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Marital Property Issues in Drafting Estate Planning Documents

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Marital Property Issues in Drafting Estate Planning Documents

By

Randall B. Wilhite

I. The Maze.

Any attorney assisting his or her client with estate planning documents needs to be aware of the potentially hidden land mines associated with marital property issues. This is particularly true because divorce professionals often find themselves unraveling, or attempting to unravel, a myriad of trusts and entities formed by clients with the help of their estate planning attorneys. This paper addresses the marital property issues that can arise in various estate planning documents and also describes some of the challenges that divorce professionals may make to trusts and entities and how to limit the effectiveness of those challenges.

II. Definition of Separate Property.

Separate property is defined by the Texas Constitution, Art. XVI, § 15, as follows:

> "Section 15. All property, both real and personal, of a spouse owned or claimed before marriage, and that acquired afterward by gift, devise or descent, shall be the separate property of that spouse; and laws shall be passed more clearly defining the rights of the spouses, in relation to separate and community property; provided that persons about to marry and spouses, without the intention to defraud pre-existing creditors, may by written instrument from time to time partition between themselves all or part of their property, then existing or to be acquired, or exchange between themselves the community interest of one spouse or future spouse in any property for the community interest of the other spouse or future spouse in other community property then existing or to be acquired, whereupon the portion or interest set aside to each spouse shall be and constitute a part of the separate property and estate of such spouse or future spouse; spouses may also from time to time, by written instrument, agree between themselves that the income or property from all or part of the separate property then owned or which thereafter might be acquired by only one of them, shall be the separate property of that spouse; if one spouse makes a gift of property to the other that gift is presumed to include all income or property which might arise from that gift of property; and spouses may agree in writing that all or part of their community property becomes the property of the surviving spouse on the death of a spouse; and spouses may agree in writing that all or part of the separate property owned by either or both of them shall be the spouses' community property."

A. The Constitution (not the Legislature) Governs the Characterization of Property.

In 1917, the Legislature defined income from separate property to be the separate property of the owner spouse. Act of April 4, 1917, ch. 194, § 1, 1917 Tex. Gen. Laws 436. The Texas Supreme Court, however, reminded the Legislature that the constitution defined the marital character of property, not the Legislature. In *Arnold v. Leonard*, 114 Tex. 535, 273 S.W. 799 (1925), the supreme court held that the Legislature did not have the constitutional authority to characterize the income from separate property as the owner's separate property. The court explained that the Legislature's authority was limited to enacting laws regulating the management and liability of marital property, not its separate or community character. *Id*. at 805. This landmark decision strengthened the constitutional principle that the Legislature may not define what is community and separate property in a manner inconsistent with article 16, section 15 of the Texas Constitution. *See generally, e.g.,* Thomas M. Featherston, Jr. & Julie A. Springer, *Marital Property Law in Texas: The Past, Present and Future*, 39 Baylor L. Rev. 861 (1987) (tracing, throughout the entire article, the evolution of marital property law from 1845 to 1987). As to the rule of 'implied exclusion,' the court stated:

> [I]t is a rule of construction of Constitutions that ordinarily, when the circumstances are specified under which any right is to be acquired, there is an implied prohibition against the legislative power to either add to or withdraw from the circumstances specified. . . . Hence, when the Constitution says that as to property, not owned or claimed by the wife at marriage, it becomes her separate property when acquired in one of three specified modes, the legislature is prohibited from saying that property acquired after marriage in some other mode may also become the wife's separate property.

Id. at 802. "In nullifying the 1917 reform, which made income from separate property separate, the court held that the constitutional provision on marital property was the sole source of the definition of that estate. By necessary implication, the constitution thus required that any property not specifically defined as separate property was community." Joseph W. McKnight, *Texas Community Property Law: Conservative Attitudes, Reluctant Change*, 56 Law & Contemp. Probs. 71, 71 (1993) (stating that "[r]eform of Texas family property law has been significantly restrained by the conclusion of the Supreme Court of Texas in 1925 that the marital property system is constitutionally defined" and that "[w]ithout the decision of 1925, ... the system could have developed very differently"). "The decision [in *Arnold v. Leonard*] that the [statutory enlargement of separate property was] in part invalid was based upon the conclusion that the people intended in adopting the Constitution to put the matter of the classes of property constituting [a spouse's] separate estate beyond legislative control and that the Legislature can neither enlarge nor diminish that property as defined in the Constitution." *Bearden v. Knight*, 228 S.W.2d 837 (Tex. 1950).

B. The Acquisition of Separate Property in Defiance of Article 16, Section 15.

In the case of *Graham v. Franco*, 488 S.W.2d 390 (Tex. 1972), the Texas Supreme Court cast a great deal of doubt on the doctrine of 'implied exclusion' by limiting *Arnold* to its specific holding. *Id*. at 392. In any event, it has long been recognized that there are numerous means by which separate property may be acquired in defiance of the article 16, section 15 definition stated above. A partial list includes mutations of separate property, increases in value of separate land and personalty, recovery for personal injury not measured by loss of earning power, improvements of separate land with an unascertainable amount of community funds, and United States securities purchased with community funds. *See* McKnight, Book Review, 46 Tex. L. Rev. 297, 301-02 (1967) (reviewing W. Huie, *Texas Cases and Materials on the Law of Marital Property Rights* (1966).

C. If Traced, Mutations of Separate Property are Separate Property.

Although such property may undergo changes or mutations, as long as it is traced and properly identified it will remain separate property. *Norris v. Vaughan*, 260 S.W.2d 676, 679 (Tex. 1953). *See also Beck v. Beck*, 814 S.W.2d 745 (Tex. 1991), cert. denied, 503 U.S. 907 (1992); *Jensen v. Jensen*, 665 S.W.2d 107 (Tex. 1984); *Vallone v. Vallone*, 644 S.W.2d 455 (Tex. 1982); *Daniel v. Daniel*, 779 S.W.2d 110 (Tex. App.-Houston [1st Dist.] 1989, no writ); *Marshall v. Marshall*, 735 S.W.2d 587 (Tex. App.-Dallas 1987, writ ref'd n.r.e.).

D. Tex. Fam. Code § 3.001.

> "A spouse's separate property consists of:
>
> (1) the property owned or claimed by the spouse before marriage;
>
> (2) the property acquired by the spouse during marriage by gift, devise, or descent; and
>
> (3) the recovery for personal injuries sustained by the spouse during marriage, except any recovery for loss of earning capacity during marriage."

E. Property Owned or Claimed Before Marriage, Inception of Title.

The terms "owned and claimed" as used in the Constitution and the Tex. Fam. Code mean that where the right to the property accrued before the marriage, the property would be separate, even though the legal title or evidence of the title might not be obtained until after marriage. Inception of title occurs when a party first has a right of claim to the property by virtue of which title is finally vested. *Welder v. Lambert*, 44 S.W. 281 (Tex. 1898). Under the Inception of Title Doctrine, the character of property, whether separate or community, is fixed at the time of acquisition. *Henry S. Miller Co. v. Evans*, 452 S.W.2d 426 (Tex. 1970). Acquiring an ownership interest or claim to property refers to the inception of the right, rather than the completion or ripening thereof. The existence or non-existence of the marriage at the time of incipiency of the right of which title finally vests determines whether property is community or separate. *Creamer v. Briscoe*, 109 S.W. 911 (Tex. 1908). Inception of title occurs when a party first has a right of claim to the property. Thus, land acquired by an earnest money contract that is signed prior to the marriage but the deed is not acquired until after the marriage, is separate property.

F. The Inception of Title Rule has been Codified by Tex. Fam. Code § 3.006.

"If the community estate of the spouses and the separate estate of a spouse have an ownership interest in property, the respective ownership interests of the marital estates are determined by the rule of inception of title." Tex. Fam. Code § 3.006. Section 3.006 does not change the law about the inception of title rule, but simply codifies the inception of title rule as it has evolved from Texas case law over many years of Texas jurisprudence.

III. Community Property.

There is no definition of community property in the Texas Constitution. The Tex. Fam. Code and case law define community property as follows: "Community property consists of the property, other than separate property, acquired by either spouse during marriage." Tex. Fam. Code § 3.002; *Douglas v. Delp*, 987 S.W.2d 879, 882 (Tex. 1999).

A. Presumption of Community.

Tex. Fam. Code § 3.003 states that all property possessed by either spouse during or at the dissolution of the marriage is presumed to be community property and that the degree of proof necessary to establish that property is separate property, rather than community property, is clear and convincing evidence. Based on the fact that the Texas Constitution and the Tex. Fam. Code specifically delineate and define what is separate property, if property cannot be proved to be separate property within the definition by clear and convincing evidence, it is community property. By deductive reasoning, if property does not fit the definition of separate property, it is community property.

B. Quasi-Community Property.

Tex. Fam. Code § 7.002 deals with quasi-community property and requires that a court divide property at divorce or annulment as community property, wherever the property is situated, if (1) the property was acquired by either spouse while domiciled in another state and the property would have been community property if the spouse who acquired the property had been domiciled in Texas at the time of the acquisition; or (2) property was acquired by either spouse in exchange for real or personal property and that property would have been community property if the spouse who acquired the property so exchanged had been domiciled in Texas at the time of the acquisition. Sometimes this property is referred to as quasi-community property. It is treated as community property for purposes of division in a divorce or annulment, even though it is considered separate property for probate purposes. Quasi-community property is inapplicable in probate proceedings. *Estate of Hanau*, 730 S.W.2d 663 (Tex. 1987).

IV. Characterization Generally.

Characterization of property is a process of identifying the property owned by the spouses as separate property or community property. Property possessed by either spouse during or on dissolution of marriage is presumed to be community property. Tex. Fam. Code § 3.003(a). *Tate v. Tate*, 55 S.W.3d 1, 4 (Tex. App. – El Paso 2000, no writ). The degree of proof necessary to rebut the community property presumption and establish that property as separate property is clear and convincing evidence. § 3.003(b). Only community property is subject to the trial court's "just and right" division. *Cameron v. Cameron*, 641 S.W.2d 210, 220 (Tex. 1982). Separate property is confirmed to the owner of the separate property. The court shall divide the community property of the parties in a manner that the court deems just and right, having due regard for the rights of each party and any children of the marriage. Tex. Fam. Code § 7.001. The appellate court will reverse a trial court if a trial court mischaracterizes separate property as community property and does not award separate property to the owner thereof. *Eggemeyer v. Eggemeyer*, 554 S.W.2d 137, 140 (Tex. 1977). *Tate v. Tate*, *supra* at p. 6.

A. The Burden of Proof.

To rebut the community-property presumption, a party must present "clear and convincing" evidence of the property's separate character. Tex. Fam. Code §3.003(b); *see McKinley v. McKinley*, 496 S.W.2d 540, 543-44 (Tex. 1973). The clear-and-convincing standard requires evidence on which "a reasonable trier of fact could have formed a firm belief or conviction that its finding was true." *Stavinoha v. Stavinoha*, 126 S.W3d 604, 607 (Tex. App. – Houston [14th Dist.] 2004, no pet.). Because of this heightened evidentiary standard, a spouse generally will have to use both testimonial and documentary evidence to support her claim of separate property. *See, e.g., Boyd v. Boyd*, 131 S.W.3d 605, 616-17 (Tex. App. – Fort Worth 2004, no pet.) (H's testimony, without specific tracing or corroborating evidence, was not clear and convincing evidence). The evidence presented should establish the time and manner the property was acquired (inception of title) and all of its mutations (tracing). But minor gaps in the tracing and corroboration of an asset's transactional history will not necessarily prevent a spouse from establishing her separate-property claim by clear and convincing evidence. *See, e.g., Faram v. Gervitz-Faram*, 895 S.W.2d 839, 843-44 (Tex. App. – Fort Worth 1995, no writ) (incomplete records on investment accounts); *Newland v. Newland*, 529 S.W.2d 105, 108-09 (Tex. App. – Fort Worth 1975, writ dism'd) (documentary evidence of "factual resegregation" of separate property existed only for most of period involved). Above text quoted from Beckman, Sydney Aaron and Wilhite, Randall Benton, *O'Conner's Texas Family Law Handbook*, ch. 2A §6, p 80 (Jones McClure Publishing 2012).

1. Expert Testimony.

Expert testimony can be used to establish the character of property. *See, e.g., Beard v. Beard*, 49 &W.3d 40, 61-62 (Tex. App. – Waco 2001, pet. denied) (CPA traced and characterized W's separate property by using community-out-first method). Experts are often used to characterize property in complex cases when cash assets have been commingled in different financial accounts with community property and when the property itself is of a unique nature. *See, e.g., Loaiza a Loaiza*, 130 S.W.3d 894, 906-07 (Tex. App. – Fort Worth 2004, no pet.) (expert testified about character of baseball contract); *Welder v. Welder*, 794 S.W.2d 420, 429 (Tex.App. – Corpus Christi 1990, no writ) (experts used to trace deposits and withdrawals from spouses' joint account). Experts used to characterize marital property are subject to the same qualification rules that apply to experts in civil cases generally. *See* Tex. R. Evid. 702. Above text quoted from *O'Conner's Texas Family Law Handbook* ch. 2A §6.1, p 80.

2. Lay Testimony.

A spouse is competent to testify about the character of her property. Because a spouse is an interested witness, in most cases the testimony of a spouse will have to be corroborated by other evidence (i.e., the testimony of another witness or documentation) to rebut the community property presumption. *See, e.g., Bahr v. Kohr*, 980 S.W.2d 723, 730 (Tex.App. – San Antonio 1998, no pet.) (testimony that proceeds from bank account were separate was insufficient without documentation showing date account was opened, its beginning balance, and debits and credits to account); *Robles v. Robles*, 965 S.W2d 605, 620 (Tex.App. – Houston fist Dist.J 1998, pet. denied) (testimony that property was purchased with inheritance was insufficient without copy of will); *Johnson v. Johnson*, 804 S.W2d 296, 300 (Tex. App. – Houston fist Dist.) 1991, no writ) (testimony that guns were inherited from father was insufficient without documentation distinguishing those guns from other guns listed on inventory). Whether uncorroborated testimony of a spouse will be sufficient to constitute clear and convincing evidence depends on whether the spouse's testimony is contradicted and how clear, direct, and positive the spouse's testimony is. Above text quoted from *O'Conner's Texas Family Law Handbook* ch. 2A §6.1, p 81.

a. Uncorroborated & Contradicted.

A spouse's uncorroborated testimony that is contradicted will not be sufficient to constitute clear and convincing evidence. *See Pace v. Pace*, 160 S.W3d 706, 714 (Tex. App.—Dallas 2005, pet. denied); *Robles*, 965 S.W2d at 620. Above text quoted from *O'Conner's Texas Family Law* Handbook ch. 2A §6.1, p 81.

b. Uncorroborated & Uncontradicted.

Generally, a spouse's uncorroborated and uncontradicted testimony will not be sufficient to constitute clear and convincing evidence. *See Boyd*, 131 S.W3d at 617; *Robles*, 965 S.W2d at 620; *Kirtley v. Kirtley*, 417 S.W2d 847, 853 (Tex. App. – Texarkana 1967, writ dism'd). But when the testimony of an interested party is uncontradicted and is clear, direct, positive, and free from inaccuracies, and when there are no circumstances tending to cast suspicion on it, the testimony is taken as true as a matter of law. *Cochran v. Wool Growers Central Storage Co.,* 166 S.W2d 904, 908 (Tex.1942). This exception to the interested-witness rule is more compelling when the opposing party has the means and opportunity of refuting the testimony but does not do so. *See Collora v. Navarro*, 574 S.W2d 65, 69 (Tex.1978). Several appellate courts have found a spouse's uncorroborated and uncontradicted testimony to be sufficient to constitute clear and convincing evidence. *See Pace*, 160 S.W.3d at 714; *Vannerson v. Vannerson*, 857 S.W2d 659, 668 (Tex. App. – Houston [1st Dist.] 1993, writ denied). Above text quoted from *O'Conner's Texas Family Law Handbook* ch. 2A §6.1, p 81.

c. Specific Examples.

A witness may testify concerning the source of funds in a bank account without producing bank records of the deposits. *Holloway v. Holloway*, 671 S.W.2d 51, 56 (Tex. App. – Dallas 1983 writ dism'd).

"The mere fact that the proceeds of the sale were placed in a joint account does not change the characterization of the separate property assets. The spouse that makes a deposit to a joint bank account of his or her separate property does not make a gift to the other spouse." *Celso v. Celso*, 864 S.W.2d 652, 655 (Tex. App. – Tyler 1993, no writ). *See also Higgins v. Higgins*, 458 S.W.2d 498, 500 (Tex. Civ. App. – Eastland 1970, no writ).

Mere testimony that property purchased with separate property funds, without any tracing of the funds, is generally insufficient to rebut the community property presumption. *McElwee v. McElwee*, 911 S.W.2d 182, 188 (Tex. App. – Houston [1st Dist.] 1995, writ denied).

In *Harris v. Venture*, the only evidence in the record with reference to two disputed accounts by the party claiming the funds were her separate property was her statement that the source of the funds was "some was gifts and some may have been my social security check. I don't remember." The court held that this testimony was no more than a scintilla of proof of the vital fact needed to be provided, i.e., that the accounts consisted of money acquired in one of the ways recognized to create separate property, and therefore the proponent did not carry her burden of proof. *Harris v. Venture*, 582 S.W.2d at 856. Note also that the testimony of an interested witness without corroboration, even when uncontradicted, only raises an issue of fact and is not conclusive. *Purser v. Purser*, 604 S.W.2d 411, 413 (Tex.Civ. App.-Texarkana 1980, no writ). *See also Hilliard v. Hilliard*, 725 S.W.2d 722, 723 (Tex. App. – Dallas 1985, no writ);

3. Documentation.

In most cases, documentation will need to be presented in addition to expert and lay testimony to rebut the community-property presumption. The most important documents are those establishing the time and manner in which the property was acquired and any later sales or exchanges of the property. *See, e.g.*, *Balir*, 980 S.W2d at 730 (to prove character of proceeds in bank account, spouse should have provided documentation showing date account was opened, its beginning balance, and debits and credits to account); *Robles*, 965 S.W2d at 620 (to prove property was purchased with inheritance, spouse should have provided copy of will). Above text quoted from *O'Conner's Texas Family Law Handbook* ch. 2A §6.1, p 81.

V. Mixed Title Property.

When property is acquired during the marriage partly with community property funds and partly with separate property funds (which can be clearly traced) the property is of mixed characterization, being partially separate property and partially community property, to the extent and in the proportion that the property was purchased with separate property funds and with community property funds. *Cook v. Cook*, 679 S.W.2 581, 583 (Tex. App. – San Antonio 1984, no writ). Similarly, if a purchase is made partly with separate property and partly with community property credit, the separate and community estates own the property as tenants in common. *Cockerham v. Cockerham*, 527 S.W.2d 162 (Tex. 1975). Each estate owns an undivided interest in the proportion that it supplies to the consideration. *Gleich v. Bongio*, 99 S.W.2d 881, 883 (Tex. 1937); *Jacobs v. Jacobs*, 669 S.W.2d 759, 763 (Tex. App. – Houston [14th Dist.] 1984, aff'd in part, 687 S.W.2d 731 (Tex. 1985)); *Scott v. Scott*, 805 S.W.2d 835, 838 (Tex. App. – Waco 1991, writ denied).

VI. Marital Property Issues in Provisions in Estate Planning Documents in Favor of Spouse.

Wills, trust agreements, and powers of attorney commonly include provisions appointing a spouse as a fiduciary or, in the case of Wills or trust agreements, naming a spouse as a beneficiary. Under Texas law, provisions in a Will or power of attorney in favor of a spouse are effectively revoked in the event of divorce. Tex. Est. Code §§ 123.001, 751.053; Tex. Health & Safety Code § 166.155. However, the divorce must be final for the revocation to be effective, meaning these documents should be reviewed and, if necessary, modified earlier in the process than the final decree of divorce. In addition, the Texas Trust Code does not contain similar provisions for an irrevocable trust naming a spouse as a fiduciary or beneficiary. Therefore, consider including provisions in a trust agreement like those contained in Appendix 1.

VII. Grantor Trusts, Powers of Substitution, and Other Powers.

Generally speaking, an intentionally defective grantor trust is a trust over which the grantor of the trust (i.e., the person who funded the trust) is deemed to have retained enough control to cause the grantor to be treated for federal income tax purposes as the owner of the trust assets. As a result, the grantor of the trust (rather than the trustee or beneficiary of the trust) will be personally responsible for all items of income attributable to the assets held in the trust. Thus, for example, if one of the assets held in the trust is Exxon stock, any dividends paid on that Exxon stock will pass to the trustee to be held in the trust or distributed to the beneficiary, but the grantor of the trust (who will not receive any portion of the dividends) will be required to report the dividends on his or her income tax return as if the grantor held the Exxon stock and received the dividend. Thus, the grantor will be responsible for paying the income taxes on that dividend from the grantor's personal assets instead of being able to look to the dividends or any other trust assets to satisfy the income tax.

Creating a grantor trust for the benefit of children or others is a wonderful estate planning technique. The grantor not only funds the trust initially, but then is required to pay all of the income taxes attributable to trust assets. Paying someone else's gift taxes feels like a gift (both to the grantor, who has assets coming out of his or her pocket, and to the beneficiaries of the trust, who receive the benefit of seeing the assets in the trust grow income-tax free). However, under the Internal Revenue Code, the grantor is required to pay these taxes, and, therefore, the benefit received by the trust beneficiaries is not a gift.

Sometimes, however, an estate planning technique can be too good. Estate planners want to reduce the size of the grantor's estate, but not bankrupt their client entirely. If the trust holds very low basis assets that the trustee decides to sell in one fell swoop, the client could be facing a very large tax bill, with no assets available to pay that bill. Thus, clients who create grantor trusts need to keep a careful eye on the asset mix in the trust and the trustee's investment plans. If it appears that an income tax event is looming, the client may wish to consider releasing the power or powers that cause the trust to be treated as a grantor trust. One issue to consider is whether the powers that cause the trust to be treated as a grantor trust, and the means of releasing those powers, should be exercisable by each spouse acting alone or by the spouses jointly, and whether anything should change in the event of divorce. For example, assume that a grantor trust was created by a married couple and funded with community property, meaning each spouse is a "grantor" of the trust. Should each spouse have the ability to substitute assets of the trust for other assets of equivalent value or should the spouses have to decide to exercise that power jointly? What if one spouse wishes to release the power and the other does not? There likely is no right or wrong answer, but consider the language included in Appendix 2 when advising clients on these issues.

As an alternative to dealing with the sticky issues associated with a married couple being the joint grantors of one trust, a married couple could partition assets (see the next section below for additional issues to consider with respect to partition agreements) before each creates a separate grantor trust. Under this approach, each of the spouses can decide for himself or herself when to exercise or release the powers that cause the trust to be treated as a grantor trust. The spouses may decide together that they can afford to continue the grantor trust status of one, but not both, trusts. Partitioning community property into separate property and then having each spouse create one trust affords them the flexibility to do so, at the cost of creating multiple, and potentially duplicative, trusts for their descendants, thereby increasing the administrative cost and hassle associated with the inheritance.

Another reason that married clients might wish to partition property in order to create separate grantor trusts relates to the treatment of a grantor trust created by two grantors upon the death of one of the grantors. In that case, it may be that upon the death of the first grantor to die, the trust will be treated as partially grantor (as to that part of the trust created by the surviving grantor) and partially non-grantor (as to that part of the trust created by the decedent grantor). The analysis that must occur upon the death of the first grantor to die, and the potentially complicated administration of the trust on a go forward basis, is one reason why married clients might wish to partition community property into separate property before creating grantor trusts. If they do so, each spouse will be the grantor as to one trust, meaning that upon the death of the first spouse, the trust created by that spouse is no longer a grantor trust, while the trust created by the surviving spouse simply continues on as a grantor trust.

VIII. Marital Property Issues in Partition Agreements.

As referenced above, a married couple might wish to partition community property in order to allow each of them to create a separate grantor trust. Spouses can, at any time, partition or exchange between themselves all or part of the community property that they currently have or will acquire. Tex. Const. art. 16, §15; Tex. Fam. Code §4.102. Property or a property interest that is transferred to a spouse by a partition/exchange agreement becomes that spouse's separate property. Tex. Const. art. 16, §15; Tex. Fam. Code §4.102. The effect of a "partition agreement" or an "exchange agreement" is the same – converting community property into separate property. Courts generally refer to these agreements simply as "partition agreements."

Spouses can partition or exchange their present or future interest in real or personal community property, including income and earnings. Tex. Fam. Code §§4.001(2), 4.101. The property interest partitioned or exchanged can be legal or equitable and vested or contingent. Id.

Spouses can designate that future earnings or income generated by partitioned or exchanged property will become the separate property of the owning spouse. Tex. Fam. Code §4.102. But unless this specific designation is made, future earnings and income generated by the partitioned or exchanged property will remain community property. See id., Acts 2005, 79th Leg., R.S., ch. 477, §1, eff. Sept. 1, 2005 (Legislature deleted language in former Tex. Fam. Code §4.102 that automatically included future earnings and income as separate property).

Partition agreements should never be entered into lightly. A change in the characterization of property from community property to separate property should result in a real difference in the negotiation of the parties in any divorce proceeding and the division of the property. In any such change with respect to property that a spouse intends to keep, there is one party who benefits as a result, and one party does not. On the other hand, if a partition agreement is entered into solely with respect to property that the spouses intend to immediately give away, there should not be any significant impact on the division of property upon a divorce because the spouses have not retained the property. However, a common estate planning technique involves a sale to a defective trust. If spouses partition community property assets and each sells those assets to a separate defective trust in exchange for a note, consideration should be given to the character of the note payments that will be received by the selling spouse. Unless the partition agreement provides otherwise, the interest payments will be community property because, under Texas law, income on separate property is community property. Thus, the assets returned to the selling spouse in the form of interest payments have the same character (community property) as they would have had in the absence of the partition agreement (again, assuming the partition agreement does not provide that the income is separate property). Any return of principal, however, will be separate property, which is a change in what the property would have been had the partition agreement not been entered into. The consequences of that change need to be carefully considered before the spouses enter into a partition agreement.

IX. Marital Property Issues in Planning for Descendants and their Spouses.

A. Gifts to Children and Other Descendants.

As noted above, gifts are the separate property of the recipient under Texas law. Generally, that is the desired result for children and other descendants, and the only issue is whether the descendant will maintain the gift in such a way as to be able to provide that the assets are separate property in the event of a divorce, sometime in the future. To avoid this issue, a client may choose to create a trust for the benefit of the child or other descendant, as opposed to giving the property outright. However, a child's spouse may want to challenge a trust in the event of divorce. Care should be taken in the drafting, funding, and maintenance stages of the trust to limit the effectiveness of the specific challenges to a trust described below.

1. Elements of a Trust.

Make sure that the required elements of the creation of the trust have been met. This can include such basic requirements such as proper signature, express intent, and actual funding of the trust. An express trust can come into existence only by the execution of an intention to create it by the one having legal and equitable dominion over the property made subject to it.

2. Merger of Title.

Merger of title occurs when both the legal title to property and *all* of the equitable interests in that property are united in one person. Thus, "[i]f a settlor transfers both the legal title and all equitable interests in property to the same person . . ., a trust is not created and the transferee holds the property as his own." Tex. Trust Code § 112.034(a). Correspondingly, except in the case of a spendthrift trust, "a trust terminates if the legal title to the trust property and all equitable interests in the trust become united in one person." Tex. Trust Code § 112.034(b). In the case of a spendthrift trust, "title to trust property and all equitable interests in the trust property may not become united in a beneficiary, . . . and in that case the court shall appoint a new trustee or cotrustee to administer the trust for the benefit of the beneficiary." Tex. Trust Code § 112.034(c).

Depending on the character of the property, both corpus and income, an aggrieved spouse may be able to assert a claim of Merger of Title. Discretionary versus mandatory disbursements from the trust will also impact the success of the merger argument.

3. Failure to Distribute Pursuant to Terms of Trust.

Other claims which are not direct attacks on the validity of the trust will include those of failure of the trustee to comply with the terms of the trust to distribute the income and/or corpus. This will occur when the beneficiary spouse, though entitled to a distribution, has not received the property according to the terms of the trust.

B. Gifts to Spouses of Children and Other Descendants.

As is the case with gifts to descendants, gifts made to a daughter-in-law or son-in-law also are separate property. However, the client may not be pleased to learn that, in the event of a divorce, if the spouse can prove that the assets are separate property, the spouse will retain that property. The client may be especially displeased if the client has given the daughter-in-law or son-in-law gifts of sentimental significance to the family or gifts of an interests in a family limited partnership (who wants an ex-spouse to have an interest in the family limited partnership?). The best approach is to advise the client of the effect of any gifts to a daughter-in-law or son-in-law so that the client can decide whether to make the gift and, if so, what property is appropriate for a gift to a daughter-in-law or son-in-law. If the client wants to make a gift to a descendant's spouse of an interest in a family limited partnership, consider advising the client to include provisions in the partnership agreement under which the interest could be bought by other partners or the ex-spouse in the event of divorce.

X. Marital Property Issues in Family Limited Partnership and LLCs.

A. Reasons to form Family Limited Partnership or LLC.

1. The Laundry List.

It is not uncommon for wealthy clients to form family limited partnerships or LLCs for a variety of reasons, including the following (the language below is a modified version of the statement of purposes in a family limited partnership agreement drafted for a client):

> (a) to consolidate the management and control of certain properties held by the contributing partners, which consolidation should improve the efficiency of the management of the properties by holding them in a single, flexible entity;
>
> (b) to educate certain partners with respect to the investment and management of assets by including each of them in the management of the partnership;

(c) to eliminate the current practice of trying to balance investments by the various contributing partners on a separate basis, and instead consolidate those investments under one umbrella;

(d) to achieve economies of scale with respect to investment of assets, including economies of scale relating to investment fees, reduction of paperwork, and the value of assets under management for purposes of qualifying as an accredited investor;

(e) to avoid the fractionalization of the ownership of certain properties;

(f) to keep the ownership of certain properties, whether direct, indirect, legal or beneficial ownership, within the partners and their families to the extent possible by providing an opportunity for the partnership, the partners and any assignees to purchase any partnership interest or assigned partnership interest prior to certain assignments becoming effective;

(g) to the extent allowed by law, to protect those properties of the partners and their families which are contributed to the partnership from any unknown future creditors of those family members who are or become partners;

(h) to identify the nature of a partner's partnership interest or an assignee's assigned partnership interest as separate property rather than community property;

(i) to avoid the potential expense and publicity of litigation related to certain properties by requiring partners and assignees to submit to arbitration for the resolution of disputes and by requiring the losers of a dispute to bear the costs associated with the dispute; and

(j) to promote the education of, and communication among, the partners and their families with respect to financial matters.

2. Liability Protection for Limited Partners; Management to General Partners.

A family limited partnership is not a legally recognized entity; rather, it is a type of limited partnership restricted to family members. A limited partnership is a legal entity recognized in one form or another in every state. The limited partnership consists of at least two classes of partners: one or more classes of general partners and one or more classes of limited partners. General partners have the same rights, duties and obligations as general partners in a general partnership. They manage and control the family limited partnership and make all the decisions for the partnership, subject to applicable law, including fiduciary duties, and restrictions in the partnership agreement, including any consent rights granted to limited partners. Consequently, general partners are exposed to all of the operational risks of the business and are responsible for any liability created by the partnership. The limited partners generally have no right to control or manage the business, but may be able to block the general partners from taking certain actions if the partnership agreement so provides. Thus, limited partners are normally not responsible for any liability created by the business. Limited partners are investors who normally stand to lose only what they have invested in the business.

3. Protection of Partnership Assets in the Event of Divorce.

Under the Uniform Partnership Act, adopted by every state except Louisiana, "[p]roperty acquired by a partnership is property of the partnership and not of the partners individually." *See* Unif. Partnership Act 1997 § 203. Courts have interpreted this to mean that partnership property cannot be characterized as marital or community or separate property, and is not divisible at divorce. *See, e.g., Marshall v. Marshall,* 735 S.W.2d 587, 594 (Tex. App.- Dallas 1987) (partnership property not part of the community estate); *Angle v. Angle*, 506 So.2d 16, 17 (Fla.App. 2 Dist. 1987) (partnership property not part of the marital estate). Thus, when a spouse conveys property to the partnership, that property does not retain the character of either separate or marital or community, but rather becomes the property of the partnership. *See, e.g., Roach v. Roach*, 672 S.W.2d 524 (Tex. App. - Amarillo 1984) (husband's separate real property conveyed to the partnership became partnership property and could not be characterized as either community or separate); *see also Kenworthy v. Hadden*, 151 Cal.Rptr. 169, 172 (Cal.App. 3 Dist. 1978); *Dotson v. Grice*, 647 P.2d 409, 412 (N.M. 1982); *Nationwide Resources Corp. v. Massabni*, 658 P.2d 210, 215 (Ariz.App. Div. 2 1982); *Noble v. Noble*, 706 N.W.2d 166, 172-74 (Wis.App. 2005). *See* Becky Beaver, Rachel M. Baccari, Lee Vanderburg & Haran Levy, *Clash of Tax and Divorce Planning*, AICPA/AAML National Conference on Divorce, Las Vegas, Nevada, May 8-9, 2008.

In the Texas Revised Partnership Act, which applies to all partnerships after December 31, 1998, a partner is not a co-owner of partnership property. Therefore, even where the spouse's partnership interest is community property, the court in a divorce cannot award specific partnership assets to the non-partner spouse. However, clients should not get carried away with the contribution of assets to the partnership. A full discussion of the types of assets that are inappropriate for a partnership (and the reasons why) is beyond the scope of this paper, but clients should be aware that contributing personal use assets, such as jewelry, furniture, or vacation homes, can defeat some of the purposes of having the partnership in the first place. One reason for this is that the IRS potentially could argue that if the partners have continued to use the assets contributed to the partnership, the partnership should be ignored pursuant to section 2036 of the Internal Revenue Code because the partners retained the use of the assets. The inability of the court to divide these partnership assets in the event of divorce presents just one more reason why they should not be in the partnership in the first place.

4. More Creditor Protection.

Two recent cases say that you cannot "pierce the veil" of a partnership, like you can a corporation. *Pinebrook Properties, Ltd. v. Brookhaven Lake Property Owners Ass'n*, 77 S.W.3d

487, 499-500 (Tex. App. – Texarkana 2002, pet. denied); *Lifshutz v. Lifshutz*, 61 S.W.3d 511, 515 (Tex. App. – San Antonio 2001, pet. denied).

B. Valuation Issues.

By transferring to descendants a limited partner interest rather than an underlying share of partnership assets, a client can better protect the descendants from creditors, including future ex-spouses. In addition, a client can continue to manage the assets contributed to the partnership, subject to the client's fiduciary duties. Because the descendants receive only a limited partner interest, the descendants have very little or no control over management. In addition, there is no market for limited partner interests in family limited partnership interests. To reflect that lack of control and lack of marketability, the value of the limited partner interest should be less than a pro rata share of the underlying assets of the partnership. The reason for the lower value of a limited partner interest as opposed to a corresponding share of the underlying partnership assets is sometimes referred to as "business valuation discount;" specifically, a discount for lack of control and a discount for lack of marketability. However, Cathy Hughes, an Estate and Gift Tax Attorney Advisor in the Office of Tax Policy of the US Treasury Department, indicated at the ABA RPTE Conference in Washington, D.C. in late April that Treasury is working on proposed regulations under Section 2704(b) of the Internal Revenue Code that might disregard these business valuation discounts in certain circumstances. As of the date of this article, no regulations have been published. Thus, for now, a transfer of a limited partner interest should translate to lower estate and gift taxes than a transfer of a corresponding share of the underlying partnership assets.

As an example, if the Smiths give a 50% limited partnership interest in a limited partnership worth $1 million to their descendants, then at a 20% discount for lack of control and lack of marketability, the limited partnership interest would be worth $400,000 (as opposed to 50% of the underlying partnership assets, which would be worth $500,000). If the Smiths' gift tax bracket is 40%, then their gift tax due (or use of exemption) would be $160,000. Compared to gift taxes of $200,000 on a $500,000 gift, the Smiths' tax savings would be $40,000. This is using a conservative discount. Imagine the result if a qualified business appraiser determined that the fair market value of the limited partner interest should be calculated based on a 30 or 40% discount from the underlying net asset value of the partnership.

C. Unforeseen Consequences - Inadvertent "Conversion" to Community Property.

1. Inadvertent "Conversion" to Community Property on Funding.

While the family limited partnership is in many ways an estate planner's dream, it can give the family lawyer a major problem. Unless the lawyer who created the estate plan has taken great care in drafting and in establishing the manner of funding the family limited partnership, an interest gifted to a spouse or funded by a spouse's separate property may be, in part or in whole, inadvertently "converted" to community property. It may be converted by virtue of commingling funds or assets beyond what is economical in terms of costs of tracing. Even if a conversion has not taken place, the family law practitioner must often go to much greater lengths to establish the separate character than would normally be necessary.

To avoid these issues, the description of the assets being contributed to the partnership should be clearly identified as community or separate property, as should the resulting partnership interests. Listing community property on one contribution schedule and separate property on another can be helpful. In addition, different classes of limited partner and general partner interests can be created. For example, the Class A Limited Partner Interests could be one spouse's separate property interests while the Class B Limited Partner Interests could be community property interests.

2. Profits Distributed From Partnership.

Distributions of partnership profits and surplus during the marriage are treated as income and are presumptively community or marital property regardless of the character of the property transferred into the partnership. *See Lifshutz v. Lifshutz*, 199 S.W.3d 9 (Tex.App.-San Antonio 2006) (where spouse contributed his separate property to a partnership, the property did not retain its separate character and distributions from the partnership were considered community property); *Harris*, 756 S.W.2d at 802 (distributions of a partner's share of profits and surplus are community property even if the partner's partnership interest is separate property); *but see Legrand-Brock v. Brock*, 2007 WL 4762535 (Tex.App.-Beaumont 2008) (where a spouse owns separate-property stock in a dissolving corporation and receives distributions of liquidated assets, the distributions remain the spouse's separate property). Becky Beaver, Rachel M. Baccari, Lee Vanderburg & Haran Levy, *Clash of Tax and Divorce Planning*, AICPA/AAML National Conference on Divorce, Las Vegas, Nevada, May 8-9, 2008.

If the assets contributed to the partnership are stocks and bonds, the rule that partnership profits and surplus are community property will not matter. Even if the partnership had not been created, dividends and other income on separate property stocks and bonds would have been community property. After the formation of the partnership, those dividends and other income will be received by the partnership and, if and when the partnership makes a distribution to its partners, the distribution will be community property. Hence, the contribution of stocks and bonds to the partnership does not convert separate property to community property. However, if the assets being contributed to the partnership are separate property mineral interests, an unintentional conversion of the income generated by those interests may occur. Consider the following:

- Proceeds from the sale of separate property are also separate property. Bonus payments constitute consideration for the transfer of certain mineral interests. Thus, bonus payments made in respect of separate property are separate property as well. However, if a client transfers separate property mineral interests to a partnership, the partnership receives a bonus payment in respect of those minerals, and the partnership subsequently distributes the bonus payment to its partners, those distributions are community property to the partners, resulting in a change of what would have been separate property (in the absence of the partnership) to community property. *Lessing v. Russek*, 234 S.W.2d 891 (Tex. Civ. App. Austin 1950, writ ref'd n.r.e.).

- Royalty payments are also considered separate property. *Alsednz v. Alsenz*, 101 S.W.3d 648 (Tex. App. Houston [1st Dist.] 2003, pet. denied). However, if a partnership receives royalty payments, then distributes those payments to its partners, the resulting distributions are the community property of any married partners. Thus, contributing separate property mineral interests to the partnership can result in the inadvertent conversion of separate property royalty payments on those mineral interests to community property partnership distributions.

In light of the foregoing, a client holding mineral interests may wish to use a trust instead of a partnership or may wish to enter into a post-marital agreement relating to distributions from the partnership.

D. Division of FLP Interests in the Event of Divorce.

A partner's interest in a partnership, that is, the "right to receive his [or her] share of the partnership profits and surplus," is divisible at divorce and can be characterized as separate or marital or community property. *Harris v. Harris*, 756 S.W.2d 798, 802 (Tex. App.-Houston [14th Dist.], 1988); *see also Lane v. Lane*, 202 S.W.3d 577 (Ky. 2006); *Nationwide Resources Corp.,* 658 P.2d at 215; *Schiller v. Schiller*, 625 So.2d 856, 859 (Fla.App. 5 Dist. 1993); *McClennen v. McClennen,* 464 P.2d 982 (Ariz.App. Div. 1 1970); *Peddycord v. Peddycord*, 479 N.E.2d 615 (Ind. Ct. App. 3d Dist. 1985); *Kluck v. Kluck*, 561 N.W.2d 263 (N.D. 1997); *Elmaleh v. Elmaleh*, 584 N.Y.S.2d 857 (N.Y.A.D. 2 Dept. 1992); *Humphrey v. Humphrey*, 157 P.3d 451 (Wyo. 2007).

The court in a divorce cannot award a community property partnership interest to the non-partner spouse. *McKnight v. McKnight*, 543 S.W.2d 863, 868 (Tex. 1976). The court can, however, give the non-partner spouse a community property assignee's interest in the partnership. This can be problematic for both spouses because they are looking to dissolve their relationship and likely prefer to not be in business together or, in some cases, even have any further communication with each other. In addition, the spouse who receives the assignee interest is stuck with an interest that (a) is not marketable, (b) may not result in any cash flow to the spouse (distributions may be at the discretion of the general partner), (c) may actually result in tax liability to the spouse because the partnership is a flow-through entity for federal income tax purposes, and (d) does not give the spouse any control over the management of partnership assets. Looking at the other side of the coin, why would the partner spouse want to be responsible for managing the assets of an entity in which the former spouse has an interest? Therefore, when representing a client who wishes to create a family limited partnership, consider including provisions by which the partner spouse would have the option to purchase any assignee interest awarded to the non-partner spouse. Sample provisions that would give the partner spouse this option are included in Appendix 3.

Note that the sample provisions in Appendix 3 specifically address the valuation of the interest to be purchased. To help support the enforceability of the valuation mechanism, the spouse of a married partner could sign the partnership agreement to acknowledge and consent to the transferability restrictions (if the spouse is not already signing anyway as a partner). Also note that although the states are in accord on the general rule that a partnership interest is subject to division and/or allocation on divorce, courts have disagreed on the proper method of valuing such interests. *See, e.g., Hertz v. Hertz*, 99 N.M. 320, 657 P.2d 1169 (1983) (partnership agreements are dispositive of value); *Drake v. Drake*, 809 S.W.2d 710 (Ky. Ct. App. 1991) (partnership agreement is only one factor in determining value); *In re Marriage of Fonstein*, 131 Cal.Rptr. 873 (Cal. 1976) (contractual withdrawal rights used to value partnership interest); *McCabe v. McCabe*, 575 A.2d 87 (Pa. 1990) (accounts receivable not includable in valuation of partnership); *In re Marriage of Huff*, 834 P.2d 244 (Colo. 1992) (trial court may consider various valuation methods, including partnership/corporate buy-sell agreements and capitalization of excess earnings); *In re Marriage of Hall*, 692 P.2d 175 (Wash. 1984) (goodwill includable in partnership interest for purposes of division); *Travis v. Travis*, 795 P.2d 96 (Okla. 1990) (goodwill not divisible upon divorce). Becky Beaver, Rachel M. Baccari, Lee Vanderburg & Haran Levy, *Clash of Tax and Divorce Planning*, AICPA/AAML National Conference on Divorce, Las Vegas, Nevada, May 8-9, 2008.

E. Specific Challenges to FLPs.

A spouse will have the same or similar complaints to the validity of a FLP as they would to a trust. Becky Beaver, Rachel M. Baccari, Lee Vanderburg & Haran Levy, *Clash of Tax and Divorce Planning*, AICPA/AAML National Conference on Divorce, Las Vegas, Nevada, May 8-9, 2008, to which the following sections are fully attributable. As is the case with trusts, care should be taken in the drafting, funding, and maintenance stages of the FLP to limit the effectiveness of the specific challenges to a FLP described below.

1. Defects in Formation and Operation.

As with trusts, the spouse attacking a FLP should first be sure that the formalities necessary to create the FLP have been followed. This scrutiny should also extend to the proper maintaining of books and records. Vernon's Ann. Civ. St. Art. 6132a §1.07. While singular deficits in attempted formation and operation may not be sufficient to invalidate a FLP, if enough inconsistencies exist, it may make room for fruitful negotiations.

2. Failure to Distribute in Accordance With FLP Terms.

Failure of the general partner to distribute income in accordance with the terms of the partnership agreement can possibly lead to favorable results for the betrayed spouse. This could include the removal of the general partner, forced dissolution (if authorized by the partnership agreement), an independent suit against the general partner for damages, or all of the above. Any and all of these complaints should be addressed in the divorce proceeding when the FLP is an integral part of the marital estate.

3. Reimbursement.

In some states, when one estate marital (*i.e.,* a spouse's separate property estate) provides a benefit to another, a claim for reimbursement exists. If a spouse contributes his separate property assets as the capitalization of a corporation or other entity formed during the marriage, and if there is no quid pro quo in receipt of an ownership in mutation of the separate property, a claim for reimbursement could exist in favor of the separate estate and against the community estate. State laws dramatically vary on the topic of reimbursement, but care should be given to being creative to come up with "common law" or reasonable solutions to issues. Counsel should think "outside the box" and come up with theories that seem to make sense to other principles of state law governing divorce in their jurisdiction.

4. Mental Capacity.

The law of contracts applies to the creation of a partnership. *Park Cities Corp. v. Byrd*, 534 S.W.2d 668, 672 (Tex. 1976). A partner must have the capacity necessary to enter into a contract in order to form a valid partnership. A party has mental capacity to contract if he appreciates the effect of what he is doing and understands the nature and consequences of the acts and business being transacted.

5. Undue Influence.

A contract, including a partnership agreement, may be set aside because of undue influence. Undue influence in the execution of an instrument is present when dominion and control is exercised over the mind of the person executing the instrument, under facts and circumstances then existing, to overcome his free agency and free will and to substitute the will of another so as to cause him to do what he would not otherwise have done but for such dominion or control. *Seymour v. American Engine & Grinding Co*., 956 S.W. 2d 49 (Tex. App. Houston [14th Dist.] 1996, writ denied); *Bailey v. Arlington Bank & Trust Co*., 693 S.W. 2d 787 (Tex. App. -Fort Worth 1985, no writ); *B.A.L. vs. Edna Gladney Home*, 677 S.W. 2d 826 (Tex. App. - Fort Worth 1984, writ ref'd n.r.e.). "Overreaching" is tricking, outwitting or cheating a person into doing an act he would not have otherwise done. *B.A.L. v. Edna Gladney Home, supra*.

6. Duress.

Duress or coercion are grounds to set aside or rescind a contract. To recover for duress or coercion, a party to a contract must prove that the other party threatened to do some act which it had no right to do, that the threat was of such a character as to destroy the free agency of the other party, that the threat overcome the free agency of the other party and caused the other party to do that which it was not otherwise legally bound to do, that restraint was imminent and that the complaining party had no means of protection. *Tennessee Gas Pipeline Co. v. Lenape Resources Corp.,* 870 S.W. 2d 286 (Tex. App. - San Antonio 1993, affirmed in part, reversed in part by, 925 S.W. 2d 565 (Tex. 1996). Duress will invalidate a contract if undue or unjust advantage has been taken of another person's economic distress or necessity to coerce him into making an agreement. *Brown v. Cain Chemical, Inc.,* 837 S.W. 2d 239 (Tex. App. - Houston [1st Dist] 1992, writ denied). Intimidation may be sufficient to constitute duress. *Windham v. Alexander, Weston & Poehner, P.C.,* 887 S.W. 2d 182 (Tex. App. -Texarkana 1994, writ denied).

7. Mistake.

A mutual mistake of fact will allow rescission of a contract. A partnership agreement, like any other agreement or relationship, may be rescinded when proper grounds exist. *Volpe v. Schlobohn,* 614 S.W. 2d 615 (Tex. Civ. App. -Texarkana 1981, no writ). When parties to an agreement have contracted under a misconception or ignorance of a material fact, the agreement will be avoided. *Williams v. Glash*, 789 S.W. 2d 243 (Tex. App. - San Antonio 1997, no writ). A unilateral mistake of fact will usually not be sufficient to set aside a contract unless the party complaining can show that the mistake was of such great consequence that to enforce the contract would be unconscionable; the mistake related to a material feature of the contract, mistake was made regardless of exercise of ordinary care and parties can be returned to status quo such than rescission of the contract would not result in prejudice to the other party except for the loss of the bargain. *Seymour v. American Engine & Grinding Co.,* 956 S.W. 2d 49 (Tex. App. -Houston [14th Dist.] 1996, writ denied).

8. Mismanagement.

A managing partner has a duty to administer the partnership affairs solely for the benefit of the partnership. *Crenshaw v. Swenson*, 611 S.W. 2d 886, 890 (Tex. Civ. App. - Austin 1980, writ ref'd n.r.e.). Included in the fiduciary duty which the general partner owes to the limited partners is the duty of loyalty. Not only is it his duty to administer the partnership affairs solely for the benefit of the partnership, he is not permitted to place himself in a position where it would be for his own benefit to violate this duty. Scott, Trusts (3d Ed.) Sec. 170; *Southern Trust & Mortgage Co. V. Daniel*, 143 Tex. 321, 184 S.W. 2d 465 (Tex. 1944).

9. Fraud.

For purposes of this article the comments will be confined to what family lawyers know as "fraud on the community" or "fraud on the spouse doctrine". *See Jackson v. Smith*, 703 S.W.2d 791, 795 (Tex. App. Dallas 1985, no writ). Jackson defines constructive fraud as the breach of a legal or equitable duty which violates a fiduciary relationship, as exists between spouses. *Id*. The opinion reiterates that the presumption of constructive fraud arises where one of the spouses disposes of the other spouse's one half interest in community property without the other's knowledge of consent. *Id.* Although fraud in this context is rather easy to detect, the real question is whether it stands as a separate cause of action in a divorce suit.

XI. Formation Checklist for Limiting the Effectiveness of a Contest of Trusts and FLPs.

Although not all inclusive, the following represent some practices that could be undertaken, where practical, to limit the effectiveness of a contest of trusts and FLPs.

(1) Each party represented by independent counsel, instead of being represented by the same lawyer.

(2) Consider the usefulness of a partition or exchange agreement being entered into prior to the formation of the trust or FLP.

(3) Advise the client of the potential consequences of creating a trust or FLP close in time to the first sign of marital problems.

(4) Engage in full discussion of the reasons for creating the trust or FLP and document those reasons to the extent practicable.

(5) Encourage the involvement of each party and that party's counsel in the preparation of documents, financials, etc. prior to the formation.

(6) Advise the client to be sure to file, in a timely manner, all required tax reporting returns, reports, etc.

(7) Advise the client to take steps to make sure the trust or FLP is administered or operated in accordance with agreement. Periodic check-ups with key advisors can be helpful in this regard.

XII. Corporations.

A corporation exists as a separate entity from its shareholders. However, this distinction can be ignored for certain purposes. The separate identity of a corporation will be ignored (i.e., the corporate veil pierced) where the corporation is the alter ego of the shareholder, and there is such a unity between the corporation and an individual that the separateness has ceased to exist. *Castleberry v. Branscum*, 721 S.W.2d 270, 272 (Tex. 1986); *Southwest Livestock & Trucking Co. v. Dooley*, 884 S.W.2d 805, 809 (Tex. App. – San Antonio 1994, writ denied). The corporate veil will be pierced when there is such a unity that the separateness has ceased to exist and adherence to the fiction of separateness would, under the circumstances, sanction a fraud or promote injustice. *Southwest Livestock & Trucking Co. v. Dooley*, 884 S.W.2d at 809; *Humphrey v. Humphrey*, 593 S.W.2d 824, 826 (Tex. Civ. App. – Houston [14th Dist.] 1980, writ dism'd). *See Zisblatt v. Zisblatt*, 693 S.W.2d 944 (Tex. App. – Fort Worth 1985, writ dism'd) (corporate veil pierced in a divorce).

A. Alter Ego.

Alter ego, which applies if 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, is one basis for disregarding the corporate fiction. Other situations in which the corporate fiction may be disregarded even though corporate formalities have been observed and corporate and individual properties have been kept separate include those in which the corporation is used as a means for perpetrating a fraud; the corporation is organized and operated as a mere "tool" or "business conduit" of another corporation; the corporate fiction is used to avoid an existing legal obligation, to achieve or perpetuate a monopoly, or to circumvent a statute; or the corporate fiction is invoked to protect crime or justify a wrong. *Castleberry v. Branscum*, 721 S.W.2d 270, 272 (Tex. 1987); *see also Zisblatt v. Zisblatt*, 693 S.W.2d 944, 950 (Tex. App.-Fort Worth 1985, writ dism'd).

1. Entity Disregarded.

To establish that a corporation is the alter ego of a controlling shareholder, it is necessary to show that a corporate entity was disregarded, thereby making the corporation a shell for the individual's private business, further losing the separate nature of the corporation. *William B. Roberts, Inc. v. McDrilling Co.,* 579 S.W.2d 335, 345 (Tex. Civ. App.- Corpus Christi 1979, no writ); *Manney & Co. v. Texas Reserve Life Insurance Co.,* 407 S.W.2d 345, 350 (Tex. Civ. App.-Dallas 1966, no writ).

2. Only in Extraordinary Circumstances.

A corporate veil may be pierced on the basis of alter ego only in extraordinary circumstances. Such circumstances may exist if an individual controls and manages the corporation in such a manner that its affairs are indistinguishable from the individual's personal affairs and it has thus become his alter ego. Such a situation may not be inferred simply because a person is a major stockholder or even the sole stockholder of the corporation. *Keith v. Woodul*, 616 S.W.2d 375, 377 (Tex. Civ. App.-Texarkana 1981, no writ). There must be such unity between the individual and the corporation that the separateness of the individual from the corporation has ceased to exist. *Humphrey v. Humphrey*, 593 S.W.2d 824, 826 (Tex. Civ. App.-Houston [14th Dist.] 1980, writ dism'd).

3. Pleadings and Burden of Proof.

The alter ego theory must be pleaded and proved. *Keith*, 616 S.W.2d at 377. The party pleading alter ego has the burden of proof. *Torregrossa*, 603 S.W.2d at 804. To meet the burden of proof, there must be direct evidence of a sham corporate structure or of a failure to follow corporate formalities and that the principals acted in their individual capacities. *See Torregrossa*, 603 S.W.2d at 804.

B. Characterization of Pierced Entity.

If the corporate veil is pierced, the corporate assets will be presumed to be community property, subject to division by the court, if no separate-property claim has been preserved. *See Zisblatt*, 693 S.W.2d at 955.

XIII. Ethical Challenges in Representing Families in Family Limited Partnerships.

Because "[l]oyalty and independent judgment are essential elements in the lawyer's relationship to the client," MRPC 1.7 prohibits (although with exceptions) the representation of "a client if the representation involves a concurrent conflict of interest." A "concurrent conflict of interest" exists if ...

(1) the representation of one client will be directly adverse to another client; or

(2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer. Similarly, a "conflict of interest," as described in the Restatement (Third) of the Law of Governing Lawyers, exists "if there is a substantial risk that the lawyer's representation of the client would be materially and adversely affected by the lawyer's own interests or by the lawyer's duties to another current client, a former client, or a third person."

A. Legal Malpractice.

In *Smith v. Hastie*, 626 S.E.2d 13 (S.C. App. 2005), the divorce of a husband and wife prompted the wife to bring a legal malpractice action against the attorney who had helped her and her husband form a family limited partnership. At about the same time that the husband and the wife were undergoing marital counseling, (The lawyer apparently did not know that the Smiths' marriage was shaky. An expert at trial testified that, even if he had not known that the couple was undergoing counseling, the lawyer should have "made inquiries to ascertain they had no existing conflicts." *Id.* at 18), the husband and his lawyer decided to form a family limited partnership. The wife was present at two short meetings with the attorney and her husband at which she was informed of the advantages of putting their assets into a family limited partnership. Apparently the lawyer did not explain to her that she would no longer have immediate access to the assets nor did he advise her of her potential inability to reclaim the assets in the event of a divorce. The court found that the wife had presented adequate evidence for her claims of fraud and breach of fiduciary duty.

B. Concurrent Conflict of Interest.

MRPC 1.7(a) begins with the general rule that prohibits a lawyer from representing a client if there is a "concurrent conflict of interest" between the interests of that client and another client "[e]xcept as provided by paragraph (b)." The notion that certain types of multiple representation are always impermissible is elaborated upon in the ACTEC Commentaries. The ACTEC Commentaries provide as examples of non-waivable conflicts: representing "opposing parties in the same litigation," representing "both parties with respect to a pre-nuptial agreement," and representing both a personal representative and "a creditor in connection with a claim against the estate."

Paragraph (b) permits a lawyer to represent clients even if there is a concurrent conflict of interest if:

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;

(2) the representation is not prohibited by law;

(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

(4) each affected client gives informed consent, confirmed in writing.

The Comments to MRPC 1.7 provide that a lawyer who is contemplating concurrent representation of multiple clients should take the following steps before undertaking the representation: "1) clearly identify the client or clients; 2) determine whether a conflict of interest exists; 3) decide whether the representation may be undertaken despite the existence of a conflict, i.e., whether the conflict is consentable; and 4) if so, consult with the clients affected ... and obtain their informed consent, confirmed in writing." "If a conflict arises after the representation has commenced, the lawyer may be required to withdraw from the representation of one or all of the clients."

C. Lawyer as Intermediary.

Some states may have retained MRPC 2.2, which appeared in the Model Rules of Professional Conduct prior to their most recent amendment. MRPC 2.2 addressed the lawyer in her role as "intermediary" among joint clients. This rule "assumed that the lawyer would assist (on an equal basis) multiple clients in a transaction or other non-litigated matter where the clients shared a common goal and enjoyed a largely harmonious relationship." This rule was not carried forward in the 2003 revision of the Model Rules but the substance of the rule and comments associated with it were moved to revised MRPC 1.7.

D. Representing the Partnership.

Also relevant to a lawyer's representation both of family members and the family limited partnership or other family business, MRPC 1.13 contemplates that a lawyer may represent both an organization and one or more of its individual constituents. Subsection (g) of MRPC

1.13 provides that a lawyer who represents an organization is not barred from representing the organization's "directors, officers, employees, members, shareholders or other constituents" provided such representation is permissible within the bounds of MRPC 1.7. The Comment to this Rule clearly delineates when the lawyer may or may not represent both an organization and one of its constituents:

"There are times when the organization's interest may be or become adverse to those of one or more of its constituents. In such circumstances the lawyer should advise any constituent, whose interest the lawyer finds adverse to that of the organization of the conflict or potential conflict of interest, that the lawyer cannot represent such constituent, and that such person may wish to obtain independent representation. Care must be taken to assure that the individual understands that, when there is such adversity of interest, the lawyer for the organization cannot provide legal representation for that constituent individual, and that discussions between the lawyer for the organization and the individual may not be privileged."

In Formal Opinion 91-361, the ABA Committee cautioned lawyers who undertake representation of both the partnership and individual partners that "simultaneous representations of partnerships and of individual partners, even on basically unrelated matters, may result in the lawyer possessing confidences of one client that may not be revealed to another...."

XIV. Conclusion.

The first line of defense is – if possible – to not have to defend. Estate planning practitioners must be cognizant of the potentially adverse consequences of estate plans and, as a part of any estate plan, advise the client of the impact of any proposed arrangement should the client be divorced. Further, in certain situations, estate planning attorneys may wish to engage the assistance of competent family law counsel to consult on the marital property issues associated in drafting estate planning documents.

Appendix 1 - Sample Language Revoking Provisions in Trust Agreement in Favor of Spouse in Event of Legal Separation, Divorce, or Annulment

Notwithstanding anything in this Agreement that is or appears to be to the contrary, if, after the Effective Date, Grantor's spouse and Grantor are legally separated or Grantor's marriage to Grantor's spouse is terminated by divorce or annulment, Grantor's spouse shall be deemed to be deceased as of the date of that legal separation, divorce, or annulment and at all times thereafter, regardless of whether the legal separation is terminated or Grantor and Grantor's spouse remarry after an event of divorce or annulment, and all provisions in and under this Agreement in favor of Grantor's spouse, specifically including but not limited to provisions in favor of Grantor's spouse as the beneficiary of any trust held under this Agreement, granting to Grantor's spouse a power to remove or appoint the trustee or trustees of any trust held under this Agreement, appointing Grantor's spouse as trustee of any trust held under this Agreement, or granting Grantor's spouse any other power, shall be null and void and of no effect. Further, if Grantor's spouse is serving as trustee of any trust held under this Agreement as of the date of the legal separation, divorce, or annulment, she shall cease serving as trustee of that trust as of the date of the legal separation, divorce, or annulment, and no power in or under this Agreement shall be exercised to appoint Grantor's spouse as trustee of any trust held under this Agreement.

Appendix 2 - Sample Language Granting Power of Substitution and Ability to Release

Power of Substitution. Grantors or the survivor of them shall have the power from time to time to reacquire the principal of any trust under this Agreement by substituting other property of an equivalent fair market value, which right Grantors or the survivor of them shall exercise in a nonfiduciary capacity within the meaning of section 675(4)(C) of the Code. If the fair market value to be paid for that principal cannot be determined by agreement between Grantors or the survivor of them and Trustee, then such fair market value shall be the fair market value of the principal on the date of the reacquisition as determined by a qualified, independent appraiser. This power may be released by either Grantor at any time, in whole or in part, by an instrument in writing delivered to Trustee. If either Grantor is incapacitated, all of such Grantor's powers under this paragraph as well as the relinquishment of those powers by such Grantor instead may be exercised by the lawful guardian of such Grantor on his or her behalf or by his or her attorney in fact if accompanied by a power of attorney generally or specifically authorizing such action on behalf of such Grantor.

Appendix 3 - Rights of First Refusal Upon Divorce of a Partner or Assignee

8.09. Divorce of Partner or Assignee. For an Assignment to occur upon the divorce of a Partner or Assignee, other than an Assignment to the divorcing Partner or Assignee, the divorcing Partner's or Assignee's spouse, if the divorce is not yet final, or former spouse, if the divorce is final, must offer the Partnership Interests or Assigned Partnership Interests, as the case may be, that are to be Assigned or that have been Assigned for sale to the divorcing Partner or Assignee, the Partnership, and the other Partners and Assignees as provided in Exhibit E no later than thirty days after the divorce is finalized.

EXHIBIT E

Rights of First Refusal Upon Divorce of a Partner or Assignee

As required by Section 8.09, the spouse or former spouse of a Partner or Assignee ("Divorced Spouse") shall offer the Partnership Interests or the Assigned Partnership Interests that are to be Assigned or that have been Assigned, as the case may be ("Offered Partnership Interests"), for sale to the Partner or Assignee ("Divorced Partner or Assignee"), the Partnership, and the other existing Partners and Assignees as provided in this Exhibit; provided that if the Fair Market Value of the Offered Partnership Interests must be determined pursuant to arbitration as provided in Exhibit G, the time limits specified for the various actions required by this Exhibit shall be suspended until the arbitration is completed.

A. The Divorced Spouse shall provide an Offering Notice to the Divorced Partner or Assignee, the Partnership, and each of the other existing Partners and Assignees, that (1) if the divorce has been finalized, provides the date on which the divorce became finalized; (2) provides a return mailing address for the Divorced Spouse for purposes of any correspondence required by this Exhibit; (3) describes the Offered Partnership Interests; (4) states that the Divorced Spouse offers to sell the Offered Partnership Interests to the Divorced Partner or Assignee, the Partnership, and the other existing Partners and Assignees according to the provisions of this Exhibit; (5) provides the terms of the Assignment; (6) provides the names and addresses of all proposed Assignees that can be determined with certainty and, to the extent possible, the names and addresses of any potential Assignees that cannot be determined with certainty; and (7) states the Divorced Spouse's opinion as to the Fair Market Value of the Offered Partnership Interests as of the Determination Date.

B. Within thirty days after receiving the Offering Notice, the Divorced Partner or Assignee shall provide written notice to the Divorced Spouse ("Divorced Partner's or Assignee's Response Notice"), with a copy to the Partnership and each of the other existing Partners and Assignees, that (1) indicates whether the Divorced Partner or Assignee will purchase any part or all of the Offered Partnership Interests; (2) if the Divorced Partner or Assignee will purchase any of the Offered Partnership Interests, states the Divorced Partner's or Assignee's opinion as to the Fair Market Value as of the Determination Date of the Offered Partnership Interests that the Divorced Partner or Assignee will purchase; and (3) if the Divorced Partner or Assignee will purchase any of the Offered Partnership Interests, specifies a date for closing the purchase that is not more than sixty days after the date on which the Divorced Spouse received the Offering Notice. If the Divorced Partner's or Assignee's Response Notice is not received by the Divorced Spouse, the Partnership and each of the other existing Partners and Assignees within thirty days as described above, it shall be deemed received on the thirtieth day after the Divorced Partner's or Assignee's receipt of the Offering Notice and shall be deemed to be an election by the Divorced Partner or Assignee not to purchase any of the Offered Partnership Interests.

C. If the Divorced Partner or Assignee decides to purchase all of the Offered Partnership Interests, the closing shall take place on the date specified in the Divorced Partner's or Assignee's Response Notice at the Principal Office or on any earlier date at any other location agreed to by the Divorced Spouse and the Divorced Partner or Assignee. In exchange for receiving the Offered Partnership Interests at the closing, the Divorced Partner or Assignee shall pay the Divorced Spouse any form of consideration deemed appropriate by Exhibit F that has a total value equal to the lesser of (1) the total consideration offered to the Divorced Spouse by the proposed Assignee or Assignees as specified in the Offering Notice, if any, provided that the Divorced Partner must purchase the Offered Partnership Interests on the same terms as specified in the Offering Notice, or (2) the Fair Market Value of the Offered Partnership Interests as of the Determination Date plus interest since the Determination Date, compounded semiannually, at the applicable federal short-term rate under Section 1274(d) of the Code.

D. If the Divorced Partner or Assignee has elected, or been deemed to have elected, not to purchase all of the Offered Partnership Interests, then within forty-five days after receiving a copy of the Offering Notice, the Partnership Management shall decide whether the Partnership will purchase any part or all of the Offered Partnership Interests not being purchased by the Divorced Partner or Assignee and shall provide written notice to the Divorced Spouse on behalf of the Partnership ("Partnership's Response Notice"), with a copy to the Divorced Partner and each of the other existing Partners and Assignees, that (1) indicates the extent to which the Partnership will purchase the remaining Offered Partnership Interests; (2) if the Partnership will purchase any of the remaining Offered Partnership Interests, states the Partnership Management's opinion as to the Fair Market Value as of the Determination Date of the Offered Partnership Interests that the Partnership will purchase; and (3) if the Partnership will purchase any of the remaining Offered Partnership Interests, specifies a date for closing the purchase that is not fewer than sixty nor more than seventy-five days after the date on which the Partnership received the Offering Notice. If the Partnership's Response Notice is not received by the Divorced Spouse, the Divorced Partner, or Assignee and each of the other existing Partners and Assignees within forty-five days as described above, it shall be deemed received on the forty-fifth day after the Partnership's receipt of the Offering Notice and shall be deemed to be an election by the Partnership not to purchase any of the Offered Partnership Interests.

E. If the Partnership Management decides that the Partnership will purchase all of the Offered Partnership Interests not being purchased by the Divorced Partner or Assignee, the closing shall take place on the date specified in the Partnership's Response Notice at the Principal Office or on any earlier date at any other location agreed to by the Divorced Spouse and the Partnership Management and, if purchasing any of the Offered Partnership Interests, the Divorced Partner or Assignee. In proportion to the Offered Partnership Interests received at the closing, the Divorced Partner or Assignee and the Partnership shall pay the Divorced Spouse any form of consideration deemed appropriate by Exhibit F that has a total value equal to the lesser of (1) the total consideration offered to the Divorced Spouse by the proposed Assignee or Assignees as specified in the Offering Notice, if any, provided that the Divorced Partner must purchase the Offered Partnership Interests on the same terms as specified in the Offering Notice, or (2) the Fair Market Value of the Offered Partnership Interests as of the Determination Date plus interest since the Determination Date, compounded semiannually, at the applicable federal short-term rate under Section 1274(d) of the Code.

F. If the Partnership has elected, or been deemed to have elected, not to purchase all of the Offered Partnership Interests not being purchased by the Divorced Partner or Assignee, then within sixty days after receiving a copy of the Offering Notice, each existing Partner and Assignee shall provide written notice to the Divorced Spouse ("Partner's or Assignee's Response Notice"), with a copy to the Partnership, the Divorced Partner, or Assignee and each of the other existing Partners or Assignees, that (1) states whether the Partner or Assignee will purchase any part or all of the Offered Partnership Interests that the Divorced Partner or Assignee and the Partnership have elected not to purchase; (2) if the Partner or Assignee will purchase any of the Offered Partnership Interests, states the Partner's or Assignee's opinion as to the Fair Market Value as of the Determination Date of the Offered Partnership Interests that the Partner or Assignee is willing to purchase; and (3) if the Partner or Assignee will purchase any of the Offered Partnership Interests, specifies a date for closing the purchase that is not fewer than seventy-five nor more than ninety days after the date on which the Partner or Assignee received a copy of the Offering Notice. Any Partner's or Assignee's Response Notice which is not received by the Divorced Spouse, the Partnership, the Divorced Partner, or Assignee and each of the other existing Partners and Assignees within sixty days as described above shall be deemed received on the sixtieth day after the Partner or Assignee received a copy of the Offering Notice and shall be deemed to be an election by the Partner or Assignee not to purchase any of the Offered Partnership Interests. If there are any existing Partners or Assignees that wish to make a purchase ("Purchasing Partners" and "Purchasing Assignees"), the closing shall take place on the earliest date specified in a Partner's or Assignee's Response Notice at the Principal Office or on any earlier date at any other location agreed to by the Divorced Spouse, all of the Purchasing Partners and Purchasing Assignees and, if purchasing any of the Offered Partnership Interests, the Partnership and/or the Divorced Partner or Assignee, as the case may be. If there are no Purchasing Partners or Purchasing Assignees, and if the Partnership or the Divorced Partner or Assignee has elected to purchase any of the Offered Partnership Interests, the closing shall take place at the Principal Office on the tenth business day after the Partnership's receipt or deemed receipt of the last Partner's or Assignee's Response Notice or on any earlier date at any location agreed to by the Divorced Spouse and, if purchasing any of the Offered Partnership Interests, the Partnership and/or the Divorced Partner or Assignee, as the case may be. If there is more than one Purchasing Partner and Purchasing Assignee, the part of the Offered Partnership Interests that the Divorced Partner or Assignee and the Partnership have elected not to purchase shall be allocated among the

Purchasing Partners and Purchasing Assignees as they may agree or, if they cannot agree, in proportion to their Capital Accounts as of the Determination Date. In proportion to the Offered Partnership Interests received at the closing, the Divorced Partner or Assignee, the Partnership, and the Purchasing Partners and Purchasing Assignees shall pay the Divorced Spouse any form of consideration deemed appropriate by Exhibit F that has a total value equal to the lesser of (1) the total consideration offered to the Divorced Spouse by the proposed Assignee or Assignees as specified in the Offering Notice, if any, provided that the Divorced Partner must purchase the Offered Partnership Interests on the same terms as specified in the Offering Notice, or (2) the Fair Market Value of the Offered Partnership Interests as of the Determination Date plus interest since the Determination Date, compounded semiannually, at the applicable federal short-term rate under Section 1274(d) of the Code.

G. To the extent that the Divorced Partner or Assignee, the Partnership, and the other existing Partners and Assignees do not purchase all of the Offered Partnership Interests, the Assignment resulting from the divorce may occur, but only on the terms specified in the Offering Notice. If the Assignment is not completed within thirty days after the closing, if the Divorced Partner or Assignee, the Partnership, or the existing Partners and Assignees purchased any of the Offered Partnership Interests, or within one hundred five days after the Divorced Partner's or Assignee's, the Partnership's, and each of the other existing Partner's and Assignee's receipt of the Offering Notice, if the Divorced Partner or Assignee, the Partnership, and the other existing Partners and Assignees did not purchase any of the Offered Partnership Interests, the Assignment shall not occur without the Divorced Spouse again complying with the provisions of this Exhibit.