REPRESENTING THE SURVIVING SPOUSE: A HANDBOOK FOR THE LAWYER OF THE DECEDENT'S SPOUSE

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I. INTRODUCTION

Preparing a handbook for the lawyer representing the surviving spouse of a decedent proved to be a real challenge in view of the many possible situations the surviving spouse could be in following the first spouse's death. The approach finally taken starts with a substantive review of the foundational principles of Texas marital property law (Chapter II, characterization, Chapter III, management, and Chapter IV, liabilities).

The next part of this paper, Chapters V-VII, gives an overview of what happens upon a spouse's death to the couple's assets and liabilities. The following two chapters, Chapter VIII and IX, address areas of the law unique to Texas that may need to be addressed following the first spouse's death-wrongful transfers and reimbursement.

The following three chapters, VIII-X, discuss in detail a methodology that may be followed in order to satisfy the deceased spouse's debts and address the surviving spouse's debts.

The outline concludes with five chapters dealing with unique types of assets—multi-party accounts, interests in revocable and irrevocable trusts and retirement benefits.

The Appendix suggests a course of action for identifying and resolving the marital property issues that could confront the surviving spouse.

II. MARITAL PROPERTY CHARACTERIZATION

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

A. Article XVI, Sec. 15

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

B. The True Test for Community

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

The court in *Graham v. Franco*, 488 S.W. 2d 390 (Tex. 1972), resorted to a more historical Spanish/Mexican approach and affirmatively defined community property as ". . . that property is community which is acquired by the works, efforts, or labor of the spouses. . . ." *See* also *Whittlesey v. Miller*, 572 S.W.2d 665 (Tex. 1978); *Bounds v. Caudle*, 560 S.W.2d 925 (Tex. 1977).

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

C. Traditional Means of Creating Separate Property

Consequently, the first step of characterization is ascertaining the facts and circumstances surrounding the acquisition of an asset -- "the inception of title rule." *Creamer v. Briscoe*, 109 S.W. 911 (Tex. 1908). The second step is determining whether those facts and circumstances place the asset within the definition of separate property. Prior to the 1980 Amendment to Art. XVI, Sec.15, there were limited means of creating separate property in Texas. Separate property was limited to:

1. <u>PREVIOUSLY EXISTING</u>

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

2. <u>GRATUITOUS TRANSFERS</u>

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

3. <u>TRACEABLE MUTATIONS</u>

   Property acquired during marriage which was traceable as a mutation of previously owned separate property. *Love v. Robertson*, 7 Tex. 6 (1851).

4. <u>MARITAL PARTITIONS</u>

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

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

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

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

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

D. 1980 Amendment

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

1. PREMARITAL PARTITIONS

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

2. SPOUSAL PARTITIONS

Spouses may now partition and exchange not only presently existing community property but also community property not yet in existence into the spouses' separate properties. *See* also Tex. Fam. Code § 4.102.

3. INCOME FROM SEPARATE PROPERTY

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

4. SPOUSAL DONATIONS

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

E. 1987 Amendment

The 1987 amendment to Art. XVI, Sec. 15 did not authorize a new way to create separate property. It simply allowed spouses to create survivorship rights with their community property.

F. 1999 Amendment

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

G. Community Presumption

Notwithstanding the significance of the substantive rules of characterization, the importance of the community presumption cannot be ignored. Generally, all assets of the spouses on hand during the marriage and upon its termination are presumed to be community property, thereby placing the burden of proof on the party (e.g., a spouse, or that spouse's personal representative, or the heirs/devisees of the spouse) asserting separate character to show by "clear and convincing evidence" that a particular asset is, in fact, separate. Tex. Fam. Code § 3.003. A "clear and convincing evidence" standard is somewhere between "preponderance" and "reasonable doubt". *Faram v. Gervitz-Faram*, 895 S.W.2d 839 (Tex. App.—Ft. Worth 1995, no writ). However, the Texas Supreme Court has held that the requirement of a clear and convincing evidence standard is another way of stating that a legal conclusion must simply be supported by factually sufficient evidence. *See Meadows v. Green*, 524 S.W.2d 509, 510 (Tex. 1975), (A decision prior to the 1987 amendment to the predecessor to Sec. 3.003 which codified the clear and convincing evidence standard.)

1. MANAGEMENT PRESUMPTION

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

2. FORM OF TITLE

The fact that record title is held in a particular way due to certain circumstances may cause the community presumption to vanish in favor of a rebuttable separate presumption. *See Smith v. Strahan*, 16 Tex. 314 (1856); *Higgins v. Johnson*'s *Heirs*, 20 Tex. 389 (1857); *Story v. Marshall*, 24 Tex. 305 (1859). The other spouse may not be allowed to rebut the presumption if that spouse was a party to the transaction. *Lindsay v. Clayman*, 151 Tex. 593, 254 S.W.2d 777 (1952).

H. Quasi-Marital Property

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

I. Personal Injury Recoveries

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

J. Observations

Today, in order to properly characterize the assets of a marriage in either an estate planning or administration situation, the practitioner will need to be thoroughly familiar with the ever changing rules of characterization and be alert to the possibility that in either a premarital or marital agreement the parties changed the legal result. For example, income from separate property is not always community property.

III. MARITAL PROPERTY MANAGEMENT

Unlike characterization, rules relating to the management of marital property are within the rulemaking authority of the legislature. *Arnold v. Leonard*, 273 S.W. 799 (Tex. 1925). The Texas Family Code now prescribes which spouse has management powers over the marital assets during the marriage.

A. Matrimonial Property Act, 1967

Historically in Texas, the husband managed not only the community property of the marriage but also the separate property of both spouses. A women's rights reform movement began in 1913 with the gradual expansion over the next fifty years of the wife's right to manage her own separate property and personal earnings. One of the early changes was to grant to the wife the right to manage her own personal earnings and the income from her separate property. This reform movement culminated when both spouses were granted separate but equal rights in the management of their respective separate properties in the Matrimonial Property Act of 1967. The Act also granted women for the first time equal rights with their husbands in the management of their community property. These concepts were then codified as Sections 5.61 and 5.62 of the Texas Family Code enacted in 1969, effective Jan. 1, 2000, and are codified currently as Sections 3.201, 3.202 and 3.203 of the Texas Family Code. See Joseph W. McKnight, "Recodification and Reform of the Law of Husband and Wife" (Texas Bar Journal, Jan. 1970).

B. Texas Family Code

1. SEPARATE PROPERTY

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

2. SOLE MANAGEMENT COMMUNITY

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

3. JOINT MANAGEMENT COMMUNITY

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

C. Special Community Property

The term "special community property" was originally defined by Texas courts as that portion of the community estate which was under the wife's exclusive control and not liable for the husband's debts following the landmark decision of *Arnold v. Leonard*, *supra*, where the Texas Supreme Court held that the legislature could not define the rents and revenue from the wife's separate property and her personal earnings as her separate property, but could exempt those assets, her "special community property," from his debts. *Moss v. Gibbs*, 370 S.W.2d 452 (Tex. 1963). Today, it is common practice to refer to the community assets subject to either spouse's "sole management, control and disposition" under Section 3.102(a) as his or her "special community property."

D. Presumptions

Notwithstanding the community presumption of Section 3.003, an asset titled in one spouse's name (or untitled but in the sole possession of one spouse) is presumed to be subject to that spouse's sole management and control. Tex. Fam. Code § 3.104. Thus, an asset held in either spouse's name is presumed to be that spouse's special community property.

E. Other Factors

1. <u>POWER OF ATTORNEY</u>

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

2. <u>HOMESTEAD</u>

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

3. <u>INCAPACITY</u>

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

IV. MARITAL LIABILITIES

In *Arnold v. Leonard*, *supra*, the Texas Supreme Court held that ". . . the Legislature may rightfully place such portions of the community as it deems best under the wife's separate control, and . . . it may likewise exempt the same from payment of the husband's debts, without the exemption being open to successful constitutional attack by either the husband or his creditors." Prior to the Matrimonial Property Act of 1967, Texas law was relatively simple. The husband was generally personally liable for all *community debts*, and the wife was not. *See Leatherwood v. Arnold*, 66 Tex. 414, 1 S.W. 173(1886). Further, all community property other than the wife's special community property was liable for the husband's debts. *Arnold v. Leonard*, *supra*. The rules changed when the legislature passed the Matrimonial Property Act of 1967 and codified its concepts into the Texas Family Code.

A. Texas Family Code

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

1. <u>SEPARATE PROPERTY EXEMPTION</u>

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

2. <u>SPECIAL COMMUNITY EXEMPTION</u>

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

3. <u>OTHER RULES OF LAW</u>

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

4. <u>CREDITOR'S RIGHTS</u>

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

5. ORDER OF EXECUTION

A judge may determine, as deemed just and equitable, the order in which particular separate or community property is subject to execution and sale to satisfy a judgment. In determining the order, the court is to consider the facts and circumstances surrounding the transaction or occurrence on which the debt is based. Tex. Fam. Code § 3.203.

B. Other Factors

1. JOINT OBLIGATIONS

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

2. VICARIOUS LIABILITY

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

3. DUTY TO SUPPORT

Each spouse has a duty to support the other spouse and a duty to support a child generally for so long as the child is a minor and thereafter until the child graduates from high school. Tex. Fam. Code Secs. 2.501 and 154.001. Accordingly, all marital assets are liable for such "necessaries." Prior to 2007 legislation, unless otherwise agreed in writing or ordered by a court, a parent's child support obligation ended when the parent died. SB 617 (2007) amended the family code to provide that court ordered child support obligations survive the obligor's death. Tex. Fam. Code Sec. 154.006. New sections of the family code now also provide that the obligor's child support obligations will be accelerated upon the obligor's death and a liquidated amount will be determined using discount analysis and other means. Tex. Fam. Code § 154.015. An amendment to the probate code makes the liquidated amount a class 4 claim. Tex. Prob. Code § 322. The court can also require that the child support obligation be secured by the purchase of a life insurance policy. Tex. Fam. Code § 154.016.

4. TAX LIABILITY

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

Medaris v. U.S., 884 F.2d 832 (5th Cir. 1989).

5. EXEMPT PROPERTY

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

6. EFFECT OF DEATH

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

C. Legislative Mandate

The legislature prescribes a logical liability system which depends on a multiple step process to determine which assets are liable for which debts:

> First, whose debt is it? It is either the debt of the husband, the debt of the wife or both spouses' debt.
>
> Second, when was the debt incurred? It was incurred either prior to or during the marriage.
>
> Third, what type of debt is it? It is either tortious in nature or contractual.
>
> Fourth, are there any other substantive, non-marital rules of law which would make one spouse personally liable for the debts of the other spouse?

After answering these four questions, one can look to Sec. 3.202 and Sec. 3.203 for the proper result.

D. No Community Debt

The Texas Family Code's liability rules do not support the notion of a "community debt." That term suggests that (i) both spouses have personal liability for the debt and (ii) all non-exempt community property can be reached to satisfy the debt. Neither statement is necessarily true. The proper methodology is to follow the legislative mandate discussed in IV, A, *supra*. *See* X, *infra*. Please also refer to this author's paper, *Marital Property Liabilities: Dispelling the Myth of the Community Debt*, State Bar of Texas, Advanced Estate Planning and Probate Course, June, 2009, and the *Marital Property Liabilities: Dispelling the Myth of Community Debt*, Featherston and Dickson, *Texas Bar Journal*, January, 2010.

E. Summary

A spouse's separate property and special community property, as well as the joint community property, are liable for that spouse's debts during the marriage. If the liability is a tort debt incurred during the marriage, the other spouse's special community property is also liable for the debt (the other spouse's separate property is exempt).

If the debt is not a tort debt incurred during the marriage, the other spouse's separate property and special community property are exempt during the marriage from the debt unless the other spouse is personally liable under other rules of law. In which event, the other spouse's property (i.e., that spouse's special community and separate) is liable as well. *See* IV, B, *supra*.

<u>Note:</u> However, the rules change when the first spouse dies. See V and X, infra.

V. DEATH OF SPOUSE

When a married resident of Texas dies, the marriage terminates and community property ceases to exist. Nonprobate assets pass to their third party beneficiaries. Death works a legal partition of the <u>community probate assets</u>; the deceased spouse's undivided one-half interest passes to his heirs and/or devisees, and the surviving spouse retains her undivided one-half interest therein.

A. Marital Liabilities

But what happens to the debts of a married couple when the first spouse dies? The question sounds simple enough. It is obvious that the debts don't go away. Not all of the debts were the debts of both spouses. There were no community debts. Prior to the first spouse's death, the surviving spouse may or may not have had personal liability for the debts of the deceased spouse, and the deceased spouse may or may not have had any personal liability for the debts of the surviving spouse.

The deceased spouse's death does not create any personal liability on any party that did not exist prior to the deceased spouse's death. The surviving spouse is still personally liable for the debts of the surviving spouse. The surviving spouse does not assume personal liability for any debts of the deceased spouse for which the survivor did not have preexisting personal liability. It is the deceased spouse's "estate" that remains liable for the deceased spouse's debts.

B. Probate v. Nonprobate

The "estate" of a decedent must initially be divided into two separate and distinct categories. Certain assets fall within the <u>probate</u> class and others are classified as <u>nonprobate</u> assets. An asset is nonprobate if during the decedent's lifetime, the decedent entered into an inter vivos transaction, as opposed to a testamentary transaction, that controls the disposition of the asset at death.

1. <u>NONPROBATE</u>

Many nonprobate dispositions are contractual arrangements with third parties or the intended beneficiaries, and the terms of the contracts control the dispositions. Common examples of these types of contractual arrangements include three of the multiple-party bank accounts discussed in Chapter XI of the Texas Probate Code, most life insurance policies and certain employee benefits. Nonprobate assets remain liable for the decedent's debts unless there exists a statutory exemption like for life insurance policies under the Insurance Code or retirement benefits under the Property Code. Tex. Prob. Code § 450.

2. <u>INTER VIVOS</u>

In other nonprobate dispositions, the ownership of a future interest in the property is transferred to the intended beneficiary during the owner's lifetime, and the future interest becomes possessory upon the death of the owner. Revocable trusts and springing executory interests are examples of these types of nonprobate dispositions. Of course, an inter vivos gift of the ownership and possession of an asset prior to the owner's death can be considered a nonprobate disposition.

<u>Note</u>*: If the deceased spouse made a nonprobate disposition of his/her special community property to a third party, see* VIII, *infra.*

Note: The fact that an asset passes nonprobate pursuant to Sec. 450 does not limit the rights of the decedent's creditors. Tex. Prob. Code § 450(b).

3. PROBATE

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

Note: Compare the distribution of powers among personal representatives and surviving spouses found in Tex. Prob. Code § 177.

C. Section 37

The deceased spouse's probate "estate" generally passes to the deceased spouse's heirs and/or devisees *subject to the deceased spouse's debts*. The decedent's "estate" is liable for the payment of the debts of the decedent. Tex. Prob. Code § 37. If appointed and qualified, the personal representative of the deceased spouse's estate shall recover possession of the decedent's "estate" and hold it in trust to be disposed of in accordance with the law. Tex. Prob Code § 37. "As trustee, the executor is subject to the high fiduciary standards applicable to all trustees." *Humane Society v. Austin National Bank*, 531 S.W.2d 574,577 (Tex. 1975).

D. The Courts' Explanation

The Texas Supreme Court has explained the legal effect of the transition of ownership and liability by reason of the owner/debtor's death by and through the decedent's "estate." "A suit seeking to establish the decedent's liability on a claim and subject property of the estate to its payment should ordinarily be instituted against the personal representative or, under certain circumstances, against the heirs or beneficiaries." Price v. Estate of Anderson, 522 S.W.2d 690, 691 (Tex. 1975). "Debts against an estate constitute a statutory lien. This lien arises at the moment of death." *Janes v. Commerce Federal Savings & Loan Association*, 639 S.W.2d 490, 491. "Possession, then, by an heir does not subject him to liability. He holds the property with the incumbrance, but he cannot be required to relieve the estate of the burden [sic]." *Blinn v. McDonald* 50 S.W. 931, 931 (Tex. 1899), *Van v. Webb* 215 S.W.2d 151, 154 (Tex. 1998).

E. Section 156

Section 37 refers only to the deceased spouse's debts, it does not mention the *debts of the surviving spouse.* However, Section 156 of the Texas Probate Code states that the one-hundred percent (100%) of the community property subject to the sole control of the deceased spouse or joint control of both spouses during the marriage continues to be subject to the *debts of the deceased spouse*. In addition, the decedent's one-half interest in the community property subject to the sole control of the surviving spouse passes to the deceased spouse's successors charged with the *deceased spouse's debts*. Tex. Prob. Code § 156.

F. Administration of Community Property

In addition to collecting the probate of the estate, paying the decedent's debts and distributing the remaining assets to the decedent's heirs and/or devisees, the administration of a married decedent's estate includes the actual partition of the community probate property. While death may work a legal partition of the community probate assets, it is often necessary to open a formal administration to effectively handle the claims of creditors and/or divide the community probate property among the surviving spouse and the decedent's heirs and/or devisees. *See* VI, *infra*.

<u>Note</u>: *Absent the opening of a formal administration, the surviving spouse can administer the community and can discharge the "community obligations." See Tex. Prob. Code Sec. 160.*

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

G. Intestate Death

1. <u>COMMUNITY PROBATE PROPERTY</u>

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

2. <u>SEPARATE PROBATE PROPERTY</u>

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

H. Testate Death

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

I. Texas "Widow's" Election

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

1. EQUITABLE ELECTION

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

2. COMMUNITY PROPERTY ELECTION

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

3. THE TEXAS RULE

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

4. PROCEDURE

The surviving spouse may be put to either an express or an implied election. In other words, the language of the will may specifically and expressly set forth the intent to require an election. *Calvert v. Ft. Worth Nat. Bank*, 348 S.W.2d 19 (Tex. Civ. App.—Austin, 1961), affirmed 163 Tex. 405, 356 S.W.2d 918 (Tex. 1962). In other situations, the election is implied from the language of the will. The question of whether the survivor is put to an election is one of law for the court. *Wright, supra*. The question of whether the survivor has made an election is one of fact. Generally, two factors are involved. First, the survivor must have been aware of the choice. Second, the survivor must intend to so elect; however, the totality of the circumstances are considered in making this determination. *Dunn v. Vinyard, supra*. Mere acceptance of benefits may be deemed an election to take under the will. *See* Dougherty, "*Election*", Texas Estate Administration §§ 8.1, 8.2.

5. TAX CONSEQUENCES

The decision to elect or not can have significant transfer and income tax consequences which are beyond the scope of this article. For a discussion of these matters and an in depth study of the Texas widow's election, *see* Kinnebrew and Morgan, "*Community Property Division at*

Death," 39 *Baylor Law Review* 1037, 1072-1079 (1987).

6. SUPER ELECTION

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

J. Protection for Surviving Spouse

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

1. HOMESTEAD

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

2. EXEMPT PERSONAL PROPERTY

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

3. FAMILY ALLOWANCE

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

Sec. 288; *Noble v. Noble*, 636 S.W.2d 551 (Tex. App.—San Antonio 1982, no writ).

VI. ADMINISTRATION OF DECEASED SPOUSE'S ESTATE

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

A. Types of Administration

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

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

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

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

3. <u>PRIORITIES</u>

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

4. <u>DEPENDENT AND INDEPENDENT ADMINISTRATIONS</u>

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

5. <u>ACCOUNTABILITY</u>

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

6. <u>THE INVENTORY</u>

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

B. Distribution of Powers Among Personal Representative And Surviving Spouse

During formal administration, the personal representative is entitled to possession of not only the deceased spouse's separate property but also the couple's joint community property and the decedent's special community property. The surviving spouse may retain possession of the survivor's special community property during administration or waive this right and allow the personal representative to administer the entire community probate estate. Tex. Prob. Code § 177.

1. <u>AUTHORITY OF REPRESENTATIVE</u>

The authority of the personal representative over the survivor's one-half of the community should be limited to what is necessary to satisfy the debts of the deceased spouse properly payable out of such community assets even if the decedent's will grants to the representative more extensive powers over the decedent's separate assets and one-half interest in the community.

<u>Note</u>: *However, if there is a will and the surviving spouse is a beneficiary of the will, the surviving spouse who accepts any benefits under the will may have elected to allow the executor to exercise more extensive powers over his or her share of the community assets during administration. See V, I, supra.*

2. <u>COMPARISON WITH FAMILY CODE PROVISIONS</u>

This division of authority dovetails with the contractual management and liability rules of the Texas Family Code and facilitates the personal representative's or ability to step into the decedent's shoes and satisfy his or her debts. Tex. Fam. Code Secs. 3.102 and 3.202. Of course, both the personal representative and surviving spouse should eventually account for both halves of the community in order to settle the estate.

However, if the community assets in possession of the personal representative and available to satisfy the deceased spouse's creditors are insufficient for that purpose, Tex. Prob. Code § 156 indicates that the deceased spouse's one-half interest in the surviving spouse's special community property can be reached to satisfy the deceased spouse's creditors; these assets were generally exempt from the claims of the deceased spouse's non-tortious creditors during the marriage. For the tort debts of the deceased spouse, please see X, B, 4. i*nfra*.

3. <u>AUTHORITY OF SURVIVING SPOUSE – NO PERSONAL REPRESENTATIVE</u>

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

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

<u>Note:</u> *In 2007, the legislature repealed the provisions of the Probate Code relating to the creation, administration and closing of an administration by a "qualified community administrator." Repealed Sec. 169 directed the community administrator to pay debts within the time, and according to the classification, and in the order prescribed for the payment of debts as in other administrations. Section 160(a) simply directs the surviving spouse to "preserve the community property, discharge community obligations and wind up community affairs."*

4. <u>AUTHORITY OF THE SURVIVING SPOUSE – PERSONAL REPRESENTATIVE</u>

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

C. Allocation of Liabilities After Death

1. PROBATE ASSETS

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

2. NONPROBATE ASSETS

In the past, practitioners could follow a general "rule of thumb": probate assets pass subject to the decedent's debts whereas nonprobate assets pass to their designated beneficiaries, free of the decedent's debts. Today, there is a growing body of statutory rules and common law which negates the application of this old "rule of thumb." See Tex. Prob. Code §§ 442, 450(b) and 461.

3. GENERAL POWER THEORY

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

4. ABATEMENT

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

5. ABATEMENT AMONG COMMUNITY AND SEPARATE ASSETS

Sec. 322B also failed to give direction to the personal representative who has both non-exempt separate and community assets in its possession and control in order to satisfy the decedent's debts. The potential conflict of interest is obvious; the expenditure of separate funds to satisfy the debt will inure to the benefit of the surviving spouse while using community funds would accrue to the benefit of the decedent's estate. Presumably Sec. 3.203 of the Texas Family Code would be relevant, and the facts and circumstances surrounding the source of the debt should be considered. For example, is it a purchase money indebtedness? Is it tortious or contractual in nature?

6. GENERAL GUIDELINES

The author is not aware of any definitive cases on point that offer any clear guidance. Accordingly, it is the author's opinion that certain claims should be paid out of the decedent's separate property or the decedent's one-half of community assets. These claims would include funeral expenses, separate property's purchase money indebtedness, and tort claims against the decreased spouse. Other debts, like credit cards, utilities, and community property purchase money indebtedness, and should be paid out 100% of the community funds. *See* X and XII, *infra*, for more discussion.

D. Closing the Estate

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

Assuming that the decedent's one-half community interest has been left to someone other than the surviving spouse, the respective ownership interests of the survivor and the decedent's distributees are subject to the possessory rights of either a court appointed personal representative or the surviving spouse for administration purposes. When administration is completed, the survivor and the distributees are entitled to their respective one-half interests in each and every community probate asset. Tex. Prob. Code §37.

1. <u>NON PRO RATA DIVISION</u>

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

2. <u>I.R.S. POSITION</u>

Three private letter rulings suggest that such an exchange is not taxable. In one, PLR 8037124, 1980 WL 134564, a husband and wife proposed to divide into two equal, but non pro rata shares, certain community assets in order to create liquidity for one to pay estate taxes upon an anticipated death; relying in part on Rev. Rul 76-85, 1976-L C.B. 215, 1976-WL 36350, the memorandum concludes that such a partition would not result in a taxable event.

In the second, PLR 8016050, 1980 WL 132102, where a husband and the executor of his wife's estate proposed an equal, but non-pro rata division, again the Service ruled the exchange was not a taxable event. In California, the ruling noted, the right of partition is to the entire community estate and not merely to some specific part, relying in part on the legal principle that the marital property interest of each spouse is an interest in the property as an entity. The legal entity principle relied on in the memorandum is, however, only mentioned in the context of Rev. Rul. 76-83, 1976-1 C.B. 213, 1976 W.L. 36350. Rev Rule. 76-83 ruled that a divorce non prorata division of community transaction was a non-taxable transaction with no gain or loss being recognized. This author has not found any definitive reference in the ruling to the community being an entity under California law. The main point of the ruling was, while a division of the community in a divorce settlement may result in a taxable event, such a division is not considered taxable when there is an equal division of the value with some assets going to the wife and other assets going to the husband. In Texas, for most purposes, community property principles do not create an entity. Community property is a form of co-ownership among a husband and wife that ceases to exist when the marriage terminates.

Note*: The 1980 private letter rulings were issue prior to the enactment of 26 U.S.C.A. Sec. 1041, which provides that no gain or loss is recognized on a transfer between spouses incident to a divorce.*

In the third, PLR 9422052, 1994 WL 237304 community assets had been placed in a revocable trust arrangement prior to the first spouse's death, and the trust agreement authorized the trustee to make non pro rata distributions following the first spouse's death among the survivor's trust and the deceased spouse's marital deduction and bypass trusts.

3. THE LAW

Do these three rulings really support the legal conclusion that a non pro rata division of assets in Texas among the surviving spouse and the heirs and/or devisees of the deceased spouse is not a taxable event, or is Texas substantive law different enough to generate a different tax result? However, as discussed below, California law may not be as different as PLR 8016050 suggested.

Perhaps PLR 9422052 suggests a possible planning advantage a revocable trust may have over a traditional testamentary plan. In a traditional testamentary plan, a safe harbor approach may be for the personal representative with appropriate authority granted in the will to enter into a partition and exchange agreement with the surviving spouse shortly after the first spouse's death and prior to any significant appreciation in value to the community assets. Care should then be taken to track the income from the partitioned assets so that the income is properly reported on the income tax returns of the survivor and the estate (or its successors).

Note*: Even if the will of the deceased spouse authorized the executor to make non pro rata distributions, it is doubtful such mandate is binding on the surviving spouse whose agreement to the division will be necessary to complete the exchange. But, consider the effect of a "widow's election." See V, I, supra.*

E. The California Approach

Notwithstanding the comfort that the above described rulings would appear to give California couples, on Jan. 1, 1999, California amended its Probate Code. Section 100 now provides: (a) upon the death of a married person, one-half of the community property belongs to the surviving spouse and the other half belongs to the decedent, (b) notwithstanding subdivision (a), a husband and wife may agree in writing to divide their community property on the basis of a non pro rata division of the aggregate value of the community property or on the basis of a division of each individual item or asset of community property, or partly on each basis. Nothing in this subdivision shall be construed to require this written agreement in order to permit or recognize a non pro rata division of community property.

Thus, it appears that, absent an agreement of the couple, California law is similar to Texas law; at death, the surviving spouse retains an undivided one-half (½) interest in each and every community asset, and the deceased spouse's undivided one-half (½) interest passes to his or her heirs/devises. California law differs because of the statute that expressly authorizes the couple to agree to a non pro rata division of the aggregate value of the community property. Further, Cal. Prob Code § 104.5, which became effective on Jan. 1 2000, permits Sec 100b agreements to be incorporated into revocable trusts.

F. The Texas Response

Since Texas does not have a statute expressly authorizing such an agreement, the question is whether Texas couples can enter into such an agreement. Would such an agreement be valid under existing Texas statutes and Art. XVI, Sec. 15 of the Texas Constitution? Arguably, such an agreement is valid under existing Texas law. Both Tex. Fam. Code § 4.102 and Art. XVI, § 15 of the Texas Constitution authorize spouses to partition between themselves all or part of their community property, then existing or to be acquired, as they may desire. It is not too much of a stretch to imagine this statutory language includes an agreement to divide the community property on the basis of a non pro rata division upon the death of the first spouse.

On the other hand, a strict construction of the constitutional and statutory language suggests that only spouses, *during the marriage*, can partition, then existing community property, or community property to be acquired in the future. The California type agreement seems to contemplate an agreement during the marriage to partition in a certain way after the marriage terminates. Thus, such an agreement may violate Art. XVI, Sec. 15.

In *Hilley v. Hilley*, a case decided prior to 1980 amendment to Art. XVI, Sec. 15 that liberalized the spousal partition rules, the Texas Supreme Court held it was unconstitutional for a couple to enter into an agreement during marriage that would avoid a pro rata partition of the community upon the first spouse's death. The couple in that case tried to attach "survivorship" rights to certain community assets. *Hilley v. Hilley*, 342 S.W.2d 565 (Tex. 1961). Of course, survivorship rights were later authorized by the 1987 amendment to Art. XVI, Sec. 15.

Lending support to the argument that the agreement may not violate Art. XVI, Sec. 15 is the old case of *Gorman v. Gause* 56 S.W.2855 (Tex. Comm. Of Appeals 1933) where the court, in the context of a pre-marital agreement, stated that ". . . it might be agreed by such parties that...a certain portion of the community estate, when acquired, would be conveyed by him to the wife and made her separate property. . . . Such an agreement would not violate either the Texas Constitution or statutes of this state. . ." Accordingly, perhaps an agreement of the spouses to partition community in a certain way following the first spouse's death would not violate existing Texas law.

VII. NONPROBATE DISPOSITIONS TO THE SURVIVING SPOUSE

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

A. Inter Vivos Gift

One spouse may give to the other spouse either the donor's separate property or the donor's interest in their community property, thereby making the asset the donee spouse's separate property. *Bradley v. Love*, 60 Tex. 472 (Tex. 1883). A spouse may transfer to the other spouse the transferor spouse's one-half community interest in community property held in either spouse's name or in both names without going through the steps of a "partition and exchange." *In re Marriage of Morrison*, 913 S.W.2d 689 (Tex. App.—Texarkana 1995 writ denied).

<u>Note:</u> *Since 1980, such a spousal gift raises a presumption that the future income generated by the donated property will also be the donee spouse's separate property. Tex. Fam. Code § 3.005.*

B. Partition

Spouses may partition or exchange between themselves all or any part of their community property then existing, or to be acquired, into their respective separate properties. A 2005 amendment corrected some confusion created by a 2003 amendment and now confirms that the spouses may also partition the future income generated by the property that has been partitioned. Tex. Fam. Code § 4.102.

C. Income Agreement

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

D. Life Insurance

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

E. Employee Benefits and Other Retirement Accounts

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

F. Sec. 450 of the Texas Probate Code

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

G. C.P.W.R.O.S.

Prior to Nov. 3, 1987, in order to create a right of survivorship of their community property for the surviving spouse, the married couple had to first partition their community property into separate property and then enter into the survivorship arrangement. *Hilley v. Hilley*, 161 Tex. 569, 342 S.W.2d 565 (1961). The 1987 amendment to Art. XVI, Sec. 15 of the Texas Constitution permitted spouses to agree in writing that all or any part of their community property shall belong to the surviving spouse without going through probate upon the death of the first spouse. Now, married couples can create survivorship rights without first partitioning the community. All that is required is a written agreement; there is no specific signature requirement in the Constitution.

1. <u>AMENDMENTS TO THE TEXAS PROBATE CODE</u>

The 1987 legislature amended Sec. 46 of the Texas Probate Code in anticipation that the amendment would pass. Amended Sec. 46 provided that spouses may agree in writing "that all or any part of their community property which is <u>titled or held with indicia of title</u> becomes the property of the surviving spouse on the death of a spouse." The highlighted language presented possible conflicts with the Constitution, most of which conflicts may have become moot because in 1989 Sec. 46 was amended again to state that Sec. 46 does not apply to any agreements between spouses regarding their community property which are now to be governed by new Part 3 of Chapter XI of the Probate Code, which was added to the Probate Code in 1989, and which has been held by the Texas Supreme Court to be the exclusive means of establishing rights of survivorship in community property. *See Holmes, infra*.

2. PART 3, CHAPTER 11 OF THE TEXAS PROBATE CODE

This part of the Texas Probate Code purports to provide a comprehensive approach to community property with survivorship rights.

a. FORMALITIES

Sec. 452 requires that the survivorship agreement be in writing and signed by both parties and includes nonexclusive "safe harbor" language for the proper manifestation of intent. It should be noted that neither the Constitution nor old Sec. 46 required a signature. Can the legislature require the signature of both parties when the Constitution does not? Can an agent sign on behalf of a party, or is this a nondelegable privilege?

Note: See VII, H, infra, for a discussion of the Texas Supreme Court's most recent holding on what is required to create CPWROS.

b. OWNERSHIP AND MANAGEMENT

Sec. 453 provides that the property subject to the valid survivorship agreement will remain community property during the remainder of the marriage. It also provides that such an agreement in and of itself does not alter the rights of management. In other words, special community property does not automatically become joint community property, which would appear to mean the managing spouse can make a valid inter vivos disposition of the same. If so, are the proceeds subject to the survivorship agreement?

c. DEATH OF FIRST SPOUSE

In the event of divorce, the rights of the parties will not be affected by the survivorship agreement, but upon the death of the first spouse, the community property subject to the survivorship agreement becomes the property of the surviving spouse through a nonprobate means. (It can be assumed that Sec. 47(d) will require the surviving spouse live for 120 hours.) If the spouses have not recorded their survivorship agreement and/or have not titled their property to reflect the survivorship agreement, the survivor will need to prove his/her ownership of the property, which will still appear on record to have been partitioned upon the death of the first spouse like any other community property asset. Accordingly, Sec. 456 creates a new judicial process whereby the survivor can establish the validity of the survivorship agreement. Accordingly, upon application, citation and proof, the survivor can avoid probate.

3. CREDITOR'S CLAIMS

Will the property still be liable for the deceased spouse's debts since the property passes nonprobate to the survivor? Common law joint tenancies, like life insurance, avoid probate and the claims of creditors, but joint bank accounts per Tex. Prob. Code Sec. 442 have second tier liability. Now Sec. 461 provides that spousal multi-party bank accounts shall be governed by Sec. 436 and that other community assets subject to survivorship rights will continue to be liable for debts as if the survivorship agreement was not in effect.

4. ESTATE TAXES

The deceased spouse's one-half interest in the community property subject to survivorship rights will be included in the deceased spouse's gross estate but will qualify for the marital deduction so that such assets are not taxed upon the death of the first spouse. Will both halves receive a step up in income tax basis under Sec. 1014(b)(6) of the Internal Revenue Code? Presumably so, *see* I.R.S. Rev. Rul. 87-98 1987-39 I.R.B. 15. However, to the extent that such assets are not consumed or otherwise removed from the tax base of the surviving spouse, such assets will be included in the surviving gross estate at the survivor's death. This result can disrupt sound marital estate planning, waste the first spouse's exemption equivalent and cause the family to pay additional death taxes.

5. SUBSTANTIVE QUESTIONS

Notwithstanding a comprehensive set of statutes, there are issues related to survivorship agreements that cause many to question its advisability in many situations.

a. REVOCABILITY

Can one spouse unilaterally rescind the agreement? Prior to the 1989 legislation, commentators argued the negative in that the property was probably joint community which required joint action of the spouses; in addition, the spouses were perhaps bound by a contract. Perhaps the survivorship arrangement itself is revocable, and breach of contract is the remedy. On the other hand, perhaps all that has been created is a non-testamentary transfer, revocable by either spouse. Added in 1989, Sec. 455 provides that one spouse may revoke by a written instrument signed by the revoking spouse and delivered to the other spouse. But, could there still be a breach of contract action?

Note: See VI, H, infra, for a discussion of the Texas Supreme Court's most recent discussion on what it takes to revoke a CPWROS agreement.

b. PROPERTY SUBJECT TO SURVIVORSHIP

Assuming a married couple desires survivorship rights for all of their community property, can they execute an agreement simply referring to "all of their community property in existence at the time of the agreement"? Can they agree to survivorship rights as to community property not yet in existence? The answer may depend in part on the proper interpretation of Art. XVI, Sec. 15 and the constitutionality and the interpretation of Sec. 46 of the Texas Probate Code prior to the effective date of the 1989 legislation, but Sec. 451 appears to contemplate an "any and all property agreement."

c. RETROACTIVITY

Assume a married couple entered into a community survivorship agreement prior to Nov. 3, 1987, and the first spouse dies after Nov. 3, 1987, will the survivorship rights be effective? This is a particularly troublesome question as it relates, for example, to a community property joint bank account with survivorship rights which the couple signed years ago without an understanding of the legal significance of their agreement. If the first spouse died prior to Nov. 3, 1987, the spouse's one-half interest then would have passed to his heirs and devisees; now, does it pass to the surviving spouse? Sec. 3 of SB 1643 provides that the amendments made by SB 1643 apply to all community property survivorship agreements entered into on or after November 3, 1987, and to any earlier agreements, if both spouses were living on that date and the agreement complies with Part 3 of Chapter XI of the Texas Probate Code. *See Estate of Stripling v. Stripling*, 812 S.W.2d 397 (Tex. App.—Eastland 1991, no writ).

d. FURTHER APPLICATION

Does new Part 3 of Chapter XI of the Texas Probate Code apply to every nonprobate disposition of community assets between spouses or only those where the agreement is for the property to pass to whomever is the surviving spouse? It is the author's opinion that Part 3 applies only to those transactions previously voided by the *Hilley* rule.

H. Holmes v. Beatty

The recent Texas Supreme Court case of *Holmes v. Beatty*, 2009 WL 1817398 (Tex.) involved a nonprobate disposition of community property from the deceased spouse to the surviving spouse. In *Holmes*, the couple had acquired over ten million dollars in brokerage accounts and acquired securities certificates issued from those accounts. The investments were community property.

1. THE INVESTMENT ACCOUNTS

The investment accounts were variously listed as "JT TEN"; "Joint Tenancy"; and "Joint (WROS)." The question presented was whether these acronyms and definitions established a right of survivorship in favor of the surviving spouse. After an in-depth discussion of the Hilley and McKnight cases, the 1987 amendment to Article XVI, Sec. 15, and *Texas Probate Code §§ 46(b), 451, 452 and 453*, the court ruled as follows:

a. "JT TEN" or "Joint Tenancy" – Such a designation in an account agreement signed by both spouses is sufficient to create rights of survivorship.

b. "Joint (WROS)" – Such a designation in an account agreement signed by both spouses is sufficient to create a right of survivorship.

A critical factor in the court's analysis of the accounts was the fact that both spouses had signed the account agreement forms provided by the financial institutions. *However, the securities issued in certificate form were not signed by the couple,*

2. THE CERTIFICATES

Eventually, some of the couple's investments acquired in the"survivorship" accounts were distributed to them in certificate form with various designations, such as "JT TEN"; "JT TEN – as joint tenants with right of survivorship" and not as "tenants in common"; and "JTWROS." The Court held that these certificates passed nonprobate to the surviving spouse at the deceased spouse's death because the issuance of the certificates did not revoke the accounts' survivorship agreements. Thus, the certificates carried forward the rights of survivorship created in the account agreements, even though neither spouse had signed any of the certificates.

3. AFFIRMATION

The court noted that all of the certificates included some type of "survivorship" language that reflected the couple's expectations initially established in the account agreements. Once the account agreements established a right of survivorship, the survivorship agreements could be revoked only by a subsequent written agreement or a disposition of the assets covered by the agreement. Texas Probate Code § 455. The issuance of the certificates to a couple with the confirming language was held not to be a disposition that revoked the survivorship agreements.

4. QUESTIONS

Holmes seems to raise more questions than it answers. What if the certificates had been issued in their names as "tenants in common" or as "Ten Com" or in their names without any designation? Would that have been a "revoking disposition?" What if the certificates were issued in only one spouse's name? What if an investment is purchased with a check written on joint account with rights of survivorship?

VIII. WRONGFUL TRANSFERS

It is not unusual to discover following the death of the deceased spouse that the decedent made a nonprobate disposition of community property to a third party or that the surviving spouse had made a gift of community property to a third party. The third party may be a child of the couple, a child by a prior marriage, a charity or an elderly parent or a paramour.

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

A. Consequences of Joint Management

If the subject of the nonprobate disposition or gift was the couple's joint community property, it is arguable that the purported disposition is void as to the other spouse because the spouse attempting the disposition simply did not have the power to make the disposition without the joinder or consent of the other spouse. Tex. Fam. Code § 3.1002(b). *See III, B, supra*. The attempted disposition may even be void as to the disposing spouse's one-half interest in the proper. Had the other spouse previously authorized the disposing spouse to generally manage the property and then there was the nonprobate disposition or gift, it would appear that the analysis should be similar to the one applied to the unilateral transfer of special community property—"fraud on the community analysis."

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

B. Managing Spouse as Trustee

In what is arguably the most significant community property case ever decided by the Texas Supreme Court, *Arnold v. Leonard*, 273 S.W. 799 (Tex. 1925), the court explained ". . . that the statutes empowering the husband to manage the . . .

community assets made the husband essentially a trustee, accountable as such to the . . . community." *See* also *Howard v. Commonwealth Building and Loan Assn.*, 94 S.W.2d 144 (Tex. 1936), where the court explained that, where title to a community asset is held in one spouse's name, that spouse has legal title and the other has equitable title, explaining: "That one in whose name the title is conveyed holds as trustee for the other. *Patty v. Middleton*, 82 Tex. 586, 17 S.W. 909 (Tex. 1891)."

C. Fiduciary Obligation

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

D. The Managing Spouse's Duty

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

E. Burden of Proof

Because the managing spouse has the power under the Texas Family Code to dispose of that spouse's special community property, the burden is on the other spouse to raise the issue of fraud on the community when the marriage terminates. That spouse may seek to establish that the managing spouse's action with respect to the managing spouse's special community property amounted either to "actual" or "constructive" fraud.

For example, to establish that the managing spouse's gift to a third party amounted to actual fraud, the other spouse must prove that the gift was made with the primary purpose of depriving the other spouse of that asset. Constructive fraud is established where a gift is found to be "unfair" to the other spouse. *See Horlock v. Horlock*, 533 S.W.2d 52 (Tex. Civ. App. — Houston [14th] 1975, writ dism'd w.o.j.). Texas courts have also set aside a gift as constructively fraudulent if the gift was capricious, excessive or arbitrary. *See Carnes v. Meador*, *supra*, and *Street v. Skipper*, 887 S.W.2d 78 (Tex. App.—Ft. Worth 1995 writ denied).

Once the issue of constructive fraud is raised, the cases suggest the burden switches to the managing spouse to prove that the gift was fair to the other spouse. *See Murphy v. Metropolitan Life Ins. Co.*, 498 S.W.2d 278 (Tex. App.—Houston [14th] 1973, writ ref'd n.r.e.), and *Givens v. The Girard Life Ins. Co.*, 480 S.W.2d 421 (Tex. App.—Dallas 1972 writ ref'd n.r.e.). *Jackson v. Smith, supra*. Factors to be considered in determining whether there has been a constructive fraud include (i) the size of the gift in relation to the total size of the community estate, (ii) the adequacy of the remaining community assets to support the other spouse, and (iii) the relationship of the managing spouse to the donee. *See Horlock v. Horlock*, *supra*. Another court described the factors to be considered as (i) whether special circumstances justify the gift and (ii) whether the community funds used were reasonable in proportion to the remaining community assets. *Givens, supra*. Most of the cases in this area involve excessive or capricious consumption of community assets, or gifts of community assets to third parties as the basis of constructive fraud on the community. *See* Stewart Gagnon, Kathryn Murphy, Ike Vanden Eykel, Texas Practice Guide - Family Law, Secs. 16:8–16:95 (West).

F. Remedies, Generally

The managing spouse's abuse of managerial powers of community assets affects not only the equitable division of the remaining community estate upon divorce but can result in the awarding of a money judgment for damages to the other spouse when the marriage terminates in order to recoup the value of the other spouse's share of the community lost through the managing spouse's wrong doing. *See Mazique v. Mazique*, 742 S.W.2d 805 (Tex. App.—Houston [1st Dist.], no writ). *Massey v. Massey*, 807 S.W.2d 391 (Tex. App.—Houston [1st Dist.] 1991, writ denied); *In re Marriage of Moore*, 890 S.W.2d 821 (Tex. App.—Amarillo 1994, no writ). A judgement for money damages against the transferee may also be possible. See *Madrigal v. Madrigal*, 115 S.W.3d 32, 35 (Tex. App-San Antonio 2003, no pet.) (Citing Estate of *Korzekwa v. Prudential Ins. Co.*; 669 S.W.2d 775,778 (Tex. App. - San Antonio 1984, writ dism'd); *Hartman v. Crain* 398 S.W.2d 387, 390 (Tex. App.-Houston 1966, no writ). Courts have also used their equitable powers to impose a constructive trust on community assets given to third parties. See *Carnes v. Meador, supra* and *In re Murrell*, 1998 Tex. App. LEXIS 7603 (Tex. App. Amarillo 1998, no writ) where the court found constructive fraud and explains that the equitable title to the property transferred to a third party was still community property.

G. The *Schlueter* Case

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

Relying on *Schlueter*, the Texas Supreme Court has recently ruled that a wife, whose husband had committed a fraud on the community prior to their divorce, was not able to hold a lawyer liable for conspiracy with the husband to commit the fraud. The court reaffirmed the *Schlueter* rationale (i.e., there is no independent tort cause of action for wrongful disposition by a spouse), noting that it is hard to see how the community has been damaged if one spouse retains the fruits of the fraud, and finally held that, if the spouse cannot be held liable for the tort and punitive damages, neither can a co-conspirator. *Chu v. Hong*, S.W.3d 441 (Tex. 2008), *rev'g* 185 S.W.3d 507 (Tex. App. – Fort Worth 2005, no pet.). The fraudulent sale was found to be void and the buyers were divested of ownership; interestingly, the lawyer represented the buyer.

H. Death of a Spouse

In the event the marriage terminates by reason of the death of a spouse, the managing spouse should be liable to the estate of the other spouse, or the estate of the managing spouse should be liable to the other spouse, for any actual damages suffered by the other spouse arising from a fraud on the community. For example, if $100,000 of community assets were wrongfully transferred by the managing spouse to a third party, the other spouse, or that other spouse's estate, has a claim for money damages in the amount of $50,000, an amount equal to the other spouse's one-half community interest in the $100,000 wrongfully transferred. If the managing spouse, or the managing spouse's estate, does not have sufficient assets to satisfy the claim for damages, the court may impose a constructive trust on the third party donee in order to retrieve one-half the community asset that had been wrongfully transferred to the donee. *Carnes v. Meador, supra*. *See Osuna v. Quintana*, 993 S.W.2d 201, 209 (Tex. App.-Corpus Christi 1999, no pet.) discussing the difference in remedies in death and divorce situations.

1. <u>THE HARPER CASE</u>

In *Harper v. Harper*, 8 W.S.3d 783 (Tex. App.—Ft. Worth 1999 pet. den.), the court cites *Schlueter* for the holding that ". . . fraud on the community exists outside the realm of tort law and cannot be brought as an independent cause of action . . ." before holding that punitive damages are not recoverable. The only damages being sought against the managing spouse in *Harper* were punitive damages since the estate of the other spouse had already received half of the sales proceeds (plus interest) in satisfaction of the other spouse's interest in the property at issue. *Harper* and *Schlueter* do not hold that the other spouse cannot seek actual damages where the managing spouse commits a fraud on the community.

2. <u>EXAMPLES</u>

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

b. If the wife dies first, any cause of action for fraud on the community belongs to her successor in interest, the personal representative of her estate or her heirs or devisees. However, the life insurance policy and the bank account, being the husband's special community property, are simply partitioned by reason of the wife's death, as probate assets. The wife's successor may then elect to pursue the fraud claim against the husband concerning the car. Of course, if the husband is the wife's sole heir or devisee, the claim is extinguished unless the wife's estate is insolvent since the claim is an asset subject to the wife's debts under Tex. Prob. Code §37.

I. *Street v. Skipper*

In *Street v. Skipper*, 887 S.W.2d 78 (Tex. App. - Ft. Worth 1995, writ denied) a special community property life insurance policy was payable to the insured spouse's probate estate, and his wife correctly argued that the husband did not have the power to devise her one-half of the policy proceeds to a third party, his devisees (an estate is not an entity). In effect, the wife was arguing that the proceeds payable to the estate were probate assets and she was entitled to one-half of the proceeds without needing to prove fraud on the community (the partition approach). In other words, the husband did not have the authority to devise the wife's one-half interest in the community, which is a fundamental concept. *See* V, H, *supra*.

However, the court held that the controlling issue was whether or not the husband had committed fraud on the community. It then considered the fact that the value of the total community estate, including the life insurance policy, was approximately $4,600,000 and that under the will the wife would retain and/or inherit more than half of that amount by reason of her husband's death. In addition, she received a portion of the husband's separate property, including her homestead rights in his separate property home. The court concluded that a fraud on the community had not occurred. The result may have been correct, but the reasoning was not. While the husband did not have the authority to devise his wife's one-half of the proceeds, perhaps it was her "election" to take under the will that estopped her from asserting her right to her one-half of the proceeds.

1. <u>THIRD PARTY DESIGNATION?</u>

Would the result in *Street* be different had the husband designated the third party as the direct beneficiary of the policy rather than designating his estate? Arguably not. Such a change in facts raises the issue of fraud on the community, and assuming the wife still retained or inherited in excess of one-half of the value of the community by reason of her husband's death, the result would depend on the overall "fairness" of the situation. *See Jackson v. Smith*, *supra* and *Readfern v. Ford*, 579 S.W.2d 295 (Tex. App.—Dallas 1979, writ ref'd n.r.e.). *See* II, F, 4, *infra*.

2. <u>TWEAKING THE FACTS</u>

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

3. <u>ELECTION?</u>

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

The tougher theoretical question may be whether the wife can assert her claim of fraud on the community (or her right to one-half of the proceeds under the partition approach) and still retain the property devised to her in the will. In other words, will she be required to, in effect, "elect against the will" in order to pursue her community interests devised to a third party or the husband's estate?

J. Federal Preemption

In *Barnett v. Barnett*, 67 S.W.3d 107 (Tex. 2001), the Texas Supreme Court held that a wife's claim for constructive fraud on the community and her corresponding claim for the imposition of a constructive trust following her husband's death were preempted by ERISA. In that case, a husband had designated a third party as the beneficiary of a life insurance policy that was part of an employee benefit plan covered by ERISA.

Although the policy was community property, the wife's claim in *Barnett* was based on Texas law (i.e., "fraud on the community") that had a connection with an ERISA plan and was, accordingly, preempted. The court explained that the application of Texas community property laws would interfere with the national uniformity of a matter central to ERISA plan administration. Thus, in the absence of actual common law fraud, the court found that Texas' concept of "fraud on the community" had no counterpart in federal common law.

<u>Note:</u> *See XVII, infra, Effect of Death on ERISA Retirement Plans.*

K. Illusory Transfers

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

<u>Query</u>: *To date, the illusory transfer argument has been applied only to revocable trusts. Would it also apply in theory to any revocable nonprobate disposition (e.g., a POD bank account)?*

L. Fraud on Creditors

Certain transfers between spouses and transfers to third parties may be set aside by creditors under both Texas and federal law. *See* the Uniform Fraudulent Transfer Act. Tex. Bus. & Comm. Code Secs. 24.001-24.013 and the U.S. Bankruptcy Code, 11 U.S.C. Sec. 544(b).

<u>Note</u>: *The definition of creditor includes a spouse who has a claim.*

IX. REIMBURSEMENT

Reimbursement between the marital estates usually arises when one spouse's separate property is improved through the expenditure of community funds or community time, talent and labor. Reimbursement may also be applicable if separate funds are expended to benefit community property. The increased importance of this concept over the last thirty years is due to the *Cameron v. Cameron*, 641 S.W.2d 210 (Tex. 1982) and *Eggemeyer v. Eggemeyer*, 554 S.W.2d 137 (Tex. 1977) cases, as well as legislative interference over the last eleven years.

A. Claim of Reimbursement

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

B. Measure of Reimbursement

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

1. <u>"COST OF THE IMPROVEMENT"</u>

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

2. <u>"ENHANCED VALUE OF THE IMPROVEMENT"</u>

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

3. <u>"LESSER OF COST OR ENHANCED VALUE"</u>

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

C. Application at Death

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

D. Case Law Developments

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

1. <u>VALLONE</u>

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

2. <u>COOK</u>

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

a. <u>Principal Reduction</u>

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

b. <u>Interest and Taxes</u>

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

c. *Improvements*

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

3. JENSEN

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

4. ANDERSON

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

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

5. PENICK

In *Penick v. Penick*, 783 S.W.2d 194 (Tex. 1988), the Supreme Court held that advancements of community funds to either reduce the principal on purchase money indebtedness secured by separate property or to make capital improvements on separate property are to be measured by the same test – the enhancement in value to the benefitted estate. In addition, the Court directed the trial court to take into consideration benefits received in return by the community estate. How does paying off the balance of a note payable enhance the value of the pledged assets?

6. HEGGEN

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

Note: The 1995 amendments to the Texas Constitution expanded the types of debts that can be secured by the homestead.

7. OTHER CASES

There have been a number of cases citing *Vallone*, *Jensen* and *Anderson*. *See generally Allen v. Allen*, 704 S.W.2d 600 (Tex. App.—Ft. Worth 1986, no writ); *Hernandez v. Hernandez*, 703 S.W.2d 250 (Tex. App.—Corpus Christi 1985, no writ);

Wren v. Wren, 702 S.W.2d 250 (Tex. App.—Houston [1st Dist.] 1985, writ dismissed w.o.j.); *Jones v. Jones*, 699 S.W.2d 583 (Tex. App.—Texarkana 1985, no writ); *Zisblatt v. Zisblatt*, 693 S.W.2d 944 (Tex. App.—Fort Worth 1985, writ dism'd w.o.j.). In *Jacobs v. Jacobs*, 687 S.W.2d 731 (Tex. 1985), the Supreme Court addressed the proof issues related to *Vallone* and *Jensen*. One court of appeals case, *Trawick v. Trawick*, 671 S.W.2d 105 (Tex. App.—El Paso 1984, no writ) appears to extend *Vallone* and *Jensen* to estate administration situations.

E. Additional Applications

1. LIFE INSURANCE

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

2. OTHER APPLICATIONS

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

F. Legislation

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

1. 1999 LEGISLATION

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

a. *Equitable Interest Defined*

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

b. *Amount of Claim*

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

c. Equitable Lien

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

d. <u>No Offsetting Benefits</u>

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

e. <u>Life Insurance</u>

The 1999 statute raised serious questions related to its application to life insurance situations. For example, where there was a separately owned policy, but community funds were used to pay some of the premiums, was this a Sec. 3.401 (1999) financial contribution? Did Sec. 3.401(b) (1999) or Sec. 3.402 (1999) apply? Or did the *McCurdy* case still apply?

f. <u>Effective Date</u>

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

2. <u>2001 LEGISLATION</u>

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

a. <u>Intent</u>

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

b. <u>Economic Contribution Defined</u>

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

c. <u>New Formula</u>

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

d. <u>Use and Enjoyment</u>

The use and enjoyment of the property during marriage did not create a claim of an offsetting benefit. Tex. Fam. Code Sec. 3.403(e). For example, the couple's occupancy of the separate property home of the husband that was improved with community funds was not an offset.

e. <u>Equitable Lien</u>

In divorce situations, an equitable lien was imposed to secure payment of the claim. In death situations, a party of interest had to request the imposition of the equitable lien. Tex. Fam. Code 3.406. The equitable lien could be imposed on any assets of the owner of the benefitted property; the court was not limited to the benefitted property itself.

f. Claims for Reimbursement

The claim for economic contribution did not eliminate from Texas law the traditional claim for reimbursement except in those fact situations that were statutorily defined claims for economic contributions. Tex. Fam. Code Sec.3.408(a). In fact, the statute gave examples of the more traditional claim for reimbursement—payment of unsecured liabilities and *Jensen* type claims. Tex. Fam Code Sec. 3.408(b). Claims for reimbursement were to be resolved using equitable principles, including "use and enjoyment" offsets. Tex. Fam. Code Sec.Sec. 3.408(c) and (d). A 2007 amendment to the section placed the burden of proof on the party seeking the offset. Tex. Fam. Code § 3.408(e).

g. Marital Property Agreement

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

3. 2009 LEGISLATION

SB 866 (effective 9/1/09) contained another major overhaul to subchapter E. There are no longer "claims for economic contribution."

a. Intent

What had been defined separately as claims for economic contribution and statutory claims for reimbursement are now combined as "claims for reimbursement."

b. Reimbursement Defined

A claim for reimbursement includes payment by one marital estate of an unsecured liability of another marital estate; inadequate compensation for the time, toil, talent and effort of a spouse by a business entity under the control and direction of that spouse; what had been considered claims for economic contribution under former Sec. 3.402(a); and the reduction by the community property estate of an unsecured debt incurred by the separate estate of one of the spouses. Tex. Fam. Code § 3.402(a). Economic contributions previously arose in six statutorily defined situations related to use of one marital estate's funds to reduce the principal amount of debt secured by another marital estate or to make capital improvements to another marital estate.

c. Equitable Principles

A claim for reimbursement is to be resolved by using equitable principles, including the principle that claims for reimbursement may be offset against each other if the court determines it to be appropriate. Tex. Fam. Code § 3.402(b). However, reimbursement for funds expended by a marital estate for improvements to another marital estate be measured by the enhancement in value to the benefited marital estate. Tex. Fam. Code § 3.402(d).

d. Use and Enjoyment

The use and enjoyment of property is to be generally offset against a claim for reimbursement for expenditures to benefit a marital estate, except a party may not claim an offset for use and enjoyment of a primary or secondary residence owned in whole or part by the separate estate against contributions made from the community estate to benefit the separate estate. Tex. Fam. Code § 3.402(c). The party seeking an offset to a claim for reimbursement has the burden of proof with respect to the offset. Tex. Fam. Code § 3.402(e).

e. Surviving Spouse's Election

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

f. Equitable Lien

Section 3.406 authorizes (rather than requires) the court, on dissolution of a marriage, to impose an equitable lien on the property of a benefited marital estate to secure a claim for reimbursement against that property by a contributing marital estate. It also authorizes (rather than requires) the court, on the death of a spouse, on application for a claim for reimbursement brought by the surviving spouse, the personal representative of the estate of the deceased spouse, or any other person interested in the estate, to impose an equitable lien on the property of a benefited marital estate to secure a claim for reimbursement against that property by a contributing marital estate.

Note: Apparently, an equitable lien can no longer be imposed on any assets of the owner of the benefited property; the lien appears to be limited to the benefited property itself.

g. Equitable Claims

Notwithstanding the repeal of Section 3.408, surely the new law does not eliminate from Texas law traditional claims for reimbursement. Section 3.409 still described some nonreimbursable claims—payment of child support, alimony or spousal maintenance, living expenses of a spouse or child, contributions or principal reductions of nominal amounts, and student loan payments. Tex. Fam. Code § 3.409.

Note: Despite some apparent confusion on the part of some courts (see Lewis v. Lewis, 1999 Tex. App. LEXIS 4920 (Tex. App.—Houston [1st Dist., no pet], "waste of community assets" should be considered as a type of fraud on the community, not a claim for reimbursement.

h. Non-Reimbursable Claims

The statute still describes some nonreimbursable claims—payment of child support, alimony or spousal maintenance, living expenses of a spouse or child, contributions or principal reductions of nominal amounts, and student loan payments. Tex. Fam. Code Sec. 3.409.

i. Marital Property Agreement

Marital property agreements executed before or after September 1, 2009, the effective date of the 2009 legislation, which waive or partition reimbursement claims or claims for economic contribution will be effective to waive claims for current claims for reimbursement. Tex. Fam. Code § 3.410.

G. Death of Non-Owner Spouse

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

1. DUTY OF PERSONAL REPRESENTATIVE

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

2. LIQUIDITY PROBLEMS

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

3. CONFLICT OF INTERESTS

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

H. Death of Owner Spouse

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

1. CONFLICT OF INTERESTS

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

2. ELECTION

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

3. OTHER PROBLEMS

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

X. EFFECT OF SPOUSE'S DEATH ON DEBTS

Borrowing a description in a different area of Texas law by the Fifth Circuit trying to explain Texas law, both "inarticulateness and over expression," as well as the failure to appreciate how the law changed in 1967 due to legislative mandates, continue to create confusion for the practitioner advising a personal representative on how debts should be paid following the death of the first spouse to die. For example, courts continue to ignore clear legislative mandate with general statements of law that might have been more accurate before the changes in the 1960s that introduced the concept of divided management and liability of marital property.

A. The Red Herring

For example, in *Estate of Herring*, 983 S.W.2d 61, 63 (Tex. App—Corpus Christi, 1998 no pet.), the court states: "The community assets of an estate, although they may vest in the surviving spouse and heirs upon the decedent's death, and held subject to the payment of community debts and subject to the right of a duly appointed and qualified personal representative to have possession and control during administration..... Moreover, while under the jurisdiction of the probate court, all community property, including the half interest of the surviving spouse, is subject to administration and sale by the probate court as part of the estate of the deceased spouse." As its authority, for this explanation of Texas law, the court cites no case later than 1971.

The court also makes a parenthetical reference to Section 177 (an executor is authorized to administer all community property subject to the sole or joint management of the deceased spouse) but the court ignores that reference in its inaccurate general statements of the law.

Of course, its general statements were accurate within the facts of the case, since the only property at issue was, in fact, joint community property prior to the first spouse's death.

B. 1971 Amendment to Sec. 156

Following the enactment of the original Texas Family Code in the late 1960s, with it revolutionary system of divided marital management and liability rules, the legislature in 1971 attempted to clarify what debts would be payable out of the community property after the death of a spouse by amending Sec. 156 of the Texas Probate Code. Prior to 1971, Section 156 simply stated: "Community property, except as is exempt from forced sale, shall be charged with all valid and enforceable debts existing at the time of the dissolution of marriage by death."

1. <u>1971 LANGUAGE</u>

"The community property subject to the sole or joint management, control, and disposition of a spouse during marriage continues to be subject to the liabilities of that spouse upon death. In addition, the interest that the deceased spouse owned in any other nonexempt community property passes to his or her heirs or devisees charged with the debts which were enforceable against such deceased spouse prior to his or her death."

2. <u>THE CONTROVERSY</u>

A key issue before the legislature in 1971 was whether the exemption from the husband's contractual debts that the wife's special community property enjoyed should survive the husband's death. The legislature adopted Professor M. K. Woodward's recommendation: The exemption would continue with respect to the wife's one-half of her special community property, but the husband's one-half would be subject to the claims of his creditors. See Remy, "The Effect of the 1971 amendments to the Probate Code on Control of Community Property After the Death of a Spouse and for Payment of Community Debts," 34 Tex. B.J. 685 (1971).

3. <u>LACK OF GUIDANCE</u>

Unfortunately, the legislature in 1971 (as well as in subsequent sessions) has not provided clear statutory guidance for other related issues. For example, during marriage, the entire community estate is generally liable for any tortions debt of either spouse incurred during marriage. Does all of the community property remain liable for the tort debts of either spouse after the first spouse dies? If the spouse who committed the tort dies, it is clear that the 100% of the deceased spouse's special community and joint community property, as well as the decedent's one-half interest in the surviving spouse's special community property, remain liable. But, Section 156 is silent as to liability of the surviving spouse's one-half of the survivor's special community property following the deceased tortfeasor's death.

4. <u>TORT CLAIMS</u>

In an analysis of the 1971 amendment to Section 156, one leading authority has concluded: "Hence, all of the community that was liable for the debts of the deceased spouse during marriage [including tort debts] will continue to be liable for the same debts after death." Woodward, Smith & Beyer, Texas Practice Series - - Probate and Decedent's Estates, § 542 (Thomson Reuters/West, 2008 ed).

Note: However, it should be noted that Section 156 literally says only the decedent's special community, the joint community and the decedent's one-half of the survivor's special community are liable for the decedent's debts. It does not list the survivor's one-half of the survivor's special community as being liable, suggesting it is exempt after the tortfeasor's death. See XII, E, *infra.*

5. SURVIVING SPOUSE'S DEBTS

Section 156 also does not mention the debts of the surviving spouse. So, what procedure does the surviving spouse's creditor follow, if the deceased spouse is not personally liable for the debt? Is the personal representative obligated to pay such a debt? *See* XIII, *infra*.

C. Community Debt - The Misnomer

Section 156 of the Texas Probate Code was enacted in 1955, effective Jan. 1,1956. It has been amended twice, in 1971 and 2007, but it is submitted that neither amendment adequately addressed the concept of divided liability described above.

1. ANNOTATIONS

Further, every decision listed in the annotations under Section 156 was decided prior to 1967. It is submitted that any pre-1967 case is questionable authority when applied to a post-1967 situation. In other words, the reference to "community debts" in Section 156's second sentence is, in the author's opinion, a misnomer under current law, and Section 156 should be interpreted in light of the 1967 changes to Texas marital property law.

2. SECTIONS 160 and 168

Sections 160 and 168 are the only other sections of the Texas Probate Code that make references to "community debts" or "community obligations."

a. If no one has qualified as the personal representative of the deceased spouse's estate, the surviving spouse "as the surviving partner of the marital partnership" has the power to sue and be sued for the recovery of community property, to sell and otherwise dispose of community property for the purpose of "paying community debts," as well as such other powers as are necessary to "discharge community obligations, and wind up community affairs." Tex. Prob. Code § 168

b. "The surviving spouse shall keep an account of "all community debts and expenses" paid. Upon final partition, the surviving spouse shall deliver to the heirs or devisees of the deceased spouse their interest in the deceased spouse's estate after deducting the proportion of the "community debts." Tex. Prob. Code § 168. If the deceased spouse died intestate and the decedent's interest in the community property passes to the surviving spouse, no administration of the community property is necessary. Tex. Prob. Code § 155

c. Sections 160 and 168 were enacted in 1955, to be effective Jan. 1, 1956, and they have been amended since the late 1960s, but it is submitted that their amendments did not adequately address the concept of divided liabilities referred to above. Again, it is submitted that any reference to "community debts" or "community obligations" is a misnomer under current law and those sections should be interpreted in light of the 1967 changes to Texas marital property law. Every relevant decision listed in the annotations under Sections 160 and 168 was decided prior to 1967 or the facts in issue occurred prior to 1967.

3. PROPER TERMINOLOGY

The term "community debt" suggests that both spouses are personally liable on the debt and/or that all community property can be reached to satisfy the debt. However, neither statement may be accurate under the circumstances. Focus under current law should be on the "debts of a spouse," not "community debts." In other words, is the debt the husband's debt, the wife's debt, or the debt of both the husband and wife? See IV, *supra*.

If the term *community debt* has a post-1967 meaning, it should be limited to those debts of both the husband and wife, (i.e. the liability is joint and several) and all of the community is available to satisfy the debt under Section 3.202, but such a definition would still not necessarily lead to an accurate interpretation of Sections, 37, 156, 160 or 168.

D. 1971 Amendments to Sec. 177

Prior to its 1971 amendment, the relevant parts of Section 177 provided: "...such executor or administrator, as the case may be, is authorized to administer, not only the separate property of the deceased spouse, but also the community property which was by law under the management of the deceased spouse during the continuance of the marriage; and the surviving spouse, as surviving partner of the marital partnership, is entitled to retain possession and control of all community property which was legally under the management of the surviving spouse during the continuance of the marriage...."

Incorporating the concepts of the then newly enacted Texas Family Code, the 1971 version stated: "...such executor is authorized to administer, not only the separate property of deceased spouse, but also the community property which was by law under the management of the deceased spouse during the continuance of the marriage and all of the community property that was by law under the joint control of the spouses during the continuance of the marriage. The surviving spouse, as surviving partner of the marital partnership, is entitled to retain possession and control of all community property which was legally under the sole management of the surviving spouse during the continuance of the marriage...."

Note: Section 177 permits the surviving spouse to waive his or her right to manage the survivor's special community property, thereby permitting the personal representative to manage the entire community during administration. Does this waiver change the rules concerning liability? No statutory answer is given. It is the author's opinion that it does not.

E. Listen to the Supreme Court

In *Arnold v. Leonard*, the Texas Supreme Court approved the authority of the legislature to define the management and liability rules related to marital property. The legislature has responded with Sections 3.101, 3.102 and 3.103 of the Texas Family Code and Sections 156 and 177 of the Texas Probate Code. The basic legislative mandate is straight forward - -

- When the first spouse dies, the couple's joint community property, the deceased spouse's special community property and the deceased spouse's separate property are the marital assets subject to administration and are available to satisfy the deceased spouse's debts.

- While the surviving spouse may allow the personal representative to administer the survivor's special community property, the decedent's separate property, the couple's joint community property and the decedent's special community property are the primary assets subject to the deceased spouse's debts. In addition, the decedent's interest in the survivor's special community is subject to the decedent's debts.

F. Testator Direction

Notwithstanding the relevant provisions of the Texas Family Code and Texas Probate Code, the deceased spouse's will may include specific instructions on how debts are to be paid. For example, a provision in the will that directs that "all of the testator's debts are to be paid out of the residuary estate" could be interpreted to mean that any debt for which the testator had personal liability is to be paid out of the testator's separate property or one-half of the community property passing as part of the residuary estate. Absent such a provision, some debts are to be paid out of both the testator's and the surviving spouse's halves of the community. The provision, therefore, benefits the surviving spouse to the detriment of the residuary beneficiaries.

A specific provision in a will could be interpreted as benefitting the residuary beneficiaries to the detriment of the surviving spouse, thereby putting the surviving spouse to an election to suffer the detriment as the price to pay for any benefits under the testator's will.

Note: Sections XII and XIII, infra, assume that there is not a specific provision in the deceased spouse's will that would affect the default rules of marital liability by reason of a spouse's death.

G. Compare Divorce

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

XI. EQUITABLE ADJUSTMENT/ REIMBURSEMENT

Sections 156 of the Texas Probate Code and 3.202 of the Texas Family Code purport to define which assets of the marriage are liable for which debts. Section 3.203 of the Texas Family Code gives a court discretion based on equitable principles to determine which marital assets are to be actually used to satisfy a particular debt. There is not a corresponding provision in the Texas Probate Code, which has as its focus satisfying the decedent's creditors during administration of the decedent's estate.

A. Lack of Statutory Guidance

Noticeably absent from the Texas Probate Code is any significant attention to the relative rights of the deceased spouse's successors in interest and the surviving spouse during the administration of the decedent's estate. What is needed is a marital property "abatement" statute, something similar to Section 322B of the Texas Probate Code, the Abatement of Bequests. Since there is not such a statute, the equitable principles explained in Section 3.203 of the Texas Family Code in satisfying the deceased spouse's debts should be followed. *See* IV, A(5), *supra*.

1. <u>EQUITABLE ADJUSTMENT</u>

For example, certain debts should be paid out of the decedent's separate property, if available, and if not and if community property is used to satisfy those debts, an "equitable adjustment" should be made in the partition and distribution of the remaining community property upon the closing of the estate so that the surviving spouse does not pay one-half of a debt that should have been paid out of the decedent's separate property.

2. <u>EQUITABLE REIMBURSEMENT</u>

Other situations may call for "equitable reimbursement" of the community estate out of the decedent's separate estate or "equitable reimbursement" of the separate estate out of the community estate, in order to achieve a fair and equitable partition and distribution of the separate and community assets being administered by the personal representation of the estate.

3. <u>AN EQUITABLE RESULT</u>

For example, certain debts should be paid with community funds, and if the decedent's separate property is used to satisfy the debt, an "equitable adjustment" should be made in the partition of any remaining community assets at the close of the estate so that the decedent's successors are not paying the part of a debt that should be paid by the surviving spouse. If an "equitable adjustment" does not reach a fair and equitable result, the surviving spouse should "reimburse" the estate for one-half of the debt that should have been paid out of community property.

B. Historical Support

While the term "equitable adjustment" may be a new term within this context, "equitable reimbursement" has been used for 150 years in Texas as a means to recompense one marital estate, when funds from that marital estate were utilized to benefit another martial estate. Historically, equitable reimbursement arose during the marriage when one spouse expended community funds to benefit that spouse's separate property, or expended separate funds to benefit community property. *See* IX, *infra*.

It is not too much of a stretch to extend the concept of "equitable reimbursement" and to add the concept of "equitable adjustment" to estate administrations where a personal representative, in its fiduciary capacity and within its duty of impartiality, needs to satisfy creditors, and at the same time, balance the relative rights of the surviving spouse and the deceased spouse's heirs and/or devisees. Early Texas cases support this idea. In *Williams v. Davis* 133 S.W.2d 275 (Tex. Civ. App. Ft. Worth—1939 no writ), the court noted that a husband, after his wife's death, could reimburse himself, if he used his separate property to pay a community debt. Another held a surviving spouse may pay community debts with separate property and reimburse himself by an appropriation of community property. See also *Sanger Bros. v. Moody Heirs,* 60 Tex. 96 (1883). This power is legalized when the surviving spouse is a "qualified community administrator" (a concept repealed in 2007). *Davis v. McCartney*, 64 Tex. 584 (1885). If it is legal in the latter, it must have been equitable in the former. See *Leatherwood v. Arnold*, 66 Tex. 414, 1 S.W. 173 (1886).

C. Tax Elections

The personal representative is required by law satisfy to the deceased spouse's debts, but the decision of how to pay a particular debt can benefit one of the parties of interest at the expense of another (just like a tax election made by an executor may benefit one beneficiary at the expense of another in that context). Noel Ice has asked whether the executer can make, or is required to make, an "equitable adjustment" to even out the effects of tax elections. His research indicated this is a developing area of law in other jurisdictions and has yet to be clearly recognized by Texas courts. See Noel Ice, Post Mortem Elections and Equitable Adjustments: A Brief Checklist(1997), http://www.trustsandestates.net/Nutshell/PostMortem chklst/postmor.htm. Mickey Davis reported in 2007 that prior to the adoption of the Uniform Principal and Income Act, Texas statutes had no provision for equitable adjustment, although it had been part of the common law in other jurisdictions for some time. Davis, "Ten Things Estate Planners Need to Know About Income Tax Matters," <u>San Antonio Estate Planning Council's Docket Call in Probate</u> (Feb. 16, 2007).

D. Partition of Co-Tenancies

Texas courts have historically applied the concept of "equitable contribution" when partitioning property owned by co-tenants. See *Roberts v. Roberts*, 36 Tex. 255, 150 S.W.2d 236 (Tex.) And 86 CJS Tenancy in Common § 21 (2009).

E. Conclusion

It is submitted that the only way a fair partition and distribution of the community can occur after the death of the first spouse is to follow the mandate of Section 3.203 and utilize the concepts of "equitable adjustment" and "equitable reimbursement."

XII. DECEASED SPOUSE'S DEBTS

The possible debts of the deceased spouse outstanding at the time of death include: (i) the decedent's unsecured contractual debts for which the surviving spouse has no personal liability ("the decedent's unsecured debts"), (ii) the decedent's contractual debts secured by the decedent's separate property for which the surviving spouse has no personal liability ("the decedent's debts secured by separate property"), (iii) the decedent's contractual debts secured by community property for which the surviving spouse has no personal liability ("the decedent's debts secured by community property"), (iv) the decedent's tort debts for which the surviving spouse has no personal liability ("the decedent's tort debts"), and (v) the contractual or tort, secured or unsecured, debts for which both spouses have personal liability ("joint debts").

<u>Note</u>: *But, as explained in XI, supra, the application of equitable principles may be needed to reach a fair partition of the community assets during administration, whether the claim is secured or unsecured, contract or tortious.*

A. Secured Creditor Notice and Election

The Family Code's marital liability rules and Probate Code's procedures appear to provide a relatively straight forward system of addressing the presentation and payment of these debts. If the debt is secured by the decedent's separate property or the decedent's special community property or the couple's joint community property (assets subject to administration pursuant to Section 177), the personal representative must give the Section 295 notice, and the creditor can elect to treat the claim as a *matured, secured claim* or a *preferred debt and lien claim*.

B. Unsecured Debts

1. <u>PRE-MARITAL DEBT</u>

If an unsecured was incurred prior to the marriage of the decedent and the decedent's spouse, regardless of the type of debt, the creditor should be able to pursue the debt in due course of administration, and legislative mandate suggests that the personal representative should pay the debt out of the decedent's separate property, if sufficient to satisfy the debt, and if not, out of the community assets in its control, normally the decedent's special community property and then the joint community property.

While the decedent's separate property, the decedent's special community property and their joint community assets are reachable by the creditor under Section 156 and Sec. 3.202 of the Texas Family Code. Sec. 3.203 of the Texas Family Code suggests that a just and equitable order of payment is to be utilized. If the personal representative needs to use community assets to satisfy the debt, equity suggests that only the decedent's one-half (i) of the decedent's special community or (ii) of the joint community should be utilized, although all of the decedent's special community and joint community are, in fact, liable and can be used, if needed to satisfy the debt.

If any of the surviving spouse's one-half of the community is used to pay the debt, wouldn't equitable adjustment or reimbursement be appropriate?

The rationale: Why should the surviving spouse pay for part of a debt that accrued prior to marriage?

2. <u>DEBT DURING MARRIAGE</u>

If the unsecured debt was incurred during the marriage, the creditor can pursue the debt in due course of administration, and legislative mandate suggests that the personal representative should assume that the debt is to be paid out of the community assets under its control, not just the decedent's one-half interest therein. Presumably, the debt was incurred for the "benefit of the community" (such as a utility bill or credit card balances for living expenses). If the community property available to the personal representative is not sufficient to satisfy the debt, the personal representative should then resort to the decedent's separate property. While the decedent's separate property and special community property, as well as the joint community property, are liable for the debt under Section 156 and Section 3.202, the equitable principles of Section 3.203 suggest such an equitable order of abatement is appropriate; and the personal representative should seek "equitable reimbursement" from the surviving spouse for one-half of the amount if separate property is used to pay the debt. Alternatively, an equitable adjustment may be appropriate in the partition and distribution of the surviving spouse's special community property.

The rationale: Why should the decedent's successors pay all of the debt when one-half of the payment accrued to the survivor's benefit?

3. <u>"NOT FOR THE COMMUNITY"</u>

If the unsecured debt was not incurred for the "benefit of the community," the equitable principles of Section 3.203 would suggest that the personal representative should satisfy the debt out of the decedent's separate property prior to using any community property and, if necessary, then the decedent's one-half of the community should be used. Examples of such a debt include an unsecured loan to benefit the decedent's separate property or a debt incurred on behalf of the decedent's child by a prior marriage.

If the decedent's separate property and the decedent's one-half of the community are not sufficient to satisfy the debt, the remaining community assets under the control of the personal representative would be used to satisfy the debt. If so, shouldn't the personal representative either (i) make an "equitable adjustment" in the subsequent partition of any remaining community assets between the surviving spouse and the decedent's successors in interest, or (ii) reimburse the survivor out of the decedent's separate property for the survivor's one-half of the survivor's community property so used?

The rationale: Why should the surviving spouse pay for such a debt of the deceased spouse?

C. Debts Secured by Separate Property

Whether incurred prior to or during the marriage, the secured creditor can pursue the claim in due course of administration and can also elect to treat the claim as a "matured, secured claim" under Section 306, thereby requiring the personal representative to satisfy the debt during administration, notwithstanding the terms of the note and the security instrument.

1. <u>USE OF SEPARATE FUNDS</u>

Whether the debt is treated as a "matured, secured claim" or a "preferred debt and lien," any payments on the debt should presumptively be paid out of the decedent's separate property, although the community property under the control of the personal representative is reachable by the creditor, assuming the decedent was personally liable on the debt. Examples of this type of debt would include purchase money indebtedness and a loan incurred for improvements to the separate property.

2. <u>USE OF COMMUNITY FUNDS</u>

If community funds are used to make any such payments, shouldn't an "equitable adjustment" be made in the division of the remaining community assets (including the surviving spouse's special community)? Alternatively, the personal representative should reimburse the surviving spouse out of the decedent's separate property for the surviving spouse's one-half of any community property used to benefit the decedent's separate property.

The rationale: Why should the surviving spouse pay part of such a debt of the deceased spouse?

3. <u>COMMUNITY BENEFIT</u>

If the debt was incurred during the marriage for the "benefit the community," the equitable principles of Section 3.203 would suggest that the debt should be paid with community funds so that the decedent's separate property passes to the decedent's successors, free of the debt. On the other hand, the decedent had voluntarily encumbered the separate property for the "benefit of the community." Would this factor negate the need for "equitable adjustment" or "equitable reimbursement," if separate funds are used to satisfy the debt?

D. Debts Secured by Community Property

The creditor with a debt secured by joint community property or the decedent's special property community can pursue the claim in due course of administration and can also elect to treat the claim as a "matured, secured claim" under Section 306, thereby requiring the personal representative to satisfy the debt during administration, notwithstanding the terms of the note and the security instrument.

1. COMMUNITY BENEFIT

Whether the debt is treated as a "matured, secured claim" or a "preferred debt and lien", any payments on the debt should presumptively be paid out of the community property under the personal representative's control, although the decedent's separate property is reachable by the creditor, assuming the decedent was personally liable on the debt. Typically, this type of debt is either a debt incurred to make an improvement to a community asset or to acquire a community asset. Obviously, the debt was incurred for the "benefit the community." If separate funds are used to satisfy the debt, shouldn't an "equitable adjustment" be made to the remaining community assets (including the surviving spouse's special community property), or the personal representative should seek "equitable reimbursement" from the surviving spouse for one-half of the payments.

The rationale: Why should the decedent's successors pay all of the debt when one-half of the payment accrued to the survivor's benefit?

2. NO BENEFIT FOR THE COMMUNITY

However, if the debt was incurred for a reason that was not for the "benefit the community," the equitable principles of Section 3.203 would suggest that the debt should be paid out of the decedent's separate property or one-half of the community property. If not, the personal representative should make an equitable adjustment of the remaining community assets (including the surviving spouse's special community) or reimburse the surviving spouse out of the decedent's separate property for the survivor's one-half of the community so used.

The rationale: Why should the surviving spouse pay for such a debt of the deceased spouse?

E. Tort Debts

The Texas Family Code mandates that all of the community is liable for the tort debts of either spouse during the marriage Tex. Fam. Code Sec. 3.201. Section 3.203's equitable principles suggest, however, that the tortfeasor's separate property should be used first to satisfy the tort. After the tortfeasor's death, Section 156 states that the decedent's separate property, the tortfeasor's special community property and the couple's joint community property remains liable for the tortfeasor's debts. In addition, Section 156 says the tortfeasor's one-half interest in the survivor's special community property passes the heirs and/or devisees, subject to the debt.

1. SURVIVOR'S ONE-HALF

Does Section 156 exempt from the decedent's tort debt the survivor's one-half interest in the survivor's special community property? A literal reading of Section 156 seems to say: "yes" even though immediately prior to the tortfeasor's death, all of the community, the decedent's special, their joint and the survivor's special, were liable for the decedent's torts.

2. THE SOLUTION?

In any event, the creditor can pursue its claim in due course of administration, and the personal representative should pay the debt out of the decedent's separate property, and if it is not sufficient, perhaps out of the decedent's one-half of the community under its control, and if that is not sufficient, then out of the survivor's one-half of the community under its control. If the creditor is still not satisfied in full, the creditor may pursue the decedent's one-half interest in the survivor's special community per Section 156 and perhaps the survivor's one-half interest, as well, if the literal interpretation of Section 156 is not followed. *See* IV, *supra*.

3. <u>EQUITABLE PRINCIPLES</u>

If community property is used to satisfy the tort debt of the deceased spouse, Section 3.203 suggests that an equitable adjustment should be made in the partition and distribution of any remaining community property or that the surviving spouse should be reimbursed for the survivor's one-half of the community used to pay the debt.

The rationale: Why should the surviving spouse pay for any part of such a debt?

F. Joint Debts

Whether tort or contract, incurred prior to or during marriage, this type of creditor can pursue the debt against either the personal representative of the estate in due course of administration or the surviving spouse, or both. If pursued against the personal representative, such a debt should generally be paid out of the community property under the control of the personal representative. If the community is insufficient and the debt is paid out of the decedent's separate property, the personal representative should then seek "equitable reimbursement" from the surviving spouse. If the surviving spouse pays the debt out of the survivor's separate property, Section 3.203 suggests that an equitable adjustment should be made in the ultimate partition of the survivor's special community or the survivor should be able to seek "equitable reimbursement" out of the decedent's separate property or one-half of the community property under the control of the personal representative.

The rationale: Shouldn't both spouses bear proportionate responsibility? However, the exact nature of the debt should be considered.

G. Joint Debt Secured by Survivor's Property

If the joint debt was secured by the decedent's separate property, or the decedent's special community property or the couple's joint community property, the personal representative should give the Section 295 notice and the creditor can elect to treat the claim as a *matured secured claim* or a *preferred debt and lien* pursuant to Section 306. However, if the debt is secured by the survivor's special community or separate property (assets not subject to administration under Section 177), questions are raised. Must the personal representative give the Section 295 notice? Can the creditor make the Section 306 election? See XIII, A.3, *infra*.

XIII. SURVIVING SPOUSE'S DEBTS

Unfortunately, the Texas Probate Code does not give any statutory guidance on how the debts of the surviving spouse are to be handled following the death of the first spouse. As explained in X, *supra*, it is a mistake to treat a debt of the deceased spouse or the surviving spouse as a "community debt." A debt is the debt of the wife, the husband or the debt of both spouses. Absent a statutory mandate, it may be necessary to adapt basic marital property and probate concepts, and perhaps introduce some new ones, equitable adjustment and reimbursement in order to reach the proper result.

A. Joint Debts

As explained in XII, F, *supra*, if both spouses had personal liability for a debt during the marriage, the creditor can pursue the claim against the personal representative of the estate of the deceased spouse in due course of administration or against the surviving spouse. These types of debts include a debt for which the spouses had joint and several liability, whether in a contract or a tort situation, a debt incurred by the surviving spouse for "necessaries" for which the decedent also had personal liability, a debt incurred by the surviving spouse while acting as the agent of the deceased spouse, or a debt of the surviving spouse which was guaranteed by the deceased spouse.

1. <u>SECTION 294(d) NOTICE</u>

Accordingly, if the claim is an unsecured claim for money, the personal representative should be able to give to the creditor the Section 294(d) notice, thereby triggering the 4 month bar rule as against the decedent's estate. If the personal representative wishes to send the notice and trigger the 4 month bar rule, it seems that the notice would need to inform the creditor of the relationship of the deceased spouse and the surviving spouse, if the relationship is not obvious under the circumstances. For example, the couple is John and Jane Smith, or John Smith and Jane Jones (she retained her maiden name); Jane purchases necessities on credit or incurs a co-pay at the emergency room in her name, not as Mrs. John Smith; John dies and John's personal representative sends the 294(d) notice to Jane's creditor under the heading of the "Estate of John Smith". How would the creditor associate the debt with John's estate? However, if proper notice is given and the creditor misses the shortened presentation deadline, is the claim against the surviving spouse barred as well? Probably not!

2. <u>SECTION 295 NOTICE</u>

If the joint debt is secured by an asset that is being administered by the personal representative (presumably their joint community or the deceased spouse's special community property), the personal representative should give the Section 295 notice to the secured creditor who, in turn, should be able to elect to treat the claim as a "matured, secured claim" or a "preferred debt and lien."

3. <u>DEBT SECURED BY SURVIVOR'S PROPERTY</u>

However, if the asset securing the joint debt is not being administered by the personal representative (presumably the surviving spouse's separate property or special community property), it would seem that the Section 295 notice is not required. Section 295(a) appears to direct the personal representative to give the notice only when the debt is secured by "real or personal property of the estate," arguably referring to the estate being by administered by the personal representative, not assets properly in the possession and control of the surviving spouse under Section 177.

Further, Section 306(a) grants to a secured creditor the right to elect to treat its debt as a *matured, secured claim* or a *preferred debt and lien*, if the creditor has a "secured claim for money against an estate," again arguably referring only to the estate being administered by the personal representative, not the surviving spouse under Section 177. However, if the creditor cannot present its claim as a *matured, secured claim*, thereby maintaining the ability to go after other assets of the decedent's estate, the creditor apparently loses the benefit of the deceased spouse's personal liability on the joint debt, presumably placing it in "preferred debt and lien" status in so far as the deceased spouse's estate is concerned. Accordingly, the creditor may not be able to make any further claims against the deceased spouse's separate property and one-half of other community assets. Of course, the creditor would still have its security interest in the asset, and the surviving spouse would still have personal liability.

4. ALTERNATIVE APPROACH

Alternatively, the proper approach may be to interpret Sections 295 and 306 to require the personal representative to give the Section 295 notice to secured creditors if the decedent had personal liability on the debt even if the asset securing the debt is the surviving spouse's separate property or special community property being administered by the surviving spouse under Section 177. Section 306 would then authorize the creditor to treat the claim as a "matured, secured claim" to maintain access to the decedent's estate. This approach could be limited to circumstances where it is readily apparent that the creditor was depending on the personal liability of the deceased spouse when the loan was made (i.e. both spouses signed the note and the security interest, or where the deceased spouse guaranteed the secured debt of the surviving spouse).

5. EQUITABLE PRINCIPLES

Whether tort or contract, incurred prior to or during marriage, this type of creditor can pursue the debt against either the personal representative of the estate in due course of administration or the surviving spouse, or both. If pursued against the personal representative, such a debt should generally be paid out of the community property under the control of the personal representative. If the community is insufficient and the debt is paid out of the decedent's separate property, the personal representative should then seek "equitable reimbursement" from the surviving spouse. If the surviving spouse pays the debt out of the survivor's separate property, Section 3.203 suggests that an equitable adjustment should be made in the ultimate partition of the survivor's special community or the survivor should be able to seek "equitable reimbursement" out of the decedent's separate property or one-half of the community property under the control of the personal representative.

The rationale: Shouldn't both spouses bear proportionate responsibility? However, the exact nature of the debt should be considered

B. Survivor's Tort Debt

Prior to the deceased spouse's death, Section 3.202 of the Texas Family Code clearly provides that all of the community property is liable for the tort debts of either spouse.

1. EFFECT OF DECEDENT'S DEATH

However, Sec. 156 of the Texas Probate Code provides that the decedent's special community property and the joint community property remain liable for the debts of the deceased spouse, whether in contract or tort. In addition, Section 156 states that the decedent's one-half interest in the surviving spouse's special community property is liable for the deceased spouse's debts. During the marriage, one hundred percent of a spouse's special community property was generally not liable for the contractual debts of the other spouse. Obviously, the death of a spouse changes the family code's marital liability rules; here the change benefits the decedent's creditors to the detriment of the deceased spouse's heirs and /or devisees.

2. TORT CREDITOR

Accordingly, did the deceased spouse's death create an exemption from the surviving spouse's tort creditors for the decedent's one-half interest in the community property? Arguably so, under Section 37 the decedent's separate property and one-half interest in the community property (whether the wife's special community, the husband's special community or their joint community property) passes to the deceased spouse's heirs and/or devisees subject only to the *debts of the deceased spouse*. The surviving spouse's tort debt is not a debt of the deceased spouse.

3. THE ARGUMENT

Section 156 then directs the personal representative on how to pay the deceased spouse's liabilities (or the debts that were enforceable against such deceased spouse), and it is submitted that debts that were enforceable against such deceased spouse refer to debts for which the deceased spouse had personal liability and not to debts that could have been paid out of the deceased spouse's property during the marriage. Accordingly, the surviving spouse's tort debts were not debts of the deceased spouse, and while any community property could have been reached by the creditor prior to the deceased spouse's death, it appears that the surviving spouse's tort debt is not a debt to be paid by the personal representative, since the deceased spouse did not have any personal liability for the debt.

4. EQUITABLE PRINCIPLES

If the decedent's one-half of the community property continues to be liable for the surviving spouse's tort debts and if the personal representative of the deceased spouse pays such debts out of the decedent's one-half of the community or out of the decedent's separate property, Sec. 3.203 suggests that an equitable adjustment in the partition and distribution of the remaining community property is appropriate. Alternatively, the personal representative should consider a reimbursement action against the surviving spouse.

C. Survivor's Contractual Debts

Prior to the deceased spouse's death, Section 3.202 provides that the surviving spouse's special community property and their joint community property were liable for the surviving spouse's contractual debts. The deceased spouse's special community property was generally exempt from the surviving spouse's contractual debts. For the reasons discussed in B, *supra*, Sections 37 and 156 appear to maintain the family code's exemption from the surviving spouse's contractual creditors for the decedent's one-half interest in the deceased spouse's special community property. However, it is submitted that the deceased spouse's one-half interest in the rest of the community passes to the deceased spouse's heirs and/or devisees, free of the unsecured contractual debts of the surviving spouse; here the decedent's death appears to cause a detriment to the creditor in favor of the decedent's heirs and/or devisees.

On the other hand, the surviving spouse's one-half interest in all of the community is now available to the surviving spouse's creditors. In addition, to the extent the surviving spouse inherits all or any part of the deceased spouse's separate property or one-half of the community, the inheritance is reachable by the surviving spouse's creditors, unless the inheritance passes into a spendthrift trust for the benefit of the surviving spouse.

D. Survivor's Secured Debts

If the surviving spouse's contractual debt is secured by the surviving spouse's separate property, the approach described in C, *supra*, would appear to be applicable. However, if the debt is secured by the surviving spouse's special community party, the deceased spouse's one-half interest in the special community property of the surviving spouse which secures the debt would pass to the deceased spouse's heirs and devisees, but it is still encumbered by the debt. However, since the deceased spouse had no personal liability on the debt, the personal representative would appear not to have any obligation to give the Section 295 notice or to satisfy the debt. Consequently, it would appear that the creditor would not be able to elect to treat the debt as a *matured, secured claim*, since the debt is not a debt of the deceased spouse. If the personal representative does pay the debt, Section 3.203 suggests that the personal representative should make an equitable adjustment as part of the partition and distribution of the remaining community assets or seek reimbursement from the surviving spouse.

E. Survivor's Pre-Marriage Debt

According to Section 3.202 of the Texas Family Code, a debt incurred prior to marriage, whether contractual or tortious in nature, is to be handled during the marriage in the same way as a contractual debt incurred by the spouse during the marriage. Accordingly, for any pre-marriage debt of the surviving spouse, refer to the discussion in C and D, above.

XIV. MULTIPLE PARTY ACCOUNTS

The most common forms of marital agreements and nonprobate dispositions are multiple-party accounts that are frequently opened by spouses during a marriage. The marital property character of multiple-party accounts are determined in part by the form of account used by the depositing spouse. The form of the account will also dictate the disposition of the funds on dissolution.

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

<u>*Note*</u>*: The question remains as to whether the multiple-party account rules apply to all joint-type accounts at brokerage firms (i.e., securities held in street name) or only those which are, effectively, checking or savings accounts. The Texas Supreme Court in Holmes, supra, indicated that Sections 451-462 of the Texas Probate Code were the exclusive means of establishing rights of survivorship in community property. See 1, F, supra.*

A. Chapter XI

Subject to the 900 lb. Gorilla rule (*see XIV*, C2, *infra*) Chapter XI of the Texas Probate Code now authorizes five different multiple-party accounts. Chapter XI does not use the term "joint tenancy" account or "joint tenancy with right of survivorship" account. Sec. 46 governs joint tenancies; Chapter XI governs multiple-party accounts.

1. <u>JOINT ACCOUNTS</u>

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

2. CONVENIENCE ACCOUNTS

Such accounts are established by the depositer and are owned by the depositer, even if additional funds are added to the account. A "co-signer" may withdraw funds from the account "for the convenience" of the owner of the account but does not acquire ownership of the account during the owner's lifetime or at the owner's death. In other words, there is no right of survivorship. Tex. Prob. Code § 438A.

Note: H.B. 3075 (2009) provided for the addition of "convenience signers" to different account types

3. SURVIVORSHIP ACCOUNTS

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

4. P.O.D. ACCOUNTS

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

5. TRUST ACCOUNTS

A "trust account" belongs to the depositing "trustee" during the trustee's lifetime and passes to the beneficiary of the account at the trustee's death, provided the beneficiary survives the trustee. The existence of such an account depends on the nonexistence of an express trust. A trust account under Chapter XI is not a private express trust. Tex. Prob. Code §§ 438(c) and 439(c).

6. DEPOSITOR INTENT

Sec. 439(a) of the Probate Code was amended to provide that an agreement is sufficient to confer survivorship in a joint account if the account states substantially that all funds or deposits of one party shall vest in and become the property of the surviving party. The question of what is necessary to "make an account survive" is still being litigated and is a subject beyond the scope of this outline.

B. Marital Property Problems

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

1. P.O.D. AND TRUST ACCOUNTS

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

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

b. Upon the death of the depositing spouse, the account belongs to the P.O.D. payee or the trust account beneficiary; provided that, if that person is not the depositor's surviving spouse, the surviving spouse may assert a claim equal to one-half of the funds by alleging that the depositing spouse committed actual or constructive fraud on the community interest of the surviving spouse. Could *Land v.*

Marshall's illusory transfer argument apply? Arguably, *see* VIII, K, *supra*.

c. Upon the death of the non-depositing spouse, the account is a probate asset and belongs one-half to the surviving depositing spouse and one-half to the heirs or devisees of the deceased spouse, subject to administration, since the account is not controlled by a contract provision in that event.

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

2. <u>JOINT ACCOUNTS/ CONVENIENCE ACCOUNTS</u>

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

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

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

3. <u>JOINT ACCOUNTS WITH SURVIVORSHIP RIGHTS</u>

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

a. During the existence of the marriage, the marital property character of the account and assets purchased with such funds will be community, unless the account is a "46b special account" - an account which partitioned the account into the spouses' separate properties. *See* XIV, C.5, *infra.*

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

c. Upon the death of either spouse subsequent to the 1987 amendment, the community account belongs to the surviving spouse, if the survivorship agreement was signed after Nov. 3, 1987.

4. <u>JOINT ACCOUNTS AND THIRD PARTIES</u>

Special community funds of a spouse are deposited into a "joint account" or a "joint account with survivorship rights" of one spouse and a third party who has not made any deposits.

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

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

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

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

e. The death of the third party prior to the death of either spouse would not affect the ownership of the account since, the third party must survive the depositer to assume ownership of the account. It remains the spouses' community property.

f. An attempt by one spouse to unilaterally deposit joint community funds into such an account may be void insofar as the survivorship rights of the third party are concerned. *See* VIII, A, *supra*.

C. Conclusions and Observations

1. <u>IMPORTANCE OF SIGNATURE CARDS</u>

It is readily apparent that to properly characterize the community or separate nature of the assets of a husband and wife, the attorney must closely examine the couple's existing signature cards, as well as their signature cards of the past, in order to accurately trace the ownership of their accounts, as well as assets purchased with funds from those funds deposited into multiple-party accounts.

2. <u>900 LB GORILLA RULE</u>

The terms of the deposit agreement provided by the financial institution may even negate some, if not all, of the rules promulgated by Chapter XI and change the ownership interests and relative rights of the parties to the account. Further, the parties to the account may have no choice other than to accept the financial institution's forms.

3. <u>IMPACT AT DIVORCE</u>

The marital character of bank accounts and assets purchased with funds out of the accounts will be of vital importance in the event of divorce since the divorce court cannot award one spouse's separate property to the other spouse. *See Eggemeyer v. Eggemeyer,* 554 S.W.2d 137 (Tex. 1977) and *Cameron v. Cameron*, 641 S.W.2d 210 (Tex. 1982).

4. <u>IMPACT AT DEATH</u>

The marital property character of joint accounts is not as important today as it was in the past in determining the effectiveness of non-testamentary transfers at death since *Hilley* has been overruled by constitutional amendment. In other words, the 1987 amendment dismissed the need for partitioned bank accounts.

5. <u>THE 46b TRAP</u>

The impact of the "46b trap" should be considered. Assume a married couple deposited community property into a "46b special account" - an account which contained both partition and survivorship language per Sec. 46 prior to the 1987 amendment. Subsequently, they purchased Blackacre with funds in the account, and the land appreciated in value during the marriage.

a. In the event of divorce, Blackacre would not be subject to a "just and right" equitable division by the divorce court since it would not be community property since it was a mutation of the "46b account."

b. In the event of a spouse's death, only the deceased spouse's interest in Blackacre would receive the tax free "step up" in income tax basis. The surviving spouse's interest would not receive the "step up" since Blackacre was not community property.

6. <u>THE HOLMES TRAP</u>

If the couple's joint checking account is a valid survivorship account and a check is written to purchase an asset in both spouses' names, does the account's right of survivorship attach to the newly acquired asset? In the *Holmes* case, stock certificates issued from a brokerage account "carried the rights of survivorship established by those accounts' agreements." The *Holmes* court held that the issuance of the certificates was not a "disposition" under Section 455 which revoked the account's survivorship agreement *See* VII, H, *infra*. It is the author's opinion that writing a check to acquire a new asset should be treated as a "disposition" under Section 455. Thus, no rights of survivorship should be carried forward to the newly acquired asset absent a new agreement among the spouses to create the survivorship rights.

XV. MARITAL PROPERTY RIGHTS IN IRREVOCABLE TRUSTS

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

A. The Private Express Trust

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

1. <u>DEFINITION</u>

A trust, when not qualified by the word "charitable," "resulting" or "constructive," is a fiduciary relationship with respect to property, subjecting the person by whom the title to the property is held to equitable duties to deal with the property for the benefit of another person, which arises as a result of a manifestation of the intention to create the relationship. Restatement Trust (Third) Sec. 2. (2003)

2. <u>CREATION</u>

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

3. <u>REVOCABLE OR IRREVOCABLE</u>

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

B. Beneficial Ownership

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

C. Interests of the Settlor's Spouse

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

D. Settlor's Retained Interest

If the settlor creates an irrevocable trust and retains a beneficial interest in the trust assets, the rights and remedies of the settlor's spouse would appear to be similar to the rights of the settlor's creditors. Creditors can generally reach the maximum amount which the trustee can pay or distribute to the settlor under the terms of the trust agreement, even if the initial transfer into the trust was not in fraud of creditors. For example, if the settlor retains an income interest in the trust assets for the rest of the settlor's life, creditors can reach the retained income interest, and if the settlor retains a general power or appointment over the entire trust estate, creditors can reach the entire trust estate. See Bank of Dallas v. Republic Nat. Bank, 540 S.W.2d 499 (Tex. Civ. App-Waco 1976, writ ref'd n.r.e. If the settlor retains an income interest for the remainder of the settlor's lifetime, the creditors can reach the income interest but not the fixed remainder interest already given to the remaindermen. If the trustee has the discretion to invade the principal for the settlor, the extent of the settlor's retained interest will probably be the entire trust estate. *See Cullum v. Texas Commerce Bank*, 1992 WL 297338 (Tex. App. Dallas 1992). The inclusion of a spendthrift provision will not insulate the settlor's retained interest from the settlor's creditors. *See* Tex. Trust Code § 112.035 and *Glass v. Carpenter*, 330 S.W.2d 530 (Tex. Civ. App.—San Antonio 1959, writ ref'd n.r.e.).

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

The application of these principles in the marital property context would suggest that any income generated by the trust estate would still be deemed community property if the settlor retained an income interest in the trust which, for example, was funded with the settlor's separate property. However, in a recent case where the trust was funded with the settlor's separate property prior to marriage and the trustee was a third party who had discretion to make income distributions to the settlor, the trustee's discretion prevented the trust's income from taking on a community character until the trustee exercised its discretion and distributed income to the settlor. The wife in a divorce action had claimed that all of the trust assets were community property since the income generated during the marriage had been commingled with the trust corpus. *See Lemke v. Lemke*, 929 S.W.2d 662 (Tex. App.—Ft. Worth 1996, writ denied) and *In re Marriage of Burns*, 573 S.W.2d 555 (Tex. App.—Texarkana 1978, writ dism'd w.o.j.). Some older cases support that same result. *See Shepflin v. Small*, 23 S.W. 432 (Tex. Civ. App., no writ 1893 no writ) and *Monday v. Vance*, 32 S.W. 559 (Tex. Civ. App. 1895 no writ).

2. <u>OTHER FACTORS</u>

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

E. Interests of the Non-Settlor Beneficiary

Because a beneficiary of a trust owns a property interest in the trust estate created by a settlor who is not the beneficiary, the ability of the spouse of the beneficiary to establish a community interest in certain assets of the trust should depend on the nature of the beneficiary's interest.

Equitable interests in property, like legal interests, are generally "assignable" and "attachable," but voluntary and involuntary assignees cannot succeed to an interest more valuable than the one taken from the beneficiary.

1. COMPARISON TO CREDITORS' RIGHTS

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

2. PRINCIPAL

The original trust estate (and its mutations and income generated prior to marriage) clearly is the beneficiary's separate property as property acquired by gift, devise or descent, or property acquired prior to marriage. Distributions of principal are likewise the beneficiary's separate property. *See Hardin v. Hardin*, 681 S.W.2d 241 (Tex. App.—San Antonio 1984, no writ)

3. DISTRIBUTED INCOME

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

4. UNDISTRIBUTED INCOME

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

F. Spendthrift Trust

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

G. Powers of Appointment

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

1. <u>SPECIAL POWERS</u>

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

2. <u>LAPSE OF POWERS</u>

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

3. <u>ASCERTAINABLE STANDARD</u>

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

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

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

XVI. COMMUNITY PROPERTY IN THE REVOCABLE TRUST

If a married individual or couple places community property into a revocable trust, the relative marital property rights of the husband and wife could be adversely affected. For example, separate and community could be commingled; community property subject to a spouse's sole management and control could become subject to the couple's joint control. Community property may be deemed partitioned.

A. Professional Responsibility

It is obvious, therefore, that the practitioner advising the couple should be alert for possible conflicts of interests and to make sure the couple understands the effect revocable trust planning could have on their marital property rights during the remainder of the marriage and on its dissolution either by death or divorce.

B. Creation and Funding

Generally, when marital property is to be placed into a revocable trust, steps should be taken to insure that the planning:

1. Is not deemed fraudulent or even "illusory" under *Land v. Marshall*, 426 S.W.2d 841 (Tex. 1968). In this case, the husband placed his sole management community property into a revocable trust; upon his death, the wife disrupted the plan by pulling her one-half interest out of the trust under the "illusory" transfer doctrine.

2. Is not deemed void because one spouse unilaterally attempted to transfer community property subject to joint control into the trust.

3. Does not amount to a "mixing" of the different types of community property so that special community assets become joint community property.

4. Does not work a commingling of community and separate funds as to risk losing the separate character of the separate property.

5. Does not amount to, nor was it intended to be, a partition of community property into their respective separate estates. In other words, precautions should generally be taken in the drafting and funding of the trust to document that the retained equitable interest in community assets placed in the trust remain community during the balance of the marriage, and if an asset was a spouse's special community property, that it maintains that character as well unless a different result is intended after due consideration of the consequences. Of course, a spouse's retained interest in any separate property should remain separate in most situations.

C. Power of Revocation

When a husband and wife fund a revocable trust with community property, should the power of revocation be exercised jointly or severally? If the document directs that either spouse can revoke the trust unilaterally, should the power extend to the whole community asset being withdrawn from the trust or only to the revoking spouse's undivided one-half interest therein?

1. JOINTLY REVOCABLE

If the power to revoke is retained jointly by the couple, the couple's equitable interest in the trust would appear to be their joint community property even though some of the community assets in the trust were a spouse's special community property prior to funding. Converting special community property into joint community property affects the relative marital property rights of the husband and wife. For example, an asset which would have been exempt from certain debts of a particular spouse would become liable. *See Brooks v. Sherry Lane National Bank*, 788 S.W. 2d 874 (Tex. App.—Dallas 1990, no writ.).

2. UNILATERAL PARTITION

To avoid converting special community property into joint community property, the document could be drafted to permit either spouse to withdraw from the trust that spouse's community one-half interest in any community asset placed in the trust. Such a power would, in effect, permit either spouse to unilaterally partition the couple's community property interests, a result which does not appear to be authorized by Art. XVI, Sec. 15 of the Texas Constitution. Only jointly can spouses partition community property into their respective separate estates. Even an agreement by the spouses to authorize such a unilateral partition would appear to violate the "mere agreement" rule of marital property. *See Kellet v. Trice* 95 Tex. 160, 66 S.W. 51 (1902); *King v. Bruce*, 145 Tex. 647, 201 S.W.2d 803 (1947); *Hilley v. Hilley*, 161 Tex. 569, 342 S.W.2d 565 (1961).

3. JOINT AND SEVERAL REVOCATION

Accordingly, the safe harbor approach would be for the couple to retain the power of revocation (i) jointly for some assets of the trust, (the joint community property assets) and (ii) severally as to other assets in the trust (special community property and separate property) after giving notice to the other spouse. If the power of revocation is exercised as to a special community asset, the withdrawn asset would remain the couple's community property but still subject to the withdrawing spouse's sole management and control. If the couple so agrees, allowing either spouse to revoke as to a joint community asset would not appear to have any adverse consequences from a constitutional, liability or tax perspective so long as the asset in its entirety is revested as community property.

D. Incapacity of a Settlor

As with any revocable trust, the trust document should address the effect the possible incapacity of a settlor will have on the power of revocation. Can an agent under a durable power of attorney revoke on behalf of the settlor/principal? Can a guardian revoke the ward's revocable trust? Or, is the power of revocation a non-delegable power? *See Weatherly v. Byrd*, 566 S.W.2d 292 (Tex. 1978). The questions evolve even further if the settlor is married and the trust is funded with the incapacitated spouse's special community property or joint community property. Does Sec. 883 of the Texas Probate Code permit the other spouse to revoke the trust on behalf of the incapacitated spouse? There appear to be no clear cut answers to these questions, but these issues should be addressed in the document.

E. Rights of Creditors

The creation and funding of an inter vivos trust by a settlor may or may not remove the trust assets from the reach of the settlor's creditors. If (i) the trust is irrevocable, (ii) the settlor has not retained an equitable interest in the trust estate and (iii) the transfer of assets into the trust was not in fraud of creditors, the assets of the trust belong to the beneficiaries and are not generally liable for the debts of the settlor. If the transfer of assets in order to fund the trust is found to have been in fraud of creditors, creditors can reach the assets in trust like any other assets transferred free of trust.

1. <u>REVOCABLE TRUSTS</u>

Most of the assets transferred by the settlor to the trustee of a Texas revocable trust will in all probability continue to be liable for the settlor's debts both during the settlor's lifetime and following the settlor's death. There is, however, authority to the contrary. *Jones v. Clifton*, 101 U.S. 225 (1980); 92 A.L.R. 282 (1934); Scott, Sec. 330.12; Bogert, Sec. 41. But the modern trend appears to adopt the premise: *if one can claim the assets at any time, they should be available to one's creditors*. *See State Street Bank v. Reiser*, 389 N.E.2d 768 (Mass. 1979).

2. <u>TEXAS AUTHORITY</u>

In Texas, the provisions of the Uniform Fraudulent Transfer Act give creditors theories whereby assets placed in the revocable trust can be reached to satisfy the settlor's debts. *See* Tex. Bus. & Comm. Code Secs. 24.001 through 24.013. Even if the Uniform Fraudulent Transfer Act is not violated, the Texas definition of a "general power of appointment" would seem broad enough to capture revocable trust assets within its coverage and thereby subject the property in question to the liabilities of the settlor/donee of the power, either during the settlor's lifetime or at the settlor's death. A general power includes "the authority to...alter, amend or revoke an instrument under which an estate or trust is created or held, and to terminate a right or interest under an estate or trust...." Tex. Prop. Code Sec. 181.001(2). The Restatement provides that appointive assets covered by a general power can be subjected to the claims of the donee or claims against the donee's estate. Restatement (Second) Property Sec. 13.1(1984). In *Bank of Dallas v. Republic National Bank*, 540 S.W.2d 499 (Tex. Civ. App. Waco 1976, writ ref'd n.r.e.), the court, after adopting the general restatement approach, stated: "If the settlor reserves for his own benefit not only a life estate but also a general power...his creditors can reach the principal." In addition, the fact that the trust is a spendthrift trust would not afford any protection from the settlor's creditors. Tex. Prop. Code Sec. 112.035(d). However, Texas courts have not specifically addressed whether the settlor's creditors can reach the assets of the settlor's revocable trust after the settlor's death. See *FCLT Loans, L.P. v. Estate of Bracher*, 93 S.W.3d 469 (Tex.App.—Houston [14th Dist.] 2002, no pet.). However, as explained above, Texas law does define a general power of appointment to include a power of revocation, and it's this author's opinion that non-exempt assets placed in the revocable trust should remain liable for the settlor's debts before and after the settlor's death.

F. Effect of Divorce

Community assets and quasi-community property held in trust where one, or both, of the spouses hold a power of revocation should be part of the "estate of the parties" subject to division by the divorce court in a just and right manner pursuant to Sec. 7.001 of the Texas Family Code.

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

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

2. VOID AND VOIDABLE TRANSFERS

If only one spouse is the settlor of a trust funded with the settlor spouse's special community property, the transfer of such community assets into the trust is deemed "illusory" as to the other spouse. *See Land v. Marshall, supra*. If the sole settlor spouse attempted to transfer into the trust joint community assets without the joinder of the other spouse, the transfer should be found to be void as to the other spouse. *See* III, B, *supra*.

3. SEPARATE TRUST ESTATE

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

4. TRANSFERS TO THIRD PARTIES

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

5. REVOCABLE TRUSTS BECOMING IRREVOCABLE

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

6. INCOME TAXES

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

G. Death of First Spouse

Upon the death of the first spouse, the decedent's separate property and one-half interest in the community assets are normally placed in a continuing decedent's trust or are distributed in accordance with the provisions of the trust document. However, the surviving spouse's separate property and one-half interest in the community property generally should be delivered to the surviving spouse or segregated into a "survivor's trust" that continues to be revocable by the surviving spouse unless a different result is desired after considering the consequences of it becoming irrevocable. In addition to the substantive advantages for the surviving spouse, continuing revocability prevents an unintended taxable gift on the part of the surviving spouse. If the surviving spouse is not a settlor of the trust (or did not otherwise agree to the terms of the trust) and does not receive the survivor's one-half interest in the community property, the settlor spouse can use the "illusory trust" argument to reclaim the survivor's one-half interests in the community trust assets. *See Land v. Marshall*, *supra*.

H. Planning Considerations

When drafting the trust document, separate trusts may be desirable for the husband's separate property, the wife's separate property and their community property. In fact it may be advisable to segregate the community property further into three separate sub-trusts, one for the husband's sole management community property, one for the wife's sole management community property, and one for their joint community property in order to maintain their relative marital property rights, to facilitate the management rules of Sections 3.101 and 3.102 of the Family Code and to continue the liability exemption rules of Section 3.202 of the Family Code. Otherwise the couple's relative rights are affected and the attorney is placed in a conflict of interest by trying to represent both spouses in the planning.

I. Community Property Basis

Since the decedent's interest in the revocable trust assets is included in the gross estate, such assets will receive a new income tax basis; however, if a married couple is creating the revocable trust and plan on placing community property in the trust, care should be taken in the drafting of the trust agreement and the other transfer documents to make sure that the funding of the trust with community property does not amount to a partition of the community property so that both halves of the community can receive a step up in income tax basis upon the death of the first spouse. *See* Rev. Rul. 66-283, 1966-2 C.B. 297.

J. Settlor's Homestead Protection

A homestead exemption from the owner's general creditors can only exist in a possessory interest in land. *See Capitol Aggregates v. Walker*, 448 S.W.2d 830 (Tex. Civ. App.—Austin 1969, writ ref'd n.r.e.); *Texas Commerce Bank v. McCreary*, 677 S.W.2d 643 (Tex. App.—Dallas 1984, no writ). In revocable trust planning, where legal title in the home is transferred to the trustee, the settlor usually retains the equitable title at least for the remainder of the settlor's lifetime. In addition, there is authority for the proposition that an "equitable interest" will support a homestead claim. *See Rose v. Carney's Lumber Co.*, 565 S.W.2d 571 (Tex. Civ. App.—Tyler 1978, no writ); *White v. Edzards*, 399 S.W.2d 935 (Tex. Civ. App.—Texarkana 1966, writ ref'd n.r.e.). In fact, one early case held that the property retained its homestead character during the settlor's lifetime notwithstanding the fact it had been conveyed to a trustee where the settlor had continued to occupy the property and the purpose of that trust was to prevent the premises from being taken by creditors. *See Archenhold v. B.C. Evans Co.*, 32 S.W. 795 (Tex. Civ. App. Ft. Worth 1895, no writ). Thus, it appears as if the homestead continues to be exempt from most creditors so long as the settlor is alive. Tex. Prop. Code Sec. 41.001. H.B. 3767 (2009) confirms that the homestead exemption is not lost because it has been transferred into a revocable trust. The same would appear to be true for exempt personal property. Tex. Prop. Code § 42.001.

K. Protection of Family

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

1. PROBATE HOMESTEAD

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

2. RIGHT OF OCCUPANCY

Will the surviving spouse have a right to occupy the home following the death of the owner when it had been placed in a revocable trust prior to its owner's death? While there are no definitive cases on point, it appears that the surviving spouse may not have such a right unless the trust document so provides. First, whether the home was community property or not, if the home was placed in the revocable trust during marriage, both spouses would have had to join in the transaction or the conveyance would have been void. Tex. Fam. Code Sec. 5.81. Second, the Texas Supreme Court has approved provisions in premarital agreements that allow one to waive his/her homestead right of occupancy. However, it has also been held that such waivers must be clear and unambiguous and with full disclosure. *See Williams v. Williams*, 569 S.W.2d 867 (Tex. 1978) and *Hunter v. Clark*, 687 S.W.2d 811 (Tex. App.—San Antonio 1985, no writ). Consideration should be given to the effect of Sec. 113.022 of the Texas Trust Code which states that a trustee may permit real estate held in trust to be occupied by a current beneficiary of the trust.

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

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

3. CREDITOR'S ARGUMENTS

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

4. EXEMPT PERSONAL PROPERTY

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

5. ALLOWANCES

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

6. CLAIMS PROCEDURES

The probate code also describes a very elaborate statutory scheme for the handling of secured and unsecured claims against a probate estate. These procedures afford protection and guidance to the persons charged with administering the decedent's estate and assure the creditors of fair treatment. It does not appear that these procedures would apply to a trust administration.

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

In *Allard v. Frech,* 754 S.W.2d 111 (Tex. 1988), the Texas Supreme Court confirmed that an employee's spouse has a community property interest in the employee spouse's employee benefit package. *See also Valdez v. Ramirez,* 574 S.W.2d 748 (Tex. 1978). The employee benefit package of a working spouse is a form of compensation and acquires a community character during marriage.

A. Application of the Apportionment Rule

Texas cases have consistently held that the community or separate character of an employee's retirement plan depends on an "apportionment" approach rather than the "inception of title rule". The "apportionment" approach gives the non-employee spouse an increasing community property interest in the employee's plan during marriage. *Berry v. Berry*, 647 S.W.2d 945 (Tex. 1983) and *Dessommes v. Dessommes*, 543 S.W.2d 165 (Tex. Civ. App.—Texarkana 1976, writ ref'd n.r.e.). While the apportionment approach should preserve an employee's separate interest in a retirement plan owned prior to marriage, the application of the rule over the years has resulted in the loss by employees of significant portions of their defined contribution plans. For example, in *McClary v. Thompson*, 65 S.W.3d 829 (Tex.App.—Ft. Worth 2002, pet. denied), the court of appeals stated that... "to determine the portion as well as the value of a defined contribution plan that is community property, courts subtract the amount contained in the plan at the time of the marriage from the total contained in the account at divorce." *See also* West Group, Texas Family Law Service, Sec. 22:29 (2004). In other words, if this statement is accurate, any appreciation in value during the marriage of what was originally a separate 401K plan, a profit-sharing plan, or an ESOP becomes community property because the employee is not permitted to trace the assets in any such plan at the beginning of the marriage into what is still in the plan at the time of divorce.

B. Tracing the Separate Interest

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

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

C. Sec. 3.007

A 2005 addition to the Texas Family Code had hoped to resolve many of the tracing issues described above. A spouse, who was a participant in a defined benefit retirement plan, was deemed to have a separate property interest in the monthly accrued benefit the spouse had a right to receive on normal retirement age, as defined by the plan, as of the date of marriage, regardless of whether the benefit had vested. The community property interest in that same plan was to be determined as if the spouse began to participate in the plan on the date of marriage and ended that participation on the date of dissolution or termination of the marriage, regardless of whether the benefit had vested. Tex. Fam. Code Sec. 3.007(a) and (b). However, in 2009, HB 866 repealed subsections (a) and (b) of Sec. 3.007, effective September 1, 2009, and apparently returns the application of the apportionment approach to defined benefit plans back to case law.

A defined contribution plan is presumed to be entirely community property. However, the separate property interest of a spouse in a defined contribution retirement plan may be traced using the tracing and characterization principles that apply to nonretirement assets. Tex. Fam. Code Sec. 3.007(c). Subsection (c) was left unchanged by HB 866 (2009).

Even more details are involved if the plan is an employer provided stock option plan or an employer provided restricted stock plan. *See* Tex. Fam. Code *§* 3.007(d) and (e). Subsection (d) was amended by HB 866 (2009), which also repealed subsection (f).

D. Divorce

Upon a divorce of the spouses, the community portion, and presumably "quasi-community" portion, of the employee's interest in the plan, just like any other community property asset, are subject to a "just and right" equitable division by the divorce court. However, the separate or "quasi-separate" portion is not divisible. Any separate property lost due to the employee's inability to trace may result in a separate claim for reimbursement. A QDRO (Qualified Domestic Relations Order) is necessary for the enforcement of the division of an ERISA plan.

XVIII. EFFECT OF DEATH ON RETIREMENT PLANS

As explained in IX, *supra,* unlike most marital assets, the separate or community character of an interest in a retirement plan is determined using the "apportionment theory" instead of the traditional "inception of title rule." Under Texas law, the community property interest of a participant is defined as the participant's community property subject to the participant's "sole management and control." *See* II, B, *supra*.

A. Federal v. Texas Law

Upon the death of the employee spouse, Texas case law has held that the other spouse retains an interest in the community portion of the employee spouse's retirement plan. In addition, federal law mandates that the other spouse be the beneficiary of a "qualified preretirement survivor's annuity" for many ERISA plans.

Upon the death of the employee's spouse, before the employee's retirement, the Texas Supreme Court has held that the deceased spouse's heirs and devisees succeed to that spouse's one-half of the community portion of the employee spouse's interest in the plan, if there has not been a valid nonprobate disposition of the same. *See Valdez* and *Allard*, *supra*.

However, while ERISA does not expressly address what happens when the spouse dies before the employee retires, the Retirement Equity Act of 1984 ("REA") amended ERISA in order to introduce mandatory spousal rights in many retirement plans so the choice of the form of benefit received from such a plan is no longer solely the employee's choice under federal law.

The *Valdez* and *Allard* cases involved federal civil service retirement benefits and a private company's retirement plan. Accordingly, a little know section of the Texas Government Code was not applicable. That section states that the death of a spouse of a member or retiree of the Texas public retirement system terminates the spouse's interest in that retirement system. Tex. Gov't Code Sec. 804.101. A federal court has interpreted the statute to define the spouse's statutory property interest as one that terminates upon the death of the spouse and for that reason held that the statute does not violate Art. XVI, Sec. 15 of the Texas Constitution. *Kunin v. Feofanov*, 69 F.3d 59 (5th Cir. 1995). No Texas cases discussing that section of the Government Code were found.

B. Retirement Equity Act of 1984

Prior to REA, federal law granted the participant's spouse very few rights to share in the participant's retirement benefits. REA's legislative history reflects Congress' "community property type" view that marriage is a partnership and that retirement benefits are derived from the contributions of both spouses. For example, REA requires that the participant's retirement benefit in a pension plan be paid in the form of a "qualified joint and survivor annuity" ("QJSA"), if the participant survives until retirement age. If a vested participant in such a plan dies before retirement, REA makes the surviving spouse a plan beneficiary with an interest called a "qualified preretirement survivor annuity" ("QPSA"). The mandatory spousal rights mandated by REA can be waived by the participant's spouse. *See* IRC Secs. 401(a) and 417.

C. Covered Plans

The QJSA and QPSA requirements apply to all defined benefit plans, money purchase plans, any defined contribution plan to which IRC Sec. 412 applies (excluding profit sharing plans), some 403(b) annuity arrangements (excluding IRAs and SEPs), and certain other defined contribution plans (profit sharing and stock bonus plans) that either do not satisfy the conditions delineated in IRC Sec. 401(a)(11)(B)(iii) or are considered to be a "transfer plan" under Reg. 1.401(a)-20, Q & A 5. *See* IRM 4.72.9(3-1-02), I.R.S.

<u>*Caveat*</u>*: The "ERISA rights" of the participant's spouse are governed by not only ERISA (USCA Title 29) but also the Internal Revenue Code (USCA Title 26), as*

well as I.R.S., Departments of Labor and Treasury interpretations of the two. The result is an incredibly complicated set of rules that do not lend themselves to easy explanation. Accordingly, a participant should inquire as to what are the spouse's rights in the participant's particular plan. The plan itself may even mandate a result different from the one prescribed by federal law.

D. Defined Contribution Plans

As explained above, some defined contribution plans, like 401K plans, are not subject to the QJSA and QPSA requirements. Accordingly, most do not offer a survivor's annuity, but if the participant dies before retirement, the participant's spouse is the presumed beneficiary of the entire death benefit, unless the spouse has waived this right. However, if the participant retires prior to death or termination, the participant can elect any option that is available under the plan without spousal consent. If the defined contribution plan is subject to the QJSA and QPSA requirements, spousal consent is necessary in order to retire and elect an option other than a QJSA, and if the participant dies prior to retirement, the spouse, absent a waiver, is entitled to an annuity for life, the actuarial equivalent of which is not less than 50% of the portion of the account balance of the participant to which the participant had a non-forfeitable right. *See* 29 USCS Sec. 1055(e)(2).

E. Defined Benefit and Money Purchase Plans

Since defined benefit and money purchase plans are subject to the QJSA and QPSA rules, a spousal waiver is required in order for the participant to elect out of either requirement. If not waived, the spouse is, generally, entitled to an annuity for life. If it is a QPSA, the payments cannot be less than the amounts which would be payable as a survivor's annuity under the QJSA rules under the plan. If the participant dies after retirement, the spouse's annuity cannot be less than 50% (or greater than 100%) of the annuity that would be payable during the joint lives of the participant and spouse and which is the actuarial equivalent of a single annuity for the life of the participant. *See* 29 USCS Sec. 1055(d) and (e).

F. IRAs and SEPs

Individual retirement accounts ("IRAs") and simplified employee pensions ("SEPs") are not subject to the QJSA and QPSA requirements. Reg. 1.401(a) - 20, Q & A 3(d). However, the participant's agreement with the financial institution serving as custodian may require spousal consent to the beneficiary designation in the event of the participant's death.

G. Spouse's Death

As explained above, an employee spouse is, in effect, required to select a "qualified joint and survivor annuity" for all pension plans and some other types of plans, unless the employee and the employee's spouse agree to another beneficiary designation. The employee's spouse is also the presumed beneficiary for other plans. ERISA also provides that retirement benefits may not be assigned or alienated. 29 U.S.C. Sec. 1056(d). Sec. 401(a)(2) of the Internal Revenue Code also provides that the benefits must be for the exclusive benefit of the employee.

While Texas courts have not yet definitely resolved the question of whether federal law preempts Texas law upon the death of the non-employee spouse, it can be assumed that *Allard* and *Valdez* have been preempted by federal law. *See Ablamis v. Roper*, 937 F.2d 1450 (9th Cir. 1991); *Meek v. Tullis*, 791 F.Supp 154 (W.D. L.A. 1992), finding preemption. On the other hand, in

Boggs v. Boggs, 82 F. 3d 90 (5th Cir. 1996), the Fifth Circuit agreed with the lower court and found that Louisiana community property law was not preempted. However, the United States Supreme Court ruled on June 2, 1997 that Louisiana law was preempted by federal law. *Boggs v. Boggs*, 117 S.Ct. 1754, 79 AFTR 2d 97-960 (1997).

H. Boggs v. Boggs

In *Boggs*, the participant, Boggs, a resident of Louisiana, was married to Dorothy until her death in 1979. At her death, two-thirds of her estate passed to their sons. Boggs married his second wife, Sandra, in 1980 and retired in 1985. At retirement, Boggs received: (i) a lump sum distribution that was "rolled over" into an IRA; (ii) shares of stock from an employee stock option plan ("ESOP"); and (iii) a monthly lifetime annuity. After Boggs died in 1989, his sons filed an action under Louisiana's community property laws to obtain their share of Dorothy's interest in Bogg's retirement benefits. The U.S. Supreme Court ruled that, notwithstanding state law that allowed Dorothy to devise to her sons her community interest in Bogg's retirement benefits prior to his retirement, Dorothy's testamentary transfer was a prohibited assignment or alienation under 29 USC Sec.1056(d)(1).

Had Boggs and Dorothy's marriage ended in divorce, the Court acknowledged that a state divorce court's division of the participant's ERISA benefits would have been effective since ERISA's QDRO provisions allow such a division. The dissent even noted that, after divorce and the entry of the QDRO, the employee's spouse can devise that spouse's interest. The Court did not hold that ERISA preempts a state's community property laws in general. The Court's holding is that the heirs and devisees of a non-participant spouse cannot succeed to that spouse's community interest in the participant's ERISA benefits when the spouse died before the participant retires.

The purpose of the anti-alienation provisions of ERISA are to ensure the economic security of the surviving spouse. Therefore, if the participant's spouse dies under these circumstances, the spouse's interest in the participant's ERISA plan is effectively terminated.

I. Post-Retirement Benefits

Assume a Texas participant retired prior to the non-participant's death and received (i) a lump sum distribution which was "rolled over" into an IRA, (ii) shares of stock from an ESOP, and (iii) a monthly annuity and further assume the participant and the participant's spouse had been married during the entire period of the participant's employment. It is this author's belief that all of the post-retirement benefits are community property subject to the participant's sole management and control under Texas law. If the couple then divorces, all of the post-retirement benefits would be subject to just and right division by the Texas divorce court. *Boggs* does not mandate a different result. In fact, the *Boggs'* holding supports that conclusion since, after retirement, the benefits are not subject to ERISA's anti-alienation provisions. The justification for federal preemption in *Boggs* is not applicable following the employee's retirement and the distribution of the retirement benefits.

1. <u>NON-PARTICIPANT'S DEATH</u>

If the marriage terminates not in divorce, but because of the non-participant's death, her interest in the annuity, if any, terminates by the very nature of the annuity. *See* VI, B-E, supra. The non-participant's one-half interest in the ESOP stock should pass to her heirs or devisees, absent some nonprobate contractual arrangement. Likewise, her one-half of the IRA should pass to her heirs or devisees, absent some nonprobate contractual arrangement. The anti-alienation rules of ERISA do not apply to IRAs. Some argue that *Boggs* extends ERISA's anti-alienation rules to IRAs, but it does not. The IRA in *Boggs* was funded after the death of the non-participant spouse when the participant later retired. At the time of Dorothy Bogg's death, the ERISA benefits were still undistributed and in the possession of the plan administrator. The Supreme Court even noted that, had they divorced, Dorothy could have devised to her sons any interests she may have acquired in the benefits through a QDRO.

2. PARTICIPANT'S DEATH

If the marriage terminates because of the participant's death after retirement, the participant's interest in the annuity terminates, but the annuity may continue for the spouse's benefit. *See* XX, B-E, *supra*. The participant's community one-half interest in the ESOP stock passes to his heirs or devisees, and the non-participant spouse retains her half, absent some contractual nonprobate disposition. His interest in the rollover IRA likely passes to the designated beneficiary of the IRA, if any, otherwise she retains her one-half interest, and the participant's one-half passes to his heirs or devisees. Any attempt by the participant to assign more than his half of the stock or the IRA to someone else would be subject to the "fraud on the community" rule. *See* III, E, *supra*.

J. Non-Rollover IRAs

Such IRAs are not subject to ERISA's anti-alienation rules and are not subject to the *Boggs* ruling. At the participant's death, her interest in the rollover IRA likely passes to the designated beneficiary of the IRA, subject to the "fraud on the community rule," otherwise, the non-participant spouse retains his one-half interest, and the participant's one-half passes to her heirs or devisees.

K. Conclusions

Although an IRA or other assets may be traceable to an ERISA plan distribution, the participant's retirement and subsequent distribution by the plan administrator to the participant or the participant's custodian terminates ERISA's control and *Boggs* application. *See* Patricia Brown, "The Mind Boggling Bog Broadened by Boggs – A Practitioner's Approach," ALI-ABA, Feb. 25, 1999; S. Andrew Pharies, "Community Property Aspects of IRAs and Qualified Plans," Probate & Property (Sept/Oct 1999); Steven E. Tritten, "The Better Half of Your Retirement Plan Distributions," ALI-ABA, May 20, 1995. All three agree with this author's conclusions. Thus, free of federal preemption, the marital property rights of the participant and the participant's spouse in the distributions after retirement are governed solely by Texas law.

APPENDIX A

Spotting the Surviving Spouse's Issues
A Discussion Following A Spouse's Death

I. As to each significant asset of the marriage (whether held in her name, his name or their names), in addition to learning how it is titled, its legal description and its estimated value, determine its martial property character immediately prior to the first spouse's death:

A. When was it originally acquired? How was it acquired?

B. Were there any pre-marital or marital agreements that affect its ownership (e.g., a partition and exchange)? *

C. Were there any other significant post acquisition transactions that might affect its marital property character (e.g., spousal gift, commingling)?

Note 1: So, was it the decedent's separate property, the survivor's separate property or their community property (or some combination of the three basic possibilities)?

Note 2: If community property, was it the decedent's special community property, the survivor's special community property, or their joint community property?

Note 3: Do the facts also suggest either spouse may have had a claim for reimbursement?

Special Note: Importantly, in view of the community presumption, are any of the relevant facts likely to be disputed? If so, is there clear and convincing evidence to support the survivor's (or the opposition's) position?

* The discussion in I-VII assumes there are no such agreements.

II. As to each significant community asset, determine who now owns it by reason of the first spouse's death:

A. Is it a "probate" or "nonprobate" asset?

B. If probate, did the decedent die testate or intestate? Since the surviving spouse retains an undivided one-half interest, who are the successors in interest to the decedent's one-half interest (heirs at law or devisees under a valid will)?

C. If nonprobate, who is the "third party beneficiary"? Is it the surviving spouse or someone else (or the survivor and someone else)?

<u>Note 1:</u> So, if the surviving spouse did not become the sole owner of a community probate asset, who is the new tenant in common under Sec. 37? What is the relationship of the surviving spouse and the new co-owner (friendly or antagonistic)? Are there any ancillary issues raised, such as reimbursement or equitable election?

<u>Note 2:</u> So, if the surviving spouse did not receive at least one-half of a community nonprobate asset, who is the primary third-party beneficiary? What is the relationship of the parties of interest? Is there a wrongful transfer claim?

<u>Special Note:</u> Notwithstanding Sec. 37, did the will, if any, purport to grant to the executor the authority to make a non-pro rata division of the community property probate assets?

III. As to each significant item of separate property, determine who now owns it by reason of the first spouse's death:

A. If it was the decedent's separate property, did it pass "probate" or "nonprobate" to someone other than the surviving spouse?

B. If so, is there an ancillary issue, like reimbursement?

C. If an asset is the surviving spouse's separate property and that spouse is not the sole beneficiary of the decedent's probate estate, do the decedent's successors in interest have a claim for reimbursement against the surviving spouse?

Special Note If the surviving spouse has a reimbursement claim against the deceased spouse's estate and is also a beneficiary under the decedent's will, do the terms of the will put the survivor to an election (i.e., accept the benefits of the will or disclaim those benefits in order to pursue the claim)?

IV. Determine which assets of the marriage are liable for which debts. In other words, as to a particular debt:

A. Whose debt was it (his, hers or theirs)?

B. What type of debt was it (contractual or tortious)?

C. When was the debt incurred (before or during marriage)?

D. Are there any facts that suggest that the other spouse may also have personal liability for a debt incurred by one spouse (e.g., necessities, vicarious liability)?

Note 1: So, whether or not the surviving spouse has personal liability for any of the decedent's debts, which probate assets are generally exempt from the decedent's debt (e.g., homestead, exempt personal property, allowance)?

Note 2: So, if both spouses had personal liability for a particular debt, which available assets should be used to satisfy the debt?

Note 3: If the surviving spouse did not have personal liability for a particular debt of the decedent, which available assets should be used to satisfy the debt?

Note 4: But, if the "probate estate" proves to be insufficient to satisfy the decedent's debts, which nonprobate assets can be reached by creditors to satisfy those debts (e.g., multi-party accounts compared to life insurance)?

Note 5: If the terms of the deceased spouse's will direct that "all of the testator's debts be paid out of the residuary," could that provision require the executor to pay the decedent's debts out of the decedent's separate property and one-half of the community assets that comprise the residuary estate?

Special Note: And perhaps most problematic, if there are debts of the surviving spouse for which the decedent did not have personal liability, are there any steps the surviving spouse should take to ensure that the community estate is properly used for the payment of both spouse's debts?

V. If there is going to be a formal administration of the decedent's estate, determine who will control which assets (i.e., the personal representative or surviving spouse):

A. Who is going to be the personal representative of the deceased spouse's estate (the surviving spouse or someone else)?

B. Assuming the surviving spouse will retain that spouse's special community property, will the surviving spouse need to account to the decedent's personal representative, creditors or successors in interest for all or any portion of the decedent's one-half interest in the survivor's special community property?

C. Is there any reason why the surviving spouse would not want to retain possession of that spouse's special community property?

D. How should administration expenses be allocated between the surviving spouse and the "estate"?

<u>Note 1:</u> If there is a will, what additional powers does it grant to the executor? If any, do these powers purport to extend to the executor's authority over the surviving spouse's one-half interest in either the decedent's special community property or the couple's joint community property being administered by the executor?

<u>Note 2:</u> Isn't the real issue whether the deceased spouse can unilaterally grant additional powers to the executor over the surviving spouse's interest in the community estate? Or is the surviving spouse's consent necessary? If the surviving spouse is a beneficiary under the will, is there an election (i.e., if you want the benefits, you must suffer the detriment: agree to the executor's additional authority).

<u>Special Note</u>: And perhaps most problematic, where the will authorizes the executor to make non-pro rata dispositions of the decedent's estate, can the executor make not only a non-pro rata distribution of the decedent's separate property and one-half of the community among the devisees in the will, but also a non-pro rata distribution of community assets between the surviving spouse and the decedent's successors in interest?

VI. As to each significant asset of the marriage, whether community or separate, consider whether either spouse had a claim for reimbursement that "matured" upon the spouse's death:

A. Is it a "separate" or "community" claim?

B. Was it the claim of the deceased spouse that became an "asset" of the deceased spouse's estate? Or, is it a claim the surviving spouse now has against the deceased spouse's estate?

<u>Note 1:</u> So, if it is a claim of the surviving spouse, does the surviving spouse have an election (either accept what was devised to the surviving spouse under the decedent's will or disclaim those benefits and assert the claim against the decedent's estate). Is the surviving spouse better off as a claimant or devisee? If it is the claim of the surviving spouse and the surviving spouse is a principal beneficiary of the decedent's estate (such as the lifetime beneficiary of the bypass and/or qtip trusts), has the claim been effectively extinguished even if there is no election?

<u>Note 2:</u> However, if the surviving spouse has a claim and is not the principal beneficiary of the decedent's estate, but fails to pursue the claim in the interest of "family harmony," has the surviving spouse made a taxable gift to the decedent's successors?

<u>Note 3:</u> On the other hand, if the claim was the decedent's claim against the surviving spouse, will the decedent's successors pursue the claim against the surviving spouse? If formal administration is opened, will the personal representative's fiduciary duty require it? Can a creditor of the decedent pursue the claim?

<u>Note 4:</u> If the estate is solvent and the personal representative and principal beneficiaries agree not to pursue it to preserve family harmony, have the beneficiaries made a taxable gift to the surviving spouse?

<u>Note 5:</u> But if the estate is insolvent, can the creditors pursue the claim?

<u>Special Note:</u> In any event, if a significant claim for reimbursement exists (in favor of or against the surviving spouse) and the surviving spouse is not the principal beneficiary of the decedent's estate, does the surviving spouse (or the lawyer for the surviving spouse) really want to deal with the conflict of interest that would exist if the surviving spouse became the personal representative of the estate?

VII. As to any significant community asset of the marriage that was not owned by the couple immediately prior to the time of the first spouse's death (or passed nonprobate by reason of the first spouse's death to someone other than the surviving spouse), consider whether the surviving spouse or the decedent's successors in interest have a "wrongful transfer" claim that "matured" on the first spouse's death:

A. Is it the claim of the surviving spouse against the decedent's estate or was it a claim of the decedent that became an asset of the decedent's estate?

B. Is the claim that the transfer was fraudulent or even "void" under federal law, or that it was void, in "fraud of the community" or "illusory" under Texas law?

C. If it is the claim of the surviving spouse, is the surviving spouse put to an "election" to pursue the claim or accept the benefits of the decedent's estate plan or disclaim the benefits in order to pursue the claim?

<u>Note 1:</u> So, if it is the claim of the surviving spouse who doesn't have an "election" to make, and if the spouse does not pursue the claim in the interest of "family harmony," has a taxable gift been made by the surviving spouse to the decedent's successors?

<u>Note 2:</u> If there is an election to be made, will the survivor be in a better position being a creditor or beneficiary of the estate?

<u>Note 3:</u> On the other hand, if the "wrongful transfer" was made by the surviving spouse prior to the decedent's death, will the decedent's successors in interest or personal representative pursue the claim against the surviving spouse after considering the same factors discussed in VI, Notes 3 and 4, *supra.*

<u>Note 4:</u> Additionally, wouldn't a post-death transfer to a third party by the surviving spouse of his or her special community property be a "wrongful transfer"? Doesn't Sec. 177 impose a "fiduciary" obligation on the surviving spouse in favor of the decedent's creditors or successors in interest as to the decedent's one-half interest in the surviving spouse's special community property?

<u>Special Note:</u> Finally, if significant "wrongful transfer" issues exist, does the surviving spouse (or the lawyer for the surviving spouse) really want to deal with the conflict of interest that would exist if the surviving spouse serves as the personal representative, if the surviving spouse is not the principal beneficiary of the decedent's estate?

VIII. If there is a validly executed pre-marital or marital agreement, its terms may not only address any and all of these issues, but negate the existence of any and all of these issues.

APPENDIX B

Relevant Texas Probate Code Provisions

I. Section 37

"When a person (spouse) dies . . . all of his estate (the deceased's spouse's separate property and undivided one-half interest in community property) . . . shall vest immediately (subject to Sec. 47) in the devisees or legatees of such estate . . . [or] in his heirs at law; subject, however, to the payment of the debts of the testator or intestate (does not mention surviving spouse's debts). . . ."

II. Section 156

"The community property subject to the sole or joint management, control and disposition of a spouse during marriage continues to be subject to the liabilities of that spouse upon death (consistent with Family Code provisions). In addition, the interest that the deceased spouse owned in any other nonexempt community property (the decedent's one-half interest in the surviving spouse's special community property) passes to his heirs or devisees charged with the debts which were enforceable against such deceased spouse prior to his or her death (inconsistent with Family Code provisions). . . .

III. Section 177

". . . the personal representative is authorized to administer, not only the separate property of the deceased spouse, but also the community property which was . . . under the management of the deceased spouse during the continuance of the marriage and all of the community . . . under the joint control of the spouses during . . . the marriage."

"The surviving spouse . . . is entitled to retain possession and control of all community property which was . . . under the sole management of the surviving spouse during the continuance of the marriage. . . ."