

# SOLUTIONS TO PROBLEMS CAUSED BY ENTITIES, THIRD PARTIES, AND TRUSTS IN A DIVORCE

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# THE THREE TYPES OF ENTITIES

# CORPORATION (LEGAL)

- A corporation is an entity distinct from its owners.
- Assets belong to the corporation, not the shareholders.
- The Corporation is liable for its debts; shareholders and officers are not (absent a personal guarantee or piercing the corporate veil).
- In a divorce there can be “reverse piercing.”
- Corporate shares are subject to turnover and sale to pay shareholder’s debt.
- Stock transfer restrictions and buy-sell agreements can prohibit or condition stock transfers.

## CORPORATION (TAX)

- A corporation is an entity for tax purposes; it files a corporate tax return (Form 1120).
- A corporation is taxed either as a C Corporation (at corporate tax rates) or an S Corporation (income is passed through to owners and taxed at personal tax rates).
- When shares are sold, the shareholder recognizes capital gain or loss.

## LIMITED LIABILITY COMPANY (LEGAL)

- An LLC is an entity distinct from its members and managers.
- Assets belong to the LLC, not its members; members are not liable for LLC debts (absent personal guarantee or piercing).
- A member's interest is not subject to foreclosure or turnover; member's creditor must seek a charging order.
- When a member's interest is sold, the member recognizes a capital gain or loss.

## LIMITED LIABILITY COMPANY (TAX)

- An LLC with only one member is “disregarded” for tax purposes, and does not file a tax return.
- An LLC with at least two members is taxed like a partnership (i.e., pass-through) unless the LLC files a Form 8832 electing to be taxed as a corporation.
- An LLC reporting as a partnership files a Form 1065 partnership tax return.
- An LLC reporting as a corp. files a Form 1120 (C-Corp) or 1120S (S-Corp).
- When a member sells her interest in an LLC, a capital gain or loss is recognized.

## PARTNERSHIP (LEGAL)

- A partnership is an entity distinct from its partners.
- Partnership assets belong to the partnership, not the partners.
- A general partnership and its partners are individually liable for partnership debts.
- In a limited partnership, the partnership and its general partner are liable for partnership debts, but not limited partners.
- Partnership creditors cannot pierce the partnership veil; *Peterson Grp. V. PLTQ Lotus Grp.* (2013); *Asshauer v. Wells Fargo Foothill* (2008); *Pinebrook Props., Ltd. v. Brookhaven Lake Prop. Owners Ass'n* (2004). But these were not reverse-piercing cases.
- A partnership interest is not subject to turnover; a partner's creditors must seek a charging order.

# PARTNERSHIP (TAX)

For tax purposes, in some ways a partnership is an entity and in some ways it is not.

- A partnership's profits and losses are reported to the IRS on a Form 1065 but are taxed to the partners to be reported on personal tax return Form 1040.
- The partnership details its profits, losses, and distributions on a Schedule K-1 sent to each partner.
- The partner reports her share of the partnership's profits or losses on Schedule E of her personal tax return.

A partner has a % share of profits, losses, and capital (not always the same), reflected on the K-1.



# DIVIDING ENTITIES UPON DIVORCE

# OPTIONS

1. Leave the spouses as co-owners of the entity.
2. Sell the entity and divide the proceeds.
3. Award the entity to one spouse and offsetting cash or property to the other spouse, or give the departing spouse a promissory note or money judgment.
4. Transfer cash or property from inside the entity to the departing spouse in liquidation of her interest (requires the consent of the entity, reverse-piercing, or imposing a resulting or constructive trust) (requires consent).
5. Subdivide the entity and award part to each spouse (requires consent).
6. Dissolve the entity and divide its assets (probably requires consent).

## LEAVING SPOUSES AS CO-OWNERS

- Avoids the need to value the business, but it can create problems **post-divorce**.
- If ex-spouses have equal control, an **impasse** can develop that may trigger lawsuits or require a court-appointed receiver.
- If one spouse has exclusive control, there can be actual or perceived minority oppression leading to a suit for breach of fiduciary duty.
- Even the controlling ex-spouse can dislike having to deal with an **unhappy minority owner** causing trouble.
- If there are other owners, splitting the community property interest may cause both ex-spouses to lose voting control, or one ex-spouse can join other minority owners in a voting block.

## SUBDIVIDING THE ENTITY

- The entity can be converted to one or more C Corps., S. Corps, LLC's, or partnerships, with component parts awarded to each spouse.
- A corporation can have a spin-off, split-off, or split-up.
- In Texas, a merger can be a joinder of two or more corporations. It can also be a “divisive merger,” where a corporation is split into two or more corporations. TBOC §1.002(55)(A)

# DIVISIVE MERGERS

- Opposite of traditional merger; instead one entity divides into multiple entities
- Dividing entity is not required to terminate, may be one of surviving entities
- Assets and liabilities of dividing entity are allocated among new entities formed
- NOT considered an assignment or transfer under Texas or Delaware state law
- May be used to avoid transfer restrictions
- Need corporate counsel; required filings with Sec'y of State; may trigger tax issues
- Failing to sufficiently allocate the assets and liabilities could have consequences

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## SELLING THE ENTITY

- Avoids having to value the business in the divorce, since the sales price establishes Fair Market Value.
- Dissension between the ex-spouses can scare off legitimate buyers, leaving only “vultures” looking for a bargain.
- If a receiver is appointed, it adds to the costs of sale.
- Sale of a partial interest is not feasible if there are other owners or transfer or buy-sell restrictions (unless the entity or the other owners buy out the departing spouse).

## SELLING THE ENTITY

- If the terms of sale are determined by a receiver, she may reduce the price for a quick sale for cash, when a longer period of marketing or more strenuous negotiations might lead to a higher sales price or better terms of sale, including earnout payments.
- Neither spouse can be required to sign a covenant not to compete, which will chase off buyers or depress the sales price.
- If a covenant will be signed, how much of the sale proceeds will be allocated to the covenant? Is that separate property?

## AWARDING ENTITY TO ONE SPOUSE, WITH OFFSETTING PROPERTY OR JUDGMENT

- Requires the entity to be valued; capital gain and costs of sale fall on the remaining spouse.
- If not enough other money/assets to offset, then payments over time are required; need interest rate commensurate with risk.
- Creates a debtor/creditor relationship: issues include promissory note vs. judgment, security for the debt, perfecting liens, post-divorce enforcement, and dischargeability in bankruptcy.
- Agreement on earn-out can avoid valuation dispute; can the court order this?
- Effect of transfer restriction or buy-sell agreement.
- For partnership, can transfer only a transferee's interest (absent consent by other partners).



## AWARDING ENTITY ASSETS

- The TBOC is clear: assets of an entity do not belong to the owners of the entity.
- A court cannot award individual assets of an entity to either spouse absent consent of the entity, reverse-piercing, or imposing a resulting or constructive trust.
- If the entity veil is pierced, assets become owned by the spouses and are subject to division.
- To pierce, does the entity have to be joined as a party?
- What to do about retained earnings?

# TRANSFER RESTRICTIONS & BUY-SELL AGREEMENTS

## STATUTORY RESTRICTIONS

- There are no Texas Business Organizations Code (TBOC) prohibitions against transferring an ownership interest in a business entity to a spouse in a divorce, except for licensed professions (law, medicine, etc.).
- Under the TBOC, the spouse of an LLC member or a partner can receive only an assignee's or transferee's interest in the LLC or partnership, which entitles the transferee to receive her share of future distributions, but only limited access to financial information and no management rights. TBOC § 101.1115 (LLC) & § 152.406 (p'ship).

## TRANSFER RESTRICTIONS & BUY-SELL AGREEMENTS

Entities can restrict the transfer of ownership interests in the governing documents.

Owners can enter into a buy-sell agreement giving the entity and non-transferring owners the option to purchase the departing spouse's interest, usually:

- A right-of-first-refusal to buy on the same terms offered to a third party;
- a set figure (like \$100 per share);
- a formula (e.g., book value plus net receivables but not goodwill);
- fair market value or fair value (determined by agreement, court, or arbitration);
- averaged appraised value (1, 2, or 3 appraisers).

Court can trigger or avoid triggering buy-sell provision.

# TAX ASPECTS OF THE PROPERTY DIVISION

## INTERNAL REVENUE CODE § 1041

- IRC § 1041 does not recognize a capital gain where a spouse conveys an interest in property to the other spouse incident to divorce (within 1 yr of cessation of marriage or related to cessation; 6-yr presumption).
- However, if the spouses want to use entity money or property to redeem a spouse's interest in the entity, it will require a distribution of that property from the entity, which is subject to income taxation.

## TREASURY REGS. UNDER § 1041

- Treasury Regs under **IRC § 1041** permit spouses to agree that a redemption or liquidation will be taxed either to the “departing spouse” as a capital gain or loss, or to the “remaining spouse” as a constructive dividend.
- At the present time, the tax rates on dividends and capital gains are the same. A capital gain tax is levied on the amount paid after subtracting the departing spouse’s tax basis in the entity, whereas a dividend tax is levied on 100% of the amount distributed.
- A capital gain can be reported on an installment basis over a period of months or years, which may lower the overall tax paid.

## TAX ASPECTS OF ACQUISITION, REDEMPTION, OR LIQUIDATION

- If one spouse acquires the other spouse's interest incident to divorce, IRC § 1041 precludes capital gain recognition. The existing tax basis is carried forward.
- If other owners acquire the departing spouse's interest, it is not clear whether IRC § 1041 protects against capital gain recognition.
- If the entity acquires the interest, it is a redemption, and the Treasury Regs. under IRC § 1041 permit the spouses to choose between a capital gain to the departing spouse or a constructive dividend to the remaining spouse.
- If the spouses do not choose, then whether IRC § 1041 applies depends on whether the entity assumed an obligation of the remaining spouse to buy-out the departing spouse. It can be complicated if you don't make a 1041 election.



# TAXATION UPON LIQUIDATING A PARTNERSHIP INTEREST

- “Inside tax basis” is the partnership’s tax basis in partnership assets.
- “Outside tax basis” is the partner’s tax basis in her partnership interest.
- Capital gain can be recognized both “inside” and “outside” the partnership.
- When a partner contributes property to a partnership, the partnership’s inside tax basis in the property is its fair market value.
- However, the contributing partner’s outside tax basis in the partnership increases by the amount of the tax basis that the partner had in the property. I.R.C. § 754.
- When a partner’s interest is sold or liquidated, the transaction is treated as a capital gain or loss to the partner.

## PARTNERSHIP “HOT” ASSETS

- In a redemption or partial liquidation of a partnership interest, a tax at ordinary tax rates (up to 39.6% under current law) can be triggered if the entity owns “hot assets.”
- Hot assets include unrealized receivables, mineral leasehold interests for which intangible drilling and investment costs were deducted, and property subject to depreciation recapture.
- Hot assets can increase the tax triggered upon redemption or liquidation.

## ASSIGNMENT OF INCOME DOCTRINE

- Income is taxed to the person whose efforts or property earned it, even if the right to receive the income is assigned to someone else *Lucas v. Earl*, 281 U.S.111 (1930).
- A lawyer or doctor who assigns part of her accounts receivable to her spouse in a divorce will have to pay the tax on that income when it is received by the other ex-spouse.
- If income of a spouse or entity is assigned, who will pay the tax liability on the income should be spelled out.
- IRC § 1041 does not protect against this.

# TAX CARRYOVERS

## Tax carryovers

- Capital losses (allocated based on ownership)
- Net operating losses (allocated to taxpayer who sustained the loss; see RR 74-175)
- Passive activity losses (added to tax basis)
- Charitable contributions (allocated based on ownership)

Tax carryovers related to separate property receive different treatment than carryovers related to community property assets

# LITIGATION INVOLVING ENTITIES UPON DIVORCE

## DIVORCE COURT'S POWERS

- Forum and conflict of laws
- Cannot award entity assets absent consent, reverse-piercing, resulting or constructive trust
- Where both spouses are record owners, does % ownership matter?
- Can award only a “transferee’s” interest in LLC/partnership to non-owner
- Can award ownership of a community property LLC or Inc. that is GP
- Dissolution of entity

# WINDING UP A DOMESTIC ENTITY

Winding up a “domestic entity” is covered in TBOC ch. 11.

Events requiring winding up under TBOC § 11.051:

- expiration date in organizing paperwork;
- voluntary decision;
- an event specified in the governing documents;
- as otherwise specified in the TBOC;
- a court decree requiring winding up based on the TBOC or “other law.”

# WINDING UP LIMITED PARTNERSHIP

TBOC ch. 153 has special rules for limited partnerships

- General partner winds up (§ 153.502(a)).
- Partner can ask court “on cause shown” to appoint person to wind up (§ 153.502(b)).
- Assets go to creditors, then to partners for return of capital and then with respect to their partnership interests (§ 153.504).
- These rules can be modified in the limited partnership agreement.



## DIVIDING OR DISSOLVING A PARTNERSHIP (LEGAL CONSIDERATIONS)

- Court cannot award partnership assets (absent consent, reverse-piercing, fraud, etc.)
- Proving that assets in a spouse's possession are partnership property
- Management rights cannot be community property
- Claims against the partnership or general partner (fraud, etc.)
- Claims to recover partnership assets (fraud, resulting or constructive trust); no piercing of partnership veil; what about reverse-piercing?
- Statutory grounds for dissolution of partnership
- Triggers for dissolution contained in partnership agreement
- Dissolution circumvents transfer restrictions & buy-sell provisions
- Characterization of property extracted from the entity

## DIVIDING OR DISSOLVING A PARTNERSHIP (PRACTICAL CONSIDERATIONS)

- Will the entity and other partners consent to a settlement?
- Joinder of entity or other partners (adds more attorneys)
- Characterizing partnership interest, excluding management rights
- Will partnership admit spouse as new partner?
- When the GP of a FLP is a community property Inc. or LLC
- Transfer restrictions; triggering buy-sell provisions
- Are there grounds for judicial termination over objection?
- Tax consequences of dissolution or termination
- Asserting claims against the partnership or its assets

# CLAIMS AGAINST SPOUSE/ENTITIES

# COMMON LAW FRAUD

To prove common law fraud you must show:

- a material representation that was false;
- made with knowledge of its falsity or made recklessly without any knowledge of the truth and as a positive assertion;
- made with the intent that the other party should act upon it;
- the party acts in reliance and thereby suffers injury.

“Pure expressions of opinion are not representations of material fact, and thus cannot provide a basis for a fraud claim.” However, a statement of opinion that the maker knows to be false is fraud. PJC 105.3D.

“Material means a reasonable person would attach importance to and would be induced to act on the information in determining his choice of actions in the transaction in question.” *Italian Cowboy Partners, Ltd. v. Prudential Ins. Co. of Am.*, (Tex. 2011); PJC 105.2.

4-year statute of limitations, TCP&RC §16.004(a)(4), extended by fraudulent concealment (knew or should have known).

## COMMON LAW FRAUD—DUTY TO DISCLOSE

PJC 105.4 “Fraud occurs when—

1. a party fails to disclose a material fact within the knowledge of that party, and
2. the party knows that the other party is ignorant of the fact and does not have an equal opportunity to discover the truth, and
3. the party intends to induce the other party to take some action by failing to disclose the fact, and
4. the other party suffers injury as a result of acting without knowledge of the undisclosed fact.

## CONSTRUCTIVE FRAUD/BREACH OF FIDUCIARY DUTY

- *Archer v. Griffith*, 390 S.W.2d 735, 740 (Tex. 1964): “Actual fraud usually involves dishonesty of purpose or intent to deceive, whereas constructive fraud is the breach of some legal or equitable duty which, irrespective of moral guilt, the law declares fraudulent because of its tendency to deceive others, to violate confidence, or to injure public interests.”
- Constructive fraud does not require proof of intent to defraud.
- Constructive fraud overlaps if not equates to breach of fiduciary duty.
- Remedies for breach of fiduciary duty include damages, disgorgement of profits, rescission, constructive trust, and injunction. PJC 115.15.
- Constructive fraud on the community estate has different elements.

# FRAUDULENT CONVEYANCES

- Tex. Bus. & Comm. Code §24.05(a)(1) defines “actual fraud” as transferring assets with the actual intent to hinder, delay, or defraud any creditor.
- TBCC §§ 24.05(a)(2) & 25.006(a) defines constructive fraud as transferring assets without receiving reasonably equivalent value when engaging in a transaction that resulted in leaving the transferor with unreasonably small assets, unable to pay debts when due, or insolvent.
- TBCC § 24.009(a) protects third party from forfeiting the asset upon showing of (i) no actual notice of debtor’s fraudulent intent and (ii) no knowledge of facts that would lead a person of ordinary prudence to suspect fraudulent intent.
- Remedies: money damages, rescission of the transaction, injunction, “any other relief the circumstances may require.” TBCC §§ 24.008 & 24.009.

## TEX. FAM. CODE § 3.102 MANAGING COMMUNITY PROPERTY

- a) During marriage, each spouse has the sole management, control, and disposition of the community property that the spouse would have owned if single, including:
- (1) personal earnings;
  - (2) revenue from separate property;
  - (3) recoveries for personal injuries; and
  - (4) the increase and mutations of, and the revenue from, all property subject to the spouse's sole management, control, and disposition.
- b) [mixing sole with sole makes joint]
- c) [rest is joint management community property]



## RECONCILING MANAGEMENT RIGHTS AND OWNERSHIP

- *Givens v. Girard Life Ins. Co. of Am.* – A problem inherent in the concept of sole management community property is the need to reconcile the ownership interest and managerial power of one spouse with the ownership interest of the other spouse.
- *Greco v. Greco* – Although a spouse has the right to dispose of community property under his or her control, he may not dispose of his spouse's interest in community funds if actual or constructive fraud exists.
- *Knight v. Knight* – a fiduciary duty exists between a husband and a wife as to the community property controlled by each spouse.

## FRAUD ON THE COMMUNITY IS NOT A TORT

- *Schlueter v. Schlueter* (Tex. 1998) – “Because a wronged spouse has an adequate remedy for fraud on the community through the ‘just and right’ property division upon divorce, we hold that there is no independent tort cause of action between spouses for damages to the community estate.” *Id.* at 585.

“[A] claim of fraud on the community is a means to an end, either to recover specific property wrongfully conveyed, ... or ... to obtain a greater share of the community estate upon divorce, in order to compensate the wronged spouse for his or her lost interest in the community estate.” *Id.* at 588.

“Because of our holding in the present case that there is no independent tort cause of action for wrongful disposition by a spouse of community assets, the wronged spouse may not recover punitive damages from the other spouse.” *Id.* at 589.

# ACTUAL FRAUD ON THE COMMUNITY

## PJC 206.2A Actual Fraud by Spouse against Community Estate—Instruction

*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.*

## PJC 206.2B Actual Fraud by Spouse against Community Estate—Questions

### QUESTION 1

Did SPOUSE A commit fraud with respect to the community-property rights of SPOUSE B?

Answer “Yes” or “No.”

Answer: \_\_\_\_\_

If you have answered Question 1 “Yes,” then answer Question 2. Otherwise, do not answer Question 2.

### QUESTION 2

State in dollars the value, if any, by which the community estate of Party A and Party B was depleted as a result of the fraud of Party A.

Answer: \$ \_\_\_\_\_

# CONSTRUCTIVE FRAUD ON THE COMMUNITY

## PJC 206.4A Constructive Fraud by Spouse against Community Estate—Instruction

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.
3. Whether the community funds used for the gift, transfer, or expenditure were reasonable in proportion to the community estate remaining.

## PJC 206.4B Constructive Fraud by Spouse against Community Estate—Questions

### QUESTION 1

Was the transfer made by SPOUSE A to THIRD PARTY fair?

Answer “Yes” or “No.”

Answer: \_\_\_\_\_

If you have answered Question 1 “No,” then answer Question 2. Otherwise, do not answer Question 2.

### QUESTION 2

State in dollars the value, if any, by which the community estate of SPOUSE A and SPOUSE B was depleted as a result of the transfer made by SPOUSE A to THIRD PARTY.

Answer: \$ \_\_\_\_\_

# RECONSTITUTING THE COMMUNITY ESTATE

Fam. Code § 7.009 provides:

- (a) In this section, “reconstituted estate” means the total value of the community estate that would exist if an actual or constructive fraud on the community had not occurred.
- (b) If the trier of fact determines that a spouse has committed actual or constructive fraud on the community, the court shall:
  - (1) calculate the value by which the community estate was depleted as a result of the fraud on the community and calculate the amount of the reconstituted estate; and
  - (2) divide the value of the reconstituted estate between the parties in a manner the court deems just and right.
- (c) In making a just and right division of the reconstituted estate under Section 7.001, the court may grant any legal or equitable relief necessary to accomplish a just and right division, including:
  - (1) awarding to the wronged spouse an appropriate share of the community estate remaining after the actual or constructive fraud on the community;
  - (2) awarding a money judgment in favor of the wronged spouse against the spouse who committed the actual or constructive fraud on the community; or
  - (3) awarding to the wronged spouse both a money judgment and an appropriate share of the community estate.

# CLAIMS AGAINST THIRD PARTIES

## SUING THIRD-PARTIES FOR FRAUD ON THE COMMUNITY

Chu v. Hong (Tex. 2008) – “Hong notes correctly that in *Schlueter* we did not decide whether torts against the community estate could be alleged against a third-party. As a general matter, they clearly can; if a third party steals community property, surely either spouse or both can seek recovery in tort for it.

But the question presented here is a narrower one: whether a third party can be held liable in tort when community property is taken by one of the spouses. We answered that question in the negative in *Cohrs v. Scott*. There, a divorcing wife settled all her property claims against her husband, and then sought damages against a third party for helping her husband transfer two cars to a mistress. This Court held that “the fraud having been initiated and carried out mainly by the husband, [the wife] must look primarily to him and his property to right the wrong.”

For several reasons, we believe that remains the proper rule. ...

Finally, the jury found that Chu knowingly participated, aided, or assisted Gyu in breaching his fiduciary duty to his former wife. Assuming such a claim exists and is somehow different from a conspiracy to breach his fiduciary duty, it too is excluded by *Schlueter* for the reasons noted above.” *Id.* at 445-47.

## SUING THIRD-PARTIES FOR FRAUD ON THE COMMUNITY

*Chu v. Hong* – “We hold the courts below erred in allowing one spouse to recover damages without first recovering the community property from the spouse who took it.” *Id.* at 443.

“[I]f one spouse can enlarge the community estate by suing the other’s relatives, many acrimonious divorce cases will undoubtedly become more so. That may be necessary when relatives have community property in their hands; but when they do not, little is gained by adding third parties if the property can be restored through orders between the former spouses. . . . *Schlueter* requires Hong to seek restitution from her own husband before seeking it from someone else’s lawyer.” *Id.* at 446.

*Barnett v. Barnett* (Tex. 2001) (not a divorce) – H replaced W with his mother as beneficiary of a community property life insurance policy. H died, and the policy proceeds were paid to the mother. W sued H’s mother for fraud on the community.

Under Texas law, Marleen Barnett has a cause of action for fraud on the community. Neither Dora nor any of the other defendants challenged the court of appeals’ holding that a fraud on the community occurred in this case. Marleen’s state-law remedy is to impose a constructive trust on one half of the proceeds of the Prudential policy that insured the life of her estranged husband.



## UNJUST ENRICHMENT/ CONSTRUCTIVE TRUST

*Hubbard v. Shankle*, 138 S.W.2d 474, 485 (Tex. App.—Fort Worth 2004, pet. denied): “A constructive trust is an equitable remedy created by the courts to prevent unjust enrichment. ... To establish that a constructive trust exists, the proponent must prove (1) breach of a special trust, fiduciary relationship, or actual fraud; (2) unjust enrichment of the wrongdoer; and (3) tracing to an identifiable res. ... While the form of a constructive trust is practically without limit, its existence depends upon the circumstances. ... Whether a constructive trust should be imposed at all is within the discretion of the trial court. ... The proponent of a constructive trust must strictly prove the elements necessary for the imposition of the trust.

## PJC 206.5A FRAUD ACTION AGAINST NONSPOUSE PARTY—INSTRUCTION

“A person commits fraud if that person participates with a spouse in a transfer of community property 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.”

## PJC 206.5B FRAUD ACTION AGAINST NONSPOUSE PARTY—QUESTIONS

### Question 1

Did *NONSPOUSE PARTY* commit fraud with respect to the *community-property* rights of *SPOUSE B*?

Answer “Yes” or “No.”

Answer: \_\_\_\_\_

If you have answered Question 1 “Yes,” then answer Question 2. Otherwise, do not answer Question 2.

### Question 2

What sum of money, if paid now in cash, would fairly and reasonably compensate the *community estate* for the damages, if any, resulting from *NON-SPOUSE PARTY*’s fraud?

Answer in dollars.

Answer: \$ \_\_\_\_\_”

# HANDLING TRUSTS UPON DIVORCE

# TYPES OF TRUSTS

## Express Trusts

- Revocable Trust
- Irrevocable Trust
- Self-Settled Trust
- Defective Grantor Trust
- “Trust” Account

## Resulting Trusts

## Constructive Trusts

# EXPRESS TRUSTS

- “‘Express trust’ means a fiduciary relationship with respect to property which arises as a manifestation by the settlor of an intention to create the relationship and which subjects the person holding title to the property to equitable duties to deal with the property for the benefit of another person.” Tex. Prop. Code § 111.004(4).
- An express trust is a relationship, not an entity.
- The trustee holds legal title for the benefit of the beneficiary.
- The beneficiary has a “beneficial interest” in the trust property. The terms of the beneficial interest are set out in the trust instrument.
- The beneficial interest is an equitable right that can be separate or community property.
- The trustee usually has broad discretion to manage assets and make distributions, but can be sued by the beneficiary for abuse of discretion.
- In recent years, the trustee and the beneficiary are often the same person (wearing different hats at same time). The typical standards governing distributions to beneficiaries are best interest of the beneficiary vs. HEMS.
- Trust instruments can have forum selection, choice-of-law, jury or waiver, and arbitration provisions.

# REVOCABLE TRUSTS

- In Texas, all trusts are revocable unless made irrevocable in writing.
- A revocable trust is a full-fledged trust until revoked; becomes nonrevocable upon death.
- Can be revoked or amended at will by the settlor. Estates Code § 112.051(a).
- If created by written instrument, can be amended or revoked only in writing. Section 112.051(c).
- If the trust instrument does not specify how revocation can occur, no specific procedure need be followed as long as intent to revoke is manifestly clear.
- Can have one or both spouses as settlors, trustees, and beneficiaries (consider fiduciary duties).
- Trust can require consent of both spouses to revoke.

## REVOCABLE TRUSTS UPON DIVORCE

- Marital property rights are governed by trust rules while the trust is in effect.
- Distributed income may be com. prop. under *Sharma v. Routh* test (because settlor has present possessor right to trust principal).
- Upon revocation, normal marital property rules (probably) apply to the recovered principal and income.
- Can divorce court order the trust to be revoked?
- Claims against trust and trust property (fraud, etc.)
- Remedies of resulting trust and constructive trust may apply.



# IRREVOCABLE TRUSTS

- No specific language is required to make a trust irrevocable, but that action must clearly reflect intent that the trust be irrevocable.
- Removes the trust property from the settlor's estate so it is not subject to estate tax.
- Trust cannot be revoked without the consent of the beneficiaries or through due process of law.
- Donative transfers of property into an irrevocable trust are gifts and are subject to IRC's reporting requirements for gifts.
- Trust can be designed to be "defective" so that income on trust property is taxed to the settlor (e.g., by retaining power to substitute trust property, etc.).
- Can contain a spendthrift clause insulating trust assets from the beneficiary's creditors' claims.
- Powers of appointment; beneficiary withdrawal rights.

# IRREVOCABLE TRUSTS UPON DIVORCE

- Rights of other current and remainder beneficiaries must be considered.
- Charitable (notice to Attorney General) or minor (need ad litem) beneficiaries.
- Interest in other entities may be impacted (could trigger buy-sell provisions).
- Non-spouse trustee may not agree to spouses' settlement terms.
- Claims can be brought against the trustee (to invalidate the entire trust) or against specific trust assets (e.g., fraud, constructive fraud, fraudulent transfer, imposition of resulting or constructive trust, etc.), raising *Chu v. Hong* questions.
- Income tax and estate tax effects when unwinding or altering estate plan.
- Consent versus litigation: different paths to different places.

## SUING TO TERMINATE OR MODIFY IRREVOCABLE TRUSTS

- Forum: state, county court
- Conflict of Laws
- Parties: necessary, permissible
- Failure in mechanics of creation
- Passive or dry trust; illusory trust; colorable trust
- Retaining too much control; alter ego
- Rescission, cancellation, reformation of trust for fraud, duress, mistake
- Judicial modification of trust terms
- Removal of trustee
- Removing assets from trust (fraud, constructive fraud, fraudulent conveyance, resulting or constructive trust)

## SELF-SETTLED TRUSTS

A trust is “self-settled” when:

- (i) the settlor and the beneficiary initially are the same person; or
- (ii) the trust was not originally self-settled, but the settlor and the beneficiary later become the same person.

An asset held in a non-self-settled trust may be treated as self-settled where the beneficiary transfers the asset to the trustee to hold in trust for the beneficiary.

A spendthrift provision in a self-settled trust does not protect the settlor/beneficiary’s assets from her creditors. Tex. Prop. Code § 112.035(d).

# INTENTIONALLY DEFECTIVE GRANTOR TRUSTS

- A trust is “defective” for income tax purposes if the settlor retains certain rights enumerated in the IRC
- A commonly retained right is the power to substitute assets held in trust
- Causes trust income to be taxed to the settlor; who has that burden after divorce?
- Issues with release of retained rights

# RESULTING TRUSTS

- “A resulting trust is based on the concept that the party who furnishes consideration for a purchase should receive equitable title. ... Due to its nature, a resulting trust must arise when legal title passed to the one on whom the trust is to be imposed.” *In re Marriage of Loftis*, 40 S.W.3d 160, 165 (Tex.App.--Texarkana 2001, no pet.).
- “A resulting trust is implied in law when someone other than the person in whose name title is taken pays the purchase price, or when an express trust failed. ... The doctrine of resulting trust is invoked to prevent unjust enrichment, and equitable title will rest with the party furnishing the consideration or trust property when an express trust fails. The trustee of a resulting trust, however, like the trustee of a passive trust, generally is responsible only for conveying the property to the beneficiary or in accordance with his directions.” *Nolana Dev. Ass’n v. Corsi*, 682 S.W.2d 246, 250 (Tex.1984).
- “Generally, the law is suspicious of resulting trusts, and consequently, a heavy burden of proof is placed on the party attempting to establish the existence of one.” *Hubbard v. Shankle*, 138 S.W.2d 474, 486 (Tex.App.—Fort Worth 2004, pet. denied).

# CONSTRUCTIVE TRUSTS

- A court can enforce “a constructive trust based upon the violation of a fiduciary duty and to prevent unjust enrichment. ... 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).
- “It is not essential for the application of the constructive trust doctrine that a fiduciary relationship exist between the wrongdoer and the beneficial owner. Actual fraud, as well as breach of a confidential relationship, justifies the imposition of a constructive trust.” *Meadows v. Bierschwale*, 516 S.W.2d 125, 128 (Tex. 1974) (party entitled to constructive trust on apartment complex is entitled to proceeds from sale of the apartment and any profit). “[A] constructive trust on unidentifiable cash proceeds is inappropriate. Even so, the award of a cash judgment to fully compensate [the plaintiff] is within the equitable powers of the court.” *Id.* at 129.

# “TRUST” ACCOUNTS

- A “trust account” is an account in the name of one or more parties as trustee for one or more beneficiaries. Tex. Estates Code § 113.004(5).
- Established by the form of the account and deposit agreement with the financial institution.
- Includes only the sums on deposit in the account.
- During the trustee’s lifetime, funds belong beneficially to the trustee, unless the terms of the account or deposit agreement “manifest a contrary intent,” or other clear and convincing evidence exists of “an irrevocable trust.”
- Trustee can terminate trust by changing the account designation or withdrawing the funds.
- If spouse places com. prop. funds in a “trust account” under her control they (probably) remain com. prop.
- Fraud, constructive fraud, fraudulent transfer, resulting trust, constructive trust, reconstitution all can apply.
- Can the court order the trustee to terminate the trust?



# ESTATE PLANNING DURING DIVORCE

- Estate planning lawyer has joint representation issues
- Altering survivorship and life insurance beneficiary designations
- Beware of restrictions in standing orders and temporary orders
- Can one spouse's will be unilaterally revoked and rewritten during divorce?
- Bifurcate existing estate plan to preserve past tax planning
- Contractual agreement for post-divorce wills
- Create life-estate in parent with remainder to children
- Trusts: amend, decant, or split; make distributions; exercise power of appointment withdrawal right

# ALTERING AN IRREVOCABLE TRUST

## COMMONLY USED METHODS

- Agreed judicial modification
- Full or partial rescission/reformation based on evidence of fraud, etc.
- Trustee exercises power to distribute assets
- Beneficiary exercises power of appointment or withdrawal right
- Decanting
- Payments in settlement of claims against trust or trust property

# DECANTING A TRUST

- Decanting is moving assets from existing trust to a new trust
- Decanting authorized by trust agreement
- Decanting under Texas Prop. Code §§ 112.072-112.087
- Decanting under the common law?
- Generally, cannot change alternate beneficiaries' rights
- However, trustee with full discretion can alter beneficiaries' rights; trustee with limited discretion cannot
- Notice to beneficiaries is required
- Conflict of Laws problems.

# THE TWO TRUSTS SOLUTION

Tex. Prop. Code §112.057 permits trustee to create two or more separate trusts without a judicial proceeding if:

- Not expressly prohibited by the trust document;
- The result does not impair the rights of any beneficiary;
- The result does not adversely affect achievement of the purposes of the original trust.
- Each spouse is given control of his/her trust
- Rights of contingent or remainder beneficiaries are not altered under the new trusts
- Preserves the tax benefits of the original trust
- Court approval not required, but may be advisable

# LITIGATING IRREVOCABLE TRUSTS

# THE COURT'S POWERS

- Interpret trust agreement
- Modify/terminate trust
- Review trustee's abuse of discretion
- Remove trustee
- Alter trustee's compensation
- Disgorge trustee's profits
- Appoint receiver/auditor
- Award money damages
- Temporary and permanent injunction
- Impose constructive/resulting trust
- Award attorney's fees (Tex. Prop. Code § 114.064)
- Divorce property division

# LEGAL MECHANICS

- What state? (minimum contacts; choice-of-forum clause, choice-of-law clause)
- What county? (divorce court vs. trustee's residence or situs of administration in past 4 years)
- What court? (district/statutory probate court; court that probates a testamentary trust)
- Standing/capacity (trustee, beneficiary, "any interested person," nec'y parties)
- Guardian/attorney ad litem for minors, absent parties, and unborn children
- Virtual representation of beneficiaries
- Estate planner as fact witness
- Arbitration provision



## STANDING/CAPACITY

- Tex. Prop. Code § 112.054(a): suit to replace trustee or modify, reform, or terminate a trust can be brought by a trustee or beneficiary (settlor is not included).
- Tex. Prop. Code §115.011: suit to intervene in the administration of a trust can be brought by “any interested person”.
- Beneficiaries can be parties, and must be joined if “necessary parties” under Tex. Prop. Code §115.001.
- Charitable trust notice to Attorney General who can intervene. Tex. Prop. Code § 123.003

# OTHER CONSIDERATIONS

## OVER-ARCHING QUESTIONS

- Who controls what entities and wealth, before and after divorce?
- Support needs during lifetimes.
- Is recovery for claims to the community estate?
- Jeopardizing estate plan; need for estate planning/tax advice.
- Rights & desires of next generation.
- Intrafamily dynamics.
- Original estate planner liability.

# FIDUCIARY DUTIES

## MARITAL FIDUCIARY DUTIES ARE UNIQUE

- The *Texas Family Code* does not say that a relationship of trust exists between spouses, or that spouses owe each other fiduciary duties.
- The view that a fiduciary relationship exists between spouses arises from multiple court of appeals opinions.
- This case law is reflected in the SBOT's Pattern Jury Charge (Family, Probate).
- Several cases say that fiduciary duty ends upon divorce. But TFC §9.011(b) creates fid. obligation for subsequently-received property awarded to the other spouse in the divorce decree.

## COMMENTS FROM COURTS OF APPEALS

- “[T]he marital relationship is a fiduciary one.”
- “A fiduciary duty exists between spouses.”
- “Husbands and wives generally owe a fiduciary duty to one another.”
- “A confidential relationship does exist between a husband and his wife.”
- “A fiduciary duty exists between a husband and a wife as to the community property controlled by each spouse.”

## FIDUCIARY DUTY REGARDING COMMUNITY PROPERTY

- Sole and joint management community property can be expended however the controlling spouse wishes, as long as it doesn't constitute a fraud on the other spouse.
- “Fraud on the community” has unique standards. In a divorce you must first seek remedy through the property division and “reconstituting” the community estate; only if inadequate can you sue third parties.
- Taking or conveying the other spouse's separate property is actionable by normal standards of theft, conversion, fraud, constructive fraud, etc.

## OTHER SOURCES OF DUTIES BETWEEN SPOUSES

- Power of *Attorney/Agency*
- Attorney-Client relationship for lawyer-spouse
- Financial manager for other spouse
- Controlling vs. minority owner of business
- Duties of partners
- Duty of full disclosure of material facts
- Partial disclosure creating duty to disclose fully
- Relationship of trust and confidence



## DUTY OF OBEDIENCE

- Must avoid acts beyond the scope of powers granted in the corporate charter and bylaws, company agreement, partnership agreement, or trust agreement.

## DUTY OF LOYALTY

- \* Agent must act solely for the benefit of the principal within the scope of agency.
- \* Trustee must invest and manage assets “solely in the interest of beneficiary”. Tex. Prop. Code § 117.007.
- Corporate directors and officers must act in good faith; personal interests cannot prevail over interests of corporation.
- Partners must account for partnership property; refrain from dealing on behalf of others with interest adverse to partnership; refrain from competing or dealing in a manner adverse to partnership.

## DUTY OF GOOD FAITH

- Trustee: must administer trust in good faith in accordance with the trust instrument and the Property Code.
- Corporate officers and directors must discharge duties in good faith (but not up to the standards of a trustee).
- Partners have an “obligation” to act in good faith.

## DUTY OF CARE

- Trustee must invest and manage assets “prudently”; use “reasonable care, skill and caution”.
- Corporate officer and director must use ordinary care.
- Partners must use the care of an ordinarily prudent person, TBOC § 152.205.

## DUTY OF DISCLOSURE

- Arm's-length transaction: no duty to disclose except to rectify an inaccurate partial disclosure or a prior disclosure that has become inaccurate.
- Fiduciary: strong duty to disclose.
- Trustee: duty of full disclosure of all material facts known to trustee that might affect the beneficiary's rights.

## NO SELF-DEALING BY FIDUCIARY

- Agent: must account to principal for profits.
- Trustee: no loans, purchases, or sales to trustee or related parties (unless allowed by trust instrument); don't commingle trust funds with trustee's funds.
- Corporation: corporate opportunity doctrine; loans to directors and officers are voidable.
- Partnership: conduct partnership business for the benefit of partnership.

# OFFICERS' DUTIES TO CORPORATIONS

- Duty of Obedience
- Duty of Loyalty
- Duty of Care
- OK to rely on certain others
- Duties to creditors
- Duty to provide oversight
- Internal Affairs Doctrine, TBOC §1.101 & §1.102.

## PARTNERS' DUTIES INSIDE GENERAL PARTNERSHIPS

- Duty of Loyalty, TBOC § 152.205.
- Obligation of good faith, TBOC § 152.204(b).
- Duty of care, TBOC § 152.206(a).
- Breach of partnership agreement or statutory duty, TBOC § 152.210.
- No duty to remain partners, *Bohatch v. Butler & Binion*, 977 S.W.2d 543, 545 (Tex. 1998).
- Future fiduciary duties can be specified in settling a divorce w. co-ownership.



## FIDUCIARY DUTIES INSIDE LIMITED PARTNERSHIPS

- General Partner: duties of loyalty, care, good faith.
- Limited Partner: no duties except possibly loyalty; full duties if assumes management.
- The partnership agreement can create contractual duties or alter statutory or common law fiduciary duties.
- Informal fiduciary relationships can exist between partners that create common law duties.
- Future fiduciary duties can be specified in settling a divorce w. co-ownership.

# STATUTORY FIDUCIARY DUTIES OF TRUSTEE OF AN EXPRESS TRUST

## I. Statutory Duties and Prohibitions:

- Duty of Good Faith, subject to statutory rules, common law, and trust agreement, TPC § 113.051
- Duty of Care, TPC § 117.003(a)
- Duty to Diversify, TPC § 117.005
- Duty of Loyalty, TPC § 117.007
- Duty of Impartiality, TPC § 117.008

## OTHER FIDUCIARY DUTIES OF TRUSTEE OF AN EXPRESS TRUST

### 2. Common Law Duties:

- Subject to statute; subject to trust instrument
- Duty of care, skill, prudence, and diligence ordinarily prudent man with similar business and similar objectives. *Varity Corp. v. Howe*, 516 U.S. 489, 497 (1996)
- No duty to violate law

### 3. Duties under the trust document

### 4. Trustee's discretion can be broad

## INFORMAL FIDUCIARY RELATIONSHIPS

- “[W]here one person trusts in and relies upon another, whether the relation is a moral, social, domestic, or merely personal one.” *Fitz-Gerald v. Hull* (Tex. 1951).
- In those cases “in which influence has been acquired and abused, in which confidence has been reposed and betrayed.” *Texas Bank & Trust Co. v. Moore* (1980).
- “A relationship of trust and confidence.” PJC 104.1
- “[T]he existence of a confidential relationship is ordinarily a question of fact.” *MacDonald v. Follett* (Tex. 1944).
- Requires fact finding that a fiduciary or confidential relationship exists.

# REMEDIES FOR BREACH OF FIDUCIARY DUTY

- Rescission
- Damages (actual & exemplary)
- Unjust Enrichment
- Disgorgement
- Injunction
- Receiver
- Constructive Trust

## NON-DISCHARGE IN BANKRUPTCY

- Bankruptcy Code § 523(a)(2), obtaining money, property, services or credit through:
  - (A) false pretenses or representations, or actual fraud, other than a statement of financial condition;
  - (B) a materially false written statement regarding financial condition, published with the intent to deceive and reasonably relied upon.
- Section 523(a)4: “Fraud or defalcation while acting in a fiduciary capacity.”

THANK YOU!