DEALING WITH UNUSUAL TRUSTS

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CHAPTER 2

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"Temporary Orders: Yes, It's Really a Trial - How to Get Prepared," 32nd Annual Advanced Family Law Course, San Antonio, Texas, August 2006.

"Should the Abuse of Discretion Standard in Child Custody Cases Be Re-Examined?,The Appellate Advocate, State Bar Appellate Practice & Advocacy Section Vol. XVIII, No. 5 (Summer 2006)

"Witness Preparation," Family Law on the Front Lines, Galveston, Texas, June 2006.

"The 10 Biggest Mistakes Physicians Make in a Divorce", THE BIGGEST LEGAL MISTAKES THAT PHYSICIANS MAKE AND HOW TO AVOID THEM (SEAK, Inc. 2005).

"Family Law Case Update," 20th Annual Texas Association of Domestic Relations Offices Conference, Austin 2004.

"Appeals and Mandamus - How to Repair Your Case and Prevent the Need for Repairs (or What to Do When Your Case is in the Ditch)", 29th Annual Advanced Family Law Course, San Antonio, Texas, August 2003.

"Early Stage Companies," Family Advocate, Vol. 25, No. 3, American Bar Association Winter 2003.

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"Business Interests: Characterization as Separate or Community Interests,"Expert Witness Manual, Volume I, Chapter 2-9, State Bar of Texas August 2002.

"Contesting and Defending Premarital Agreements", 28th Annual Advanced Family Law Course, Dallas, Texas, August 2002.

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"Valuation of Law Practice in Divorce," American Academy of Matrimonial Lawyers, Sanibel, Florida March 2002.

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"Professional Partings: Valuing Medical/Legal Professional Practices", 27th Annual Advanced Family Law Course, San Antonio, Texas, August 2001.

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Internal Procedures in the Texas Supreme Court, 26 TEX. TECH L. REV. 935 (1995)

"Internal Procedures and Motion Practice in the Supreme Court," Seventh Annual Advanced Civil Appellate Practice Course, Austin 1993 (speaker and author)

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DEALING WITH UNUSUAL TRUSTS

I. INTRODUCTION

This Article is the compilation of several other articles. It discusses the interface between Texas divorce law and the law of trusts. It includes an analysis of the law relating to gift and inheritance, and consideration of express, resulting and constructive trusts as well as estate planning trusts and offshore trusts. The Article also analyzes possible ways to attack express trusts.

II. GIFT

A gift is a transfer of property made voluntarily and gratuitously. *Hilley v. Hilley*, 161 Tex. 569, 342 S.W.2d 565, 568 (Tex. 1961). A gift requires: 1) an intent to make a gift; 2) delivery of the property; and 3) acceptance of the property. *See Grimsley v. Grimsley*, 632 S.W.2d 174, 177 (Tex. App.--Corpus Christi 1982, no writ). The burden of proving a gift is on the party claiming the gift. *Woodworth v. Cortez*, 660 S.W.2d 561, 564 (Tex. App.--San Antonio 1983, writ ref'd n.r.e.).

A. Lack of Consideration

Lack of consideration is an essential characteristic of a gift; an exchange of consideration precludes a gift. *Pemelton v. Pemelton*, 809 S.W.2d 642, 647 (Tex. App.--Corpus Christi 1991), *rev'd on other grounds sub nom. Heggen v. Pemelton*, 836 S.W.2d 145 (Tex. 1992); *Kunkel v. Kunkel*, 515 S.W.2d 941 (Tex. Civ. App.--Amarillo 1974, writ ref'd n.r.e.). "Gift" and "onerous consideration" are exact antitheses and a recital of onerous consideration "negatives the idea of a gift." *Pemelton*, 809 S.W.2d at 647; *Ellebracht v. Ellebracht*, 735 S.W.2d 658, 659 (Tex. App.--Austin 1987, no writ); *Kitchens v. Kitchens*, 372 S.W.2d 249, 255 (Tex. Civ. App.--Waco 1963, writ dism'd). An exchange of consideration precludes a gift. *Williams v. McKnight*, 402 S.W.2d 505, 508 (Tex. 1966). *See Saldana v. Saldana*, 791 S.W.2d 316, 319 (Tex. App.--Corpus Christi 1990, no writ) (wife's testimony that she paid $ 10.00 to husband's mother in exchange for real estate was sufficient to support the trial court's finding that the property was community property and not gift).

1. Donative Intent

A controlling factor in establishing a gift is the donative intent of the grantor at the time of the conveyance. *Ellebracht*, 735 S.W.2d at 659. In *Scott v. Scott*, 805 S.W.2d 835, 839-40 (Tex. App.--Waco 1991, writ denied), the jury found that the wife did not make a gift of money to the husband, even though she put a $ 100,000 certificate of deposit in his name alone. A gift cannot occur without the intent to make a gift. *Campbell v. Campbell*, 587 S.W.2d 513, 514 (Tex. Civ. App.--Dallas 1979, no writ). In *Scott*, the wife testified she had no donative intent, the jury believed her, and the appellate court affirmed. *See Haile v. Holtzclaw*, 414 S.W.2d 916, 927 (Tex. 1967) (proper to find gift based on circumstances, despite transferor's testimony of no donative intent.)

2. Transfer from Parent to Child Presumptively Gift

A conveyance of title from parent to child is presumed to be a gift, but the presumption is rebuttable by evidence showing the facts and circumstances surrounding the deed's execution in addition to the deed's recitations. *Woodworth v. Cortez*, 660 S.W.2d 561, 564 (Tex. App.--San Antonio 1983, writ ref'd n.r.e.).

3. Gift to Both Spouses

A gift made by a third party to both spouses leaves the spouses owning the gifted asset in equal undivided one-half separate property interests. *Roosth v. Roosth*, 889 S.W.2d 445, 457 (Tex. App.--Houston [14th Dist.] 1994, writ denied) (engagement gifts and wedding gifts to both spouses were one-half the separate property of each); *Kamel v. Kamel*, 721 S.W.2d 450, 452 (Tex. App.--Tyler 1986, no writ) (where husband's father made payments on a liability owed by both spouses, the payments were a gift one-half to each spouse).

4. Gift Between Spouses

A spouse can make a gift of community property to the other spouse. *See Pankhurst v. Weitinger & Tucker*, 850 S.W.2d 726, 730 (Tex. App.--Corpus Christi 1993, writ denied) (husband gave one-half of his community property interest in a cause of action to wife, to hold as her separate property). When one spouse makes a gift of property to the other spouse, the gift is presumed to include all the income or property which might arise from the property given. TEX. CONST. art XVI, § 15, TEX. FAM. CODE § 3.005.

5. Gift of Encumbered Property

A grantor may make a gift of encumbered property and the conveyance may be a gift even if the grantee assumes an obligation to extinguish the encumbrance. *Taylor v. Sanford*, 108 Tex. 340,

193 S.W. 661, 662 (1917); *Kiel v. Brinkman*, 668 S.W.2d 926, 929 (Tex. App.--Houston [14th Dist.] 1984, no writ) (no showing that parents transferred land to son *in exchange* for his extinguishing the debt); *Van v. Webb*, 237 S.W.2d 827, 832 (Tex. Civ. App.--Amarillo 1951, writ ref'd n.r.e.).

III. DEVISE AND DESCENT

Tex. Const. art. XVI, § 15, and TEX. FAM. CODE § 3.001(2) prescribe that property acquired during marriage by devise or descent are separate property. PJC 202.03 defines "devise" as "acquisition of property by last will and testament. PJC 202.03 defines "descent" as "acquisition of property by inheritance without a will."

Under Texas law, legal title vests in estate beneficiaries immediately upon the death of the donor. TEX. PROB. CODE § 37; *Dyer v. Eckols*, 808 S.W.2d 531, 533 (Tex. App.--Houston [14th Dist.] 1991, writ dism'd by agr.). An argument can therefore be made that income of an estate is community property of the married heirs or devisees, even though the assets are titled in the decedent and the income arising from the assets may still be in the hands of the executor.

IV. COMMUNITY PROPERTY HELD BY SPOUSES WITH RIGHT OF SURVIVORSHIP

TEX. CONST. art. XVI, § 15, and TEX. PROB. CODE § 451, permit spouses to hold community property with a right to survivorship in the surviving spouse. The Constitution says that the spouses "may agree in writing." The Probate Code says that an agreement between spouses creating a right of survivorship in community property "must be in writing and signed by both spouses." TEX. PROB. CODE § 452. Upon death, the transfer to the surviving spouse occurs as a result of the agreement, and is not considered to be a testamentary transfer. *Id.* at § 454.

V. CATEGORIES OF TRUSTS

Trusts can be broken down into two categories: (1) testamentary trusts, which are trusts created by a will, and (2) inter vivos, or living trusts, which are created by a person or persons who are still alive. Inter vivos trusts are further divided into two categories: revocable and irrevocable. A revocable trust is one that can be amended or terminated by the settlor. On the other hand, an irrevocable trust is one that cannot be amended or terminated by the settlor for some period of time. In Texas, all trusts are revocable unless the trust document expressly states otherwise. TEX. PROP. CODE § 112.051(a).

The Supreme Court of Texas has recognized three types 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. The 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.* (Vernon 1960); *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. 111-115 (Vernon 1995 & Supp. 1998). 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. The 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, must be modified for transactions involving spouses. With spouses, the inception of title rule applies, so that a resulting trust can arise only at the inception of title, even if title passes at a later time. 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, a resulting trust in favor of the community even where title is held in the name of one spouse alone. *See* TEX. FAM. CODE § 3.003.

C. The 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).

VI. "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.]

VII. HOW TO CREATE AN EXPRESS TRUST.

According to §112.00 of the Texas Trust Code, a trust may be created by: (i) a property owner's declaration that the owner holds the property as trustee for another person; (ii) a property owner's inter vivos transfer of the property to another person as trustee for the transferor or a third person; (iii) a property owner's testamentary transfer to another person as trustee for a third person; (iv) an appointment under a power of appointment to another person as trustee for the donee of the power or for a third person; or (v) a promise to another person whose rights under the promise are to be held in trust for a third person.

A. Intent to Create.

It must be clear from the instrument that the settlor manifested an intention to create the trust. Texas Trust Code §112.002.

B. Consideration Not Necessary.

No consideration is necessary to create a valid express trust. However, a promise to create a trust in the future is valid only if it meets the requirements of an enforceable contract. Texas Trust Code §112.003.

C. Necessity of Written Instrument.

It is mandatory that the terms of the express trust in real or personal property be in writing and be signed by the settlor, or his authorized agent. Texas Trust Code §112.004. A trust consisting of personal property is only enforceable if: 1) the trust property is transferred to a trustee who is neither the settlor or beneficiary, if the transferor expresses simultaneously with, or prior to the transfer the intention to create a trust; 2) there is a written declaration by the owner that the owner holds the property for another, or for the owner and another person as beneficiary. Texas Trust Code §112.004.

D. Trust Property Must Be in Existence.

A trust cannot be created unless there is trust property. Texas Trust Code §112.005. One dollar has been held as sufficient to create a valid trust. *In Re the Estate of Canales*, 837 S.W.2d 662, 664 (Tex. App. -San Antonio 1992, no writ).

E. Settlor's Capacity.

The capacity to create a trust is determined in the same manner as that of any other person to transfer, will or appoint free of trust. Texas Trust Code §112.007. This would also encompass the authority of the settlor to transfer or will community property.

F. Capacity of Trustee.

The trustee must have the legal capacity to take, hold and transfer the trust property. If a corporate trustee, it must have powers to act under state law. Additionally, the settlor of a trust may be the trustee of the trust. Texas Trust Code §112.008.

G. Acceptance by Trustee.

The signature of the person named as trustee on the writing evidencing the trust or on a separate written acceptance is conclusive evidence that the person accepted the trust. A person named as trustee who exercises power or performs duties under the trust is presumed to have accepted the trust. However, a person named as trustee who does not accept the trust incurs no liability with respect to the trust. Texas Trust Code § 112.009.

H. Trust Purposes.

A trust may be created for any purpose that is not illegal. Additionally, the terms of the trust may not require the trustee to commit a criminal or tortuous act or an act that is contrary to public policy. Texas Trust Code § 112.031.

I. Merger of Legal and Beneficial Title = NO TRUST.

When both the legal and beneficial title to property is transferred to the same person, no trust is created and the transferee holds the property as his own. If the equitable and legal title merge in the grantor, he then holds the property free of trust. Texas Trust Code §112.034.

J. Revocation. Modification and Amendment.

Unless made irrevocable by the expressed terms of the trust or amendment, a grantor retains the right to modify the terms of a trust. However, the duties may not be enlarged without the consent of the trustee. If the trust was created by written instrument, the revocation, modification, or amendment must also be in writing. Texas Trust Code §112.051.

K. Judicial Modification or Termination.

A trustee or beneficiary may petition a court to modify the terms of the trust, enlarge or restrict the trustee's power, or request that the trust be terminated. However, the court's authority to modify or terminate a trust is limited. A request to terminate or modify a trust can only be granted if: 1) the purposes of the trust have been fulfilled; 2) the purposes of the trust have become illegal or impossible to fulfill, or 3) because of circumstances not known to or anticipated by the settlor, compliance with the terms of the trust would defeat or substantially impair the purposes of the trust. Texas Trust Code §112.054.

Query: What authority does the divorce court have to modify the terms of the trust allegedly improperly created without consent of one of the spouses? What about trust property that is under the sole management and control of one of the spouses?

VIII. PROPERTY HELD IN EXPRESS TRUST

Property held by a trustee for the benefit of a spouse is not owned by a spouse, and cannot be marital property. However, where the spouse/beneficiary has an unconditional right to have the property free of trust, then the property is treated as if it is owned by the spouse, even though still in the hands of the trustee. Where the spouse is both settlor and beneficiary of the trust, the income of the trust property is likely community income. Where the trust is established by gift or will, case law is conflicting as to whether trust distributions of income are separate or community property.

A. Assets Held in Trust for Spouse

1. <u>What is an "Express Trust"?</u>

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. Literally speaking, under Texas property law, a trust is not an entity, like a corporation. It is a *relationship*, between an individual (i.e., the trustee) and certain property. Thus, it is not really accurate to talk about "commingling inside of a trust," or "the character of distributions from a trust." We should instead talk of the commingling of property held by a trustee, or the character of distributions by a trustee of property held in trust.

2. <u>"Trust" Accounts</u>

In Texas, the act of depositing funds in an account designated as a "trust account" for another person does not establish an express trust for the other person's benefit. Recitals on the bank signature card that the funds are held "in trust" for another are evidentiary only, and do not give rise to a presumption that a trust was intended. *Fleck v. Baldwin*, 141 Tex. 340, 172 S.W.2d 975, 978 (1943). Probate Code Section 438, provides:

> A joint account belongs, during the lifetime of all parties, to the parties in proportion to the net contributions by each to the sums on deposit, unless there is clear and convincing evidence of a different intent.

TEX. PROB. CODE § 438. This statute establishes a presumption that depositing funds into a joint account does not constitute a gift or other transfer of ownership. The statute also puts the burden on the party claiming transfer to prove *on clear and convincing evidence* that a transfer of ownership to him/her occurred.

In connection with a "trust account," case law requires that the settlor 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 is found to have been intended, it is a revocable inter vivos trust, which terminates upon the death of the settlor/trustee and 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").

3. Securities Held in Settlor's Name, "as Trustee"

The rules discussed above for funds on deposit "in trust" for another also apply to securities held "in trust" for 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.

4. Undistributed Assets Held in Discretionary Distribution Trust Are Not Marital Property

According to the following cases, property held in trust for a spouse was 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). This is not so, however, when assets are voluntarily left with the trustee. *See In re Marriage of Long*, 542 S.W.2d 712 (Tex. Civ. App.--Texarkana 1976, no writ) (where one half of the corpus of the trust had passed to the husband free of trust, the income on that half of the corpus belonged to the community, despite the fact that the husband left that half in the hands of the trustee). Additionally, trust income that a married beneficiary does not receive, and to which he has no claim other than an expectancy interest in the corpus, has been held to constitute separate property. *Cleaver v. George Staton, Co.*, 908 S.W.2d 468, 470 (Tex. App--Tyler 1995, writ denied), *Ridgell v. Ridgell*, 960 S.W.2d 144 (Tex.App. -Corpus Christi 1997, no writ).

In *Hardin v. Hardin*, the court characterized a husband's interest in a trust as a separate property gift. 681 S.W.2d 241, 242 (Tex. App.–San Antonio, 1984, no writ). The husband's beneficial interest in the trust was created by a former employer, after Mr. Hardin had retired, in appreciation for his service. Id. The court held that this interest was acquired by gift and was properly characterized as his separate property, "(s)ince the employer was under no obligation to establish the trust or to make any payments to the husband at the time of his retirement. *Id.* at 242-243. *See also In the Matter of the Marriage of Burns*, 573 S.W.2d 555, 557 (Tex.Civ.App. – Texarkana 1978, writ dism'd) where it was undisputed that a testamentary trust interest created by the husband's parents was his separate property.

B. Assets Distributed from Trust to Spouse

1. Where Spouse Creates Trust for His/Her Own Benefit Using Own Assets

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, is 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 the case of *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. 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 corpus distributed out of the self-created trust was received by the spouse as separate property. *Id.* at 150.

If the income distribution is discretionary as opposed to mandatory, the undistributed income will likely remain separate. *Lemke v. Lemke*, 929 S.W.2d 662, 664 (Tex. App. - Fort Worth 1996, writ denied). Prior to marriage, Mr. Lemke as settlor, created an irrevocable spendthrift trust with proceeds he had received from a personal injury settlement. He was the sole beneficiary and a third party was named as trustee. Upon divorce wife argued that the undistributed income of the trust was community. *Id.*at 663. In rejecting her claim the court, citing *Burns*, held that there being no evidence that the trust was created in fraud of wife or evidence that husband had neither actually or constructively, acquired the undistributed income, the community estate had no interest. *Id.*at 664. The court followed the rationale in *Burns* by stating that the undistributed income remained a part of the trust and was not community. *Id.* It should be noted that the court emphasized the presence of the spendthrift provision, but never really explains the importance of such term as it relates to their decision. In another case involving the characterization of accumulated undistributed earnings the *Lemke* holding was followed. *Lipsey v. Lipsey*, 983 S.W.2d 345, 347 (Tex. App. - Fort Worth 1998, no writ). Prior to his marriage, Husband had rolled over his retirement plan into a 401(k) plan. Under the terms of the plan, husband could not demand distributions until he was 70 years of age. The trial court found the plan to be separate, but the increase in the plan value to be community. *Id.*at 347. Husband appealed the characterization of that increase in value as community property. Wife argued that under ERISA she was automatically deemed husband's beneficiary, and as such, she had a cognizable interest in the plan during marriage. *Id.*at 348. This contention was rejected by the appellate court. Absent fraud, a spouse may create a trust from separate property, and so long as the income remains undistributed during marriage and there is no right to compel distribution, the income is not acquired during marriage and remains separate trust property. *Id.*at 351. Query: Would there be a different result if husband had begun receiving distributions?

2. Trust Funded by Gift or Devise

There are a number of cases which say that income from a trust which was created in a separate property manner (i.e., by will or by gift) 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 most often quoted of the 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 *Mc-Clelland*, 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).

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 the case of *In re Marriage of Thurmond*, 888 S.W.2d 269, 272-75 (Tex. App.--Amarillo 1994, writ denied), 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 Tax Court case has 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. This occurred in *Wilmington Trust Co. v. United States*, 83-2 USTC (1983). 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.
>
> 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 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).

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 cites *Commissioner v. Porter*, 148 F.2d 566, 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 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. *Long* can be read as tacitly agreeing that distributed income from a trust can be community property.

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. 1935), the Fifth Circuit held that income from property held in trust for a married man was received by him as community property, although the corpus was not community property. However, 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.

3. Commingling Inside Trust

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, which is created by gift of their parents, hold that interest 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 corpus of the 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 the gross income was commingled in trust bank accounts with separate

property receipts, the whole fund became community property, and the subsequently-acquired property was community in nature, and the oil income therefrom was similarly community.

C. TUTMA and Trusts.

The family law practitioner should also be familiar with the difference between Texas Uniform Transfers to Minors Act (TUTMA) and the formation of an express trust for the benefit of the children of one or both spouses. Tex. Prop. Code §141.001, *et seq.* [Comment: *The TUTMA is the successor to the former TUGMA which was amended Sept. 1, 1997 to create the current act. The TUTMA validates all similar transfers made prior to the effective date of the new act*]. These are two entirely different methods of financially providing for minors and will have a tremendous impact on the divorce court's ability to divide the assets contained in one of those forms of transfer. Depending upon the revocability of the trust document, the intent of the settlor(s), and the source of the property used to fund a trust for a spouse's child, a divorce court may be able to reach the trust assets and divide them upon divorce. *See Land v. Marshall*, *supra*. However, TUTMAs are a different story. When property is transferred pursuant the TUTMA, the assets so transferred indefeasibly vest in the minor and is irrevocable. Tex. Prop. Code §141.012(b) . Invariably, the family law practitioner is faced with the case where one of the spouses has transferred community property under TUTMA for or more of the children. Based upon the rationale in *Land v. Marshall*, if the transfer was not authorized by one of the spouses ,the only remedy will most likely be a judgment (recoupment) for the one-half of the unauthorized transferred funds in favor of the non consenting spouse. Apparently the trial court does not have the power or authority to order removal of any assets from the TUTMA. *See In the Matter of the Marriage of McCurdy*, 489 S.W.2d 712, 717 (Tex. Civ. App. - Amarillo 1973, writ dism'd). (Where community funds used for TUGMA accounts constituted a relatively high percentage of the total community estate and wife's consent was questionable, the trial court did not err in awarding judgment against husband for approximately one half of the value of the accounts). Bottom line on transfers made under TUTMA: once the assets go in, they ain't coming out unless it is disbursed pursuant to the Act.

IX. 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).

A. (GST) Generation-skipping Dynasty Trust

A GST is created by the older generation for the benefit of children, grandchildren and even great grandchildren. The trust corpus remains in the trust for as many generations as possible, sometimes capped 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 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 Rule, 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 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 who are in succeeding generations. The trust assets are not included in the taxable estate of each generation to die. Sometimes the beneficiaries will have limited powers of appointment that permit them to control to some extent how the assets flow to the next generation. Often a trust beneficiary is trustee or co-trustee. Usually there is discretionary distribution of corpus and income.

B. QPRT (Qualified Personal Residence Trust)

A personal residence, such as a principal residence or a vacation home, may be transferred to a Qualified Personal Residence Trust. ("QPRT"), an irrevocable trust. If this is done, the

property can continue to be used by the transferor during his or her life or for a term of years such as ten or twenty years. At the end of the term the trust terminates, and the residence or vacation home passes to the remaindermen of the trust at a transfer tax cost based on its current value reduced by the value of the taxpayer's right to occupy the residence or vacation home for the term of the trust, i.e. the value of the remainder, not the full fair market value of the residence. The longer the term of a QPRT, the less the current value of the gifted remainder interest. All the income and expenses of the residence or vacation home flow through to the taxpayer's personal income tax return. If the grantor is the trustee, no trust income tax return need be filed. If the grantor survives the term of the QRPT, there is no interest passing to his or her children at the end of the term; they were previously given the residence subject to a term of years that has now expired. At the end of the life estate or term of years, the children have the entire residence together with all increases and appreciation from the date the property was originally placed in trust. If the trustor dies during the term, the residence goes to the trustor's estate or revocable inter-vivos trust, and the residence is included in the taxpayer's gross estate for estate tax purposes. I.R.C. § 2036.

Query: If the trust is funded with a residence that consists of community property, what happens in the event of a divorce? The initial reaction might be to allocate the residence held in trust to one spouse in exchange for that spouse's interest in another asset. However, the sale of the residence by the trust, directly or indirectly, to the grantor or grantor's spouse is specifically prohibited as is the sale to another grantor trust of the grantor or grantor's spouse. Treas. Reg. § 25.2702-5(c)(9).

Query: Would the exchange of a residence held in trust to one spouse in exchange for that spouse's interest in another asset constitute a sale since the division of property at the time of divorce constitutes a non-taxable transaction?

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, 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 greatly reduced value, while retaining a finite stream of payments for the grantor. The value of the gift into trust is measured by the remainder interest. Appreciation on the corpus during the life of the trust passes to the remaindermen without gift tax.

E. Life Insurance Trust.

Irrevocable life insurance trusts have been extensively used to remove death benefits from an insured decedent's estate for estate tax purposes, allowing death benefits to be paid to beneficiaries free of income and estate tax. An irrevocable trust that owns a life insurance policy insuring the life of a decedent successfully removes the proceeds of the policy from his or her estate if: (1) the trust has an independent trustee; (2) the premiums are paid by the trust; (3) the decedent has none of the incidents of ownership of the policy; and 4) if the proceeds are payable to the trust.

In Texas, estate planners should advise a client who is setting up a life insurance trust that the gifts to the trust are to be made from the separate property cash of the insured. This can frequently be accomplished by the Husband and Wife executing annual partition and exchange agreements, which have the effect of partitioning cash, which would in turn create separate property cash for the insured to make the required gift. On the other hand, if community cash were used to make the gift, a portion of the life insurance proceeds would be included in the estate of the insured spouse under §2036 of the Internal Revenue Code.

F. Inter Vivos or Living Trust.

The Inter Vivos or Living Trust is a type of trust that says how you want property you put into the trust to be managed and distributed. This type of trust can be revocable or irrevocable. If the trust is revocable, it can be changed or revoked.

The living trust can be a means of avoiding probate and keeping the family wealth a private matter. It can also be an effective means of avoiding an ancillary probate when out-of-state realty is involved, even if it is funded only with the out-of-state realty. Furthermore, the Inter Vivos or Living Trust may also be an effective tool in

planning for the incapacity of a spouse. However, the use of this type of trust for some or all of these purposes may affect either or both spouses' marital property rights in the assets used to fund the trust during their lifetime.

G. Q-Tip Trust.

The Q-Tip Trust is an exception to the terminable interest rule because on a certain event the property will pass to someone other than the surviving spouse. The Q-Tip Trust is nothing more than an interest in property which passes from the decedent and in which the surviving spouse has a "qualifying income interest" for life and for which a qualifying election is made.

An example of the language used for a Q-Tip Trust would be as follows:

> "The trustee shall pay all the income to my spouse in at least annual installments. On the death of my wife, assets of this trust shall pass to my children."

H. §2503(C) Trust.

A 2503(c) Trust receives assets that are to vest in the beneficiary at the age of 21. The Trustee may distribute income and/or principal to the beneficiary prior to the time the beneficiary reaches the age of 21. Gifts to this type of trust qualify for the annual gift tax exclusion (presently $12,000 per donor). The trust instrument may provide the beneficiary with withdrawal right(s) when the beneficiary attains the age of 21. However, in the event that right is waived, the trust continues. Although the trust assets are considered to be the separate estate of the beneficiary, income earned on the trust assets (such as dividends, interest, and rents) during marriage are community property, even if they are retained in the trust after the 21st birthday. The family law practitioner should investigate relevant dates and birthdates in a situation involving a trust of this type in order to determine if tracing is necessary to prove up the portion of trust assets claimed as separate property.

X. 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. Several possible methods to defeat or penetrate express trusts are outlined below.

A. 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 bank account with a signature card reading "in trust," or securities held "as trustee" for another, are so informal that a clear intention to create a trust is not readily ascertainable from the documentation.

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 Supreme Court of Colorado.

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 restricted approach to parol evidence. In *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 an 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 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); RESTATEMENT (SECOND) OF TRUSTS §§ 23 & 24 (1959).

B. Failure in Mechanics of Creation

The Texas Trust Code has certain 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 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).

a. Exception for Personalty

There are two exceptions to this rule, for trusts which involve only personalty.

(1) 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.

(2) 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 (Vernon 1995). 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). This exception would also apply to stocks, bonds, CD's, etc. 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.).

b. No Exception for Realty.

No exception to the requirement of a writing exists for realty. Thus, 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.

c. Resulting and Constructive Trusts Outside of Rule

The Texas Trust Code, by its very terms, does not apply to resulting or constructive trusts. TEX. PROP. CODE § 111.003. Cases also hold that the requirement of a writing, contained in the old Trust Act, and in the statute of frauds provisions of the Property 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 to be valid. *Cutrer v. Cutrer*, 334 S.W.2d 599, 605 (Tex. Civ. App.--San Antonio 1960), *aff'd*, 162 Tex. 166, 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.

C. 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*, 100 Tex. 550, 101 S.W. 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 w.o.m.). 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.

The doctrine of "dry trust" was explored in *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.

1. <u>Cases From Other States</u>

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

a. Pennsylvania

The Supreme Court of Pennsylvania addressed the doctrine of dry trust in connection with a fraudulent conveyance. 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.

D. 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.

See generally Simpkins, TEXAS FAMILY LAW § 21:24 (5th ed. 1976); *Husband as Manager of the Community Estate: Illusory Trusts*, 10 S. TEX. L.J. 301 (1968); *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.

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, 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).]

4. Spouse's Participation Forecloses Attack.

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).

5. Law From Other Jurisdictions

The illusory trust doctrine has been litigated in a number of other jurisdictions.

a. Massachusetts

The high court of Massachusetts considered the illusory trust doctrine, in the case of *Sullivan v. Burkin*, 390 Mass. 864, 460 N.E.2d 572 (1984). Reversing precedent, the Court announced that the estate of the decedent would, for purposes of the surviving spouse's heirship rights, include "the value of assets held in an inter vivos trust created by the deceased spouse as to which the deceased spouse alone retained the power during his or her life to direct the disposition of those trust assets for his or her benefit, as, for example, by the exercise of a power of appointment or by revocation of the trust." *Id.* at 574-75. The rule was to be applied prospectively only. The Court preferred its definite standard to the "rather unsatisfactory process of determining whether the inter vivos trust was, on some standard, 'colorable,' 'fraudulent,' or 'illusory.'" *Id.* at 577. The Court also saw itself as bringing the heirship law into line with the equitable distribution law applicable to divorce proceedings in Massachusetts. The Court observed:

> The interests of one spouse in the property of the other have been substantially increased upon the dissolution of a marriage by divorce. . . . It is neither equitable nor logical to extend to a divorced spouse greater rights in the assets of an inter vivos trust created and controlled by the other spouse than are extended to a spouse who remains married until the death of his or her spouse.

Id. at 577.

> The rule announced in *Sullivan* accomplishes much the same effect as the illusory trust doctrine in Texas and some other states. However, the rule in Massachusetts is probably a matter of law for the court, whereas the illusory trust doctrine in Texas may involve fact issues. Note that the illusory trust doctrine of *Land v. Marshall* extends only to community property, and not to property acquired by spouses while domiciled in other jurisdictions, which would be divisible in a Texas divorce. Perhaps that discontinuity between spousal rights in property on divorce and on death in Texas should be addressed by Texas legislature.

b. New York

One of the leading cases on illusory trusts is *Newman v. Dore*, 275 N.Y. 371, 9 N.E.2d 966 (1937), a case cited in *Land v. Marshall*. In *Newman*, the husband by will created a trust for the benefit of his wife, to contain one-third of his property, and to pay her the income for life. Under New York law, this provision in his will eliminated the wife's right to elect to partake of the husband's estate, as if he died intestate. Three days before his death, the husband conveyed all of his property into a trust. If the trust was valid, his widow would get none of his estate, since the provision in the will eliminated her widow's election, and there was no property on hand to fund her testamentary trust. The trial judge invalidated the inter vivos trust, finding that the husband's motive was to evade the laws of the state. The high court, however, concluded that "[m]otive or intent is an unsatisfactory test of the validity of a transfer of property." *Id.* at 968. "The fact that the [person] desired to evade the law, as it is called, is immaterial, because the very meaning of a line in the law is that you intentionally may go as close to it as you can if you do not pass it." *Id.* at 967 (quoting *Bullen v. Wisconsin*, 240 U.S. 625 (1916)). The Court adopted the "illusory trust" doctrine, saying:

> The test has been formulated in different ways, but in most jurisdictions the test applied is

> essentially the test of whether the husband has in good faith divested himself of ownership of his property or has made an illusory transfer. "The 'good faith' required of the donor or settlor in making a valid disposition of his property during life does not refer to the purpose to affect his wife but to the intent to divest himself of the ownership of the property. It is, therefore, apparent that the fraudulent intent which will defeat a gift inter vivos cannot be predicated on the husband's intent to deprive the wife of her distributive . . . share as a widow." Benkart v. Commonwealth Trust Co., of Pittsburgh, 269 Pa. 257, 259, 112 A. 62, 63.

Id. at 969. In *Newman*, the husband retained the income for life, and the power to revoke the trust, and also the right to control the trustees. Thus, "[j]udged by the substance, not by the form, the testator's conveyance [was] illusory, intended only as a mask for the effective retention by the settlor of the property which in form he had conveyed." *Id.* at 969. Although the judgment is not stated in the opinion, it appears that the property was included in the husband's estate, and therefore passed into the testamentary trust, for the benefit of the widow.

Newman was followed in *President & Directors of Manhattan Co. v. Janowitz*, 172 Misc. 290, 14 N.Y.S.2d 375 (1939), which said that the test was whether the settlor in good faith divested himself of ownership, or instead made an illusory transfer to hide the effective retention of the property. An illusory trust was found because the settlor reserved the right to revoke the trust, reserved income from the trust for life, and reserved substantial control over the trust during his lifetime.

An illusory trust was also found in *Burns v. Turnbull*, 266 App. Div. 779, 41 N.Y.S.2d 448 (1943), where the settlor was one of two trustees, and reserved the authority to replace the other trustee, and retained exclusive control over the corpus, and reserved the right to amend or revoke the trust.

c. Oklahoma

Oklahoma has case law applying the illusory trust doctrine. In *Thomas v. Bank of Oklahoma*, 684 P.2d 553 (Okl. 1984), the Supreme Court of Oklahoma determined that a forced heir election under Oklahoma statutes could not be defeated by placing assets in a revocable inter vivos trust. The Court acknowledged that, under Oklahoma law, a spouse could freely give away his or her separate property, in that neither the spouse nor the children had a claim to the separate property, except insofar as the donor is liable for their support. *Id.* at 554. However, the gift must be bona fide and complete. "A gift is not a gift if the donor retains right of complete control and dominion, and especially the right to take back the "gift" at any time." *Id.* at 554. The Court relied upon Oklahoma cases holding that a gift, in which the donor retains during lifetime complete control of the property and acts as if he still owns it, creates a resulting trust only, and beneficial interest remains with the donor. The Court also cited New York and Kansas cases involving the illusory trust doctrine. The trustee argued that the Uniform Testamentary Addition to Trust Act, which declared that "pour-over" provisions in a will were valid even though the inter vivos trust to be funded upon death was revocable, established the validity of the trust. The Court rejected this argument, saying:

> We also distinguish between the general revocability of a trust, the legality of which there is not doubt, and the effect of revocability on a forced heir's right under [Oklahoma law]. Such revocable power cannot be allowed to defeat a survivor's rights to the estate.

Id. at 556. The retention by the settlor, in *Thomas*, of the right to revoke the inter vivos trust, subjected the trust assets to forced heirship.

Thomas demonstrates three important points: (i) the Court acknowledged the illusory trust doctrine; (ii) in Oklahoma, a gift to a third party creates merely a resulting trust, where the donor retains control over the property, and especially where the gift is revocable; thus, although legal title may pass, beneficial title remains with the donor, and is subject to forced heirship; (iii) the law permitting trusts to be revocable does not insulate revocable trusts from forced heirship.

d. West Virginia

The illusory trust doctrine was examined by the Supreme Court of West Virginia in *Davis v. KB & T Co.*, 309 S.E.2d 45 (W. Va. 1983). There the husband conveyed his non-tangible personalty into a trust, retaining the right to the income for life, and if his wife survived him, then to her for her life, with a remainder interest to certain named beneficiaries. The widow sued

asserting a dower interest in the property conveyed by the husband into trust. The Court said:

> The question of the validity of an inter vivos trust which impairs the statutory right of the surviving spouse to share in the settlor's estate is an issue which has been addressed in numerous jurisdictions. . . . Generally , in resolving the issue, courts have taken one of two approaches. The first approach involves a determination of whether the transfer of property is real and bona fide, or whether the settlor has reserved such powers of ownership and control over the trust property as to make the transfer illusory or testamentary in character. . . . The second approach involves examination of the question whether the transfer of property in trust constituted a fraud upon the rights of the spouse.

Id. at 49. The West Virginia Court applied both tests to the case.

In *Davis*, the primary basis for the illusory trust attack was that the husband reserved the right to amend or revoke the trust during lifetime. The Court said that "[i]t is well established, however, that the retention by the settlor of the power to revoke or modify a trust is insufficient, standing alone, to render the trust illusory or testamentary." *Id.* at 49 (citing I.A. Scott, THE LAW OF TRUSTS 57.1 (3d ed. 1967). The Court also quoted RESTATEMENT (SECOND) OF TRUSTS § 57 (1959) in support of the rule. The illusory trust attack was rejected.

E. 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 quotes different authorities on the meaning of the term "colorable," as used in this context. He concludes:

> 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). Whether the doctrine, if available at all in Texas, applies only upon the settlor's death is an open question. TEX. PROP. CODE § 112.008 (Vernon 1995).

F. 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. The doctrine might be available to contest whether certain property is actually "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 pointedly observed that the wife in that case had not challenged the husband's trust as being the alter ego of the husband.

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) (Vernon 1995) (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.

1. *Castleberry v. Branscum*

The Supreme Court examined the contours of the alter ego theory as to corporations, in great detail, 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.* at 271-73. 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 a trust relationship to property is conducted in a manner that makes the trustee an alter ego of the settlor, the beneficiary, or the person who is acting as trustee. If the facts warrant it, plead the cause of action, and if the trial judge won't go for it, take it up and see what happens.

2. Colorable Trust vs. Alter Ego

While some might wonder at the usefulness of drawing distinctions between two trust doctrines, neither of which has as yet become established law in this state, one can draw certain distinctions between a "colorable" trust and a trust relationship which is conducted so as to make the trustee the "alter ego" of the settlor, the beneficiary or the trustee. To prove that a trust is colorable, the proponent must show an agreement between the settlor and the trustee such that the settlor retains ownership of the res 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 presumably have to 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 fiduciary obligations deriving from 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, success may be available on alter ego grounds, because of the way the trust property is handled, in practice.

G. Trust as Instrument of Fraud

No Texas cases were found which disregarded the separateness of a 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 caselaw from other states is examined.

1. Comparison to Cases Piercing the Corporate Veil

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, besides 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 which apply to use of a corporation to perpetrate a fraud can be adapted to express trusts, perhaps equity will allow the court in a divorce to disregard the trust "fiction."

H. 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 defendant; (2) the victim detrimentally relied upon the false representation; and (3) injury resulted to the victim. *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. *Rumfield v. Rumfield*, 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 ref'd n.r.e.). Where the victim has 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 a 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, for example, 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 arguably exists between spouses, and the husband's failure to disclose the existence of a girlfriend or his intent to seek a divorce, the evidence should support rescission of the conveyance into trust, for fraud in the inducement. Proof of actual fraud eliminates the need to show a fiduciary relationship. *Meadows v. Bierschwale*, 516 S.W.2d 125 (Tex. 1974).

2. Accident

The Texas Supreme Court has 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, the settlor could alternatively reform the trust agreement to make it revocable, and then later exercise his power to revoke the trust.

a. 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).

b. Mistake as Basis for Rescission and Cancellation

To rescind or cancel an agreement for mistake, the mistake generally 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.). Generally, 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, which 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 after rescission. *James T. Taylor, Etc. v. Arlington Ind. School Dist.*, 335 S.W.2d 371, 373 (Tex. 1960).

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.). In the area of will contests, where undue influence 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), wherein 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 different burden of proof 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).

I. 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).

1. 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 "person who took in good faith and for a reasonably equivalent value or against any subsequent transferee or obligee."
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*, 455 S.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.

2. Debtor's Transfer Not for Value

Section 24.005 of the 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. TEX. BUS. & COM. CODE § 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*, 87 S.W.2d 765, 767 (Tex. Civ. App.--Amarillo 1935), *aff'd* 112 S.W.2d 1047 (Tex. 1938).

J. 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, etc. were the transfer into trust rescinded.

K. Fraud-on-the-spouse Doctrine

There are a number of Texas cases asserting that actual or constructive fraud can arise when a spouse gives community property to a third party. In such a situation, the court will rescind the transfer of the complaining spouse's one-half interest in the community property that was transferred. 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).

1. Actual Fraud

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 high court of Kentucky 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 PJC 206.2A (2006) 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]

2. Constructive Fraud

The authorities agree that, even without proof of actual intent to defraud the spouse, the court will rescind a transaction whereby one spouse unfairly gives away of the other spouse's one-half interest in community property. The doctrine of constructive fraud is one tool the practitioner can use to undo one spouse's conveyance of the other spouse's share 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 PJC 206.4A (2006) 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]

a. In Conveyances During Lifetime

The following cases, among others, have addressed the issue of constructive fraud-on-a-spouse in inter vivos conveyances to third parties: *Carnes v. Meador*, 533 S.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); *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); *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).

b. In Conveyances Effective Upon Death

The following cases have addressed the issue of constructive fraud-on-a-spouse in conveyances taking effect upon death: *Givens v. Girard Life Ins. Co. of America*, 480 S.W.2d 421 (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).

L. 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 no longer in trust.

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

> 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 . . . . 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, 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 and multiple beneficiaries, a unification of legal and equitable title in the trustees and beneficiaries collectively 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.

M. 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 well-recognized distinction between the validity of a transaction under state property law and the validity of the transaction for tax purposes, the parallels are inescapable. 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 local 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.

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.

N. Breaking Charitable Trusts

If someone wants to break up or break into a charitable trust, there are special problems relating to the Attorney General set out in Chapter 123 of the Texas Property Code.

1. Attorney General's Participation

The Texas Property Code gives the Texas Attorney General the right to participate in litigation relating to charitable trusts. The relevant section provides:

> § 123.002. Attorney General's Participation
>
> For and on behalf of the interest of the general public of this state in charitable trusts, the attorney general is a proper party and may intervene in a proceeding involving a charitable trust. The attorney general may join and enter into a compromise, settlement agreement, contract, or judgment relating to a proceeding involving a charitable trust.

TEX. PROP. CODE § 123.002.

2. Notice to the Attorney General

The Texas Property Code requires that the Texas Attorney General be given notice of litigation relating to charitable trusts. The relevant section provides:

> § 123.003. Notice
>
> (a) Any party initiating a proceeding involving a charitable trust shall give notice of the proceeding to the attorney general by sending to the attorney general, by registered or certified mail, a true copy of the petition or other instrument initiating the proceeding involving a charitable trust within 30 days of the filing of such petition or other instrument, but no less than 25 days prior to a hearing in such a proceeding. This subsection does not apply to a proceeding that is initiated by an application that exclusively seeks the admission of a will to probate, regardless of whether the application seeks the appointment of a personal representative, if the application:
>
> (1) is uncontested; and
> (2) is not subject to Section 83, Texas Probate Code.
>
> (b) Notice shall be given to the attorney general of any pleading which adds new causes of action or additional parties to a proceeding involving a charitable trust in which the attorney general has previously waived participation or in which the attorney general has otherwise failed to intervene. Notice shall be given by sending to the attorney general by regis-

tered or certified mail a true copy of the pleading within 30 days of the filing of the pleading, but no less than 25 days prior to a hearing in the proceeding.

(c) The party or the party's attorney shall execute and file in the proceeding an affidavit stating the facts of the notice and shall attach to the affidavit the customary postal receipts signed by the attorney general or an assistant attorney general.

TEX. PROP. CODE § 123.003.

3. Voidable Judgment or Agreement

The Texas Property Code makes a judgment involving a charitable trust voidable if the Texas Attorney General was not notified of the proceeding. The relevant section provides:

§ 123.004. Voidable Judgment or Agreement

(a) A judgment in a proceeding involving a charitable trust is voidable if the attorney general is not given notice of the proceeding as required by this chapter. On motion of the attorney general after the judgment is rendered, the judgment shall be set aside.

(b) A compromise, settlement agreement, contract, or judgment relating to a proceeding involving a charitable trust is voidable on motion of the attorney general if the attorney general is not given notice as required by this chapter unless the attorney general has:

(1) declined in writing to be a party to the proceeding; or

(2) approved and joined in the compromise, settlement agreement, contract, or judgment.

TEX. PROP. CODE § 123.004.

O. Joinder of Beneficiaries

As a general rule, both the trustees and the beneficiaries should 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 on 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 this suit must be examined to determine whether a suit may be prosecuted with the trustee without joining the beneficiaries. *Id.* at 833.

P. 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.

Q. Will Claims for Economic Contribution and Reimbursement Apply?

1. Economic Contribution. Provided that the requirements necessary to establish an economic contribution claim are present, there would be no reason why the contributing estate could not make a claim against the benefitted estate because it is a trust. TEX. FAM. CODE §3.401-3.402. A common example that family lawyers frequently encounter involves separate property trust funds being used to reduce the secured debt of the party's community property homestead. Once one has grasped the concepts and rules related to an economic contribution claim, the type of entity of the benefitted, or contributing estate, as the case may be, should make no difference. However, if the benefitted estate was a spendthrift trust, it may be doubtful whether the court could impose a foreclosable lien on the trust, or any of its assets. However, has the contributing estate really gained anything?

2. Reimbursement. The same rationale would be applied to reimbursements claims of a contributing estate. Payment by the community of income tax liability on a separate property entity such as a trust would be a good example of such a claim. As cases are reported interpreting economic contribution and reimbursement statutes, the picture may be easier to see whether these types of claims will truly be applicable to trusts.

X. OFFSHORE TRUSTS

Two of the more complicated types of trusts is the Offshore and Asset Protection Trusts. The family law practitioner usually has to know through their client or a third party that such a trust exists, as obtaining information on the trust through normal discovery means is almost impossible. Since offshore trusts are set up by account numbers, if you do not have the account number and password, you cannot obtain any information on the trust. Jurisdictions that party's often set up offshore trusts in, such as the Cook Islands or the Cayman Islands, do not recognize United States judgments. Therefore, it is extraordinarily expensive to pursue an offshore trust. In order to attack the trust, a party would have to hire local counsel in the particular jurisdiction, and there is an extremely high burden, set out below, to attack an offshore trust. The following information about offshore and asset protection trusts sets out some of the hurdles the family law practitioner has to clear, as well as some of the obstacles that need to be overcome in dealing with offshore trusts.

A. Definition of Asset Protection Trusts.

An Asset Protection Trust ("ATP") is an offshore trust structure used to protect an individual's assets from claims of potential future creditors. Basically, an APT is a trust that designates the law of a debtor-friendly jurisdiction (rather than a law of the settlor's domicile) as controlling the trust's governance and effect in order to benefit from that jurisdiction's abolition of the so-called self-settled spendthrift trust rule. Gideon Rothschild & Daniel S. Rubin*, Asset Protection After Anderson: Much Ado About Nothing?*, 26 Est. Plan. 466, 467 (December 1999).

Jurisdictions that have repealed the self-established spendthrift trust rule (such as the Cook Islands) allow a trust established for the settlor's own benefit to be protected from future (but not current) creditors. Gideon Rothschild, *Establishing and Drafting Offshore Asset Protection Trusts*, 23 Est. Plan. 65 (Feb 1996). Shielding assets from future creditors is often a major concern for individuals who are at high risk for various types of liability. APTs that allow conscientious professionals future protection against egregious malpractice claims also have the effect of leaving "involuntary" creditors with no recourse of clear remedy at law and facilitate the intentional avoidance of "current" debt owed by judgment debtors. Randall J. Gingiss, *Putting A Stop To 'Asset Protection' Trusts*, 51 Baylor L. Rev. 987, 988 (1999) (Gingiss). Placing assets in trust in a jurisdiction which will not recognize a United States judgment is a time-honored strategy to avoid the claim of creditors. Gingiss at 995.

B. Recognition and Enforcement of Foreign Judgments.

Assets held by a foreign trustee in a "tax haven" jurisdiction are virtually impossible to seize. In order for a creditor to enforce a foreign judgment and claim assets in an offshore APT, a recognition (the first step in an attempt to enforce a foreign judgment) and enforcement action must be brought in the local courts of the foreign jurisdiction where the creditor's lawyer is not licensed to practice law, not afforded the opportunity to come before the local court pro hac vice, and is rarely (only when extremely lucky, stars are perfectly aligned and the moon is as close as it has been in 400 years) allowed to sit at counsel's table. The creditor is further disadvantaged by differences in language, customs and public policy, as well as, conflicting and unfamiliar laws. Finding competent local counsel is often a formidable challenge to the creditor, as is paying the staggering legal fees seemingly imposed to thwart success of the case. Quickly becoming cost prohibitive, claims are usually dropped. Moreover, bank secrecy codes serve to shield trusts from discovery attempts, frustrating effort to obtain financial records that would otherwise divulge what assets were being held from whom, where and in what amounts.

C. Barriers to Recovery.

Although basic comity principles are well established and generally agreed upon, application becomes frustrated when limitations are imposed by conflicting laws and public policies. Some jurisdictions maintain a reciprocity requirement, while others whose 1989 trust statute was co-authorized by Barry S. Engel, an asset protection lawyer in Englewood, Colorado (see Debra Baker, *"Island Castaways*," A.B.A.J. 54 (October 1998), for example, does not recognize court judgments from the rest of the world. *See* William C. Smith, "*Offshore Trust Busting: A Contempt Ruling May Mean Trouble in Debtors' Paradise*," A.B.A.J. 32 (November 1999)(Smith). Thus, a U.S. judgment creditor seeking assets from a Cook Island trust must relitigate the claim in the capital city of Rarotonga, located some 2,800 miles south of Honolulu. *Id.*; *See also*, *Federal Trade*

Commission v. Affordable Media, 179 F. 3d 1228 (9th Cir. 1999) (Anderson) (The FTC was forced to bring suit against the Anderson Trust before the Cook Islands' courts and have to date been unsuccessful).

Finding local counsel is only the first of many barriers facing creditors in the Cook Islands. Smith at 32. To set aside a fraudulent conveyance, the claim must be brought within one year of the transfer, and fraudulent intent must be established beyond a reasonable doubt. *Id.* Further, a transfer is presumptively non-fraudulent if it did not leave insolvent the settlor who created it. *Id.* Even if a creditor manages to prove a fraudulent conveyance, the recovery is limited to the amount of the tainted transfers rather than the entire trust fund. *Id*.

Legislation in the Cayman Islands [Special Trusts (Alternative Regime) Law (1997) (Cayman Islands)] shows a bold attempt to accommodate settlors by setting up a category of "special trusts," eliminating the requirement that trust from rights of the beneficiaries, and provides for "enforcers" who may be named in the trust instrument and are responsible for all enforcement of all enforceable rights of the beneficiaries. Gingiss at 1004.

D. Fraudulent Conveyance Law.

The most powerful weapon a creditor has to attack an APT is the ability to claim that "the settlor's conveyance or transfer into the trust was fraudulent." Alan R.l Jahde & Michael P. Franzmann, "What Are Creditors' Rights Against Asset Protection Trusts?", 26 Est. Plan. 410, 411 (November 1999). (Jahde). A fraudulent conveyance or transfer may generally be defined as a transaction by means of which the owner of real or personal property has sought to place such property beyond the reach of existing creditor demands. *Id.*, citing 37 Am. Jur. 2d Fraudulent Conveyances §21.

E. Requisites for a Present Creditor .

If the party contesting the transfer has the status of a present creditor, he must generally first establish that the transfer of assets into the trust was made without the transferor receiving a reasonably equivalent value in exchange. Since transfers into an APT are generally made voluntary and without consideration, this normally does not present a problem for a present creditor. Jahde at 411, 412. The determination of whether adequate consideration was received is a question of fact. *Id.* at 412. In addition to showing that the transfer was made for less than reasonably equivalent value, a present creditor must prove that the Debtor was insolvent at the time of the transfer or that the debtor became insolvent as a result of the transfer. *Id.* The distinction between a present and a future creditor is crucial. If a creditor does not have the status of a present creditor, a more challenging subjective standard must be met before the conveyance into the trust will be set aside. The creditor, whether present or future, can meet the standard by showing that the debtor made the transfer with the actual intent to hinder, dely or defraud any creditors of the debtor. UFTA §4.

F. Creditor's Burden to Prove Fraudulent Conveyance.

Beneficiaries of APTs are commonly family members, clearly insiders under the UFTA and, as with gifts, rarely does the debtor receive adequate consideration for the transfer. *Id.* at 413. However, other factors may be significantly harder to prove depending on certain variables such as the settlor's post-transfer actions, the settlor's UFTA solvency status, existence of the creditor's cause of action and the creditor's timing in bringing the cause of action. *Id.* If the evidence shows the debtor's concealment, insolvency, and claims of creditors to exist on the date of the transfer of assets or that the trust was established in anticipation of liability, insolvency or fraud, then the creditor should be able to convince the Court the transfer was fraudulent. *Id.* Courts have found requisite fraudulent intent in literally thousands of cases in which the creditor's claim or cause of action existed on the date of transfer, *see, e.g., Zahra Spiritual Trust v. United States*, 910 F.2d 240 (5th [th] Cir., 1990), but very few relating to claims of creditors whose claim or cause of action arose after the transfer, *i.e.*, a future creditor. *But cf.* Alperin, "Conveyance as Fraudulent Where Made in Contemplation of Possible Liability for Future Tort," 38 ALR 3d 597; *see also Mandolini Co. v. Chicago*[st]*Produce Suppliers*, 540 N.E. 2d 505 (III. App. 1 Dist., 1989).

The remedy afforded a creditor who is able to establish that the debtor's transfer into the APT was fraudulent is the ability to void the transfer to the extent necessary to satisfy the creditor's claim. Jahde at 413. However, a creditor has a problem if the creditor is unable to obtain jurisdiction over the APR as transferee, or its assets, or if the creditor's claim of fraudulent conveyance is time-barred under the governing law of another country and that county's law is determined to be the governing law. *Id.*

G. Statute of Limitations.

In all common law jurisdictions, a suit to set aside a fraudulent conveyance must be instituted within the applicable statute of

limitations, depending on which jurisdiction's law will apply. In this regard, the situs of an APT is critical, the impending question being, "whose law applies?" If the law of the debtor's residence applies, the statute of limitation is generally four years from the date of the transfer or one year from the date of the creditor's notice of the transfer. *Id* at 414. If the law of the offshore jurisdiction applies, limitations will be much shorter. Additionally, many countries with asset protection legislation have statutes that bar claims of creditors whose claims did not exist on the date of the statute. *Id.*

Foreign jurisdictions that are "debtor-friendly" generally have significantly shorter limitations periods in which creditors are permitted to challenge transfers as being fraudulent. For example, with respect to either present or future creditors, the UFTA has an alternative limitations period of the grantor of (1) four years from the date of the transfer, or (2) one year from the date the creditor discovered the transfer or should have discovered the transfer. *Id.* In contrast, the Cook Islands limitations period is *immediate* as to future creditors and generally two years as to present creditors, and the Cook Islands statute does not include a known or should have known definition. *Id.*

H. Burden of Proof.

Differences between the laws of the various asset protection jurisdictions and the laws of a given state are numerous and dramatic. For example, the Cook Islands state requires that a fraudulent transfer be proven by a creditor beyond a reasonable doubt, a much higher burden of proof for the creditor to meet than the preponderance of the evidence or even a clear and convincing standard typically found in the United States. *Id.* Where a trust consists of personal property, it is usually construed by the jurisdiction designated as the "governing law" in the trust instrument and according to that jurisdiction's rules of construction. Therefore, in situations when it is not possible to determine the intent of the settlor by reference to the trust instrument, a role of law of the jurisdiction specified in the trust instrument will be applied to fill in the gap. Restatement (Second) of Conflict of Laws §224. Similarly, matters regarding administration of the trust, such as the authority of the trustee to make certain investments and to take specific action with respect to the trust assets, will also be based on the law of the jurisdiction specified in the trust instrument. *Id.* §§268 and 271.

As one can see, it can be difficult to locate an offshore trust and even if one is located, there are many barriers to easily recovering assets in an offshore trust. The family law practitioner may want to ask that the court order the other party to do a specific act (i.e., transfer funds to a joint account in the United States) and if the person fails to do so, the lawyer can initiate contempt proceedings, rather than jump into the murky waters of attacking an offshore trust.