VALUATION -

THE IMPACT OF BUY SELL AGREEMENTS

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I. INTRODUCTION

A buy-sell agreement is an agreement between the owners of a business which establishes rules and restrictions applicable to changes in ownership, and specifically which details what is to occur upon certain triggering events. Such triggering events may include any circumstance which might cause a partner or shareholder to dispose of an ownership interest. These events include a partner or shareholder's retirement, disability, bankruptcy, insolvency, death or divorce. Generally, buy-sell agreements provide that, on the occurrence of a triggering event, a partner or shareholder's interest in the business must be sold at a specified price to the other owner(s) or to the business entity itself. Such agreements are designed to protect the business from unwanted persons becoming owners or acquiring an interest in the business. The specified purchase price at which the interest will be sold is generally set forth in the agreement itself. Common methods for determining the purchase price include (1) establishing a fixed price in the agreement, (2) requiring an appraisal of the business, (3) specifying a formula for determining the value such as a percentage of book value or net asset value, or (4) indexing the purchase price to a multiple of the business' earnings.

Some buy-sell agreements require, as a condition of the owner spouse's right to hold an interest in or participate in the business, that spouses of partners or shareholders to execute spousal consents, acknowledging that their community interest in the business is subject to the terms of the buy-sell agreement. Although the spouse may not be involved in the drafting or negotiating of the buy-sell agreement or the formula for determining the purchase price, he or she may nevertheless be bound by terms of the agreement. Thus, it is important that spouses who sign buy-sell agreements understand the meaning and effect of the terms of the agreement before they sign. For example, the spouse should have independent counsel and should be involved in negotiating the method of determining the purchase price. *See* Wendy L. Hunkele Martinez, Buy/Sell Agreements From a Spouse's Perspective, 55 Tex.B.J. 932 (1992). Further, the spouse should be provided with full disclosure of the entity's current business operations and financial positions. *Id.*

II. Finn and Von Hohn

Previously, it had been held by the Dallas Court of Appeals that in valuing a spouse's interest in a partnership it was not proper to consider the business' accrued goodwill or future earning capacity when placing a value on the community interest as the buy sell provisions in the partnership agreement did not provide any compensation for goodwill. *Finn v. Finn*, 658 S.W.2d 735, 742 (Tex. App.—Dallas 1983, writ ref'd n.r.e.). However, a recent opinion from the Tyler Court of Appeals in a case styled *Von Hohn v. Von Hohn and in the Interest of H.B.V.H. and A.S.V.H, Minor Children*, may indicate a change in the way that professional partnership interests are valued upon divorce. 260 S.W. 3d 631 (Tex. App.--Tyler 2008, no writ). The *Von Hohn* opinion has a significantly different holding and thus there is conflict among the appellate courts in Texas as to the proper method for considering buy sell provisions in valuing partnership interests on divorce when the partnership agreement is silent as to valuation of the entity on divorce.

In *Von Hohn*, the husband, Edward Von Hohn, was a partner in a law firm. *Id*. at 634. The partnership agreement allotted each partner units of participation, assigned each partner an undivided profits account and capital account, and included a formula for calculating a partner's interest in the partnership on the date of death, or as of his effective date of retirement, withdrawal or expulsion from the firm. *Id*. However, as in *Finn* the partnership agreement provided no method for valuing the partnership interest in the event of a divorce. *Id.*

The trial court found that in determining the value of the community interest in the firm for purposes of divorce the Court could consider other methods of valuation than those set out in the partnership agreement. *Id*. at 639. In fact, in the trial court's charge to the jury, the court stated that, "although the jury could not consider personal goodwill or time and labor to be expended after divorce, the jury could consider the commercial goodwill, if any of the firm, the partnership agreement, and the amendments to the partnership agreement." *Id*. After a jury trial, the jury determined that the value of Mr. Von Hohn's interest in the law firm was $4.5 million, subject to taxes. *Id*. at 634.

Mr. Von Hohn appealed and asserted that the value of his interest in the law firm was determined by the partnership agreement and that the community

estate was not entitled to a greater interest than that to which he was entitled in the firm's commercial goodwill. *Id*. at 639. First, the *Von Hohn* Court briefly reviewed the law on professional goodwill. Professional goodwill is that goodwill that attaches to the person of the professional based on that person's skill, ability and reputation and would be extinguished in that person's death, retirement, or disability. *Id*. at 638 (*citing Keith*). It is well established that professional goodwill is not property of the estate and is not a divisible asset upon divorce. *Id*. However, to the extent that goodwill exists in the professional practice separate and apart from the professional's personal ability and reputation, that goodwill has a commercial value and is a community asset subject to division on divorce. *Id*. (*citing Finn*). The test to determine whether goodwill attaches to the professional practice and is therefore subject to division upon divorce is two pronged. First, the goodwill must be found to exist independently of the personal ability of the professional spouse. *Id. (citing Finn*). And next, if such goodwill exists, it must be determined whether that goodwill has a commercial value in which the community estate is entitled to share. *Id. (citing Finn).*

Next, in reviewing the ruling of the trial court, the *Von Hohn* Court examined the opinions, whether majority, concurring or dissenting, in *Keith v. Keith*, *Finn v. Finn*, and *R.V.K. v. L.L.K.* which all examine not only the issue of the divisibility of personal and professional goodwill as an asset in a divorce, but also the limitations a buy sell agreement may place on including a value for the goodwill in an entity on divorce. *Keith v. Keith*, 763 S.W. 2d 950, 952 (Tex. App.—Fort Worth 1989, no writ); *Finn v. Finn*, 658 S.W.2d 735 (Tex. App.—Dallas 1983, writ ref'd n.r.e.); and *R.V.K. v. L.L.K.*, 103 S.W.3d 612 (Tex. App.—San Antonio 2003, no pet.).

Von Hohn noted that the majority in *Finn* held that the husband, who was a senior partner in a law firm, and whose partnership agreement did not address valuation upon divorce, could only realize accrued goodwill through continued practice with the law firm. *Finn*, at 742. Therefore, the *Finn* Court found that this realization of goodwill was only an expectancy that was dependent on the husband's continued partnership in the firm and as such his interest in the firm's goodwill was not actually an asset of the community estate. *Id.*

Next the *Von Hohn* Court examined the concurring opinion in *Finn*. Justice Stewart in her concurrence, stated that the partnership agreement did not control the value of each individual partner's interests on divorce and that the asset being divided was the partner's interest in the partnership as a going business, not his contractual death benefits or withdrawal rights. *Id*. at 639. While the formula in the partnership agreement may represent the present value of the husband's interest, it should not preclude the consideration of other factors. *Id.* Therefore, the value of the partner's interest should be based on the present value of the partnership entity as a going business, which would include consideration of partnership goodwill. *Id.*

The *Von Hohn* opinion further noted that in *Keith v. Keith*, the Fort Worth Court of Appeals has adopted the reasoning of the concurring opinion in *Finn*. The partnership agreement at issue in the *Keith* case also contained no buy sell agreement specifically applicable to divorce. The Court in *Keith* concluded that since the partnership was not being terminated, the provision in the partnership agreement that determined the value of the business if the partner withdrew or died was not applicable. *Id*. at 640 (*citing Keith*). The *Keith* Court further specifically held that the formula regarding death or withdrawal was not necessarily determinative of the value of the partner's interest in an ongoing partnership at the time of divorce. *Id*. (*citing Keith*).

However, the *Von Hohn* Court found the dissent in *R.V.K.* to be more persuasive and noted that the dissent in *R.V.K.* held that since the partner was neither withdrawing nor had died, none of the actual triggering events in the partnership agreement had occurred. *Id*. at 640 (*citing R.V.K.).* Therefore, until such events occurred, the *Von Hohn* Court saw no legal reason to be limited to the formula in the agreement when determining the value of the partner's share upon divorce. *Id*. (*citing R.V.K.*). Further, the *Von Hohn* Court restated the dissent in *R.V.K.*, pointing out that the partner's interest should be based on present value of the entity as a going business, taking into consideration the limitations imposed by the shareholder agreements and commercial goodwill. *Id*. (*citing R.V.K.*).

R.V.K. was a doctor and shareholder in a medical practice group and the doctor also owned stock in other affiliated corporations which were subject to buy sell agreements. *R.V.K.*, at 615. At the time of divorce, R.V.K argued that the community value of the stock was limited by the terms of the buy sell provisions in the partnership agreement as set out in *Finn v. Finn* and L.L.K., the opposing party, asserted that commercial goodwill was divisible in reliance on *Keith v. Keith*, as no event had triggered the buy sell provisions in the partnership agreement.

Id. at 617. (The partnership agreement contained a specific buy sell provision for divorce that was only triggered if the shareholder's stock was awarded to his or her spouse and not the shareholder. *Id.* at 615.). The trial court determined that the *Keith* case applied and that the value of the stock was not limited by the buy sell agreement and used L.V.K.'s expert's opinion as the fair market value of the stock. Instead of discussing whether *Keith* or *Finn* applied, the appellate Court in *R.V.K.* determined that the real issue was whether the trial court erred in concluding that the buy sell agreements did not limit the value of the stock for valuation in divorce. *Id*. at 617. The Fourth Court of Appeals held that the buy sell agreement did limit the market value of the stock and that L.L.K.'s value did not represent fair market value at the time of the divorce. *Id*. at 617. As such, the majority in *R.V.K*. never reached a determination as to whether *Keith* or *Finn* should apply in valuing the partnership interest if none of the triggering events had occurred in the partnership agreement as the ultimate issue in *R.V.K.* came down to the marketability discounts in the valuation of stock in the partnership. *Id*. at 619.

After reviewing and considering all of these opinions, the *Von Hohn* Court determined that the formula in the partnership agreement was not applicable since it did not address the event of divorce and as Mr. Von Hohn had neither died nor withdrawn from the partnership. *Von Hohn*, at 640. Therefore, the valuation formula in the partnership agreement was not determinative of the value of Mr. Von Hohn's interest in the firm, and the trial court had properly allowed other methods of valuation. *Id*.

III. Effect of Spousal Consents

In each of the cases discussed above, the partnership agreements' buy-sell provisions did not provide for valuation in the event of a partner's divorce. No reported case to date in Texas has involved an agreement containing provisions purporting to bind the spouse and the Court to a valuation formula in the event of divorce. If a buy-sell agreement contains provisions governing what happens in the event of a partner or shareholder's divorce, most will require the consent of the partner/shareholder's spouse, and require the spouse to execute either the agreement itself or execute a separate document confirming that the provisions of the buy-sell agreement are binding on the spouse. Such spousal consents serve, among other things, to protect the entity from a partner or shareholder's spouse who seeks to acquire a community property interest in the business in the event of a divorce. The question then becomes whether these buy-sell agreements, if signed by the spouse, are binding on the spouse and the divorce court and in effect constitute a valid and enforceable marital property agreement under Texas law.

Although Section 4.102 of the Texas Family Code refers to only to "partition or exchange" agreements and provides only that spouses may partition or exchange property between themselves, the scope of marital property agreements is actually much broader. Marital property agreements may also include contractual provisions similar to those in pre-marital agreements. *See* Cameron, Hoffman & Ytterberg, Marital and Premarital Agreements, 39 Baylor L.Rev. 1095, 1124 (1987). Section 4.003 of the Texas Family Code sets forth the permissible contents of pre-marital agreements. Section 4.003 states, in pertinent part:

> (a) The parties to a premarital agreement may contract with respect to:
>
> (1) the rights and obligations of each of the parties in any of the property of either or both of them whenever and wherever acquired or located;
> (2) the right to buy, sell, use, transfer, exchange, abandon, lease, consume, expend, assign, create a security interest in, mortgage, encumber, dispose of, or otherwise manage and control property;
> (3) the disposition of property on separation, marital dissolution, death, or the occurrence or nonoccurrence of any other event;
> (4) the modification or elimination of spousal support;
> (5) the making of a will, trust, or other arrangement to carry out the provisions of the agreement;
> (6) the ownership rights in and disposition of the death benefit from a life insurance policy;
> (7) the choice of law governing the construction of the agreement; and
> (8) any other matter, including their personal rights and obligations, not in violation of public policy or a statute imposing a criminal penalty.

Tex. Fam. Code § 4.003(a). Thus, the parties entering into a marital property agreement after marriage may also contract with respect to the above listed matters.

Cameron et al., Marital and Premarital Agreements, 39 Baylor L.Rev. at 1124.

The Texas Family Code sets forth the formal requirements for marital property agreements. Section 4.104 of the Texas Family Code provides that agreements between spouses "must be in writing and signed by the parties." Tex. Fam. Code § 4.104. Additionally, Texas courts have held that an agreement between spouses must contain specific language indicating the intent of the parties to effect an actual partition and exchange of property or to otherwise define the parties' rights and duties. *See Collins v. Collins*, 752 S.W.2d 636 (Tex. App.--Fort Worth 1988, writ ref'd); *McBride v. McBride*, 797 S.W.2d 689 (Tex.App.-Hous. (14 Dist.) 1990). For example, a mere listing of assets designated as the separate property of one spouse, although a writing signed by the parties, does not constitute a valid marital property agreement. *See Collins*, 752 S.W.2d at 637 (listing of property as separate property in a joint tax return was not sufficient to be a partition agreement); *see also Byres v. Byres*, 10 S.W.3d 556 (Tex. App.--Fort Worth 2000, no pet.) (agreement incident to divorce not considered a partition agreement unless specifically stated to be the same). Although there are no reported Texas cases addressing the issue of whether a buy-sell agreement which is signed by both the partner/shareholder and the partner/shareholder's spouse constitutes a marital property agreement, it would seem that these buy-sell agreements contain at least the requisite formalities of a marital property agreement, provided that the agreements contain specific language concerning the parties' intent.

Even if the requisite formalities are met, is such a buy-sell agreement enforceable as a marital property agreement under Texas law? Section 4.105 of the Texas Family Code governs the enforceability of marital property agreements. Section 4.105 places the burden on a party resisting the enforcement of a marital property agreement by creating a rebuttable presumption that the agreement is enforceable. *See Pletcher v. Goetz*, 9 S.W.3d 442 (Tex.App.-Fort Worth 1999); *Blonstein v. Blonstein*, 831 S.W.2d 468 (Tex.App.-Hous. (14 Dist.) 1992). Section 4.105 states:

(a) A partition or exchange agreement is not enforceable if the party against whom enforcement is requested proves that:

> (1) the party did not sign the agreement voluntarily; or
> (2) the agreement was unconscionable when it was signed and, before execution of the agreement, that party:
>
> > (A) was not provided a fair and reasonable disclosure of the property or financial obligations of the other party;
> > (B) did not voluntarily and expressly waive, in writing, any right to disclosure of the property or financial obligations of the other party beyond the disclosure provided; and
> > (C) did not have, or reasonably could not have had, adequate knowledge of the property or financial obligations of the other party.

(b) An issue of unconscionability of a partition or exchange agreement shall be decided by the court as a matter of law.

(c) The remedies and defenses in this section are the exclusive remedies or defenses, including common law remedies or defenses.

Thus, under Section 4.105 of the Texas Family Code, a marital property agreement is enforceable unless the party resisting enforcement proves either that (1) the agreement was not signed voluntarily, or (2) the agreement was unconscionable when signed and the party did not receive proper financial disclosure from the other party. *See* Tex. Fam. Code § 4.105(a).

The Texas Family Code provides no definition of "voluntarily." In construing Section 4.105(a), Texas courts have previously referred to commercial law governing enforcement of contracts for guidance. *See Marsh v. Marsh*, 949 S.W.2d 734, 739-40 (Tex.App.-Houston [14th Dist.] 1997, no writ) (looking to contract cases for definition of "unconscionable"). In the commercial context, voluntary has been defined as an action taken "by design, intentionally, purposefully, by choice, of one's own accord, or by the free exercise of will." *Nesmith v. Berger*, 64 S.W.3d 110, 113-16 (Tex.App.-Austin 2001); *see also Sheshunoff v. Sheshunoff*, 172 S.W.3d 686, 695-96 (Tex.App.-Austin 2005) (defining voluntary as having "knowledge regarding the meaning and effect of the agreement."). At least one state court has held that a spouse who signed a buy-sell agreement was not bound by the valuation provisions in the agreement where she "had never participated in the actual operation of the business, had no financial experience, no real concept of corporate structure or meaning of the Buy and Sell Agreements, did not understand the legal purport thereof, was unable to understand the financial

statements, had not seen the financial statements, had not seen the corporation tax returns." *Suther v. Suther*, 627 P.2d 110 (Wash.App. Div. 1 1981).

With respect to unconscionability, even though a marital property agreement may be disproportionate, unfairness is not material to the enforceability of the agreement. *Chiles v. Chiles*, 779 S.W.2d 127, 129 (Tex.App.-Houston [14 Dist.] 1989, writ denied). A factual finding that a marital agreement is unfair does not satisfy the burden of proof required to establish unconscionability. *Id*. Additionally, the language of section 4.105 makes clear that marital property agreements should be enforced even if unconscionable, unless a spouse did not receive adequate disclosure of property and financial obligations. *Sheshunoff*, 172 S.W.3d at 692. A consenting spouse to a buy-sell agreement is rarely provided with information regarding the business' operations or financial positions before signing the agreement. Full and complete financial disclosure concerning the entity would necessarily include future business projections, as well as all benefits to which the partner/shareholder spouse is entitled as a result of his or her business interest. Generally, this disclosure simply is not provided to the signing spouse. However, as discussed above, even if such disclosure is not provided, a Court could presumably still find that the buy-sell agreement is enforceable as a marital property agreement unless the court finds that the agreement is also unconscionable.

Neither the legislature nor Texas courts have defined "unconscionable" in the context of marital property agreements. *Marsh v. Marsh*, 949 S.W.2d 734, 739 (Tex. App.–Houston [14th Dist.]1997, no writ.). Instead, Texas courts have addressed the issue of unconscionability on a case-by-case basis, looking to the entire atmosphere in which the agreement was made. *Pearce v. Pearce*, 824 S.W.2d 195, 199 (Tex.App.-El Paso 1991). Thus, in determining whether a buy-sell agreement executed by both spouses is unconscionable, Texas courts would likely look at factors including but not limited to whether the signing spouse was provided with information concerning the financial state of the business, whether the signing spouse was provided with the agreement in advance of signing with ample time to review, whether the signing spouse had an opportunity to consult with an attorney regarding the meaning and effect of the agreement, the bargaining power of the signing spouse and the oppressiveness or one-sided nature of the agreement.

IV. Conclusion

The current state of Texas law concerning the binding nature of valuation provisions in buy-sell agreements at divorce is wholly unclear. If the buy-sell agreement specifically provides for valuation of the partner spouse's interest in the event of divorce and the partner's spouse signs the agreement, then perhaps the agreement, including the valuation formula contained therein, is enforceable as a marital property agreement. However, because no reported case to date in Texas has addressed an agreement containing provisions purporting to bind the spouse to a valuation formula in the event of divorce, divorce attorneys are necessarily left to attempt to reconcile the conflict in the *Finn, Keith, R.V.K.* and *Von Hohn* line of cases if the buy-sell agreement does not contain provisions addressing valuation at divorce (and perhaps in fact even if it does).