WHAT A SPOUSE CAN DO TO UNILATERALLY PROTECT THAT SPOUSE'S "ESTATE" FROM THE OTHER SPOUSE AND THE OTHER SPOUSE'S CREDITORS AND HEIRS

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I. INTRODUCTION

The trusts and estates practice in Texas continues to evolve. Less emphasis is placed on tax planning in view of increased exemptions and the unlimited marital deduction – even possible repeal of the estate tax. More emphasis is placed on asset preservation in view of non-tax concerns such as the impact of divorce or incapacity and the claims of creditors.

In other words, clients are asking more frequently for techniques that preserve not only what was brought into the marriage but also what is going to be accumulated during the marriage. In these situations, a client typically states that the planning goal is to insulate "my estate" from (i) the claims of my spouse in the event of divorce, (ii) the claims of my spouse, or my spouse's heirs and devisees, in the event of death, and (iii) the claims of my spouse's creditors during the marriage and in the event of bankruptcy or death.

Fortunately, Texas law now provides effective and practical means whereby a couple planning to marry, or an already married couple, can alter by agreement the traditional rules of marital property characterization, management and liability in order to accomplish this goal.

However, the focus of this article is on what a person who is intending to marry, or who is already married, can legitimately do to unilaterally preserve that person's estate. In other words, absent a premarital or marital agreement, what can be done to insulate what the client considers to be the client's estate from the client's spouse, the spouse's creditors, and the spouse's heirs and/or devisees.

For purposes of this article, the "estate" the client wishes to preserve includes the assets brought into the marriage by the client, other assets acquired in that client's name during the marriage, and the income those assets generate, as well as the client's personal income, whether in the form of wages, salaries or contributions to a retirement plan.

The first step in the process of accomplishing as much of the client's goal as is possible is a review of the "default" rules of Texas marital property law. This process requires an understanding of the rules of marital property characterization, management, and liability. It also includes an understanding of what happens to the estates of the spouses when the marriage terminates either by divorce or the death of a spouse.

II. CHARACTERIZATION

The Supreme Court of Texas in *Arnold v. Leonard*, 114 Tex. 535, 273 S.W. 799 (1925) and *Kellett v. Trice*, 95 Tex. 160, 66 S.W. 51 (1902) made it clear to practitioners and the legislature that it is the Texas Constitution which ultimately defines what is separate or community property and not the legislature or the parties involved. Accordingly, in order to properly characterize marital assets in Texas, it is necessary to understand the Texas Constitution.

A. Article XVI, Sec. 15

All property, both real and personal, of a spouse owned or claimed before marriage, and that acquired afterward by gift, devise or descent, shall be the separate property of that spouse; and laws shall be passed more clearly defining the rights of the spouses, in relation to separate and community property; provided that persons about to marry and spouses, without the intention to defraud preexisting creditors, may by written instrument from time to time partition between themselves all or part of their property, then existing or to be acquired, or exchange between themselves the community interest of one spouse or future spouse in any property for the community interest of the other spouse or future spouse in other community property then existing or to be acquired, whereupon the portion or interest set aside to each spouse shall be and constitute a part of the separate property and estate of such spouse or future spouse; spouses may also from time to time, by written instrument, agree between themselves that the income or property from all or part of the separate property then owned or which thereafter might be acquired by only one of them, shall be the separate property of that spouse; and if one spouse makes a gift of property to the other that gift is presumed to include all the income or property which might arise from that gift of property; spouses may agree in writing that all or part of their community property becomes the property of the surviving spouse on the death of a spouse; and spouses may agree in writing that all or part of the separate property owned by either or both of them shall be the spouses' community property.

B. The True Test for Community

It is important to note that the Constitution does not define community property. *Arnold v. Leonard*, *supra*, explained the significance of the Texas constitutional approach to characterization: if an asset does not fall within the constitutional definition of separate property, it must be community property — "the rule of implied exclusion." A logical extension of this rule leads to a more practical definition for the term "community property": *that property of the marriage which is not proven to be separate property. See* II.G, *infra*.

The court in *Graham v. Franco*, 488 S.W. 2d 390 (Tex. 1972), resorted to a more historical Spanish/Mexican approach and affirmatively defined community property as ". . . that property is community which is acquired by the works, efforts, or labor of the spouses. . . ." *See* also *Whittlesey v. Miller*, 572 S.W.2d 665 (Tex. 1973); *Bounds v. Caudle*, 560 S.W.2d 925 (Tex. 1977); and *Nickerson v. Nickerson*, 65 Tex. 281 (1886).

Absent an agreement of the parties and notwithstanding these cases, the author is of the opinion that "the rule of implied exclusion" remains the true test of what is community property. The affirmative test mentioned in *Graham* has been used only in those situations where the implied exclusion rule would have worked an awkward result, such as in personal injury recoveries.

C. Traditional Means of Creating Separate Property

Consequently, the first step of characterization is ascertaining the facts and circumstances surrounding the acquisition of asset -- "the inception of title rule." *Creamer v. Briscoe*, 109 S.W. 911 (Tex. 1908). The second step is determining whether those facts and circumstances place the asset within the definition of separate property. Prior to the 1980 Amendment to Article XVI, § 16, there were limited means of creating separate property in Texas. Separate property was limited to:

1. <u>PREVIOUSLY EXISTING</u>

Property owned prior to marriage. Tex. Fam. Code § 3.001.

2. <u>GRATUITOUS TRANSFERS</u>

Property acquired during marriage by gift, devise or descent. Tex. Fam. Code § 3.001.

3. <u>TRACEABLE MUTATIONS</u>

Property acquired during marriage which was traceable as a mutation of previously owned separate property. *Love v. Robertson*, 7 Tex. 6 (1885).

4. <u>MARITAL PARTITIONS</u>

Property resulting from the partition of presently existing community property. Tex. Fam. Code § 4.102.

5. <u>CERTAIN CREDIT ACQUISITIONS</u>

Property acquired on credit during marriage is separate property if the creditor agreed to look only to separate property for repayment. *Broussard v. Tian*, 156 Tex. 371, 295 S.W.2d 405 (1956).

6. <u>CERTAIN PERSONAL INJURY RECOVERIES</u>

Personal injury recoveries (other than for loss of earning capacity). Tex. Fam. Code § 3.001.

D. 1980 Amendment

The 1980 amendment to Art. XVI, § 15 authorized the creation of separate property in new ways:

1. <u>PREMARITAL PARTITIONS</u>

Persons intending to marry can partition and exchange community property not yet acquired. *See* also Tex. Fam. Code § 4.003.

2. <u>SPOUSAL PARTITIONS</u>

Spouses may now partition and exchange not only presently existing community property, but also community property not yet in existence, into the spouses' separate properties. *See* also Tex. Fam. Code § 4.102. According to a 2003 amendment to Sec. 4.102, a partition of property presumptively includes the future income generated by the partitioned property.

3. <u>INCOME FROM SEPARATE PROPERTY</u>

Spouses may also agree that income from one spouse's separate property will be that spouse's separate property. *See* also Tex. Fam. Code § 4.103.

4. <u>SPOUSAL DONATIONS</u>

A gift by one spouse to the other spouse will be presumed to include the income generated by the donated property so that both the gift and the future income from the gift are the donee/spouse's separate property. *See* also Tex. Fam. Code § 3.005.

E. 1987 Amendment

The 1987 amendment to Art. XVI, § 16 did not authorize a new way to create separate property. It simply allowed spouses to create survivorship rights with their community property.

F. 1999 Amendment

The 1999 amendment to Art. XVI, Sec. 15 permitted spouses to convert by agreement separate property into community property, as of January 1, 2000.

G. Community Presumption

Notwithstanding the significance of the substantive rules of characterization, the importance of the community presumption cannot be ignored. Generally, all assets of the spouses on hand during the marriage and upon its termination are presumed to be community property, thereby placing the burden of proof on the party (a spouse, or that spouse's personal representative, or the heirs/devisees of the spouse) asserting separate character to show by "clear and convincing evidence" that a particular asset is, in fact, separate. Tex. Fam. Code § 3.003. A "clear and convincing evidence" standard is somewhere between "preponderance" and "reasonable doubt". *Faram v. Gervitz-Faram*, 895 S.W.2d 839 (Tex. App.—Ft. Worth 1995, no writ). However, the Texas Supreme Court has held that the requirement of a clear and convincing evidence standard is another way of stating that a legal conclusion must simply be supported by factually sufficient evidence. *See Meadows v. Green*, 524 S.W.2d 590, 510 (Tex. 1975), (A decision prior to the 1987 amendment to the predecessor to Sec. 3.003 which codified the clear and convincing evidence standard.)

1. <u>MANAGEMENT PRESUMPTION</u>

The fact that an asset is held in one spouse's name only, or is in the sole possession of a particular spouse, is not determinative of its marital character and only raises a presumption that the asset is subject to that spouse's sole management and control while the community presumption dictates it is presumptively community. Tex. Fam. Code § 3.104.

2. <u>FORM OF TITLE</u>

The fact that record title is held in a particular way due to certain circumstances may cause the community presumption to vanish in favor of a rebuttable separate presumption. *See Smith v. Strahan*, 16 Tex. 314 (1856); *Higgins v. Johnson*, 20 Tex. 389 (1857); *Story v. Marshall*, 24 Tex. 305 (1859). The other spouse may not be allowed to rebut the presumption if that spouse was a party to the transaction. *Lindsay v. Clayman*, 155 Tex. 593, 254 S.W.2d 777 (1952).

3. <u>TRACING</u>

The community presumption prescribed by Sec. 3.003 requires the party asserting that a particular asset is separate to prove the facts that justify that legal conclusion by "clear and convincing evidence." The burden can be met by tracing an existing asset through its mutations to its original separate property source. Hopefully, the spouse has maintained records of asset acquisitions, sales, purchases and other transactions and kept segregated bank accounts for separate deposits with interest payable to a different community account. Separate property will retain its separate character through a number of mutations so long as contemporaneous records have been retained. *Rose v. Houston*, 11 Tex. 323 (1854). A detailed discussion of tracing is beyond the scope of this article. For further discussion, *see* Gagnon and Patierno, "*Reimbursement and Tracing: The Bread and Butter to a Gourmet Family Law Property Case*." 49 <u>Baylor Law Review</u>, 323.

4. <u>COMMINGLING</u>

Sizable separate estates have been lost during marriage because the owner could not meet the statutory burden of proof usually because separate and community property were so mixed, they could not be resegregated, thus, the separate assets became "commingled" and lost their separate identity. The spouse whose separate estate has been lost may have a claim for reimbursement when the marriage terminates. *Horlock v. Horlock*, 535 S.W.2d Tex. App.—Houston [14th Dist.] 1975. *See* XIII.L., *infra*.

5. <u>COMMUNITY OUT FIRST RULE</u>

According to many commentators, where community funds and separate funds are deposited in a single account and there is an absence of contemporaneous records accounting for the separate and community funds thereafter expended, it is generally presumed that community funds are first withdrawn whether the withdrawals are used for the support and maintenance of the family or the purchase of property. Further, the funds remaining in the account remain separate to the extent the account balance never drops below the amount of separate funds deposited. This presumption is consistent with the community presumption in that any investments so acquired are presumed community absent clear and convincing evidence to the contrary. *See* Kazen, <u>Texas Practice and Procedure</u>, § 11.24 [1] [b], Matthew Bender (1995). However, this author is not aware of a definitive case which says "community out first" is the law.

H. Quasi-Marital Property

According to the Texas Family Code, the separate property of a spouse which was acquired while the spouses were not residing in Texas, but what would have been community had they resided in Texas at the time of acquisition, will be treated in a divorce proceeding as if it were community property. Tex. Fam. Code § 7.002. *See Cameron v. Cameron*, 641 S.W.2d 210 (Tex. 1982). A 2003 amendment to Sec. 7.002 treats as separate property any community property that was acquired while the couple resided in another state that would have been separate had they resided in Texas at the time of its acquisition. Quasi-community property is still treated as separate if the marriage terminates by reason of a spouse's death. *Hanau v. Hanau*, 730 S.W.2d 663 (Tex. 1987). Presumably "quasi-separate" property would be treated as community property if the marriage terminates by reason of a spouse's death, if the reasoning of the *Hanau* case, *supra*, is followed.

I. Personal Injury Recoveries

Personal injury recoveries for loss of earning capacity during marriage are defined as community property. Tex. Fam. Code § 3.001(9)(3). Notwithstanding this statutory provision, the author is of the opinion that actual "lost earnings" should be deemed community property while "loss of earning capacity" should be considered separate property. Lost earnings are properly characterized as community property since the community estate will be liable for payment of medical expenses and will suffer as a result of losing one spouse's community earnings. However, characterizing the recovery for lost earning capacity as community property requires a presumption that the husband and wife will remain married indefinitely. In reality, should the spouses divorce following the injury community recoveries will be divided on a just and right basis; or should the non-injured spouse die, his estate will be entitled to one-half of the entire recovery. Since the primary purpose of a personal injury recovery is to compensate the injured spouse, classifying lost earning capacity as community property and giving the non-injured spouse a one-half interest therein may leave the injured spouse with only a fraction of the amount awarded. The potential for such a situation clearly warrants a distinction between lost earnings and lost earning capacity which characterizes the former as community and the latter as separate.

III. MANAGEMENT OF MARITAL PROPERTY

Unlike characterization, rules relating to the management of marital property are within the rulemaking authority of the legislature. *Arnold v. Leonard*, *supra*. During the marriage, the Texas Family Code prescribes which spouse has management powers over the marital assets.

A. Texas Family Code

1. SEPARATE PROPERTY

Each spouse has sole management, control and disposition of his or her separate property. Tex. Fam. Code § 3.101.

2. SPECIAL COMMUNITY PROPERTY

Each spouse has sole management, control and disposition of the community property that he or she would own, if single, including personal earnings, revenue from separate property, recoveries for personal injuries and increases and revenues from his or her "special community property." Tex. Fam. Code § 3.102(a).

3. JOINT COMMUNITY PROPERTY

All other community property is subject to both spouses' joint management, control and disposition – "the joint community property." Tex. Fam. Code § 3.102(b).

B. The Marital Opportunity Theory

Some have argued for application of what may be called the "marital opportunity" theory, a concept related to the "corporate opportunity" concept of corporate law. Advocates argue that any investment opportunity arising during the marriage is community property, and a spouse breaches the fiduciary duty owing the other spouse by taking advantage of the marital opportunity and making the investment separate by investing separate funds. Proponents and opponents alike can cite *Norris v. Vaughan*, 260 S.W.2d 767 (Tex. 1953).

1. THE BETTER VIEW

The better view, in the opinion of the author, and the one more consistent with established law, is one which gives the owner of separate property the right to invest separate property as the owner deems appropriate and to expend a reasonable amount of time, talent and labor in the management of the separate estate, without the fear of breaching a fiduciary duty owing the other spouse, or converting separate property into community property, or without the fear of creating a claim for reimbursement for the other spouse. *Jensen v. Jensen*, 665 S.W.2d 107 (Tex. 1984). Investing separate funds rather than community property should not be considered a breach of fiduciary duty, or a fraud on the community, by the managing spouse absent extraordinary circumstances. See III, E, *infra*.

2. CLOSELY HELD BUSINESSES

An extension of the "marital opportunity" theory is the argument that any business entity formed by a spouse during marriage is community property because the spouse's idea, or the partners' initial concept, that later evolves into the formation of the business entity has its inception during the marriage. The better view is that the separate or community character of the shares of stock or the partner's interest should depend on the character of the consideration used to capitalize the entity, if any. If separate consideration, the investment is separate.

The original idea or concept is more closely analagous to a spouse's education, a license to practice a profession, or professional goodwill acquired during marriage; it is an intangible that is neither community nor separate property. *Nail v. Nail*, 486 S.W.2d 761 (Tex. 1972); *Frausto v. Frausto*, 611 S.W.2d 656 (Tex.App. 1980). Further, the other spouse's "community interests" are effectively protected through the concepts of "reimbursement," if the owner spouse is not adequately compensated by the entity for the owner's time, talent and labor, and "reverse veil piercing," if the entity is the owner's alter ego or it is operated as a sham. *See* VIII, *infra* and XI, *infra.*

For example, if a general partnership is created at the time of the partners' "handshake" rather than at the time the partnership agreement is signed, the individual partner's interest in the partnership becomes property at that time and is likely to be community property under the inception of title rule. It was not acquired by gift, devise or descent; and if the "idea" or "concept" was an intangible that did not have a separate or community charter, the partnership interest would appear not to be traceable back to any separate property of the partner.

On the other hand, if the general partnership is not created until the partnership agreement is signed, the partner's interest is more like a shareholder's stock in a corporation, and it should be the partner's separate property, if separate property was contributed by the partner to the partnership in exchange for the partner's interest. Such a partnership interest is analogous to a shareholder's stock, which is separate property, if acquired with separate property.

C. Other Factors

1. HOMESTEAD

An important statutory exception prohibits the managing spouse from selling, conveying or encumbering the homestead without the joinder of the other spouse, even if the homestead is the managing spouse's separate property or special community property. Tex. Fam. Code §5.001.

2. POWER OF ATTORNEY

The above described powers of management can be modified by the parties through a power of attorney. The Family Code also provides that joint community property can become the subject of one spouse's control if the spouses so provide by power of attorney or other agreement. Tex. Fam. Code § 3.102. There is authority that suggests that such an agreement can be oral. *LeBlanc v. Waller*, 603 S.W.2d 265 (Tex. App.—Houston 1980, no writ). A written power of attorney can be made to continue the authority of the agent even if the principal becomes incapacitated. *See* Tex. Prob. Code §§ 482 and 484.

3. INCAPACITY

In the event of the incapacity of the managing spouse as to special community, or of one of the spouses as to joint community property, the competent spouse may petition the probate court pursuant to Sec. 883 of the Texas Probate Code, for authority to manage the entire community estate, without a guardianship. A guardianship may be needed for the incompetent spouse's separate property.

4. CONFLICTING AUTHORITY-THIRD PARTY AGENT

If a third party has been designated as a spouse's agent under a durable power of attorney and the spouse is later declared incapacitated by the court and a guardian qualifies, the authority of the agent terminates. The agent is then required to deliver the spouse's assets to the guardian. The competent spouse would then appear to have the opportunity to become community administrator and assume authority to demand possession of the community assets unless such spouse would be disqualified to serve as guardian. Accordingly, a spouse who does not wish the other spouse to assume authority over his or her assets, either as guardian or as community administrator in the event of incapacity, needs to execute a "pre-need" guardianship designation pursuant to Sec. 679. This designation could expressly disqualify the other spouse as guardian under Sec. 681(9) and as community administrator under Sec. 883.

D. Dispositions Between Spouses

It has become commonplace for spouses to arrange certain marital assets so that prior to death of the first spouse, or upon the death of first spouse, the asset belongs to the donee spouse without going through probate administration.

1. INTER VIVOS GIFT

One spouse may give to the other spouse either the donor's separate property or the donor's interest in their community property, thereby making the asset the donee spouse's separate property. *Bradley v. Love*, 60 Tex. 472 (Tex. 1883). Since 1980, such a spousal gift raises a presumption that the future income generated by the donated property will also be the donee spouse's separate property. Tex. Fam. Code § 3.005. A spouse may transfer to the other spouse the transferor spouse's one-half community interest in community property held in either spouse's name or in both names without going through the steps of a "partition and exchange." *In the Matter of the Marriage of Morrison*, 913 S.W.2d 689 (Tex. App.—Texarkana 1995).

2. PARTITION

Spouses may partition or exchange between themselves all or any part of their community property then existing, or to be acquired, into their respective separate properties. Tex.Fam.Code § 4.102. A 2003 amendment to Sec. 4.102 created a presumption that any further income generated by a partitioned asset would also be the owner's separate property.

3. INCOME AGREEMENT

Since 1980, spouses may agree that income from separate property will be the separate property of the owner spouse. Tex. Fam. Code § 4.103.

4. LIFE INSURANCE

A spouse can purchase a life insurance policy on his or her own life and designate the other spouse as beneficiary. Whether the policy was community or separate, the proceeds belong to the survivor upon the insured's death. *Martin v. McAlister*, 63 S.W. 624 (Tex. 1901).

5. EMPLOYEE BENEFITS AND OTHER RETIREMENT ACCOUNTS

A married employee can designate the other spouse as beneficiary of the employee's retirement plans whether the employee's interest in the plan is community or separate property. This result is even mandated by federal law for certain qualified retirement plans. I.R.C. § 417(b).

6. SURVIVORSHIP RIGHTS

The 1987 amendment to Art. XVI, Sec. 15 allows spouses to enter into survivorship arrangements for their community property assets. Legislation prescribes the formalities required in order to have a valid agreement as to their community assets. See X, *infra*. Spouses can also utilize "P.O.D. accounts" and "trust accounts" as means of transferring community property from one to another pursuant to Chapter XI of the Texas Probate Code. Spouses, like other parties, can enter into survivorship agreements for their separate property assets. Tex. Prob.

Code § 46 (a). *See Hilley v. Hilley*, 342 S.W.2d 565 (Tex. 1961).

7. SEC. 450 OF THE TEXAS PROBATE CODE

Section 450 of the Texas Probate Code can apparently be utilized by spouses, as well as other individuals. This section confirms traditional non-probate dispositions and opens the door for other creative non-probate dispositions. Tex. Prob. Code § 450(b). Mutual fund accounts were added to the list in 2001.

E. Fraud on the Community

The Texas Family Code generally grants to the managing spouse the power, with or without consideration, to transfer to a third party 100% of that spouse's special community property without the joinder, the consent or even the knowledge of the other spouse. *Massey v. Massey*, 807 S.W.2d 391 (Tex. App.—Houston [1st Dist] 1991, writ denied).

1. MANAGING SPOUSE AS TRUSTEE

In what is arguably the most significant community property case ever decided by the Texas Supreme Court, *Arnold v. Leonard*, 273 S.W. 799 (Tex. 1925), the court defined the legislature's role in determining the rules of characterization, management and liability of marital property and also explained ". . . that the statutes empowering the husband to manage the . . . community assets made the husband essentially a trustee, accountable as such to the . . . community." *See* also *Howard v. Commonwealth Building and Loan Assn.*, 94 S.W.2d 144 (Commission of Appeals 1937), where the court explained that, where title to a community asset is held in one spouse's name, that spouse has legal title and the other has equitable title, explaining: "That one in whose name the title is conveyed holds as trustee for the other. *Patty v. Middleton*, 82 Tex. 586, 17 S.W. 1909)."

2. FIDUCIARY OBLIGATION

As to the special community property, the managing spouse's power is limited by a fiduciary obligation owing to the other spouse due to the existence of the marital relationship. A trust relationship exists between the spouses as to the special community property controlled by each spouse. *See Carnes v. Meador*, 533 S.W.2d 365 (Tex. App.—Dallas 1975, writ ref'd nre). This special relationship has many of the characteristics of a private express trust: (i) identifiable property – a spouse's special community property; (ii) separation of legal and equitable title – the managing spouse has legal title and the equitable titled is owned equally by both the spouses; and (iii) fiduciary duty – while not defined by the intent of a settlor, the Texas Trust Code or the common law, and while not the same, nor nearly as extensive, as the duties generally imposed on trustees of express trusts, the managing spouse's power of management is limited by the duty not to commit "fraud on the community."

3. THE MANAGING SPOUSE'S DUTY

The managing spouse has the duty not to commit a fraud on the community property rights of the other spouse (i.e., not to dispose, transfer or diminish that spouse's special community property in fraud of the other spouse's rights to that property). *See In Re Marriage of Moore*, 890 S.W.2d 821 (Tex. App.—Amarillo 1994 no writ) and *Jackson v. Smith* 703 S.W.2d 791 (Tex. App.—Dallas 1985), where the court refers specifically to the fiduciary relationship that exists between spouses.

4. BURDEN OF PROOF

Because the managing spouse has the power under the Texas Family Code to dispose of that spouse's special community property, the burden is on the other spouse to raise the issue of fraud on the community when the marriage terminates. That spouse may seek to establish that the managing spouse's action with respect to managing spouse's special community property amounted either to "actual" or "constructive" fraud. For example, to establish that the managing spouse's gift to a third party amounted to actual fraud, the other spouse must prove that the gift was made with the primary purpose of depriving the other spouse of that asset. Constructive fraud is established where a gift is found to be "unfair" to the other spouse. *See Horlock v. Horlock*, 533 S.W.2d 52 (Tex. App. —Houston [14th] 1975). Texas courts have also set aside a gift as constructively fraudulent if the gift was capricious, excessive or arbitrary. *See Carnes v. Meador*, *supra*, and *Street v. Skipper*, 887 S.W.2d 78 (Tex. App.—Ft. Worth 1994). Once the issue of constructive fraud is raised, the cases suggest the burden switches to the managing spouse to prove that the gift was fair to the other spouse. *See Murphy v. Metropolitan Life Insurance Co.*, 498 S.W.2d 278 (Tex. App.—Houston [14th] 1973, writ ref'd nre), and *Givens v. The Gerrard Life Ins. Co.*, 480 S.W.2d 421 (Tex. App.—Dallas 1972 writ ref'd nre). *Jackson v. Smith*, *supra*. Factors to be considered in determining whether there has been a constructive fraud include (i) the size of the gift in relation to the total size of the community estate, (ii) the adequacy of the remaining community assets to support the other spouse, and (iii) the relationship of the managing spouse to the donee. *See Horlock v. Horlock*, *supra*. Another court described the factors to be considered as (i) whether special circumstances justify the gift and (ii) whether the community funds used were reasonable in proportion to the remaining community assets. *Givens, supra*. Most of the cases in this area involve excessive or capricious consumption of community assets, or gifts of community assets to third parties as the basis of constructive fraud on the community. *See Kazen*, Family Law, Texas Practice and Procedure, § 52.10 [3] [j] Matthew Bender (1995).

5. REMEDIES, GENERALLY

The managing spouse's abuse of managerial powers of community assets affects not only the equitable division of the remaining community estate upon divorce but can result in the awarding of a money judgment for damages to the other spouse when the marriage terminates in order to recoup the value of the other spouse's share of the community lost through the managing spouse's wrong doing. *See Mazique v. Mazique*, 742 S.W.2d 805 (Tex. App.—Houston [1st Dist.], no writ). *Massey v. Massey*, 807 S.W.2d 391 (Tex. App.—Houston [1st Dist.] 1991, writ denied); In re *Marriage of Moore*, 890 S.W.2d 821 (Tex. App.—Amarillo 1994, no writ). Courts have also used their equitable powers to impose a constructive trust on community assets given to third parties to bring the assets back into the authority of the divorce court. *Carnes v. Meador*, *supra* and *In the Matter of the Marriage of J.L Murrell*, 1998 Tex. App. LEXIS 7603 (Amarillo 1998), where the court found constructive fraud and explains that the equitable title to the property transferred to a third party was still community property.

6. *THE SCHLEUTER CASE*

In *Schleuter v. Schlueter*, 975 S.W.2d 584 (Tex. 1998), the Court emphasized that fraud on the community is not a separate tort cause of action, but is a form of fraud cognizable within the equitable division of the community estate, consequently punitive damages are not appropriate. According to *Schlueter*, a money judgment for actual damages can be entered to allow the wronged spouse to recoup the community estate loss due to the other spouse's fraud on the community; the amount of the judgment is specifically referable to the value of the lost community and cannot exceed the total value of the community estate.

7. DEATH OF A SPOUSE

In the event the marriage terminates by reason of the death of a spouse, the managing spouse should be liable to the estate of the other spouse, or the estate of the managing spouse should be liable to the other spouse, for any actual damages suffered by the other spouse arising from a fraud on the community. For example, if $100,000 of community assets were wrongfully transferred by the managing spouse to a third party, the other spouse, or that other spouse's estate, has a claim for money damages in the amount of $50,000, an amount equal to the other spouse's one-half community interest in the $100,000 wrongfully transferred. If the managing spouse, or the managing spouse's estate, does not have sufficient assets to satisfy the claim for damages, the court may impose a constructive trust on the third party donee in order to retrieve one-half the community asset that had been wrongfully transferred to the donee. *Carnes v. Meador, supra*. *See Osuna v. Quintana*, 993 S.W.2d 201, 209 (Tex. App. Corpus Christi (1999) discussing the difference in remedies in death and divorce situations.

8. THE HARPER CASE

In *Harper v. Harper*, 8 W.S.3d 783 (Tex. App.—Ft. Worth 1999 pet. den.), the court cites *Schlueter* for the holding that ". . . fraud on the community exists outside the realm of tort law and cannot be brought as an independent cause of action . . ." before holding that punitive damages are not recoverable. The only damages being sought against the managing spouse in Harper were punitive damages since the estate of the other spouse had already received half of the sales proceeds (plus interest) in satisfaction of the other spouse's interest in the property at issue. *Harper* and *Schlueter* do not hold that the other spouse cannot seek actual damages where the managing spouse commits a fraud on the community. *See Barnett v. Barnett*, 67 S.W.3d 107 (Tex. 2001) where the Texas Supreme Court confirmed that the other spouse had a cause of action under Texas law for constructive fraud on the community after the managing spouse died, but that it was preempted by federal law. See III.E, *infra*.

9. EXAMPLES

Assume that a husband gives his mother his special community car, or a husband designates his child by a previous marriage as beneficiary of an insurance policy which is the husband's special community property, or a husband deposits special community cash into a bank account payable at his death to his paramour. Upon the husband's death, the car is still owned by the husband's mother and the proceeds of the policy and the funds on deposit belong to the designated third party beneficiary unless the transfer to the mother, child or paramour is set aside as to the wife's one-half interest because the transfer is found to have been in fraud of the surviving spouse's rights. The court should, however, first attempt to make the wife whole by an award of money damages out of the husband's estate, if fraud on the community is established.

10. PROBATE v. NONPROBATE DISPOSITIONS

In *Street v. Skipper*, *supra*, a special community life insurance policy was payable to the insured spouse's probate estate and his wife argued that the husband did not have the power to devise her one-half of the policy proceeds to a third party. In effect, the wife was arguing that the proceeds payable to the estate were probate assets and she was entitled to one-half of the proceeds without proof of fraud on the community. The court held that the controlling issue was whether or not there had been a fraud on the community and then considered the fact that the value of the total community estate, including the life insurance policy, was approximately $4,600,000 and that under the will the wife would retain and/or inherit more than half of that amount by reason of her husband's death. In addition, she received a portion of the husband's separate property, including her homestead rights in his separate property home. The court concluded that a fraud on the community had not occurred.

11. THIRD PARTY

Would the result in *Street* be different had the husband designated the third party as the direct beneficiary of the policy, rather than designating his estate? Arguably not, assuming the wife still retained or inherited in excess of one-half of the value of the community by reason of her husband's death, the result appears to depend on the overall "fairness" of the situation. *See Jackson v. Smith*, *supra* and *Redfearn v. Foxd*, 579 S.W.2d 295 (Tex. App.—Dallas 1979, writ ref'd n.r.e.).

12. TWEAKING THE FACTS

Would the result in *Street* be different had the wife not received at least one half of the total community estate and a significant devise of the husband's separate property? For example, assume that the third party had been designated the beneficiary of the community-owned insurance and was also the sole devisee under the husband's will. In other words, the wife retained only her one-half of the community probate assets and her homestead right of occupancy in the husband's separate property home. Obviously, that situation is the classic example of the commission of a fraud on the community.

However, in the previous hypothetical, how would the analysis differ had the husband devised to his wife a portion of his half of the community property or some of his separate property, but the value of what was devised to the wife was less than the value of her one half of the insurance proceeds payable to a third party? Absent actual fraud, the answer appears to depend in part on the fairness factors to be considered in determining if the insurance designation amounted to a constructive fraud on the community.

13. ELECTION?

The tougher theoretical question may be whether the wife can assert her claim of fraud on the community and still retain the property devised to her in the will. In other words, will she be required to, in effect, "elect against the will" in order to pursue the fraud claim. *See* VI, E *infra*.

F. Federal Preemption

In *Barnett v. Barnett*, 67 S.W.3d 107 (Tex. 2001), the Texas Supreme Court held that a wife's claim for constructive fraud on the community and her corresponding claim for constructive trust were preempted by ERISA. In that case, a husband had designated a third party as the beneficiary of a life insurance policy that was part of employee benefit plan covered by ERISA. In the absence of actual common law fraud, the court found that Texas' concept of "fraud on the community" had no counterpart in federal common law.

However, even without proof of fraud on the community, federal law voids a non-spousal designation in certain qualified retirement plans unless the spouse consented to the designation. Retirement Equity Act of 1984, Pub. L. No. 98-397, 29 U.S.C. 1055.

G. Illusory Transfers

In *Land v. Marshall*, 426 S.W.2d 841 (Tex. 1968), the Texas Supreme Court held that a husband's creation of a revocable trust with his special community property was illusory as to his wife's one-half community interest therein since the husband had, in effect, retained essential control over the trust assets. The key factor was the revocability of the trust. Accordingly, the wife was able to set aside the trust as to her one-half interest upon her husband's death.

Query: To date, the illusory transfer argument has been applied only to revocable trusts. Would it also apply in theory to any revocable non-probate disposition (like a POD" bank account)?

H. Lack of Partition

Historically, Texas law has not encouraged non-probate dispositions of property upon the owner's death. In 1848, the Texas legislature "abolished" joint tenancies. Law of March 18, 1848, ch. 103, § 12, 1848 Tex. Gen. Laws 129. Anglo-American common law at the time presumed that co-ownership of property included the "right of survivorship"— upon the death one co-owner, the property vested in the surviving co-owner. Texas law created a presumption of "tenancy in common," rather than "joint tenancy"; however, co-owners could agree to create survivorship rights— convert a tenancy in common into a joint tenancy with rights of survivorship. *Chandler v. Kountze*, 130 S.W.2d 327 (Tex.Civ.App. 1939, writ ref'd).

1. STATUTORY BACKGROUND

In 1955, the Texas concept of co-ownership described above was incorporated into the Texas Probate Code with the enactment of Sec. 46 of the Texas Probate Code. Until 1989, Sec. 46 was even captioned as "Joint Tenancies Abolished."

This Texas approach to co-ownership merged nicely with its community property system which created a form of co-ownership between spouses as to their community property. Historically, when the first spouse died, the "community" ceased to exist and the deceased spouse's one-half interest in the community property passed *probate* to the decedent's heirs/devisees and the surviving spouse retained an undivided one-half interest, thereby creating a tenancy in common between the surviving spouse and the decedent's heirs/devisees, unless the surviving spouse was the sole heir or devisee. Until 1987, it was even unconstitutional for spouses to create survivorship rights in their community property. See *Hilley v. Hilley*, 342 S.W.2d 565 (Tex. 1961) and V, infra.

2. BAD CASE LAW

Today, however, it is common practice for property to avoid *probate* (i.e., pass non-probate) upon the death of its owner. The legislature has even encouraged "non-testamentary" transfers. *See* Tex. Prob. Code § 450. However, some courts and practitioners do not always properly apply the principles evolving from a merger of Texas' community property system and the rules relating to non-probate dispositions generally. For example, in *Hass v. Voight*, 940 S.W.2d 198 (Tex.App.—San

Antonio, 1997, pet. denied), the court of appeals relied on two old cases that were not only effectively overruled by a later amendment to the Texas Constitution but were not good precedent for the facts before the court, even if the cases had not been overruled. *Hilley v. Hilley, supra* and *Williams v. McKnight*, 402 S.W.2d 505 (Tex. 1966) both held that the spouses could not create "rights of survivorship" among themselves with their community property regardless of which spouse died first (i.e., a joint tenancy) without first partitioning the community property into their separate properties because the Texas Constitution did not authorize that type of transaction. In 1987, Art. XVI, Sec. 15 was amended to authorize spouses to create "rights of survivorship" among themselves with their community property.

In *Haas*, the issue was not whether spouses had created "rights of survivorship" among themselves regardless of which spouse died first; the question was whether the husband could make a non-probate disposition of a community asset to a third party by depositing community funds into a "joint account with rights of survivorship" with his son. The son did not acquire an ownership interest in the account by his father making the deposit since the son had not contributed to the account. Tex.Prob.Code§438(a). The account remained the community property of the husband and wife until the husband's death, when according to the terms of the account agreement, ownership passed to the son. Tex.Prob.Code § 439(a).

Ignoring Chapter 3, Subchapter B of the Texas Family Code and Chapter XI of the Texas Probate Code, the court of appeals held that this disposition failed because the community asset had not been partitioned by the spouses. The issue should have been whether the husband had properly exercised his power of management granted by the Texas Family Code. Entering into the survivorship agreement with the bank was either (i) within the husband's authority because the community funds were subject to his "sole management, control and disposition" or (ii) not within his authority, and therefore, void because the community funds were subject to the "joint management, control and disposition" of the husband and wife.

If the community funds were subject to the husband's "sole management, control and disposition," the question should have become whether he had committed a "fraud on the community" or whether the account was "illusory". See III, E and G, *supra*. The failure of the husband and wife to partition the funds should not have been the determinative factor.

I. Void Transfers

The Texas Supreme Court has not yet determined whether one spouse can assign his or her own undivided one-half interest in joint community property to a third party without the joinder of the other spouse. The view more consistent with the overall statutory scheme would void such a unilateral attempt as an attempt to unilaterally partition; partitions require the joinder of both spouses. The courts of appeals are divided. *See Williams v. Portland State Bank*, 514 S.W.2d 124 (Tex. Civ. App.—Beaumont, 1974, writ dism'd); *Vallone v. Miller*, 663 S.W.2d 97 (Tex. App.—Houston [14th Dist.] 1983, writ ref'd n.r.e.); *Dalton v. Jackson*, 691 S.W.2d 765 (Tex. App.—Austin 1985, writ ref'd n.r.e.). It would certainly follow that such a transaction would be void as to the other spouse's one-half interest. Compare *In the Matter of the Marriage of Morrison, supra*. *See* III C.1, *supra*.

J. Fraud on Creditors

Certain transfers between spouses and transfers to third parties may be set aside by creditors under both Texas and federal law. *See* the Uniform Fraudulent Transfer Act. Tex. Bus. & Comm. Code §§ 24.001-24.013 and the U.S. Bankruptcy Code, 11 U.S.C. § 544(b). Note: TUTA's definition of creditor includes a spouse who has a claim.

K. Multiple-Party Bank Accounts

One of the more common forms of non-probate disposition is the multiple-party account that is frequently opened by spouses during marriage. The marital property character of multiple-party accounts are determined in part by the form of account used by the depositing spouse. The form of the account will also dictate the disposition of the funds on dissolution.

A multiple-party account is defined as a contract of deposit of funds between a depositor and a financial institution. It includes checking accounts, savings accounts, certificates of deposit, share accounts and *other like arrangements*. The term "financial institution" now includes "brokerage firms that deal in the sales of and purchases of stocks, bonds, and other types of securities." *See* Tex. Prob. Code § 436 (1) and (3).

Note: The question remains as to whether the multiple-party account rules apply to all joint type accounts at brokerage firms (i.e., securities held in street name) or only those which are, effectively, checking or savings accounts.

1. MULTIPLE-PARTY ACCOUNTS

Chapter XI of the Texas Probate Code now authorizes five different multiple-party accounts. Chapter XI does not use the term "joint tenancy" account or "joint tenancy with right of survivorship" account. Sec. 46 governs joint tenancies; Chapter XI governs multiple-party accounts.

a. Joint Accounts/Convenience Accounts

Such accounts belong, during the joint lifetimes of the parties, to the parties in proportion to their "net contributions" to the account, and at the death of a party, the surviving party and the heirs or devisees of the deceased party continue to own the account in proportion to their "net contributions." There is no right of survivorship. Tex. Prob. Code §§ 438a and 438A.

b. Survivorship Accounts

A "joint account with survivorship rights" belongs to the parties during their joint lifetimes in the same manner as the previously described joint account. However, at one party's death, the entire account belongs to the surviving party. Tex. Prob. Code § 439(a).

c. P.O.D. Accounts

A "P.O.D. account" belongs to the depositor during the depositor's lifetime but passes to the "P.O.D. payee" upon the depositor's death, provided such payee survives the depositor. Tex. Prob. Code §§ 438(b) and 439(b).

d. Trust Accounts

A "trust account" belongs to the depositing "trustee" during the trustee's lifetime and passes to the beneficiary of the account at the trustee's death, provided the beneficiary survives the trustee. The existence of such an account depends on the nonexistence of an express trust. Tex. Prob. Code §§ 438(c) and 439(c).

e. Depositor Intent

Sec. 439(a) of the Probate Code was amended to provide that an agreement is sufficient to confer survivorship in a joint account if the account states substantially that all funds or deposits of one party shall vest in and become the property of the surviving party. The question of what is necessary to "make an account survive" is still being litigated and is a subject beyond the scope of this outline. See Glenn Karisch's excellent outline, "*Multi-Party Accounts in Texas*," accessible at www.texasprobate.com.

2. MARITAL PROPERTY PROBLEMS

The deposit of community property into a multiple party account raises several substantive issues in the estate practice, the resolution of which will depend in part on the form of account used by the depositing spouse.

a. P.O.D. and Trust Accounts

Special community property of a spouse is deposited by that spouse into a "P.O.D. account" or "trust account" with the depositing spouse as the original payee or trustee.

(1) The account remains community property during the existence of the marriage. An asset purchased with funds in the account would be community property.

(2) Upon the death of the depositing spouse, the account belongs to the P.O.D. payee or the trust account beneficiary; provided that, if that person is not the depositor's surviving spouse, the surviving spouse may assert a claim equal to one-half of the funds by alleging that the depositing spouse committed actual or constructive fraud on the community interest of the surviving spouse. Could *Land v. Marshall's* illusory transfer concept apply? Arguably, see III, F *infra*.

(3) Upon the death of the non-depositing spouse, the account is a probate asset and belongs one-half to the surviving depositing spouse and one-half to the heirs or devisees of the deceased spouse subject to administration, since the account does not pas non-probate.

(4) Upon the death of the P.O.D. payee or the trust account beneficiary who is not the non-depositing spouse, the account remains community property since the P.O.D. payee or trust account beneficiary must survive the depositing spouse to receive the account.

b. Joint Accounts/Convenience Accounts

Community property is deposited into such an account of the spouses.

(1) The account is community property, and assets purchased with funds in the account are presumptively community property. Depending on the circumstances, one spouse's withdrawal of funds may be considered to be a gift by the other spouse so that an asset purchased with the withdrawn funds is the donee spouse's separate property, but the burden is on the "donee" to prove the "donor's" donative intent.

(2) Upon the death of either spouse, the account is a probate asset and belongs one-half to the surviving spouse and one-half to the heirs or devisees of the deceased spouse, subject to administration.

c. Joint Accounts with Survivorship Rights

Community property is deposited into a "joint account with survivorship rights" between the spouses.

(1) During the existence of the marriage, the marital property character of the account and assets purchased with such funds will be determined as provided in X, G.b., *supra*, unless the account is a "46b special account" - an account which partitioned the sums on deposit into the spouses' separate properties.

(2) Upon the death of either spouse prior to the 1987 amendment, the account was a probate asset, subject to administration, and belonged one-half to the surviving spouse and one-half to the heirs or devisees of the deceased spouse unless the account was a "46b special account"; in which event, the funds belonged entirely to the surviving spouse.

(3) Upon the death of either spouse subsequent to the 1987 amendment, the account belongs to the surviving spouse, if the survivorship agreement was signed after Nov. 3, 1987. Does the same result occur if the account was opened prior to the 1987 amendment. Yes, *see* X, F.3., *infra* for further comment.

d. Joint Accounts and Third Parties

Special community funds of a spouse are deposited into a "joint account" or a "joint account with survivorship rights" of one spouse and a third party.

(1) During the existence of the marriage, the account remains community property. Withdrawal of funds by the third party may be a gift by the depositing spouse, if donative intent is established. Any such withdrawal may be in fraud of the non-depositing spouse's community property rights.

(2) Upon the death of the depositing spouse, the account is a probate asset and belongs one-half to the surviving spouse and one-half to the heirs or devisees of the deceased spouse, if there is not a survivorship agreement.

(3) If there is a survivorship agreement, upon the death of the depositing spouse, the account belongs to the third party, but subject to the imposition of a constructive trust to remedy a possible fraud on the community property rights of the non-depositing spouse. Could *Land v. Marshall's* illusory transfer concept apply? Arguably, see III, F *supra*.

(4) Upon the death of the non-depositing spouse, the account is a probate asset and belongs one-half to the surviving spouse and one-half to the heirs or devisees of the deceased spouse, subject to administration, thereby, effectively, terminating the contractual survivorship rights of the third party as to the deceased spouse's one-half.

(5) The death of the third party prior to the death of either spouse would not affect the ownership of the account, since the third party must survive the depositor to acquire ownership of the account. It remains the spouses' community property.

(6) An attempt by one spouse to unilaterally deposit joint community funds into such an account may be void insofar as the survivorship rights of the third party are concerned. *See* III, G., infra.

IV. MARITAL PROPERTY LIABILITY

In *Arnold v. Leonard, supra*, the Texas Supreme Court held that ". . . the Legislature may rightfully place such portions of the community as it deems best under the wife's separate control, and . . . it may likewise exempt the same from payment of the husband's debts, without the exemption being open to successful constitutional attack by either the husband or his creditors."

A. Statutory Plan

The legislature's rules of marital property liability are found in Sec. 3.202 and Sec. 3.203 of the Texas Family Code.

1. SEPARATE PROPERTY EXEMPTION

A spouse's separate property is not subject to the liabilities of the other spouse. Tex. Fam. Code § 3.202(a).

2. SPECIAL COMMUNITY EXEMPTION

A spouse's special community property is not subject to any of the liabilities incurred by the other spouse prior to the marriage or any nontortious liabilities of the other spouse incurred during the marriage. Tex. Fam. Code § 3.202(b).

3. OTHER RULES OF LAW

The above exemptions exist unless both spouses are personally liable under "other rules of law." Tex. Fam. Code § 3.202(a) and (b).

4. CREDITOR'S RIGHTS

A spouse's separate property and special community property and the spouses' joint community property are subject to any liabilities of that spouse incurred before or during the marriage. In addition, the special community estates of both spouses are subject to the tortious liabilities of either spouse incurred during marriage. Tex. Fam. Code § 3.202(c) and (d).

5. ORDER OF EXECUTION

Sec. 3.203 gives the court discretion in determining the order in which marital assets will be taken in satisfaction of a spouse's liabilities. Tex. Fam. Code § 3.203.

B. Observations

It appears that the legislature contemplated a logical liability system which depends on a multiple step process to determine which assets are liable for which debts: First, whose debt is it? It is either the debt of the husband, the debt of the wife or both spouses' debt. Second, when was the debt incurred? It was incurred either prior to or during the marriage. Third, what type of debt is it? It is either tortious in nature or nontortious. Fourth, are there any other substantive, non-marital rules of law which would make one spouse personally liable for the debts of the other spouse? After answering these four questions, one can look to Sec. 3.202 for the proper result.

C. Community Debt

Despite the plain import of the statutory plan enacted by the legislature, the courts and commentators alike continue to create confusion for the practitioner by referring to the term, "community debt," as if the community were an entity separate and apart from the spouses, which "entity" could own property and incur debts.

1. COCKERHAM

In *Cockerham v. Cockerham*, 527 S.W.2d 162 (Tex. 1975), the Texas Supreme Court explained that ". . . debts contracted during marriage are presumed to be on the credit of the community and thus are joint community obligations, unless it is shown the creditor agreed to look solely to the separate estate of the contracting party for satisfaction."

It is the author's opinion that the court erroneously cited as its authority for the concept of "community debt" the cases of *Broussard v. Tian*, 156 Tex. 371, 295 S.W.2d 405 (1956) and *Gleich v. Bongio*, 178 Tex. 606, 99 S.W.2d 881 (1937), which cases held that property acquired on credit is community unless the creditor agreed to look only to separate property for repayment. These cases addressed the characterization of the property acquired on credit and do not support the "community debt" concept.

2. JUDICIAL/LEGISLATIVE INCONSISTENCIES

References to "community debts" imply that the "community" is liable for the debt, i.e. all community property can be used to satisfy the debt; it also suggests that both spouses are personally liable because they are the community. This result is inconsistent with legislative mandate and the statutory plan of Sec. 3.202 of the Family Code. For example, a wife's special community property is not liable for the husband's contractual debts unless she is liable under another substantive rule of law. Marriage itself does not create joint and several liability. *See* IV, D., *infra*.

3. TOTALITY OF THE CIRCUMSTANCES

Cockerham also seemed to extend the facts and circumstances under which one spouse could be held liable for the debts of the other spouse by announcing, in effect, a "totality of the circumstances" test and thereby placed at risk all of the assets of either spouse whenever either spouse incurred a liability during the marriage, a result obviously not contemplated by the legislature in enacting the predecessor to Sec. 3.202.

4. ANTI-COCKERHAM LEGISLATION

1987 legislation should be interpreted as putting an end to the *Cockerham* test. Tex. Fam. Code § 3.201 provides that one spouse will be personally liable for the acts of the other spouse only if the other spouse acts as the agent of the otherwise innocent spouse or the other spouse incurs a debt for "necessaries." Tex. Fam. Code § 3.201. In addition, the predecessor to Sec. 3.202 was amended to refer specifically to the predecessor to Sec. 3.201 in determining when one spouse's special community property would be liable for the debts of the other spouse. Hopefully, this legislation will place the determination of marital property liability where it belongs . . . the statutory plan of Sec. 3.202. At least one court of appeals case indicates that the courts may finally be accepting the legislative mandate. *See Carr v. Houston Business Forms, Inc.*, 794 S.W.2d 849 (Tex. App.—Houston [14th Dist.] 1990, no writ).

D. Other Factors

1. JOINT OBLIGATIONS

Of course, both spouses may sign a contract or commit a tort which would make them jointly and severally liable and thereby subjecting all of the marital assets to liability.

2. VICARIOUS LIABILITY

The law has defined situations where any person can be held personally liable for certain acts of another. These situations include the following relationships, respondeat superior, principal/agency, partnership, joint venture, etc. These special relationships can exist between husband and wife and can impose vicarious liability on an otherwise innocent spouse. *See Lawrence v. Hardy*, 583 S.W.2d 795 (Tex. App.—San Antonio 1979, writ ref'd n.r.e.). However, the marriage relationship alone is not sufficient to generate vicarious liability. Tex. Fam. Code § 3.201.

3. DUTY TO SUPPORT

Each spouse has a duty to support the other spouse and a duty to support a child generally for so long as the child is a minor and thereafter until the child graduates from high school. Tex. Fam. Code §§ 2.501 and 154.001. Accordingly, all marital assets are liable for such "necessaries."

4. TAX LIABILITY

Because each spouse only owns one-half of the community income, notwithstanding the rules of management, if the spouses file separate income tax returns, each spouse is to report one-half of his/her community income and one-half of the other spouse's community income, thereby becoming personally liable for the tax liability of one-half of the total community income. However, it appears as if the IRS can attach (i) one-half of the special community property of the other spouse and (ii) all of the deficient spouse's special community property to satisfy the tax liability of the deficient spouse. *See Medaris v. U.S.*, 884 F.2d 832 (5th Cir. 1989).

5. EXEMPT PROPERTY

Of course, the family homestead and certain items of personal property are generally exempt from most debts, notwithstanding the Family Code rules. Tex. Prop. Code §§ 41.001 and 42.001. Such exemptions may extend beyond the death of the owner, if the owner is survived by a constituent family member. Sec. 42.0021 of the Texas Property Code also exempts certain retirement benefits.

6. EFFECT OF DEATH

The death of a spouse can change the statutory framework of marital property liability. For example, the Texas Probate appears to allow the decedent's one-half interest in the other spouse's special community property to be reached in order to satisfy a nontortious debt incurred during marriage by the decedent. *See* XII, B *infra*.

V. DISSOLUTION OF THE MARRIAGE

While a detailed study of the termination of a marriage by reason of divorce is beyond the scope of this paper, it is necessary to remember that the basic rules of marital characterization, management and liability continue only during the marriage. Community property cannot exist without a marriage. Accordingly, when the marriage terminates by either death or divorce, community property ceases to exist, and generally either the probate court or the divorce court will resolve the characterization, reimbursement, management, waste, fraud on the community and liability issues that arose during the marriage.

A. Just and Right Division at Divorce

The Texas Family Code directs the court in a divorce proceeding to award child custody, provide for child support and divide the "estate of the parties" in a just and right manner. Tex. Fam. Code § 7.001. The Texas Supreme Court has limited the term "estate of the parties" to community property only. *See Eggemeyer v. Eggemeyer*, 554 S.W.2d 137 (Tex. 1977) and *Cameron v. Cameron*, 641 S.W.2d 210 (Tex. 1982). There is an exception related to the concept of quasi-community property (generally separate property acquired while the couple was residing in another state but which would have been community had they been residing in Texas). On the other hand, quasi-separate is not divisible. *See* Tex. Fam. Code, § 7.002(b). *See* II, H *supra*.

B. Liability for Waste/Fraud

The managing spouse's abuse of managerial powers of community assets affects not only the equitable division of the remaining community estate upon divorce but can result in the awarding of a money judgment for damages to the other spouse when the marriage terminates. *See Mazique v. Mazique*, 742 S.W.2d 805 (Tex. App.—Houston [1st Dist.], no writ). *Massey v. Massey*, 807 S.W.2d 391 (Tex. App.—Houston [1st Dist.] 1991, writ denied); In re *Marriage of Moore*, 890 S.W.2d 821 (Tex. App.—Amarillo 1994, no writ). Most of the cases in this area involve excessive or capricious consumption of community assets, or gifts of community assets to third parties as the basis of constructive "fraud on the community." *See Kazen,* <u>Family Law, Texas Practice and Procedure,</u> § 52.10 [3] [j] Matthew Bender (1995). In *Schleuter v. Schlueter*, 975 S.W.2d 584 (Tex. 1998), the Court emphasized that fraud on the community is not a separate tort cause of action, but is a form of fraud cognizable within the equitable division of the community estate, consequently punitive damages are not appropriate. A money judgment for actual damages can be entered to allow the wronged spouse to recoup the community estate loss due to the other spouse's fraud on the community. Courts have also used their equitable powers to impose a constructive trust on community assets given to third parties to bring the assets back into the authority of the divorce court. *Carnes v. Meador*, *supra* and *In the Matter of the Marriage of J.L Murrell*, 1998 Tex. App. LEXIS 7603 (Amarillo 1998), where the court found constructive fraud and explains that the equitable title to the property transferred to a third party was community. *See* III, D *supra*.

C. Maintenance

While permanent alimony is still contrary to public policy in Texas, in 1995 the legislature authorized a form of post-death non-contractual alimony as part of its welfare reform package to provide for the "minimum reasonable needs" of an ex-spouse who is unable to be self-supporting or who is custodian of a child who requires special care. In order for the court to order such "maintenance" payments, the couple must have been married at least ten years. Monthly payments cannot exceed $2,500 or 20% of the payor's monthly income and cannot extend for more than three years unless the payee spouse is disabled. Maintenance can also be ordered in certain other instances where the payor has been convicted (or received deferred adjudication) for an act of family violence. Payments terminate upon the death of either spouse, the remarriage of the payee spouse or the payee spouse's cohabitation with another. *See* Tex. Fam. Code §§ 8.001-8.108.

D. Rights of Creditors

While the divorce court can impose on one spouse or the other the responsibility for satisfying a particular debt insofar as the relative rights of the divorcing couple are concerned, such allocation of responsibility does not insulate the "non-responsible" spouse from the debts for which such spouse was personally liable insofar as the creditor is concerned. Further, the assets which could be used to satisfy a creditor's claim prior to divorce can still be reached by that creditor after divorce. The net effect is to leave the "non-responsible" spouse with a claim for indemnification against the responsible spouse. *See Stewart Title Company v. Huddleston*, 598 S.W.2d 321 (Tex. App.—San Antonio 1980), aff'd, 608 S.W.2d 611 (Tex. 1980) (per curium) and *Anderson v. Royce*, 624 S.W.2d 621 (Tex. App.—Houston [14th Dist.] 1981, writ ref'd n.r.e.).

E. Spousal Tort Claims

The doctrine of interspousal immunity was abolished as to intentional torts in *Bounds v. Caudle*, 560 S.W.2d 925 (Tex. 1977), and as to unintentional torts, in *Price v. Price*, 732 S.W.2d 36 (Tex. 1987). Further, in *St. Elizabeth's Hospital v. Garrard*, 730 S.W.2d 649 (Tex. 1987), the Texas court abolished the rule requiring a physical injury in order to recover for emotional stress. Accordingly, tort claims are becoming commonplace in divorce actions and can be anticipated in future probate proceedings as well; and, if successfully asserted, the injured spouse can attach non-exempt separate property.

F. ERISA Benefits

Qualified retirement plans may not be effectively divided on divorce unless the court's order qualifies as a "qualified domestic relations order" pursuant to the Retirement Equity Act of 1984. 29 USC § 1056(d)(3)(A). *See also* Tex. Fam. Code § 9.101. Notwithstanding Tex. Fam. Code §§ 9.301 and 9.302 which generally void the designation of an ex-spouse as the beneficiary of a life insurance policy or a retirement plan, Federal law appears to preempt the application of those two Texas statutes in situations involving life insurance policies and retirement plans provided by an employer and governed by ERISA. However, the question remains as to whether federal common law effectively prevents the ex-spouse from retaining the benefits. *See Engelhoff v. Engelhoff*, 121 S. Ct. 1322 (2001) (a case arising out of Washington); and *Manning v. Hayes*, 212 F.3d 866 (5th Cir. (Tex.) 2001, cert. denied, 121 S. Ct. 1401 (2001). Compare *Weaver v. Keen*, 43 S.W.3d 537 (Tex. App.—Waco 2001 no pet. h.) and *Heggy v. Am. Trading Employee Retirement Account Plan*, 2001 Tex. App. LEXIS 5399 (Tex. App.—Houston [14th] 2001, no pet. n.). Compare the effect divorce has on a devise to an "ex-spouse" in the decedent's will. Tex. Prob. Code § 69.

VI. MARITAL PROPERTY IN PROBATE

When a married resident of Texas dies, the marriage terminates and community property ceases to exist. Death works a legal partition of the community probate assets; and the deceased spouse's undivided one-half interest passes to his heirs and/or devisees, and the surviving spouse retains an undivided one-half interest therein. There is not a "just and right" division of the community as in the divorce court; neither is the concept of quasi-community recognized. *See* V.A., *supra* and *Hanau v. Hanau*, 730 S.W.2d 663 (Tex. 1987).

A. Administration of Community Property

In addition to collecting the assets of the estate, paying the decedent's debts and distributing the remaining assets to the Decedent's heirs and/or devisees, the administration of a married decedent's estate includes the actual partition of the community probate property. While death may work a legal partition of the community probate assets, it is often necessary to open an administration to effectively handle the claims of creditors and/or divide the community probate property among the surviving spouse and the decedent's heirs and/or devisees. Absent the opening of a formal administration, the surviving spouse administers the community and can discharge the "community obligations." *See* Tex. Prob. § 160. The survivor may also open a "qualified community administration" under Sec. 161 but this procedure is rarely used.

Note: If the deceased spouse died intestate and the surviving spouse is the sole heir, there is no need for any type of formal administration. Tex. Prob. Code § 155.

B. Probate v. Non-Probate

The estate of a decedent must initially be divided into two separate and distinct categories. Certain assets fall within the probate class and others are placed in the non-probate classification.

1. NON-PROBATE

An asset is non-probate, if during the decedent's lifetime, the decedent entered into an inter vivos transaction, as opposed to a testamentary transaction, that controls the disposition of the asset at death. Many non-probate dispositions are contractual arrangements with third parties or the intended beneficiaries and the terms of the contracts control the dispositions. Common examples of these types of contractual arrangements include three of the multiple-party bank accounts discussed in Chapter XI of the Texas Probate Code, most life insurance policies and certain employee benefits. Tex. Prob. Code § 450. In other non-probate dispositions, the ownership of a future interest in the property is transferred to the intended beneficiary during the owner's lifetime, and the future interest becomes possessory upon the death of the owner. Revocable trusts and springing executory interests are examples of these types of non-probate dispositions. Of course, an inter vivos gift of the ownership and possession of an asset prior to the owner's death can be considered a non-probate disposition. As to the legal consequences of community assets being made non-probate, *see* III, C and D *supra*.

2. PROBATE

Probate assets are those assets which are not controlled by an inter vivos arrangement and pass at the owner's death through probate administration and on to the owner's heirs or devisees. A married individual's probate estate consists of the decedent's separate probate assets and his one-half of the community assets which are not subject to an inter vivos or non-probate arrangement. The surviving spouse retains, not inherits, his or her one-half interest in the community probate assets.

C. Intestate Death

1. COMMUNITY PROBATE PROPERTY

If a spouse dies intestate, the surviving spouse continues to own (not inherits) an undivided one-half interest in the community probate assets. If there are not any descendants of the deceased spouse surviving, or all surviving descendants are also descendants of the surviving spouse, the decedent's one-half interest passes to the surviving spouse, who would then own the entire community probate estate. If there are any descendants surviving who are not descendants of the surviving spouse, the decedent's one-half interest in the community probate assets passes to the decedent's descendants, per capita with right of representation. Tex. Prob. Code §§ 43, 45. Prior to September 1, 1993, the surviving spouse inherited the deceased spouse's one-half of the community only if no descendants of the deceased spouse were then surviving. Tex. Prob. Code § 45. The rules relating to "representation" were modified to be effective September 1, 1991. Tex. Prob Code § 43.

2. SEPARATE PROBATE PROPERTY

If a spouse dies intestate, the decedent's separate probate assets are divided in the following manner: (i) one-third of the personal property passes to the surviving spouse and two-thirds thereof to the decedent's descendants and (ii) the surviving spouse receives a life estate in one-third of the separate real property and the descendants of the decedent receive the balance of the separate real property. If there are no descendants, the surviving spouse receives all of the personal property and one-half of the real property. The other one-half of the real property passes in accordance with the rules of intestate succession. Tex. Prob. Code § 38.

D. Testate Death

Every person who is or has been married has received a broad grant of authority from the legislature to dispose of his probate property. There is no forced heirship in Texas. Tex. Prob. Code §§ 57 and 58. This broad grant of testamentary authority is, however, effectively limited to the testator's separate probate property and his one-half interest in the community probate property. *Avery v. Johnson*, 108 Tex. 294, 192 S.W. 542 (1917). Not even the divorce court can enjoin a spouse from exercising the spouse's testamentary power. *See* Tex. Prob. Code § 69A.

E. Texas "Widow's" Election

It is fundamental that the deceased spouse has testamentary power over only one-half of the community probate assets, whether the community assets are held in the husband's name, the wife's name, or both of their names. An attempt to dispose of both halves of the community is ineffective unless the attempt triggers the application of "equitable election." In Texas, this doctrine has been termed the "widow's election" whether the survivor is a widow or widower.

1. EQUITABLE ELECTION

Whenever any devisee is entitled to a benefit under a will and asked to suffer a detriment under the will, the devisee cannot accept the benefit without suffering the detriment. The choice is left to the devisee who can elect to accept under the will or elect against the will. The most common example of an election is when the testator attempts to dispose of property which the testator does not own while at the same time devising other property to the actual owner. *See Wright v. Wright*, 154 Tex. 138, 274 S.W.2d 670 (1955). *Dunn v. Vinyard*, 251 S.W. 1043 (Tex. Com. App. 1923, opinion adopted).

2. COMMUNITY PROPERTY ELECTION

It is common for one spouse to attempt to leave a community asset to a third party while leaving the surviving spouse another asset. Such a disposition would put the surviving spouse to an election. The surviving spouse is also put to an election when the decedent gives the surviving spouse a life estate in the entire community estate while expecting the survivor to allow her one-half of the community to pass under the decedent's will. *United States v. Past*, 347 F.2d 7 (9th Cir. 1965); *Vardell's Est. v. Comm.*, 307 F.2d 688 (5th Cir. 1962). Compare with the "illusory" intervivos transfer concept. *See* III, E., *supra*.

3. THE TEXAS RULE

In *Wright v. Wright, supra*, the Texas Supreme Court explained the Texas rule. First, the will must dispose of property owned by the surviving spouse while at the same time granting some benefits to the surviving spouse. Second, the surviving spouse must elect to allow all or part of his property to pass as provided in the will before accepting the benefits conferred. Third, the will must clearly put the survivor to an election.

4. PROCEDURE

The surviving spouse may be put to either an express or an implied election. In other words, the language of the will may specifically and expressly set forth the intent to require an election. *Calvert v. Ft. Worth Nat. Bank*, 348 S.W.2d 19 (Tex. Civ. App.—Austin, 1961). In other situations, the election is implied from the language of the will. The question of whether the survivor is put to an election is one of the law for the court. *Wright, supra*. The question of whether the survivor has made an election is one of fact. Generally, two factors are involved. First, the survivor must have been aware of the choice. Second, the survivor must intend to so elect; however, the totality of the circumstances are considered in making this determination. *Dunn v. Vinyard, supra*. Mere acceptance of benefits may be deemed an election to take under the will. *See* Dougherty, "*Election*", Texas Estate Administration §§ 8.1, 8.2.

5. TAX CONSEQUENCES

The decision to elect or not can have a significant transfer and income tax consequences which are beyond the scope of this article. For a discussion of these matters and an in depth study of the Texas widows election, *see* Kinnebrew and Morgan, "*Community Property Division at Death*", 39 Baylor Law Review 1037, 1072-1079 (1987).

6. SUPER ELECTION

Traditionally, the doctrine of election has required the electing spouse's benefit and detriment to be found in the same disposition (e.g., the deceased spouse's will or revocable trust). Perhaps it is time to consider the "super election" in view of the prevalent use of probate and non-probate dispositions as part of a comprehensive estate plan. For example, a husband designates his wife as beneficiary of a $1 million life insurance policy, but purports to specifically devise in his will both halves of a certain $100,000 community asset to his kids by a prior marriage, without naming his wife as a beneficiary in the will. Should she be able to accept the $1 million and also assert her rights to one-half of the community asset specifically devised to the kids? Or, if she accepts a significant benefit in the comprehensive place, shouldn't she be deemed to have accepted the detriment in another part of the plan?

F. Protection for Surviving Spouse

Despite the very broad general grant of testamentary power given a married testator and the limited rights of inheritance given the surviving spouse when the decedent dies intestate, there exists certain constitutional and statutory provisions which protect the surviving spouse, whether the decedent died testate or intestate.

1. <u>HOMESTEAD</u>

The Texas Constitution still exempts the homestead from the claims of some of the decedent's creditors. Tex. Const. Art. XVI Sec. 50. In addition, notwithstanding the provisions of the decedent's will or the rules of intestate succession, the surviving spouse is given an exclusive right of occupancy of the homestead so long as she elects to occupy it as her home. Tex. Const. Art. XVI, Sec. 52. This right of occupancy exists whether the home is separate property of the deceased spouse or the couple's community property. In the event there is not a family home, the probate court is required to set aside an allowance in lieu of a homestead. Tex. Prob. Code § 273.

2. <u>EXEMPT PERSONAL PROPERTY</u>

Certain items of tangible personal property are exempt from creditors of the decedent if the decedent is survived by a spouse. Tex. Prob. Code §§ 271 and 281. These items are described in the Texas Property Code and generally include the household furnishings, personal effects and automobiles in an amount that does not exceed $60,000. Tex. Prop. Code § 42.002. In addition, during administration, the surviving spouse can retain possession of these items and will receive ownership of these items if the decedent's estate proves to be insolvent; otherwise the decedent's interest in these items passes to his heirs and/or devisees when the administration terminates. Tex. Prob. Code § 278. There is also an allowance in lieu of exempt personal property. Tex. Prob. Code § 273.

3. <u>FAMILY ALLOWANCE</u>

In addition to the allowances in lieu of homestead and exempt personal property, an allowance for one year's maintenance of the surviving spouse and minor children may be established by the probate court. Tex. Prob. Code §§ 286 and 287. The allowance is paid out of the decedent's property subject to administration. *Ward v. Braun*, 417 S.W.2d 888 (Tex. Civ. App.—Corpus Christi, 1967, no writ). The amount is determined in the court's discretion and is not to be allowed if the surviving spouse has a sufficient separate estate. Tex. Prob. Code § 288; *Noble v. Noble*, 636 S.W.2d 551 (Tex. App.—San Antonio 1982, no writ).

VII. ADMINISTRATION OF COMMUNITY PROPERTY

The purposes of a decedent's estate administration are to collect the assets of the estate, to pay the decedent's debts and to distribute the remaining assets to the decedent's heirs and/or devisees. In addition, the administration of a married decedent's estate includes the actual partition of the community probate property. As discussed previously, death works a legal partition of the community probate assets, but it is often necessary to open an administration to effectively set aside the homestead, exempt property and family allowance, handle the claims of creditors and/or divide the community probate property among the surviving spouse and the decedent's heirs and/or devisees.

A. Types of Administration

1. <u>FORMAL AND INFORMAL ADMINISTRATION</u>

Whether the decedent died testate or intestate, it is possible in Texas for the decedent's surviving spouse and distributees to informally administer the decedent's estate. In other words, the assets can be collected, the debts paid and the balance properly distributed without a court appointed personal representative. It may be necessary to admit the decedent's will to probate as muniment title, or to have a judicial determination of heirship and order of no administration entered by the probate court, in order to establish the distributees' title. Tex. Prob. Code § 89 and Tex. Prob. Code §§ 48-56. Other situations will require the appointment of a personal representative to formally administer the estate. The personal representative can either be (i) an administrator or executor or (ii) an independent administrator or independent executor. In any event, it is the personal representative's function to accomplish the purposes of estate administration.

2. <u>NECESSITY OF ADMINISTRATION</u>

In order to open a formal administration, the need for an administration must be established to the satisfaction of the probate court. A necessity is deemed to exist if two or more debts against the estate exist, or it is desired that the probate court partition the estate among the distributees. These two statutory provisions are not exclusive. Tex. Prob. Code § 178. The decedent's designation of an executor in his will is sufficient cause for the opening of a formal administration.

3. PRIORITIES

If there is a need for formal administration, the persons named as executors in the will are given priority in the selection process of the personal representative. If the named executors are not able to qualify, the surviving spouse, then others, are given priority. If the decedent dies intestate, letters of administration are first granted to the surviving spouse, then others. Tex. Prob. Code § 77.

4. DEPENDENT AND INDEPENDENT ADMINISTRATIONS

The personal representative appointed by the court will be designated either (i) the independent administrator or independent executor or (ii) the executor or administration. An independent administration is created by will or pursuant to certain specified procedures and allows the independent personal representative to administer the estate free of routine supervision by the probate court. Tex. Prob. Code §§ 145-154A. If the court fails to grant an independent administration, the personal representative's actions are supervised on a routine basis, and the personal representative must seek the court's authority prior to entering into many transactions. Sec. 145(r) permits an independent executor named in the will who refuses to so act or resigns to qualify as a dependent personal representative.

5. ACCOUNTABILITY

During a dependent administration, the personal representative must file (i) an inventory and list of claims, (ii) annual accountings and (iii) final accountings. These documents must be approved by the probate court. An independent personal representative must file and have approved his inventory and list of claims but has no other formal accounting requirements; however, the representative is accountable to the distributees as is any fiduciary.

6. THE INVENTORY

While there is disagreement among the commentators, it is this author's opinion that the inventory and list of claims should list the assets of the estate which are subject to administration by the personal representative, identifying which assets were community. Since both halves of the certain community probate assets are subject to administration, the inventory and list of claims should account for both halves of the community probate assets, as well as the decedent's separate probate assets. *Cain v. Church*, 131 S.W.2d 400 (Tex. Civ. App. 1939, no writ). It may be appropriate to identify the decedent's one-half interest in the survivor's special community as a claim. The decedent's nonprobate assets and the surviving spouse's separate property are not subject to administration and do not belong on the inventory. Tex. Prob. Code § 250. *See* Ikard and Golden, *Administration of Community Property* . . . 1996 Adv. Est. Planning and Probate Course (State Bar of Texas).

B. Distribution of Powers Among Personal Representative And Surviving Spouse

During formal administration, the personal representative is entitled to possession of not only the deceased spouse's separate property but also the couple's joint community property and the decedent's special community property. The surviving spouse may retain possession of the survivor's special community property during administration or waive this right and allow the personal representative to administer the entire community probate estate. Tex. Prob. Code § 177(b). The authority of the personal representative over the survivor's one-half of the community should be limited to what is necessary to satisfy the debts of the deceased spouse properly payable out of such community assets even if the decedent's will grants to the representative more extensive powers over the decedent's separate assets and one-half interest in the community. However, if there is a will and the surviving spouse is a beneficiary of the will, the surviving spouse who accepts any benefits under the will may have elected to allow the executor to exercise more extensive posers over her share of the community assets during administration. *See* XI, E. *supra*.

1. STATUTORY INCONSISTENCY

It should be noted that the first sentence of Sec. 177(b) had for years authorized only an "executor" to take possession of the joint community; however, the last sentence of that section had suggested that this authorization extends to administrators and executors. The predecessor to the present statute specifically referred in the first sentence to both executors and administrators. It is the author's opinion that Sec. 177(b) should apply to both types of personal representatives. HB 1131 (2001) has eliminated this inconsistency.

2. COMPARISON WITH FAMILY CODE PROVISIONS

This division of authority dovetails with the contractual management and liability rules of the Texas Family Code and facilitates the personal representative's ability to step into the decedent's shoes and satisfy his debts. Tex. Fam. Code §§ 3.102 and 3.202. Of course, both the personal representative and surviving spouse should eventually account for both halves of the community in order to settle the estate. If the community assets in possession of the personal representative and available to satisfy the deceased spouse's creditors are insufficient for that purpose. Tex. Prob. Code § 156 indicates that the deceased spouse's one-half interest in the surviving spouse's special community property can be reached to satisfy the deceased spouse's creditors; these assets were generally exempt from the claims of the deceased spouse's non-tortious creditors during the marriage. Both halves of those community assets are liable for any tortious debts of the deceased spouse.

3. AUTHORITY OF SURVIVING SPOUSE – NO PERSONAL REPRESENTATIVE

When there is no personal representative for the estate of the deceased spouse, Sec. 160(a) enables the surviving spouse to sue in order to recover community property, to sell or otherwise dispose of community property to pay debts payable out of the community estate, and to collect claims owing to the community estate. The survivor may be sued by a third party in a matter relating to the community estate. That section also grants to the surviving spouse the authority needed under the circumstances to exercise such other powers as are necessary to preserve the community estate, to discharge obligations payable out of community property and to generally "wind up community affairs."

When satisfying claims of creditors, the survivor is to follow the classification and priority system prescribed in the Texas Probate Code for formal probate administrators. Tex. Prob. Code §§ 169-174. The survivor is entitled to a "reasonable commission" for administering the community and can incur reasonable expenses in the management of the estate. Like any other fiduciary, the surviving spouse is accountable to the deceased spouse's heirs and/or devisees who are entitled to their share of the remaining community assets after the debts properly payable out of the community assets have been paid. *See* Tex. Prob. Code §§ 156 & 168 and *Grebe v. First State Bank*, 150 S.W. 2d 64 (Tex. 1941).

4. AUTHORITY OF THE SURVIVING SPOUSE – PERSONAL REPRESENTATIVE

When a personal representative is administering the estate of the deceased spouse, including the surviving spouse's one-half of the decedent's special community and the couple's joint community, the surviving spouse's fiduciary authority over the survivor's special community property enables the survivor to exercise all the powers granted to the surviving spouse where there is no administration pending. Tex. Prob. Code § 177(b). This statutory language suggests that the survivor can deduct from the special community being administered "necessary and reasonable expenses" and a "reasonable commission." The survivor shall keep a distinct account of all community debts allowed or paid. *See* Tex. Prob. Code § 156.

C. Allocation of Liabilities After Death

1. PROBATE ASSETS

As pointed out previously, the Texas Probate Code's division of authority tracks the contractual management and liability rules of the Texas Family Code and facilitates the personal representative's ability to step into the decedent's shoes and satisfy primarily the deceased spouse's contractual debts but it does not resolve all the issues related to which assets are liable for which debts.

2. NON-PROBATE ASSETS

In the past, practitioners could follow a general "rule of thumb": probate assets pass subject to the decedent's debts whereas non-probate assets pass to their designated beneficiaries, free of the decedent's debts. Today, there is a growing body of statutory rules and common law which negates the application of this old "rule of thumb."

3. GENERAL POWER THEORY

Even if the Uniform Fraudulent Transfer Act is not violated, the Texas definition of a general power of appointment would seem broad enough to capture most non-probate depositions, including joint tenancies and revocable trusts, within its coverage and, thereby, subject the property in question to the liabilities of the donee of the power, either during the donee's lifetime or at death, unless there is a specific statutory exemption.

4. ABATEMENT

Despite the growing need for a comprehensive statute which would complement Sec. 450(b) of the Texas probate Code and define the rights of creditors in and to the probate and non-probate assets of a deceased debtor, the legislature has only codified the order in which property in the probate estate would be liable for debts and expenses properly chargeable to the probate estate. This new section, Sec. 322B of the Texas Probate Code, does not apply to death taxes.

5. ABATEMENT AMONG COMMUNITY AND SEPARATE ASSETS

Sec. 322B also failed to give direction to the personal representative who has both non-exempt separate and community assets in its possession and control in order to satisfy the decedent's debts. The potential conflict of interest is obvious; the expenditure of separate funds to satisfy the debt will inure to the benefit of the surviving spouse while using community funds would accrue to the benefit of the decedent's estate. Presumably Sec. 3.203 of the Texas Family Code would be relevant and the facts and circumstances surrounding the source of the debt should be considered. For example, is it a purchase money indebtedness? Is it tortious or contractual in nature? The author is not aware of any definitive cases on point that offer the personal representative any clear guidance. Accordingly, the personal representative should pay certain claims out of the decedent's separate property or the decedent's one-half of community assets. These claims would include funeral expenses, separate property's purchase money indebtedness, and tort claims against the decreased spouse. Other debts, like credit cards, utilities, community property purchase money indebtedness, should be paid out of the community funds being administered by the personal representative.

D. Closing the Estate

Upon the death of the first spouse to die and while record legal title still reflects that some community assets are held in the decedent's name, some are held in the survivor's name and others are held in both spouse's names, the surviving spouse and the heirs and/or devisees of the deceased spouse are, in effect, tenants in common as to each and every community probate asset, unless the surviving spouse is the sole distributee of some or all of the deceased spouse's one-half interest in such assets.

Assuming that the decedent's one-half community interest has been left to someone other than the surviving spouse, the respective ownership interests of the survivor and the decedent's distributees are subject to the possessory rights of either a court appointed personal representative or the surviving spouse for administration purposes. When administration is completed, the survivor and the distributees are entitled to their respective one-half interests in each and every community probate asset.

1. NON-PRO RATA DIVISION

Accordingly, can the survivor and the personal representative (or the decedent's distributees) agree to make a non-pro rata division of the community estate so that the surviving spouse receives 100% of some of the assets and the distributees receive 100% of other community assets. The answer is an obvious yes. The authority of an executor to enter into such a transaction should depend on the powers granted to the executor in the decedent's will. Of course, even if the will purports to enable the executor to make a non-pro rata division of the community, the surviving spouse's agreement is still required. However, the surviving spouse may have already agreed by accepting benefits under the will through either an express or equitable election. *See* XI, E. *supra*. The real issue is whether any such agreement will be considered a taxable exchange, subjecting the parties to capital gain exposure to the extent the assets have appreciated in value since the decedent's date of death.

2. I.R.S. POSITION

Three technical advice memoranda suggest that such an exchange is not taxable. In one, Tech. Adv. Mem. 8037124, a husband and wife proposed to divide into two equal, but non-pro rata shares, certain community assets in order to create liquidity for one to pay estate taxes upon an anticipated death; and the memorandum concludes that such a partition would not result in a taxable event. In the second memorandum, Tech. Adv. Mem. 8016050, where a husband and the executor of his wife's estate proposed an equal, but non-pro rata division, again the Service ruled the exchange was not a taxable event. In California, the memorandum noted, the right of partition is to the entire community estate and not merely to some specific part, relying in part on the legal principle that the marital property interest of each spouse is an interest in the property as an entity. In Texas for most purposes, community property principles do not create an entity. Community property is a form of co-ownership among a husband and wife that ceases to exist when the marriage terminates. In the third memorandum, Tech. Adv. Memo 9422052, community assets had been placed in a revocable trust arrangement prior to the first spouse's death, and the trust agreement authorized the trustee to make non-pro rata distributions following the first spouse's death among the survivor's trust and the deceased spouse's marital deduction and bypass trusts.

3. THE LAW

Do these three memoranda really support the legal conclusion that a non-pro rata division of assets in Texas among the surviving spouse and the heirs and/or devisees of the deceased spouse is not a taxable event, or is Texas substantive law different enough to generate a different tax result. Even if the will of the deceased spouse authorized the executor to make non-pro rata distributions, it is doubtful such mandate is binding on the surviving spouse whose agreement to the division will be necessary to complete the exchange. Perhaps the 1994 memorandum suggests a possible planning advantage a revocable trust may have over a traditional testamentary plan. In a traditional testamentary plan, a safe harbor approach may be for the personal representative with appropriate authority granted in the will to enter into a partition and exchange agreement with the surviving spouse shortly after the first spouse's death and prior to any significant appreciation in value to the community assets. Care should then be taken to track the income from the partitioned assets so that the income is properly reported on the income tax returns of the survivor and the estate (or its successors).

VIII. COMMUNITY CLAIM FOR REIMBURSEMENT

The last twenty-five years have seen several important cases which have specifically added to the evolvement of the equitable concept of reimbursement between the marital estates that usually arises when one spouse's separate property is improved through the expenditure of community funds or community time, talent and labor. The increased importance of this concept is due to the *Cameron v. Cameron*, 641 S.W.2d 210 (Tex. 1982) and *Eggemeyer v. Eggemeyer*, 554 S.W.2d 137 (Tex. 1977) cases.

A. Claim of Reimbursement

The law related to reimbursement evolved very slowly from the first case addressing the issue, *Rice v. Rice*, 21 Tex. 58 (1858), until 1982. During that period of time, the Texas courts would apply the equitable theory of reimbursement to recompense one marital estate, usually the wife's separate property or the community estate, when funds from that estate were utilized to benefit another marital estate, usually the husband's separate property.

B. Measure of Reimbursement

Once the right of reimbursement was found to exist, the Texas courts have not been very precise in determining the measure of reimbursement. Over the years three distinctive type means of measurement evolved.

1. "COST OF THE IMPROVEMENT"

In *Rice*, the Texas Supreme Court held that the measure of reimbursement was the original cost of the improvement paid for by the community.

2. "ENHANCED VALUE OF THE IMPROVEMENT"

In *Clift v. Clift*, 72 Tex. 144, 10 S.W. 338 (1888), the Texas Supreme Court applied a measure of reimbursement based on the enhanced value of the property at the time of the dissolution of the marriage due to the improvement paid for by the community.

3. "LESSER OF COST OR ENHANCED VALUE"

In *Dakan v. Dakan*, 125 Tex. 305, 83 S.W.2d 620 (1935), the Texas Supreme Court seemed to favor a method of reimbursement which would compensate the community for either the cost of the improvement or the enhanced value, whichever was less.

C. Application at Death

The *Dakan* court also held that the community claim for reimbursement existed at the owner's death, thereby putting the surviving spouse to an equitable election (i) to accept the benefits conferred in the will and waive the claim, or (ii) to assert the claim and waive the benefits under the will. It would also follow that the claim exists upon death of the non-owner, thereby imposing a duty on the personal representative to pursue the claim against the surviving/owner spouse.

D. Case Law Developments

There have been several cases since *Cameron* and *Eggemeyer* which have significantly added to the concept of reimbursement.

1. VALLONE

In *Vallone v. Vallone*, 644 S.W.2d 455 (1982), the Texas Supreme Court expanded the concept of reimbursement to include situations where one spouse, the owner of the business, had expended an inordinate amount of uncompensated community time, talent and labor to increase the value of the owner's separately owned closely held corporation.

2. COOK

In *Cook v. Cook*, 665 S.W.2d 161 (Tex. Civ. App.—Ft. Worth 1983, writ ref'd n.r.e.), the court of appeals neatly categorized a number of situations where the right of reimbursement can arise involving one spouse's separate real estate.

a. *"Principal Reduction"*

Wherever one spouse uses the property of one marital estate to retire the principal of a previously existing purchase money debt of an asset of another marital estate, the contributing estate is entitled to recover its share of the exact dollar amount contributed, regardless of the underlying asset's increase in value. *But, see* the *Penick* case, *infra*.

b. *"Interest and Taxes"*

Wherever one marital estate contributes funds to pay either the interest on the purchase money indebtedness secured by an asset of another marital estate or the ad valorem taxes owing due to such asset, a balancing test is applied to determine whether the contributing estate enjoyed the current benefits of income or occupancy as quid pro quo for the payment of current expenses.

c. *"Improvements"*

Whenever one marital estate expends funds to improve the assets of another estate, the contributing estate is to be reimbursed for the enhancement in value due to the expenditure as provided in the *Clift* case. *See* the *Anderson* case, *infra*.

3. JENSEN

In *Jensen v. Jensen*, 665 S.W.2d 107 (Tex. 1984), the Texas Supreme Court reinforced the principle that the expenditure of community time, talent and labor by one spouse on separate property does not convert separate property into community property except in very limited situations. *See Norris v. Vaughan*, 152 Tex. 491, 260 S.W.2d 676 (Tex. 1953). Nevertheless, the expenditure of community time, talent and labor in excess of what is necessary to reasonably manage one's separate property can give rise to a community right of reimbursement to the extent that excess time, talent or labor is not compensated. The Court did not provide a precise measure of reimbursement.

4. ANDERSON

In *Anderson v. Gilliland*, 684 S.W.2d 673 (1985), the community had expended approximately $20,000 to build a home on the separate property of the husband. At the time of the husband's death, the home was found to have enhanced the husband's separate property by $54,000. The Supreme Court stated:

We hold that a claim for reimbursement for funds expended by an estate for improvements to another estate is to be measured by the enhancement in value to the benefitted estate. This rule is more likely to insure equitable treatment of both the contributing and benefitted estates in most situations. [emphasis added]

5. PENICK

In *Penick v. Penick*, 763 S.W.2d 194 (Tex. 1988), the Supreme Court held that advancements of community funds to either reduce the principal on purchase money indebtedness secured by separate property or to make capital improvements on separate property are to be measured by the same test – the enhancement in value to the benefitted estate. In addition, the Court directed the trial court to take into consideration benefits received in return by the community estate. How does paying off the balance of a note payable enhance the value of the pledged assets?

6. HEGGEN

Although it is in the nature of a claim against the individual spouse, a reimbursement claim can be secured by the court imposing an equitable lien against the property benefitted. An equitable lien can even be imposed on the residential homestead to secure reimbursement for a community funds expended for taxes, purchase money or improvements. *Heggen v. Pemelton*, 836 S.W.2d 145 (Tex. 1992) Note: The 1995 amendments to the Texas Constitution expanded the types of debts that can secure by the homestead.

7. OTHER CASES

There have been a number of recent cases citing *Vallone*, *Jensen* and *Anderson*. *See generally Allen v. Allen*, 704 S.W.2d 600 (Tex. App.—Ft. Worth 1986, no writ); *Hernandez v. Hernandez*, 703 S.W.2d 250 (Tex. App.—Corpus Christi 1985, no writ); *Wren v. Wren*, 702 S.W.2d 250 (Tex. App.—Houston [1st Dist.] 1985, writ dismissed); *Jones v. Jones*, 699 S.W.2d 583 (Tex. App.—Texarkana 1985, no writ); *Zisblatt v. Zisblatt*, 693 S.W.2d 944 (Tex. App.—Fort Worth 1985, writ dism'd). In *Jacobs v. Jacobs*, 687 S.W.2d 731 (Tex. 1985), the Supreme Court addressed the proof issues related to Vallone and Jensen. One court of appeals case, *Trawick v. Trawick*, 671 S.W.2d 105 (Tex. App.—El Paso 1984, no writ) appears to extend *Vallone* and *Jensen* to estate administration situations.

E. Additional Applications

1. LIFE INSURANCE

Reimbursement can arise in other situations. One of the more common situations is where one spouse owns separately an insurance policy on that spouse's life and uses community property to pay the premiums; upon the insured spouse's death, the proceeds are payable to a third party. In *McCurdy v. McCurdy*, 372 S.W.2d 381, 63 (Tex. Civ. App.—Waco 1963, writ ref'd), the court held that the community was entitled to reimbursement in the amount of the premiums paid by the community.

2. OTHER APPLICATIONS

It does not appear that *Anderson* changes or should change the measure of reimbursement for either a Jensen or *McCurdy* situation. It should also be recognized that the *Vallone* and *Jensen* type of reimbursement may exist in a situation where the non-owner spouse expends an inordinate amount of uncompensated community time, talent and labor to enhance the separate property of the other spouse. As in *Jensen*, the focus should be on the value of the services rendered and actual compensation received. For further study, *see* Weekley, "*Reimbursement Between Separate and Community Estates*", 39 Baylor Law Review 945 (1987).

F. Legislation

The 1999 legislature added a new Subchapter E to Chapter 3 of the Texas Family Code and created in effect, a new type of reimbursement - "statutory reimbursement."

1. 1999 LEGISLATION

Financial contributions made with community property that enhanced the value of separate property during the marriage created an "equitable interest" of the community estate in the separate property. Tex. Fam. Code § 3.401 (1999)

a. *Equitable Interest Defined*

However, an equitable interest did not create an ownership interest; it created a claim against the spouse who owns the property that matured on the termination of the marriage. Tex. Fam. Code § 3.006(b) (1999). Compare, however, the language in Sec. 3.403(b) (1999), and note the inconsistency.

b. *Amount of Claim*

The claim was measured by the "net amount of the enhancement" in value of the separate property during the marriage. Tex. Fam. Code § 3.401(b) (1999). If community funds were used to discharge all or a part of a debt on separate property, the statute described a formula to compute the amount of the claim. Tex. Fam. Code § 3.402 (1999).

c. *Equitable Lien*

The court was instructed to impose an equitable lien to secure the claim. The statute also indicated that the lien could be assessed against other assets as well. Tex. Fam. Code § 3.406 (1999).

d. *No Offsetting Benefits*

Where statutory reimbursement is appropriate the use and enjoyment of the property during marriage did not create offsetting benefits. Tex. Fam. Code § 3.405 (1999).

e. *Life Insurance*

The 1999 statute raised serious questions related to its application to life insurance situations. For example, where there was a separately owned policy, but community funds were used to pay some of the premiums, was this a Sec. 3.401 (1999) financial contribution? Did

Sec. 3.401(b) (1999) or Sec. 3.402 (1999) apply? Or did the *McCurdy* case still apply?

f. *Effective Date*

According to language in the statute, the changes in law made by the relevant portions of the Act, HB 734, apply only to a suit for dissolution of a marriage pending on September 1, 1999, or filed on or after that date. Did this mean that statutory reimbursement was limited to divorce actions? Following the death of a spouse, a reimbursement claim may arise in a probate proceeding, or in independent cause of action . Most commentators believed it applied in probate situations.

2. 2001 LEGISLATION

HB 1245 (2001) contains a major overhaul to subchapter E. For example, statutory reimbursement is no longer referred to as an "equitable interest." It is more accurately referred to as a "claim for economic contribution."

a. *Intent*

Section 1 of HB 1245 clearly states that economic contributions by one marital estate for the benefit of another creates a claim for the contributing marital estate in the property of the benefitted estate—"claim for economic contribution."

b. *Economic Contribution Defined*

Economic contributions arise in six statutorily defined situations related to use of one marital estate's funds to reduce the principal amount of debt secured by another marital estate or to make capital improvements to another marital estate. Tex. Fam. Code § 3.402(a). Economic contribution does not include expenditures for ordinary maintenance or repair, or for taxes, interest or insurance, or for the contribution of time, toil, talent or effort (Jensen type claims). Tex. Fam. Code § 3.402(b).

c. *New Formula*

Sec. 3.403(h) describes a new, and apparently workable, formula to be used in economic contribution situations. *See* Gagnon, *Statutory Reimbursement: The Equitable Enigma*," State Bar of Texas, Advanced Family Law Course, August 2001, and Goodman, "*Guest Commentary*," State Bar Section Report—Family Law, Vol. 2001-2 Summer.

Note: The new formula allows the claim to participate in the benefitted property's appreciation or depreciation.

d. *Use and Enjoyment*

The use and enjoyment of the property during marriage does not create a claim of an offsetting benefit. Tex. Fam. Code § 3.403(e). Obviously, the couple's occupancy of the separate property home of the husband that was improved with community funds is not an offset. But, if the property is income producing, or generating tax benefits, shouldn't that benefit to the community offset the claim for economic contribution?

Note: The statute uses the language "use and enjoyment," not "use and benefit."

e. *Surviving Spouse's Election*

If the owner spouse devises the benefitted separate property to the other spouse, the other spouse should not be able to accept the devise and also assert a claim for economic contribution. The correct analysis may be to explain that the surviving spouse is put to an election. Even if the benefitted property is devised to a third party, the other spouse may have to elect between accepting what other assets were devised to her and asserting the claim for economic contribution. *See* XI, E *supra*.

f. *Equitable Lien*

In divorce situations, an equitable lien is imposed to secure payment of the claim. In death situations, a party of interest must request the imposition of the equitable lien. Tex. Fam. Code 3.406.

Note: The equitable lien can be imposed on any assets of the owner of the benefitted property; the court is not limited to the benefitted property itself.

g. *Claims for Reimbursement*

The claim for economic contribution does not eliminate from Texas law the traditional claim for reimbursement except in those fact situations that are statutorily defined claims for economic contributions. Tex. Fam. Code §3.408(a). In fact, the statute gives examples of the more traditional claim for reimbursement—payment of unsecured liabilities and Jensen type claims. Tex. Fam Code § 3.408(b). Claims for reimbursement are to be resolved using equitable principles, including "use and enjoyment" offsets. Tex. Fam. Code §§ 3.408(c) and (d). The statute does describe some non reimbursable claims—payment of child support, alimony or spousal maintenance, living expenses of a spouse or child, contributions or principal reductions of nominal amounts, and student loan payments. Tex. Fam. Code § 3.409. Despite some apparent confusion on the part of some courts (*see Lewis v. Lewis*, 1999 Tex. LEXIS 4920 Houston [1st], "waste of community assets" should be considered as a type of fraud on the community, not a claim for reimbursement. *See* V. B, *supra*.

h. *Marital Property Agreement*

Marital property agreements executed before or after September 1, 1999 (effective date of the 1999 legislation) which waive or partition traditional reimbursement claims will be effective to waive claims for economic contribution. Tex. Fam. Code § 3.410.

G. Death of Non-Owner Spouse

Upon the death of the non-owner spouse, the non-owner spouse's one-half interest in the community claim for reimbursement or economic contribution would pass to that spouse's heirs or devisees.

1. DUTY OF PERSONAL REPRESENTATIVE

If the sole heir or devisee is not the owner spouse or if the estate is insolvent, the personal representative would appear to be under a duty to pursue the claim against the owner spouse.

2. LIQUIDITY PROBLEMS

The existence of the claim may result in a much larger estate than had been anticipated. The deceased spouse's interest in the claim would be included in the deceased spouse's gross estate for death tax purposes and may cause an immediate liquidity problem.

3. CONFLICT OF INTERESTS

The existence of the claim may create a conflict of interest for both the personal representative and the attorney who are attempting to represent the entire family.

H. Death of Owner Spouse

Upon the death of the owner spouse, the asset which is the subject of the community claim for reimbursement or economic contribution will remain the owner's separate property and pass under the owner's will or by intestate succession; however, the claim continues to exist.

1. CONFLICT OF INTERESTS

Such a situation can create a conflict of interest (i) between the surviving spouse and the decedent's heirs or devisees where the surviving spouse is not the sole heir or devisee or (ii) between the heirs or devisees where the heirs or devisees of the separate property are not the same as the heirs or devisees of the community property. This potential conflict can be particularly troublesome for the personal representative or attorney who attempts to represent all members of the family.

2. ELECTION

As explained in *Dakan*, the doctrine of equitable election may force the surviving spouse to (i) assert the claim and waive any and all benefits under the will or (ii) accept the benefits conferred in the will and forego the claim. The doctrine of equitable election is applied where any devisee receives a benefit and suffers a detriment in a will. Accordingly, the election concept might work against any party involved.

3. OTHER PROBLEMS

The existence of such a claim with an uncertain value is likely to delay the administration of the estate and create liquidity problems.

I. Gift Tax Consequences

Failure to assert a claim for reimbursement or economic contribution by the non-owner spouse, or heirs and devisees of a deceased non-owner spouse, may be considered to be a taxable gift to the heirs and devisees of the owner spouse, or the owner spouse.

J. Rights of Creditors

Is the community claim for reimbursement or economic contribution a community asset that could be attached by one spouse's creditor in order to indirectly reach the separate property of the other spouse? The author is not aware of any Texas authority on point but believes it is a distinct possibility. Further, upon death or divorce, the nonowner spouse (or such spouse's heirs or devisees) may become the owner's largest creditor due to the community claim for reimbursement.

K. Separate Property Claims

A claim for reimbursement or economic contribution can also exist in favor of a spouse's separate estate where separate funds are used to enhance the community estate. One unique application of the separate claim for reimbursement is found in *Horlock v. Horlock*, 533 S.W.2d 52 (Tex. App.—Houston [14th Dist.] 1975), where separate property brought into the marriage was reimbursed out of the community for the separate estate lost due to the husband's inability to overcome the community presumption and trace his separate property when the marriage terminated.

L. Post Mortem Opportunities

In the right family situation, the existence of the community claim for reimbursement or economic contribution may also present an opportunity for creative post-mortem tax planning.

1. OWNER'S DEATH

If the owner spouse dies first with a will that does not provide for optimal marital deduction planning, the claim can be used to reduce the decedent's taxable estate by the amount owed to the surviving spouse, thereby shifting value from the first spouse's estate to the surviving spouse's estate and deferring death taxes until the survivor's death.

2. NON-OWNER'S DEATH

If the non-owner spouse dies first with a will that does not leave the residuary estate to the owner spouse in a manner which qualifies for the marital deduction, the claim creates the opportunity to shift value from the surviving spouse's presumably more valuable estate through the non-owner's probate estate to the spouses' children with less overall transfer taxes.

M. Planning Considerations

If a person intending to marry owns property that is likely to generate a claim for reimbursement or economic contribution during the marriage, the best plan is to avoid creating situations during the marriage that would give rise to the claim, if possible. A sale or gift of the property subject to any such claim does not cause the claim to be extinguished. The other spouse's claim will still exist when the marriage terminates.

1. CLOSELY HELD BUSINESSES

The owner of a separately owned business should be paid adequate compensation for the value of services rendered. The amount and adequacy of the compensation, whether in the form of salary or fringe benefits, should be documented in order to be in the position to defend the other spouse's *Jensen* claim for reimbursement when the marriage terminates. Any infusion of community cash during the marriage should be documented as a loan with adequate interest, and the loan should be repaid. An owner of a "flow through" entity, like a Subchapter S corporation or a partnership, should pay out of separate funds any resulting income tax liabilities generated and retained by the entity and reported on the owner's individual income tax returns. The owner should avoid personal liability for any debts of the entity whenever possible. If required, the owner should try to negotiate with the lender for the lender to agree to look only to the owner's separate property for repayment. In any event, any debts of the entity should be repaid with entity funds or the separate funds of the owner, if possible.

2. REAL ESTATE

The use of community funds to reduce the principal amount of any indebtedness secured by separate real property or to make an improvement to separate real property creates a claim for economic contribution which is not "offset" by the use and enjoyment of the property during the marriage. Sec. 3.403(e) of the Texas Family Code may not even allow community rental income to "offset" economic contribution claims. The use of community funds to make interest payments, to pay ad valorem taxes, to pay ordinary repairs, or to pay casualty insurance premiums may create a reimbursement claim, if the benefits enjoyed by the "community estate" do not "offset" the costs to the "community estate." Accordingly, separate funds should be used whenever possible to pay for any capital improvements or to pay the principal of any such indebtedness. Separate funds should also be expended to pay any expenses that may generate a claim for reimbursement if the benefits the community enjoys does not exceed the cost to the community. The client should also be made to realize that the expenditure of uncompensated "time, talent and labor" to improve separate property may give rise to a *Jensen* type reimbursement claim when the marriage terminates.

3. UNSECURED DEBTS AND LIFE INSURANCE

Premiums for separately owned life insurance policies should be paid with clearly traceable separate funds. Any unsecured loans incurred prior to marriage should be paid with separate funds. Any such payments should be documented and the documentation retained in order to meet the burden of proof required of the owner of separate property.

4. OTHER SITUATIONS

Tangible personal property, like automobiles, boats, and planes, can give rise to an economic contribution or reimbursement claims that are also not extinguished by the transfer of the asset to a third party. Payments of community funds to reduce the principal of a debt secured by tangible personal property also creates a claim for economic contribution with no offset for any benefits the "community estate" derived from its use during the marriage. Whenever possible separate funds should be used to pay the debt and make any improvements. Casualty insurance premiums and costs of ordinary maintenance and repair can be "offset" by the benefits the "community estate" derives through the property's use.

N. Election Planning

If the surviving spouse has a claim for reimbursement or economic contribution against the estate of the deceased spouse, can the surviving spouse assert that claim and still accept the benefits devised to the surviving spouse in the deceased spouse's will (including perhaps the devise to the surviving spouse of the deceased spouse's claim for reimbursement or economic contribution against the survivor)? In other words, is the surviving spouse put to an election to either elect against the will and assert the survivor's community property rights or elect to accept the benefits under the will and forego asserting any such community property rights? Absent language in the will expressly putting the surviving spouse to such an election, the parties will likely argue over whether or not there is an implied election that prevents the surviving spouse from accepting under the will and asserting community property rights inconsistent with the intent expressed in the will. *See* VI. E, *supra*.

1. EXAMPLES

For example, if the separate asset of the deceased spouse generating the claim is devised outright to the surviving spouse, it would appear that the surviving spouse's acceptance of the devise should estop the surviving spouse from asserting the claim against the decedent's estate. However, if the asset is not left outright to the survivor, but is left to another beneficiary and the survivor is left other assets, or if the asset is devised to a QTIP trust or a bypass trust for the benefit of the surviving spouse, the parties will likely argue over the possibility of there being an implied election for the surviving spouse. This situation may be similar to the one where the separate property homestead of the deceased spouse is left to his children by the previous marriage and the surviving spouse is left other assets. Can she accept the benefits and assert her homestead right to occupy the separate homestead?

2. EXPRESS ELECTION

To avoid the uncertainty, controversy and possible litigation that such a claim could create, the first spouse to die could devise any such claim of the deceased spouse to the surviving spouse expressly conditioned on the surviving spouse effectively either (i) waiving the survivor's claim against the decedent's estate or (ii) assigning the claim to the devisees of the asset that generated the claim. If the spouses' respective claims are not roughly equivalent in value, or if the decedent's claim does not exceed the surviving spouse's claim, other devises in the will in favor of the surviving spouse could be conditioned on the survivor effectively foregoing his or her claim against the estate.

3. MARITAL DEDUCTION PROBLEM

This express election approach avoids the uncertainty of whether the surviving spouse is put to an implied election, but it does not avoid the negative effect a condition attached to a devise to the decedent's surviving spouse can have on the marital deduction. Such a condition may cause the devise to the surviving spouse to be treated as a nondeductable terminable interest.

4. PRESERVING THE MARITAL DEDUCTION

Accordingly, if preserving the marital deduction is important to the planning, the debt payment clause in the deceased spouse's will could direct that all claims for economic contribution or reimbursement of the surviving spouse be charged against any assets passing to the surviving spouse, or if no assets are passing outright to the surviving spouse, charged against the assets passing into any trust created for the benefit of the surviving spouse. Under this approach, any marital deduction lost on the estate tax return should be made up by the deductible claim for reimbursement or economic contribution.

5. EFFECTIVE CONDITIONS

Alternatively, conditions could be attached to devises to, or for the benefit of, the surviving spouse which would not affect the marital deduction. For example, if the surviving spouse asserts such a claim, the standard for distributions of income and/or principal from the bypass trust could be made more restricted, or possibly distributions of principal from the QTIP trust could be eliminated.

6. REVOCABLE TRUST PLANS

The planning ideas discussed above could also be incorporated into a revocable trust plan.

IX. MARITAL PROPERTY RIGHTS IN IRREVOCABLE TRUSTS

The private express trust is a unique concept and one that is frequently misunderstood by members of the public and practitioners alike. The common law established that the trust is not an entity; it cannot own property; it cannot incur debt. Although it may be treated as if it were an entity for some purposes, it remains today a form of property ownership. *See* Tex. Trust Code § 111.004(4). Certain other common law principles remain relevant today. For example, a person serving as trustee is not a legal personality separate from such person in his or her individual capacity. A person serving as trustee is not the agent of either the trust, the trust estate or the beneficiaries of the trust. Finally, the trust assets are not considered to be the property of the person serving as trustee; such assets belong in equity to the beneficiary. These principles can affect the marital property rights of the parties.

A. The Private Express Trust

One noted authority describes the private express trust as"...a device for making dispositions of property. And no other system of law has for this purpose so flexible a tool. It is this that makes the trust unique....The purposes for which trusts can be created are as unlimited as the imagination of lawyers." Scott, Trusts 3, 4 (3rd Ed. 1967).

1. DEFINITION

A trust, when not qualified by the word "charitable," "resulting" or "constructive," is a fiduciary relationship with respect to property, subjecting the person by whom the title to the property is held to equitable duties to deal with the property for the benefit of another person, which arises as a result of a manifestation of the intention to create the relationship. Restatement Trust (Second) § 2.

2. CREATION

According to § 112.002 of the Texas Trust Code a trust may be created by: (i) a property owner's declaration that the owner holds the property as trustee for another person; (ii) a property owner's inter vivos transfer of the property to another person as trustee for the transferor or a third person; (iii) a property owner's testamentary transfer to another person as trustee for a third person; (iv) an appointment under a power to appointment to another person as trustee for the donee of the power or for a third person; or (v) a promise to another person whose rights under the promise are to be held in trust for a third person.

3. REVOCABLE OR IRREVOCABLE

Inter vivos trusts are further divided into two categories: revocable and irrevocable. A revocable trust is one that can be amended or terminated by the settlor. An irrevocable trust, in contrast, is one which cannot be amended or terminated by the settlor for at least some period of time. The presumption regarding the revocability of inter vivos trusts varies by jurisdiction. For example, in Texas all inter vivos trusts created since April 19, 1943 are revocable unless the trust document expressly states otherwise, while in some other states trusts (including Texas trusts created prior to April 19, 1943) are deemed irrevocable unless the trust document states otherwise. Tex. Prop. Code Ann. § 112.051. *See* Restatement (Second) Trusts, Sec. 330; Bogert, Law of Trusts and Trustees, § 998 (1983).

B. Beneficial Ownership

While record legal title to the assets of the trust is held by the trustee, equitable title — true ownership — belongs to the beneficiaries. For example, trust law generally exempts the assets of the trust from any personal debt of the trustee not related to the administration of the trust. This exemption even applies if the trust property is held by the trustee without identifying the trust or the beneficiaries. The rationale behind this exemption is the concept that the assets of the trust really belong to the beneficiaries. *See* Tex. Prop. Code § 101.002 and Tex. Trust Code § 114.0821. These principles confirm that trust assets belong to the beneficiaries and not the trustees. Accordingly, a trustee's spouse generally does not acquire any marital property interest in trust property, but spouses of the beneficiaries may, depending on the circumstances.

C. Interests of the Settlor's Spouse

The creation and funding of an inter vivos trust by a settlor may or may not remove the trust assets from the reach of the settlor's spouse. If (i) the trust is irrevocable and (ii) the settlor has not retained an equitable interest in the trust estate, the assets of the trust really belong to the beneficiaries and no longer have either a separate or community character insofar as the settlor's spouse is concerned. If the transfer of community assets in order to fund the trust is found to have been in fraud of the interests of the settlor's spouse, the spouse can reach the assets of the trust like any other assets transferred to a third party, free of trust, but in fraud of the community interests of the wronged spouse.

D. Settlor's Retained Interest

If the settlor creates an irrevocable trust and retains a beneficial interest in the trust assets, the rights and remedies of the settlor's spouse would appear to be similar to the rights of the settlor's creditors. Creditors can generally reach the maximum amount which the trustee can pay or distribute to the settlor under the terms of the trust agreement, even if the initial transfer into the trust was not in fraud of creditors. For example, if the settlor retains an income interest in the trust assets for the rest of the settlor's life, creditors can reach the retained income interest, and if the settlor retains a general power or appointment over the entire trust estate, creditors can reach the entire trust estate. *See Bank of Dallas, infra*. If the settlor retains an income interest for the remainder of the settlor's lifetime, the creditors can reach the income interest but not the fixed remainder interest already given to the remaindermen. If the trustee has the discretion to invade the principal for the settlor, the extent of the settlor's retained interest will probably be the entire trust estate. *See Cullum v. Texas Commerce Bank*, 1992 WL 297338 (Tex. App. Dallas 1992). The inclusion of a spendthrift provision will not insulate the settlor's retained interest from the settlor's creditors. *See* Tex. Trust Code § 112.035 and *Glass v. Carpenter*, 330 S.W.2d 530 (Tex. Civ. App.—San Antonio 1959, writ ref'd n.r.e.).

1. <u>MARITAL PROPERTY ISSUES</u>

The application of these principles in the marital property context would suggest that any income generated by the trust estate would still be deemed community property if the settlor retained an income interest in the trust which, for example, was funded with the settlor's separate property. However, in a recent case where the trust was funded with the settlor's separate property prior to marriage and the trustee was a third party who had discretion to make income distributions to the settlor, the trustee's discretion prevented the trust's income from taking on a community character until the trustee exercised its discretion and distributed income to the settlor. The wife in a divorce action had claimed that all of the trust assets were community property since the income generated during the marriage had been commingled with the trust corpus. *See Lemke v. Lemke*, 929 S.W.2d 662 (Tex. App.—Ft. Worth 1996, writ denied) and *In re Marriage of Burns*, 573 S.W.2d 555 (Tex. App.—Texarkana 1978, writ dism'd). Some older cases support that same result. *See Shepflin v. Small*, 235 S.W. 432 (Tex. Civ. App., no writ 1893) and *Monday v. Vance*, 32 S.W. 559 (Tex. Civ. App. 1895).

2. <u>OTHER FACTORS</u>

Had the trust been funded with community property without the consent of the other spouse, the other spouse could challenge the funding of the trust as being in fraud of the community. Had the assets been subject to the spouses' joint control, the other spouse could argue that the transfer was void since the other spouse did not join in the transfer. Had the settlor retained a general power of appointment, the other spouse could argue that the transfer of community property into the trust was "illusory" as to her community interests therein. *See* XVIB, *infra*. Accordingly, the only safe conclusion to reach is that the proper application of marital property principles should depend on the nature and extent of the retained interest and perhaps the timing of the creation of the trust.

E. Interests of the Non-Settlor Beneficiary

Because a beneficiary of a trust owns a property interest in the trust estate created by a settlor who is not the beneficiary, the ability of the spouse of the beneficiary to establish a community interest in certain assets of the trust should depend on the nature of the beneficiary's interest. Equitable interests in property, like legal interests, are generally "assignable" and "attachable," but voluntary and involuntary assignees cannot succeed to an interest more valuable than the one taken from the beneficiary.

1. COMPARISON TO CREDITORS' RIGHTS

Again, a review of the rights of creditors of the beneficiary appears relevant. For example, if the beneficiary owns a remainder interest, a creditor's attachment of the beneficiary's remainder interest cannot adversely affect the innocent life tenant's income interest. On the other hand, if the beneficiary is only entitled to distributions of income at the discretion of the trustee for the beneficiary's lifetime, a creditor of the beneficiary cannot attach the interest and require the trustee to distribute all the income. In fact, a creditor may not be able to force the trustee to distribute any income to the creditor since it would infringe on the ownership interests of the remaindermen.

2. PRINCIPAL

The original trust estate (and its mutations and income generated prior to marriage) clearly is the beneficiary's separate property as property acquired by gift, devise or descent, or property acquired prior to marriage. Distributions of principal are likewise the beneficiary's separate property. *See Hardin v. Hardin*, 681 S.W.2d 241 (Tex. App.—San Antonio 1984)

3. DISTRIBUTED INCOME

If the discretionary income beneficiary is married, it would logically follow that distributed income should be considered separate. The exercise of discretion by the trustee, in effect, completes the gift. The result may be different if the beneficiary is the trustee or can otherwise control the distributions. On the other hand, if the trustee is required to distribute the trust's income to the married beneficiary, the income could be considered community once it is distributed since it arguably could be considered income from the beneficiary's equitable separate property. *See Ridgell v. Ridgell*, 960 S.W.2d 144 (Tex. Civ. App.—Corpus Christi 1997). However, there is recent case authority that holds that trust income required by the trust document to be distributed to the beneficiary is the beneficiary's separate property, at least where the trust was created prior to the marriage. *Cleaver v. Cleaver*, 935 S.W.2d 491 (Tex. App.—Tyler 1996, no writ). *See also In the Matter of the Marriage of Long*, 542 S.W.2d 712 (Tex. App.—Texarkana 1976, no writ), and *Wilmington Trust Company v. United States*, 753 F.2d 1055 (5th Cir. 1985).

4. UNDISTRIBUTED INCOME

Undistributed income is normally neither separate nor community property. *See In the Matter of Burns, supra; Buckler v. Buckler*, 424 S.W.2d 514 (Tex. App.—Ft. Worth 1967, writ dism'd), and *McClelland v. McClelland*, 37 S.W. 350 (Tex. Civ. App., 1896, writ ref'd). But, if the beneficiary has the right to receive a distribution of income but does not take possession of the distribution, such retained income may create marital property rights in the beneficiary's spouse. *See Cleaver, supra*. Depending on the intent of the beneficiary in allowing the distribution to remain in the trust, such income (and income generated by the retained income) may be considered to have taken on a community character or may be considered to have been a transfer to the other beneficiaries of the trust and subject to possible fraudulent transfer on the community scrutiny. But, *see* IX.E.3. *supra*.

F. Spendthrift Trust

Texas law permits the settlor of a trust to prohibit both the voluntary and involuntary transfer of an interest in trust by the beneficiary prior to its actual receipt by the beneficiary. In fact, the settlor may impose this disabling restraint on the beneficiary's interest by simply declaring that the trust is a "spendthrift trust." Such a restraint is not effective if the beneficiary has a mandatory right to a distribution but simply has not yet accepted the interest. Further, such a restraint is not effective to insulate a settlor's retained interest from the settlor's creditors. *See* Tex. Trust Code § 112.035. This rationale suggest that the settlor's intent as to the nature of the beneficiary's interest may be relevant in determining whether the beneficiary's spouse acquires a community interest in the trust estate, the undistributed income or any distributed income.

G. Powers of Appointment

If the beneficiary has the absolute authority under the trust agreement to withdraw trust assets or to appoint trust assets to the beneficiary or the beneficiary's creditors, the beneficiary is deemed to have the equivalence of ownership of the assets for certain purposes. For example, such beneficiary would appear to have such an interest that cannot be insulated from the beneficiary's creditors by either the non-exercise of the power or a spendthrift provision. An appointment in favor of a third party could be found to have been in fraud of creditors. *See Bank of Dallas, supra*. While inconsistent with the common law which treated the assets over which a donee had a general power as belonging to others until the power was exercised, application of this modern view may treat the assets over which a married donee has a general power as the separate property of the donee, but that any income generated by those assets may be community property.

1. SPECIAL POWERS

Many beneficiaries are given limited general powers (i.e. "Crummey" and the so-called "Five or Five" power, both of which permit the beneficiary to withdraw a certain amount from the trust estate at certain periods of time).

2. LAPSE OF POWERS

If the beneficiary allows the withdrawal power to lapse, can the creditors still go after that portion of the estate that could have been withdrawn or can the beneficiary's spouse claim either a possible community interest in the assets allowed to continue in trust, or the income thereafter generated? In other words, does the lapse of the power make the beneficiary "a settlor" of the trust? The Legislature has answered some of these questions. Section 112.035(d) of the Texas Trust Code was amended by the Legislature in 1997 to confirm that a beneficiary of a trust is not to be considered a settlor of a trust because of a lapse, waiver or release of the beneficiary's right to exercise a "Crummey right of withdrawal" or "Five or Five" power.

3. <u>ASCERTAINABLE STANDARD</u>

If the beneficiary's power of withdrawal is limited to an ascertainable standard (i.e., health, support, etc.), creditors who provided goods or services for such a purpose should be able to reach the trust estate, but not other creditors. And it follows that any income distributed for such purposes but not so expended may be community since such expenses are normally paid out of community funds.

4. <u>NON-GENERAL POWERS</u>

A beneficiary's power to appoint only to persons other than the beneficiary, the beneficiary's creditors and the beneficiary's estate are generally deemed personal to the beneficiary and not attachable by the beneficiary's creditors. It would also follow that such a power would not give the spouse any interest in the trust estate. But, if the power is exercised to divert community income from the beneficiary, could it be subject to possible fraud on the community scrutiny?

X. MARITAL PROPERTY IN THE REVOCABLE TRUST

If prior to, or during a marriage, a spouse transfers separate property into a revocable trust arrangement, (a) the original trust estate and its traceable mutations should retain the separate character of the separate property contributed to the trust, (b) any trust income distributed to the settlor will be community property, and (c) any undistributed income and its mutations is also likely to be community property due to the settlor's power of revocation.

A. *Land v. Marshall*

The retention of any trust income in the trust is likely to be considered by a court as an "illusory" transfer of the other spouse's community interest in the undistributed income to the trust under *Land v. Marshall*, 426 S.W.2d 841 (Tex. 1968). In this case, the husband placed his sole management community property into a revocable trust; upon his death, the wife disrupted the plan by pulling her one-half interest out of the trust under the "illusory" transfer doctrine.

B. Creation and Funding

Accordingly, when separate property is to be placed into a revocable trust, steps should be taken to insure that the planning does not work a commingling of community and separate funds as to risk losing the separate character of the separate property. In other words, precautions should generally be taken in the drafting and funding of the trust to document that the retained equitable interest of any community assets in the trust remain community during the balance of the marriage, and if an asset is the settlor's special community property, that it maintains that character as well. Of course, a spouse's retained interest in any separate property should be "earmarked" to retain its separate character.

C. Effect of Divorce

Community assets and quasi-community property held in trust where a spouse holds a power of revocation is likely to be part of the "estate of the parties" subject to division by the divorce court in a just and right manner pursuant to Sec. 7.001 of the Texas Family Code.

1. <u>POWERS OF APPOINTMENT</u>

A power of revocation is defined in the Texas Property Code as a general power of appointment, giving the holder thereof the equivalence of ownership over the assets subject to the power. *See* Tex. Prop. Code, § 181.001.

2. <u>VOIDABLE TRANSFERS</u>

If only one spouse is the settlor of a trust funded with the settlor spouse's special community property or allowed trust income to be accumulated in the trust, the "transfer" of such community assets into the trust is deemed "illusory" as to the other spouse. *See Land v. Marshall, supra*.

3. <u>TRANSFERS TO THIRD PARTIES</u>

Any trust income, or any other community assets held in the trust, distributed by the trustee to a third party, such as a child of the settlor from the settlor's prior marriage, is usually deemed to be a completed gift by the settlor to the third party for tax purposes (unless the distribution satisfied the settlor's legal obligations of the support) and is subject to attack by the other spouse as being a transfer in fraud of the other spouse's community property rights.

4. <u>REVOCABLE TRUSTS BECOMING IRREVOCABLE</u>

If during the marriage, a revocable trust becomes irrevocable due to a modification by the settlor, or due to the trusts own terms (e.g., the trust provides that it becomes irrevocable upon the settlor's incapacity or death), (a) the interests of the non-settlor beneficiaries may become fixed, vested and/or ascertainable, (b) the settlor may be deemed to have made a completed gift for tax purposes and (c) the now completed transfers to the non-settlor beneficiaries are subject to scrutiny as being transfers in fraud of the other spouse's community property rights.

5. INCOME TAXES

The income generated by the assets of a revocable trust is taxable to the settlor whether or not the income is distributed to the settlor, retained in the trust or distributed to another beneficiary of the trust. Since the income either retained in the trust or distributed to a third party is still reported on the settlor's individual income tax return (typically a joint return with the settlor's spouse), the payment of the consequential income tax liability due to the sale of any separate property with community funds could adversely affect the rights of the other spouse.

D. Death of a Spouse

If the client is the first spouse to die, the decedent's separate property and one-half interest in the community assets are normally placed in a continuing decedent's trust or are distributed in accordance with the provisions of the trust document. However, the surviving spouse's one-half interest in the community property should be delivered to the surviving spouse. If the surviving spouse does not receive the survivor's one-half interest in the community property, the settlor spouse can use the "illusory trust" argument to reclaim the survivor's one-half interests in the community trust assets. *See Land v. Marshall, supra*. If the other spouse dies first, the terms of the trust should direct that the trustee deliver to that spouse's personal representative that spouse's one-half of any community property.

E. Planning Considerations

When drafting the trust document, separate trusts may be desirable for the client's separate property and the community property. Since the decedent's interest in the revocable trust assets is included in the gross estate, such assets will receive a new income tax basis.

F. Settlor's Homestead Protection

A homestead exemption from the owner's general creditors can only exist in a possessory interest in land. *See Capitol Aggregates v. Walker*, 448 S.W.2d 830 (Tex. Civ. App.—Austin 1969, writ ref'd n.r.e.); *Texas Commerce Bank v. McCreary*, 677 S.W.2d 643 (Tex. App.—Dallas 1984, no writ). In revocable trust planning, where legal title in the home is transferred to the trustee, the settlor usually retains the equitable title at least for the remainder of the settlor's lifetime. In addition, there is authority for the proposition that an "equitable interest" will support a homestead claim. *See Rose v. Carney's Lumber Co.*, 565 S.W.2d 571 (Tex. Civ. App.—Tyler 1978, no writ); *White v. Edzards*, 399 S.W.2d 935 (Tex. Civ. App.—Texarkana 1966, writ ref'd n.r.e.). In fact, one early case held that the property retained its homestead character during the settlor's lifetime notwithstanding the fact it had been conveyed to a trustee where the settlor had continued to occupy the property and the purpose of that trust was to prevent the premises from being taken by creditors. *See Archenhold v. B.C. Evans Co.*, 32 S.W. 795 (Tex. Civ. App. 1895, no writ). Thus, it appears as if the homestead continues to be exempt from most creditors so long as the settlor is alive. Tex. Prop. Code § 41.001. The same would appear to be true for exempt personal property. Tex. Prop. Code § 42.001.

G. Joint Revocable Trusts

If a couple insists on a joint revocable trust, separate trusts are desirable for the husband's separate property, the wive's separate property, and their community property. In fact, it is also advisable to segregate the community property further into three separate sub-trusts, one for the husband's sole management community property, one for the wife's sole management community property, and one for their joint community property in order to maintain their relative marital property rights, to facilitate the management rules of Sections 3.101 and 3.102 of the Family Code, and to continue the liability exemption rules of Section 3.202 of the Family Code. For example, each spouse should retain the right to unilaterally revoke the trust as to that spouse's separate property and sole management community property.

H. Protection of Family

However, upon the settlor's death, the transfer of assets to the revocable trust may result in the loss of certain probate provisions which protect the surviving members of the family from the settlor's creditors (i.e., the probate homestead, exempt personal property, widow's allowance and the claims procedures followed in probate administration) following a decedent's death.

1. PROBATE HOMESTEAD

The Texas Constitution provides that on the death of a homestead owner, the homestead is to descend and vest in like manner as other real property of the deceased but that it shall not be partitioned among the heirs of the deceased during the lifetime of the surviving spouse for so long as the survivor elects to use or occupy the same as a homestead, or so long as the guardian of the minor children of the deceased may be permitted, under the order of the proper court having the jurisdiction, to use and occupy the same. Tex. Const. Art. XVI. § 52 (1987). The effect of this constitutional mandate is to vest a life estate in the surviving spouse until abandonment, or a right to receive an estate until majority for minor children. *Thompson v. Thompson*, 236 S.W.2d 779 (Tex. 1951). In addition, the Texas Probate Code provides that following the owner's death, if the owner is survived by a spouse, minor children or unmarried child remaining at home, the homestead will not be liable for any debts, except for the purchase money thereof, the taxes due thereon, or work and material used in constructing improvements thereon. Tex. Prob. Code § 270. Further, the probate code directs the probate court to set apart for the use and benefit of the surviving spouse and minor children all such property of the estate as is exempt from execution or forced sale by the constitution and laws of the state.

2. RIGHT OF OCCUPANCY

Will the surviving spouse have a right to occupy the home following the death of the owner when it had been placed in a revocable trust prior to its owner's death? While there are no definitive cases on point, it appears that the surviving spouse may not have such a right unless the trust document so provides. If the home was placed in the revocable trust during marriage, both spouses would have had to join in the transaction or the conveyance would have been void. Tex. Fam. Code § 5.81. Consideration should be given to the effect of Sec. 113.022 of the Texas Trust Code which states that a trustee may permit real estate held in trust to be occupied by a current beneficiary of the trust.

In addition, if the home had been placed into the revocable trust by its owner before the marriage, or if the owner places it in trust during the marriage but before it is used as the home, the survivor's right of occupancy may never have even come into existence since the right can attach only to the actual property interest owned by the owner, which in the revocable trust situation is an equitable life estate that terminates upon the settlor's death. This same rationale may even defeat the possession rights of the owner's minor children. On the other hand, perhaps public policy in favor of the surviving spouse and minor children will lead the courts to extend the "illusory transfer" concept to such a situation to protect the rights of the surviving spouse and minor children to occupy the home like it did to protect the surviving spouse's community one-half interest unilaterally placed in a revocable trust in *Land v. Marshall*, 426 S.W.2d 841 (Tex. 1968).

This probable loss of the right of occupancy is consistent with the constitutional and statutory homestead provisions since both contemplate the homestead being a probate asset upon the death of the owner. If the home has been placed into a revocable trust, the settlor's life estate terminates and the remainderman's interest becomes possessory upon the death of the settlor instead of going through probate.

3. CREDITOR'S ARGUMENTS

Assuming the settlor is survived by a constituent family member, will the home placed in a revocable trust continue to be exempt from most creditors of the settlor upon the settlor's death? Again, there are no definitive cases and the likely result is not very clear. First, a creditor could argue that if the constituent family members have lost their right of occupancy, the purpose in exempting the property is frustrated and, therefore, the creditors should be able to reach the asset like any other revocable trust asset. Second, the creditors will point out that the exemption from creditors is found in the probate code and is directed at probate assets; since the owner elected to make the home out of probate, its exemption is lost. On the other hand, the basic theory that supports the creditor's position, in effect, ignores the existence of the trust, thereby revesting the settlor with the property and returning it to his probate estate where it would have been exempt from the claims of the creditors in the first place. In other words, the creditors have essentially forced the settlor to revoke the trust thereby making the home probate property again and, therefore, entitled to probate protection.

4. EXEMPT PERSONAL PROPERTY

Normally, certain items of tangible personal property are exempt from most of the decedent's creditors if the decedent is survived by a constituent family member. Tex. Prob. Code §§ 271 and 281. These items are described in the Texas Property Code and generally include the household furnishings, personal effects and automobiles in an amount that does not exceed $60,000. Tex. Prop. Code § 42.002. In addition, during administration, the family members can retain possession of these items and will receive ownership of these items if the decedent's estate proves to be insolvent; otherwise the decedent's interest in these items passes to his heirs and/or devisees when the administration terminates. Tex. Prob. Code § 278. The arguments "pro" and "con" as to whether these rights exist if these items of property which would otherwise be exempt are placed in a revocable trust would seem to parallel the above homestead discussion.

5. ALLOWANCES

In addition to the allowances in lieu of homestead and exempt personal property, an allowance for one year's maintenance of the surviving spouse and minor children may be established by the probate court. Tex. Prob. Code §§ 286 and 287. The allowance is paid out of the decedent's property subject to administration. *Ward v. Braun*, 417 S.W.2d 888 (Tex. Civ. App.—Corpus Christi, 1967, no writ). Thus, it appears that the family allowance would be lost if all of the decedent's assets have been placed in a revocable trust.

XI. FAMILY BUSINESS PLANNING

The use of modern business entities, such as corporations, partnerships and limited liability companies, has become an integral part of family estate planning. One popular technique is for family members to contribute assets to a family limited partnership in exchange for interests in the partnership. A client intending to marry can also take advantage of this planning opportunity to preserve the assets contributed to the family limited partnership for the client and the children of a prior marriage. The client's partnership interest should remain the client's separate property during the marriage. In other words, the assets contributed to the partnership, as well as assets acquired by the partnership, should be partnership assets, not the marital assets of the owner and the owner's spouse.

A. Entity Theory

The assets contributed to the partnership become the assets of the partnership, and the partners receive partnership interests. The marital character of a spouse's partnership interest should depend on the separate or community nature of the assets contributed in exchange for the interest itself. If an interest in the partnership was acquired as a gift, the interest itself is, of course, the separate property of the donee spouse. The assets of the partnership, including undistributed income and profits, belong to the entity and do not take on a separate or community character under normal circumstances. *See* Art. 6132b–2.01 of the Texas Revised Partnership Act and *see also Harris v. Harris*, 765 S.W.2d 798 (Tex. App.—Houston [14th] 1989, writ ref'd). Caution should be taken in the day to day management of the partnership to avoid claims for economic contribution and reimbursement. *See* VIII, *supra*. *See also* III, B, *supra*, Marital Opportunity Theory.

B. Distributed Profits

When the partnership distributes its profits to its partners, the profits distributed to a married partner are community property, whether the partner's partnership interest is separate or community property. This result can work a conversion of what would ordinarily be separate property into community property. For example, if a spouse contributes separately owned oil and gas royalty interests into a partnership, the royalties collected by the partnership and then distributed to the partners as partnership profits is community property. Had the spouse not contributed the royalty interest to the partnership, the royalties received would have been the owner's separate property. *See Marshall v. Marshall*, 735 S.W. 2d 587 (Tex. App.—Dallas 1987, writ ref'd. n.r.e).

C. Comparison to Corporations

Partnerships, limited partnerships and limited liability companies are treated as entities under Texas law. The owners do not own the entity's assets; they own interests in the entity similar to shares of stock in a corporation. Non-liquidating distributions by the entity to the owners take on a community character like ordinary cash dividends distributed by a corporation to its shareholders. Accordingly, established corporate law concepts, like the alter ego theory of *Dillingham v. Dillingham*, 434 S.W.2d 459 (Tex. App.—Ft. Worth 1968) and reimbursement for the expenditure of community time, talent and labor like in *Jensen* and *Vallone* should apply to these new entities as well.

D. Convert Sole Proprietorships

Even if the client is not willing to share a business enterprise with other members of the family, a sole proprietorship should be converted into an entity, like a corporation, prior to the marriage. Proper management and record keeping can maintain the client's stock in the corporation as separate property and the assets of the corporation as corporate assets, not marital assets. *See* XI, E, *infra*. Continuing to operate the "business" as a sole proprietorship during the marriage is likely to result in a commingling of separate and community assets so that over time the "business" becomes community property because of the client's inability to trace which of the business assets were owned prior to marriage or traceable to assets owned prior to marriage. Caution should be taken in the day to day management of the corporation to avoid claims for economic contribution and reimbursement.

E. Reverse Veil Piercing

The assets of a separately owned corporation have been held by Texas courts to be part of the community estate and subject to a just and right division by the divorce court. See *Zisblatt v. Zisblatt*, 693 S.W.2d 944 (Tex.App.—Ft. Worth 1985, writ dism'd); *Spruill v. Spruill*, 624 S.W.2d 694 (Tex.App.—El Paso 1981, writ dism'd); *Dillingham v. Dillingham*, 434 S.W.2d 459 (Tex.App.—Ft. Worth 1968, writ dism'd).

While the cases are not numerous and the theories used to justify the result are not always consistent, reverse veil piercing is a reality. In its landmark case, *Castleberry v. Branscum*, 721 S.W.2d 270 (Tex. 1986), the Texas Supreme Court explained the basic theories that can be used to disregard a corporate entity: alter ego, sham to perpetrate a fraud, or actual fraud. The court further explained that veil piercing is an equitable doctrine that can be used to prevent an unfair or unjust result.

In a recent case, *Lifshutz v. Lifshutz*, 61 S.W.3d 511 (Tex.App.—San Antonio 2001, pet denied) the court purported to explain the elements necessary to disregard the corporate entity. First, there must be a finding that the corporation is the alter ego of the shareholder (i.e., there is a unity between the corporation and the shareholder). Second, the shareholder's use of the corporation damaged the community estate beyond that which could be remedied by a claim for reimbursement. While some courts have required that the shareholder must be the sole shareholder, other courts have not. *See Zisblatt supra*.

The *Lifshutz* court also suggested that the use of the corporation must also have had a negative impact on the community estate. In other words, even if the corporation is the shareholder's alter ego, the corporation may not be disregarded unless community property was transferred to the corporation.

XII. OTHER SPOUSE'S INTEREST IN THE EMPLOYEE'S RETIREMENT PLAN

Due to *Allard v. Frech*, 754 S.W.2d 111 (Tex. 1988), an employee must be aware of the other spouse's community property interest in the employee spouse's employee benefit package. *See also Valdez v. Ramirez*, 574 S.W.2d 748 (Tex. 1978). The employee benefit package of a working spouse is a form of compensation and acquires a community character during marriage. Unlike most marital assets, the community character of an interest in a retirement plan is determined using the "apportionment theory" instead of the traditional "inception of title rule." The "apportionment theory" gives the non-employee spouse an increasingly community property interest in the employee's plan during marriage. *Berry v. Berry*, 647 S.W.2d 945 (Tex. 1983) and *Dessommes v. Dessommes*, 543 S.W.2d 165 (Tex. Civ. App.—Texarkana 1976, writ ref'd n.r.e.).

A. Application of the Apportionment Rule

While the apportionment rule appears to preserve an employee's separate interest in a retirement plan owned prior to marriage, the application of the rule can result in the loss of a significant portion of the plan. For example, in *McClary v. Thompson*, 65 S.W.3d 829 (Tex.App.—Fort Worth 2002, pet. denied), the court of appeals stated that ..."to determine the portion as well as the value of a defined contribution plan that is community property, courts subtract the amount contained in the plan at the time of the marriage from the total contained in the account at divorce." *See also* West Group, Texas Family Law Service, § 22:29 (2004). In other words, if this statement is accurate, any appreciation in value during the marriage of what was originally a separate 401K plan, a profit-sharing plan, or an ESOP becomes community property, because the employee is not permitted to trace the assets in any such plan at the beginning of the marriage into what is still in the plan at the time of divorce.

It is this author's opinion that the employee should be permitted to trace the assets in the plan on the date of the marriage into their "traceable mutations" in existence at the time of divorce. Definitive authority for this position is lacking since most authority is found in court decisions involving defined benefit plans and not defined contribution plans. *See Berry v. Berry*, 647 S.W.2d 945 (Tex. 1983); *Taggert v. Taggert*, 552 S.W.2d 422 (Tex. 1977); and *Cearley v. Cearley*, 544 S.W.2d 661 (Tex. 1976) (defined benefit plans are to be apportioned based on the relative time periods). Subsequent courts of appeals have failed to consistently distinguish defined contribution and defined benefit plans. *Iglinsky v. Iglinsky,* 735 S.W.2d 536 (Tex.App.—Tyler 1987, no writ) and *Hatteberg v. Hatteberg*,, 933 S.W.2d 522 (Tex.App.—Houston [1st Dist.] 1994, no writ), recognized the differences

However, *Pelzig v. Berkebile*, 931 S.W.2d 398 (Tex.App.—Corpus Christi, 1996, no writ), *Baw v. Baw*, 949 S.W.2d 764 (Tex.App—Dallas 1997, no pet), and *Smith v. Smith*, 22 S.W.3d 140 (Tex.App.—Houston [14th Dist] 2000, no pet.) have all taken the position that the community interest in a defined contribution plan is calculated by subtracting the value of the plan as of the date of the marriage from the value of the plan as of the date of the divorce. It is important to note that the tracing rules do apply to mutual funds in general. *See Bakken v. Bakken*, 503 S.W.2d 315 (Tex.App.—Dallas 1977, no writ), which recognized that increases in mutual fund shares as either separate or community property depends on whether the increases were due to dividends or capital gain distributions.

B. Divorce

Upon a divorce of the spouses, the community portion of the employee spouse's interest in the plan is subject to the "just and right" equitable division of the community estate by the divorce court. *Berry v. Berry*, *supra*. Qualified retirement plans may not be effectively divided on divorce unless the court's order qualifies as a "qualified domestic relations order" pursuant to the Retirement Equity Act of 1984. 29 USC § 1056(d)(3)(A). *See also* Tex. Fam. Code § 9.101. Notwithstanding Tex. Fam. Code §§ 9.301 and 9.302 which generally void the designation of an ex-spouse as the beneficiary of a life insurance policy or a retirement plan, Federal law appears to preempt the application of those two Texas statutes in situations involving life insurance policies and retirement plans provided by an employer and governed by ERISA. However, the question remains as to whether federal common law effectively prevents the ex-spouse from retaining the benefits. *See Egelhoff v. Egelhoff*, 121 S. Ct. 1322 (2001) (a case arising out of Washington); and *Manning v. Hayes*, 212 F.3d 866 (5th Cir. (Tex.) 2001, cert. denied, 121 S. Ct. 1401 (2001). Compare *Weaver v. Keen*, 43 S.W.3d 537 (Tex. App.—Waco 2001 no pet. h.) and *Heggy v. Am. Trading Employee Retirement Account Plan*, 2001 Tex. App. LEXIS 5399 (Tex. App.—Houston [14th] 2001, no pet. n.). Compare the effect divorce has on a devise to an "ex-spouse" in the decedent's will. Tex. Prob. Code § 69.

C. Death

Upon the death of the employee spouse, Texas case law has held that the other spouse retains an interest in the community portion of the employee spouse's plan. In addition, federal law mandates that the other spouse be the beneficiary of a "qualified survivor's annuity" for many ERISA plans. I.R.C. § 417(b). Upon the death of the employee's spouse, the Texas Supreme Court has held that the deceased spouses' heirs and devisees succeed to that spouse's one-half of the community portion of the employee spouse's interest in the plan, if there has not been a valid non-probate disposition of the same. *See Valdez* and *Allard, supra*. ERISA does not expressly address what happens to the other spouse's interest, if that spouse dies before the employee.

D. ***Boggs v. Boggs***

The Retirement Equity Act of 1984 created what may be called "federal marital property law" due to its conflicts with state law. Under the Act, the employee spouse is required to select a "qualified joint and survivor annuity" for all pension plans and many profit sharing plans, unless the employee and the employee's spouse agree to another beneficiary designation. *See* I.R.C. § 417(b). E.R.I.S.A. also provides that pension plans may not be assigned or alienated. 29 U.S.C. Sec. 1056(d). Sec. 401(a)(2) of the Internal Revenue Code also provides that the benefits must be for the exclusive benefit of the employee. While Texas courts have not yet resolved the question of whether federal law preempts Texas law upon the death of non-employee spouse it can be assumed that *Allard* and *Valdez* have been pre-empted by federal law. *See Ablamis v. Roper*, 937 F.2d 1450 (9th Cir. 1991); *Meek v. Tullis*, 791 F.Supp 154 (W.D. Louisiana 1992), finding preemption. However, in *Boggs v. Boggs*, 82 F. 3d 90 (5th Cir. 1996), the Fifth Circuit agreed with the lower court and found that Louisiana community property law was not preempted. *See* Golden*, ERISA Beneficiary Designations and Community Property Laws...*1997 Advanced Drafting: Estate Planning (State Bar of Texas). However, the United States Supreme Court ruled on June 2, 1997 that Louisiana law was preempted by federal law. *Boggs v. Boggs*, 117 S.Ct. 1754, 79 AFTR 2d 97-960 (1997).

APPENDIX

25 Points to Make with the Client Intending to Marry!

1. A review of the basic “default” rules of Texas marital property law (i.e., the rules of marital property characterization, management and liability) is necessary. (I)

2. All assets of the spouses are presumed to be community property, thereby placing the burden of proof on the party (a spouse, or that spouse's personal representative, or the heirs/devisees of the spouse) asserting separate character to show by "clear and convincing evidence" that a particular asset is, in fact, separate. A logical extension of this rule leads to the practical definition of “community property”: *the property of the marriage which is not proven to be separate property*. In other words, if you can’t prove it, you lose it. (II, B)(II)

3. The fact that an asset is held in one spouse's name only is not determinative of its marital character and only raises a presumption that the asset is subject to that spouse's sole management and control. It is still presumptively community property. (II, G(1))

4. The managing spouse has the duty not to commit a fraud on the community property rights of the other spouse (i.e., not to dispose, transfer or diminish that spouse’s special community property in fraud of the other spouse’s rights to that property) when managing a spouse’s sole management community property (i.e., “special community property”). (III, E)

5. Investing separate funds rather than community funds should not be considered a breach of fiduciary duty, or a fraud on the community, absent extraordinary circumstances. (III, B)

6. A spouse, who does not wish the other spouse to assume authority over his or her assets, in the event of incapacity, needs to execute a “pre-need” guardianship designation. (III, C)

7. A spouse's separate property is generally not subject to the liabilities of the other spouse. A spouse's special community property is generally not subject to any of the liabilities incurred by the other spouse prior to the marriage or any nontortious liabilities of the other spouse incurred during the marriage. Joint community property is liable for both spouses’ debts. (IV)

8. The Texas Family Code directs the divorce court divide the "estate of the parties" in a just and right manner. The Texas Supreme Court has limited the term "estate of the parties" to community property only. There is a statutory exception related to the concept of quasi-community property (generally separate property acquired while the couple was residing in another state but which would have been community had they been residing in Texas). (V)

9. The marital property character of multiple-party bank accounts is determined in part by the form of account used by the depositing spouse, and the form of the account will frequently dictate the disposition of the funds on dissolution. (III, K)

10. When a spouse dies, the marriage terminates, and community property technically ceases to exist. Death works a legal partition of the community probate assets; and the deceased spouse's undivided one-half interest passes to his heirs and/or devisees, and the surviving spouse retains an undivided one-half interest therein. (VI)

11. A deceased spouse’s testamentary authority is limited to the decedent's separate probate property and one-half interest in the community probate property. (VI, D)

12. Notwithstanding the grant of testamentary power, there exists certain constitutional and statutory provisions which protect the surviving spouse, whether the assets are separate or community. (VI, F)

13. During formal administration, the personal representative is generally entitled to possession of not only the deceased spouse's separate property but also the couple's joint community property and the decedent's special community property. The surviving spouse retains possession of the survivor's special community property during administration. (VII, B)

14. When a personal representative is administering the estate of the deceased spouse, the surviving spouse is also acting in a fiduciary capacity over the survivor's special community property. (VII, B, 4)

15. The personal representative should pay certain claims out of the decedent’s separate property or the decedent’s one-half of community assets, and other claims should be paid with the community funds. (VII, C)

16. The last twenty-five years have seen important cases and significant legislation which have added to the continuing evolution of the concept of reimbursement between the marital estates that usually arises when one spouse's separate property is improved through the expenditure of community funds or community time, talent and labor. (VIII)

17. Claims for economic contribution arise in six statutorily defined situations related to use of one marital estate’s funds to reduce the principal amount of debt secured by another marital estate or to make capital

improvements to another marital estate. The use and enjoyment of the property during marriage does not offset the claim. (VIII, F)

18. If a person intending to marry owns property that is likely to generate a claim for reimbursement or economic contribution during the marriage, situations during the marriage that would give rise to the claim, should be avoided, if possible. A sale or gift of the property subject to any such claim does not cause the claim to be extinguished. The other spouse's claim will still exist when the marriage terminates. (VIII, M)

19. To hopefully avoid any disruption in the spouse's estate plan that a claim for reimbursement or economic contribution can create, the spouse can devise any such claim the spouse has against the surviving spouse, or any other property, to the surviving spouse expressly conditioned on the surviving spouse waiving the survivor's claim against the decedent's estate, thereby forcing the surviving spouse to an "election." (VIII, W)

20. If a spouse's parents create an irrevocable trust for the spouse and the spouse's children, the client's interest in the original trust estate (and its mutations and income generated prior to marriage) is separate property. Distributions of principal to the spouse are the spouse's separate property. If the trust calls for discretionary distribution of income, the distributed income should be considered separate assuming the spouse is not the trustee. On the other hand, if the trustee is required to distribute the trust's income, or if the spouse has the discretion to distribute the income to himself, the income may be community. Income properly retained in the trust has been held to be neither separate nor community property. (IX)

21. If prior to, or during a marriage, a spouse transfers separate property into a revocable trust arrangement, (a) the original trust estate and its traceable mutations can retain the separate character of the separate property contributed to the trust, (b) any trust income distributed to the settlor during marriage will be community property, and (c) any undistributed income and its mutations are also likely to be community property due to the settlor's retained power of revocation. (X)

22. If a married couple insists on creating a joint revocable trust, separate trusts should be created for the husband's separate property, the wife's separate property, and their community property. It is also advisable to divide the community property further into three separate sub-trusts, one for the husband's special community property, one for the wife's special community property, and one for their joint community property in order to maintain their relative marital property rights, to facilitate the management rules, and to continue the liability exemption rules. (X, G)

23. The use of modern business entities, such as corporations and partnerships, has become an integral part of family estate planning. One popular technique is for family members to contribute assets to a family limited partnership in exchange for interests in the partnership. A client intending to marry can also take advantage of this planning opportunity to preserve the assets contributed to the family limited partnership for the client and the children of a prior marriage. (XI)

24. While the apportionment rule appears to preserve an employee's separate interest in a retirement plan owned prior to marriage, the application of the rule can result in the loss of a significant portion of the plan in the event of divorce. At the employee's death, federal law mandates that the other spouse be the beneficiary of a "qualified survivor's annuity" for many ERISA plans. (XII)

25. **Most Importantly! Texas law provides effective and practical means whereby a couple planning to marry, or an already married couple, can alter by agreement the traditional rules of marital property characterization, management and liability in order to accomplish the goal of keeping one's "estate" separate. (I)**