THE COMMON LAW FIDUCIARY DUTIES OF BUSINESS OWNERS

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I. INTRODUCTION

Common law fiduciary relationships are a dynamic and ubiquitous part of our everyday lives. They generally arise organically and by operation of law whenever an individual reposes her special trust and confidence in another person. For example, consider two friends who set out to create the next major social media platform. They devote their time, energy, capital, expertise, and connections into getting the platform up and running, all without ever stopping to consider the legal context of their relationship. With their financial, professional, and perhaps even personal lives on the line, these individuals place their trust and confidence in one another. Undoubtedly, these individuals have formed a context-based fiduciary relationship by operation of law and are protected by common law fiduciary duties.[1] Now, imagine that the social media platform is gaining traction, the business is beginning to profit, and the friends decide to consult a business attorney. The attorney recommends that these entrepreneurs convert their business into a closely held corporation in order to limit their potential liability to corporate creditors and tort claimants. Overnight, the friends go from two business associates, presumptively operating as partners, to closely held shareholders in the eyes of the law. Does this change the fundamental nature of their relationship? Are they no longer subject to fiduciary duties?

The answer to these questions is a resounding no. Regardless of the label a business statute imposes upon them, these individuals continue to maintain their relationship of trust and confidence; they continue to pour their blood, sweat, and tears into the business they built together from scratch, and, consequently, they continue to enjoy the protections provided by the common law of fiduciary relationships. Any other result would be absurd. Given the fundamental relationships underlying closely held corporations, as well as

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[1] These individuals have also formed a partnership by operation of law and will be simultaneously subject to status-based fiduciary duties as partners under applicable state law.

limited liability companies, limited partnerships, and other business forms, Kentucky courts should confirm that the common law has and always will protect individuals based on the context of their relationship, regardless of the business form they employ. Given that an overwhelming majority of Kentucky businesses are closely held corporations or limited liability companies, the fact that these types of fiduciary relationships have not been explored by Kentucky courts is surprising. It follows that a large portion of the state's business owners have been left in a state of uncertainty. When will Kentucky courts reaffirm their historical common law rights?

The purpose of this Article is to urge Kentucky courts to confirm the existing common law context-based approach to imposing fiduciary duties among business owners in instances where the individuals have placed mutual and profound trust and confidence in one another. This approach would not apply fiduciary duties to all shareholders in closely held corporations categorically, as the Massachusetts Supreme Court did in *Donahue v. Rodd Electrotype Co.*[2] That decision, now followed by a majority of state courts, accorded fiduciary status to all closely held corporation shareholders based on a partnership analogy.[3] In contrast, the common law's context-based approach imposes fiduciary duties only when the business owners' relationship with each other contextually rises to the fiduciary level.[4] Part II of this Article will explore how the history of common law fiduciary relationships has consistently followed a context-based approach to fiduciary duties. Part III will demonstrate how fiduciary duties continue to exist independently of and supplementary to Kentucky's business entity statutes, as well as how Kentucky courts have applied this concept. Finally, Part IV urges Kentucky courts to expressly confirm the traditional context-based approach to imposing fiduciary duties on business owners.

II. HISTORY OF COMMON LAW FIDUCIARY DUTY

Over two-hundred years ago, the people of Kentucky set out to separate themselves from the Commonwealth of Virginia, and in doing so became the fifteenth state to join the Union.[5] Kentucky incorporated this lineage into its state constitution by explicitly adopting all general laws in effect in Virginia on June 1, 1792.[6] At that time, Virginia's legal system was based almost

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[2] Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 519 (Mass. 1975).

[3] *Id.* at 512.

[4] *See* Tamar Frankel, *Fiduciary Law*, 71 CALIF. L. REV. 795, 816–21 (1983).

[5] Wilford Allen Bladen & Wilma Dykeman, *Kentucky*, ENCYCLOPEDIA BRITANNICA, https://www.britannica.com/place/Kentucky/History (last visited Mar. 12, 2019).

[6] KY. CONST. § 233.

entirely on English common law, or the system of unwritten law based on English reasoning and custom that is made manifest through judicial decisions.[7] Consequently, by way of Virginia, the English common law provided the foundation for Kentucky's common law tradition.[8] Kentucky and Virginia common law have continued to evolve from their decidedly English roots. However, each states' common law has become increasingly similar as courts around the country are influenced by the American Law Institute's Restatements, which distill established common law principles into single compilations.[9] Indeed, there has been significant convergence of the common law of the states as judges look to the Restatements to guide their decisions.[10]

Interestingly, fiduciary duties were not originally a part of the English common law.[11] This legal doctrine first developed in courts of chancery, or courts of equity, which were tasked with enforcing English trusts.[12] However, the genius of the common law system was that it was able to develop its jurisprudence in the crucible of human experience, developing common law that fully recognized the intensity of the fiduciary relationship. Imagine the first common law judge faced with facts similar to those presented to the Kentucky Supreme Court in *Estep v. Werner*.[13] In this case, two entrepreneurs built an iron railing business, and after several years of working together, Estep and Werner converted the business into a closely held corporation.[14] However, when the business started experiencing financial difficulty, Werner used his power as majority shareholder to fire Estep, remove him from the board, and transfer the company's remaining assets to his own competing business.[15] If this case was brought before an early

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[7] James Audley McLaughlin, *The Idea of the Common Law in West Virginia Jurisprudential History: Morningstar v. Black & Decker Revisited*, 103 W. VA. L. REV. 125, 131 (2000).

[8] Moore v. Stills, 307 S.W.3d 71, 79 (Ky. 2010). However, this influence was not limited to the state's inception, as modern Kentucky courts continue to cite and discuss Virginia common law and the effect it has on the state's current jurisprudence. *See, e.g.*, Hoskins v. Maricle, 150 S.W.3d 1, 28–32 (Ky. 2004) (Keller, J., dissenting) (noting the role of Virginia common law in recent matters of criminal law).

[9] *See generally* Josh Fund, *When Restating the Law Can Become Empowering the Sex Police*, NAT'L REV. (May 15, 2016), http://www.nationalreview.com/corner/little-known-powerful-american-law-institute ("These 'Restatements' are an effort to codify common law. In many areas, statutes do not govern us but 'case law' or judicial precedent, does. The ALI tells courts what the case law is, and Courts [sic] routinely rely on the ALI Restatements as authority for what the law is.").

[10] *See, e.g.*, RESTATEMENT (SECOND) OF AGENCY (AM. LAW INST. 1958); RESTATEMENT (THIRD) OF AGENCY (AM. LAW INST. 2006).

[11] David J. Seipp, *Trust and Fiduciary Duty in the Early Common Law*, 91 B.U. L. REV. 1011, 1011 (2011).

[12] *Id.*

[13] Estep v. Werner, 780 S.W.2d 604 (Ky. 1989).

[14] *Id.* at 605.

[15] *Id.*

common law court, Werner would have argued that he used his business knowledge to defeat the interests of Estep, that this was a caveat emptor or buyer-beware business relationship, and that the court should respect the commercial volition of the parties. The judge may have been initially receptive to Werner's position, noting that there was no evidence of underhanded behavior, but, rather, that Werner was simply maximizing his own best interest to the detriment of Estep's best interest. But then, the other shoe drops. The judge would realize that this was not an arm's-length transaction—there was much more to the parties' relationship. Both Warner and Estep contributed blood, sweat, tears, time, and money to make their business successful; they shared power over their ideas and assets in order to cultivate a relationship of mutually reposed trust and confidence. Any remnants of an arm''s-length relationship had dissolved from the moment they undertook to create their commercial venture and execute its mission. The judge would determine that when individuals create special relationships of trust and confidence, fiduciary duties arise for the protection of the parties by operation of common law that extend throughout the scope of those relationships.[16]

In holding that fiduciary relationships arise by operation of law where there has been a contextual reposal of trust and confidence, English and then American courts continually deepened their focus on the dynamic human relationships underlying the business form.[17] Over time, the common law of fiduciary duty slowly expanded to generally apply to certain types of actors in legally defined roles who have consensually assumed power over the property of others.[18] Virtually all courts came to agree that agents, trustees, partners, and corporate directors, among other defined roles, are all

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[16] Unfortunately, this is not how the Kentucky Supreme Court resolved the case in *Estep*. The issue before the court was "whether the trial court properly found that Joseph Werner breached his fiduciary duties as a shareholder to his fellow shareholder, Estep, in a closely-held corporation by terminating Estep from his employment with the Company." *Id.* at 605–06. Most significantly, the Supreme Court noted that Estep had not asserted a breach of fiduciary duty claim in his original complaint. As a result, the court stated, it did "not believe that this action should be decided in terms of breach of fiduciary duty as the facts of this case do not justify such a holding." *Id.* at 606. In reaching its conclusion, however, the court expressly acknowledged that "there may be certain non-statutorily imposed fiduciary duties that exist among shareholders in closely-held corporations." *Id.* In a vigorous dissent, Justice Leibson strongly rejected the majority's decision, stating its principal error was failing to "discuss the existence and extent" of fiduciary duties among shareholders in a closely held corporation when "[i]t was precisely to review this issue that [the court] accepted discretionary review, and the issue is squarely before us." *Id.* at 608. Indeed, Justice Leibson urged the court to establish a categorical status-based fiduciary relationship for shareholders in closely held corporations, as adopted by the Massachusetts Supreme Court in *Donahue v. Rodd Electrotype Co.*, 328 N.E.2d 505, 515 (1975). *Id.* at 609; *see infra* Part III.D.

[17] *See generally* Frankel, *supra* note 4.

[18] *Id.* at 805.

fiduciaries.[19] After all, each of these particular categories of fiduciaries involve actors in whom trust and confidence is generally reposed, based on their status, as opposed to actual reposals of trust and confidence in particular contexts. Thus, two types of fiduciary relationship emerged, those based on special factual contexts and those based on legal status.[20]

These traditional, categorical, status-based roles are deemed fiducial, not based on the context of their specific relationships with their protected beneficiaries, but because they are generally entrusted with power over their beneficiaries by virtue of the authority of their positions.[21] This general assumption of power over the property of others imposes duties on these fiduciaries corelative to their assumed powers over their beneficiaries' assets, whether as agents, trustees, partners, or directors.[22] Status-based fiduciary relationships have largely been developed in common law judicial decisions,[23] but also by subsequent legislative enactments, and, in many instances, by both. However, the types of roles deemed to be categorically fiducial, and, accordingly, status-based fiduciaries, generally mirror those categories already established by the common law.

In contrast, context-based fiduciary relationships are created under the common law in special factual and circumstantial contexts that tend to defy general categorization.[24] In situations where individuals have clearly imposed special trust and confidence in one another, a fiduciary relationship arises by operation of law, and each person becomes subject to duties of utmost good

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[19] *Id.*

[20] These status-based fiduciary relationships have never been held to "exhaust the scope of fiduciary accountability." Robert Flannigan, *The Boundaries of Fiduciary Accountability*, 83 CAN. B. REV. 35, 49 (2004). Both status-based and context-based fiduciary analysis have been consistently employed by legislatures and courts. The preponderance of status-based analysis may be due largely to its evidentiary advantages and that most fiduciary breaches are committed by persons who are status-based fiduciaries. *Id.* at 49–50. These status-based or *nominate* fiduciary relationships provide *taxonomic convenience* based on the underlying presumptions that categorial trust and confidence have been reposed with resultant vulnerabilities to the beneficiaries in these relationships. However, these nominate categories, including trustees, guardians, agents, partners, and directors, among others, are significantly under-inclusive. In contrast, context-based fiduciary relationships are based on the actual fiduciary character of particular relationships in highly variable contexts, based not on presumed reposals of trust, but rather on actual reposals of trust and confidence in others. *See* Robert Flannigan, *Fiduciary Duties of Shareholders and Directors*, J. BUS. L., May 2004, at 277. According to Professor Flannigan, "[t]he proper application of fiduciary responsibility is crucially dependent on understanding [this] distinction." *Id.* at 278.

[21] *See* Flannigan, *supra* note 20, at 48–49.

[22] *Id.* at 37.

[23] Because a reposal of trust and confidence is presumed by status, a step in the common law analysis is effectively skipped, and courts have likewise enjoyed the added determinacy and judicial economy that such an approach has afforded.

[24] *See* Strong v. Repide, 213 U.S. 419 (1909) (discussing the analogous "special facts doctrine").

faith and loyalty.[25] This common law principle is well-established and operates independently of any corporate statute and any particular legal status.[26] Indeed, an individual's title or position within their business is largely irrelevant to determining whether they are subject to context-based fiduciary duties.[27] The critical element in the formation of a fiduciary relationship by operation of law is a special reposal of trust[28] and confidence. A context-based approach to fiduciary relationships recognizes the reality of the world we live in, to the extent that one court found "it implicit that people who enter into a small business enterprise . . . place their trust and confidence in each other."[29] In fact, every day people enter into relationships in which they mutually agree to work for each other's benefit, willingly exposing their vulnerabilities to each other on the premise that they will protect each other's assets to maximize profits, all without ever contemplating the technicalities of a fiduciary relationship or their legal status. Fortunately, the common law remains flexible enough to impose fiduciary duties based on the context of their relationships in specific factual situations.[30]

Once a context-based fiduciary relationship has been established, the scope of the fiduciary duties must be determined. Generally, "[t]he scope of the common-law fiduciary duty among [business associates] is defined as a

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[25] *See* Burt v. Burt Boiler Works, 360 So. 2d 327, 332 (Ala. 1978).

[26] *Id.*

[27] *Id.* ("Where several owners carry on an enterprise together (as they usually do in a close corporation), their relationship should be considered a fiduciary one similar to the relationship among partners. The fact that the enterprise is incorporated should not substantially change the picture."). *See also* Harbison v. Strickland, 900 So. 2d 385 (Ala. 2004).

[28] For a review of the literature on trust, see Ronald J. Colombo, *Trust and the Reform of Securities Regulation*, 35 DEL. J. CORP. L. 829 (2010). Colombo notes, "Trust experts all seem to agree that trust is a state of mind that enables its possessor to be willing to make herself vulnerable to another – that is, to rely on another despite a positive risk that the other will act in a way that can harm the truster." *Id.* (quoting Claire A. Hill & Erin Ann O'Hara, *A Cognitive Theory of Trust*, 84 WASH. U. L. R. 1717, 1724 (2006)). More specifically, Colombo argues that "[w]hen [trust] is grounded primarily in emotion, such trust is referred to as 'affective trust' and constitutes a general, optimistic disposition that the subject of one's trust will behave honorably and appropriately." *Id.* at 835. This is the trust of "family, friends, and lovers," the "stuff of which tragedy is made." *Id.* Conversely, "cognitive trust" is "[g]rounded primarily in reason," in which "[t]he potential vulnerabilities accepted are not due to 'trust,' but to rational risk management – to the fact that 'the expected gain from placing oneself at risk to another is positive.'" *Id.* at 836. Some degree of trust is extended by the parties to all commercial transactions. However, it is only when individuals place affective trust in one another, a trust that represents the "essence of the human condition," does the relationship become sufficiently intense to create a fiduciary relationship by operation of the common law. *Id.* at 835.

[29] Hagshenas v. Gaylord, 557 N.E.2d 316, 324 (Ill. App. Ct. 1990).

[30] It should be noted that context-based and status-based fiduciary duties are not mutually exclusive. If a relationship arises to the level of a fiduciary relationship, context-based fiduciary duties are imposed upon those individuals, despite their individual or relationship status. The next section explores how business associates' status-based fiduciary duties may be altered, while their context-based fiduciary duties remain constant.

requirement to deal 'openly, honestly, and fairly' with each other."[31] However, the "intensity of the fiduciary obligation" increases as the individual gains more power and discretion over her associate's "critical resources," such as the assets or other vulnerabilities the associate has willingly exposed to the relationship.[32] In addition to the amount of discretion a fiduciary wields over their associate's assets, the reasonable expectations of the parties is an important factor in determining the scope of common law fiduciary duty. Though expressed in the context of minority shareholder oppression, Professor F. Hodge O'Neal, the preeminent scholar on closely held corporations, has long advocated the reasonable expectations test to determine whether conduct by controlling shareholders impinges on what the minority shareholders reasonably expected to gain from joining a business venture.[33] Similarly, courts could determine the scope of fiduciary duties based on the parties' reasonable expectations going into the fiduciary relationship. In the widely cited opinion *Rosenthal v. Rosenthal*,[34] the Maine Supreme Court approved four specific fiduciary duties owed by business owners to each other in closely held corporations:

> (1) To act with that degree of diligence, care and skill which ordinarily prudent persons would exercise under similar circumstances in like positions;
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> (2) To discharge the duties affecting their relationship in good faith with a view to furthering the interests of one another as to the matters within the scope of the relationship;
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> (3) To disclose and not withhold from one another relevant information affecting the status and affairs of the relationship;
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> (4) To not use their position, influence or knowledge respecting the affairs

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[31] Keogh v. John Henry Foster Minnesota, Inc., 2008 WL 1747936, at *5 (Minn. Ct. App. Apr. 15, 2008) (quoting Berreman v. West Publ'g Co., 615 N.W.2d 362, 371 (Minn. App. 2000)). For example, "every action taken by corporate directors qua directors is subject to fiduciary constraint," given that the director exercises significant control over the corporation's assets; whereas, "physicians act as fiduciaries in only a narrow range of activities." D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1483 (2002).

[32] Smith, *supra* note 31, at 1483.

[33] *See* 2 F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL AND THOMPSON'S CLOSE CORPORATIONS AND LLCS: LAW AND PRACTICE § 9:19 (West rev. 3d ed. 2009).

[34] Rosenthal v. Rosenthal, 543 A.2d 348 (Me. 1988). *See* DOUGLAS M. BRANSON, JOAN MACLEOD HEMINWAY, MARK J. LOEWENSTEIN, MARC I. STEINBERG, & MANNING GILBERT WARREN III, BUSINESS ENTERPRISES: LEGAL STRUCTURES, GOVERNANCE, AND POLICY 433–62 (3d ed. 2016); *see also* JAMES D. COX & MELVIN A. EISENBERG, BUSINESS ORGANIZATIONS: CASES AND MATERIALS 561–62 (12th ed. 2019).

> and organization that are subject to the relationship to gain any special privilege or advantage over the other person or persons involved in the relationship.[35]

Ultimately, the scope of fiduciary duty eludes a concrete definition,[36] and courts must again study the context of the relationship, the power over assets each member wields, and the reasonable expectations of the parties, in order to fully understand the scope of common law fiduciary duties after the existence of the fiduciary relationship has been established.

III. CONTEXT-BASED FIDUCIARY RELATIONSHIPS AND BUSINESS ENTITY LAWS

Although fiduciary duties are creatures of common law, state legislatures have attempted to codify status-based fiduciary duties, especially those in the partnership, corporate, and limited liability company contexts.[37] For example, KRS 273.215 states that a corporate director must 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."[38] The Kentucky Supreme Court found that this statute imposes fiduciary duties on corporate directors, solely due to their categorical status as directors.[39] However, even absent such explicit statutes, the common law of context-based fiduciary duties continues to operate independently of and supplementary to any business entity statutes in cases where individuals mutually repose trust and confidence in one another. Indeed, as the Illinois Appellate Court stated:

> A fiduciary relation exists in all cases in which a confidential relationship has been acquired. The origin of the confidence is immaterial. It may be moral, social, domestic, or purely personal. . . . 'Their decision to form and operate as a corporation rather than a partnership [or any other business form, for that matter] does not change the fact that they were embarking on a joint enterprise, and their mutual obligations were similar to those of

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[35] *Rosenthal*, 543 A.2d at 352.

[36] *See* Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045 (1991). But perhaps no attempt to define the scope of fiduciary duties is more widely cited than Justice Cardozo's language in *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928).

[37] *See* Melanie B. Leslie, *Common Law, Common Sense: Fiduciary Standards and Trustee Identity*, 27 CARDOZO L. REV. 2713 (2006).

[38] KY. REV. STAT. ANN. § 273.215 (LEXIS through 2019 Regular Session and 2019 First Extraodinary Session).

[39] Ballard v. 1400 Willow Council of Co-Owners, Inc., 430 S.W.3d 229, 241 (Ky. 2013).

partners.'[40]

To illustrate this principle, imagine that an individual owns a restaurant as a sole proprietor. Over the years, one employee in particular dedicates herself completely to the business. Eventually, the sole proprietor asks the employee to join her as a business partner. Together, they merge their capital, ideas, time, and energy to take the restaurant to the next level by opening three other locations around the city. Since the individuals have placed their mutually reposed trust and confidence in one another, they enter a context-based fiduciary relationship by operation of the common law.[41] Simultaneously, the individuals become partners by operation of law and are also subject to status-based fiduciary duties pursuant to Kentucky partnership law.[42] Years later, the restaurants are thriving, and the partners' attorney suggests they convert the business to a limited liability company or a closely held corporation. After converting the business, the parties are no longer bound by any fiduciary duties recognized by the Kentucky Uniform Partnership Act.[43] Instead, by changing the business' technical legal form from a partnership to a limited liability company or corporation, the business entity then becomes governed by the Kentucky Limited Liability Company Act or the Kentucky Business Corporation Act, respectively.[44] Notably, these laws do not impose any fiduciary relationships on these business owners, and do not otherwise require members or closely held shareholders to treat one another with the utmost care and loyalty.[45] Does this mean that by simply changing business forms, our restaurateurs no longer enjoy their well-established fiduciary relationship? Has their lawyer, in changing the legal form of their business without any corresponding actual change in the

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[40] Hagshenas v. Gaylord, 557 N.E.2d 316, 322 (Ill. App. Ct. 1990). This sentiment was echoed by the Supreme Court of Texas in *Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014), when it "acknowledged that an *informal* fiduciary duty may be owed by a shareholder [in a closely held corporation] to another shareholder based on a moral, social, domestic, or purely personal relationship of trust and confidence prior to and independent from the parties' business relationship." Elizabeth S. Miller, *Fiduciary Duties, Exculpation, and Indemnification in Texas Business Organizations* 6 (St. B. Tex. 13th Ann. Advanced Real Estate Strategies, 2019), *available at* https://www.baylor.edu/law/facultystaff/doc.php/117971.pdf. Texas has also recognized context-based fiduciary duties, or informal fiduciary duties, in the context of LLCs. *See id.*

[41] *See* Miller, *supra* note 40, at 5.

[42] *See* KY. REV. STAT. ANN. § 362.175; *id.* § 362.1-404.

[43] *See id.* § 362.175(2) ("[A]ny association formed under any other statute of this state . . . is not a partnership.").

[44] *See* Kentucky Limited Liability Company Act, *id.* § 275.003 ("[T]he Kentucky Limited Liability Company Act shall govern relations among the limited liability company"); Kentucky Business Corporation Act, *id.* §§ 271B.1-010–271B.18-070.

[45] *See generally* Kentucky Business Corporation Act, *id.* §§ 271B.1-010–271B.18-070; Kentucky Limited Liability Company Act, *id.* §§ 275.001–275.540.

business owners' interpersonal understanding, destroyed the fiduciary nature of their relationship? This result would be absurdly illogical. If their business is changed to the corporate form, the corporate statute simply does not address the relationships of shareholders, and, consequently, whatever their relationship was before simply stays the same. If their business is changed to a limited liability company, and they do not consensually and explicitly modify their relationship in the operating agreement,[46] they remain in their common law fiduciary relationship, protected by their context-based fiduciary duties to each other.[47]

In our hypothetical, the individuals' personal relationship remains unchanged, despite the business's new form of entity. They continue to work in the depths of their business's trenches, holding steady in their interpersonal relationship, so enriched by the dynamics of trust that the legal label attached to their relationship hardly matters from a common law perspective. Context-based fiduciary duties continue chugging along, before and after the implementation of differing business entity statutes, and independently of statutory labels. In reality, business owners are less aware of statutory labels and business forms than their own powers and vulnerabilities that result from their mutually reposed trust and confidence in each other. In many cases, these vulnerabilities could threaten the participants' very survival if they were left without the common law's protection. Scholars have noted "many participants in closely held corporations" and other similar business forms "are . . . unsophisticated in business and financial matters. Not uncommonly, participants . . . invest all their assets in the business."[48] If such individuals were left high and dry by their business associates, who suddenly did not owe fiduciary duties merely due to their choice of a new business form, that person could easily lose their house, savings, and everything they hold dear. In sum, although the individuals' fiduciary status may be altered or amended by changing business forms, their personal relationship of trust and

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[46] Delaware law provides that fiduciary duties "may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing." DEL. CODE ANN. tit. 6, § 18-1101(c) (LEXIS through 82 Del. Laws, ch. 219). However, it has been persuasively argued that the Delaware legislature is constitutionally prohibited from preventing Delaware Courts of Chancery from applying fiduciary duties, which are the creation of equity, as those judges think appropriate, whether or not private agreements purport to eliminate those duties. *See* Lyman Johnson, *Delaware's Non-Waivable Duties*, 91. B. U. L. REV. 701, 702 (2011) ("Judges themselves . . . should not refrain from applying traditional fiduciary duties as they have always done – i.e., as a particular context may equitably require.").

[47] *See* Baptist Physicians Lexington, Inc. v. New Lexington Clinic, P.S.C., 436 S.W.3d 189, 198 (Ky. 2013) (stating that the common law fiduciary duties apply if the statute is silent).

[48] F. Hodge O'Neal, *Close Corporations: Existing Legislation and Recommended Reform*, 33 BUS. LAW. 873, 884 (1978).

confidence, and, therefore, their context-based common law fiduciary duties, must continue uninterrupted and unaffected for the protection of Kentucky's interreliant business owners.

Legal history supports the notion that common law fiduciary duties continue to undergird business and corporate laws, and, indeed, provide the foundation on which those statutes are based. Common law was well-developed long before the English Parliament passed its first business entity statutes. It follows that the first laws "were primarily designed to confirm, codify, limit and supplement the law made by the courts."[49] This principle is also reflected in the Kentucky Constitution which formally adopted the common law until such law is altered or repealed by the state's General Assembly.[50] Moreover, the United States Supreme Court has repeatedly recognized that when a legislature adopts a common law term, like "fiduciary duty," it incorporates the general common law principles embodied by that term.[51]

It is well-established that Kentucky's common law continues to govern until expressly overturned by statute in a variety of scenarios.[52] For example, the Kentucky Supreme Court found that "[w]hile various provisions of [Kentucky's] Limited Liability Company Act address how the law of agency operates with respect to limited liability companies, to the extent the act is not inconsistent with the common law of agency, the latter still applies."[53] The court has also expressly rejected arguments that the Kentucky Revised Statues abrogate the common law.[54] The Kentucky Court of Appeals has recognized that in addition to the statutory duties imposed by corporate codes, non-statutorily imposed fiduciary duties continue to exist.[55] In other

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[49] ALAN S. GUTTERMAN, GOING GLOBAL: A GUIDE TO BUILDING AN INTERNATIONAL BUSINESS § 8.4 (2018).

[50] *See* KY. CONST. § 233.

[51] The United States Supreme Court has repeatedly recognized this well-established principle by holding that "'where Congress uses terms that have accumulated settled meaning under . . . the common law, a court must infer, unless the statute dictates otherwise, that Congress means to incorporate the established meaning of these terms.'" Neder v. United States, 527 U.S. 1, 21 (1999) (quoting Nationwide Mut. Ins. Co. v. Darden, 503 U.S. 318, 322 (1992)).

[52] *See, e.g.*, Strader v. Commonwealth, 42 S.W.2d 736, 737 (Ky. 1931) ("The common-law offense of perjury was found too limited in scope to meet the necessity of justice, and many years ago the General Assembly supplemented it by creating the statutory crime of false swearing.").

[53] Pannell v. Shannon, 425 S.W.3d 58, 81 (Ky. 2014).

[54] *See* Baptist Physicians Lexington, Inc. v. New Lexington Clinic, P.S.C., 436 S.W.3d 189, 198 (Ky. 2013).

[55] *See* Conlon v. Haise, No. 2014-CA-001581-MR, 2016 Ky. App. Unpub. LEXIS 884, at *7 (Ky. Ct. App. Sept. 30, 2016) ("We are well aware that in addition to the statutory duties imposed by the BCA, 'there may be certain nonstatutorily imposed fiduciary duties that exist . . . .'") (quoting Estep v. Werner, 780 S.W.2d 604, 606 (Ky. 1989)). The court's recognition of certain non-statutory duties appeared in an otherwise overbroad and baseless opinion in which the Kentucky Court of Appeals incorrectly determined

words, Kentucky's common law of context-based fiduciary duties continues to operate independently of and supplementary to the state's business entity statutes, unless the common law is specifically altered or repealed by legislative action. The following cases serve to illustrate this principle.

A. Steelvest Inc. v. Scansteel Service Center, Inc.

Thomas Scanlan was employed by structural steel distributor Steel Suppliers, Inc., when the company's assets were purchased by Steelvest, Inc.[56] Steelvest maintained Steel Suppliers as a separate, unincorporated operating division, and Scanlan continued as the president and general manager.[57] Scanlan also became a director of Steelvest and served on its executive committee.[58] While still holding these positions, Scanlan took steps to form his own competing steel business, including securing advice of counsel, contacting potential investors, purchasing property, seeking financing, and even soliciting funds from two of Steelvest's major clients.[59] After resigning his positions at Steel Suppliers and Steelvest, Scanlan commenced the business operations of Scanlan Service Center.[60] Shortly thereafter, nine of Steelvest's employees began working for Scanlan.[61] Largely as a result of its former manager's creation of a dominant competitor, Steelvest experienced financial difficulties, and, ultimately, bankruptcy.[62] Steelvest brought an action against Scanlan and his investors for breach of fiduciary duty.[63] The trial and appellate courts granted Scanlan's motion for summary judgment.[64] The Kentucky Supreme Court then granted discretionary review to determine whether there was sufficient evidence to determine if Scanlan breached any fiduciary duties to Steelvest by planning and organizing a directly competing business.[65]

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that closely held corporate shareholders did not owe one another fiduciary duties. *See id.* This opinion does not rise to controlling precedent, given that the Kentucky Supreme Court has designated the appellate ruling as an unpublished decision. *See* Conlon v. Haise, No. 2016-SC-000604-D, 2017 Ky. LEXIS 55 (Feb. 9, 2017).

[56] Steelvest, Inc. v. Scansteel Serv. Ctr., Inc., 807 S.W.2d 476, 478 (Ky. 1991).

[57] *Id.*

[58] *Id.* at 479.

[59] *Id.*

[60] *Id.*

[61] *Id.*

[62] *Id.*

[63] *Id.*

[64] *Id.*

[65] *Id.*

The first step in the Kentucky Supreme Court's analysis was to determine whether Scanlan was in a fiduciary relationship with Steelvest.[66] In order to reach this decision, the court turned to the status-based common law of fiduciary duty.[67] The court found that Scanlan's position as a director and officer of Steelvest "provides for an established basis of fiducial confidence as between the corporate employer and Scanlan, who, therefore, owed a duty of loyalty and faithfulness to the corporation."[68] Moreover, when discussing whether Scanlan's investor, First National Bank, breached its fiduciary duty to its client, Steelvest, in the midst of this debacle, the court recognized context-based fiduciary duties.[69] The court opined that, as a general rule, a 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 interests of the one reposing confidence.'"[70]

Importantly, when determining the existence of a fiduciary relationship, the *Steelvest* court was not influenced by any fiduciary duties *statutorily* imposed on corporate officers or directors. Indeed, the Kentucky Business Corporation Act is not cited at all in this opinion. Accordingly, this case clearly illustrates that the Kentucky Supreme Court has recognized both status-based and context-based common law fiduciary relationships independent of business entity statutes.

B. Baptist Physicians Lexington, Inc. v. New Lexington Clinic, P.S.C.

In 2008, the New Lexington Clinic ("NLC") brought a breach of fiduciary duty action against three of its former physicians.[71] NLC claimed that the doctors, through their positions on the organization's board of directors, used confidential information to recruit NLC personnel to Baptist Physicians Lexington, a competing healthcare facility.[72] The lower court granted summary judgment in favor of the physician defendants on the basis that KRS 271B.8-300, which establishes the general fiduciary duties of directors, nullified the directors' common law fiduciary duties.[73] The Kentucky Supreme Court strongly disagreed.[74]

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[66] *Id.* at 483.
[67] *Id.*
[68] *Id.*
[69] *Id.* at 484.
[70] *Id.* at 485 (quoting Sec. Trust Co. v. Wilson, 307 S.W. 336, 338 (Ky. 1948)).
[71] Baptist Physicians Lexington, Inc. v. New Lexington Clinic, P.S.C., 436 S.W.3d 189 (Ky. 2013).
[72] *Id.* at 191.
[73] *Id.*
[74] *Id.*

The Kentucky Business Corporations Act includes a provision sometimes referred to as Kentucky's Business Judgment Rule.[75] The statute provides in relevant part that

> any action taken as a director, or any failure to take any action as a director, shall not be the basis for monetary damages . . . unless . . . the breach or failure to perform constitutes willful misconduct or wanton or reckless disregard for the best interests of the corporation and its shareholders.[76]

After reviewing the statute's plain language and its legislative commentary, the Kentucky Supreme Court found that this statute only applies to corporate directors' decisions made within their capacity as directors—not choices made to promote their own individual interests.[77] Since the physician directors were acting on their own accord in anticipation of competing with NLC, the court reasoned that this provision was inapplicable to the case at hand, and the lower court's grant of summary judgment was improper.[78]

The court then expressly rejected NLC's claims that the Kentucky Business Corporations Act abrogated the common law of fiduciary duty.[79] Instead, it noted that "Kentucky courts have long recognized that corporate directors owe fiduciary duties to the corporation and its shareholders, duties emanating from common law."[80] Indeed, the Kentucky Business Corporations Act never uses the term "fiduciary duty," and never addresses the fiduciary relationship and its inherent duties. The statute simply did not need to, given they were well-established under Kentucky common law long before the statutes were enacted. Accordingly, *Baptist Physicians* strongly supports the principle that both status-based and context-based fiduciary duties continue to govern independently of and supplementary to Kentucky's business entity statutes.[81]

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[75] KY. REV. STAT. ANN. § 271B.8-300 (LEXIS through 2019 Regular Session and 2019 First Extraordinary Session).

[76] *Id.*

[77] *Baptist Physicians*, 436 S.W.3d at 198.

[78] *Id.*

[79] *Id.* at 200.

[80] *Id.* at 194.

[81] As Professor Lyman Johnson has elegantly stated:

> Corporate law is 'bi-vocal.' On the one hand, the legislatively-enacted corporate statute is 'permissive, enabling, and expansive in its thrust,' while, on the other hand, judicially-imposed duties serve as a counterforce that constrains and tempers managerial misbehavior that goes too far. Each voice vitally depends on the other to co-produce a desirable balance in corporate law.

Johnson, *supra* note 46, at 724.

C. Patmon v. Hobbs

In *Patmon v. Hobbs*, the Kentucky Court of Appeals addressed the fiduciary relationship between members of a limited liability company.[82] Hobbs and Patmon were both members of American Leasing, a build-to-suit leasing company, when Hobbs secretly diverted the company's funds to support his own competing business, American Development.[83] When these indiscretions came to light, Patmon successfully sued Hobbs for the misdirected funds.[84] Patmon brought a second suit under the Kentucky Limited Liability Company Act, specifically KRS 275.170, which statutorily imposes duties of care and loyalty upon members of limited liability companies.[85] She asserted that Hobbs breached his fiduciary duty by usurping business opportunities from American Leasing.[86] The lower court found that since American Leasing would have been unable to perform the leasing contract Hobbs secured for his competing business, no business opportunity existed.[87] Therefore, the claim for damages under the statute was barred.[88] However, the trial court noted the lack of Kentucky cases addressing business opportunity loss in fiduciary duty cases.[89]

On appeal, the court framed the issue as "whether under KRS 275.170 or by common law, Hobbs owed a fiduciary duty to American Leasing *and Patmon*."[90] Notably, the court began its analysis by stating that common law fiduciary duties may arise based on the circumstantial context whenever "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."[91] It then stated that "even in the absence of a statutorily imposed duty," the common law would continue to impose fiduciary duties on an officer or director of a company.[92] Accordingly, the court held that the common law imposes fiduciary duties upon all officers and members of limited liability companies, in the absence of explicit contrary provisions in the operating agreement.[93]

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[82] Patmon v. Hobbs, 280 S.W.3d 589 (Ky. 2009).
[83] *Id.* at 592.
[84] *Id.*
[85] *Id.* at 591.
[86] *Id.* at 592.
[87] *Id.* at 593.
[88] *Id.*
[89] *Id.*
[90] *Id.* (emphasis added).
[91] *Id.* (quoting Steelvest, Inc. v. Scansteel Serv. Ctr., Inc., 807 S.W.2d 476, 485 (Ky. 1991)).
[92] *Id.*
[93] *Id.* at 594.

The court continued its discussion of whether a managing member of a limited liability company owes fiduciary duties to his fellow members.[94] The court turned to Kentucky partnership law, which requires partners to treat one another with the "utmost good faith" given their relationship of trust and confidence.[95] The court then stated that since

> partners owe good faith to each other, we believe it follows logically and equitably that a managing member of a limited liability company also owes such a duty to other members (partners). Furthermore, this standard, in combination with KRS 275.170, leads us to the conclusion that Hobbs violated the duty of loyalty, and therefore, breached his fiduciary duty to his fellow members and to the company.[96]

Based on this holding, the court remanded the case for further proceedings. *Patmon* was ultimately overturned on an appeal of the remanded case, but solely on issues outside the scope of this Article.[97]

Many Kentucky attorneys have analyzed *Patmon* in an effort to provide guidance to the countless limited liability company members across the state. For instance, Scott Dolson concluded in his commentary, *Fiduciary Duty Standards of Conduct for Kentucky LLCs*, that because the *Patmon* opinion addressed common law fiduciary duties before analyzing KRS 275.170's duty of loyalty provision, "it appears likely that the court would have held that a fiduciary duty of loyalty exists for LLC management, with or without the LLC Act's adoption of that duty."[98] Moreover, Mr. Dolson interpreted the court's holding that Hobbs breached his fiduciary duty to his fellow LLC members as "suggesting that fiduciary duties run not just from management and members to the LLC, but also between and among the LLC's management and members."[99] Both of these observations support the

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[94] *Id.* at 595.

[95] *Id.*

[96] *Id.*

[97] *See* Patmon v. Hobbs, No. 2012-CA-001814-MR, 2014 Ky. App. Unpub. LEXIS 19 (Ky. Ct. App. Jan. 10, 2014).

[98] Scott W. Dolson, *Fiduciary Duty Standards of Conduct for Kentucky LLCs*, KY. B. ASS'N 4 (2011), https://cdn.ymaws.com/www.kybar.org/resource/resmgr/Hot_topics/2011_hottopic_01.pdf.

[99] *Id.* Additionally, in *Griffin v. Jones*, 975 F. Supp. 2d 711 (W.D. Ky. 2013), a federal district court expressly adopted *Patmon*:

> Kentucky courts have held that a member of a limited liability company owes a duty of loyalty to fellow members and the company. Patmon held that a 'partner has a duty to share with the partnership those business opportunities clearly related to the subject of its operations.' Just as partners owe good faith to each other, so too do members of a limited liability company. Patmon remains valid law.

Id. at 724 (internal citations omitted). However, in a later case involving the same parties, the same court appeared to change course. In Jones v. Griffin, 170 F. Supp. 3d 956 (W.D. Ky. 2016), the court

principle that context-based, common law fiduciary duties govern members of a limited liability company in instances where the relationship is one of mutually reposed trust and confidence, independently of the state's business entity statutes.[100]

D. Donahue v. Rodd Electrotype Co. of New England, Inc.

Massachusetts was one of the first states to recognize that shareholders in closely held corporations generally have such a strong context-based fiduciary relationship that, given their typical reposal of trust and confidence in each other, the relationship should be elevated to a categorical, status-based fiduciary relationship.[101] In this case, Harry Rodd and Joseph Donahue were employed by Royal Electrotype Company of New England, Inc. when they were given the opportunity to purchase shares in the company.[102] Mr. Rodd ultimately became a majority shareholder, as well as the company's president and general manager.[103] He renamed the company Rodd Electrotype and brought his children into the business as officers and directors.[104] Upon Mr. Rodd's retirement, the corporation purchased forty-five of Mr. Rodd's shares in the company.[105] When the Donahues discovered that the corporation had purchased Mr. Rodd's shares, they requested their shares be purchased by the corporation at the same price.[106] When Rodd Electrotype refused, Mrs. Donahue brought a breach of fiduciary duty claim.[107]

Mrs. Donahue claimed that the Rodds, as controlling shareholders, owed her a fiduciary duty as a minority shareholder to provide an equal opportunity to sell her shares to the corporation.[108] The court began its analysis by limiting its holding to close corporations, which it defined as corporations with "(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."[109] Based on this definition, the

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distinguished *Patmon* by finding that if an entity is manager-managed, rather than member-managed, the members did not owe one another fiduciary duties.

[100] Further evidence of this principle is the fact that, in general, common law torts are governed by common law doctrines, not by business statutes.

[101] Donahue v. Rodd Electrotype Co. of New England, Inc., 328 N.E.2d 505 (Mass. 1975).

[102] *Id.* at 509.

[103] *Id.*

[104] *Id.*

[105] *Id.* at 510.

[106] *Id.* at 511.

[107] *Id.*

[108] *Id.*

[109] *Id.*

court noted the striking similarities between close corporations and partnerships.[110] For instance, in both types of businesses, "the relationship among the stockholders must be one of trust, confidence and absolute loyalty if the enterprise is to succeed."[111] Moreover, shareholders in a close corporation typically contribute "capital, skills, experience and labor" to the project just as partners would.[112] Such similarities indicated to the court that there might be other links between partners and shareholders of closely held corporations, including the fiduciary duties inherent in these types of relationships.[113]

The court then discussed the inherent risks closely held corporations present to minority shareholders, including shareholder freezeouts.[114] Freezeouts occur where the majority shareholders "refuse to declare dividends," drain corporate earnings through exorbitant salaries, "deprive minority shareholders of corporate offices," or "cause the corporation to sell its assets at an inadequate price" to themselves, all in frustration of the minority shareholders' reasonable expectations.[115] While the minority shareholders could protect themselves from freezeouts by bringing a suit against the majority shareholders or the corporation, the majority's decisions may be protected from judicial review by the business judgment rule.[116] Additionally, their status as minority shareholders will typically prevent them from forcing the corporation to dissolve and distribute residual assets.[117] Moreover, the minority shareholders lack a public market in which they can easily sell their corporation's shares.[118] "Thus, . . . the minority shareholders may be trapped in a disadvantageous situation," which has the potential to significantly harm minority shareholders who have invested a "substantial percentage of their personal assets" in the corporation or whose livelihood heavily relies on a salary drawn from the corporation.[119] Ultimately, the court stated:

> 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

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[110] *Id.* at 512.
[111] *Id.*
[112] *Id.*
[113] *Id.*
[114] *Id.* at 513.
[115] *Id.*
[116] *Id.*
[117] *Id.* at 514.
[118] *Id.*
[119] *Id.* at 514–15.

> 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.[120]

Importantly, this holding extends to all shareholders in a closely held corporation, despite the fact that it was controlling majority shareholders that breached their fiduciary duties in this case.[121] Indeed, it is true that in many breach of fiduciary duty cases, the breaching shareholder is the majority shareholder.[122] This is a natural result of the power held by the majority over the minority shareholders. However, in the rare case where the minority shareholder is in a position to harm the majority, both the *Donahue* holding and the common law of fiduciary duty act as a restraint against minority shareholders who become bad actors.[123]

We do not advance the position that Kentucky should or should not join Massachusetts in categorically imposing status-based fiduciary duties on all shareholders in closely held corporations. Rather, the facts presented in *Donahue* illustrate the importance, and practicality, of recognizing common law fiduciary duties on a contextual basis. At some point in the history of a given business, the interreliant human relationships among shareholders may dissipate. In *Donahue*, the mutual relationship of trust and confidence that Mr. Rodd and Mr. Donahue once held with each other had dissolved, as both aged out of the company, and Mr. Rodd had even given his stock to his children. At the time of the alleged breach of fiduciary duty, the Rodd Electrotype shareholders were no longer placing their mutually reposed trust in one another, they were no longer exposing their vulnerabilities, or placing their economic fate in the hands of their fellow shareholders. Instead, these closely held shareholders were merely collecting dividends while the elder Rodd children ran the company. Therefore, while the Massachusetts court categorically imposed fiduciary duties on the parties based on their status as shareholders in a closely held company, the actual context of the Donahues' relationship with the other shareholders likely no longer rose to the level of a fiduciary relationship under the common law. Studying the context of the shareholders' relationship prior to the breach is a more practical and equitable

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[120] *Id.* at 515.

[121] *Id.* at 515–16.

[122] *Donahue* elevated all closely held shareholders to the fiduciary level, when in most cases, a rule imposing fiduciary duties solely upon majority shareholders would have been sufficient to prevent minority shareholder abuse. *See, e.g.*, *id.* at 513 (noting that minority shareholders have a cause of action against majority shareholders if the latter breach their fiduciary obligations to the corporation itself).

[123] For examples of minority shareholders breaching their fiduciary duties to majority shareholders, see A.W. Chesterton Co., Inc. v. Chesterton, 128 F.3d 1 (1st Cir. 1997); Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657 (Mass. 1976); and Sletteland v. Roberts, 16 P.3d 1062 (Mont. 2000).

method for imposing fiduciary duties upon closely held shareholders because this approach takes into account the fact that human relationships are always changing, evolving, and even dissipating.[124] When courts or legislatures categorically impose fiduciary duties, they may subject business owners, who for all intents and purposes may be complete strangers, to the highest duties of good faith and loyalty.[125] The minority may continue to need the status-based fiduciary protection mandated by *Donahue*, but they are not fiduciaries of each other under the traditional context-based common law of fiduciary relationships.

A.W. Chesterton Company, Inc. v. Chesterton illustrates this point precisely.[126] This First Circuit case involves the infrequent situation in which a minority shareholder in a closely held corporation has the opportunity to abuse their fellow shareholders.[127] Mr. Chesterton owned 26% of A.W. Chesterton Company, Inc., and his relatives owned the remainder of the corporation.[128] After becoming discontent with the company's performance, Mr. Chesterton sought to sell his interest in the corporation.[129] The majority shareholders brought legal action against Mr. Chesterton in order to prevent the sale, given that it would result in the corporation and the shareholders owing millions of dollars in additional income tax.[130] The court applied the *Donahue* rule imposing fiduciary duties on all closely held shareholders and found that the sale would constitute a breach of the fiduciary duties Mr. Chesterton owed to the other shareholders.[131] This decision left Mr. Chesterton in limbo—he wanted out of the company, but he could not sell his shares.

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[124] The *Donahue* court should have examined the majority shareholders' relationship to the Donahues at the time of the breach. However, if Mr. Rodd was still involved in the corporation, and Mr. Donahue had brought the breach of fiduciary duty suit against Mr. Rodd, the court's inquiry would be different—it does not matter if members of a fiduciary relationship become hostile by the time of the alleged breach, the parties were not hostile when they entered the confidential relationship, and, therefore, their context-based fiduciary duties continue by operation of law. *See* Hagshenas v. Gaylord, 557 N.E.2d 316, 324 (Ill. App. Ct. 1990) ("We find it implicit that people who enter into a small business enterprise . . . place their trust and confidence in each other[, and] a fiduciary relation exists in all cases in which a confidential relationship has been acquired. . . . The important point in time is not the time at which the parties' differences became irreconcilable but, rather, the time in which they entered into the business relationship.").

[125] *See* Peter K. Smyth, *Minority Shareholders Are Fiduciaries Too*, LEXOLOGY (Oct. 15, 2018), https://www.lexology.com/library/detail.aspx?g=656162df-68f4-458e-92b0-7d454dd77245.

[126] *See A.W. Chesterton Co.*, 128 F.3d at 1.

[127] *Id.*

[128] *Id.* at 3.

[129] *Id.* at 4.

[130] *Id.* at 5.

[131] *Id.*

This case highlights one of the shortcomings of the *Donahue* rule and emphasizes the importance of imposing fiduciary duties on a contextual basis. Like many closely held corporations, A.W. Chesterton Company, Inc. was a family company "formed as a vehicle to pass wealth from one generation to the next."[132] While the founding members of the organization may have worked hand-in-hand to foster the company's growth and success, as younger generations join the company and eventually gain control, they may no longer have relationships that rise to the fiduciary level. This reality creates problems in jurisdictions that categorically impose fiduciaries duties on closely held shareholders. Peter K. Smyth advises that "[a]dvanced recognition that family members may not want to remain business partners indefinitely provides opportunities for amicable separation," and "reduces the likelihood that any owner will breach his fiduciary duties to the others."[133] In fact, "failure to plan for an amicable business separation invites turmoil within the company as well as the undoing of family relationships—precisely what the founders of most family companies seek to avoid."[134] While chaos within a family business may be prevented by careful foreplanning, imposing fiduciary duties based on the context of the shareholders' relationship, rather than their status in the company, may be a more consistent solution for closely held corporations. Instead of forcing all of Mr. Chesterton's descendants into a fiduciary relationship, the court might have studied the context of the shareholders' relationships. Clearly, Mr. Chesterton's hands-off relationship with the other shareholders did not rise to the fiduciary level by operation of law. Indeed, the common law likely would have respected Mr. Chesterton's commercial volition to sell his shares, despite the financial harm it would cause the other shareholders.

IV. RESOLUTION

Kentucky courts should expressly confirm the universally accepted principle that common law fiduciary duties arise based on the context of the business owners' relationship. Our courts already consistently recognize that a "[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."[135] In order to

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[132] Smyth, *supra* note 125.

[133] *Id.*

[134] *Id.*

[135] Steelvest, Inc. v. Scansteel Serv. Ctr., Inc., 807 S.W.2d 476, 485 (Ky. 1991).

determine whether a relationship qualifies as a fiduciary relationship under the common law, courts must analyze the nature of the human relationship. In a business context, how an attorney structured the enterprise, whether it be as a partnership, limited liability company, limited partnership, or a close corporation, is generally irrelevant. If the individuals placed their special confidence in one another and each relied on the other's implicit promise to operate the business in each other's mutual best interest, they have formed a fiduciary relationship and are protected by the common law.

The flexible application of the common law also accommodates the complexities of fiduciaries in the twenty-first century corporation. While legal textbooks must discuss corporate roles one-dimensionally in order to guide student learning, the reality of corporations is that these players are likely holding several positions simultaneously. For example, a corporation's chief executive officer may also be a member of the board of directors and a major stockholder of the company. A family owned close corporation may have one or two people filling all corporate roles. Professor F. Hodge O'Neal has noted that "[i]n view of the informal way in which the affairs of most close corporations are conducted, there is usually no necessity for distinguishing between the fiduciary duties of the controlling participants in their various capacities as shareholders, directors, and officers."[136] In these types of situations, a court must take a close look at the context of the situation, who is acting, which hat are they wearing when they act, and whose interests are they acting in, in order to determine whether common law fiduciary duties are applicable.

If a fiduciary relationship exists, common law duties of loyalty, care, disclosure, and utmost good faith will continue to govern unless specifically abrogated by statute. This principle has been noted by Kentucky courts in a variety of contexts and is supported by the Kentucky Constitution.[137] However, some scholars seem to have overlooked this basic premise.[138] It has been posited that since Kentucky's Uniform Partnership Act establishes that partners owe one another fiduciary duties, and similar provisions are lacking from Kentucky's Business Corporation Act, the legislature must not have

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[136] 2 F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL AND THOMPSON'S CLOSE CORPORATIONS AND LLCS: LAW AND PRACTICE § 9:19 (West rev. 3d ed. 2009). Although others have expressed disagreement with this sentiment on the basis that majority shareholders may not owe fiduciary duties to their fellow shareholders due to their majority status, majority shareholders could indeed owe fiduciary duties to shareholders in their role as directors. *See, e.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).

[137] *See* Baptist Physicians Lexington, Inc. v. New Lexington Clinic, P.S.C., 436 S.W.3d 189, 191 (Ky. 2013).

[138] *See, e.g.*, Thomas E. Rutledge, *Shareholders Are Not Fiduciaries: A Positive and Normative Analysis of Kentucky Law*, 51 U. LOUISVILLE L. REV. 535 (2013).

intended for shareholders in a closely held corporation to owe fiduciary duties to each other.[139] However, this argument is misguided given that the Kentucky Uniform Partnership Act does not, in fact, *establish* the fiduciary relationship of partners, but simply *recognizes* the partners' fiduciary relationship under the common law and certain duties that emanate from that relationship.[140] Indeed, the common law continues to govern independently of Kentucky's partnership statutes.

Moreover, the Kentucky Business Corporation Act—and indeed, the Model Business Corporation Act upon which it is based—never mentions the phrase "fiduciary duties," or even standards of conduct against which performance of those fiduciary duties might be measured.[141] The statutes never state that corporate officers are fiduciaries; they never state that corporate employees are fiduciaries; they never state that corporate directors are fiduciaries; and they never state that majority shareholders may be fiduciaries. The statutes do not even mention that corporate employees, officers, directors, and shareholders are subject to fiduciary duties of loyalty, largely because these duties were well-established by the common law long before enactment of those statutes. These otherwise glaring omissions in the business entity statutes were intentional, given that the common law had long recognized those holding these positions as status-based fiduciaries subject to fiduciary duties of loyalty, among others. For example, the Kentucky Supreme Court has clearly stated that under Kentucky law, partners owe one another fiduciary duties.[142] Moreover, it is well-established in this state and across the country that a majority shareholder owes fiduciary duties to minority shareholders given the potential that they may abuse the minority for their own self-interest. In fact, the United States Supreme Court has stated in regard to controlling stockholders that, "[t]he majority has the right to control; but when it does so, it occupies a fiduciary relation towards the minority, as much so as the corporation itself or its officers and directors."[143]

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[139] *Id.* at 544.

[140] *See* Allan W. Vestal & Thomas E. Rutledge, Jr., *Modern Partnership Law Comes to Kentucky: Comparing the Kentucky Revised Uniform Partnership Act and the Uniform Act From Which It Was Derived*, 95 KY. L. J. 715, 732–33 (2006).

[141] *See* KY. REV. STAT. ANN. § 271B.1-010 (LEXIS through 2019 Regular Session and 2019 First Extraodinary Session).

[142] *See* Lach v. Man O'War, LLC, 256 S.W.3d 563, 569 (Ky. 2008) ("Under Kentucky law, partners owe the utmost good faith to each and every other partner. The scope of the fiduciary duty has been variously defined as one requiring utter good faith or honesty, loyalty or obedience, as well as candor, due care, and fair dealing." (internal citations omitted)).

[143] Zahn v. Transamerca Corp., 162 F.2d 36, 42 (3d Cir. 1947) (quoting S. Pac. Co. v. Bogert, 250 U.S. 483, 487 (1919)). It is remarkable that for over seventy-five years, courts have had no trouble finding that remote majority shareholders can somehow owe fiduciary duties to minority shareholders, with whom

It is universally accepted that partners, directors, officers, and other corporate employees, including majority shareholders, are all subject to fiduciary duties, despite the fact that the Kentucky statutes and the model business entity statutes on which they are based fail to specifically address fiduciary relationships. Those statutes omitted fiduciary references in deference to preexisting common law. Consequently, common law fiduciary relationships, and the fiduciary duties assumed, continue to operate independently of and supplementary to business entity statutes. Legislatures have had no reason to define fiduciary relationships or their related duties within the statutory scheme. Indeed, all business entity statutes are built on this common law foundation. Without the common law, these statutes would be dysfunctional.

It has also been suggested that limited liability companies are not subject to the common law because limited liability companies are creatures of statute and, "unlike corporations, did not exist at common law."[144] This claim is also without merit. When faced with this precise issue, the Kentucky Supreme Court noted that while limited liability companies are "not primarily" governed by common law, it is only "to the extent that statutes conflict with common law, [that] the common law is displaced."[145] More specifically, the court stated, "[w]hile various provisions of [Kentucky's] Limited Liability Company Act address how the law of agency operates with respect to LLCs, to the extent the act is not inconsistent with the common law of agency, the latter still applies."[146] Fundamentally, it is irrelevant whether limited liability companies are creatures of statute or primarily governed by the common law. The only thing that matters under the common law is whether there is a relationship of mutually reposed trust and confidence between two business owners. When this type of dynamic human relationship exists, common law fiduciary duties arise by operation of law, regardless of how the legislature chooses to define or label the business form. Accordingly, the notion that LLC members are somehow exempt from common law fiduciary duties is baseless.

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they place no mutually-reposed trust and confidence, and yet Kentucky courts have not strongly confirmed that closely held corporate shareholders owe common law fiduciary duties to one another based on the context of their relationship. Indeed, there is a much stronger policy basis for imposing fiduciary duties among two interreliant entrepreneurs than among a large corporation holding the majority of a company's shares and a minority shareholder, with whom that corporation will never come into direct contact, holding perhaps a single share of stock and living in rural Kentucky.

144 CML V, LLC v. Bax, 28 A.3d 1037, 1044–45 (Del. 2011).

145 Pannell v. Shannon, 425 S.W.3d 58, 68 (Ky. 2014).

146 *Id.* at 81.

A third theme often discussed in relevant case law and commentary is the principle that shareholders of closely held corporations owe one another fiduciary duties because of the similarities between these shareholders and partners in general partnerships. Accordingly, the principle goes, since partners owe fiduciary duties,[147] so should shareholders in a closely held corporation. Again, we do not attempt to weigh in on the similarities and differences between partners and shareholders in a closely held corporation, although the wisdom in approaching fiduciary duties in such a broad, absolute manner might be reasonably questioned. The common law does not care how the relationships are labeled, whether it be partner, member, or a shareholder. Rather, the common law looks to the context of the relationship to determine if a fiduciary relationship has developed and what fiduciary duties are owed. It follows that the authors are not advocating that Kentucky courts adopt the *Donahue* rule in establishing that all closely held corporation shareholders are fiduciaries on the basis of their status as shareholders of closely held corporations. Kentucky courts should, at the very least, follow the common law in its purest form by assessing fiduciary duties on a contextual, case-by-case basis.

Ultimately, if the Kentucky legislature or courts were to narrow the application of fiduciary duties to specified business entity relationships, or if business lawyers representing business owners were to contract around preexisting fiduciary relationships, the state's economy and business owners would likely suffer.[148] Individuals who feel as though they can no longer repose their trust and confidence in their associates would be unable to effectively form or manage a business. Indeed, Professor Colombo has posited that "[t]rust is a critical, if not the critical ingredient to the success of the capital markets (and of the free market economy in general)."[149] Moreover, psychological studies show that individuals in a trusting relationship may actually be more vulnerable to associates' wrongdoing.[150]

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[147] *See* Page v. Page, 359 P.2d 41, 44 (Cal. 1961) ("Even though the Uniform Partnership Act provides that a partnership at will may be dissolved by the express will of any partner . . . this power, like any other power held by a fiduciary, must be exercised in good faith.").

[148] *See generally* ROBERT D. PUTNAM, BOWLING ALONE: THE COLLAPSE AND REVIVAL OF AMERICAN COMMUNITY 288 (2000) ("Where people are trusting and trustworthy . . . everyday business and social transactions are less costly. There is no need to spend time and money making sure that others will uphold their end of the arrangement or penalizing them if they don't.").

[149] Colombo, *supra* note 28, at 830.

[150] In his article, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, Professor Donald C. Langevoort, perhaps the leading corporate law scholar in the field of behavioral economics, expressed the principle that "[o]nce trust is established . . . in a relationship, it tends to trump information that the [fiduciary] has conflicting incentives." 95 VA. L. REV. 1025, 1052 (2009). He adds:

> [P]sychological research shows that the effect [of conflicts disclosure by the fiduciary] can be pernicious. People who receive conflict disclosure may well believe that the other party is more

Without common law fiduciary duties, these business owners are left to fend for themselves precisely when they need the law's protection the most. Anti-fiduciary duty measures would ultimately harm our state and create a business climate that investors should take care to avoid.

V. CONCLUSION

In reality, business owners may lack the expertise to appreciate the legal consequences of employing certain business structures, as well as the potential effects their chosen entity may have on their interpersonal relationships. Choice of entity decisions are typically made by lawyers or even non-lawyer paralegals, based on preexisting firm biases, preferences for a particular type of entity, and the firm's business entity templates. In fact, many, if not most, lawyers today presume the limited liability company to be the default choice of entity based on its enhanced freedom of contract. Accordingly, these legal professionals often proceed to form the limited liability company for business owners without meaningful input from their non-lawyer business clients. The business owners, deferring to the legal expertise of their attorneys, simply acquiesce in what is essentially the lawyers' professional decision on choice of entity. Their lawyers' professional advice may rarely, if ever, address or even touch upon any effect the characteristics of the chosen form of entity might have on their preexisting, interpersonal fiduciary relationships based on their mutual trust and confidence. These business owners are never disabused of their essential belief that they will continue to promote the best interests of their fellow business owners and their enterprise over any personal interests. They continue to base their relationship on trust and confidence and have no notions at all that the decisions made by their lawyers may have arguably transformed their fiduciary relationships to arm's-length ones. In other words, issues of legal personality, likely not even understood by these lay business owners, remain personally unrecognized and fully subordinate to the parties' preexisting fiduciary relationships. Given that their mutually reposed trust and confidence is at the heart of their relationship and of the business they have built together, they would likely be profoundly surprised by any suggestion that the lawyers' choice of entity decision had reversed the essential quality of their relationship from a fiduciary relationship to the arm's-length relationship typical of relative strangers. Indeed, if this

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trustworthy simply as a result of the disclosure. Worse, people making conflict disclosures often feel the freedom to act in a less trustworthy way precisely because of the disclosure.

Id.

transformation actually served to radically change the nature of their relationship and they were so informed of this legalistic reversal, they would likely abandon their chosen business form. Given these realities, and the importance of this issue to the state's entrepreneurs and business owners, it is vital that Kentucky courts expressly recognize the context-based common law fiduciary relationships of business owners in order to restore and maintain a sense of morality in business entity law. Common law fiduciary duties enforce both the conscience and the interpersonal understandings of interreliant business owners.