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What Every Attorney Should Know about the Ambiguous and Far-Reaching Minefield of New Changes to Family Code section 721

By Gregory W. Herring

The Governor's recent signing of Senate Bill 1936, which will go into effect on January 1, 2003, amends section 721 of the Family Code in a manner that raises a minefield of issues concerning the duties and liabilities of spouses engaging in financial transactions during marriage. The amendments to section 721 are highly ambiguous. They are also potentially extremely far-reaching in effect. All family law and other civil law practitioners should be aware of the changes in Family Code section 721 in advising their clients, including individuals and businesses, who and which are involved in any financial transactions concerning marital ("community") property.

Amended Family Code section 721 will continue to provide that, in any property transactions between themselves, spouses are fiduciaries who owe each other the highest duty of good faith and fair dealing. It will continue to expressly incorporate, as part of this marital duty, the obligations that are set forth in Corporations Code sections 14403, 16404 and 16503 in relation to duties between business partners. These require a businessperson, when requested by a partner, to provide access to books, information and accountings relating to particular business transactions. Thus, the law will continue to treat spouses as business partners in the marital context.

Until the Governor signed SB 1936 last month, the duty set forth in Family Code section 721 clearly excluded the so-called "Prudent Investor Rule," which is stated in Probate Code section 16040.

The Prudent Investor Rule strictly governs the nature and scope of transactions in which a trustee may reasonably engage while managing a trust. Under Probate Code section 16040, a trustee's standard of care is to administer a trust "with reasonable care, skill, and caution under the circumstances then prevailing that a prudent person acting in a like capacity would use in the conduct of an enterprise of like character and with like aims to accomplish the purposes of the trust as determined from the trust instrument."

Under Probate Code section 16047(c), the circumstances that a trustee must consider as part of the above include:

(1) General economic conditions.

(2) The possible effect of inflation or deflation.

(3) The expected tax consequences of investment decisions or strategies.

(4) The rule that each investment or course of action plays within the overall trust portfolio.

(5) The expected total return from income and the appreciation of capital.

(6) Other resources of the beneficiaries known to the trustee as determined from information provided by beneficiaries.

(7) Needs for liquidity, regularity of income, and preservation or appreciation of capital.

(8) An asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

Ambiguities:

The main ambiguity with SB 1936 is that it is unclear whether or not it incorporates the Prudent Investor Rule into amended Family Code section 721.

An analysis of the ambiguity requires a brief review of the recent marital dissolution case, *Marriage of Duffy* ((2001) 91 Cal.App.4th 923). The wife in that case, which involved a 34-year marriage, had been a "stay-at-home mom" while raising the parties' seven children. Early in the marriage she had managed the parties' checkbook. She had never managed a checking account before, however, and she had no experience with managing finances. In her own words at trial, her management of the checkbook was "a disaster."

The husband consequently took complete charge of the family finances. During the marriage he guided the family's purchase of a large house, certain real property and a small business. Some of the investments turned out well, and some turned out poorly.

As part of his management of the family finances, the husband rolled the community's interest in his prior employer's profit sharing plan into a brokerage account. The wife knew about this, and she even accompanied the husband to the bank to accomplish the transaction. After the account was established, however, the husband did not affirmatively discuss it with the wife. Nor did the wife, who reviewed some of the pertinent statements from time to time, ever affirmatively ask for information about the account's performance.

At trial, the wife complained that the husband had mismanaged the account and had failed to fully disclose the account's risks and performance. The trial court agreed, and awarded a judgment against the husband of over $400,000.

The Court of Appeal reversed. It held that, as a factual matter, the husband did not breach the duty of full disclosure, as there was no evidence that he refused to provide information when asked. It also held that the husband did not owe the wife a duty of care in investing the community assets. Inasmuch as the husband did not owe the wife a duty of care, the Court held that he, therefore, could not have breached that duty.

SB 1936 adds a provision to Family Code section 721, stating "[i]t is the intent of the Legislature in enacting this act to . . . abrogate the ruling in *In re Marriage of Duffy* . . . ." While it is unclear which of the two above holdings is abrogated (the holding as to the duty of full disclosure or the holding as to the lack of a duty of care, or both), this language could reasonably be interpreted to indicate that the Prudent Investor Rule *is* incorporated. Moreover, this interpretation would be consistent with the express goals of the women's groups that helped promote the Bill into law.

This is bolstered by the introduction to SB 1936, stating, "[t]his bill would subject a husband or wife that enters into any real property transaction with the other to those general rules governing fiduciary relationships where the transaction involves the administering of a trust."

Unfortunately, even this "explanatory" language is unclear. The reference to only "real property" is inexplicable, inasmuch as section 721 otherwise expressly applies to *all* property transactions. Nonetheless, this language does undeniably express a general intent to import the Prudent Investor Rule, at least to some extent, into section 721.

On the other hand, amended Family Code section 721(b) provides, "[e]xcept as provided in sections . . . 16040, and 16047 of the Probate Code, . . . a husband and wife are subject to the general rules governing fiduciary relationships . . . ." This is substantially identical to the prior language of section 721, which expressly excluded the Prudent Investor Rule. This would indicate that the Prudent Investor Rule *is not* incorporated.

The legislative history of SB 1936 (particularly including the Governor's pertinent press release) is unclear as to whether or not the Prudent Investor Rule is included.

Attorneys are thus advised to take the most cautious route and assume that the Prudent Investor Rule is now incorporated into amended Family Code section 721.

Far-Reaching Effects:

Assuming, in an abundance of caution, that the Prudent Investor Rule will now be part of every transaction involving community property, the law's effects will be extremely far-reaching.

Under this analysis, *family law lawyers* will be ensured of full employment. With every economic downturn will come the prospect of "breach of duty" lawsuits, whether or not a marital dissolution

case is pending. This is because nothing in section 721, as presently existing or as modified, requires a pending marital dissolution case for one spouse to sue the other.

Marital dissolution cases will now require a scrutiny of every financial transaction during the marriage. Purchases and sales of residences and businesses, investments in equities, applications for loans and decisions regarding retirement planning will all be scrutinized in the heat of battle in family court. As in *Marriage of Duffy*, the historical communications (or lack thereof) between the spouses concerning each transaction will require intricate analysis. The analyses will be particularly complicated and expensive to the extent transactions under review may have included intermingled community and separate funds.

Additionally, *all civil practitioners* will be wise to begin advising their married clients that the clients may effectively become "guarantors" of all financial transactions involving any community funds. To avoid potential malpractice liability, attorneys will also need to consider routinely advising such clients to "get it in writing" (although what "it" would be is also unclear under SB 1936) with the other spouse every time the client enters into a subject transaction. Additionally, counsel may have to begin advising clients to routinely retain investment advisors for purely prophylactic purposes.

Further, *corporate counsel* will face special considerations. To the extent that a couple may have a community interest in a close corporation, for instance, counsel will have to consider whether the new law requires express disclosures to both spouses of all corporate transactions.

Due to the ambiguities in SB 1936, we will likely have to wait for cases to percolate through the courts for a dependable interpretation of whether or not the Prudent Investor Rule is or is not included in amended Family Code section 721. Assuming for now that the Rule *is* included, the far reaching effects of the law warrant that all attorneys would be advised to carefully consider the ramifications to their clients' marital "enterprises."