ARKANSAS LAW REVIEW

VOLUME 63 NUMBER 3

THE ANALYTIC PROTOCOL FOR THE DUTY OF LOYALTY UNDER THE PROTOTYPE LLC ACT

THOMAS E. RUTLEDGE & THOMAS EARL GEU

Reprinted from
ARKANSAS LAW REVIEW
Volume 63, Number 3

The Analytic Protocol for the Duty of Loyalty Under the Prototype LLC Act

By Thomas E. Rutledge and Thomas Earl Geu[*]

I. Introduction

The Prototype LLC Act (Prototype)[1] was an important template against which a significant number of the various LLC Acts were initially drafted.[2] Section 402(B) of the Prototype recites the default[3] duty of loyalty applicable to LLCs, providing:

> Every member and manager must account to the [LLC] and hold as trustee for it any profit or benefit derived by that person without the consent of more than one half by number of the disinterested managers or members, or other persons participating in the management of the

---

[*] Rutledge is a member of Stoll Keenon Ogden PLLC law firm in its Louisville, Kentucky office. Geu is a Professor of Law at the University of South Dakota School of Law. Both are elected members of the American Law Institute (ALI), served as ABA advisors in the drafting of the Revised Uniform Limited Liability Company Act (RULLCA), and are frequent commentators in the law of limited liability companies (LLCs) and other forms of unincorporated business organizations. Both authors would like to thank Melanie R. Siemens of Stoll Keenon Ogden for her editorial assistance, and Allan G. Donn for his comments and insights on an earlier draft.

1. 3 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES (2d ed. 2008) [hereinafter RIBSTEIN & KEATINGE ON LLCs], app. C [hereinafter the "PROTOTYPE"]. The Prototype was drafted by a task force of the Committee on Partnerships and Unincorporated Business Organizations, since renamed the Committee on LLCs, Partnerships, and Unincorporated Entities, Section of Business Law, American Bar Association.

2. Drafting of the Uniform Limited Liability Company Act (ULLCA) began in 1992; it was initially completed in 1994, by which time some 44 states had already adopted an LLC act. The Prototype was completed and released in 1992, at which time only 12 states had passed an LLC act. *See* Thomas E. Rutledge and Lady E. Booth, *The Limited Liability Company Act: Understanding Kentucky's New Organizational Option*, 83 KY. L.J.1, 4 n.2 (listing LLC acts adopted through 1994).

3. As detailed below, the duty of loyalty as recited in Prototype § 402 may be modified in the operating agreement. PROTOTYPE, *supra* note 1, § 402(B) cmt., app. C-51.

> business or affairs of the [LLC], from (1) any transaction connected with the conduct or winding up of the [LLC]; or (2) any use by the member or manager of its property, including, but not limited to, confidential or proprietary information of the [LLC] or other matters entrusted to the person as result of his status as manager or member.[4]

Kentucky adopted Prototype section 402(B) verbatim in its LLC Act.[5] In *Patmon v. Hobbs*,[6] the Kentucky Court of Appeals issued an opinion interpreting this provision, thereby providing an example of a "partial right answer but wrong reason,"[7] which has prompted this article.

The objectives of this article are threefold. First, the article seeks to review and elucidate Prototype section 402(B), an exceptionally powerful provision. Careful parsing of the Prototype's language is important to understanding the default rule against which contrary private ordering may be agreed as well as to understanding the limitations and requirements imposed by its statutory formula. Second, this article reviews *Patmon v. Hobbs* as an example of how an LLC loyalty case can go easily astray in absence of careful attention to the governing statute. Third, it reviews more generalized lessons from *Patmon v. Hobbs* concerning analytic protocol and LLC-act interpretation.

---

4. PROTOTYPE, *supra* note 1, § 402(B).

5. Since then the Kentucky adoption of Prototype § 402(b) has been amended. *See* Thomas E. Rutledge, *The 2007 Amendments to the Kentucky Business Entity Statutes*, 97 KY. L.J. 229, 249 (2008-09). The amendments, however, did not go to the substantive obligation in a manner relevant to the dispute. In 2010, subsequent and in response to *Patmon v. Hobbs*, 280 S.W.3d 589 (Ky. Ct. App. 2009), the provision was amended to expressly label the obligation as the duty of loyalty. 2010 Ky. Acts ch. 133, § 32 (codified as amended at KY. REV. STAT. ANN. § 275.170(2) (West 2010)).

6. 280 S.W.3d 589. The *Patmon* decision is the first published ruling of a Kentucky court addressing section 275.170(2) of the Kentucky Revised Statutes, which is an adoption of the duty of loyalty embodied in Prototype § 402(B). This decision was not appealed to the Kentucky Supreme Court.

7. When one of the authors (Rutledge) took algebra from Brother Emeric at St. Xavier High School, that meant no credit.

II. History and Application of the Prototype

A. UPA § 21(1) as the Source of Section 402(B)

An initial appreciation of Prototype section 402(B) begins with an understanding that it is not a sua sponte description of the duty of loyalty. Rather, the section embodies the duty of loyalty that appears in the 1914 Uniform Partnership Act (UPA),[8] a fact made manifest by a side-by-side comparison.

UPA § 21(1)	**Prototype § 402(B)**
Every partner must account to the partnership for any benefit, and hold as trustee for it any profits derived by him without the consent of the other partners from any transaction connected with the formation, conduct, or liquidation of the partnership or from any use by him of its property.	Every member and manager must account to the [LLC] and hold as trustee for it any profit or benefit derived by that person without the consent of more than one half by number of the disinterested managers or members, or other persons participating in the management of the business or affairs of the [LLC] from: (1) Any transaction connected with the conduct or winding up of the [LLC]; or (2) Any use by the member or manager of its property, including, but not limited to, confidential or proprietary information of the [LLC] or other matters entrusted to the person as a result of his status as manager or member.

Beyond the side-by-side comparison that demonstrates the provenance of Prototype section 402(B), the comment to that section makes the lineage clear, stating in part: "Subsection (B),

8. UNIF. P'SHIP ACT § 21(1) (1914), 6 U.L.A. 194 (2001).

which is based on UPA § 21, sets forth the duty of loyalty of LLC managers and managing members—that is, the duty to act without being subject to an obvious conflict of interest."[9] Therefore, interpretations of UPA section 21(1) help interpret Prototype section 402(B).[10]

In turn, UPA section 21(1) may be understood to codify *Latta v. Kilbourn*,[11] where the United States Supreme Court stated that it is:

> [W]ell settled that one partner cannot, directly or indirectly, use partnership assets for his own benefit; that he cannot, in conducting the business of a partnership, take

---

9. PROTOTYPE, *supra* note 1, § 402 cmt, app. C-52.

10. *See, e.g.*, Prudential Bldg. & Loan Ass'n v. City of Louisville, 464 S.W.2d 625, 626-27 (Ky. 1971):

> The legislature is presumed to have been familiar with the judicial construction, and to have adopted it as a part of law, where a statute which has been construed by the courts of last resort has been reenacted in the same terms, or where a statute so construed has been reenacted in substantially the same terms according to the authorities on the question, unless a contrary intent clearly appears, or a different construction is expressly provided for; *and the rule applies in the construction of a statute enacted after a similar or cognate statute has been judicially construed.*

(citations omitted). Statutory interpretation is fraught with apparently inconsistent canons. One confusing area is the use of "reference to related statutes" and "the probative force of analogous legislation." 2B NORMAN J. SINGER & J.D. SHAMBIE SINGER, STATUTES AND STATUTORY CONSTRUCTION 247 (7th ed. 2008). In some ways it seems that "reference to related statutes" and "the probative force of analogous legislation" are two sides of the same coin. In any event, they both involve classification and taxonomy. *Id.* at 381. For example, reference to related statutes includes the doctrine of *in pari materia* which is used to reference statutes "when they relate to the same person or thing, to the same class of persons or things, or have the same purpose or object." *Id.* at 235, 237. The doctrine requires a level of harmonization between the statutes. *Id.* at 381. On the other hand, there are "[l]imitations on the probative force of analogous legislation." *Id.* at 398. Thus: "Caution must be exercised in applying the rule that one statute will be interpreted to correspond to analogous but unrelated statutes because an inclusion or exclusion may show an intent or convey a meaning exactly contrary to that expressed by analogous legislation." *Id.* Interpreting entity laws in the same state, therefore, requires determining whether a statutory provision in one act is *in pari materia* with a similar provision in another act (interpret by reference); or whether the provisions are merely analogous. This leads to fine but nice legal distinctions. For example, it would seem that LLCs and corporations are neither the "same person nor thing" or "the same class of persons or things." Thus, to use the doctrine of *in pari materia* would require the separate corporate and LLC acts to "have the same purpose or object." Provisions within those acts that are stated in markedly different terms (like fiduciary duty) would seem not be closely related enough to support a harmonizing interpretation. Rather, the relationship seems to be only one of analogy which requires emphasizing the differences in meaning caused by the use of different words.

11. 150 U.S. 524 (1893).

> any profit clandestinely for himself; that he cannot carry on the business of the partnership for his private advantage; that he cannot carry on another business in competition or rivalry with that of the firm, thereby depriving it of the benefit of his time, skill, and fidelity without being accountable to his copartners for any profit that may accrue to him therefrom; that he cannot be permitted to secure for himself that which it is his duty to obtain, if at all, for the firm of which he is a member; nor can he avail himself of knowledge or information; which may be properly regarded as the property of the partnership, in the sense that it is available or useful to the firm for any purpose within the scope of the partnership business.[12]

Thus, while courts that assert that there is a dearth of law construing the language of Prototype section 402(B)[13] are technically correct, they miss the significance of a number of interpretations of UPA section 21(1); a section which uses very similar language to the Prototype in the context of a partnership, another unincorporated entity.

B. The Application of Section 402(B) in a Member or Manager Managed LLC

Before applying the rule of Prototype section 402(B), it is necessary to determine who is subject to its obligations. Most LLC acts require the organization to elect to be "member managed" or "manager managed."[14] Whether an LLC is member managed or manager managed is determined by referring to the election made in the articles of organization and

---

12. *Id.* at 541; *see also* Bakalis v. Bressler, 115 N.E.2d 323, 327 (Ill. 1953) (stating "[t]he fiduciary relation prohibits all forms of trickery, secret dealings and preference of self in matters relating to and connected with a partnership and joint venture").

13. *See, e.g.*, Purcell v. S. Hills Invs., LLC, 847 N.E.2d 991, 996 (Ind. Ct. App. 2006) ("In Indiana, there is relatively little case law regarding LLCs and no case law concerning fiduciary duties in the LLC context."); Patmon v. Hobbs, 280 S.W.3d 589, 593 (Ky. Ct. App. 2009) ("In Kentucky, there is relatively little caselaw regarding [LLCs] and no case law concerning fiduciary duties in the [LLC] context.").

14. *See* Thomas E. Rutledge & Steven G. Frost, *RULLCA Section 301—The Fortunate Consequences (and Continuing Questions) of Distinguishing Apparent Agency and Decisional Authority*, 64 BUS. LAW. 37 (20080-; 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, 739-42 (2004-05).

is not determined by a substantive review of the *inter se* management structure defined in the operating agreement.[15] As set forth in the comment to Prototype section 401, "Irrespective of the provisions in the operating agreement, whether an LLC is 'manager-managed,' as that phrase is used in the Act, depends on whether the articles of organization so provide."[16] Prototype section 402(C) clarifies who is subject to the duties imposed by section 402(B), depending upon whether the LLC is member managed or manager managed.[17] It provides, *inter alia*, that in a manager-managed LLC, the duty of loyalty is owed only by those who are managers.[18] Alternatively, in a member-managed LLC, the duty of loyalty is required of every member.[19]

The imposition of a duty of loyalty upon the members of a member-managed LLC is consistent with the positional apparent agency authority enjoyed by each member[20] and the right, as a member, to participate in the management of the venture.[21] Conversely, where the LLC is manager managed and the members *qua* members have neither apparent agency authority on behalf of the LLC[22] nor a role in *inter se* management not

15. *See, e.g.*, KY. REV. STAT. ANN. § 275.025(1)(d) (West 2010); PROTOTYPE, *supra* note 1, § 202(D) cmt., app. C-29.

16. PROTOTYPE, *supra* note 1, § 401 cmt.

17. This toggle is also applicable to the PROTOTYPE § 402(A) duty of care.

18. PROTOTYPE, *supra* note 1, § 402 (C). "One who is a member of [an LLC] in which management is vested in managers under § 401 and who is not a manager shall have no duties to the [LLC] or to the other members solely by reason of acting in the capacity of a member." PROTOTYPE, *supra* note 1, § 402(C). A similar provision appears in the Uniform Limited Liability Company Act (ULLCA). *See* UNIF. LTD. LIAB. CO. ACT § 409(h)(1), 6B U.L.A. 598 (2008).

19. For a review of the implications of this duty of loyalty vis-à-vis the power (or not) to resign from the LLC, see, for example, Thomas E. Rutledge, *You Just Resigned—Now What? Different Paradigms for Withdrawing From a Venture*, 12 J. PASSTHROUGH ENTITIES 43 (Nov.-Dec. 2009).

20. *See, e.g.*, PROTOTYPE *supra* note 1, § 301(A); *see also* RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. e (2006) ("If the relationship between two persons is one of agency as defined in this section, the agent owns a fiduciary obligation to the principal."). For further discussion see *infra* notes 149 through 156 and accompanying text.

21. *See, e.g.*, IND. CODE ANN. § 23-18-4-1(a) (West 2010); KY. REV. STAT. ANN. § 275.165(1) (West 2010); PROTOTYPE, *supra* note 1, § 401(A)

22. *See, e.g.*, IND. CODE ANN. § 23-18-4-1(b); KY. REV. STAT. ANN. § 275.135(2); PROTOTYPE, *supra* note 1, § 301(B);

involving fundamental decisions,[23] the members are relieved of the duty.[24] Applying the latter rule in *Mitchell v. Smith*, a district court in Utah stated: "Because Defendant's Counterclaim relies solely upon Plaintiffs' status as members [of the LLC] for the existence of fiduciary duties, and because Utah law prohibits such a finding based solely upon membership, the Court finds that Defendant has failed to state a cause of action upon which relief may be granted."[25] Interpreting the equivalent provision in the Georgia LLC Act,[26] the court in *ULQ, LLC v. Meder* held: "Because the plain language of OCGA § 14-11-305 provides that non-managing members in manager-managed LLCs owe no duties to the LLC or other members, we hold that non-managing members owe no fiduciary duties to the LLC or the other members."[27] Similarly, a court applying the Uniform Limited Liability Company Act's (ULLCA) equivalent to Prototype section 402(C) dismissed a breach of fiduciary duty against a member in *Dragt v. Dragt/DeTray, LLC*, "because the Dragts were merely members of the manager-managed LLC, they owed no fiduciary duties and the trial court erred in imposing fiduciary duties on them."[28]

The "solely by reason of acting in the capacity of a member" language of Prototype section 402(C) warrants special additional attention because it is a limitation on the exemptive effect of the balance of the provision.[29] Simply stated, a member's actions may implicate fiduciary duties. For example, a member misappropriating company funds entrusted to him for deposit will be liable for breach of the duty of loyalty in addition

---

23. *See, e.g.*, IND. CODE ANN. § 23-18-4-3(b); KY. REV. STAT. ANN. § 275.165(2); PROTOTYPE, *supra* note 1, § 401(B).

24. KY. REV. STAT. ANN. § 362.2-305(1) (West 2010); UNIF. LTD. P'SHIP ACT § 305(a), 6A U.L.A. 424 (2001) ("A limited partner does not have any fiduciary duty to the limited partnership or to any other partner solely by reason of being a limited partner.").

25. No. 1:08-CV-103 TS, 2009 WL 891908, at *2 (D. Utah Mar. 31, 2009).

26. GA. CODE ANN. § 14-11-305(1) (West 2010):

> Except as otherwise provided in the articles of organization or a written operating agreement, a person who is a member of [an LLC] in which management is vested in one or more managers, and who is not a manager, shall have no duties to the [LLC] or to the other members solely by reason of acting in his or her capacity as a member . . . .

27. 666 S.E.2d 713, 721 (Ga. Ct. App. 2008).

28. 161 P.3d 473, 482 (Wash. Ct. App. 2007).

29. PROTOTYPE, *supra* note 1, § 402(c).

to exposure to charges of theft and conversion.[30] Conversely, a member who, without utilizing company assets, competes with the manager-managed LLC—in which she is a member—violates no duty unless otherwise provided in the operating agreement.

Prototype section 402(C) is an important provision that not only says what it means but means what it says.[31] Clearly ascertaining the structure of the LLC at issue and ascertaining the status of the person to be charged with a breach of fiduciary obligation is a crucial step because, absent a duty, there can be no breach.[32]

In summary, a claim against a member for breach of the duty of loyalty will fail where: (1) the controlling act contains a provision equivalent to Prototype section 402(C); (2) the LLC is manager managed, and the member in question is not a manager; (3) there is no statutory provision bringing a pseudo manager[33] within the statutory fiduciary duties and the member does not engage in conduct identified by such a provision; (4) there is no claim that the complained of actions were taken other than as a member; and (5) the operating agreement has not

30. *See* RESTATEMENT (THIRD) OF EMP'T LAW § 8.03 (Tentative Draft No. 3, 2010) (stating that a former employee's breach of the duty of loyalty to a former employer occurs when an employee utilizes his employer's confidential information in competition with his employer).

31. *See* THE LAST EMPEROR (COLUMBIA PICTURES 1987) ("If you cannot say what you mean, your majesty, you will never mean what you say and a gentleman should always mean what he says.").

32. *See, e.g., In re* Heritage Org., L.L.C., No. 04-35574-BJH-11, 2008 WL 5215688, at *18 (Bankr. N.D. Tex. Dec. 12, 2008) ("Without a duty, there can be no breach of duty or resulting harm."); Turkey Creek, L.L.C. v. Rosania, 953 P.2d 1306, 1312 (Colo. App. 1998) ("Before there can be a breach of a fiduciary duty, a fiduciary relationship or a confidential relationship must exist.") (citing Vikell Investors Pac., Inc. v. Kip Hampden, Ltd., 946 P.2d 589 (Colo. App. 1997)).

33. *See, e.g.*, 805 ILL. COMP. STAT. ANN. 180/15-3(g)(3) (West 2010); W. VA. CODE ANN. § 31B-4-409(h)(3) (West 2010); UNIF. LTD. LIAB. CO. ACT § 409(h)(3), 6B U.L.A. 598 (2009):

> [A] member who pursuant to the operating agreement exercises some or all of the rights of a manager in the management and conduct of the company's business is held to the standards of conduct in subsections (b) through (f) to the extent that the member exercises the managerial authority vested in a manager by this [Act] . . .

See also Katris v. Carroll, 842 N.E.2d 221, 226 (Ill. App. Ct. 2005) (finding defendant, as a member of a manager-managed LLC, owed no fiduciary duty to the LLC).

modified the statutory default rules by providing member fiduciary duty for all or select activities.[34]

III. Fiduciary Duties and the Prototype

A. The Modifiability of the Prototype's Standard of Loyalty

LLCs are creatures of contract[35] and statute.[36] As a general rule, LLC acts set forth default rules that may be modified *inter se* by the members by private ordering in the operating agreement.[37] Prototype section 402(B) is expressly a default

---

34. While it is certainly possible under the Delaware LLC Act to utilize managers, see for example title 6 section 18-402 of the Delaware Code, stating "if an [LLC] agreement provides for the management in whole or in part, of [an LLC] by a manager, the management of the [LLC] to the extent so provided shall be vested in the manager . . .," Delaware does not by doing so preclude members from apparent ageney authority on behalf of the company or exempt them from fiduciary obligations. *See* DEL. CODE ANN. tit. 6, § 18-402; *see also* Rutledge and Frost, *supra* note 14, at 45-46.

35. *See* KY. REV. STAT. ANN. § 275.003(1) (West 2010) ("It shall be the policy of the General Assembly through this chapter to give maximum effect to the principles of *freedom of contract and the enforceability of operating agreements.*") (emphasis added); *see also Fisk Ventures, LLC v. Segal*, No. 3017-CC, 2008 WL 1961156 at *1 (Del. Ch. May 7, 2008) (stating the operating agreement "defines the seope, structure, and personality of [LLCs]"); TravelCenters of Am., LLC v. Brog, No. 3516-CC, 2008 WL 1746987, at *1 (Del. Ch. Apr. 3, 2008) ("[LLCs] are creatures of contract, 'designed to afford the maximum amount of freedom of contract, private ordering and flexibility to the parties involved.'") (quoting *In re* Grupo Dos Chiles, LLC, C.A. No. 1447-N, 2006 WL 668443, at *2 (Del. Ch. Mar. 10, 2006)); Walker v. Res. Dev. Co., 791 A.2d 799, 813 (Del. Ch. 2000) ("LLC members' rights begin with and typically end with the Operating Agreement."). The language employed in the Delaware LLC Act at section 18-1101(b) is for all intents and purposes identical to the language employed in the Kentucky LLC Act at section 275.003(1) of the Kentucky Revised Statutes. Neither ULLCA nor RULLCA contains such an express textual statement.

36. *See, e.g.*, KY. REV. STAT. ANN. § 275.020(2) (stating the existence of an LLC begins upon filing by the secretary of state of the articles of organization). The statement that "LLCs are creatures of contract and of statute" is surprisingly controversial in some contractarian comers even though it is a truism because an LLC must comply with statutory filing requirements in order to be recognized by either the state or third parties with whom it might interact. Moreover, contract really does not seem to apply where there exists a single-member LLC. The comments to RULLCA state that an LLC is a creature of both contraet and statute. REV. UNIF. LTD. LIAB. CO. ACT § 110 cmt., 6B U.L.A. 445 (2008); REV. UNIF. LTD. LIAB. CO. ACT § 112 cmt. to subsection (d), 6B U.L.A. 451 (2008).

37. *See, e.g.*, General Considerations Underlying the ULLCA Project, ULLCA Prefatory Note, UNIF. LTD. LIAB. CO. ACT, 6B U.L.A. prefatory cmt. at 547-48 (2008) ("The Committee believes that flexibility is an important hallmark of the LLC form. Accordingly, the Act gives the members maximum freedom to adopt eustomized rules

rule applicable, "[u]nless otherwise provided in an operating agreement...."[38] Thus, private ordering could, for example, subject a broader or narrower class of persons to fiduciary duties than provided by the default statutory rule.[39] Additionally, it could alter the scope of the duties to be broader or narrower than the statutory formula.[40] It could provide an alternative mechanism for approval of a particular transaction that violates or may violate the applicable default standard, or it could even

---

including rules concerning voting rights and fiduciary duties."); KY. REV. STAT. ANN. § 275.003 ("It shall be the policy of the General Assembly through this chapter to give maximum effect to the principles of freedom of contract and the enforceability of operating agreements."). *Accord* RESTATEMENT (SECOND) OF TRUSTS § 222(1) (1957) (stating an express provision to the trust instrument governs over the trustee's generally applicable duty of loyalty); RESTATEMENT (THIRD) OF TRUSTS § 78 c(2), illus. (2007). ("A trustee may be authorized by the terms of the trust, expressly or by implication, to engage in transactions that would otherwise be prohibited by the rules of undivided loyalty stated in subsections (1) and (2)."); Rutheford B. Campbell, Jr., *Bumping Along the Bottom: Abandoned Principles and Failed Fiduciary Standards in Uniform Partnership and LLC Statutes*, 96 KY. L.J. 163, 168-69 (2007-08):

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

Id. (citations omitted).

38. PROTOTYPE, *supra* note 1, § 402. This provision is not subject to a statute of frauds mandating that any modification be in writing, but certain state adoptions do so require. *See, e.g.*, KY. REV. STAT. ANN. § 275.170; Rutledge, *The 2007 Amendments to the Kentucky Business Entity Statutes, supra* note 5, at 248-49; *see also* Olson v. Halvorsen, 986 A.2d 1150, 1161 (Del. 2009) (addressing the inter-relationship between oral and implied operating agreements and the statute of frauds).

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

40. In other instances the "opportunity" may be waived. *See, e.g.*, Joint Task Force of Comm. on LLCs, P'Ships, and Unincorporated Entities and the Comm. on Taxation, ABA Section of Bus. Law, *Model Real Estate Development Operating Agreement with Commentary*, 63 BUS. LAW 385, 413 (Feb. 2008); Stoker v. Bellemeade LLC, 615 S.E.2d 1, 10 (Ga. Ct. App. 2005) *rev'd on other grounds*, 631 S.E.2d 693, 695-96 (Ga. 2006); *see also* II ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON PARTNERSHIP (2010) § 6.07(d) (noting that partnership opportunity doctrine is often waived in certain categories of partnerships).

eliminate the duty entirely.[41] In light of the capacity to modify

41. The possibility of eliminating fiduciary duties by agreement is determined on a state-by-state basis, and various LLC acts vary to the extent of fiduciary duties and whether they may be eliminated. No Kentucky court has addressed the question of how far parties may go in the operating agreement in modifying or even entirely eliminating a fiduciary obligation. The Delaware Supreme Court held that the then existing language in the Delaware Limited Partnership Act providing that fiduciary duties may, in a limited partnership agreement, be expanded or restricted was not sufficient to permit the elimination of fiduciary duties. Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 817 A.2d 160, 167-68 (Del. 2002). DEL. CODE ANN. tit. 6, § 17-1101(d)(2) (West 2003) (amended 2004). In 2004, the Delaware General Assembly amended the Delaware limited partnership, general partnership, and LLC acts to provide expressly that the organic agreement between the participants may "eliminate" fiduciary obligations. *See, e.g.*, DEL. CODE ANN. tit. 6, § 18-1101(c) (West 2010):

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

See also DEL. CODE ANN. tit. 6, § 18-1101(e) ("[An LLC] agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager, or other person to [an LLC] . . . . "). It has been argued that the formulae employed in the Prototype do not permit the elimination of fiduciary obligations. *See* Frances S. Fendler, *A License to Lie, Cheat and Steal? Restriction or Elimination of Fiduciary Duties in Arkansas Limited Liability Companies*, 60 ARK. L. REV. 643, 680-86 (2007). The Delaware common law requires that any waivers of fiduciary duties must be carefully crafted. *See* Willie Gary LLC v. James & Jackson LLC, Civ. No. 1781, 2006 WL 75309, at *2 (Del. Ch. Jan. 10, 2006), *aff'd*, 906 A.2d 76, 82 (Del. 2006). Further, if the modification is sufficiently specific, parties thereto should not thereafter seek to undo the deal to which they have entered. Miller v. Am. Real Estate Partners, L.P., Civ. No. 16788, 2001 WL 1045643, at *8 (Del. Ch. 2001). ("This court has made clear that it will not [be] tempted by the piteous pleas of limited partners who are seeking to escape the consequences of their own decisions to become investors in a partnership whose general partner has clearly exempted itself from traditional fiduciary duties.") (citation omitted). Under RUPA and ULPA, the ability of loyalty may not be eliminated, but it may be qualified. *See* KY. REV. STAT. ANN § 362.1-103(2)(e) (West 2010); KY. REV. STAT. ANN. § 362.2-110(2)(e); REV. UNIF. P'SHIP ACT § 103(b)(3)(i), 6 U.L.A. 73 (2001); UNIF. LTD. P'SHIP ACT § 110(b)(5)(A), 6A U.L.A. 378 (2009); *see also* RESTATEMENT (THIRD) OF AGENCY § 8.06 cmt b. (2006):

> Moreover, although a person may empower another to take action without regard to the interests of the person who grants the power, the law applicable to relationships of agency as defined in § 1.01 imposes mandatory limits on the circumstances under which an agent may be empowered to take disloyal action. These limits serve protective and cautionary purposes. Thus, an agreement that contains general or broad language purporting to release an agent in advance from the agent's general fiduciary obligation to the principal is not likely to be enforceable. This is because a broadly sweeping release of an agent's fiduciary duty may not reflect an adequately informed

or even eliminate the duty of loyalty, the unconditional statement, "members in a member-managed Prototype LLC have a fiduciary duty of loyalty" is at best an overbroad generalization and at least misstates the operative legal rule applicable to many existing LLCs. It is easy to correct, however, by adding the simple preface, "assuming the operating agreement does not provide to the contrary."[42]

B. A Duty to the LLC

Prototype section 402(B) clearly states that, absent private ordering to the contrary, the duty of loyalty is owed to the LLC; by way of omission it is not owed *inter se* to the members.[43] This conclusion is clear when Prototype section 402(B) is compared to section 402(A).[44] The latter section addresses liability "to the [LLC] or the members of the [LLC]."[45] In contrast, section 402(B) addresses responsibilities to account and hold as trustee benefits that flow to the LLC, and other members are not identified as beneficiaries of these

---

judgment on the part of the principal; if effective, the release would expose the principal to the risk that the agent will exploit the agent's position in ways not foreseeable by the principal at the time the principal agreed to the release.

42. Some have argued that there should be an irreducible minimum to reducing, in advance, the duty of loyalty in LLCs. *See, e.g.*, Sandra K. Miller, *What Fiduciary Duties Should Apply to the LLC Manager After More Than a Decade of Experimentation?*, 32 J. CORP. L. 565, 600-06 (2007). Such limitations have been otherwise embodied in business-organization law. *See, e.g.*, KY. REV. STAT. ANN. § 362.1-103(2)(e); KY. REV. STAT. ANN. § 362.2-110(2)(e); REV. UNIF. P'SHIP ACT § 103(b)(3), 6 U.L.A. 73 (2001); UNIF. LTD. P'SHIP ACT § 110(b)(5), 6A U.L.A. 378 (2008). No such limitation exists in the Prototype. *See* PROTOTYPE, *supra* note 1. Some may argue that this absence demonstrates a failure of the act. *See, e.g.*, Allan W. Vestal, *Fundamental Contractarian Error in the Revised Uniform Partnership Act of 1992*, 73 B.U. L. REV. 523, 549 (1993). Others would hail the absence of such a limitation as confirming the primacy of the agreement entered into between the parties. *See, e.g.*, Larry E. Ribstein, *An Analysis of the Revised Uniform Limited Liability Company Act*, 3 VA. L. & BUS. REV. 35, 66-71 (2008).

43. *See* PROTOTYPE, *supra* note 1, § 402(B). *Contrast* KY. REV. STAT. ANN. § 275.170(2) (West 2010) ("shall account to the [LLC] and hold as trustee for it . . . . "); *with* KY. REV. STAT. ANN. § 275.170(1) (West 2010) (discussing liability "to the [LLC] or the members of the [LLC]").

44. *Compare* PROTOTYPE, *supra* note 1, § 402(A) *with* PROTOTYPE, *supra* note 1, § 402(B).

45. *See* PROTOTYPE, *supra* note 1, § 402(A); *see also* KY. REV. STAT. ANN. § 275.170(1).

obligations.[46] There is no question that a duty of loyalty may be, and elsewhere has been, crafted to flow to both the organization and to its constituent owners. For example, under ULLCA section 409(a)[47] and Revised Uniform Limited Liability Company Act (RULLCA) section 409,[48] the duty of loyalty flows to both the LLC and the other members. Under both the 1997 UPA (RUPA)[49] and Uniform Limited Partnership Act (2001) (ULPA), the duty of loyalty flows to both the partnership and the other partners.[50] The Prototype, therefore, stands in stark juxtaposition to those other acts.[51] Therefore, at least

46. *See* PROTOTYPE, *supra* note 1, § 402(B); *see also* KY. REV. STAT. ANN. § 275.170(2).

47. UNIF. LTD. LIAB. CO. ACT § 409(b), 6B U.L.A. 597 (2008) ("A member owes to a member-managed company and its other member . . . the duty of loyalty . . .").

48. REV. UNIF. LTD. LIAB. CO. ACT § 409(a), 6B U.L.A. 488 (2008). *See generally* Carol R. Goforth, *Why Arkansas Should Adopt the Revised Uniform Limited Liability Company Act*, 30 U. ARK. LITTLE ROCK L. REV. 31 (2007).

49. REV. UNIF. P'SHIP ACT § 404(a), 6 U.L.A. 143 (2001). The 1997 Uniform Partnership Act is referred to as "RUPA."

50. *See* REV. UNIF. P'SHIP ACT § 404(a), 6 U.L.A. 143 (2001) ("The only fiduciary duties a partner owes to the partnership and the other partners are the duty of loyalty and the duty of care . . . ." REV. UNIF. P'SHIP ACT § 404(b), 6 U.L.A. 143 (2001) (discussing "a partner's duty of loyalty to the partnership and the other partners"); REV. UNIF. P'SHIP ACT § 404(c), 6 U.L.A. 143 (2001) (recognizing "a partner's duty of care to the partnership and the other partners"); UNIF. LTD. P'SHIP ACT § 408(a), 6A U.L.A. 439 (2008) ("The only fiduciary duties that a general partner has to the limited partnership and the other partners are the duties of loyalty and care . . . ."); UNIF. LTD. P'SHIP ACT § 408(b), 6A U.L.A. 439 (2008) (citing "a general partner's duty of loyalty to the limited partnership and the other partners"); UNIF. LTD. P'SHIP ACT § 408(c), 6A U.L.A. 439 (2008) (discussing "a general partner's duty of care to the limited partnership and the other partners"); *see also* KY. REV. STAT. ANN. § 362.1-404(1) (West 2010) (recognizing fiduciary duties of partners owed "to the partnership and the other partners"); KY. REV. STAT. ANN. § 362.1-404(2)-(3) (West 2010); KY. REV. STAT. ANN. § 362.2-408(1)-(3).

51. *See, e.g.*, Kasten v. MOA Invs., LLC, 731 N.W.2d 383, 2007 WL 677804 (Wis. Ct. App. 2007) (holding that the duty of loyalty ran to the LLC and could be enforced only through a derivative action). Decisions such as *Anderson v. Wilder*, in which a court held that, based upon analogy to closely held corporations, the fiduciary duty owed by each member to the LLC under the statutory formula is also owed *inter se* to the members, do violence to legislatures' prerogatives to define the law and make it nearly impossible to draft an agreement that will be enforced as written. No. E2003-00460-COA-R3-CV, 2003 WL 22768666 (Tenn. Ct. App. Nov. 21, 2003); *see also* Tzolis v. Wolff, 884 N.E.2d 1005 (N.Y. 2008) (acknowledging that in the approval of the New York LLC Act a proposed provision on derivative actions was deleted but determining that members could bring a derivative action). What is important to appreciate is that differing statutory rules do not indicate a defect or deficiency in one formulation versus another. Rather, different forms of business organizations provide different answers for similar questions. The capital lock-in of the corporate form is not a "better" or "more correct" answer than is the

typically, the Prototype section 402(B) duty of loyalty should be enforced[52] by means of a derivative and not direct action,[53] assuming no private ordering to the contrary.[54]

C. The Temporal Scope of Section 402(B)

The temporal scope of Prototype section 402(B) is limited to the conduct and operation of the LLC and its winding up.[55] It

absence of capital lock-in in a traditional at-will partnership. It is only the presence of these differing default rules that gives rise to a varied menu of organizational forms.

52. Prototype section 1102 provides that in determining whether to in the name of the LLC initiate legal action against a member or manager, the vote of the conflicted member or manager is not considered. In drafting operating agreements, care must be taken not to inadvertently eliminate the protections afforded by this requirement of disinterestedness. *See, e.g.*, Ward v. Hornik, No. 02.944, 2002 WL 1199249 (E.D. Pa. June 3, 2002) (finding that by defining a voting threshold to act and not providing for the exclusion of certain members from that vote, the statutory provision for such exclusion was overridden); Maitland v. Int'l Registries, Civ. No. 3644-CC, 2008 WL 2440521 (Del. Ch. June 6, 2008) (holding, where one member sued the LLC, the other member could not retain counsel on behalf of a two-member LLC in which the operating agreement provided that all decisions would be made by a majority of the members).

53. *See* 1 ROBERT B. THOMPSON & BLAKE THOMPSON, O'NEAL AND THOMPSON'S OPPRESSION OF MINORITY SHAREHOLDERS AND LLC MEMBERS § 3.17 nn.2-28 and accompanying text; *see also id.* § 3.18 nn.69-70 and accompanying text. Pursuant to the Kentucky LLC Act, which does not include the procedural requirements imposed upon derivative actions brought in the context of a corporation or limited partnership, the likely consequence of characterizing the action as derivative, rather than direct, is that the damages are paid to the LLC. *See* KY. REV. STAT. ANN. § 271B.7-400 (West 2010); KY. REV. STAT. ANN. §§ 362.2-1002 to 1005; KY. REV. STAT. ANN. §§ 362.511 to -.517.

54. For cases in which the limited partners were permitted to bring a direct claim for violations of the duty of loyalty, see James R. Burkhard, *LLC Member and Limited Partner Breach of Fiduciary Duty Claims: Direct or Derivative Actions?*, 7 J. SMALL & EMERGING BUS. L. 19, 41-45 (2003). Derivative versus direct suits is an interesting topic. There are no derivative actions available by statute under RUPA for either general or limited liability partnerships, but RULPA, ULPA, ULLCA and RULLCA all provide for derivative proceedings. The *ALI Principles of Corporate Governance* state that in "the case of a closely held corporation the court in its discretion may treat an action raising derivative claims as a direct action" under certain circumstances. 2 ALI PRINCIPLES OF CORPORATE GOVERNANCE § 7.01(d) (1992) (citation omitted). In other words, the topics of derivative actions contain public policy tensions that cross jurisdictional and type-of-entity boundaries.

55. *See* KY. REV. STAT. ANN. § 275.170(2)(a) (West 2010) (limiting itself to "[a]ny transaction connected with the conduct or winding up of the [LLC]."); *see also* KY. REV. STAT. ANN. § 362.1-404(2)(a); KY. REV. STAT. ANN. § 362.2-408(2)(a). Although section 275.170(2)(b) of the Kentucky Revised Statutes is not prefaced with "the conduct or winding up of the [LLC]," as it is focused upon property of the LLC and an LLC cannot have property before it exists, the temporal reach of the provision cannot extend prior to the organization of the LLC to the formation phase. KY. REV. STAT. ANN. § 275.170(2)(b).

does not apply to the period prior to formation.[56] This is a shift away from older partnership law. Under UPA and the common law of partnerships, the fiduciary obligations between the partners exist during the formation phase.[57] A similar change in the law took place between UPA and the Revised Uniform Partnership Act (RUPA); that is, unlike under UPA, RUPA does not apply the duty of loyalty during the formation phase.[58] Although arguments to the contrary exist, the absence of a duty of loyalty during the formation phase protects possible owners from exposure for deciding not to participate. Additionally, the absence of the duty avoids the anomaly of statutory duties being owed pursuant to a statute that does not apply until the venture comes into existence as an LLC[59] by the filing of its articles of organization.[60] Disagreement between statutory LLC models and acts concerning the fundamental question of whether an LLC can validly exist without at least one member is consistent with making fiduciary duties conditional on LLC existence.[61]

---

56. *Compare* UNIF. P'SHIP ACT § 21(1) (1914), 6 U.L.A. 194 (2001) (applying during the formation phase as well as during the conduct and liquidation of the partnership). *See also* KY. REV. STAT. ANN. § 362.250(1) (applying to the same phases).

57. *See* UNIF. P'SHIP ACT § 21(1) (1914), 6 U.L.A. 194 (referring to "formation . . . of the partnership."); *see also* KY. REV. STAT. ANN. § 362.250(1) (West 2010) (adopting UPA § 21(1) verbatim); BROMBERG & RIBSTEIN, *supra* note 40, § 6.07(a) (reviewing the issue of when in the formation of a partnership fiduciary duties arise).

58. *See* ROBERT W. HILLMAN, ALLAN W. VESTAL & DONALD J. WEIDNER, REV. UNIF. P'SHIP ACT, Authors Comments to § 404 cmt. at 264, 278-80 (HILLMAN *et al.*, 2008-09 ed.).

59. Longview Aluminum, L.L.C. v. Indus. Gen., L.L.C., No. 02.C.0168, 2003 WL 21518585 (N.D. Ill. July 2, 2003); Ramone v. Lang, No. 592-N, 2006 WL 905347 at *13 n.62 (Del. Ch. 2006) (holding that there was not a partnership among members who were anticipating the formation of an LLC). There remains outstanding, and we do not here address, the issue of at what point the formation phase ends and the conduct phase begins. *See also* O'Bryan v. Bickett, 419 S.W.2d 726, 729 (Ky. 1967) (holding that although an agreement to form a partnership was not sufficient to satisfy the statute of frauds, it set forth the "basic framework of a 'deal'" and as such was "sufficiently definite so as to warrant equitable recognition").

60. *See, e.g.*, KY. REV. STAT. ANN. § 275.020(2) (West 2010) ("Unless a delayed effective date is specified, the existence of the [LLC] shall begin when the articles of organization are filed by the Secretary of State . . . .").

61. Certain LLC acts permit an LLC to be organized without, as of the time of formation, a member or members. *See, e.g.*, TEX. BUS. ORGS. CODE ANN. § 3.010 (West 2010); VA. CODE ANN. § 13.1 (West 2010); REV. UNIF. LTD. LIAB. CO. ACT § 201, 6B U.L.A. 456 (2008); *see also* REV. UNIF. LTD. LIAB. CO. ACT § 201 cmt. to subsection (e), 6B U.L.A. 458 (2008). Other states, including Kentucky, require that an LLC have at least one member from the time of formation. *See* KY. REV. STAT. ANN. § 275.015(11).

IV. Liability for Self-Dealing Under the Prototype

A. The Two Aspects of Prototype Section 402(B): Self-Dealing and Personal Exploitation of LLC Property

The commentary to Prototype section 402(B) provides in pertinent part:

> The duty of loyalty under this section is defined to include two major components: "self-dealing," or a manager's reaping an individual profit by or through an LLC transaction in which the manager participated; and liability for appropriating for personal use property belonging to the LLC without the firm's consent. Such appropriation would amount to, in effect, unauthorized compensation. This duty is based on the fact that LLC property is owned by the firm as a whole rather than by individual managers or members. Note that "property" is defined to include records of the LLC that are in the manager's control. Because of the similarity of this section with the UPA,[62] it is anticipated that the courts will interpret a section such as this to impose duties similar to those in the general partnership, including the duty not to appropriate partnership opportunities.[63]

Examples of self-dealing include the sale of goods or services to the LLC or the acquisition of a distinct benefit upon the sale of company property, such as the release of a personal guaranty.[64] Appropriation of company property means the use of the property for the member's personal benefit, rather than for the benefit of the venture.[65]

---

62. *Compare* UNIF. P'SHIP ACT § 21(1) (1914), 6 U.L.A. 194 (2001) *with* KY. REV. STAT. ANN. § 362.250(1) (West 2010).

63. PROTOTYPE § 402, *supra* note 1, cmt. Language equivalent to Prototype § 402(B) appears in section 409(b)(1) of ULLCA. UNIF. LTD. LIAB. CO. ACT, 6B U.L.A. 597 (2008) (labeling and describing language in the comment thereto as a duty of loyalty).

64. *See generally* Loyola Fed. Sav. Bank v. Fickling, 58 F.3d 603 (11th Cir. 1995) (discussing a general partner who agreed to not contest foreclosure on partnership property in return for bank's satisfaction of $430,000 of partnership debt and release of partner's guarantee); Spinelli, Kehiayan-Berkman, S.A. v. Imas Gruner, A.I.A & Assocs., 602 F. Supp. 372 (D. Md. 1985) (discussing a partner who received an interest in the purchaser of partnership property); Jennison v. Bierer, 601 F. Supp. 1167 (D. Vt. 1984) (noting a partner received an employment agreement in connection with purchase of partnership property).

65. *See generally* Enea v. Superior Court, 34 Cal. Rptr. 3d 513 (Cal. Ct. App. 2005) (holding a partner's leasing of partnership property at less than market rates to be a

Opportunities are included within the scope of venture properties that may not be used for personal benefit. The iconic partnership loyalty case of *Meinhard v. Salmon* is an opportunity case.[66] Therein, the owner offered the opportunity to acquire a building leased and rehabilitated by a joint venture, together with adjacent properties, to Salmon, one of the two joint venturers.[67] Salmon took this opportunity for himself and never told the other venturer (Meinhard) of the offer.[68] In awarding Meinhard a forty-nine percent interest in the new development (the same ownership he enjoyed in the original venture), the court noted that Salmon was the managing partner of the Salmon/Meinhard joint venture and, therefore, as its agent could accept the development only on behalf of the joint venture because he was given the opportunity solely as a direct result of his position in the joint venture.[69] The same kind of resolution was reached in *Monim v. Monim* where a former partner in a milk-hauling partnership was held to have breached his duty by bidding on a contract previously performed by the partnership.[70] In *Marsh v. Gentry*, a partner was found to have violated his fiduciary obligations to his co-partner[71] by, without disclosing that he was doing so, secretly bidding on a partnership horse being sold at auction and another time being the undisclosed

breach of the partner's duty of loyalty); Veale v. Rose, 657 S.W.2d 834 (Tex. Civ. App. 1983) (discussing a partner who utilized partnership's employee and offices for partner's accounting work); Spiritas v. Robinowitz, 544 S.W.2d 710 (Tex. Ct. App. 1976) (granting a lien on partnership property given to secure partner's personal note); *see also* RESTATEMENT (THIRD) OF AGENCY § 8.05 (2006) ("An agent has a duty (1) not to use property of the principal for the agent's own purposes or those of a third party; and (2) not to use or communicate confidential information of the principal for the agent's own purposes or those of a third party.").

66. 164 N.E. 545 (N.Y. 1928).

67. *Id.* at 546.

68. *Id.*

69. *See generally* Bakalis v. Bressler, 115 N.E.2d 323 (Ill. 1953) (discussing that the partner's purchase of property was leased to the partnership); Lavin v. Ehrlich, 363 N.Y.S.2d 50 (N.Y. 1974). One school of thought about the meaning of *Meinhard v. Salmon* is that it is a managing partner case rather than a mere partner-as-agent case. *See generally* Larry E. Ribstein, *Are Partners Fiduciaries?* 2005 U. ILL. L. REV 209 (2005); *cf.* Thomas Earl Geu, *A Selective Overview of Agency, Good Faith and Delaware Entity Law*, 10 DEL. L. REV. 17 (2008) (discussing agency law as having either a symbiotic or parasitic relationship to business entities).

70. 785 S.W.2d 499, 500 (Ky. Ct. App. 1989).

71. 642 S.W.2d 574, 576 (Ky. 1982) (citing KY. REV. STAT. ANN. § 362.250(1) (West 2010)).

counter-party to a private sale of partnership property.[72] Even as the partnership realized the stipulated purchase price for the horse, "[t]he requirement of full disclosure among partners as to partnership business cannot be escaped."[73]

Must the LLC be in a financial position to take advantage of the opportunity for there to be a breach of loyalty? Although there are certainly cases to the contrary,[74] a careful consideration of the case law and the theory of fiduciary obligation show it to be both the better theory and the better practical rule that incapacity of the venture, actual or merely asserted,[75] should not be a defense to having appropriated the opportunity.[76] Rather, absent clear waiver, the venture should be the beneficiary of the opportunity and reap the rewards of its exercise.[77]

---

72. *Id.* at 575-76.

73. *Id.* at 576.

74. *See, e.g.*, Triple Five of Minn., Inc. v. Simon, 280 F. Supp. 2d 895 (D. Minn. 2003), *aff'd in part and rev'd in part*, 404 F.3d 1088 (8th Cir. 2005); Lightfoot v. Hardaway, 751 S.W.2d 844 (Tenn. Ct. App. 1988); Huffington v. Upchurch, 532 S.W.2d 576 (Tex. 1976); Gottsacker v. Monnier, 697 N.W.2d 436 (Wis. 2005).

75. If incapacity is even a defense, the burden of demonstrating incapacity must be upon the actor who appropriated the opportunity. *See, e.g.*, ALI PRINCIPLES OF CORPORATE GOVERNANCE § 5.05(c) (1994).

76. *See, e.g.*, J. WILLIAM CALLISON & MAUREEN A. SULLIVAN, PARTNERSHIP LAW AND PRACTICE § 12.8 (West 2010):

> If an opportunity belongs to a partnership and it is not presented to it, the courts generally hold the usurping partner accountable for all profits derived from the opportunity, even when the partner argues that the partnership did not have access to the funds or other resources with which to pursue the opportunity if it had been so offered to it.

BROMBERG & RIBSTEIN, *supra* note 40, § 6.07(d) ("If an opportunity is deemed to belong to the partnership, the courts will usually hold the usurping partner accountable (unless the other partners were aware of the opportunity and turned it down), even if the defendant claims that the partnership would have been unable or unwilling to take advantage of the opportunity if it had been offered.") (citations omitted); 2 CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶ 10.03[1][a][v] ("The 'account for' statutes therefore have dramatic implications for self-dealing transactions. If the transaction has been completed and the person with managerial authority has profited, that person must either show the required consent or disgorge all profits. It is generally no defense that the transaction was fair to the [LLC] . . . .") (citation omitted); RIBSTEIN & KEATINGE ON LLCS, *supra* note 1, § 9.3 ("A manager may not appropriate for personal use property belonging to the LLC without the firm's informed and disinterested consent.") (internal citation omitted).

77. *See infra* note 148.

By way of quick summary, once appropriate adjustments are made for a reduced temporal reach,[78] its modifiability,[79] its application,[80] and potential waivers;[81] Prototype section 402(B) can be understood, interpreted, and applied in light of the rich body of law that has arisen under UPA section 21(1).[82] The appropriation of an LLC opportunity by a member or manager subject to Prototype section 402(B) duties is a violation of the statutory duty of loyalty.[83] As previously discussed, the duty applies only during the operation and winding up of the LLC; it may be modified by agreement of the members, it applies to different classes of persons depending on whether the LLC is member or manager managed; and it may be waived.

B. Waiver of Conflict Transactions

As previously mentioned, there can be an *ab initio* waiver of the section 402(B) duty of loyalty, in whole or in part, in the operating agreement.[84] Conversely the members or managers[85] may waive the duty of loyalty at the time of a transaction otherwise violating section 402(B) or after the transaction has

---

78. *See supra* notes 56-61 and accompanying text; *see also* RESTATEMENT (THIRD) OF AGENCY § 8.05 (2006):

> An agent has a duty (1) not to use property of the principal for the agent's own purposes or those of a third party; and (2) not to use or communicate confidential information of the principal for the agent's own purposes or those of a third party.

79. *See supra* note 38 and accompanying text.

80. *See supra* notes 14-34 and accompanying text.

81. *See infra* notes 85-105 and accompanying text.

82. *See* UNIF. P'SHIP ACT § 21 (1914), 6 U.L.A. 194, at 195-242 (2008) (including collected cases) ; UNIF. P'SHIP ACT § 21 (1914), 6 U.L.A. 194, 45-46 (Supp. 2010).

83. In certain instances there will be a question as to whether a particular opportunity fell/falls within the business of the venture. *See* BROMBERG & RIBSTEIN, *supra* note 40, § 6.07(d).

84. As is discussed below, the adage "It is better to beg forgiveness than to ask permission" is not applicable under Prototype § 402(B) even if it is consistent with corporate law such as that embodied in Model Business Corporation Act section 8.61(b). *See infra* notes 92-97 and accompanying text.

85. *See, e.g.*, KY. REV. STAT. ANN. § 275.170(2) (West 2010) ("without the consent of more than one-half (1/2) by number of the disinterested managers, or a majority-in-interest of the members . . . "); *see also* KY. REV. STAT. ANN. § 275.170(3) (requiring a vote of the disinterested members); Rutledge, *The 2007 Amendments to the Kentucky Business Entity Statutes*, *supra* note 5, at 258.

been implemented.[86] A member who is subject to the conflict of interest owes a duty of complete and accurate disclosure when asking for the approval of the proposed transaction, and all doubts as to the adequacy of the disclosure should be resolved against the member obligated to make the disclosure.[87]

It is useful to contrast the waiver provisions of Prototype section 402(B) with those of the Model Business Corporation Act (MBCA) (specifically sections 8.61, 8.62 and 8.63),[88] as their similarity may camouflage crucial differences. A vote of those members of management who are disinterested may sanction the proposed conduct and waive the duty of loyalty under both the MBCA and the Prototype.[89] One difference between the two laws is the MBCA does not permit a single director to approve a conflict transaction.[90] The Prototype

86. The ability to waive the duty of loyalty with respect to a particular transaction is consistent with the predecessor partnership law. *See* UNIF. P'SHIP ACT § 21(1) (1914), 6 U.L.A. 194 (2001) (liability for benefits "derived by him *without the consent of the other partners*.") (emphasis added); KY. REV. STAT. ANN. § 362.250(1) (West 2010).

87. *See* PROTOTYPE, *supra* note 1, § 405(C); *see also* KY. REV. STAT. ANN. § 275.185(3); Beerman v. Graff, 621 N.E.2d 173 (Ill. App. Ct. 1993); Aero Drapery of Ky., Inc. v. Engdahl, 507 S.W.2d 166, 169 (Ky. 1974) ("Whenever a reasonably prudent fiduciary is aware of a conflict between his private interest and the corporate interest, he owes the duty of good faith and full disclosure of the circumstances to the corporation."); RESTATEMENT (THIRD) OF AGENCY § 8.06(1)(a)(ii) (requiring that, in seeking the consent of the principal for conduct that otherwise reaches a duty undertaken, the agent must "disclo[se] all material facts that the agent knows, has reason to know, or should know would reasonably affect the principal's judgment unless the principal has manifested that such facts are already known by the principal or that the principal does not wish to know them . . . ."); RESTATEMENT (THIRD) OF AGENCY § 8.06 cmt. c ("An agent has the burden of establishing that the principal consented to the agent's acquisition of a material benefit. The rule entitles the principal to assume that the agent will make the disclosures requisite to effective consent by the principal.").

88. Subchapter F. (Directors' Conflicting Interest Transactions) to the MBCA comprises sections 8.60 through 8.70. It was initially adopted in 1989 and amended in 2005. The rules contained in sections 8.61, 8.62, and 8.63 were embodied in section 8.31 of the prior edition of the MBCA. Comm. on Corp. Laws, ABA Section of Bus. Law, *Changes in the Model Business Corporation Act*, 60 BUS. LAW. 943, 943 (2005).

89. *See* KY. REV. STAT. ANN. § 362.1-401(10) (West 2010); PROTOTYPE, *supra* note 1, § 402(B) (concerning waiver by majority of the disinterested managers); MODEL BUS. CORP. ACT § 8.62(a) (concerning waiver by majority of disinterested directors). Under RUPA, an action in contravention of the partnership agreement, including one otherwise in contravention of the partner's duty of loyalty, absent private ordering to the contrary, is authorized only if it receives the unanimous approval of the partners. *See* REV. UNIF. P'SHIP ACT § 401(j), 6 U.L.A. 133 (Supp. 2002); KY. REV. STAT. ANN. § 362.1-401(10) (West 2010).

90. *See* MOD. BUS. CORP. ACT § 8.62(a).

contains no similar minimum threshold. Both the MBCA and the Prototype provide that a transaction may be approved by equity holders.[91] Under the MBCA, shares controlled or held by a person related to the director who is subject to the conflict do not participate in the approval vote.[92] The Prototype, on the other hand, refers only to a vote of the disinterested members, without further elaboration.[93] Even so, the Prototype and the MBCA generally track one another as to an *a priori* approval by disinterested persons to allow conduct otherwise violating the duty of loyalty. The Prototype and the MBCA materially depart, however, over the inclusion of a third mechanism for absolving a conflict of interest by the MBCA, namely an *ex post* assessment that the transaction "was fair to the corporation."[94] Under the MBCA, the fiduciary's conduct may be sanctioned on the basis that the deal was fair, even absent disclosure and disinterested approval of the conflict-of-interest transaction.[95] Typically the fiduciary who undertook the conflict transaction without prior approval will bear the burden of proving

---

91. *See* MOD. BUS. CORP. ACT § 8.63; PROTOTYPE, *supra* note 1, § 402(B).

92. *See* MOD. BUS. CORP. ACT § 8.60(2)-(5), .63(b).

93. Certain enactments of PROTOTYPE § 402 expand on the requirement of disinterestedness in a member vote that waives the duty of loyalty. *See, e.g.*, KY. REV. STAT. ANN. § 275.170(3); *see also* Rutledge, *The 2007Amendments to the Kentucky Business Entity Statutes, supra* note 5, at 249. Additional requirements may be included in the operating agreement. *See supra* note 38 and accompanying text.

94. *See* MOD. BUS. CORP. ACT § 8.61(b)(3); *see also* KY. REV. STAT. ANN. § 271B.8-310(1)(c) (West 2010). The "fair to the [entity]" test is incorporated as well in the Uniform Statutory Trust Entity Act (USTA). *See* UNIF. STATUTORY TRUST ENTITY ACT § 507(c). Under section 5.05 of the *Principles of Corporate Governance*, while an *ex post* fairness test may be applied, if there was no disinterested and informed rejection of the opportunity after its presentation, fairness is not a defense if the opportunity was never offered. *See* PRINCIPLES OF CORPORATE GOVERNANCE § 5.05(a); § 5.05(a) cmt.; *see also infra* note 147.

95. MOD. BUS. CORP. ACT § 8.60(6). This mechanism has been classified as the "liability rule":

> A liability rule allows transactions to be imposed on an unwilling minority, but ensures that the minority is adequately compensated in objective market-value terms. This category includes systems which allow a controlling owner with a conflict of interests to vote, but require that the transaction be "fair." Although the measure of fairness is objective, by permitting the controlling owner to vote, the controlling party is allowed to impose the transaction on the minority and, in effect, to appropriate its property.

See Zohar Goshen, Voting and Economics of Self-Dealing: Theory Meets Reality 5 (May 23, 2003), *available at* http://ssrn.com/abstract=229273.

fairness,[96] but some states impose the burden of proving a lack of fairness on the complaining shareholder.[97] No similar provision for *ex post* "fairness" analysis appears in the Prototype or the predecessor partnership law, the UPA.[98] Instead, both the Prototype and the UPA direct that the benefit of an unwaived conflict-of-interest transaction must be held for the benefit of the LLC or partnership in a constructive trust.[99] In the colloquial formula, "begging forgiveness" by asserting or even demonstrating fairness is not a substitute for "asking permission."

C. The Breach v. Liability Distinction

Assume, for current purposes, that an individual subject to the duty of loyalty is engaged in conduct that was within the scope of the duty of loyalty and that there was no waiver of the duty by members or managers. While the inclination to proceed to the determination of "damages" is obvious, doing so skips a

---

96. *See, e.g.*, MOD. BUS. CORP. ACT § 8.61 cmt. 2 (explaining that under section 8.61(b)(3) the interested director has the burden of establishing that the transaction was fair); ALI PRINCIPLES OF CORPORATE GOVERNANCE § 505(c); *see also* Kahn v. Tremont Corp., 694 A.2d 422 (Del. 1997); Kahn v. Lynch Commc'n Sys., 638 A.2d 1110 (Del. 1994).

97. *See, e.g.*, Krukemeier v. Krukemeier Mach. & Tool Co., 551 N.E.2d 885, 888 (Ind. Ct. App. 1990).

98. *See, e.g.*, BROMBERG & RIBSTEIN, *supra* note 40, § 6.07(b) ("If there is no informed consent, the mere fact that the transaction is fair to the partnership may be insufficient to validate it.") (citation omitted). This mechanism has been classified as the "property rule":

> A property rule prevents any transaction from proceeding without the minority owner's consent. In general, a property-type protection establishes a system in which both transaction performance and price demand are determined on a purely consensual basis. That is, a transaction is only performed with the consent of the disinterested group, at a price that is a function of the group's subjective evaluation of its worth. This category may include systems which either deny interested parties a vote in the matter or require the approval of the disinterested "majority of the minority" before the transaction may proceed.

Goshen, *supra* note 95 at 5.

99. While corporate law permits reference to a hypothetical bargain to assess the propriety of a conflicted transaction, the Prototype does not provide for an after-the-fact analysis. Section 8.61(b)(3) of the MBCA may be understood as holding in abeyance the determination of whether the otherwise conflicted director violated her duties until the conclusion of the proceeding in which "fair to the corporation" is assessed. MOD. BUS. CORP. ACT § 8.61(b)(3). In contrast, the breach of duty in an LLC is determined at the time of the transaction for which approval was not sought.

necessary step, namely determining whether liability for the breach has been eliminated.[100]

Prototype section 404(A) provides that an operating agreement may eliminate liability for monetary damages arising out of the breach of a section 402 duty.[101] This provision is similar in effect to section 102(b)(7) of the Delaware General Corporation Law[102] and section 2.02(b)(4) of the MBCA,[103] each of which permits, to a limited degree, the elimination of liability for a breach of duty.[104] There are distinctions, however, between the modification or elimination of a duty and the elimination of liability for the breach of that duty. Simply, there cannot be a breach if the duty has been eliminated. On the other hand, if there is a duty it can be breached even though the breach will not result in monetary liability to the exculpated actor.[105]

---

100. The order of the analytical steps in this article tracks a theoretically linear organization and is useful for explanatory purposes. In practice, this step will probably be the first step in the analysis.

101. *See* PROTOTYPE, *supra* note 1, § 404(A) (noting that the operating agreement may "eliminate or limit the personal liability of a member or manager for monetary damages for breach of any duty provided for in § 402"). Under the Prototype, there is no requirement that such a limitation be in a written operating agreement, though certain state enactments do contain such a statute of frauds. *See, e.g.*, IND. CODE ANN. § 23-18-4-4 (West 2010); KY. REV. STAT. ANN. § 275.180 (West 2010).

102. DEL. CODE ANN. tit. 8, § 102(b)(7) (West 2010):

> A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 if this title; or (iv) for any transaction from which the director derived at an improper personal benefit.

103. MOD. BUS. CORP. ACT § 2.02(b)(4):

> The articles of incorporation may set forth a provision eliminating or limiting the liability of a director to the corporation or its shareholders for money damages for any action taken, or any failure to take any action, as a director, except liability for (A) the amount of a financial benefit received by a director to which the director is not entitled; (B) an intentional infliction of harm on the corporation or the shareholders; (C) a violation of section 8.33; or (D) an intentional violation of criminal laws . . . .

104. While corporate law does not permit the limitation or waiver of culpability for breach of the duty of loyalty, Prototype § 404(A) allows the limitation. PROTOTYPE, *supra* note 1, § 404(A).

105. Consequently, while there cannot be aiding and abetting liability for the breach of a duty that has, as to the primary actor, been eliminated, it is open to debate whether the secondary actor, having not been relieved of liability on the breach, may be

The latter is narrower than the former; in the face of such a provision, even when there has been a breach of an applicable duty, there is no liability for the breach. Careful attention to the scope of the elimination permitted by the controlling statute and the agreement at issue is necessary;[106] however, because relief from "monetary damages" leaves injunctive and other equitable relief available to the plaintiff.

D. Remedies for Breach

A claim for violation of the duty of loyalty, having threaded a more perilous passage than that between Scylla and Charybdis,[107] now turns to the question of remedy. At least the initial remedy for violation of the duty of loyalty is provided by the following text: "Every member and manager must account to the [LLC] and hold as trustee for it any profit or benefit derived by that person...."[108] Thus, the culpable member or manager must disgorge to the LLC all profits and benefits derived from the improper transaction.[109]

Merely requiring the return of the benefits realized from the diversion of venture assets (including opportunities) may be insufficient to compensate the LLC. Moreover it may be insufficient to discourage breaches of the duty of loyalty because, like in some corporate derivative actions, the profits

---

responsible for aiding and abetting even as the primary actor is not. *See, e.g.*, Fendler, *supra* note 41, at 677 n.156 (2007-08).

106. *See, e.g.*, Manhattan, Inc. v. Clark, No. 2000-CA-2451-MR 2001, Ky. App. LEXIS 1413, at *6-7 (Dec. 28, 2001) (holding a provision permitting parties in joint venture to engage in "any other business venture . . . even if competitive with the business of the Venture" did not permit a venturer, for its own account, to deal in the venture's property).

107. *See* HOMER, THE ODYSSEY 274 (Robert Fagles trans., 1996).

108. PROTOTYPE § 402(B), *supra* note 1.

109. PROTOTYPE § 402(B), *supra* note 1; KY. REV. STAT. ANN. § 275.170(2) (West 2010) ("each member and manager shall account to the [LLC] and hold as trustee for it any profit or benefit derived."). *Accord* KY. REV. STAT. ANN. § 362.250(1); KY. REV. STAT. ANN. § 362.1-404(2)(a)(West 2010); KY. REV. STAT. ANN. § 362.2-408(2)(a); *see also* Chambers v. Johnston, 201 S.W. 488, 493-94 (Ky. 1918); Demoulas v. Demoulas, 784 N.E.2d 1122 (Mass. App. Ct. 2003); Van Stee v. Ransford, 77 N.W.2d 346 (Mich. 1956); *In re* Kohn's Estate, 116 N.Y.S.2d 167 (N.Y. Sur. Ct. 1952), *aff'd without opin.* 282 App. Div. 1045, 126 N.Y.S.2d 897 (1953); *In re* Estate of Wilson, 315 P.2d 287 (Wash. 1957); BROMBERG & RIBSTEIN, *supra* note 40, § 6.07(i) ("The measure of damages for fiduciary breach clearly includes any profits earned as a result of the breach.") (internal citation omitted).

will be returned to a venture that is under the control of the malefactor.[110] Similarly, even exemplary damages, if any are found, will be paid to the LLC because the duty is owed the LLC under the Prototype.[111] Consequently the damages awarded may well be under the control of the defalcating fiduciary. This problem is avoided in ventures that provide that the duty of loyalty is owed to the members as well as the LLC. In *Meinhard v. Salmon*, for example, Meinhard's recovery was a forty-nine percent (*i.e.*, minority) position in the expanded venture, one under Salmon's control.[112] It is safe to assume those partnership meetings were, at best, chilly.

Indeed, if disgorgement were the sole remedy, a fiduciary contemplating disloyal conduct would be presented with a "heads I win and tails you lose" situation. The successful fiduciary expropriates to her account the benefit of the venture's asset unless challenged. If, however, the conduct is challenged and only the benefits are ordered paid over to the venture, then the fiduciary is no worse off than she would have been absent her breach.[113] In those circumstances, there is little marginal

---

110. *See* THOMPSON & THOMPSON, *supra* note 53, § 3.17 ("Recovery or restitution of the misappropriated property, however, might not be a complete or final remedy if the same dishonest management responsible for the misappropriation remains in control of the corporation.") (internal citation omitted).

111. *See supra* notes 43-54 and accompanying text.

112. *See supra* notes 66-69and accompanying text.

113. *See* Frank H. Easterbook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 441 (1993):

> When violations are hard to detect, penalties must be a multiple of the loss in a particular case. So, for example, a thief who steals $100 and is caught one time in three must be fined at least $300, or theft will carry an anticipated profit. The duty of loyalty defines a variety of theft, so just as the optimal sanction for crime exceeds the loot, so the optimal sanction for breach of the duty of loyalty must exceed the fiduciary's profits. Profits alone are an inadequate remedy. Instead of using a multiplier, the law uses a principle of suspicion: the *appearance* of a breach of duty is treated as a wrong, substantially increasing the probability that a breach of duty will be detected (and reducing the need for a profits multiplier when detection occurs). Both the strict duty and the disgorgement remedy turn out to be what the parties would have provided by contract in a world without transactions costs.

Id. (summarizing the position of Robert Coster & Bradley J. Freeman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045 (1991)); Diamond v. Oreamuno, 248 N.E.2d 910, 912 (N.Y. App. Div. 1969):

> This is because the function of such an action [for breach of fiduciary duty], unlike an ordinary tort or contract case, is not merely to *compensate* the plaintiff for wrongs committed by the defendant but, as this court

out-of-pocket risk for the fiduciary undertaking disloyal conduct.

Exemplary damages against the breaching fiduciary may help,[114] even though paid to an LLC that the fiduciary controls, because exemplary damages increase the cost to the malefactor of being caught to the extent they represent a real personal monetary loss as compared to a mere return of ill-gotten gains. Attorneys' fees[115] and equitable relief may also be appropriate in order to increase the marginal cost of disloyal conduct and to make sure the malefactor pays the full cost of the conduct.[116] For example, a court acting in equity could adjust the sharing ratios in the original venture to reduce or preclude the fiduciary from benefiting from allocations or distributions derived from the venture she initially sought to divert.[117] In addition, egregious defalcations of fiduciary obligations could justify criminal prosecution.[118]

E. Prototype Section 402(B) and Recourse to Common Law Fiduciary Duties

Many court cases have looked first to the general common law of fiduciary duties, rather than to the operating agreement and then to the controlling LLC act in attempting to identify and delineate the fiduciary duties owed by members and managers in an LLC. *Patmon v. Hobbs*, discussed in greater detail below, is one such case.[119] *Purcell v. Southern Hills Investments, LLC*

> declared many years ago to *prevent* them, by removing from agents and trustees all inducement to attempt dealing for their own benefit in matters which they have undertaken for others, or to which their agency or trust relates.

(emphasis added) (internal citations omitted).

114. *See* BROMBERG & RIBSTEIN, *supra* note 40, § 6.07(i); *see also* THOMPSON & THOMPSON, *supra* note 53, § 3.17; note 34 and accompanying text.

115. *See* BROMBERG & RIBSTEIN, *supra* note 40, § 6.07(i).

116. *Id.*

117. *See* Thompson v. Price, 59 Cal. Rptr. 174, 178 (Cal. Ct. App. 1967) (depriving the malefactor of a prospective benefit in the venture by means of a constructive trust after requiring him to make the corporation whole from the consequences of the breach of loyalty).

118. *See, e.g.*, Jennifer Peltz, *Brooke Astor's Son Sentenced: Guilty of Looting Fortune over Years*, N.E. JOURNAL GAZETTE (Fort Wayne Ind.), Dec. 22, 2009 at 5A; Editorial, *The Time of His Life: Brooke Astor's Thieving, Abusing Son is Getting Off Easy*, N.Y. DAILY NEWS (Dec. 22, 2009).

119. *See infra* notes 144-209 and accompanying text.

also provides an example.[120] There the court analogized an LLC to a closely held corporation or a partnership and determined that members owe fiduciary duties to one another[121] even as it cited Indiana's adoption of Prototype section 402(A)[122] for the willful and reckless standard of culpability.[123] Reference to the common law of other entities does not, in the first instance, follow appropriate analytic protocol. Rather, the analysis must begin with the particularized agreement of the parties. To the extent the agreement addresses fiduciary obligations, the only remaining tasks are to: (1) make sure the governing statute has not prohibited the particular modification, and; (2) then apply the agreement's standards to the conduct in question. If, on the other hand, the agreement is silent, then the controlling LLC act must be consulted for the existence and parameters of the default duty.[124] In turn, the default duty will then be applied to the conduct in question.

In almost all situations the analysis will end there; that is, the conduct either was or was not permitted under the controlling operating agreement and act.[125] Further analysis outside these sources can be dangerous because of the risks of introducing into the agreement terms that were not the result of a bargain by the parties or of infecting the act with inappropriate doctrine. For example and as previously observed, a simple statement that a person is a fiduciary and therefore owes a duty of loyalty is misleading because it is incomplete.[126] The duty of

120. 847 N.E.2d 991, 997 (Ind. Ct. App. 2006).

121. Indiana follows, *inter alia*, the rule that shareholders owe fiduciary obligations to one another. *See, e.g.*, Barth v. Barth, 659 N.E.2d 559, 561 (Ind. 1995).

122. This suit alleged self-dealing by Purcell. Purcell v. S. Hills Invs., LLC, 847 N.E.2d 991, 993 (Ind. Ct. App. 2006). The *Purcell* Court should have focused on section 23-18-4-2(b) of the Indiana Code, which is the Indiana adoption of Prototype § 402(B).

123. *See Purcell*, 847 N.E.2d at 999.

124. *See, e.g.*, Katris v. Carroll, 842 N.E.2d 221, 224 (Ill. Ct. App. 2005) ("We look to the applicable provisions of the Act in determining the fiduciary duties owned by the managers and members of the LLC.").

125. This analysis parallels the one suggested in an article written by Chief Justice Steele of the Delaware Supreme Court. *See* Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 25 (2007).

126. By analogy, just because a snail and an eagle both have eyes and can see does not mean they see the same things or that their eyes are physiologically similar. *See, e.g.*, RICHARD DAWKINS, CLIMBING MOUNT IMPROBABLE 139-40 (1st Am. ed. 1996).

loyalty is not a monolithic, self-defined, and self-effective rule or series of rules; rather, different duties of loyalty are applicable under different circumstances.[127] A bare declaration that a person is a fiduciary subject to a duty of loyalty and that his conduct violated the duty ignores the crux of the question; that is, the nature of the duty of loyalty as relating to particular facts and circumstances. The only way the duty of loyalty can be properly evaluated is by making an inquiry that includes interpretation of the applicable agreement and of the particular governing statute and applying the same to the unique facts and circumstances of the case.[128]

Perhaps a factor influencing the resort to common law in spite of the existence of statutory provisions is the reliance upon Delaware law as the touchstone of business-entity law. The distinction all too often overlooked is that, unlike most states' statutes, Delaware's business-entity statutes do not define the standards of care and loyalty. Rather, those standards are left to the agreement of the participants and the common law in Delaware.[129] To that end, cases such as *Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC*[130] held, absent private ordering to the contrary, that: (1) managers of an LLC owe "traditional fiduciary duties of loyalty and care to the members of the LLC,"[131] and (2) members in an LLC owe to one another "the traditional fiduciary duties that directors owe a

127. *See, e.g.*, Easterbrook & Fischel, *supra* note 113, at 432-34 (1993) (cataloging various duties of loyalty and identifying distinctions between them). In a similar vein, there are different duties of care. For example, a Kentucky-organized LLC requires that conduct not be "wanton or reckless." KY. REV. STAT. ANN. § 275.170(1) (West 2010). Auctioneers and the officers and executive board of a condominium association are bound to a duty of reasonable care (*i.e.*, simple negligence). *See* 201 KY. ADMIN. REGS. 11:121(1)(4)(e)(2010); 2010 Ky. Acts ch. 97, § 35, codified at KY. REV. STAT. § 381.9169.

128. *See* Elizabeth S. Miller & Thomas E. Rutledge, *The Duty of Finest Loyalty and Reasonable Decisions: The Business Judgment Rule in Unincorporated Business Organizations*, 30 DEL. J. CORP. L. 343, 379-87 (2005) (reviewing the issues involved in applying a common-law business-judgment rule in the context of a contractually agreed to standard of care).

129. *See* Elizabeth S. Miller, *Are the Courts Developing a Unique Theory of Limited Liability Companies or Simply Borrowing from Other Forms?*, 42 SUFFOLK U. L. REV. 617, 634 (2009) (describing Delaware as having an LLC act that does not specify duties or standards but does authorize contractual modifications of the duties and standards.).

130. No. 3658-VCS, 2009 WL 1124451 (Del. Ch. Apr. 20, 2009).

131. *Id.* at *9.

corporation."[132] Such statements are appropriate because the statute is silent and in the referenced case the agreement was silent, too. Other state legislatures have defined the applicable standard of care or loyalty; for example, by adopting the standards in Prototype sections 402(A) and 402(B). In those states, broad recourse to the general common law for a normative scope and standard of particular fiduciary duties is misplaced.[133]

Moreover, and as a matter of interpretive policy, the law of business associations seems to have become more "statutory" over time in ways other than through the invention or recognition of "new" entities.[134] Even the fiduciary provisions

---

132. *Id.* In *Kelly v. Blum*, the court stated "[U]nless the LLC agreement in a manager-managed LLC explicitly expands, restricts, or eliminates traditional fiduciary duties, managers owe those duties to the LLC and its members and controlling members owe those duties to minority members." No. 4516-VCP, 2010 WL 629850, at *10 (Del. Ch. Feb. 24, 2010).

133. Principles of common law apply "in the absence of controlling statutory law." 15A AM. JUR. 2D *Common Law* § 1 (2000) (internal citations omitted). As observed by Delaware Chief Justice Steele:

> For purposes of this article, it must be accepted that fiduciary duties will be developed in each new business context by drawing analogies from duties recognized in already existing contexts . . . . But given [limited partnership's and LLC's] rapid growth and continued variety, there is also a danger in continuing to analogize principles of fiduciary duty as used in the corporate governance context to the internal governance of limited partnerships and [LLCs]. Wrong analogies can be drawn for many possible reasons: a lack of appropriate focus, a desire to effect a particular purpose or result, or a desire to delegate or distribute power so that the fiduciary can act more effectively while preventing the fiduciary from effecting its own conflicting needs.

Steele, *supra* note 125, at 8-9 (emphasis added) (citation omitted).

134. The limited cooperative association is one of the newest types of entities to join the entity circus. It grew out of an unincorporated cooperative statute enacted in Wyoming in 2001, and the uniform act, the Uniform Limited Cooperative Association Act (ULCAA), was promulgated by the Uniform Law Commission during its annual meeting in summer, 2007. It differs from other cooperative statutes (almost all of which are corporate though unincorporated cooperatives have a long history) because it allows the existence of "investor members" who are not patrons but who may share profits from, and vote in, the limited cooperative. It attempts to mitigate the disadvantage of the use of traditional cooperatives concerning attracting equity capital other than from government sanctioned or designed sources. Even so, ULCAA attempts to statutorily articulate, protect, and encourage values frequently denominated "cooperative principles." For a detailed introduction and comprehensive analysis of ULCAA see Thomas Earl Geu & James B. Dean, *The New Uniform Limited Cooperative Association Act: A Capital Idea for Principled Self-Help Value Added Firms, Community Based Economic Development, and*

within states like Delaware are the subject of great statutory detail.[135] Professor Langbein has explored this same trend toward statutes in trust law,[136] suggesting several reasons for the "statutorification"[137] of trust law including speed,[138] comprehensiveness,[139] and the ability to bring specific expertise to bear in increasingly complicated and interrelated topical areas of law.[140] It seems those reasons could also help explain the general trend of the increase in statutory business-association law. If this supposition is correct, courts *should* exercise great care when analyzing or generalizing from one statute to another where the different statutory schemes vary in manner of expression, detail of regulatory method, and scope of application.

Finally, the evolutionary history and the bifurcation points of different "species" of organizations should provide clues to interpretation. An evolutionary analysis of the interpretation of business-association law would add the notion that different

---

Low-Profit Joint Ventures, 44 REAL PROP. TRUST & EST. L.J. 55 (2009) (containing an introduction to the law of traditional cooperatives).

135. Even the Delaware business-entity statutes contain legislative course corrections to common law developments. For example, the legislature amended the Delaware limited partnership and LLC acts to legislatively modify the case *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.* *See supra* note 41; Mohsen Manesh, *Legal Asymmetry and the End of Corporate Law*, 34 DEL. J. CORP. L. 465, 481-82 (2009).

136. *See generally* John H. Langbein, *Why Did Trust Law Become Statute Law in the United States?*, 58 ALA. L. REV. 1069 (2007).

137. *Id.* at 1078.

138. Some "fields [outside trust law] developed too recently and too rapidly for the accretive processes of the common law to have been able to supply timely and adequate guidance." *Id.* at 1071. In the case of trusts, however, Langbein suggests it is the pace of change and not the *newness* of creation that favors legislative speed over common law accretion stating:

[T]he trust of today bears only a distant relationship to the trust of former centuries. The trust that we know is mainly a creature of the twentieth century; accordingly, common law processes of incrementalism were no more suitable for today's trust law than for the regulation of nuclear power plants.

Id.

139. Langbein, for example, states the merging of law and equity into a single court tended to favor "the guidance of precise and authoritative statutory rules." *Id.* at 1080. Further, he observes in the trust area, "[e]ven in a state with a well-developed common law of trusts, authority regarding many points is lacking, or unclear, or sometimes conflicting [and a] particular attraction of field-occupying legislation is that it resolves many such issues." *Id.*

140. *Cf. id.* (discussing drafters who are "academic specialists," the use of bar association advisors for uniform law drafting projects, and the demise of the specialized equity judge).

species of organizations and entities in the same kingdom will be more closely related in fundamental ways if they also share the same phylum, class, order, family, and genus. The evolutionary analysis seems to suggest, for example, that analogies between unincorporated organizations would typically be better than analogies between unincorporated and incorporated organizations.[141]

V. Patmon v. Hobbs

A. The Case

The Kentucky LLC Act is based upon the Prototype[142] and contains a verbatim adoption of Prototype section 402(B)'s duty of loyalty.[143] In *Patmon v. Hobbs*, the Kentucky Court of Appeals addressed the existence and quality of the duty of loyalty in LLCs.[144] Unfortunately, it is, an instance of a "partial right answer but wrong reason."

Hobbs, as the fifty-one percent managing member of a member-managed LLC,[145] American Leasing and Management, LLC (American Leasing LLC), purported to transfer certain build-to-suit lease agreements between American Leasing LLC and a third party to another LLC of which he was the sole owner.[146] Hobbs did not seek approval for the transfers (or a

141. For an article-length example of using evolutionary analysis as an interpretive aid for law, see Thomas Earl Geu, *A Single Theory of Limited Liability Companies: An Evolutionary Analysis*, 42 SUFFOLK U. L. REV. 507 (2009).

142. *See* Rutledge & Booth, *The LLC Act*, *supra* note 2, at 9. The statement in *Randy Wenty and Hartford Fire Ins. Co. v. Hargus Sexton*, No. 2000-CA-002847-MR, slip op. (Ky. Ct. App. Feb. 1, 2002) (unpublished), stating that "the Kentucky [LLC] Act . . . is generally similar to the model act promulgated by the Uniform Law Commissioners" is accurate only to the extent that ULLCA is similar to the Prototype Act.

143. In 2007, after *Patmon v. Hobbs* was initiated, the Kentucky adoption of Prototype § 402(B) was amended, but not in a manner directly relevant to this dispute. *See* Rutledge, *The 2007 Amendments to the Kentucky Business Entity Statutes*, *supra* note 5, at 248-49. Curiously, section 275.170(2) of the Kentucky Revised Statutes, as quoted by the court of appeals, is the statute as it existed after its amendment in 2007 and not as it existed in 2004, while it is paraphrased in its 2004 form by the *Patmon* court. *See Patmon*, 280 S.W.3d at 595.

144. 280 S.W.3d at 590. The *Patmon* decision is the first published ruling of a Kentucky court addressing section 275.170 of the Kentucky Revised Statutes. This decision was not appealed to the Kentucky Supreme Court. Neither author has served as legal counsel, an expert witness or otherwise in this case.

145. *See supra* note 15 and accompanying text.

146. *Patmon*, 280 S.W.3d at 592.

waiver of the duty of loyalty) from the other members of American Leasing LLC[147] and the LLC received nothing in consideration for the transferred agreements.[148] Patmon, a member of American Leasing LLC, brought suit against Hobbs individually and in the name of the LLC.[149] The trial court required that Hobbs reimburse American Leasing LLC for its out-of-pocket expenditures that benefited his separate LLC.[150] However, it determined that no other damages were due American Leasing LLC consequent to Hobbs's transfer of the build-to-suit lease agreement since the LLC was not in a financial condition to perform the contracts.[151]

On Patmon's appeal, the Kentucky Court of Appeals found that Hobbs had violated his duty of loyalty to the LLC only after an unfortunate and unnecessary diversion through the business-corporation act[152] and various other decisions on fiduciary duties.[153] Only the opinion's conclusion focused on the language of section 275.170(2) of the Kentucky Revised Statutes Annotated and (correctly) identified it as the statutory recitation of the standard of loyalty for Kentucky LLCs.[154] The court ultimately determined that Hobbs had violated his duty of

147. *Id.* at 593; *see also* KY. REV. STAT. ANN. § 275.170(2) (West 2010) (addressing the requirement of disinterested approval of what is otherwise a conflict-of-interest transaction).

148. *Patmon*, 280 S.W.3d at 592.

149. *Id.* at 589.

150. *Id.* at 596.

151. *Id.*

152. *Id.* at 591. Treating, it would seem, the corporate model of fiduciary duties in general and its duty of loyalty in particular as the normative paradigm for all business organizations, a point of reference neither supported in the decision nor supportable in general. Rather, choice of entity matters. The rights, duties, and obligations of participants in different types of business structures are different depending upon the type selected. There likely exist no normative rights and duties, with the exception of the contractual obligations of good faith and fair dealing, which apply universally irrespective of form.

153. *Patmon*, 280 S.W.3d at 591. For example, the court discussed *Steelvest, Inc. v. Scansteel Service Center, Inc.*, 807 S.W.2d 476 (Ky. 1991), an iconic decision that defined a breach of fiduciary duty as a species of fraud.

154. *Patmon*, 280 S.W.3d at 598. Consequent to this decision, section 275.170(2) of the Kentucky Revised Statutes was expressly labeled the LLC Act's duty-of-loyalty provision. *See* KY. REV. STAT. ANN. § 275.170(2) *amended by* 2010 Ky. Acts, ch. 133, § 32; *see also* Thomas E. Rutledge & Dean Dennis R. Honabach, *Kentucky Business Entity Laws: The 2010 Amendments*, 74 BENCH & B. 6, 9 (Sept. 2010).

loyalty[155] and was liable for damages only after: (1) stating that Kentucky courts have not determined whether members have a duty of loyalty[156] (notwithstanding that the statute makes it clear that they do);[157] (2) discussing Hobbs's duty of loyalty in the context of the LLC because his conduct violated the statutory conflict-of-interest provision of the business-corporation act;[158] and (3) addressing whether an opportunity exists if the LLC is unable to take advantage of it,[159] subject to the LLC's recovery to a "futility defense."[160]

B. The Statutory Duty of Loyalty and Agency

The LLC in question was member managed,[161] and therefore Hobbs, as a member, owed the company a statutory duty of loyalty under the LLC Act that included the obligation to

---

155. Mason v. Underhill, No. 2006-CA-002144-MR, 2008 WL 1917179, at *7 (Ky. Ct. App. May 2, 2008) (stating that a "partner has a duty to share with the partnership those business opportunities clearly related to the subject of its operations . . . .") (quoting 59A AM. JUR. 2D *Partnership* § 295 (2003)). As detailed in a leading treatise on partnership law, "A partner cannot, without consent of his partners, acquire for himself a partnership asset, e.g., by substituting a contract with himself for one with the partnership . . ." ALAN R. BROMBERG, CRANE AND BROMBERG ON PARTNERSHIP (West 1968) (citations omitted). "Nor may he divert to his own use or profit a 'partnership opportunity.'" *Id.* at 391; *see also* BROMBERG & RIBSTEIN, *supra* note 40, § 6.07(c) (listing, as an example of taking an unauthorized benefit from partnership property "taking over a partnership contract").

156. 280 S.W.3d at 593; *see also supra* note 13.

157. This point was recognized by the trial court, which wrote in its conclusions of law "KRS 275.170(2) creates a statutory duty of loyalty . . . ." American Leasing and Management, LLC v. Hobbs, 04CI4901, slip op. (Ky. Jefferson County Cir. Ct. Sept. 24, 2007).

158. 280 S.W.3d at 597. (stating "we must determine not only that Hobbs's activities breached the statutory standards found in KRS 275.170 *and* KRS 271B.8-310(1) . . . .") (emphasis added).

159. *Id.* at 597-98.

160. *See* 3 WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 862.10 (noting that certain courts have held that the futility defense is available only in instances of full disclosure). This rule has been embodied in the *Principles of Corporate Governance*, which provide that while fairness, which includes futility, may be a defense to the misappropriation of an opportunity when there has been full disclosure, it is not available in the absence of disclosure. *See* ALI PRINCIPLES OF CORPORATE GOVERNANCE § 5.05(a); cmt. to § 5.05(a) ("Section 5.05(a) sets forth the general rule requiring a director or senior executive to first offer an opportunity to the corporation before taking it for personal advantage. If the opportunity is not offered to the corporation, the director or senior executive will not have satisfied § 5.05(a)."); *see also supra* note 75 and accompanying text.

161. *See supra* note 15 and accompanying text.

not use its property for his own account.[162] It is unnecessary to analogize the position of a member to that of other positions in other forms of business organizations except perhaps to emphasize the differences in the comparative statutory provisions that govern them. Moreover, in some circumstances, analogy to other entity statutes is not only unhelpful but confusing.[163] While it may be fair to state that corporate officers and directors owe fiduciary duties to the corporation and that partners owe duties to the partnership,[164] it does not follow that "being similar to Kentucky partnerships and corporations,"[165] LLCs impose fiduciary obligations upon their "officers and members."[166] Rather, it is the LLC Act as modified by the operating agreement and supplemented by other private ordering that *ab initio* imposes defined obligations.[167]

At least initially, the *Patmon* Court based the determination that Hobbs was a fiduciary to American Leasing LLC on his statutory agency on behalf of the LLC.[168] It is true that a member has apparent agency authority on behalf of the LLC in a member-managed LLC.[169] It is also true that, all else being equal, an agent bears a fiduciary duty to the principal.[170] Nonetheless, a member in a member-managed LLC, undeniably owes the duties required by the controlling agreement and the

162. *See* KY. REV. STAT. ANN. § 275.170(2) (West 2010).

163. *See Patmon*, 280 S.W.2d at 594 ("For the foregoing reasons, this Court finds that Kentucky [LLCs], being similar to Kentucky partnerships and corporations, impose a common-law fiduciary duty on their officers and members in the absence of contrary provisions in the [LLC] operating agreement."). Statements of this nature are troubling in that they fail to identify the basis upon which the purported analogy relies. For example, if LLC members are similar to corporate shareholders, how can it be concluded that the former are fiduciaries? Kentucky courts have not adopted *Donahue v. Rodd Electrotype Corp.* or section 7.01(d) of the *Principles of Corporate Governance*, both of which impose fiduciary obligations upon shareholders qua shareholders. The analogy would suggest that members are not fiduciaries, an analogy that must fail as the LLC Act provides expressly, in a member-managed LLC, that members are fiduciaries.

164. *See Patmon*, 280 S.W.2d at 594-95.

165. *Id.* at 594.

166. *Id.*

167. *See* KY. REV. STAT. ANN. § 275.170 (West 2010) (establishing the default rule unless otherwise provided in a written operating agreement).

168. 280 S.W.3d at 594 (citing KY. REV. STAT. ANN. § 275.135(1)).

169. KY. REV. STAT. ANN. § 275.135(1) ("(1) Except as provided in subsection (2) of this section, every member shall be an agent of the [LLC] for the purpose of its business or affairs . . . .")

170. *See* RESTATEMENT (THIRD) OF AGENCY § 1.01.

LLC Act and is only then subject to duties under general agency law to the extent that those duties are not already addressed by the agreement and act.[171] For example, under agency law an agent is held to a care standard of simple negligence[172] while, under the Kentucky LLC Act, a member is held to a standard of wanton or reckless misconduct.[173] Likewise, both agents and LLC members must observe standards of loyalty, but the LLC Act is the primary source of the conduct and liabilities of an LLC member.[174] It is at best misleading to say that the fiduciary standards applicable to members in a member-managed LLC first arise from the default status of being an agent for the company. At the very least, it needs to be recognized that member fiduciary duties can be modified or even eliminated by the operating agreement.

Hobbs's duty of loyalty to the LLC was imposed and defined by statute.[175] In this case, the statutory duty appears not to have been modified in a written operating agreement even though it is less than clear such a determination was made, as a matter of fact in the case.[176]

---

171. For example, while on a prospective basis a member's fiduciary obligations will terminate upon ceasing to be a member, a former member may not then utilize trade secrets learned in the course of being a member against and in competition with the LLC. *See, e.g.*, KY. REV. STAT. ANN. § 275.280(3).

172. *See* RESTATEMENT (THIRD) OF AGENCY § 8.08.

173. KY. REV. STAT. ANN. § 275.170(1) (West 2010).

174. *Compare* RESTATEMENT (THIRD) OF AGENCY § 8.02 to .04, 8.06 *with* KY. REV. STAT. ANN. § 275.170(2).

175. The LLC Act does not impose a fiduciary duty of good faith upon the participants in an LLC. *See* Patmon v. Hobbs, 280 S.W.3d 589, 595 (Ky. Ct. App. 2009). While the common law of partnerships treated good faith as a fiduciary duty, no inclusion of that concept was made in the LLC Act and, in modern business-organization acts, good faith is treated as a contractual, and not a fiduciary, obligation. *Compare e.g.*, KY. REV. STAT. ANN. §§ 362.1-404(4) (West 2010), 362.2-408(4) *with* KY. REV. STAT. ANN. §§ 362.1-404(i), 362.2-408(i). To the extent good faith exists as a fiduciary, and not a contractual, obligation, it is integrated as a "subsidiary element" of the duty of loyalty. *See* Stone v. Ritter, 911 A.2d 362, 369-70 (Del. 2006).

176. While the opinion references an "Executive/Partnership Agreement," and indicates that it somehow addressed Hobbs's duty of loyalty, its contents are never expanded upon. *Patmon*, 280 S.W.3d at 594. This agreement was an exhibit to the Appellant's brief to the Court of Appeals. Brief for Appellant Patmon at 65-68, Patmon v. Hobbs, 280 S.W.3d 589 (Ky. Ct. App. 2009).

C. Were the Contracts Company Property?

American Leasing LLC was in the build-to-suit leasing business.[177] That is, after determining the real estate needs of a prospective tenant it would enter into a contract to buy the location, build a structure according to the lessee's specifications and then lease the property to the lessee.[178] The LLC had performed at least one agreement with O'Reilly Auto Parts and was negotiating three additional agreements with O'Reilly.[179] The *Patmon* Court described those agreements as "pending" when Hobbs directed O'Reilly to wholly substitute the name of his separate LLC for American Leasing LLC.[180] There was only one other modification necessary in order for the contracts to be executed.[181] It stretches credibility to treat a deal so near closing as being a mere opportunity rather than a current asset; though that distinction is not relevant under the Prototype's duty of loyalty.

Another factual matter not addressed by either the trial court or the court of appeals is the "consent resolution and agreement" of the members of the LLC that was in evidence and was referenced by the court of appeals.[182] Interestingly, that agreement provided that any member could have other business activities, even those that compete with the company, "with the exception of O'Reilly Auto Parts, Inc."[183] Thus, by agreement

---

177. *Patmon*, 280 S.W.3d at 591.

178. *Id.*

179. *Id.*

180. *Id.* at 592.

181. An O'Reilly representative testified that he was prepared to sign the agreements with the LLC. *Id.*

182. *Patmon*, 280 S.W.3d at 591. This document was filed as an exhibit to the Appellants' Brief to the Court of Appeals. Brief for Appellant Patmon at ex. 11, Patmon v. Hobbs, 280 S.W.3d 589 (Ky. Ct. App. 2009).

183. This provision of the Consent Resolutions and Agreement, which otherwise appointed Hobbs the "President" and the "managing Member" of American Leasing LLC, provides in full:

> FURTHER RESOLVED, that this agreement shall not be construed to require the continued or full time services of any member and each member is free to pursue such other business opportunities as he may determine in his own best interest with the exception of O'Reilly Auto Parts Inc., including without limitation, any business or venture that may be competitive with the Company.

of the parties, the O'Reilly relationship was singled out as belonging to the LLC.

Hobbs's authority to direct that the agreements be executed in the name of his separate LLC rested solely in his position as the managing member of American Leasing LLC.[184] He, however, argued that American Leasing LLC's lack of financial capacity to perform the contracts excused his assignment of them because they were somehow no longer opportunities for American Leasing LLC.[185]

The duty of loyalty in a Kentucky LLC developed under partnership law and provides that expropriation of the opportunity gives rise to the obligation to disgorge all of the benefits derived therefrom, irrespective of the ability of the venture to directly exploit the opportunity.[186] The violation of the duty to the LLC is the taking of the opportunity irrespective of the LLC's capacity to perform.[187] That is, it is the action, not the consequent damage that is the focus of the duty of loyalty under the Prototype LLC Act as adopted by Kentucky.[188] It is as to this point that the *Patmon* opinion most clearly fails. Even having determined that Hobbs diverted LLC property for his

---

184. While Hobbs was the managing member of the American Leasing LLC, consequent to the terms of its articles of organization, it remained member managed. *See supra* note 15-16 and accompanying text. It is questionable whether the assignment of the O'Reilly contracts to another LLC was within the scope of Hobbs's agency authority on behalf of American Leasing LLC. *See* KY. REV. STAT. ANN. § 275.135(3) (West 2010):

> An act of a manager or a member which is apparently not for the carrying on in the usual way of the business or affairs of the [LLC] shall not bind the [LLC] unless, at the time of the transaction or at any other time, the act is authorized in accordance with the operating agreement.

See also KY. REV. STAT. ANN. § 275.095.

> All persons purporting to act as or on behalf of [an LLC], knowing there has been no organization under this chapter, or who assume to act for [an LLC] without authority to do so, shall be jointly and severally liable for all liabilities created while so acting.

185. *See Patmon*, 280 S.W.3d at 597 (holding that by relying on the LLC's alleged inability to perform on the O'Reilly agreements, Hobbs implicitly acknowledged that they were otherwise LLC assets). Hobbs's brief to the court of appeals cited no authority for the proposition that "For there to have been an ALM opportunity, there must be the ability to perform by ALM." Brief for Appellee at 7-8, *Patmon*, 280 S.W.3d 389 (Ky. Ct. App. 2009).

186. *See supra* notes 75, 143, 151.

187. PROTOTYPE, *supra* note 1, § 402(B).

188. *See* KY. REV. STAT. ANN. § 275.135(3).

own benefit,[189] the court imposed the burden of demonstrating that the LLC had or could acquire the capacity to perform on the agreements.[190]

The two positions are irreconcilable. The build-to-suit lease agreements cannot be assets of the LLC diverted by Hobbs in violation of his fiduciary duty,[191] on one hand, but on the other hand not be assets for purposes of determining the remedy for the breach. The court implicitly took those inconsistent positions by requiring Patmon to demonstrate the LLC's capability to perform.[192] Having determined that Hobbs violated his duty of loyalty,[193] the question should turn immediately to the question of damages and other relief. Were financial capability to perform an element of the duty, it would go to the question of whether company property was appropriated. That is, if capacity is a factor in defining what is company property, and capacity is lacking, then there is no property. If there is no property, there can be no breach of loyalty for having appropriated what does not exist.[194]

It appears that the Kentucky Court of Appeals made "ability to perform" an element of the proof of damages, *i.e.*, if the LLC could not perform, it lost nothing. This implication, however, conflicts with the court's recognition that the contracts

---

189. *Patmon*, 280 S.W.3d at 597 ("[T]he trial court has already determined that Hobbs's diversion of the O'Reilly build-to-suit lease projects was indeed a corporate opportunity of [the LLC] that he diverted for his own use.").

190. *Id.* at 598 ("[I]t is still necessary for Patmon to establish that [the LLC] had the financial wherewithal to undertake the O'Reilly project."); *see also id.* at 599 ("Finally, Patmon will be able to present evidence as to whether [the LLC] could have taken advantage of the business opportunity of the O'Reilly build-to-suit leases.").

191. *Id.* at 598. ("Thus, we remand this case to the trial court to determine a remedy for Hobbs's common-law breach of fiduciary duty and failure to follow the statutory guidelines of KRS 275.170. Pursuant to KRS § 275.170, at a minimum, Hobbs is required to hold in trust all benefits and profits derived by him as the result of his misuse of the build-to-suit leases.").

192. *See supra* note 174; *see also Patmon*, 280 S.W.3d at 596 ("One theory of this doctrine holds that opportunity does not exist for a business if the business is financially unable to undertake the opportunity.").

193. *Patmon*, 280 S.W.3d at 598. ("[W]e remand this case to the trial court to determine a remedy for Hobbs's common-law breach of fiduciary duty and failure to follow the statutory guidelines of KRS § 275.170.").

194. *Id.* ("In Kentucky, however, the focus is on the fiduciary's duty–not the lost opportunity."). The *Patmon* decision does not consider whether the futility defense of financial incapacity is even available absent disclosure. *See supra* note 160.

had value even if the LLC could not perform them.[195] Even if lack of capacity to perform was a factor in determining whether the opportunity was property, the burden of demonstration should be upon the agent and not upon the principal.[196]

---

195. *Patmon*, 280 S.W.3d at 598 ("Further, a possibility exists that [the LLC] could have sold its business opportunity to another venture and profited in that manner."); *see also* 1 RIBSTEIN & KEATINGE ON LLCS, *supra* note 1, § 9.3 ("Even if the firm cannot engage in the activity, it should at least have the opportunity to obtain and sell an option or information about the activity to a third party or to the manager."). We observe, but do not otherwise pursue, the notion that this case may be characterized as one of waste rather than as one of breach of loyalty by the appropriation of a company asset. "Waste" occurs when a venture "is caused to effect a transaction on terms that no person of ordinary, sound business judgment could conclude represent a fair exchange." Steiner v. Meyerson, Civ. A. No. 13139, 1995 WL 441999, * 1 (Del. Ch. July 18, 1995). In another formulation waste is "a transfer of corporate assets that serves no corporate purpose; or for which no consideration at all is received."; Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000); *see also* Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997). While typically seen in the context of corporations, waste can occur (and is equally actionable) in the context of a partnership. *See, e.g.*, EEC Property Co. v. Kaplan, 578 N.W.2d 381 (Minn. Ct. App. 1998) (upholding arbitrator's determination that a majority of partner's engaged in waste of partnership assets by means of a below market lease agreement); *In re* Dissolution of Demoville Partnership, 26 So. 3d 366, 376 (Miss. Ct. App. 2009) ("Margaret allowed [Margie Allen] to waste partnership assets at a time when she knew her mother was suffering from dementia, which included impaired judgment and memory."); *In re* Matter of the Estate of William Brandt, 81 A.D.2d 268, 279 (N.Y. 1981) ("We are also of the view that the trusts, as a limited partner, have standing to complain of a waste and diversion of partnership assets which results in a diminution of the value of the partnership itself with consequent effect upon the trusts' interest therein."). It is uncontroverted that Hobbs's act of transferring to his own LLC the O'Reilly contracts was not for the purpose of advantaging American Leasing LLC and that it received no consideration for that transfer. Another possible approach would be a claim for conversion by the LLC against Hobbs. *See* Ky. Assn'n of Cntys. All Lines Fund Trust v. McLendon, 157 S.W.3d 626, 632 n. 12 (Ky. 2005) (reciting the elements of a claim for conversion). The element of a demand for return should be abated under the doctrine of adverse domination until suit was brought. *See* Wilson v. Payne, 288 S.W.3d. 284 (Ky. 2009).

196. *See supra* note 96; *see also* Irving Trust Co. v. Deutsch, 73 F.2d 121, 124 (2d Cir. 1934):

> If directors are permitted to justify their conduct on such of theory that, by reason of its financial straits, the corporation could not make the purchase as proposed, and that the fiduciaries should therefore be permitted to assume a position in which their individual interests might be in conflict with those of the corporation, 'there will be a temptation to refrain from exerting their strongest efforts on behalf of the corporation since, if it does not meet the obligations, an opportunity of profit will be open to them personally.

Northeast Harbor Gold Club, Inc. v. Harris, 661 A.2d 1146, 1149 (Me. 1995) ("Reliance on financial ability will also act as a disincentive to corporate executives to solve corporate financing and other problems.").

D. Approval by the Other Members?

American Leasing LLC was owned fifty-one percent by Hobbs, forty-four percent by Patmon, and five percent by Gray.[197] The necessary approval of a transaction that would otherwise violate Hobbs's duty of loyalty was vested in Patmon.[198] Nonetheless, Hobbs never asked the other members to approve the transaction so there was never even the opportunity for them to consent.[199] Hobbs's right to compete with American Leasing LLC did not extend to the relationship with O'Reilly under the "consent resolution and agreement."[200]

In summary, the LLC Act provided Hobbs's conduct could have been excluded from his duty of loyalty in the operating agreement or sanctioned by the other members. The operating agreement was silent, and the approval of competing activities set forth in the "consent resolution and agreement" did not extend to the O'Reilly contracts.[201] Hobbs did not present the issue to the other members for their waiver.[202] Consequently, he violated his duty of loyalty in expropriating company property to his own benefit.

E. Ergo, Hobbs's Liability

The court's determination that Hobbs violated his statutory duty of loyalty was correct, as was the predicate conclusion that the O'Reilly contracts were company property. The question should then have turned to the matter of remedy. Initially, Hobbs was obligated to surrender to the LLC all profits and benefits derived from the diverted contracts.[203] He should not be able to reduce the amount owed by identifying proceeds that were diverted to others he had brought into his LLC;[204] that is,

---

197. *Patmon*, 280 S.W.3d at 592.

198. *See* KY. REV. STAT. ANN. § 275.170(2) (West 2010) (stating that a conflict of interest may be waived by a majority of the disinterested members).

199. *Patmon*, 280 S.W.3d at 595 ("Hobbs concedes and the court found that he never obtained consent from any member of [the LLC] . . .").

200. *See supra* note 182 and accompanying text.

201. *Patmon*, 280 S.W.3d at 595.

202. *Id.*

203. KY. REV. STAT. ANN. § 275.170(2) (West 2010) (stating each member and manager "shall account to the [LLC] and hold as trustee for it . . . . ").

204. *Patmon*, 280 S.W.3d at 592 ("Subsequently, Hobbs and Steve Habeeb (Habeeb) formed another [LLC] which was eventually assigned these leases. The company

the fruits of the expropriation should not be reduced by the value of gain transferred to other actors.[205] A claim for attorney fees has substantial authority[206] as does a claim for punitive damages.[207] While the court of appeals suggested that the trial court, in dissolving the American Leasing LLC and distributing its net assets among the members, could adjust the sharing ratios among the members,[208] it cited no authority for doing so.[209] Doing so pursuant to the court's equitable power avoids other issues previously identified.[210]

VI. Conclusion

The Prototype LLC Act defines the existence and parameters of the duty of loyalty as they exist in the context of an LLC that is organized under the statutory formula.[211] It is a bar against using LLC property for personal purposes or gain. The statute is clear that a breach of the duty of loyalty requires complete disgorgement, and there is no requirement that the LLC was able to otherwise perform and directly receive the benefit of the expropriated transaction. While this rule may appear harsh, in reality: (1) it is not different from that applied under partnership or agency law because they have no general "fairness" defense; (2) its application is easily avoided by refraining from transactions that violate the duty of loyalty; and (3) it may be modified by agreement or waiver and consent by the other members.

It is unnecessary and inappropriate to look to common law to determine the existence and nature of a duty of loyalty owed LLCs in *Patmon v. Hobbs* because the Kentucky statute answers

---

was started so that Hobbs would provide the leases and Habeeb would obtain the financing for the projects.").

205. *See* Grahm Douthwaite, *Profits and Their Recovery*, 15 VILL. L. REV. 346, 370 (1970); GEORGE G. BOGERT & GEORGE T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES, § 543(V) n.5 (Rev. 2d. ed. 1993); D. DOBBS, HANDBOOK OF THE LAW OF REMEDIES 224 (1978).

206. *See supra* note 115 and accompanying text.

207. *See supra* note 115 and accompanying text; *see also* Steelvest, Inc. v. Scansteel Serv. Ctr., Inc., 807 S.W.2d at 476, 487 (Ky. 1991) ("Accordingly, we determine, as a matter of law, that a breach of fiduciary duty is equivalent to fraud.").

208. *Patmon*, 280 S.W.3d at 599.

209. *See also supra* note 115.

210. *See supra* notes 108-12 and accompanying text.

211. *See* PROTOTYPE, *supra* note 1 § 402 (B). .

those questions.[212] Similarly, it is unnecessary and inappropriate to apply the law of corporate opportunity and a conclusion that capacity to perform is
required rather than applying the statutory remedy for breach of the duty of loyalty.[213]

Practitioners drafting operating agreements need to be sensitive to the interpretive protocol of LLC acts in addition to the substantive provisions of those acts in order to craft agreements reflecting the intentions of the parties. Courts assessing allegations of breaches of the duty of loyalty should appreciate and apply the interpretive protocol of those acts that require careful analysis of the controlling operating agreement as well as the substantive statutory rules of the governing LLC law.

The *Patmon v. Hobbs* court repeated the frequently-used description that an LLC "is a hybrid . . . entity having attributes of both a corporation and a partnership."[214] A more apt description, however, may be that the LLC is like a pair of pliers. Pliers can be used to simulate dozens of sizes and types of wrenches. Sometimes pliers are even used to simulate hammers. Nonetheless, pliers are neither wrenches nor hammers. Moreover, even attempting to describe "generic" pliers requires great care as the analogies are neither precise nor universal because, in addition to being used for several different purposes, pliers come in many sizes and varieties (*e.g.*, needle-nosed, lineman, and channellock). Likewise courts should exercise great care in selecting and using analogies for the duty of loyalty in LLCs.[215]

---

212. *See, e.g.*, Bank of St. Helens v. Mann's Ex'r, 11 S.W.2d 144, 145 (Ky. 1928) (stating that courts are bound by statutory law as written).

213. Expressly not addressed herein is whether in the context of a business or other corporation the opportunity doctrine does or should require that the opportunity be exercisable by the corporation in order for there to be a claim for its misappropriation.

214. 280 S.W.3d at 593.

215. J. William Callison has recently compared a feature of some LLC acts to a tool or blade in a folding knife with multiple tools. J. William Callison, *L3Cs: Useless Gadgets?*, 19 BUS. L. TODAY 55 (Nov. Dec. 2009).