

By Garrett C. Dailey, Esq., CFLS¹

Prudent Investor Rule Does Not Apply To Investment Decisions Made During Marriage – Yet

Introduction: With the passage of SB 1936, the Legislature amended Family Code §721, effective January 1, 2003, to include the italicized provisions:

“(b) 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:”²

Since Probate Code §16047 is referred to as “the Prudent Investor Rule,” it appeared that the Legislature intended to codify the holding of *In re Marriage of Duffy* (2001) 91 Cal.App.4th 923, 111 Cal.Rptr.2d 160 that the Prudent Investor Rule did not apply financial investment decisions made by spouses during marriage. However, in an uncodified section to SB 1936, the Legislature stated that it intended to abrogate the contrary ruling in *In re Marriage of Duffy*. Since *Duffy* is primarily known as the case that held that the Prudent Investor Rule did not apply during marriage, instead of clarifying its intent, the Legislature caused confusion.

In the last edition of the *Family Law News*, the lead article “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,” the authors argue that “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.” Although it is understandable how this conclusion can be reached, this article takes the position that when the Legislative history to SB 1936 and the last few amendments to the fiduciary duty statutes are reviewed, it becomes clear that the Legislature’s intention was to do exactly the opposite.

Hypothetical: To understand the Legislature’s latest attempt at defining the marital duties let’s look at the following hypothetical:

In Year 1, Hank, who had traditionally made the investment decisions for the family, invested approximately \$100,000 in a hypothetical stock let’s call Accucomm and \$100,000 in a 4% 5-year certificate of deposit. In Year 3, the Accucomm investment was worth \$2.8 million³ and the CD approximately \$113,000. In Year 5 the stock is worth \$10,000 and the CD \$125,000.

For many, this example might well have been taken from their own investment portfolios. What are the ramifications in a dissolution of marriage? Up until recently, we would have simply taken the current values of the investments and divided them in kind if they were community or assigned them if they were separate. But, if the backers of bills such as SB 1936 have their way, the analysis will get a lot more complicated.

First, assume that when Hank made the investments, he had \$100,000 of community and \$100,000 of his separate property inheritance to invest. Regardless of which way he made the investments, it can be argued that by not obtaining his wife’s consent prior to making

either investment, he breached his fiduciary duty and is liable to the community.

* If the property division occurs when the Accucomm stock is worth \$2.8 million, it could be argued that Hank usurped a community opportunity by investing his separate property in a stock that was appreciating at 1,400% per year while locking the community into a 4% investment.

* If he invested community money in the stock but didn’t sell it at its peak, his wife may seek to charge him with the \$2,790,000 that the stock dropped in value arguing that his failure to sell and/or diversify was a breach of the Prudent Investor Rule.

Prudent Investor Rule: Far fetched? Not really. These are essentially the facts of *In re Marriage of Duffy* (2001) 91 Cal.App.4th 923, 111 Cal.Rptr.2d 160 in which a highly respected Los Angeles family law judge charged the husband with the difference between the peak value of a briefly soaring high tech stock and its value at the time of trial. One of the major issues at trial was the wife’s access to information about the investments during marriage. The Court of Appeal reversed, holding:

“In short, a spouse generally is not bound by the Prudent Investor Rule and does not owe to the other spouse the duty of care one business partner owes to another. [¶] To summarize, [Husband did not owe Wife] a duty of care in investing the community assets. Inasmuch as [he owed her] no duty of care, he cannot have breached that duty.” (Id. at p. 940.)

What did Family Code §721 formerly provide? Subsection (b) stated, in part: “Except as provided in Sections 143, 144, 146, and 16040 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.”

Probate Code §16040 (a), which Family Code §721 exempted from the marital fiduciary duty, states: “The trustee shall administer the trust with reasonable care, skill, and caution under the circumstances then prevailing that a prudent person....” However, it does not incorporate “investment and management functions governed by the Uniform Prudent Investor Act.”

Thus, although Family Code §721 defined married persons as fiduciaries, it also did not seem to incorporate the Prudent Investor Rule into those duties. *Duffy* made that omission expressly. In doing so, it enraged activists such as the Coalition for Family Equity, California Women Lawyers, SF Women Lawyers’ Alliance, California Commission on the Status of Women, and many others, who demanded that Legislature overrule it by amending Family Code §721 to “hold[] marital partners, when managing the community property, to the same high fiduciary standard of care imposed on partners in a business.”⁴ They requested that Family Code §721 be amended to eliminate any ambiguity that it did not require a “duty of care” when investing community assets.⁶ Further, they sought to *include* Probate Code §16040 as a marital duty, rather than *exclude* it, as the statute then provided. Finally, they requested that the words “including but not limited to the following...” be added when defining marital duties. The *Duffy* court found the absence of this phrase of enlargement significant.

The initial version of the bill as proposed by the Coalition for Family Equity was introduced by Senator John Burton in this form on February 22, 2002. It was supported by a broad range of women’s organizations. It was opposed by the State Bar Family Law Section and Southern California chapter of the American Academy of Matrimonial Lawyers. The State Bar Family Law Section argued:

“Application of the proposed amendment would make a spouse ‘in charge’ of a financial transaction during marriage a virtual guarantor of the success of the transaction unless the prior consent of the other spouse were obtained. The amendment does not provide how this con-

sent will be obtained, memorialized, etc. Would the consent have to be an 'informed' consent? How would the 'in charge' spouse know if the other spouse understood the transaction? Would the other spouse need to be represented by counsel? Would a writing be required? The committee believes that it would be unreasonable to require spouses to behave like business partners during the course of their marriage. They are not 'in business.' Marriage vows invoke 'good faith,' not guarantees."

Although it is not clear from the legislative history what occurred, a compromise appears to have been reached and on July 2, 2002, the bill was amended such that not only was Probate Code §16040 not included in marital duties, but Probate Code §16047, the "Prudent Investor Rule" was also expressly *excluded* as being part of the marital fiduciary duty. Then, however, in an uncodified section of SB 1936, the following piece of legislative intent was added:

"It is the intent of the Legislature in enacting this act to clarify that Section 721 of the Family Code provides 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, and to abrogate the ruling in *In re Marriage of Duffy* (2001) 91 Cal.App.4th 923, to the extent that it is in conflict with this clarification."

The Legislature did not specify which "ruling" in *Duffy* it wished to "abrogate." The part of *Duffy* that the Coalition for Family Equity primarily wanted abrogated was the exclusion of the Prudent Investor Rule from marital duties. The Legislature imputedly rejected this approach and opted for a more moderate set of duties encompassed in Corporations Code sections 16403, 16404 and 16503. These sections provide for access to the books and records and, when appropriate, "[w]ithout demand, any information concerning the partnership's business and affairs reasonably required for the proper exercise of the partner's rights and duties...." They spell out the duties, including, "[t]o refrain from competing with the partnership in the conduct of the partnership business...."¹⁰ But, they also provide: "[a] partner does not violate a duty or obligation under this chapter or under the partnership agreement merely because the partner's conduct furthers the partner's own interest."¹¹

This was one of the holdings in *Duffy*. There, the Court of Appeal permitted the husband to get by with an inconsistent pattern of providing his wife limited and often-grudging information about the family's investments. After reviewing the above, it is clear that was the holding that the Legislature abrogated, as well it should have.

Conclusion: Thus, it appears that spouses will not be held to the Prudent Investor Rule, at least in 2003. However, at some point the Legislature is going to have to focus squarely on marital duties and define them without the artifice of analogizing to the duties of partners and trustees. Read in the context of a marriage, these sections make little sense. For example, Corp. Code §16503 deals primarily with the right of a partner to sell or transfer his/her interest in the partnership and the rights of the transferee of the partnership property. It has very little relevance to spouses and using it to define marital duties can do nothing but add further confusion and litigation.

Endnotes

- 1 Garrett C. Dailey is the co-author of Attorney's BriefCase® California Family Law, author of SupporTax® and co-author of Lawgic Marital Agreement and Lawgic Premarital Agreements. His practice is now limited to appellate work, consultations on complex issues, expert witness and drafting property agreements.
- 2 SB 1936 also changed the references from Corp. Code §§15019, 15020, 15021 and 15022 to Corp. Code §§16403, 16404 and 16503. These, however, were because of statute renumbering, not substantive changes.

- 3 Although Accucomm is hypothetical, this is roughly the increase that Qualcomm stock experienced 1997 and 1999. Qualcomm stock did not fall as far as the hypothetical stock, however. Many other hi-tech stocks did.
- 4 *In re Marriage of Duffy*, supra, 91 Cal.App.4th at p. 940.
- 5 Letter from Coalition for Family Equity, sponsors of SB 1936, to Honorable Martha Escutia, Chair, Senate Judiciary Committee, April 23, 2002.
- 6 For example, in a letter of April 25, 2002 to Senator Burton urging support for the bill, the SF Women's Alliance stated: "In requiring that the same fiduciary standards apply to marital and nonmarital partners, SB 1936 does not preclude risky investments by a spouse. Just as with nonmarital business partners, the partner-spouse simply needs consent from the other partner. If consent is not obtained, then the partner making the risky investment bears the risk."
- 7 Letter to Senator John Burton, dated April 25, 2002.
- 8 Section 2 of 2002 SB 1936 (Chapter 310).
- 9 Corp. Code §16403 (c)(1).
- 10 Corp. Code §16404 (b)(3).
- 11 Corp. Code §16404 (e). ■

Dennis A. Cohen, Esq. • Raymond R. Goldstein, Esq.

Center for Enforcement of Family Support

Established 1979

A Law Firm dedicated to the collection
of past due child and spousal support

Tough Debtor? We'd love a chance!
No Recovery = No Fee

Charging Orders • Private Placement
Litig. • Dep. Exams • QDRO's
Asset Restraining Orders • Contempt
Real Estate Levies • Turnover orders

with an emphasis on
Creative lawyering and dogged persistence

www.EnforceSupport.com
310.417.4141 • (877) PAST DUE
355 Green Valley Circle, Suite 315 • Culver City • 90230

Attorney fees collected Referrals appreciated

We look forward to assisting you and your clients.