Defined Benefit & Contribution Plans

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I. INTRODUCTION

The purpose of this article is to explore the methods of dividing defined contributions plans and defined benefits plans when the plan is not 100 percent community property. A totally new *Texas Family Code* § 3.007 became effective September 1, 2005 and applied to suits pending as of September 1, 2005 or filed on or after September 1, 2005. Sections 3.007(a)(b) provided a statutory formula to determine what portion of a defined benefit retirement plan was participant's separate property and what portion was community property. Section 3.007(c) stated that the separate property interest of a spouse in a defined contribution plan may be traced using tracing and characterization principles that apply to a nonretirement asset.

Texas Family Code § 3.007(a)(b) were repealed by the Texas Legislature effective September 1, 2009 for all cases pending on that date and for cases filed on or after September 1, 2009. This article will explore the impact of § 3.007(a)(b)(c) and the repeal of (a) and (b) on Texas jurisprudence. Prior to their repeal on September 1, 2009, subsections (a) and (b) of 3.007 read as follows:

> "(a) A spouse who is a participant in a defined benefit plan has a separate property interest in the monthly accrued benefit the spouse had a right to receive on normal retirement age, as defined by the plan, as of the date of marriage, regardless of whether the benefit had vested.
>
> "(b) The community property interest in a defined benefit plan shall be determined as if the spouse began to participate in the plan on the date of marriage and ended that participation on the date of dissolution or termination of the marriage, regardless of whether the benefit had vested.
>
> Section 3.007(c) still reads as follows:
> "(c) The separate property interest of a spouse in a defined contribution retirement plan may be traced using the tracing and characterization principles that apply to a nonretirement asset."

This paper will also discuss the importance of properly changing the designation of a survivor beneficiary of a retirement plan and how the wording of a decree really matters.

II. REVIEW OF CHARACTERIZATION PRINICPLES

Characterization of property is a process of identifying the property owned by the spouses as separate property or community property. Property possessed by either spouse during or on dissolution of marriage is presumed to be community property. *Texas Family Code* § 3.003(a). *Tate* v. *Tate*, 55 S.W.3d 1, 4 (Tex.App.-El Paso 2000, no pet.). The degree of proof necessary to rebut the community property presumption and establish that property as separate property is clear and convincing evidence. § 3.003(b). Only community property is subject to the trial court's "just and right" division. *Cameron* v. *Cameron*, 641 S.W.2d 210, 220 (Tex. 1982). Separate property is confirmed to the owner of the separate property. The court shall divide the community property of the parties in a manner that the court deems just and right, having due regard for the rights of each party and any children of the marriage. *Texas Family Code* § 7.001. An equal division of community property is not required. *In re Marriage of Jackson*, 506 S.W.2d 261, 267 (Tex.Civ.App.-Amarillo 1974, writ dism'd). A trial court has broad discretion in dividing the marital estate in a manner that the Court deems just and right. *Texas Family Code* § 7.001; Murff v. *Murff*, 615 S.W.2d 696, 698 (Tex. 1981); *Smith* v. *Smith*, 22 S.W.3d 140, 143 (Tex.App.-Houston [14th Dist.] 2000, no pet.). Texas appellate courts will not reverse the division of community property by the trial court unless the appellate court finds the trial court has abused its discretion. *Bell* v. *Bell*, 513 S.W.2d 20, 22 (Tex. 1974); *Murff* v. *Murff*, 615 S.W.2d 696, 698 (Tex. 1981); *Smith* v. *Smith*, *supra* at p. 143. The appellate court will reverse a trial court if a trial court mischaracterizes separate property as community property and does not award separate property to the owner thereof. *Eggemeyer* v. *Eggemeyer*, 554 S.W.2d 137, 140 (Tex. 1977). *Tate* v. *Tate*, *supra* at p. 6.

Texas Family Code § 3.001 defines separate property as property owned or claimed by a spouse before marriage; the property acquired the spouse during marriage by a gift, devise or descent; and the recovery for personal injury sustained by the spouse during the marriage, except for any recovery for loss or earning capacity during marriage. Additionally, separate property can be created by partition and exchange as set forth in the Texas Constitution, Art. XVI, section 15, persons about to marry and spouses, without the intention to defraud pre-existing creditors,

may by written instrument from time to time, partition between themselves property that would ordinarily be community property into property that is separate property.

Texas Family Code § 3.002 states that community property consists of property, other than separate property, acquired by either spouse during marriage.

Inception of Title.

Whether property is separate or community is determined by its character at inception. *Barnett* v. *Barnett*, 67 S.W.3d 107, 111 (Tex. 2001). Inception of title occurs when a party first has a right of claim to the property by virtue of which title is finally vested. *Welder* v. *Lambert*, 44 S.W. 283 (Tex. 1898); *Alsenz* v. *Alsenz*, 101 S.W.3d 648, 652 (Tex.App.-Houston [1st Dist.] 2003 pet denied). Under the inception of title doctrine, the character of property, whether separate or community is fixed at the time of acquisition. *Henry S. Miller Co.* v. *Evans*, 452 S.W.2d 426 (Tex. 1970). Acquiring an ownership interest or claim to property refers to the inception of title, rather than the completion or ripening thereof. The existence or non-existence of the marriage at the time of incipiency of the right of which title finally vests, determines whether the property is community or separate. *Creamer* v. *Briscoe*, 109 S.W. 911 Tex. 1908). Inception of title occurs when a party first has the right of claim to the property. Thus, land acquired by an earnest money contract that is signed prior to the marriage, but the deed is not acquired until after the marriage, is separate property.

The inception of title rule has been codified by *Texas Family Code* § 3.006, which states, "If the community estate of the spouses and the separate estate of the spouse have an ownership interest in property, the respective ownership interests of the marital estates are determined by the rule of inception of title." Section 3.006 does not change the law about the inception of title rule, but simply codifies the inception of tile rule as it has evolved from Texas case law over many years of Texas jurisprudence.

III. Defined Benefit Plans

A defined benefit plan is any plan that is not a defined contribution plan. 26 *U.S.C.* § 414(j); 29 U.S.C. §1002(35). A defined benefit plan usually involves the payment of benefits according to a formula. The formula takes into account the contributions, if any, made by the member of the plan; the time accredited to employment; the highest salary average over a period of years of the member; and the contributions made by the employer. If a defined benefit plan has cash balance, called a cash balance pension plan, a formula may not be needed. If the member has retired at the time of divorce and the amount of the benefits are known, that amount may be divided. However, if the member has not retired at time of divorce, there are unknowns in the formula. At this point, the formulas we have been discussing deal with the calculation of benefit to participant of the plan. Next, we are going to discuss use of formulas in dividing a defined benefit plan when the retirement benefits are partially separate property and partially community property.

Prior to September 1, 2005, the effective date of *Texas Family Code* § 3.007(a)(b), a defined benefit retirement plan that was partially separate property and partially community property was divided either by the *Taggart* formula or *Berry* formula. *Taggart* v. *Taggart*, 552 S.W.2d 422, 424 (Tex. 1977); *Berry* v. *Berry*, 647 S.W.2d 945, 947 (Tex. 1983). The details of these two cases and the formulas will be discussed below. Sections (a) and (b) essentially repealed the prior case law and instituted a statutory formula to determine the separate property portion and the community property portion of a defined benefit plan. However, these mathematical formulas were flawed and sections (a) and (b) were repealed effective September 1, 2009, bringing back all of the prior case law of *Taggert* and *Berry* and the many cases that followed.

A privately sponsored defined benefit plan is commonly referred to as "qualified" plan and is governed by the Employee Retirement Income Security Act (ERISA) § 206(d)(3) and the Internal Revenue Code § 414(p). A qualified domestic relations order (QDRO) must meet the requirements of ERISA. Examples of non-ERISA defined benefit plans are the Texas Teacher Retirement System and military retirement benefits. TRS and military retirement plans are divided by a domestic relations order (DRO). Regardless of the type of defined benefit retirement plan, the repeal of subsections (a) and (b) of *Texas Family Code* § 3.007 reinstates the application of prior case law.

A. Case Law

The Texas Supreme Court first considered the issue of characterization and division of retirement

benefits in *Cearley* v. *Cearley*, 544 S.W.2d 666 (Tex. 1976). In the *Cearley* case, husband was in the military and at the time of divorce had not served long enough to be able to retire and receive his military retirement pension. The Texas Supreme Court determined that the military retirement benefits attributable to husband's military service during the marriage were community property. The Supreme Court further recognized that husband's military service after the time of divorce was husband's separate property. The court held that the military retirement benefits were subject to division as vested contingent community property rights, even though the present right has not fully matured.

The post-divorce increases in the value of an individual's defined benefit retirement plan are attributable to the person's continued employment, such as raises, promotions and services rendered post divorce are the individual's separate property and not subject to division. *Boyd* v. *Boyd*, 67 S.W.3d 398, 408 (Tex.App.-Ft. Worth 2002), no pet.); *Grier* v. *Grier*, 732 S.W.2d 931, 932 (Tex. 1987) (holding that retirement benefit increases due to post-divorce promotion were separate property). Post-divorce cost-of-living increases and other increases in value that are not attributable to the employee's continued employment after divorce are community property subject to division. See *Grier*, 731 S.W.2d at 933; (awarding nonemployee wife percentage of husband's retirement benefits that were community property valued at date of divorce, plus future increases *other than* those attributable to post-divorce elevation in rank for services rendered; *Reiss* v. *Reiss*, 40 S.W.3d 605, 611 n.5 (Tex.App.-Houston [1st Dist.] 2001, pet denied) (noting that post-divorce cost-of-living increases and interest accruing on nonemployee spouse's community portion of retirement benefits are subject to community property division); *Bloomer* v. *Bloomer*, 927 S.W.2d 118, 121 (Tex.App.-Houston [1st Dist.] 1996, writ denied) (awarding nonemployee spouse fifty percent interest in cost-of-living increases associated with retirement benefits that were community property).

B. Use *Taggert* Formula When Participant Retired at Time of Divorce

In *Taggert*, ex-wife sued for a portion of her ex-husband's military retirement benefits after he retired. The couple married in 1947 and divorced in 1968. Mr. Taggert retired from the Navy in 1974. The Texas Supreme Court held that ex-wife owned, as part of her community estate a share in the contingent right to ex-husband's military retirement benefits even though the right had not matured at the time of the divorce. *Taggart* v. *Taggart*, 552 S.W.2d 422, 424 (Tex. 1977). Ex-husband had 360 months of active and retired naval service, and only 246 months were earned during the marriage. The court awarded the ex-wife one-half of 246/360 of the ex-husband's total retirement pay (*Id.* at page 424) thus the community's interest when the employee spouse is already retired at time of divorce is calculated in accordance with the Taggert formula follows:

number of months married under the plan
÷
total number of months employed under the plan
x
value of the retirement benefits (e.g., monthly annuity) as of date of retirement
=
extent of community's interest

C. Use *Berry* Formula When Employee Spouse is Not Retired at Time of Divorce

In *Berry* v. *Berry*, 647 S.W.2d 945 (Tex. 1983), the Supreme Court settled the question of the valuation and apportionment of the community interest in a defined benefit plan when the employee spouse is not retired at time of divorce. Non-employee spouse may not share in any of the employee spouse's post-divorce earnings and efforts (Id. at 947). The *Berry* apportionment is as follows:

number of months married under the plan
÷
number of months employed under the plan as of date of divorce
x
value of the retirement benefits (e.g., the monthly annuity) as of date of divorce
=
extent of the community's interest

Also see *Albrecht* v. *Albrecht*, 974 S.W.2d 262 (Tex.App.-San Antonio 1998, no pet), holding that the *Berry* formula should be used, not the *Taggert* formula, when an employee has not retired as of the time of divorce.

Prague v. *Prague*, 190 S.W.3d 31, (Tex.App.-Dallas 2005, pet. denied) appears to be the last case to

follow the *Taggert* formula prior to the implementation of *Texas Family Code* § 3.007 (a)(b). The *Prague* case involved teacher retirement benefits. Husband and wife married in September 1976 and wife retired in May 2002 after participating in TRS for thirty-three years, nine before the marriage and twenty-four during the marriage. Husband and wife were divorced in April 2004. Because wife was already retired at the time of divorce, the trial court correctly used the *Taggert* formula to determine the value of the community and separate property portions of the TRS lump-sum and the TRS annuity.

As a result of the repeal of subsections (a) and (b) of *Texas Family Code* § 3.007, the case law quoted above is now applicable law and sets forth the correct valuation and apportionment formulas when an employee spouse is retired at the time of divorce and when an employee spouse is not retired at time of divorce.

IV. Defined Contribution Plans

A defined contribution plan is one that provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant's account and any income, expenses, gains and losses, and any forfeiture of accounts of other participants that may be allocated to the participant's account. Defined contributions plans are plans in which the employer and/or employee make contributions to an individual account set up for the employee. 22 *U.S.C.* § 414(i); 29 *U.S.C.* § 1002(34). A characteristic of these plans that each participant has an ascertainable monetary account balance credited to the participant that will include contributions and earnings on the account. Examples of a defined contribution plan are 401(k) plans and retirement savings plans.

WARNING: The application of the *Taggert* formula or Berry formula to a defined contribution plan is an abuse of discretion by the court *Hatteberg* v. *Hatteberg*, 933 S.W.2d 522, 531 (Tex.App.-Houston [1st Dist.] 1994, no writ); *Pelzig* v. *Berkebile*, 931 S.W.2d 398, 402 (Tex.App.-Corpus Christi 1996, no writ); *Iglinski* v. *Iglinski*, 735 S.W.2d 536, 537-38 (Tex.App.-Tyler 1983, no writ); (citing *Berry* v. *Berry*, 647 S.W.2d 945 (Tex. 1983)).

Texas Family Code § 3.007(c) effective September 1, 2005 (and still in effect as it was not repealed by the 2009 legislative session) states, "The separate property interest of a spouse in a defined contribution plan may be traced using the tracing and characterization principles that apply to a nonretirement asset." Prior to September 1, 2005, when an employee had participated in a defined contribution plan prior to marriage and also during the marriage, the separate property portion of the defined contribution plan was determined by looking at the balance in the defined contribution plan at the time of marriage. The difference between the balance at the time of marriage and the balance at time of divorce was the community property portion. The court simply subtracted the pre-marriage sum from the sum at the time of divorce to determine the portion that was added during the marriage and therefore was community and subject to division. *Boyd* v. *Boyd*, 67 S.W.3d 398, 410 (Tex.App.-Ft. Worth 2002, no writ history; *Smith* v. *Smith*, 22 S.W.3d 140, 149 (Tex.App.-Houston [14th Dist.] 2000, no pet'n); *Baw* v. *Baw*, 949 S.W.2d 764, 767-68 (Tex.App.-Dallas 1997, no writ); *Pelzig* v. *Berkebile*, 931 S.W.2d 398, 402 (Tex.App.-Corpus Christi 1996, no writ).

A paper I wrote on *Principles of Characterizing and Tracing* for the 2002 Advanced Family Law Course, chapter 17, page 30 challenged the simple subtraction method as follows:

WARNING: The simple subtraction method set forth in the above cases, should only be used when all of the property in the defined contribution plan is cash. If the assets in the defined contribution plan consist totally or partially of stock or mutual funds, the simple subtraction of the value at date of marriage from the value at date of divorce, can produce an incorrect result. For example, if on the date of marriage, the defined contribution plan consisted of 100 shares of Dell stock at $10.00 per share, the value of the defined contribution plan at date of marriage would be $1,000.00. If as of the date of divorce, there were 420 shares of Dell stock in the defined contribution plan, at $20.00 per share, the value of the defined contribution plan would be $8,400.00. In this example, only 20 shares of Dell stock were added to the defined contribution plan during the marriage. The increase from 100 shares to 400 shares was due to stock splits. A stock split of separate property stock is separate property. *Tirado* v. *Tirado*, 357 S.W.2d 468, 473 (Tex.Civ.App.-Texarkana 1982, writ dism'd). Therefore, the increase from 100 shares to 400 shares because of two, two for one stock splits, would result in the 400 shares being separate property. The

appreciation in value of the 400 shares would also be separate property. The increase in value of separate property stock during the marriage due to market conditions is separate property. *Dillingham* v. *Dillingham*, 434 S.W.2d 459 (Tex.Civ.App.-Ft. Worth 1968, writ dism'd). The only community property portion of the defined contribution plan would be the additional 20 shares added to the plan during the marriage. The simple subtraction approach of $1,000.00 value at date of marriage subtracted from $8,400.00 value at date of divorce, would give an incorrect result of $7,400.00 of community property. However, when the defined contribution plan is thoroughly analyzed, the community property share is only $400.00. Consequently, any time you have a defined contribution plan that consists of assets other than one hundred percent cash, a thorough analysis must be made, on a statement by statement basis, of what has happened to the plan and why the value at date of divorce is different from the value at the date of marriage.

Two excellent Dallas attorneys, Dawn Fowler and Jim Wingate challenged the simple subtraction formula in an article they wrote for the July 2002 *Texas Bar Journal*, entitled, *Characterization of Retirement Assets: Divestiture of Separate Property Is Alive and Well in Texas.* Dawn Fowler and Jim Wingate traced the history of the old cases and explained how confusion between defined benefit plans and defined contributions plans and a misreading of the early cases resulted in the simple subtraction method. In the Dell stock example above, the simple subtraction method resulted in a divesture of separate property by treating $7,000 of separate property as community property. On the other hand, if the value of the defined contribution plan assets decreased because of market forces, the simple subtraction method could cheat the community property estate. For example, on the date of marriage the value of the defined contribution plan was $100,000 and at time of divorce due to bad economy the value in the defined contribution plan is $70,000. During the marriage community property contributions were made into the retirement plan totaling $30,000. The simple subtraction method would treat the $70,000 as all separate property, thus cheating the community estate.

Thus, *Texas Family Code* 3.007(c) allows utilization of characterization and tracing principles within a defined contribution plan to the same extent that characterization and tracing principles can be utilized for nonretirement assets.

V. TRACING

A. Rebutting Community Presumption by Tracing

The character of separate property is not changed by the sale, mutation, exchange, substitution or change in form of separate property. *Gleich* v. *Bongio*, 99 S.W. 2d 881 (Tex. 1937). If separate property can be definitely and accurately traced and identified, it remains separate property regardless of the fact that the separate property undergoes mutations or changes in form. To overcome the presumption of community, the party asserting separate property must trace and clearly identify the property which is claimed to be separate property by clear and convincing evidence. *McKinley* v. *McKinley*, 496 S.W.2d 540, 543 (Tex. 1973); *Tarver* v. *Tarver*, 394 S.W.2d 780, 783 (Tex. 1965). The Court of Appeals in *Faram* v. *Gervitz-Faram*, 895 S.W.2d 839, 842 (Tex.App.-Fort Worth 1995, no writ) explained tracing as follows:

> "...the party claiming separate property must trace and identify the property claimed as separate property by clear and convincing evidence. Tracing involves establishing the separate origin of the property through evidence showing the time and means by which the spouse originally obtained possession of the property. *Hilliard* v. *Hilliard*, 725 S.W.2d 722, 723 (Tex.App.-Dallas 1985, no writ). Separate property will retain its character through a series of exchanges so long as the party asserting separate property ownership can overcome the presumption of community property by tracing the assets on hand during the marriage back to property that, because of its time and manner of acquisition, is separate in character. *Cockerham* v. *Cockerham*, 527 S.W.2d 162, 168 (Tex. 1975)..."

Rents, revenues and income from separate property is community property. *Arnold* v. *Leonard*, 273 S.W. 799 (Tex. 1925).

Cash dividends on separate property stock are community property, *Amarillo National Bank* v. *V. Liston*, 464 S.W.2d 764 (Tex.Civ.App.-Amarillo 1970, writ ref'd n.r.e.).

Stock dividends and stock splits on separate property stock, new stock from a merger of separate property stock or a liquidating cash dividend from separate property stock are all separate property. *Horlock* v. *Horlock*, 533 S.W.2d 52 (Tex.Civ.App.-Houston [1st Dist] 1976, writ dism'd).

In order to rebut the community property presumption, the party claiming separate property must trace and identify the property claimed as separate property by clear and convincing evidence. *Texas Family Code* § 3.003(b); *Cockerham* 527 S.W.2d at 167; *Celso*, 864 S.W.2d at 655. Tracing involves establishing the separate origin of the property through evidence showing the time and means by which the spouse originally obtained possession of the property. Separate property will retain its character through a series of exchanges so long as the party asserting separate ownership can overcome the presumption of community property by tracing the assets on hand during the marriage back to property that, because of its time and manner of acquisition, is separate in character. *Cockerham*, 527 S.W.2d at 167; *Celso*, 864 S.W.2d at 654.

As long as separate property can be definitely traced and identified, it remains separate property regardless of the fact that it may undergo mutations and changes. *Estate of Hanau* v. *Hanau*, 730 S.W.2d 663, 667 (Tex. 1987); *Norris* v. *Vaughn*, 260 S.W.2d at 679; *Harris* v. *Harris*, 765 S.W.2d 798, 802 (Tex.App.- Houston [14th Dist.] 1989, writ denied). However, if separate property and community property have been so commingled as to defy segregation and identification, the statutory community property presumption applies. *Estate of Hanau*, 730 S.W.2d at 667. Also see *Cockerham* v. *Cockerham*, 527 S.W.2d 162 (Tex. 1975). When tracing separate property, it is not enough to show that separate funds could have been the source of a subsequent deposit of funds. *Gibson* v. *Gibson*, 614 S.W.2d 487, 489 (Tex.Civ.App.-Tyler 1981, no writ). *Characterization, Tracing and Reimbursement in Family Law Litigation: An Overview, Checklist and Update of Advanced Issues*, State Bar of Texas Advanced Family Law Course - 1997, Sally Holt Emerson and Christopher K. Wrampelmeier.

B. Purposes of Tracing

The most common reasons for tracing are:

1. to establish the separate character of funds or assets held on account during marriage;

2. to establish the separate character of an asset acquired during marriage from separate funds or assets;

3. to support a reimbursement claim by demonstrating the use of funds or assets of one marital estate to benefit or enhance another marital estate; and economic contribution.

4. to defeat a reimbursement claim from one marital estate to another by demonstrating that the benefit or enhancement was paid by the estate receiving the benefit.

C. Tracing Rules

There are six principal rules for tracing and clearly identifying separate property. Commentators have labeled these theories as:

a. the clearinghouse method of tracing or the identical sum inference;
b. the minimum sum balance method;
c. the community out first rule;
d. pro-rata approach;
e. item tracing; and
f. value tracing.

The persuasiveness of a particular tracing rule or theory depends upon the facts of the case and the appropriateness of the tracing rule to those facts.

1. Clearinghouse and Identical Sum Inference Methods

The clearinghouse method is useful if a party had an account into which separate funds were temporarily deposited and then withdrawn (and possibly then used to acquire assets that are claimed as separate property). The clearinghouse method assumes that after one or more identifiable sums of separate funds went into the account, identifiable withdrawals were made that are clearly the withdrawals of the separate funds and are therefore separate property themselves. See e.g. *Estate of Hanau* v. *Hanau*, 730 S.W.2d 664 (Tex. 1987); *Peterson* v. *Peterson*, 595 S.W.2d 889 (Tex.Civ.App.-Austin 1980, writ dism'd w.o.j.); *Latham* v. *Allison*, 560 S.W.2d 481 (Tex.Civ.App.-Fort Worth 1978, writ ref'd n.r.e.) (unsuccessful tracing); *Beeler* v. *Beeler*, 363 S.W.2d 305 (Tex.Civ. App.-Beaumont 1962, writ dism'd). The clearinghouse method loses its persuasiveness if long periods of time separate the transactions. *Tracing*,

State Bar of Texas Advanced Family Law Course - 1995, Cheryl L. Wilson.

The identical sum inference method is similar to the clearinghouse method except that it involves only one deposit, rather than a series of deposits, followed by an identical withdrawal, usually a short time later. *Tracing*, State Bar of Texas Advanced Family Law Course - 1995, Cheryl L. Wilson. See e.g., *McKinley* v. *McKinley*, 496 S.W.2d 540 (Tex. 1973). The identical sum inference method is sometimes referred to as identification of specific transaction method.

2. Minimum Sum Balance Method

The minimum sum balance method is used when you have an account with separate property funds in it, into which community funds are deposited and when there have only been a few identifiable transactions. The party seeking to prove the amount of separate funds traces the account through each transaction to show that the balance of the account never went below the amount proven to be separate property. This theory presumes that only separate property remains after all other withdrawals are made. *Tracing*, State Bar of Texas Advanced Family Law Course -1995, Cheryl L. Wilson. See *Pardon* v. *Pardon*, 670 S.W.2d 354, 357 (Tex.App.-San Antonio 1984, no writ). *Snider* v. *Snider*, 613 S.W.2d 8, 11 (Tex.Civ.App.-Dallas 1981, no writ) (probate suit).

3. Community Out First Rule

Under this rule, withdrawals from a mixed separate and community fund are presumed to be community to the extent that community funds exist. Withdrawals are presumed to be from separate funds only when all community funds have been exhausted. See, e.g., *Sibley* v. *Sibley*, 286 S.W.2d 658 (Tex. 1955); *Welder* v. *Welder*, 794 S.W.2d at 428-29; *Gibson*, 614 S.W.2d at 489 (court required proponent to prove separate character of funds by community out first theory); *Harris* v. *Venture*, 582 S.W.2d 853 (Tex.Civ.App.-Beaumont 1979, no writ). The only requirement for tracing in the application of the community-out-first presumption is that the party attempting to overcome the community presumption must produce clear evidence of the transactions affecting the commingled account. *Welder* v. *Welder*, 794 S.W.2d at 434. *Characterization, Tracing and Reimbursement in Family Law Litigation: An Overview, Checklist and Update of Advanced Issues*, State Bar of Texas Advanced Family Law Course - 1997, Sally Holt Emerson and Christopher K. Wrampelmeier.

4. Pro Rata Approach

Under the pro rata approach, if mixed funds are withdrawn from an account, the withdrawal should be pro rata in proportion to the respective balances of separate and community funds in the account. By using the pro rata approach, it would not be necessary to analyze the character of each withdrawal. *Characterization, 20 Rules - 20 Examples and More*, State Bar of Texas Advanced Family Law Course - 1995, Richard R. Orsinger.

The Fort Worth Court of Appeals used the pro rata approach in an embezzlement case in which the deceased employee's wife had to prove what funds belonging to her husband (as opposed to his employer) flowed into each asset to which the employer had traced its embezzled funds. The husband had deposited the embezzled funds into an account and used that account to pay incrementally the premiums of a life insurance policy. When he killed himself, his employer and his wife disputed who owned the policy proceeds. *Marineau* v. *Gen.Am. Life Ins.*, 898 S.W.2d 397, 400, 403 (Tex.App.-Fort Worth 1995, writ denied). The employer contended that the wife failed to meet her burden of proof because she only offered evidence of the proportion of embezzled money to personal money deposited into the account used to pay the insurance premiums. The employer argued that the wife had to prove the ownership proportion of each payment to calculate the ownership of the policy, and absent such proof, the presumption is that all of the commingled funds are held in trust for the employer.

The court of appeals disagreed. The court relied on *G & M Motor Co.* v. *Thompson*, 567 P.2d 80, 84 (Okla. 1977), in which the Oklahoma Supreme Court held that the employer of the embezzling employee was entitled to a pro rata share of the life insurance policy proceeds where the wrongfully acquired funds were partially used to pay the premiums.

5. Item Tracing

An item of separate property on hand at dissolution of marriage must be traced to its inception of title. The proponent of the separate property characterization must establish by clear and convincing evidence that the item on hand was either acquired as separate property before marriage or by

gift, devise or descent during marriage, or by the use of separate property funds or separate property credit. *Cockerham* v. *Cockerham*, 527 S.W.2d 162 (Tex. 1975).

6. Value Tracing

Value tracing is used to trace cash assets in order to determine the character of cash on hand at the dissolution of marriage. The proponent of separate property must trace all funds brought into and out of an account. Each deposit and each check must be accounted for. *In re Marriage of Tandy*, 532 S.W.2d 714 (Tex.Civ.App.-Amarillo 1976, no writ).

D. Bidirectional Commingling, Application of Trust Law

The primary source for this part of the paper is an article entitled *Handling the Divorce Involving Tracing of Separate Property Through Accounts*, State Bar of Texas Marriage Dissolution Institute - 1998,James D. Stewart and Robert L. Graul, Jr.

Commingling refers to a process by which community property and separate property are mixed together so that they cannot be separately identified or resegregated, commonly resulting in treatment of the entire mass as community property. In other words, if separate property gets too commingled with community property that the separate property loses its identity, separate property is treated as community property. *McKinley* v. *McKinley*, 496 S.W.2d 540 (Tex. 1973); Jackson v. *Jackson*, 524 S.W.2d 308 (Tex. Civ.App.-Austin 1975, no writ).

The source of the commingling rule is from trust law. If a trustee mixes his personal property with the corpus of the trust so that it can no longer be identified, the trustee's personal property becomes a part of the trust corpus.

1. Normal Commingling

Normal or regular commingling occurs when community property and separate property have been mixed, causing the entire mass to become community property. If community and separate property have been hopelessly commingled as to defy resegregation and identification, the presumption of community property controls and the entire amount is community property. *Cockerham* v. *Cockerham*, 527 S.W.2d 162 (Tex. 1975).

2. Reverse Commingling

Reverse commingling occurs when community property and separate property have been hopelessly mixed, and the entire mass becomes separate property. In *Sibley* v. *Sibley*, 286 S.W.2d 657 (Tex.Civ.App.-Dallas 1955, writ dism'd), husband commingled community property with wife's separate property to the extent that the community property and wife's separate property became so commingled as to defy resegregation and identification. Based on the application of trust principles, husband had a fiduciary duty to protect wife's separate property, thus the entire mass became wife's separate property. Therefore, commingling can be bidirectional, where separate property and community property funds are commingled and the entire mass becomes community property (normal or regular commingling) or where separate funds and community funds are commingled and the entire mass becomes separate property (reverse commingling).

3. Important Exception

Sibley v. *Sibley*, 286 S.W.2d 657 (Tex. Civ.App.-Dallas, 1955, writ dism'd) sets out the general rule and the exception.

The presumption is that where funds are commingled so as to prevent their proper identity as separate or community funds, they must be held to be community funds. However, there are exceptions to rules or presumptions. In divorce proceedings our courts have found no difficulty in following separate funds through bank accounts. *Farrow* v. *Farrow*, 238 S.W.2d 255 (Tex.Civ.App.-Austin, 1951, no writ); *Coggin* v. *Coggin*, 204 S.W.2d 47 (Tex.Civ.App.-Amarillo 1947, no writ). Equity impresses a resulting trust on such funds in favor of the wife and where a trustee draws checks on a fund in which trust funds are mingled with those of the trustee, the trustee is presumed to have withdrawn his own money first, and is therefore an exception to the general rule.

The rule is that if the commingler would benefit and the innocent spouse would suffer, then the presumption is against the wrongdoer's interest, regardless of whether that interest is community or his separate property.

Under the case law that establishes community out first rule of tracing to overcome commingling, if this rule worked to the financial advantage of the "bad actor" (the spouse who manages the accounts) and to the detriment of the other spouse (the beneficiary

under trust law), then the **burden of tracing** would shift to the managing spouse in order to protect the estate of the other spouse, as recognized in *Farrow* v. *Farrow*, 238 S.W.2d 255, 256 (Tex.Civ.App.-Austin 1951, no writ).

In *Andrews* v. *Brown*, 10 S.W.2d 707 (1928), cited with approval in *Mooers* v. *Richardson Petroleum Company*, 146 Tex. 174, 204 S.W.2d 606 (Tex. 1947), the following appears:

> "'If a man mixes trust funds with his own,' it is said, 'the whole will be treated as trust property, **except so far as he may be able to distinguish what is his own.' ...,** That principle seems to have recognition in most, if not all, American jurisdictions...
>
> "Analogous doctrines are part of the law of accession and specification..., and of confusion of goods ... The principle, we apprehend is but a part of equity's declination to extricate the wrongdoer from self-imposed hard conditions, or to tax the innocent, where one of two not in pari delicto must suffer."

If a managing spouse mixes his separate funds with community funds and fails to meet his burden to trace and prove what portion belongs to his separate estate, then the whole will become community property (normal commingling). On the other hand, if the managing spouse mixes his wife's separate funds with community funds and fails to meet his burden to trace and prove what portion is her separate property and what portion is the community estate (in which he owns an interest), then the whole will become the wife's separate property (reverse commingling).

4. Husband or Wife?

With the advent of the Texas Equal Rights Amendment, *Texas Constitution*, Article I, Section 3a (1972), it should not make any difference whether the spouse seeking to trace separate property is the husband or wife. However, one spouse or the other, typically the husband, will be the legal or actual "manager" of most of the assets of the parties' separate and community estates. The "trust theory" as stated in the cases of *Farrow* v. *Farrow*, supra, and *Sibley* v. *Sibley*, supra, as well as the long line of cases that have followed, provide that the spouse who is managing the assets of the marriage will be treated as a "trustee" who will suffer the loss of those assets separately belonging to him if he mixes them with the "trust assets" that are community assets and does not meet his burden of tracing. In most cases, this will mean that the managing spouse's separate property estate can be lost through commingling.

The loss of the managing spouse's separate estate to commingling is consistent with the general rule that a "trust relationship" exists between a husband and wife as to property controlled by the managing spouse. *Mazique* v. *Mazique*, 742 S.W.2d 805, 807 (Tex.App.-Houston [1st Dist.] 1987, mand. overruled); *Carnes* v. *Meador*, 533 S.W.2d 365, 370 (Tex.Civ.App.-Dallas 1975, writ ref'd n.r.e.); *Brownson* v. *New*, 259 S.W.2d 277, 281 (Tex.Civ.App.-San Antonio 1953, writ dism'd w.o.j.). The burden is on the managing spouse to prove that a gift or disposition of community funds was not unfair to the other spouse. *Mazique* v. *Mazique*, 742 S.W.2d at 808; *Jackson* v. *Smith*, 703 S.W.2d 791, 795 (Tex.App.-Dallas 1979, writ ref'd n.r.e.). "Thus, constructive fraud will usually be presumed unless the managing spouse proves that the disposition of the community funds was not unfair to the other spouse." *Mazique*, 742 S.W.2d at 808; *Carnes*, 533 S.W.2d at 370. "Where the managing spouse has received community funds and the time had come to account for such funds, the managing spouse has the burden of accounting for their proper use." *Mazique*, 742 S.W.2d at 808; *Maxell's Unknown Heirs* v. *Bolding*, 36 S.W.2d 267, 268 (Tex.Civ.App.-Waco 1931, no writ).

5. Fiduciary Duty is Owed by Managing Spouse

Many cases have found a fiduciary or trust relationship to exist between spouses when the managing spouse has gifted or squandered the community assets. *Reaney* v. *Reaney*, 505 S.W.2d 338 (Tex.Civ.App.-Dallas 1974, no writ) (wife given money judgment for $9,062.87 against husband for "abuse of his managerial powers", which resulted in dissipation of community assets squandered in gambling and gifts); *Pride* v. *Pride*, 318 S.W.2d 715, 718 (Tex.Civ.App.-Dallas 1958, no writ) (wife given money judgment for her share of $3,000 cash concealed in hole in floor and not accounted for); *Swisher* v. *Swisher*, 190 S.W.2d 382 (Tex. Civ.App.-Galveston 1945, no writ); *Givens* v. *Girard Life Ins. Co. of Am.*, 480 S.W.2d 421 425 (Tex.Civ.App.-Dallas 1972, writ ref'd n.r.e.) (wife had no burden to establish fraudulent intent to protect her interest in the community from "abuse of husband's managerial powers.")

Once the trust relationship is established, the managing spouse has the burden to produce records and to show fairness in dealing with the interests of the other spouse. *Morrison* v. *Morrison*, 713 S.W.2d 377, 380 (Tex.App.-Dallas 1986, writ dism'd) (burden on husband manager of community assets to produce records to justify expenditures on other women); *Spruill* v. *Spruill*, 624 S.W.2d 694, 697 (Tex.App.-El Paso 1981, writ dism'd) (trust relationship exists between husband and wife as to that community property controlled by each spouse. Burden of proof is upon the disposing spouse to show fairness).

If the managing spouse is in fact handling both community property **and the other spouse's separate property**, then the managing spouse has the burden of producing records and tracing the community portion. If he fails to meet his burden, then under the trust principles announced in *Farrow* v. *Farrow*, supra, and *Sibley* v. *Sibley*, supra, the interests of the managing spouse in the community are lost and the mixture becomes the other spouse's separate property.

6. Background in Trust Accounting Rules

Farrow v. *Farrow*, 238 S.W.2d 255 (Tex.Civ.App.-Austin 1951, no writ) was the first of the modern tracing cases to apply trust doctrine to the tracing or commingling of community and separate funds in a marriage:

(a) If a man mixes trust funds with his own, the whole will be treated as trust property, except so far as he may be able to distinguish what is his own.

(b) An owner who wrongfully permits the property of another to become so intermingled and confused with his own property as to render impossible the identification of either, is under the burden of disclosing such facts as will insure a fair division, and if he fails or refuses to do so, the combined property or its value will be awarded to the injured party.

(c) But there must be a willful or wrongful invasion of rights in order to induce the merited consequences of forfeiture.

(d) If the goods are of the same nature and value and the portion of each owner is known or if a division can be made of equal proportionate value, as in the case of a mixture of corn, coffee, tea, wine or other article of the same kind and quality, then each owner may claim his proportionate part.

Under *Sibley* v. *Sibley*, 286 S.W.2d 657, 659 (Tex.Civ.App.-Dallas 1955, writ dism'd), the application of the trust doctrine in a divorce case meant that "the trustee (husband) is presumed to have checked out his money first."

From these general trust principles, a number of separate accounting rules permitting tracing have developed, some of which have a life independent of their source in trust law.

The primary concern in tracing cases applying trust doctrine is to see that a wrongdoer does not prosper by his actions. Most of the cases address situations where a person mixes trust funds with his or her property.

The "community out first" rule of tracing is now firmly established in our Texas jurisprudence. In other words, this rule has taken on a "life of its own" and no longer relies on trust law. *Welder* v. *Welder*, 794 S.W.2d 420 (Tex.App.-Corpus Christ 1900, no writ); *DePuy* v. *DePuy*, 483 S.W.2d 883 (Tex. Civ.App.-Corpus Christi 1972, no writ); *Horlock* v. *Horlock*, 533 S.W.2d 52 (Tex.Civ.App.-Houston [14th dist.] 1975, writ dism'd); *Harris* v. *Venture*, 582 S.W.2d 853 (Tex.Civ. App.-Beaumont 1979, no writ); *Snider* v. *Snider*, 613 S.W.2d 8 (Tex.App.-Dallas 1981, no writ); *Gibson* v. *Gibson*, 614 S.W.2d 487 (Tex.Civ.App.-Tyler 1981, no writ); *Kuehn* v. *Kuehn*, 594 S.W.2d 158 (Tex.Civ.App.-Houston [14th Dist.] 1980, no writ).

Similarly, if a person has been given managerial powers over the other spouse's estate and uses the separate funds as collateral to obtain loans to purchase assets and the lender intends to only look to the separate funds for repayment, should not all of the assets be the separate property of the wife? What if her separate estate paid off that loan? Would this create a constructive or resulting trust?

The Court of Appeals in *Farrow* v. *Farrow*, 238 S.W.2d 255 (Tex.Civ.App.-Dallas 1955, writ dism'd) cited 9 *Tex.Jur. Confusion of Goods*, Sec. 2 for the principle that, "(A)n owner who wrongfully permits the property of another to become so intermingled and confused with his own property as to render impossible the identification of either is under the burden of disclosing such facts as will insure a fair division, and if he fails or refuses to do so, the

combined property or its value will be awarded to the injured party." *Farrow,* 238 S.W.2d at 257.

Applying this principle to the situation described above would indicate that the burden would be on the managing spouse to disclose facts insuring a fair division, or risk forfeiture of the property in which he has an interest whether community or separate, and awarding the property or its value to the injured party. *Handling the Divorce Involving Tracing of Separate Property Through Accounts*, State Bar of Texas Marriage Dissolution Institute - 1998, James D. Stewart and Robert L. Graul, Jr.

VI. United States and Texas Supreme Cases Involving Designation of Beneficiary of Retirement Benefit

1. *Estate of Kennedy, Deceased* v. *Plan Administrator for Dupont Savings and Investment Plan*, 129 S.Ct. 865 (2009)

In 1971, husband and wife were married. At that time husband was already employed by employer. In 1974, husband named wife beneficiary of his savings and investment plan (SIP) governed by ERISA. In 1994, husband and wife divorced. The divorce decree contained a waiver by wife that claimed to divest wife of her interest in the SIP benefits, but husband did not execute a document removing wife as the SIP beneficiary as required by ERISA. The decree awarded husband all of the SIP. Husband retired from employer in 1998, and died in 2002. Following husband's death, the executrix of husband's estate asked for the SIP funds to be distributed to estate. However, employer, relying on husband's designation form, paid the $400,000 in proceeds from SIP to wife. Estate filed suit alleging that wife's waiver was an assignment or alienation of her interest in any SIP benefits in the divorce decree, and thus employer violated ERISA by paying her.

The Federal District Court for the Eastern District of Texas entered summary judgment for estate, ordering employer to pay the benefits to the estate. Fifth Circuit reversed, holding that wife's waiver was an assignment or alienation of her interest to the estate, which is not allowed under ERISA. Estate appealed to the U.S. Supreme Court, who granted certiorari and affirmed. Wife did not attempt to direct her interest in the SIP benefits to estate or any other potential beneficiary. Therefore, absent a properly filed change in beneficiary form, employer was required to distribute the proceeds to wife. While it is true that the anti-alienation provisions of ERISA do not apply to a QDRO, husband and wife's divorce decree did not meet the standards to be considered a QDRO. There was no QDRO because the Decree of Divorce awarded husband one-hundred percent of the SIP. In the absence of a QDRO, an ERISA plan administrator is required by statute to look to the terms of the plan in order to determine to whom distributions should be made. This is not to say that a beneficiary cannot waive his or her rights to payments. However, the SIP terms required a contemporaneous direction to another beneficiary in order for a waiver to be valid. Since wife's waiver in the divorce decree did not direct that the benefits be paid estate or any other potential beneficiary, it failed under the terms of the SIP. As such, employer was required to distribute proceeds to wife, the only properly named beneficiary under the terms of the SIP.

2. *Holmes* v. *Kent*, 221 S.W.3rd 662 (Tex. 2007)

The Teacher Retirement System (TRS) allows a retiree to elect, instead of a standard service retirement annuity, an optional annuity that provides reduced payments to the retiree during his life and, at death, continued payments to and throughout the life of a designated beneficiary. Only one beneficiary can be designated, and changing the designation is restricted, since the value of the optional annuity, and hence the cost to TRS, depend on the beneficiary's longevity. To revoke the beneficiary designation, the retiree must strictly follow the TRS requirements: prescribed forms must be used, and either (1) a divorce court must approve or order the revocation or accept a property settlement or (2) the beneficiary spouse must sign a notarized consent to the revocation. See *Gov't Code* §§ 824.101(c), 924.1012, 824.1013. Provisions in a divorce decree that awarded the retiree all retirement benefits and divested the beneficiary spouse of all right to the benefits did not constitute an order for a change of beneficiary and was not accepted by TRS. *Holmes* v. *Kent*, 221 S.W.3rd 622 (Tex. 2007). The decree must clearly order a change of beneficiary or a revocation of the spouse as beneficiary and a substitution of a new beneficiary.

As a result of the *Kennedy* and *Holmes* cases, our office created a letter addressing this issue. Please see Appendix A. The letter is mailed to the client at the end of the case and serves a dual purpose of informing the client and protecting the lawyer.

VII. SUMMARY

The valuation and apportionment of defined benefit plans and defined contribution plans represent complex challenges and what seems to be ever-changing law. With the repeal of subsections (a) and (b) of *Texas Family Code* § 3.007, thirty-five year old cases dividing defined benefit plans control again. Characterization and tracing principles that apply to nonretirement assets now apply to defined contribution plans, rather than the simple subtraction formula.

As the recent United States and Texas Supreme Court cases illustrate, if the decree is not worded correctly or if an employee spouse does not properly and timely designate a new beneficiary for retirement death benefits, an unintended result will follow.

VIII. AFTERTHOUGHT

How do you obtain the needed information from retirement plan administrators so you can properly represent your client? Ask for it by using form 19-1, Letter to Plan Administrator, and form 19-2, QDRO Fact Sheet for the Plan, as well as other forms found in Volume 3 of the *Texas Family Law Practice Manual*. Form 19-1 asks the plan administrator to provide the following:

1. a copy of the formal plan documents;
2. a copy of the summary plan description or employee booklet;
3. a copy of the summary annual report;
4. a copy of the company's written procedures for determining the qualified status of qualified domestic relations orders, if any;
5. a statement of accrued benefits;
6. an Internal Revenue Form 5500.

Form 19-2, the QDRO Fact Sheet for the Plan, asks for all the other pertinent information needed for a defined benefit plan or a defined contribution plan, and contains an Affidavit for Business Records.

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_____, 2010

RE: Retirement and Death benefits

Dear _____:

If you have named your spouse as a survivor beneficiary for death benefits from your retirement plan wherein your spouse would receive some of your retirement benefits upon your death and you do not want your spouse to receive these benefits, it is critically important for you to change your beneficiary designation with the appropriate people within your retirement plan and to use and precisely follow the forms on changing the designation of your retirement plan death beneficiary. Whether your divorce decree awards you one-hundred percent of your retirement plan or a portion of your retirement plan, you must change the beneficiary designation or risk your ex-spouse receiving death benefits from your retirement plan.

I am going to give you two examples showing how the failure to change a beneficiary designation as per the retirement plan requirements resulted in an ex-spouse receiving retirement plan benefits despite the opposite intention of the spouse who was awarded the retirement plan benefits. The first example involved a Texas school teacher who was retired at the time of her divorce. The divorce decree awarded her one-hundred percent of her Teacher Retirement System benefits. She failed to change the beneficiary designation utilizing the forms and following the instructions of Texas Teacher Retirement System. Sometime after the divorce she died and the Teacher Retirement System paid the survivor benefits to her ex-spouse. The Texas Supreme Court upheld this result in *Holmes v. Kent*, 221 S.W.3d 662, (Tex. 2007).

The second example involved a Texas divorce wherein husband was awarded all of this retirement benefits with DuPont. Since husband was awarded all of his retirement benefits with DuPont, including a defined contribution plan (401k plan) and a defined benefit plan (pension plan), there was no need for a qualified domestic relations order. After the divorce, husband changed his

beneficiary designation from his ex-wife to his daughter on his pension plan, but not on his 401k plan. Subsequently husband died and his daughter having been named as the new beneficiary for the pension plan received the pension plan retirement benefits. However, since husband did not change the beneficiary designation on his 401k plan, his ex-wife, rather than his daughter, received over $400,000.00 from his 401k plan. This result was confirmed by the United State Supreme Court in the *Estate of Kennedy*, 129 S.Ct. 965 (2009).

I hope these two examples clearly illustrate the absolute importance of promptly changing the survivor beneficiary of retirement plan benefits and to utilize the forms provided by the retirement plan administrator and precisely follow the instructions on changing the beneficiary designation. If you desire to change your retirement plan beneficiary designation, contact your plan administrator immediately to obtain the appropriate forms and instructions for completing the forms.

Respectfully,