HANDLING THE DIVORCE INVOLVING TRUSTS OR FAMILY LIMITED PARTNERSHIPS

RICHARD R. ORSINGER
ATTORNEY AT LAW
1616 Tower Life Building
San Antonio, Texas 78205
(210) 225-5567 (Telephone)
(210) 267-7777 (Telefax)
rrichard@txdirect.net
http://www.txdirect/users/rrichard

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Handling the Divorce Involving Trusts or Family Limited Partnerships©

by

Richard R. Orsinger
Board Certified in Family Law
and Civil Appellate Law by the
Texas Board of Legal Specialization

I. INTRODUCTION This Article discusses the interface between Texas divorce law, trusts and family limited partnerships. This includes an analysis of the law relating to gift and inheritance; consideration of express, resulting and constructive trusts; and Texas partnership law. The Article also analyzes possible ways to attack express trusts.

II. GIFT A gift is a transfer of property made voluntarily and gratuitously. *Hilley v. Hilley*, 161 Tex. 569, 342 S.W.2d 565, 568 (Tex. 1961). A gift requires: 1) an intent to make a gift; 2) delivery of the property; and 3) acceptance of the property. *See Grimsley v. Grimsley*, 632 S.W.2d 174, 177 (Tex. App.--Corpus Christi 1982, no writ). The burden of proving a gift is on the party claiming the gift. *Woodworth v. Cortez*, 660 S.W.2d 561, 564 (Tex. App.--San Antonio 1983, writ ref'd n.r.e.).

A. Lack of Consideration Lack of consideration is an essential characteristic of a gift; an exchange of consideration precludes a gift. *Pemelton v. Pemelton*, 809 S.W.2d 642, 647 (Tex. App.--Corpus Christi 1991), *rev'd on other grounds sub nom. Heggen v. Pemelton*, 836 S.W.2d 145 (Tex. 1992); *Kunkel v. Kunkel*, 515 S.W.2d 941 (Tex. Civ. App.--Amarillo 1974, writ ref'd n.r.e.). "Gift" and "onerous consideration" are exact antitheses and a recital of onerous consideration "negatives the idea of a gift." *Pemelton*, 809 S.W.2d at 647; *Ellebracht v. Ellebracht*, 735 S.W.2d 658, 659 (Tex. App.--Austin 1987, no writ); *Kitchens v. Kitchens*, 372 S.W.2d 249, 255 (Tex. Civ. App.--Waco 1963, writ dism'd). An exchange of consideration precludes a gift. *Williams v. McKnight*, 402 S.W.2d 505, 508 (Tex. 1966). *See Saldana v. Saldana*, 791 S.W.2d 316, 319 (Tex. App.--Corpus Christi 1990, no writ) (wife's testimony that she paid $ 10.00 to husband's mother in exchange for real estate was sufficient to support the trial court's finding that the property was community property and not gift).

1. Donative Intent A controlling factor in establishing a gift is the donative intent of the grantor at the time of the conveyance. *Ellebracht*, 735 S.W.2d at 659. In *Scott v. Scott*, 805 S.W.2d 835, 839-40 (Tex. App.--Waco 1991, writ denied), the jury found that the wife did not make a gift of money to the husband, even though she put a $ 100,000 certificate of deposit in his name alone. A gift cannot occur without the intent to make a gift. *Campbell v. Campbell*, 587 S.W.2d 513, 514 (Tex. Civ. App.--Dallas 1979, no writ). In *Scott*, the wife testified she had no donative intent, the jury believed her, and the appellate court affirmed. *See Haile v. Holtzclaw*, 414 S.W.2d 916, 927 (Tex. 1967) (proper to find gift based on circumstances, despite transferor's testimony of no donative intent.)

2. Transfer From Parent to Child Presumptively Gift A conveyance of title from parent to child is presumed to be a gift, but the presumption is rebuttable by evidence showing the facts and circumstances surrounding the deed's execution in addition to the deed's recitations. *Woodworth v. Cortez*, 660 S.W.2d 561, 564 (Tex. App.--San Antonio 1983, writ ref'd n.r.e.).

3. Gift to Both Spouses A gift made by a third party to both spouses leaves the spouses owning the gifted asset in equal undivided one-half separate property interests. *Roosth v. Roosth*, 889 S.W.2d 445, 457 (Tex. App.--Houston [14th Dist.] 1994, writ denied) (engagement gifts and wedding gifts to both spouses were one-half the separate property of each); *Kamel v. Kamel*, 721 S.W.2d 450, 452 (Tex. App.--Tyler 1986, no writ) (where husband's father made payments on a liability owed by both spouses, the payments were a gift one-half to each spouse).

4. Gift Between Spouses A spouse can make a gift of community property to the other spouse. *See Pankhurst v. Weitinger & Tucker*, 850 S.W.2d 726, 730 (Tex. App.--Corpus Christi 1993, writ denied) (husband gave one-half of his community property interest in a cause of action to wife, to hold as her separate property). When one spouse makes a gift of property to the other spouse, the gift is presumed to include all the income or property which might arise from the property given. TEX. CONST. art XVI, § 15, TEX. FAM. CODE ANN. § 3.005 (Vernon 1998).

5. Gift of Encumbered Property A grantor may make a gift of encumbered property and the conveyance may be a gift even if the grantee assumes an obligation to extinguish the encumbrance. *Taylor v. Sanford*, 108 Tex. 340, 193 S.W. 661, 662 (1917); *Kiel v. Brinkman*, 668 S.W.2d 926, 929 (Tex. App.--Houston [14th Dist.] 1984, no writ) (no showing that parents transferred land to son *in exchange* for his extinguishing the debt); *Van v. Webb*, 237 S.W.2d 827, 832 (Tex. Civ. App.--Amarillo 1951, writ ref'd n.r.e.).

III. DEVISE AND DESCENT Tex. Const. art. XVI, § 15, and TEX. FAM. CODE ANN. § 3.001(2) (Vernon 1998) prescribe that property acquired during marriage by devise or descent are separate property. PJC 202.03 defines "devise" as "acquisition of property by last will and testament. PJC 202.03 defines "descent" as "acquisition of property by inheritance without a will."

Under Texas law, legal title vests in estate beneficiaries immediately upon the death of the donor. TEX. PROB. CODE ANN. § 37 (Vernon Supp. 1998); *Dyer v. Eckols*, 808 S.W.2d 531, 533 (Tex. App.--Houston [14th Dist.] 1991, writ dism'd by agr.). An argument can therefore be made that income of an estate is community property of the married heirs or devisees, even though the assets are titled in the decedent and the income arising from the assets may still be in the hands of the executor.

IV. COMMUNITY PROPERTY HELD BY SPOUSES WITH RIGHT OF SURVIVORSHIP TEX. CONST. art. XVI, § 15, and TEX. PROB. CODE ANN. § 451 (Vernon Supp. 1998), permit spouses to hold community property with a right to survivorship in the surviving spouse. The Constitution says that the spouses "may agree in writing." The Probate Code says that an agreement between spouses creating a right of survivorship in community property "must be in writing and signed by both spouses." TEX. PROB. CODE ANN. § 452 (Vernon Supp. 1998). Upon death, the transfer to the surviving spouse occurs as a result of the agreement, and is not considered to be a testamentary transfer. *Id.* at § 454.

V. THREE CATEGORIES OF TRUSTS The Supreme Court of Texas has recognized three categories of trusts: express trusts, resulting trusts, and constructive trusts. *Mills v. Gray*, 147 Tex. 33, 210 S.W.2d 985, 987-88 (1948). These terms are defined below.

A. The Express Trust. An express trust comes into existence by the execution of an intention to create it by one having legal and equitable dominion over the property made subject to the trust. *Mills v. Gray*, 147 Tex. 33, 210 S.W.2d 985, 987-88 (1948).

Express trusts were controlled by the common law in Texas, until April 19, 1943. On that date, the Texas Trust Act went into effect. *See* TEX. REV. CIV. STAT. ANN. art. 7425a *et seq.* (Vernon 1960); *Land v. Marshall*, 426 S.W.2d 841, 845 (Tex. 1968). The Texas Trust Act controlled express trusts until its repeal, effective December 31, 1983. On January 1, 1984, the Texas Trust Code went into effect. *See* TEX. PROP. CODE ANN. chs. 111-115 (Vernon 1995 & Supp. 1998). The old Texas Trust Act still controls the validity of trusts created while the Act was in effect, and actions taken relating to express trusts while the Act was in effect. The new Texas Trust Code applies to trusts created on or after January 1, 1984, and to transactions relating to prior trusts, but which occur on or after January 1, 1984.

B. The Resulting Trust A resulting trust arises by operation of law when title is conveyed to one party while consideration is provided by another. *Cohrs v. Scott*, 338 S.W.2d 127, 130 (Tex. 1960). A resulting trust can arise only when title passes, not at a later time. *Id.*, at 130. [This rule, often stated in the case law, does not apply between spouses. Between spouses, the inception of title rule applies, so that a resulting trust can arise only at the inception of title, even if title passes at a later time.] A resulting trust also arises when a conveyance is made to a trustee pursuant to an express trust, which fails for any reason. *Nolana Development Ass'n v. Corsi*, 682 S.W.2d 246, 250 (Tex. 1984). Ordinarily, the proponent of a resulting trust has the burden of overcoming the presumption of ownership arising from title by "clear, satisfactory and convincing" proof of the facts giving rise to the resulting trust, *Stone v. Parker*, 446 S.W.2d 734, 736 (Tex. Civ. App.--Houston [14th Dist.] 1969, writ ref'd n.r.e.). However, when marital property is in issue, the presumption of community prevails over the presumption of ownership arising from title, so proof that property is possessed by a spouse during marriage is sufficient to establish, prima facie, a resulting trust in favor of the community even where title is held in the name of one spouse alone. *See* TEX. FAM. CODE ANN. § 3.003 (Vernon 1998).

C. The Constructive Trust A "constructive trust" is not really a trust; it is an equitable remedy. The court imposes a "constructive trust" when an equitable title or interest ought to be, as a matter of equity, recognized in someone other than the taker or holder of legal title. The Supreme Court described the doctrine as follows:

> A constructive trust does not, like an express trust, arise because of a manifestation of intention to create it. It is imposed by law because the person holding the title to property would profit by a wrong or would be unjustly enriched if he were permitted to keep the property.

Omohundro v. Matthews, 341 S.W.2d 401, 405 (Tex. 1960). *Accord*, *Mills v. Gray*, 147 Tex. 33, 210 S.W.2d 985, (1948).

1. <u>"Resulting Trust" vs. "Constructive Trust."</u> In *Mills v. Gray*, 147 Tex. 33, 210 S.W.2d 985, 987-88 (1948), the Texas Supreme Court drew the following distinction between a resulting trust and a constructive trust:

> Resulting and constructive trusts are distinguishable, but there is some confusion between them. From a practical viewpoint, a resulting trust involves primarily the operation of the equitable doctrine of consideration - the doctrine that valuable consideration and not legal title determines the equitable title or interest resulting from a transaction - whereas a constructive trust generally involves primarily a presence of fraud, in view of which equitable title or interest should be recognized in some person

> other than the taker or holder of the legal title. [Citing 54 AM. JUR. 22, § 5.]

VI. PROPERTY HELD IN EXPRESS TRUST.

Property held by a trustee for the benefit of a spouse is not owned by a spouse, and cannot be marital property. However, where the spouse/beneficiary has an unconditional right to have the property free of trust, then the property is treated as if it is owned by the spouse, even though still in the hands of the trustee. Where the spouse is both settlor and beneficiary of the trust, the income of the trust property is likely community income. Where the trust is established by gift or will, case law is conflicting as to whether trust distributions are separate or community property.

A. Assets Held in Trust for Spouse

1. What is an "Express Trust"? An express trust is defined in the Texas Trust Code as a fiduciary relationship with respect to property "which arises as a relationship and which subjects the person holding title to the property to equitable duties to deal with the property for the benefit of another." TEX. PROP. CODE ANN. § 111.004(4) (Vernon 1995). Literally speaking, under Texas property law, a trust is not an entity, like a corporation. It is a *relationship*, between an individual (i.e., the trustee) and certain property. Thus, it is not really accurate to talk about "commingling inside of a trust," or "the character of distributions from a trust." We should instead talk of the commingling of property held by a trustee, or the character of distributions by a trustee of property held in trust.

2. "Trust" Accounts. In Texas, the act of depositing funds in an account designated as a "trust account" for another person does not establish an express trust for the other person's benefit. Recitals on the bank signature card that the funds are held "in trust" for another are evidentiary only, and do not give rise to a presumption that a trust was intended. *Fleck v. Baldwin*, 141 Tex. 340, 172 S.W.2d 975, 978 (1943). Probate Code Section 438, provides:

> A joint account belongs, during the lifetime of all parties, to the parties in proportion to the net contributions by each to the sums on deposit, unless there is clear and convincing evidence of a different intent.

TEX. PROB. CODE ANN. § 438 (Vernon 1980). This statute establishes a presumption that depositing funds into a joint account does not constitute a gift or other transfer of ownership. The statute also puts the burden on the party claiming transfer to prove *on clear and convincing evidence* that a transfer of ownership to him/her occurred.

In connection with a "trust account," case law requires that the settlor demonstrate the intent to create a trust "by a larger number of acts than in the case of an ordinary trust." *Frost Nat. Bank of San Antonio v. Stool*, 575 S.W.2d 321, 322 (Tex. Civ. App.--Beaumont 1978, writ ref'd n.r.e.). If a trust is found to have been intended, it is a revocable inter vivos trust, which terminates upon the death of the settlor/trustee and the proceeds are payable to the beneficiary. *See Citizens Nat. Bank of Breckenridge v. Allen*, 575 S.W.2d 654, 657 (Tex. Civ. App.--Eastland 1978, writ ref'd n.r.e.) (involving certificate of deposit held "in trust").

3. Securities Held in Settlor's Name, "as Trustee" The rules discussed above for funds on deposit "in trust" for another also apply to securities held "in trust" for another. In *Citizens Nat. Bank of Breckenridge v. Allen*, 575 S.W.2d 654 (Tex. Civ. App.--Eastland 1978, writ ref'd n.r.e.), the issue was whether the settlor/trustee intended to create a trust when she acquired a certificate of deposit in her own name, "as Trustee for" another person. The jury found, and judgment was rendered, that the settlor/trustee intended to establish a revocable trust for the benefit of the third person. The Court of Civil Appeals affirmed the judgment, finding that such an inter vivos revocable trust is permissible under Texas law, and that it becomes irrevocable and payable upon the death of the settlor/trustee. The Court also extended the rule to stock certificates held in the name of the purchaser in trust for another, where the purchaser so intends. As stated by the Court:

> The ultimate and controlling question is the intent of the purchaser. The recitals on the certificate that such is held "in trust" for another are evidentiary only, and do not give rise to a presumption that a trust was intended.

Id. at 658.

4. Undistributed Assets Held in Trust Are Not Marital Property According to the following cases, property held in trust for a spouse was not marital property: *Buckler v. Buckler*, 424 S.W.2d 514 (Tex. Civ. App.--Fort Worth 1967, writ dism'd) (undistributed income in a spendthrift trust not part of the estate of the parties, where distribution of such income was discretionary with the trustee); *In re Marriage of Burns*, 573 S.W.2d 555 (Tex. Civ. App.--Texarkana 1978, writ dism'd) (undistributed income inside discretionary distribution trust not "acquired" by the spouse during marriage, and was therefore not part of the community estate); *Currie v. Currie*, 518 S.W.2d 386 (Tex. Civ. App.--San Antonio 1974, writ dism'd) (property inside of discretionary distribution trust was not community property of the husband; property inside another trust, as to which husband was remainder beneficiary, was not

"acquired" by the spouse, and was therefore not part of the community estate). This is not so, however, when assets are voluntarily left with the trustee. *See In re Marriage of Long*, 542 S.W.2d 712 (Tex. Civ. App.--Texarkana 1976, no writ) (where one half of the corpus of the trust had passed to the husband free of trust, the income on that half of the corpus belonged to the community, despite the fact that the husband left that half in the hands of the trustee).

B. Assets Distributed From Trust to Spouse

1. Where Spouse Creates Trust for His/Her Own Benefit Using Own Assets In *Mercantile National Bank at Dallas v. Wilson*, 279 S.W.2d 650 (Tex. Civ. App.--Dallas 1955, writ ref'd n.r.e.), the Court held that the undistributed income of a trust created by wife for her own benefit, prior to marriage, is community property. *See In re Marriage of Burns*, 573 S.W.2d 555 (Tex. Civ. App.--Texarkana 1978, writ dism'd) (income on separate property corpus of trust created by spouse for his own benefit was community property to the extent it was received by husband). In the recent case of *Ridgell v. Ridgell*, 960 S.W.2d 144 (Tex. App.--Corpus Christi 1997, no writ), the appellate court says that the income a spouse receives from a trust is community property. The court also said that if the spouse does not receive income from the trust and has no more than an expectancy interest in the corpus, the income remains separate property. *Id.* at 148. In *Ridgell* some of the trusts were funded by gift or devise and one was funded by the spouse prior to marriage. Also in *Ridgell*, the court recognized that separate property corpus distributed out of the self-created trust was received by the spouse as separate property. *Id.* at 150.

2. Trust Funded by Gift or Devise There are a number of cases which say that income from a trust which was created in a separate property manner (i.e., by will or by gift) is received by the spouse/beneficiary as separate property. These cases do not address the question of whether a trust created by a spouse for his own benefit, using separate property, gives rise to separate or community income.

McClelland v. McClelland, 37 S.W. 350 (Tex. Civ. App. 1896, writ ref'd), is probably the most often quoted of these older cases. *McClelland*, which involved a testamentary trust created for the husband by his father, presented the issue as being a contest between the intent of the testator and community property claims of the wife. In *McClelland*, the intent of the testator won out. Thus, a monthly allowance paid by the trustee to the husband, pursuant to a provision in the will, as well as other discretionary distributions made by the trustee under the will, were held to be the husband's separate property. *See Sullivan v. Skinner*, 66 S.W. 680 (Tex. Civ. App. 1902, writ ref'd) (where wife received a life estate in land under her father's will, which provided that she was to receive the income for her sole and separate use, the rentals from the land were wife's separate property).

Several other old cases, involving a conveyance by one spouse into trust for the benefit of the other spouse, held that income from the property held in trust was also separate property. *See Hutchinson v. Mitchell*, 39 Tex. 488 (1873) ("We can find nothing in any of the Constitutions or laws of the state or republic which would prevent a man from declaring an express trust in favor of his wife, and giving her the exclusive use and enjoyment of all the rents, revenues and profits of the trust estate, provided there is no fraud in the transaction against creditors . . ."); *Shepflin v. Small*, 23 S.W. 432 (Tex. Civ. App.--El Paso 1893, no writ) (where husband and wife joined in conveyance of wife's separate property to trustee, to collect the income and use it to support the wife and children, the income was withdrawn from the community estate).

In the case of *In re Marriage of Thurmond*, 888 S.W.2d 269, 272-75 (Tex. App.--Amarillo 1994, no writ), the court of appeals without explanation treated a trust distribution from a testamentary trust as entirely separate property, even though the distribution included interest earned by the trust.

A Tax Court case has reviewed the broad panorama of Texas cases on marital property law and trusts, and concluded that, where a trust is established by gift, the correct view is that distributions from the trust to a married beneficiary are the beneficiary's separate property, notwithstanding some authorities to the contrary. This occurred in *Wilmington Trust Co. v. United States*, 83-2 USTC (1983). The Court stated:

> It is concluded that, under the law of Texas, as developed and expounded by the Texas courts, the income derived during the marriage of [the spouses] from the seven trusts that are involved in the present case constituted the separate property of [the wife], and was not community property of [the spouses]. [The wife] never "acquired"--and she will never acquire--the corpus of any of these trusts. The corpus of each trust is to be held and controlled by the trustee or trustees during [the wife's] lifetime, and, upon [the wife's] death, the corpus will pass to her issue. Accordingly, the corpus of each trust was not [the wife's] separate property, and the trust income was not from [the wife's] separate property.
>
> What [the wife] "acquired"--and what she used to purchase the stocks and establish the bank accounts that are involved in the litigation--was the income from the trust property. As the income resulted from the gifts made to

> trustees for [the wife's] benefit, the income necessarily constituted her separate property under section 15 of article XVI of the Texas Constitution.

Id. See also Taylor v. Taylor, 680 S.W.2d 645, 649 (Tex. App.--Beaumont 1984, writ ref'd n.r.e.) (trust distributions held to be separate property where trust instrument said that income of trust became part of the corpus and the parties had stipulated that corpus was separate property).

Ridgell v. Ridgell, 960 S.W.2d 144, 149 (Tex. App.--Corpus Christi 1997, no writ), contains language that suggests that the court might have found trust distributions to be separate property if the settlors had included language in the trust instruments indicating a desire for the trust income not be treated as community property in the event the beneficiary married. The court cites *Commissioner v. Porter*, 148 F.2d 455, 568 (5th Cir. 1945) for the proposition that trust distibutions might be separate property if the trust instrument indicates that desire "in a precise and definite way, with language of 'unmistakable intent'."

On the other hand, there are several cases suggesting that income on property held in trust is community property, even where the trust is established by gift or devise.

In *In re Marriage of Long*, 542 S.W.2d 712 (Tex. Civ. App.--Texarkana 1976, no writ), the husband was the beneficiary of a trust created prior to marriage by his parents. Prior to the divorce, the husband's right to receive half of the corpus free of trust had matured, but the husband left that half in the hands of the trustee. The Court held that once the husband's right to receive half of the corpus matured, the income on such half began to belong to the community. However, the half of the corpus which emerged from trust was itself the husband's separate property, and the income on the other half of the corpus, which remained in trust, did not belong to the community since it still "belonged to the trust." It appears to have been important to that last determination that the distribution of income was discretionary with the trustee. *Id.* at 718. *Long* can be read as tacitly agreeing that distributed income from a trust can be community property.

In *In re Marriage of Burns*, 573 S.W.2d 555 (Tex. Civ. App.--Texarkana 1978, writ dism'd), the Court determined that undistributed income in several trusts was not community property because it had been neither received nor constructively received by the husband during marriage. This rule was applied not only to several trusts established for the husband by his parents and grandparents, but also to a trust established by the husband for himself, three months after marriage, using husband's separate property. The opinion suggests, albeit somewhat obliquely, that if the income from the trusts had been received by the husband, either actually or constructively, that the income would have been community property.

In *Commissioner of Internal Revenue v. Porter*, 148 F.2d 566 (5th Cir. 1945), the Fifth Circuit Court of Appeals concluded that income distributed from a trust established by the spouse's father was received by the spouse/beneficiary as community property. The Court said that while the income remained in the hands of the trustee, it was "protected," but once it was distributed it became subject to the "ordinary impact of the law."

In *Commissioner of Internal Revenue v. Wilson*, 76 F.2d 766 (5th Cir. 1955), the Fifth Circuit held that income from property held in trust for a married man was received by him as community property, although the corpus was not community property. However, some of the distributed trust income derived from royalties and bonuses on "separate property" corpus. Also, delay rentals were received by the trustee. According to the Fifth Circuit, the delay rentals would be community property, while the royalties and bonuses would not; therefore, whatever portion of the trust income could be shown to be derived from royalties and bonuses would be separate property when received by the beneficiary. This analysis required tracing of the distributions to income received by the trust. In this regard, the Court said:

> In the accounting, outlays by the trustee specially connected with [royalties] are to be considered, and also a fair proportion of the general expenses of the trust, so as to ascertain what part of the net payment to the beneficiaries really came from royalties.

Id. at 770. Proceeds from sale of trust assets was not an issue in the case.

3. Commingling Inside Trust In *McFaddin v. Commissioner*, 148 F.2d 570 (5th Cir. 1945), a tax case, a trust was created by the mother and father of the McFaddin children. The parents conveyed two large cattle ranches into trust, subject to the debts secured by the properties and further subject to an annual payment to the mother of $30,000 per year, payable from income or, if insufficient, from the corpus.

The Tax Court ruled that children who are beneficiaries of a trust, which is created by gift of their parents, hold that interest as separate property. The Tax Court further found that the rights of the beneficiaries did not attach to the gross income, but rather to the distributable net income, of the trust, and that the gross income of the trust used by the trustees to purchase additional property could not be community income of the beneficiaries. The Tax Court further held that the fact that the property was conveyed into trust subject to debts and liens did not

convert what was otherwise a gift into a transfer for onerous consideration. And oil royalties and bonuses distributed by the trustee remained the beneficiaries' separate property.

The Fifth Circuit agreed that the res of the trust was a gift, and thus separate property. *Id.* at 572. Therefore, the oil royalties, bonuses and profits from the sale of the land "came to" the McFaddin children as separate property, taxable as separate income.

Nonetheless, the Court held that property acquired by the trust during the beneficiaries' marriages was community because separate and community funds had been commingled within the trust. The Court stated:

> The theory of the Tax Court that none of the commingled property with which the after-acquired property was purchased was community property because, under the terms of the trust instrument, gross income was treated as corpus, the rights of the beneficiaries did not attach to gross income but only to the distributable net income, and the gross income used by the trustees was, therefore, not community property, will not at all do. The taxpayers were the beneficial owners of the trust properties, and every part and parcel of them, including income from them, belonged beneficially to them, either as separate or as community property, in the same way that it would have belonged to them had the property been deeded to the taxpayers and operated by themselves. The greater part of the normal income from the property during the years preceding the tax years in question was community income. When it was commingled in a common bank account with other funds of the trust so that the constituents had lost their identity, the whole fund became community; and when it was used by the trustees to purchase additional properties, those properties, taking the character of the funds which bought them, were community property. [footnotes omitted]

Id. at 573.

The Fifth Circuit Court of Appeals also rejected the Commissioner of Internal Revenue's argument that because the trusts were spendthrift trusts, they were in effect conveyances of income to the separate use of the beneficiaries. *Id.* at 574.

In sum, the *McFaddin* case stands for proposition that income received by a trust is community or separate by the same rules as would apply had the income been received outside of trust. And if those funds are commingled, then the separate corpus of the trust can be lost to the community, upon subsequent distributions to the beneficiaries.

This rule was applied to the gross income of the trust, not just to the distributable net income. *Id.* at 573. Since the gross income was commingled in trust bank accounts with separate property receipts, the whole fund became community property, and the subsequently-acquired property was community in nature, and the oil income therefrom was similarly community.

VII. ESTATE PLANNING TRUSTS The most popular estate planning trusts are: GST (generation-skipping dynasty trust; QPRT (qualified personal residence trust); CRT (charitable remainder trust); GRAT (grantor retained annuity trust) and GRUT (grantor retained unitrusts). *If you run into one of these in a divorce, consult with an estate planning lawyer.*

A. (GST) Generation-Skipping Dynasty Trust A GST is created by the older generation for the benefit of children, grandchildren and even great grandchildren. The trust corpus remains in the trust for as many generations as possible, sometimes capped by the Rule Against Perpetuities.

1. The Rule Against Perpetuities The Texas Constitution provides that "[p]erpetuities ... are contrary to the genius of free government, and shall never be allowed." Tex. Const. Art. I, § 26. Texas courts have enforced this provision by applying the rule against perpetuities. *Trustees of Casa View Assem. of God Ch. v. Williams*, 414 S.W.2d 697, 702 (Tex. Civ. App.--Austin 1967, no writ). Under the Rule, no interest is valid unless it must vest, if at all, within twenty-one years after the death of some life or lives in being at the time of the creation of the interest. *Peveto v. Starkey*, 645 S.W.2d at 772; *Foshee v. Republic Nat'l Bank of Dallas*, 617 S.W.2d 675, 677 (Tex. 1981).

The Rule relates only to the vesting of estates or interests, not vesting of possession, and is not applicable to present interests, or future interests which vest at their creation. *Kelly v. Womack*, 153 Tex. 371, 268 S.W.2d 903 (1954). You must therefore, examine the challenged conveyance as of the date the instrument was executed, and the conveyance is void if, by any possible contingency, the interest could vest outside the perpetuities period. *Peveto v. Starkey*, 645 S.W.2d at 772; *Brooker v. Brooker*, 130 Tex. 27, 106 S.W.2d 247, 254 (1937).

2. Irrevocable, Spendthrift Trust. A GST is ordinarily an irrevocable, spendthrift trust with multiple beneficiaries who are in succeeding generations. The trust assets are not included in the taxable estate of each generation to die. Sometimes the beneficiaries will have limited powers of appointment that permit them to control to some extent how the assets flow to the next generation. Often a trust beneficiary is trustee or co-

trustee. Usually there is discretionary distribution of corpus and income.

B. QPRT (Qualified Personal Residence Trust) A QPRT is an irrevocable trust created by homeowners, into which they convey their principal residence or vacation home, retaining the right to live there rent-free, for a specified term of years. The plan is to outlive this rent-free period. The grantors usually can direct the trustee to sell one home and buy another. If the house is sold and a new house is not purchased, the proceeds are usually invested in an annuity paid to the grantors. At the end of the specified trust term, the residence goes to the remaindermen (usually the grantors' children, or a trust for the children). If the grantors are still alive, they can rent from the children.

Sometimes the house is partitioned before it is conveyed into trust, and sometimes a community property house is conveyed into trust. The conveyance into trust will be reflected by a deed which is recorded.

This arrangement reduces the value of the gift into trust to the extent of the free tenancy retained by the grantors. The value of the remainder interest is usually very small.

C. CRT (Charitable Remainder Trust) A CRT is an irrevocable trust that provides for a specified annual payment to the grantors or other non-charitable beneficiaries for life or a term of years, and with the remainder to a charity. Some CRTs generate an income tax charitable deduction and some generate a gift tax charitable deduction. Under a CRT, the wealth leaves the family upon the death of the income beneficiaries or end of the term certain.

D. GRAT (Grantor Retained Annuity Trust) and GRUT (Grantor Retained Unitrusts) GRATs are trusts that reserve to the grantor an annual payment of a fixed sum, determined by a percentage of the value of the trust assets at the time of initial funding. GRATs can be funded only once, at the beginning. GRUTs reserve to the grantor an annual payment of a fixed percentage of the value of trust assets, determined annually. GRUTs can receive additional contributions over time. For both GRATs and GRUTs, the remaindermen are usually the grantors' children.

GRATs and GRUTs remove assets from the estate at a greatly reduced value, while retaining a finite stream of payments for the grantor. The value of the gift into trust is measured by the remainder interest. Appreciation on the corpus during the life of the trust passes to the remaindermen without gift tax.

VIII. CHALLENGES TO VALIDITY OF EXPRESS TRUSTS What appears to be an express trust may in fact not be a trust, or it may be vulnerable to attacks which would defeat the trust. Several possible methods to defeat or penetrate express trusts are outlined below.

A. Challenging Intent to Create the Trust Before there can be a trust, the settlor must intend the creation of the trust. *See* TEX. PROP. CODE ANN. § 112.002 (Vernon 1995) ("A trust is created only if the settlor manifests an intention to create a trust"); *Gonzalez v. Gonzalez*, 457 S.W.2d 440 (Tex. Civ. App.--Corpus Christi 1970, writ ref'd n.r.e.); *Tolle v. Sawtelle*, 246 S.W.2d 916, 918 (Tex. Civ. App.--Eastland 1952, writ ref'd).

Some trust arrangements, such as funds deposited in a bank account with a signature card reading "in trust," or securities held "as trustee" for another, are so informal that a clear intention to create a trust is not readily ascertainable from the documentation.

The issue of intent can arise even in connection with formal trust documents. For example, in the case of *In re Estate of Daniels*, 665 P.2d 594 (Colo. 1983), the decedent executed a formal trust agreement, but never funded it. She never advised the co-trustee of the trust's creation, and the co-trustee never signed the trust agreement. The Decedent's attorney testified to giving the decedent legal advice that the trust agreement would have no effect until it was signed by the co-trustee and funded. The trial court concluded that, notwithstanding the settlor's signing the agreement, she never intended the trust agreement to take effect. That judgment was affirmed by the Supreme Court of Colorado.

Thus, intent of the settlor to create the trust is the first thing to check when considering an assault on an express trust.

1. Extrinsic Evidence of Intent, Generally The parol evidence rule normally prohibits the use of extrinsic evidence to add to or vary the terms of a written document, absent allegations of ambiguity, fraud, duress or mistake. *Guardian Trust Co. v. Bavereisen*, 132 Tex. 396, 121 S.W.2d 579, 583 (1938). However, the court may consider parol evidence as to the circumstances surrounding the creation of the document, for the purpose of applying the document to the subject with which it deals, and for the purpose of ascertaining the real intention of the parties. *Id.*, at 583. *See* McClung, *A Primer on the Admissibility of Extrinsic Evidence of Contract Meaning*, 49 TEX. BAR. J. 703 (1986).

On the other hand, some courts have taken a more restricted approach to parol evidence. In the case of *Otto v. Klement*, 656 S.W.2d 678 (Tex. App.--Amarillo

1983, writ ref'd n.r.e.), the court refused to consider parol evidence on intent where the proof was offered to vary a survivorship provision contained on a bank signature card. In *Isbell v. Williams*, 705 S.W.2d 252 (Tex. App.--Texarkana 1986, writ ref'd n.r.e.), parol evidence was admitted only because a conflict between printed language and writing on an account signature card created an ambiguity.

2. Intent to Create a Trust There is specific authority that parol evidence may be considered in determining whether a person intended to create a trust in a particular circumstance. As stated by the Texas Commission of Appeals in connection with funds deposited in an account "in trust" for another:

> The ultimate controlling fact to be determined is the intention of the donor. Such a transaction does or does not create a trust according as the donor intended. Since in this case no one but Mrs. Baldwin knew or could have known what were her real intentions in these transactions, that fact must be arrived at by a consideration of her relevant acts and declarations, prior to, at the time of, and subsequent to the various transactions. As stated in the application for writ of error:
>
> "The intention referred to is to be ascertained, not by the application of barren concepts to a single fact, but 'by rational deductions' based upon all the facts."

Fleck v. Baldwin, 141 Tex. 340, 172 S.W.2d 975, 978-79 (1943).

Other states have held that evidence of the settlor's words and conduct is admissible on the issue of the settlor's intent to create a trust. *See Porreca v. Gaglione*, 358 Mass. 365, 265 N.E.2d 348, 350 (1970) (parol evidence admissible where parties were not attempting to vary or contradict terms of trust agreement, but rather were challenging the very existence of the trust); RESTATEMENT (SECOND) OF TRUSTS §§ 23 & 24 (1959).

B. Failure in Mechanics of Creation The Texas Trust Code has certain requirements for express trusts that must be observed. When these conditions are not met, an express trust cannot be recognized in a court proceeding.

1. Must be in Writing The Texas Trust Code provides that an express trust containing real or personal property is unenforceable unless it is created by a written instrument, signed by the settlor, containing the terms of the trust. TEX. PROP. CODE ANN. § 112.004 (Vernon 1995). The mere designation of a party as "trustee" on an instrument does not alone create a trust. *Nolana Development Ass'n v. Corsi*, 682 S.W.2d 246, 249 (Tex. 1985).

a. Exception for Personalty There are two exceptions to this rule, for trusts which involve only personalty.

(1) Personalty Transferred to Another With Intent Expressed Where the trust includes only personalty, the trust is enforceable if the personalty is transferred to a trustee who is not a beneficiary or settlor, and the settlor expresses the intention to create a trust, either before or at the time of the transfer. TEX. PROP. CODE ANN. § 112.004 (Vernon 1995). In such a situation, written evidence of the trust is not required.

(2) Personalty Retained by Settlor With Writing Reflecting Trust A trust of personalty is also enforceable where an owner of personalty states *in writing* that certain personalty is held by that person as trustee for another, as beneficiary, or for himself and another, as beneficiaries. TEX. PROP. CODE ANN. § 112.004 (Vernon 1995). This exception would apply to funds which the party has deposited in a financial institution, where the account reflects the party as "trustee" for another. *See Jameson v. Bain*, 693 S.W.2d 676 (Tex. App.--San Antonio 1985, no writ). This exception would also apply to stocks, bonds, CD's, etc. carried in the name of the party, "as trustee" for another. *See Citizens Nat. Bank of Breckenridge v. Allen*, 575 S.W.2d 654, 658 (Tex. Civ. App.--Eastland 1979, writ ref'd n.r.e.).

b. No Exception for Realty. No exception to the requirement of a writing exists for realty. Thus, where one person holds title to real estate as "trustee," and no written trust agreement exists, the relationship is not an express trust. It may, however, be a resulting trust.

c. Resulting and Constructive Trusts Outside of Rule The Texas Trust Code, by its very terms, does not apply to resulting or constructive trusts. TEX. PROP. CODE ANN. § 111.003 (Vernon 1995). Cases also hold that the requirement of a writing, contained in the old Trust Act, and in the statute of frauds provisions of the Property Code, do not apply to resulting and constructive trusts. *Rankin v. Naftalis*, 557 S.W.2d 940, 944 (Tex. 1977); *Rowe v. Palmer*, 277 S.W.2d 781, 783 (Tex. Civ. App.--Texarkana 1955, no writ).

2. A Transfer is Necessary There must be a present transfer of legal title of property from the settlor to the trustee for the trust to be valid. *Cutrer v. Cutrer*, 334 S.W.2d 599, 605 (Tex. Civ. App.--San Antonio 1960), *aff'd*, 162 Tex. 166, 345 S.W.2d 513 (1961). However, the settlor may "transfer" legal title to the property to himself as trustee as long as his words or acts clearly reflect his intent to relinquish individual ownership in favor of holding the property merely as trustee for the beneficiary. *Westerfeld v. Huckaby*, 474 S.W.2d 189

(Tex. 1972). *Accord*, TEX. PROP. CODE ANN. § 112.004(2) (Vernon 1995). The settlor may retain rights in the property, or may be the initial trustee, and may retain the right to revoke the trust, without violating this rule. *Westerfeld*, *supra* at 193.

C. Dry Trust The Texas Supreme Court has said that "[w]hen a trustee has no duties to perform, the purposes of the trust having been accomplished, it becomes a simple, passive or dry trust, as it is termed in the law, and the cestui que trust is entitled to have the full legal title and control of the property, because no other person has an interest in the property." *Lanius v. Fletcher*, 100 Tex. 550, 101 S.W.2d 1076, 1078 (1907). Under these circumstances, the beneficiary is entitled to possession of the contents of the trust. *Hall v. Rawls*, 188 S.W.2d 807, 815 (Tex. Civ. App.--Beaumont 1945, writ ref'd). Similarly, if the trustee is not given affirmative powers and duties in the trust instrument, the trust is passive or dry, and legal title is vested in the beneficiaries, not the trustee. *Nolana Development Ass'n v. Corsi*, 682 S.W.2d 246, 249 (Tex. 1984). Consider, however, the effect of Section 112.004 of the Texas Trust Code, which recognizes the enforceability of a trust of personalty in certain situations, even though the terms of the trust are not specified.

The doctrine of "dry trust" was explored in the case of *Zahn v. National Bank of Commerce*, 328 S.W.2d 783 (Tex. Civ. App.--Dallas 1959, writ ref'd n.r.e.). The settlor's will provided that land was to be held for two years after her death and if at that time, oil or minerals were not found, the land was to be sold and the oil and mineral rights reserved and placed in trust for the benefit of five cousins. The trustee asked for a construction of the will to determine if this trust was valid. The Court of Civil Appeals determined that it was permissible for the trust to remain "dry" or unfunded for the two-year period. If the oil or mineral rights were found within that period, the beneficiaries would receive title in fee simple. If not, the trust would be funded (with the oil and mineral rights as the *res*) for administration on behalf of the beneficiaries.

1. Cases From Other States. The doctrine of dry trusts has been adjudicated in other states.

a. Pennsylvania The Supreme Court of Pennsylvania addressed the doctrine of dry trust in connection with a fraudulent conveyance. In *Eaves v. Snyder*, 368 Pa. 459, 84 A.2d 195 (1951), Snyder, Sr., conveyed certain real estate to his son, Snyder, Jr., and his son's wife. At the same time, the grantees signed a "deed of trust" back to Snyder, Sr. The deed to Snyder, Jr., and wife was recorded, but the deed of trust was not. Shortly thereafter, Snyder, Sr., filed for bankruptcy. Some years after the bankruptcy was closed, and shortly before Snyder, Jr., and his wife were divorced, the deed of trust was filed of record. Ten years later, the ex-wife sued Snyder, Jr., for her half of the land, arguing that although a fraudulent conveyance is void as against creditors, it is valid as against the fraudulent grantor. The Court rejected the argument, saying it applied only where there is a mere agreement to reconvey, or where the grantor seeks to establish a resulting or constructive trust. In this case, the deed and the deed of trust must be construed together, with the result that the transaction created a dry trust in the hands of Snyder, Jr., and wife, who held legal title merely for conveyance back to Snyder, Sr. Both the legal and equitable estates in the land vested immediately in Snyder, Sr., who was the beneficiary of the dry trust.

D. Illusory Trust An express trust can be challenged on the ground that it is an "illusory trust." The leading Texas case on illusory trusts is *Land v. Marshall*, 426 S.W.2d 841 (Tex. 1968). In *Land v. Marshall*, the husband had created an inter vivos trust using almost all of the community property. He retained, however, the power to revoke the trust, the right to consume the principal, to control the trustee, and other beneficial interests during his lifetime. Upon his death, the trust passed title in the community property to the parties' daughter. In a challenge brought by the wife after the husband's death, the entire trust was held by the Supreme Court to be invalid. The test announced by the Supreme Court for an "illusory trust" was:

> Did the decedent, by his conveyance in his lifetime, retain such a large interest in the property that, at least as to his wife, his inter vivos trust was illusory?

Id. at 848. If so, then the trust was "illusory," and failed as to the wife's one-half community property interest. This happened in *Land v. Marshall*. However, in *Land v. Marshall*, the Court also nullified the trust as to the husband's one-half of the property, because the removal of the wife's one-half interest in the property was seen as defeating the husband's testamentary intent. *Id.*, at 849.

See generally Simpkins, TEXAS FAMILY LAW § 21:24 (5th ed. 1976); *Husband as Manager of the Community Estate: Illusory Trusts*, 10 S. TEX. L.J. 301 (1968); *The Illusory Trust and Community Property*, 22 SW. L.J. 447 (1968) Annot., 39 A.L.R.3d 14 (1971). *See also* Bell, *Community Property Trusts--Challenges by the Non-Participating Spouse*, 22 BAY. L. REV. 311 (1970). A similar concept was described in *Hunter v. Clark*, 687 S.W.2d 811, 814 (Tex. App.--San Antonio 1985, no writ), that a spouse could not defeat the other spouse's survivor's homestead right by conveying the homestead during lifetime.

1. Is It Only Upon Death? The "illusory trust" doctrine was developed in common law jurisdictions to defeat attempts by the husband, by means of a lifetime conveyance, to circumvent the wife's survivor-interest in

his property. *Land v. Marshall*, 426 S.W.2d at 847. The doctrine was transplanted to Texas in *Land v. Marshall*, where the husband sought to make an essentially testamentary disposition of his wife's community interest in property through the use of an inter vivos trust. Texas law prohibited the husband from bequeathing his wife's community interest in the property. The question in *Land v. Marshall* was whether the husband could do by inter vivos trust what he could not do by will. *Id.* at 846. The Texas Supreme Court concluded that, where the conveyance into trust was illusory, the trust failed as to the wife's one-half community interest. The case was seen by the Court to involve "a problem created by our community property protection of the wife's distribution share." *Id.* at 848.

One may ask whether the illusory trust doctrine can be used during the settlor's lifetime, to nullify a conveyance into trust. There is no statement in Texas cases that the illusory trust argument can only be raised after the settlor's death.

2. <u>Only When Non-Consenting Spouse's Property is Used to Fund a Trust</u> The illusory trust doctrine "is limited to instances in which a non-consenting spouse's property is used to fund a trust." *Westerfeld v. Huckaby*, 474 S.W.2d 189 (Tex. 1971). Consequently, the remedy is available only to the extent that the complaining spouse's separate property, or share of the community property, is used without her consent. As explained in *Westerfeld*, the trust in *Land v. Marshall* was an illusory trust only as to the wife's interest in the property. *Westerfeld*, 74 S.W.2d at 191. However, the entire trust failed, even as to the husband's interest in the property, because the loss of half of the trust corpus was deemed to defeat the husband's plan of distribution. *Id.*, at 849.

3. <u>Excessive Control Not Sole Basis of "Illusory Trust" Attack</u> In *Land v. Marshall*, the Supreme Court determined that the inter vivos trust was invalid. The Court said:

> The Marshall trust was invalid. The trustor transferred the legal title of the corpus to a trustee, but he retained complete control over the trustee. Marshall had and could exercise every power over the corpus of the trust after the creation of the trust that he possessed before its creation. As expressed by respondent, Marshall created a trust, but nothing happened. Mr. Justice Holmes in Leonard v. Leonard, 181 Mass 458, 63 N.E. 1068 (1902) expressed the same idea when he said that the transfer took back all that it conveyed except legal title.

Id., at 846-47. However, as explained by a majority of the Supreme Court in *Westerfeld v. Huckaby*, 474 S.W.2d 189, 191 (Tex. 1972), the trust in *Land v. Marshall* did not fail simply because the husband reserved too much control over his own property. In *Westerfeld* the Court said:

> Land v. Marshall dealt with a problem created by our community property protection of the wife's distributive share. We therefore could not look solely to the husband's reservation of powers over his own property but had to bring additional policy considerations to bear.

Id. at 191.

In *Westerfeld*, the administratrix of a decedent sought to set aside inter vivos trusts created by the decedent, on the grounds that the decedent had retained too much control and the trusts were "illusory." The administratrix's attack was rejected by a majority of the Supreme Court which felt that the decedent could create valid trusts even though she reserved in herself broad beneficial rights, as well as the right to revoke the trusts and the right to control or manage the trustees. *Id.* at 192. [There was no problem of community property in *Westerfeld*, because the decedent was a single woman (feme sole).]

4. <u>Spouse's Participation Forecloses Attack</u>. An illusory trust attack cannot be raised by a spouse who participated in the original conveyance into trust. *United States v. Gordon*, 406 F.2d 332, 343 (5th Cir. 1969).

5. <u>Law From Other Jurisdictions</u> The illusory trust doctrine has been litigated in a number of other jurisdictions.

a. <u>Massachusetts</u> The high court of Massachusetts recently considered the illusory trust doctrine, in the case of *Sullivan v. Burkin*, 390 Mass. 864, 460 N.W.2d 572 (1984). Reversing precedent, the Court announced that the estate of the decedent would, for purposes of the surviving spouse's heirship rights, include "the value of assets held in an inter vivos trust created by the deceased spouse as to which the deceased spouse alone retained the power during his or her life to direct the disposition of those trust assets for his or her benefit, as, for example, by the exercise of a power of appointment or by revocation of the trust." *Id.* at 574-75. The rule was to be applied prospectively only. The Court preferred its definite standard to the "rather unsatisfactory process of determining whether the inter vivos trust was, on some standard, 'colorable,' 'fraudulent,' or 'illusory.'" *Id.* at 577. The Court also saw itself as bringing the heirship law into line with the equitable distribution law applicable to divorce proceedings in Massachusetts. The Court observed:

> The interests of one spouse in the property of the other have been substantially increased upon the

dissolution of a marriage by divorce. . . . It is neither equitable nor logical to extend to a divorced spouse greater rights in the assets of an inter vivos trust created and controlled by the other spouse than are extended to a spouse who remains married until the death of his or her spouse.

Id. at 577.

> The rule announced in *Sullivan* accomplishes much the same effect as the illusory trust doctrine in Texas and some other states. However, the rule in Massachusetts is probably a matter of law for the court, whereas the illusory trust doctrine in Texas may involve fact issues. Note that the illusory trust doctrine of *Land v. Marshall* extends only to community property, and not to property acquired by spouses while domiciled in other jurisdictions, which would be divisible in a Texas divorce. Perhaps that discontinuity between spousal rights in property on divorce and on death in Texas should be addressed by Texas legislature.

b. New York One of the leading cases on illusory trusts is *Newman v. Dore*, 275 N.Y. 371, 9 N.E.2d 966 (1937), a case cited in *Land v. Marshall*. In *Newman*, the husband by will created a trust for the benefit of his wife, to contain one-third of his property, and to pay her the income for life. Under New York law, this provision in his will eliminated the wife's right to elect to partake of the husband's estate, as if he died intestate. Three days before his death, the husband conveyed all of his property into a trust. If the trust was valid, his widow would get none of his estate, since the provision in the will eliminated her widow's election, and there was no property on hand to fund her testamentary trust. The trial judge invalidated the inter vivos trust, finding that the husband's motive was to evade the laws of the state. The high court, however, concluded that "[m]otive or intent is an unsatisfactory test of the validity of a transfer of property." *Id.* at 968. "The fact that the [person] desired to evade the law, as it is called, is immaterial, because the very meaning of a line in the law is that you intentionally may go as close to it as you can if you do not pass it." *Id.* at 967 (quoting *Bullen v. Wisconsin*, 240 U.S. 625 (1916)). The Court adopted the "illusory trust" doctrine, saying:

> The test has been formulated in different ways, but in most jurisdictions the test applied is essentially the test of whether the husband has in good faith divested himself of ownership of his property or has made an illusory transfer. "The 'good faith' required of the donor or settlor in making a valid disposition of his property during life does not refer to the purpose to affect his wife but to the intent to divest himself of the ownership of the property. It is, therefore, apparent that the fraudulent intent which will defeat a gift inter vivos cannot be predicated on the husband's intent to deprive the wife of her distributive . . . share as a widow." Benkart v. Commonwealth Trust Co., of Pittsburgh, 269 Pa. 257, 259, 112 A. 62, 63.

Id. at 969. In *Newman*, the husband retained the income for life, and the power to revoke the trust, and also the right to control the trustees. Thus, "[j]udged by the substance, not by the form, the testator's conveyance [was] illusory, intended only as a mask for the effective retention by the settlor of the property which in form he had conveyed." *Id.* at 969. Although the judgment is not stated in the opinion, it appears that the property was included in the husband's estate, and therefore passed into the testamentary trust, for the benefit of the widow.

Newman was followed in *President & Directors of Manhattan Co. v. Janowitz*, 172 Misc. 290, 14 N.Y.S.2d 375 (1939), which said that the test was whether the settlor in good faith divested himself of ownership, or instead made an illusory transfer to hide the effective retention of the property. An illusory trust was found because the settlor reserved the right to revoke the trust, reserved income from the trust for life, and reserved substantial control over the trust during his lifetime.

An illusory trust was also found in *Burns v. Turnbull*, 266 App. Div. 779, 41 N.Y.S.2d 448 (1943), where the settlor was one of two trustees, and reserved the authority to replace the other trustee, and retained exclusive control over the corpus, and reserved the right to amend or revoke the trust.

c. Oklahoma Oklahoma has case law applying the illusory trust doctrine. In *Thomas v. Bank of Oklahoma*, 684 P.2d 553 (Okl. 1984), the Supreme Court of Oklahoma determined that a forced heir election under Oklahoma statutes could not be defeated by placing assets in a revocable inter vivos trust. The Court acknowledged that, under Oklahoma law, a spouse could freely give away his or her separate property, in that neither the spouse nor the children had a claim to the separate property, except insofar as the donor is liable for their support. *Id.* at 554. However, the gift must be bona fide and complete. "A gift is not a gift if the donor retains right of complete control and dominion, and especially the right to take back the "gift" at any time." *Id.* at 554. The Court relied upon Oklahoma cases holding that a gift, in which the donor retains during lifetime complete control of the property and acts as if he still owns it, creates a resulting trust only, and beneficial interest remains with the donor. The Court also cited New York and Kansas cases involving the illusory trust doctrine. The trustee argued that the Uniform Testamentary Addition to Trust Act, which declared that "pour-over" provisions in a will were valid even though the inter vivos trust to be funded upon death was

revocable, established the validity of the trust. The Court rejected this argument, saying:

> We also distinguish between the general revocability of a trust, the legality of which there is not doubt, and the effect of revocability on a forced heir's right under [Oklahoma law]. Such revocable power cannot be allowed to defeat a survivor's rights to the estate.

Id. at 556. The retention by the settlor, in *Thomas*, of the right to revoke the inter vivos trust, subjected the trust assets to forced heirship.

The *Thomas* case demonstrates three important points: (i) The Court acknowledged the illusory trust doctrine; (ii) in Oklahoma, a gift to a third party creates merely a resulting trust, where the donor retains control over the property, and especially where the gift is revocable; thus, although legal title may pass, beneficial title remains with the donor, and is subject to forced heirship; (iii) the law permitting trusts to be revocable does not insulate revocable trusts from forced heirship.

d. West Virginia The illusory trust doctrine was examined by the Supreme Court of West Virginia in *Davis v. KB & T Co.*, 309 S.E.2d 45 (W. Va. 1983). There the husband conveyed his non-tangible personalty into a trust, retaining the right to the income for life, and if his wife survived him, then to her for her life, with a remainder interest to certain named beneficiaries. The widow sued asserting a dower interest in the property conveyed by the husband into trust. The Court said:

> The question of the validity of an inter vivos trust which impairs the statutory right of the surviving spouse to share in the settlor's estate is an issue which has been addressed in numerous jurisdictions. . . . Generally , in resolving the issue, courts have taken one of two approaches. The first approach involves a determination of whether the transfer of property is real and bona fide, or whether the settlor has reserved such powers of ownership and control over the trust property as to make the transfer illusory or testamentary in character. . . . The second approach involves examination of the question whether the transfer of property in trust constituted a fraud upon the rights of the spouse.

Id. at 49. The West Virginia Court applied both tests to the case.

In *Davis*, the primary basis for the illusory trust attack was that the husband reserved the right to amend or revoke the trust during lifetime. The Court said that "[i]t is well established, however, that the retention by the settlor of the power to revoke or modify a trust is insufficient, standing alone, to render the trust illusory or testamentary." *Id.* at 49 (citing I.A. Scott, THE LAW OF TRUSTS 57.1 (3d ed. 1967). The Court also quoted RESTATEMENT (SECOND) OF TRUSTS § 57 (1959) in support of the rule. The illusory trust attack was rejected.

E. Colorable Trust The "colorable trust" doctrine may be a tool available to dismantle a trust. In *Land v. Marshall*, 426 S.W.2d 841, 846 (Tex. 1968), the Texas Supreme Court said the following about a colorable trust:

> Under the doctrine, the husband has the power to create an inter vivos trust as a part of his managerial powers over the wife's share [of the community property]; but when her share is involved, the wife can require the trust to be real rather than illusory, genuine rather than colorable.[4]

Footnote 4 provides:

> 4. ". . . The term "colorable" as used herein, indicates a transfer which may be absolute on its face, but which, actually, is not a transfer at all because, through some secret or tacit understanding, the parties intend that ownership is to be retained by the donor . . . ." Edward A. Smith, 44 Mich.L. Rev. 151, 153; Martin v. Martin, 282 Ky. 411, 138 S.W.2d 509 (1940).

Id., at 846 n. 4.

The "colorable trust" doctrine was discussed in a 1970 law review article by John L. Bell, Jr. Mr. Bell quotes different authorities on the meaning of the term "colorable," as used in this context. He concludes:

> The heirs of the settlor who would be deprived of the assets if the testamentary provisions of the purported trust instrument were given effect, may seek a judicial declaration of the invalidity of the colorable transfer on the grounds that the transaction is fraudulent. This is purely a fraud doctrine and is not affected by community property considerations.

Bell, *Community Property Trusts--Challenges by the Non-Participating Spouse*, 22 BAY. L. REV. 311, 319 (1970). Whether the doctrine, if available at all in Texas, applies only upon the settlor's death is an open question. TEX. PROP. CODE ANN. § 112.008 (Vernon 1995).

F. Alter Ego Family lawyers know that the independence or separateness of a corporation or other business entity can be attacked under the "alter ego" doctrine. The doctrine might be available to contest whether certain property is actually "held in trust." The Court of Civil

Appeals, in *In re Marriage of Burns*, 573 S.W.2d 555, 557 (Tex. Civ. App.--Texarkana 1978, writ dism'd), acknowledged this potential attack, when it pointedly observed that the wife in that case had not challenged the husband's trust as being the alter ego of the husband.

The necessary legal standards to establish a trust as an alter ego can be adapted from cases where a spouse has sought to pierce the corporate veil. *See Spruill v. Spruill*, 624 S.W.2d 694 (Tex. Civ. App.--El Paso 1981, writ dism'd); *Duke v. Duke*, 605 S.W.2d 408 (Tex. Civ. App.--El Paso 1980, writ dism'd); *Humphrey v. Humphrey*, 593 S.W.2d 824 (Tex. Civ. App.--Houston [14th Dist.] 1980, writ dism'd); *Goetz v. Goetz*, 567 S.W.2d 892 (Tex. Civ. App.--Dallas 1978, no writ). *Martin v. Martin*, 628 S.W.2d 534 (Tex. App.--Fort Worth 1982, no writ). *See generally* TEX. PROP. CODE ANN. § 112.008(c) (Vernon 1995) (settlor and beneficiary may be trustee, except where merger would occur). It should be noted that a trust may be operated as an alter ego of the settlor, or of the beneficiary, or of the trustee.

1. *Castleberry v. Branscum* The Supreme Court examined the contours of the alter ego theory as to corporations, in great detail, in *Castleberry v. Branscum*, 721 S.W.2d 270 (Tex. 1986). There the Court discussed seven recognized grounds for disregarding the corporate fiction: (i) alter ego; (ii) because "the corporate form has been used as part of a basically unfair device to achieve an inequitable result; (iii) fraudulent conveyance; (iv) the trust fund doctrine; (v) breach of fiduciary duties; (vi) the denuding theory; and (vii) inadequate capitalization. *Id.* at 271-73. As to the alter ego theory the Court said:

> Alter ego applies when there is such unity between corporation and individual that the separateness of the corporation has ceased and holding only the corporation liable would result in injustice. *First Nat. Bank in Canyon v. Gamble*, 132 S.W.2d 100, 103 (Tex. 1939). It is shown from the total dealings of the corporation and the individual, including the degree to which corporate formalities have been followed and corporate and individual property have been kept separately, the amount of financial interest, ownership and control the individual maintains over the corporation, and whether the corporation has been used for personal purposes. [Citations omitted.] Alter ego's rationale is: "if the shareholders themselves disregard the separation of the corporate enterprise, the law will also disregard it so far as necessary to protect individual and corporate creditors."

Id. at 272.

The policy reasons which support disregarding the corporate fiction may well also apply to situations where a trust relationship to property is conducted in a manner that makes the trustee an alter ego of the settlor, the beneficiary, or the person who is acting as trustee. If the facts warrant it, plead the cause of action, and if the trial judge won't go for it, take it up and see what happens.

2. Colorable Trust vs. Alter Ego While some might wonder at the usefulness of drawing distinctions between two trust doctrines, neither of which has as yet become established law in this state, one can draw certain distinctions between a "colorable" trust and a trust relationship which is conducted so as to make the trustee the "alter ego" of the settlor, the beneficiary or the trustee. To prove that a trust is colorable, the proponent must show an agreement between the settlor and the trustee such that the settlor retains ownership of the res of the trust, notwithstanding the apparently completed conveyance to the trustee. To establish that a trust is being operated as an alter ego, the proponent would presumably have to show that the settlor, or trustee, or beneficiary, as the case may be, dealt with the trust property as if it was not subject to the fiduciary obligations deriving from the trust instrument. Thus, even if the attempt to prove an *agreement* between the trustee and the settlor is unsuccessful, and the colorable trust attack fails, success may be available on alter ego grounds, because of the way the trust property is handled, in practice.

G. Trust as Instrument of Fraud No Texas cases were found which disregarded the separateness of a trust on the ground that it was used to perpetrate a fraud. However, this cause of action exists in some other jurisdictions. In this subsection, an analogy is drawn to Texas precedent disregarding the corporate fiction, and some caselaw from other states is examined.

1. Comparison to Cases Piercing the Corporate Veil In the case of *Castleberry v. Branscum*, 721 S.W.2d 270 (Tex. 1986), the Supreme Court discussed disregarding the corporate fiction where the corporate entity is used to perpetrate a fraud. The Court indicated that the corporate veil could be pierced upon a showing that the corporate form had been used in such a way as to amount to constructive fraud. The Court said:

> Because disregarding the corporate fiction is an equitable doctrine, Texas takes a flexible fact-specific approach focusing on equity.

Id. at 273. There are a number of Texas cases discussing constructive fraud-on-the-spouse, in situations involving the conveyance of community property by a spouse to a third party. However, these cases would address only the conveyance by a spouse of property into trust. One can imagine other instances of constructive fraud in connection with a trust, besides a spouse's conveyance of

community property into trust. Take, for example, the man who, shortly prior to marriage, conveys all of his income-producing property into trust, and then, either as trustee or through control over the trustee, uses undistributed trust income to acquire assets such as the car which he drives, the house in which he lives, etc.--items which would have been community property had the income been received by him free of trust. This activity would not constitute a constructively fraudulent conveyance of community property, but might constitute use of an express trust in a constructively fraudulent manner. If the principles which apply to use of a corporation to perpetrate a fraud can be adapted to express trusts, perhaps equity will allow the court in a divorce to disregard the trust "fiction."

H. Rescission, Cancellation and Reformation for Fraud, Duress, Mistake, Etc. Conveyances into trust, like every other transaction, are subject to rescission, cancellation or reformation on the grounds of fraud, accident, mistake, undue influence, duress, failure of consideration, etc. *See* 72 TEX. JUR.3d *Trusts* § 154 (1990).

1. Fraud in the Inducement as Basis for Rescission In order to rescind a conveyance for fraud in the inducement, it must be shown that: (1) a false representation was made by the defendant; (2) the victim detrimentally relied upon the false representation; and (3) injury resulted to the victim. *Citizens Standard Life Ins Co. v. Muncy*, 518 S.W.2d 391, 194 (Tex. Civ. App.--Amarillo 1974, no writ). The misrepresentation must relate to a material fact. *Runfield v. Runfield*, 324 S.W.2d 304, 406 (Tex. Civ. App.--Amarillo 1959, writ ref'd n.r.e.). The speaker need not know the falsity of the representation. *Citizens Standard Life Ins. Co. v. Muncy*, 518 S.W.2d 391, 195 (Tex. Civ. App.--Amarillo 1974, no writ). The failure to disclose a material fact will not support rescission, unless the wrongdoer had a duty to disclose arising from the nature of the relationship between the wrongdoer and the victim. *Anderson v. Anderson*, 620 S.W.2d 815, 819 (Tex. Civ. App.--Tyler 1981, no writ). A promise regarding future behavior will not support rescission unless the wrongdoer had no intent to carry out the promise at the time it was made. *Bassett v. Bassett*, 590 S.W.2d 531, 533 (Tex. Civ. App.--Houston [1st Dist.] 1979, writ dism'd). Where the victim has knowledge of the falsity, rescission will not lie. *Shaw Equipment Co. v. Hoople Jordan Const. Co.*, 428 S.W.2d 835, 839 (Tex. Civ. App.--Dallas 1968, no writ).

In the context of a trust, it can be imagined that the settlor, or someone claiming through him, might assert fraud in the inducement as a ground to rescind the conveyance into trust. Consider, for example, the following scenario. Assume that the wife is induced by her husband to join in a conveyance of their community property into trust, with the income from the trust to be paid in equal portions to husband and wife, for their lives, and then to the survivor, for life, and with the remainder to go to the spouses' children. Shortly after the conveyance, the husband files for divorce, and moves in with his girlfriend. The wife's lawyer wants to rescind the conveyance into trust. Given the fiduciary relationship which arguably exists between spouses, and the husband's failure to disclose the existence of a girlfriend or his intent to seek a divorce, the evidence should support rescission of the conveyance into trust, for fraud in the inducement. Proof of actual fraud eliminates the need to show a fiduciary relationship. *Meadows v. Bierschwale*, 516 S.W.2d 125 (Tex. 1974).

2. Accident The Texas Supreme Court has discussed what constitutes an accident sufficient to rescind or cancel a transaction. In *Henry S. Miller Co. v. Evans*, 452 S.W.2d 426, 432 (Tex. 1970), the Court described such an accident as:

> an unforeseen and unexpected event, occurring externally to the party affected by it, *and of which his own agency is not the proximate cause*, whereby, contrary to his own intention and wish, he loses some legal right or becomes subject to some legal liability and another acquires a corresponding legal right, which it would be a violation of good conscience for the latter person, under the circumstances, to retain . . . . If the party's own agent is the proximate cause of the event, it is mistake rather than an accident.

See Lott v. Kaiser, 61 Tex. 665, 668-69 (Tex. 1884).

3. Mistake Equity recognizes "mistake" as a ground for reformation, rescission or cancellation of a transaction. It should be noted that if rescission or cancellation is not available, the settlor could alternatively reform the trust agreement to make it revocable, and then later exercise his power to revoke the trust.

a. Mistake as Basis for Reformation Reformation is an equitable proceeding in which a document which is erroneously written is caused to conform to the true agreement between the parties. *Continental Oil Co. v. Doornbos*, 402 S.W.2d 879, 883 (Tex. 1966). Ordinarily, the mistake in the document must be mutual, and not unilateral, in order to support reformation. To warrant reformation, the proponent must prove the true agreement of the parties, and that the written memorandum deviates from the true agreement as a result of mutual mistake. *Brown v. Havard*, 593 S.W.2d 939, 942 (Tex. 1980). However, unilateral mistake by one party will support reformation where it is accompanied by fraud or inequitable conduct by the other party. *Ace Drug Marts, Inc. v. Sterling*, 502 S.W.2d 935, 939 (Tex. Civ. App.--Corpus Christi 1974, writ ref'd n.r.e.). For example, where the other party knows

of the mistake but fails to mention it, inequitable conduct exists to support reformation based upon unilateral mistake. *Cambridge Companies, Inc. v. Williams*, 602 S.W.2d 306, 308 (Tex. Civ. App.--Texarkana 1980), *aff'd*, 615 S.W.2d 172 (Tex. 1981).

b. Mistake as Basis for Rescission and Cancellation To rescind or cancel an agreement for mistake, the mistake generally must be mutual. *Hanover Ins. Co. v. Hoch*, 469 S.W.2d 717, 722 (Tex. Civ. App.--Corpus Christi 1971, writ ref'd n.r.e.). The mistake must relate to a material and essential issue, not an incidental one. *Simpson v. Simpson*, 387 S.W.2d 717, 719 (Tex. Civ. App.--Eastland 1965, no writ). The mistake cannot have resulted from the negligence of the party seeking to negate the transaction. *Plains Cotton Cooperative Assn. v. Wolf*, 553 S.W.2d 800, 803 (Tex. Civ. App.--Amarillo 1977, writ ref'd n.r.e.). Generally, an error in predicting the future will not support rescission or cancellation. *City of Austin v. Cotten*, 509 S.W.2d 554, 557 (Tex. 1974). A mistake as to a party's existing legal rights can support rescission. *Plains Cotton Cooperative Assn. v. Wolf*, 553 S.W.2d 800, 803 (Tex. Civ. App.--Amarillo 1977, writ ref'd n.r.e.). Unilateral mistake, which is not known to or induced by the other party, will not support rescission or cancellation of an agreement. *Johnson v. Snell*, 504 S.W.2d 397, 399 (Tex. 1973). However, unilateral mistake can support rescission where the mistake is of such a magnitude that to enforce the contract would be unconscionable; the mistake involves a material feature of the agreement; the mistake was made despite the exercise of ordinary care; and the parties can be returned to the status quo after rescission. *James T. Taylor, Etc. v. Arlington Ind. School Dist.*, 335 S.W.2d 371, 373 (Tex. 1960).

c. Cancellation of Trust Agreements American Law Reports, Second Edition, contains an annotation on the subject of when an irrevocable inter vivos trust can be cancelled on the ground of mistake or misunderstanding. Annot., 59 A.L.R.2d 1229 (1958).

One federal judge concluded that under Texas law, a settlor may reform a trust agreement to insert a power of revocation where that power was omitted from the trust agreement by mistake. *See DuPont v. Southern Nat. Bank of Houston, Texas*, 575 F. Supp. 849, 859 (S.D. Tex. 1983), *aff'd in part*, *rev'd part on other grounds*, 771 F.2d 874 (5th Cir. 1985). The Court also dealt with rescission of a trust on the grounds of mistake as to tax consequences, and suggested that Texas law would require the following showing before rescinding the trust: (1) that the trust was created solely for tax considerations; (2) that these tax considerations had been definitely changed or frustrated by an actual assessment of tax liability or by a change in law that would lead an expert to conclude that a transfer tax liability would more likely than not accrue on the transaction; (3) that the changed tax circumstance amounts to a material mistake; (4) that the settlor proves that but for the mistake he would not have entered into the transaction; and (5) that when plaintiff knew or should have known of the mistake he acted immediately to remedy the situation. *Id.* at 861.

d. Undue Influence Undue influence can support rescission or cancellation of a transaction. It is a form of legal fraud. *Bounds v. Bounds*, 382 S.W.2d 947, 951 (Tex. Civ. App.--Amarillo 1964, writ ref'd n.r.e.). In the area of will contests, where undue influence arises, the term is defined as such an influence as would subvert or overpower the mind at the time of the transfer in question, and without which influence the transfer would not have been made. *Bohn v. Bohn*, 455 S.W.2d 401, 409 (Tex. Civ. App.--Houston [1st Dist.] 1970, writ dism'd). *See In Re Estate of Willenbrock*, 603 S.W.2d 348, 350 (Tex. Civ. App.--Eastland 1980, writ ref'd n.r.e.). The same definition was applied to a suit to rescind a real estate conveyance, in *Edwards v. Edwards*, 291 S.W.2d 783, 786 (Tex. Civ. App.--Eastland 1956, no writ), wherein a daughter sought to rescind a conveyance of real estate by her mother to her half-brother. Where the conveyance is made in the context of a confidential or fiduciary relationship, and the fiduciary thereby profits, a different burden of proof may apply. *Mason v. Mason*, 366 S.W.2d 552 (Tex. 1963), is an example of a testamentary trust that was invalidated when the will creating it was held invalid for undue influence.

e. Duress Duress may be used as a basis to cancel instruments. Duress exists when: (1) there is a threat to do some act which the party threatening has no legal right to do; (2) there is some illegal exaction or fraud or deception; and (3) the restraint is imminent and such as to destroy free agency without present means of protection. *Housing Authority of City of Dallas v. Hubbell*, 325 S.W.2d 880 (Tex. Civ. App.--Dallas 1959, writ ref'd, n.r.e.). *Hailey v. Fenner & Beane*, 246 S.W. 412, 412 (Tex. Civ. App.--Dallas 1923, no writ).

I. Fraudulent Conveyances A conveyance into trust can be set aside if it violates one of the fraudulent transfer statutes. The general features of these doctrines are discussed below.

Chapter 24 of the Texas Business and Commerce Code sets out the Uniform Fraudulent Transfer Act. By using this Act, a spouse can perhaps undo a conveyance into trust.

The provisions of Chapter 24 apply to "transfers," including every mode of or parting with an interest in an asset. TEX. BUS & COM. CODE § 24.002(12) (Vernon Supp. 1998) [UFTA]. A spouse is a "creditor" who can invoke the provisions of the statute. UFTA § 24.002(4).

1. Transfers Made with Intent to Defraud Section 24.005(a)(1) of UFTA voids transfers made with the intent to hinder, delay or defraud creditors. Transferred property cannot be recovered from a "bfp" who gave a reasonably equivalent value for the transfer. UFTA § 24.009(a). Cases involving spouses under earlier law include: *Lott v. Kaiser*, 61 Tex. 665 (1884) (for transfer made during divorce in which wife sought alimony); *Goodwin v. Goodwin*, 451 S.W.2d 532 (Tex. Civ. App.--Amarillo), *rev'd on other grounds*, 456 S.W.2d 885 (Tex. 1970) (regarding transfer by husband occurring between date of rendition and date of signing of decree of divorce awarding wife judgment against husband); *Spence v. Spence*, 455 S.W.2d 365 (Tex. Civ. App.--Houston [14th Dist.] 1970, writ ref'd n.r.e.) (regarding transfer by husband between the date the decree of divorce was signed and the date it became final, where wife received an unsecured money judgment against husband); *Rilling v. Schultze*, 95 Tex. 352, 67 S.W.2d 401 (1902) (regarding transfer by ex-husband after entry of divorce decree ordering him to pay child support to ex-wife. *See generally White v. White*, 519 S.W.2d 689 (Tex. Civ. App.--San Antonio 1975, no writ), in which the husband was held not to be a creditor of the wife where the spouses had partitioned their property and exchanged deeds dividing their community estate.

2. Debtor's Transfer Not for Value Section 24.005 of the Business and Commerce Code states that a transfer made by a debtor without receiving a reasonably equivalent value is void with respect to an existing creditor if: (1) the debtor was about to engage in a transaction for which his/her assets were unreasonably small; (2) the debtor believed that he/she would incur debts beyond the debtor's ability to pay as they come due. TEX. BUS. & COM. CODE § 24.005(a)(2) (Vernon Supp. 1998). Intent by the debtor to defraud a creditor or interested person is not an issue under this provision. *See First State Bank of Mobeetie v. Goodner*, 168 S.W.2d 941, 944 (Tex. Civ. App.-- Amarillo 1943, no writ). The burden of proving insolvency is on the creditor. *Wester v. Strickland*, 87 S.W.2d 765, 767 (Tex. Civ. App.--Amarillo 1935), *aff'd* 112 S.W.2d 1047 (Tex. 1938).

J. Conveyances During Divorce Section 6.707 of the Texas Family Code provides that a transfer of community property, or the incurring of community debt, by a spouse while a divorce is pending is void as against the other spouse, if done with the intent to injure the rights of the other spouse. TEX. FAM. CODE ANN. § 6.707 (Vernon 1998). The statute further provides, however, that the transfer or debt is not void as to the transferee or lender who had no notice of the intent to injure. The complaining spouse has the burden to prove such notice. While the mere pendency of the divorce is not constructive notice to third parties of fraudulent intent, *First Southern Properties, Inc. v. Gregory*, 538 S.W.2d 454, 458 (Tex. Civ. App.--Houston [1st Dist.] 1976, no writ), it would seem that courts might be more inclined to negate gratuitous transfers into trust made during the pendency of a divorce, where the transferee would suffer no loss of consideration, etc. were the transfer into trust rescinded.

K. Fraud-on-the-Spouse Doctrine There are a number of Texas cases asserting that actual or constructive fraud can arise when a spouse gives community property to a third party. In such a situation, the court will rescind the transfer of the complaining spouse's one-half interest in the community property that was transferred. Most actual and constructive fraud-on-the-spouse cases have involved either outright gifts to third parties or the designation of a third party as beneficiary of a community property life insurance policy. However, the conveyance of community property into an inter vivos or testamentary trust can just as easily support a fraud-on-the-spouse case. This was recognized by the Texas Supreme Court, in dicta, in *Land v. Marshall*, 426 S.W.2d 841 (Tex. 1968).

1. Actual Fraud No Texas cases were found where a conveyance into trust was attacked as constituting actual fraud upon a spouse. However, the issue was examined in *Martin v. Martin*, 282 Ky. 411, 138 S.W.2d 509 (1940). In that case, the issue was whether a man who was about to marry could transfer his property to a third party with the intent to deprive his intended spouse of a distributive share of his estate, upon his death. The high court of Kentucky made the following statement of the law:

> [A] man may not make a voluntary transfer of either his real or personal estate with the intent to prevent his wife, *or intended wife*, from sharing in such property at his death and that the wife, on the husband's death, may assert her marital rights in such property in the hands of the donee. [Emphasis added.]

Id. at 515. The TEXAS PATTERN JURY CHARGES PJC 206-2A (1996) gives the following instruction regarding actual fraud of a spouse's interest in community property:

> A spouse commits fraud if *that spouse transfers community property or expends community funds for the primary purpose of depriving the other spouse of the use and enjoyment of the assets involved in the transaction*. Such fraud involves dishonesty of purpose or intent to deceive. [Italicized language is subject to substitution of different language, depending on facts of case]

2. Constructive Fraud The authorities agree that, even without proof of actual intent to defraud the spouse, the court will rescind a transaction whereby one spouse unfairly gives away of the other spouse's one-half interest in community property. The doctrine of constructive fraud is one tool the practitioner can use to undo one spouse's conveyance of the other spouse's share of community property into a trust. *See Stephens County Museum, Inc. v. Swenson*, 517 S.W.2d 257 (Tex. 1975) (a non-marital case remanded to trial court for determination of constructive fraud issue regarding transfer into trust).

The TEXAS PATTERN JURY CHARGES PJC 206-3A (1996) gives the following instruction regarding constructive fraud as to a spouse's interest in community property:

> *A spouse may make moderate gifts, transfers, or expenditures of community property for just causes to a third party. However, a gift, transfer, or expenditure of community property that is capricious, excessive, or arbitrary is unfair to the other spouse. Factors to be considered in determining the fairness of a gift, transfer, or expenditure are—*
>
> 1. *the relationship between the spouse making the gift, transfer, or expenditure and the recipient*;
>
> 2. *whether there were any special circumstances tending to justify the gift, transfer, or expenditure; and*
>
> 3. *whether the community funds used for the gift, transfer, or expenditure were reasonable in proportion to the community estate remaining*. [Italicized language is subject to substitution of different language, depending on facts of case]

a. In Conveyances During Lifetime The following cases, among others, have addressed the issue of constructive fraud-on-a-spouse in inter vivos conveyances to third parties: *Carnes v. Meador*, 533 S.W.2d 365 (Tex. Civ. App.--Dallas 1976, writ ref'd n.r.e.) (widow sued to negate gifts of community property from deceased husband to his children from prior marriage); *Horlock v. Horlock*, 533 S.W.2d 52 (Tex. Civ. App.--Houston [14th Dist.] 1975, writ dism'd) (wife sought to recover from husband in divorce proceeding for gifts of community property he made to his children from a prior marriage); *Logan v. Barge*, 568 S.W.2d 863 (Tex. Civ. App.--Beaumont 1978, writ ref'd n.r.e.) (widow sued step-children to recover one-half of gifts of community property made to them by her deceased husband).

b. In Conveyances Effective Upon Death The following cases have addressed the issue of constructive fraud-on-a-spouse in conveyances taking effect upon death: *Givens v. Girard Life Ins. Co. of America*, 480 S.W.2d 4211 (Tex. Civ. App.--Dallas 1972, writ ref'd n.r.e.) (widow sued deceased husband's girlfriend to recover proceeds from community property life insurance policy on life of deceased husband); *Murphy v. Metropolitan Life Ins. Co.*, 498 S.W.2d 278 (Tex. Civ. App.--Houston [14th Dist.] 1973, writ ref'd n.r.e.) (decedent's mother sued insurance company and decedent's wife for proceeds of community property life insurance policy on decedent's life).

L. Merger The essence of an express trust is the separation of the legal title from the equitable title in property, with the trustee holding legal title and the beneficiary holding equitable title. *Jameson v. Bain*, 693 S.W.2d 676, 680 (Tex. App.--San Antonio 1985, no writ). Whenever legal title and equitable title to trust property are joined in the same person, the two interests merge, and the property no longer in trust.

The doctrine of merger is expressly set out in Section 112.034 of the Texas Trust Code. The Code provides:

> [I]f a settlor transfers both the legal title and all equitable interests in property to the same person or retains both the legal title and all equitable interests in property in himself as both the sole trustee and the sole beneficiary, a trust is not created and the transferee holds the property as his own . . . . Except as provided by subsection (c) of this section, a trust terminates if the legal title to the trust property and all equitable interests in the trust become united in one person.

TEX. PROP. CODE ANN. § 112.034 (Vernon 1995). The Code further provides that merger cannot occur for the beneficiary (other than the settlor) of a spendthrift trust, and that if such occurs, the court must appoint a new trustee or co-trustee to administer the trust.

Merger can occur at the outset of the trust, as a result of a design defect in the trust instrument, or it can result from a subsequent act of the beneficiary. For example, when the beneficiary of an express trust conveys equitable title to the trustee, so that legal title and equitable title are merged in the trustee, the trust is terminated and the trustee has an unrestricted right to the property. *See Becknal v. Atwood*, 518 S.W.2d 593 (Tex. Civ. App.--Amarillo 1975, no writ). In *Becknal*, where the father conveyed real property to his wife as trustee for their children, and the children later conveyed their remainder interest back to their mother, for her use and enjoyment during her lifetime, and then to the trustor-father, for his use during his lifetime, legal and equitable title merged and the property in question exited

the trust. However, other trust property not involved in the re-conveyance continued to remain in trust.

Note that the merger provision of the Texas Trust Code speaks of merger of legal and equitable title in *one* person. Note the Code's use of the words "sole trustee" and "sole beneficiary." There is a general view that, where there are multiple trustees and multiple beneficiaries, a unification of legal and equitable title in the trustees and beneficiaries collectively does not constitute merger. *See* Annot., 7 A.L.R.4th 621 (1981). However, this argument did not avoid merger in the *Becknal* case, discussed above, where there were two trustees.

In sum, whenever the legal and equitable titles to property held in trust are combined, the possibility of merger arises.

M. Internal Revenue Code Standards The Internal Revenue Code addresses issues analagous to the "illusory trust," "colorable trust," and alter ego doctrines in connection with taxation of trust income and the inclusion of trust property in the estate of a decedent. While there is a well-recognized distinction between the validity of a transaction under state property law and the validity of the transaction for tax purposes, the parallels are inescapable. The similarity was touched upon in *Sullivan v. Burkin*, 390 Mass. 864, 460 N.E.2d 572, 575 (1984).

1. Income Tax Considerations The Internal Revenue Code recognizes a trust as a separate taxable entity only when there is a genuine relinquishment of the settlor's control over his wealth. If the settlor retains too much control over the trust, the income of the trust will be taxed to the settlor. The Code also taxes trust income to the settlor if the income is used to make payments which the settlor is obligated to make, such as child support. I.R.C. 674(b)(1), 677(b); Regs. §§ 1.674; 1.677. While recognition of a trust as a taxable entity under the Internal Revenue Code is different from recognition of a trust under local property law, in most instances the Code standards relate to the true "separateness" of the trust from the settlor. Also, the failure to meet Code requirements makes the trust's income taxable to its grantor, creating a liability for his community estate, and perhaps bolstering the claim that if income is taxable to the community, then the conveyance into trust should be declared to be ineffective. [If the trust is nonetheless valid under property law, then perhaps a right of reimbursement arises for community property used to pay taxes on the income of the trust.] For a discussion of the specific questions addressed by the Internal Revenue Code on the subject, see 33 AM. JUR.2d *Federal Taxation* § 3000-3038 (1996).

2. Estate Tax Considerations The Internal Revenue Code also contains provisions which cause property conveyed into a trust to be included in the decedent's estate, for estate tax purposes. The rules are similar to those discussed above in connection with income taxation. See 34A AM. JUR.2d *Federal Taxation* § 143,179 (1996).

N. Breaking Charitable Trusts If someone wants to break up or break into a charitable trust, there are special problems relating to the Attorney General set out in Chapter 123 of the Texas Property Code.

1. Attorney General's Participation The Texas Property Code gives the Texas Attorney General the right to participate in litigation relating to charitable trusts. The relevant section provides:

> § 123.002. Attorney General's Participation
>
> For and on behalf of the interest of the general public of this state in charitable trusts, the attorney general is a proper party and may intervene in a proceeding involving a charitable trust. The attorney general may join and enter into a compromise, settlement agreement, contract, or judgment relating to a proceeding involving a charitable trust.

TEX. PROP. CODE ANN. § 123.002 (Vernon 1995).

2. Notice to the Attorney General The Texas Property Code requires that the Texas Attorney General be given notice of litigation relating to charitable trusts. The relevant section provides:

> § 123.003. Notice
>
> (a) Any party initiating a proceeding involving a charitable trust shall give notice of the proceeding to the attorney general by sending to the attorney general, by registered or certified mail, a true copy of the petition or other instrument initiating the proceeding involving a charitable trust within 30 days of the filing of such petition or other instrument, but no less than 10 days prior to a hearing in such a proceeding.
>
> (b) Notice shall be given to the attorney general of any pleading which adds new causes of action or additional parties to a proceeding involving a charitable trust in which the attorney general has previously waived participation or in which the attorney general has otherwise failed to intervene. Notice shall be given by sending to the attorney general by registered or certified mail a true copy of the pleading within 30 days

of the filing of the pleading, but no less than 10 days prior to a hearing in the proceeding.

(c) The party or the party's attorney shall execute and file in the proceeding an affidavit stating the facts of the notice and shall attach to the affidavit the customary postal receipts signed by the attorney general or an assistant attorney general.

TEX. PROP. CODE ANN. § 123.003 (Vernon Supp. 1998).

3. Voidable Judgment or Agreement The Texas Property Code makes a judgment involving a charitable trust voidable if the Texas Attorney General was not notified of the proceeding. The relevant section provides:

§ 123.004. Voidable Judgment or Agreement

(a) A judgment in a proceeding involving a charitable trust is voidable if the attorney general is not given notice of the proceeding as required by this chapter. On motion of the attorney general after the judgment is rendered, the judgment shall be set aside.

(b) A compromise, settlement agreement, contract, or judgment relating to a proceeding involving a charitable trust is voidable on motion of the attorney general if the attorney general is not given notice as required by this chapter unless the attorney general has:

(1) declined in writing to be a party to the proceeding; or

(2) approved and joined in the compromise, settlement agreement, contract, or judgment.

TEX. PROP. CODE ANN. § 123.004 (Vernon 1995).

O. Joinder of Beneficiaries As a general rule, both the trustees and the beneficiaries should be made parties to suits involving trust property. *Starcrest Trust v. Berry*, 926 S.W.2d 343, 355 (Tex. App.--Austin 1996, no writ). However, beneficiaries need not be joined in the action if the dispute does not involve a conflict between the trustee and beneficiaries, or between the beneficiaries themselves. *Id.* at 355. Also, the beneficiaries need not be joined if the trust instrument places the power to litigate exclusively on the trustee. *Hedley Feedlot, Inc. v. Weatherly Trust*, 855 S.W.2d 826, 833 (Tex. App.--Amarillo 1993, writ denied). The terms of the trust instrument and the purpose of this suit must be examined to determine whether a suit may be prosecuted with the trustee without joining the beneficiaries. *Id.* at 833.

P. Trustee's Attorney-Client Privilege In *Huie v. DeShazo*, 922 S.W.2d 925 (Tex. 1996), the Supreme Court held that the attorney-client privilege applies to communications between a trustee and the lawyer hired by the trustee, even as against beneficiaries of the trust.

IX. (FLP) FAMILY LIMITED PARTNERSHIP

FLPs are an estate planning device used by the older generation to reduce the value of their taxable estates without relinquishing control over the assets.

A. Retaining Control The FLP is usually arranged so that the older generation who is contributing the assets retains control by being the general partner in a limited partnership, or owning a business that is the general partner. The younger generations are given limited partnership interests, that give them a right to profits, and the right eventually to receive the partnership assets upon dissolution, but no control.

B. Protection of Assets Often the FLP is for a long term, like 50 years, and there are restrictions on transferrability of an interest in the partnership. By partnership law, a spouse or creditor of a partner receives only an assignee's interest, not a true partnership interest. The owner of an assignee's interest in a partnership has no management rights.

C. Valuation Discounts Since limited partnership interests lack marketability, can't force distribution of profits, and can't force liquidation, they are heavily discounted in value.

X. TEXAS FAMILY LAW AND PARTNERSHIPS.

The exact relationship between Texas marital property law, Texas law of divorce, and partnerships, is unclear. The few cases there are do not present a uniform approach to the problem. Although this Article address primarily partnerships, essentially the same rules apply to joint ventures. *See Thompson v. Thompson*, 500 S.W.2d 203, 209 (Tex. Civ. App.--Dallas 1973, no writ).

A. Character of Partnership Rights. Under TUPA, the property rights of a partner in a general partnership include: (1) his/her rights in specific partnership property; (2) his/her interest in the partnership; and (3) his/her right to participate in the management of the partnership. TUPA § 24. Of these, according to TUPA, only the partner's interest in the partnership can be community property. His/her right in specific partnership property, and his/her right to participate in the management of a partnership cannot be community property. TUPA § 28-A.

Under TRPA, a partner has no ownership rights in specific partnership property, TRPA § 5.01. Under TRPA, a partner's partnership interest can be community

property, TRPA § 5.02(a), but his/her management rights cannot be community property, TRPA § 4.01(d).

1. <u>Rights in Specific Partnership Property.</u> TUPA's three rights of a partner in specific partnership property are discussed below.

a. <u>The Partner's Rights Under TUPA in Specific Partnership Property.</u> A partner's rights in specific partnership property are described in Section 25 of TUPA. Under Section 25, a partner is a co-owner with his partners of specific partnership property, which they all hold as tenants in partnership. Each partner has an equal right to possess specific partnership property for partnership purposes, and can possess partnership property for non-partnership purposes, but only with the consent of his partners. TUPA § 25(2)(a). A partner's rights in specific partnership property are not assignable except where all partners assign their rights in the same property. TUPA § 25(2)(b). A partner's rights in specific partnership property are not subject to attachment or execution, except for a claim against the partnership. TUPA § 25(2)(c). The tenants in partnership have a right of survivorship. That is, on the death of a partner, his rights in specific partnership property vest in the surviving partner or partners, unless the dying partner is the last partner, in which event his rights in the partnership property vest in his legal representative. TUPA § 25(2)(d). By surviving, a partner or his heirs still only accede to the right to possess partnership property for partnership purposes. *Id.* However, upon dissolution of the partnership, such heirs are entitled to receive their benefactor's interest in the partnership.

It is important to recognize that under TUPA the "entity" theory of partnerships does not obstruct a direct ownership relationship between the partners and specific partnership property. Each partner, individually, owns an undivided interest in each partnership asset. That ownership may be subject to restrictions as to use, seizure, etc., but the ownership relation between each partner and each partnership asset is direct. TUPA partnerships are very different from corporations, in this respect. This fact may have significance when considering whether a specific partnership asset is "acquired" by a partner-spouse for purposes of determining the constitutionality of Section 28-A's proscription of a community property interest in specific partnership property, as discussed below.

It should be noted that the view just expressed is not in accord with the view of Alan R. Bromberg, author of the commentary to TUPA published in Volume 17 of the Texas Revised Civil Statutes. Prof. Bromberg speaks of TUPA as largely adopting an "entity" approach to partnerships, as opposed to an "aggregate" approach. TEX. REV. CIV. STAT. ANN. art. 6132b § 1 Bromberg, *Source and Comments* (Vernon 1970) [hereinafter cited as "Bromberg," followed by the section of the statute where the comment can be found]. Prof. Bromberg says that a partner's rights in specific partnership property "are wholly subordinated to the rights of the partnership entity as owner of the property." Bromberg § 1. It is more accurate to say that the rights of each partner are subordinated to the rights of the *other partners*, not to the partnership entity. At any rate, in Prof. Bromberg's view, the provision in TUPA § 25(1), that a partner is co-owner with his partners of all partnership property, "does not alter the fact that the partnership is the owner of the property. It merely defines the derivative rights of the partners as co-owners of the business." Bromberg, § 25. Prof. Bromberg's views were endorsed by the Court of Appeals in *Seidman & Seidman v. Schwartz*, 665 S.W.2d 214, 218 (Tex. App.--San Antonio 1984, writ dism'd), which stated that "the rights of the individual partners in specific partnership property is subordinate to the right of ownership of the partnership itself." *See generally Humphrey v. Bullock*, 666 S.W.2d 586 (Tex. App.--Austin 1984, writ ref'd n.r.e.) (upon death of partner, heirs take only partnership interest, which is personalty, not proportionate interest in partnership realty).

b. <u>A Spouse's Rights in Partnership Property.</u> A partner's rights in specific partnership property are not subject to dower, curtesy, or allowances to widows, heirs or next-of-kin. TUPA § 25(2)(e). As stated above, they cannot be community property, either. TUPA § 28-A. From the foregoing, it is apparent that in Texas a spouse ordinarily has no community claim against specific partnership assets. *See McKnight v. McKnight*, 543 S.W.2d 863 (Tex. 1976) (Secs. 28-A and 28-B prohibit award of specific partnership assets to partner's spouse, in divorce); *Roach v. Roach*, 672 S.W.2d 524 (Tex. App.--Amarillo 1984, no writ) (beyond power of court to award specific partnership property to one of the spouses as community property).

(1) Fraud on Spouse. An exception no doubt exists as to assets transferred by a spouse to a partnership in actual fraud or constructive fraud of the other spouse's interest. In keeping with this view, the commentary by Professor Bromberg following TUPA § 28-A in the Texas statute provides: "A transfer of community property to a partnership in fraud of a wife would leave her in the same position as if the transfer were to a corporation, trust or third person; the Act in no way reduces the wife's rights in this respect." Bromberg, § 28-A. To recover title to property from a partnership, the partnership would have to be joined as a party, in which event the recovery of the asset from the partnership would be authorized under TUPA § 25(2)(c).

(2) Comparison to Sole Proprietorships. As far as characterization of partnership assets is concerned, it can be argued that the commingling of cash, inventory and equipment that occurred in the sole proprietorships involved in *Green v. Ferguson*, *Epperson v. Jones*,

Smith v. Bailey, *Middlebrook Bros. v. Zapp*, *Schmidt v. Huppman*, *Rousseau v. Featherston*, *Hardee v. Vincent*, *Walker-Smith Co. v. Coker*, *Moss v. Gibbs* and *Goodridge v. Goodridge*, discussed in pp. 9 through 12 of this Article above, cannot occur inside a TUPA general partnership. Since a spouse has no community interest in any particular partnership asset, there are no community assets of the partnership to commingle with separate property partnership assets. As discussed below, however, there may be a need to segregate partnership distributions of capital from distributions of income, which may require a tracing of capital versus income within the partnership. Additionally, if a "community ownership" (á la *Jensen*) right in specific partnership property can exist, or if TUPA § 28-A is unconstitutional, then the proprietorship cases may apply. And if *Smoot v. Smoot* (see discussion at p. E-25 below) is the law, that the character of a partnership interest is determined upon a source-of-funds theory, considering contributions to, and distributions from, and earnings retained within, the partnership, then tracing will definitely be an issue. In *Smoot*, the appellate court affirmed the trial court's finding that the husband's partnership interest was his separate property because the partnership records, which were "detailed and complete," showed that distributions to partners had exceeded any accumulation of profits other than those attributable to the sale of separate property real estate. *Id.* at 181.

(3) What Constitutes Partnership Property? Section 8 of TUPA defines partnership property as "all property originally brought into the partnership stock or subsequently acquired by purchase or otherwise, on account of the partnership . . . ." TUPA § 8. The statute provides that property acquired with partnership funds is partnership property, unless the contrary intention appears. *Id.* One case says this statute creates a presumption that property acquired with partnership funds belongs to the partnership. *Conrad v. Judson*, 465 S.W.2d 819, 828 (Tex. Civ. App.--Dallas 1971, writ ref'd n.r.e.), *cert. den.*, 405 U.S. 1041 (1972).

Partnership property can be held in the name of the partnership. See TUPA § 8(3). Or, it can be held in the name of just one of the partners, where such property is held "on account of the partnership." *See* TUPA § 10(3) (regarding real property held in the name of one partner alone).

TRPA contains similar provisions. *See* TRPA § 2.05.

Therefore, in any particular case, there is a possibility that property held in the name of the partnership belongs to one of the spouses, and there is a possibility that property held in the name of the husband or wife may belong to a partnership.

For example, in *Roach v. Roach*, 672 S.W.2d 524 (Tex. App.--Amarillo 1984, no writ), the wife deeded separate property real estate to the partnership, but the partnership agreement provided that the property would remain her separate property. *Id.* at 528. The husband also conveyed separate property realty to the partnership, but there was no equivalent language in the partnership agreement that his real estate would remain his separate property, and there was no expression of intent that the property would not belong to the partnership. The husband's land thus became partnership property, and husband and wife, who were the partners, owned it as tenants in partnership. *Id.* at 531.

On the other hand, consider the case of *In re Marriage of Allen*, 692 S.W.2d 112 (Tex. App.--Amarillo 1985), *rev'd on other grounds*, 717 S.W.2d 311 (Tex. 1986), involving a piece of real property held in the name of both spouses, the husband's ex-business partner and his wife. The property was not expressly mentioned in the agreement incident to divorce or the divorce decree. The husband argued that ownership of the land passed to him under the clause in the agreement which gave the husband "all household goods, vehicles and personal property presently under the control or in the possession of husband." This was because the real property, according to the husband, belonged to a partnership in which the husband was a partner, and a partner's interest in the partnership is personal property. The Court of Appeals pointed out that no Texas case has ruled that "partnership real estate must be regarded as personalty for all purposes." *Id.* at 115. The Court did not resolve that question, however, concluding that such a determination, coupled with the underlying issue of "whether the property in question was indeed partnership property or whether it was community property to be used by the partnership, with the community to be reimbursed for such use," was outside the scope of the instant proceeding, which was a motion to enforce the decree of divorce. *Id.* at 116. The Supreme Court did not resolve the question, either, choosing rather to affirm the trial court on the independent ground that the husband was entitled to reform the agreement incident to divorce for mutual mistake in failing to award the property to him. *Allen*, 717 S.W.2d at 313.

c. <u>Court's Power on Divorce.</u> As a result of TUPA, the court in a divorce has no power to award a specific partnership asset to a partner's spouse. *McKnight v. McKnight*, 543 S.W.2d 863, 867 (Tex. 1976); *Roach v. Roach*, 672 S.W.2d 524, 531 (Tex. App.--Amarillo 1984, no writ). *But c.f. Gaines v. Gaines*, 519 S.W.2d 694 (Tex. Civ. App.--Houston [1st Dist.] 1975, writ ref'd n.r.e.) (award to spouse of husband's undivided interest in specific partnership asset sufficient to establish res judicata when other spouse later sought partition of undivided partnership property). Of course, all conveyances are subject to recision upon the proper showing, so that a conveyance of property to a partner-

ship might be set aside in a divorce proceeding. Also, the partnership "entity" may be disregarded upon a proper showing, such as alter ego, fraud, etc. See discussion at p. 15 et seq. above, as to ignoring the corporate entity.

2. Partner's Interest in the Partnership. TUPA Section 26 provides that a partner's interest in the partnership "is his share of the profits and surplus, and the same is personal property for all purposes." TRPA Section 1.01(12) defines "partnership interest" to include the partner's share of profits and losses" or similar items, and the right to receive distributions, but not the partner's right to participate in management. The normal rules of marital property govern whether a partnership interest is separate or community property at the time it is acquired. Not so certain is the issue of whether the pure inception of title rule applies to the partnership interest, or whether some form of apportionment applies.

a. Character of Partnership Interest. There are some interesting problems that present themselves when considering the character of a partnership interest.

(1) Character at the Time of Acquisition. The normal rules of marital property apply to characterizing a partnership interest as of the time of acquisition. The partnership interest is separate property if acquired before or after, but not during, marriage. And the partnership interest is separate property if acquired during marriage by gift, devise or descent, or if it can be traced to separate property, or if it is set aside as the spouse's separate property by valid partition or exchange agreement with the other spouse. *See In re Marriage of Higley*, 575 S.W.2d 432 (Tex. Civ. App.--Amarillo 1978, no writ) (partnership interest acquired prior to marriage was separate property); *Horlock v. Horlock*, 593 S.W.2d 743 (Tex. Civ. App.--Houston [1st Dist.] 1980, writ ref'd n.r.e.) (limited partnership interest acquired by husband after divorce was his separate property); *York v. York*, 678 S.W.2d 110 (Tex. App.--El Paso 1984, writ ref'd n.r.e.) (partnership interest acquired during marriage deemed to be community property). A partnership interest acquired by any other means during marriage is community property. *See* TEX. CONST. art. 16 § 15. A partnership interest acquired on credit during marriage is presumptively acquired on community credit, and would therefore belong to the community estate.

(2) Effect of Partnership Debts at Time of Acquisition. When a spouse acquires an interest in a general partnership during marriage, issues can arise as to whether the partnership interest is taken as separate or community property. Even if the purchasing spouse provides separate property money in exchange for the partnership interest, what effect if any, does the existence of partnership debts have on the transaction? Section 17 of TUPA provides that a person admitted as a partner into an existing partnership is liable for all the obligations of the partnership arising before his admission as though he had been a partner when such obligations were incurred, except that this liability shall be satisfied only out of partnership property. TUPA § 17. Thus, the mere act of becoming a partner does not make the new partner *personally* liable for existing partnership debts. If the consideration paid for acquiring a partnership interest is otherwise separate, then the effect of Section 17 of TUPA may be to make the new partner's liability for existing partnership debts a separate property liability, since the liability extends only to the partner's separate estate, and in fact, only to a part of that separate estate, to-wit: the part of that separate estate which constitutes his interest in the partnership. However, if the partnership interest is mutable, so that it may over time become community property, then there would be a possibility of community liability--to the extent of an after-acquired community interest in the partnership.

Note that the strict rule of separate property liability cannot apply in this situation. Under the *Cockerham* case, discussed at p. 3 above, debts contracted during marriage are presumed to be on the credit of the community, unless it is shown that the creditor *agreed* to look solely to the separate estate of the contracting spouse for satisfaction. *Cockerham*, 527 S.W.2d at 171. Where a partner buys into a going partnership, there will ordinarily be no agreement between the creditor and the new partner to look solely to his separate estate. However, the law provides that liability is limited to the assets of the partnership, and if these assets belong to the spouse as his separate property then presumably separate credit is involved, and the partnership interest is not community, or partly community, as a result of the liability factor. However, if a partner signs personal guarantees or participates in the refinancing of indebtedness in connection with acquisition of an interest in the partnership, the presumption of community liability would apply as in the normal credit transaction.

(3) Does the Apportionment Rule Apply? A question arises as to the mutability of a partnership interest. If a partnership interest is separate property of a spouse at some point in time, will the distribution of sums equivalent in value to the separate property interest on the date of marriage, or the retention by the partnership of profits during marriage, or the contribution of additional community property capital, slowly change the character of the partner-spouse's partnership interest from separate property into community property. This possibility is suggested by the case of *Smoot v. Smoot*, 568 S.W.2d 177 (Tex. Civ. App.--Dallas 1978, no writ). In *Smoot*, the Court said:

> The community or separate nature of each partner's interest depends on the source of the property. If a married partner contributes community property, or if partnership assets are accumulated from rents or profits, then, to that

> extent, his interest is community property, even through such rents or profits may have resulted from the use of separate property . . . . On the other hand, if a married partner contributes separate property, then his interest in the partnership is separate property to that extent, and any appreciation in its value as a result of general economic conditions, as distinguished from labor and effort beyond that required for preservation of the separate property, remains separate property. [Citations omitted.]

Id. at 180. *Smoot* is reminiscent of the apportionment or source-of-funds method for characterizing assets, where "acquisition" of a property right is deemed to continue over time, and character is seen to change, depending upon events subsequent to inception of title.

b. When the Partnership Interest is Community. Under Section 28-A of TUPA and under § 5.02(a) of TRPA, a partner's interest in the partnership can be community property. Thus, the community may own a share in the profits and surplus (TRPA says profit and loss and "similar items") of a partnership. Note that the statute does not limit the partner's interest to profits and surplus which are *distributed*. A partner has an interest in all profits and surplus, both distributed and *undistributed*. If the partnership interest is community property, the community may have an ownership interest in *undistributed* profits and surplus retained in the partnership.

Since the right to participate in the management of the partnership cannot be community property, it would appear that a partnership interest, if community, would be the partner-spouse's sole management community property, regardless of the nature of the consideration given in exchange for the partnership. As a consequence, it would not be subject to the pre-marital debts and marital contractual debts incurred during marriage of the other spouse.

c. When the Partnership Interest is Separate. Several questions arise in connection with a partnership interest that is separate property.

(1) Effect of Community Credit. An important feature of partnerships is the fact that all partners are jointly and severally liable for all debts and obligations of the partnership. TUPA § 15. Consequently, a spouse who conducts business as a partner is subjecting the community estate to liability for the partnership's debts. That is, the partner-spouse is using what is presumptively community credit in the partnership's business. Under Texas law, that which is acquired with community credit is deemed community property. Does the community have a claim, either by way of ownership, reimbursement or some other form of remedy, for the partnership's use of community credit to acquire assets or make a profit?

An analogous question was examined in the case of *Faulkner v. Faulkner*, 582 S.W.2d 639 (Tex. Civ. App.--Dallas 1979, no writ), where the husband and his wife, together with other members of the husband's family and their wives, signed a promissory note to borrow funds to build a truck stop on land belonging to a corporation then owned by the husband's parents. The parents later transferred shares of stock in the corporation to the husband. On divorce, the wife argued that she and her husband should have 25% community property interest in the corporation by virtue of their using community credit for the construction of the building. The court rejected this analysis, saying that there was no conveyance to the husband of any interest in the corporation or the real estate as a result of the use of the community's credit. The court observed that the wife had cited no authority to support the view that a married couple can obtain a community interest in an incorporated enterprise by co-signing the corporation's note, "and we know of none that would even remotely tend to support such a view." *Id.* at 640. Her contention was therefore rejected.

The *Faulkner* case may mitigate against the argument that the involvement of the community's credit in a partnership business gives rise to some claim on behalf of the community. On the other hand, a partner under TUPA does have an ownership interest, albeit undivided, in each asset acquired by the partnership, whereas an owner of corporate stock owns only the stock, and not the assets of the corporation. Therefore it could be said that property is acquired by the partner through the use of community credit where a partnership asset is acquired on credit. How can the rule that property acquired on community credit is community property be reconciled with TUPA § 28-A, which provides that a partner's interest in specific partnership assets cannot be community property. Is Section 28-A constitutional?

3. The Right to Participate in Management. As stated above, a partner's right to participate in the management of the partnership cannot be community property. TUPA § 28-A & TRPA § 4.01(d). If a partner's interest in a partnership is assigned to his spouse in a divorce, the receiving spouse is regarded as an assignee and purchaser of such interest from such partner. TUPA § 28-B & TRPA § 5.04(a). The same rule applies in the event of a post-divorce partition of an undivided community property interest in a partnership or joint venture. *McKean v. Thompson*, 555 S.W.2d 136, 137 (Tex. Civ. App.--Dallas 1977, no writ). The same is true for a spouse or heirs who accede to a partner's interest in partnership after the death of the partner. *Id.* An assignee or purchaser of a partner's interest has no right to "interfere in the management or administration of the partnership business or affairs." TUPA § 27 & see TRPA § 5.03. The assignee is merely entitled to receive, in accordance with his assignment, "the profits to which

the assigning partner would otherwise be entitled and, for any proper purpose, to require reasonable information or account of partnership transactions and to make reasonable inspection of the partnership books." *Id.* Such an assignee has no obligation to make contributions to cover the expenses of the partnership. *See McKean v. Thompson*, 555 S.W.2d 136, 137 (Tex. Civ. App.--Dallas 1977, no writ). If the partnership later dissolves, the assignee is entitled to receive the assignor's interest. *Id.*

4. Ownership Claim for Enhancement? Even though a partner's rights in specific partnership property cannot be community property, and even though a spouse's management rights cannot be community property, it is possible that the community estate may have ownership claims of some kind relative to such property. Consider the argument of the dissenters in the *Vallone* case, and the argument of Justice Kilgarlin in the *Jensen* case, as they might be applied to partnerships.

The dissenters in *Vallone* considered the wife's claim to the enhancement in the husband's separate property stock as a *characterization* issue. The dissenters were convinced that the community *owned* the appreciation in the corporate stock during marriage. Yet Justice Sondock's opinion never suggested that any portion of Mr. Vallone's stock in the corporation was community property, and therefore alienable and assignable to Mrs. Vallone.

It is clear from Justice Kilgarlin's opinion in the *Jensen* case that the members of the Court who supported the "community ownership" theory, as opposed to the "reimbursement" theory, had no intention of taking Mr. Jensen's stock from him and awarding it to Mrs. Jensen. The language of Justice Kilgarlin's first majority opinion in *Jensen*, made it clear that Mr. Jensen's stock "is and remains his separate property." Enhancement in value of the corporate stock attributable to community time, toil and effort, nonetheless, "belonged" to the community, and the community was, according to Justice Kilgarlin, entitled to be compensated for this increase in value. *Jensen*, 26 Tex. Sup. Ct. J. at 482 (opinion withdrawn).

Applying these ideas to partnerships, it appears that the "community ownership" theory espoused by the minority in *Vallone*, and by those who joined in Justice Kilgarlin's first majority opinion in *Jensen*, would give the community estate a legal, as opposed to an equitable, interest in the increase in value of a separate property partnership attributable to the time, toil and effort of the partner's spouse. This need not be expressed by a divestiture of some of the partner-spouse's property rights as a partner. Community ownership of the increase in value could be taken into account by a divorce court either through the award of offsetting community property or through a money judgment against the partner spouse.

Although the "community ownership" theory is apparently dead letter as far as corporations are concerned, reasons exist for partnerships to be treated differently from corporations, when it comes to the choice between the "community ownership" and "reimbursement" approaches.

a. TUPA Partnership Not Entity for all Purposes. There are several respects in which a general partnership under TUPA is not an entity like a corporation.

(1) Co-Ownership of Specific Assets. For example, a partner is a co-owner with his partners of specific partnership property, holding as a tenant in partnership. TUPA § 25(1). Each partner has an equal right to possess partnership assets for partnership purposes. TUPA § 25(2)(a). A shareholder of a corporation does not have such a co-ownership of specific corporate assets with other shareholders.

(2) Joint and Several Liability. Also, all general partners are jointly and severally liable, *personally*, for all partnership debts. TUPA § 15. In contrast, there is no individual, personal liability of shareholders of a corporation for corporate debts. Thus, the community estate is "at risk" for the business activities of a spouse who pursues his goals through a partnership, but not for a spouse who acts through a corporation. Also, the community estate is liable for the acts of other partners of a partnership. There is no equivalent liability for the community estate of a corporate shareholder.

(3) Undistributed Income Taxed to Partners. Additionally, income earned by a partnership must be reported to the government by the individual partners as income, even if the partnership does not distribute such income to the partners. This is not true for a corporation, where the income of the corporation is taxed to the entity. The owners of a corporation are taxed on the profits of the corporation only when these profits are distributed to them in the form of dividends. Thus, the tax liability for undistributed partnership income is a community liability. This situation has no parallel in a corporation.

It is thus apparent that partnerships are entities for some purposes, but not for other purposes. Consequently, the arguments invoked in *Jensen* in support of the "reimbursement" theory, as opposed to the "community ownership" theory, do not necessarily translate to partnerships.

5. Is Section 28-A Constitutional? In *Arnold v. Leonard*, 114 Tex. 535, 273 S.W. 799 (1925), the Texas Supreme Court determined that the definition of separate property contained in the Texas Constitution is complete and exclusive. In other words, the Legislature is not free

to narrow or expand the definition of separate property contained in the Texas Constitution.

Section 28-A of TUPA purports to determine that a partner's rights in specific partnership property are not community property, and that a partner's right to participate in the management is not community property. It could be argued that, where the rights in specific partnership property and the right to participate in management are acquired during marriage by other than gift, devise or descent, that such rights *cannot* be separate property because they are not defined as separate property in the Texas Constitution.

One will recall that an equally "sticky wicket" was avoided in the case of *Graham v. Franco*, discussed at p. 2 above. In *Graham v. Franco*, the Supreme Court determined that a personal injury recovery, and the chose in action thereby created, is separate property except as to compensation for lost earning capacity during marriage. The Court was able to avoid the limiting effect of the constitutional definition of separate property by concluding that a personal injury, and its resultant chose in action, is not "property" that was "acquired" during marriage. It therefore exists "outside the Constitution," and under Spanish law constitutes separate property. One wonders whether the same escape route is available to the Supreme Court regarding TUPA § 28-A. That is, can it be said that a partner's rights in specific partnership property is not "property" as used in the Constitution? If such rights are property, can it be said that they are not "acquired" by the spouse, as that term is used in the Constitution. It should be noted that Donald R. Smith, a highly-regarded former family law practitioner in Dallas, once wrote that he sees no constitutional difficulty with Section 28-A. *See* Smith, *Division of Partnership Interests on Divorce*, STATE BAR OF TEXAS MARRIAGE DISSOLUTION COURSE H-14 (1986).

If TUPA § 28-A is unconstitutional in these respects, then the issue of commingling community assets inside the partnership, and the mutability of the partnership interest, become much more significant problems. However, even if the Legislature cannot specify the character of the property rights of a partner, the Legislature can no doubt control the management powers over such property. Thus, TUPA § 28-A(3), which declares that management rights of a partner cannot be community property, could be re-expressed by the Legislature in the form of a statute providing that a spouse's community property management rights on a partnership are subject to the sole management of the partner-spouse.

B. PARTNERSHIP INCOME AND DISTRIBUTIONS. There are some interesting question involving marital property law and partnership income and distributions. Under Texas law, the income which a spouse acquires during marriage is community property, regardless of whether the income arises from separate or community property. *Arnold v. Leonard*, 114 Tex. 535, 273 S.W. 799 (1925). This rule can be altered by a inter-spousal gift or by premarital or post-marital partition or exchange. Thus, one would think that all partnership distributions received by a partner-spouse during marriage would be community income. However, the answer is not that clear.

1. Character of Partnership Distributions.

a. When Partnership Interest is Separate Property. Recognizing that a partner's interest in the partnership is his share of profits and surplus, what happens when that partnership interest itself is separate property? If the partner-spouse's share of profits and surplus is separate property, then are such profits and surplus his separate property *before* they are distributed? Are they his separate property *after* they are distributed? Or are they instead received by the partner-spouse as income derived from separate property which, under Texas community property law, is community property? Former Dallas divorce practitioner Don Smith held to the latter view. *See* Smith, *Division of Partnership Interests on Divorce*, STATE BAR OF TEXAS MARRIAGE DISSOLUTION COURSE H-15 (1986). *Marshall v. Marshall*, 735 S.W.2d 587, 594-595 (Tex. App.--Dallas 1987, writ ref'd n.r.e.), held that distributions of partnership profits to a spouse during marriage are community property.

2. Transmutation of Partnership Distributions. One wonders if the Texas doctrine of transmutation applies in the area of partnerships. As discussed on pp. 5 and 6 above, Texas law recognizes that the application of community labor to a separate asset can transmute the resultant product from separate into community property. In the case of *Norris v. Vaughan*, 152 Tex. 491, 260 S.W.2d 676 (1953), the test of transmutation was applied to the husband's conduct of oil and gas development through various partnerships. *Norris v. Vaughan* predated the adoption of TUPA, and therefore was decided under the common law "aggregate" theory of partnership. Whether the rule applied in *Norris v. Vaughan* to specific partnership assets will be applied to partnerships under TUPA or TRPA remains to be seen.

The question is whether, if distributions from a separate property partnership interest are deemed by Texas courts to be separate property, the commitment by the partner-spouse of more than the time necessary to preserve his partnership interest transmutes his partnership distributions from separate to community property. If a husband spends all of his time working on partnership business, there will be a strong feeling among the judges that the partnership distributions should be deemed to be community property. Texas may end up with a problem much like those states which must apportion income from separate property into its separate

(return on capital) and community (fruits of labors) components. Although Texas does not recognize a return on separate capital as being separate property, it may be just the profits which are generated and distributed by a partnership that will constitute community property.

What if the partner-spouse has labored over some specific partnership assets to a degree that would cause transmutation of the proceeds from sale had such assets been owned by the partner-spouse in his own right? See discussion of Texas' doctrine of transmutation at pages 5 and 6 above.

3. What About Distributions of Capital? Another question arises as to partnership distributions which contain neither profits nor surplus. For example, where a partnership liquidates a partnership asset and distributes the proceeds from that sale to the partners, it is not a distribution of profits or surplus--at least to the extent of the cost of such property. Even if distributions of partnership income are community property, distributions of partnership capital may have the same character as the property rights of the partner. If the distributions from a partnership are considered to be community property income only to the extent that they represent profits and surplus, but not the liquidation of separate property capital, then someone may have to trace the flow of funds inside the partnership to allocate the portion of the distribution attributable to the partner's capital (separate) and the portion attributable to partnership income (community). If this is the law, then perhaps the principles involved in sole proprietorships will apply, in which event the parties will be concerned with the presence or lack of "modern bookkeeping" records, the community-out-first presumption, and the possibility of commingling the cash, stock-in-trade and equipment of the partnership.

Another issue involves the sale of appreciated property. A separate property asset which appreciates in value and is sold, generates separate property proceeds. A partnership asset which appreciates and is sold, generates profit, to the extent of the appreciation. If profits of a separate property partnership are community, then the appreciation of separate property inside a partnership may belong to the community estate, whereas appreciation in the same asset if held by the spouse individually would belong to his separate estate.

4. Character of Undistributed Partnership Income. The character of undistributed partnership income raised some of the same, but also some entirely new, issues.

a. Undistributed Profits and Surplus Constitute Specific Partnership Assets. Undistributed partnership profits are held by the partnership as some type of asset(s). TUPA § 28-A says that a partner's rights in specific partnership property cannot be community property. Thus, it would appear that a spouse could not assert a claim against any particular sums or assets of the partnership which represent undistributed partnership profits. On the other hand, Section 28-A may be unconstitutional in this respect, or the community estate may be entitled to a "community ownership" claim or "reimbursement" claim, along the lines of either Justice Wallace's or Justice Kilgarlin's views in the *Jensen* case. Perhaps a money judgment would be available in such circumstances.

TRPA § 5.01 provides that a partner has no direct ownership of partnership assets. That law means partnership assets are not marital property, and therefore cannot be separate or community property of a spouse. This law does not present constitutional difficulties, except as applied to property rights that vested under TUPA, before TRPA became effective as to the partnership in question.

b. No Jurisdiction Over Specific Partnership Assets. A divorce court is not empowered to award specific partnership assets to a partner's spouse. *See McKnight v. McKnight*, 543 S.W.2d 863 (Tex. 1976).

c. Graham v. Franco Revisited. There is also a question as to whether, under TUPA, undistributed partnership profits are "property" which is "acquired" by a partner-spouse. Community property is defined as all property acquired during marriage, except for a spouse's separate property. *See* TEX. FAM. CODE ANN. § 3.002 (Vernon 1998). In *Arnold v. Leonard*, *supra*, the Supreme Court said that the definition of separate property contained in the Texas constitution is complete and exclusive. Thus, the only property acquired during marriage that is separate property is property acquired by gift, descent or devise, or which is set aside as separate property by interspousal partition or exchange, or which can be traced to other separate property. TEX. CONST. art. 16 § 15. The Supreme Court, in *Graham v. Franco*, 488 S.W.2d 390 (Tex. 1972), circumvented the exclusivity of the Constitutional definition of separate property in order to characterize the personal injury recovery of a spouse as separate property. It did this by finding that a personal injury, and its related chose in action, are not "property," and are not "acquired" during marriage. Therefore, they exist in "limbo," without the realm of the Texas Constitution, and thus are subject to Spanish law, under which the items are separate property. One wonders whether the Supreme Court would now hold that undistributed partnership profits and surplus are either not "property" or not "acquired," as those terms are used in the Constitution. This would throw us back on Spanish law regarding undistributed partnership income, which may not have existed when the Constitution was adopted.

d. Partnership Interest is Share of Profits and Surplus. A partner's interest in the partnership is "his share of the profits and surplus, which is personal property for all purposes." TUPA § 26. *See* TRPA § 1.01(12). Under

TUPA § 28-A, that share can be community property. When a partnership interest is community property, does the community have a right to receive, or otherwise be compensated for, its "share of the profits and surplus, which is personal property for all purposes"? Even if the community estate has no claim against specific partnership assets, cannot a spouse sue the partnership to recover the value of the community interest in undistributed profits and surplus?

e. <u>Valid Business Purposes.</u> There is also the issue of the right of the partnership to retain profits for a valid business purpose, and whether a divorce court should be empowered to interfere with the business' exercise of discretion as to whether or not to distribute profits. Some courts have determined that, as a matter of public policy, the answer to that question is no.

(1) The Brazier Case (Idaho). The Court of Appeals of Idaho examined the character of undistributed partnership earnings in connection with a divorce, in the case of *Brazier v. Brazier*, 13 B.N.A. FAM. L. REP. 1021 (Idaho App. 1986). In that case, the wife was a partner with her brothers in a business, managed by their father. The partnership never distributed earnings to the partners but the partners nonetheless reported their shares of partnership earnings on their individual tax returns and paid income taxes on them. The wife's tax liability was paid with community funds. The husband contended that the wife's share of the partnership's undistributed earnings represented income from separate property which, in Idaho, belongs to the community estate. The husband also asserted that by retaining and reinvesting the earnings, the partnership commingled the wife's community and separate property to the extent that her entire partnership interest became community property.

The appeals court in *Brazier* examined the Idaho Supreme Court case of *Simplot v. Simplot*, 526 P.2d 844 (Idaho 1974), where it was held that retained earnings of a corporation in which the husband owned a minority separate property interest did not constitute community property, since the husband had no legal right to compel distribution of the retained earnings, and since the retention of earnings was a sound business decision made by the corporation. In *Simplot*, the Idaho Supreme Court said that awarding the wife a share in the retained earnings of the corporation would be tantamount to forcing the corporation to declare a dividend, substituting the divorce court's judgment for that of the directors of the corporation.

The appeals court in *Brazier* applied the analysis of the *Simplot* case to partnerships. The court indicated that the distribution of profits is a joint decision made by the partners collectively, or by the managing partner. The decision to reinvest or distribute earnings was a business judgment. The husband had not asserted any improper exercise of such judgment. Were retained earnings to be treated as community property, the ability of the partnership to make sound business decisions would be impaired. This would undercut the policy embodied in Idaho marital property law which recognizes that a spouse is entitled to preserve his or her separate property.

The husband's argument that the retained earnings of a partnership must be treated differently from the retained earnings of a corporation because they are taxed differently was rejected on the grounds that the Internal Revenue Code is not dispositive of the character of property. *See Porter v. Porter*, 67 Ariz. 273, 195 P.2d 132 (1948) (taxation of Subchapter S corporate profits to shareholders didn't affect character of such profits); *Nelson v. Nelson*, 114 Ariz. 369, 560 P.2d 1276 (App. 1977) (involving Subchapter S corporation, and saying that the treatment which income receives for tax purposes is not determinative of character).

The appeals court in *Brazier* looked to the other two community property states that treat income from separate property as community: Texas and Louisiana. The court found no Texas authorities. The court did find *Succession of Guercio*, 359 So. 2d 996 (La. App. 1977), which arguably could be interpreted as holding that retained earnings of a partnership are community property under Louisiana law. In that case, however, the Louisiana court said that the retained earnings at issue were "almost entirely related to common labor and industry on behalf of the community and not at all related to an initial investment . . . on behalf of [one spouse's] separate estate." The Idaho court found this language to be consistent with Idaho decisions recognizing that where community labor has been expended in a separate property business, no gift is intended, and where the community has not received fair compensation for its services, the community is entitled to such compensation upon divorce. In the *Brazier* case, the wife had been a passive partner, and contributed no labor toward the partnership. Therefore the community had no claim for compensation based on her services.

Having rejected the husband's assertion of an ownership right on behalf of the community in the partnership's retained earnings, the court addressed the question of whether the community should receive compensation for paying income taxes on the wife's share of partnership earnings. Feeling that the claim existed and had not been resolved, the court remanded the case for a determination of the community's entitlement to compensation for such payments.

(2) Comparable to Corporate Retained Earnings. To the extent that undistributed partnership profits and surplus are analogous to retained earnings in corporations, the case law is unfavorable. The following cases have found no community or marital interest in corporate retained earnings of a close corporation: *J.D.P. v. F.J.H.*, 399

A.2d 207 (Del. 1979); *Mifflin v. Mifflin*, 97 Idaho 895, 556 P.2d 854 (1976); *Hoffman v., Hoffman*, 676 S.W.2d 817 (Mo. 1984); *Thomas v. Thomas*, 738 S.W.2d 342, 344 (Tex. App.--Houston [1st Dist.] 1987, writ denied); *Snider v. Snider*, 613 S.W.2d 8 (Tex. Civ. App.--El Paso 1981, no writ).

C. VALUATION OF PARTNERSHIP INTEREST ON DIVORCE. In many respects, the valuation of a partnership is no different from the valuation of any other type of going business. Special considerations apply where the partnership is a professional partnership. Buy-sell provisions in the partnership agreement can also have an impact.

1. Goodwill and the Professional Partnership. Ever since *Nail v. Nail*, 486 S.W.2d 761 (Tex. 1972), there has been uncertainty as to exactly how the goodwill of a professional is involved in that person's divorce. *Nail* stands for the proposition that the goodwill of a sole practitioner doctor is individual to him, and is not a martial asset to be valued or divided in the divorce.

In the later case of *Geesbreght v. Geesbreght*, 570 S.W.2d 427 (Tex. Civ. App.--Fort Worth 1978, writ dism'd), it was held that a doctor-husband's interest in a medical corporation included as an element of value the corporation's goodwill. In *Geesbreght*, the corporation employed a number of doctors to perform emergency medical services under contracts the corporation had with various hospitals. The identity of the particular doctors, and the relationships between the doctors and their patients, were not significant to their practice. The Court felt that the corporation had goodwill which was independent from the individual doctor-husband, and could be considered as an element of value of the corporation.

In the case of *Finn v. Finn*, 658 S.W.2d 735 (Tex. App.--Dallas 1983, writ ref'd n.r.e.) (en banc), the court considered how to value the husband's interest in a law partnership, for purposes of divorce. The Dallas Court of Appeals, sitting en banc, and with dissenters, determined that there was a two-fold test regarding the divisibility of goodwill of a professional practice in a divorce. First, the court must determine whether the goodwill exists independently of the personal ability of the professional spouse. Second, if such goodwill is found to exist, then the court must determine whether that goodwill has a commercial value in which the community estate is entitled to share. *Id.* at 741. In the *Finn* case, there was evidence that the law firm had goodwill independent of the husband's professional ability. The firm consisted of 20 senior partners, 22 junior partners and 43 associates, and had been in business for some 90 years. Thus, the first prong of the test was satisfied, in that goodwill existed independently of the personal ability of the professional spouse. As explained below, however, because of the terms in the partnership agreement, the partner-spouse, and therefore the community estate, had no right to share in this goodwill.

2. Buy-Sell Restrictions in Partnership Agreement Affect Value. In *Finn v. Finn*, 658 S.W.2d 735 (Tex. App.--Dallas 1983, writ ref'd n.r.e.) (en banc), the Court considered the effect of buy-sell provisions in a partnership agreement on the determination of the value of the spousal partner's interest in the partnership. As explained above, the Court found that the partnership had goodwill independent from the husband, which would ordinarily be part of the value of the husband's rights in the partnership. However, since the community estate was not entitled to a greater interest in the firm's goodwill than that to which the husband was entitled, and the husband's interest in such goodwill was governed by the partnership agreement, it was necessary to consider the effect of the partnership agreement. Under the partnership agreement, were the husband to die or withdraw from the partnership, he would be entitled only to (1) the amount contained in his capital account, (2) any earned income which had not been distributed, and (3) his interest in the firm's reserve account, less 10% of his proportionate share in the accounts receivable for clients' disbursement. *Id.* at 741-42. The Court noted that the husband could be forced to withdraw from the partnership by a vote of 3/4ths of the senior partners. In such an event, he would be entitled to the same compensation for his interest as if he had voluntarily withdrawn to practice law elsewhere. If the husband withdrew from the law firm and did *not* practice law elsewhere, his compensation was increased. Most importantly, the partnership agreement did not provide any compensation for accrued goodwill to a partner who ceased to practice law with the firm, nor did it provide any mechanism to realize the value of the firm's goodwill. *Id.* at 742.

The crux of the Court's reasoning is as follows:

> The lack of any legal right of the husband to realize the value of the firm's goodwill is a decisive factor. . . . In the present case the only mechanism through which the husband may possibly realize the value of the accrued goodwill is through continuing to practice as a member of the firm, a circumstance depending not only on his own individual capacity, but also on the uncontrolled discretion of his partners. . . . Consequently, we hold that the trial court properly instructed the jury not to consider the law firm's accrued goodwill or future earning capacity when placing a value on the community interest in the husband's law practice. [Footnote omitted]

Id. at 742.

In short, although the law firm concededly had goodwill independent from Mr. Finn, the partnership agreement destroyed its value to Mr. Finn, except insofar as he might continue to practice law in the partnership and realize the goodwill through future earnings. As a consequence, the goodwill of the partnership was not an element of the value of Mr. Finn's rights in the partnership.

In *Keith v. Keith*, 763 S.W.2d 950 (Tex. App.--Fort Worth 1989, no writ), the appellate court rejected the majority view in *Finn* and instead held that a buy-sell agreement is not necessarily determinative of value for purposes of divorce.

In the case of *Weaver v. Weaver*, 11 B.N.A. FAM. L. REP. 1204 (N.C. App. 1985), the Court considered the valuation of a husband's rights in a partnership on divorce. In calculating the value of these rights, the trial court added the husband's capital account to the remainder of his partnership interest, to arrive at a value of some $113,000. Under the terms of the partnership agreement, this sum was not to be paid upon withdrawal from the partnership, but rather was paid out in quarterly installments over five years, with no interest. The trial court therefore discounted that flow of funds to a present value.

The appellate court approved the trial court's use of the partnership agreement's payment plan for a withdrawing partner to value the husband's partnership rights. As explained by the appellate court, the partnership agreement separated out the partner's capital account, representing his equity in the retained earnings, or undistributed profits, including cash, receivables and equipment. The payment plan then arrived at a percentage, based on the partner's prior contribution to fees, and applied that percentage to the partnership profits earned over the five years immediately following withdrawal. Half of that sum is to be paid to the withdrawing partner in installments over the five-year period. These installment payments reflect the withdrawing partner's share of the goodwill of the firm, and his share of the work-in-process.

In approving this approach, the appellate court aligned itself with those jurisdictions which consider goodwill as an asset that must be valued in the equitable distribution of an interest in a going concern. As an aside, the appellate court rejected the husband's argument that the trial court erred in ignoring taxes he might have to pay on his interest in the partnership were he to withdraw. Courts are not required to consider possible taxes when determining the value of property in the absence of proof that a taxable event has occurred during the marriage, or will occur with the division of marital property.

An opposing view was presented in *In re Marriage of Marron*, 215 Cal. Rptr. 894 (Ct. App. 1985). There, the court in a divorce valued the husband's interest in a law partnership based upon provisions in the articles of partnership providing that a withdrawing partner's claim on the partnership would be limited to his capital account plus the undrawn portion of his share of the profits for the year. This figure was substantially less than the figure given by the wife's expert. The Court of Appeals ruled that the trial court should have also considered the husband's share of the firm's accounts receivables, work in progress, and fixed assets, plus any goodwill. The Court observed:

> The value of the contractual withdrawal right may provide a basis for ascertaining the value of the community interest [but] it does not preclude a consideration of other facts. [It should be understood] that the asset being divided [is] the community interest in the partnership, not the professional spouse's contractual withdrawal rights.

Id.

D. JENSEN-TYPE REIMBURSEMENT FOR PARTNERSHIP. If the *Jensen* approach is applied to partnerships, then presumably a right of reimbursement would exist in favor of the community estate for undercompensated time, toil and labor of the community used to enhance the separate property interest in the partnership, beyond that amount needed to preserve the separate estate.

1. Calculating Such Reimbursement. The burden of proof of such a claim would be on the party seeking reimbursement to establish the value of the services rendered by the partner-spouse to the partnership, the reasonableness of the compensation received from the partnership, and the enhancement in value of the spouse's property rights in the partnership resulting from uncompensated community effort. The issue may be complicated by the fact that a partner, absent an agreement to the contrary, is not entitled to remuneration for acting in the partnership business. TUPA § 18.

XI. APPENDIX

APPENDIX