THE PERFECT STORM: WHEN TRUSTS, FIDUCIARY DUTY ISSUES, AND DIVORCE MIX

Richard R. Orsinger
richard@ondafamilylaw.com
http://www.orsinger.com

Orsinger, Nelson, Downing
& Anderson, L.L.P.

San Antonio Office:
Tower Life Building, 26th Floor
San Antonio, Texas 78205
(210) 225-5567
http://www.orsinger.com

Dallas Office:
5950 Sherry Lane, Suite 800
Dallas, Texas 75225
(214) 273-2400

Frisco Office:
2600 Network Blvd., Ste. 200
Frisco, Texas 75034
Tel: (972) 963-5459

STATE BAR OF TEXAS
ADVANCED FAMILY LAW COURSE
August 8-11, 2022, San Antonio, Texas

Chapter 31

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by

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

I. INTRODUCTION. This Article sets out the concepts and rules that govern trusts under Texas law. It then describes the different types of trusts used for estate planning and creditor protection. Recognizing that many estate plans no longer work for the family if the settlors (trust creators) divorce, the Article discusses ways to alter or dismantle express trusts, by consent and through court action. If court action is triggered, statutory and procedural considerations come into play that are unfamiliar to family lawyers. These issues, and the grounds that exist for unwinding or attacking trusts, or recovering assets from trust, are examined. Next the Article discusses marital property issues that have been litigated in Texas courts and discussed in CLE conference rooms. The Article ends with consideration of how fiduciary duties run between trustees and their spouses, between beneficiaries and their spouses, and between combined trustees/beneficiaries and their spouses.

Whiles some aspects of the way trust law interacts with family law are fairly clear, some important issues are uncertain, and much litigation occurs in the area of confusion or uncertainty. Family Lawyers who find themselves at the intersection of trust law and family law should get assistance from an estate planning lawyer and tax planner, so that the divorce settlement does not trigger unanticipated estate, gift, and income tax consequences. If a controversy will require litigation in divorce court, or probate court, the family lawyer may want to consider associating a trust litigator.

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

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

Express trusts were controlled by the common law in Texas, until April 19, 1943. On that date, the Texas Trust Act went into effect. *See* TEX. REV. CIV. STAT. art. 7425a *et seq.*; *Land v. Marshall*, 426 S.W.2d 841, 845 (Tex. 1968). The Texas Trust Act controlled express trusts until its repeal, effective December 31, 1983. On January 1, 1984, the Texas Trust Code went into effect. *See* TEX. PROP. CODE chs. 101, 111-115. The old Texas Trust Act still controls the validity of trusts created while the Act was in effect, and actions taken relating to express trusts while the Act was in effect. The newer Texas Trust Code applies to trusts created on or after January 1, 1984, and to transactions relating to prior trusts, but which occur on or after January 1, 1984.

B. Resulting Trust. A resulting trust arises by operation of law when title is conveyed to one party while consideration is provided by another. *Cohrs v. Scott*, 338 S.W.2d 127, 130 (Tex. 1960). Generally, a resulting trust can arise only when title passes, not at a later time. *Id*. at 130. This rule, often stated in the case law, does not apply in certain instances between spouses. If before marriage a person acquires a right to later acquire title to property, and then marries and actually acquires title during marriage, the property is separate property under the inception of title rule, because the right to acquire the property had its inception prior to marriage. The rule of consideration underlying resulting trust does not apply in that instance, even if community property consideration is provided in connection with taking title to the property. A resulting trust also arises when a conveyance is made to a trustee pursuant to an express trust, which fails for any reason. *Nolana Development Ass'n v. Corsi*, 682 S.W.2d 246, 250 (Tex. 1984). Ordinarily, the proponent of a resulting trust has the burden of overcoming the presumption of ownership arising from title by "clear, satisfactory and convincing" proof of the facts giving rise to the resulting trust, *Stone v. Parker*, 446 S.W.2d 734, 736 (Tex. Civ. App.--Houston [14th Dist.] 1969, writ ref'd n.r.e.). However, when marital property is in issue, the presumption of community prevails over the presumption of ownership arising from title, so proof that property is possessed by a spouse during marriage is sufficient to establish, prima facie, community property even where title is held in the name of one spouse alone. *See* TEX. FAM. CODE § 3.003(a). Resulting trusts are excluded from coverage in the Texas Trust Code. TEX. PROP. CODE § 111.003(2).

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

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

Omohundro v. Matthews, 341 S.W.2d 401, 405 (Tex. 1960), *accord*, *Mills v. Gray*, 147 Tex. 33, 210 S.W.2d 985, (1948). Constructive trusts are excluded from coverage in the Texas Trust Code. Tex. Prop. Code § 111.003(2).

III. "RESULTING TRUST" VS. "CONSTRUCTIVE TRUST." In *Mills v. Gray*, 147 Tex. 33, 210 S.W.2d 985, 987-88 (1948), the Texas Supreme Court drew the following distinction between a resulting trust and a constructive trust:

> Resulting and constructive trusts are distinguishable, but there is some confusion between them. From a practical viewpoint, a resulting trust involves primarily the operation of the equitable doctrine of consideration - the doctrine that valuable consideration and not legal title determines the equitable title or interest resulting from a transaction - whereas a constructive trust generally involves primarily a presence of fraud, in view of which equitable title or interest should be recognized in some person other than the taker or holder of the legal title.[Citing 54 AM. JUR. 22, § 5.]

IV. EXPRESS TRUSTS. Property held by a trustee for the benefit of a beneficiary is not owned by the beneficiary. See **Paragraph X.B** below. Instead, the trustee owns legal title and the beneficiary has a beneficial interest in the trust property. *Bradley v. Shaffer*, 535 S.W.3d 242, 248 (Tex. App.--Eastland 2017, no pet.). However, where the beneficiary has an unconditional right to have the property free of trust, then the property is treated as if it is owned by the beneficiary, even if legal title continues to be held in the name of the trustee. *See Sharma v. Routh*, 302 S.W.3d 355 (Tex. App.--Houston [14th Dist.] 2009, no pet); *In Re Marriage of Long*, 542 S.W.2d 772 (Tex. Civ. App.--Texarkana 1976, no writ).

A. Different Kinds of Express Trusts.

1. What is an "Express Trust"? An express trust is defined in the Texas Trust Code as a fiduciary relationship with respect to property "which arises as a relationship and which subjects the person holding title to the property to equitable duties to deal with the property for the benefit of another." TEX. PROP. CODE § 111.004. Under Texas law, a trust is not an entity, like a corporation. It is a *relationship*, between the trustee, and certain property, and the beneficiary for whose benefit the trustee holds the property. Thus, it is not really accurate to talk about "trust property"; we should instead say "property held in trust." For the same reason you do not sue a trust; you sue the trustee.

2. "Trust" Accounts. In Texas, "trust accounts" were once governed by case law but are now governed by the Texas Estates Code. Under the case law, the mere act of depositing funds in an account designated as a "trust account" for the benefit of another person did not establish an express trust. Case law required that the beneficiary/claimant demonstrate the intent to create a trust "by a larger number of acts than in the case of an ordinary trust." *Frost Nat. Bank of San Antonio v. Stool*, 575 S.W.2d 321, 322 (Tex. Civ. App.--Beaumont 1978, writ ref'd n.r.e.). If a trust was found to have been intended, it was a revocable trust, which matured only upon the death of the settlor/trustee, at which time the proceeds are payable to the beneficiary. *See Citizens Nat. Bank of Breckenridge v. Allen*, 575 S.W.2d 654, 657 (Tex. Civ. App.--Eastland 1978, writ ref'd n.r.e.) (involving certificate of deposit held "in trust"). Recitals on the bank signature card that the funds in the account were held "in trust" for another were considered to be evidentiary only, and did not give rise to a presumption that a trust was intended. *Fleck v. Baldwin*, 141 Tex. 340, 172 S.W.2d 975, 978 (1943).

The Legislature adopted a statutory framework for multiple-party accounts, including trust accounts, in 1979. Tex. Probate Code §§ 436-449. That statutory framework was replaced in 2015 by the Texas Estates Code, which governs accounts created on or after September 1, 2015. (Prior law continues to govern accounts formed previously). The current statutory framework is conceptually similar to the previous statutory framework. Under the Estates Code, a "trust account" is one form of a multi-party account governed by Chapter 113 of the Texas Estates Code. Tex. Estates Code § 113.004(3). The Code defines a "trust account" as an account in the name of one or more parties as trustee for one or more beneficiaries. Tex. Estates Code § 113.004(5). The trust relationship is established by the form of the account and deposit agreement with the financial institution. *Id.* There can be no subject of the trust other than the sums on deposit in the account. *Id.* The deposit agreement does not have to address payment to the beneficiary. The term "trust account" does not include a "regular trust account" under a testamentary trust or trust agreement that is separate from the trust account. Tex. Estates Code § 113.004(5)(A). The term also does not include a "fiduciary account" arising from a fiduciary relationship, such as the attorney-client relationship. Tex. Estates Code § 113.004(5)(B).

Texas Estates Code Section 113.104 provides that the funds in a trust account, during the trustee's lifetime, belong beneficially to the trustee, unless the terms of the account or deposit agreement "manifest a contrary intent," or other clear and convincing evidence exists of "an irrevocable trust." Where there are two or more trustees of such a trust account, their rights in the funds are governed by Section 113.102, meaning that the funds belong to the person who contributed them to the account. When the trust account is an irrevocable trust, the beneficial interest belongs to the beneficiary. Tex. Estates Code § 113.104(c). The statute bears further analysis. First, if the "trust" is revocable, the statute makes the trustee the true beneficiary during the trustee's lifetime. If the "trust" is irrevocable, the statute makes the account beneficiary the true beneficiary during the trustee's lifetime. Second, the "terms of the account or the deposit agreement" prevail over the statutory allocation of beneficial rights. Third, the statute creates a rebuttable presumption that the "trust" is revocable, unless the terms of account or deposit agreement indicate irrevocability, or "other clear and convincing evidence of an irrevocable trust exists." Thus, presumption of revocable trust does not vanish in the face of evidence of contrary intent, but instead carries through to the fact-finders' decision. Fourth, where there are multiple trustees, the rule of ownership in proportion to net contributions applies.

A succinct summary of the law of trust accounts is set out in the statutory form prescribed for setting up a trust account. It says:

> The parties named as trustees to the account own the account in proportion to the parties' net contributions to the account. A trustee may withdraw funds from the account. A beneficiary may not withdraw funds from the account before all trustees are deceased. On the death of the last surviving trustee, the ownership of the account passes to the beneficiary. The trust account is not a part of a trustee's estate and does not pass under the trustee's will or by intestacy, unless the trustee survives all of the beneficiaries and all other trustees.

There are two blanks in the form to enter the names of the trustees, and two blanks to enter the name(s) of the beneficiaries, and two blanks to enter the name(s) of the convenience signer(s). Tex. Estates Code § 113.052(7).

To sum up, if a person puts funds in an account in her name, but the account indicates that she is "trustee" for someone, the trustee/depositor continues to own the funds and is free to withdraw the funds. The account is essentially a revocable trust. The beneficiary's right to the funds does not mature until all named trustees die. Tex. Estates Code § 113.104. However, this can be altered if the terms of the account or deposit agreement manifest a contrary intent, or if other clear and convincing evidence exists of an irrevocable trust. Tex. Estates Code § 113.104(1) & (2). This statute establishes a presumption that depositing funds into a "trust account" is not a conveyance of an interest (including a beneficial interest) to a third party, and that no fiduciary obligations are owed to the beneficiary during the trustee's lifetime. That presumption can be overcome, and an irrevocable trust established, but only if the terms of account or deposit agreement say so, or there is other clear and convincing evidence.

When a "trust account" becomes an issue in a divorce, because the arrangement is presumed to be a revocable trust, there is no special theory of recovery that must be asserted to establish the settlor-trustee's ownership of those funds. Under the law, the funds on deposit belong to the trustee and not the beneficiary. If the trustee is getting divorced, the court may award the funds on deposit according to the normal rules of property division. If the beneficiary is getting divorced, the funds on deposit are neither separate nor community property of the beneficiary. However, it is possible for a party to claim that the trust is irrevocable, and if the terms of account or deposit agreement make the trust irrevocable, or if they can prove that on clear and convincing evidence, then the funds on deposit do not belong to either the trustee or the beneficiary, but are instead property held in trust.

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

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

Id. at 658. The Texas Estates Code says that the rules regarding multiple-party accounts apply to "accounts" at a "financial institution." The terms "accounts" includes checking, savings, CD, share account, or "other similar arrangement," at a financial institution. Tex. Estates Code § 113.001(1). "Financial institution" is defined to include a bank, savings bank, building and loan association, credit union, and securities brokerage firm. Tex. Estates Code § 113.001(3). However, in describing trust accounts Texas Estates Code Section 113.004(5) refers to "sums on deposit," so an argument can be made that cash in a "share account" is governed by the Estates Code Chapter 13 while securities (stock and bonds) are not. *But see In re Estate of Dillard*, 98 S.W.3d 386 (Tex. App.--Amarillo 2003, writ denied), which applied the multiple-party account provisions in the Probate Code to a Merrill Lynch account containing "more than a million dollars of property." *Id.* at 398 n. 4.

4. Revocable Trust. A revocable trust is a trust that can be revoked or amended at will by the settlor. Section 112.051(a) makes all Texas trusts revocable unless they are made irrevocable in writing. A revocable trust is a full-fledged trust while it is in effect, and it is subject to the terms of Chapter 112 of the Texas Property Code. Sec. 112.051 of the Texas Property Code says this about revocable trusts:

Sec. 112.051REVOCATION, MODIFICATION, OR AMENDMENT BY SETTLOR.

(a)A settlor may revoke the trust unless it is irrevocable by the express terms of the instrument creating it or of an instrument modifying it.

(b)The settlor may modify or amend a trust that is revocable, but the settlor may not enlarge the duties of the trustee without the trustee's express consent.

(c)If the trust was created by a written instrument, a revocation, modification, or amendment of the trust must be in writing.

If the trust is revocable and does not specify how revocation can occur, no specific procedure need be followed, but the settlor's intent to revoke must be manifestly clear. *Jenkins v. Jenkins* 522 S.W.3d 771, 782 (Tex. App.--Houston [1st Dist.] 2017, no pet.). An unanswered question is whether one settlor acting alone can revoke a revocable trust that contains a provision that both settlors of the trust must consent to revocation. If not, then can one co-trustee revoke the trust as to the property s/he conveyed into trust?

It is safe to say that the complications mentioned in this paper about amending or unwinding trusts, or removing assets from trust, are lessened with a revocable trust. A settlor of a revocable trust has constructive possession and control over property held in revocable trust. While the case law does not address this specifically, the author believes that income earned on property held in a revocable trust during the settlor's marriage can be treated by a divorce court according to normal marital property rules. A question exists whether assets transferred to the trustee of a revocable trust, which are neither separate nor community property, while held in trust, reacquire their former separate or community character if removed from trust.

5. Irrevocable Trust. No specific language is needed to make a trust irrevocable. However, action in question must clearly reflect the settlor's intent that the trust be irrevocable. *Jenkins v. Jenkins* 522 S.W.3d 771, 782 (Tex. App.--Houston [1st Dist.] 2017, no pet.). Irrevocable trusts establish rights in beneficiaries that are protected both by trust law and property law, so they cannot be revoked without their consent or due process of law.

6. Spendthrift Trust. A spendthrift trust is a trust that contains a clause prohibiting a beneficiary or her creditors from obtaining trust principal or income before it is distributed to the beneficiary. Tex. Prop. Code § 112.035(a). Assets held in a discretionary distribution spendthrift trust are impervious to creditor's claims. All that is required to make a trust a spendthrift trust is a declaration in the trust instrument. Tex. Prop. Code § 112.035(b). However, where the settlor is also a beneficiary of the trust (a self-settled trust), they assets are not exempt from creditor's claims. Tex. Prop. Code § 112.035(d). Various exceptions to this rule are set out in Section 112.035. *Shurley v. Tex. Comm. Bank–Austin, N.A.*, 115 F.3d 333, 338 (5th Cir. 1997) ("We have recognized that a beneficiary's interest in a spendthrift trust is not subject to claims of creditors under Texas law '[u]nless the settlor creates the trust and makes himself beneficiary.' The rationale for this 'self-settlor' rule is obvious enough: a debtor should not be able to escape claims of his creditors by himself setting up a spendthrift trust and naming himself as beneficiary. Such a maneuver allows the debtor, in the words of appellees, to 'have his cake and eat it too.'" (Citation omitted).

7. Self-Settled Trust. A self-settled trust is a trust where the settlor and the beneficiary are the same persons; said differently, a self-settled trust is where the settlor conveys property to a trustee for the benefit of the settlor as beneficiary. Self-settled trusts are not protected from creditors' claims. See Section IV.A.6.

V. ESTATE PLANNING TRUSTS. The most popular estate planning trusts are:GST (generation-skipping dynasty trust); QPRT (qualified personal residence trust); CRT (charitable remainder trust); GRAT (grantor retained annuity trust), and GRUT (grantor retained unitrusts). *If you run into one of these trusts in a divorce, consult with an estate planning lawyer. Actions taken with divorce in mind may have income, gift, or estate tax consequences, or may alter what third parties will receive under the estate plan.*

A. (GST) GENERATION-SKIPPING DYNASTY TRUST. A GST is created by the older generation for the benefit of children, grandchildren, and their descendants. The trust corpus (principal) can remain in the trust for as many generations as possible, sometimes to the limit set by the Rule Against Perpetuities.

1. The Rule Against Perpetuities. The Texas Constitution provides that "[p]erpetuities ... are contrary to the genius of free government, and shall never be allowed." Tex. Const. art. I, § 26.Texas courts have enforced this provision by applying the common law Rule Against Perpetuities. *Trustees of Casa View Assem. of God Ch. v. Williams*, 414 S.W.2d 697, 702 (Tex. Civ. App.--Austin 1967, no writ). Under the Common law Rule Against Perpetuities, no interest is valid unless it must vest, if at all, within twenty-one years after the death of some life or lives in being at the time of the creation of the interest. *Peveto v. Starkey*, 645 S.W.2d 770, 772 (Tex. 1982); *Foshee v. Republic Nat'l Bank of Dallas*, 617 S.W.2d 675, 677 (Tex. 1981). The Rule of Perpetuities applies to all Texas trusts except charitable trusts. Tex. Prop. Code § 112.036 (a). Section 112.036(c)(2) adds to lives in being "a period of gestation."

In 2021, the Texas Legislature changed the vesting deadline for the Rule Against Perpetuities to 300 years, after the effective date of the trust, but only for trusts with an effective date of September 1, 2021 or later. Tex. Prop. Code § 112.036 (c)(1).

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

2. Irrevocable, Spendthrift Trust. A GST is ordinarily an irrevocable, spendthrift trust with multiple beneficiaries in successive generations who become primary beneficiaries when the older generations die off. The "spendthrift" provision prohibits the beneficiary or her creditors from obtaining the trust assets, other than by distributions according to the terms of the trust. *Bradley v. Shaffer*, 535 S.W.3d 242, 248 (Tex. App.--Eastland 2017, no pet.). Because the trust property is owned by the trustee and not the beneficiaries, the trust assets are not included in the taxable estate of a trustee or beneficiary who dies. The trustee usually has the "power to invade," meaning the power to distribute not only trust income but also trust principal, to beneficiaries. However, the settlor can specify mandatory distribution of trust principal or income. If the distributions exceed what is needed for the beneficiary's "best interest," the trust principal may be included by the IRS in the beneficiary's taxable estate at death. If the beneficiary is also the sole trustee with the power to invade, the invasion must be done only as required for the beneficiaries' health, education, maintenance, and support (a "HEMS" standard) or else the trust assets on date of death may be included in the beneficiary's estate. Sometimes the beneficiaries will have limited powers of appointment that permit them to control how the assets flow when the beneficiary dies.

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

Sometimes the house is partitioned before it is conveyed into trust, and sometimes a community property house is conveyed into trust. The conveyance into trust will be reflected by a deed which is recorded. This arrangement reduces the value of the gift into trust to the extent of the free tenancy retained by the grantors. The value of the remainder interest at the time of the conveyance into trust is usually very small, using up only a small part of the homeowners' lifetime gift tax exemption, which is presently set at $12.06 million.

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

D. GRAT (GRANTOR RETAINED ANNUITY TRUST) AND GRUT (GRANTOR RETAINED UNITRUSTS). GRATs are trusts that reserve to the grantor an annual payment of a fixed sum (i.e., an annuity), determined by a percentage of the value of the trust assets at the time of initial funding. GRATs can be funded only once, at the beginning. GRUTs reserve to the grantor an annual payment of a fixed percentage of the value of trust assets, determined annually. GRUTs can receive additional contributions over time. For both GRATs and GRUTs, the remaindermen are usually the grantors' children.

GRATs and GRUTs remove assets from the estate at a fixed value, with later appreciation accruing to the trust, while retaining a finite stream of payments for the grantor. There is no gift except to the extent that the remainder interest exceeds the value of the annuity payments. The assets of the trust are not included in the grantor's estate upon death, and appreciation on the trust principal (corpus) during the life of the trust passes to the remaindermen without gift or estate tax.

It should be noted that a GRAT and a GRUT do not involve a purchase. With a GRAT and a GRUT, the grantor *retains* the right to receive the annual payments. GRATs and GRUTs when they terminate, usually roll over to a remainder trust. If they terminate with a distribution to the beneficiaries free of trust, the beneficiaries receive a gift, and if married the inception of title relates back to the creation of the trust for the benefit of the beneficiary.

E. "DEFECTIVE" TRUST. If the settlor retains certain powers, such as the power to substitute assets in the trust, the trust is "defective" and the trust income is taxed to the settlor. The settlor's estate is thus diminished by the income taxes paid after transfer in trust, without incurring a gift tax. The "defective" tax status in no way suggests that the trust is "defective" under state law. It can be that the estate plan for the benefit of decedents went too far in transferring wealth or income, given the situations the settlor spouses find themselves in after a divorce. This may indicating a need for "switching off" the grantor tax status of one or more trusts.

VI. CONSENSUAL UNRAVELING OF AN ESTATE PLAN. In this day and time, a spouse sometimes comes into the lawyer's office seeking a divorce when the spouses have conveyed some or most of their assets into an estate planning vehicle, like a trust or family limited partnership. There can be tax consequences to unraveling an estate plan, so the family lawyer should get the assistance of a CPA or tax lawyer before taking steps to dismantle the estate plan. Where both spouses agree to the unraveling, the attorney who created the estate plan may be the best person to undo what was done. However, if the spouses have different ideas about what should be done, the estate planning lawyer may have a conflict of interest and be disqualified from acting for either or both parties in the unwinding process.

A. REVOCABLE VS. IRREVOCABLE TRUST. If the estate planning device is a revocable trust, the trust can be terminated, or all the property distributed from trust back to the settlor(s), without regard to the rights of beneficiaries. Where, however, the trust is an irrevocable trust ("IRT") with beneficiaries other than the two spouses, the rights of the other beneficiaries cannot be impaired by the actions of the settlors, or the trustees, or primary beneficiaries, without the consent of *all* the beneficiaries. See Tex. Prop. Code § 112.054(d) ("The court may not take the action permitted by subsection (a)(5) unless all beneficiaries of the trust have consented to the order or are deemed to have consented to the order").

B. CONSENT OF BENEFICIARIES. You would expect that a grateful child would not object, if his/her parents are divorcing, to the parents taking some or all of their estate back, due to the changes in life plan resulting from divorce. However, it would be imprudent to dissolve a IRT, or distribute all or substantially all of the assets held in an IRT, without the consent of the beneficiaries, who might otherwise later sue for breach of fiduciary duty. An adult child-beneficiary can consent to the unwinding transaction, with or without legal and financial advice. Due to the disabilities of minority, a minor child-beneficiary would not be bound to consent given while a minor. And unborn or unascertained beneficiaries may have interests that must be protected in any action to rescind or modify the trust instrument. The safest practice and the statutory requirement is to have a guardian ad litem appointed by the court to advise minor children and represent the interests of unborn or unascertained beneficiaries. See Tex. Prop. Code § 112.054(d). The court has the authority to appoint a guardian ad litem and attorney ad litem under Tex. Prop. Code § 115.014.

C. JUDICIAL VS. NON-JUDICIAL MODIFICATION. The court in *Musik v. Reynolds*, 798 S.W.2d 626 (Tex. App.–Eastland 1990, no writ), said that an IRT can be modified by an agreement with no court participation but only on the condition that the settlor and all beneficiaries consent and no beneficiary is under any incapacity. This case may be taken to be an expression of the common law of Texas on non-judicial modification of trusts. Tex. Prop. Code § 112.054 governs judicial modification, reformation, or termination of express trusts. Texas Prop. Code § 112.054(d) requires the consent of *all* beneficiaries, and minors and unborn or unascertained beneficiaries cannot consent except through court-appointed representatives. Even if all beneficiaries are adult and consenting, a court order approving the settlement is advantageous, because once the judgment goes final it establishes a res judicata bar against beneficiaries later claiming fraud, and the bar can only be circumvented by proving extrinsic fraud in a bill of review proceeding brought within four years (subject to a claim of fraudulent concealment or the discovery rule). Also, a court finding of statutory grounds for modification or termination could be an effective shield if the IRS were to later argue that the beneficiaries made a gift back to the settlors.

D. PRECAUTIONARY PARTITION AND EXCHANGE. If separate property was conveyed into an IRT and the desire is to have the property come back out of trust as separate property, it would be a wise precaution to have the spouses partition and exchange the property upon distribution to assure its separate property character. There is no case law on point, but consider the idea behind *Marshall v. Marshall*, 735 S.W.2d 587 (Tex. App.--Dallas 1987, writ ref'd n.r.e.) (property held by partnership has no marital property character, so tracing into and back out of a partnership is not possible).

E. CREATING TWO POST-DIVORCE TRUSTS. Tex. Prop. Code § 112.057 provides that "[t]he trustee may, unless expressly prohibited by the terms of the instrument establishing the trust, divide a trust into two or more separate trusts without a judicial proceeding if the result does not impair the rights of any beneficiary, or adversely affect achievement of the purposes of the original trust." Divorcing spouses can agree to leave the trust framework unchanged as to residual beneficiaries, while creating two post-divorce trusts, one under the control of each former spouse, with liberal discretion for each former spouse to use his or her trust property or distribute income or principal to him/herself according to an ascertainable standard. This has the advantage of giving each former spouse sole post-divorce control over his/her half of the spouses' former community estate, while preserving the estate tax benefits of the generation-skipping trust framework.

F. DECANTING. Under the rules of "decanting" a trust, it is possible to move the assets of an old trust into a new trust with more desirable features (like decanting wine from a bottle to a crystal decanter). Some trusts have this decanting power built in by express language. Absent that, the litigants must rely on the applicable state decanting statute or common law. The Texas decanting statutes are Tex. Prop. Code §§ 112.072 - 112.087. There are articles in the State Bar's on-line library and on the internet about decanting. This should be done by an estate planning lawyer, not a divorce lawyer. A fundamental requirement to the decanting process is that alternate beneficiaries' rights should not be impaired. Under the Texas decanting statutes, a trustee with "full discretion to distribute the principal of a trust" has the power to favor some beneficiaries over other beneficiaries in the decanting process. Tex. Prop. Code § 112.072. A trustee with "limited discretion to distribute the principal of a trust" cannot alter the rights of beneficiaries under the trust. Tex. Prop. Code § 112.073. In either situation, the trustee exercising statutory decanting power must give notice to the trust beneficiaries. Tex. Prop. Code § 112.074. If a charity is a beneficiary, the trustee must give written notice to the Texas Attorney General of the intent to decant. Tex. Prop. Code § 112.074(c). If the trust to be decanted contains a choice-of-law clause, a question may arise as to whether the law of the specified jurisdiction controls the decanting process, or the law of Texas. See Section VII.A.5 below. Decanting can be a simple solution to some problems, but the availability of decanting and the method to accomplish it are matters for an estate planning expert.

VII. CHALLENGES TO VALIDITY OF EXPRESS TRUSTS. What appears to be an express trust may in fact not be a trust, or it may be vulnerable to attacks which would defeat the trust or cause selected assets to be removed from trust. Several possible methods to defeat or penetrate express trusts are discussed below.

A. PROCEDURAL CONSIDERATIONS. There are procedural aspects of trust litigation to consider when litigating against or about trusts in connection with divorce.

1. What State? The answer to the question "in what state should I file the trust-related claim," is obviously the state where the divorce is pending. However, if the trustee lives in South Dakota, the trust agreement chooses South Dakota law to apply to formation and operation, and the agreement selects South Dakota courts as the exclusive forum for litigation, a Texas court may be induced to dismiss a claim brought in a Texas court in favor of litigation in South Dakota courts.

Forum-selection clauses are generally enforceable and are presumptively valid. *In re Laibe Corp.*, 307 S.W.3d 314, 316 (Tex. 2010) (per curiam). A forum selection clause in a Mexican trust agreement electing jurisdiction of the courts of Reynosa, Tamaulipas, Mexico was upheld in *In re Longoria*, 470 S.W.3d 616, 624 (Tex. App.–Houston [14th Dist.] 2015, orig. proceeding).

Bogert's THE LAW OF TRUSTS AND TRUSTEES § 292, Judicial Jurisdiction (updated on Westlaw as of June 2019) says:

> Before exercising jurisdiction in proceedings relating to a multistate trust, the forum court must have jurisdiction over one or more of the trust, the trust parties, or the trust property. Whether the court will choose to exercise its jurisdiction, and the extent of its exercise, will depend upon a number of factors, including the parties properly before it; the nature of trust assets subject to the court's jurisdiction, interests which may be affected by a decree; and the type of relief sought. [FN 27] Whether to exercise jurisdiction will usually require a very factually-intensive analysis.

If the ties between the settlor, trustee, beneficiary, and trust assets and the selection forum are tenuous or non-existent, a Texas court could be persuaded that a forum selection clause should not be enforced. If the Texas court does not have personal jurisdiction over a trustee, consistent with due process of law, there is a constitutional barrier to altering that beneficiary's property rights. *See generally International Shoe v. Washington*, 326 U.S. 310 (1945); *Dawson-Austin v. Austin*, 968 S.W.2d 319, 326 (Tex. 1998) (minimum contacts necessary to litigate property rights in a Texas divorce).

2. What Court? The district court and the statutory probate court have concurrent jurisdiction over suits relating to trusts. Tex. Prop. Code § 115.001; Tex. Estates Code § 32.006;Tex. Estates Code § 32.007. The court in which a claim relating to a trust is first-filed has dominant jurisdiction. If the trust-related claim is first-filed in the probate court, and a divorce is later filed, and the trust-related claim is then filed in the divorce proceeding, does the divorce court have to wait for the trust-related claim to be resolved in the probate court before the divorce can be concluded? This is a difficult question.

If the trust is a testamentary trust established in a last will and testament that has been admitted to probate, then the probate court that probated the will has a residual claim to exclusive jurisdiction. If the estate is still open when a claim is brought against a testamentary trustee, the question arises whether the claim likely will fall within the probate court's exclusive jurisdiction, or pendent and ancillary jurisdiction. If the claim targets property of an estate that is then in probate, or requires the interpretation of a will, particular attention should be paid to exclusive jurisdiction in the probate court.

The case of *Soefje v. Jones*, 270 S.W.3d 617, 627 (Tex. App.–San Antonio 2008, no pet.), raises an important point. In that case, the county court had jurisdiction over probating a will, but not court proceedings relating to a trust created by the testator before she died, which had to be litigated in the district court. Even though the county court did not have jurisdiction over the trust proceedings, the district court considered certain factual issues resolved in the county court proceeding to create a collateral estoppel bar in the trust-related proceeding. So the litigant who sought an trust accounting in district court was held to have lost that right in connection with the county court proceeding. As a result, the issues within the exclusive jurisdiction of the district court were effectively decided by the county court.

3. What County? Venue of a suit under Section 115.001 of the Texas Property Code (including suits to construe a trust instrument, determine applicable law, appoint or remove a trustee, etc.) is governed by Tex. Prop. Code § 115.002. That statute says that where there is a single, non-corporate trustee, venue is in the county in which the trustee resides or has resided at any time during the four-year period preceding the date the action is filed, or where the situs of administration of the trust is maintained or has been maintained at any time during the four-year period preceding the date the action is filed.

If there are multiple non-corporate trustees, then the suit must be brought in the county that is the situs of administration or in which the trustee has maintained an office during the preceding four years. Other permutations are set out in Section 115.002. Courts have held that Section 115.002 is a mandatory venue provision. *In re Green*, 527 S.W.3d 277, 279 (Tex. App.–El Paso 2016, orig. proceeding); *In re Wheeler*, 441 S.W.3d 430, 434 (Tex. App.–San Antonio 2014, orig. proceeding). However, upon agreement of all parties, the court can transfer a case to any other county. Tex. Prop. Code § 115.002(e).

4. What Parties? As to possible plaintiffs, Tex. Prop. Code § 112.054(a) provides that a court can entertain a request to replace a trustee, or modify, reform, or terminate a trust "[o]n the petition of a trustee or a beneficiary." The settlor of the trust is not included on the list. However, Tex. Prop. Code § 115.011 permits "[a]ny interested person" to bring a suit under Section 115.001, which permits the court to take a wide array of actions respecting trusts. Tex. Prop. Code 111.004(7) says that "[w]hether a person, excluding a trustee or named beneficiary, is an interested person may vary from time to time and must be determined according to the particular purposes of and matter involved in any proceeding." In *Lemke v. Lemke*, 929 S.W.2d 662 (Tex. App.--Fort Worth 1996, writ denied), the court ruled that a spouse of a settlor was not an interested person who could bring suit to challenge the validity of a trust when she was not a trustee or beneficiary, and had no community property interest in property held in trust. Tex. Prop. Code § 113.019 says that "[a] trustee may compromise, contest, arbitrate, or settle claims of or against the trust estate or the trustee."

The Supreme Court in *Ray Malooly Tr. v. Juhl*, 186 S.W.3d 568, 570 (Tex. 2006), said: "The general rule in Texas (and elsewhere) has long been that suits against a trust must be brought against its legal representative, the trustee."

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

Where the proceeding is brought under Tex. Prop. Code § 115.001, there is a statutory provision regarding "necessary parties." Contingent beneficiaries designated as a class are not necessary parties. Section 115.001(b). However, the following are necessary parties: (i) a beneficiary of the trust on whose act or obligation the action is predicated; (ii) a beneficiary of the trust designated by name (unless the interest has been distributed, extinguished, terminated or paid); (iii) a person who is actually receiving trust distributions at the time suit is filed; and (iv) the trustee. Section 115.001(b). In this context, "necessary parties" probably equates to "Persons to be Joined if Feasible" under Tex. R. Civ. P. 30(a), meaning that the plaintiff must name the person as a party, and if s/he fails to do so the court must order that s/he be joined as a party (defendant or involuntary plaintiff).

Also, a beneficiary of the trust may intervene and contest the right of a plaintiff to recover trust assets for a tortious or contractual claim against the trustee acting in his representative capacity. Section 115.001(d).

Texas Property Code § 115.015 contains a notice provision regarding contract and tort claims against a trustee in his representative capacity. The court cannot render judgment on a tort or contract claim unless the plaintiff proves that s/he gave notice to each beneficiary known to the trustee who then had a present or contingent interest. Section 115.015(a)(1). If the trust is a charitable trust, notice must be given to the Attorney General and any corporate beneficiary. Section 115.015(a)(2).

The case of *Cleaver v. George Staton Co.*, 908 S.W.2d 468, 470 (Tex. App.--Tyler 1995, writ denied), involved a suit brought by an estranged husband against a trust of which his wife was beneficiary. The Court said that "[t]he trust provides for current mandatory payments of income from the corpus to the Wife for life; she was conveyed no ownership interest in the corpus of the trust and has no present possessory interest in the corpus. The trust income payments to the Wife are thus her separate property." *Id*. at 470. The court held that "Wife is a necessary party in Husband's suit for the recovery of trust funds for their community estate." *Id*. at 479. There is a host of other cases discussing who is and who is not a necessary party to various claims bought by or against a trustee. See the annotations to Tex. Prop. Code § 115.011 on Westlaw.

As to suits brought on behalf of a trust, the trustee is the proper party to bring suit. "It is only when the trustee cannot or will not enforce the cause of action that he has against the third person that the beneficiary is allowed to enforce it. In such a case, the beneficiary is not acting on a cause of action vested in him, but is acting for the trustee ...." *Interfirst Bank-Houston, N.A. v. Quintana Petrol. Corp.*, 699 S.W.2d 864, 874 (Tex. App.--Houston [1st Dist.] 1985, writ ref'd n.r.e.); *accord*, *Rideau v. Keller Indep. Sch. Dist.*, 819 F.3d 155, 162 (5th Cir. 2016).

5. Which State's Law? The case law on conflict-of-laws and trust litigation is sparse. The older cases apply the principles in the Restatement (First) of Conflict of Laws (1935) (lex loci contractus; law of domicile as to personal property; law of situs as to realty). The principles of the Restatement (Second) of Conflict of Laws (1971) (the most significant relationship test) would now be applied. *See* James P. George & Randy D. Gordon, *Conflict of Laws (2017)*, 3 SMU Annual Texas Survey 129 (2017); *Hughes Wood Prods, Inc. v. Wagner*, 18 S.W.3d 202, 204 (Tex. 2000) ("Since 1979, this Court has applied the Restatement's 'most significant relationship' test to decide choice of law issues").

Trust agreements can and often do contain a choice-of-law clause, specifying the law governing validity and the law governing operation of the trust, or both. The Texas Supreme Court has upheld the validity of choice-of-law clauses in contracts generally. The seminal modern Texas case is *DeSantis v. Wackenhut Corp.*, 793 S.W.2d 670, 677 (Tex. 1990), *cert. denied*, 498 U.S. 1048 (1991), where the Court said:

> When parties to a contract reside or expect to perform their respective obligations in multiple jurisdictions, they may be uncertain as to what jurisdiction's law will govern construction and enforcement of the contract. To avoid this uncertainty, they may express in their agreement their own choice that the law of a specified jurisdiction apply to their agreement. Judicial respect for their choice advances the policy of protecting their expectations. This conflict of laws concept has come to be referred to as party autonomy. See R. WEINTRAUB, COMMENTARY ON THE CONFLICT OF LAWS 269–271 (1971) ["Weintraub"]. However, the parties' freedom to choose what jurisdiction's law will apply to their agreement cannot be unlimited. They cannot require that their contract be governed by the law of a jurisdiction which has no relation whatever to them or their agreement. And they cannot by agreement thwart or offend the public policy of the state the law of which ought otherwise to apply. So limited, party autonomy furthers the basic policy of contract law. With roots deep in two centuries of American jurisprudence, limited party autonomy has grown to be the modern rule in contracts conflict

of laws. See SCOLES, supra at 632–652; WEINTRAUB, supra at 269–275; RESTATEMENT (SECOND) OF CONFLICT OF LAWS ["THE RESTATEMENT"] § 187 (1971).

The Restatement (Second) of Conflict of Laws § 268(1) provides that a choice-of-law clause in a will or other instrument creating a trust in movables should be honored if it relates to matters within the power of the testator or settlor. Comment (b) to this section says that "it is not necessary that this state have any connection with the trust." As to validity of the trust, Section 270(a) says to apply the chosen law "provided that this state has a substantial relation to the trust and that the application of its law does not violate a strong public policy of the state with which, as to the matter at issue, the trust has its most significant relationship ...." Comment (b) to Section 270 says that a substantial relationship exists if at the time the trust is created: (1) the trustee or settlor is domiciled in the state; (2) the assets are located in the state; and (3) the beneficiaries are domiciled in the state. The question is well-analyzed in *In re Zukerkorn*, 484 B.R. 182 (9th Cir. Bnkr. Panel 2012), a split decision in which the court's majority held that Hawaii's law, not California's law, regarding spendthrift trusts would be applied in the bankruptcy of a trust beneficiary residing in California, where the trust agreement specified that Hawaii law would apply. The dissenting Justice laid out strong arguments as to why California law should apply. For more context, see Thomas P. Gallanis, *The Use and Abuse of Governing-Law Clauses in Trusts: What Should the New Restatement Say?*, 103 IOWA L. REV. 1711 (2018).

6. Title to Land. Suit to resolve a (non-divorce) dispute involving a claim of superior title and the determination of possessory interests in real property must be brought as a trespass-to-try title action. *Jenkins v. Jenkins* 522 S.W.3d 771, 786 (Tex. App.--Houston [1st Dist.] 2017, no pet.) (holding that the Texas Declaratory Judgment Act cannot be used to adjudicate rights to land held in a testamentary trust). In a divorce, it is simply a matter of pleading a claim relating to real estate as a trespass-to-trial-title claim, instead of a declaratory judgment claim.

7. Time Limitation Bar. In Texas, prior to 1967, limitations were tolled for married women who suffered under the disabilities of coverture. V.A.T.S. 5535. *Padgett v. Padgett*, 487 S.W.2d 850, 852 (Tex. Civ. App.–Eastland 1972, writ ref'd n.r.e.). Later the tolling statute was changed to include married persons while under age 21. V.A.T.S. 5535. The tolling provision was repealed in 1985, so at this time there is no tolling due to marriage.

A cause of action accrues, and ordinarily the statute of limitations begins to run, when facts come into existence that authorize a claimant to seek a judicial remedy. *Johnson & Higgins of Texas, Inc. v. Kenneco Energy, Inc.*, 962 S.W.2d 507, 514 (Tex. 1998). The four-year statute of limitations applies to claims of fraud and breach of fiduciary duty. Tex. Civ. Prac. & Rem. Code § 16.004(a). The residual limitations period of four years applies to all claims not covered by a specific statute of limitations. Tex. Civ. Prac. & Rem. Code § 16.051. However, Section 16.0051 expressly does not apply to "an action for the recovery of real property."

The fraudulent concealment doctrine exists as an affirmative defense to the statute of limitations. "Where a defendant is under a duty to make disclosure but fraudulently conceals the existence of a cause of action from the party to whom it belongs, the defendant is estopped from relying on the defense of limitations until the party learns of the right of action or should have learned thereof through the exercise of reasonable diligence." *Borderlon v. Peck*, 661 S.W.2d 907, 908 (Tex.1983). In *Ford v. Exxon Mobil Chem. Co.*, 235 S.W.3d 615, 618 (Tex. 2007), the Supreme Court held that an action to set aside a *voidable* deed for fraud or on equitable grounds was governed by the four-year statute of limitations. Where the suit is to set aside a deed, the four-year statute of limitations begins to run when the deed is recorded, if the claimant had actual or imputed knowledge of the deed. *Renfro v. Cavazos*, No. 04-10-00617-CV *10 (Tex. App.–San Antonio Sept. 12, 2012, pet. denied) (memo. op.). In *Dyer v. Dyer*, 616 S.W.2d 663, 664-65 (Tex. App.–Corpus Christi 1981, writ dism'd), the court held that the wife's claim in a divorce to set aside a conveyance of land from her to her husband was barred by the four-year statute of limitations. In *Williams v. Wachovia Mortg. Corp.*, 407 S.W.3d 391, 397 (Tex. App.–Dallas 2013, pet. denied), the court held that the four-year statute of limitations applied to a suit to invalidate a home equity loan that was not signed by both spouses, as required by law. *Accord*, *Kyle v. Strasburger*, 520 S.W.3d 74, 79 (Tex. App.--Corpus Christi 2015, no pet.) (agreeing with the *Williams v. Wachovia Mortg.* decision).

The court in *In re Estate of Herring*, 970 S.W.2d 583, 587 (Tex. App.--Corpus Christi 1998, no pet.), applied the discovery rule to a claim of fraud on the community based on breach of the fiduciary duty between spouses. *See Maxson v. Travis County Rent Account*, 21 S.W.3d 311, 320 (Tex. App.--Austin 1999, pet. denied), which applied the discovery rule to a breach of fiduciary duty claim, saying that the statute of limitations for constructive fraud began to run when "the claimant knew or should have known of facts that in the exercise of reasonable diligence would have led to the discovery of the wrongful act," citing *Little v. Smith*, 943 S.W. 2d 414, 420 (Tex. 1997).

There is no statute of limitations on a suit to remove a trustee from a trust. *Ditta v. Conte*, 298 S.W.3d 187, 190 (Tex. 2009). This is because the trustee-beneficiary relationship is ongoing, rather than an event in time, and removal turns not on a particular breach of fiduciary duty, but rather the "special status of the trustee as a fiduciary and the ongoing relationship between trustee and beneficiary ...." *Id*. at 191.

8. Trustee's Attorney-Client Privilege. In *Huie v. DeShazo*, 922 S.W.2d 925 (Tex. 1996), the Supreme Court held that the attorney-client privilege applies to communications between a trustee and the lawyer hired by the trustee, even as against beneficiaries of the trust. There is a crime-fraud exception to the attorney-client privilege. Tex. R. Evid. 503(d)(1).

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

Some trust arrangements, such as funds deposited in a financial account with a depositor's agreement or signature card reading "in trust," or securities held "as trustee" for another, or land taken "in trust" for an unspecified beneficiary, are so vague that a clear intention to create a trust is not readily ascertainable from the documentation. Texas case law has traditionally treated such "trust" designations as no more than weak evidence of intent or no more than a revocable trust. Special statutory rules for "trust" financial accounts are discussed in Section VI.A.2 & 3 above. These statutory rules make such "trusts" presumptively revocable, absent explicit language in the account agreement or clear and convincing evidence to the contrary.

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

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

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

On the other hand, some courts have taken a more restrictive approach to parol evidence. In the case of *Otto v. Klement*, 656 S.W.2d 678 (Tex. App.--Amarillo 1983, writ ref'd n.r.e.), the court refused to consider parol evidence on intent where the proof was offered to vary a survivorship provision contained on a bank signature card. In *Isbell v. Williams*, 705 S.W.2d 252 (Tex. App.--Texarkana 1986, writ ref'd n.r.e.), parol evidence was admitted only because a conflict between printed language and writing on a financial account signature card created an ambiguity.

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

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

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

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

C. FAILURE IN MECHANICS OF CREATION. The Texas Trust Code has requirements for express trusts that must be observed. When these conditions are not met, an express trust cannot be recognized in a court proceeding.

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

There are exceptions to this rule.

a. No exception to the requirement of a writing exists for realty. Where one person holds title to real estate as "trustee," and no written trust agreement exists, the relationship is not an express trust. It may, however, be a resulting trust, if the consideration was provided by someone other than the holder of title.

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

c. Personalty Retained by Settlor With Writing Reflecting Trust. A trust of personalty is also enforceable where an owner of personalty states *in writing* that certain personalty is held by that person as trustee for another, as beneficiary, or for himself and another, as beneficiaries. Tex. Prop. Code § 112.004. Under the case law, this exception would apply to funds which the party has deposited in a financial institution, where the account reflects the party as "trustee" for another. *See Jameson v. Bain*, 693 S.W.2d 676 (Tex. App.--San Antonio 1985, no writ). But under the current statutory framework in the Estates Code, the recital of "in trust" or "trustee" on a financial account presumptively creates a revocable trust. Under the old case law, the exception would apply to stocks and bonds, carried in the name of the party "as trustee" for another.

See Citizens Nat. Bank of Breckenridge v. Allen, 575 S.W.2d 654, 658 (Tex. Civ. App.--Eastland 1979, writ ref'd n.r.e.). Whether non-cash assets in a brokerage account are covered by Tex. Estates Code 113.004(5) is not clear. See Section VI.A.3 above.

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

2. A Transfer is Necessary. There must be a present transfer of legal title of property from the settlor to the trustee for the trust come into existence. *Cutrer v. Cutrer*, 334 S.W.2d 599, 605 (Tex. Civ. App.--San Antonio 1960), *aff'd*, 345 S.W.2d 513 (1961). However, the settlor may "transfer" legal title to the property to himself as trustee as long as his words or acts clearly reflect his intent to relinquish individual ownership in favor of holding the property merely as trustee for the beneficiary. *Westerfeld v. Huckaby*, 474 S.W.2d 189 (Tex. 1972). *Accord*, TEX. PROP. CODE § 112.004(2). The settlor may retain rights in the property, or may be the initial trustee, and may retain the right to revoke the trust, without violating this rule. *Westerfeld*, *supra* at 193.

D. PASSIVE OR DRY TRUST. The Texas Supreme Court has said that "[w]hen a trustee has no duties to perform, the purposes of the trust having been accomplished, it becomes a simple, passive or dry trust, as it is termed in the law, and the cestui que trust is entitled to have the full legal title and control of the property, because no other person has an interest in the property." *Lanius v. Fletcher*, 101 S.W.2d 1076, 1078 (1907). Under these circumstances, the beneficiary is entitled to possession of the contents of the trust. *Hall v. Rawls*, 188 S.W.2d 807, 815 (Tex. Civ. App.--Beaumont 1945, writ ref'd). Similarly, if the trustee is not given affirmative powers and duties in the trust instrument, the trust is passive or dry, and legal title is vested in the beneficiaries, not the trustee. *Nolana Development Ass'n v. Corsi*, 682 S.W.2d 246, 249 (Tex. 1984). Consider, however, the effect of Section 112.004 of the Texas Trust Code, which recognizes the enforceability of a trust of personalty in certain situations, even though the terms of the trust are not specified. Finally, "a trust cannot be created unless there is trust property." Tex. Prop. Code § 112.005.

Passive or dry trust issues arose in *Rife v. Kerr*, 513 S.W.3d 601, 612 (Tex. App.--San Antonio 2016, pet. denied). The court repeated the standard descriptions of when a trust is a passive or dry trust, but also stated that "[a] trustee of a dry or passive trust has no power to convey the trust property without the direction and consent of the beneficiary.… The trustee of a passive trust 'generally is responsible only for conveying the property to the beneficiary or in accordance with his directions.'"). Passive or dry trusts were discussed in *Estate of Lee*, 551 S.W.3d 802, 814 (Tex. App.--Texarkana 2018, no pet.). The court cited earlier case authority that "[a] trustee who has no duty except to make payments as they become due is the trustee of a 'passive' or 'dry' trust." *Id*. at 814. The court went on to hold that a passive or dry trust could not be a spendthrift trust, because legal title is vested in the beneficiaries, not the name trustee. *Id*. at 814.

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

The doctrine of dry trusts has been adjudicated in other states.

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

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

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

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

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

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

One may ask whether the illusory trust doctrine can be used during the settlor's lifetime, to nullify a conveyance into trust. There is no statement in Texas cases that the illusory trust argument can only be raised after the settlor's death. Also, the trust in *Land v. Marshall* was a *revocable* trust, and consequently during the marriage it constructively remained community property until death. Had the trust been irrevocable, and the contest had arisen before the husband's death, the wife would want to use fraud-on-the-community remedies rather than illusory trust remedies.

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

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

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

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

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

Id. at 191.

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

4. Spouse's Participation Forecloses Attack. In one case the court held that an illusory trust attack cannot be raised by a spouse who participated in the original conveyance into trust. *United States v. Gordon*, 406 F.2d 332, 343 (5th Cir. 1969). One would expect a claim of fraudulent inducement or mistake in such a situation.

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

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

Footnote 4 provides:

> 4."... The term "colorable" as used herein, indicates a transfer which may be absolute on its face, but which, actually, is not a transfer at all because, through some secret or tacit understanding, the parties

> intend that ownership is to be retained by the donor . . . ." Edward A. Smith, 44 MICH. L. REV. 151, 153; *Martin v. Martin*, 282 Ky. 411, 138 S.W.2d 509 (1940).

Id., at 846 n. 4.

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

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

Bell, *Community Property Trusts--Challenges by the Non-Participating Spouse*, 22 BAY. L. REV. 311, 319 (1970). Although the doctrine was discussed in a death-related case, there is no reason why it should be limited to death.

G. EXCESSIVE RETENTION OF CONTROL. In recent decades, it has become popular for estate planners to create trusts in which the beneficiary is the trustee of her own trust. Sometimes the settlor, trustee, and beneficiary are the same person, wearing three different hats. The IRS will permit this "hat trick" if the trustee-beneficiary's power to distribute trust property to herself is limited by an "ascertainable standard," usually articulated as the "HEMS standard" of health, education, maintenance, and support of the beneficiary. Distributions by the trustee to herself as beneficiary that violate the HEMS standard could be used as evidence that the legal title and equitable title are separate in name only. A trustee's distribution of trust income to himself as beneficiary was the issue in *Sharma v. Routh*, 302 S.W.3d 355 (Tex. App.--Houston [14th Dist.], discussed in Section X.F.2 below. The *Sharma v. Routh* case bears close scrutiny, not just as to the marital property character of distributed income, but also in the context of one spouse conveying community property into trust during marriage (not an issue in *Sharma v. Routh*). Chief Justice Hedges' original Majority Opinion (withdrawn) deserves renewed attention when the issue involves a claim brought by a spouse during divorce to set aside a conveyance of community property into trust. Apart from disregard of the HEMS standard that was central to *Sharma v. Routh*, the power of the trustee-beneficiary to "appoint" trust assets to beneficiaries not fixed by the trust agreement may be considered to be evidence that the conveyance into trust was not complete enough to constitute a true relinquishment of control, so that the conveyance into trust was not genuine. All aspects of the trust, not just the HEMS standard and the power of appointment, should be examined to see if they support a claim of incomplete conveyance or excessive retention of control.

H. ALTER EGO. Family lawyers know that the independence or separateness of a corporation or other business entity can be attacked under the "alter ego" doctrine, or more broadly, on several grounds for disregarding the separate identity of an entity. The doctrine could be used to contest whether certain property is truly "held in trust." The Court of Civil Appeals, in *In re Marriage of Burns*, 573 S.W.2d 555, 557 (Tex. Civ. App.--Texarkana 1978, writ dism'd), acknowledged this potential attack, when it noted that the wife in that case had not challenged the husband's trust as being the alter ego of the husband. The same is true of *Lemke v. Lemke*, 929 S.W.2d 662, 664 (Tex. App.–Fort Worth 1996, writ denied). The doctrine of alter ego was applied to trusts in the following cases cited by in a State Bar of Texas CLE article: *U.S. v. Rigler*, 885 F. Supp.2d 923, 933 (S.D. Iowa 2012) (concluding that trust was Rigler's alter ego because Rigler "is in no way independent of the Trust," "denies knowing of any Trust beneficiaries,"and "Rigler also acknowledged that the Trust has no bank account and no taxpayer identification number"); *Greenspan v. LADT*, No. B222539 (Cal. Ct. App. 2d Dist. 2010) ("Based on a trio of California cases as well as out-of-state authority, we conclude the alter ego doctrine may apply to a trustee but not a trust."); *Schwerin v. Kuhns*, No. A138444, 2014 WL 1435898 (Cal. Ct. App. 1st Dist. 2014); *In re Gillespie*, 269 B.R. 383,(E.D. Arkansas) (finding that "[a]lthough the doctrine [of alter ego] is most often applied with regard to corporations, it also applies to trusts, and 'the trust functioned merely as an appendage of Ms. Gillespie and her various businesses,' 'no respect for separate corporate or trust identities,' and 'the only evidence that the trust or corporate entities even existed were the documents which created them. For all other purposes, the trust and corporations were virtually nonexistent."); *FPP Enterprises v. U.S.*, 830 F.2d 114, 118 (8th Cir. 1987) (holding "on this record, the district court's finding that the trusts are shells acting as alter egos for the Beasons and therefore not separate persons from the taxpayers will not be disturbed"). [Author unknown] *The Perfect Storm: Estate Planning and the Crossover with Divorce* (State Bar of Texas 13th Annual Fiduciary Litigation Course (December 6-7, 2018) p. 13.

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

However, alter ego is just one of several grounds to disregard the separate identity of an entity, as discussed below.

1. *Castleberry v. Branscum*. The Supreme Court examined the contours of piercing the corporate veil in *Castleberry v. Branscum*, 721 S.W.2d 270 (Tex. 1986). There the Court discussed seven recognized grounds for disregarding the corporate fiction: (i) alter ego; (ii) because "the corporate form has been used as part of a basically unfair device to achieve an inequitable result; (iii) fraudulent conveyance; (iv) the trust fund doctrine; (v) breach of fiduciary duties; (vi) the denuding theory; and (vii) inadequate capitalization. *Id*. at271-73. As to the alter ego theory the Court said:

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

Id. at 272.

The policy reasons which support disregarding the corporate fiction may well also apply to situations where an ostensible trust relationship in property is conducted in a manner that meets the conditions for disregarding the separate identity of an entity. If the facts warrant it, plead the cause of action, and if the trial judge will not allow it, take it up on appeal.

2. Colorable Trust vs. Alter Ego. One can draw some distinctions between a "colorable" trust and a trust relationship which should be disregarded on recognized grounds. To prove that a trust is colorable, the proponent must show an agreement between the settlor and the trustee such that the settlor retains the benefit of the principal and income of the trust, notwithstanding the apparently completed conveyance to the trustee. To establish that a trust is being operated as an alter ego, the proponent would show that the settlor, or trustee, or beneficiary, as the case may be, dealt with the trust property as if it was not subject to the limitations in the trust instrument. Thus, even if the attempt to prove an *agreement* between the trustee and the settlor is unsuccessful, and the colorable trust attack fails, the trust relationship may be disregarded on other grounds.

Where the beneficiary is also the trustee, (and especially also the settlor), the situation becomes very problematic. Past behavior may demonstrate that the trust structure is a pretense, driven by estate tax motives but not real in the actual operation.

I. TRUST AS INSTRUMENT OF FRAUD. No published Texas appellate case has disregarded a conveyance into trust on the ground that it was used to perpetrate a fraud. However, this cause of action exists in some other jurisdictions. In this subsection, an analogy is drawn to Texas precedent disregarding the corporate fiction, and some case law from other states is examined.

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

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

Id. at 273. There are a number of Texas cases discussing constructive fraud-on-the-spouse, in situations involving the conveyance of community property by a spouse to a third party. However, these cases would address only the conveyance by a spouse of property into trust. One can imagine other instances of constructive fraud in connection with a trust, apart from a spouse's conveyance of community property into trust. Take, for example, the man who, shortly prior to marriage, conveys all of his income-producing property into trust, and then, either as trustee or through control over the trustee, uses undistributed trust income to acquire assets such as the car which he drives, the house in which he lives, etc.--items which would have been community property had the income been received by him free of trust. This activity would not constitute a constructively fraudulent conveyance of community property, but might constitute use of an express trust in a constructively fraudulent manner. If the principles that apply to use of a corporation to perpetrate a fraud can be adapted to express trusts, equity would allow the court in a divorce to disregard the trust "fiction."

J. RESCISSION, CANCELLATION AND REFORMATION FOR FRAUD, DURESS, MISTAKE, ETC. Conveyances into trust, like every other transaction, are subject to rescission, cancellation or reformation on the grounds of fraud, accident, mistake, undue influence, duress, failure of consideration, etc. *See* 72 TEX. JUR.3d *Trusts* § 154 (1990).

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

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

The reader should differentiate fraudulent inducement from actual fraud and constructive fraud/breach of fiduciary duty. Fraudulent inducement requires only a false inducement, not a <u>knowingly</u> false inducement. Actual fraud involves scienter. Constructive fraud involves only unfairness to the victim to whom a fiduciary or special duty is owed.

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

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

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

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

a. Mistake as Basis for Rescission and Cancellation. To rescind or cancel an agreement for mistake, the mistake in most instances must be mutual. *Hanover Ins. Co. v. Hoch*, 469 S.W.2d 717, 722 (Tex. Civ. App.--Corpus Christi 1971, writ ref'd n.r.e.). The mistake must relate to a material and essential issue, not an incidental one. *Simpson v. Simpson*, 387 S.W.2d 717, 719 (Tex. Civ. App.--Eastland 1965, no writ). The mistake cannot have resulted from the negligence of the party seeking to negate the transaction. *Plains Cotton Cooperative Assn. v. Wolf*, 553 S.W.2d 800, 803 (Tex. Civ. App.--Amarillo 1977, writ ref'd n.r.e.). Ordinarily, an error in predicting the future will not support rescission or cancellation. *City of Austin v. Cotten*, 509 S.W.2d 554, 557 (Tex. 1974). A mistake as to a party's existing legal rights can support rescission. *Plains Cotton Cooperative Assn. v. Wolf*, 553 S.W.2d 800, 803 (Tex. Civ. App.--Amarillo 1977, writ ref'd n.r.e.).

Unilateral mistake, that is not known to or induced by the other party, will not support rescission or cancellation of an agreement. *Johnson v. Snell*, 504 S.W.2d 397, 399 (Tex. 1973). However, unilateral mistake can support rescission where the mistake is of such a magnitude that to enforce the contract would be unconscionable; the mistake involves a material feature of the agreement; the mistake was made despite the exercise of ordinary care; and the parties can be returned to the status quo ante after rescission. *Taylor v. Arlington Ind. School Dist.*, 335 S.W.2d 371, 373 (Tex. 1960).

"Unilateral mistake by one party, and knowledge of that mistake by the other party, is equivalent to mutual mistake." *Davis v. Grammar*, 750 S.W.2d 766, 768 (Tex. 1988).

b. Mistake as Basis for Reformation. Reformation is an equitable proceeding in which a document which is erroneously written is caused to conform to the true agreement between the parties. *Continental Oil Co. v. Doornbos*, 402 S.W.2d 879, 883 (Tex. 1966).Ordinarily, the mistake in the document must be mutual, and not unilateral, in order to support reformation. To warrant reformation, the proponent must prove the true agreement of the parties, and that the written memorandum deviates from the true agreement as a result of mutual mistake. *Brown v. Havard*, 593 S.W.2d 939, 942 (Tex. 1980). However, unilateral mistake by one party will support reformation where it is accompanied by fraud or inequitable conduct by the other party. *Ace Drug Marts, Inc. v. Sterling*, 502 S.W.2d 935, 939 (Tex. Civ. App.--Corpus Christi 1974, writ ref'd n.r.e.).For example, where the other party knows of the mistake but fails to mention it, inequitable conduct exists to support reformation based upon unilateral mistake. *Cambridge Companies, Inc. v. Williams*, 602 S.W.2d 306, 308 (Tex. Civ. App.--Texarkana 1980), *aff'd*, 615 S.W.2d 172 (Tex. 1981).

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

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

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

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

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

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

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

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

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

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

6. Fraud-on-the-Spouse Doctrine. There are many Texas cases stating that actual or constructive fraud can arise when a spouse gives community property to a third party. In such a situation, the court will reconstitute the community estate based on the injury to the community estate. Tex. Fam. Code § 7.009. Most actual and constructive fraud-on-the-spouse cases have involved either outright gifts to third parties or the designation of a third party as beneficiary of a community property life insurance policy. However, the conveyance of community property into an inter vivos or testamentary trust can just as easily support a fraud-on-the-spouse case. This was recognized by the Texas Supreme Court, in dicta, in *Land v. Marshall*, 426 S.W.2d 841 (Tex. 1968).

a. Actual Fraud on the Community Estate. Bogert's TRUSTS AND TRUSTEES, Section 211, says:

> A trust, like any other transfer, conveyance, or contract, may be invalid because it is intended to accomplish an illegal purpose. Trusts for which the settlor's primary purpose was to defraud private persons or corporations of their common law or statutory rights, or defraud the government, or encourage crime or other highly unsocial conduct, will not be carried out by the courts and will be set aside on application of interested and innocent parties.

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

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

Id. at 515.The TEXAS PATTERN JURY CHARGES (FAMILY & PROBATE) (2018) PJC 206.2A gives the following instruction regarding actual fraud of a spouse's interest in community property:

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

b. Constructive Fraud on the Community Estate. Texas case law establishes that, even without proof of actual intent to defraud the spouse, the court will rescind or otherwise compensate for a transaction whereby one spouse unfairly transfers community property. *See Greco v. Greco*, No. 04–07–00748–CV, 2008 WL4056328, *5 (Tex. App.--San Antonio Aug. 29, 2008, no pet.) (mem. op.); *Mazique v. Mazique*, 742 S.W.2d 805, 807-08 (Tex. App.--Houston [1st Dist.] 1987, no writ). The doctrine of constructive fraud is one tool the practitioner can use to undo one spouse's conveyance of community property into a trust. *See Stephens County Museum, Inc. v. Swenson*, 517 S.W.2d 257 (Tex. 1975) (a non-marital case remanded to trial court for determination of constructive fraud issue regarding transfer into trust).

The TEXAS PATTERN JURY CHARGES (FAMILY & PROBATE) (2018) PJC 206.4A gives the following instruction regarding constructive fraud as to a spouse's interest in community property:

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

i. Conveyances During Lifetime. The following cases, among many others, have addressed the issue of constructive fraud-on-a-spouse in inter vivos conveyances to third parties: *Horlock v. Horlock*, 533 S.W.2d 52 (Tex. Civ. App.--Houston [14th Dist.] 1975, writ dism'd) (wife sought to recover from husband in divorce proceeding for gifts of community property he made to his children from a prior marriage); *Carnes v. Meador*, 533S.W.2d 365 (Tex. Civ. App.--Dallas 1976, writ ref'd n.r.e.) (widow sued to negate gifts of community property from deceased husband to his children from prior marriage); *Logan v. Barge*, 568 S.W.2d 863 (Tex. Civ. App.--Beaumont 1978, writ ref'd n.r.e.) (widow sued step-children to recover one-half of gifts of community property made to them by her deceased husband); *Jackson v. Smith*, 703 S.W.2d 791, 795 (Tex. App.--Dallas 1985, no writ) ("A presumption of constructive fraud arises where one spouse disposes of the other spouse's one-half interest in community property without the other's knowledge or consent"); *Zieba v. Martin*, 928 S.W.2d 782, 789 (Tex. App.--Houston [14th Dist.] 1996, no pet.) ("A presumption of constructive fraud arises where one spouse disposes of the other spouse's one-half interest in community property without the other's knowledge or consent"); *In re Estate of Vackar*, 345S.W.3d588(Tex. App.–San Antonio 2011, no pet.) (husband leaving $100,000 in insurance proceeds to his sister was set aside as unfair). In *Barnett v. Barnett*, 67 S.W.3d 107, 112 (Tex. 2001), where the husband surreptitiously named his estate as beneficiary of a community property life insurance policy, and after his death the proceeds were immediately transferred by the executor to other family members, the Supreme Court said that under Texas law the wife had a cause of action for fraud on the community, and the court could impose a constructive trust on one-half of the proceeds, except that state law was preempted by ERISA in that case).

ii. Conveyances Effective Upon Death. The following cases have addressed the issue of constructive fraud-on-a-spouse in conveyances taking effect upon death: *Barnett v. Barnett*, 67 S.W.3d 107 (Tex. 2001) (deceased husband designated his estate as beneficiary of community property life insurance, with his mother and not his wife receiving the insurance proceeds; wife's fraud claim was viable under Texas law but was preempted by ERISA); *Givens v. Girard Life Ins. Co. of America*, 480 S.W.2d 4211 (Tex. Civ. App.--Dallas 1972, writ ref'd n.r.e.) (widow sued deceased husband's girlfriend to recover proceeds from community property life insurance policy on life of deceased husband); *Murphy v. Metropolitan Life Ins. Co.*, 498 S.W.2d 278 (Tex. Civ. App.--Houston [14th Dist.] 1973, writ ref'd n.r.e.) (decedent's mother sued insurance company and decedent's wife for proceeds of community property life insurance policy on decedent's life);

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

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

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

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

Merger can occur at the outset of the trust, or as a result of a design defect in the trust instrument, or it can result from a subsequent act of the beneficiary. For example, when the beneficiary of an express trust conveys equitable title to the trustee, so that legal title and equitable title are merged in the trustee, the trust is terminated and the trustee has an unrestricted right to the property. *See Becknal v. Atwood*, 518 S.W.2d 593 (Tex. Civ. App.--Amarillo 1975, no writ). In *Becknal*, where the father conveyed real property to his wife as trustee for their children, and the children later conveyed their remainder interest back to their mother, for her use and enjoyment during her lifetime, and then to the trustor-father, for his use during his lifetime, legal and equitable title merged and the property in question exited the trust. However, other trust property not involved in the re-conveyance continued to remain in trust.

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

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

L. STANDARDS IN THE INTERNAL REVENUE CODE. The Internal Revenue Code addresses issues analogous to the "illusory trust," "colorable trust," and alter ego doctrines in connection with taxation of trust income and the inclusion of trust property in the estate of a decedent. While there is a distinction between the validity of a transaction under state property law and the validity of the transaction for tax purposes, the parallels cannot be avoided. The similarity was touched upon in *Sullivan v. Burkin*, 390 Mass. 864, 460 N.E.2d 572, 575 (1984).

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

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

VIII. CONTESTED MODIFICATION/TERMINATION OF TRUST. There may be instances where the a divorcing spouse may want to leave an existing trust in place, but modify certain terms of the trust. There are common law grounds for modification of express trusts, and statutory grounds.

A. DOCTRINE OF DEVIATION. Two Texas courts have recognized a "doctrine of deviation implicit in the law of trusts." According to that doctrine, "a court of equity will order a deviation from the terms of the trust if it appears to the court that compliance with the terms of the trust is impossible, illegal, impractical or inexpedient, or that owing to circumstances not known to the settlor and not anticipated by him, compliance would defeat or substantially impair the accomplishment of the purpose of the trust." *Amalgamated Transit Union, Local Div. 1338 v. Dallas Pub. Transit Bd.*, 430 S.W.2d 107, 117 (Tex. Civ. App.--Dallas 1968, writ ref'd n.r.e.). As support, the Texas court cited a 1947 Ohio Court of Appeals case, and the Restatement (Second) of the Law of Trusts § 167, p. 351. The Ohio case was subsequently cited by Ohio courts, most recently twenty years ago. More recently, the doctrine of deviation was confirmed in *Conte v. Ditta*, 287 S.W.3d 28, 37 (Tex. App.–Houston [1st Dist.] 2007), *rev'd on other grounds*, 298 S.W.3d 187 (Tex. 2009).

B. STATUTORY-BASED MODIFICATION OR TERMINATION. Texas Prop. Code § 112.054, entitled "Judicial Modification, Reformation, or Termination of Trusts," governs court proceedings to modify or terminate trusts. A suit to modify or terminate a trust can be brought by a trustee or beneficiary. The statute does not include settlors. However, Tex. Prop. Code § 115.011 permits "[a]ny interested person" to bring a suit under Section 115.001, which permits the court to take a wide array of actions respecting trusts. Tex. Prop. Code 111.004(7) says that "[w]hether a person, excluding a trustee or named beneficiary, is an interested person may vary from time to time and must be determined according to the particular purposes of and matter involved in any proceeding."

The grounds for modification or termination are stated in Tex. Prop. Code § 112.054(a):

> (1) the purposes of the trust have been fulfilled or have become illegal or impossible to fulfill;
> (2) because of circumstances not known to or anticipated by the settlor, the order will further the purposes of the trust;
> (3) modification of administrative, nondispositive terms of the trust is necessary or appropriate to prevent waste or impairment of the trusts administration;
> (4) the order is necessary or appropriate to achieve the settlors tax objectives or to qualify a distributee for governmental benefits and is not contrary to the settlors intentions; or
> (5) subject to Subsection (d):
> (A) continuance of the trust is not necessary to achieve any material purpose of the trust; or
> (B) the order is not inconsistent with a material purpose of the trust.

However, action under Section 112.054(a)(5) requires the consent of all beneficiaries. Tex. Prop. Code § 113.054(d).

Tex. Prop. Code § 112.054(b) provides that--

> The court shall exercise its discretion to order a modification or termination under Subsection (a) or reformation under Subsection (b-1) in the manner that conforms as nearly as possible to the probable intention of the settlor. The court shall consider spendthrift provisions as a factor in making its decision whether to modify, terminate, or reform, but the court is not precluded from exercising its discretion to modify, terminate, or reform solely because the trust is a spendthrift trust.

Under Section 112.054(b-1),"reforming" the trust is differentiated from modifying the trust. Section 112.054(b-1) permits reformation if:

> (1) reformation of administrative, nondispositive terms of the trust is necessary or appropriate to prevent waste or impairment of the trusts administration;
>
> (2) reformation is necessary or appropriate to achieve the settlors tax objectives or to qualify a distributee for governmental benefits and is not contrary to the settlors intentions; or
>
> (3) reformation is necessary to correct a scriveners error in the governing document, even if unambiguous, to conform the terms to the settlor's intent.

However, reformation under Section 112.054(b-1)(3) requires proof of the settlor's intent by clear and convincing evidence.

The Legislature set out in Section 112.054(f) the following powerful provision:

> Subsection (b-1) is not intended to state the exclusive basis for reformation of trusts, and the bases for reformation of trusts in equity or common law are not affected by this section.

In *Willa Peters Hubberd Testamentary Trust*, 432 S.W.3d 358 (Tex. App.–San Antonio 2014, no pet.), the court evaluated agreed-upon amendments to a testamentary trust by ascertaining the intent of the testator who created the trust as reflected in the unambiguous language of the will. The court found that some of the modifications were permissible and they were affirmed, while others were impermissible and they were reversed.

IX. REMOVAL OF TRUSTEE. In some instances, a divorce client may wish to leave a trust in force, but want to remove the trustee of the trust, whether that be the other spouse or a third person. If the prescribed method for naming a replacement trustee is not desirable, a request to remove a trustee could be coupled with a request to modify the terms of the trust pertaining to the appointment of a successor trustee. Texas Prop.

Code § 112.054, entitled "Judicial Modification, Reformation, or Termination of Trusts," permits a court to order that a trustee be changed, or prohibited from certain actions authorized by the trust.

"The Trust Code provides courts wide latitude in deciding whether to remove a trustee...." *Ditta v. Conte*, 298 S.W.3d 187, 191 (Tex. 2009). Tex. Prop. Code § 113.082(a) provides:

> (a) A trustee may be removed in accordance with the terms of the trust instrument, or, on the petition of an interested person and after hearing, a court may, in its discretion, remove a trustee and deny part or all of the trustee's compensation if:
>
> (1) the trustee materially violated or attempted to violate the terms of the trust and the violation or attempted violation results in a material financial loss to the trust;
> (2) the trustee becomes incapacitated or insolvent;
> (3) the trustee fails to make an accounting that is required by law or by the terms of the trust; or
> (4) the court finds other cause for removal.

An "interested person" means "a trustee, beneficiary, or any other person having an interest in or a claim against the trust or any person who is affected by the administration of the trust. Whether a person, excluding a trustee or named beneficiary, is an interested person may vary from time to time and must be determined according to the particular purposes of and matter involved in any proceeding." Tex. Prop. Code § 111.004(7). An "interest" is defined as "any interest, whether legal or equitable or both, present or future, vested or contingent, defeasible or indefeasible." Tex. Prop. Code § 111.004(6). In *Davis v. Davis*, 734 S.W.2d 707, 709–10 (Tex. App.--Houston [1st Dist.] 1987, writ ref'd n.r.e), the court found that a claimant who would inherit an interest in the trust only upon the death of a prior beneficiary who dies intestate did not have a sufficient interest to have standing to sue the trustees for breach of duty and for an accounting. In *Aubrey v. Aubrey*, 523 S.W.3d 299, 302 (Tex. App.–Dallas 2017, no pet.), the court found the claimant to be an interested person when he had a remainder interest that would vest when his mother died. *Jenkins v. Jenkins* 522 S.W.3d 771, 781 (Tex. App.--Houston [1st Dist.] 2017, no pet.), explained that a remainder interest is vested if the remainder interest is in an ascertainable person and no condition precedent exists other than termination of the prior estates.

Hostility between the trustee and other trustees or beneficiaries can be grounds for removal of a trustee. The RESTATEMENT (THIRD) OF TRUSTS § 37(b) addresses removal of a trustee. Comment e (1) illustration 7, provides the following example of grounds for removal of a trustee:

> The settlor named two of her five children as co-trustees of a trust for all of the children and their families. Over several years, extreme ill will has developed among the children and is now impairing the proper functioning of the trust. It is within the reasonable discretion of the court to remove and replace the trustees.

See Bergman v. Bergman Davison Webster Charitable Tr., No. 07-02-0460-CV (Tex. App.–Amarillo Jan. 2, 2004, no pet.) (memo op.) (trial court properly removed trustee who harassed and intimidated other trustees).

X. MARITAL PROPERTY ISSUES. There are some complication arising from the intersection between trust law and marital property law. An older article on the subject that discusses Texas cases is Steve D. Baker *The Texas Mess: Marital Property Characterization of Trust Income*, 5 Est. Plan. & Community Property L.J. 217 (Summer 2013).

A. BENEFICIAL INTEREST. A beneficiary's interest in property held in trust for the beneficiary is an equitable *interest*, not an ownership *right*. The parameters of that beneficial interest are set by the trust instrument. Most trusts with substantial wealth are discretionary distribution spendthrift trusts, which give the beneficiary little or no control over trust principal and trust income. The beneficial interest, if considered to be property at all, would be subject to characterization as separate property by gift (an intervivos trust) or devise (a testamentary trust). *See Hardin v. Hardin*, 681 S.W.2d 241, 243 (Tex. Civ. App.--San Antonio 1984, no writ) (beneficiary's interest in trust treated as separate property by virtue of gift).

B. ASSETS HELD IN TRUST. According to the following cases, property held in trust for a spouse is not marital property: *Buckler v. Buckler*, 424 S.W.2d 514 (Tex. Civ. App.--Fort Worth 1967, writ dism'd) (undistributed income in a spendthrift trust not part of the estate of the parties, where distribution of such income was discretionary with the trustee); *In re Marriage of Burns*, 573 S.W.2d 555 (Tex. Civ. App.--Texarkana 1978, writ dism'd) (undistributed income inside discretionary distribution trust not "acquired" by the spouse during marriage, and was therefore not part of the community estate); *Currie v. Currie*, 518 S.W.2d 386 (Tex. Civ. App.--San Antonio 1974, writ dism'd) (property inside of discretionary distribution trust was not community property of the husband; property inside another trust, as to which husband was remainder beneficiary, was not "acquired" by the spouse, and was therefore not part of the community estate). It has become accepted, however, that when assets are no longer held in trust but are voluntarily left with the trustee., they have been constructively received and are marital property.

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

C. INCOME IN SELF-SETTLED TRUST. A "self-settled" trust is a trust in which the settlor is also the beneficiary. In *Mercantile National Bank at Dallas v. Wilson*, 279 S.W.2d 650 (Tex. Civ. App.--Dallas 1955, writ ref'd n.r.e.), the Court held that the undistributed income of a trust created by wife for her own benefit, prior to marriage, was community property. *See In re Marriage of Burns*, 573 S.W.2d 555 (Tex. Civ. App.--Texarkana 1978, writ dism'd) (income on separate property corpus of trust created by spouse for his own benefit was community property to the extent it was received by husband). In *Ridgell v. Ridgell*, 960 S.W.2d 144 (Tex. App.--Corpus Christi 1997, no writ), the appellate court said that the income a spouse receives from a trust is community property. The court also said that if the spouse does not receive income from the trust and has no more than an expectancy interest in the corpus, the income remains separate property. *Id*. at 148 (should say "nonmarital property"). In *Ridgell* some of the trusts were funded by gift or devise and one was funded by the spouse prior to marriage. Also in *Ridgell*, the court recognized that separate property principal distributed out of the self-settled trust was received by the spouse as separate property. *Id*. at 150.

The question is impacted by Tex. Prop. Code § 112.035 regarding self-settled spendthrift trusts. Section 112.035(d) says:

> (d) If the settlor is also a beneficiary of the trust, a provision restraining the voluntary or involuntary transfer of the settlor's beneficial interest does not prevent the settlor's creditors from satisfying claims from the settlor's interest in the trust estate. A settlor is not considered a beneficiary of a trust solely because:
>
> (1) a trustee who is not the settlor is authorized under the trust instrument to pay or reimburse the settlor for, or pay directly to the taxing authorities, any tax on trust income or principal that is payable by the settlor under the law imposing the tax; or
>
> (2) the settlor's interest in the trust was created by the exercise of a power of appointment by a third party.

In *Lemke v. Lemke*, 929 S.W.2d 662, 664 (Tex. App.--Fort Worth 1996, writ denied), the court of appeals considered a self-settled spendthrift trust created by a husband before marriage, to hold damages he recovered in a medical malpractice case for a brain injury he suffered. The self-settled trust had husband as sole beneficiary, and an independent trustee with sole discretion to distribute principal or income to husband for his health, education, maintenance and welfare. The remainder beneficiaries were husband's parents, brother, and their descendants. The trustee made distributions during marriage for trust expenses and for the spouses' living expenses. Citing *In re Marriage of Burns*, the Fort Worth Court of Appeals held that the income held in trust was not marital property because the it had not been distributed and husband had no right to require distribution. The Fort Worth Court of Appeals rejected the wife's claim that the self-settled trust exception to the spendthrift trust rule in Tex. Prop. Code § 112.0359(d), applied, without any explanation other than referring to *Burns*.

The Fort Worth Court of Appeals adopted the same position in *Lipsey v. Lipsey*, 983 S.W.2d 345 (Tex. App.--Ft. Worth 1998, no pet.), where before marriage the husband rolled over a pension into a 401(k) "Capital Accumulation Plan." The plan manager was a trustee, and under the plan husband deferred receipt of any distributions until he attained age 70-1/2. The trial court found the increase on the Capital Accumulation Plan during marriage to be community property. The Fort Worth Court of Appeals noted that the Plan was a trust created prior to marriage, and that no trust assets had been distributed during marriage, and husband had no right to compel distributions during marriage. Therefore he had not acquired the income, and it was not community property. *Id*. at 350-51. No import was given to the fact that the trust was self-settled.

D. TRUST CREATED OR FUNDED BY GIFT OR DEVISE. Where a trust is created as a gift, the beneficial interest in the trust is separate property. *Hardin v. Hardin*, 681 S.W.2d 241, 243 (Tex. Civ. App.--San Antonio 1984, no writ). There are a number of very old cases that say that income from a trust that was created by gift or inheritance is received by the spouse/beneficiary as separate property. These cases do not address the question of whether a trust created by a spouse for his own benefit, using separate property, gives rise to separate or community income.

McClelland v. McClelland, 37 S.W. 350 (Tex. Civ. App. 1896, writ ref'd), is probably the mos-often-quoted of these older cases. *McClelland*, which involved a testamentary trust created for the husband by his father, presented the issue as being a contest between the intent of the testator and community property claims of the wife. In *McClelland*, the intent of the testator won out. Thus, a monthly allowance paid by the trustee to the husband, pursuant to a provision in the will, as well as other discretionary distributions made by the trustee under the will, were held to be the husband's separate property. *See Sullivan v. Skinner*, 66 S.W. 680 (Tex. Civ. App. 1902, writ ref'd) (where wife received a life estate in land under her father's will, which provided that she was to receive the income for her sole and separate use, the rentals from the land were wife's separate property). *But see Arnold v. Leonard*, 273 SW.799 (Tex. 1925) (rents and revenues from the wife's separate property are community property, per the Texas Constitution).

Several other old cases, involving a conveyance by one spouse into trust for the benefit of the other spouse, held that income from the property held in trust was also separate property. *See Hutchinson v. Mitchell*, 39 Tex. 488 (1873) ("We can find nothing in any of the Constitutions or laws of the state or republic which would prevent a man from declaring an express trust in favor of his wife, and giving her the exclusive use and enjoyment of all the rents, revenues and profits of the trust estate, provided there is no fraud in the transaction against creditors . . ."); *Shepflin v. Small*, 23 S.W. 432 (Tex. Civ. App.--El Paso 1893, no writ) (where husband and wife joined in conveyance of wife's separate property to trustee, to collect the income and use it to support the wife and children, the income was withdrawn from the community estate). In 1980, the Texas Constitution, art. XVI, § 15, was amended to provide that, if one spouse makes a gift of property to the other, then the gift is presumed to include all of the income or property which might arise from that gift of property. The Constitution thus recognized a gift between spouses of future income. No case has held that the presumption of a gift of future income does or does not apply to a gift from one spouse to the trustee for the other spouse.

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

A Federal Court of Claims case reviewed the broad panorama of Texas cases on marital property law and trusts, and concluded that, where a trust is established by gift, the correct view is that distributions from the trust to a married beneficiary are the beneficiary's separate property, notwithstanding some authorities to the contrary. *Wilmington Trust Co. v. United States*, 4 Ct. Cl.6 (1983), *aff'd*, 753 F.2d 1055 (Fed. Cir. 1985). The Court stated:

> It is concluded that, under the law of Texas, as developed and expounded by the Texas courts, the income derived during the marriage of [the spouses] from the seven trusts that are involved in the present case constituted the separate property of [the wife], and was not community property of [the spouses]. [The wife] never "acquired"--and she will never acquire--the corpus of any of these trusts. The corpus of each trust is to be held and controlled by the trustee or trustees during [the wife's] lifetime, and, upon [the wife's] death, the corpus will pass to her issue. Accordingly, the corpus of each trust was not [the wife's] separate property, and the trust income was not from [the wife's] separate property.
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> What [the wife] "acquired"--and what she used to purchase the stocks and establish the bank accounts that are involved in the litigation--was the income from the trust property. As the income resulted from the gifts made to trustees for [the wife's] benefit, the income necessarily constituted her separate property under section 15 of article XVI of the Texas Constitution.

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

In *Cleaver v. George Staton Co.*, 908 S.W.2d 468, 470 (Tex. App.--Tyler 1995, writ denied), the wife was a beneficiary of a testamentary trust that provided for mandatory payments of income from the corpus to the wife for life, but she was conveyed no ownership interest in the corpus of the trust and had no present possessory interest in the corpus. The Court said: "The trust income payments to the Wife are thus her separate property," citing *In re Marriage of Long*, 542 S.W.2d 712, 717-18 (Tex. App.--Texarkana 1976, no writ).

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

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

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

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

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

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

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

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

The Tax Court ruled that children who are beneficiaries of a trust, that is created by gift of their parents, hold their interest in trust property as separate property. The Tax Court further found that the rights of the beneficiaries did not attach to the gross income, but rather to the distributable net income, of the trust, and that the gross income of the trust used by the trustees to purchase additional property could not be community income of the beneficiaries. The Tax Court further held that the fact that the property was conveyed into trust subject to debts and liens did not convert what was otherwise a gift into a transfer for onerous consideration. And oil royalties and bonuses distributed by the trustee remained the beneficiaries' separate property.

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

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

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

Id. at 573.

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

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

This rule was applied to the gross income of the trust, not just to the distributable net income. *Id*. at 573. Since community property income was commingled with separate property trust assets, the whole fund became community property, and the new investments were therefore community property trust assets in character.

F. TRUST DISTRIBUTIONS.

1. Trust Principal. *In re Marriage of Long*, 542 S.W.2d at 718, supports the view that a distribution of principal from trust to a married beneficiary is received as separate property if the principal was conveyed into trust by gift or devise or was funded prior to marriage. It would seem that, where a spouse conveys separate property into trust and then recovers it back as a trust distribution during marriage, it would be received by the beneficiary spouse as separate property. *Ridgell v. Ridgell* 960 S.W.2d 144, 150 (Tex. App.--Corpus Christi 1997, no writ). However, an argument can be made that conveying the separate property into trust destroys the identity of the asset as separate property, so that the property has no marital property character while held in trust, and that the character of the distributed principle will be determined without tracing principles. *See generally Marshall v. Marshall*, 735 S.W.2d 587 (Tex. App.--Dallas 1987, writ ref'd n.r.e.) (tracing not allowed when separate property is contributed to partnership and is then distributed out); *see Lifshutz v. Lifshutz*, 199 S.W.3d 9 (Tex. App.--San Antonio 2006, pet. denied) (distribution from partnership was community property even though the asset distributed was not cash but was a business entity owned by the partnership before marriage). Whether the inception of title rule comes into play is yet to be determined.

2. Trust Income (*Sharma v. Routh*). The case of *Sharma v. Routh*, No. 14-06-00717-CV (Tex. App.--Houston [14th Dist.] 2009) (opinion withdrawn), *opinion on rehearing*, 302 S.W.3d 355 (Tex. App.--Houston [14th Dist.] 2009, no pet.), has had an impact on the question of the character of distributions from trust to a married beneficiary. Because the case is more recent than many, and perhaps because the issues were more sharply drawn, more ably briefed, and more comprehensively analyzed by the appellate court, *Sharma v. Routh* has been given significant weight by practitioners and forensic experts. The Court reversed itself on rehearing, and the case was actually a close call, so it would be beneficial to examine the Court of Appeals' activity in some detail.

a. Four Opinions: Two Rulings. In *Sharma v. Routh*, the Fourteenth Court of Appeals initially held that trust distributions received by a husband (Sharma) during marriage were community property. The initial Majority Opinion was written by Chief Justice Adele Hedges, joined by Justice Eva Guzman; the Dissenting Opinion was written by Justice Kem Frost. [Chief Justice Hedges' Opinion, later withdrawn, has been officially destroyed; however, the copy is available on www.leagle.com.] After this initial decision, University of Texas School of Law Professor Stanley M. Johanson wrote a letter to the Court, scolding the Justices for their ruling and explaining what the correct ruling would be. On rehearing, Justice Guzman switched her vote. Justice Frost, who dissented first time around, wrote the new Majority Opinion, joined by Justice Guzman. Chief Justice Hedges changed her vote as well, but she issued a Concurring Opinion. The Court's final Majority Opinion determined that the trust distributions received by the husband during marriage were his separate property. Justice Guzman, later moved to the Texas Supreme Court.

b. The Facts. In *Sharma v. Routh*, the husband's previous wife established in her last will and testament two trusts, the "Marital Trust" and the "Family Trust." The husband was both trustee and beneficiary of the Marital Trust. The Marital Trust agreement required mandatory distribution of trust income to the husband. The Marital Trust agreement also gave the trustee (i.e., the husband) the discretion to distribute trust principal for his own health, support and maintenance, "in accordance with the standard of living to which [he] is accustomed." As to the Family Trust, husband was named as both trustee and beneficiary, and husband as trustee had the discretion to distribute trust principal and income as necessary for his own health, support and maintenance, in order to maintain himself at the standard of living to which he had become accustomed. A charitable foundation was the remainder beneficiary of both trusts. Husband, acting as trustee of both trusts, sold the real estate held in both trusts, taking in exchange promissory notes with payments of principal and interest.

After his previous wife died, husband remarried and then a short time later got divorced from his second wife. The evidence showed that the husband had deposited principal and interest payments received by both trusts into his personal account for approximately 4 years, including 1 year during his second marriage. The Marital Trust had mandatory distribution of income, which amounted to $2,272,063 during marriage. The interest on the Family Trust note during marriage was $32,955. The husband reported the interest payments as his personal income on his tax returns and on a loan application. The trial court found that the interest on the promissory notes held in trust that accrued during marriage was community property, and divided it 50-50.

c. The Final Majority Opinion. Justice Frost's final Majority Opinion on rehearing restated her original Dissenting opinion. She stated the controlling rule of law: "We hold that, when a spouse receives distributions of trust income under an irrevocable trust during marriage, the income distributions are community property only if the recipient has a present possessory right to part of the corpus" 302 S.W.3d at 357. Justice Frost restated the four possible rules listed in her previous Dissenting Opinion, and said: "We adopt Rule C." *Id*. at 364.

d. The Final Concurring Opinion. Chief Justice Hedges issued a Concurring Opinion on rehearing. Perhaps reflecting the influence of Professor Johanson's amicus curiae letter brief, she treated the distributions of trust principal during marriage as improper handling of trust property, because no evidence suggested that the husband as trustee complied with the trust requirements that trust principal could be distributed only when needed for husband's health, support, or maintenance. Chief Justice Hedges continued to adhere to her rule that distributions of trust income are community property only if the recipient has an interest in the trust corpus. Chief Justice Hedges, thus, applying her own test, changed her mind and agreed that the income distributions were separate property.

e. Take-Away from the Case.

- On rehearing, Justice Frost (joined by Justice Guzman) adopted a narrow test that distributions of income from a testamentary trust are community property only if the beneficiary has a *present possessory right* to part of the corpus. Chief Justice Hedges adopted a broader rule that the distributed income is community property if the beneficiary has *an interest in* trust corpus.

- Following Professor Johanson's lead, Justice Frost did not consider the husband trustee/beneficiary's power to distribute trust principal to himself to be a present possessory right to part of the principal *because the power to invade trust principal was limited by an ascertainable (HEMS) standard*.

- Justice Frost believed that the husband did not receive distributions of corpus. Chief Justice Hedges believe that principal payments on the trust notes were deposited into the husband's person accounts, but improperly, so that they were not truly distributions.

- Professor Johanson's argument that the HEMS standard was violated appears to have won over Chief Justice Hedges, even absent evidence on the point.

- Both final Opinions on rehearing noted that husband was not the remainder beneficiary of either trust. That probably would not have mattered under Justice Frost's "present possessory right to part of the corpus" test, but it may have mattered under Chief Justice Hedges' "interest in the trust corpus" test.

- Justice Frost's view was dictated by the unambiguous language of the two trust instruments. Chief Justice Hedges' view was influenced by the facts, particularly (initially) that the husband deposited both principal and interest payments on the promissory notes in his personal account, reported the income on his personal tax return, and listed trust property on his personal financial statement. In the end however, the absence of evidence that the HEMS standard had been respected was treated by Chief Justice Hedges as an indication that the HEMS standard had been violated. This is an interesting assumption; one could argue that the presumption of community would have put the burden on the husband to prove that he had violated his duties as trustee owed to the remainder beneficiaries.

- Justice Frost accepted the view that income on trust corpus held pursuant to a testamentary trust, when distributed, is received by the beneficiary as a gift or inheritance.

- Justice Frost's depiction of previous trust cases, as presenting an array of choices to pick from, tends to minimize differences in the factual circumstances of prior cases. The wide variety of facts in trust cases makes it difficult to derive a uniform rule to apply in all future cases.

f. Agreement from San Antonio. The San Antonio Court of Appeals agreed with the *Sharma* rule that distributions from a testamentary or inter vivos trust to a married beneficiary are community property only if the recipient has a present possessory right to part of the corpus. *Benavides v. Mathis*, 433 S.W.3d 59, 63 (Tex. App.--San Antonio 2014, pet. denied).

G. REVOCABLE TRUSTS. While no Texas appellate opinions address the subject, there are reasons to consider the income on property held in a spouse's revocable trust to be community property. The settlor of a revocable trust has an interest in the property held in trust, in that s/he can reacquire the property at will. *Moon v. Lesikar* 230 S.W.3d 800, 804 (Tex. App.--Houston [14th District] 2007, pet. denied), held that a remainder beneficiary under a revocable trust has no standing to sue over the settlor's management of the revocable trust, since the beneficiary had no pecuniary interest in the revocable trust, but Justice Guzman concurred, arguing that standing existed but no claim existed. The El Paso Court of Appeals followed Justice Guzman's concurrence, in *Mayfield v. Peck*, 546 S.W.3d 253, 262 (Tex. App.--El Paso 2017, no pet.).

Professor Featherston has written: "Community assets and quasi-community property held in trust where one or both of the spouses hold a power of revocation are likely part of the 'estate of the parties' subject to division by the divorce court in a just and right manner pursuant to Sec. 7.001 of the Texas Family Code." Thomas M. Featherston, Jr., *Handbook on Texas Marital Property Law For Estate Administration and Planning*, ch. 3, p. 66 (State Bar of Texas 40th Annual Advanced Estate Planning & Probate Court June 22-24, 2016).

H. REMAINDER INTERESTS. Some trusts, like GSTs, go on for generations. Most Texas trust-related divorce appellate opinions to date have dealt with distributions made to a primary or life beneficiary, as opposed to a remainder beneficiary. What happens when the spouse is a remainder beneficiary, and the primary beneficiary dies and the trust terminates and trust principal and accumulated undistributed income are conveyed to the beneficiary free of trust? *Currie v. Currie*, 518 S.W.2d 386, 389 (Tex. Civ. App.--San Antonio 1974, writ dismissed), held that a contingent beneficiary, who acceded to benefits upon the death of a life beneficiary, had no right to income or principal prior to accession. In *Dickinson v. Dickinson*, 324 S.W.3d 653, 658-59 (Tex. App.--Fort Worth 2010, no pet.), where the husband was a remainder beneficiary who would receive benefits after the death of his father and another person, the court held that the husband's remainder interest was received by devise and was his separate property.

XI. CRISS-CROSSING FIDUCIARY DUTIES.

A. MARRIED TRUSTEE'S FIDUCIARY DUTIES. The trustee owes a fiduciary duty to the beneficiaries of the trust, in accordance with the terms of the trust instrument. Other descriptions of fiduciary duties are stated in the Texas Trust Code and case law. In general, the statutory and case-law-derived fiduciary duties can be varied by the trust instrument, except (probably) that the duty of loyalty may be somewhat curtailed but not eliminated. If the beneficiary's spouse is included as a beneficiary in the trust instrument, the trustee's duties to that spouse again are governed by the terms of the trust agreement. Is the spouse mentioned by name, or as "the spouse of" named beneficiary? Is the spouse a primary beneficiary, or does s/he only become primary upon the death of the primary beneficiary? Is the trustee given discretion on making distributions to the spouse, or are distributions mandatory?

In the hierarchy of duties owed by a trustee, a trustee's fiduciary duty to his or her spouse is clearly subordinate to the trustee's fiduciary duty to trust beneficiaries under the trust instrument, the Texas Trust Code, and common law.

B. TRUSTEE/BENEFICIARY. In recent decades, it has become fashionable for family estate planners and trust drafters to make the trust beneficiaries the trustees of their own trusts. As long as the discretion to make distributions for their own benefit is governed by an ascertainable standard (i.e., HEMS), the IRS will recognize the trust as a separate tax-paying entity. In a divorce, the other spouse may claim that the spouse/trustee managed the trust in fraud of the other spouse or of the community estate. The author is aware of several cases where much money was spent on such claims, but not aware of any such claim succeeding in a trial. [Please email the author if you know of such a case.]

Spouses sometimes claim that investments made by the trustee/spouse during the marriage should have been made by the beneficiary/spouse as a community property investment instead of a trust investment. There are three problems with such claims. The first, is that the so-called "community opportunity doctrine," although much talked about, has never been held by a Texas appellate court to be a valid claim in Texas. The second is that the trust instrument's spendthrift clause precludes creditors of a beneficiary from reaching property held in trust in satisfaction of claims against the beneficiary. The third is that a spouse of a beneficiary may have no standing to attack a trust or seek trust property because s/he is not an "interested person" with standing to attack the trust. *Lemke v. Lemke*, 929 S.W.2d 666 (Tex. App.--Fort Worth 1996, writ denied).

C. TRUST PROPERTY HELD IN NAME OF BENEFICIARY. Some trust instruments permit a trustee/beneficiary to hold trust assets in the name of a beneficiary. There is nothing wrong with this. The settlor is free to lay down whatever rules s/he wants in the trust instrument. If this occurs, and the other spouse makes a claim of community property, and the court must decide if the assets in question are trust property or marital property. The initial presumption of community property set out in Texas Family Code Section 3.003(a) applies to any asset possessed by a spouse during marriage but the elevated burden to prove separate property by clear and convincing evidence does not apply to proving that property is held in trust. Since Section 3.003(a) gives only a starting presumption and not the burden of persuasion for a finding of trust property, a question arises whether Section 3.003(a) is a Thayer-like presumption that disappears from the case when controverting evidence is admitted, or a Morgan-like presumption that places the burden of persuasion on the adverse party. *See Weed v. Frost Bank*, 565 S.W.3d 397 (Tex. App.--San Antonio, pet. denied). The fact that Section 3.003(b) states the burden of persuasion for proving separate property, suggests that Section 3.003(a) allocates the burden of producing evidence but not the burden of persuasion. If the community property claim is brought against a spouse/beneficiary possessing property titled in the name of the trust, it would seem that the spouse possessing the property would have the burden to produce evidence that the property is trust property, and the burden would then shift to the party claiming a community property interest to prove that trust property was distributed to the other spouse, in which event the burden would then be on the beneficiary/spouse to prove separate property. The jury questions might be: Question 1: Do you find from a preponderance of the evidence that Property A is owned by [spouse] free of trust? If so, answer Question 2 (a); otherwise do not answer Question 2. Question 2: Do you find from the clear and convincing evidence that Property A is [spouse's] separate property?

D. OTHER FIDUCIARY DUTIES. If other types of entities are involved in the case, there can be more fiduciary duties to consider. Formal fiduciary duties (i.e., recognized by operation of law) have been recognized for agent/principal, trustee/beneficiary, attorney/client, administrator/executor/devisees, guardian/ward, partner/partner, joint venturer/joint venturer, corporate directors-officers-managers/company & owners & creditors, the holder of the executive right to lease minerals/other interest owners, spouse/spouse, parent/child. The managers of an LLC do not as a matter of law owe a fiduciary duty to members, nor do members automatically owed a fiduciary duty to other members. An informal fiduciary relationship (confidential relationship) can spring from moral, social, domestic, or merely personal relationships, where

one party has developed a degree of trust and reliance on another person. The relationship must pre-exist the transaction in question in order to impose a fiduciary duty based on such a relationship. These matters are explored in greater detail in Orsinger, *The Clash of Business Fiduciary Duties With Other Duties*, State Bar of Texas' 15th Annual Fiduciary Litigation Course (Dec. 10-11, 2020), available in the State Bar of Texas On-Line Library or at:
<https://www.orsinger.com/s/The-Clash-of-Business-Fiduciary-Duties-With-Other-Fiduciary-Duties-Dec.2020>.