

WHEN ESTATE PLANNING MET MARITAL PROPERTY LAW

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I. INTRODUCTION

Estate planning attorneys have to take into account a wide variety of legal sources in their everyday practice—federal tax laws, state tax laws, and the Texas Estates Code, just to name a few.¹ However, the intersection of estate planning and Texas marital property law is perhaps one of the most fundamental and important areas of our practice.² This Article is meant to highlight some specific examples of that intersection and how to avoid unintended results.³

II. SEPARATE AND COMMUNITY PROPERTY, GENERALLY

The Texas constitution, as interpreted by the Texas Family Code, contains the relevant definitions of community and separate property in Texas.⁴ Community property is essentially everything that is not separate property.⁵ In fact, there is a presumption that all assets acquired during marriage are community property, which can only be rebutted by clear and convincing evidence.⁶

1. See Laura Jackson, *Estate Planning Guide and Checklist for 2024*, NAT'L COUNS. ON AGING (Aug. 21, 2023), <https://www.ncoa.org/adviser/estate-planning/estate-planning-guide-checklist/> [https://perma.cc/N2L7-THSS].

2. See Thomas M. Featherston, Jr., *Handbook on Texas Marital Property Law for Estate Administration and Planning*, ADVANCED EST. PLAN. & PROB. STATE BAR OF TEX. 1, 1 (June 22, 2016), <https://law.baylor.edu/sites/g/files/ecbvkj1546/files/202311/Handbook%20on%20Texas%20Marital%20Property%20Law%20Advanced%20Estate%20Planning%20%26%20Probate%20SBOT%20San%20Antonio%20June%202016.pdf> [https://perma.cc/EQ3T-NC3M].

3. See discussion *infra* Parts III–V.

4. TEX. CONST. art. XVI, § 15; TEX. FAM. CODE ANN. §§ 3.001–.002.

5. TEX. CONST. art. XVI, § 15; FAM. §§ 3.001–.002.

6. FAM. § 3.003.

Accordingly, it is critical to understand the categories of separate property in order to maintain their separate nature.⁷ Separate property includes “property owned or claimed by the spouse before marriage; the property acquired by the spouse during marriage by gift, devise, or descent; and the recovery for personal injuries sustained by the spouse during marriage, except any recovery for loss of earning capacity during marriage.”⁸

Another important rule is the “inception of title” rule.⁹ The characterization of marital property is determined based on when the property is acquired.¹⁰ If acquired before marriage, the property will be considered the separate property of the acquiring spouse, regardless of whether community funds are used to enhance the separate property.¹¹ Further, an asset purchased with separate property or received upon the sale of separate property will retain its separate character (although a right of reimbursement to the non-owner spouse may apply in certain situations).¹²

These rules are generally straightforward and should be easy to follow.¹³ However, things can get really complicated due to the biggest sticking point when it comes to marital property characterization: the rule that “income” derived from separate property is community property.¹⁴ Of course, spouses can always agree to change any of these rules in a legally enforceable marital agreement, but in that case, this discussion would not be necessary (although it may underscore the benefit of such an agreement).¹⁵

The characterization of marital property matters in several contexts:

- Upon the divorce of the spouses, where the court can make a “just and right” division of the community estate but cannot award one spouse’s separate property to the other spouse.¹⁶
- Upon the death of the first spouse, where their estate includes all separate property and one-half of the community estate.¹⁷

7. *See id.* § 3.001.

8. *Id.*

9. *See id.* § 3.006.

10. *Id.*

11. *See id.* § 3.001.

12. *See id.* § 3.402.

13. *See id.* §§ 3.001–.003.

14. Bryan Joseph Fagan, *How Is Income from Separate Property Treated in a Texas Divorce?*, L. OFF. OF BRYAN FAGAN, PLLC (Mar. 20, 2020), <https://www.bryanfagan.com/blog/2020/march/how-is-income-from-separate-property-treatedin/#:~:text=However%2C%20in%20most%20other%20scenarios,considered%20to%20be%20community%20property> [https://perma.cc/5BVE-VETM].

15. *See* FAM. § 4.102.

16. *See id.* § 7.001.

17. *See* Adriane Grace, *New to Texas? What You Need to Know About Community Property Law*, GRACE EST. L. (Aug. 15, 2022), <https://www.gracelawoffice.com/blog/what-you-need-to-know-about-community-property-law/> [https://perma.cc/W9HE-CPMP].

- In the event of a creditor's claim against a spouse, where the community estate is at risk but the non-debtor spouse's separate property is protected.¹⁸

As discussed below, the characterization of marital property can change depending on the type of vehicle being used and, therefore, can have a profound impact on the planning choices that are considered.¹⁹

III. MARITAL PROPERTY CHARACTERIZATION OF INTERESTS IN TRUSTS

As a general matter, trusts are often used to provide creditor protection to the beneficiary, including protection of the trust assets from the claims of a non-beneficiary spouse upon divorce.²⁰ Although a spouse's separate property would remain the separate property of the owner, if the separate property is invested and generates income or if the separate property is simply deposited in an account with community funds, the community presumption would apply; it becomes increasingly difficult to maintain the separate property nature of the underlying asset.²¹ On the other hand, if the separate property is owned by a trust and the income generated by that separate property remains in the trust, then it may retain its separate property character and be protected from a non-beneficiary spouse.²²

As good as this sounds, there are some limitations, and the Texas courts have determined that in certain situations the income generated by separate property trust corpus can be characterized as community income.²³ The outcome typically depends upon the particular features of the trust created for the benefit of the beneficiary.²⁴ These cases are not uniform nor do they address every possible scenario, but they do provide strong guidance as to whether income is separate property or community in certain situations.²⁵

A. "Acquisition" Theory

In general, the characterization of trust income as community or separate property depends upon whether the spouse has "acquired" an interest

18. See FAM. § 3.201.

19. See discussion *infra* Part III.

20. See Nikki Nelson, *Using Trusts to Protect Your Assets*, WOLTERS KLUWER (Dec. 24, 2020), <https://www.wolterskluwer.com/en/expert-insights/using-trusts-to-protect-your-assets> [<https://perma.cc/LV33-MYCS>].

21. EILEEN GAFFNEY & RANDALL B. WILHITE, O'CONNOR'S TEXAS FAMILY LAW HANDBOOK Ch. 2-A § 4 (2024 ed.).

22. *Id.*

23. *Id.*

24. *Id.*

25. See discussion *infra* Sections III.A–D.

in the corpus of the trust.²⁶ For example, in *Wilmington Trust Co. v. United States*, parents created a trust for the benefit of their married daughter, in which the trust agreement required that the trustee distribute only income to the daughter for her life and gave the daughter no access to the corpus.²⁷ The court found that the trust income was separate property because the daughter never acquired, and could never acquire, the underlying corpus.²⁸ The court reasoned that the gift from the parents was not of the underlying trust corpus but rather an interest in the income from that corpus.²⁹ The trust corpus had no marital property characteristics (community or separate) because it was not owned by the daughter; therefore, the gift (the income interest) was not derived from community property.³⁰ The general rule can extend to distributions of trust income when such distributions are compelled by the terms of the governing instrument.³¹

The general rule is that income from a trust in which the beneficiary spouse has no present right to acquire the trust corpus will be considered that spouse's separate property.³² This rule can apply even if the spouse creates the trust for their own benefit with separate property. In *Lemke v. Lemke*, the husband used a trust to effectively shield income from certain separate property against the claims of his wife in a divorce proceeding.³³ The husband won a substantial amount of money prior to his marriage due to a personal injury settlement.³⁴ He then used that money to fund an irrevocable trust for his benefit that lasted for his lifetime, named a third party as the trustee, and gave the trustee sole discretion to make distributions of income and corpus for his health, education, maintenance, and welfare.³⁵ At the time of the divorce, the wife alleged that the trust consisted of community property and that the original separate property investments had produced income that was still held in the trust.³⁶ The court disagreed, stating that because the husband had no right to invade the trust corpus and the trustee had sole discretion to make distributions, the undistributed income was part of the separate trust estate and not subject to division by the court at divorce.³⁷

Based on the foregoing, the key to ensuring that trust income will not be considered community property is to prevent the beneficiary from obtaining unfettered access to the trust corpus.³⁸ Therefore, it is important to

26. See *Wilmington Tr. Co. v. United States*, 753 F.2d 1055, 1056 (Fed. Cir. 1985).

27. *Id.*

28. *Id.*

29. *Id.*

30. *Id.*

31. See *Sharma v. Routh*, 302 S.W.3d 355, 364–65 (Tex. App.—Houston [14th Dist.] 2009, no pet.).

32. See *Lemke v. Lemke*, 929 S.W.2d 662, 664 (Tex. App.—Fort Worth 1996, writ denied).

33. *Id.*

34. *Id.* at 663.

35. *Id.*

36. *Id.*

37. *Id.* at 664.

38. See *id.*

discuss ways a beneficiary may acquire an interest in the trust corpus, thus altering the character of trust income from separate property to community property.³⁹

B. Power to Revoke Trust

Typically, when a grantor creates a trust for their own benefit, the grantor will retain the power to revoke the trust at any time.⁴⁰ The fact that a grantor of a revocable trust places separate property in a trust does not prevent undistributed income from being classified as community property because the grantor has the power to pull out the separate property from the trust as if it had never been placed there in the first place.⁴¹ Texas law is well established that a revocable trust cannot be used to defeat the claims of creditors.⁴²

In contrast, the court in *Lemke* held that the trust created by the husband for his own benefit would be respected and the undistributed income would be classified as separate property because he did not have the power to revoke the trust.⁴³ In addition, the trust contained a spendthrift clause that prevented the husband from “alienating, anticipating, assigning, encumbering, or hypothecating his interest in the principal or income of the trust.”⁴⁴

C. Right to Corpus Due to Power to Terminate Trust

Similar to the power to revoke, once a spouse has the unrestricted right to receive trust corpus by terminating the trust, regardless of whether such right is exercised, the income from that corpus is considered community property.⁴⁵ In *In re Marriage of Long*, the husband’s parents created a trust with oil and gas interests for his benefit whereby the trustee had the discretion to distribute or accumulate income, and after the husband reached age twenty-five, the trust terminated as to one-half with the remaining one-half to be distributed at age thirty.⁴⁶ Prior to the time of divorce, the husband had attained age twenty-five but elected to keep the one-half in the trust.⁴⁷ The court held that because he had the unrestricted right to one-half of the trust property after age twenty-five, at the time of divorce the one-half of the

39. *Id.*

40. TEX. PROP. CODE ANN. § 112.033.

41. *See Lemke*, 929 S.W.2d at 664.

42. PROP. § 112.035(d).

43. *Lemke*, 929 S.W.2d at 664.

44. *Id.*

45. *In re Marriage of Long*, 542 S.W.2d 712, 717 (Tex. App.—Texarkana 1976, no writ).

46. *Id.* at 715.

47. *Id.*

undistributed income from the trust that accumulated after the husband reached age twenty-five was considered community property.⁴⁸

In contrast, if the trust agreement provides that the trust will terminate when the spouse reaches a certain age, but at the time of divorce the spouse has not yet reached that age, then the spouse does not have an unrestricted right to trust corpus, and the undistributed income may be considered separate property.⁴⁹

D. Power to Compel Distributions

The ability to compel distributions can be manifested in several ways.⁵⁰ The beneficiary may have the right to compel the trustee to make distributions, or more commonly, the beneficiary may serve as trustee and have the power to make distributions of trust corpus and income for any reason whatsoever.⁵¹

On one extreme, the beneficiary's power to compel or make distributions to himself of trust corpus without limitation would undoubtedly cause the undistributed income to be classified as community property because the beneficiary has the power to acquire the trust corpus at any time.⁵²

On the other extreme, if a third party is named as trustee and the trustee has sole discretion over distributions, the undistributed income is clearly not considered community property.⁵³ In fact, the discretion of the trustee does not need to be based on any standard.⁵⁴ For example, the trustee in *In re Marriage of Burns* was given complete discretion to make distributions for any reason, whereas the trustee in *Lemke* was limited to health, education, maintenance, and welfare (an ascertainable standard).⁵⁵

However, what happens if the beneficiary is also the trustee and the trust distributions are limited by an ascertainable standard?⁵⁶ While this is certainly the most common question faced in estate planning, we can only

48. *Id.* at 718.

49. *In re Marriage of Burns*, 573 S.W.2d 555, 557 (Tex. App.—Texarkana 1978, writ dismissed).

50. See *Ten Things That Every Trust Beneficiary in Texas Should Know*, IKARD L. 1, 2, <https://ikardlaw.com/wp-content/uploads/2019/04/TEN-THINGS-THAT-EVERY-TRUST-BENEFICIARY-IN-TEXAS-SHOULD-KNOW-3.pdf> (last visited Mar. 7, 2024) [<https://perma.cc/4FTZ-KLZZ>].

51. See *Trust Beneficiary Rights: Can a Beneficiary Sue a Trustee?*, KEYSTONE L. GRP., P.C., <https://keystone-law.com/rights-of-a-trust-beneficiary-to-sue-a-trustee/#:~:text=If%20trustees%20fail%20to%20diligently,the%20requirements%20of%20their%20role> (Feb. 2, 2024) [<https://perma.cc/HH4P-JW7C>].

52. *In re marriage of Long*, 542 S.W.2d at 718.

53. *In re Marriage of Burns*, 573 S.W.2d at 557; *Lemke v. Lemke*, 929 S.W.2d 662, 664 (Tex. App.—Fort Worth 1996, writ denied).

54. See *In re Marriage of Burns*, 573 S.W.2d at 557; *Lemke*, 929 S.W.2d at 664.

55. See *In re Marriage of Burns*, 573 S.W.2d at 557; *Lemke*, 929 S.W.2d at 664.

56. Author's original thought.

speculate on the answer.⁵⁷ In *Sharma v. Routh*, which was decided in 2009, the non-beneficiary spouse argued that the beneficiary spouse, who was serving as trustee and had the power to distribute corpus to himself for his health, support, and maintenance, therefore, had possession and control of the trust corpus to require the income to be characterized as community property.⁵⁸ The court rejected this argument, stating there was no allegation the trusts “were created, funded, or operated in fraud of [the non-beneficiary spouse’s] rights.”⁵⁹ Accordingly, the court found that the “fact that an income beneficiary also holds legal title to the corpus in his capacity as trustee should not be a controlling factor in the marital-property characterization of the trust income.”⁶⁰

IV. MARITAL PROPERTY CHARACTERIZATION OF INTERESTS IN LIMITED PARTNERSHIPS AND LIMITED LIABILITY COMPANIES

As with trusts, limited partnerships (LPs) and limited liability companies (LLCs) can provide useful protection to a spouse who wishes to preserve that spouse’s separate property from the claims of the non-owner spouse upon divorce or at death.⁶¹ A spouse who contributes their separate property to an LP or LLC in exchange for an interest in the entity can retain an interest in the entity and, thus, benefit from the potential revenue generated by the separate property—which would need to be distributed pursuant to the governing documents.⁶² With a trust, the spouse would typically part with ownership of the asset for the benefit of others.⁶³ Furthermore, an LP or LLC will be more flexible than a trust.⁶⁴ However, despite these benefits, the few Texas cases that address the marital property characterization of partnership distributions create significant uncertainty and could result in unintended conversion of a separate property asset.⁶⁵

57. *Id.*

58. *Sharma v. Routh*, 302 S.W.3d 355, 366 (Tex. App.—Houston [14th Dist.] 2009, no pet.).

59. *Id.*

60. *Id.*

61. Mario A. Mata, *Asset Protection Techniques for Real Estate Owners*, AM. L. INST. - AM. BAR ASS’N CONTINUING LEGAL EDUC. 605, 664 (2005); WINSTEAD PC, *Transferring Company Ownership Interests in Divorce Settlements - A Transaction in Which Both Spouses Need to Exercise Significant Caution*, JD SUPRA (May 11, 2018), <https://www.jdsupra.com/legalnews/transferring-company-ownership-54662/> [<https://perma.cc/Z87D-A3QP>].

62. See WINSTEAD PC, *supra* note 61.

63. See Patrick Hicks, *Should I Have a Joint Trust or Separate Trust with My Spouse?*, TR. & WILL, <https://trustandwill.com/learn/joint-trust-vs-separate-trust> (last visited Mar. 20, 2024) [<https://perma.cc/L6Q9-QW3C>].

64. See Andrew Beattie, *Limited Liability Partnership (LLP): Meaning and Features*, INVESTOPEDIA, <https://www.investopedia.com/articles/investing/090214/limited-liability-partnership-llp-basics.asp#:~:text=Limited%20liability%20partnerships%20%28LLPs%29%20are%20a%20flexible%20legal,their%20liability%20for%20the%20actions%20of%20other%20partners> (Jan. 13, 2024) [<https://perma.cc/D87Y-FRT9>].

65. *Richardson v. Richardson*, 424 S.W.3d 691, 701 (Tex. App.—El Paso 2014, pet. denied).

A. The “Aggregate” Theory vs. the “Entity” Theory

Prior to the passage of the Texas Uniform Partnership Act, Texas courts characterized partnership interests as separate property under the theory that partnership assets were owned by the individual partners.⁶⁶ This was known as the “aggregate” theory.⁶⁷ In *Norris v. Vaughan*, the partnership owned three producing oil and gas wells prior to the marriage, and the court held the husband’s interest in the three wells was his separate property and the gas produced and proceeds from the sale of such gas were also separate property.⁶⁸

The aggregate theory was replaced by the Texas Uniform Partnership Act, enacted in 1961, which adopted the “entity” theory.⁶⁹ The entity theory provides that assets held by a partnership are owned by the partnership and not by the individual partners.⁷⁰ The Uniform Partnership Act was subsequently replaced by the Texas Revised Partnership Act, which was subsequently replaced by the Texas Business Organizations Code, but the entity theory has been retained throughout.⁷¹

B. The Effect of the Entity Theory on Marital Property Characterization

As a result of the entity theory, courts have determined that partnership assets are neither the community nor separate property of the individual partners.⁷² This determination has had a profound effect on the way the courts have viewed undistributed and distributed assets from a partnership.⁷³

In *Marshall v. Marshall*, the husband was the owner of an interest in a partnership that owned and produced oil and gas interests which were acquired prior to the marriage.⁷⁴ The opinion does not state whether these are working or non-working interests.⁷⁵ However, in the court’s opinion, the analysis of *Norris* (which would have held such separate property proceeds remain separate) no longer applies due to the application of the entity theory: “Further, the *Norris v. Vaughan* characterization of proceeds from the production of oil and gas is inapplicable to a partnership receipt of such

66. *Norris v. Vaughan*, 260 S.W.2d 676, 676–77, 681–82 (Tex. 1953).

67. See TEX. TAX CODE ANN. Ch. 171.

68. *Norris*, 260 S.W.2d at 679–80.

69. *Marshall v. Marshall*, 735 S.W.2d 587, 593–94 (Tex. App.—Dallas 1987, writ ref’d n.r.e.).

70. *Id.* See *Harris v. Harris*, 765 S.W.2d 798, 802 (Tex. App.—Houston [14th Dist.] 1989, writ denied).

71. See TEX. REV. CIV. STAT. ANN. art. 6132b-2.04; TEX. BUS. ORGS. CODE § 152.101.

72. *Marshall*, 735 S.W.2d at 593. See *Harris*, 765 S.W.2d at 799.

73. *Harris*, 765 S.W.2d at 800.

74. *Marshall*, 735 S.W.2d at 593.

75. *Id.*

proceeds, for they are simply partnership property and are not subject to characterization as separate or community property.”⁷⁶

Accordingly, income produced by an asset owned by a partnership would not be considered community property, even if such income would be considered community property if the asset was owned outside the partnership.⁷⁷ For example, a delay rental, which is normally considered community property if the mineral is owned by the spouse, is no longer considered community property when owned in a partnership.⁷⁸ The same theory holds true with receipts that are normally separate property, such as royalties.⁷⁹ All income received by the partnership remains partnership property.⁸⁰ Put simply, the marital property rules can be significantly altered when assets are held in a partnership.⁸¹

If the assets held by the partnership are not separate or community, then what is?⁸² According to the Texas Business Organizations Code, the partnership interest held by the partner can be separate or community property.⁸³ As stated by the court in *Marshall*, “a partner’s partnership interest, the right to receive his share of the profits and surpluses from the business, is the only property right a partner has that is subject to a community or separate property characterization.”⁸⁴

C. The Mutation Principle and Partnership Distributions

It is well settled that the partnership interest held by a spouse is marital property, and the spouse holds no marital property interest in the underlying partnership assets.⁸⁵ So long as the partnership makes no distributions, the income generated within the partnership takes on no marital property characteristics.⁸⁶ However, once a distribution is made, the distributed property will need to be characterized.⁸⁷ This is the fundamental question that is addressed in *Marshall*.⁸⁸

76. *Id.* at 594–95.

77. *Id.* at 594.

78. Jay Frazier, *Characterization of Oil and Gas Interests Under Texas Community Property Laws*, TOEPPICH & ASSOCS., <https://toeppichlaw.com/characterization-of-oil-and-gas-interests-under-texas-community-property-laws/#:~:text=Since%20delay%20rentals%20accrue%20merely,community%20property%20of%20both%20spouses> (last visited Feb. 6, 2024) [<https://perma.cc/FR7G-U3JP>].

79. *Id.*

80. *Marshall*, 735 S.W.2d at 594.

81. *Id.*

82. *Id.*

83. TEX. BUS. ORGS. CODE ANN. § 154.001(b).

84. *Marshall*, 735 S.W.2d at 594.

85. *Id.*

86. *Id.*

87. *Id.* at 595.

88. *Id.*

In *Marshall*, the partnership distributed amounts to the husband that were characterized as “salary” or “distributions of profits.”⁸⁹ Upon divorce, the court found that the distributions were community property, holding that “if the partner receives his share of profits during the marriage, those profits are community property, regardless of whether the partner’s interest in the partnership is separate or community in nature.”⁹⁰ Further, the court found that, even if the distributions consisted of a return of the partner’s capital contribution as opposed to partnership profits or income, the result would be the same.⁹¹ The husband in *Marshall* argued that the distributions were a return of capital, and therefore his separate property, based on the rule that mutations of separate property remain separate property if properly traced.⁹² The court disagreed with that argument, stating that the mutation principle does not apply to partnership assets because the assets themselves have no marital property characteristics.⁹³ According to the court, the husband had no ownership interest in his original capital contribution; the partnership was the owner.⁹⁴ Therefore, a distribution of assets from the partnership, whether it is in the form of profits or a return of capital, is not subject to the mutation principle and, thus, may be considered community property.⁹⁵ As the court stated, “[T]here can be no mutation of a partner’s separate contribution; that rule is inapplicable in determining the characterization of a partnership distribution from a partner’s capital account.”⁹⁶

However, the mutation principle still applies to the partnership interest held by the partner or spouse in the event of a buyout.⁹⁷ Property established as separate property remains separate property regardless of the fact that it may undergo any number of mutations and changes in form.⁹⁸ If a partner receives assets from the partnership in redemption of his separate property partnership interest, the assets will be considered separate property because they are a mutation of the original partnership interest.⁹⁹ This rule applies regardless of the fact that the partnership interest has appreciated in value.¹⁰⁰

89. *Id.* at 591.

90. *Id.* at 594.

91. *Id.*

92. *Id.* at 592.

93. *Id.* at 594.

94. *Id.*

95. *Id.*

96. *Id.*

97. *Harris v. Harris*, 765 S.W.2d 798, 803 (Tex. App.—Houston [14th Dist.] 1989, writ denied).

98. *Id.* at 802.

99. *Id.* at 803.

100. *Id.*

D. A Note About LLCs

Thus far, the cases discussed herein have contemplated interests in partnerships, not LLCs.¹⁰¹ If an LLC were to be used instead of an LP, would the outcome be any different?¹⁰² An LLC, like a partnership, would be subject to the entity theory and, thus, the reasoning behind the cases discussed above should apply equally to LLCs.¹⁰³ However, it is worth noting that since the rules governing LLCs are more recent, there are fewer cases involving LLCs, and, accordingly, this may be a reason to use a partnership instead of an LLC.¹⁰⁴

V. MARITAL PROPERTY CONSIDERATIONS WITH MINERAL INTERESTS

A. Characterization of Oil and Gas Receipts

Mineral interests owned prior to marriage or acquired during the marriage by gift, devise, or descent will clearly be separate property.¹⁰⁵ Otherwise, the characterization of mineral interests acquired during the marriage will depend on the inception of title rule.¹⁰⁶ If a mineral interest is determined to be community property, then all receipts related to the minerals would be community.¹⁰⁷ However, if the underlying interests are separate property, then the characterization of the receipts will depend on the nature of the payments.¹⁰⁸

Delay rentals are considered community property, as they are amounts paid to defer the drilling of oil and gas and do not relate to the extraction of the minerals.¹⁰⁹ This is consistent with the characterization of payments for trust accounting purposes and would presumably include other “income” receipts such as the interest factor on production payments.¹¹⁰

Bonus payments are considered separate property as part of the consideration paid for the minerals.¹¹¹ This is consistent with the principal that the proceeds from the sale of separate property are also separate property.¹¹²

101. *Id.*; *Norris v. Vaughan*, 260 S.W.2d 676, 681 (Tex. 1953); *Marshall*, 735 S.W.2d at 594.

102. *See Norris*, 260 S.W.2d at 681; *Marshall*, 735 S.W.2d at 594; *Harris*, 765 S.W.2d at 803.

103. *See Norris*, 260 S.W.2d at 681; *Marshall*, 735 S.W.2d at 594; *Harris*, 765 S.W.2d at 803.

104. *See Norris*, 260 S.W.2d at 681; *Marshall*, 735 S.W.2d at 594; *Harris*, 765 S.W.2d at 803.

105. *See* TEX. FAM. CODE ANN. § 3.001.

106. *See id.*

107. *See id.* § 3.002.

108. *See id.* § 3.001.

109. *Lessing v. Russek*, 234 S.W.2d 891, 894 (Tex. App.—Austin 1950, writ ref’d n.r.e.).

110. *See supra* text accompanying note 78.

111. *Lessing*, 234 S.W.2d at 894.

112. *See supra* text accompanying note 79.

Royalty payments are also considered separate property for the same reason—the payment is being made to purchase the asset from the ground, which is part of the separate estate.¹¹³ Over time, the oil and gas will be depleted (even as we discover new ways to extract the minerals), and the extraction is part of the corpus of the estate and not income.¹¹⁴ Contrast this result with trust accounting principles, which typically allocate a portion of the royalty payment to income in order to achieve an “equitable” result.¹¹⁵ There is no such concept in marital property law.¹¹⁶

Payments received for working interests should follow the same rules as royalty payments, however, it can be a bit more complicated if the working owner is also the operator.¹¹⁷ Assuming the working interests are separate property, the efforts to extract the minerals may, in theory, give rise to a right of reimbursement to the non-owner spouse if the court determines that community efforts were used to enhance the value of the owner’s separate estate.¹¹⁸ A discussion of possible reimbursement claims is beyond the scope of this Article.¹¹⁹

B. Implications of Marshall on Planning with Mineral Interests

A useful technique for estate planning with mineral interests involves holding those interests in an entity, such as an LP or LLC.¹²⁰ There are numerous benefits to this approach, including creditor protection and avoiding probate, but perhaps the most important benefit is preventing future fractionalization of mineral interests (fractionalization can make the management of such interests less economically efficient over time).¹²¹ Once the mineral interests are conveyed to the entity, interests in the entity can be transferred to others (individuals or trusts, for example) without having to transfer ownership of the underlying minerals.¹²²

Despite the obvious benefits, the implications of *Marshall* and its progeny can have a profound and unintended impact on planning with mineral interests.¹²³ In effect, these cases appear to allow a partnership to transform what would otherwise be considered separate property into

113. *Alsensz v. Alsensz*, 101 S.W.3d 648, 653 (Tex. App.—Houston [1st Dist.] 2003, pet. denied).

114. *Id.*

115. *Id.*

116. *Id.* at 653–54.

117. *See id.*

118. *See id.*

119. *See* discussion *supra* Parts I–VII.

120. *See* discussion *supra* Sections IV.A–D.

121. *See Managing Mineral Interests: Solving the “Fractionalization” Puzzle*, THE NAT’L ASS’N OF ROYALTY OWNERS & THE NAT’L ASS’N OF DIV. ORD. ANALYSTS, <https://www.naro-us.org/resources/Site/fractionalization.pdf> (last visited Feb. 4, 2024) [<https://perma.cc/3H6A-KCUZ>].

122. *See id.*

123. *See generally Marshall v. Marshall*, 735 S.W.2d 587, 591 (Tex. App.—Dallas 1987, writ ref’d n.r.e.) (discussing the transformation of certain property into community property).

community property.¹²⁴ Proceeds received from a royalty interest would be separate property in the hands of the mineral owner; comparatively, in the hands of a partnership, it is a receipt of partnership property, and upon distribution to the partner (who may own the partnership interest as separate property), it is community property as a distribution of “profits.”¹²⁵ Accordingly, any client considering contributing producing mineral interests to a partnership must consider the marital property implications.¹²⁶

VI. TEXAS DOCTRINE OF FRAUD ON THE SPOUSE

A. Fraud on the Spouse Explained

When representing one spouse and not the other in an estate planning engagement, the Texas practitioner must be keenly aware of the perils and pitfalls of the Texas doctrine of “fraud on the spouse” (also known as fraud on the community).¹²⁷ Although a spouse has the exclusive right to that spouse’s sole management of their community property, the manager-spouse still owes a fiduciary obligation to the non-manager-spouse.¹²⁸

What are the elements of a successful claim of fraud on the spouse?¹²⁹ How would they apply to an irrevocable trust containing the entire community estate created by the managing spouse for the benefit of both halves of the community?¹³⁰ Can a claim for fraud on the spouse be brought as an independent action?¹³¹ This part of the Article attempts to answer these questions while highlighting existing case law on this topic.¹³²

1. Sole Management Community Property

Texas community property law begins with the basic principle that a husband and wife each own an undivided, one-half interest in their community property, regardless of who has management power and control.¹³³ However, depending on the nature of the property, one spouse may have sole management power over certain community property, such as that

124. *See id.*

125. *See id.*

126. *See id.*

127. *See* Kathryn J. Murphy, *Fraud on the Community and the Reconstituted Estate*, GORANSON BAIN AUSLEY, PLLC 1, 1, <http://gbfamilylaw.com/wp-content/uploads/2021/08/Fraud-and-Reconstituted-Estate-Section-Report-Winter-2020.pdf> (last visited Feb. 4, 2024) [<https://perma.cc/X3PC-FTHT>].

128. *See id.* at 3.

129. *See id.* at 1.

130. *See id.*

131. *See id.*

132. *See* discussion *infra* Section VI.A.1.

133. *See* Massey v. Massey, 807 S.W.2d 391, 401 (Tex. App.—Houston [1st Dist.] 1991, writ denied).

spouse's earned income, income derived from separate property, and insurance bought with community funds.¹³⁴ As sole manager, that spouse has the right to control and dispose of community property subject to their sole management and is not required to seek the other spouse's approval when doing so.¹³⁵

2. *A Fiduciary Relationship Exists Between the Spouses*

Despite one spouse's exclusive rights to manage their sole management community property, a fiduciary relationship exists between spouses and requires that a disposition of sole management community property be fair to the other spouse.¹³⁶ In order to protect their interest in the community estate, the non-managing spouse may allege fraud on the spouse if they feel that the manager has unfairly disposed of community assets.¹³⁷ The fraud on the spouse doctrine is a judicially created concept based on the theory of constructive fraud.¹³⁸ Its purpose is to achieve a just result, where the wrong to the spouse is so clear that intent is immaterial.¹³⁹

3. *Two Main Categories of Fraud on the Spouse*

Fraud on the spouse cases generally fall into two categories: (1) gifts of community property, such as money, land, or stock, to persons outside the community and (2) designations of third parties as beneficiaries of community-owned life insurance policies.¹⁴⁰ While the doctrine has been discussed extensively, courts have not agreed on what is needed to successfully prove fraud on the spouse.¹⁴¹ As the case law will show, the test is very fact-intensive, and no two cases are alike.¹⁴²

4. *Fraud Is Presumed if the Gift Is Excessive or Capricious*

The doctrine of fraud of the spouse begins with the presumption that an unfair disposition of community funds is fraudulent as to the non-manager spouse, and then the burden shifts to the manager to show that the transfer

134. *See id.*

135. *See id.*

136. *See* *Wheeling v. Wheeling*, 546 S.W.3d 216, 225 (Tex. App.—El Paso 2017, no pet.).

137. *See id.*

138. *See* *Givens v. Girard Life Ins. Co. of Am.*, 480 S.W.2d 421, 425 (Tex. App.—Dallas 1972, writ ref'd n.r.e.).

139. *See id.*

140. *See* *Murphy*, *supra* note 127, at 3–7.

141. *Wheeling*, 546 S.W.3d at 225; *Zieba v. Martin*, 928 S.W.2d 782, 789 (Tex. App.—Houston [14th Dist.] 1996, no writ).

142. *See* *Wheeling*, 546 S.W.3d at 225; *Zieba*, 928 S.W.2d at 789.

was fair.¹⁴³ But what facts give rise to the presumption?¹⁴⁴ Is it any disposition or just certain types of dispositions?¹⁴⁵ As it will become readily apparent after inspection of the majority of fraud on the spouse cases, this is where the courts begin to differ.¹⁴⁶ Gifts that are “excessive or capricious” will almost always trigger the presumption.¹⁴⁷ The definition of excessive and capricious is not fixed, but it is more a matter of degree.¹⁴⁸ Also, a gift of a beneficiary designation of community-owned life insurance to an unrelated person will give rise to the presumption.¹⁴⁹

5. Moderate Gifts May Also Create Presumption

While courts generally agree that a managing spouse may make moderate gifts of community property to persons outside the community, that spouse may still have to prove the gift was fair.¹⁵⁰ Some courts have gone so far as to say *any* disposition of community assets, if done without the knowledge and consent of the non-managing spouse, gives rise to a presumption of constructive fraud.¹⁵¹ In addition, some courts have presumed fraud when the beneficiary of a community-owned life insurance policy is related to the insured.¹⁵² Based on existing case law, there is no hard-and-fast rule as to when a presumption of fraud on the spouse arises.¹⁵³

6. Once a Presumption of Fraud on the Spouse Is Established, the Burden Shifts to the Managing Spouse

Once a spouse establishes a presumption of fraud, the managing spouse has the burden of proving that the disposition was fair to the non-managing spouse.¹⁵⁴

B. The Four Factors of Fraud on the Spouse

To determine whether the disposition was fair, courts have looked at four factors: (1) the relationship between the transferor and transferee;

143. *Mazique v. Mazique*, 742 S.W.2d 805, 808 (Tex. App.—Houston [1st Dist.] 1987, no writ).

144. *Id.* See *Wheeling*, 546 S.W.3d at 225.

145. Author's original thought.

146. *Mazique*, 742 S.W.2d at 808; *Wheeling*, 546 S.W.3d at 225; *Zieba*, 928 S.W.2d at 789.

147. *Reaney v. Reaney*, 505 S.W.2d 338, 340 (Tex. App.—Dallas 1974, no writ).

148. *Id.* at 340.

149. See *Givens v. Girard Life Ins. Co. of Am.*, 480 S.W.2d 421, 425 (Tex. App.—Dallas 1972, writ ref'd n.r.e.). See also *Great Am. Rsrv. Ins. Co. v. Sanders*, 525 S.W.2d 956, 958 (Tex. 1975).

150. See *Great Am. Rsrv. Ins. Co.*, 525 S.W.2d at 958. See also *Wheeling*, 546 S.W.3d at 225.

151. *Jackson v. Smith*, 703 S.W.2d 791, 795 (Tex. App.—Dallas 1985, no writ) (emphasis added).

152. *Id.* See *Murphy v. Metro. Life Ins. Co.*, 498 S.W.2d 278, 282 (Tex. App.—Houston [14th Dist.] 1973, writ ref'd n.r.e.).

153. *Jackson*, 703 S.W.2d at 795; *Murphy*, 498 S.W.2d at 282.

154. *Jackson*, 703 S.W.2d at 795; *Murphy*, 498 S.W.2d at 282.

(2) whether there are special circumstances that tend to justify the transfer; (3) the value of the assets transferred in relation to the total value of the community estate; and (4) whether the non-managing spouse has been adequately provided for out of the remaining community property and the separate property of the managing spouse.¹⁵⁵ The way courts have applied these factors has been anything but uniform.¹⁵⁶ Courts will consider a combination of factors, and it is common for one factor to outweigh the others.¹⁵⁷ Which factors are the most important?¹⁵⁸ Does the managing spouse have the burden to prove all of the factors in order to prevail?¹⁵⁹ These are important questions and, unfortunately, the case law gives little guidance.¹⁶⁰ What follows is a discussion of each of the four factors and the weight they have been given in various cases.¹⁶¹

1. *The Relationship Between the Transferor and Transferee*

If the gift is to someone who is not related to the spouse who made the gift, it tends to weigh more strongly in favor of a finding of fraud.¹⁶² In *Mazique v. Mazique*, the husband gave community property to his various girlfriends, and in *Givens v. Girard Life Insurance Co. of America*, the insured husband designated an “unrelated friend” as his beneficiary for no apparent reason.¹⁶³ Wasting community property on bad loans or gambling where there is no relationship to a third party also tends to indicate fraud.¹⁶⁴ However, while most cases involve the transfer of community assets to a related third party, such as a parent, sibling, or child of a former marriage, the fact of this relationship does not, by itself, overcome a presumption of fraud.¹⁶⁵

155. See *Mazique v. Mazique*, 742 S.W.2d 805, 808 (Tex. App.—Houston [1st Dist.] 1987, no writ); *Zieba v. Martin*, 928 S.W.2d 782, 789 (Tex. App.—Houston [14th Dist.] 1996, no writ).

156. See *Mazique*, 742 S.W.2d at 808; *Zieba*, 928 S.W.2d at 789.

157. See *Mazique*, 742 S.W.2d at 808; *Zieba*, 928 S.W.2d at 789.

158. Author’s original thought.

159. *Id.*

160. See *Mazique*, 742 S.W.2d at 808; *Zieba*, 928 S.W.2d at 789.

161. See discussion *infra* Sections VI.B.1–4.

162. See *Mazique*, 742 S.W.2d at 807–08; *Givens v. Girard Life Ins. Co. of Am.*, 480 S.W.2d 421, 425 (Tex. App.—Dallas 1972, writ ref’d n.r.e.).

163. *Mazique*, 742 S.W.2d at 807; *Givens*, 480 S.W.2d at 421.

164. See *Massey v. Massey*, 807 S.W.2d 391, 403 (Tex. App.—Houston [1st Dist.] 1991, writ denied) (finding fraud where the husband took out several loans with community assets and squandered the money); *Reaney v. Reaney*, 505 S.W.2d 338, 340 (Tex. App.—Dallas 1974, no writ) (finding fraud when the husband admitted to squandering money on gambling and parties).

165. See *Cantu v. Cantu*, 556 S.W.3d 420, 427 (Tex. App.—Houston [14th Dist.] 2018, no pet.); *Kazmi v. Kazmi*, No. 03-22-00330-CV, 2023 WL 7932473, at *12 (Tex. App.—Austin Nov. 17, 2023, no pet.).

In many cases, a close relationship coupled with an obligation to support weighs strongly in favor of upholding the gift.¹⁶⁶ A perfect example of this is found in *Tabassi v. NBC Bank*, where the husband gave hundreds of thousands of dollars in community funds to his two sons from a prior marriage who followed him over from Iran.¹⁶⁷

At the same time, courts have routinely struck down gifts despite the fact that they were made to close family members and for legitimate reasons.¹⁶⁸ For example, in *Carnes v. Meador*, the court found fraud despite the fact that the decedent made gifts to his daughter and her husband.¹⁶⁹

Since most of the spousal fraud cases involve transfers to a spouse's relative, courts seem to weigh the other factors more carefully in their determination.¹⁷⁰

2. Whether Special Circumstances Tend to Justify the Transfer

What are special circumstances?¹⁷¹ This is the most malleable factor that courts will consider.¹⁷² For instance, an obligation to support a relative will sometimes, though not always, tend to justify the gift.¹⁷³ In *Great American Reserve Insurance Co. v. Sanders*, the court said that while a husband's gift of community life insurance to his ex-wife was usually presumed fraudulent, because he bought the policy for her to secure his delinquent support payments for his minor children, the court found no constructive fraud.¹⁷⁴ However, another court reached the opposite result in *Murphy v. Metropolitan Life Insurance Co.*; despite a strong showing of special circumstances, the court held that a son's "moral" obligation to support his indigent mother was not enough to overturn the trial court's determination of

166. *Tabassi v. NBC Bank*—San Antonio, 737 S.W.2d 612, 616 (Tex. App.—Austin 1987, writ ref'd n.r.e.).

167. *See Horlock v. Horlock*, 533 S.W.2d 52, 56 (Tex. App.—Houston [14th Dist.] 1975, writ diss'm'd) (holding that the husband was allowed to make gifts to his daughters from a prior marriage); *Redfearn v. Ford*, 579 S.W.2d 295, 297 (Tex. App.—Dallas 1979, writ ref'd n.r.e.) (upholding the decedent's designation of the infant son as a beneficiary of community-owned life insurance based on the wife's inability to provide for the child).

168. *See Carnes v. Meador*, 533 S.W.2d 365, 371 (Tex. App.—Dallas 1975, writ ref'd n.r.e.).

169. *Id. See Murphy v. Metro. Life Ins. Co.*, 498 S.W.2d 278, 282 (Tex. App.—Houston [14th Dist.] 1973, writ ref'd n.r.e.) (finding fraud in the gift to the mother); *Jackson v. Smith*, 703 S.W.2d 791, 796 (Tex. App.—Dallas 1985, no writ) (finding fraud in the gift to the sister).

170. *See Carnes*, 533 S.W.2d at 370–72; *Murphy*, 498 S.W.2d at 281–82; *Jackson*, 703 S.W.2d at 796–97.

171. *See Great Am. Rsrv. Ins. Co. v. Sanders*, 525 S.W.2d 956, 959 (Tex. 1975); *Est. of Korzekwa v. Prudential Ins. Co. of Am.*, 669 S.W.2d 775, 778 (Tex. App.—San Antonio 1984, writ diss'm'd).

172. *See Great Am. Rsrv. Ins. Co.*, 525 S.W.2d at 959; *Est. of Korzekwa*, 669 S.W.2d at 778; *Tabassi v. NBC Bank*—San Antonio, 737 S.W.2d 612, 616–17 (Tex. App.—Austin 1987, writ ref'd n.r.e.); *Mazique v. Mazique*, 742 S.W.2d 805, 808 (Tex. App.—Houston [1st Dist.] 1987, no writ); *Grant v. Grant*, No. 01-98-00352-CV, 1999 WL 1063433, at *8–13 (Tex. App.—Austin Nov. 24, 1999, no pet.).

173. *See Freeman v. Morales*, 151 S.W. 644, 645 (Tex. App.—Austin 1912, writ ref'd); *Grant*, 1999 WL 1063433, at *8–13.

174. *Great Am. Rsrv. Ins. Co.*, 525 S.W.2d at 959.

constructive fraud.¹⁷⁵ Based on the case law, there is no accurate way to determine which circumstances will tend to justify a gift and which circumstances will not.¹⁷⁶

3. *The Value of the Assets Transferred in Relation to the Total Value of the Community Estate*

This is a “smell test” factor when, if it looks really bad, the courts will tend to find fraud.¹⁷⁷ If the managing spouse transfers all or essentially all of the community estate to a third party, the court will most likely find fraud absent a strong showing of other factors.¹⁷⁸ For example, in *Hartman v. Crain*, the husband opened a joint bank account with right of survivorship with his sister, which contained more than double the community assets he left to his wife.¹⁷⁹ If the transfer is small enough, it should escape scrutiny.¹⁸⁰

However, there have been situations where, despite the fact the managing spouse transferred a large portion of the community estate, the court upheld the gift because other factors prevailed.¹⁸¹ In *Redfearn v. Ford*, the decedent husband designated his infant son as beneficiary of community life insurance worth \$73,000, where his wife only received \$25,000 of the remaining community estate.¹⁸²

175. *Murphy*, 498 S.W.2d at 283. See *Jackson*, 703 S.W.2d at 796 (finding constructive fraud in the gift of insurance to the decedent's sister despite the fact that she needed money to care for his minor children).

176. See *Murphy*, 498 S.W.2d at 283; *Jackson*, 703 S.W.2d at 796; *Great Am. Rsrv. Ins. Co.*, 525 S.W.2d at 957–59; *Est. of Korzekwa*, 669 S.W.2d at 776–78; *Tabassi*, 737 S.W.2d at 613–17; *Mazique*, 742 S.W.2d at 806–08; *Grant*, 1999 WL 1063433 at *8–13; *Freeman*, 151 S.W. at 644–45.

177. See *Hartman v. Crain*, 398 S.W.2d 387, 391 (Tex. App.—Houston [1st Dist.] 1966, no writ); *Logan v. Barge*, 568 S.W.2d 863, 865–66 (Tex. App.—Beaumont 1978, writ ref'd n.r.e.); *Carnes v. Meador*, 533 S.W.2d 365, 368–72 (Tex. App.—Dallas 1975, writ ref'd n.r.e.).

178. See *Hartman*, 398 S.W.2d at 391; *Logan*, 568 S.W.2d at 865–66; *Carnes*, 533 S.W.2d at 368–72.

179. See *Hartman*, 398 S.W.2d at 391; *Logan*, 568 S.W.2d at 865–66 (noting the husband transferred the majority of community real estate to his children before his death, leaving the wife with only \$10,000); *Carnes*, 533 S.W.2d at 372 (noting the husband gifted \$34,000 in community funds to the daughter and son-in-law when the wife depended entirely on social security).

180. See *Horlock v. Horlock*, 533 S.W.2d 52, 56 (Tex. App.—Houston [14th Dist.] 1975, writ dism'd) (noting gifts to the daughter amounted to 13% of community estate); *Brown v. Brown*, 282 S.W.2d 90, 92 (Tex. App.—Waco 1955, writ ref'd n.r.e.) (noting the gift of insurance to the children and the grandchildren were \$1,500, whereas the wife received \$250,000 from the remaining community property).

181. See *Redfearn v. Ford*, 579 S.W.2d 295, 296–97 (Tex. App.—Dallas 1979, writ ref'd n.r.e.).

182. *Id.*

4. Whether the Non-Managing Spouse Has Adequately Been Provided for out of the Remaining Community Property and the Separate Property of the Managing Spouse

Many courts find this factor to be the most important.¹⁸³ Apparently, courts are willing to overlook an otherwise obvious case of fraud when the non-managing spouse can be made whole out of the remaining community property and other assets.¹⁸⁴ A perfect example of this can be found in *Street v. Skipper*, where the decedent left over \$1 million in life insurance to his estate but the wife received over \$2 million in the other community property and some of her husband's separate property.¹⁸⁵ The court held that, despite a clear abuse of her husband's managerial power, the wife was made whole out of the remaining assets and, therefore, failed to establish constructive fraud.¹⁸⁶ Of course, if the managing spouse has disposed of nearly all of the community property, the court will most likely find fraud because it is impossible to make the other spouse whole.¹⁸⁷ Even in cases where the spouse failed to establish constructive fraud, courts prefer to remedy the injustice by making the defrauded spouse whole out of the remaining assets.¹⁸⁸ This situation typically arises in a divorce proceeding, where a judge can consider the fraud when making a "just and right" division of the community property.¹⁸⁹

C. Texas Fraud on the Spouse Cases Involving Trusts

Here is a plausible situation: a client engages an estate planning attorney to create a revocable management trust to hold a certain amount of their sole-management community property.¹⁹⁰ In this case, the client has accumulated vast real estate holdings across the United States and wishes to consolidate title in Texas under one instrument.¹⁹¹ The trust will be for the benefit of the client and their spouse for their lifetimes, then upon the

183. See *Street v. Skipper*, 887 S.W.2d 78, 81 (Tex. App.—Fort Worth 1994, writ denied).

184. *Id.*

185. *Id.*

186. *Id.* See *Tabassi v. NBC Bank—San Antonio*, 737 S.W.2d 612, 616 (Tex. App.—Austin 1987, writ ref'd n.r.e.); *Horlock v. Horlock*, 533 S.W.2d 52, 56 (Tex. App.—Houston [14th Dist.] 1976, writ dismissed).

187. See *Logan v. Barge*, 568 S.W.2d 863, 866 (Tex. App.—Beaumont 1978, writ ref'd n.r.e.); *Murphy v. Metro. Life Ins. Co.*, 498 S.W.2d 278, 282 (Tex. App.—Houston [14th Dist.] 1973, writ ref'd n.r.e.).

188. See *Reaney v. Reaney*, 505 S.W.2d 338, 340 (Tex. App.—Dallas 1974, no writ).

189. *Id.*

190. Author's original hypothetical.

191. *Id.*

survivor's death, pass to their issue.¹⁹² In the trust agreement, the client retains sole power to revoke the trust.¹⁹³

Although the above plan seems straightforward and without malice, it may be subject to a successful claim of fraud on the spouse.¹⁹⁴ Why?¹⁹⁵ After all, the property is subject to the sole management of the client and will continue to be used for the benefit of the client's spouse and eventually their children.¹⁹⁶ Nevertheless, there is a possibility of trouble.¹⁹⁷ Unfortunately, there are only a handful of cases that concern the use of trusts which, not surprisingly, offer inconsistent views.¹⁹⁸

1. No Constructive Fraud Found Where Husband Creates Trust for the Benefit of His Children: Becknal v. Atwood

Becknal v. Atwood is a fraud on the spouse case in which the husband put the majority of the community estate into an irrevocable spendthrift trust for the benefit of his children.¹⁹⁹ The trust consisted entirely of the couple's real property, it was to terminate in ten years with the remainder passing to the children, and the wife was named as trustee.²⁰⁰ In a dispute over title to some of the property, the trial court held that the wife owned an undivided one-half interest in the land despite the trust.²⁰¹ In its finding of fact and conclusions of law, the trial court wrote that "the conveyance would be such an excessive gift of the community estate that it would constitute a constructive fraud upon the [wife's] interest in the community estate."²⁰²

The court of appeals reversed the trial court's decision, holding that neither the evidence nor the pleadings would support a finding of constructive fraud.²⁰³ Given the wife's active role in the trust as trustee and her complete failure to produce evidence of "deceit, violation of confidence, or injury to public interests," the court reasoned that she failed to carry her burden of proof for constructive fraud.²⁰⁴ This result differs from other constructive fraud cases in that it seems to place a burden on the spouse to produce some evidence of fraud.²⁰⁵

192. *Id.*

193. *Id.*

194. Author's original thought.

195. *Id.*

196. *Id.*

197. *Id.*

198. *Id.*

199. *Becknal v. Atwood*, 518 S.W.2d 593, 595 (Tex. App.—Amarillo 1975, no writ).

200. *Id.*

201. *Id.* at 596.

202. *Id.* at 597.

203. *Id.* at 597–98.

204. *Id.*

205. *See id.* at 595.

2. *The Illusory Trust Doctrine Is Used to Invalidate Trust: Land v. Marshall*

Probably the most important, and arguably the most controversial, case dealing with the use of trusts funded with community property is *Land v. Marshall*.²⁰⁶ In that case, the husband created a revocable trust funded by the entire community estate for the benefit of himself and his wife.²⁰⁷ Along with the power to revoke, Mr. Marshall had the power to direct the trustee to sell, dispose of, or encumber the trust assets and to invade the principal for his benefit.²⁰⁸ After he died, the trust became irrevocable as to Mrs. Marshall, and she filed suit to set aside the trust and recover her undivided one-half interest in the community property.²⁰⁹

The Texas Supreme Court may have wanted to settle the issue under the fraud on the spouse doctrine, but because the issue was not raised on appeal, the court held the trust invalid under the “illusory trust” doctrine.²¹⁰ The illusory trust doctrine is a tool courts use to invalidate trusts in which the grantor retains so much control over the trust property that it is as if they never gave it away.²¹¹ The doctrine has been developed in a number of jurisdictions, but this was the first time it had been applied by a Texas court.²¹² The court wrote that, “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.”²¹³

By deciding *Land v. Marshall* under the illusory trust doctrine, the court left open the question of whether a “real” trust, funded with community property, would withstand an attack of fraud on the spouse.²¹⁴ On the one hand, the court seemed to indicate that a trust funded with community property would defeat the non-managing spouse’s ability to dispose of their property at death and would operate as a testamentary disposition that deprives them of their distributive share.²¹⁵ Essentially, this was the underlying principle which motivated the court to invalidate the trust.²¹⁶

However, the court also indicated that the managing spouse has the power to create an *inter vivos* trust with both halves of the community estate, so long as the trust is “real rather than illusory, genuine rather than

206. *Land v. Marshall*, 426 S.W.2d 841, 842 (Tex. 1968).

207. *Id.*

208. *Id.* at 842–43.

209. *Id.*

210. *Id.* at 846.

211. *Id.* at 847.

212. *See id.*

213. *Id.*

214. *Id.* at 846.

215. *Id.* at 849.

216. *See id.* at 844.

colorable.”²¹⁷ Is the court saying that if Mr. Marshall had made the trust irrevocable, and had not retained so much power over the trust, that it would have been valid?²¹⁸ The court never answers this question, so we are forced to speculate.²¹⁹

While the creation of a “genuine” irrevocable trust would prevent the managing spouse from enjoying the benefits of ownership in life, it would still have the effect of depriving the non-managing spouse of their distributive share at death.²²⁰ An irrevocable trust created by the manager deprives the non-manager of the ability to dispose of their half of the community estate at their death.²²¹ If the non-manager dies first, the manager will retain the use of the non-manager’s share until the manager dies, when the remainder passes to their children.²²² In addition, the manager, as grantor and initial trustee, retains some control over the trust property.²²³ Although the manager may be limited to making distributions under a “health, education, maintenance, and support” standard, the fact that the manager is a trustee may bring the irrevocable trust under the same scrutiny as the trust in *Land v. Marshall*.²²⁴

D. Fraud on the Spouse Is Not an Independent Cause of Action

Regardless of whether or not the manager has committed fraud on the non-manager’s community property rights, it is unlikely that the non-manager would be able to challenge the action on the basis of fraud on the spouse before dissolution of the marriage.²²⁵ The Texas Supreme Court held in *Schlueter v. Schlueter* that there is no recognizable action for fraud on the spouse outside the division of the marital estate.²²⁶ The wife in *Schlueter* had filed for divorce and added a tort claim for fraud on the community.²²⁷ In reversing the court of appeals, the court quoted *Belz v. Belz*: “[A] claim of fraud on the community is a means to an end, either to recover specific property wrongfully conveyed, . . . or . . . to obtain a greater share of the community estate upon divorce, in order to compensate the wronged spouse for his or her lost interest in the community estate.”²²⁸

217. *Id.* at 846.

218. Author’s original thought.

219. *Id.*

220. *Land*, 426 S.W.2d at 849.

221. *Id.*

222. *Id.* at 846.

223. *Id.* at 847.

224. *See id.* at 848.

225. *Schlueter v. Schlueter*, 975 S.W.2d 584, 588 (Tex. 1998).

226. *Id.*

227. *Id.* at 586.

228. *Id.* at 588 (quoting *Belz v. Belz*, 667 S.W.2d 240, 246–47 (Tex. App.—Dallas 1984, writ ref’d n.r.e.)).

The court held that Mrs. Schlueter was entitled to recover the amount that her husband depleted from her half of the community property, but that the appropriate method was through the “just and right” division upon divorce.²²⁹ If the remaining assets of the community estate are insufficient to compensate the defrauded spouse, the court has the option of awarding a money judgment against the wrongdoer, but only to the extent of recouping the value of the defrauded spouse’s lost share.²³⁰ The idea is not to punish the wrongdoer but to put the wronged spouse in the position they would be in if the community estate had not been depleted.²³¹

The result in *Schlueter* is not surprising given the context of the typical fraud on the spouse case.²³² All of the cases discussed herein took place in the context of either a divorce proceeding, where the court made a just and right division, or a probate proceeding, where the surviving spouse challenged the disposition of community assets.²³³ None of the cases involved a challenge based on fraud on the spouse during the marriage; they all took place at the time of or after dissolution.²³⁴

The Fort Worth Court of Appeals was asked to consider punitive damages assessed against a husband for allegedly committing fraud on the spouse by purchasing a farm with community funds for the benefit of his mistress.²³⁵ In that case, the court cited the Texas Supreme Court’s holding in *Schlueter* for the proposition that “there is no independent cause of action for wrongful disposition by a spouse of community assets.”²³⁶ Because the cause of action is not based on tort, the court held that punitive damages are not recoverable.²³⁷ However, it is important to note that *Harper* and *Schlueter* do not preclude recovery for actual damages based on fraud on the spouse if the claim is brought within the context of the dissolution of the marriage by divorce or death.²³⁸

VII. FEDERAL PREEMPTION OF COMMUNITY PROPERTY LAW

A. ERISA Preempts Texas Community Property Law

Despite the well-established legal history of community property in Texas, when dealing with an employee benefit governed under the Employee Retirement Income Security Act of 1974 (ERISA), the concept of Texas

229. *Id.* at 589–90.

230. *Id.* at 589.

231. *Id.*

232. *Id.* at 588.

233. See discussion *supra* Part VI.

234. *Id.*

235. *Harper v. Harper*, 8 S.W.3d 782, 784 (Tex. App.—Fort Worth 1999, pet. denied).

236. *Id.*

237. *Id.*

238. *Id.*; *Schlueter v. Schlueter*, 975 S.W.2d 584, 589–90 (Tex. 1998).

community property law simply does not apply.²³⁹ Instead, federal law preempts Texas community property law, and as a result, a claim of fraud on the spouse will almost assuredly fail if it involves an employee benefit governed by ERISA.²⁴⁰

ERISA generally governs certain benefits that are granted in the context of employment.²⁴¹ These benefits include qualified retirement plans (such as 401(k) plans) and can also include life insurance if purchased as part of an employee benefits plan.²⁴² The types of benefits governed by ERISA are heavily regulated and subject to uniform administration.²⁴³

In order to ensure the uniform administration of all ERISA plans across the country, ERISA preempts any state laws that relate to an employee benefit plan subject to ERISA.²⁴⁴ The question of whether a state's laws relate to an ERISA plan has been an ongoing subject of litigation across the country, with several cases winding up in the Supreme Court of the United States.²⁴⁵ In *Shaw v. Delta Air Lines, Inc.*, the Supreme Court held that a state law relates to an employee benefit plan governed by ERISA if it has (1) a connection with or (2) a reference to such a plan.²⁴⁶ While a "reference to" an ERISA plan is generally clear-cut, a "connection with" an ERISA plan is a much more ambiguous and complex standard and subject to interpretation, thus ensuring the continuation of litigation in this area.²⁴⁷

It was this precise question that was before the Texas Supreme Court in *Barnett v. Barnett*.²⁴⁸ *Barnett* has all the hallmarks of a typical fraud on the spouse case.²⁴⁹ During the marriage, the husband's company purchased a life insurance policy on his life as part of an employee benefit plan governed by ERISA, and the husband designated the wife as the beneficiary of this policy.²⁵⁰ The husband and wife began divorce proceedings, and the husband removed the wife as the beneficiary of the policy and named his estate instead.²⁵¹ At the same time, the husband executed a new will excluding his wife as a beneficiary and named his mother as executor and principal beneficiary of his estate (he made some small gifts to his children).²⁵² Prior

239. *ERISA Claims & Employer-Provided Life Insurance*, TEX. LIFE INS. LAWS., <https://www.texaslifeinsurancelawyers.com/erisa-life-insurance> (last visited Feb. 4, 2024) [<https://perma.cc/2ZJ3-G5LD>].

240. *Id.*

241. *Id.*

242. Julia Kagan, *Employee Retirement Income Security Act (ERISA) History, Purpose*, INVESTOPEDIA, <https://www.investopedia.com/terms/e/erisa.asp> (Mar. 25, 2022) [<https://perma.cc/6KQ7-68Y6>].

243. *See* 29 U.S.C. § 1001(a)–(b).

244. *Id.* § 1144(a).

245. *See Shaw v. Delta Air Lines, Inc.*, 463 U.S. 85, 91 (1983).

246. *Id.* at 96–97.

247. *See id.*

248. *Barnett v. Barnett*, 67 S.W.3d 107, 108 (Tex. 2001).

249. *See id.*

250. *Id.* at 109.

251. *Id.*

252. *Id.*

to the resolution of the divorce proceedings, the husband died.²⁵³ The wife then filed suit against the husband's mother, asserting a fraud on the spouse claim against the husband for naming his mother as the beneficiary of the life insurance policy and seeking to impose a constructive trust on her community one-half of the life insurance proceeds.²⁵⁴

Under normal circumstances, this case would likely be easily resolved in the wife's favor, considering that the life insurance proceeds constituted a significant portion of the community estate.²⁵⁵ Unfortunately for the wife, the life insurance policy was governed by ERISA, and as a result, the normal rules did not apply.²⁵⁶

At the Texas First Court of Appeals, the wife was able to persuade the court that her fraud on the spouse claim was not preempted by ERISA.²⁵⁷ Her argument was based on the fact that her suit did not directly implicate ERISA or any administrator of an ERISA plan; rather, she sought recovery from the estate of her deceased husband and from his mother as executor of the estate.²⁵⁸ However, the Texas Supreme Court rejected this argument out of hand, stating that "where there is a clash between community property rights and the purposes of ERISA, state-law rights are preempted even though they were asserted against the beneficiary of an ERISA plan after the plan's administrator had paid the benefits to the designated beneficiary."²⁵⁹

The court examined several cases involving the conflict between state laws (and in some cases, community property states) and the federal preemption of ERISA, noting that the issue had not been decided uniformly across the country.²⁶⁰ Ultimately, the court was persuaded by the reasoning of the United States Supreme Court in *Egelhoff v. Egelhoff*, which involved a Washington statute that would have nullified the designation of a former wife as beneficiary of an ERISA plan upon divorce.²⁶¹ In finding that the Washington statute was preempted by ERISA, the United States Supreme Court explained that

Requiring ERISA administrators to master the relevant laws of 50 States and to contend with litigation would undermine the congressional goal of minimizing their administrative and financial burdens. Differing state regulations affecting an ERISA plan's system for processing claims and

253. *Id.*

254. *Id.*

255. *See id.*

256. *Id.* at 126.

257. *Barnett v. Barnett*, 985 S.W.2d 520, 524 (Tex. App.—Houston [1st Dist.] 1998, pet. granted).

258. *Barnett*, 67 S.W.3d at 113 (citing *Boggs v. Boggs*, 520 U.S. 833, 844 (1997)).

259. *Id.* at 113.

260. *Id.* at 109.

261. *Egelhoff v. Egelhoff*, 532 U.S. 141, 144 (2001).

paying benefits impose precisely the burden that ERISA pre-emption was intended to avoid.²⁶²

In applying the United States Supreme Court's reasoning in *Egelhoff* to the facts of *Barnett*, the Texas Supreme Court stated: "The state law embodied in the statute at issue in *Egelhoff* was far easier for a plan administrator to discern and follow and far less fact intensive in applying than the community property law of Texas that gives rise to a claim for constructive trust."²⁶³ Ultimately, the court believed that the fraud on the spouse claim was an assertion against the very nature of the ERISA benefit itself, thus establishing the required "connection" to the plan and subjecting the claim to preemption under federal law.²⁶⁴

B. Limits of Preemption

Despite the far-reaching implications of *Barnett v. Barnett* and *Egelhoff v. Egelhoff*, there are, in fact, some limitations to ERISA preemption.²⁶⁵ In *Egelhoff*, the United States Supreme Court held that ERISA preempts a Washington statute that provides the designation of a spouse as a beneficiary of a life insurance policy or employee benefit plan is automatically revoked upon divorce.²⁶⁶ Texas has a similar statute which was the focus of the Texas Supreme Court's analysis in *Keen v. Weaver*.²⁶⁷

In *Keen*, the husband had designated his wife as a beneficiary in an ERISA-controlled benefit plan.²⁶⁸ Subsequently, the husband and wife divorced, and as a part of the divorce decree, the wife waived any interest she had in her husband's employee benefit plans.²⁶⁹ Before the husband's death, the husband failed to modify the beneficiary designation on his plan after the divorce, and the wife (now former wife) was still named as the beneficiary, thus claiming the proceeds from the plan.²⁷⁰ The husband's contingent beneficiaries sued the former wife for the proceeds.²⁷¹

While the court cites *Egelhoff* for the proposition that ERISA preempts Texas's redesignation statute, it distinguishes the facts in *Keen* from those in *Egelhoff* to find that ERISA did not preclude the application of federal common law to the dispute.²⁷² The court reasoned that under federal common

262. *Id.* at 142.

263. *Barnett*, 67 S.W3d at 124.

264. *Id.* at 126.

265. *See id.* at 128; *Egelhoff*, 532 U.S. at 150–52.

266. *Barnett*, 67 S.W3d at 128; *Egelhoff*, 532 U.S. at 148–50.

267. *Keen v. Weaver*, 121 S.W.3d 721, 723 (Tex. 2003).

268. *Id.* at 722.

269. *Id.*

270. *Id.*

271. *Id.*

272. *Id.* at 724.

law, the wife effectively waived her interest in her husband's benefits in the divorce decree, and the application of this uniform legal standard would not interfere with ERISA.²⁷³ Unlike community property laws, which are unique to only a handful of states, the federal common law of waiver does not require a plan administrator to look to a state's laws to determine the beneficiary of the plan.²⁷⁴

C. Preemption Can Be Avoided Upon Divorce

While the preemption of state redesignation statutes by ERISA is somewhat muted by the application of the federal common law principle of waiver, the whole issue of preemption in a divorce context can be avoided simply by obtaining a Qualified Domestic Relations Order (QDRO) as part of the divorce proceeding.²⁷⁵ ERISA provides fairly detailed requirements that allow a divorced spouse to retain certain rights (or give up all rights completely) in an ERISA-governed employee benefits plan through a court-issued QDRO.²⁷⁶ If effective, the beneficiary designated in the QDRO will override any beneficiary designated in the original plan, thus avoiding the problem of a spouse's failure to change a beneficiary designation after a divorce.²⁷⁷ If fraud on the spouse is alleged in a divorce context, the divorce court can simply award the non-manager spouse a larger share of the community estate, which may include being designated as beneficiary of certain employee benefits as provided in a QDRO.²⁷⁸

VIII. CONCLUDING THOUGHTS

The foregoing represents only a portion of numerous issues that exist at the crossroads of estate planning and marital property law in Texas.²⁷⁹ The concepts of community and separate property permeate virtually every facet of estate planning, and it is incumbent on every Texas estate planner to tread carefully when representing a married couple.²⁸⁰ Good luck!²⁸¹

273. *Id.*

274. *Id.*

275. See TEX. FAM. CODE ANN. § 9.101–.105.

276. See 29 U.S.C. § 1056(d)(3)(A).

277. *Id.*

278. See *Barnett v. Barnett*, 67 S.W.3d 107, 119–21 (Tex. 2001).

279. See discussion *supra* Parts III–VII.

280. See *id.*

281. Author's original thought.