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### **What Words Don't You Understand - - Fiduciary or Duty? In Amending Family Code Section 721, The Legislature Gives Unhappy Couples One More Thing to Fight About**

*by Peter M. Walzer and Gregory W. Herring*

The amendments to Family Code section 721 as fashioned by Senate Bill 1936 are effective January 1, 2003. The purpose of the amendment is to clarify that “the fiduciary relationship between spouses includes all of the same rights and duties in the management of community property as the rights and duties of unmarried business partners managing partnership property, as provided in sections 16403, 16404, and 16503 of the Corporations Code.” The legislature apparently intends by this amendment that, henceforth, any financial transactions that result in a loss to the community or any act that results in a loss of a community opportunity will be actionable as a breach of fiduciary duty. But because there is ambiguity in the wording of the statute, it is not clear what the duty one spouse actually has to the other.

The amendment to section (b) of 721 specifically excludes the application of the Prudent Investor Rule as set forth in Probate Code section 16047 to transactions between spouses. This language of exclusion can be construed as being inconsistent with the new uncodified intent language in section 2 of section 721, which abrogates the holding in *In re Marriage of Duffy* (2000) 91 Cal. App.123 (holding in part that the Prudent Investor Rule does not apply to transactions between spouses). Despite this apparent inconsistency, the Coalition for Family Equity, which was the sponsor of this legislation, intends to clarify that spouses do have a fiduciary duty to one another and it is akin to the duty that business partners have to one another. The sponsors refer to this duty as the Prudent Investor Rule.

Amended Family Code section 721 continues to provide that, in transactions between themselves, spouses are fiduciaries who owe each other the highest duty of good faith and fair dealing. It continues to expressly incorporate, as part of this marital duty, the obligations that are



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set forth in Corporations Code sections 16403, 16404 and 16503 (formerly Corporations Code sections 15019, 15020, and 15022) in relation to duties between business partners. These sections require a businessperson, when requested by a partner, to provide access to books, information and an accounting 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, however, spouses were not held to the standard of A Prudent Investor.” This was per the holding in *In re Marriage of Duffy* (2001) 91 Cal.app.4th 923.

The Prudent Investor Rule defines the duty of a trustee to the beneficiaries of a trust. Under Probate Code section 16040, a trustee must 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 his duty 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 assets special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

It would be a high standard, indeed, if the Prudent Investor Rule as described above were applied to married couples.

#### **AMBIGUITIES:**

It is unclear whether the newly amended Family Code section 721 makes the Prudent Investor Rule the standard for reviewing marital transactions. An analysis of *Marriage of Duffy*, supra, is necessary to understand the nature of this ambiguity, and to understand why the Legislature initiated this amendment.

The Duffys were married 34 years. Patricia was a stay-at-home mom who raised their seven children. She managed the parties' checkbook early in the marriage. She had never managed a



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checking account before, and she had no experience in financial management. She testified at trial that her management of the checkbook was "a disaster."

Vincent later took charge of the family finances. He purchased a large house, certain real property and a small business during the marriage. Some of the investments increased in value, but others failed.

When Vincent left his long-term employment with MCA Records, he rolled the MCA stock and other funds in his profit-sharing plan into an IRA account. Patricia accompanied Vincent when he went to the bank to transfer the funds.

Vincent later transferred the funds to a brokerage account. After establishing the account, however, he refrained from further discussing "his" investments with Patricia. On the other hand, Patricia, who reviewed some of the pertinent statements from time to time, never asked for information about the account's performance. Vincent invested his entire portfolio in a volatile technology stock, Excaliber Technologies Corporation. The stock portfolio at one time rose to a value of \$611,698, then declined to \$261,483.

At trial, Patricia asserted that Vincent had mismanaged the account and that he had failed to fully disclose the risks involved in the investment as well as its decidedly negative performance. The trial court agreed, and found that Vincent had breached his fiduciary duty of disclosure under Family Code section 1100. It awarded Patricia a judgment of over \$400,000.

The Court of Appeal reversed. It held that, as a factual matter, Vincent did not breach his duty of full disclosure to Patricia under Family Code section 1100. The Court held that there was no evidence that Vincent refused to provide information to Patricia when asked. The court also held that Vincent did not owe Patricia a duty of care under Family Code section 721 to invest the community assets prudently. This holding, in particular, incensed the members of the Coalition for Family Equity, who were the progenitors of fiduciary duty legislation in California in the late nineteen eighties.

In reaction to the ruling in *Duffy*, the Coalition for Family Equity sponsored Senate Bill 1936, which added an uncodified 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* . . . . It is unclear, however, which holding in *Duffy* was abrogated. Whether it was the holding (1) that Vincent did not violate his duty of full disclosure or the holding (2) that he lacked a duty of care to Patricia, or both, the amendment can, at any rate, reasonably be interpreted to indicate that the Prudent Investor Rule now defines the duty spouses have to each other. Moreover, this interpretation would be consistent with the express goals of the Coalition for Family Equity.

The *Duffy* court narrowed the application of Family Code section 721 by limiting the duty one spouse owes to another by its reference to duties expressly set forth in the statute. The court said:



By narrowing the scope of the fiduciary duty to rights specifically enumerated therein, the Legislature removed another duty of care. The Legislature did this by deleting the phrase, “but not limited to,” from the phrase, “including, but not limited to,” the enumerated rights. The enumerated rights directly echo the rights found in the sections of the Corporations Code that former Civil Code § 5103(b), identified as delineating the scope of spouses’ fiduciary duty.”

In order to “abrogate the ruling” in *Duffy* and to expand the rights of spouses to hold each other accountable to one another, Senate Bill 1936 also adds the language, “but not limited to” after the word “including” when referring to the specific duties listed in Family Code section 721(b) (1), (2) and (3).

The sponsors wanted it to be clear that the duties one spouse owes the other are not just the duties which are specifically outlined in sections (1), (2), and (3) of 721(b). By not limiting the right of spouses to sue each other for only the rights specifically enumerated in Family Code section 721(b), the new code section allows spouses to sue each other for breach of fiduciary duty even though not specifically listed in Family Code section 721(b).

Family Code section 721 (b) now states as follows

Except as provided in Sections 143, 144, 146, 16040, and 16047 of the Probate Code, in transactions between themselves, a husband and wife are subject to the general rules governing fiduciary relationships which control the actions of persons occupying confidential relations with each other. This confidential relationship imposes a duty of the highest good faith and fair dealing on each spouse, and neither shall take any unfair advantage of the other. This confidential relationship is a fiduciary relationship subject to the same rights and duties of nonmarital business partners, as provided in Sections 16403, 16404, and 16503 of the Corporations Code, including, but not limited to, the following:

- (1) Providing each spouse access at all times to any books kept regarding a transaction for the purposes of inspection and copying.
- (2) Rendering upon request, true and full information of all things affecting any transaction which concerns the community property. Nothing in this section is intended to impose a duty for either spouse to keep detailed books and records of community property transactions.
- (3) Accounting to the spouse, and holding as a trustee, any benefit or profit derived from any transaction by one spouse without the consent of the other spouse which concerns the community property.



The interpretation that the fiduciary duty described in the newly amended section 721 is the same obligation as that mandated by the Prudent Investor Rule is bolstered in the introduction to Senate Bill 1936 in the Legislative Digest. The introduction says, A[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 confusing. The reference to only real property makes no sense, inasmuch as section 721 otherwise expressly applies to all property transactions. Nonetheless, this language undeniably expresses an intent to apply the Prudent Investor Rule to marital transactions.

There is likely to be an issue as to whether Family Code section 721 is simply a clarification of prior law and is retroactive or a new statute entirely and is therefore not retroactive. It is not clear whether the law will only apply to cases that are filed after January 1, 2003, or whether it will apply to cases still pending on January 1.

When counseling clients, advise them to take the most cautious route and assume that there is at least a fiduciary duty akin to the Prudent Investor Rule in the amended Family Code section 721.

#### **FAR-REACHING EFFECTS:**

Assuming that spouses will be accountable to one another for every transaction involving community property, the new section 721 will fundamentally affect every marital transaction.

If trial court judges have to review every transaction during marriage, every opportunity lost, and every debt incurred with an eye to a potential breach of fiduciary duty, the courts will have a new category of fiscal misfeasance with which to cope. Economic downturns will fuel a breach of duty litigation. On the other hand, prosperity will fuel breach of fiduciary duty litigation for missed opportunities.

Family law counsel and their forensic accountants will scrutinize every marital transaction. Purchases and sales of property, investments in equities, decisions regarding retirement planning, and incurring excessive debt will be examined in our family courts. Communications (or lack thereof) between the spouses concerning each transaction will require detailed analysis.

Attorneys who represent married businesspersons should now advise their clients that community property transactions are risky without obtaining the express written consent of the spouse. Without this consent, the businessperson may be liable for financial losses. Express written consent may not even be sufficient protection without the full disclosure required by Family Code section 1100.



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Corporate counsel should advise clients who have a community interest in a close corporations that they should consider disclosing the details of corporate transactions and obtain the necessary written consent.

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 the standard of care in the amended Family Code section 721. Assuming for now that the Rule is the standard, the far reaching effects of the law will require us to carefully advise our clients of the risks of conducting business during marriage.