Fiduciary Duty Standards of Conduct for Kentucky LLCs

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Since the enactment of the Kentucky Limited Liability Company Act (the "LLC Act") in 1994, limited liability companies (LLCs) have become the entity of choice for holding investment assets or operating closely-held businesses. LLC equity ownership is often divided into separate camps of majority and minority owners. Some LLC members are active in management while others are passive investors. The combination of the ever growing number of Kentucky LLCs with the broad range of management and ownership configurations has created a fertile breeding ground for conflict. Understanding the role played by fiduciary duty standards of conduct in regulating management and ownership conduct is increasingly critical when dealing with these conflicts. More importantly, understanding fiduciary duties will put LLC owners and their advisors in position to incorporate favorable provisions into an operating agreement.

Standards of conduct governing the relationship among management and owners are referred to as "fiduciary duties." LLCs are governed by statutes included in the LLC Act and provisions of operating agreements. The LLC Act has codified default fiduciary duty standards of conduct. These standards of conduct may generally be strengthened, qualified or, in some cases, eliminated in a written operating agreement.

This article identifies the fiduciary duty standards of conduct included in the LLC Act and found in common law. The article considers how a Kentucky court would apply these standards of conduct. After addressing the law and policy behind fiduciary duties, the article concludes with a practical outline of provisions and concepts that majority and minority owners should consider during the process of negotiating the terms of an operating agreement.

The Law of Fiduciary Duties in Kentucky

What are Fiduciary Duties?

Historically, the role of the fiduciary was a device courts used in appropriate circumstances to ensure that the trust and confidence of a vulnerable party was not abused.[1] The Kentucky Supreme Court described the nature of a fiduciary duty as existing in a variety of circumstances: "[i]t exists in all cases where there has been a special confidence reposed in one who in equity and good conscience is bound to act in good faith and with due regard to the interests of the one reposing confidence."[2] In the modern entity context, fiduciary duties are express and implied standards of conduct that are generally attached to the exercise of management powers and sometimes to the relationship among a business entity's owners. Fiduciary duties are intended to ensure that members and managers act in a manner consistent with an LLC's interest rather than their own self-interest.

Most breach of fiduciary duty claims involves management misconduct. Examples of misconduct include misappropriating company funds, unauthorized personal use of company property, misappropriating the LLC's business opportunities, competing against the LLC, and self-dealing in business relationships with the LLC. Gross negligence by management in the course of running an LLC could also qualify as a breach of fiduciary duty. Finally, actions taken by management or majority owners that harm minority owners may constitute breaches of fiduciary duty, especially if those actions have no valid business purpose benefiting the LLC.

The first step in considering fiduciary duty issues is to determine who is serving in a fiduciary capacity. In the LLC world, a management role may be assigned to members, managers, officers or a board of directors or managers. A Kentucky court may determine that any or all of these management personnel are fiduciaries. A Kentucky court could also find that fiduciary duty standards apply not only to those expressly designated as management, but also to any person in control, regardless of title.[3]

Fiduciary duty standards of conduct developed first in Kentucky's common law of partnerships and are now codified in various entity statutes. The LLC Act establishes default fiduciary duty standards of conduct (the fiduciary duties of care and loyalty) which may be strengthened, weakened or in some cases eliminated in an LLC's operating agreement. Kentucky's courts could impose additional fiduciary duties beyond those explicitly provided for in the LLC Act. Other state's courts have expanded fiduciary duties to include the duty of good faith and fairness, and the duty of full disclosure (candor). Courts and commentators sometimes refer to the existence of additional "special fiduciary duties" in connection with examining majority owners' misconduct and oppressive actions directed towards minority owners. A close relative to fiduciary duties is the implied covenants of good faith and fair dealing, usually associated with issues involving the performance of contracts. Courts sometimes rely on these implied covenants when parties use oppressive or underhanded tactics to deny the other side the fruits of their bargain without violating the express terms of their agreement.[4] Recent amendments to the LLC Act adopted an explicit requirement that LLC members and managers discharge duties and exercise rights consistent with an obligation of good faith and fair dealing.[5]

Through December 2010, *Patmon v. Hobbs* is the only published decision addressing fiduciary duty standards of conduct in the Kentucky LLC context.[6] Numerous published decisions address fiduciary duties issues under the laws of Delaware and other states. The handling of fiduciary duty issues by Delaware's courts should be of particular interest due to the large number of Delaware LLCs utilized by Kentucky business owners and investors.

The Fiduciary Duty of Care

The fiduciary duty of care is a standard of conduct required of persons providing management services. The standard is somewhat vague but can be described generally as a requirement of management that it use at least the same level of effort in managing the LLC as it would use in transacting business on its own behalf.

The LLC Act gives organizers a choice of selecting a manager-managed or member-managed management structure. In manager-managed LLCs, the duty of care would apply to the LLC's managers. In member-managed LLCs, the duty of care would apply at least to those members with management responsibilities. Presumably, this duty would also extend to LLC officers who have agency authority to act on the LLC's behalf (i.e., treated as managers under the LLC Act) and individuals serving on an LLC's governing board, even if the individual is not a member or technically a "manager" under the LLC Act. A written operating agreement should provide that individuals serving as LLC officers or as members of an LLC's board of directors or managers are bound by the fiduciary duty standards of conduct applicable to managers

KRS 275.170(1) establishes an affirmative duty of care: "[u]nless otherwise provided in a written operating agreement: (1) [w]ith respect to any claim for breach of the duty of care, a member or manager shall not be liable, responsible, or accountable in damages or otherwise to the limited liability company or the members of the limited liability company for any action taken or failure to act on behalf of the limited liability company unless the act or omission constitutes wanton or reckless misconduct."[7] So, at the very least, an LLC manager has the obligation to avoid wanton or reckless misconduct. Kentucky's formulation of the duty of care is an easier standard to meet than those state statutes requiring LLC management to act in good faith and exercise the care of an ordinarily prudent person in a like position under similar circumstances – a common formulation. The LLC Act does not provide any guidelines for satisfying the fiduciary duty of care.

The American Bar Association's prototype LLC act commentary observes that the duty of care provision (the same provision as adopted by Kentucky) "is similar to the standard commonly applied to corporate directors, managing partners, or general partners of limited partnerships. In general, as long as managers avoid self-interested and grossly negligent conduct, their actions are protected by the business judgment rule."[8] Given this commentary, a Kentucky court should be inclined to apply the business judgment rule in determining whether an LLC manager should be held liable for a poor decision. The business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption."[9]

LLC members should consider explicitly incorporating the business judgment rule or other standards for reviewing management conduct. A good source to draw upon is the Revised Uniform Limited Liability Company Act, which provides that in discharging the duty of care, a member (or manager) may rely in good faith upon opinions, reports, statements, or other information provided by another person that the member/manager reasonably believes is a competent and reliable source for the information.[10] Some drafters of operating agreement may elect to adopt a strict standard of conduct if most or all decisions are delegated to management. The theory behind this position would be that LLC members are more vulnerable and deserving of greater protection if they delegate substantial management power and control.

Management's fiduciary duty of care could be strengthened by incorporating in an operating agreement a stricter standard than "grossly negligent conduct" or "wanton and reckless misconduct." For example, adopting a prudent person standard would bring a Kentucky LLC into line with many states' statutory duty of care standard. Since Delaware's courts have associated a gross negligence threshold with the business judgment rule, this standard should be expressly rejected if a higher (e.g., mere negligence or prudent person standards) duty of care standard is desired.

KRS 275.180(1) provides that personal liability for a breach of the duty of care can be eliminated in an operating agreement. This provision does not provide for the elimination of the duty itself, but merely allows an LLC's members to waive in advance damages claims for breaches of the duty of care. Presumably, the LLC's members have a right to seek injunctive relief barring further misconduct or undertake an action to remove the manager.[11]

The wording of KRS 275.170(1) raises the issue of whether the duty of care can be eliminated by language in an operating agreement.[12] The provision doesn't state that there is a duty of care unless otherwise provided in an operating agreement. The provision instead establishes that, unless otherwise provided in a written operating agreement, the standard for breaching the duty of care is wanton or reckless misconduct. Obviously, LLC members are free to adopt a stricter standard for the duty of care in their operating agreement. But does the statute give members the right to eliminate the duty altogether? The general principle of freedom of contract applicable in the LLC context gives LLC members a good argument that they have the right to both modify or eliminate the duty of care.[13] A point supporting the opposite conclusion, however, is that the Kentucky legislature could have clearly stated that LLC members have the power to eliminate the duty of care if it wanted to make that option available.

The fiduciary duty of care is not explicitly set forth in the Delaware's LLC statutes, but a Delaware court recently held that unless LLC members clearly and unambiguously opt out of fiduciary duties in their LLC agreement, management is subject to the full range of corporate-type duties.[14] Delaware's courts have held that the duty of care only requires managers to inform themselves of material information reasonably available to them before making a decision, and to act in good faith and with an honest belief that they are acting in the LLC's best interests.[15] Delaware's LLC statutes provide that management will be protected if it relies in good faith on the expertise of professionals or experts.[16] Incorporating these standards into a Kentucky LLC operating agreement is worth considering.

The Fiduciary Duty of Loyalty

The fiduciary duty of loyalty is a standard of conduct requiring those falling within its scope to act in the best interests of the LLC rather than in their own best interests. Most management misconduct litigation focuses on the fiduciary duty of loyalty. Examples of actions that might constitute a breach of the duty of loyalty include reaping an undisclosed and unapproved individual profit through an LLC transaction, misappropriation of LLC property, competing with the LLC, usurpation of LLC business opportunities, or personal use of the LLC's assets or trade secrets.

KRS 275.170(2) references the duty of loyalty and provides that benefits derived by members or managers through the LLC, including through use of its confidential or proprietary information, belong to the LLC unless the transaction is consented to by disinterested management.[17] A majority-in-interest of members or a majority of disinterested managers can consent to a transaction that would otherwise constitute a breach of a manager's fiduciary duties.[18]

The LLC Act excludes from the scope of the fiduciary duty of loyalty, actions by non-manager members in a manager-managed LLC, so long as those members are acting solely in their member capacity.[19] This language appears to allow non-manager members to compete with their LLC or reap the benefits of a contract between the member and the LLC without concern over whether the arrangement is fair to the LLC (the LLC's management would be looking out for the LLC's interests). Presumably, this safe-harbor would not shield a member from liability for misappropriation of an LLC's trade secrets or the undisclosed use of LLC property for personal recreation or gain. In those instances, Kentucky's courts would likely entertain a cause of action outside of the fiduciary duty context, or determine that the member was acting in a management capacity.

Members desiring to compete with their LLC or engage in other activities that could be construed as a breach of the duty of loyalty should make sure that the LLC is manager-managed and avoid participating in management. Members who want to make sure that non-manager members cannot compete with the LLC should address this issue in the operating agreement.

In *Patmon v. Hobbs*,[20] the Court of Appeals considered whether a 51 percent LLC manager-member who transferred build-to-suit lease agreements to his affiliated entity breached his fiduciary duties to the LLC and its members. The decision authored by Judge Denise Clayton first concluded that "this Court finds that Kentucky limited liability companies, being similar to Kentucky partnerships and corporations, impose a common-law fiduciary duty on their officers and members in the absence of contrary provisions in the limited liability company operating agreement."[21] The court then affirmed the trial court's holding that "KRS 275.170(2) creates a statutory duty of loyalty for self interested transactions. . . "[22] Based on the order of importance assigned to the common law formulations of the duty of loyalty, it appears likely that the court would have held that a fiduciary duty of loyalty exists for LLC management, with or without the LLC Act's adoption of that duty.

After discussing both the common law and statutory duty of loyalty, the court then cited partnership precedent for the proposition that "given that partners owe good faith to each other, we believe it follows logically and equitably that a managing member of a limited liability company owes such a duty to other members (partners). Furthermore, this standard, in combination with KRS 275.170, leads us to the conclusion that Hobbs violated the duty of loyalty, and therefore, breached his fiduciary [duty] to his fellow members and to the company."[23] The opinion could be interpreted to be adopting a separate fiduciary duty to act in good faith, similar to the one adopted by the Delaware Supreme Court. A more reasonable view, however, is that the court's reference to "good faith" merely represents an element of the duty of loyalty. *Patmon* can also be interpreted as suggesting that fiduciary duties run not just from management and members to the LLC, but also between and among the LLC's management and members.

The court then considered whether Kentucky should adopt the "business opportunity doctrine" when determining whether a manager-member has breached his fiduciary duty of loyalty by appropriating a business opportunity.[24] The court held that it was not merely enough to determine that an opportunity had been appropriated by management resulting in a breach of fiduciary duty, but it was also necessary before damages could be awarded to prove that the injured LLC would have been able to undertake and benefit from the business opportunity.[25] This analysis seems misguided, as the issue of whether someone has breached their fiduciary duty of loyalty should be based on the conduct in question, not on whether the conduct actually damaged the LLC under the circumstances. If a manager steals a painting that turns out to be a worthless imitation, the manager is no less a thief and still has breached his duty of loyalty.

KRS 275.170 begins with the language "except as otherwise provided in a written operating agreement," suggesting that the fiduciary duty of loyalty can be narrowed, waived altogether or strengthened by including stricter conduct standards. The LLC Act also contemplates that operating agreement language can be crafted to eliminate personal liability for a breach of the duty of loyalty.[26] Given the focus on common law fiduciary duties by the *Patmon* court, a prudent drafter should expressly eliminate both the statutory (KRS 275.170(2)) <u>and</u> the common law fiduciary duties of loyalty if the goal is to completely eliminate the duty of loyalty.

Delaware's courts have held that "in the absence of a contrary provision in the LLC Agreement, the manager of an LLC owes the traditional fiduciary duties of loyalty and care to the members of the LLC."[27] One example of how a Delaware court addressed an egregious breach of the duty of loyalty is found in *VGS, Inc. v. Castiel*.[28] Virtual Geosatellite, LLC was managed by three managers. A manager, David Castiel, held a controlling block of the LLC's equity through affiliated entities. When the remaining two managers became dissatisfied with Castiel's actions as the LLC's CEO, they used their majority control of the board of managers to secretly merge the LLC into a newly-formed corporation. In conjunction with the merger, one of the two managers contributed cash to the new corporation in exchange for additional equity, and as a result, voting control shifted away from Castiel. Castiel was not notified in advance of the "vote" on the merger plan in order to prevent him from wielding his controlling equity interest to remove the hostile managers before the merger plan could be approved. The Delaware Supreme Court may have been troubled by the issues raised by the two managers regarding Castiel's conduct and performance as CEO, but it nevertheless held that the merger should be unwound, on the grounds that the actions of the two managers in orchestrating the merger ambush constituted a breach of their duty of loyalty.

What happens if an LLC member or manager wants to compete with an LLC or hold onto a business opportunity? Can the member or manager resign from the member's fiduciary capacity? KRS 275.280(3)(a) provides that members in a member-managed LLC may withdraw from the LLC upon 30 days notice, thereby abrogating the member's fiduciary duties. The member becomes an assignee of his membership interest. But under KRS 275.280(3)(b), a member-manager in a manager-managed LLC has no similar statutory right to withdraw as a member unless the operating agreement gives the member that right. Manager-managed operating agreement should address whether managers have the right to resign as members or managers.

Other Fiduciary Duty Standards

In addition to the traditional fiduciary duties of care and loyalty, other states' courts have developed several additional fiduciary duties to combat management and majority owner misconduct. Given the right circumstances, a Kentucky court might adopt one or more of these fiduciary duty conduct standards. Neither the LLC Act nor the other Kentucky entity statutes address the existence of additional fiduciary duties.

Good faith and fairness[29] are most often identified as being contractually based standards of conduct or rules of contract construction (governing how parties to a contract conduct themselves when performing the contract) rather than freestanding fiduciary duty standards arising out of the relationship of the parties. The Delaware Supreme Court has recognized, however, the existence of an independent fiduciary duty of good faith requiring directors to act honestly and in a manner that is not knowingly unlawful or contrary to public policy.[30] In contrast, the Delaware Court of Chancery has repeatedly held that the standards of good faith and fairness are merely a "subsidiary" of the duty of loyalty rather than being a separate fiduciary duty.[31] It would not be surprising if a Kentucky court adopted a separate fiduciary duty of good faith and fairness as these standards are firmly entrenched in the partnership context.[32]

In *Patmon*, the Kentucky Court of Appeals referred to a duty of good faith, but an overall reading of the decision suggests that this reference was merely intended to describe good faith as a subsidiary element of the duty of loyalty. The distinction between treating good faith as a separate fiduciary duty versus a contractual obligation sometimes appears to be a distinction without a substantive difference. The best answer as to why this distinction matters in the real world is that the bar is higher for satisfying a fiduciary standard of conduct than a contractually based rule of contract construction. Traditionally, fiduciaries are generally held to higher standards of conduct than persons who are merely parties to contracts. For example, in the partnership context, the requirement that Kentucky partners act in good faith has been settled law for a century and has always required a high standard of conduct.[33]

Several state courts have imposed a duty of full disclosure (duty of candor) to prevent majority LLC members from unfairly appropriating profits by purchasing LLC interests with the knowledge that those interests could be sold for a substantial profit to a third party. The facts of these cases include misrepresentations about value of an LLC interest and failure to disclose the imminent resale of the LLC interest at a substantial profit. In most cases, the misconduct is perpetrated by persons who otherwise have a fiduciary relationship (i.e., managers and majority members with access to inside information) and the imposition of the duty of full disclosure could be an offshoot of the court's attempts to put restraints on misconduct.[34] These cases suggest that an LLC member who does not otherwise have a fiduciary role may nevertheless be found to have a fiduciary duty of full disclosure.

Covenant of Good Faith and Fair Dealing

The 2010 amendments to the LLC Act adopted an explicit requirement that LLC members discharge duties and exercise rights consistent with an obligation of good faith and fair dealing.[35] KRS 275.003(7) allows LLC members to establish standards in their operating agreements against which the performance of these obligations will be measured "provided that the standards are not manifestly unreasonable." Presumably, this reference is the drafters' nod to established Delaware standards such as the business judgment rule and the entire fairness standard.[36] Delaware's LLC statutes were amended in 2004 to allow for the elimination of all fiduciary duties. But the Delaware statutes were subsequently amended to provide that contractual covenant of good faith and fair dealing cannot be eliminated, nor can liability for its breach be limited or eliminated.[37] New KRS 275.003(7) appears to be an express adoption of Delaware's position on the role of good faith and fair dealing in the LLC context.

Kentucky's courts have held that acting in good faith with respect to a contract generally requires "faithfulness to an agreed common purpose and consistency with the justified expectations of the parties."[38] The Delaware Court of Chancery refers to this standard of conduct as the "implied covenant of good faith and fair dealing," and has commented that the covenant is "a judicial convention designed to protect the spirit of the agreement, when, without violating the express terms of the agreement, one side uses oppressive or underhanded tactics to deny the other side the fruits of the parties' bargain."[39] The Delaware Court of Chancery also applies the covenant to instances of intentional fraud, deceit, trickery, or misrepresentation.[40] The covenant of good faith and fair dealing is often invoked where a party complies with the literal terms of a contract while attempting to gain an unexpected or unfair advantage. Unlike fiduciary duties, the implied covenant of good faith and fair dealing permits a degree of self-interested behavior, but does not permit self-dealing.[41] This is another way of saying that the bar for invoking this covenant should be higher than where misconduct is perpetrated by someone acting in a fiduciary capacity.

Fiduciary Duties in Squeeze-out Transactions

Owners who enjoy management or voting control sometimes engage in conduct intended to oppress the LLC's minority owners. This conduct includes actions intended to economically harm or "squeeze-out" members from ownership, often through forced cash-out merger, the issuance of large blocks of additional equity, or an asset sale by the LLC to an entity controlled by the majority owners.

Squeeze-out transactions are fertile territory for breach of fiduciary duty claims, as they often involve perceived "bad faith conduct" in the exercise of management authority or majority voting control. In Kentucky, if an LLC's management engages in oppressive conduct against minority members, the minority members may have a claim under KRS 275.170(2) for a breach of the duty of loyalty, particularly if the conduct benefits management or the majority owners at the expense of the minority owners and there is an absence of benefit to the LLC. If a cash-out merger or similar transaction does not disproportionately benefit an LLC's management or majority owners, then the focus should switch to whether management has properly exercised its duty of care under KRS 275.170(1). If the oppressive conduct benefits the LLC (at the expense of the minority members), then management may have a good argument that it should be protected by the business judgment rule (such acts would not constitute wanton or reckless conduct). In *Yeager v. Paul Simonin Co.*, the plaintiff argued that management had breached its fiduciary duties by approving a transaction with no business purpose other than to force the minority owners out of a corporation.[42] The Kentucky Court of Appeals rejected this business purpose argument in the context of a squeeze-out merger transaction, but this holding was based on the availability of the corporate dissenters' rights statutes as a fair remedy.[43] The result could well be different in the absence of the protections afforded by dissenters' rights to ensure that minority owners receive fair value for their equity interests.

Oppressive conduct may also trigger scrutiny of whether the actions taken violate the implied covenant of good faith and fair dealing associated with the performance of management's obligations under an LLC operating agreement. This would be particularly true where the action taken is literally allowed by an LLC's operating agreement, but clearly violates the parties' intent when they entered into the agreement.

Some squeeze-out transactions involve actions taken by majority owners solely in their owner capacity. LLC members might use their voting control to cause the LLC to engage in a cash-out merger squeezing-out minority owners. The possibility of oppressive conduct by majority owners raises the question of whether a Kentucky court would hold that majority owners are "fiduciaries" whose actions are subject to fiduciary duty standards of conduct. Courts outside of Kentucky have held that controlling shareholders stand in a fiduciary relationship to the corporation and to minority shareholders (i.e., holding that majority owners have "special fiduciary duties" towards minority owners).[44] In fact, when the facts involve close corporations, courts have often applied enhanced fiduciary duty standards of conduct usually applicable to partnership relationships.[45]

The LLC Act does not expressly provide for special fiduciary duties to minority owners. The *Patmon* decision suggests that Kentucky's courts might look at how this issue has been addressed in the partnership and corporation contexts. In the partnership context, there is ample authority for the proposition that members are held to a high standard of fairness towards each other. Kentucky's highest court has stated that "the relationship of partners is a close one and imposes on each the obligation of loyalty, integrity and utmost good faith and fairness with respect to partnership affairs, and the obligation begins with preliminary negotiations and continues throughout life the of the relationship."[46] In the corporate context, the available analogies are less definitive, but there is Kentucky authority for the conclusion that controlling owners owe a duty to treat minority owners fairly and avoid engaging in bad faith behavior in connection with "oppressive conduct."[47]

A Kentucky court might conclude that majority owners who do not participate in management are shielded from any obligation of special fiduciary duties towards minority owners. KRS 275.170(4) provides that members who do not participate in management owe no duties to the LLC or other members solely by reason of acting in a member capacity (e.g., such as by exercising majority voting control). Of course, many majority owners will also have a management role in the LLC, negating this shield. But if a transaction is approved and undertaken by majority owners solely for the purpose of squeezing out minority members, and the principal purpose of the transaction is to benefit management or majority owners at the expense of minority owners, a Kentucky court might adopt the entire fairness test established by the Delaware courts given the absence of the dissenters' rights remedy.

Under the Kentucky Business Corporation Act[48], shareholders dissenting from a merger or transfer of substantially all of a corporation's assets have a statutory means for obtaining the fair value for their shares.[49] Absent fraud, the exercise of dissenters' rights has generally considered to be the sole remedy available to a shareholder in a squeeze-out transaction. The Delaware Supreme Court in *Weinberger* described appraisal as a shareholder's usual and basic remedy in fundamental corporate change, but expressly stated that a non-appraisal remedy would be permitted in circumstances where "fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross and palpable overreaching are involved."[50] The Kentucky Court of Appeals has held that a merger transaction with no business purpose other than "freezing out" a minority shareholder was permissible because the Kentucky statutes give dissenting shareholders the right of appraisal. The court also commented that while the appraisal remedy is generally the only remedy for a dissenting stockholder in the case of a merger, exceptions exist where illegality or fraud are involved.[51] *Yeager* makes it unlikely that a Kentucky court would conclude in a corporate merger transaction that the absence of a business purpose beyond the desire to squeeze-out minority shareholders constitutes "illegality or fraud." A finding of illegality or fraud would require some additional misconduct beyond a deep conflict of interest. But since statutory dissenters' rights are not mandated for LLCs, management or majority owners engaging in squeeze-out transactions might see a higher conduct standard imposed on their activities.

In Delaware, the actions of management are generally judged by standards associated with the business judgment rule, which presumes that business decisions are made on an informed basis, in good faith and in the honest belief that the action was taken in the best interests of the company, thereby requiring a plaintiff to prove otherwise (and requiring for a breach of the duty of care that misconduct rise to the level of wanton and reckless misconduct – a gross negligence standard).[52] If management's actions are tainted by conflict, however, the test shifts to "entire fairness," which requires the conflicted fiduciary to prove that the transaction satisfies the standards of fair price and fair dealing.[53] The reason why a shift away from the business judgment rule to the entire fairness test can be so significant to the outcome of litigation is that when the business judgment rule applies, courts generally give management the benefit of the doubt that they are acting in the best interests of the company and are reluctant to substitute their judgment for management's decision making. When management is deeply conflicted, however, the Delaware courts have held that a transaction is subject to "judicial scrutiny" and the court often becomes the objective arbiter.[54]

Management or majority owners who contemplate engaging in oppressive conduct should consider structuring transactions that minimize breach of fiduciary duty arguments. Strategies to minimize fiduciary duty claims might include incorporated unqualified call rights in an operating agreement, avoiding unrelated misconduct prior to engaging in a squeeze-out transaction, paying appraised fair market value for a minority owner's interest, and including contractual dissenters' rights in an operating agreement. The LLC Act confirms that dissenters' rights may be adopted in an LLC's articles of organization or operating agreement, or included in an applicable merger or other transaction agreement.[55] If dissenters' rights are adopted, the operating agreement should set forth the procedural details of the process due to the absence of any express provisions addressing dissenters' rights in the LLC Act (in contrast to the detailed procedures set forth in the corporation statutes).[56] Obviously, it would be helpful to the majority owners if the operating agreement provides that dissenters' rights are the sole and exclusive remedy upon the occurrence of a squeeze-out transaction. Finally, the presence of a valid principal business purpose for undertaking any squeeze-out transaction (i.e., beyond successfully engineering the squeeze-out of minority owners) should reduce the likelihood of a successful breach of fiduciary duty claim.

Indemnification of Fiduciaries

KRS 275.180(2) confirms that LLC members may provide for indemnification of members and managers in their operating agreement. But the most important take-away from this provision is that, unlike the corporate indemnification statutes (KRS 271B.8-500 through 590), there is no statutory indemnification unless the operating agreement affirmatively provides for indemnification. Also, KRS 275.180(2) does not address a number of important issues, including limitations on or standards for indemnification, a requirement for mandatory indemnification under certain circumstances, or the advancement of expenses. Much of the litigation involving indemnification of LLC management has focused on operating agreement provisions dealing with the advancement of expenses.[57]

Given the limited scope of KRS 275.180(2), controlling LLC owners and management should negotiate for mandatory indemnification and advancement of expenses. Minority owners should focus on incorporating restrictive standards for indemnification (e.g., acting in good faith; absence of gross negligence, fraud, bad faith or misconduct; no material breach of operating agreement) and advancement of expenses.

Fiduciary Duty Litigation

Breach of fiduciary duty claims by LLC members are usually brought as derivative actions on behalf of the LLC against the perpetrator of the misconduct. Derivative actions are often coupled with direct actions by the plaintiff LLC member. Ann Patmon's claims were brought against Lanier Hobbs both individually and derivatively on her LLC's behalf .[58]

KRS 275.335 provides that, unless otherwise provided in an operating agreement, a suit brought on behalf of an LLC may be brought only by members with the approval of more than one half of the members eligible to vote, excluding for this purpose the vote of the LLC member against whom the claim is to be brought. Drafters of Kentucky operating agreement should take note that this statute refers to members voting on a per-capita basis rather than on the basis of their percentage ownership interests in the LLC. The issue of whether an action can be brought as a derivative action is usually important as courts often rule that the LLC should pay a plaintiff's legal fees and expenses if the action is brought on behalf of the LLC (in contrast to a direct action by the member).

Ann Patmon was only one of the three members of American Leasing and Management, LLC when she brought a derivative action on behalf of the LLC against the Lanier Hobbs, the 51 percent owner. Neither the Jefferson Circuit Court nor the Court of Appeals addressed the application of KRS 275.335 to Patmon's derivative action. Unless a different standard was adopted in the LLC's operating agreement, KRS 275.335 should have required the approval of both Patmon and Gray (the third member) to bring the derivative action. Perhaps in light of *Lourdes Medical Pavilion, LLC*, which applied now repealed KRS 275.340, this issue was not raised by the defendant.[59] Now that KRS 275.340 has been repealed, the majority (on a per-capita basis) approval requirement for derivative actions is likely to receive more scrutiny.

Remedies for Fiduciary Duty Breaches

Members or managers who breach their fiduciary duties of care or loyalty are generally held accountable to the LLC for any wrongfully obtained gains.[60] Courts have further determined that a breaching fiduciary may also be held liable for compensatory damages, and in some instances, punitive damages.[61] Managers or members may also be denied a right to be indemnified for expenses incurred in connection with actions where the manager or member is found to have breached a fiduciary duty.

The *Patmon* court plowed new ground in Kentucky on the issue of damages in LLC fiduciary duty claims. Based on Hobbs' misconduct, the court authorized the Jefferson Circuit Court to dissolve the LLC and "conclude its affairs, collect its assets and distribute the assets to its members." The court must have concluded that where a 51% owner has been found to engage in misconduct, it is "not reasonably practicable to carry on the business of the limited liability company in conformity with the operating agreement."[62] Dissolution of an LLC due to fiduciary misconduct and oppression is supported by statutes in a number of states, but not explicitly addressed in the LLC Act. KRS 275.290 provides only that a Kentucky Circuit Court may dissolve an LLC if it is established that it is not reasonably practicable to carry on the business of the LLC in conformity with the operating agreement.

If the misconduct was perpetrated by management that did not hold a controlling equity interest, the court may have considered removal of the offending fiduciary from a management role rather than dissolution. Other remedies that have been employed in other states include the appointment of a custodian to operate the business after removal of management engaged in misconduct, the judicially mandated purchase of the plaintiff's equity by the controlling owners[63], and in a rare instance, the judicially mandated sale by the majority owners to an oppressed minority shareholder.[64]

In *Patmon*, the Court of Appeals commented that "in light of Hobbs's misconduct, the court will need to decide, in the interest of justice, the percentage to be used in dividing the assets among the members." This statement is interesting as it suggests that a possible additional remedy for owner misconduct is a reallocation of ownership interests, even where the perpetrator of the misconduct is required to make the LLC whole for the damages caused by the misconduct. *Patmon* suggests that Kentucky's courts would not be shy in considering the application of a broad range of remedies for combating fiduciary misconduct.

There is a line of Delaware cases supporting the position that management and other controlling persons of entities who operate in a fiduciary role such as acting as a corporate manager of an LLC are subject to claims if they are found to have personally benefited from misconduct.[65] Attorneys may also be found liable for aiding and abetting a breach of fiduciary duty.[66]

Drafting Kentucky LLC Operating Agreements

Freedom of Contract Principles

The LLC Act is largely a set of default provisions that apply only if they are not modified by the operating agreement. The LLC Act was adopted with the explicit understanding that LLCs are largely intended to be creatures of contract. KRS 275.003(1) provides in part that "[i]t shall be the policy of the General Assembly through this chapter to give maximum effect to the principles of freedom of contract and the enforceability of operating agreements." This provision expresses one of the cornerstones of the LLC Act – LLC owners have the ability to establish their own rules in an operating agreement and the courts are directed to respect the owners' rules. Various provisions in the LLC Act are modified by a proviso that the statute will function as written unless modified in a written operating agreement. This freedom of contract principle most likely includes the right to modify the duty of care and loyalty standards established by the LLC Act, along with the right to indemnification and provisions limiting personal liability for breaches of fiduciary duties.

An astute LLC member will rarely rely entirely on the default provisions of the LLC Act. There are many opportunities to negotiate for a better position during the drafting of an LLC's operating agreement. Several Delaware decisions highlight the need for careful drafting if there is an intention to limit or eliminate fiduciary duties in an operating agreement.[67] Courts are particularly likely to find these provisions to be poorly drafted and ambiguous if there is evidence of material misconduct.

A Checklist of Practical Drafting Suggestions

An attorney working on entity formation transactions involving multiple owners should confirm the identity of their client through engagement letters and conflict waivers. In some cases, attorneys will represent the LLC and none of the owners individually. Each owner may have separate counsel represent his or her interests. In other cases, attorneys will clearly disclose which member's interests he represents, with the understanding that the remaining owners are free to obtain separate counsel.

Given the general freedom to expand, contract or waive altogether fiduciary duties by agreement, there are a number of points to consider when drafting Kentucky LLC operating agreements.

Provisions Favoring Majority Owners and Management

Majority owners and management should consider including the following provisions in an operating agreement:

- a provision confirming explicitly and in detail management's right to manage the LLC (both with respect to decision-making and acting as the LLC's agent), including confirmation of voting control with respect to key decisions;
- a provision eliminating personal liability for the fiduciary duty of care both under KRS 275.170(1) and common law, and loyalty under KRS 275.170(2) and common law;
- a provision establishing a high standard (e.g., fraud, gross negligence, breach of fiduciary duty or material breach of the operating agreement) for removal of management, on the theory

that establishing an agreed-upon high standard for removal is better than being silent or stating that management cannot be removed. Providing that management cannot be removed or remaining silent on the issue might give a court the leeway to fashion an unfavorable standard for removal;

- a provision confirming management's (or the controlling members') right to issue additional membership units for adequate consideration, in situation where the LLC needs additional capital for operations or growth (perhaps including pre-emptive rights for the benefit of the minority members);
- a provision incorporating the business judgment rule as the agreed-upon standard of care for management. Consideration should be given to incorporating language from the Delaware LLC statutes and/or the Revised Uniform Limited Liability Company Act regarding management's right to rely on opinions, reports, experts, etc. in connection with the exercise of such business judgment);
- a provision identifying exceptions to the LLC's right to members' business opportunities (i.e., express modification of the default fiduciary duty of loyalty);
- a provision confirming that non-manager members are subject to fiduciary duties (thereby modifying KRS 275.170(4));
- a provision identifying exceptions to limitations on competing with the LLC or soliciting the LLC's employees or customers applicable to management and controlling members;
- a provision adopting dissenters' rights in connection with mergers and the sale of substantially all of the LLC's assets (also, consider incorporating a statement that dissenters' rights are the members' sole remedy in connection with the applicable triggering events);[68]
- a provison establishing call rights on members' interests under circumstances that might favor management;
- a provision requiring mandatory indemnification and advancement of attorneys' fees and expenses; and
- a provision confirming that the LLC will obtain directors and officers liability insurance coverage for the LLC's management;
- a provision confirming that a member-manager has a right to withdraw from an LLC and escape the clutches of the manager's fiduciary duty obligations (modifying KRS 275.280(3)(b);
- a provision establishing call (purchase) rights for the LLC with respect to the minority owners' equity interests, including upon the death or dissolution of minority owner and perhaps upon the occurrence of certain other events;
- a provision establishing favorable valuation terms for the buy-out of minority owners, including applying valuation discounts (e.g., marketability and minority ownership); and
- a provision establishing "drag along" rights that give controlling owners the ability to require minority owners to sell their equity interests on the same terms as the majority owners.

Provisions Favoring Minority Owners

Minority owners should consider including the following provisions in an operating agreement:

- a provision establishing limitations on the rights of management and controlling members, through super-majority voting requirements on key issues such as the issuance of additional equity, amendment of the operating agreement or articles, mergers, asset sales, admission of additional members, and self-dealing transactions between the LLC and management;
- a provision establishing standards for removal and replacement of management (which could include a broad for-cause removal provision);
- a provision requiring approval of annual budgets and business plans by super-majority vote (coupled with the requirement that management operates the business within the guidelines established by those budgets and business plans);
- a provision establishing comprehensive and detailed guidelines for the LLC's operation and terms of the owners' relationship (the goal is to establish detailed key guidelines up front in order to avoid reliance on member voting for decision-making, where minority owners can be outvoted);
- a provision explicitly confirming that management and majority owners are subject to the fiduciary duties of care and loyalty, and setting forth more

demanding standards for such fiduciary duties (e.g., rather than the business judgment rule standard for the duty of care, establish a standard of common negligence as a breach; adoption of Delaware's "entire fairness" standard);

- a provision confirming that management and majority owners are subject to a separate fiduciary duty of good faith and fair dealing;
- a provision establishing strict performance standards for satisfying the requirement under KRS 275.003(7) that management and majority members must discharge all duties consistently with their obligation of good faith and fair dealing;
- a provision confirming that there are special fiduciary duties running from majority members in favor of minority owners to act fairly and in good faith (again, consider the "entire fairness" standard);
- a provision confirming that majority owners cannot engage in a transaction (i) where a principal purpose is squeezing out minority owners, (ii) that does not have a valid and material LLC business purpose;
- a provision confirming that the LLC has no obligation to indemnify management or majority owners when they are found by a court to have breached their fiduciary duties or otherwise engaged in any material misconduct (this provision should also provide that no expenses will be advanced by the LLC to management or majority owners to defend a direct or derivative fiduciary duty or misconduct claim, or at least the party being advanced expenses must agree to reimburse the LLC if he unsuccessfully defends such claims;
- a provision requiring the reimbursement of minority owners for litigation fees and expenses if such members bring a derivative or direct action and management or the majority owners are found to have breached their fiduciary duties;
- a provision identifying the scope of the LLC's right to management's and the majority owners' business opportunities (along with any express exceptions those rights, and any covenants with respect to the minority owners' business opportunities);
- a provision prohibiting management's (i) competition with the LLC, and (ii) solicitation of customers or employees (along with any express exceptions to those restrictive covenants);
- a provision expanding the minority owners' rights to inspection of books and records and rights to receive periodic financial information (there should be consideration of whether annual audited financials should be required);
- a provision confirming that minority owners have the right to bring a derivative action on behalf of the LLC (even though they represent less than a majority or the members on a per-capita basis); and
- a provision establishing dissenters' rights for minority owners in connection with mergers, asset sales, material changes in their economic rights, and other key triggering events;
- a provision establishing put (withdrawal) rights for minority owners upon the occurrence of certain key triggering events;
- a provision establishing that valuation of membership interest for buy-out purposes will be at appraised fair market value without any discounts (e.g., no marketability or minority owner discounts); and
- a provision establishing "tag along" rights (also referred to as "go along" rights) which give the minority owners the right to sell their LLC interest in the same terms as the majority owners (if the majority owners enter into an agreement to sell their LLC interests).

Conclusions

Applying the law of fiduciary duties to real world business relationships can be more of an art than a science. In some cases, it may be better to pass on negotiating for one or more of the provisions discussed above if doing so would risk opening up negotiations that would not end favorably or could possibly inflict damage on a new business partnership. In many cases, however, LLC members should be able to incorporate provisions into an operating agreement protecting their position without being overreaching or instigating a dispute. Many provisions might ultimately favor controlling or minority members seem reasonable when they are incorporated into an operating agreement at the time of an LLC's formation. The take-away from this is that LLC members with the best understanding of how to apply fiduciary duty standards of conduct to business relationships will have an advantage in negotiating the terms of the operating agreement.

Key Kentucky LLC Act Provisions

275.003. Construction of chapter.

(1) It shall be the policy of the General Assembly through this chapter to give maximum effect to the principles of freedom of contract and the enforceability of operating agreements. Unless displaced by particular provisions of this chapter, the principles of law and equity shall supplement this chapter. Although this chapter is in derogation of common law, the rules of construction that require strict construction of statutes which are in derogation of common law shall not apply to its provisions. This chapter shall not be construed to impair the obligations of any contract existing when this chapter, or any amendment of it, becomes effective, nor to affect any action or proceeding begun or right accrued before the chapter or amendment takes effect.

(7) Each member and manager and any other party to an operating agreement shall discharge all duties and exercise all rights consistently with the obligation of good faith and fair dealing. The obligation of good faith and fair dealing may not be eliminated in the operating agreement, but it may prescribe the standards by which the performance of the obligation is to be measured provided the standards are not manifestly unreasonable.

275.170. Duties of care and loyalty Approval of conflict of interest transactions Remedy for breach of the duty of loyalty.

Unless otherwise provided in a written operating agreement:

(1) With respect to any claim for breach of the duty of care, a member or manager shall not be liable, responsible, or accountable in damages or otherwise to the limited liability company or the members of the limited liability company for any action taken or failure to act on behalf of the limited liability company unless the act or omission constitutes wanton or reckless misconduct.

(2) The duty of loyalty applicable to each member and manager shall be to account to the limited liability company and hold as trustee for it any profit or benefit derived by that person without the consent of more than one-half (1/2) by number of the disinterested managers, or a majority-in-interest of the members from:

(a) Any transaction connected with the conduct or winding up of the limited liability company; or

(b) Any use by the member or manager of its property, including, but not limited to, confidential or proprietary information of the limited liability company or other matters entrusted to the person as a result of his or her status as manager or member.

(3) In determining whether a transaction has received the approval of a majority-in-interest of the members, membership interests owned by or voted under the control of the member or manager whose actions are under review in accordance with subsection (2) of this section, and membership interests owned by an entity owned by or voted under the control of that member or manager, shall not be counted in a vote of the members to determine whether to consent, and the membership interests shall not be counted in determining whether a quorum, if required by a written operating agreement, exists to consider whether to consent.

(4) A member of a limited liability company in which management is vested in managers under KRS 275.165(2) and who is not a manager shall have no duties to the limited liability company or the other members solely by reason of acting in his or her capacity as a member.

275.180. Operating agreement provisions on personal liability and indemnification.

A written operating agreement may:

(1) Eliminate or limit the personal liability of a member or manager for monetary damages for breach of any duty provided for in KRS 275.170; and

(2) Provide for indemnification of a member or manager for judgments, settlements, penalties, fines, or expenses incurred in a proceeding to which a person is a party because the person is or was a member or manager.

275.335. Persons who may sue in company's name.

Unless otherwise provided in a written operating agreement, a suit on behalf of the limited liability company may be brought in the name of the limited liability company only by:

(1) One (1) or more members of a limited liability company, whether or not the operating agreement vests management of the limited liability company in one (1) or more managers, who are authorized to sue by the vote of more than one half (1/2) of the number of members eligible to vote thereon, unless the vote of all members shall be required pursuant to KRS 275.175(1). In determining the vote required under KRS 275.175, the vote of any member who has an interest in the outcome of the suit that is adverse to the interest of the limited liability company shall be excluded; or

(2) One (1) or more managers of the limited liability company, if an operating agreement vests management of the limited liability company in one (1) or more managers, who are authorized to do so by the vote required pursuant to KRS 275.175 of the managers eligible to vote thereon. In determining the required vote, the vote of any manager who has an interest in the outcome of the suit that is adverse to the interest of the limited liability company shall be excluded.

ENDNOTES

1. Christine L. Eid, *Lawyer Liability for Aiding and Abetting Squeeze-outs*, 34 Wm. Mitchell L. Rev. 1177, 1189 (2008).
2. *Steelvest, Inc. v. Scansteel Service Center, Inc.*, 807 S.W.2d 476, 485 (Ky. 1991).
3. *In re OODC, LLC*, 321 B.R. 128 (Bkrtcy. D. Del. 2005), the court held that a holder of preferred equity breached fiduciary duties to an LLC even though the holder was not an officer, director or majority owner of the LLC, because the member had actual control over the LLC.
4. *Chamisol v. Healthtrust,* C.A. No. 15904, 1999 Del. Ch. LEXIS 14 (Del. Ch. Jan. 12, 1999).
5. KRS 275.003(7).
6. *Patmon v. Hobbs*, 280 S.W. 3d 589 (Ky. Ct. App. 2009).
7. Kentucky's fiduciary duty of care language (KRS 275.170(1)) is taken directly from the American Bar Association Prototype Limited Liability Company Act (1992) (the "ABA Prototype"). KRS 275.170(1) was amended in 2010 to expressly identify the section as the codification of the fiduciary duty of care.
8. Commentary to Section 402(A) of the ABA Prototype. See Elizabeth S. Miller and Thomas E. Rutledge, *The Duty of Finest Loyalty and Reasonable Decisions: The Business Judgment Rule in Unincorporated Business Organizations?*, 30 Del. J. Corp. L. 343 (2005).
9. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). See also Elizabeth S. Miller and Thomas E. Rutledge supra n. 8 at 345-353.
10. *Revised Uniform Limited Liability Company Act* § 409(c).
11. See Miller and Rutledge supra n. 8 at 353 and footnote 40.
12. Miller and Rutledge appear to believe that drafters do have the ability to eliminate the duty of care by stating that "a number of jurisdictions permit the operating agreement to modify duties and/or liabilities without expressly limiting such power." Miller and Rutledge supra n. 8 at 368-369.
13. KRS 275.003(1) provides that "it shall be the policy of the General Assembly through this chapter [Kentucky's LLC Act] to give maximum effect to the principles of freedom of contract and the enforceability of operating agreements."
14. *Bay Center Apartments Owner, LLC v Emery Bay PKI, LLC*, No. 3658-VCS, 2009 WL 1124451 (Del. Ch. April 20, 2009). Del. Code Ann. Tit. 6, § 18-1101(c) provides that the fiduciary duties of care and loyalty may be expressly expanded, limited or eliminated in an LLC agreement, provide that the LLC agreement may not eliminate the implied contractual covenant of good faith and fair dealing.
15. *Minn. Invco of RSA # 7, Inc. v. Midwest Wireless Holdings LLC*, 903 A.2d 786, 797 (Del. Ch. 2006).
16. Del. Code Ann. Tit. 6, § 18-406.
17. KRS 275.170(2), as amended in 2010 to expressly reference the duty of loyalty, provides "[u]nless otherwise provided in a written operating agreement: . . . (2) The duty of loyalty applicable to each member and manager shall be to account to the limited liability company and hold as trustee for it any profit or benefit derived by that person without the consent of more than one-half (1/2) by number of the disinterested managers, or a majority-in-interest of the members from: (a) Any transaction connected with the conduct or winding up of the limited liability company; or (b) Any use by the member or manager of its property, including, but not limited to, confidential or proprietary information of the limited liability company or other matters entrusted to the person as a result of his or her status as manager or member."
18. *Id*. A "majority-in-interest of the members" is defined under KRS 275.015(14) and KRS 275.175(3) to mean members who made the majority of the unreturned

capital contributions unless the articles of organization or operating agreement provides for different voting percentages (the operating agreement typically does).

19. KRS 275.170(4) provides that "[a] member of a limited liability company in which management is vested in managers under KRS 275.165(2) and who is not a manager shall have no duties to the limited liability company or the other members solely by reason of acting in his or her capacity as a member." KRS 275.025(1)(d) requires every LLC to set forth in its articles of organization whether it is member or manager managed.
20. 280 S.W. 3d 589 (Ky. Ct. App. 2009).
21. *Id.* at 594. The attention paid by the Court of Appeals in the *Patmon* decision to the common law of fiduciary duties seems misplaced given the fact that the LLC Act has codified the fiduciary duty of loyalty. While the common law of fiduciary duties may be useful for framing the nature of conduct constituting a breach of the duty, and the standards associated with satisfying that duty, KRS 275.170(2) eliminates the need to focus on whether the duty of loyalty exists in common law.
22. *Id*. at 595.
23. *Id.*
24. The Court of Appeals cited the formulation of the business opportunity doctrine outlined in *Miller v. Miller*, 222 N.W.2d 71 (Minn. 1974): "[W]e believe a more helpful approach is to combine the 'line of business' test with the 'fairness' test and to adopt criteria involving a two-step process for determining the ultimate question of when liability for wrongful appropriation of a corporate opportunity should be imposed. The threshold question to be answered is whether a business opportunity presented is also a 'corporate' opportunity, i.e., whether the business opportunity is of sufficient importance and so closely related to an existing or prospective activity of the corporation as to warrant judicial sanctions against its personal acquisition by a managing officer or director of the corporation." *Id*. at 597.
25. *Id*. at 598.
26. KRS 275.180(1) provides that "[a] written operating agreement may. . . "Eliminate or limit the personal liability of a member or manager for monetary damages for breach of any duty provided for in KRS 275.170" [the duties of care and loyalty].
27. *Bay Center Apartments Owner LLC*, supra n. 14 at 18.
28. 2000 WL 1277372 (Del. Ch. 2000), aff'd, 781 A. 2d 696 (Del. 2001).
29. Courts and statutes refer to interchangeably to "good faith and fairness" or "good faith and fair dealing" in the context of fiduciary duties and implied contract covenants.
30. *Cede & Co. v. Technicolor Inc.*, 634 A.2d 345 (Del. 1993).
31. See *Orman v. Cullman*, 794 A.2d 5 (Del. Ch. 2002); David Rosenberg, *Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contractarian Approach*, 29 Del. J. of Corp. L. 491 (2004); Hillary A. Sale, *Delaware's Good Faith*, 89 Cornell L. Rev. 456 (2004), Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 Duke L.J. 1 (2005) and Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 Del. J. Corp. Law 1 (2007).
32. *Stephens v. Stephens*, 183 S.W.2d 822, 824 (Ky. 1944) (discussing "loyalty, integrity and the upmost good faith and fairness") and *Curtis v. Campbell*, 336 S.W.2d 355, 359 (Ky. 1960) (stating that "partners are obligated to deal with each other in upmost good faith and fairness").
33. *Axton v. Kentucky Bottlers Supply Co*, 166 S.W. 776, 778 (Ky. 1914). Kentucky's highest court has stated that "[t]he relationship of partners is a close one and imposes upon each the obligation of loyalty, integrity and the utmost good faith and fairness with respect to partnership affairs. This obligation begins with the preliminary negotiations and continues throughout the life of the relationship." See *Stephens v. Stephens* supra n. 32 at 824.
34. *Salm v. Feldstein*, 799 N.Y.S.2d 104 (N.Y. App. Div. 2005); *Blue Chip Emerald LLC v. Allied Partners, Inc.*, 750 N.Y.S.2d 291 (N.Y. App. Div. 2002). See Sandra K. Miller, *What Fiduciary Duties Should Apply to the LLC Manager After More Than a Decade of Experimentation*, 32 Iowa J. Corp. L. 565 (2007).
35. KRS 275.003(7)
36. See the discussion at the text for footnotes 52 and 53.
37. Del. Code Ann. Title 5, §§ 18-1101(c) and (e).

38. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).
39. *Bakerman v. Sidney Frank Importing Company*, 2006 WL 3927242 (Del. Ch. 2006), quoting from *Chamison v. Healthtrust*, 735 A.2d 912 (Del. Ch. 1999).
40. *Abry Partners V, L.P. v F & W Acquisition LLC*, 891 A.2d 1032 (Del. Ch. 2006); *Pami-Lemb I Inc. v. EMBH-NHC, LLC*, 857 A.2d 998 (Del. Ch. 2004).
41. See Miller supra n. 34 at 596-597.
42. 69 S.W.2d 227 (Ky. Ct. App. 1985).
43. *Id.*; See Rutherford B. Campbell, Jr., *Corporate Fiduciary Duties in Kentucky*, 93 Ky. L.J. 551, 595-597 (2004-2005).
44. F. Hodge O'Neal and Robert B. Thompson, *Oppression of Minority Shareholders and LLC Members* at 7-13 and footnote 14 (Revised 2nd ed.).
45. *Id.* at 7-25 to 7-28; See *Donahue v. Rodd Electrotype Co of New England, Inc.*, 328 N.E.2d 505 (Mass. 1975).
46. *Stephens* supra n. 32 at 824.
47. See *Beha v. Martin*, 171 S.W. 393 (Ky. 1914) and *Caldwell Stone, Co. v. D. K. Albright*, No. 82-CI-108, Slip Op. (Boyle Circuit Court, June 20, 1984).
48. KRS Chapter 271B.
49. KRS 271B.13-010 et seq.
50. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 714 (Del. 1983).
51. *Yeager v. Paul Semonin Co.*, 691 S.W.2d 227, 229 (Ky. Ct. App. 1985).
52. See *Aronson* supra n. 9
53. *Weinberger* supra n. 50. See Rutherford B. Campbell, Jr. supra n. 43 at 568.
54. *Weinberger* supra n. 50 at 710 and *Marciano v. Nakash*, 535 A.2d 400, 404 (Del. 1987). See *Nixon v. Blackwell*, 626 A.2d 1366 (Del. 1993).
55. KRS 275.030(6) addresses dissenting in connection with the amendment of articles of organization; KRS 275.350(4) addresses dissenting in connection with mergers; KRS 275.247 addresses dissenting in connection with the sale of assets outside of the regular course of business.
56. The only real guidance to be found in Kentucky's LLC Act is the definition of "dissent" found at KRS 275.015(6): "'Dissent' means a right to object to a proposed action or transaction and, in connection therewith, to demand a redemption of a limited liability company interest."
57. *Senior Tour Players v. Golftown 207 Holding Company LLC*, 853 A.2d 124 (Del. Ch. 2004). In *Senior Tour Players*, the operating agreement provided that advancement could not be awarded (i) where the conduct complained of constituted gross negligence, fraud, misrepresentation, bad faith or willful misconduct, (ii) where there was a material breach of the limited liability company agreement, or (iii) where the complained of conduct was outside the scope of employment with the LLC and no advancement of expenses would be granted absent a written understanding from the purported indemnitee to repay the amounts advanced if it was ultimately determined that indemnification was not justified); *Majkowski v. American Imaging Management Services, LLC*, 913 A.2d 572 (Del. Ch. 2006) (holding that "indemnify and hold harmless" language in an operating agreement required the company to advance expenses).
58. See *Patmon* supra n. 20.
59. See *Lourdes Medical Pavilion, LLC v. Catholic Healthcare Partners, Inc.*, 2006 WL 7530805 (W.D. Ky., 2006).
60. KRS 275.170(1) provides by negative inference that a member or manager will be liable, responsible and accountable in damages for actions that rise to the level of wanton or reckless misconduct (the fiduciary duty of care) and KRS 275.170(2) provides that members and managers are accountable to their LLC and must hold as trustee for the LLC any profit or benefit derived by that person in connection with a transaction connected with the LLC or the use of its property (the fiduciary duty of loyalty) unless properly approved.
61. *Flippo v. CSC Associates III, L.L.C.*, 547 S.E.2d 216 (Va. 2001); *Jordan v. Holt*, 608 S.E.2d 129 (S.C. 2005).
62. This is the standard set forth for judicial dissolution under KRS 275.390.
63. See *Sauer v. Moffitt*, 363 N.W.2d 269 (Iowa Ct. App. 1984) and *Maddox v. Norman*, 669 P.2d 230 (Mont. 1983).
64. See *Muellenberg v. Bikon Corporation*, 669 A.2d 1382 (N.J. 1996).
65. See *In re USA Cafes, L.P. Litigation*, 600 A.2d 43 (Del. Ch. 1991); *Bay Center Apartments Owner, LLC*, supra n. 14.
66. *Bay Center Apartments Owner, LLC* supra n. 14; In *Globis Partners, L.P. v.*

Plumtree Software, Inc., No. 1577-VCP, 2007 WL 4292024 (Del. Ch. Nov. 30, 2007), the Delaware Court of Chancery held that to state a claim for aiding and abetting a breach of fiduciary duty, a plaintiff must demonstrate: "(1) the existence of a fiduciary relationship; (2) the fiduciary breached its duty; (3) a defendant, who is not a fiduciary, knowingly participated in a breach; and (4) damages to the plaintiff resulted from the concerted action of the fiduciary and the nonfiduciary." See also, Christine L. Eid, supra n. 1.

67. *Kahn v. Pornoy,* 2008 WL 5197164 (Del. Ch. Dec 11, 2008); *Bay Center Apartments Owner, LLC* supra n. 14.

68. Note that a Kentucky court may apply standards developed in *Semonin* – i.e., that the concept of dissenters' rights as an exclusive remedy is limited to transactions that are not being effected in contravention of law or where some species of fraud is being worked upon the dissenters. See *Yeager* supra n. 51.

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