POINT / COUNTERPOINT –
A DEBATE ON
FIDUCIARY DUTIES

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I. FIDUCIARY DUTY DEFINED

The fiduciary relationship "may exist under a variety of circumstances; it 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 interest of the one reposing confidence." Steelvest, Inc. v. Scansteel Serv. Ctr., 807 S.W.2d 476, 485 (Ky. 1991) (quoting Security Trust Co. v. Wilson, 210 S.W.2d 336, 338 (Ky. 1948). The relationship can be informal, but it "must evidence circumstances showing both parties agreed that one party would be acting in the interest of the other." In re Sallee, 286 F.3d 878, 893 (6th Cir. 2002). "Determining whether a fiduciary relationship exists is a fact intensive inquiry that requires the consideration of a number of factors." James T. Scatuorchio Racing Stable, LLC v. Walmac Stud Mgmt., LLC, 2014 U.S. Dist. LEXIS 68981, *38 (E.D. Ky., May 20, 2014).

A. Fiduciary Duties

1. Duty of care – Fiduciary will act as a reasonably prudent person.

2. Duty of loyalty – Fiduciary must act in the best interest of the plaintiff and must act without personal economic benefit unless the conflict is fully disclosed and approved. "Whenever a reasonably prudent fiduciary is aware of conflict between his private interest and the corporate interest, he owes the duty of good faith and full disclosure of the circumstances to the corporation." Aero Drapery of Kentucky, Inc. v. Enghdahl, 507 S.W.2d 166, 169 (Ky. 1974).

B. Elements of Fiduciary Claim

1. Relationship existed before the transaction at issue took place;

2. The party claiming a fiduciary relationship must show that reliance was not subjective;

3. The party claiming a fiduciary relationship must show that the nature of the relationship imposed a duty upon the fiduciary to act in the principal's interest, even if such action was to the detriment of the fiduciary.

Ballard v. 1400 Willow Council of Co-Owners, Inc., 430 S.W.3d 229, 242 (Ky. 2013); see also In re Sallee, 286 F.3d 878.
II. KENTUCKY LIMITED LIABILITY COMPANIES

"A limited liability company is a hybrid business entity having attributes of both a corporation and a partnership. Its owners are its members. Like corporations and limited partnerships, limited liability companies are creatures of statute. In Kentucky, there is relatively little case law regarding limited liability companies," and prior to 2009, there was no Kentucky case law concerning fiduciary duties in the limited liability company context. Patmon v. Hobbs, 280 S.W.3d 589, 593 (Ky. App. 2009).

A. Statutory Fiduciary Duties – Kentucky Limited Liability Company Act

1. Member managed limited liability companies.

In a member managed limited liability company, every member is an agent and owes a fiduciary duty to the LLC. The default rule under KRS 275.135(1), absent a contrary provision in an operating agreement, is that "every member shall be an agent of the limited liability company for the purpose of its business or affairs . . . " Agents have fiduciary duties to their principles. Stewart v. Kentucky Paving Co., Inc., 557 S.W.2d 435, 437 (Ky. App. 1977).

2. Manager managed limited liability companies.

"If the articles of organization provide that management of the limited liability company is vested in a manager or managers

a. No member, solely by reason of being a member, shall be an agent of the limited liability company; and

b. Every manager shall be an agent of the limited liability company for the purpose of its business or affairs, and the act of any manager, including, but not limited to, the execution in the name of the limited liability company of any instrument, for apparently carrying on in the usual way the business or affairs of the limited liability company of which he is the manager shall bind the limited liability company, unless the manager so acting has, in fact, no authority to act for the limited liability company in the particular matter, and the person with whom the manager is dealing has knowledge or has received notification of the fact that the manager has no such authority."

KRS 275.135(2).


Unless otherwise provided in a written operating agreement:
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.

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 (½) 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.

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. That a transaction was fair to the limited liability company shall not constitute a defense to the failure to request and receive the required consent of the disinterested managers or members.

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 275.170.

B. Kentucky Common Law Fiduciary Duties

Limited liability companies are hybrids of corporations and partnerships. While the entities may be creatures of statute, common law fiduciary
duties applicable to corporations and partnerships are applicable to limited liability companies in certain circumstances. Kentucky has long recognized common law fiduciary duties in case law discussing corporations and partnerships.

1. Corporations.

   a. "Ordinarily, of course, the directors, especially where they own a majority of the stock of the corporation, are invested with large powers in the matter of the selection of, and the salaries to be paid, officers of the corporation. With this broad discretion the courts will not ordinarily interfere. It is also the rule that in the absence of statutory or other provisions regulating the constitutional powers of the managing body, the majority of the stockholders must determine how its affairs are to be conducted, and to whom and under what restrictions the management of those affairs shall be entrusted." Lindl. Comp. (5th Ed.), 298. The right of a majority of the stockholders either to originally direct or affirm a contract between the company and a director or directors personally interested in the contract, is not, however, absolute and unqualified, but is subject to the qualification that the affirmance or adoption must not be brought about by unfair or improper means, and must not be illegal or fraudulent, or oppressive towards those stockholders who oppose it. North Western Transportation Co. v. Beatty, L. R., 12 App., 589 (Jud. Council, 1887). "It is likewise well settled that the majority of the stockholders, although they may deal with the assets of the company, cannot so deal with them as to divide the assets, more or less, between themselves, to the exclusion of the minority." Beha v. Martin, 171 S.W. 393, 395 (Ky. 1914) (emphasis added).

   b. "Minority stockholders do not have many rights as against the action of the majority, but whatever they have should be protected. There is no doubt that holders of a majority of the stock in a corporation in selling all its property and dissolving it owe the duty of exercising diligence and good faith to the minority to obtain the largest amount possible and to protect their interests." 13 Am. Jur., Corporations, §§423, 1002. "In such matters the majority stockholders and the directors will not be permitted to further their own selfish interests to the detriment of the minority. This is well expressed in Southern Pacific Company v. Bogert, 250 U.S. 483, 39 S. Ct. 533, 535, 63 L. Ed. 1099, as follows: 'The rule of corporation law and of equity invoked is well settled and has been often applied. The majority has the right to control; but when it does so, it occupies a fiduciary relation toward the minority, as much so as the corporation itself or its officers and directors. If
through that control a sale of the corporate property is made and the property acquired by the majority, the minority may not be excluded from a fair participation in the fruits of the sale."

Kaye v. Kentucky Public Elevator Co., 175 S.W.2d 142, 144-145 (Ky. 1943) (emphasis added).

c. "The shareholders in closely held corporations bear a personal relationship to one another similar to that of a partnership and, as a consequence, the shares in such corporations signify more than a mere property interest. The restrictive stock agreement is one of the devices evolved for assuring the succession in interest of persons most likely to act harmoniously with the other shareholders. 18 C.J.S., Corporations, §391; Fletcher, Private Corporations, §§5456, 5457; 37 Va. L. R. 229."

Krebs v. McDonald's Executrix, 266 S.W.2d 87 (Ky. 1953).

d. "Fiduciary duty is not renounced at will at the termination of employment. 'It is as sacred and inviolable after as before the expiration of its term.' Trice v. Comstock, 121 F. 620, 625 (8th Cir. 1903). After the termination of his fiduciary relationship he is allowed the freedom to compete, and he may carry with him his personal experience, enterprise, and knowledge, but he may not use prior fiducial confidences to profit at the expense of his former employer. The expiration of this fiduciary relationship is the termination of actual responsibilities[.]

Aero Drapery of Kentucky, Inc. v. Engdahl, 507 S.W.2d 166, 169-170 (Ky. 1974).

e. "We do not deny the applicability of KRS 271A to corporations but do note, however, that there may be certain nonstatutorily imposed fiduciary duties that exist among shareholders in closely-held corporations. For example, in Aero Drapery of Kentucky, Inc. v. Engdahl, 507 S.W.2d 166 (Ky. 1974) the court held that a fiduciary duty is owed by a director to the corporation even though such a duty is no longer imposed by statute. In Aero, the plaintiff alleged that a ten percent shareholder, director and treasurer of the company occupied a fiduciary relationship to the company. The court, referring to a prior repealed statute that imposed such a duty, stated, 'Even without this statute there existed a fiduciary relationship between Engdahl [the stockholder, officer and director] and Aero [the company].'" Id. at 168.

Estep v. Werner, 780 S.W.2d 604, 606 (Ky. 1989).
2. Partnerships.

a. "The 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. George v. Sohn's Adm'r, 230 S. W. 904 (Ky. 1921); Jones v. Nickell, 179 S. W. 2d 195 (Ky. 1944). No undue advantage of one over another by misrepresentation or concealment will receive the approval of the law. A court of equity will always grant relief to the partner who has suffered from a breach of the obligation. One partner will not be permitted to obtain secretly any right that should belong to the partnership and put it to his own individual profit. Of such character is the securing of a contract. The criterion is not an actual evil motive, for the courts look to the result of any such action regardless of evil intent. If such action results in profit or advantage, the courts will require an accounting."

Stephens v. Stephens, 183 S.W.2d 822, 824 (Ky. 1944).

b. "We should state, at the outset, that there is no relation of trust or confidence known to the law that requires of the parties a higher degree of good faith than that of a partnership. Nothing less than absolute fairness will suffice. Each partner is the confidential agent of all the others and each has a right to know all that the others know. Nor will one partner be permitted to benefit at the expense of the firm. See Hollowell v. Satterfield, 185 Ky. 397, 215 S.W. 63. In Axton v. Kentucky Bottlers' Supply Co., 159 Ky. 51, 166 S.W. 776, 778, we had this to say on the subject: 'The obligation of good faith is not even confined to persons who are actually partners. It extends to persons negotiating for a partnership, and to persons who have dissolved partnership, and have not completely wound up and settled the partnership affairs."

Van Hooser v. Keenon, 271 S.W.2d 270, 273 (Ky. 1954) (emphasis added)

c. "We must bear in mind that partners are obligated to deal with each other in utmost good faith and fairness. This is particularly true when one partner seeks to purchase the interest of another partner."

Curtis v. Campbell, 336 S.W.2d 355, 359 (Ky. 1960).

In *Patmon*, Hobbs became the managing member of American Leasing and Management, LLC, ("American Leasing") which was in the business of build-to-suit leases. Hobbs learned that American Leasing had leases with a client to perform three projects but American Leasing did not have the financial means to fund the projects. Hobbs then formed a second company, American Development, without informing the other members of American Leasing. As the managing member of American Leasing, he sent new leases to the client changing the proposed landlord to the second company, American Development. American Leasing received no consideration for the transfer of the leases. A member of American Leasing found out about the transfer and brought various claims against Hobbs, including breach of fiduciary duty. The Kentucky Court of Appeals addressed fiduciary duties in the limited liability company context for the first time, stating:

"The Kentucky Supreme Court described the nature of a fiduciary duty:

The [fiduciary] relation[ship] may exist under a variety of circumstances; it 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.

*Steelvest, Inc. v. Scansteel Service Center, Inc.*, 807 S.W.2d 476, 485 (Ky. 1991) (quotation omitted). **Further, the Court held that even in the absence of a statutorily imposed duty, an officer or director of a company owes a fiduciary duty to the company.** *Aero Drapery of Kentucky, Inc. v. Engdahl*, 507 S.W.2d 166, 168 (Ky. 1974). *Aero* goes further in describing the duty of loyalty:

[w]henever a reasonably prudent fiduciary is aware of a conflict between his private interest and the corporate interest, he owes the duty of good faith and full disclosure of the circumstances to the corporation.

*Id.* at 169. Regarding partnership and the duty of loyalty, a 'partner has a duty to share with the partnership those business opportunities clearly related to the subject of its operations.' See 59A Am. Jur.2d Partnership §295 (2003). See also *Van Hooser v. Keenon*, 271 S.W.2d 270, 273 (Ky. 1954). "For the foregoing reasons, **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."

Patmon, 280 S.W.3d at 593-594.

In 2014, the Kentucky Court of Appeals affirmed their decision in Patmon in an unpublished opinion that addressed the same litigation, Patmon v. Hobbs, 2014 Ky. Unpub. LEXIS 19 (Ky. App. Jan. 10, 2014). The Court of Appeals reiterated that it "noted the existence of a common law duty of loyalty owed to members of a limited liability company, as well as the existence of a statutory duty, set forth in KRS 275.170[.]" Id. at *2.

The Kentucky Court of Appeals specifically stated that Kentucky limited liability companies impose a common-law fiduciary duty on its members absent provisions in the operating agreement. The debate since Patmon, which addressed a manager managed LLC and the breach by the manager, is do members of a manager managed LLC owe a fiduciary duty to other members?

III. DEVELOPING ISSUES IN LIMITED LIABILITY FIDUCIARY DUTIES TO MINORITY SHAREHOLDERS AND MEMBERS OF MANAGER MANAGED LLCs

A. Yeager v. Paul Semonin, Co., 691 S.W.2d 227 (Ky. App. 1985)

In Yeager v. Paul Semonin Co., the Kentucky Court of Appeals addressed a claim by a dissenting shareholder who argued that a "merger was illegal because it had no business purposes for the corporation itself, but was only for the purpose of 'freezing out' the minority, and had the effect of an illegal corporate dissolution as to them inasmuch as they would be ousted from continued participation in corporate affairs while the majority continued to participate." 691 S.W.2d 227, 228 (Ky. App. 1985).

The Court of Appeals affirmed the trial court's dismissal pursuant to CR 12.02 based on the availability of the corporate dissenters' right statute. However, the Court of Appeals rejected the idea that the dissenters' right statute was the only remedy for a dissenting stockholder in the case of a merger, stating:

We can agree that this appears to be what the Legislature intended as the general rule, but it does not appear to us as likely that it intended dissenting stockholders to be so limited where a merger was being effected in contravention of law, or where some species of fraud was being worked upon the dissenters. This would be a signal departure from the customary public policy where illegal or fraudulent acts are involved. See, e.g., Security Trust Co. v. Dabney, 372 S.W.2d 401 (Ky. 1963). In the absence of a more specific expression of legislative policy to the contrary, we do not
construe a legislative purpose to deny judicial relief in a merger situation where illegality or fraud are involved.

*Id.* at 228. The opinion leaves open the question of the majority's fiduciary duties owed to the minority when the majority acts fraudulently or when the dissenters' right statute is not applicable.

B. **Ballard v. 1400 Willow Council of Co-Owners, Inc., 430 S.W.3d 229 (Ky. 2013)**

The Kentucky Supreme Court addressed a breach of fiduciary duty claim against a non-profit condominium association regarding replacement costs of windows in a condo owned by Ballard. In addressing fiduciary duties the Supreme Court relied on KRS 273.215, which governs directors of a nonprofit corporation. The Court held:

Ballard contends that the Court of Appeals erred when it relied upon KRS 273.215(1), which sets forth standards to be followed by directors of a nonprofit corporation. Specifically, Ballard argues that she "did not bring a derivative suit against the [Council's] directors in their individual capacities for breach of their statutory fiduciary duties to the [Council] as an entity; she sued the [Council] as an entity for breach of its contractual obligations and common law fiduciary duties to her, individually." Ballard contends that her claims are against the Council as an entity and not against its directors in their individual capacities; therefore, KRS 273.215 is inapplicable. According to Ballard, that statute does not address the duties which a nonprofit corporation owes to individual members or co-owners. Those duties are established by common law.

We agree with Ballard that KRS 273.215 does not apply to the instant case because Ballard only brought suit against the Council and not its Board of Directors. However, we cannot say that the Council has a fiduciary duty to the individual owners. Ballard has not cited to any Kentucky authority which provides that a nonprofit corporation has a fiduciary duty. Rather, we believe it is the officers and directors that have a fiduciary duty, and that duty is to the nonprofit corporation. See KRS 273.215. Additionally, Ballard has failed to cite to any Kentucky authority which provides that a nonprofit corporation may be held vicariously liable for a director's breach of fiduciary duty.

Even if the nonprofit corporation can be held vicariously liable for a director's breach of fiduciary duty, the directors in this case only owed a fiduciary duty to the corporation. Specifically, KRS 273.215 provides that a director shall discharge his duties "(a) In good faith; (b) On an informed
basis; and (c) In a manner he honestly believes to be in the best interests of the corporation." (Emphasis added). As correctly noted by the Court of Appeals, this is a reasonable interpretation because the co-owners in this case could have competing agendas, which may not be in the best interests of the Council. Thus, the board of directors had a fiduciary duty to the Council as a whole and not to the individual unit owners, such as Ballard.

Ballard v. 1400 Willow Council of Co-Owners, Inc., 430 S.W.3d 229 at 240-41. Despite Ballard's claim that the breach of fiduciary duty claim was based on common law, the Kentucky Supreme Court only held that the statutory duties under Chapter 273 are to the corporation and not the condominium owners, leaving common law fiduciary duties open to interpretation.


Three physicians were former employees of New Lexington Clinic ("NLC"). They resigned from NLC to begin practice at Baptist Physicians Lexington, Inc. Despite the employment agreements permitting them to leave on sixty days' notice, NLC brought claims for "breach of fiduciary duties owed in their capacity as members of the NLC board of directors." 436 S.W.3d at 191. The trial court granted summary judgment pursuant to KRS 271B.8-300 which governs breach of a Kentucky corporate director's duties. The Supreme Court remanded the case to the trial court, holding:

Contrary to the lower courts' conclusions, KRS 271B.8-300 does not abrogate common law fiduciary duty claims against directors in Kentucky but essentially codifies a standard of conduct and standard of liability for directors that is derived from business judgment rule principles. As it explicitly states, the statute applies to "any action taken as a director" and "any failure to take any action as a director." Preparing for and participating in a competing venture does not constitute the type of internal corporate governance conduct addressed in KRS 271B.8-300 and consequently the statute does not apply. Accordingly, NLC properly pled common law fiduciary duty claims on these alleged facts and this action must be remanded.

Baptist Physicians Lexington, Inc. v. New Lexington Clinic, P.S.C., 436 S.W.3d at 191-192. The Kentucky Supreme Court elaborated on the common law fiduciary duty that governs directors of a corporation outside of their capacity as directors:

Kentucky courts have long recognized that corporate directors owe fiduciary duties to the corporation and its shareholders, duties emanating from common law. Urban
J. Alexander Co. v. Trinkle, 311 Ky. 635, 224 S.W.2d 923, 926 (1949) (a director has a "fiducial relation to the corporation and its shareholders"; he must act in the "utmost good faith and to further the corporation's interest and business" and may not acquire interests in "conflict or competition" with the corporation he serves). The duty of care and the duty of loyalty are the fundamental duties owed by a director although the evolution of corporate law nationally, particularly through decisions of the Delaware courts, has led some commentators to suggest that there are additional duties. See Julian Velasco, "How Many Fiduciary Duties are there in Corporate Law?" 83 So. Cal. L. Rev. 1231 (2010) (recognizing the basic duties of care and loyalty as well as the more recently articulated duty of good faith and positing a case for two additional duties).

This case requires consideration of the effect of KRS 271B.8-300, entitled "General Standards for Directors," on a claim that a corporate director has breached his fiduciary duties by misusing confidential information, seeking to hire corporate employees or otherwise acting contrary to the corporation's interest in anticipation of participation in a competing venture. As noted, both lower courts have concluded that this statute abrogates the common law and that any breach of a director's duties, including breach of the duties of "loyalty, faithfulness, honesty and fair dealing" as alleged in this case, must be pursued under the statute. We conclude otherwise, given the plain language of the statute.

The cardinal rule of statutory construction is to give effect to the legislative intent, and the courts must derive that intent, if at all possible, from the language chosen by the General Assembly. Shawnee Telecom Resources, Inc. v. Brown, 354 S.W.3d 542, 551 (Ky. 2011). Here, the legislature has stated a standard of conduct for a director in the "discharge of his duties." The KRS 271B.8-300(1) requirements of good faith, acting on an informed basis and in the best interests of the corporation are principles most often associated with the business judgment rule. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (business judgment rule presumes that "in making a business decision the directors . . . 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.") While the drafters of the Model Business Corporation Act emphasize that somewhat similar standard of conduct and director liability language in sections 8.30 and 8.31 of the Model Act is not intended to codify the business judgment rule, KRS 271B.8-300 has been aptly referred to as the
Kentucky business judgment statute. Rutheford B. Campbell, Jr., "Corporate Fiduciary Duties in Kentucky," 93 Ky. L. J. 551, 570 (2004-05) (statute offers directors the protection of the business judgment standard). Certainly it codifies both the standard of conduct applicable to a director and the circumstances in which the director can be held liable for monetary damages or subjected to injunctive relief. Significantly, subsection (5) limits a corporate director's liability but it does so only in the context of "any action taken as a director, or any failure to take any action as a director." In short, when acting in his or her directorial capacity, a director must comply with the statutory standard of conduct. If he fails to do so, injunctive relief is available and if the conduct at issue is willful misconduct or reflects wanton or reckless disregard for the corporation and its shareholders, then monetary damages may also be recovered.

The limiting language in KRS 271B.8-300(5) clearly evinces the legislature's intent to accord corporate director's protection in making decisions regarding the corporation and the conduct of its business. But just as clearly, the statute does not purport to address circumstances where a director is acting, not in his capacity as a director, but in his own individual interest with respect to a matter beyond the conduct of the corporation's business, even if that extra-corporate matter may have some impact on the corporation. If a director is acting on his own accord in anticipation of competing with the corporation which he still serves, that conduct implicates the director's common law fiduciary duties, not KRS 271B.8-300.

The references to the "internal affairs of a corporation," courts "judging corporate business decisions" and "the ordinary director's normal risk-taking in honest decision-making" [in the commentary accompanying KRS 271B.8-300] emphasize that the focus of KRS 271B.8-300 is corporate governance, not any action whatsoever that a person may take with respect to extra-corporate matters during his tenure as a director.

This interpretation is further supported by a decision of the Virginia Supreme Court, Simmons v. Miller, 261 Va. 561, 544 S.E.2d 666 (Va. 2001), construing similar language in the Virginia corporation statute. . . . In rejecting Miller's argument that the statute controlled the breach of fiduciary duty claim, the Virginia court stated:
Code §13.1-690 applies to the "discharge [of] duties as a director," and makes no distinction between duties of care and loyalty. We recognized in Willard v. Moneta Building Supply, Inc., 258 Va. 140, 151, 515 S.E.2d 277, 284 (1999) that "Code §13.1.690(A) does not abrogate the common law duties of a director." However, the protection of §13.1-690(C) applies only to acts "taken as a director, or any failure to take any action," and is confined to the exercise of business judgment on behalf of the corporation. When the acts in question do not meet these criteria, Code §13.1-690 does not apply.

The acts cited by Simmons as constituting Miller's breach of duty to Las Palmas include "secretly organizing Las Palmas International/Profesor Sila." Clearly, the organization of International, a competitor, was not a corporate act of Las Palmas. In taking this action, Miller was not exercising business judgment on behalf of Las Palmas. Although implicating a common law duty of loyalty, this act does not fall within the scope of Code §13.1-690.

544 S.E.2d at 676.

A similar conclusion is warranted here and, in fact, the U.S. District Court for the Eastern District of Kentucky has construed the Kentucky statute in precisely the same way. In Gundaker/Jordan American Holdings, Inc. v. Clark, 2008 U.S. Dist. LEXIS 80907, 2008 WL 4550540 *3 (E.D. Ky. 2008), the court stated:

In Steelvest, Inc. v. Scansteel Service Center, Inc., 807 S.W.2d 476 (Ky. 1991) and Aero Drapery of Kentucky, Inc. v. Engdahl, 507 S.W.2d 166 (Ky. 1974), the Kentucky Supreme Court analyzed claims of breach of fiduciary duty based on the common law. Steelvest and Aero Drapery differ from the instant case in two important ways. First, the operative facts in both of the earlier cases occurred prior to the enactment of the statutes. Second, even if the statutes had been in force, they would not have applied. KRS §271B.8-300(6) and §271B.8-420(6) apply only to actions "taken
as a director or officer and to "failure[s] to take action" as a director or officer. Neither of the above-cited cases involves actions taken as a director or officer or failures to take action as a director or officer. In both cases, the breach of fiduciary duty was based on the defendant's formation of a competing business. Forming a competing business is not part of a director or officer's official role, and, therefore, cannot be considered to be an action taken as a director or officer or a failure to take action as a director or officer.

Contrary to the conclusions of the trial court and the Court of Appeals, KRS 271B.8-300 simply does not speak to all actions an individual takes while serving as a corporate director but only to those which he or she takes or fails to take while acting in a directorial role, i.e., actions or inactions regarding corporate governance and the affairs of the corporation. For claims alleging breach of a director's fiduciary duties, especially the duty of loyalty, in the context of preparation for and participation in a competing enterprise, the common law principles elucidated in *Aero Drapery* and *Steelvest* continue to apply.

*Baptist Physicians Lexington, Inc. v. New Lexington Clinic, P.S.C.*, 436 S.W.3d at 194-198. The Kentucky Supreme Court specifically stated that common law fiduciary duties continue to apply outside of the statutory language for corporations. This reasoning should apply to Limited Liability Companies as well for managing partners acting outside of their capacity as managers.

IV. SPECIAL FIDUCIARY DUTIES FOR MINORITY SHAREHOLDERS IN OTHER JURISDICTIONS

A. *Donahue v. Rodd Electrotype Co.*, 328 N.E.2d 505 (Mass. 1975)

In *Donahue*, a minority shareholder of a close corporation brought suit against the directors of Rodd Electrotype alleging that the directors violated their fiduciary duty to her as a minority shareholder. The directors, officers and majority stockholders agreed to the corporate purchase of Harry Rodd's, a majority stockholder, shares at $800 per share, but did not offer the minority stockholder the same opportunity to sell her shares. 328 N.E.2d 505. The Supreme Court of Massachusetts defined a close corporation as: "(1) a small number of stockholders; (2) no ready market for the corporate stock; and (3) substantial majority stockholder participation in the management, direction and operations of
the corporation.” Id. at 511. The court noted that the close corporation "bears striking resemblance to a partnership. Commentators and courts have noted that the close corporation is often little more than an 'incorporated' or 'chartered' partnership." Id. at 512. Recognizing the potential for a minority stockholder to be disadvantaged by certain situations, the court extended the strict duty of loyalty to all stockholders in close corporations. Elaborating on the potential difficulties a minority shareholder might face in a close corporation, the court stated:

In a large public corporation, the oppressed or dissident minority stockholder could sell his stock in order to extricate some of his invested capital. By definition, this market is not available for shares in the close corporation. In a partnership, a partner who feels abused by his fellow partners may cause dissolution by his "express will . . . at any time" (G. L. c. 108A, §31[1][b] and [2]) and recover his share of partnership assets and accumulated profits. Fisher v. Fisher, 349 Mass. 675, 678 (1965). Fisher v. Fisher, 352 Mass. 592, 594-595 (1967). G. L. c. 108A, §38. If dissolution results in a breach of the partnership articles, the culpable partner will be liable in damages. G. L. c. 108A, §38(2)(a)II. By contrast, the stockholder in the close corporation or "incorporated partnership" may achieve dissolution and recovery of his share of the enterprise assets only by compliance with the rigorous terms of the applicable chapter of the General Laws. Rizzuto v. Onset Cafe, Inc., 330 Mass. 595, 597-598 [592] (1953). "The dissolution of a corporation which is a creature of the Legislature is primarily a legislative function, and the only authority courts have to deal with this subject is the power conferred upon them by the Legislature." Leventhal v. Atlantic Fin. Corp., 316 Mass. 194, 205 (1944). To secure dissolution of the ordinary close corporation subject to G. L. c. 156B, the stockholder, in the absence of corporate deadlock, must own at least fifty percent of the shares (G. L. c. 156B, §99[a]) or have the advantage of a favorable provision in the articles of organization (G. L. c. 156B, §100[a][2]). The minority stockholder, by definition lacking fifty percent of the corporate shares, can never "authorize" the corporation to file a petition for dissolution under G. L. c. 156B, §99(a), by his own vote. He will seldom have at his disposal the requisite favorable provision in the articles of organization.

Thus, in a close corporation, the minority stockholders may be trapped in a disadvantageous situation. No outsider would knowingly assume the position of the disadvantaged minority. The outsider would have the same difficulties. To cut losses, the minority stockholder may be compelled to deal with the majority. This is the capstone of the majority plan. Majority "freeze-out" schemes which withhold
dividends are designed to compel the minority to relinquish stock at inadequate prices. See Lydia E. Pinkham Medicine Co. v. Gove, 303 Mass. 1, 12 (1939); Mansfield Hardwood Lumber Co. v. Johnson, 263 F. 2d 748, 756 (5th Cir.), reh. den. 268 F.2d 317 (5th Cir.), cert. den. 361 U.S. 885 (1959); Cochran v. Channing Corp., 211 F.Supp. 239, 242-243 (S. D. N. Y. 1962); Gottfried v. Gottfried, 73 N.Y.S.2d 692, 695 (Sup. Ct. 1947); Patton v. Nicholas, 154 Texas 385, 393 (1955). When the minority stockholder agrees to sell out at less than fair value, the majority has won.

Because of the fundamental resemblance of the close corporation to the partnership, the trust and confidence which are essential to this scale and manner of enterprise, and the inherent danger to minority interests in the close corporation, we hold that stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another. In our previous decisions, we have defined the standard of duty owed by partners to one another as the "utmost good faith and loyalty." Cardullo v. Landau, 329 Mass. 5, 8 (1952). DeCotis v. D'Antona, 350 Mass. 165, 168 (1966). Stockholders in close corporations must discharge their management and stockholder responsibilities in conformity with this strict good faith standard. They may not act out of avarice, expediency or self-interest in derogation of their duty of loyalty to the other stockholders and to the corporation.

Donahue v. Rodd Electrotype Co., 328 N.E.2d at 514-515. The rationale behind these fiduciary duties should be applied to manager managed LLCs and the members of the LLCs. Other jurisdictions have adopted enhanced fiduciary duties in close-corporation settings as well. See Galbreath v. Scott, 433 So.2d 454, 456-57 (Ala. 1983); Hagshenas v. Gaylord, 557 N.E.2d 316 (Ill. App. Ct. 1990).

B. In re USACafes, L.P. Litigation, 600 A.2d 43 (Del. Ch. 1991)

The Delaware Chancery Court extended fiduciary duties to limited partners in a limited partnership in In re USACafes. USACafes, L.P. was a Delaware limited partnership that sold a majority of its assets to a corporation. The limited partnership unitholders brought suit against the General Partner (USACafes General Partner, Inc.); USACafes, L.P., Sam and Charles Wyly who own all of the stock of the General Partner, four individuals who sat on the board of directors of the General Partner, and the corporation that purchased the assets. The court addressed the defendants’ motion to dismiss on the basis that the directors of the General Partner did not owe a fiduciary duty to the limited partners. In dismissing the motion to dismiss, the court stated:
While I find no corporation law precedents directly addressing the question whether directors of a corporate general partner owe fiduciary duties to the partnership and its limited partners, the answer to it seems to be clearly indicated by general principles and by analogy to trust law. I understand the principle of fiduciary duty, stated most generally, to be that one who controls property of another may not, without implied or express agreement, intentionally use that property in a way that benefits the holder of the control to the detriment of the property or its beneficial owner. There are, of course, other aspects – a fiduciary may not waste property even if no self interest is involved and must exercise care even when his heart is pure – but the central aspect of the relationship is, undoubtedly, fidelity in the control of property for the benefit of another. See generally Robert Flannigan, "The Fiduciary Obligation," 9 Oxford J. Legal St. 285 (1989).

The law of trusts represents the earliest and fullest expression of this principle in our law, but courts of equity have extended it appropriately to achieve substantial justice in a wide array of situations. Thus, corporate directors, even though not strictly trustees, were early on regarded as fiduciaries for corporate stockholders. E.g., Koehler v. Black River Falls Iron Co., 67 U.S. (2 Black) 715, 17 L. Ed. 339 (1863); Wardell v. Union Pac. R.R. Co., 103 U.S. 651, 26 L. Ed. 509, 13 Otto 651 (1881). When control over corporate property was recognized to be in the hands of shareholders who controlled the enterprise, the fiduciary obligation was found to extend to such persons as well. Allied Chemical & Dye Corp. v. Steel & Tube Co., Del. Ch., 14 Del. Ch. 1, 120 A. 486, 491 (1923).

While the parties cite no case treating the specific question whether directors of a corporate general partner are fiduciaries for the limited partnership, a large number of trust cases do stand for a principle that would extend a fiduciary duty to such persons in certain circumstances. The problem comes up in trust law because modernly corporations may serve as trustees of express trusts. Thus, the question has arisen whether directors of a corporate trustee may personally owe duties of loyalty to cestui que trusts of the corporation. A leading authority states the accepted answer:

The directors and officers of (a corporate trustee) are certainly under a duty to the beneficiaries not to convert to their own use property of the trust administered by the corporation. . . . Furthermore, the directors and officers are under a duty to the
beneficiaries of trusts administered by the corporation not to cause the corporation to misappropriate the property. . . . The breach of trust need not, however, be a misappropriation . . . . Any officer (director cases are cited in support here) who knowingly causes the corporation to commit a breach of trust causing loss . . . is personally liable to the beneficiary of the trust. . . .

Moreover, a director or officer of a trust institution who improperly acquires an interest in the property of a trust administered by the institution is subject to personal liability. He is accountable for any profit . . . . Even where the trustee [itself] is not liable, however, because it had no knowledge that the director was making the purchase . . . , the director . . . is liable to the beneficiaries. . . . The directors and officers are in a fiduciary relation not merely to the [corporation] . . . but to the beneficiaries of the trust administered by the [corporation].


The theory underlying fiduciary duties is consistent with recognition that a director of a corporate general partner bears such a duty towards the limited partnership. That duty, of course, extends only to dealings with the partnership's property or affecting its business, but, so limited, its existence seems apparent in any number of circumstances. Consider, for example, a classic self-dealing transaction: assume that a majority of the board of the corporate general partner formed a new entity and then caused the general partner to sell partnership assets to the new entity at an unfairly small price, injuring the partnership and its limited partners. Can it be imagined that such persons have not breached a duty to the partnership itself? And does it not make perfect sense to say that the gist of the offense is a breach of the equitable duty of loyalty that is placed upon a fiduciary? It appears true that the same result might be rationalized as aider and abettor liability, but I am unsure what such indirection would add that is useful where a self-dealing transaction or other diversion of partnership property is alleged. Indeed in some instances, for example the use by a director of confidential information concerning the partnership’s
business not yet known by the board of the general partner, there may be no breach of loyalty or care by the general partner itself to abet, yet there may be director liability to the partnership by the director. Cf. cases cited at 4 Scott on Trusts §326.3, at n.7.


While these authorities extend the fiduciary duty of the general partner to a controlling shareholder, they support as well, the recognition of such duty in directors of the General Partner who, more directly than a controlling shareholder, are in control of the partnership’s property. It is not necessary here to attempt to delineate the full scope of that duty. It may well not be so broad as the duty of the director of a corporate trustee. But it surely entails the duty not to use control over the partnership’s property to advantage the corporate director at the expense of the partnership. That is what is alleged here.

In re USACafes, L.P. Litigation, 600 A.2d at 48-49.

V. CONCLUSION

A. Kentucky’s common law of fiduciary duties as applied to partnerships and closely held corporations should also govern LLCs.

B. Kentucky courts have recognized that fiduciary duties apply to LLCs and their managers and members but there is limited case law on the duties or applicable circumstances leaving much ambiguity that is open to interpretation. The applicable fiduciary duties should be governed on a case by case basis.

C. Kentucky courts should look to other jurisdictions that extend fiduciary duties in closed corporations and limited partnerships to protect a minority shareholder’s interest since Kentucky case law has already recognized the potential injustice minority shareholders can face. See Beha v. Martin, 171 S.W.2d 142 (Ky. 1943); Kaye v. Kentucky Public Elevator Co., 175 S.W.2d 142 (Ky. 1943).
SOME OF THE WHO, TO WHOM, WHEN, TO DO WHAT AND
NOT TO DO WHAT OF FIDUCIARY OBLIGATIONS

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But to say that a man is a fiduciary only begins analysis; it gives
direction to further inquiry. To whom is he a fiduciary? What
obligations does he owe as a fiduciary? In what respect has he
failed to discharge these obligations? And what are the
consequences of his deviation from duty? ¹

I. INTRODUCTION

The bare assertion that someone is a fiduciary may, as presented, be
grammatically correct, but seldom, if ever, does it actually convey any
information. "Mr. X is a fiduciary" is a conclusory statement based upon an
assessment (correct or otherwise) as to a particular relationship in which we
must assume Mr. X is a participant. "Mr. X is a fiduciary" is only the subject; it
requires a predicate in order to convey information. Actual information, subject
and predicate, exists in: "Mr. X is a fiduciary to Y such that he must/must not …."

The last element, "such that he must/must not," is crucial to the fiduciary
analysis. Different fiduciary duties impose different obligations to either act or not
act in particular circumstances. Put another way, there are different duties of
care and there are different duties of loyalty.

Ultimately, the following issues must be addressed:²


² This discussion is almost exclusively focused upon Kentucky law. It may not be assumed that
the principles here reviewed and the rules recited are equally applicable in other jurisdictions. For
example, while in a Kentucky member-managed LLC it is clear, absent contrary private ordering,
that a member owes fiduciary obligations, whether a member in a Delaware organized LLC owes
fiduciary obligations is open to dispute. Contrast Myron T. Steele, "Freedom of Contract and
Default Contractual Fiduciary Duties in Delaware Limited Partnerships and Limited Liability
Companies," 46 Am. Bus. L.J. 221 (Summer 2009) (positing that there are no default fiduciary
duties in limited partnership or LLCs organized under Delaware law), with Auriga Capital Corp. v.
Gatz Properties, LLC, 40 A.3d 839, 844 (Del. Ch. 2012) (holding that there exist default fiduciary
duties in Delaware LLCs), and Auriga Capital Corp. v. Gatz Properties, LLC, 40 A.3d 839 (Del.
2012) (holding LLC manager had violated contractually defined standards and chastising Chancel-
lor Steele for reviewing hypothetical of what are the standards absent a contractually
agreed standard and declaring those portions of his opinion dicta). Then, in Feeley v. NHAOCG,
LLC, 62 A.3d 649, 663 (Del. Ch. 2012), Vice Chancellor Laster adopted the reasoning and path of
analysis employed by Chancellor Strine in Auriga Capital, writing "Until the Delaware Supreme
Court speaks, the long line of Court of Chancery precedents and the Chancellor's dictum provide
persuasive reasons to apply fiduciary duties by default to the manager of a Delaware LLC."
Amendments to the Delaware LLC Act adopted in 2013 (Del. Code Ann., tit. 6, §19-1104) express-
ly incorporate "the rule of law and equity relating to fiduciary duties" into the LLC Act.
II. WHO IS A FIDUCIARY?

A fiduciary relationship begins with a relationship of unequal position, knowledge or skill.

The [fiduciary] relation[ship] may exist under a variety of circumstances; it 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.3

On the other hand, a fiduciary relationship does not exist between the parties to an arms-length contractual relationship. For example, in Gonzalez v. Imaging Advantage, LLC, the court observed:

Gonzalez's claim for breach of fiduciary duty fails outright. Basic contractual relationship (such as the contract between Gonzalez and IA [Imaging Associates]) do not give rise to fiduciary duties.4

Particular relationships are defined by statute as being fiduciary in nature, a conclusion drawn not so much from the use of the word fiduciary (although that does happen), but rather the definition of duties owed; if the duties are fiduciary in nature then the person owing them is a fiduciary:

- Directors of a Corporation5

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3 Steelvest, Inc. v. Scansteel Service Center, Inc., 807 S.W.2d 476, 485 (Ky. 1991) (quotation omitted).


5 Ky. Rev. Stat. Ann. 271B.8-300(1); id. at §273.215(1). Under prior law, the relationship between a corporate director and the corporation was expressly labeled as being "fiduciary" in nature. See Ky. Rev. Stat. Ann. §271.365 (enacted 1946 Ky. Acts, ch. 141, §1) ("Officers and directors shall be deemed to stand in a fiduciary relation to the corporation, and shall discharge the duties of their respective positions in good faith, and with that diligence, care and skill which ordinary prudent men would exercise under similar circumstances in like positions.").
• General Partners

• Members in a Member-Managed LLC

• Real Estate Agents

• Common Law Agents

• Common Law Employees

• Trustees of a Statutory Trust

Other relationships are defined as not being fiduciary in nature:

• Limited Partners

• Members in a Manager-Managed LLC

• Corporate Shareholders

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8 201 KAR 11:121(1)(4)(e) (“the following fiduciary duties owed to the licensee's client”).

9 “Agency is the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act.” CSX Transp., Inc. v. First Nat'l Bank, 14 S.W.3d 563, 567 (Ky. App. 2000) (quoting McAlister v. Whitford, 365 S.W.2d 317, 319 (Ky. 1962)); see also Restatement (Third) of Agency §1.01 (“Agency is the fiduciary relationship….”); id. at §8.05; id. at §8.08.

10 Restatement (Third) of Employment Law §8.01(a) (Tentative Draft No. 3 (Apr. 8, 2010)) (“Employees owe a duty of loyalty….”); Stewart v. Kentucky Paving Co., Inc., 557 S.W.2d 438 (Ky. App. 1977).

11 Ky. Rev. Stat. Ann. §386A.5-050(1) (“Subject to KRS 386A.5-010(2), in exercising the powers of trusteeship, a trustee shall act in good faith, on an informed basis, and in a manner the trustee reasonably believes to be in the best interests of the statutory trust.”); id. at §386A.5-050(2) (“A trustee shall discharge his or her duties with the care that an ordinarily prudent person in a similar position would reasonably believe appropriate under similar circumstances.”).

12 Ky. Rev. Stat. Ann. §362.2-305(1) (“A limited partner does not have any fiduciary duty to the limited partnership or to any other partner solely by reason of being a limited partner.”).


14 The existence (actually the lack of existence) of fiduciary duties inter-se the shareholders of a Kentucky corporation is reviewed in depth in Rutledge, "Shareholders Are Not Fiduciaries – A Positive and Normative Analysis of Kentucky Law," 51 U. Louisville L. Rev. 535 (2013). A shorter treatment of the same issue is set forth at Rutledge, "Minority Shareholder Oppression? - The Problem is Not with the Answer But Rather with the Question," 17 J. Passthrough Entities 55 (July/Aug. 2014). See also Haldeman v. Haldeman, 197 S.W. 376, 381 (Ky. 1917) (“A stockholder occupies a position and owes a duty radically different from a director. A stockholder
In other instances it is necessary to ascertain the aspects of the particular relationship to determine whether or not it is fiduciary in nature. As addressed by the Sixth Circuit in Sallee v. Fort Knox National Bank:¹⁵

To make out a claim that a fiduciary relationship existed, the party claiming the fiduciary relationship must first show the relationship existed before the transaction that is the subject of the action. Second, the party claiming a fiduciary relationship must show that reliance was not merely subjective. Third, the party claiming a fiduciary relationship must show that the nature of the relationship imposed a duty upon the fiduciary to act in the principal’s interest, even if such action were to the detriment of the fiduciary.¹⁶

As to the second requirement, the party seeking to have a fiduciary relationship recognized must show more than mere subjective trust. An aggrieved party must also show that he trusted the other party to act as a fiduciary and that such trust was reasonable under the circumstances. Only in rare commercial cases is it reasonable to believe the other party will put your interests ahead of their own.

The Kentucky Supreme Court has observed:

A fiduciary, moreover, is one who has expressly undertaken to act for the plaintiff’s primary benefit. Although fiduciary relationships can be informal, a fiduciary duty does not arise from the universal business duty to deal fairly nor is it created by a unilateral decision to repose trust and confidence; it derives from the conduct or undertaking of the purported fiduciary.¹⁷

This is obviously a fact intensive determination, but the burden is high – most business relationships are not fiduciary in nature. As set forth in Crestwood Farm Bloodstock v. Everest Stables, Inc.:

That the two were friends, even close friends, may well explain why they did business together. But that does not establish a fiduciary relationship – that Crestwood was charged with putting

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¹⁵ 286 F.3d 878, 892 (6th Cir. 2002).

¹⁶ See also CNH Capital America LLC v. Hunt Tractor, Inc., No. 3:10-CV-350, 2013 WL 1310878, at *12 (W.D. Ky. Mar. 26, 2013) (after discussing the Sallee standard, the court observed that there was no reason to hold a corporate officer as fiduciary to a corporate creditor, which would have “obligated [the officer] to put [the creditor’s] interests ahead of this own.”).

Everest's interest above its own. Many friends do business together. But not all friends are fiduciaries, and in the world of arms-length commercial negotiations few are. See, e.g., Sallee, 286 F.3d at 891-92 ("[T]he fact that the relationship has been a cordial one, of long duration, [is not] evidence of a [fiduciary] relationship." (internal quotation marks omitted)); 90 C.J.S. Trusts §197 ("The mere existence of mutual respect and confidence does not make a business relationship fiduciary.")

Setting forth a tour-de-force recitation of the elements of a fiduciary relationship, the James T. Scatuorchio Racing Stable, LLC v. Walmac Stud Management, LLC, the court wrote:

Under Kentucky law, to establish the existence of a fiduciary duty, a party must demonstrate that: (i) the parties' relationship existed prior to the transaction that is subject of the claim; (ii) the reliance was not merely subjective but reasonable; and (iii) the nature of the relationship imposed a duty upon the fiduciary to act in the principal's interest, even if such action were to the detriment of the fiduciary. In re Sallee, 286 F.3d at 892; Ballard v. 1400 Willow Council of Co-Owners, Inc., 430 S.W.3d. 229, 242 (Ky. 2013). A fiduciary duty requires more than the generalized business obligation of good faith and fair dealing. See In re Sallee, 286 F.3d at 891; see also Gresh v. Waste Servs. of Am., 311 F. App'x 766, 771 (6th Cir. 2009); Quadrille Bus. Sys. v. Ky. Cattlemen's Ass'n, 242 S.W.3d 359, 365 (Ky. App. 2007) ("An ordinary business relationship or an agreement reached through arm's length transactions cannot be turned into a fiduciary one absent factors of mutual knowledge of confidentiality or the undue exercise of power or influence." (quotation marks and citation omitted). "Only in rare commercial cases is it reasonable to believe the other party will put your interest ahead of their own." In re Salle, 286 F.3d at 892. Rather, "extraordinary facts are necessary" to support such a belief. Id.; see also Crestwood Farm Bloodstock v. Everest Stables, 751 F.3d at 442.

III. TO WHOM ARE THEY A FIDUCIARY?

A fiduciary duty arises out of a fiduciary relationship; the duty is owed to the counter-party in the relationship. In certain instances the statute will define the counter-party. For example:

18 751 F.3d 434, 443 (6th Cir. 2014).

Fiduciary | Beneficiary
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Corporate Directors | KRS §271B.8-300(1) Duty is owed "to the corporation"  
KRS §273.215(1) Duty is owed "to the corporation"  
*See 1400 Willow Council of Co-Owners v. Ballard*  
*See Griffin v. Jones*  

General Partners | KRS §362.1-404(1) "The fiduciary duties a partner owes the partnership and the other partners"

Members in a Member-Managed LLC | KRS §275.170(1) Fiduciary duty of care owed to the LLC and the other members  
KRS §275.170(2) Fiduciary duty of loyalty owed to the LLC  

Common Law Agents | Restatement (Third) of Agency §8.01  
Agent has fiduciary duty to act loyally for the principal's benefit  
Restatement (Third) of Agency §1.01 cmt. e (2006) "If the relationship between two persons is one of agency as defined in this section, the agent owns a fiduciary obligation to the principal."

If the fiduciary duty is not owed to a particular person, then a third-party, as to that fiduciary, cannot assert there has been a breach of duty except through some type of authorized representational capacity such as where a:

- Parent, as next friend of a minor, may sue the trustee of a trust for child's benefit to enforce the terms of the trust; or

- Shareholder of corporation may on the corporation’s behalf initiate a derivative action.

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20  430 S.W.3d 229 (Ky. 2013) (director's fiduciary duties are owed to the corporation).


22  See also *Patmon v. Hobbs*, No. 2012-CA-001814-MR, 2014 WL 97464, at *2 n.7 (Ky. App. Jan. 10, 2014) ("The common law fiduciary duty owed by directors and officers of a corporation generally runs directly to the corporation, not its members, as to the statutory duties. 18B Am.Jur.2d "Corporations" §1462 (2011). Likewise, the statute governing the duty of loyalty to members of a limited liability company instructs that the duty is to "account to the company." See KRS 275.170(2).”).  

It is important to focus upon the words of the statute both as to who owes the duty and to whom the duty is owed. If those parameters have been determined by the General Assembly then there will seldom if ever be additional obligors or beneficiaries save and except as created by private ordering. As observed by the Kentucky Supreme Court in *Pannell v. Shannon*:

> [The] common law of business entities has largely been abrogated by the adoption of the various statutes like the Kentucky Business Corporation Act and the Kentucky Limited Liability Company Act. In fact, "limited liability companies are creatures of statute," controlled by Kentucky Revised Statutes (KRS) Chapter 275, *Turner v. Andrew*, 413 S.W.3d 272, 275 (Ky. 2013) (*quoting Spurlock v. Begley*, 308 S.W.3d 657, 659 (Ky.2010)), not primarily by the common law. To the extent that common law doctrines could arguably govern limited liability companies, the Kentucky Limited Liability Company Act "is in derogation of common law," KRS 275.003(1), and the traditional rule of statutory construction that "require[s] strict construction of statutes which are in derogation of common law shall not apply to its provisions." *Id.* Thus, to the extent the statutes conflict with common law, the common law is displaced.

This Court must therefore first look at the controlling statutory law.

An example of this problem is the decision rendered in *Mason v. Underhill* where, notwithstanding that as of the time of the drafting of the limited partnership agreement at issue Kentucky had adopted both the Uniform Partnership Act (1914) and the Revised Uniform Limited Partnership Act (1985), neither of which was actually mentioned, the Court quoted *Meinhard v. Salmon* at length in describing the fiduciary duties of the general partner of a limited

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24 425 S.W.3d 58 (Ky. 2014).

25 425 S.W.3d at 68; *see also Roethke v. Sanger*, 68 S.W.3d 352, 358 (Ky. 2001) ("[R]egardless of any common law theories, the existence or nonexistence of a partnership in 1992 . . . was governed by the Uniform Partnership Act . . . adopted as the law of Kentucky in 1954. Thus the facts of the case are governed, not by pre-existing common law cases, but by the following statutory provisions.").

partnership. Of course, the statutorily defined fiduciary standards\textsuperscript{27} are materially different from the language of Meinhard v. Salmon.

This is an area as to which reference to the law of Delaware can be particularly troubling. While Kentucky courts often look to those of Delaware for guidance as to points of particular corporate law when the issue is not squarely addressed by Kentucky law (whether statutory or common),\textsuperscript{28} care needs to be taken to assure that the rules and principles of Kentucky law, especially positive law, are not set aside. To provide an example from outside the fiduciary context, under the Delaware General Corporation Law the shareholders may act outside of a meeting by majority action.\textsuperscript{29} In contrast, in Kentucky the shareholders of a business corporation may act outside of a meeting by unanimous consent,\textsuperscript{30} or, if so authorized by the articles of incorporation, by a threshold not lower than 80 percent of the shareholders.\textsuperscript{31} Obviously the simple majority threshold of Delaware law is both different and more relaxed than in Kentucky law. That differential is, however, of no import. The two rules are simply different; neither is better or worse than the other.\textsuperscript{32}

The caution is especially applicable if there are fiduciary duties. In Delaware, the law of fiduciary duties has been left to the courts, most particularly the Chancery Court. The DGCL does not contain provisions setting forth the fiduciary duty of those who are directors or officers of a Delaware corporation. The Delaware LLC Act only references the existence of fiduciary duties in LLC, without providing any further detail thereon,\textsuperscript{33} a provision added only to resolve, to the extent of the language, whether or not fiduciary duties as a default exist in Delaware LLCs. While Delaware has adopted the Revised Uniform Partnership Act (1997),\textsuperscript{34} it excluded §404 thereof in defining the fiduciary duties of partners.\textsuperscript{35}

\textsuperscript{27} See Ky. Rev. Stat. Ann. §362.250(1); id. §362.447; see also id. §§362.1-404(2), (3); id. §§362.2-408(1), (2), (3).

\textsuperscript{28} See, e.g., Bacigalupo v. Kohlhepp, 240 S.W.3d 155, 157 (Ky. App. 2007) ("Delaware has long been a bastion for corporate law and its development" and this Court "has previously adopted Delaware case law when examining corporate statutes....").

\textsuperscript{29} See Del. Code Ann. tit. 8, §228(a).


\textsuperscript{32} See also Rutledge, "Going to Delaware (?)," 16 J. Passthrough Entities 45 (July/Aug. 2013).

\textsuperscript{33} Amendments to the Delaware LLC Act adopted in 2013 (Del. Code Ann. tit. 6, §19-1104) expressly incorporate "the rule of law and equity relating to fiduciary duties" into the LLC Act, thereby adopting the view that there exist fiduciary duties in the absence of a contractual elimination or modification.

\textsuperscript{34} See Del. Code Ann. tit. 6, §15-101 et seq.

Delaware’s exclusion of statutory fiduciary duties is in marked contrast to the proactive positive law approach utilized in Kentucky. The Kentucky Business Corporation and Nonprofit Corporation Acts provide detailed formulae of the fiduciary duties and by directors and officers. Those same acts go on to detail the standard of culpability for monetary damages and allocate the burden of proof to the plaintiffs. The Kentucky adoption of RUPA, while modifying the formulae of RUPA §404 defines the fiduciary duty of partners. The LLC Act, since its adoption in 1994, has defined the fiduciary duties found in LLCs, defined who owes those duties (as well as who does not) and to whom the duties are owed. Kentucky, in contrast with Delaware, has by statute defined numerous (sometimes all) aspects of the fiduciary duties of participants in various organizational forms. For that reason, reference to Delaware law will often be inappropriate. Rather, reference to Delaware law will be appropriate if and only if Delaware is integrating a statute or a contractual provision employing the same formulae as that employed in Kentucky.

IV. WHEN DOES THE FIDUCIARY RELATIONSHIP BEGIN?

The fiduciary burdens imposed upon the fiduciary come into being upon the initiation of the fiduciary relationship. But when does that take place? Is the presentation of the relationship sufficient to initiate the obligations, or does that consequence await the initiation of the formal relationship?

Under the 1914 Uniform Partnership Act, the fiduciary relationship among the partners arose upon the negotiation of the terms of the partnership. In contrast, under the 1997 Revised Uniform Partnership Act the fiduciary duties did not arise until the partnership’s actual formation.

Recently the New York Court of Appeals wrestled with, but did not answer, the question of whether, upon solicitation of investments in to-be-formed LLCs, the


37 See id. §271B.8-300(5); id. §273.229(5).

38 See id. §271B.8-300(6); id. §273.229(6).

39 See id. ch. 362.1.


42 See id. §275.170(4).

43 See id. §275.170(1).

fiduciary relationship attached prior to the investment in the LLC. Working from the proposition that there does not exist a partnership among the anticipated participants in an LLC prior to its formation, that the fiduciary obligations arise from member status and that prior to the LLC's organization there are no members, we need to consider the nature (if any) of the limits on opportunistic behavior among the members. Be aware that "from the perspective of fiduciary law there are none" may be the correct determination.

V. WHEN DOES THE BURDEN OF THE FIDUCIARY RELATIONSHIP END?

The question of "when do the burdens of the fiduciary relationship end?" yields the classic lawyer answer – "It depends." The answer is dependent upon the nature of the different fiduciary obligations.

Consider first a corporate director's or a partner's duty of care. Upon the resignation as a director or resignation as a partner, there is no further involvement in the venture's management and affairs. From there, there is no further duty of care.

In contrast, consider a fiduciary's duty of loyalty. While the resigned director or partner may have no further involvement in prospective management, he or she is going to know the venture's confidential information; the "neuraliser" has not yet been invented. Even after the termination, as an active relationship, of the circumstances creating the fiduciary burden, the fiduciary is bound by ongoing obligations. The fiduciary may not utilize information derived from the relationship against the others and the information cannot be used in competition with the beneficiary of the fiduciary relationship and must otherwise protect the confidentiality of the information. Ergo:

After the termination of his fiduciary relationship [the fiduciary] is allowed the freedom to compete, and he may carry with him his personal experience, enterprise, and knowledge, but he may not use prior financial confidences to profit at the expense of his former employer.


48 See, e.g., id. §§362.1-603(2)(b), (c).

49 See Men In Black (motion picture released by Columbia Pictures July 2, 1997).

Engdahl also breached his duty to the corporation by exposing the confidential stock-bonus plan, both before and after the termination of his employment with Aero. Fiduciary duty is not renounced at will at the termination of employment. "It is as sacred and inviolable after as before the expiration of its term."

VI. A FIDUCIARY IS NOT ALWAYS A FIDUCIARY

It is an all too oft-overlooked point that a fiduciary is not always bound to act in accordance with fiduciary principles, primarily that to look solely to the interests of the principal without divided loyalty for the benefit of the fiduciary or a third-party.

Consider an employee; an employee has a fiduciary duty of loyalty to the employer. Assume that this employee has skills that are difficult to replace and which were learned and developed at the employer's expense. When the employee, without notice, announces that she is immediately terminating her employment relationship with the employer, we do not charge her with breach of fiduciary duty. The abrupt departure, highly disruptive to the beneficiary of the fiduciary obligation, is not itself a breach of fiduciary duty even though it cannot be suggested that the action was in the employer's best interest.

The partner is the prototypical fiduciary, owing duties to both the partnership and the other partners. We do not, however, charge a partner with disloyalty and breach of duty in insisting that, based upon her production and client orientation, that in this next year her sharing ratio needs to be increased, a demand which if accepted will result in fewer firm revenues being available to be split among the other partners. Admittedly the alteration in the sharing ratios likely will require the consent of the other partners. Do they have a fiduciary obligation to agree to the sharing ratio alteration? – surely not.

To provide another example, assume a member-managed LLC; each member owes a fiduciary duty of loyalty to the LLC and a fiduciary duty of care to the LLC and each of the other members. The written operating agreement obligates

51 Aero Drapery, 507 S.W.2d at 169 (quoting Trice v. Comstock, 121 F. 620, 625 (8th Cir. 1903)). See also Rutledge, "Care and Loyalty after the Dissociation from or Dissolution of an Unincorporated Entity," in Research Handbook on Partnerships, LLCs and Alternative Forms of Business Organizations (Robert W. Hillman and Mark J. Loewenstein eds.) (Edward Elgar Publishing, 2015).

52 See also II Alan R. Bromberg and Larry E. Ribstein, Bromberg and Ribstein on Partnership §6.07(a) ("The partners owe fiduciary duties to each other and to the partnership, although they do not have such duties in all circumstances.") (citations omitted); id. n.16 (collecting cases).


55 See id. §§275.170(1), (2), (4).
Scott, a member of the LLC, to sell it to Blackacre for $1,000. Notwithstanding having undertaken this obligation in the operating agreement, Scott refuses to close on the sale. Clearly the LLC has a claim against Scott for breach of the operating agreement. But there is no claim for breach of Scott's fiduciary obligations to either the LLC or the other members. The breach of contract is not morphed into a breach of fiduciary duty by reason of the fact that one of the parties to the agreement, in this instance the party causing the breach, owed fiduciary duties. Simply put, in this circumstance the member is acting not as a member subject to fiduciary obligations, but rather as a vendor. The law of contract, has long addressed how breach, either monetary damages or specific performance (the latter likely being the outcome in this hypothesis), should be handled.

Clearly a fiduciary is not required as to all actions impacting upon the beneficiary of the relationship to act in accordance with fiduciary restraints.

VII. THE OBLIGATION OF GOOD FAITH AND FAIR DEALING IS NOT A FIDUCIARY OBLIGATION

Before turning to the substance of the fiduciary obligations, it is important to distinguish the contractual obligation of good faith and fair dealing. In Kentucky, every contract incorporates and imposes upon the parties thereto an obligation of good faith and fair dealing. The implied covenant of the good faith and fair dealing obligates a party to a contract to do "everything necessary" to carry out the contract. There is also a negative burden to not act to "prevent [ ] the creation of the condition under which payment would be due." The implied covenant informs the interpretation of the agreed upon terms of the contract; it does not provide extra-contractual terms. The covenant of good faith and fair dealing will not preclude a party from exercising its contractual rights.

56 See id. §275.003(4) (the LLC is a party to and bound by the operating agreement).

57 See Farmers Bank and Trust Co. of Georgetown, Kentucky v. Willmott Hardwoods, Inc., 171 S.W.3d 4, 11 (Ky. 2005) ("Within every contract there is an implied covenant of good faith and fair dealing, and contracts impose on the parties thereto a duty to do everything necessary to carry them out."); see also Ky. Rev. Stat. Ann. §275.003(7); id. §362.1-404(4); id. §362.2-408(4); id. §386A.1-060(6). Accord Restatement (Second) of Contracts §205 (1981).


important point is that the implied covenant does not serve to preclude self-dealing conduct, but rather only police it at the margins by protecting the express contractual terms.

As to allegations that "constitute self-dealing," a party may act in its own interest and not breach the covenant of good faith and fair dealing, as long as its discretion is not used in a way that is contrary to the spirit of the agreement.62

This is not to suggest that good faith and fair dealing are inapplicable in a fiduciary relationship; rather the reverse is the typical rule. The fiduciary must discharge the obligations undertaken by contract consistent with good faith and fair dealing.

VIII. WHAT AFFIRMATIVE AND NEGATIVE OBLIGATIONS BURDEN THE FIDUCIARY?

After these other steps are completed, it is necessary to determine the fiduciary obligations that bind the fiduciary. In order to assess whether a violation of a limitation has taken place it is necessary to know the parameters of that limitation. What is crucial to appreciate is that there are different fiduciary limitations even within the same category. Speed limits provide an analogous situation; speed limits bind each driver. There are, however, different speed limits. Some roads permit 55 mph, some 70 mph, and within a school zone the speed limit is 25 mph. Knowing that a particular driver was going 60 mph does not tell you whether they were speeding unless you also know the speed limit along the stretch of road in question.

Speaking in the broadest terms, a fiduciary is held to duties of care and loyalty.63 Care requires that the fiduciary exercise responsibilities and discharge obligations undertaken in accordance with a performance standard. Loyalty requires that the fiduciary act in a self-abrogating manner; the fiduciary may not,

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63 Other obligations at times identified as being fiduciary in nature include that to act lawfully, the duty of candor, and a duty of good faith. In accordance with the holding of the Delaware Supreme Court in Stone v. Ritter, 911 A.2d 362 (De. 2006), it is here assumed that the duty of good faith is a component of the duty of loyalty. As a concession to the brevity of life, I will not here pursue the question of whether the duty of care is itself a component of the duty of loyalty.
absent informed consent, benefit (beyond agreed to compensation) from or transact business with the beneficiary or the subject matter of the fiduciary relationship. The crucial point bears emphasis – there are different standards of care and there are different standards of loyalty. The correct determination that X is a fiduciary in favor of Y and that X engaged in conduct that violates fiduciary standard Z is entirely irrelevant unless until it is demonstrated that standard Z is that at issue in their fiduciary relationship. If X is guilty of negligence but not gross negligence, and the fiduciary standard for X’s conduct on Y’s behalf is gross negligence, there is no fiduciary breach and no fiduciary liability.

A. Care

Care is generally a positive duty; it requires that in the discharge of particular acts by the fiduciary that the fiduciary discharge those well. What is "well" in a particular form of organization is typically defined by the statute. Certain fiduciaries, such as simple agents, are held to a standard of simple negligence. None have doubted that partners in partnerships organized under the 1914 Uniform Partnership Act are subject to a duty of care even as the statute is silent as to the point, the standard having been ascertained by means of the common law. At other times a statutory duty is defined or there is specified, without defining the underlying standard, the level of culpability required in order to be held responsible. Sometimes the requirement is subjective while at other times it is objective.

Some assert that a fiduciary is protected from criticism for breach of the duty of care by the Business Judgment Rule (the "BJR"). This is a gross overstatement. First, the BJR, in order to trigger its benefits, requires a number of distinct showings such as an informed decision and a demonstration that the transaction being challenged did not involve a breach of the duty of loyalty. Second, the BJR is a unique construct of

64 See also Rutheford B. Campbell, Jr., "Corporate Fiduciary Duties in Kentucky," 93 Ky. L.J. 551, 555 n.16 (2004-05) (differentiating "care" as being implicated in decisions that (could) increase corporate wealth from "loyalty," it being implicated in decisions that reallocate corporate wealth among constituencies).


66 See, e.g., Ky. Rev. Stat. Ann. §271B.8-300(1) (a director of a corporation is to discharge his or her obligations "(a) in good faith; (b) on an informed basis; and (c) in the manner he honestly believes to be in the best interests of the corporation.").


70 See, e.g., Kaplan v. Centrix Corp., 284 A.2d 119, 124 (Del. Ch. 1971) (protection of the business judgment rule not available where the directors made no decision); Smith v. Van Gorkom, 488 A.2d 858, 870-71 (Del. 1985) ("benefit of Business Judgment Rule not available
the law governing a particular class of fiduciaries, namely the directors of
a corporation. To suggest that the BJR protects the actions of trustees,
simple agents, partners or the members or managers of an LLC is at
minimum unsupported or more likely simply incorrect.71

It is important to here understand that the "duty of care" describes a
range of obligations as contrasted with a single monolithic standard.
Certain fiduciaries are subject to a duty of care, an example being a
simple agent, imposing a standard of simple negligence.72 Absent an
agreement by the principal to hold the fiduciary to a less exacting
standard, the agent will be responsible to the principal for the discharge of
their obligations where that discharge did not meet the standard of a
reasonable person. A similar (and non-uniform) provision is utilized in
Kentucky Revised Uniform Partnership Act.73 As such, the bare assertion
that a particular fiduciary is subject to a "duty of care" begs the most
crucial question, namely which standard of care.

Even then, the violation of the standard of care imposed by the statute, an
example being the requirement that a director act "in good faith,"74 does
not compel a conclusion that the director or other fiduciary is subject to
liability. Many of the statutes, while sometimes defining a standard of
care, define a different and more relaxed standard for imposing liability.
By way of example, the Business Corporation Act defines an aspirational
standard of care applicable to directors.75 Alone, the violation of those
standards does not result in liability; rather, liability for monetary damages
attaches only if the breach constituted either willful misconduct or a
wanton or reckless disregard for the best interest of the corporation and
its shareholders.76 If and only if such theory of breach is pled77 and

where directors acted on an uninformed basis"); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)
(same); FDIC v. Castetter, 184 F.3d 1040, 1046 (9th Cir. 1999) (benefits of business judgment
rule not available where directors were either not disinterested or not independent).

71 See generally Elizabeth S. Miller and Thomas E. Rutledge, "The Duty of Finest Loyalty and

72 See, e.g., Restatement (Third) of Agency §8.08 (2006) ("Subject to any agreement with the
principal, an agent has a duty to the principal to act the care, confidence, and diligence normally
exercised by agents in similar circumstances.").


74 See id. §271B.8-300(1)(a); id. §273.215(1)(a).

75 See id. §§271B.8-300(1)(a)-(c).

76 See id. §271B.8-300(5)(b).

not allege that director "committed willful misconduct or that he acted with wanton or reckless
disregard for the best interest of the corporation or its shareholders . . . did not sufficiently allege
a cause of action under KRS 271B.8-300.").
proved will the director be answerable in damages for violation of the duty of care.

B. Loyalty

It is the fiduciary duty of loyalty that presents the most problems and the most opportunities for breach. Meinhard v. Salmon, the prototypical case regarding the fiduciary obligations among partners, is a duty of loyalty case, yielding the following oft-cited prose:

Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.

In another formulation it is stated:

"'Fiduciary duty' is defined as 'a duty of utmost faith, trust, confidence and candor owed by a fiduciary (such as a lawyer or corporate officer) to the beneficiary . . . ; a duty to act with the highest degree of honesty and loyalty toward the other person and in the best interest of the other person (such as the duty that one partner owes to another).""

And in still another:

A fiduciary relationship creates the highest order of duty imposed by law. If a fiduciary relationship exists, the fiduciary cannot profit from the relationship without the knowledge and permission of the principal. In a fiduciary relationship, the fiduciary must make every effort to avoid having his own interest conflict with those of the principal. When conflict is unavoidable, the fiduciary must place the interests of the principal above his own. A fiduciary duty requires more than the generalized business obligation of good faith and fair dealing.

79 249 N.Y. 458 (N.Y. 1928).
80 Id. at 463-64.
It bears highlighting that the obligations of the fiduciary under all of these standards relate to the duty of loyalty, the requirement that the fiduciary subordinate personal interests to those of the beneficiary of the fiduciary relationship. None of these formulae go to the duty of care, the obligation of the fiduciary to, in a sense, "do a good job."  

Ultimately, a fiduciary bound by a duty of loyalty is precluded from:

1) Self-dealing (the fiduciary reaping a profit or benefit in or from a transaction in which the focus of the fiduciary relationship is a party);

2) Appropriation (utilizing an asset of the fiduciary relationship for personal benefit or gain); and

3) Making differential judgments among equally situated beneficiaries (i.e., within a class giving certain benefits to only certain members of the class or within a class subjecting only certain beneficiaries to certain burdens).

In different contexts the fiduciary's conduct as to appropriation may be subject to different standards. Under almost all systems an appropriation may be permitted upon full disclosure by the fiduciary and approval by the beneficiaries. In the corporate context it is also possible, ex ante, to show that the terms of the transaction were "fair to the corporation." It is important to recognize that KRS 271B.8-310 is simply a safe harbor provision; it sets forth alternative mechanisms by which a conflicted

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83 It has been asserted by some that only loyalty, and not care, is a fiduciary obligation. See, e.g., Larry E. Ribstein, "Are Partners Fiduciaries?," 2005 U. Ill. L. Rev. 209 (2005). That is not a point that need be here resolved.

84 See, e.g., Prototype Limited Liability Company Act (1992), section 402, comment; Stewart v. Kentucky Paving Co., Inc., 557 S.W.2d 435, 437 (Ky. App. 1977), (citing Byer v. International Paper Co., 314 F.2d 831 (10th Cir. 1963); Conklin v. Joseph C. Hofgesang Sand Co., Inc., 407 F. Supp. 1090 (W.D. Ky. 1975) ("One who acts as agent for another is not permitted to deal in the subject matter of the agency for his own benefit without the consent of the principal . . . . Profits realized by an agent in the execution of his agency belong to the principal in the absence of an agreement to the contrary. The agent is bound to a high degree of good faith toward his employer, and is not entitled to avail himself of any advantage that his position may give him to profit at the employer's expense beyond the terms of the employment agreement . . . . ").

85 Ky. Rev. Stat. Ann. §271B.8-310(1)(c). A conflict of interest transaction that is subject to a fairness safe-harbor will result in liability if and only if it can be demonstrated that the transaction was not in the best interests of the corporation. See also Strine, Hamermesh, Balotti & Gorris, "Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law," 98 Geo. L. J. 629 (2010).

86 See also James C. Seiffert, Corporation Law (Kentucky Practice v. 17, 2d ed.) §3:94 ("However, it is not uncommon for directors, from time to time, to engage in business transactions that are in conflict with the interests of the corporation and its shareholders. In an effort to balance these interests, a safe harbor exist which protects a director engaged in a conflict of interests transaction, if approved in a specified manner.").
transaction may be sanctioned and thereby rendered non-voidable. It is possible only to satisfy the statute's terms and requirements and so gain the benefit of the safe harbor; it is not possible to violate the statute. To that end it does not set forth a substantive standard of loyalty. Rather, an unsanctioned conflict of interest transaction that is not fair to the corporation is a violation of the director's duty to discharge the obligations imposed by KRS 271B.8-300(1) and with particularity the obligation to act "in the best interests of the corporation."

In approving a conflict transaction the disinterested directors are required to discharge their fiduciary standards. The shareholders are not restrained by fiduciary obligations in granting or denying approval of the proposed conflict transaction.

The Business Corporation Act does not in KRS 271B.8-310 address, in connection with the "fair to the corporation" safe harbor, whether it is the obligation of the director charged with having acted under a conflict to demonstrate fairness, or rather a duty of the objector to prove a lack of fairness. That is, however, a myopic reading of the statute. Rather, attention needs to be focused upon KRS 271B.8-300(1), which sets forth the substantive fiduciary obligations of directors; a conflict of interest transaction, if a breach of duty, is not a violation of KRS 271B.8-310, but rather a breach of KRS 271B.8-300(1). The statute provides that, in order to prevail on a claim for a breach of duty to be remedied by monetary damages, it is the plaintiff's burden to prove the breach and as well causation. It goes on to provide that the burden is on the plaintiff to demonstrate, in effect, the absence of fairness. This allocation of burden is admittedly in contrast to that under the law of Delaware, but it is the

87 There must be at least two disinterested directors to sanction a conflict transaction; a single director does not have that faculty. See Ky. Rev. Stat. Ann. §271B.8-310(3).

88 See id. §§271B.8-300(1)(a)-(c).

89 Id. §271B.8-300(5) ("In addition to any other limitation on a director's liability for monetary damages contained in any provision of the corporation's articles of incorporation adopted in accordance with subsection (2)(d) of KRS 271B.2-020, any action taken as a director, or any failure to take any action as a director, shall not be the basis for monetary damages or injunctive relief unless: (a) The director has breached or failed to perform the duties of the director's office in compliance with this section; and (b) In the case of an action for monetary damages, the breach or failure to perform constitutes willful misconduct or wanton or reckless disregard for the best interests of the corporation and its shareholders."). I freely, and not without careful consideration, admit that this analytic path is at odds with that set forth by Professor Campbell and his determination, inter alia, that the interested director bears the burden of affirmatively demonstrating fairness. See Campbell, supra note 64, at 578-81. KRS 271B.8-300(5), (6) are not specifically cited or discussed in his analysis.


Kentucky General Assembly, and not the Delaware courts, that has the first order responsibility for determining the rules applicable in Kentucky business organizations generally and in corporations in particular.  

Retaining the traditional rule, a "fairness" defense is not available under Kentucky’s partnership, LLC, or statutory trust laws; it matters not that the source of the gain or benefit was zero sum vis-à-vis the fiduciary relationship. Rather, in those contexts there is strict liability absent complete disclosure and disinterested consent. In the case of the statutory trust, the disinterested consent must precede the conduct and there is no capacity for the *ex post* sanction. In other forms the approval may be *ex post*.

Consider then actor X, both a director of a Kentucky corporation and the manager of a Kentucky LLC. It is clear that he owes fiduciary obligations to each entity. With respect to both the corporation and the LLC he causes the organization to enter into a clearly conflicted transaction with a third-party that is under his control; X never discloses his interests in and never solicits (much less receives) disinterested approval for the transactions. X realizes $1,000 on each transaction.

Under corporate law, X may retain the $1,000 unless it is demonstrated by the plaintiff that the terms of the conflicted transaction were not fair to the corporation and that the transaction was not entered into in good faith. On the other hand, X must surrender to the LLC the $1,000 gain realized from the conflicted transaction; fairness is not a defense.

For these and other reasons, it is not possible to say that any particular conduct (and here we assume that the conduct does not involve a knowing or willful violation of either law or applicable standards) violates a duty of care or a duty of loyalty. Rather, it is necessary to first ascertain what is the duty of care or the duty of loyalty applicable to that particular

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<td>Ky. Const. §190.</td>
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<td>95</td>
<td>See id. §271B.8-300(1); id. §§275.170(1), (2).</td>
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<td>96</td>
<td>See id. §271B.8-300(5).</td>
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<td>97</td>
<td>See id. §275.170(2). Those desiring to use the LLC form but being unhappy with this rule may modify it in a written operating agreement. Conversely, it does not appear that the shareholders, by private ordering in the articles or bylaws, can deprive a director of the fairness defense.</td>
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fiduciary, and it is as well necessary to determine whether any particular exculpatory procedure was employed to sanction conduct that would otherwise be impermissible.

IX. ASSUMING, OF COURSE, THAT THE DEFAULT FIDUCIARY STANDARDS HAVE NOT BEEN BY PRIVATE AGREEMENT ALTERED

The law of corporations is rather straightforward as to fiduciary obligations in that they are not subject to modification in the articles of incorporation or otherwise.98 The law of the various unincorporated business organizations is far less restrictive. In that realm it is possible to modify the fiduciary duties that are, as a default rule, provided by statute. In the context of a partnership or limited partnership governed by, respectively, the Kentucky Revised Uniform Partnership Act (2006)99 or the Kentucky Uniform Limited Partnership Act (2006),100 the statutes impose maximum limits to the degree in which the default duties may be altered, and neither permits a duty to be eliminated.101 Conversely, in the Kentucky LLC Act, it is possible to not only modify but as well eliminate the default statutory duties.102

Focusing for these purposes upon the LLC as the now prototypical unincorporated organization, it needs to be recognized that LLCs are creatures of contract103 and statute.104 As a general rule, the LLC Act set forth default rules

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98 A Delaware 102(b)(7) or Kentucky 271B.2-020(2)(d) provision does not alter a director's fiduciary obligations, but rather only alters the standard of culpability for monetary damages. Further, those provisions are themselves limited to certain conduct and cannot alter the standard of culpability with respect to other conduct.

99 KRS ch. 362.1.

100 KRS ch. 362.2.


102 See Ky. Rev. Stat. Ann. §275.170 ("Unless otherwise provided in a written operating agreement . . . ."); see also id. §275.180(1) (providing that a written operating agreement may eliminate personal liability for a breach of a duty provided for in KRS 275.170).

103 See id. §275.003(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.") (emphasis added); see also Fisk Ventures, LLC v. Segal, No. 3017-CC, 2008 WL 1961156, at *1 (Del. Ch. May 7, 2008) (stating the operating agreement "defines the scope, structure, and personality of limited liability companies"); TravelCenters of Am., LLC v. Brog, No. 3516-CC, 2008 WL 1746987, at *1 (Del. Ch. April 3, 2008) ("[LLCs] are creatures of contract, 'designed to afford the maximum amount of freedom of contract, private ordering and flexibility to the parties involved.'") (quoting In re Grupo Dos Chiles, LLC, C.A. No. 1447-N, 2006 WL 668443, at *2 (Del. Ch. Mar. 10, 2006)); Walker v. Res. Dev. Co., 791 A.2d 799, 813 (Del. Ch. 2000) ("LLC members' rights begin with and typically end with the Operating Agreement."). The language employed in the Delaware LLC Act at section 18-1101(b) is for all intents and purposes
that may be modified inter se by the members by private ordering in the operating agreement. Prototype section 402 is expressly a default rule applicable, "[u]nless otherwise provided in an operating agreement . . . ." Thus, private ordering can, for example, subject a broader or narrower class of

identical to the language employed in the Kentucky LLC Act at section 275.003(1) of the Kentucky Revised Statutes.

104 See, e.g., Ky. Rev. Stat. Ann. §275.020(2) (stating the existence of an LLC begins upon filing by the secretary of state of the articles of organization). The statement that "LLCs are creatures of contract and of statute" is surprisingly controversial in some contractarian corners even though it is a truism because an LLC must comply with statutory filing requirements in order to be recognized by either the state or third parties with whom it might interact. Moreover, contract really does not seem to apply where there exists a single-member LLC. The comments to RULLCA state that an LLC is a creature of both contract and statute. See Rev. Unif. Ltd. Liab. Co. Act §110 cmt., 6B U.L.A. 445 (2008); Rev. Unif. Ltd. Liab. Co. Act §112 cmt. to subsection (d), 6B U.L.A. 451 (2008).

105 See, e.g., General Considerations Underlying the ULLCA Project, ULLCA Prefatory Note, Unif. Ltd. Liab. Co. Act, 6B U.L.A. prefatory cmt. at 547-48 (2008) ("The Committee believes that flexibility is an important hallmark of the LLC form. Accordingly, the Act gives the members maximum freedom to adopt customized rules including rules concerning voting rights and fiduciary duties."); Ky. Rev. Stat. Ann. §275.003(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."). Accord Restatement (Second) of Trusts §222 (1957) (stating an express provision to the trust instrument governs over the trustee's generally applicable duty of loyalty); Restatement (Third) of Trusts §78. cmt. c(2) ("A trustee may be authorized by the terms of the trust, expressly or by implication, to engage in transactions that would otherwise be prohibited by the rules of undivided loyalty stated in [S]ubsections (1) and (2)."); Rutheford B. Campbell, Jr., "Bumping Along the Bottom: Abandoned Principles and Failed Fiduciary Standards in Uniform Partnership and LLC Statutes," 96 Ky. L.J. 163, 168-69 (2007-08):

Perhaps most fundamental is the principle that managers and investors in unincorporated entities, if they are able, ought to be permitted to shape the terms of their arrangements between or among themselves, provided that their arrangements do not generate material adverse third-party effects. The moral and economic right of parties, in the absence of third-party effects, to pursue their own preferences is supported by their own consent and thus can be traced to both Kantian moral theory and utilitarianism. Allowing parties to set their own terms is respectful of the autonomy of rational beings (broadly, a Kantian notion) and promotes the maximization of overall utility or happiness (a utilitarian goal).

(citations omitted); Monumental Life Ins. Co. v. Nationwide Retirement Solutions, Inc., 242 F. Supp. 2d 438, 449 (W.D. Ky. 2003) (applying Kentucky law) ("Where a contract exists defining the scope of the principal-agent relationship . . . the existence and extent of the agent's duties are determined by the agreement between the parties."); Restatement (Second) of Agency §376; see also Martindale v. Hartman Harlow Bassi Robinson and McDaniel PLLC, 119 So.3d 338 (Miss. Ct. App. 2012) (even if expulsion of member and determination of redemption price is subject to "intrinsic fairness," that obligation is not violated by applying the terms of the written agreement.).

persons to fiduciary duties than provided by the default statutory rule.\textsuperscript{107} Additionally, a written operating agreement can alter the scope of the duties to be broader or narrower than the statutory formula.\textsuperscript{108} It could provide an alternative mechanism for approval of a particular transaction that violates or may violate the applicable standard, or it could even eliminate the duty entirely.\textsuperscript{109} In light of the

\textsuperscript{107} For example, it could be applied to all "affiliates" of the managers or applied to the members, as well as the managers, in a manager-managed LLC.

\textsuperscript{108} In other instances the "opportunity" may be waived. See, e.g., ABA Section of Bus. Law, Joint Task Force of Comm. on LLCs, Partnerships and Unincorporated Entities and the Comm. on Taxation, "Model Real Estate Development Operating Agreement with Commentary," 63 Bus. Law. 385, 413 (Feb. 2008); Stoker v. Bellemeade LLC, 615 S.E.2d 1, 10 (Ga. Ct. App. 2005), rev’d on other grounds, 631 S.E.2d 693, 695-96 (Ga. 2006); see also II Alan R. Bromberg & Larry E. Ribstein, Bromberg & Ribstein on Partnership (2010) §6.07(d) (noting that partnership opportunity doctrine is often waived in certain categories of partnerships).

\textsuperscript{109} The possibility of eliminating fiduciary duties by agreement is determined on a state-by-state basis, and various LLC acts vary to the extent of fiduciary duties and whether they may be eliminated. No Kentucky court has addressed the question of how far parties may go in the operating agreement in modifying or even entirely eliminating a fiduciary obligation. The Delaware Supreme Court held that the then existing language in the Delaware Limited Partnership Act providing that fiduciary duties may, in a limited partnership agreement, be expanded or restricted was not sufficient to permit the elimination of fiduciary duties. Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 817 A.2d 160, 167-68 (Del. 2002); Del. Code Ann. tit. 6, §17-1101(d)(2) (prior to 2004 amendment). In 2004, the Delaware General Assembly amended the Delaware limited partnership, general partnership, and LLC acts to provide expressly that the organic agreement between the participants may "eliminate" fiduciary obligations. See, e.g., Del. Code Ann. tit. 6, §18-1101(c):

To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to [an LLC] or to another member or manager or to another person that is a party to or is otherwise bound by [an LLC] agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the [LLC] agreement; provided that the [LLC] agreement may not eliminate the implied contractual covenant of good faith and fair dealing.

See also Del. Code Ann. tit. 6, §18-1101(e) ([An LLC] agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager, or other person to [an LLC] . . . . ). It has been argued that the formulae employed in the Prototype (and by implication as adopted in Kentucky) do not permit the elimination of fiduciary obligations. See Frances S. Fendler, "A License to Lie, Cheat and Steal? Restriction or Elimination of Fiduciary Duties in Arkansas Limited Liability Companies," 60 Ark. L. Rev. 643, 680-86 (2007). The Delaware common law requires that any waivers of fiduciary duties must be carefully crafted. See Willie Gary LLC v. James & Jackson LLC, No. Civ.A. 1781, 2006 WL 75309, at *2 (Del. Ch. Jan. 10, 2006), affd, 906 A.2d 76, 82 (Del. 2006). Further, if the modification is sufficiently specific, parties thereto should not thereafter seek to undo the deal to which they have entered. Miller v. Am. Real Estate Partners, L.P., Civ. No. 16788, 2001 WL 1045643, at *8 (Del. Ch. 2006) ("This court has made clear that it will not [be] tempted by the piteous pleas of limited partners who are seeking to escape the consequences of their own decisions to become investors in a partnership whose general partner has clearly exempted itself from traditional fiduciary duties.") (citation omitted). Under RUPA and ULPA, the ability of loyalty may not be eliminated, but it may be qualified. See Ky. Rev. Stat. Ann. §362.1-103(2)(e); id. §362.2-110(2)(e); Rev. Unif. P'ship Act §103(b)(3)(i), 6 U.L.A. 73 (2001);
capacity to modify or even eliminate the duty of loyalty, the unconditional statement, "members in a member-managed LLC have a fiduciary duty of loyalty" is at best an overbroad generalization and at least misstates the operative legal rule. It is easy to correct, however, by adding the simple preface, "assuming the operating agreement does not provide to the contrary."¹¹⁰

In any partnership, limited partnership or LLC, in assessing any question involving fiduciary duties, it is crucial to first examine the controlling private agreement. If it alters the fiduciary stands and does so within permissible limits, those privately structured rules control.

It bears noting that simply because something can be done, it does not follow that it should be done. Departing from the default fiduciary duties is a complicated undertaking that requires that the drafter consider and address at least:

1. What is the duty?
2. When is it owed?
3. Who owes it?
4. To whom is it owed?
5. At what point does the duty terminate?

(6) By what means is it enforced?
(7) What is the standard of culpability?
(8) Who bears the burden of showing breach?
(9) Who bears the burden of showing that the standard of culpability has or has not been met?

Failure to address any of these points creates an ambiguity in the agreement.

X. CONTRACTUAL DUTIES TYPICALLY ARE NOT "FIDUCIARY"?

Kentucky law expressly permits a written operating agreement to modify the fiduciary standards of case and loyalty set forth in KRS 275.170. Assume a written operating agreement, in class opposition to both the statute and as to the duty of care of the common law, that comprehensively addresses all elements of the duty of care and all elements of the duty of loyalty. With those standards now in place, assume conduct that arguably violates the contractually defined duty of loyalty.

The essential question is whether the matter will proceed as a claim for breach of contract or rather as a claim in tort for breach of fiduciary duty. The outcome of that determination will have a number of implications including but not limited to the appropriate remedy and whether punitive damages will be available for breach.

Typically the branch of an express contracted obligation, even if undertaken by a fiduciary, gives rise to an action for breach of contract and not a claim in tort for breach of fiduciary duty.

111 See Ky. Rev. Stat. Ann. §275.120 ("except as otherwise provided in a written operating agreement"); see also id. §275.180 (written operating agreement may eliminate liability for breach of KRS §275.170 standards).

112 Under the 2010 amendments to KRS 275.170(2), it is now manifest the common law does not provide the applicable duty of loyalty in an LLC; rather, the statute is exclusive.

113 See, e.g., Thornton V. Western & Southern Financial Group Beneflex Plan, 797 F. Supp. 2d 796, 812 (W.D. Ky. 2011) ("Under Kentucky law, "[a] breach of a duty which arises under the provisions of a contract between the parties must be redressed under contract, and a tort action will not lie. A breach of a duty arising independently of any contract duties between the parties, however, may support a tort action." Presnell Construction Mgrs., Inc. v. EH Const., LLC, 134 S.W.3d 575, 589 (Ky. 2004) (Keller, J., concurring) (emphasis in original); Glorvigen v. Cirrus Design Corp., 816 N.W.2d 572, 584 (Minn. 2012) ("Tort actions and contract actions protect different interests. Through a tort action, the duty of certain conduct is imposed by law and not necessarily by the will or intention of the parties . . . . On the other hand, contract actions protect the interests in having promises performed. Contract obligations are imposed because of conduct of the parties manifesting consent, and are owed only to the specific parties named in the contract.") (quoting 80 South Eighth Street Ltd. Partnership v. Carey-Canada, Inc., 486 N.W.2d 393, 395-96 (Minn. 1992)); In re Kitchin, 445 B.R. 472, 480 (Bankr. E.D. Pa. 2010) ("As stated by the Third Circuit, a claimant is barred from tort recovery "when the parties' obligations are defined by the terms of the contracts, and not by the larger social policies embodied by the law of torts."
XI. IN WHAT CONTEXT IS A BREACH OF FIDUCIARY DUTY EQUIVALENT TO FRAUD?

In the iconic decision Steelvest v. Scansteel Service, Inc.,\textsuperscript{114} the Kentucky Supreme Court stated "Accordingly, we determine, as a matter of law, that a breach of fiduciary duty is equivalent to fraud."\textsuperscript{115} This same statement was repeated in Lach v. Man O’War, LLC.\textsuperscript{116}

The question is whether this statement is categorically true. A careful review of both of those opinions and others makes clear that the statement of the equivalency of breach of fiduciary duty with fraud is made in connection with determining whether certain attorney-client privileged communications are exempt from discovery or, conversely, the fraud exception applied, thereby eliminating the privilege. Furthermore, (i) it does not appear that this principle of equivalency has been utilized outside of the question of the privilege, and (ii) it appears the courts that have considered doing so have rejected the opportunity.

In Pixler v. Huff,\textsuperscript{117} the Court considered and rejected the assertion that the complaint in a derivative action brought with respect to an LLC alleging breach of fiduciary duty should be held to the standards of F.R.C.P. 9(b). Responding specifically to the statement in Steelvest that a breach of fiduciary duty is "equivalent to fraud," the Court observed:

\textsuperscript{114} 807 S.W.2d 476 (Ky. 1991).

\textsuperscript{115} Id. at 487.

\textsuperscript{116} 256 S.W.3d 563, 572 (Ky. 2008).


Having reviewed these authorities, the Pixler Court determined:

The Court agrees and finds that Steelvest is limited to its facts, and does not apply to the determination of the pleading standard in the present case.

Turning to those authorities, in Bariteau the Sixth Circuit wrote:

A "breach of fiduciary duty is equivalent to fraud," the [Steelvest] court stated, in addressing whether the attorney-client privilege applies to certain communications. But the case says nothing about whether a breach of fiduciary duty is equivalent to fraud for discovery-rule purposes.\footnote{285 Fed. App’x at 223.}

The Bariteau court went on to note the inconsistency of treating a breach of fiduciary as subject to the limitations period of KRS 413.120(7), the general catchall, rather than KRS 413.120(12), relating to claims in fraud, citing Ingram v. Cotes.\footnote{74 S.W.3d 783, 787 (Ky. App. 2002).}

The Gundaker/Jordan decision only cited Bariteau and Ingram without otherwise expanding upon the issue, but on the basis of those rulings would not equate breach of fiduciary duty with fraud for purposes of awarding punitive damages.

In Ingram v. Cotes,\footnote{Id.} the decision relied upon by Bariteau, the Court was called upon to address the applicable statute of limitations for a claim against the holder of a power of attorney, a species of agency subject to a fiduciary duty. Without any discussion of the Steelvest equivalency, the court found that for a "breach of fiduciary duties," "[T]here is no specific statutory provision providing a statute of limitations" and therefore applied KRS 413.120(7). Citing Ingram, the Court of Appeals in McCormick v. Becker wrote "In Ingram v. Cates this Court applied KRS 413.120(7) to actions alleging a breach of a fiduciary duty."\footnote{Id.}

Ergo, the equivalency between a breach of fiduciary duty and fraud as set forth in both Steelvest and Lach extends only to the fraud exception to the attorney-client privilege.
An action subject to KRS 413.120(7) is subject to a discovery rule, and the doctrine of adverse domination may on particular facts apply to the same effect.

XII. CONCLUSION

Fiduciary obligations are by their very nature slippery; they exist to impose limitations upon conduct that is difficult to limit by contract. At the same time, fiduciary obligations are not all encompassing – not every relationship involves fiduciary obligations, a fiduciary is not at all times acting in a fiduciary capacity, and not all conduct that might be complained of by the beneficiary of the fiduciary obligation is a breach of duty. Ultimately different fiduciary duties exist in different circumstances, and careful attention to the particulars of the particular relationship is crucial.

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123 See KRS 413.130(3).
