

# **PROTECTING ASSETS FOR INTENDED BENEFICIARIES – MARITAL PROPERTY CONCERNS**

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19<sup>th</sup> Annual Advanced Estate Planning Strategies Course  
State Bar of Texas  
Santa Fe, NM  
April 4, 2013

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## **I. INTRODUCTION**

Going into a marriage, especially a subsequent one, a client may be more interested in protecting the client's "estate" from the significant other (and/or the significant other's creditors and successors) than planning for the benefit of the significant other. The client's perception of the "estate" is likely to include not only what the client brings into the marriage and that which is acquired during the marriage by "gift, devise or descent," but also what those assets generate during the marriage (gains, rents, dividends, interest, etc.). The client may even consider the client's compensation during the marriage (whether in the form of salary, bonus, contributions to retirement plans and other fringe benefits) to be part of the "estate" in need of asset protection.

Changing laws and developing planning techniques have led to new and creative planning strategies.

## **II. KEY MARITAL PROPERTY CONCEPTS**

An understanding of the characterization/reimbursement rules, the management/liability rules and the termination/dissolution rules are essential to marital property planning, either prior to or during the marriage. However, a detailed discussion of those rules is beyond the scope of this paper. See Featherston *Marital Property Characterization and Reimbursement and Fraud on the Community*, 2012 Advanced Estate Planning Strategies, State Bar of Texas. However, there are nine key concepts that should be in the "back of the planner's mind" and perhaps explained to the client during the pre-marital planning process.

### **A. The Community Presumption**

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 §§ 3.001, 3.003.

### **B. Community Claims for Reimbursement**

Reimbursement between the marital estates usually arises when one spouse's separate property is improved through the expenditure of community funds. Reimbursement may also be applicable if separate funds are expended to benefit community property. In addition, 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 claim for reimbursement to the extent that excess time, talent or labor is not compensated. Another common reimbursement situation is where one spouse owns separately an insurance policy on that spouse's life and uses community property to pay the premiums, and upon the insured spouse's death, the proceeds are payable to a third party. Tex. Fam. Code §§ 3.401 – 3.410.

### **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*, 273 S.W. 799 (Tex. 1925), where the Texas Supreme Court held that the legislature could not define the rents and revenue from the wife's separate property 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. Fraud on the Community**

In *Arnold v. Leonard*, *supra*, 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)." A breach of that fiduciary duty will likely result in a "fraud on the community" claim when the marriage terminates. See Tex. Fam. Code § 7.009.

#### **E. Marital Liabilities**

The Texas Family Code creates an "in rem" system of marital property liability. Tex. Fam. Code §§ 3.201 – 3.203. 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 from the debt unless the other spouse is personally liable under other rules of law (e.g., the "necessaries rule"). In which event, the other spouse's property (i.e., that spouse's special community and separate) is liable as well.

Note: *The marriage relationship, in and to itself, does not make one spouse personally liable for the debts of the other spouse unless it is a debt for a "necessary."* Tex. Fam. Code § 3.201.

#### **F. Death of a Spouse**

When a married resident of Texas dies, the marriage terminates and community property ceases to exist. Nonprobate assets pass to the designated beneficiaries. Tex. Prob. Code § 450. Death works a legal partition of the community probate assets; 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. Tex. Prob. Code § 37. A spouse's testamentary power is generally limited to that spouse's separate property and undivided one-half interest in the community property. *Avery v. Johnson*, 108 Tex. 294, 192 S.W. 542 (1917).

#### **G. Death of Claimant Spouse**

Upon the death of the spouse who has a reimbursement claim or claim for fraud on the community against the surviving spouse, the claimant spouse's one-

half interest in the claim passes to that spouse's heirs or devisees.

1. DUTY OF PERSONAL REPRESENTATIVE

If the heir or devisee is not the other spouse (or if the estate is insolvent), the personal representative has a duty to pursue the claim against the surviving 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 is included in the deceased spouse's gross estate for estate 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. Claimant as the Surviving Spouse**

Upon the death of the other 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 of the surviving spouse continues to exist, as does any claim that the deceased spouse committed a fraud on the community or attempted to unilaterally transfer joint community property prior to death.

1. CONFLICT OF INTERESTS

Either situation can create a conflict of interest (i) between the surviving spouse and the decedent's heirs or devisees 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

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

3. OTHER PROBLEMS

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

**I. 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. When administration is completed, the survivor and the distributees are generally entitled to their respective one-half interests in each and every remaining community probate asset. Tex. Prob. Code § 37.

### **III. SUBSEQUENT MARRIAGE CONCERNS**

Absent a pre-marital agreement, what effect is a subsequent marriage going to have on the client's "estate." The first response may be that, even absent effective planning, any property the client owned before the subsequent marriage can (not necessarily will) remain his or her separate property.

#### **A. Existing Assets**

Generally, as soon as the client remarries, each and every item of property of either spouse will be presumed to be community property. Each traceable asset acquired prior to marriage, as well as any property acquired during the marriage as separate property (e.g., a gift or inheritance), can remain the client's separate property, if the community property presumption can be overcome by clear and convincing evidence. See II, A, *supra*.

#### **B. Future Acquisitions**

However, the spouses' respective salaries and other forms of compensation (i.e., employer contributions to retirement plans) will be community property. The income being generated by their respective separate properties will be community property. Any other assets acquired by either spouse during the marriage will be presumed

community property unless proven to be separate property (e.g., traceable to clearly identifiable separate property). Tex. Fam. Code §§ 3.001 - 3.002.

#### **C. Unilateral Gifts/"Fraud"**

In addition, the client needs to understand that any unilateral gifts (inter vivos or nonprobate) of the client's special community property by the client to a child, a child by a prior marriage, or other third party may later be found by a probate or divorce court to have been a breach of a duty owing by the donor spouse to the other spouse and a "fraud on the community." See II, D, *supra*.

*Note:* A unilateral attempt to transfer joint community property may be void as a matter of law. See Tex. Fam. Code § 3.102.

#### **D. Debts**

Further, if the spouse incurs a tort debt during marriage, the creditor may be able to enforce any resulting judgment against any and all community property, even if the client does not have personal liability for the debt, and the creditor can take advantage of the community presumption. A breach of contract claim will expose the client's one-half interest in the joint community and the spouse's special community to liability as well. A debt, contract or tort, incurred before marriage by the spouse will expose the client's interest in any joint or the spouse's special community property to liability. See II, E, *supra*.

#### **E. The Necessaries Doctrine**

A spouse who fails to discharge his or her duty of support is liable to others who provide necessities to the other spouse. Tex. Fam. Code § 2.501(b). Accordingly,



when third parties (e.g., doctors, hospitals, nursing homes – perhaps even lawyers) provide services deemed reasonably necessary for one spouse's support, both spouses become personally liable for the costs of such services. While the spouse who actually incurs the debt may be deemed to be "primarily liable," both spouses are "jointly and severally" liable to the third party under the necessities doctrine. Tex. Fam. Code § 3.201(a)(2). A debt incurred for necessities will expose the entire non-exempt marital estate to liability. Tex. Fam. Code § 3.202.

## F. Divorce

In the event of a divorce, generally any community property will be subject to an equitable division by the divorce court and separate property will not. See Tex. Fam. Code § 7.001.

*Note: While contractual alimony can be incorporated into a divorce decree, absent such an agreement, the Texas divorce court cannot award alimony to a spouse. Alimony is contrary to Texas public policy. A limited form of alimony, "maintenance," is available in certain defined situations. See Tex. Fam. Code §§ 8.001 – 8.059.*

## G. Reimbursement Issues

Whether the marriage eventually terminates in death or divorce, its dissolution will be even more complicated due to the possibility of reimbursement issues accruing during the marriage and maturing upon its termination. See II, B, and II, D, *supra*.

## H. Death of First Spouse

Upon the first spouse's death, the deceased spouse will only have testamentary

power over the decedent's separate property and one-half of the community property. The surviving spouse can retain his or her own separate property and one-half of the community after the deceased spouse's debts are paid. See II, F, *supra*. The surviving spouse may have homestead rights and/or rights to an "allowance" or to certain exempt personal property.

## I. Portability

The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 introduced the concept of "portability" to estate and gift taxation. Portability creates the possibility that the surviving spouse can take advantage of the unused tax applicable exemption amount for estate and gift tax purposes from the estate of a pre-deceased spouse. For a complete discussion, see Marc Bekerman, *Portability of Estate and Gift Tax Exemptions Under TRA 2010*, Tax Management Estates, Gifts and Trusts Journal, May/June 2011. The American Taxpayer Relief Act of 2012 made portability "permanent."

### 1. "APPLICABLE EXCLUSION AMOUNT"

The "applicable exclusion amount" is the sum of a decedent's basic exclusion amount (currently \$5 million *plus* and indexed for inflation) plus, in the case of a surviving spouse, the "deceased spousal unused exclusion amount" – the basic exclusion amount of the deceased spouse, less the amount exemption actually used at the deceased spouse's death (the "DSUE amount").

### 2. LIMITATIONS

The surviving spouse's estate is limited to the unused exclusion amount

of his/her most recent deceased spouse. The surviving spouse's estate cannot take advantage of the deceased spouse's unused exclusion unless the deceased spouse's estate timely filed U.S. Estate Tax Return reflecting the amount of the unused exclusion amount.

### 3. EFFECT ON GIFT TAX AND GST TAX

While it appears that a surviving spouse will be able to utilize the deceased spouse's unused exclusion amount in making inter vivos gifts, there are a number of unanswered questions concerning its application, which are beyond the scope of this paper. Portability does not apply to the generation-skipping transfer tax. Any unused generation-skipping transfer tax exemption cannot be used to increase the surviving spouse's exemption.

### 4. OVERLOOKED RESOURCE

Going into a second marriage, a surviving spouse should consider any DSUE amount from a deceased spouse as a separate and valuable resource to be utilized like any other separate property resource. In addition, if the value of the prospective spouse's estate is likely to be less than the basic exclusion amount, the potential benefit of the prospective spouse's DSUE amount should not be ignored in the event the client survives the prospective spouse.

## J. To He\_\_ (Double Hockey Sticks) With This!

In view of all of these complications, the client may wish to "opt out" of the Texas community property regime, a result that can be accomplished in a well-crafted pre-

marital agreement. Through such an agreement, parties intending to marry address these issues, perhaps even create a "community free" marriage where all property is the separate property of one spouse or both spouses and possibly eliminate other spousal rights.

## IV. UNILATERAL PLANNING

Even in the absence of a pre-marital agreement, the client unilaterally can take steps prior to and during the marriage to minimize the complications of a subsequent marriage to maintain the separate character of the client's separate property and avoid many other issues that would otherwise arise during the subsequent marriage.

### A. Segregated Accounts

At a minimum, the client should be advised to "keep separate, separate" by maintaining existing assets in the client's name and opening bank and brokerage accounts in the client's individual name (perhaps with a designation "separate account") and only depositing into the accounts separate property. Contemporaneous business records showing the source of any and all separate deposits should be retained in the event proof of separate character of the account is later needed.

*Note: The creation and funding of a revocable trust prior to marriage may be an effective way to maintain the separate character of the settlor's assets*

### B. Avoid Inadvertent Commingling

Since income from separate property is generally community property, any interest (or other income generated by a separate investment) should be paid into a

“special community account” in order to avoid a “commingling” of community and separate funds in the same account. If an account is “commingled,” the account becomes community property.

*Note: Prior to the marriage, the client may want to consider creating an entity, like a family limited partnership, and exchange some portion of the client’s estate for interests in the partnership. The partnership interest remains the client’s separate property; the assets of the partnership should be treated as partnership assets if the partnership is properly administered. Paying a reasonable salary for services rendered should avoid Jensen claims. Not making community contributions during the marriage can avoid reimbursement and fraud on the community claims.*

#### **C. 401(k) Plans**

While Texas generally follows the “apportionment” approach to determine the marital property character of defined benefit and contribution retirement plans, the separate nature of such a defined contribution plan brought into a marriage can easily be lost during the marriage through commingling. To maintain the separate character of the plan as it existed on the date of the marriage, the separate property interest will have to be traced using the same tracing rules that apply to non-retirement assets. See Tex. Fam. Code § 3.007(a). For employer-provided stock option plans and restricted stock plans, see Tex. Fam. Code § 3.007(d).

#### **D. Earmark Future Holdings**

Any future gift to or inheritance by the client, or property purchased with separate funds, should be held in the client’s name only. Further, titled assets, especially

real estate, should be conveyed to the client “as separate property.” Again, contemporaneous business records can serve as evidence of the nature of the transaction and the separate character of the asset and should be retained.

#### **E. Family Entities**

If the client is to become a partner in a family partnership, a member in a family-oriented limited liability company or a shareholder in a closely-held corporation, the client’s interest should be given to the client as a gift (or purchased by the client with traceable separate property). Again contemporaneous business records of the nature of the transaction should be retained.

#### **F. Closely Held Business Interests**

Capital contributions to any existing or subsequently acquired separately owned closely held business interest should be funded with clearly documented separate funds or structured in the form of a loan from community funds. If the client expends any “time, talent or labor” in the management of the entity, reasonable documented compensation for those services can hopefully avoid a later reimbursement claim by the client’s spouse. See XI, *infra*.

#### **G. Asset Protection Trusts**

Any and all of future inter vivos or testamentary gifts to the client by others could be placed by the donor in an asset protection trust for the client’s benefit. The spendthrift provisions will help not only insulate the interest from the claims of the client’s creditors, but also any community property claims of the spouse, the spouse’s successors or creditors. The inclusion of a statement in the trust agreement that it is the settlor’s intent that any and all interests of

the client, as well as any and all distributions of the trust, are the client's separate property may not be conclusive, but may prove to be persuasive in future litigation. Limiting distributions of income and/or principal to an ascertainable standard (health, education, maintenance, or support) is especially important if the client is going to be the trustee or is going to be given general power of appointment. If a third party is going to serve as trustee, income distributions to the client could be at the discretion of the trustee or pursuant to an ascertainable standard. Caution should be exercised in granting any other powers to the client over the trustee or the trust estate. Carefully planning, drafting and administering the trust could prove to be persuasive in maintaining the client's interests in the trust, as well as distributions from the trust, as separate property. See XII, *infra*.

#### **H. Fraud on the Community/ Reimbursement Issues**

An understanding of the concepts of "wrongful transfers" and "reimbursement" can minimize the risks that such issues will become material issues when the marriage eventually terminates. For example, the client can avoid using community property to make improvements to separate property or to make principal and interest payments on indebtedness secured by separate property or to pay the premiums on any separately owned life insurance policies. Gifts to children by a prior marriage and others should be given from separate sources or with documented approval of the spouse if community property is given.

#### **I. Take Advantage of Portability**

If the previous marriage ended in the prior spouse's death, portability allows for the DSUE amount from the deceased

spouse's estate to be used during the lifetime of the surviving spouse or at the surviving spouse's death. Thus, portability is another reason gifts to or for the benefit of the client's descendants should be considered.

#### **J. Legal Fees**

Legal fees paid by the client during the marriage for this type of planning should be paid by the client with separate property to avoid any claim by the spouse that the client misused their community property to the spouse's detriment.

### **V. PREMARITAL AGREEMENTS – FORMALITIES**

If the couple is open to pre-marital planning, Texas law permits persons intending to marry to enter into a wide variety of property agreements that can convert into separate property what would otherwise be community property and therefore subject to the claims of certain creditors of both spouses, or subject to division by a divorce court, or partition by a probate court. A spouse's separate property is generally exempt from the creditors and claims of the other spouse. The ability to accomplish this result depends initially on satisfying the formality requirements specified in the Uniform Premarital Agreement Act.

#### **A. Uniform Premarital Agreement Act**

The 1987 Legislature enacted the Texas version of the Uniform Premarital Agreement Act. This legislation attempted to define what parties intending to marry could accomplish in a premarital agreement. However, the power to contract in these matters is ultimately controlled by the Texas

Constitution. *See* VI, *infra*. The Uniform Premarital Agreement Act did affect the formal requirements and enforceability of premarital agreements. Among other technical changes, there was a dramatic shift in the burden of proof when the validity of an agreement is placed in question.

## **B. Formalities**

As under prior law, a premarital agreement must be in writing and signed by the parties. It need not be witnessed, acknowledged or sworn to. It is enforceable without consideration. Tex. Fam. Code § 4.002. It becomes effective on marriage. Tex. Fam. Code § 4.004. It can be amended by a written agreement of the parties. Tex. Fam. Code § 4.005.

## **C. Burden of Proof**

Under prior law, the burden of proof was imposed on the party seeking to enforce the agreement to establish by clear and convincing evidence that the other party gave “informed consent” and that the agreement was not obtained by fraud, duress or overreaching. Now, the burden of proof is placed on the party asserting the agreement’s invalidity. Tex. Fam. Code § 4.006.

## **D. The Opponent’s Burden**

The party opposing the agreement must now prove that (i) the agreement was not entered into voluntarily, or (ii) it was unconscionable when it was executed and the opponent was not provided with a fair and reasonable disclosure of the proponent’s financial situation, or did not waive such disclosure and did not have adequate knowledge of such situation. In other words, there is a statutory presumption of validity.

## **1. INVOLUNTARINESS**

The issue of involuntariness (i) relates to the issue of whether the opponent entered into the agreement “freely” and (ii) incorporates effectively the possible contractual defenses of competency, fraud, misrepresentation, duress and coercion as evidenced by the terms of the agreement or the surrounding facts and circumstances. Other relevant factors may be the opponent’s understanding of the agreement at the time it was executed and whether the opponent had adequate time to consider the terms of the agreement prior to execution. *See* Fullenweider and Rainey, “Litigating Premarital Agreements,” *Advanced Family Law Course, State Bar of Texas* (1988).

## **2. UNCONSCIONABILITY**

Section 4.006(b) of the Texas Family Code provides that the issue of unconscionability is a question of law to be decided by the court, not the jury. The relevant factors for the court to consider may include the negotiating atmosphere, the relative bargaining abilities of the parties, and over-reaching by a party, as well as the legality of the contract and whether or not it violates public policy. Fullenweider and Rainey refer to the Uniform Premarital Agreement Act, 9(b) UCA 20, to include factors such as concealment of assets and sharp dealing not consistent with the obligation of marital partners to deal fairly with each other. *See* Fullenweider, *supra*. However, it is important to remember that, according to Sec. 4.006(b), even an unconscionable agreement can be enforced if it was entered into voluntarily by an opponent who was

either provided fair and reasonable disclosure or who waived such disclosure or who did not already have adequate knowledge of the financial situation of the proponent.

### 3. WAIVER

Generally, in order to be valid, a waiver of a statutory right must be a voluntary and intentional release of the right. It must be clear, specific and unequivocal. The party signing the waiver must have full knowledge of its consequences.

### 4. FAIRNESS

Notwithstanding the discussion of involuntariness and unconscionability, it is important to remember that there is no requirement that a premarital agreement be fair to be enforced. In *Chiles v. Chiles*, 779 S.W.2d 127 (Tex. App.—Houston [14th Dist.] 1989, writ denied), overruled on other grounds by *Twyman v. Twyman*, 855 S.W.2d 619 (Tex. 1993), the court held: “Parties should be free to execute agreements as they see fit and whether they are ‘fair’ is not material to validity.” Accordingly, Texas law currently appears to require only that a premarital agreement be fairly entered into and not that it be fair in application to both parties.

### 5. COMMON LAW DEFENSES

In *Daniel v. Daniel*, 779 S.W.2d 110 (Tex. App.—Houston [1st Dist.] 1989, no writ), the court discussed whether old Sec. 5.46’s comparable section for marital agreements, old Sec. 5.55, abolishes common law contract defenses (e.g. such as fraud, duress and competency), and concluded that it did

not. However, the predecessor to Sec. 4.006 eliminated the common law defenses for agreements executed on or after September 1, 1993, but they still appear to be incorporated into the concepts of involuntariness or unconscionability.

### 6. RECENT CASES

In *Sheshunoff v. Sheshunoff*, 172 S.W.3d 686 (Tex. App.—Austin 2005, pet. denied), the court discussed the premise that premarital agreements are presumptively enforceable, even if they are unconscionable, unless they were entered into unfairly. Other courts have followed this presumption that premarital agreements are enforceable. See *Larson v. Prigoff*, 2001 WL 13352 (Tex. App.—Dallas, Jan. 8, 2011).

#### **E. Statute of Limitations**

The statute of limitations applicable to any breach of the agreement is tolled until the marriage is terminated. Equitable defenses, such as laches and estoppel, are, however, preserved. Tex. Fam. Code § 4.008.

#### **F. Disclosure/Assistance of Counsel**

The law does not require that the parties be represented by separate legal counsel at the time of the agreement; however, the lack of independent counsel representing the party opposing the agreement’s enforcement is likely to be an important factor in determining an agreement’s enforceability. Failing to fully disclose the client’s financial situation can be problematic even if a waiver of such information is obtained from the other party.

## VI. PREMARITAL AGREEMENTS – SUBSTANCE

Prior to 1987, the Texas Family Code granted blanket authority to parties to enter into such agreements as they desired, subject, of course, to the limitations of the Texas Constitution and other public policy concerns. The Uniform Premarital Agreement Act, which includes a laundry list of subjects that can be addressed in a premarital agreement, was adopted in 1987. Today, the parties can still enter into such property agreements as they may desire, but the agreement is still subject to the limitations of the Texas Constitution and certain public policy concerns.

### A. Mere Agreement Rule

In 1902 the Texas Supreme Court announced what became known as the mere agreement rule: “The question whether particular property is separate or community must depend upon the existence or nonexistence of the facts, which, by the rules of law, give character to it, and not merely upon the stipulations by the parties that it shall belong to one class or the other.” *Kellet v. Trice*, 95 Tex. 160, 66 S.W. 51 (1902). The net effect of the mere agreement rule is that the constitutional definition of separate property limits the flexibility of spouses and those about to marry in their property agreements.

Note: *The mere agreement rule today can be summarized as follows: The provisions of an agreement which attempt to change the character of property in a manner not authorized by Art. XVI, Sec. 15, are void.*

## B. Constitutional Amendments

The 1948 amendment to Art. XVI, Sec. 15, permitted spouses to partition and exchange presently existing community property. The 1980 amendment to Art. XVI, Sec. 15 authorized the creation of separate property in more 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.

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

**C. Sec. 4.003, Texas Family Code**

Currently, parties to a premarital agreement are authorized by statute to contract with respect to:

1. The rights and obligations of each of the parties in any of the property of either or both of them whenever and wherever acquired or located.
2. The right to buy, sell, use, transfer, exchange, abandon, lease, consume, expend, assign, create a security interest in, mortgage, encumber, dispose of, or otherwise manage and control property.
3. The disposition of property on separation, marital dissolution, death, or the occurrence or nonoccurrence of any other event.
4. The modification or elimination of spousal support.
5. The making of a will, trust, or other arrangement to carry out the provisions of the agreement.
6. The ownership rights in and disposition of the death benefit from a life insurance policy.
7. The choice of law governing the construction of the agreement.

8. Any other matter, including their personal rights and obligations, not in violation of public policy or a statute imposing a criminal penalty.

**D. Standard Provisions**

It is common for premarital agreements to simply confirm the status of Texas law. For example, the parties agree that certain itemized assets brought into the marriage and their mutations are to remain the owner's separate property. They may also confirm that anything acquired during marriage by gift, devise or descent will be separate property. They may even agree that such separate property will not be subject to a just and equitable division at divorce. *Eggemeyer v. Eggemeyer*, 554 S.W.2d 137 (Tex. 1977) and *Cameron v. Cameron*, 641 S.W.2d 210 (Tex. 1982).

**E. Income from Separate Property**

Parties may agree that income from separate property is the owner's separate property. Since the Constitution expressly authorizes only spouses to make such agreements and not persons intending to marry, it may be advisable to draft such an agreement as a partition, since both spouses and persons intending to marry can partition community property not yet in existence (i.e., future income from separate property). Accomplishing this result through a partition, however, may not be necessary since by statute a premarital agreement becomes effective on marriage; thus, spouses are really making the agreement. Tex. Fam. Code § 4.004. On the other hand, why does the Constitution distinguish between parties intending to marry and spouses? See *Fanning v. Fanning*, 828 S.W.2d 135 (Tex. App.–Waco 1992), rev'd in part on other grounds, 847 S.W. 2d 225



(Tex. 1993); *Dokmanovic v. Schwarz*, 880 S.W.2d 272 (Tex. App.–Houston [14th Dist.] 1994, no writ).

#### **F. Wages, Salaries, Personal Earnings**

Following the passage of the 1980 amendment practitioners questioned whether the parties to a premarital agreement should be able to agree that wages and salaries and other personal earnings will be the acquiring spouse's separate property. For example, Professor Sampson noted:

It remains to be seen whether revising the type of agreement entered into here to contemplate a present partition of future earnings will suffice to take the parties completely out of the community property system. Generally, I hope not, although I also tend to believe that folks ought to be able to do what they want with their property. On the other hand, an agreement such as this between a doctor and his to be housewife seems clearly abusive and overreaching. Editor's note, Family Law, State Bar Section Report, Vol. 87-6, Fall 1987, pp. 35-36.

Professor Sampson's comments followed a discussion of *Bradley v. Bradley*, 725 S.W.2d 503 (Tex. App.–Corpus Christi 1987, no writ), where the court held that a particular premarital agreement did not effectively partition the parties' future earnings. It should be noted that the Bradley agreement itself was not drafted to accomplish a direct partition of future earnings, but was an agreement to partition future earnings once the earnings came into existence.

#### **G. Partition and Exchange**

Notwithstanding Professor Sampson's initial concerns, Art. XVI, Sec. 15 of the Texas Constitution appears to clearly authorize the partition and exchange of any and all community property not yet in existence, including, but not limited to, personal earnings, retirement benefits, I.R.A.s, trust income, income from separate property, and property acquired on credit; so does the legislature. See Sec/ 4.001(2) of the Texas Family Code. The cases of *Fanning v. Fanning*, *supra*, and *Winger v. Pianka*, 831 S.W.2d 853 (Tex. App.–Austin 1992, writ denied) have confirmed this viewpoint.

#### **H. Community Free Marriage**

It is, therefore, the "partition and exchange" agreement which can be effectively used to create the "community free marriage." By eliminating community property from the marriage, wrongful transfer issues, like "fraud on the community" are also eliminated. This type of agreement also allows the couple to address some otherwise troubling issues.

##### **1. REIMBURSEMENT**

If there still exists the possibility of a community claim for reimbursement, it would be advisable to address specifically any such potential claim in the premarital agreement. For example, perhaps the nonowner spouse could agree to waive the claim for reimbursement. *Stoker v. Stoker*, 2008 WL 4837084 (Tex. App.–Houston [1st Dist.] 2008), involved a premarital agreement that waived economic contribution claims by the nonowner spouse. The court held that this was permissible under Tex. Fam. Code § 3.410. However, it may be advisable for

the couple to partition the claim in a manner which would at least limit the exposure the owner spouse would have by reason of the community claim for reimbursement.

## 2. QUASI-COMMUNITY PROPERTY

Separate property acquired by a couple while residing in a common law state that would have been community had they been residing in Texas can be divided by a Texas divorce court on a just and right basis. Tex. Fam. Code § 7.002. The Family Code does not convert such asset into community property, but allows for it to be treated as such in a divorce proceeding. This concept is not available in probate. See *Hanau v. Hanau*, 730 S.W.2d 663 (Tex. 1987). Since such property is merely quasi-community and not actually community property, can it be subject to a partition and exchange agreement as authorized by the constitution and the statutes? Is this a right that the nonowner spouse can waive in a premarital agreement? There does not appear to be a good answer to this question, but it is an issue that should be addressed specifically in this agreement, if relevant.

## 3. QUASI-SEPARATE PROPERTY

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. 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. Since such property is merely quasi-separate and not actually separate property, this category of community property should be subject to a partition and exchange agreement.

## 4. PROFESSIONAL DEGREES, LICENSES

In view of the trend in some states to treat professional degrees and licenses as property and therefore capable of division by the divorce court and possible partition by the probate court, the possibility of such a result in Texas should be anticipated although the only case in Texas to date on point has held to the contrary. See *O’Brien v. O’Brien*, 489 N.E.2d 712 (N.Y. 1985) and *Frausto v. Frausto*, 611 S.W.2d 656 (Tex. Civ. App.–San Antonio 1980, writ dismissed w.o.j.). If professional degrees and licenses are eventually found to be property in Texas and consequently community property, if acquired during marriage, they should be treated as such in the agreement and could be subjected to a partition and exchange, if the parties so agree.

## 5. CERTAIN PERSONAL INJURY RECOVERIES

Personal injury recoveries for loss of earning capacity during marriage are defined as community property. Tex. Fam. Code § 3.001(a)(3). Notwithstanding this statutory provision and *Graham v. Franco*, *supra*, the author is of the opinion that actual “lost earnings” should be deemed to be 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 couple 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, the 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. In view of current law possibly creating such an inequitable result, possible personal injury recoveries could be addressed in a partition and exchange agreement.

#### 6. PERSONAL SERVICE CONTRACTS

Wages and salaries earned during the marriage are clearly community property, but the characterization of money earned during the marriage pursuant to a contract signed before marriage, or money received after the marriage pursuant to a deferred compensation agreement signed during the marriage, can be complicated. Even if wages and salaries generally are not

going to be partitioned, these other issues could be addressed in the premarital agreement to avoid future confusion and litigation.

#### I. **Division of Property Upon Divorce**

The parties should be able to agree as to a certain division of any community and their respective separate properties in the event of divorce instead of awaiting an "equitable division" of the community by the divorce court. Of course, such an agreed to division cannot affect a parent's child support obligations. Such an agreement may also affect the determination of whether an agreement is unconscionable or not.

#### J. **Contracts Concerning Succession**

The parties to a premarital agreement may also agree that they will not assert inheritance rights upon the first spouse's death or that one spouse is to leave to the other spouse certain assets in the event the marriage terminates by reason of the obligor's death. Sec. 59A of the Texas Probate Code was amended in 2003 in order to confirm that a contract to make a will or devise can be established by either (i) provisions in a will stating that the contract exists and the material provisions of the contract, or (ii) the provisions of a written agreement that is binding and enforceable. Even without the addition of the latter provision, this author is of the opinion that Sec. 59A was never intended to apply to an agreement whereby a spouse is required to leave property to the other spouse pursuant to a premarital agreement. This situation is not one where there are reciprocal testamentary promises but one where there is current consideration in exchange for a testamentary promise.

**K. Homestead, Exempt Personal Property and Allowances**

In *Williams v. Williams*, 569 S.W.2d 867 (Tex. 1978), the Texas Supreme Court approved the provisions of a premarital agreement whereby one party waived his right following the first spouse's death to occupy the other party's separate property home, to utilize the exempt personal property and to claim a family allowance.

1. SELECTION AND ABANDONMENT

The premarital agreement presents the opportunity for a couple to agree which of their homes will be the homestead and what process should be followed to abandon and select a new one.

2. SALE OR ENCUMBRANCE

The *Williams* case involved the surviving spouse's rights following the owner's death. Sec. 5.001 of the Texas Family Code prohibits the owner of the homestead from selling or encumbering it during the marriage without the joinder of the non-owner spouse. Can this right of the non-owner be waived in a premarital agreement? Sec. 4.003(a)(2) appears to authorize it.

3. LIABILITY

So long as the owner is alive, the homestead and certain items of personal property continue to be exempt from the claims of certain creditors. Tex. Prop. Code §§ 41.001 and 42.002. However, if the non-owner has waived the right of occupancy and possession upon the death of the owner, will such property continue to be exempt from most

creditors following the owner's death? Presumably yes, if the owner also was survived by a minor child. But if the only constituent family member surviving the owner is the spouse who previously waived these rights, the answer is not so clear.

Note: Prior to 2005, Texas case law appeared to grant the exemption from creditors if the owner was survived only by an unmarried child living at home. 2005 amendments to Sections 271 and 272 may have inadvertently eliminated that exemption.

**L. The Universal Community**

Can the parties to a premarital agreement agree that the property they are bringing into the marriage and/or the property to be acquired during marriage by gift, devise or descent are to be community property? In other words, can those intending to marry agree to an "all community" marriage? Notwithstanding the 1999 amendment, such an agreement would still appear to violate the Texas Constitution, which does not expressly offer a procedure for parties intending to marry to accomplish the result. *Tittle v. Tittle*, 148 Tex. 102, 220 S.W.2d 637 (1949). Of course, once married, one spouse may give the other spouse one-half of the donor's separate property, thereby making them tenants in common, and spouses over a period of time can allow their separate estates to become commingled and, therefore, community property. In addition, since January 1, 2000, spouses can enter into a transmutation agreement once they are married. Or, is a premarital agreement really a marital agreement?

*Note: Some practitioners follow the practice of having the couple re-execute the pre-marital agreement following the wedding, a practice which is not necessary, in the author's opinion, if the original agreement is a properly drafted "partition and exchange agreement." Further, the Texas Family Code states that a pre-marital agreement actually becomes effective upon marriage.*

### **M. Preserving Portability**

The parties should consider a provision in the agreement that requires that the first spouse to die is to direct the personal representative of his or her estate to elect to transfer to the surviving spouse the deceased spouse's DSUE amount by filing a United States Estate Return whether one is otherwise required to be filed or not. As consideration for the agreement, the surviving spouse may be required to reimburse the estate of the deceased spouse for any expenses that would not otherwise be incurred by the deceased spouse's personal representative. See *Portability and Prenuptials: A Plethora of Preventative, Progressive and Precautionary Provisions*, George K. Karibjanian and Lester B. Law, *Probate Property* (May/June 2013).

### **N. Addressing Necessaries**

Notwithstanding a spouse's duty of support and the necessities doctrine, increasingly lawyers with clients considering marriage but concerned with the potential overwhelming costs of caring for an elderly spouse are focused on the Texas version of the Uniform Premarital Agreement Act, specifically Section 4.003(a)(4) of the Texas Family Code, which states that the parties to a premarital agreement may contract with respect to "the modification or elimination of *spousal*

*support.*" Can a Texas couple by an agreement eliminate the spouses' mutual obligation of support and a third party's rights under the necessities doctrine? See VIII, *infra*.

## **VII. EFFECTIVENESS OF THE PRENUPTIAL AGREEMENT**

Assuming a valid, enforceable agreement has been executed in order to create a "community free marriage," have the goals of insulating each spouse's separate estate from the claims of the other spouse and the other spouse's creditors and successors been accomplished? The answer: "Maybe!"

For one thing, since everything is his or her separate property, each spouse is free generally to manage his or her property without interference from the other spouse. However, absent an effective waiver, the homestead rules will still prohibit a transfer or encumbrance of the home without the joinder of the other spouse.

Further, the separate assets of one spouse are generally exempt from the creditors of the other spouse. In the event of divorce, there is no community property to divide on a just and right basis; and upon the death of a spouse, the decedent's estate passes to the decedent's heirs and devisees, and the surviving spouse retains his or her estate untainted by the claims of the decedent's heirs and devisees.

However, the situation may not be as perfect as it may appear.

### **A. Necessaries**

Generally, each spouse still has the legal duty to support the other spouse and their children for so long as the children are minors and thereafter until they graduate from high school. Tex. Fam. Code §§ 2.501

and 154.001. Therefore, both spouses' separate properties are liable for such necessities unless the mutual duty of support can be waived by the spouses in the agreement. *See IX, infra*.

### **B. Child Support**

As would be expected, an agreement between spouses to limit either's child support obligations would be against public policy. This concept has been codified in Sec. 4.003 of the Texas Family Code.

### **C. Tax Liability**

For any tax year that the spouses file joint income tax returns, each spouse remains jointly and severally liable for any tax liability arising from that year's tax.

### **D. Spousal Torts**

Will public policy prevent the anticipatory waiver of spousal tort claims in premarital agreement? Should there be a different rule for negligence and intentional torts? In general, see "Releases: An Added Measure of Protection from Liability," 39 *Baylor L. Rev.* 487 (1987).

### **E. Joint Ventures**

A spouse remains personally liable for the acts of the other spouse if the other spouse is an agent or otherwise innocent spouse. Tex. Fam. Code § 3.201. Although the marital relationship itself does not create a principal/agency relationship among the married couple, their being engaged together in a business venture or other joint action can create vicarious liability and expose each spouse's separate property to any liability arising therefrom.

### **F. Preexisting Creditors**

Section 4.106 of the Family Code says that a partition and exchange agreement is void with respect to the rights of preexisting creditors whose rights are intended to be defrauded therein. It is interesting to note that it is not clear whether this provision applies to premarital partition and exchange agreements. Also, such provision does not by its own terms apply to spousal income agreements under Sec. 4.102.

### **G. U.F.T.A. and the Bankruptcy Code**

Creditors may avoid and recover fraudulent transfers. The trustee in bankruptcy can avoid transfers deemed fraudulent under the Texas version of the Uniform Fraudulent Transfer Act. This means that certain prepetition transfers of community property by a filing spouse to a nonfiling spouse, by way of gift or partition, can be avoided because the transfer acted to deprive creditors of property that would otherwise be available to creditors as part of the bankruptcy estate. Each type of transfer must be analyzed under the fraudulent transfer theory to determine if assets otherwise within the reach of a creditor have been pulled beyond the creditor's reach by virtue of the challenged transfer. For example, a spouse might impermissibly transfer his own interest in existing community property by way of a partition. Yet the same spouse could probably renounce, by way of a premarital partition, an interest in community property to be acquired in the future since the parties to the partition had no vested interest in the future community property absent the partition. Of course, these sections of the U.F.T.A. and the Bankruptcy Code also invalidate

transfers involving actual or constructive fraud.

## H. ERISA Plans

ERISA “shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan...” 29 U.S.C.A. Sec. 1144. Further, ERISA requires for many qualified retirement plans that the participant’s spouse receive a mandatory death benefit upon the death of the participant or a joint and survivor annuity upon the retirement of the participant, regardless of the marital property character of the participant’s interest in the plan. Of course, the spouse may waive these statutory rights in a consent procedure described by statute. 29 U.S.C.A. Sec. 1055(c).

Several cases have held that these ERISA granted rights of the participant’s spouse cannot be waived in a premarital agreement. In *Manning v. Hayes*, 212 F.3d 866 (5th Cir. (Tex.) 2000), cert. denied, 121 S.Ct. 1401 (2001), language in a premarital agreement was not sufficiently explicit to result in a waiver of an ex-wife’s beneficiary status under an ERISA plan. In *Hurwitz v. Sher*, 789 F.Supp. 134 (S.D.N.Y. 1992), aff’d by 982 F.2d 778 (2nd Cir. 1992), cert. denied 508 U.S. 912 (1995), the decedent and his spouse executed a premarital agreement waiving any rights with respect to the other’s separate property and the court held that the wife had not waived her rights to the plan benefits to which she was entitled because only a spouse, not a fiancé, can waive such rights under federal law. A similar result was reached in *Nellis v. Bowling Co.*, 1992 WL 122773, 15 Employee Benefits Vas. 1651 (D. Kan. 1992); further, the court noted that language in the agreement stating that the agreement was to take effect upon marriage did not save the agreement. In *Zinn v. Donaldson*

*Co.*, 799 F.Supp. 69 (D. Minn. 1992), the court even held that a constructive trust could not be imposed on the surviving spouse to equitably enforce the premarital agreement. A similar result was affirmed by the Sixth Circuit in *Howard v. Branham & Baker Coal Co.*, No. 91-5913, 968 F.2d 1214 (table), (6th Cir. 1992) (text in Westlaw).

## I. Trap for the Unwary

Accordingly, a properly prepared or premarital agreement under Texas law may ensure that the employee’s interest in the retirement plan is separate property in the event of divorce, but such a result, in and of itself, does not negate whatever rights the spouse may have under ERISA at the time of the employee’s retirement or death absent an effective ERISA waiver of those rights.

## J. Future Legislative Changes

The potential impact of future state and federal legislation (e.g., amending ERISA or adopting the concepts of quasi-community property at death, or a statutory share system, or even permanent alimony) should be considered and addressed in the agreement. Of course, these potential rights could be expressly waived in the premarital agreement, but is the waiver of a right that is not yet in existence enforceable? Generally, to be enforceable, a waiver of statutory rights must be clear, specific and unequivocal, and given by a party who has full knowledge of its consequences. In any event, the issues should be addressed and identified as specifically as possible.

## K. Income Tax Basis

To the extent property is held as community property, both halves receive a new income tax basis upon the death of the

first spouse under Sec. 1014(b)(6) of the Internal Revenue Code. This tax advantage is lost if community property has been partitioned into separate property.

## VIII. WAIVING SPOUSAL SUPPORT

Some commentators have suggested that a couple can, by agreement, avoid joint and several liability by waiving their mutual duty of support. The treatise *Texas Family Law: Practice and Procedure*, VI, 130, Waiver of Spousal Support During Marriage (Matthew Bender & Company 2012), states that the parties to a premarital agreement can modify or eliminate “the duty of spousal support.” It further states that, in the premarital agreement, the parties “. . . may waive the right of *spousal support*, limit it to a certain amount, or provide that the *duty of support* arises only if one spouse becomes disabled or unemployed.” Similar language is found in Matthew Bender’s *Texas Transaction Guide – Legal Forms*, § 93.230 (2012). Unfortunately, the only authority cited for the assertions is Tex. Fam. Code § 4.003(a)(4).

### A. Texas Premarital Agreement Act

Section 4.003(a)(4) of the Texas Family Code states that the parties to a premarital agreement may modify or eliminate *spousal support*. It does not state that the parties can modify or eliminate the *duty of support*. In addition, a review of the annotations under Section 4.003 does not reveal any real authority to support the argument that such an agreement can eliminate or modify a spouse’s *duty of support* of the other spouse during the marriage, or a third party’s rights under the necessities doctrine. Section 4.003’s laundry list of matters which can be addressed in a premarital agreement

suggests that the parties can contract with each other concerning their mutual rights and obligations, and the contract is enforceable among themselves and their successors in interest as long as the agreement does not violate public policy.

A matter which extends beyond the parties’ mutual rights and obligations and which affects third parties should be subject to a more stringent public policy examination prior to being enforceable against a third party, especially a third party creditor that provided services deemed reasonably necessary for either spouse’s support.

*Note: It is important to note that Subchapter B of Title 1, Chapter 4 of the Texas Family Code, which relates to agreements between spouses during the marriage, does not contain similar language. This omission suggests that, once married, spouses may not be able to enter into a contract that modifies or eliminates spousal support.*

### B. The Community-Free Marriage

Texas public policy does allow the parties to the premarital agreement to create a “community-free marriage” – a marriage where all assets are either the separate property of one spouse, or the other, or both spouses. Art. XVI, § 15, Texas Constitution. Even existing spouses can create a community-free marriage. Tex. Fam. Code § 4.102. Such a marital agreement cannot prejudice the rights of pre-existing creditors. Tex. Fam. Code § 4.106. Subject to the provisions of Section 4.106, creating a community-free marriage is a valid means of affecting the rights of third parties, including the spouses’ creditors, since generally one spouse’s separate property is not liable for the contract debts



or tort debts of the other spouse. Tex. Fam. Code § 3.202(a).

Even if the parties have a community-free marriage, each spouse is still personally liable for a debt of the other spouse if (i) the other spouse acted as the spouse's agent when incurring the debt or (ii) the other spouse incurred a debt for necessities. Accordingly, that spouse's separate property is reachable by the creditor of the other spouse that provided services that are deemed to have been reasonably necessary for the other spouse's support. Tex. Fam. Code § 3.201.

### C. Effect of Support Waiver

If the terms of an otherwise valid, enforceable premarital agreement purport to eliminate or modify the spouses' mutual obligation of support, its effectiveness should be limited to the relative rights and obligations between the parties themselves and their successors. Public policy considerations suggest that the agreement should not affect the rights of a third party who provided uncompensated services deemed reasonably necessary for the other spouse's support. Those same public policy considerations suggest that a spouse's *duty of support* during the marriage still exists notwithstanding the agreement; consequently, the agreement should be able to only affect "reimbursement" claims among the spouses upon termination of the marriage. Tex. Fam. Code §§ 3.401-3.410.

### D. Reimbursement Between Spouses

Absent such an agreement when the marriage terminates, a spouse is not entitled to reimbursement from the other spouse for expending separate funds during the marriage for the support of the other spouse because of the spouses' mutual duty of support. *Burney v. Burney*, 225 S.W.3d 208

(Tex. App.—El Paso 2006, no pet.); *In re Marriage of Case*, 28 S.W.3d 154 (Tex. App.—Texarkana 2000, no pet.). However, if a premarital agreement contains a "waiver of support," the spouse who is required to pay a third party under the necessities doctrine should be able to seek reimbursement from the other spouse upon the termination of the marriage. Notwithstanding the terms of the agreement, the bottom line is each spouse still has a duty to support the other spouse during the marriage, even if they have agreed, in effect, that each spouse is primarily liable for his/her own necessities.

### E. "Spousal Support"

Critics of this position will point out that both the Uniform Premarital Agreement Act and its Texas version specifically state that a premarital agreement can modify or eliminate *spousal support*; however, neither expressly states that the agreement can modify or eliminate the parties' mutual *duty of support* that attaches during their marriage. The *duty of support* is not the same concept as *spousal support*. The term "*spousal support*," as used in both the Uniform Premarital Agreement Act and the Texas version, was intended to refer to the more politically correct equivalence of "alimony" – *spousal support*. *Spousal support* is the generally accepted term used to describe payments required from one spouse to another after divorce. It is synonymous with the terms "alimony" and "maintenance."

### F. But Texas Doesn't Have Alimony!

Accordingly, it is likely that a Texas court would interpret the term "*spousal support*" within the context of Section 4.003(a)(4) to be its generally accepted meaning – a legal obligation on a

person to provide financial support to an ex-spouse after divorce. Critics of this interpretation will argue that Texas does not recognize alimony; thus, the Legislature must have retained that specific provision from the uniform act for a reason. The counter to that argument is that, while Texas (then and now) maintains its policy prohibiting court-ordered permanent alimony, (i) the parties to the agreement may marry and then move to a state that has more traditional spousal support statutes or (ii) the Legislature may in the future adopt a more traditional spousal support statute. Accordingly, it is likely that the Legislature retained Section 4.003(a)(4) anticipating that the parties intending to marry in Texas may wish to address those situations in their premarital agreements.

#### **G. Texas Maintenance**

In 1997, a limited form of post-divorce spousal support was enacted. See Chapter 8, Court-Ordered Maintenance, Title 1, Subchapter C, of the Texas Family Code. However, the Texas Family Code does not expressly address whether court-ordered maintenance can be waived in a premarital or marital agreement although Sec. 4.003 does refer to the waiver of spousal support in premarital agreements. Since court-ordered maintenance was created as part of a welfare reform package, such a waiver may be against Texas public policy, notwithstanding the language to the contrary in the premarital agreement act.

#### **H. UPAAC Comments**

The official comment of the uniform act states:

Paragraph (4) of subsection (a) specifically authorizes the parties to deal with

*spousal support* obligations. There is a split in authority among the states as to whether a premarital agreement may control the issue of *spousal support*. Some few states do not permit a premarital agreement to control this issue (see, e.g., *In re Marriage of Winegard*, 278 N.W.2d 505 (Iowa 1979); *Fricke v. Fricke*, 42 N.W.2d 500 (Wis. 1950)). However, the better view and growing trend is to permit a premarital agreement to govern this matter if the agreement and the circumstances of its execution satisfy certain standards (see, e.g., *Newman v. Newman*, 653 P.2d 728 (Colo. Sup. Ct. 1982); *Parniawski v. Parniawski*, 359 A.2d 719 (Conn. 1976); *Volid v. Volid*, 286 N.E.2d 42 (Ill. 1972); *Osborne v. Osborne*, 428 N.E.2d 810 (Mass. 1981); *Hudson v. Hudson*, 350 P.2d 596 (Okla. 1960); *Unander v. Unander*, 506 P.2d 719 (Ore. 1973)).

All of the cases mentioned in this official comment involve post-divorce alimony, maintenance or support. It seems obvious that the relevant section of the uniform act was not intended to address the spouses' mutual duty of support or third party rights under the necessities doctrine.

## I. Other States' Laws

Surprisingly, there is very little authority in other jurisdictions addressing whether a “waiver of support” can eliminate the necessities doctrine. Most of the cases that have discussed the waiver of spousal support were references to it in the context of post-divorce alimony and not in terms of the spouses’ *duty of support* during marriage. In *Rathjen v. Rathjen*, No. 05-93-00846-CV, 1995 Tex. App. LEXIS 3759 (Tex. App.—Dallas May 30, 1995, no pet.), the Texas court, applying the law of Hawaii, refers to the Hawaiian Supreme Court decision of *Lewis v. Lewis/Reese v. Reese*, 60 Haw. 497, 748 P.2d 1362 (1988) and noted that other states have held that a premarital agreement is unenforceable if its application would result in public assistance. This rationale is sound public policy that should be followed absent clear statutory authority to the contrary.

## J. UPAA – Texas Version

When the Legislature adopted the Uniform Premarital Agreement Act, deleted from the uniform act’s “enforceability” provisions language stating that, even if the agreement eliminated or modified the *spousal support*, and if such a provision causes a spouse to be eligible for public assistance, a court, upon divorce, could still require the other spouse to provide support to the extent necessary to avoid that eligibility. In a comment, the author suggests that this change in the Texas statute suggests that a Texas court cannot change the terms of a premarital agreement just because it results in a spouse’s eligibility for public assistance. Amberlyn Curry, *The Uniform Premarital Agreement Act and Its Variations Throughout the State*, 23 J. Am. Acad. Matrimonial Law, 335 (2010). The more likely reason for the deletion was

Texas’ prohibition of post-divorce court-ordered permanent alimony.

## IX. AGREEMENTS DURING MARRIAGE

During marriage, spouses can generally accomplish the same results that could have been generated in a premarital agreement. They can partition or exchange among themselves their existing community property and any community property to be acquired in the future. Tex. Fam. Code § 4.102. Spouses may also agree that income from a spouse’s separate property will be separate property. Tex. Fam. Code § 4.103. Accordingly, spouses, like persons intending to marry, have the legal ability to create a “community free marriage.”

### A. 2003 and 2005 Legislation

Section 4.102 was amended in 2003 to provide that, if community property is partitioned, the income the partitioned property thereafter generates is also partitioned into separate property unless the parties agree such income will be community property. HB 885 (2003). However, due to concerns that the 2003 amendment may have been unconstitutional, HB 202 (2005) amended Sec. 4.102 again to negate the presumption that future earnings and income would be separate property so that now Sec. 4.102 only authorizes such an agreement.

Accordingly, the parties to a partition and exchange agreement now have the express statutory authority to partition and exchange the future earnings and income from the property they had agreed to partition, a right already granted to them by the 1980 amendment to Art XVI, Sec. 15 of the Texas Constitution and Sec. 4.102 as originally enacted.

### 1. PRE-2005 PARTITIONS

Unfortunately, it can be anticipated that someone will argue and perhaps even convince a court that Texas spouses did not have until the effective date of the 2005 amendment the right to partition the future earnings of income of the community property being partitioned, thereby casting doubt on the effectiveness of any such agreements entered into prior to that time. Hopefully, the courts will rule that spouses have had the constitutional right to enter into these types of agreements since November 4, 1980, and that the legislature was not even trying to take this right away in their later legislation. Nevertheless, there also remains the question of the effectiveness of partition and exchange agreements entered into between the effective dates of the 2003 and 2004 amendments that do not expressly divide the future earnings and income of the property being partitioned.

### 2. PARTITIONS WITHOUT CONSIDERATION

HB 202 (2005) also amended Sec. 4.104 by adding a sentence that provides: “Either agreement (referring to both Sec. 4.103 and Sec. 4.102 agreements) is enforceable without consideration.” This sentence makes sense as applied to Sec. 4.103 agreements but may be unconstitutional as to Sec. 4.102 partition and exchange agreements. A partition and exchange agreement contemplated by Art. XVI, Sec. 15 requires some type of consideration received by both parties to the agreement, otherwise the agreement is, in reality, a gift if one party receives 100% of the property being partitioned.

The court in *Byrnes v. Byrnes*, 19 S.W.3d 556, 559 (Tex. App.–Ft. Worth 2000, no pet.), stated the obvious:

The term “partition” as used in this section contemplates a division of property among the parties, not a complete forfeiture or assignment. See *McBride v. McBride*, 797 S.W.2d 689, 692 (Tex. App.–Houston [14th Dist.] 1990, writ denied). Absent a specific reference to a partition or language indicating that such a division was intended, Texas courts have refused to uphold transactions between spouses as partitions. See *Maple v. Nimitz*, 615 S.W.2d 690 (Tex. 1981); *Collins v. Collins*, 752 S.W.2d 636, 637 (Tex. App.–Ft. Worth 1988, writ ref’d).

Of course, a gift by one spouse to the other of presently existing community property is permissible under Art. XVI, Sec. 15, but that section may not allow such a gift of any and all community property to be acquired in the future. Other than income from separate property, other future community acquisitions (e.g., future personal earnings) can only be partitioned under Art. XVI, Sec. 15. Of course, a gift of presently existing community property by one spouse to the other is presumed to include any future income generated by the gift. Tex. Fam. Code § 3.005, as authorized by Art. XVI, Sec. 15.

### 3. FORM OVER SUBSTANCE

This 2005 amendment implies that spouses could “partition” an item of community property so that it becomes one spouse’s separate property. Accordingly, without an express partition of the future income, the future income the partitioned property

generates would be community property. However, if one spouse gives to the other spouse an item of community property, the property is the donee spouse's separate property, and the future income it generates will also be separate property, unless the donor spouse expressly retains a community income interest. Form over substance should not prevail; if a "partition" results in one spouse receiving 100% of the property being "partitioned," it's not a partition, but rather, it is a gift. Why create confusion by enacting a statute that says a partition does not need consideration?

## **B. Formalities**

The formalities required and the rules of enforcement for marital agreements are essentially the same as for premarital agreements. Tex. Fam. Code §§ 4.104 and 4.105. On the other hand, these agreements would appear to be particularly susceptible to charges of involuntariness and unconscionability. Further, any such agreement cannot prejudice the rights of preexisting creditors. Tex. Fam. Code § 4.106.

*Note: An agreement in order to settle property rights incident to a divorce requires the approval of the divorce court. Tex. Fam. Code § 7.006. In other words, a divorce settlement cannot be disguised as a marital agreement to avoid court involvement in property division at divorce.*

## **C. Transmutation**

Prior to January 1, 2000, it was unconstitutional for a married couple to convert by agreement separate property into community property. Many believed that couples should have that flexibility since

they had the ability to convert community into separate by agreement. They already had the ability to allow their separate assets to become commingled and therefore community property. They could also exchange a separate asset for a community asset. So why not allow the conversion of separate into community by agreement? Perhaps a couple would like to take advantage of the "step up in basis" community property enjoys upon the death of one spouse. Perhaps they wish to rescind an earlier agreement to convert community into separate so that property which was community is community again. There are any number of legitimate reasons why a couple should have the ability to change the character of their marital assets from community to separate, or separate to community.

### **1. CHANGE IN LAW**

Accordingly, the 1999 Legislature approved both HB 734 and HJR 36. HB 734 (1999) described a procedure whereby spouses could by agreement change separate property into community property. See Tex. Fam. Code § 4.202. Their ability to utilize this procedure depended on a constitutional amendment to Art. XVI, Sec. 15 (HJR 36) being approved by the voters in November 1999. It was approved by the voters on November 2, 1999, and became effective January 1, 2000.

### **2. FORMALITIES**

An agreement to convert separate property into community property must be in writing and: (a) be signed by the spouses; (b) identify the property being converted; and (c) specify that the property is being converted into the

spouses' community property. Tex. Fam. Code § 4.203.

### 3. MANAGEMENT

An agreement to convert a spouse's separate property into community does not necessarily mean that the newly created asset is subject to joint management. Management still depends on record title or possession. Tex. Fam. Code § 4.204.

### 4. ENFORCEABILITY

The agreement is not enforceable if the spouse against whom enforcement is sought proves that the spouse did not: (a) execute the agreement voluntarily; or (b) receive a fair and reasonable disclosure of the legal effect of converting the property into community property. Tex. Fam. Code § 4.205.

### 5. PRESUMPTION OF FAIR DISCLOSURE

An agreement that contains the following statement, or substantially similar words, prominently displayed in bold-faced type, capital letters, or underlined, is rebuttably presumed to provide a fair and reasonable disclosure of the legal effect of converting property to community property:

*This instrument changes property to community property. This may have adverse consequences during marriage and on termination of the marriage by death or divorce. For example:*

*Exposure to creditors. If you sign this agreement, all or part of the separate*

*property being converted to community property may become subject to the liabilities of your spouse. If you do not sign this agreement, your separate property is generally not subject to the liabilities of your spouse unless you are personally liable under another rule of law.*

*Loss of management rights. If you sign this agreement, all or part of the separate property being converted to community property may become subject to either the joint management, control and disposition of you and your spouse or the sole management, control and disposition of your spouse alone. In that event, you will lose your management rights over the property. If you do not sign this agreement, you will generally retain those rights.*

*Loss of property ownership. If you sign this agreement and your marriage is subsequently terminated by the death of either spouse or by divorce, all or part of the separate property being converted to community property may become the sole property of your spouse or your spouse's heirs. If you do not sign this agreement, you generally cannot be deprived of ownership of your separate property upon termination of your marriage, whether by death or divorce.*

*See Tex. Fam. Code § 4.205(b).*

### 6. PREEXISTING CREDITORS

A conversion of separate property to community property does not affect the rights of a preexisting creditor of the spouse whose separate property is being converted. Tex. Fam. Code § 4.206. After all, a

transmutation agreement is a “transfer” of property from one spouse to the other.

## **X. PLANNING FOR DESCENDANTS**

In the client’s estate plan, the client should consider possible marital property planning for the client’s descendants, especially if they reside in a community property state. For example, whether or not the client trusts the son-in-law, steps can be taken to hopefully enable the daughter to maintain the separate character of any inter vivos or testamentary gifts.

### **A. Segregated Accounts**

At a minimum, the daughter should be advised to “keep her separate, separate” by opening bank and brokerage accounts in her individual name (perhaps with a designation “separate account”) and only depositing into the account her separate property. Contemporaneous business records showing the source of any and all separate deposits should be retained in the event proof of separate character of the account is later needed.

### **B. Avoid Inadvertent Commingling**

In a state like Texas, where income from separate property is community property, any interest (or other income generated by the account) should be paid into a different account in her name (perhaps with a designation of “special community account”) in order to avoid a “commingling” of community and separate funds in the separate account. If an account is “commingled,” it becomes community property.

### **C. Separate Investments**

Any investment given to her, purchased with funds in her “separate account” or certificates issued out of her separate account, should be held in her name only. Further, real estate conveyed to her should be conveyed to her “as her separate property.” Again, contemporaneous business records can serve as evidence of the nature of the transaction and the separate character of the asset and should be retained.

### **D. Family Entities**

If the daughter is to be a partner in a family partnership, a member in a family-oriented limited liability company or a shareholder in a closely-held corporation, her interest should be given to her as a gift (or purchased with traceable separate property). Again contemporaneous business records of the nature of the transaction should be retained. If she expends any “time, talent or labor” in the management of the entity, paying her a reasonable compensation for those personal services should be considered to hopefully avoid a later reimbursement claim by her husband.

### **E. Asset Protection Trusts**

Any and all of the inter vivos or testamentary gifts could be placed in an asset protection trust for the daughter’s benefit during her lifetime. The spendthrift provisions will help not only insulate the daughter’s interest from the claims of her creditors, but also any community property claims of the son-in-law. Including a statement in the trust agreement that it is the settlor’s intent that any and all interests of the daughter, as well as any and all distributions to her out of the trust, are her separate property may not be conclusive, but

may prove to be persuasive in future litigation.

Limiting distributions of income and/or principal to an ascertainable standard (health, education, maintenance, or support) is especially important if the daughter is going to be the trustee or is going to be given general power of appointment. If a third party is going to serve as trustee, income distributions to her could be at the discretion of the trustee or pursuant to an ascertainable standard. Caution should be exercised in granting any other powers to the daughter over the trustee or the trust estate. Carefully planning and drafting the terms of the trust could prove to be persuasive in maintaining the trust as her separate property.

#### **F. Daughter's Counsel**

Counsel can be retained to advise the daughter on what other planning tools are available to her in order to insulate "her estate" from any possible community property claims of her husband (or his successors or creditors) and/or to review the daughter's planning to ensure that what can be done has been done to insulate the daughter's inheritance from any possible claims of the son-in-law (or his successors or creditors).

Finally, the fees of the daughter's counsel should be paid by the daughter with her separate property or by the client to avoid any claim by the son-in-law that the daughter misused their community property to his detriment.

### **XI. FAMILY BUSINESS PLANNING**

The use of modern business entities, such as corporations, partnerships and limited liability companies, has become an integral part of family estate planning. One

popular technique is for family members to contribute assets to a family limited partnership in exchange for interests in the partnership. A client intending to marry can also take advantage of this planning opportunity to preserve the assets contributed to the family limited partnership for the client and the children of a prior marriage. The client's partnership interest should remain the client's separate property during the marriage. In other words, the assets contributed to the partnership, as well as assets acquired by the partnership, should remain partnership assets and not become marital assets of the owner and the owner's spouse during the subsequent marriage.

*Note: In any separately-owned, closely-held business enterprise where a spouse is involved in the management, Jensen v. Jensen must be factored into the planning. See II, B, supra. The short answer is to pay reasonable compensation for services rendered by the owner during marriage and maintain contemporaneous business records of the reasonableness of the compensation paid.*

#### **A. Entity Theory**

The assets contributed to the partnership become the assets of the partnership, and the partners receive partnership interests. The marital character of a spouse's interest in a partnership created during marriage should depend on the separate or community nature of the assets contributed in exchange for the interest itself. If an interest in the partnership was acquired as a gift, the interest itself is, of course, the separate property of the donee spouse. The assets of the partnership, including undistributed income and profits, belong to the entity and do not take on a separate or community character under normal circumstances. See Sec. 152.056 of



the Texas Business Organizations Code and see also *Harris v. Harris*, 765 S.W.2d 798 (Tex. App.—Houston [14th Dist.] 1989, writ denied). Caution should be taken in the day-to-day management of the partnership to avoid claims for reimbursement because of the expenditures of uncompensated time, talent or labor or contributions of community property to the separate property business. See III, B, *supra*.

### **B. Distributed Profits**

When the partnership distributes its profits to its partners, the profits distributed to a married partner are community property, whether the partner's partnership interest is separate or community property. This result can work a conversion of what would ordinarily be the separate property into community property. For example, if a spouse contributes separately owned oil and gas royalty interests into a partnership, the royalties collected by the partnership and then distributed to the partners as partnership profits are community property. Had the spouse not contributed the royalty interest to the partnership, the royalties received would have been the owner's separate property. See *Marshall v. Marshall*, 735 S.W.3d 587 (Tex. App.—Dallas 1987, writ ref'd n.r.e.). The *Marshall* case has been cited for the proposition that all partnership distributions during marriage are community property. However, some commentators argue that a distribution in excess of current or retained earnings or other distributions of capital should be separate property. See Jack Marr, *Business and Divorce*, 34<sup>th</sup> Annual Marriage Dissolution Institute (2011).

### **C. Comparison to Corporations**

Partnerships, limited partnerships and limited liability companies are treated as entities under Texas law. The owners do not own the entity's assets; they own interests in the entity similar to shares of stock in a corporation. A divorce court cannot award specific partnership assets to the other spouse. *Gibson v. Gibson*, 190 S.W. 3d 821 (Tex. App.—Ft. Worth 2006, no pet.). Non-liquidating distributions by the entity to the owners generally take on a community character like ordinary cash dividends distributed by a corporation to its shareholders. But, do established corporate law concepts, like the alter ego/reverse veil piercing, *Dillingham v. Dillingham*, 434 S.W.2d 459 (Tex. Civ. App.—Ft. Worth 1968, writ dismissed w.o.j.) and reimbursement for the expenditure of community time, talent and labor like in *Jensen* apply to these new entities as well?

Reverse veil piercing has been held to be inapplicable to partnerships. See *Lifshutz v. Lifshutz*, 61 S.W. 3d 511 (Tex. App.—San Antonio, 2001, pet. denied) and *Pinebrook Properties, Ltd. v. Brookhaven Lake Property Owners' Association*, 77 S.W. 3d 487 (Tex. App.—Texarkana, 2002, pet. denied). Marr notes that the same rule may apply to limited partnerships and limited liability partnerships. See Marr, *supra*. However, he notes that the concept has been applied to limited liability companies. See *McCarthy v. Wani Venture, A.S.*, 251 S.W. 3d 573 (Tex. App.—Houston [1<sup>st</sup> Dist.] 2007, pet. denied).

The concepts of fraud on the community and reimbursement would appear to apply to any entity situation.

#### **D. Corporate Veil Piercing**

Notwithstanding the “entity” rule, the assets of a separately owned corporation have been held by Texas courts to be part of the community estate and subject to a just and right division by the divorce court in some situations. See *Zisblatt v. Zisblatt*, 693 S.W.2d 944 (Tex. App.—Ft. Worth 1985, writ dism’d w.o.j.); *Spruill v. Spruill*, 624 S.W.2d 694 (Tex. App.—El Paso 1981, writ dism’d w.o.j.); *Dillingham v. Dillingham*, 434 S.W.2d 459 (Tex. Civ. App.—Ft. Worth 1968, writ dism’d w.o.j.).

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

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

The *Lifshutz* court also suggested that the use of the corporation must also have had a negative impact on the community estate. In other words, even if the corporation is the shareholder’s alter

ego, the corporation may not be disregarded unless community property was transferred to the corporation.

#### **E. Convert Sole Proprietorships**

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

#### **F. Partnership Formation**

Some divorce lawyers take the position that a general partnership interest acquired during marriage is always community property. See Marr, *supra*, citing one case decided over twenty-five years ago, *York v. York*, 678 S.W. 2d 110 (Tex. App.—El Paso 1984, writ ref’d n.r.e.). Marr’s article does state that the regular rules of characterization do apply to shares of corporate stock, limited partnership interest, interests in limited liability partnerships and interest in limited liability companies. The better view is that the separate or community character of the partner’s interest (like shares of stock)

should depend on the character of the consideration used to acquire the interest (i.e., capitalize the entity), if any. If separate consideration, the investment should be separate.

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

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

## **XII. MARITAL PROPERTY RIGHTS IN IRREVOCABLE TRUSTS**

The private express trust is a unique concept and one that is frequently misunderstood by members of the public and practitioners alike. The common law established that the trust is not an entity; it cannot own property; it cannot incur debt. Although it may be treated as if it were an entity for some purposes, it remains today a form of property ownership. *See* Tex. Trust Code § 111.004(4). Certain other common law principles remain relevant today. For example, a person serving as trustee is not a legal personality separate from such person

in his or her individual capacity. A person serving as trustee is not the agent of either the trust, the trust estate or the beneficiaries of the trust. Finally, the trust assets are not considered to be the property of the person serving as trustee; such assets belong in equity to the beneficiary. These principles can affect the marital property rights of the parties.

### **A. The Private Express Trust**

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

#### **1. DEFINITION**

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

#### **2. CREATION**

According to Section 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. REVOCABLE OR IRREVOCABLE

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

Note: *If the trust is revocable, it is deemed “illusory” and is effectively ignored for marital property purposes (i.e., the “trust veil” is pierced). See Land v. Marshall, 426 SW.2d 841 (Tex. 1968). See VIII, I, supra.*

### **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 may be able to 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 VIII, *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 that 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 of appointment over the entire trust estate, creditors can reach the entire trust estate. *See Bank of Dallas v. Republic Nat. Bank of Dallas*, 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 Dallas, Nat. Ass'n.*, 05-91-01211-CV, 1992 WL 297338 (Tex. App.—Dallas Oct. 14, 1992) (not designated for publication). 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. MARITAL PROPERTY ISSUES

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.—Fort Worth 1996, writ denied) and *Matter of Marriage of Burns*, 573 S.W.2d 555 (Tex. Civ. App.—Texarkana 1978, writ dism'd w.o.j.). Some older cases support that same result. *See Shepflin v. Small*, 4 Tex. Civ. App. 493, 23 S.W.432 (1893, no writ) and *Monday v. Vance*, 32 S.W. 559 Tex. Civ. App. 1895 no writ).

### 2. OTHER FACTORS

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 VIII, 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. 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 Matter of Marriage of Long*, 542 S.W.2d 712 (Tex. Civ. App.—Texarkana 1976, no writ), and *Wilmington Trust Co. v. United States*, 753 F.2d 1055 (5th Cir. 1985).

#### 4. UNDISTRIBUTED INCOME

Undistributed income is normally neither separate nor community property. *See Matter of Marriage of Burns, supra; Buckler v. Buckler*, 424 S.W.2d 514 (Tex. Civ. App.—Fort 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.

#### 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. SPECIAL POWERS

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

#### 2. LAPSE OF POWERS

If the beneficiary allows the withdrawal power to lapse, can the creditors still go after that portion of the estate that could have been withdrawn or

can the beneficiary's spouse claim either a possible community interest in the assets allowed to continue in trust, or the income thereafter generated? In other words, does the lapse of the power make the beneficiary "a settlor" of the trust? The Legislature has answered some of these questions. Section 112.035 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. ASCERTAINABLE STANDARD

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. NON-GENERAL POWERS

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?

*Note: See Sharma v. Routh, 302 S.W.3d 355 (Tex. App.—Houston [14th Dist] 2009, no pet.), for an example of a divorce case where the court examines the nature of the spouse's interests in irrevocable trusts to determine their marital character.*