contract rights is subtracted from the business’ net earnings.

When the owner of a business leaves that business, its net earnings will be affected. The estimated amount of that effect represents personal goodwill (8), and can be subtracted from the business’ net earnings along with the values of the tangible and other intangible assets. The remaining portion of the fair market value of the business represents the business’ commercial goodwill (9).

Note that a sole proprietorship does not own any tangible assets, nor does it hold any contract or intellectual property rights. When a sole proprietorship is valued, the assumption is made that the tangible and intangible assets used by the sole proprietorship would be sold along with it. But in a divorce, those assets might not be readily fungible.

III

Sole Proprietorships & Goodwill

A. Fundamental Marital Property Rules for Sole Proprietorships – Zeptner

Three essential marital property concepts—character, goodwill, and reimbursement—all intersect in a recent case from the Fort Worth Court of Appeals, Zeptner v. Zeptner, involving a sole proprietorship.

In Zeptner, Husband owned and operated a sole proprietorship that was formed before marriage. During the marriage, the business had increased in value, acquired equipment, and made disbursements to third parties. Upon divorce, Wife sought reimbursement on behalf of the community estate against Husband’s separate estate that was comprised of three components:

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34 111 S.W.3d 727 (Tex. App.–Fort Worth 2003, no pet.) (op. on reh’g).

35 Id. at 738. The sole proprietorship manufactured molded plastics for construction purposes, did business under the name “Accu-Tech Machine & Manufacturing,” and has since been incorporated.

36 Id. at 738-39.
the equipment purchased by the community and used by the business;

- the improvements made to the real property that housed the business using community funds;\(^{37}\) and

- the inadequate compensation for Husband’s time, talent and labor expended in running the business.\(^{38}\)

In the decree, the trial court confirmed the entire interest in the sole proprietorship, *along with* all of its assets and equipment, as Husband’s separate property.\(^{39}\) The trial court also combined the equitable reimbursement and *Jensen* claim together into a single cash award that represented the “enhanced value” of the business.\(^{40}\) Husband appealed.

The appellate court’s opinion can be analyzed as establishing 5 general principles:

1. The ownership interest in a sole proprietorship created before marriage is separate property.

*Zeptner* held that the trial court’s confirmation of the sole proprietorship as separate property was correct because the business was started before marriage.\(^{41}\) By extension, any other means of acquiring separate property\(^{42}\) would also create a separate property sole proprietorship. Conversely, the interest in a sole proprietorship started during marriage is presumptively community property.\(^{43}\)

2. The tangible assets acquired by a separate property sole proprietorship during marriage are (presumptively) community property.

*Zeptner* held that “the equipment acquired during the marriage but used by the business was community property.”\(^{44}\) By extension, the other assets of the sole proprietorship acquired during marriage would also be community property, assets such as inventory, cash, receivables, contractual rights, and so on.\(^{45}\) It is as if the spouse who owns the sole proprietorship is acquiring the property himself.

Wife had argued, and the trial court agreed, that the purchase of the equipment should form the basis of a reimbursement claim. But there was no reimbursement claim available for that equipment because it had been mischaracterized and confirmed as Husband’s separate property, when it actually should have been divided as part of the community estate. In other words, the community cannot reimburse the community; community property divided to one spouse should be offset with community property divided to the other, not with a reimbursement claim.

3. Certain intangible assets of a separate property sole proprietorship—such as personal goodwill—are not divisible.

*Zeptner* held that, in the context of a sole proprietorship, “professional goodwill is not a community asset subject to division.”\(^{46}\) By extension,}

\(^{37}\) Note that the judgment in *Zeptner* was signed before the effective date of the economic contribution statute. *See* Act of May 22, 2001, 77th Leg., R.S., ch. 838, § 2, eff. Sept. 1, 2001, *repealed* by Act of May 19, 2009, 81st Leg., R.S., ch. 768, § 11(3), eff. Sept. 1, 2009. The *Zeptner* opinion does not indicate whether the improvements were paid for directly by the community estate (and thus reimbursable under the common law), or whether the community estate paid the principal on a debt incurred for those improvements (and thus reimbursable under the economic contribution statute, old Family Code section 3.402(a)(3)(C)). With the repeal of economic contribution in 2009, this distinction became merely academic, and has little practical importance to interpreting *Zeptner*.

\(^{38}\) *Id.*

\(^{39}\) *Id.* at 733.

\(^{40}\) *Id.* at 732.

\(^{41}\) *Id.* at 738 (“We note at the outset that the trial court did not assign a value to Accu-Tech, which was Owen’s sole proprietorship before the marriage and thus his separate property.”).

\(^{42}\) By gift, devise, or descent, Tex. Fam. Code §3.001(2), by personal injury damages, Tex. Fam. Code §3.001(3), or by mutation of other separate property. *See*, e.g., *Chapman v.*

\(^{43}\) *But see* section II.B.1., infra, for a more thorough discussion of the application of the principles of mutation and inception of title to a sole proprietorship.

\(^{44}\) *See* Butler v. Butler, 975 S.W.2d 765, 768 (Tex. App.–Corpus Christi 1998, no pet.).

\(^{45}\) *Zeptner*, 111 S.W.3d at 738 (citing Tex. Fam. Code § 3.003(a)) (and continuing: “The trial court erred by not characterizing the equipment as community property and by confirming it as Owen’s separate property.”).

\(^{46}\) *Hopf v. Hopf*, 841 S.W.2d 898, 900 (Tex. App.–Houston [14th Dist.] 1992, no writ); *see also* Allen, 704 S.W.2d at 604 n. 1.

*Allen*, 15 Tex. 278, 284 (1855). *But see* section II.B.1., infra, for a more thorough discussion of the application of the principles of mutation and inception of title to a sole proprietorship.
under Nail’s progeny, personal goodwill of a community property sole proprietorship would also be an indivisible asset. Conversely, commercial goodwill would be a community asset subject to division where the sole proprietorship was community property. 

Husband had argued that the entirety of the goodwill associated with his sole proprietorship was personal goodwill. The Court ultimately rejected this argument by pointing out that there was no evidence of any goodwill—either personal or commercial—in the record. The lesson is that the amount of the goodwill that a spouse claims exists as part of the valuation of a sole proprietorship must be proven in order for the improper division of personal goodwill to be challenged on appeal.

4. An equitable reimbursement claim may be made for payment of improvements to separate property used by a sole proprietorship.

Zeptner held that an equitable reimbursement claim for community funds spent on improvements to the separate property real estate in which the sole proprietorship did business could properly be recognized. Wife did not adequately prove such a claim, but the Court did acknowledge its viability.

The Court also explained that “the measure of reimbursement when one marital estate expends funds or assets to improve the real property of another marital estate is the enhancement in value to the receiving estate.”

“Enhanced value” is not the actual amount of funds expended, but instead the difference in fair market value of the receiving estate attributable to the expended funds. In contract, the measure of an equitable reimbursement claim for principal payments on a loan secured by separate property used by a sole proprietorship is the amount of the payments made.

The new reimbursement statute, Family Code section 3.402, permits two different methods for calculating the amount of a reimbursement award: either enhancement in value, or dollar-for-dollar repayment. Each method applies in different circumstances. The measure of reimbursement for capital improvements paid directly by one marital estate is “the enhancement in value to the benefited marital estate.” However, the measure of reimbursement for capital improvements paid for by one marital estate by reducing the principal of a debt—secured by a lien on the improved property, and incurred to make those improvements—is the amount of the payments made on the principal of that debt.

In a situation like Zeptner with a sole proprietorship doing business on the premises of the separate property, whether the community directly paid for the improvements, or paid the debt incurred to make those improvements, is of critical importance when proving-up a reimbursement claim.

Keep in mind, the sole proprietorship is only incidental to a reimbursement claim for improvements to property used by the business. The situation in Zeptner is to be conceived of as if the sole proprietorship did not exist at all. That is because a sole proprietorship is not an entity, and owns no property to which any “improvements” may be made.

See generally Tex. Fam. Code § 3.402(a).

...probably, but not explicitly.

Tex. Fam. Code § 3.402(a)(8), (d) (emphasis added).


...a distinct concept from “enhancement in value.”

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47 See Nail, 486 S.W.2d at 764 (“It is to be understood that in resolving the question at hand we are not concerned with good will...that may exist in a professional partnership or corporation apart from the person of an individual member.”); Geesbrecht, 570 S.W.2d at 436 (“It is as applied to the foregoing that we consider [business] to possess what we treat as ‘good will’ as part of its worth and value under the circumstances of this case, and therefore an asset which would have value to some extent apart from [spouse’s] person as a professional practitioner.”).

48 See id.

49 Zeptner, 111 S.W.3d at 738.

50 When Zeptner was tried, most equitable reimbursement claims were governed by the common law. After the 2009 amendments to the Family Code, most equitable reimbursement claims are governed by section 3.402, et seq. Claims under both the common law (some of which probably still remain) and the Family Code are governed by equitable principles, although the descriptors “common law” and “statutory” might be more accurate than “equitable.”

51 Zeptner, 111 S.W.3d at 738-39.

52 Id.


54 Id. (“...It is not the actual cost.”) (citing Vickery v. Vickery, 999 S.W.2d 342, 371 (Tex. 1999) and Anderson, 684 S.W.2d at 675); see also Sharp v. Stacy, 535 S.W.2d 345, 351 (Tex. 1976).

55 See generally Tex. Fam. Code § 3.402(a).

56 ...probably, but not explicitly.

57 Tex. Fam. Code § 3.402(a)(8), (d) (emphasis added).


59 ...a distinct concept from “enhancement in value.”
5. **An equitable reimbursement claim for inadequate compensation may be made for enhancement to a separate property sole proprietorship.**

*Zeptner* held that an equitable reimbursement claim for inadequate compensation for a spouse’s time, talent and labor expended to unreasonably benefit his separate property sole proprietorship could be properly recognized.\(^{60}\) Again, Wife did not adequately prove such a claim, but the Court did acknowledge its viability.\(^{61}\)

The new reimbursement statute, Family Code section 3.402, codifies what had been known under the common law as a “Jensen claim.”\(^{62}\) Sole proprietorships are ripe for statutory inadequate compensation claims, since one of the specific requirements under the Code is that the business that inadequately compensated the spouse was under that spouse’s control and direction.\(^{63}\)

At common law, *Jensen* claims were not limited to situations where the undercompensated spouse controlled and directed the business. Thus, *Jensen* claims were upheld where one spouse’s time, toil, talent and effort were undercompensated by a business owned, in whole or in part, as the other spouse’s separate property. By extension, a *Jensen* claim on behalf of the community against a separate property sole proprietorship could be based on the undercompensated efforts of *either* spouse, not just the efforts of the spouse who owned and operated the business.

The measure of reimbursement when a spouse’s time, toil, talent and effort expended to enhance the separate estate of a spouse are inadequately compensated is the value of the undercompensated labor, not the enhanced value of the property itself.\(^{66}\)

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60 *Zeptner*, 111 S.W.3d at 738-39.

61 Id.


63 Tex. Fam. Code § 3.402(a)(2)


66 *Rogers v. Rogers*, 754 S.W.2d 236, 240 (Tex. App.—Houston [1st Dist.] 1988, no writ). Note that Rogers addressed a common law *Jensen* claim; there is no appellate authority—neither for nor against—addressing whether the standards for old common law undercompensation claims also apply to new statutory ones.

B. **Fundamental Marital Property Rules for Sole Proprietorships – General Cases**

Several other cases have addressed issues pertaining to sole proprietorships in divorces, albeit with a much narrower scope than *Zeptner*.

1. **The profits of a sole proprietorship are (presumptively) community property, regardless of the character of the ownership interest.**

The profits earned by a separate property sole proprietorship uses as inventory goods that are also the separate property of the owner spouse. The sale of these goods comprises the entire amount of the business’ gross receipts. All net profits after expenses are paid are used to acquire new inventory, which is then sold, and the proceeds reinvested, all throughout the marriage. Shortly before divorce, the sole proprietorship, and all of its inventory, is sold.

Is the portion of the funds from the sale accounting for the value of the inventory community or separate property?

Under the inception of title rule, the business’ initial inventory was the separate property of the owner. That property was sold for cash, which was in turn used to purchase additional property later sold, and so on. The separate property inventory in this situation mutated.\(^{68}\)

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67 *Schechter v. Schechter*, 579 S.W.2d 502, 505 (Tex. Civ. App.—Dallas 1978, no writ); *Vallone v. Vallone*, 644 S.W.2d 455, 462 (Tex. 1982) (Sondock, J., dissenting) (“The increase from a spouse’s operation of a business always has been considered community property, even when the business itself was owned by one spouse prior to the marriage and thus was the separate property of that spouse.”); *Zisblatt v. Zisblatt*, 693 S.W.2d 944 (Tex. App.—Fort Worth 1985, writ dism’d); *Epperson v. Jones*, 65 Tex. 425, 428 (1886) (Supreme Court held that profits from operation of business are “community property, and cannot, therefore, be said to increase...[spouse’s] separate estate to the extent of a single dollar.”).

68 *Yaklin v. Glusing, Sharpe & Krueger*, 875 S.W.2d 380, 385 (Tex. App.—Corpus Christi 1994, no writ) (Husband “could have attempted to trace his ownership of the business back to before his marriage. Had he been successful, only the profit from the notes receivable would have been presumptively community in character. Rather than attempt that burden, the judgment proof reflects that [Husband] stipulated (through
from its original form into another identifiable form, under a set of conditions that would likely make tracing relatively simple. In this situation, the profits of the sole proprietorship would be separate property. In other words, the profits of the sole proprietorship would not be “income” at all.

2. An equitable reimbursement claim may be made for commingled separate and community profits earned from the operation of a sole proprietorship.

In Hartman v. Hartman—a situation similar to the hypothetical presented supra—Husband expended separate property funds to operate his sole proprietorship, and reinvested the profits from the business. The funds used by the sole proprietorship were commingled with community funds in the same account. The court held that Husband was entitled to seek reimbursement for those funds despite the fact that they were commingled.

3. Inception of title of a sole proprietorship does not “carry forward” through its reformation as a business entity.

In Allen v. Allen, Wife incorporated her separate property sole proprietorship during marriage. The trial court found that the ownership interest in the resulting corporation was community property, and the appellate court affirmed, holding that, under the inception of title doctrine, title to the corporation was created at the time of incorporation. Because a corporation does not exist until the certificate of incorporation is issued, Wife’s corporation was not merely a transformation of an ongoing entity from one form to another.

Wife also argued that even if the sole proprietorship was no recapitalized as a corporation, the contribution of the sole proprietorship’s goodwill rendered Wife’s interest in the corporation separate property. The Court of Appeals rejected this argument as well, but only because Wife failed to provide any evidence as to the value of the goodwill she claimed was used to capitalize the corporation. Inferentially, had Wife presented evidence of the value of that goodwill contributed and its character as either personal goodwill or separate commercial goodwill, the corporation would have been separate property.

4. A sole proprietorship can have a fair market value.

The ownership interest in a sole proprietorship can have a fair market value:

The fair market value of any interest of a decedent in a business, whether a partnership or a proprietorship, is the net amount which a willing purchaser, whether an individual or a corporation, would pay for the interest to a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.

C. Goodwill for Sole Proprietorships in Divorce Cases

There are 7 important cases that track the development of the concept of goodwill and sole proprietorships in a divorce:

Nail • Geesbreght • Finn • Hirsch • Finch • Smith • Holland

1. Personal Goodwill in a Divorce – Nail

The Texas Supreme Court introduced the concept of goodwill having a value for the purposes of divorce in

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70 Id.
71 Id. (citing Farrow v. Farrow, 238 S.W.2d 255 (Tex. Civ. App.–Austin 1951, no writ) (Husband had thoroughly documented receipts and expenditures connected with buying and selling real estate and livestock, and the separate funds of both spouses which had been commingled in accounts with the receipts did not lose its separate character); see also Schmidt v. Huppmann, 73 Tex. 112, 11 S.W. 175 (1889).
72 704 S.W.2d 600 (Tex. App.–Fort Worth 1986, no writ).
73 Id. at 604.
74 Id.
75 Id.
76 The Court of Appeals concluded that the goodwill that comprised the alleged contribution was not personal goodwill. Id. at 605 n. 2. Because the sole proprietorship was separate property, the contribution of its commercial goodwill would have (potentially) created a separate property corporation.
77 Id. at 604-05
78 Id. at 605.
79 Treas. Reg. § 20.2031-3 (emphasis added); see also Treas. Reg. § 25.2512-3
Nail v. Nail. Husband operated a community property medical practice;\textsuperscript{80} upon divorce, the trial court identified virtually the entire value of the business as goodwill, and divided a portion of that goodwill to Wife.\textsuperscript{81} The Court analyzed the principle of goodwill as articulated in the treatises and authorities of other jurisdictions, and concluded that this goodwill did not “constitute an asset separate and apart from [Husband’s] person, or from his individual ability to practice his profession.”\textsuperscript{82}

The critical factor for the Supreme Court was that the goodwill was not an “earned or vested property right at the time of divorce,” but rather just an expectancy, and therefore could not possibly have been property subject to division.\textsuperscript{83}

It is important to note that Nail did not conduct a thorough analysis of why the goodwill value found by the trial court was entirely personal goodwill, and lacked any component of commercial goodwill. In fact, the Court explicitly recognized this limitation in the scope of its opinion:

> It is to be understood that in resolving the question at hand we are not concerned with good will as an asset incident to the sale of a professional practice, or that may exist in a professional partnership or corporation apart from the person of an individual member, or that may be an element of damage by reason of tortious conduct.\textsuperscript{84}

2. Commercial Goodwill in a Divorce – Geesbreght

The Fort Worth Court of Appeals addressed that deficiency in Nail five years later:

> Here we have that very question with which the supreme court stated itself not to be concerned, i.e., good will in [Husband’s medical practice] upon which there was the necessity to find what portion, if any, apart from [Husband’s] person as an individual employee member, existed in that the corporation occasioning enhancement in the value of its corporate stock.\textsuperscript{85}

The feature in Geesbreght that distinguished it from Nail is that Husband did not operate an individual medical practice,\textsuperscript{86} but rather a large-scale provider of specialized medical services.\textsuperscript{87} The court noted:

> [Husband] is a physician. Had his practice been that of an individual,\textsuperscript{88} then, in the event of divorce, the “good will” existent and which might have a value upon a sale of his practice or interest therein to another member of the same profession (with whom he might agree not to compete) would not be properly considered as part of the property to be taken into consideration in the property division to be made as part of the parties' estate because there was a divorce.\textsuperscript{89}

Two facts in particular led the court to conclude that Husband’s professional corporation contained commercial goodwill: the large number of employees other than Husband who performed services,\textsuperscript{90} and the trade name of the business.\textsuperscript{91}

\textsuperscript{80} Nail, 486 S.W.2d at 762-63.

\textsuperscript{81} Id. at 764.

\textsuperscript{82} Id. (citing Busby v. Busby, 457 S.W.2d 551 (Tex. 1970)); see generally Von Hohn, 260 S.W.3d 631.

\textsuperscript{83} Id. (emphasis added).

\textsuperscript{84} Geesbreght, 570 S.W.2d at 434.

\textsuperscript{85} Unlike Nail, the practice in Geesbreght was a professional corporation. Id. at 433.

\textsuperscript{86} See id. at 434-35.

\textsuperscript{87} ...as in Nail, for example.

\textsuperscript{88} Id. at 433 (citing Nail, 486 S.W.2d 461) (emphasis added). This articulation reflects the principle that an individual practice, that is, a sole proprietorship, would not have any divisible commercial goodwill, only personal goodwill.

\textsuperscript{89} Id. at 435 (“Little, if any, of the hospital emergency room services at locations other than Harris was ever personally performed by [Husband]....[O]ver the entire field of operations by Emergency Medicine there are about ten full-time, and 50 to 100 part-time physicians with whom Emergency Medicine has employment contracts to fulfill its obligations to furnish emergency services at the hospitals with which it has contracted.”).

\textsuperscript{90} Id. at 435-36 (“If ‘The Doe Company’ builds up a reputation for service there may be a change in personnel performing the service upon a sale of its business but the sale of such business naturally involves the right to continue in business as ‘The Doe Company’. The ‘good will’ built up by the company would continue for a time and would last while the new management, performing the same personal services, would at least have the opportunity to justify confidence in such management while it attempted to retain the ‘good will’ of customer clients of the former operators.)
Thus, the court concluded it was error for the trial court to fail to consider the value of the divisible community property commercial goodwill in the ownership interest of the professional corporation.\textsuperscript{92}

3. The Test for Divisible Commercial Goodwill – \textit{Finn} and \textit{Hirsch}

\textit{Finn v. Finn}\textsuperscript{93} and \textit{Hirsch v. Hirsch}\textsuperscript{94} extended the \textit{Nail} and \textit{Geesbrecht} holdings, and articulated a two-prong test for dividing commercial goodwill in a divorce:

\begin{quote}
\text{[G]oodwill is not to be included or considered when placing a value on a professional corporation unless it can be determined first, that the goodwill exists independently of the personal ability of the professional person, and second, that if such goodwill does exist, it has a commercial value in which the community estate is entitled to share.}\textsuperscript{95}
\end{quote}

The \textit{Hirsch} court also added “where the entity is a one person professional corporation conducting business in that person’s name, it would be difficult to get past the first prong of the test.”\textsuperscript{96} By extension, because a “one person professional corporation” is very similar to a sole proprietorship with regards to the features of personal goodwill,\textsuperscript{97} the first criterion would be difficult to fulfill for a sole proprietorship as well.

\textit{However,} “difficult” is different from “impossible,” and it is the latter that \textit{Geesbrecht} concluded applied to “the practice of an individual.”\textsuperscript{98} Thus, for the first time, the inference arose that some component of a sole proprietorship might potentially have divisible commercial goodwill.


\textit{Finch v. Finch}\textsuperscript{99} was the first Texas case where a sole proprietorship was held to have commercial goodwill separate and apart from the person of the sole proprietor. In \textit{Finch}, Husband argued that the trial court\textsuperscript{100} had erroneously included personal goodwill in the valuation of his sole proprietorship.\textsuperscript{101} The Court of Appeals was not able to determine whether Judge Montgomery had actually considered any goodwill in his valuation, but assumed, \textit{arguendo}, that the trial court had included goodwill. The court cited \textit{Nail}\textsuperscript{102} and analyzed the features of this particular sole proprietorship to see whether it had any \textit{commercial} goodwill that would have been properly divisible:

[Husband] employed some men to work on cars at his shop. [Husband] did not perform all of the work on the vehicles brought to his shop. Had [Husband] retired, died, or been disabled, the good will would not have been extinguished because persons other than [Husband] performed some of the work at the shop and fostered the good will toward the customers. The \textit{good will of the business did not attach to the person of [Husband] because others performed some of the work on the vehicles. The good will attached to the alternator and starter business and was divisible upon divorce.}\textsuperscript{103}

\textsuperscript{92} \textit{Id.} at 436.

\textsuperscript{93} 658 S.W.2d 735 (Tex. App.–Dallas 1983, writ ref’d n.r.e.).

\textsuperscript{94} 770 S.W.2d 924 (Tex. App.–El Paso 1989, no writ).

\textsuperscript{95} \textit{Hirsch}, 770 S.W.2d at 927 (citing \textit{Finn}, 658 S.W.2d at 741).

\textsuperscript{96} \textit{Id.}

\textsuperscript{97} The professional’s “skills, knowledge, efforts, training, or reputation in making a business successful” inhere in the same way to both a sole proprietorship and a single-member professional corporation.

\textsuperscript{98} \textit{Geesbrecht}, 570 S.W.2d at 433; see also note 89, supra.

\textsuperscript{99} 825 S.W.2d 218 (Tex. App.–Houston [1st Dist.] 1992, no writ).

\textsuperscript{100} Hon. John Montgomery of the 309th District Court, Harris County, Texas.

\textsuperscript{101} The \textit{Finch} opinion does not explicitly state that Husband’s business was a sole proprietorship. However, multiple secondary sources define it as such. See Tex. Prac. Guide Family Law § 8.401, Goodwill and covenants not to compete—Sole proprietorships—Case law; 33 Tex. Prac., Handbook Of Texas Family Law § 10:8 (2011-12 ed.), Dividing specific assets—Goodwill: personal v. business

\textsuperscript{102} “Professional good will is not divisible upon divorce. Professional good will attaches to the person of the professional as a result of confidence in the person's skill and ability. Professional good will is extinguished at the death, retirement, or disablement of the professional.” \textit{Id.} at 224 (citing \textit{Nail}, 486 S.W.2d at 763).

\textsuperscript{103} \textit{Id.} at 224-25 (emphasis added).
The structure of this holding is important. Each of the first four sentences emphasizes that much of the actual work performed and services rendered by the sole proprietorship were done by the employees, not the owner Husband. As in Geesbreght, the goodwill of the business did not attach to the owner because others performed some of the work of the business.\(^{104}\)

The court also stated (in the third sentence) that the work done by others was what fostered the goodwill of the business, and specifically distinguished this form of commercial goodwill from the classic definition of personal goodwill.\(^{105}\)

The holding in Finch not only established that a sole proprietorship could have goodwill separate and apart from the sole proprietor, it also identified one of the components that would constitute that commercial goodwill: the expectancy of continued patronage created by the business’ work force.

The very same panel\(^ {106}\) from the same Court of Appeals addressed a similar issue barely four months later in Smith v. Smith.\(^ {107}\) In Smith, the trial court issued a specific finding of fact that it did not consider goodwill in valuing Husband’s sole proprietorship.\(^ {108}\) The appellate court was skeptical,\(^ {109}\) however, because the only evidence in the record to support a value in the range the trial court found was adduced from Wife’s expert witness, who valued Husband’s “personal future earning capacity, [not] the value of the business.”\(^ {110}\)

104 See Geesbreght, 570 S.W.2d at 435; see also note 90, supra.

105 That is, what would be extinguished if the owner had retired, died, or been disabled. See Nail, 486 S.W.2d at 764; Keith, 863 S.W.2d at 952, and note 32, supra.

106 Justices Duggan, O’Connor and Dunn. Justice Dunn wrote Finch, and Justice O’Connor wrote Smith. Justice Dunn wrote a concurring and dissenting opinion in Smith in which she dissented on the points of error in which the majority mentioned the issue of goodwill, but her dissent did not address that issue.


108 Id. at 689-90.

109 Id. at 690 n. 1.

110 Id. at 692. Justice Dunn explained that the method of valuation employed by Wife’s expert did not violate the principle that “a spouse is not entitled to a percentage of his or her spouse’s future income.” Id. at 695 (Dunn, J., dissenting). Rather, the “discounted future earnings method is the forecast of the future earnings of the business that would be available to a hypothetical purchaser (in this case the husband), and then an appropriate discount rate will be applied to arrive at a business’ present value.” Id. (emphasis added).

Again citing Nail,\(^ {111}\) the court wrote that the sole proprietorship’s value “depended entirely on whether the husband could continue working, and was not an asset separate and apart from his person.”\(^ {112}\) This approach is conceptually analogous to a business valuation impermissibly containing post-divorce non-marital property.\(^ {113}\)

The way to reconcile Finch and Smith is to recognize that panel’s interpretation of Nail: if the value of a spouse’s sole proprietorship contains goodwill attributable to his own efforts and labor in the future, then the goodwill is personal and indivisible. But, if the value of that business contains goodwill attributable to the efforts and labor of others in the past, then the goodwill is commercial and (potentially) divisible.

Note that the distinction between whether the labor associated with the goodwill had been performed in the past or would be performed in the future is illusory; when a buyer pays more than book value for a business, the goodwill they are purchasing is the “expectancy of continued patronage, for whatever reason.”\(^ {114}\) A hypothetical buyer paying for goodwill axiomatically assumes that some of the conditions which have sustained that goodwill will remain after the change in ownership, and the “continued patronage” is due to the continued efforts of the business’ employees.

Also note that the “expectancy” principle that guided the Supreme Court in Nail was used to conclude that the property right in goodwill for future labor was not yet vested, and therefore not subject to division.\(^ {115}\) But goodwill as an intangible asset is always itself an expectancy that has yet to vest. Nail’s holding should either be used as authority for rendering all goodwill—both personal and commercial—indivisible, or it should be entirely discarded as antithetical to the fundamental essence of goodwill.\(^ {116}\)

\(^{111}\) Id. at 690 (citing Nail, 486 S.W.2d at 764 (The accrued goodwill “did not possess value or constitute an asset separate and apart from [Husband’s] person, or from his individual ability to practice his profession. It would be extinguished in event of his death, or retirement, or disablement, as well as in the event of the sale of his practice or loss of his patients, whatever the cause.”)).

\(^{112}\) Id.

\(^{113}\) Id. at 692 (“A spouse is not entitled to a percentage of his or her spouse's future income. A spouse is only entitled to a division of property that the community owns at the time of the divorce.” (citing McBride v. McBride, 256 S.W.2d 250, 255 (Tex. App.–Houston 1953, no writ)); see note 83, supra.

\(^{114}\) Boe, 307 F.2d at 343 (emphasis added).

\(^{115}\) Nail, 486 S.W.2d at 764, and note 83, supra.

\(^{116}\) “[M]odification of Nail is a task for the Supreme Court of Texas.” Guzman v. Guzman, 827 S.W.2d 445, 448 n. 3 (Tex. App.–Corpus Christi 1992, writ denied).
A year after Smith, the crosstown Court of Appeals decided in Holland v. Holland\(^{117}\) that there was no evidence that Husband’s sole proprietorship possessed any goodwill attributable to the company apart from Husband.\(^{118}\) As in Smith, Wife’s expert based his valuation (which, unlike Smith, did include goodwill) on the “earning capacity” of the sole proprietorship.\(^{119}\) The court specifically found that the sole proprietorship “did not possess goodwill value that is separate and apart from [Husband]’s person and would be extinguished if he died, retired, or became disabled.”\(^{120}\) Implicit in this holding, however, is the possibility that there could have been some evidence in some situation of divisible commercial goodwill associated with a sole proprietorship.

D. Identities, Rules and Corollaries

Several governing identities, rules and corollaries can be derived from this case law.

**IDENTITY 1**

A sole proprietorship is not an independent entity, like a corporation or partnership.

Therefore, the sole proprietorship owns no property, holds no assets, offers no liability protection, and so on.

**IDENTITY 2**

There are four types of property rights related to a sole proprietorship:

1. the ownership interest in the business;
2. the tangible assets used by the business (such as inventory and equipment);
3. the intangible assets used by the business (such as contract and intellectual property rights, and personal goodwill); and
4. the intangible asset of commercial goodwill associated with the business.

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\(^{118}\) Id. at *2.

\(^{119}\) Id. (emphasis removed).

\(^{120}\) Id.

**FIRST COROLLARY TO IDENTITY 2**

The character of the first and last types of property rights (“the extremes”) is independent from the character of the second and third (“the means”).

That is, a sole proprietorship can be separate property, and use tangible and intangible assets that are community property. Conversely, a community property sole proprietorship can use separate property tangible and intangible assets.

**RULE 1**

The character of the ownership interest in a sole proprietorship is determined by the inception of “title” to the business.

That is, if the sole proprietorship is started before marriage, the ownership interest will be separate property. Likewise, if that ownership interest is acquired from someone else before marriage, or during marriage by gift, devise or descent, it will be separate property.

Because “title” can be transferred from one proprietor to another, but is not created by the contribution of any fungible resource (i.e. it is not capitalized), acquisition of an ownership interest through mutation has a unique application.

**COROLLARY TO RULE 1**

A separate property ownership interest is acquired by mutation only when the ownership interest is acquired from another in exchange for the spouse’s separate property.

This corollary is true because the creation of a sole proprietorship is not dependent on the contribution of any assets at the time of formation. Stated another way:

A sole proprietorship created by a spouse during marriage can never be separate property under the default rule.

Thus, separate property cannot itself mutate into a separate property sole proprietorship (as it could mutate into a separate property interest in a corporation by being used to capitalize that entity). Separate property can only mutate into a separate property sole proprietorship by being exchanged for an interest in a business that was created by someone else.
RULE 2

The character of the tangible assets used by the sole proprietorship is determined by the regular application of the inception of title doctrine.

Thus, the inventory and equipment used by the sole proprietorship that were acquired before marriage will be separate property, or if acquired after marriage will be community property.

The tangible assets used by the sole proprietorship that are acquired by gift, devise, or descent, in exchange for personal injury damages, or in exchange for other separate property, will be separate property.

Tangible assets used by the sole proprietorship that are owned by a third party (whether a person or an entity) are not marital property.

Each tangible asset is characterized separately from every other tangible asset.

RULE 3

The character of the intangible assets used by the sole proprietorship is determined by the regular application of the inception of title doctrine.

Thus, the contract and intellectual property rights used by the sole proprietorship that were acquired before marriage will be separate property, or if acquired after marriage will be community property.\(^\text{121}\)

The intangible assets used by the sole proprietorship that are acquired by gift, devise, or descent, in exchange for personal injury damages, or in exchange for other separate property, will be separate property.\(^\text{121}\)

Intangible assets used by the sole proprietorship that are owned by a third party (whether a person or an entity) are not marital property.

Each intangible asset is characterized separately from every other intangible asset.

\(^{121}\) With regards to intellectual property, see *Alsenz v. Alsenz*, 101 S.W.3d 648 (Tex. App.—Houston [1st Dist.] 2003, pet. denied) (“It is unquestionable that, had these patents been taken out during the marriage, the patents and the income they generated would be community property.” (emphasis added)).

IDENTITY 3

Personal goodwill is never a divisible asset in a divorce.

Thus:

COROLLARY TO RULE 3

The personal goodwill of the sole proprietor used by the sole proprietorship is never a divisible asset in a divorce.

In most circumstances, the goodwill associated with a sole proprietorship is entirely personal goodwill. There are some exceptions, however (see Rule 4).

SECOND COROLLARY TO IDENTITY 2

The character of the second and third types of property rights (“the means”) are independent of each other, and independent internally.

RULE 4

The character of the intangible asset of commercial goodwill is determined by the inception of “title” to the business.

The commercial goodwill of a sole proprietorship attaches to the business, and is divisible upon divorce if the ownership interest in the business is also divisible upon divorce.

THIRD COROLLARY TO IDENTITY 2

The character of the first type of property right will determine the character of the fourth type of property right.

RULE 5

The value of a sole proprietorship is its fair market value.

The fair market value of a business is the sum of its assets, both tangible and intangible, minus its liabilities.
Corollary to Rule 5

The fair market value of a sole proprietorship is the value of its commercial goodwill.

A sole proprietorship owns no tangible assets. It owns no intangible assets, and the only asset that attaches directly to it is residual commercial goodwill.

Examples of such commercial goodwill are the workforce and the name of the business.

Rule 6

Both common law and statutory reimbursement claims are available for funds expended by a marital estate pertaining to the separate property ownership interest in the sole proprietorship.

Funds from the community estate could be used to enhance the value (that is, generate commercial goodwill) of the separate property sole proprietorship; a classic example would be advertising. This situation would be governed by common law reimbursement.122

Community funds could also be used to pay the principle on a debt secured using separate credit to purchase the ownership interest in the sole proprietorship. This situation would be governed by statutory reimbursement.

Both situations are community estate claims against the sole proprietor spouse’s separate estate for community property expended in a manner pertaining to the ownership interest in the sole proprietorship.

Corollary to Rule 6

The measure of the reimbursement claim is either the actual amount expended or the enhancement of value, depending on the object of the contributing estate’s contribution.

If the contributing estate contributes something reimbursable under the statute, the measure is the amount expended; if something reimbursable under the common law, the enhancement in value.

Rule 7

The character of the profits of a sole proprietorship is determined by the character of the source of those profits.

The profits of a sole proprietorship are (presumptively) community property. But the profits can be separate property, insofar as they represent the return on the sale of separate property tangible or intangible assets (such as the sale of separate property inventory or contract rights).

In this way, “profits” are always the property of the sole proprietor spouse—not the sole proprietorship—and character is determined using the same rules applicable to that spouse’s separate property.

Corollary to Identity 1

Property used by a sole proprietorship is never the property of the sole proprietorship itself.

Such property is either the spouse’s community, one spouse’s separate, or the non-marital property of a third party or independent business entity.

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122 The term “pertaining to” has been chosen in lieu of “to enhance the value of” and “for the benefit of,” for reasons apparent from the application of this Rule.

123 Extending the Guzman court’s sense of “fairness,” this type of expenditure should create community commercial goodwill, which would nullify the Third Corollary to Identity 2, supra. See Guzman, 827 S.W.2d 448 n. 3 (“We question the fairness of the result in Nail...The argument that goodwill does not exist independently from the professional, in our opinion, is not a compelling reason for the rule in Nail. Goodwill which accrues during marriage can be ascertained, and therefore divided by the trial court.”).
E. Structural Chart of Identities, Rules and Corollaries

IDENTITY 1 A sole proprietorship is not an independent entity, like a corporation or partnership.

COROLLARY Property used by a sole proprietorship is never the property of the sole proprietorship itself.

There are four types of property rights related to a sole proprietorship:

(1) the ownership interest in the business;

IDENTITY 2

(2) the tangible assets used by the business (such as inventory and equipment);

(3) the intangible assets used by the business (such as contract and intellectual property rights, and personal goodwill); and

(4) the intangible asset of commercial goodwill associated with the business.

COROLLARY 1 The character of the first and last types of property rights (“the extremes”) is independent from the character of the second and third (“the means”).

COROLLARY 2 The character of the second and third types of property rights (“the means”) are independent of each other, and independent internally.

COROLLARY 3 The character of the first type of property right will determine the character of the fourth type of property right.

IDENTITY 3 Personal goodwill is never a divisible asset in a divorce.

RULE 1 The character of the ownership interest in a sole proprietorship is determined by the inception of “title” to the business.

COROLLARY A separate property ownership interest is acquired by mutation only when the ownership interest is acquired from another in exchange for the spouse’s separate property.

A sole proprietorship created by a spouse during marriage can never be separate property under the default rule.

RULE 2 The character of the tangible assets used by the sole proprietorship is determined by the regular application of the inception of title doctrine.

RULE 3 The character of the intangible assets used by the sole proprietorship is determined by the regular application of the inception of title doctrine.

COROLLARY The personal goodwill of the sole proprietor used by the sole proprietorship is never a divisible asset in a divorce.

RULE 4 The character of the intangible asset of commercial goodwill is determined by the inception of “title” to the business.

RULE 5 The value of a sole proprietorship is its fair market value.

COROLLARY The fair market value of a sole proprietorship is the value of its commercial goodwill.

RULE 6 Both common law and statutory reimbursement claims are available for funds expended by a marital estate pertaining to the separate property ownership interest in the sole proprietorship.

COROLLARY The measure of the reimbursement claim is either the actual amount expended or the enhancement of value, depending on the object of the contributing estate’s contribution.

RULE 7 The character of the profits of a sole proprietorship is determined by the character of the source of those profits.
F. Exercise

Wife’s unmarried Sister owns and operates a clothing boutique as a sole proprietorship. Upon her death, Sister bequeaths the ownership interest in the boutique to her adult son, and the remainder of all of her property to Wife. Wife uses the cash from Sister’s estate to purchase the ownership interest in the boutique from her nephew for $10,000.

Wife runs the newly-acquired boutique using the inventory and equipment she inherited from Sister, and does not change the business’ name. Wife enters into new employment agreements with the employees, and new sales contracts with the suppliers.

The proceeds from the sale of the boutique’s goods are deposited in Wife’s joint bank account along with all of Husband’s wages from his job. The proceeds are then used to pay overhead for the storefront (taxes, utilities, maintenance and repairs), wages for the employees, and to acquire new inventory (clothing and shoes) and equipment (clothing racks, display cases, etc.). These expenditures deplete all of the proceeds.

Wife does much of the work maintaining the business herself, although her employees do most of the work assisting the customers on a day-to-day basis. Wife takes no salary for operating the business.

Shortly after acquiring the boutique, Wife takes out a loan, collateralized by the real property in which the store operates, where the lender agrees to seek repayment only against Wife’s separate property. Wife uses these loan proceeds to purchase advertising for the boutique. Wife and Husband use their community property from Husband’s wages to pay the principal on this note.

Upon divorce, the Trial Court finds the following:

- the fair market value of the sole proprietorship, along with all of the assets it uses, is $100,000;
- the value of the sole proprietorship’s tangible assets (storefront, inventory and equipment) is $50,000;
- the value of the sole proprietorship’s commercial goodwill is $25,000;
- the value of Wife’s personal goodwill is $15,000;
- the value of Wife’s uncompensated time, toil, talent and effort is $50,000; and
- the principal on the note paid by the community was reduced in amount by $20,000, and the enhancement in value to the boutique due to advertising is $10,000.

Characterize and value all property rights. Identify and value any reimbursement claims.

Sample Answer

Character of the Property Rights

The ownership interest in the sole proprietorship is Wife’s separate property; although it was acquired during marriage, it was purchased using (inherited) separate property funds. The initial value of that ownership interest—i.e. the commercial goodwill associated with it—was $10,000 at the time of acquisition.

The tangible assets used by the sole proprietorship are separate property, assuming they can be traced. The initial tangible assets were Wife’s (inherited) separate property, and all tangible assets used by the sole proprietorship upon divorce were acquired from the proceeds from the sale of separate property. The fact that these proceeds were commingled with community property in the spouses’ joint bank account does not alter their character.

The intangible assets used by the business are partially community and partially non-community. The contract rights with the employees and suppliers are community property because they were acquired by Wife during marriage. Wife’s personal goodwill is not community property subject to division.

The commercial goodwill of the sole proprietorship is Wife’s separate property, because the ownership interest in the sole proprietorship is her separate property. The remaining unallocated portion of commercial goodwill ($25,000 – $10,000 initial amount – $10,000 community enhancement) is separate property.

Value of the Property Rights

The fair market value of the sole proprietorship and all of the assets it uses ($100,000) is comprised of the separate property tangible assets ($50,000), the community property contract rights (unknown), Wife’s personal goodwill ($15,000), and the sole proprietorship’s commercial goodwill ($25,000). That is:

\[
100,000 = 50,000 + x + 15,000 + 25,000
\]

The value of the community property contract rights is therefore $10,000.

Character & Value of the Reimbursement Claims

The community estate has a Jensen claim for $50,000 in uncompensated time, toil, talent and effort. This claim is against Wife’s separate estate, because the sole proprietorship was benefitted, and is her separate property.

The community estate has an election of remedies between statutory and common law reimbursement for the advertising (assuming such enhancement was a capital improvement). Under the former, the value is the reduction in principal ($20,000), and under the latter, the value of the enhancement ($10,000).