WHEN AN OFFICER DIVORCES:

HOW A COMPANY CAN BE AFFECTED BY AN OFFICER'S DIVORCE

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CHAPTER 13

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I. OVERVIEW. This Article discusses recent important family law legislative changes. Next it discusses corporate involvement in employees' divorces. Finally, the Article discusses the challenges of pension benefits and risks to financial security in retirement.

II. RECENT LEGISLATIVE CHANGES TO THE FAMILY CODE.

A. DEFINED BENEFIT RETIREMENT PLANS. The law regarding the way to characterize defined benefit retirement plans between separate and community property has changed.

1. Case Law. Under Texas case law going back to *Taggart v. Taggart*, 552 S.W.2d 422, 424 (Tex. 1977), the extent of the community estate's interest in a defined benefit retirement plan is determined by a fraction, the numerator of which represents the number of months the parties were married while the retirement plan was in effect, and the denominator of which represents the total number of months the employee spouse was employed under the plan. Thus, 8 years of employment during marriage out of 20 years of total employment results in retirement benefits being 40% community property.

2. The 2005 Statute. On September 1, 2005, Texas Family Code Section 3.007 of the Family Code went into effect. Subsections (a) and (b) governed the character of a spouse's interest in a defined benefit plan:

> Section 3.007 Property Interest in Certain Employee Benefits
>
> (a) A spouse who is a participant in a defined benefit retirement plan has a separate property interest in the monthly accrued benefit the spouse had a right to receive on normal retirement age, as defined by the plan, as of the date of marriage, regardless of whether the benefit had vested.
>
> (b) The community property interest in a defined benefit plan shall be determined as if the spouse began to participate in the plan on the date of marriage and ended that participation on the date of dissolution or termination of the marriage, regardless of whether the benefit had vested.

Tex. Fam. Code § 3.007.

There is a controversy over the meaning of Subsection (a), the application of Subsection (b), and the fact that the two taken together may not mathematically account for 100% of the retirement benefit, leaving an unallocated portion. Some trial courts have interpreted Subsection (a) to require that the pre-marital portion of a DBP be valued as of the date of marriage, as if the spouse retired on the date of marriage. Since that assumption uses a figure for 'average final compensation" that is much lower than the one used at the time of retirement, it yields an artificially low separate property retirement benefit. Subsection (b) requires the court to assume the spouse started work on the date of marriage and retired on the date of divorce. Of course, that assumption won't work if the spouse retires before divorce. Additionally, that assumption won't work if the employee stops accruing a benefit before divorce (as would happen if s/he reaches a cap on the number of years of accrual, or if the plan is frozen due to underfunding, etc.).

3. The 2009 Statute. Senate Bill 866, passed unanimously by both Houses in May 2009, and signed by the Governor, eliminated the problems with Section 3.007(a) and (b) by repealing them. The repeal is effective for all divorces pending but not tried before September 1, 2009, and all divorces filed on or after that date. It also applies to all deaths on or after September 1, 2009.

B. EMPLOYEE STOCK OPTIONS. The law for characterizing employee stock options has been through changes.

1. Case Law. Under Texas case law, employee stock options were governed by the inception of title rule: if the option was granted before marriage it was separate property; if the option was granted during marriage it was community property. It didn't matter that an employee might have to remain employed for the option to mature and become exercisable. *See e.g.*, *Charriere v. Charriere*, 7 S.W.3d 217 (Tex. App.–Dallas 1999, no pet.) (rejecting the argument that employee stock options were governed by a time-allocation rule). In *Boyd v. Boyd*, 67 S.W.3d 398, 410 (Tex. App–Fort Worth 2002, no pet.), the court of appeals said:

> Texas courts have consistently held that stock options acquired during marriage are a contingent property interest and a community asset subject to division upon divorce.

This "winner take all" approach to the character of employee stock options was out of synch with the time-allocation approach to defined benefit plans. Although the rule was endorsed by a number of courts of appeals, the Family Law bar was dissatisfied, and the Bar promoted a legislative override of the case law.

2. The 2005 Statute. On September 1, 2005, Texas Family Code Section 3.007 of the Family Code went into effect. Subsection (d) governs the character of a spouse's interest in employee stock options and restricted stock. The statute provides for a time allocation based on a fraction. For an option granted before marriage, the separate estate's portion is a fraction, the numerator of which is the length of time from the date of grant to the date of marriage, and the denominator of which is the length of time from the date of marriage to the date the option becomes exercisable. Similarly, if the option is granted during marriage but requires post-divorce employment to mature, the separate property interest is determined by a fraction, the numerator of which is the length of time from the date of divorce to the date of maturity, and the denominator of which is the length of time between the date of grant and the date the option becomes exercisable. Subsection 3.007(f) provided for the characterization to be altered, even after the divorce became final, if the vesting period on the options or restricted stock was later changed. This created a problem with Texas' finality of judgment rule.

3. The 2009 Statute. Senate Bill 866, passed unanimously by both Houses in May 2009, and signed by the Governor, amended Family Code Section 3.007(d) to deal with options granted before marriage that do not mature until after divorce. The statute now reads:

> (d) A spouse who is a participant in an employer-provided stock option plan or an employer-provided restricted stock plan has a separate property interest in the options or restricted stock granted to the spouse under the plan as follows:
>
> > (1) if the option or stock was granted to the spouse before marriage but required continued employment during marriage before the grant could be exercised or the restriction removed, the spouse's separate property interest is equal to the fraction of the option or restricted stock in which:
> >
> > (A) the numerator is the sum of:
> >
> > > (i) the period from the date the option or stock was granted until the date of marriage; and
> > >
> > > (ii) if the option or stock also required continued employment following the date of dissolution of the marriage before the grant could be exercised or the restriction removed, the period from the date of dissolution of the marriage until the date the grant could be exercised or the restriction removed; and

(B) the denominator is the period from the date the option or stock was granted until the date the grant could be exercised or the restriction removed; and

(2) if the option or stock was granted to the spouse during the marriage but required continued employment following the date of dissolution of the [~~after~~] marriage before the grant could be exercised or the restriction removed, the spouse's separate property interest is equal to the fraction of the option or restricted stock in which:

(A) the numerator is the period from the date of dissolution [~~or termination~~] of the marriage until the date the grant could be exercised or the restriction removed; and

(B) the denominator is the period from the date the option or stock was granted until the date the grant could be exercised or the restriction removed.

Another portion of House Bill 866 Subsection (f) eliminated the provision for reopening the divorce property division if the vesting period for the option changed after the divorce became final. The amendment to Section 3.007(d) and (f) are effective for all divorces pending but not tried before September 1, 2009, and all divorces filed on or after that date. It also applies to all deaths on or after September 1, 2009.

C. ECONOMIC CONTRIBUTION. Since time immemorial, Texas has recognized a claim for reimbursement where one marital estate pays debts of another marital estate, or one marital estate pays for valuable improvements to another marital estate. In 1999, an activist legislator induced the Legislature to change the common law rules in a succession of statutes that required complicated mathematical calculations to calculate such claims between marital estates. The most recent iteration of the concept was "economic contribution claims." The formula in the statute did not work in some fact situations, and sometimes required a retroactive appraisal of real estate many years in the past. The statute was universally disliked, and the Family Law Bar succeeded in getting the economic contribution statute neutered, so that it now includes traditional marital property reimbursement claims. This was done in Senate Bill 866, passed unanimously by both Houses in May 2009, and signed by the Governor. The amended statute contains statutory rules that mimic the common law rules; however, the statute does negate the old common law offset of reasonable rental value against a community property claim for reimbursement for paying down the separate property mortgage debt on a separate property house. Also, the statute describes a reimbursement claim for "the reduction of the principal amount of that part of a debt," when discussing debt secured by a lien in property. It is unresolved whether the repeal of the economic contribution provisions restored the common law reimbursement claim for paying interest, insurance, and taxes, or whether the reimbursement claim is now limited to the reduction in the principal balance of the secured debt.

D. SIXTY-DAY WAITING PERIOD FOR DIVORCE. Texas Family Code Section 6.702 provides that a divorce must be on file for 60 days before a judgment can be rendered and signed. House Bill 72 passed in May 2009, eliminates this waiting period where the respondent has been finally convicted of family violence or the petitioner has an active protective order resulting from family violence.

E. AUTHORIZATION FOR NON-PARENT RELATIVE TO TAKE PARENTAL ACTIONS. Senate Bill 1598, passed in May 2009 establishes a procedure for parents to authorize a relative to obtain medical, dental, psychological, or surgical treatment or immunization for a child, or to obtain medical insurance coverage, enroll the child in day care or extracurricular activities, obtain a learner's driver permit, enroll the child in school, etc. The relative can be a grandparent, adult sibling, or adult aunt or uncle of the child. If a custody order is in place for the child, the court must give written approval. One parent can execute the authorization without the joinder of the other parent, upon ten days' notice by mail.

F. CHILD'S CUSTODY PREFERENCE. Family Code Section 153.008 permitted a child to execute a written statement of preference of custodial parent. The statement eliminated the necessity of proving changed circumstances as a precondition to modifying custody arrangements. The written preference was eliminated by House Bill 1012 passed in May 2009, and the Legislature substituted an oral preference by a child older than age 12, to be stated to the court in chambers.

G. DESIGNATING PRIMARY RESIDENCE. Family Code Section 153.133 forced parties and the court to award the right to establish a child's primary residence to one parent or the other. This forced the selection of a "winner" and a "loser" in a shared custody arrangement. House Bill 1012 passed in May 2009, eliminated that problem, by allowing the parents to agree that the child's primary residence will be in a specified geographical area, without forcing the naming of one parent as primary custodian.

H. TEMPORARY ORDERS DURING MILITARY DEPLOYMENT. Senate Bill 279 passed in May 2009, establishes new Section 153.701 et seq., which provide for a court to issue temporary orders when a parent is assigned to military deployment or temporary duty at a substantial distance. These temporary orders expire when the parent returns. During a parent's absence, the possession of the parent can be exercised by a designated person and there are provisions for the deployed parent to get make-up time when back from deployment.

I. GRANDPARENT ACCESS. Ever since the United State Supreme Court curtailed grandparent access in *Troxel v. Granville*, 530 U.S. 57, 120 S.Ct. 2054 (2000), grandparents have been on the short end of the stick when it comes to seeing their grandchildren. In 2005, the Texas Legislature adopted a statute establishing a presumption that a parent acts in the best interest of the parent's child. A grandparent whose own child (who is parent of the grandchild in question) has been imprisoned within 3 months of filing suit, or is legally incompetent, or is dead, or does not have court-ordered possession or access to the child, can get court-ordered access, if the grandparent proves, by a preponderance of the evidence, that denial of possession or access to the grandchild would significantly impair the child's physical health or emotional well-being. Tex. Fam. Code § 153.431. HB 1012, enacted in May 2009, requires that a suit for grandparent access be accompanied by an affidavit setting out facts which support a claim of significant impairment. The court must deny the request unless the court finds that the allegations in the affidavit, if true, would meet the statutory test.

III. PRE-TRIAL DISCOVERY ISSUES. Companies can become embroiled in an employee's divorce in several different ways. One potential involvement is pretrial discovery relating to claims asserted in the divorce. The rules involved in such a situation are discussed below.

A. THE SCOPE OF DISCOVERY.

1. The Rule. The scope of discovery is stated in Tex. R. Civ. P. 192.3:

> Tex. R. Civ. P. 192.3, Scope of Discovery
>
> *(a) Generally.* In general, a party may obtain discovery regarding <u>any matter that is not privileged and is relevant to the subject matter of the pending action, whether it relates to the claim or defense of the party seeking discovery or the claim or defense of any other party</u>. It is not a ground for objection that the information sought will be inadmissible at trial if the information sought appears

reasonably calculated to lead to the discovery of admissible evidence. [Emphasis added.]

(b) Documents and Tangible Things. A party may obtain discovery of the existence, description, nature, custody, condition, location, and contents of documents and tangible things (including papers, books, accounts, drawings, graphs, charts, photographs, electronic or videotape recordings, data, and data compilations) that constitute or contain matters relevant to the subject matter of the action. A person is required to produce a document or tangible thing that is within the person's possession, custody, or control. [Emphasis added.]

(c) Persons with Knowledge of Relevant Facts. A party may obtain discovery of the name, address, and telephone number of persons having knowledge of relevant facts, and a brief statement of each identified person's connection with the case. A person has knowledge of relevant facts when that person has or may have knowledge of any discoverable matter. The person need not have admissible information or personal knowledge of the facts. An expert is "a person with knowledge of relevant facts" only if that knowledge was obtained first-hand or if it was not obtained in preparation for trial or in anticipation of litigation.

(d) Trial Witnesses. . . . .

(e) Testifying and Consulting Experts. The identity, mental impressions, and opinions of a consulting expert whose mental impressions and opinions have not been reviewed by a testifying expert are not discoverable. A party may discover the following information regarding a testifying expert or regarding a consulting expert whose mental impressions or opinions have been reviewed by a testifying expert:

(1) the expert's name, address, and telephone number;

(2) the subject matter on which a testifying expert will testify;

(3) the facts known by the expert that relate to or form the basis of the expert's mental impressions and opinions formed or made in connection with the case in which the discovery is sought, regardless of when and how the factual information was acquired;

(4) the expert's mental impressions and opinions formed or made in connection with the case in which discovery is sought, and any methods used to derive them;

(5) any bias of the witness;

(6) all documents, tangible things, reports, models, or data compilations that have been provided to, reviewed by, or prepared by or for the expert in anticipation of a testifying expert's testimony;

(7) the expert's current resume and bibliography.

(f) Indemnity and Insuring Agreements. . . .

(g) Settlement Agreements. . . . .

(h) Statements of Persons with Knowledge of Relevant Facts. A party may obtain discovery of the statement of any person with knowledge of relevant facts--a "witness statement"--regardless of when the statement was made. A witness statement is (1) a written statement signed or otherwise adopted or approved in writing by the person making it, or (2) a stenographic, mechanical, electrical, or other type of recording of a witness's oral statement, or any substantially verbatim

transcription of such a recording. Notes taken during a conversation or interview with a witness are not a witness statement. Any person may obtain, upon written request, his or her own statement concerning the lawsuit, which is in the possession, custody or control of any party.

(i) Potential Parties. . . .

(j) Contentions. . . .

2. Discussion.

Relevance. The test for discoverability is relevance to the subject matter of the pending action. Texas Rule of Evidence 401 provides that "relevant evidence" is "evidence having any tendency to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence." The evidence does not have to be admissible to be discoverable. Inadmissible evidence is discoverable it is it reasonably calculated to lead to the discovery of admissible evidence. Privileged information, however, even if relevant, is not discoverable.

No Fishing Expeditions. The Texas Supreme Court said: "This Court has repeatedly emphasized that discovery may not be used as a fishing expedition. . . . Rather, requests must be reasonably tailored to include only matters relevant to the case." *In re American Optical Corp.*, 988 S.W.2d 711, 713 (Tex. 1998).

Trial Court's Discretion. The scope of discovery is largely within the trial court's discretion. *Dillard Dep't Stores, Inc.*, 909 S.W.2d 491, 492 (Tex. 1995). However, mandamus will be granted is this discretion is clearly abused and there is no adequate remedy by appeal. *In re Colonial Pipeline Co.*, 968 S.W.2d 938, 941 (Tex. 1998).

Not Just Personal Knowledge. When it comes to deposing a witness, the witness is subject to discovery if s/he has knowledge of relevant facts, meaning knowledge of any discoverable matter. It is not necessary that the person have personal knowledge. That means that a witness can be deposed to find out what they heard about some discoverable matter.

Testifying Experts. An employee of a company can become a "testifying expert" by the unilateral act of one of the parties designating that person as a testifying expert in his or her response to Rule 194 requests for disclosure. Consent of the witness is not required, and the witness does not have to be retained, or paid a fee. By virtue of being designated as a testifying expert, the witness can be drawn into the expert discovery provisions of the Rules of Civil Procedure.

Employee Benefits. Unpaid bonuses are a possible issue that might cause a spouse to seek discovery from the other spouse's employer. In *Boyd v. Boyd*, 67 S.W.3d 398 (Tex. App–Fort Worth 2002, no pet.), a mediated settlement agreement was set aside due to the husband's failure to disclose a future bonus that was not yet paid at the time of mediation. Where the employee is high enough in management to have unconventional benefits, the HR department might draw discovery requests to explore fringe benefits or non-qualified plan benefits.

Company Value. If the employer is not a publicly-traded company, and the divorcing employee is an owner, the opposing spouse may attempt to get financial information from the company to use in valuing the employed-spouse's interest in the company. This can create discomfort, to have outsiders pouring over the company's confidential financial information. The company should file a motion for protective order and attempt to limit the inquiry as much as possible, and to put the information under a confidentiality order (not a confidentiality agreement) so that it cannot be disseminated to others. The case of *Finn v. Finn*, 658 S.W.2d 735, 740 (Tex. App.--Dallas 1983, writ ref'd n.r.e.), involved a buy-sell provision in a law partnership agreement. The divorcing wife of a partner-spouse sought discovery to value the law firm, but the trial court limited her discovery to the law firm's partnership agreement and retirement plan, and to the husband's IRS K-1 schedules, which provided annual summaries of his share of the firm's assets and earnings. The trial court denied her access to the law firm's balance sheets, profit and loss statements, and records reflecting salaries and disbursements to senior partners. The appellate court held this was error, saying:

> The wife was entitled to inspect those financial records of the firm necessary to calculate the husband's interest in the firm under the formula contained in the partnership agreement. The fact that one of her experts was able to estimate that amount from secondary sources of information does not negate her right to the most accurate information available. We recognize the need to protect the confidentiality of the firm's records. However, this need not be an absolute bar to discovery because the court may order an in camera inspection of the documents to protect their privacy.

Id. at 742-746.

Possession or Control. The case of *In re Kuntz*, 124 S.W.3d 179 (Tex. 2003), involved an ex-wife's claim that she was entitled to participate in overriding royalty interests her former husband received after the divorce. She sought discovery of important documents by discovery requests to her ex-husband. The ex-husband objected that the documents belonged to a Louisiana company, and were subject to a confidentiality agreement. The trial court ordered that the documents be produced. The Texas Supreme Court ruled that the employee did not have "possession, custody or control" of the documents in his individual capacity, and that the documents could not be obtained through the ex-husband. *Id.* at 184.

The trial court's initial order of production was issued in December of 2001. The Texas Supreme Court ruled in December of 2003. The ex-wife took her discovery request to the third party, which was located in Louisiana. The third party corporation fought the discovery up to the Louisiana Supreme Court, which remanded the case in May of 2006. The Louisiana court of appeals reaffirmed the trial court's discovery order in October of 2008. The company was finally required to turn over documents, subject to a confidentiality order. All these years and all this money, fighting to protect its trade secrets, and the ex-husband was not even an employee of the Louisiana corporation.

Privileged Information. The Rules of Procedure do not allow a party to object to a discovery request based on privileged information. Instead, the party raising the privilege makes a "withholding statement" in a discovery response or separate document. Tex. R. Civ. P. 193.3. The withholding statement must indicated that information has been withheld, the request to which the information relates, and the privilege asserted. *Id.* The party seeking discovery can then serve a written request for the withholding party to identify the information withheld. The withholding party has 15 days to do so. *Id.* This response must describe the information withheld to the extent that the requesting party can assess the applicability of the privilege, and the privilege for each item must be stated. *Id.*

Tax Returns. Income tax returns are conditionally privileged, and can be discovered only to the extent they are relevant. *Crane v. Tunks*, 160 Tex. 182, 328 S.W.2d 434, 440 (Tex. 1959). In *Sears, Roebuck & Co. v. Ramirez*, 824 S.W.2d 558, 559 (Tex. 1992), the Supreme Court rejected discovery of income tax returns when the information in them was unnecessarily duplicative of information contained in annual reports. The Court acknowledged "reluctance to allow uncontrolled and unnecessary discovery of federal income tax returns." The burden is on the party seeking discovery to show that the tax returns are material and relevant to the issues in the case. *El Centro del Barrio Inc. v. Barrow*, 894 S.W.2d 775, 779 (Tex. App.--San Antonio 1994, orig. proceeding).

Trade Secrets. Trade secrets are privileged under Tex. R. Evid. 507. The rule does not define trade secret. The allowance of the privilege cannot tend conceal fraud or "otherwise work and injustice." A trade secret is "any formula, pattern, device or compilation of information which is used in one's business and presents an opportunity to obtain an advantage over competitors who do not know or use it." *In re Bass*, 113 S.W.3d 735, 739 (Tex. 2003). The Texas Supreme Court has adopted the Restatement of Torts' six-factor test, which it weighs in the context of the surrounding circumstances:

(1) the extent to which the information is known outside of his business;
(2) the extent to which it is known by employees and others involved in his business;
(3) the extent of the measures taken by him to guard the secrecy of the information;
(4) the value of the information to him and to his competitors;
(5) the amount of effort or money expended by him in developing the information; and
(6) the ease or difficulty with which the information could be properly acquired or duplicated by others. Restatement of Torts § 757 cmt. B. (1939). 113 S.W.3d at 739.

B. LIMITATIONS ON SCOPE OF DISCOVERY.

1. The Rule. Tex. R. Civ. P. 192.4 provides:

> Rule 192.4, Limitations on Scope of Discovery
>
> The discovery methods permitted by these rules should be limited by the court if it determines, on motion or on its own initiative and on reasonable notice, that:
>
> (a) the discovery sought is unreasonably cumulative or duplicative, or is obtainable from some other source that is more convenient, less burdensome, or less expensive; or
>
> (b) the burden or expense of the proposed discovery outweighs its likely benefit, taking into account the needs of the case, the amount in controversy, the parties' resources, the importance of the issues at stake in the litigation, and the importance of the proposed discovery in resolving the issues. [Emphasis added.]

2. Discussion. The court where the case is pending is empowered to limit discovery if the information is obtainable from a source that is more convenient, less burdensome, or less expensive. A company can file a motion for protective order to invoke this power. Rule 192.4 establishes a balancing test, weighing the burden and expense of the discovery against the likely benefit, considering the amount in controversy, the parties' resources, the importance of the issue, the importance of the discovery, etc. A company can use this provision to deflect disruptive or costly incursions into the company's business.

C. PROTECTIVE ORDERS.

1. The Rule. Tex R. Civ. P 192.6 provides:

> Rule 192.6, Protective Orders
>
> *(a) Motion.* A person from whom discovery is sought, and any other person affected by the discovery request, may move within the time permitted for response to the discovery request for an order protecting that person from the discovery sought. A person should not move for protection when an objection to written discovery or an assertion of privilege is appropriate, but a motion does not waive the objection or assertion of privilege. If a person seeks protection regarding the time or place of discovery, the person must state a reasonable time and place for discovery with which the person will comply. A person must comply with a request to the extent protection is not sought unless it is unreasonable under the circumstances to do so before obtaining a ruling on the motion.

> *(b) Order.* To protect the movant from undue burden, unnecessary expense, harassment, annoyance, or invasion of personal, constitutional, or property rights, the court may make any order in the interest of justice and may--among other things--order that:
>
> > (1) the requested discovery not be sought in whole or in part;
> >
> > (2) the extent or subject matter of discovery be limited;
> >
> > (3) the discovery not be undertaken at the time or place specified;
> >
> > (4) the discovery be undertaken only by such method or upon such terms and conditions or at the time and place directed by the court;
> >
> > (5) the results of discovery be sealed or otherwise protected, subject to the provisions of Rule 76a. [Emphasis added.]

2. Discussion. Rule 192.6 sets out parameters for a motion for protective order against discovery. The motion must be filed before the response deadline. If a complaint is raised about time or place of discovery, the movant must offer an alternative. The movant must comply with the discovery request to the extent protection is not sought, to the extent compliance is not unreasonable.

Protective orders could be used to avoid a unwanted deposition of a company employee, or to oppose a subpoena to produce information in discovery relating to the company or its employees. Another frequent basis for a motion for protective order is to get a court order that the requesting party pay for the cost of gathering and presenting the requested information.

Privacy Rights. The courts recognize a right to privacy as a basis to limit discovery. The Supreme Court once said: "The protection of privacy is of fundamental--indeed, of constitutional--importance." *Maresca v. Marks,* 362 S.W.2d 299, 301 (Tex. 1962) (in connection with tax returns). The U.S. Supreme Court's privacy decisions typically deal with the individual's freedom to choose, or autonomy. However, another aspect of privacy recognized by the Texas Supreme Court is "disclosural privacy," or the "the ability of individuals 'to determine for themselves when, how, and to what extent information about them is communicated to others.'" *Industrial Foundation of the South v. Texas Indus. Acc. Bd.*, 540 S.W.2d 668, 679 (Tex. 1976).

Applied to the business world:

> A party asserting that privacy rights protect information from disclosure must present evidence showing disclosure would cause "a particular, articulated and demonstrable injury." . . . Stated another way, the party must establish that it has such a privacy interest in the information as to bar disclosure. . . . An insurance company may request limitation of discovery to protect the privacy of its insureds. *See Alpha Life Ins. Co. v. Gayle*, 796 S.W.2d 834, 836 (Tex. App.--Houston [14th Dist.] 1990, orig. proceeding). [Some citations omitted.]

In re Kemper Lloyds Ins. Co., 2006 WL 475436, *4 (Tex. App.--Tyler 2006, orig. proceeding) (memorandum opinion). Constitutional protection usually applies to information regarding marital relations, procreation, contraception, family relationships, child rearing, education, and medical records. *Id.* at *5. However, personal financial records and appointment books of a non-party testifying expert are protected from discovery except upon a showing of bias. *In re Makris*, 217 S.W.3d 521, 523-25 (Tex. App.--San Antonio 2006, orig. proceeding). The corporation should therefore assert privacy rights for itself and as to its employees.

D. DISCOVERY FROM NONPARTIES.

1. The Rule. Tex. R. Civ. P. 205 governs discovery from nonparties to the lawsuit:

> **Rule 205.1, Forms of Discovery; Subpoena Requirement**
>
> A party may compel discovery from a nonparty--that is, a person who is not a party or subject to a party's control--only by obtaining a court order under Rules 196.7, 202, or 204, or by serving a subpoena compelling:
>
> (a) an oral deposition;
> (b) a deposition on written questions;
> (c) a request for production of documents or tangible things, pursuant to Rule 199.2(b)(5) or Rule 200.1(b), served with a notice of deposition on oral examination or written questions; and
> (d) a request for production of documents and tangible things under this rule.
>
> **205.2. Notice.**
>
> A party seeking discovery by subpoena from a nonparty must serve, on the nonparty and all parties, a copy of the form of notice required under the rules governing the applicable form of discovery. A notice of oral or written deposition must be served before or at the same time that a subpoena compelling attendance or production under the notice is served. A notice to produce documents or tangible things under Rule 205.3 must be served at least 10 days before the subpoena compelling production is served. [Emphasis added.]
>
> **205.3. Production of Documents and Tangible Things Without Deposition.**
>
> *(a) Notice; Subpoena.* A party may compel production of documents and tangible things from a nonparty by serving--a reasonable time before the response is due but no later than 30 days before the end of any applicable discovery period--the notice required in Rule 205.2 and a subpoena compelling production or inspection of documents or tangible things.
>
> *(b) Contents of Notice.* The notice must state:
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> (1) the name of the person from whom production or inspection is sought to be compelled;
>
> (2) a reasonable time and place for the production or inspection; and
>
> (3) the items to be produced or inspected, either by individual item or by category, describing each item and category with reasonable particularity, and, if applicable, describing the desired testing and sampling with sufficient specificity to inform the nonparty of the means, manner, and procedure for testing or sampling.
>
> *(c) Requests for Production of Medical or Mental Health Records of Other Nonparties.* If a party requests a nonparty to produce medical or mental health records of another nonparty, the requesting party must serve the nonparty whose records are sought with the notice required under this rule. This requirement does not apply under the circumstances set forth in Rule 196.1(c)(2).
>
> *(d) Response.* The nonparty must respond to the notice and subpoena in accordance with Rule 176.6.
>
> *(e) Custody, Inspection and Copying.* The party obtaining the production must make all materials produced available for inspection by any other party on reasonable notice, and must furnish copies to any party who requests at that party's expense.
>
> *(f) Cost of Production.* A party requiring production of documents by a nonparty must

reimburse the nonparty's reasonable costs of production.

2. Discussion. A company can receive a subpoena requiring the company to designate a representative(s) to attend an oral deposition, or to give answers to a deposition on written questions, or to bring records to the deposition. The company can also receive a subpoena to produce records at another location, such as the office of a party's attorney, not in connection with a deposition.

E. DEPOSITIONS.

1. The Rule. Tex. R. Civ. P. 199.2 discusses the procedure for noticing an oral deposition.

Tex. R. Civ. P. 199.2, Procedure for Noticing Oral Deposition

(a) Time to Notice Deposition. A notice of intent to take an oral deposition must be served on the witness and all parties a reasonable time before the deposition is taken. An oral deposition may be taken outside the discovery period only by agreement of the parties or with leave of court. [Emphasis added.]

(b) Content of Notice.

(1) Identity of Witness; Organizations. The notice must state the name of the witness, which may be either an individual or a public or private corporation, partnership, association, governmental agency, or other organization. If an organization is named as the witness, the notice must describe with reasonable particularity the matters on which examination is requested. In response, the organization named in the notice must--a reasonable time before the deposition--designate one or more individuals to testify on its behalf and set forth, for each individual designated, the matters on which the individual will testify. Each individual designated must testify as to matters that are known or reasonably available to the organization. This subdivision does not preclude taking a deposition by any other procedure authorized by these rules. [Emphasis added.]

(2) Time and Place. The notice must state a reasonable time and place for the oral deposition. The place may be in:

(A) the county of the witness's residence;

(B) the county where the witness is employed or regularly transacts business in person;

(C) the county of suit, if the witness is a party or a person designated by a party under Rule 199.2(b)(1);

(D) the county where the witness was served with the subpoena, or within 150 miles of the place of service, if the witness is not a resident of Texas or is a transient person; or

(E) subject to the foregoing, at any other convenient place directed by the court in which the cause is pending.

(3) Alternative Means of Conducting and Recording. . . .

(4) Additional Attendees. . . .

(5) Request for Production of Documents. A notice may include a request that the witness produce at the deposition documents or tangible things within the scope of discovery and within the witness's possession, custody, or control. If the witness is a nonparty, the request must comply with Rule 205 [Discovery From Nonparties] and the designation of materials required to be identified in the subpoena must be attached to, or included in, the notice. The nonparty's response to the request is governed by Rules

> 176 [Subpoenas] and 205. When the witness is a party or subject to the control of a party, document requests under this subdivision are governed by Rules 193 and 196.
>
> **199.3. Compelling Witness to Attend**
>
> A party may compel the witness to attend the oral deposition by serving the witness with a subpoena under Rule 176. If the witness is a party or is retained by, employed by, or otherwise subject to the control of a party, however, service of the notice of oral deposition upon the party's attorney has the same effect as a subpoena served on the witness.
>
> **199.4. Objections to Time and Place of Oral Deposition**
>
> A party or witness may object to the time and place designated for an oral deposition by motion for protective order or by motion to quash the notice of deposition. <u>If the motion is filed by the third business day after service of the notice of deposition, an objection to the time and place of a deposition stays the oral deposition until the motion can be determined</u>. [Emphasis added.]

Rule 199.5 discusses the process during the deposition. Rule 199.6 discusses hearings on objections.

Rule 200 discusses depositions upon written questions.

2. Discussion. A deposition notice addressed to an organization cannot specify the person whom the entity will tender for deposition. The notice must describe with reasonable particularity the subject matter, and the organization may name one or more individuals to testify. The organization must specify what witness will testify on what topic. The representative must testify to what is known to the organization, not just what is known to the representative. That means that the representative will have to become acquainted with the institutional knowledge and institutional memory of the organization prior to the deposition.

The corporation can file a motion to quash the deposition or motion for protective order to object to the time and place of the deposition. *If the motion is filed within three days of service* of the notice, the deposition is automatically quashed until the motion can be determined by the court.

3. Apex Depositions. An "apex deposition" is a deposition of a president or other high corporate official. If a litigant issues a notice for an apex deposition, the corporation can file a motion for protective order (be sure to file it within three days) supported by the official's affidavit denying knowledge of any relevant facts. The trial court can permit the apex deposition to go forward only if the court finds that the litigant has "arguably shown" that the corporate official has "any unique or superior personal knowledge of discoverable information," and that the litigant has made a "good faith effort to obtain the discovery through less intrusive means" that have proven to be "unsatisfactory, insufficient or inadequate." *Crown Centeral Petroleum Corp. v. Garcia*, 904 S.W.2d 125, 128 (Tex. 1995). In the case of *In re Alcatel, USA, Inc.*, 11 S.W.3d 173, 177 (Tex. 2000), the Supreme Court said that a generalized claim that a corporate executive has knowledge of company policies does not establish unique or superior knowledge. Less-intrusive means could include deposing lower-level employees or directing the discovery request to the corporation itself, rather than targeting specific high-ranking officers. *See Crown Central*, 904 S.W.2d at 128.The trial court's decision on the apex deposition is reviewable immediately by mandamus to the court of appeals and then to the Texas Supreme Court. The apex deposition doctrine applies only when the deponent is noticed for deposition because of his corporate position. *Simon v. Bridewell*, 950 S.W.2d 439, 442 (Tex. App.–Waco 1997, no writ); *Boales v. Brighton*

Builders, Inc., 29 S.W.3d 159, 168 (Tex. App.--Houston [14th Dist.] 2000, pet. denied) (apex doctrine did not apply because litigant alleged that deponent had first-hand knowledge of certain facts). The apex doctrine does not protect named parties to a lawsuit. *Id.* at 443. As to partnerships, general partners are subject to deposition in legal actions involving the partnership. *Id.*

F. SUBPOENAS. A company can receive a subpoena relating to a employee's divorce. Sometimes the deadline can be short, so the company should be ready to react quickly.

1. The Rule. Texas Rule of Civil Procedure 176 governs subpoenas. Subdivision 1 governs form. Subdivision 2 allows the subpoena to require a person to attend and give testimony at a deposition, hearing or trial. Subdivision 2 also permits the subpoena to require the witness to produce records. Subdivision 3 limits the range of a subpoena to 150 miles of the witness's residence. Subdivision 4 says subpoenas can be issued by the clerk of the court, or a licensed attorney, or a notary public. Subdivision 5 governs service of the subpoena. Subdivision 6 discusses responses to the subpoena. Subdivision 7 sets out standards for protecting the witness from undue burden or expense. Subdivision 8 governs enforcement of the subpoena by contempt, attachment, and fine.

> 176.6. Response
>
> *(a) Compliance Required.* Except as provided in this subdivision, a person served with a subpoena must comply with the command stated therein unless discharged by the court or by the party summoning such witness. A person commanded to appear and give testimony must remain at the place of deposition, hearing, or trial from day to day until discharged by the court or by the party summoning the witness.
>
> *(b) Organizations.* If a subpoena commanding testimony is directed to a corporation, partnership, association, governmental agency, or other organization, and the matters on which examination is requested are described with reasonable particularity, the organization must designate one or more persons to testify on its behalf as to matters known or reasonably available to the organization. [Emphasis added.]
>
> *(c) Production of Documents or Tangible Things.* A person commanded to produce documents or tangible things need not appear in person at the time and place of production unless the person is also commanded to attend and give testimony, either in the same subpoena or a separate one. A person must produce documents as they are kept in the usual course of business or must organize and label them to correspond with the categories in the demand. A person may withhold material or information claimed to be privileged but must comply with Rule 193.3. A nonparty's production of a document authenticates the document for use against the nonparty to the same extent as a party's production of a document is authenticated for use against the party under Rule 193.7. [Emphasis added.]
>
> *(d) Objections.* A person commanded to produce and permit inspection or copying of designated documents and things may serve on the party requesting issuance of the subpoena--before the time specified for compliance--written objections to producing any or all of the designated materials. A person need not comply with the part of a subpoena to which objection is made as provided in this paragraph unless ordered to do so by the court. The party requesting the subpoena may move for such an order at any time after an objection is made. [Emphasis added.]
>
> *(e) Protective Orders.* A person commanded to appear at a deposition, hearing, or trial, or to produce and permit inspection and copying

of designated documents and things, and any other person affected by the subpoena, may move for a protective order under Rule 192.6(b)--before the time specified for compliance--either in the court in which the action is pending or in a district court in the county where the subpoena was served. The person must serve the motion on all parties in accordance with Rule 21a. A person need not comply with the part of a subpoena from which protection is sought under this paragraph unless ordered to do so by the court. The party requesting the subpoena may seek such an order at any time after the motion for protection is filed. [Emphasis added.]

(f) Trial Subpoenas. A person commanded to attend and give testimony, or to produce documents or things, at a hearing or trial, may object or move for protective order before the court at the time and place specified for compliance, rather than under paragraphs (d) and (e).

Rule 176.7, Protection of Person from Undue Burden and Expense

A party causing a subpoena to issue must take reasonable steps to avoid imposing undue burden or expense on the person served. In ruling on objections or motions for protection, the court must provide a person served with a subpoena an adequate time for compliance, protection from disclosure of privileged material or information, and protection from undue burden or expense. The court may impose reasonable conditions on compliance with a subpoena, including compensating the witness for undue hardship. [Emphasis added.]

2. Discussion. "[R]equests must be reasonably tailored to include only matters relevant to the case . . . ." *In re American Optical Corp.*, 988 S.W.2d 711, 713 (Tex. 1998). Some requests are overbroad and burdensome on their face. In other instances, the resisting party who is claiming that discovery is unduly burdensome or unnecessarily harassing, must offer evidence in support of the claim. *In re Alford Chevrolet-Geo*, 997 S.W.2d 173, 181 (Tex. 1999).

IV. JOINDER OF CORPORATION IN DIVORCE. Occasionally a corporation will be joined as a party in a divorce.

A. RULES OF JOINDER. Under Rule 39, a party must be joined in a law suit if, among other things, "in his absence complete relief cannot be accorded among those already parties . . . ." Long ago the Houston Court of Civil Appeals held that an insurance company who owed a contractual annuity obligation to a spouse was not an indispensable party to the divorce. *Aetna Life Ins. Co. v. Creel*, 390 S.W.2d 522 (Tex. Civ. App.--Houston 1965, writ ref'd). However, Rule 40 allows permissive joinder of defendants "if there is asserted against them . . . any right to relief in respect of or arising out of the same transaction, occurrence, or series of transactions or occurrences and it any question of law or fact common to all of them will arise in the action." Although joinder of employers in divorce cases is not as prevalent as it once was, in certain circumstances a family lawyer might decide to join an employer in the divorce, such as to establish a constructive trust over employee benefits or secure a declaration or injunction pertaining to the payment of some future benefit, like non-qualified pension payments or non-qualified stock options, phantom stock, etc. In *Hopkins v. Hopkins*, 539 S.W.2d 242 (Tex. Civ. App.--Fort Worth 1976, writ dism'd), the husband brought a divorce, and the wife cross-claimed against the husband's employer Bell Helicopter. The wife secured an injunction against Bell Helicopter, requiring it to withhold part of the husband's wages and pay them to the wife as temporary support. The court of appeals found that Bell Helicopter was properly joined in the divorce. *Id*. at 246. However, the temporary injunction was void because the wife did not post a bond; although a bond is waived for injunctions between husband and wife, the waiver doesn't extend to injunctions against third parties. *Id*. The appellate court noted that, by virtue of Bell Helicopter's joinder in the divorce, it was officially apprised of the wife's ownership of the funds and was bound to give them to her at the conclusion of the divorce. *Id*.

B. TEMPORARY ORDERS. The court in a divorce has extensive powers to issue temporary orders to protect the parties and preserve the marital estate. Tex. Fam. Code § 6.502. These include appointing a receiver for the preservation and protection of the property of the parties. § 6.502(a)(5) & (b). Injunctions issued against third parties are governed by the Rules of Procedure pertaining to TROs and temporary injunctions, including the requirement of a bond.

C. RECEIVERSHIPS. There is a potential for some tension to exist with regard to the divorce court's authority under the Texas Family Code to appoint a receiver in connection with a divorce and the Civil Practice and Remedies Code provisions regarding receivers, and the entity laws governing appointment of receivers for entities, and the law regarding charging orders as the method of collecting claims against owners of partnerships and LLCs.

Texas Civil Practices and Remedies Code Section 64.001 authorizes the appointment of a receiver "(3) in an action between partners or others jointly owning or interested in any property or fund, " . . . "(5) for a corporation that is insolvent, is in imminent danger of insolvency, has been dissolved, or has forfeited its corporate rights; or (6) in any other case in which a receiver may be appointed under the rules of equity."

Section 64.002 states:

> Persons Not Entitled to Appointment
>
> (a) A court may not appoint a receiver for a corporation, partnership, or individual on the petition of the same corporation, partnership, or individual.
>
> (b) A court may appoint a receiver for a corporation on the petition of one or more stockholders of the corporation.
>
> (c) This section does not prohibit:
>
> > (1) appointment of a receiver for a partnership in an action arising between partners; or
> > (2) appointment of a receiver over all or part of the marital estate in a suit filed under Title 1 or 5, Family Code.

TBCA Section 7.07A plainly states:

> No receiver shall be appointed for any corporation to which this Act applies or for any of its assets or for its business except as provided for and on the conditions set forth in this Act.

TBCA § 7.07A. Family Code section 6.502, entitled "Temporary Injunction & Other Temporary Orders," gives the court in a divorce the power of "appointing a receiver for the preservation and protection of the property of the parties. . . ." Tex. Fam. Code §6.502(a)(5). Courts have construed this section to extend only to the spouses and not third parties. *Mallou v. Payne & Vendig*, 750 S.W.2d 251, 255 (Tex. App.–Dallas 1988, writ denied) (regarding receivers); *Commonwealth Mortgage Corporation v. Wadkins*, 709 S.W.2d 679, 680 (Tex. App.–Houston [14th Dist.] 1985, no writ) (corporation was not a "party" as contemplated by the Family Code). Case law recognizes the court's right to appoint a receiver to liquidate community property pursuant to the divorce decree. *Nelson v. Nelson*, 193 S.W.3d 624, 629 (Tex. App.–Eastland 2006, no pet.); *Young v. Young*, 765 S.W.2d 440, 444 (Tex. App.–Dallas 1988, no writ) (authority to appoint receiver in decree of divorce is Family Code provision on dividing the community estate, not Civil Practice and Remedies Code provisions regarding receivers). Texas Rule of Civil Procedure 695a permits a court in a divorce to waive the requirement of a bond upon appointing a receiver. How these powers of a divorce interface with the venue provisions of the TBCA regarding receivers deserves some attention. *Rusk v. Rusk*, 5 S.W.3d 299, 306 (Tex. App.–Houston [14th Dist.] 1999, pet. denied), held that a court cannot, in a divorce decree, appoint a receiver over separate property. Remember that the partnership law says that a partner's management rights cannot be community property. That suggests that appointing a receiver in a divorce to exercise control over a spouse's interest in a partnership might not be appropriate.

It should be noted that appointing a receiver over community property shares is not the same as appointed a receiver for a corporation. However, if the community property shares constitute a controlling interest in a corporation which has other shareholders, turning de facto control of a corporation over to a receiver appointed in a divorce may be expected to draw an intervention by the corporation or the other shareholders in the divorce.

V. MARITAL PROPERTY CLAIMS REGARDING BUSINESSES.

A. ASSETS OF THE BUSINESS ARE NOT MARITAL PROPERTY. Since a shareholder owns shares in the corporation and not the assets of the corporation, corporate assets are neither separate nor community property. *See Snider v. Snider*, 613 S.W.2d 8, 11 (Tex. Civ. App.–El Paso 1981, no writ) ("Prior to the actual declaration of a dividend, all the accumulation of surplus in the corporation merely enhanced the value of the shares held by Husband as his separate property and the community had no claim thereto"). The same rule applies to partnerships. The increase during marriage in value of a separate property corporation belongs to the separate estate. *Jensen v. Jensen*, 665 S.W.2d 107, 109 (Tex. 1984). The same is true of partnerships.

B. PIERCING THE ENTITY. A number of cases permit the spouse of a shareholder to "pierce the corporate veil" and claim as community property assets that belong to the corporation. This is sometimes called "reverse piercing," because the third party claimant is reaching corporate assets through the shareholder, and not reaching the shareholder through the corporation. The Pattern Jury Charges recognize such a claim in TEXAS PATTERN JURY CHARGES (FAMILY) PJC 205.1-205.4 (2008). The court in *Lifshutz v. Lifshutz*, 61 S.W.3d 511, 517 (Tex. App.–San Antonio 2001, pet. denied), says that the injury from improper use of the corporation must damage the community estate "beyond that which might be remedied by a claim for reimbursement." In *Robbins v. Robbins*, 727 S.W.2d 743 (Tex. App.--Eastland 1987, no writ), the spouse used the alter ego theory to impress community property character on the corporate stock–a possible misconception of how the doctrine works.

Note that alter ego is just one of several bases to pierce the corporate veil, along with arguments that the corporate form has been:

1. used as a sham to perpetrate a fraud;
2. resorted to as a means of evading an existing legal obligation;
3. employed to achieve or perpetrate a monopoly;
4. used to circumvent a statute; or
5. relied on as a protection of crime or to justify wrong.

See Castleberry v. Branscum, 721 S.W.2d 270, 272 (Tex. 1986); TEXAS PATTERN JURY CHARGES (FAMILY) 205.2 (2008).
In *Young v. Young*, 168 S.W.3d 276, 281 (Tex. App.–Dallas 2005, no pet.), the court said:

> Under certain circumstances, a spouse may be able to reach the assets of the other spouse's separately owned corporation. A finding of alter ego allows piercing of the corporate veil. Piercing the corporate veil, in turn, allows the trial court to characterize as community

> property assets that would otherwise be the separate property of a spouse. *Lifshutz v. Lifshutz*, 61 S.W.3d 511, 516 (Tex. App.–San Antonio 2001, pet. denied). In the divorce context, piercing the corporate veil allows the trial court to achieve an equitable result. *Id.*

The *Young* court said this about the remedy: In a divorce case, a finding of alter ego sufficient to justify piercing the corporate veil requires: (1) unity between the separate property corporation and the spouse such that the separateness has ceased to exist; and (2) the spouse's improper use of the corporation damaged the community estate beyond that which might be remedied by a claim for reimbursement. *Id*. at 281-82.

In *Zisblatt v. Zisblatt*, 693 S.W.2d 944, 955 (Tex. App.–Fort Worth 1985, writ dism'd), the husband had a separate property corporation, which held title to the couple's home, and which paid for and owned the couple's furniture. Id. at 947. The husband's income came from the corporation and he deposited his earned income into a corporate account. Id. at 955. The trial court pierced the corporate veil, and the appellate court said that "to uphold the fiction of [the corporation] as an entity separate from [the husband] would be a clear and material prejudice to the rights of [the wife] and the community estate and an evasion of an existing legal obligation of [the husband] to devote his time, talent, and industry to the community." *Id. See Parker v. Parker*, 897 S.W.2d 918, 928 (Tex. App.–Fort Worth 1995, writ denied) (where corporation was found to be alter ego of husband, corporate assets could become part of community estate; assets owned by corporation at the time of marriage were husband's separate property, but assets acquired by the corporation during marriage were community property, absent tracing). Note that the events giving rise to a claim for piercing may occur well after the date of marriage. In that situation it would seem that the acquisition of community assets would begin on the day that the wrongful events occurred, which would be later than the date of marriage.

Texas Business Corporation Act arts. 2.21A(1) & (2) require contract creditors to prove actual fraud, not just constructive fraud, to pierce the corporate veil. Additionally, TBCA art. 2.21A(3) has eliminated piercing the corporate veil for any "obligation of the corporation" based on "failure of the corporation to observe any corporate formality." Note that a spouse asserting a reverse piercing claim is usually not a contract creditor, and there is no appellate opinion addressing whether a piercing claim of a spouse in a divorce is an "obligation of the corporation" for purposes of Article 2.21A(3).

Two Texas courts have held that partnerships are not susceptible to a piercing of the veil: Lifshutz v. Lifshutz, 61 S.W.3d 511, 518 (Tex. App.–San Antonio 2001, pet. denied); Pinebrook Properties, Ltd. v. Brookhaven Lake Prop. Owners Ass'n, 77 S.W.3d 487, 499-500 (Tex. App.–Texarkana 2002, pet. denied).

C. DISTRIBUTIONS OF PROFITS AND CAPITAL.

1. Distributions of Profits. All cash dividends paid by a corporation to married shareholders are community property. *Hilliard v. Hilliard*, 725 S.W.2d 722, 723 (Tex. App.–Dallas 1985, no writ); *Bakken v. Bakken*, 503 S.W.2d 315, 317 (Tex. Civ. App.–Dallas 1973, no writ). In this sense, however, dividends are distributions made from earnings and profits. If the distributions are not made from earnings and profits, do they have the same character as the ownership interest? For federal income tax purposes, every distribution of a corporation to its shareholders is deemed to be made out of earnings and profits, to the extent there are any. See Treas. Reg. § 1.316-2(a). The distribution is deemed to come from current earnings first, and then from accumulated earnings from prior years. Id. After current and retained earnings are exhausted, what is left, by process of elimination must be a distribution of capital. Under the *Marshall* case, distributions of profits from a partnership to a married partner were held to be community income. *Marshall v. Marshall*, 735 S.W.2d 587, 594-95 (Tex. App.–Dallas 1987, writ ref'd n.r.e.). Would the result be different if all profits had already been distributed? What if the business had operated at a loss during the entire marriage? Or from the inception of the businesses, so that there were no current earnings and no retained earnings?

2. Distributions of Capital. Some lawyers and forensic CPAs take the position that a business entity cannot make a capital distribution other than in complete liquidation of the entity; any other distributions they say are community property. Others argue that it is within the power of the board of directors, or the partners, to distribute capital instead of current income or retained income. Coupled with the position that a distribution of capital has the same character as the ownership interest it comes from, this reasoning leads to the conclusion that even a distribution of capital from an ongoing business with current or retained earnings to a spouse owning separate property shares or a separate property interest is received as separate property. On a corporate balance sheet, retained earnings (sometimes referred to as earned surplus) represents corporate earnings that have not been distributed to owners. When all profits have been distributed, and earned surplus is zero, it can be argued that any further distributions to the owner are by necessity from paid-in capital, and thus constitute a return of capital.

In a partnership, there is no equity account that reflects either paid-in capital or undistributed profits per se. Paid-in capital for each partner must be reconstructed from records showing how much capital each partner has contributed since becoming involved with the partnership, and the net of profits and losses charged to that partner's capital account, less any distributions to the partner.

TRLPA mentions distributions of capital from a limited partnership. TRLPA provides that "distributions that are a return of capital shall be made on the basis of the agreed value . . . ." TRLPA § 5.04. TRLPA has the following definition for "return of capital":

> unless otherwise provided in a written partnership agreement, any distribution to a partner to the extent that the partner's capital account, immediately after the distribution, is less than the amount of that partner's contribution to the partnership as reduced by prior distributions that were a return of capital.

TRLPA § 1.02(13). That description of a return of capital can be altered by written partnership agreement. So it is clear that a limited partnership can distribute capital as opposed to profits. The issue is not whether capital can be distributed. The issue is really whether capital distributed to the owner of a separate property limited partnership is received as separate property by that owner. See "liquidation" in section VII.I infra.

Corporation. Distributions of profits from a separate property corporation are community property. Such distributions are usually in the form of dividends paid to a spouse-shareholder. What about the return of capital from a corporation? Questions arise as to what constitutes a dividend from a corporation. Dividends are the distribution of current or accumulated earnings to the shareholders of a corporation pro rata based on the number of shares owned. Black's Law Dictionary 331 (6th ed., abridged ed., West 1995); Glenn A. Welsch and Charles T. Zlatkovich, Intermediate Accounting 759 (8th ed. 1989). For financial reporting purposes, a dividend payment requires a credit to the account representing the item distributed to the shareholder (for example, cash, and a debit to retained earnings). Four dates are relevant in accounting for dividends: 1) date of declaration; 2) date of record; 3) ex-dividend date; and 4) date of payment. For cash or property dividends, the declaration date is important because courts have held that the formal declaration of the dividend by the entity's board of directors constitutes an enforceable contract between the corporation and the stockholders. In the case of stock dividends, a corporation has a right to revoke the dividend declared up to the date of issuance.

Complete and partial liquidations from corporations are discussed infra.

Partnership. For purposes of characterization, income from separate property is community property, including the income from a separate property partnership interest. Some forensic accountants have interpreted the Marshall case, discussed supra, in a broad way to support a position that any and all distributions from a partnership are community property, not just distributions of income or profit of the entity. What if the distributions exceed the actual earnings of the partnership or actually constitute a return of the capital of the entity? Forensic accountants may account for the profits or earnings of the partnership and separate them from capital. It is then possible to attribute the partnership's income and profit to certain distributions, call them community, attribute distributions in excess of such earnings to capital, and call them separate property? This is especially applicable when the partnership agreement itself provides for distributions that are a return of capital to the partners. Questions may arise as to the treatment of the undistributed income, which is property of the entity and not of a marital estate. Is the entity's income cumulative and is the community estate entitled to have previously undistributed cumulative earnings deemed to be community property whenever a distribution occurs? Should the treatment of assets received in dissolution of a partnership differ for a corporate liquidation or redemption of a shareholder's interest?

3. Liquidation of the Entity.

a. Complete Liquidation. There is case authority that liquidating distributions from a corporation that is ceasing to do business are received by the owning spouse with the same character as his/her interest in the business. Thus, separate property stock begets a separate property liquidating distribution. *Legrand-Brock v. Brock*, 246 S.W.3d 318, 322-24 (Tex. App.--Beaumont 2008, pet. denied).

b. Partial Liquidation. A controversy exists today as to whether a business entity, like a corporation or a partnership, can make a partial liquidating distribution that has the same character as the spouse's ownership interest in the entity. The TBCA recognizes that a corporation may distribute a "payment . . . in liquidation of all or a portion of its assets." TBCA art. 1.02A(13). This seems to recognize a partial liquidation by corporations. The court of appeals in *Legrand-Brock v. Brock*, 246 S.W.3d 318, 322 (Tex. App.--Beaumont 2008, pet denied), suggests this same theory based on the following quotation:

> A liquidating distribution includes a transfer of money by a corporation to its shareholders in liquidation of all or a portion of its assets. See Black Law's Dictionary 508 (8th ed. 2004) (A "liquidating distribution" is "[a] distribution of trade or business assets by a dissolving corporation or partnership."); see also Tex. Bus. Corp. Act. Ann. art. 1.02(A)(13)(c) (Vernon Supp. 2007) (" 'Distribution' means a transfer of money ... by a corporation to its shareholders ... in liquidation of all or a portion of its assets.") (emphasis added) Ibid. at 322. One federal court, ruling in a tax case, wrote of corporate dividends:
>
> > The Code generally treats corporate distributions (or dividends) out of earnings and profits as ordinary income to the shareholder taxpayer. But if a corporation pays a dividend which exceeds its earnings and profits (as measured by § 316(a)), the Code treats that portion of the dividend as a nontaxable return of capital to the shareholder taxpayer to the extent of the taxpayer's basis in the securities, and as a capital gain to the taxpayer once the

> taxpayer's basis is exhausted. *Mazzocchi Bus Co., Inc. v. C.I.R.*, 14 F.3d 923, 927 (3rd Cir. 1994).

The *Brock* court quoted Black's Law Dictionary for the following definition: "a 'liquidation dividend' is defined as '[a] dividend paid to a dissolving corporation's shareholders, [usually] from the capital of the corporation, upon the decision to suspend all or part of its business operations.' Black Law's Dictionary 513 (8th ed. 2004)." *Brock*, at 321 n. 3.

As part of the Uniform Principal and Income Act, applicable to trusts, Texas Property Code §116.151 makes the following statement: "Money is received in partial liquidation: (1) to the extent that the entity, at or near the time of a distribution, indicates that it is a distribution in partial liquidation; or (2) if the total amount of money and property received in a distribution or series of related distributions is greater than 20 percent of the entity's gross assets, as shown by the entity's year-end financial statements immediately preceding the initial receipt."

The exhaustion-of-capital approach was endorsed in the following quotation taken from *Brooks v. Brooks*, 612 S.W.2d 233, 237 (Tex. Civ. App.–Waco 1981, no writ), where the trial court awarded reimbursement to the husband's separate estate for the use of capital of a separate property corporation to pay family living expenses and to acquire personal assets:

> In summary, here was a corporation which was a going concern and wholly owned by Appellee Mr. Brooks at the time he married Appellant Mrs. Brooks, worth $63,266.00 at the time of the marriage; during the six years of marriage the parties drew $166,575.00 out of the corporation for living expenses and the acquisition of a sizeable community estate, thereby spending during such six year period not only all the corporation earned during the marriage, but also depleting the corpus of the corporation by $48,020.88. The right of reimbursement is an equitable doctrine. To us it seems fair and equitable under this record for the trial court to reimburse Appellee Mr. Brooks for this capital depletion, particularly where it is undisputed that the community estate acquired by the parties substantially exceeds the amounts reimbursed to Appellee.

Id. at 237.

<u>Phantom Income.</u> With a pass-through entity (like a Sub-S corporation, a partnership or an entity that elects to be taxed like a partnership), earnings of the business will be passed through to the owners to be reported on their personal tax returns. If the earnings are retained inside the entity, then there will be no actual income received to use to pay the income tax due on the "phantom income." If the spouse's interest in the pass-through entity is separate property, then the value of the separate estate will increase by the amount of that undistributed income, even though the community estate is liable for the tax on the undistributed income. In Texas, the existing case authority says that the undistributed earnings are not community property. *Thomas v. Thomas*, 738 S.W.2d 342, 344 (Tex. Civ. App.–Houston [1st Dist.] 1987, writ denied). If community money is used to pay the tax on the phantom income, reimbursement is in order. What if the entity distributes just enough earnings to the spouse to pay the tax on the phantom income? The distributions are presumptively community property, and if they are used to pay the tax on the phantom income it can be argued that reimbursement is still due for using community money to pay a separate debt–even though the entity actually paid the tax on the phantom income by distributing out the tax payment to the owners. One way to fix this problem is a written waiver of reimbursement. However, there is no statutory authority for post-marital waiver of reimbursement claims. Can the waiver be repudiated prior to divorce because it constitutes an agreement incident to divorce, under Tex. Fam. Code §7.006(a)? Another way to avoid such a reimbursement claim is to partition the distribution so that it is received as separate

property, so that separate cash is paying the tax on the phantom income. Phantom income can also be a concern for a non-partner spouse who receives an assignee's interest in a partnership after divorce. Will there be phantom income? Does the partnership agreement require the partnership to distribute enough money to pay the phantom tax? If such a provision does exist, at the time of divorce, can it be amended later despite opposition from the assignee spouse?

VI. CAUGHT IN THE CROSS-FIRE. Two cases involve post-divorce tort law suits against corporations alleging that the companies cooperated with the employed former spouses to injure the other spouse.

In *Earthman's, Inc. v. Earthman*, 526 S.W.2d 192 (Tex. Civ. App.–Houston [1st Dist.] 1975, no writ), the ex-wife sued her ex-husband's family for conversion in refusing to deliver to her shares of stock that were awarded to her in the decree of divorce. At least part of the stock in question was subject to a transfer restriction in the articles of incorporation. A jury found conversion and awarded nearly $650,000 in damages. The appellate court found that the stock transfer restriction was not applicable to a divorce-related transfer between spouses, and that the corporation could properly be held liable for failing to deliver the stock. *Id.* at 202. The judgment was reversed, however, for the trial court's failure to instruct the jury that "a refusal to deliver property on request may be justified in order to secure reasonable time to investigate the rights of the parties and in an appropriate case, no conversion results if such is made in a good faith effort to resolve a doubtful matter." *Id.* at 206.

In *Echols v. Austron, Inc.*, 529 S.W.2d 840 (Tex. Civ. App.–Austin 1975, writ ref'd n.r.e.), the former wife sued her former husband and the company where he worked for fraudulently depriving her of stock awarded to her in the divorce, and conspiring to delay a bonus payment until after the divorce. There was a hung jury, and the trial court rendered judgment essentially denying the ex-wife all her relief. The appellate court looked at the evidence and held that the facts supported the valid exercise of business judgments as much as a conspiracy, and thus constituted no evidence of conspiracy. *Id.* at 845.

Under Tex. R. Civ. P. 43, a party holding property that might belong to either of two parties can file an interpleader, interplead the two defendants, leave the property in the registry of the court, and step out of the law suit. This might be the best posture for the company to take if an employee and his/her spouse or ex-spouse are both claiming something held by the company.

VII. OLD AGE AND RETIREMENT. The golden years of retirement are based on the "three-legged stool" of employer-sponsored retirement benefits, Social Security benefits, and savings. All three legs are wobbly, and there are indications that many older Americans will have to retire later, reduce their post-retirement lifestyles, and perhaps work at less desirable jobs after retirement. Pensions provide 18% of the aggregate income for people age 65 and older; asset income provides 15%; Social Security provides 37%; and earnings provide 28%. Orszag (Oct. 7, 2008).

A. DEFINED BENEFIT RETIREMENT PLANS (PRIVATE). A defined benefit pension plan (DBP) is a retirement plan that uses a specific predetermined formula to calculate the amount of an employee's future benefit. The formula usually involves the number of years of credited service (similar to, but not always identical to, the number of years worked) multiplied by average final salary (such as, for example, the average of the annual salaries for the highest three out of the last ten years of employment). In private industry, DBPs are typically ERISA-qualified plans that are funded exclusively by employer contributions. DBPs for government employees often require employee contributions. From a policy perspective, an important feature of DBPs is that the employer bears the risk of meeting the employee's retirement needs if the plan's investment history will not support the required retirement payments. Keating (2007) p. 440.

The biggest news in recent years about DBPs is (i) the reduction in prevalence of DBPs compared to the growing use of defined contribution plans; and (ii) the serious under-funding of DBPs for private company employees. While DBPs used to be considered one of the three legs of the retirement stool, many employers have frozen or terminated their DBPs. A good overview of the DBP situation is *The Coverage of Employer-Provided Pensions: Partial and Uncertain* (Oct. 2008) by the AARP Public Policy Institute <http://assets.aarp.org/rgcenter/econ/d19108_pensions.pdf>.

DBPs–An Endangered Species. DBPs in America are primarily a product of the post-WWII economy, where stable companies, encouraged by tax policy, offered pension benefits as an inducement for employees to spend their entire career working for one employer. Befort (2007) p. 947. In 1979, half of all private-sector workers were covered by a pension. Befort (2007) p. 947. DBPs were particularly prevalent in heavy industries, like mining, manufacturing, and transportation, where laborers were unionized. By 2007, the percentage of private sector employees covered by a DBP had shrunk to 17%. Keating (2007) p. 445. Some companies have closed existing DBPs to new employees, while others have frozen further contributions to their DBPs or converted them to cash balance plans (which requires Texas to rethink its *Taggart* and *Berry* formula approaches to characterizing DBPs). An important factor contributing to the decline of DBPs is the need for companies to eliminate the risk associated with guaranteeing a stream of payments over time, because the company must transfer assets from the company to the DBP sufficient to make up for any shortfalls in investment caused by fluctuations in the stock market or changes in interest rates. By establishing defined contribution plans, the employer can transfer this risk to the employee.

Many DBPs are in older industries, where workers were represented by labor unions, and where a substantial number of covered employees have retired. In 2006, GM had four retirees per active worker, while Ford had two retirees per active worker. Keating (2007) pp. 462-463. As DBPs tilt toward fewer workers supporting more retirees, there is pressure on employers to apply profits to retirees and not current employees. The interests of current workers in present income can be pitted against the interests of retirees. Retirees typically have no vote in labor contracts. Keating (2007) pp. 438-439.

Failed Plans. A number of corporate bankruptcies have resulted in underfunded DBPs being offloaded to the Pension Benefit Guarantee Corporation (PGBC). These bankruptcies include airlines, which account for 38% of the PBGC's deficit (Braniff, Eastern, Pan American, Trans World Airlines, United Airlines, US Airways, Aloha Airlines, Delta Airlines), financial (Lehman Brothers), and manufacturing (Allis-Chalmers, Bethlehem Steel, LTV, Steel, National Steel Corporation, Kaiser Aluminum).

The mechanics of a plan sponsor's bankruptcy on a DBP is discussed in Rosenberg (2006).

When the PBGC takes over a DBP, it will not fully replace the retirement income of higher-paid retirees. Instead, payments are capped at the maximum benefit guarantee for the year in which the plan is terminated. For plans terminating in 2009, the maximum benefit guarantee is $4,500 a month, or $54,000 a year, for a single life annuity beginning at age 65. <http://pbgc.gov/workers-retirees/benefits-information/content/page789.html>.

DBPs–Underfunding. For a DBP, the risk of underperforming investments is born by the sponsor of the plan, not the employee. Therefore a DBP is supposed to represent a more reliable source of retirement money than a defined contribution plan or personal savings. However, many DBPs are in financial difficulty, and their sponsoring employers likewise are suffering, so that the actuarial soundness of some DBPs is in jeopardy. The actuarial soundness of a DBP is determined by comparing the current value of the plan's assets to its projected benefit obligation. Standard & Poor's (1998) p. 100. Standard & Poor's April 22, 2009, *The Outlook* newsletter, contained an article on the financial condition of DBPs in the S&P 500 companies. According to the author, the market downturn that started in October 2007 has greatly reduced the value of assets needed to cover the present value of future obligations of these plans. Standard & Poor's found that 60% of companies in the S&P 500 Index had underfunded DBPs at the end of the most recent fiscal years for which data was available. ExxonMobile Corporation's (XOM) DBP was underfunded by $15 billion. However, XOM has $31.4 billion in cash and $9.4 billion in debt, so the article says the money is there to fund the plan. The article listed the following DBPs as being troubled: CBS Corp., Eastman Kodak Co., General Motors Corp., Hershey Co., Kraft Foods Inc., News Corp., Southwestern Energy Co., Time Warner Inc., and Time Warner Cable Inc. The Director of the Congressional Budget Office (CBO) testified to a Congressional committee in October of 2008 that the value of assets in DBPs declined 15% in the twelve months ending October 2008. This decline was partially offset by increased interest rates, which increased the discount rate used by actuaries to calculate the present value of pension obligations, which therefore declined. Orszag (Oct. 7, 2008). Standard & Poor's estimates that for each percentage point increase or decrease in the discount rate, the degree of funding or underfunding moves by 10% to 15%. Standard & Poor's (1998) p. 100. However, bond yields have fallen since the Director testified, driving plans further into actuarial insolvency. Mercer, a wholly-owned subsidiary of Marsh & McLennan Companies, keeps track of the total combined funded status of DBPs operated by S&P 1500 companies on a monthly basis. The ratio of assets to liabilities, which was 104% at the end of 2007, stood at 75% at the end of 2008. The aggregate deficit for DBPs was $409 billion. This shortfall must be reflected on corporate financial statements as a debt-like component, which reduces net worth and will adversely affect capital expenditures, loan covenants, and corporate credit ratings. And if funding falls below 80%, the plan sponsor must provide additional funding, restrict benefits, or freeze the plan. Mercer projects that pension expense will go from $10 billion in 2008 to $70 billion in 2009. <www.mercer.com/summary.htm?siteLanguage=100&idContent=1332250>. Under a process called "smoothing," companies can average fluctuations in value and in the discount rate over several years to avoid wide swings. However, even though DBP underfunding will improve if stock prices climb again, even at the high in October 2007, DBPs were only 107% overfunded, compared to being 25% underfunded now. Although interest rates will certainly rise at some point, thus reducing the present value of future payouts, underfunding will continue to be a concern in the future for many plans. And the drag on corporate profits will prompt companies to freeze or terminate their DBPs.

<u>PBGC</u>. In 1974, in adopting ERISA, the U.S. Congress created the Pension Benefit Guarantee Corporation (PBGC), to serve as an insurer of DBPs. The PBGC capitalizes its insurance fund by assessments on DBPs operating in the United States. There have been some spectacular failures of DBPs in the past (for example Bethlehem Steel in 2002), and in these instances the PBGC covered only part of the defaulted pension obligations. The PBGC is presently insolvent and, until the insolvency is corrected, PBGC's ability to fund its guarantees must be considered suspect. While some may expect the U.S. government to bail out the PBGC, there may be political resistance to this preferential use of government funds for a select group of citizens while so many other Americans have no retirement benefits, and questions arise as to the ability of the U.S. government to fund all the bailouts it has undertaken and may in the future undertake.

Insolvency. The Pension Benefit Guarantee Corporation (PBGC) is a wholly-owned federal corporation established under ERISA, with a three-member board of Directors made up of the Secretaries of Labor (who is the Chair), Commerce, and Treasury. Under the Pension Protection Act of 2006, the Director of PBGC is appointed by the President and confirmed by the Senate. The PBGC guarantees payment of part of the benefits due from private sector defined benefit pensions plans, covering nearly 44 million American workers in more than 29,000 plans. The PBGC, traditionally allocated its investment portfolio 75-85% fixed income and 15-25% equities. In February of 2008, the Board adopted a new mix for its $55 billion investment portfolio: 45% equities, 45% fixed income, and 10% alternative investments (including private equity and private real estate). This was done because two studies showed that the existing investment policy gave the PBGC only a 19% chance of achieving full funding for the agency in 10 years (without increasing premiums), while the new policy would give it a 57% chance of full funding in 10 years (without increasing premiums). The move was criticized at the time as involving too much risk. The PBGC acting director told Congress on May 20, 2009 that, as of March 31, 2009, PGBC had the largest deficit in the agency's 35-year history: $33.5 billion up from $11 billion in September 2008. $11 billion of the deficit was from completed and probable pension plan terminations, $7 billion from a decrease in the discount rate used to calculate liabilities, $3 billion in investment losses, and $2 billion in actuarialcharges.<http://www.pbgc.gov/media//news-archive/testimony/tm16758.html>. The PBGC is not immediately insolvent, because its payment obligation stretch over time. However, insolvency must be addressed at some point. The PBGC is between a rock and a hard place: if it dramatically increases premiums charged on functioning defined benefit plans, it may cause more plans to be curtailed. It is estimated that the PBGC will be on the hook for $42 billion of the $77 billion in underfunded pensions for GM and Chrysler, and related supply companies. An excellent explanation of the PBGC is at <www.coffi.org/pubs/PBGC%20A%20Primer.pdf>. See Section XII.9 of *Understanding the Economy* regarding conflict-of-interest issues.

B. DEFINED CONTRIBUTION PLANS. A defined contribution plan (DCP) is a retirement plan in which the amount of the employer's annual contribution is specified. Individual accounts are set up for participants and benefits are based on the amounts credited to these accounts (through employer contributions and, if applicable, employee contributions) plus any investment earnings on the money in the account. In a DCP, future benefits are not guaranteed by the employer. This is an important distinction from DBPs, where the investment performance risk is shouldered by the employer, backed up by the PBGC. Participation in many DCPs is voluntary on the part of the employee. In DCPs, future benefits are determined by (i) contributions, (ii) investment earnings, and (iii) the retirement-age values of the investments in the plan. The most common type of defined contribution plan is a savings and thrift plan. Under this type of plan, the employee contributes a predetermined portion of his or her earnings (usually pretax) to an individual account, all or part of which is matched by the employer." DCPs are generally ERISA-qualified 401k plans. There are three big problems with DCPs as retirement security: (i) under-participation by employees; (ii) inadequate funding to meet retirement needs; and (iii) non-optimal investment decisions.

Under-Participation. In contrast of DBPs, where employee participation is mandatory, participation in a DCP is voluntary. Congress is presently looking at a possible way to boost participation in DCPs such as mandating automatic inclusion in a company's DCP, subject to "opting out," but no law has been passed. Another problem with DCPs is withdrawal of funds before retirement, which can occur at the time the employee changes jobs or in order to meet certain financial needs.

Failure to Diversify. In most DCPs, the employee is free to direct the investment of some or all of that assets held in his/her account. Employees often do not manage the investments in their DCP account, in which case the default investment allocations put in place when the account is established continue. Employees whose funds are in cash or CDs generally lose value each year against inflation. Employees who are invested entirely in stocks are at risk of a stock market downturn at the time investment funds are withdrawn. And plan participants who do actively invest will put their money in individual stocks rather than a well-diversified portfolio, thereby assuming greater risk without greater reward. A better choice would be index funds that mimic a broad stock market index like the S&P 500. Another problem exists where the DCP assets are invested in the employer's stock. This can happen when the employee elects to invest in his/her employer's stock or when the employer's matching contribution to the DCP is made in company stock, sometimes with transfer restrictions. The danger is exemplified in the Enron collapse. Enron's contribution to employee 401k plans was in company stock, and Enron employees were prohibited from selling those shares prior to age 50. Befort (2007) p. 958. Sixty-two percent of the funds in Enron 401(k) plans was invested in Enron stock, which was wiped out in bankruptcy. Befort (2007) p. 956. Analogous declines befell employees of Lucent, Polaroid, and Global Crossing. *Id.* These employees failed to, or could not, diversify their financial risk, and thus lost part of their retirement savings when they lost their jobs. ERISA limits DBPs from investing more than 10% of Plan assets in stock of the employer, but no statutory limit exists for DCPs. Befort (2007) p. 959. The Director of the Congressional Budget Office wrote on October 8, 2008, that 47% of 401(k) participants were enrolled in plans that offered company stock as an option, and that 7.3% of those participants held more than 90% of their assets in their employer's stock, and over 15% held more than half of their assets in their employer's stock. Fortunately, that number has been declining, since the percent of total 401(k) assets held in employers' stock has fallen from 19.1% in 1999 to 11.1% in 2006. The 2006 Pension Protection Act limits the amount of time that an employer can require participants to stay invested in company stock. See Orszag (October 8, 2008).

Decline in the Value of DCP Assets. The Director of the Congressional Budget Office (CBO) testified in October of 2009 that over two-thirds of the assets in DCPs are invested in equities, either directly or through mutual funds. Orszag (Oct. 7, 2008). The recent severe decline in the stock market has lowered DCP asset values. Fidelity Investments, which manages plans for 11 million participants, said that their average work-related savings account dropped from $69,200 at the end of 2007 to $50,200 at the end of 2008. VanDerhei (Feb. 2009) p. 4 n. 8. A study by the Employee Benefit Research Institute found that from the beginning to the end of 2008, participants with plan balances of $10,000 or less made up for losses with contributions, while those with $50-100,000 broke even, and plans with balances in excess of $200,000 lost 25%. *Id.* pp. 5-6. The study also found that 22% of the oldest participants had 90% or more of their 401(k)s in equities. Forty-three percent had 70% or more invested in equities. *Id.* p. 11. These are people who have the least amount of time to rebuild their balances before retirement.

C. SOCIAL SECURITY. President Roosevelt signed the Social Security Act on August 14, 1935. Monthly benefits began in January 1940. Since that time Social Security has been a blessing to many retired people of limited means. However, in the future, the Social Security program will deplete its reserves and be unable to pay scheduled benefits to retirees.

The Social Security Trust Fund is funded by a 12.4% tax on gross earnings, paid half by the employer and half by the employee (or 12.4% self-employment income). The Social Security tax applies only to the first $106,800 in income.

Congress provided for cost of living adjustments (COLAs) to Social Security benefits in 1950. The COLAs were tied to inflation in 1975 as reflected by the Consumer Price Index-all workers (CPI-W). Based on the CPI-W, for third quarter 2007 to third quarter 2008, the COLA for 2009 was 5.8%. That is the largest increase since 1982, due mainly to increases in gas and energy. The Congressional Budget Office is currently projecting no COLAs for 2010, 2011 and 2012. Inflation has a negative impact on taxation of Social Security benefits. Individuals earning less than $25,000, and married couples filing jointly with less than $32,000 annual income do not have to pay income tax on their Social Security benefits. Above those thresholds, benefits are taxed all the way up to 85%. Those thresholds are not indexed for inflation, meaning that with inflation more people will have to pay tax, just because of inflation. Munnell and Muldoon (Oct. 16, 2008) p. 4.

The Social Security Trust Fund is supposed to contain $ 2.4 trillion. <www.ssa.gov/OACT/ ProgData/investheld. html>. However, the Social Security Trustees by law are required to invest only in non-marketable securities issued by the U.S. Treasury. The Social Security Trust Fund now consists of U.S. Treasury bonds, the sum total of which is contained in a small three-drawer filing cabinet filled with ring binders containing these special Treasury bonds. See <www.chrismartenson.com/files/ u4/Bush_ holding_SS_bond.jpg>.

Everyone who has examined the issue agrees that the Social Security Trust Fund is actuarially unsound. In America we have people who are living longer and having fewer children. Additionally, the Baby Boom generation of Americans will soon reach retirement age, increasing the percentage of American who are over age 65. Because of these factors, the number of workers paying into the Social Security system for each beneficiary (the "dependency ratio") will decline. In 2005, the number of workers per elderly person was 4.1. This is projected to fall to 2.9 in 2020. The Social Security Administration explains it this way:

> People are living longer, the first baby boomers are nearing retirement, and the birth rate is lower than in the past. The result is that the worker-to-beneficiary ratio has fallen from 16.5-to-1 in 1950 to 3.1-to-1 today. Within 20 years it will be 2.1-to-1. At this ratio there will not be enough workers to pay scheduled benefits at current tax rates.

<www.ssa.gov/qa.htm>. In April of 2009, the Congressional Budget Office (CBO) projected that the outflow of Social Security benefits will exceed Social Security tax revenue in 2017 (that's only 8 years from now). The 2009 Social Security Trust Fund Trustees Report pegs that date at 2016. That shortfall will have to be financed by interest paid by the federal government on the bonds it required the Trust Fund to buy. <cboblog.cbo.gov/?p=239>. At this point, the combination of Social Security tax revenues and the income on the Social Security Trust Fund "investments" (i.e., IOUs from the U.S. government) will exceed Trust Fund outflows until 2024. At that point, the Social Security Trustees will have to start redeeming the Fund's federal bonds. Unfortunately, at that time the federal budget will be in deficit, so repayments to the Social Security Trust Fund will have to be financed with new government borrowing from investors competing with corporate bond issuances and putting upward pressure on interest rates. The negative cash flow condition will continue until the U.S. government pays back all the money it has borrowed from the Trust Fund since the 1970s, and from that point forward, absent a change in the law, Social Security will convert to a pay-as-you-go program. The Trustees project that this will occur in 2020 for the Disability Insurance Fund (the CBO says 2019; See <cboblog.cbo.gov/?p=239> and in 2037 for the Old Age and Survivors Insurance Fund. The CBO projects that revenue at that time will be only 84% of scheduled outlays, so that benefits will have to be lowered 16% below the scheduled

amount. See *Updated Long-Term Projections for Social Security*, p. 3. <www.cbo.gov/ftpdocs/96xx/doc9649/08-20-SocialSecurityUpdate.pdf>; Munnell (March 2008). The Social Security Administration web site says that, without changes in the law, in 2037 only 76% of benefits will be paid. <www.ssa.gov/qa.htm>.

Social Security, Medicare, and Medicaid presently amount to of 8% of GDP; by 2030, it is estimated that that will rise to 15%. Befort (2007) p. 946.

Social Security benefits are indexed to "headline inflation." See Section III.L.1.c of *Understanding the Economy*. That means that Social Security benefit increases are correlated to increases in price for food and energy.

Options to "fix" Social Security include: increasing payroll tax; raising the payroll tax ceiling ($102,000 in 2008); increasing the portion of Social Security benefits subject to income tax; reducing benefits; raising the retirement age; altering the indexing of initial benefit amounts; reducing cost-of-living adjustments; investing part of the Social Security Fund in the stock market; creating private accounts. Befort (2007) p. 966-969. Any increase in Social Security taxes may be expected to reduce consumer spending and thus economic activity. One study found that raising payroll tax by 1% (to 13.4%), increasing the normal retirement age from 66 to 69 years, and investing 25% of Social Security Trust funds in equities, the Fund balance would remain positive until 2101. <http://www.mrrc.isr.umich.edu/publications/findings/pdf/SOCIALSECURITY.pdf>.

The sooner we implement changes, the fairer they will be, as the tax increases or reduced benefits will be spread over more age groups. The government will also need to induce workers to postpone retirement, which both increases contributions and reduces benefits.

D. MAINTAINING STANDARD OF LIVING DURING RETIREMENT. The Health and Retirement Study conducted in 1992 showed that 80% of families then aged 51-61were on track to maintain their standard of living after retirement and 20% would fall short. Munnell, Webb and Golub-Sass (2007) pp. 1 & 6. The National Retirement Risk Index (NRRI) study conducted in 2004 found that 35% of households that age were at risk of not being able to maintain pre-retirement living standards. *Id.* p. 3. In the NRRI 2004 study, the risk varied for different "cohorts" (age groups). For early Baby Boomers (born 1946-1954), the "at risk" figure was 35%. For Late Baby Boomers (born 1955-1964), the percent at risk was 44%. *Id.* p. 2. Of the Generation Xers (born 1965-1972), 49% were "at risk." The later groups' increasing risk was influenced by 1) increased longevity, 2) a "contracting retirement income system," partly due to Social Security's Normal Retirement Age rising from 65 to 67 years of age, and 3) declining interest rates diminishing investment income. *Id.* pp. 2 & 5. Also, while the percent of employees covered by private retirement benefits remained the same, the coverage has shifted from defined benefit plans to defined contribution plans, for which the median plan balance at retirement was $60,000. *Id.* Considering all families combined, the NRRI 2004 study found that 43% of families sampled were "at risk" of not being able to maintain their standard of living if they were to retire at age 65 (which is later than the average actual retirement age of 63). When the NRRI was updated to 2006, it found that 44% of all households were "at risk," and that the cohorts broke down as follows: Early Baby Boomers were 35%; Late Baby Boomer were 44%; and Generation Xers were 48% at risk. Munnell, Soto, Webb, Golub-Sass, and Muldoon (Feb. 2008) p. 2. In a later study, Munnell et al. factored in the projected increases of health care costs. That raised the the "at risk" percentages as follows: Early Baby Boomers went from 35% to 50%, the Late Baby Boomers from 44% to 61%, the Generation Xers from 48% to 68%, and the overall average from 44% to 61%. *Id.* p. 4.

An Ernst & Young report, in July 2008, mentions two concerns for Baby Boomers: the risk of reduced standard of living in retirement; and outliving their wealth. Ernst & Young (2008) p. 1. The report identified four major retirement risks: replacement rate risk; longevity; risk; investment performance risk; and inflation risk. *Id.* p. 2.

Replacement Rate. "The replacement rate is a basic measure of the performance of retirement income systems. It gauges the extent to which benefits replace earnings before retirement and thereby allow workers to maintain a reasonable approximation of their pre-retirement standard of living." Munnell and Soto (August 2005) p. 2. Retirement planners say that people should assume a replacement rate of 70 to 85% of pre-retirement income, meaning that expenditures during retirement will be 70 to 85% of pre-retirement income. Scholz and Seshadri (2008) p. 3. Scholz and Seshadri argue that the true replacement rate depends on a number of different factors, including lifestyle before retirement. Then there is a terminology question as to what income "replacement" is measured against: is it income in the year immediately prior to retirement, or average income during the working life, or income in "n" years immediately prior to retirement? *Id.* p. 3, n. 4. A comprehensive analysis of replace-ment rates is at Biggs and Springstead (2008). Biggs and Springstead indicate that there is no uniform measure of pre-retirement income, so that replacement rate calculations vary widely. "Replacement rate risk" is the possibility that retirement income will not be enough to cover needs. This could result from insufficient guaranteed income, insufficient assets, insufficient real (inflation-adjusted) rates of return, and living beyond the point retirement assets are consumed. Munnell, Webb and Golub-Sass (2007) p. 2. The NRRI study conducted in 2004 used a replacement rate of 65% to 85% of pre-retirement income as a benchmark for adequate replacement, depending on household income and marital status. Munnell, Webb and Golub-Sass (2007) p. 7 n. 1. The replacement rate is less than 100% because retirees pay less in taxes, no longer need to save for retirement, work-related expenses decline, mortgages are paid off, and children have left the home. In the NRRI study, if the family annuitized all of its wealth on the day of retirement, including the receipts from reverse mortgages on their homes, and the resulting income fell more than 10% below the target pre-retirement income replacement rate, then the family was considered to be "at risk." Munnell, Webb and Golub-Sass (2007) p. 1. The Social Security Administration has published an analysis of the replacement rates of private and federal pensions. See <www.ssa.gov/policy/docs/ssb/v65n1/v65n1p17.html>.

Inadequate Saving. There is a widespread concern that Americans are not saving enough for retirement. Given that the saving rate has been so low in recent years (see Section III.H of *Understanding the Economy*), it makes sense.

One study, conducted under the auspices of the University of Michigan Retirement Research Center, found little evidence that Americans born prior to 1954 have prepared poorly for retirement, and found that only 4% of households have a net worth below their optimal targets. See Scholz and Seshadri (2008). Scholz and Seshadri criticize the use of the NIPA aggregate of consumer saving (see Section III.H of *Understanding the Economy*) as a measure of individual saving for retirement. *Id.* p. 3. NIPA saving excludes not only accrued but also *realized* capital gains. Also, investing in consumer durables is not part of NIPA personal savings. And the NIPA numbers say nothing about how total savings is distributed across families. *Id.* p. 3.

Accumulated Wealth. The combination of wealth and income compared to expenses is what counts during retirement. Unrealized capital gains in stock or housing contribute to retirement security. In the study, Scholz and Seshadri have assumed that "housing wealth is fungible and can be used to support consumption in old age." *Id.* p. 17. This could be accomplished through home equity loans or reverse mortgages. The recent decline in the stock markets and in real estate values has wiped out much capital gain and wealth. This would certainly change the assessment of preparedness in the Scholz and Seshadri study. For younger workers, time will allow them to repair the damage by restoring stock and home values. For those who must liquidate during the downturn, the losses will be permanent. In the study, Scholz and Seshadri found that in most age ranges 95% to 98% of families exceed their "optimal Net Worth Target," as defined in the study. The exception is early Baby Boomers, of whom 10.2% are below the optimal net worth target, presumably because their children have recently become self-supporting. *Id.* p. 17.

<u>Longevity Risk</u>. "Longevity Risk" is the risk that you will outlive your wealth. This is a function of wealth at the time of retirement, the amount of Social Security and private pension payments, expenses during retirement, and length of life. A study released in July, 2008, by Ernst & Young entitled *Retirement Vulnerability of New Retirees: the Likelihood of Outliving Their Financial Assets*, found that 60% of middle-class retirees will probably outlive their financial assets if they try to maintain their current pre-retirement standard of living. Ernst & Young (July, 2008) p. 1. Middle-Income Americans would have to reduce their standard of living by an average of 32% to avoid outliving their financial assets. *Id.* p. i. Near retirees (those within 7 years of retirement) without a guaranteed source of income (like an annuity or deferred contribution plan) would have to reduce their standard of living by 45% to avoid outliving their financial assets. This is assuming a replacement rate of 59 to 71% of pre-retirement wages. *Id.* p. i. In June of 2009, Ernst & Young released an update of the study. Ernst & Young (June 2009). The updated study noted that from July 1, 2008, to December 31, 2008, large cap stock values declined 28%, small cap stocks declined 34%, and international stocks declined 37%. *Id.* p. 2. After these market declines, a married couple with pre-retirement income of $75,000 and no defined benefit plan had a 96% chance of outliving their retirement assets. To avoid this, the couple would have to reduce retirement expenditures to 49% of pre-retirement income. *Id.* p. 3. If the couple has a defined benefit plan, the chance of outliving their financial assets is 69%, and it would require a reduction of 28% of pre-retirement standard of living to avoid this. *Id.* p. 3.

<u>Investment Performance Risk</u>. "Investment Performance Risk" is the danger that investments will not perform at the level required to meet post-retirement needs. This is a function of the choice of investments and market conditions. Lack of diversification of investments has a large impact on investment performance risk. Ernst & Young points out that investing over a long horizon permits wealth to be invested in a diversified way, with a balanced composition of equity and bond investments. *Id.* p. 2. Financial advisors recommend a greater weighting of equities for a long investment horizon, shifting to bonds as retirement gets closer. *Id.*

<u>Health Care Costs During Retirement.</u> According to the Center for Retirement Research, the major health care expenses faced by retired households include premiums for Medicare Part B (physicians and outpatient hospital services) and Part D (medications), plus co-payments under Medicare, and services not covered by Medicare. Munnell, Soto, Webb, Golub-Sass, and Muldoon (Feb. 2008) pp. 2-3. In 2007, the Centers for Medicare and Medicaid Services estimated that out-of-pocket expenses under Medicare would average $3,800 per year for a single individual. *Id.* p. 3. Add to that things not covered by Medicare, like dental care, eye glasses, hearing aids, etc., estimated to cost $500 per year. *Id.* These costs are expected to grow at the rate of 5.9% per year for the next 20 years. *Id.* The same paper indicates that more than two-thirds of persons over age 65 will need long-term care at some point in their lives. *Id.* p. 5. Of that group, they project that over 40% will require care for more than two years. *Id.* Those costs are not included in the NRRI "at risk" calculations. *Id*. Inflation is a problem, too. Medicare Part B premiums are automatically deducted from Social Security payments. The average rate of increase of premiums in Medicare Part B over the last three decades has been 9% per

year. The average cost of living increase in Social Security has been 3.8%. So over time, Social Security benefits, after deducting Part B premiums, have been declining. Munnell and Muldoon (Oct. 16, 2008) p. 3.

VIII. UNDERSTANDING THE ECONOMY. The Author of this Article prepared a 165-page paper for another continuing legal education course in August of 2009, *Understanding the Economy: How Did We Get Here? Where Are We? Where Are We Going?* You may find the paper useful. The paper is available at <http://www.orsinger.com/understanding_the_economy.pdf>.

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