

# Adverse Domination—Tolling the Statute of Limitations in Kentucky Business Organizations (Part I)

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## INTRODUCTION

THE doctrine of adverse domination provides that the statute of limitations within which a corporation may bring an action against wrongdoing directors is tolled while those wrongdoers are in control of the corporation. In *Wilson v. Paine*,<sup>2</sup> a case of first impression, the Supreme Court of Kentucky held that the doctrine of adverse domination would apply to toll the two-year statute of limitations<sup>3</sup> applicable to claims by a corporate plaintiff against directors to recover an impermissible dividend.<sup>4</sup>

After an examination of *Wilson* and a brief review of the rules governing corporate dividends, including the liability imposed upon directors for dividends improperly declared, this Article turns to other issues of corporate and business entity law to which the doctrine may be applied. Specifically, this Article analyzes the possibility of applying adverse domination to the statute of limitations applicable to distribution statutes for other entity forms, as well as applying the doctrine to toll general statutes of limitations. Finally, this Article addresses the use of the doctrine to hold third parties liable where their actions aided the concealment of the directors' wrongdoing.

## I. *WILSON V. PAINE*

In *Wilson*, the Supreme Court of Kentucky granted the certification request of the US Bankruptcy Court for the Western District of Kentucky to determine whether and how adverse domination applies under Kentucky law.<sup>5</sup> In 2006, Franklin Career Services (FCS) filed Chapter 7 bankruptcy.<sup>6</sup> Thereafter, the bankruptcy trustee for FCS sued a former parent company along with the former officers and directors of FCS, alleging several counts of corporate malfeasance.<sup>7</sup> Seeking recovery of property as preferences and fraudulent transfers, the trustee alleged that the distributions violated Kentucky Revised Statute (KRS)

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<sup>2</sup> *Wilson v. Paine*, 288 S.W.3d 284 (Ky. 2009).

<sup>3</sup> KY. REV. STAT. ANN. § 271B.8-330(3) (West 2010).

<sup>4</sup> *Id.* § 271B.6-400(3). This provision is a near verbatim adoption of section 6.40(c) of the MODEL BUSINESS CORPORATION ACT.

<sup>5</sup> *Wilson*, 288 S.W.3d at 285-86.

<sup>6</sup> *Id.* at 286.

<sup>7</sup> *Id.*

section 271B.6-400(3)<sup>8</sup> and that the directors who had authorized those dividends were liable to the corporation under KRS section 271B.8-330.<sup>9</sup> The directors moved to dismiss on the grounds that the claim was barred by the two-year statute of limitations in KRS section 271B.8-330(3),<sup>10</sup> to which the trustee responded by arguing for the application of the equitable tolling doctrine of adverse domination.<sup>11</sup>

## II. LIMITATIONS UPON DISTRIBUTIONS

The statutory limitations on the ability of a corporation to declare a distribution<sup>12</sup> evolved from the trust fund doctrine. The trust fund doctrine provides that when a corporation is insolvent, or is made so by the distribution, the property of the corporation is held as a trust fund for the benefit of creditors such that “all its creditors are entitled, in equity, to have their debts paid out of the corporate property before any distribution thereof among the stockholders.”<sup>13</sup> If a distribution is improperly made to shareholders, the trust fund doctrine allows such distributions to be recovered from the shareholders in a proper proceeding.<sup>14</sup> The same result is reached under general trust law, from which many corporate concepts originated.<sup>15</sup> If a creditor is entitled to reach trust property to satisfy his claim, and the trustee

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<sup>8</sup> The statute provides, inter alia, that distributions may not be made if, as of the time the effect thereof is measured, the corporation’s assets would be less than the sum of its liabilities or the corporation would be unable to satisfy its debts in the ordinary course of business. See KY. REV. STAT. ANN. § 271B.6-400(3).

<sup>9</sup> *Wilson*, 288 S.W.3d at 286. KRS section 271B.8-330(1) provides:

A director who votes for or who assents to a distribution made in violation of KRS 271B.6-400 or the articles of incorporation shall be personally liable to the corporation for the amount of the distribution that exceeds what could have been distributed without violating KRS 271B.6-400 or the articles of incorporation if it is established that he did not perform his duties in compliance with KRS 271B.8-300.

KY. REV. STAT. ANN. § 271B.8-330(1). KRS section 271B.8-300 requires a director to discharge his obligations in good faith, on an informed basis, and in a manner he honestly believes to be in the best interests of the corporation. *Id.* § 271B.8-300.

<sup>10</sup> KRS section 271B.8-330(3) provides that a proceeding to recover the amount of an improper distribution from a director “shall be barred unless it is commenced within two (2) years after the date on which the effect of the distribution was measured under subsection (5) or (7) of KRS 271B.6-400.” *Id.* § 271B.8-330(3).

<sup>11</sup> *Wilson*, 288 S.W.3d at 286. While the concept of tolling statutes of limitations based on a “control” or “domination” exception appears in cases as early as 1897, the theory of adverse domination became widely invoked in the wake of the recent savings and loan crisis, when federal regulators pled the theory in order to side-step limitations issues in hundreds of director and officer liability cases. See Matthew G. Dore, *Statutes of Limitation and Corporate Fiduciary Claims: A Search for Middle Ground on the Rules/Standards Continuum*, 63 BROOK. L. REV. 695, 700 (1997).

<sup>12</sup> The most common types of corporate distributions are operating dividends and liquidating distributions. KRS sections 271B.8-330 and 271B.6-400 apply to all types of distributions. See KY. REV. STAT. ANN. §§ 271B.8-330, -400.

<sup>13</sup> *Hollins v. Brierfield Coal & Iron Co.*, 150 U.S. 371, 384 (1893).

<sup>14</sup> 18B AM. JUR. 2D *Corporations* § 1145 (2010). This differs from KRS section 271B.8-300, which does not provide for creditor recovery directly from the shareholders. KY. REV. STAT. ANN. § 271B.8-300.

<sup>15</sup> See generally Justice Joseph T. Walsh, *The Fiduciary Foundation of Corporate Law*, 27 J. CORP. L. 333 (2002).

transfers the trust property to the beneficiary before the claim has been paid, the creditor can ordinarily hold the beneficiary personally liable for the claim to the extent of the value of the trust property.<sup>16</sup>

KRS section 271B.6-400 is part of Kentucky's statutory codification of the trust fund doctrine for business corporations. It provides, inter alia, that in addition to limitations set forth in the articles of incorporation,<sup>17</sup> a corporation may not make a distribution if either of two tests is not satisfied, namely:

the net liabilities of the corporation exceed its net assets;<sup>18</sup> or  
the corporation is not able to pay its debts as they come due in the ordinary course of business.<sup>19</sup>

Any director who votes for or assents to a distribution in violation of these limitations is personally liable to the corporation for the amount the distribution exceeds the amount that could have been distributed without violating KRS section 271B.6-400.<sup>20</sup> A director who is held personally liable can seek contribution from every other director who could also be held liable for the unlawful distribution and from each shareholder for the amount the shareholder accepted knowing<sup>21</sup> that the distribution was improper.<sup>22</sup> A proceeding to recover from the

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<sup>16</sup> RESTATEMENT (SECOND) OF TRUSTS § 279 (2010). The beneficiary will not be held personally liable, however, where the beneficiary is a bona fide purchaser or has changed his position so that it would be inequitable to hold him personally liable. Again, this differs from KRS section 271B.8-300, which does not provide for creditor recovery directly from the shareholders. KY. REV. STAT. ANN. § 271B.8-300.

<sup>17</sup> KY. REV. STAT. ANN. § 271B.6-400(1). For example, the articles could provide that no distributions may be made to the common shares unless and until a priority distribution has been made to a class of preferred shares. See also *id.* § 271B.6-010(3)(d). Additional limitations on dividends, such as in loan covenants, are contractual obligations to third-parties and, if violated, do not implicate these statutory limitations.

<sup>18</sup> *Id.* § 271B.6-400(3)(b).

<sup>19</sup> *Id.* § 271B.6-400(3)(a). The board may base its determination that a distribution does not violate either of these tests on financial statements that have been prepared on the basis of reasonable accounting practices, fair valuation, or other methods that are reasonable under the circumstances. See *id.* § 271B.6-400(4). When the effect of a distribution is measured depends on the type of distribution. The effect of a distribution by purchase, redemption, or other acquisition of the corporation's shares is measured as of the earlier of "(1) [t]he date money or other property is transferred or debt incurred by the corporation, or (2) [t]he date the shareholder ceases to be a shareholder with respect to the acquired shares." *Id.* § 271B.6-400(5). The effect of a distribution of indebtedness is measured as of the date the indebtedness is distributed. For all other types of distributions, the effect is measured as of "(1) [t]he date the distribution is authorized if the payment occurs within one hundred twenty (120) days after the date of authorization, or (2) [t]he date the payment is made if it occurs more than one hundred twenty (120) days after the date of authorization." *Id.*

<sup>20</sup> *Id.* § 271B.8-330(1). The statute references violation of the standard of KRS section 271B.8-300, presumably focusing on the duty to act "on an informed basis," § 271B.8-330(1)(b), which duty is informed by the director's ability to rely upon expert opinions and reports. See *id.* § 271B.8-300(3). Consequently, it is not clear whether this statute is one of strict liability or whether there exists a due diligence defense.

<sup>21</sup> By the use of "knowing," as contrasted with "known" or "should have known," there would seem to be no due diligence obligation upon the recipient shareholder.

<sup>22</sup> § 271B.8-330(2). There is a latent question in this imposition of personal liability. In a case such as that which gave rise to *Wilson*, a trustee stands in the shoes of the corporation and may enforce the director's liability by a direct action. Alternatively, the shareholders, by means of a derivative action, may enforce the director's liability. Appreciating, however, that the common law basis for the statute is to protect the creditor's expectation that corporate assets will be applied to satisfy their claims before shareholders, as residual claimants, see a return on their investment, the issue arises as to how the liability may be enforced by the creditors. In *C&B, Inc. v. WMC Corp.*, No. 2000-CA-001650-MR (Ky. Ct. App. Aug. 3, 2001) (unpublished), the court permitted an action to be brought by a

directors the improper amount of the dividend or for a director to seek contribution from other directors or the recipient shareholders is barred unless it is commenced within two years from the date the effect of the distribution is measured.<sup>23</sup> The trustee in *Wilson* did not file his claim within this two-year statute of limitations but raised the issue of adverse domination in order to effect a toll.<sup>24</sup>

### III. ADVERSE DOMINATION

Equitable tolling, consequent to adverse domination, shares the same theoretical underpinnings as the discovery rule.<sup>25</sup> The discovery rule, which arose in the area of medical malpractice, provides that the statute of limitations does not begin to run until the injury is discovered or from the date it should, in the exercise of ordinary care and diligence, have been discovered.<sup>26</sup> Thus, the discovery rule was a way for the courts to ease the harshness of the statute of limitations when the plaintiff's injury was not immediately discoverable.<sup>27</sup> Under this rule, the statute will not begin to run until the plaintiff knows or should have known of the basis for a claim.<sup>28</sup> More specifically, the plaintiff must know he has been wronged and who committed the wrong.<sup>29</sup>

The doctrine of adverse domination is the discovery rule for the corporate context.<sup>30</sup> Just as the unknowable character of the injury is crucial to the rationale behind the discovery rule, so too is the lack of knowledge of the corporate plaintiff the rationale for the doctrine of adverse domination. As the court noted, "a corporate plaintiff cannot 'discover' injuries to the

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creditor for violation of KRS section 271B.6-400(3) for an unlawful distribution through KRS section 446.070 ("A person injured by the violation of any statute may recover from the offender such damages as he sustained by reason of the violation, although a penalty or forfeiture is imposed for such violation." § 446.070. Confusingly, however, the opinion discussed the principles of piercing the corporate veil, unfortunately commingling the director's statutory liability for having declared an improper distribution with the common law remedy of piercing to access shareholders assets.

<sup>23</sup> § 271B.8-330(3). *See also id.* § 271B.6-400(5) (defining when the effect of a distribution is measured).

<sup>24</sup> *Wilson v. Paine*, 288 S.W.3d 284, 286 (Ky. 2009).

<sup>25</sup> *Id.* at 287. *See also* *Lease Resolution Corp. v. Larney*, 719 N.E.2d 165, 170 (Ill. App. Ct. 1999) ("The adverse domination doctrine is simply a common sense application of the discovery rule to a corporate plaintiff.") (quoting *Resolution Trust Corp. v. Chapman*, 895 F. Supp. 1072, 1078 (C.D. Ill. 1995); *Resolution Trust Corp. v. Farmer*, 865 F. Supp. 1143, 1153 (E.D. Pa. 1994) ("At the heart of both doctrines is the question whether the plaintiff knew or using reasonable diligence should have known of the claim.") (citation omitted); *FDIC v. Smith*, 980 P.2d 141, 147 (Or. 1999) ("[W]e hold that Oregon recognizes the adverse domination doctrine, which is analogous to Oregon's discovery rule in the context of a claim by a corporation against its former directors and officers for their alleged mismanagement of corporate affairs."); *Resolution Trust Corp. v. Grant*, 901 P.2d 807, 813 (Okla. 1995) ("It [the discovery rule], much like the doctrine of adverse domination, arises from the inability of the injured, despite the exercise of due diligence, to know of the injury or its cause.").

<sup>26</sup> *Wilson*, 288 S.W.3d at 286. Needless to say the rule is not limited to claims of medical malpractice. *See, e.g.*, *Queensway Financial Holdings, Ltd. v. Cotton & Allen, P.S.C.*, 237 S.W.3d 141 (Ky. 2007) (applying the discovery rule to a claim of accounting malpractice).

<sup>27</sup> *Wilson*, 288 S.W.3d at 286.

<sup>28</sup> *Id.*

<sup>29</sup> *Id.*

<sup>30</sup> *Id.* at 287.

corporation caused by those who control the corporation.”<sup>31</sup> A corporate plaintiff will not have knowledge of an injury to itself until two things occur: first, the individuals who control the corporation know of the injury; and, second, they are willing to act on that knowledge.<sup>32</sup> Since in most cases the potential defendants’ control of the corporation will make it impossible for the corporation to acquire knowledge of the wrongdoing in order to bring suit, the rule is based on the premise that knowledge of the injury will not be available until the corporation is no longer under the control of the culpable directors, thus resulting in the statute of limitations on a cause of action being tolled while the corporation is controlled by wrongdoers.<sup>33</sup> Tolling the statute of limitations prevents the wrongdoing directors from benefiting from their failure to act in the best interests of the corporation.<sup>34</sup> Directors are not able to act in violation of the applicable duty of care, hide the injury from the corporation<sup>35</sup> and its shareholders while the statute of limitations runs, and then claim that any action brought against them is time-barred.<sup>36</sup>

While the doctrine of adverse domination has been widely applied by federal courts and considered by many states,<sup>37</sup> the applicability of adverse domination in Kentucky statutes

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<sup>31</sup> *Id.* (quoting *Clark v. Milam*, 452 S.E.2d 714, 718 (W. Va. 1994)). See also RESTATEMENT (THIRD) OF AGENCY § 5.04 (2006) (subject to a third-party having dealt with the principal in good faith, a principal is not deemed to have notice of information provided or available to an agent acting adversely to the principal).

<sup>32</sup> *Wilson*, 288 S.W.3d at 287. See also *Resolution Trust Corp. v. Farmer*, 865 F. Supp. 1143, 1155–56 (E.D. Pa. 1994) (“A corporate plaintiff does not have ‘knowledge’ of an injury to itself until those individuals who control it know of the injury and are willing to act on that knowledge. . . . It would be unreasonable not to interpret the concept of knowledge to encompass both cognizance of an injury and the willingness and practical ability to act on that knowledge.”); *Resolution Trust Corp. v. Grant*, 901 P.2d 807, 816 (Okla. 1995) (“This party [someone other than the wrongdoing directors] must have both the ability and the motivation to bring suit.”) (citations omitted); *Lease Resolution Corp. v. Larney*, 719 N.E.2d 165, 173 (Ill. App. Ct. 1999) (“[T]he ability to act on knowledge of the wrong is as important as the knowledge itself.”).

<sup>33</sup> *Wilson*, 288 S.W.3d at 288; see also RESTATEMENT (THIRD) OF AGENCY § 5.04 (2006); *Owsley Co. Deposit Bank v. Burns*, 244 S.W. 755 (Ky. 1922) (“The general rule that knowledge possessed by an agent will be presumed to be possessed by his principal is bottomed upon the presumption that the agent will do his duty toward his principal and impart to the latter the knowledge of the former; but that presumption has no basis when the transaction relates to personal matters of the agent, and where his interests are adverse to those of his principal.”) (citations omitted); *FDIC v. American Surety Co. of N.Y.*, 39 F. Supp. 551, 556 (W.D. Ky. 1941) (“The general rule that knowledge on the part of an agent is imputed to his principal is subject to the well-recognized exception that the agent’s knowledge will not be imputed to his principal where the agent is acting adversely to the interests of his principal. . . . [S]ince he is acting adversely to the interests of his principal he would not communicate the fact of the controversy to his principal but would for that reason alone probably conceal the facts from the principal.”) (citations omitted); Deborah A. DeMott, *When is a Principal Charged with an Agent’s Knowledge?*, 13 DUKE J. COMPARATIVE INT’L L. 291 (2003).

<sup>34</sup> See KY. REV. STAT. ANN. § 271B.8-300(1)(c) (West 2010) (obligating each director to discharge his duties as a director “[i]n a manner he honestly believes to be in the best interests of the corporation”).

<sup>35</sup> See CICERO, DE OFFICIIS 325, 327 (Walter Miller trans., The Macmillan Co. 1921) (“The fact is that merely holding one’s peace about a thing does not constitute concealment, but concealment consists in trying for your own profit to keep others from finding out something that you know, when it is for their interest to know it.”).

<sup>36</sup> *Id.*; see also § 271B.8-300(1)(a).

<sup>37</sup> *Wilson*, 288 S.W.3d at 287 n.1. The court refers to *Resolution Trust Corp. v. Grant*, 901 P.2d 807, 812 n.16 (Okla. 1995), as a reference for an “exhaustive list of states that have considered and applied adverse domination,” though not necessarily under this name. *Wilson*, 288 S.W.3d at 287 n.1. These states include: Alabama, California, Delaware, Illinois, Indiana, Kansas, New York, Maine, Mississippi, Texas, and Utah. *Grant*, 901 P.2d at 812 n.16.

was an issue of first impression for the *Wilson* court.<sup>38</sup> As such, the court still had two major issues to address: (1) the degree of domination of the board that is required in order for the corporation to claim protection by adverse domination; and (2) the degree of culpability of the directors.<sup>39</sup>

Tackling first the issue of the degree of domination, the court noted that a majority of jurisdictions that apply the doctrine follow the “disinterested majority test,”<sup>40</sup> pursuant to which the plaintiff must show that a majority of the directors were culpable during the time period the plaintiff wishes to toll the statute of limitations.<sup>41</sup> A justification for the disinterested majority approach is that it takes only a majority of wrongdoing directors to control the flow of information and thus prevent disclosure of the incriminating information.<sup>42</sup> Additionally, it takes a majority of the directors to bring suit on behalf of the corporation.<sup>43</sup> The court pointed out that it is unreasonable to expect that the wrongdoing directors will bring suit against themselves and so, “as a practical matter, only when a majority of the board no longer consists of wrongdoers can an action be initiated.”<sup>44</sup> Under the disinterested majority test, while the plaintiff has the initial burden of pleading and presenting facts that a majority of the board comprised culpable directors during the period tolling is sought, the defendants have

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<sup>38</sup> *Wilson*, 288 S.W.3d at 287. But see *Nichols v. Deloitte & Touche LLP (In re Ky. Cent. Life Ins. Co.)*, No. 1999-CA-000659-MR, 2001 WL 726781 (Ky. Ct. App. June 29, 2001) (depublished), where the issue of adverse domination was considered by the Kentucky Court of Appeals. Ultimately, though, the court held that it was not necessary to adopt the doctrine since it found that the statute of limitations at issue had not run due to the rule regarding accrual of a cause of action for professional negligence. See also *Harrison v. Valentini*, 184 S.W.3d 521, 525 (Ky. 2005), where the Supreme Court of Kentucky adopted the “continuous course of treatment” doctrine which is analogous to the adverse domination doctrine in that it tolls the statute of limitations as long as the patient is under the continuing care of the physician for the injury caused by the physician’s negligent act or omission; under both doctrines the statute of limitations is tolled while the plaintiff is under the control of the wrongdoer.

<sup>39</sup> *Wilson*, 288 S.W.3d at 288.

<sup>40</sup> *Id.* The court noted, by way of example, that the following jurisdictions follow the disinterested majority test: the Fifth Circuit, the Southern District of Texas, the District of Maryland, and the District of Puerto Rico. The court noted that other jurisdictions have applied the more demanding “complete domination” test. Under this test, the plaintiff must show that all of the directors were culpable. This standard places the entire burden on the plaintiff who must negate the possibility that an informed shareholder or director could have persuaded the corporation to bring suit. Jurisdictions using this test include the Tenth Circuit, Ninth Circuit, and District of Kansas. *Id.* at 289.

<sup>41</sup> *Id.* at 288.

<sup>42</sup> *Id.* Note that “adverse domination does not depend on a showing of affirmative efforts by directors to conceal information” but rather it is the fact that the directors have control over the information that makes adverse domination necessary. Dore, *supra* note 10, at 749.

<sup>43</sup> *Wilson*, 288 S.W.3d at 288. Although the Kentucky corporate act is not express on this point, in a decision to initiate a suit in the name of the corporation against a director for malfeasance, the director’s interest in avoiding suit and the corporation’s interest in a recovery are manifestly adverse to one another.

<sup>44</sup> *Id.* This assertion does not account for the fact that the shareholders could bring a derivative action on behalf of the corporation. See Michael E. Baughman, *Defining the Boundaries of the Adverse Domination Doctrine: Is There Any Repose For Corporate Directors?*, 143 U. PA. L. REV. 1065 (1995) (noting the difficulty in successfully bringing a derivative action and explaining that the minority directors, who are not engaged in wrongdoing, could give the necessary information to shareholders to bring a derivative action and encourage them to do so). This, however, could only occur if the minority had knowledge of the cause of action against the wrongdoing directors. See also Dore, *supra* note 11, at 744-45 (noting why a shareholder derivative suit is a poor substitute for corporate litigation brought by a disinterested board of directors). Even if a shareholder does have sufficient information to bring a derivative action, the shareholder is not under any obligation to do so. Thus, a derivative action will only be pursued where the shareholders have adequate incentives to bring such claims.

the ultimate burden; they must show that there were a sufficient number of directors who had the knowledge, ability, and motivation to bring suit during the period of corporate control at issue in order to rebut the presumption of the applicability of the doctrine.<sup>45</sup>

The Kentucky Supreme Court concluded that the disinterested majority test is the most practical and equitable approach.<sup>46</sup> Because the directors are the ones in control of the corporate records, they are in the position to know both the status of the corporation's finances and the impact thereon of a distribution.<sup>47</sup> Thus, it is fair to place the burden of rebutting a presumption of control on the directors, rather than placing a burden on the plaintiff to show that no informed shareholder or director could have compelled the board to bring suit. The court found that this is "consistent with the general rule that the party raising the statute of limitations bears the burden of presenting evidence to establish the time bar."<sup>48</sup> According to the court, this test also "comports with both common sense and human nature,"<sup>49</sup> because it is reasonable to assume that the wrongdoing directors will act in their own interests, conceal information, and fail to pursue the corporation's claims, making it almost impossible for the corporation to discover and pursue its rights while the wrongdoers are in control.<sup>50</sup> Therefore, in the interest of fairness, the party who is most likely to be in possession of the information, which is the board of directors, should carry "the burden to rebut a presumption that accrual of the claim does not occur until a disinterested majority has replaced the controlling culpable directors."<sup>51</sup>

After determining that only a majority of directors need to be culpable in order for the corporation to benefit from the adverse domination doctrine, the court next turned to the issue of the required level of culpability of these directors.<sup>52</sup> The court noted that three theories have emerged.<sup>53</sup> The first theory is that simple negligent conduct is sufficient to apply the doctrine.<sup>54</sup> The second theory is that something more than negligent conduct is necessary,

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<sup>45</sup> *Wilson*, 288 S.W.3d at 289. This shift of the burden to the directors parallels the rule that, in order to satisfy the "fair to the corporation" test of KRS section 271B.6-310(1)(c), the burden rests upon the director subject to the conflict of interest to demonstrate fairness. KY. REV. STAT. ANN. § 271B.6-310(1)(c) (West 2010). See also MODEL BUS. CORP. ACT § 8.61 cmt. 2 (2002) ("Under section 8.61(b)(3) the interested director has the burden of establishing that the transaction was fair."); PRIN. OF CORP. GOVERNANCE § 505(c) (1994); Kahn v. Tremont Corp., 694 A.2d 422 (Del. 1997); Kahn v. Lynch Commc'n Sys., 638 A.2d 1110 (Del. 1994).

<sup>46</sup> *Wilson*, 288 S.W.3d at 289.

<sup>47</sup> Although not cited by the court, directors are obligated to act "on an informed basis." See KY. REV. STAT. ANN. § 271B.300(1)(b). While certain states have adopted a standard described as "empty head but warm heart," (see VA. CODE ANN. § 13.1-690(A) (2010)), under Kentucky law a director has a duty of inquiry. See also KY. REV. STAT. ANN. § 271B.8-300(2).

<sup>48</sup> *Wilson*, 288 S.W.3d at 289.

<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

<sup>51</sup> *Id.* at 289-90. In the absence of a discovery rule initiating the statute of limitations, the two year period of KRS section 271B.8-330(3) would function as an unconstitutional statute of repose. See, e.g., Perkins v. Ne. Log Homes, 808 S.W.2d 809 (Ky. 1991).

<sup>52</sup> *Wilson*, 288 S.W.3d at 289-90.

<sup>53</sup> *Id.* at 290.

<sup>54</sup> *Id.*

although these jurisdictions have not defined what more is required.<sup>55</sup> Finally, at least one court has held that the level of culpability is irrelevant since the reason for tolling the statute of limitations is that the plaintiffs cannot discover the cause of action, regardless of whether that action was based on negligence or intentional wrongdoing.<sup>56</sup>

While acknowledging that the simple negligence theory would seem to be the logical answer since adverse domination is the corollary to the discovery rule and the discovery rule arose from medical negligence claims,<sup>57</sup> the *Wilson* court ultimately agreed with the jurisdictions that require something more than mere negligence, noting that a negligence standard would make the doctrine of adverse domination too widespread.<sup>58</sup> Following a pure negligence standard would practically eliminate the statute of limitations since even when only one director actively injured the corporation the other directors would be negligent for not ab initio protecting against this injury or not investigating and remedying a completed injury.<sup>59</sup> Furthermore, a negligence standard does not comport with the underlying premise of the doctrine, namely that the directors who engage in the wrongdoing will make it difficult for others to discover the misconduct.<sup>60</sup> As the court noted, “[t]he danger of fraudulent concealment by a culpable majority of a corporation’s board seems small indeed when the culpable directors’ behavior consists only of negligence.”<sup>61</sup> Therefore, the court found that a corporate plaintiff cannot toll the statute of limitations under adverse domination unless it shows that a majority of its directors engaged in some act of intentional wrongdoing.<sup>62</sup>

Here, it may be argued, the court went too far. The requirement of the corporate plaintiff to show *intentional* wrongdoing in order to toll the statute of limitations is a standard of wrongdoing higher than that required to hold a director liable for monetary damages under KRS section 271B.8-300(5)(b) and substantially higher than what is required to hold a director personally liable for assenting to the wrongful distribution in the first place. In order to maintain an action for monetary damages against a director, the plaintiff must show that the director has breached his/her fiduciary duty to the corporation and that such breach constituted “willful misconduct or wanton or reckless disregard for the best interests of the

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<sup>55</sup> *Id.*

<sup>56</sup> *Id.*

<sup>57</sup> *Id.*

<sup>58</sup> *Id.*

<sup>59</sup> *Id.* (citing *FDIC v. Dawson*, 4 F.3d 1303, 1312 (5th Cir. 1993)).

<sup>60</sup> *Id.*

<sup>61</sup> *Id.* (alteration in original) (citing *Dawson*, 4 F.3d at 1312-13). It should be noted that the statutory scheme is not one of strict liability, i.e., that a director who approves a distribution is liable to the corporation to the extent the distribution exceeds the permissible threshold. Rather, that liability is contingent upon a finding that the director, in consenting to the distribution, “did not perform his duties in compliance with KRS 271B.8-300,” and it is provided as well that a director will have “all of the defenses ordinarily available to a director.” See KY. REV. STAT. ANN. § 271B.8-330(1) (West 2010). The *Model Business Corporation Act* clarifies that “all of the defenses” includes the highly-deferential business judgment rule defense. See MODEL BUS. CORP. ACT § 8.33 (2002) official comment.

<sup>62</sup> *Wilson*, 288 S.W.3d at 290. The court notes that “intentional wrongdoing of some kind, which would include fraud, is required,” implying that fraud, while sufficient to constitute “intentional wrongdoing,” is not necessary in order to toll the statute of limitations under adverse domination.



corporation and its shareholders.”<sup>63</sup> Since the director can be liable for monetary damages for his/her gross negligence (*i.e.*, a wanton or reckless action) as opposed to intentional action alone, the standard for tolling the statute of limitations under adverse domination is higher and the burden on the plaintiff more demanding.

Likewise, the standard of tolling the statute of limitations for an improper distribution is higher than that required to hold the director personally liable for voting or assenting to the improper distribution when the action is brought within the statute of limitations. The director will be personally liable for a wrongful distribution if he assents to the wrongful distribution in violation of his duties under KRS section 271B.8-300.<sup>64</sup> This section provides, *inter alia*, that a director must discharge his duties (1) in good faith, (2) on an informed basis, and (3) in a manner he honestly believes to be in the best interest of the corporation.<sup>65</sup> A director discharges his duty to act on an informed basis if he inquires into the issue “with the care an ordinarily prudent person in a like position would exercise under similar circumstances.”<sup>66</sup> The subjective “honestly believes” standard in subsection three and the objective standard in section one for making informed decisions are significantly lower standards of wrongdoing than an act of intentional wrongdoing.<sup>67</sup> Thus, the culpable conduct of the directors must be significantly more severe to toll the statute of limitations for improper distributions than to hold the directors personally liable for improper distributions within the statute of limitations or to award monetary damages for breach of their fiduciary duties.<sup>68</sup>

The requirement to show intentional wrongdoing is a higher standard of culpability than gross negligence. In a Fifth Circuit case applying Texas law, the court was faced with the issue of whether gross negligence was sufficiently “more than negligent” in order to affect a

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<sup>63</sup> KY. REV. STAT. ANN. § 71B.8-300(5)(b) (emphasis added).

<sup>64</sup> *Id.* § 271B.8-330(1).

<sup>65</sup> *Id.* § 271B.8-300(1). MODEL BUSINESS CORPORATION ACT section 8.30(a) (2002) provides that directors have a duty to act “in good faith and in a manner the director reasonably believes to be in the best interests of the corporation.” While not directly listing the duty to act on an informed basis as a duty of the directors, it is implied in the next subsection, which sets out the duty of care. This subsection provides that a director, “when becoming informed in connection with their decision-making function or devoting attention to their oversight function, shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances.” MODEL BUS. CORP. ACT § 8.30(b) (2002).

<sup>66</sup> KY. REV. STAT. ANN. § 271B.8-300(2).

<sup>67</sup> *Id.* §§ 271B.8-330, 271B.8-300(1).

<sup>68</sup> Requiring a demonstration from the plaintiff of a breach of duty, as contrasted with only a *prima facie* demonstration that the distribution violated the statutory thresholds, presents significant issues. A statute of limitations, as an affirmative defense, would typically bar consideration of both the merits of the complaint and the substantive defenses to liability such as, in this instance, the thresholds of KRS section 271B.8-300(5)(b). If the *Wilson* court is requiring a demonstration by the plaintiff of the director’s violation of the substantive duty and that the conduct is culpable as well, it in effect is requiring proof on the merits before the tolling of the statute of limitations may be had. Surely that is not the intended protocol. See *Dore*, *supra* note 10, at 567-69. *Dore* notes that adverse domination tolling standards inevitably postpone resolution of limitations issues until trial and thus raise several serious policy concerns: (1) it substantially defeats any prospects of repose for potential defendants; (2) the statute of limitations defense will no longer bar litigation of stale claims in any meaningful way since the outcome of the limitations defense depends on answers to fact questions that are typically decided along with the merits of plaintiff’s claims; (3) it makes it more difficult for directors to obtain insurance against potential corporate claims; and (4) it defeats the goals of statutes of limitations, which is to promote an efficient judicial system by relieving courts of the burden of litigating claims where the fact-finding task is likely to be impaired by stale evidence. *Id.*

toll of the statute of limitations pursuant to adverse domination.<sup>69</sup> Similar to what Kentucky required in *Wilson*, Texas law required the relevant conduct of the wrongdoing directors to be more than “simply negligent”<sup>70</sup> by demanding “active participation in wrongdoing or fraud.”<sup>71</sup> While acknowledging that gross negligence and simple negligence are separate standards, the court found the difference to be one of degree, not kind.<sup>72</sup> It defined gross negligence as “that entire want of care which would raise the belief that the act or omission complained of was the result of a conscious indifference to the right or welfare of the person or persons to be affected by it.”<sup>73</sup> Though gross negligence is certainly “more” than simple negligence, it is not “sufficiently ‘more’ to encompass the requirement that the directors have been active participants in wrongdoing or fraud.”<sup>74</sup> The same result would likely be reached by Kentucky courts, which have held that “a finding of gross negligence clearly requires more than a failure to exercise ordinary care. It requires a finding of a failure to exercise even slight care such as to demonstrate a wanton or reckless disregard for the rights of others.”<sup>75</sup> Like the Fifth Circuit applying Texas law, Kentucky courts could find that while gross negligence is certainly more than negligence, gross negligence does not rise to the level of intentional conduct sufficient to toll the statute of limitations through the adverse domination doctrine.

Ultimately, while the express adoption of the doctrine of adverse domination protects corporate creditors, the *Wilson* court’s requirement of such a high demonstration of culpability by a majority of the directors will likely limit its real impact.

#### IV. APPLYING THE DOCTRINE TO TOLL THE STATUTE OF LIMITATIONS FOR CONTRIBUTIONS

*Wilson* discussed the effect of the doctrine of adverse domination on the two-year statute of limitations for holding a director personally liable to the corporation for assenting to an improper distribution. That same two-year statute of limitations also applies to a proceeding by a director for contribution from other culpable directors and from shareholders who accepted the distribution knowing it was wrongfully made.<sup>76</sup> Whether the doctrine would apply to toll the statute of limitations for a director to seek contribution seems unlikely.

The basic premise of the doctrine of adverse domination is that the corporation cannot discover the injury it has suffered, and hence has no knowledge of its cause of action while under the control of a majority of wrongdoing directors. In the situation where a culpable

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<sup>69</sup> *Resolution Trust Corp. v. Acton*, 49 F.3d 1086 (5th Cir. 1995).

<sup>70</sup> *Id.* at 1090.

<sup>71</sup> *Id.*

<sup>72</sup> *Id.* at 1091.

<sup>73</sup> *Id.* at 1090 (quoting *Burk Royalty Co. v. Walls*, 616 S.W.2d 911, 917 (Tex. 1981)).

<sup>74</sup> *Id.* at 1091.

<sup>75</sup> *Peoples Bank of N. Ky., Inc. v. Crowe Chizek & Co.*, 277 S.W.3d 255, 268 (Ky. Ct. App. 2008) (citing *Phelps v. Louisville Water Co.*, 103 S.W.3d 46, 51-52 (Ky. 2003)).

<sup>76</sup> See KY. REV. STAT. ANN. § 271B.8-330(3) (West 2010). (“A proceeding *under this section* shall be barred . . . .” (emphasis added)).

director is seeking contribution, the same is not true: at the time the director votes for or assents to the wrongful distribution, he has (or at minimum should have) knowledge of his right of contribution. There is a question, however, whether this section creates an unconstitutional statute of repose. Subsection three provides that a proceeding “under this section,” which includes a proceeding for contribution, will be barred “unless it is commenced within two (2) years *after the date on which the effect of the distribution was measured.*”<sup>77</sup> Subsection two provides that a director “held liable” for a wrongful distribution is entitled to contribution. If the director is not held liable for the wrongful distribution until more than two years after the date the distribution is measured (due to the corporate plaintiff’s successful assertion of adverse domination), then it would appear that the director’s cause of action was “taken away by legislation which shortens the period of limitation to a time that has already run,” which has been held unconstitutional in Kentucky.<sup>78</sup>

Regardless of whether the wording of KRS section 271B.8-330 creates a statute of repose for directors seeking contribution, adverse domination should not be used to effect a toll of the statute of limitations for the culpable directors. Adverse domination is a doctrine used to protect innocent parties who do not have knowledge of their injury. It should not be available to aid a director who knows he would be entitled to contribution if held liable while he continues to hide the fact of the wrongful distribution to avoid liability. When the injury is discovered by the corporation, it would not seem equitable to then allow the director to use adverse domination to collect contributions from others.<sup>79</sup>

Part II of this Article will review how the doctrine of adverse domination as adopted in *Wilson v. Paine* may be applied in the context of business organization forms other than the corporation.

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<sup>77</sup> *Id.* § 271B.8-330(3).

<sup>78</sup> *Perkins v. Ne. Log Homes*, 808 S.W.2d 809, 814 (Ky. 1991) (citing *Saylor v. Hall*, 497 S.W.2d 218, 225 (Ky. 1973)). This issue will not arise in states that have adopted the MODEL BUSINESS CORPORATION ACT’S provision regarding liability for unlawful distributions. Section 8.33(c) provides a similar two year statute of limitation for holding a director liable for a wrongful distribution but a one year statute of limitation for a proceeding by a director for contribution. MODEL BUS. CORP. ACT § 8.33(c) (2002). This one year statute of limitations begins to run after the director’s liability has been fully adjudicated. Therefore, the situation would never arise where the statute has already run before the director is held liable because the section provides two different statutes of limitations that begin to run at the occurrence of different events. Indeed, the official comment to this section explains that “this one-year period specified in clause (2) may end within *or extend beyond* the two-year period specified in clause (1).” *Id.*

<sup>79</sup> See *Dore*, *supra* note 11, at 733-34, noting that “[i]n fraudulent concealment cases, courts withhold repose not only because of plaintiff’s discovery problems, but also because *defendant caused those problems by intentionally concealing her wrongdoing after the fact . . .* thereby reducing her legitimate expectations of repose.” (emphasis added). However, since directors can only hold shareholders liable for contribution if they knew the distribution was wrongful, we would be dealing with two wrongful parties. In this scenario, the equity argument may not be applicable.

# Adverse Domination—Tolling the Statute of Limitations in Kentucky Business Organizations (Part II)

Mary C. Garris<sup>80</sup>

## I. THE IMPACT OF *WILSON V. PAINE* BEYOND THE BUSINESS CORPORATION

WHILE the court in *Wilson* made the specific holding that the doctrine of adverse domination may be applied to toll the statute of limitations under Kentucky Revised Statute (KRS) section 271B.8-330(3) for distributions that violated KRS section 271B.6-400,<sup>81</sup> this decision is likely to have an impact on all Kentucky business organizations. Adverse domination is based on the idea of control/power; those in control of the company have engaged in wrongdoing and, because of their control, the filing of a suit on behalf of the organization is doubtful since it is more than likely that they will not file suit against themselves or initiate any action contrary to their own interests.<sup>82</sup> In the context of wrongful distributions, this control/power has three aspects: (1) the statutory or contractual power to make distributions; (2) the power to control the flow of information so no one able to bring suit on the venture's behalf can discover that the distribution made is wrongful; and (3) the power to initiate or, more importantly, refrain from initiating, a suit on the venture's behalf. These aspects of control are not unique to corporations. Many other forms of Kentucky business entities place, or permit to be placed, control of the organization in the hands of one person or a group of persons. Thus, depending on who has the control/power necessary to make distributions and the ability of the wrongdoers to conceal their malfeasance, the doctrine of adverse domination could be applied to toll the statute of limitations for wrongful distributions made by business entities other than corporations.<sup>83</sup>

### A. Cooperatives and Associations

Cooperatives and associations are forms of Kentucky business entities where adverse domination would likely be applied to effect a toll on the relevant statutes of limitations since cooperatives and associations are essentially corporations incorporated to carry out a special

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<sup>81</sup> *Wilson v. Paine*, 288 S.W.3d 284, 290-91 (Ky. 2009).

<sup>82</sup> *See id.* at 288-89.

<sup>83</sup> Because the Kentucky business trust act is silent as to both distributions and limitations thereon, the business trust is intentionally ignored in the following discussion.

function.<sup>84</sup> There are several types of cooperatives and associations: agricultural cooperative associations and cooperative livestock associations governed by KRS chapter 272,<sup>85</sup> and rural electric cooperatives and rural telephone cooperatives governed by KRS chapter 279.<sup>86</sup> Each type of cooperative can choose to be either for-profit or nonprofit, and the respective act will govern to the extent not otherwise set forth in the cooperative acts.<sup>87</sup> None of the cooperative association acts contain statutes regarding distributions, and thus, if the cooperative is for profit, KRS sections 271B.6-400 and 271B.8-330 will apply to determine when a distribution can be made and the consequences of making wrongful distributions. If the cooperative is nonprofit, KRS section 273.237 will apply, prohibiting the nonprofit from making any distribution.

Similar to corporations, each type of cooperative or association delegates the managerial power to a body separate from the members/shareholders. Agricultural cooperative associations, cooperative livestock associations, and electric cooperatives must have a board of directors that acts as the governing body.<sup>88</sup> Telephone cooperatives are managed by a board of trustees.<sup>89</sup> In the situation where the board, whether it be of directors or of trustees, retains the power to make distributions, adverse domination should apply for the same reason discussed by the court in *Wilson* so long as the disinterested majority and intentional wrongdoing tests are met.<sup>90</sup> Namely, the board could authorize an improper distribution and conceal the fact of their wrongdoing so that more than two years passes before the wrongdoing is discovered.

#### *B. Limited Liability Companies*

Kentucky's Limited Liability Company Act provides that no distributions can be made if it would cause the limited liability company (LLC) to be unable to pay its debts as they become due or if it would cause the LLC's assets to be less than its total liabilities.<sup>91</sup> The LLC Act

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<sup>84</sup> See, e.g., KY. REV. STAT. ANN. § 272.101 (West 2010).

<sup>85</sup> *Id.* § 272.000.

<sup>86</sup> *Id.* § 279.000.

<sup>87</sup> See *id.* §§ 272.1001, 279.310.

<sup>88</sup> *Id.* § 272.171(1) ("The affairs of the association shall be managed by a board of not less than five (5) directors . . ."); *id.* § 272.440(1) ("The affairs of the association shall be managed by a board of not less than five (5) directors . . ."); *id.* § 279.080(1) ("Each corporation formed under this chapter shall have a board of directors of not less than five (5) members, which shall be the governing body of the corporation . . .").

<sup>89</sup> *Id.* § 279.380 ("The business of a cooperative shall be managed by a board of not less than five (5) trustees . . .").

<sup>90</sup> Note that the possibility of tolling the statute of limitations will be shorter for electric cooperatives than for telephone cooperatives and corporations in general because the directors of an electric cooperative are limited to a term of four years. See *id.* § 279.080(1).

<sup>91</sup> *Id.* § 275.225. Note, however, that while under the Corporation Act a dividend may be improper by the terms of the articles of incorporation, subjecting the directors to liability under KRS section 271B.8-330, until 2010 the LLC Act did not similarly reference the LLC's operating agreement when discussing what distributions may not be made. But see *id.* § 275.230(1), (2)(b) (discussing distributions that violate the operating agreement). In 2010 the LLC Act was amended to include in the category of impermissible distributions those in violation of the operating agreement. See *id.* § 275.225(1)(c).

goes on to provide that the member or manager who votes for or assents to an improper distribution in breach of the standard of care will be personally liable to the LLC for the amount that exceeds a distribution that could have been made.<sup>92</sup> This statute also provides for contribution from each member or manager who could also be liable for voting for or assenting to the unlawful distribution and from each member who received an unlawful distribution.<sup>93</sup> One distinction between the LLC and the Corporation Act is that in order for a director to be entitled to contribution from a shareholder who received a distribution, the shareholder had to have accepted the distribution knowing that it was made in violation of KRS section 271B.6-400 or the articles of incorporation.<sup>94</sup> Under the LLC Act, a member or manager liable for approving an improper distribution can seek contribution from each member who received the unlawful distribution regardless of whether the member knew that the distribution violated KRS section 275.225.<sup>95</sup>

Despite small differences between the LLC and corporate statutes, they essentially embody the same right to make a distribution and the same liability for doing so unlawfully. Arguably, adverse domination should apply to toll the statute of limitations here as well. However, the question of whether this doctrine will apply is dependent upon the particular LLC's internal decision-making structure; whether it is manager-managed or member-managed.<sup>96</sup> Of course, if either type of LLC has a board of directors with the authority to declare distributions, this would be identical to the situation of corporations and the doctrine should be applicable, so long as the disinterested majority and intentional wrongdoing tests are met.

The manager-managed situation will often be similar in its allocation of decision authority (including the making of distributions) to that between the director and shareholders of a corporation.<sup>97</sup> In both situations, the management function is turned over to a person or group of persons who may be separate and distinct from the owners of the entity. Therefore, it seems likely that a *Wilson* situation could occur where a majority of the managers of an LLC engage in some act of intentional wrongdoing and more than two years pass before the members learn of the wrongdoing. Due to the managers' control of the information and their probable unwillingness to sue themselves, the company cannot bring suit against the

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<sup>92</sup> See *id.* §§ 275.170(1), 275.230(1).

<sup>93</sup> Even though the primary actor's liability to make the LLC whole for the benefit of creditors is not modifiable in the operating agreement, there appears to be no policy basis for not permitting an operating agreement to waive the right to such contribution, to impose contribution exposure only upon members who knowingly receive an improper distribution, or to otherwise modify the second-tier liability.

<sup>94</sup> § 271B.330(2)(b).

<sup>95</sup> *Id.* § 275.230(2)(b).

<sup>96</sup> See *id.* § 275.025(1)(d) (election in articles of organization of manager-managed or member-managed status).

<sup>97</sup> See Thomas E. Rutledge, *The Lost Distinction Between Agency and Decisional Authority: Unfortunate Consequences of the Member-Managed Versus Manager-Managed Distinction in the Limited Liability Company*, 93 KY. L.J. 737, 741-42 (2005) ("As there is no requirement that the managers be members, the manager-managed LLC affords the opportunity for the complete separation of ownership and agency authority. This model is sometimes referred to as the 'corporate model' because ownership (member or shareholder) is entirely separated from agency authority (manager or officer)."). However, it should be noted that it is possible for the operating agreement to provide that the members of a manager-managed LLC have the power to make distributions. See § 275.003(1). In those cases, the doctrine would most likely not apply for the reasons provided in the next section on member-managed LLCs.

managers within the statute of limitations. All the equitable reasons for applying adverse domination seem to be equally applicable in the case of a manager-managed LLC.

When the LLC is member-managed, however, at first glance it seems that adverse domination may not apply. A basic premise behind the doctrine is that no suit can be brought within the statute of limitations because there is no knowledge of the injury as a result of the fraudulent concealment by those in control. In the member-managed situation, all of the members are theoretically in control and thus have access to the information.<sup>98</sup> So it appears that the main rationale of adverse domination, lack of knowledge, is not an issue in this situation and thus the doctrine should not apply.

The LLC statute regarding delegation of powers, however, may change this conclusion. KRS section 275.165(3) provides that a member can delegate his or her power to manage or control the business and affairs of the LLC to one or more other persons.<sup>99</sup> Therefore, the situation could arise in a member-managed LLC where the members have delegated to either a subset of the members or to a third party the authority to declare distributions. That group or person may wrongfully make a distribution of which the members are not aware. Since the members have a right but not a duty to inspect the LLC's records,<sup>100</sup> it is possible that the members would not become aware of the wrongful distribution within the statute of limitations. It is also more than likely that the person delegated to make distributions will fraudulently conceal evidence that an unlawful distribution has been made. For example, this person's compensation may be linked to distributable cash flow, providing an incentive to inflate or even invent available funds. In addition, while the LLC Act provides that notice to any member of any matter relating to the business or affairs of the LLC is deemed to be notice to or knowledge of the LLC, there is an exception to this general rule in the case of a fraud on the LLC by or with the consent of the member who received such notice.<sup>101</sup> If the doctrine of adverse domination was applied to this situation, the LLC plaintiff would still have to meet the test of a disinterested majority, and thus, would have the burden of proving that the delegated person concealed all records of the wrongdoing so that there was no one in a position to bring suit on the LLC's behalf.

### C. Limited Partnerships

The doctrine of adverse domination may also be applicable to limited partnerships. Kentucky has three statutory structures for limited partnerships, being adoptions of the uniform limited partnership acts of 1916, 1985, and 2001.<sup>102</sup> Each will be considered in turn.

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<sup>98</sup> See §§ 275.165(1), 275.175(1); see also Rutledge, *supra* note 18, at 747 ("In most statutory formulations, the member-managed LLC is directly managed by the members, vesting in them the authority to direct the day-to-day and extraordinary activities of the business.")

<sup>99</sup> See Rutledge, *supra* note 18, at 745 (noting that a member-managed LLC may, at any time, designate a particular agent with actual authority irrespective of whether the agent is a member).

<sup>100</sup> See § 275.185(2).

<sup>101</sup> *Id.* § 275.145(1).

<sup>102</sup> This statement ignores KRS sections 362.010 to 362.130 as repealed by 1970 Ky. Acts ch. 97, § 31. The 1916 Act was adopted in 1970 (1970 Ky. Acts 470) (ch. 97)) and prospectively repealed in 1988. The 1985 Act was adopted in 1988 (1988 Ky. Acts 755-74) (ch. 284)) and prospectively repealed in 2006. The 2001 Act was adopted in 2006 (2006 Ky. Acts 303-451) (ch. 149)). See also Dean Allan W. Vestal & Thomas E. Rutledge, *The Uniform Limited Partnership Act (2001) Comes to Kentucky: An Owner's Manual*, 34 N. KY. L. REV. 411, 414-16 (2007).

The Kentucky Uniform Limited Partnership Act (2006) prohibits a limited partnership from making a distribution if it violates the partnership agreement or if, after the distribution, the limited partnership would not be able to pay its debts or if its total assets would be less than its total liabilities.<sup>103</sup> A general partner who consents to a prohibited distribution is personally liable to the limited partnership if such consent was given in violation of the general partner's fiduciary duties owed to the limited partnership and other partners.<sup>104</sup> A partner or transferee that knew the distribution was wrongful is also personally liable to the limited partnership.<sup>105</sup> The general partner has a right of contribution from any other general partner who consented to the wrongful distribution, as well as any partner or transferee who received a distribution with knowledge that it violated KRS section 362.2-508.<sup>106</sup> A proceeding under this statute is barred unless it is commenced within two years of the distribution.<sup>107</sup>

Each general partner has equal rights in the management of a limited partnership and, with the exception of a few extraordinary events, any matter relating to the activities of the limited partnership may be decided exclusively by the general partner or, if there is more than one, a majority of the general partners.<sup>108</sup> With the general partners in charge of the limited partnership's affairs, it is not hard to imagine a *Wilson* situation where the limited partners are not aware of a general partner's wrongful distribution until after the two-year statute of limitations has run. Thus, it would be appropriate to apply the doctrine of adverse domination. Like the LLC situation, however, the limited partnership situation will require a more fact-based determination since it is possible for the limited partners to participate in the management of the limited partnership.<sup>109</sup> The ability of limited partners to participate in management means that the limited partnership plaintiff may have a harder time proving that there was no one with the knowledge and ability to initiate a suit on the limited partnership's behalf.

The Kentucky Revised Uniform Limited Partnership Act (1988) likewise provides a statutory limitation on distributions. Similar to the other distribution statutes discussed, this Act prohibits partners from receiving a distribution from the limited partnership if the liabilities

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<sup>103</sup> 362.2-508(1), (2).

<sup>104</sup> *Id.* § 362.2-509(1). The duty of care of a general partner in a limited partnership governed by the KENTUCKY UNIFORM LIMITED PARTNERSHIP ACT (2006) is set forth in KRS section 362.2-408(3). Subject to KRS section 362.2-110(2)(f), the duty of care may be modified in the partnership agreement.

<sup>105</sup> § 362.2-509(2). This differs from the parallel corporate and limited liability company statutes which provide that shareholders/members are liable to the director/manager/member for contribution but are not themselves held personally liable to the entity. Here, the partner or transferee can be held personally liable to the limited partnership and liable to the general partner for contribution. (However, this does not allow both the partnership and the general partner to recover the distribution; the limited partner or transferee is liable only up to the amount received that exceeded what could have properly been received.) *See id.* § 362.2-509(3).

<sup>106</sup> *Id.* § 362.2-509(3).

<sup>107</sup> *Id.* § 362.2-509(4).

<sup>108</sup> *Id.* § 362.2-406(1). This default rule is subject to modification in the partnership agreement. *See id.* § 362.2-110(1).

<sup>109</sup> *See id.* § 362.2-110(1); *see also id.* § 362.2-303(1) (permitting limited partners to participate in management without the loss of limited liability).



of the partnership would then exceed the fair value of the partnership assets.<sup>110</sup> There are two circumstances where the partner would have to return a distribution made to the partner in the form of a return of the partner's contribution to the partnership.<sup>111</sup> First, the partner is liable to the limited partnership for one year to the extent required to satisfy creditor claims, even if there is no violation of the partnership agreement or KRS section 362.471.<sup>112</sup> Second, if the partner received the distribution in violation of the partnership agreement or KRS section 362.471, the partner is liable to the limited partnership for six years for the amount of the distribution wrongfully received.<sup>113</sup> The general partner will be held liable for the wrongful distribution pursuant to KRS section 362.447(2), which incorporates the liabilities of a partner in a non-limited liability partnership. Therefore, the general partner should be held liable for a wrongful distribution as a breach of his duty to the partnership.

Despite these differences with the 2006 Kentucky limited partnership act, the analysis is the same. A *Wilson* situation could occur where a majority of the general partners intentionally make a wrongful distribution and the applicable statute of limitations runs before the wrongdoing is discovered, assuming the general partners had retained the power to make distributions and the control over the flow of the information received by the limited partners.<sup>114</sup> Conversely, if the limited partners participate in management, or they are given the power to make distributions, it will be harder to prove that they did not have knowledge of the wrongdoing in order to bring suit on behalf of the limited partnership.

The still older Kentucky limited partnership act, effective in 1970 and replaced in 1988,<sup>115</sup> also contains two distribution statutes. Pursuant to KRS section 362.560, a limited partner may receive a distribution of his contribution if all of the liabilities of the partnership have been paid or if there is enough partnership property to sufficiently cover the liabilities.<sup>116</sup> All of the partners, both general and limited, must consent to such a distribution.<sup>117</sup> Unlike the other limited partnership acts, this Act does not contain a provision that permits the partners to be held personally liable, nor does it provide a statute of limitations within which a suit against the partners to recover the wrongful distribution may be brought. The general partnership act, which would govern here,<sup>118</sup> provides that the general partners are jointly and severally liable for the debts and obligations of the partnership,<sup>119</sup> and KRS section 413.120 would apply to

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<sup>110</sup> *Id.* § 362.473.

<sup>111</sup> This differs from the previous distribution statutes discussed because these statutes of limitations apply to actions to recover the wrongful amount of the distribution from the limited partners, not from the general partner who authorized the distribution.

<sup>112</sup> § 362.475(1)(a).

<sup>113</sup> *Id.* § 362.475(1)(b).

<sup>114</sup> Note that KRS section 362.441 provides the limited partners a right, but not a duty, to inspect partnership records.

<sup>115</sup> Although repealed on a prospective basis in 1988, this act continues to govern limited partnerships formed thereunder, which have not elected to be governed by a subsequent act. See §§ 362.521, 362.2-1204.

<sup>116</sup> KY. REV. STAT. ANN. § 362.560(1)(a) (LexisNexis 1987).

<sup>117</sup> KY. REV. STAT. ANN. § 362.560(1)(b) (West 2010).

<sup>118</sup> See, e.g., KY. REV. STAT. ANN. § 362.523 (LexisNexis 1987).

<sup>119</sup> KY. REV. STAT. ANN. § 362.220(1)(b) (West 2010).

provide a five-year statute of limitations. Regardless, adverse domination would not apply to toll this statute of limitations. Since all of the partners must consent to the distribution, assuming that this cannot be changed by the partnership agreement, a *Wilson* situation would never occur. The decision to make a distribution is not limited to the hands of a few but is a group decision that requires unanimous consent. As such, there is no small faction that could grant an improper distribution and then hide the fact of the distribution for the requisite period. Thus, the statute of limitations for an action brought by the limited partnership pursuant to KRS section 362.560 will never be tolled.

Adverse domination may, however, toll the statute of limitations for an action brought pursuant to the limited partnership's second distribution statute, KRS section 362.550. This statute provides that a limited partner may receive a distribution of the limited partnership's profits so long as the partnership's assets exceed the partnership's liabilities.<sup>120</sup> Again, there is no provision providing for personal liability for partners who consent to a wrongful distribution or a period of limitations within which such a suit must be brought. General partnership rules would apply, as well as the general statute of limitations. Unlike the distribution statute discussed above, however, a *Wilson* situation could occur here since a distribution of profits does not require the consent of all the partners, but rather can be made by the general partners. Thus, the general partners could make a wrongful distribution, conceal the fact of the distribution from the limited partners, and more than five years could pass before someone with the ability to bring suit on the partnership's behalf learns of the wrongdoing. Adverse domination should apply in this situation to toll the statute of limitations.

#### *D. Limited Liability Partnerships*

Until 2010, both the Kentucky Uniform Partnership Act (KyUPA) and the Kentucky Revised Uniform Partnership Act (2006) (KyRUPA) were silent on the issue of distribution limits, the effect of a wrongful distribution, and any statute of limitations for recovering wrongful distributions. Prior to 2010, the adverse domination analysis for wrongful distributions in limited liability partnerships would be based on statutes providing general liability of the partners and the general statute of limitations. As a default rule, both acts provide that each partner is entitled to an equal share of the partnership's profits<sup>121</sup> and "a partnership may maintain an action against a partner for a breach of the partnership agreement, or for the violation of a duty to the partnership causing harm to the partnership."<sup>122</sup> KRS chapter 413 governs statutes of limitations applicable to any cause of action.<sup>123</sup> Thus, if the partnership agreement contains restrictions on when distributions of the profits can be made, or if a court finds that a distribution made while the partnership is

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<sup>120</sup> KY. REV. STAT. ANN. § 362.550 (LexisNexis 1987).

<sup>121</sup> See KY. REV. STAT. ANN. §§ 362.235(1), 362.1-401(2) (West 2010).

<sup>122</sup> *Id.* § 362.1-405(1).

<sup>123</sup> *Id.* § 632.1-405(3).

insolvent is a breach of duty owed to the partnership,<sup>124</sup> the partnership can maintain an action against the partner personally for the wrongful distribution so long as the action is brought within the applicable statute of limitations set forth in KRS chapter 413.

In 2010, both KyUPA and KyRUPA were amended to include prohibitions against wrongful distributions by LLPs.<sup>125</sup> Pursuant to these statutes, a limited liability partnership cannot make a distribution if the partnership is insolvent or would become so after giving effect to the distribution.<sup>126</sup> If the partner or transferee of a partner receives a wrongful distribution, she is liable to the partnership for the amount of the distribution that exceeds that amount that could have been made without violating the statute.<sup>127</sup> This section provides for a two-year statute of limitations, beginning on the date the distribution is paid to the partner or transferee, within which a claim must be brought.<sup>128</sup>

These additions brought KyUPA and KyRUPA more in line with the other Kentucky business entity acts in regards to the positive law on improper distribution and the analysis of whether adverse domination will toll the applicable statute of limitations within which an improper distribution can be recovered. So long as there is a statute that prohibits certain distributions, whether expressly or impliedly, and a statute of limitations, whether specific to wrongful distributions or for causes of action generally, the issue of whether adverse domination applies depends on the partnership's management structure.

Under the partnership acts, each partner has an equal right to participate in the management of the partnership's business.<sup>129</sup> Furthermore, differences arising as to matters in the ordinary course of the partnership business, which includes distributing partnership profits, will be decided by a majority of the partners.<sup>130</sup> Where all of the partners are participating in management, there can be no claim of lack of knowledge of a wrongful distribution. In that circumstance, adverse domination will not toll the statute of limitations

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<sup>124</sup> See *id.* § 362.1-404 (listing the fiduciary duties a partner owes to the partnership and the other partners). It is simply posited that a distribution while or rendering a partnership insolvent is a breach of a duty owed; no suggestion should be inferred that such is argued to be the case.

<sup>125</sup> See *id.* §§ 362.601(1), 362.1-1003(1); see also Thomas E. Rutledge & Dean Dennis R. Honabach, *Kentucky Business Entity Laws: The 2010 Amendments*, 74 BENCH & BAR, Sept. 2010, at 6, 7.

<sup>126</sup> §§ 362.601(1), 362.1-1003(1). In a KyUPA LLP, the statute provides only a partial liability shield to the partners. See *id.* § 362.220(3). See generally THOMAS E. RUTLEDGE & ALLAN W. VESTAL, RUTLEDGE AND VESTAL ON KENTUCKY PARTNERSHIPS AND LIMITED PARTNERSHIPS § 2.11.1, at 146-49 (2010). The insolvency test therefore looks to liabilities for which the partners are liable versus those for which they are not in determining insolvency.

<sup>127</sup> §§ 362.601(2), 362.1-1003(2).

<sup>128</sup> See *supra* note 48.

<sup>129</sup> See *id.* §§ 362.235(5), 362.1-401(6).

<sup>130</sup> *Id.* §§ 362.235(5), 362.1-401(10).

since the non-culpable partners could have initiated an action on the partnership's behalf within the established time frame.<sup>131</sup>

Conversely, if the limited liability partnership agreement provides that the authority to make distributions can be delegated to one or more persons, then a *Wilson* situation can occur. The power to make the distribution will be held in the hands of a few. If this person or group is also able to control the information regarding the distribution so that the partners are unaware of the wrongful nature of the distribution, then the equitable rationale of the application of the adverse domination doctrine would be equally applicable here, assuming the disinterested majority and intentional wrongdoing tests are met.

## II. ENTITY GOVERNANCE AND STATUTES OF LIMITATIONS IN GENERAL

The decision in *Wilson* applied the doctrine of adverse domination to toll the statute of limitations set forth in KRS section 271B.8-330. Part II of this Article has to this point focused on the applicability of the doctrine to similar statutes regarding unlawful distributions, but the impact of *Wilson* could be much broader. Adverse domination could be applied to toll any of the statutes of limitations set forth in KRS chapter 413, which deals with statutes of limitations in general. For instance, KRS section 413.120(2) provides a five-year statute of limitations for actions based upon a liability created by statute when the statute fixes no other time. Also, KRS section 413.160 provides a ten-year statute of limitations for actions for relief not provided for by a statute. For the same rationales set forth by the court in *Wilson*, the doctrine of adverse domination could apply to toll these statutes of limitations for any action by an entity where a majority of those in charge of the entity engaged in intentional wrongful conduct and controlled the flow of information so that the wrongdoing could be concealed.<sup>132</sup>

In an unpublished Kentucky Court of Appeals decision that predates *Wilson*, *Nichols v. Deloitte & Touche LLP (In re Kentucky Central Life Insurance Co.)*, the court contemplated applying the doctrine of adverse domination to toll the statute of limitations for professional negligence under KRS section 413.245.<sup>133</sup> This statute provides that a civil action for professional malpractice must be "brought within one (1) year from the date of the occurrence or from the date when the cause of action was, or reasonably should have been, discovered by the party injured."<sup>134</sup> The court acknowledged the doctrine of adverse domination as an "equitable interpretation of the discovery rule and general agency principles" and noted that

the doctrine operates to toll the running of the statute of limitations when the directors or officers charged with wrongful conduct dominate the board of the corporation to the extent that there are no directors who have knowledge of the facts giving rise to possible liability and who could have

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<sup>131</sup> See *id.* § 362.1-405(2) (providing inter alia that any one partner can bring a suit against another partner).

<sup>132</sup> *E.g.*, *Resolution Trust Corp. v. Acton*, 49 F.3d 1086, 1089-92 (5th Cir. 1995) (considering the applicability of adverse domination to toll the general statute of limitations for negligence, breach of fiduciary duty, and gross negligence).

<sup>133</sup> *Nichols v. Deloitte & Touche LLP (In re Ky. Cent. Life Ins. Co.)*, 2001 WL 726781, at \*5-6 (Ky. Ct. App. 2001) (depublished).

<sup>134</sup> § 413.245.

or would have induced the corporation to sue.<sup>135</sup>

However, the court concluded that the matter before it could be resolved without adopting adverse domination as a new rule of law.<sup>136</sup> Due to the determination of when the actual injury occurs in a professional negligence case, the court found that the one-year statute of limitations had not run and so the issue of whether adverse domination would apply was moot.<sup>137</sup> Now that the *Wilson* court has adopted the doctrine of adverse domination in Kentucky, courts are likely to see more arguments, like the one made by the plaintiff in *Kentucky Central Life*, for an expansion of the doctrine to all statutes of limitations in situations where a majority of persons controlling an entity (be they directors, managers, members, partners, or trustees) have committed intentional wrongdoing and concealed the fact of such wrongdoing.

### III. IMPACT ON THIRD PARTIES

Another interesting facet of adverse domination raised by *Kentucky Central Life* was whether the doctrine could apply to claims against third parties who were not parties to the intentional misconduct of the directors.<sup>138</sup> Here, the plaintiff, a liquidator in bankruptcy for an insurance company, sought to hold the accounting firm and its partners liable for professional negligence in auditing the insurance company's financial statements.<sup>139</sup> The defendants argued that the claim was time-barred, to which the plaintiff responded by arguing for the application of the adverse domination doctrine.<sup>140</sup> The defendants claimed that even if the doctrine applied in Kentucky, it did not apply to claims against third parties.<sup>141</sup> As implied by this Article and as noted by the *Wilson* court, the doctrine is applied mostly to prevent wrongdoers from benefiting from concealment of wrongdoing for the statutory period. The court acknowledged, however, that some jurisdictions have expanded the doctrine to "third-party negligence claims which were not pursued by the officer and wrongdoing directors because the filing of a negligence action would have revealed their own malfeasance."<sup>142</sup> The court cited to *Resolution Trust Corp. v. Farmer*<sup>143</sup> for this proposition. In *Farmer*, the court held that the doctrine of adverse domination applied equally to toll the statute of limitations for claims against the attorneys of the directors as it did for the directors due to the fact that the directors were not able to sue the attorneys without possibly exposing their own

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<sup>135</sup> *Ky. Cent. Life*, 2001 WL 726781, at \*5-6.

<sup>136</sup> *Id.* at \*6.

<sup>137</sup> *Id.* at \*12.

<sup>138</sup> *Id.* at \*5.

<sup>139</sup> *Id.* at \*2.

<sup>140</sup> *Id.*

<sup>141</sup> *Id.* at \*5.

<sup>142</sup> *Id.* at \*6.

<sup>143</sup> *Resolution Trust Corp. v. Farmer*, 865 F. Supp. 1143 (E.D. Pa. 1994).

wrongdoing.<sup>144</sup> The court found it immaterial to the tolling issue that the attorneys were not on the company's board of directors and that their wrongdoing may not have risen above negligence.<sup>145</sup>

It is the majority view that adverse domination applies to a corporation's claim against third parties in the circumstances described above.<sup>146</sup> Still, not all states that have adopted the doctrine of adverse domination have expanded it to toll the statute of limitations to hold third parties liable. In *FDIC v. Shrader & York*, the plaintiff sought to invoke the doctrine of adverse domination to toll the two-year statute of limitations on legal malpractice in order to hold outside counsel of a company liable for its negligence.<sup>147</sup> The plaintiff argued that the chairman of the board/CEO of the company prevented the company from suing the law firm in order to avoid exposure to liability for his own wrongdoing.<sup>148</sup> The court refused to extend the adverse domination doctrine beyond corporate officers and directors, noting that the law firm had not committed any intentional torts nor conspired with the wrongdoing director to defraud the company.<sup>149</sup>

## CONCLUSION

*Wilson* was a case of first impression for Kentucky courts. While the holding of *Wilson* was narrow—adopting the doctrine of adverse domination to toll the statute of limitations as to wrongful distributions so long as a corporation's board of directors is controlled by a majority of culpable directors who acted intentionally in making the wrongful distribution<sup>150</sup>—the impact of this case could be quite broad. Kentucky courts could extend the doctrine to toll the statutes of limitations for wrongful distributions for other business entities, as well as to toll statutes of limitations for other causes of action based on the intentional wrongful acts of a majority of those in control of the entity. The doctrine of adverse domination could apply to any Kentucky business entity where a person or group smaller than all of the owners controls the entity, whether directly or through delegated authority, and thus has the power to engage in wrongdoing and conceal the fact of the wrongdoing. Since this group is highly unlikely to cause the entity to sue them, and because there is no one else with the knowledge and ability to bring suit on the entity's behalf, the statute of limitations could run before the entity has knowledge of its cause of action.

Like the discovery rule, the doctrine of adverse domination eases the harshness of the

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<sup>144</sup> *Id.* at 1158-59.

<sup>145</sup> *Id.* at 1158; *see also* *Resolution Trust Corp. v. Gardner*, 798 F. Supp. 790, 795-96 (D.D.C. 1992). In tolling the statute of limitations to hold the corporation's attorney liable for receiving improper payments, the court noted that an attorney "was in a fiduciary relationship with the corporation, which further decreased the likelihood of [the corporation] bringing suit against him." *Id.*

<sup>146</sup> Matthew G. Dore, *Statutes of Limitation and Corporate Fiduciary Claims: A Search for Middle Ground on the Rules/Standards Continuum*, 63 *BROOK. L. REV.* 695, 700, 758 (1997).

<sup>147</sup> *FDIC v. Shrader & York*, 991 F.2d 216, 220 (5th Cir. 1993).

<sup>148</sup> *Id.* at 227. It is unclear whether this court would have applied the doctrine if the third party's actions had been intentional, as opposed to merely negligent.

<sup>149</sup> *Id.*

<sup>150</sup> *Wilson v. Paine*, 288 S.W.3d 284, 290 (Ky. 2009).

statute of limitations where the injury is not immediately discoverable. The effect of applying the doctrine, however, is to expand the timeframe of potential liability for directors, managers, and partners, as well as possibly the attorneys and accountants for these entities. Possible consequences of the doctrine include reluctance to hold such positions and difficulty for these control people to obtain insurance for potential entity claims. On the other hand, it should encourage such control persons to play by the rules, knowing that they can no longer simply conceal their wrongdoing for the requisite statute of limitations and claim that any action against them is time-barred. Whatever the consequences, there is no doubt that *Wilson* will have a broad impact on Kentucky entities and the people who control them.

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