

Fiduciary Duties in Business Entities Revisited

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I. INTRODUCTION

As indicated by its title, this Article, in significant part, reprises one published in early 2006.¹ That earlier article had its genesis in the confluence of several trends that emerged during the period from 1990 through 2005. First, on the legislative front, Kansas enacted and subsequently totally revised statutes recognizing two new forms of business entities, limited liability companies² and limited liability partnerships,³ adopted a completely revised general partnership act,⁴ and significantly updated its corporation code.⁵ Second, because Kansas had consciously chosen to follow Delaware's lead in business legislation, Kansas courts began to articulate explicitly the persuasive effect of Delaware precedent in Kansas.⁶ Finally, there had been a discernible convergence in much of the law governing fiduciaries in business entities. Certainly, that trend was due in part to the invention of the limited liability company, which is a hybrid that can exhibit

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1. Edwin W. Hecker, Jr., *Fiduciary Duties in Business Entities*, 54 U. KAN. L. REV. 975 (2006).

2. Kansas Limited Liability Company Act, ch. 80, 1990 Kan. Sess. Laws 585 (repealed effective January 1, 2000); Kansas Revised Limited Liability Company Act, ch. 119, 1999 Kan. Sess. Laws 701 (effective January 1, 2000) (codified at KAN. STAT. ANN. §§ 17-7662 to -76,143 (2007 & Supp. 2012)).

3. Act of Apr. 7, 1994, ch. 140, 1994 Kan. Sess. Laws 526 (repealed effective July 1, 1999); Uniform Partnership Act, ch. 93, §§ 17(c), 53–64, 1998 Kan. Sess. Laws 393, 401, 419–425 (effective January 1, 1999) (codified at KAN. STAT. ANN. §§ 56a-306(c), -1001 to -1204 (2005 & Supp. 2012)).

4. Uniform Partnership Act, ch. 93, 1998 Kan. Sess. Laws 393 (effective January 1, 1999) (codified at KAN. STAT. ANN. §§ 56a-101 to -1305 (2005 & Supp. 2012)).

5. Act of May 17, 2004, ch. 143, 2004 Kan. Sess. Laws 1210 (codified in scattered sections of KAN. STAT. ANN. §§ 17-6001 *et seq.* (2007 & Supp. 2012)).

6. *E.g.*, *Burcham v. Unison Bancorp, Inc.*, 77 P.3d 130, 144–45 (Kan. 2003) (observing that Kansas corporation law was patterned after Delaware law and adopting a rule of the Delaware Supreme Court); *Achey v. Linn Cnty. Bank*, 931 P.2d 16, 21 (Kan. 1997) (stating that “decisions of the Delaware courts involving corporation law are persuasive” in interpreting Kansas corporation law). Because this practice has become even more commonplace, this Article will continue to rely heavily on Delaware case law.

characteristics of both partnerships and corporations and that had no history of its own upon which to draw. More broadly, however, it seemed clear that managers of businesses were fiduciaries regardless of the technical form in which the enterprise was organized,⁷ and that the real-life problems attendant on such managerial status often resisted pigeonholing on the basis of entity form. Consequently, the borrowing of workable concepts,⁸ and even specific precedent,⁹ from other forms of enterprise appeared to be an increasingly common practice.

The activity since 2005 has been almost exclusively on the judicial, rather than the legislative, front and involves all three major forms of business entity. The trend of Kansas courts looking to Delaware precedent has continued unabated.¹⁰ However, the trend of homogenization of fiduciary duty law as applied to different forms of entity has suffered some setbacks with respect to partnerships¹¹ and limited liability companies.¹² In addition, the law of corporate directors' and officers' fiduciary duties underwent a major paradigm shift shortly

7. *See, e.g.*, *Carson v. Lynch Multimedia Corp.*, 123 F. Supp. 2d 1254, 1259 (D. Kan. 2000) (upholding a cause of action for breach of fiduciary duty against managers of a limited liability company); *Newton v. Hornblower, Inc.*, 582 P.2d 1136, 1151 (Kan. 1978) (affirming judgment of damages for breach of fiduciary duty against directors and officers of a corporation acting as a general partner of a limited partnership).

8. For example, in a parallel to corporate law, the statutes governing limited liability companies and limited partnerships both provide for the possibility of derivative litigation instituted by a minority member or partner to redress a breach of duty to the enterprise. KAN. STAT. ANN. §§ 17-76,130 to -76,133 (2007); *id.* §§ 56-1a551 to -1a554 (2005). Of course, countervailing considerations, such as differences in the wording of governing statutes, may prevent parallel treatment across entity lines. *Compare* *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007) (holding that creditors of an insolvent corporation have standing to bring a derivative action on its behalf), *with* *CML V, LLC v. Bax*, 28 A.3d 1037 (Del. 2011) (holding that DEL. CODE ANN. tit. 6, § 18-1002 (West 2011) restricts derivative plaintiffs to members and assignees of members and therefore prevents creditors of an insolvent limited liability company from instituting derivative litigation).

9. *See, e.g.*, *Blackmore Partners, L.P. v. Link Energy LLC*, No. Civ. A. 454-N, 2005 WL 2709639, at *5-6 (Del. Ch. Oct. 14, 2005) (directly applying corporate precedent, without comment, to limited liability company).

10. *E.g.*, *Becker v. Knoll*, 239 P.3d 830, 835 (Kan. 2010) (adopting the Delaware view that a plaintiff need only make a prima facie showing of self-dealing to shift the burden of proof to the defendant to establish fairness); *Lightner v. Lightner*, 266 P.3d 539, 547-48 (Kan. Ct. App. 2011) (holding that Kansas courts give "significant precedential value" to Delaware cases and applying Delaware's "quintessential test" for distinguishing direct from derivative causes of action).

11. *See* *Welch v. Via Christi Health Partners, Inc.*, 133 P.3d 122, 138-39 (Kan. 2006) (holding that partners are not true trustees and are held to a lesser standard of loyalty than that applicable to corporate directors).

12. *See* *Gatz Props., LLC v. Auriga Capital Corp.*, 59 A.3d 1206, 1218-20 (Del. 2012) (disapproving as unwarranted dictum the Court of Chancery's opinion that equity imposes default fiduciary duties on managers of limited liability companies).

after publication of the original article.¹³ Like the original, the modest goal of this Article is to survey generally the law of fiduciary duties with respect to Kansas corporations, partnerships (general and limited liability), limited partnerships, and limited liability companies, and to illustrate the extent to which corporate law concepts and precedents are being applied (or not applied) in the context of these other forms of business organization. Part II considers fiduciary status, Part III the duty of care, and Part IV the duty of loyalty.

II. FIDUCIARY STATUS

A fiduciary relationship is one in which a person transacts business or manages money or property, not primarily for the person's own benefit, but for the benefit of another. It involves discretionary authority on the part of the fiduciary and dependency and reliance on the part of the beneficiary.¹⁴

A. Corporations

In Kansas and elsewhere, the bedrock statutory corporate norm is that the business and affairs of a corporation are managed by or under the direction of its board of directors.¹⁵ In pursuit of this function, the board elects officers¹⁶ who are agents of the corporate entity¹⁷ and who exercise the managerial authority formally and informally delegated to them by the board. Because they manage the business for the benefit of the shareholders, corporate directors and officers have long been recognized to occupy a fiduciary relationship to both the corporation and its shareholders.¹⁸

13. See *Stone v. Ritter*, 911 A.2d 362, 369–70 (Del. 2006) (holding that good faith is a part of the duty of loyalty rather than a separate, freestanding fiduciary duty); *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 52–53 (Del. 2006) (distinguishing lack of good faith from gross negligence).

14. *Carson v. Lynch Multimedia Corp.*, 123 F. Supp. 2d 1254, 1258–59 (D. Kan. 2000); *Dension State Bank v. Madeira*, 640 P.2d 1235, 1241 (Kan. 1982); BLACK'S LAW DICTIONARY 702 (9th ed. 2009).

15. KAN. STAT. ANN. § 17-6301(a) (2007).

16. *Id.* § 17-6302(a), (b).

17. Although technically, neither the board of directors nor an individual director is, as such, an agent of the corporation, corporate officers are agents. RESTATEMENT (SECOND) OF AGENCY § 14C & cmts. (1958); RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. f(2) (2006). Agency, by definition, is a fiduciary relationship. RESTATEMENT (SECOND) OF AGENCY § 1(1); RESTATEMENT (THIRD) OF AGENCY § 1.01.

18. *E.g.*, *Gantler v. Stephens*, 965 A.2d 695, 708 (Del. 2009) (holding that corporate officers are subject to the same fiduciary duties as corporate directors); *Newton v. Hornblower, Inc.*, 582

Shareholders, on the other hand, traditionally have not been regarded as fiduciaries.¹⁹ This result is justified on the basis that, when acting as a shareholder, a person acts as an owner rather than in a representative, managerial capacity. Controlling shareholders, however, have come to stand on a different footing.

Because directors and officers manage the business, nearly all situations that spawn breach of fiduciary duty allegations involve director or officer conduct. If a controlling shareholder is an individual, the shareholder usually will also be a director and officer and will be subject to fiduciary duties in those capacities.²⁰ If a controlling shareholder is another business entity, it cannot personally be a director or officer, but it typically will place its own officers, agents, and employees in those positions.²¹ If the controlling shareholder dominates and controls those individuals when they act in a managerial capacity as corporate directors and officers, they will be treated as “interested” in the transaction or conduct at issue, and the controlling shareholder will be subject to vicarious fiduciary responsibility as a matter of basic agency law.²²

This theory of fiduciary responsibility, and the distinction between acting as an owner and acting in a representative, managerial capacity, are both clearly articulated in the classic case of *Zahn v. Transamerica Corp.*²³ The court emphasized:

P.2d 1136 (Kan. 1978) (“Kansas has always imposed a . . . fiduciary duty on officers and directors . . . to act in the best interest of the corporation and its stockholders.”). In addition, if a corporation is insolvent, creditors replace the shareholders as ultimate stakeholders, and the directors’ focus in managing the business must shift accordingly. *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 102 (Del. 2007). However, corporate creditors, unlike shareholders, are not the direct beneficiaries of directors’ fiduciary duties and may not assert individual causes of action against the board. *Id.* at 103; *see also* *Speer v. Dighton Grain, Inc.*, 624 P.2d 952, 961 (Kan. 1981) (stating that directors are only liable to creditors in certain situations, not including corporate insolvency).

19. *E.g.*, *Hunt v. Data Mgmt. Res., Inc.*, 985 P.2d 730, 732 (Kan. Ct. App. 1999) (“The law does not impose a strict fiduciary duty on a shareholder to act in the best interest of the corporation.”); *Ritchie v. McGrath*, 571 P.2d 17, 24 (Kan. Ct. App. 1977) (finding no breach of fiduciary duty when majority shareholders sold stock for more than book value).

20. *Cf.* PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 1.23(b) (1994) (stating that a shareholder is “interested” in a transaction or conduct if the shareholder is a party or if the shareholder is also interested in the shareholder’s capacity as a director or officer).

21. Occasionally, this will also be true of a controlling shareholder who is an individual.

22. *See, e.g.*, *In re Trados Inc. S’holder Litig.*, No. 1512-CC, 2009 WL 2225958, at *1 (Del. Ch. July 24, 2009); PRINCIPLES OF CORPORATE GOVERNANCE § 1.23(a)(4); RESTATEMENT (SECOND) OF AGENCY §§ 1, 2, 212, 219; RESTATEMENT (THIRD) OF AGENCY §§ 1.01, 2.04, 7.04, 7.07.

23. 162 F.2d 36 (3d Cir. 1947).

[T]here is a radical difference when a stockholder is voting strictly as a stockholder and when voting as a director; that when voting as a stockholder he may have the legal right to vote with a view of his own benefits and to represent himself only; but that when he votes as a director he represents all the stockholders in the capacity of a trustee for them and cannot use his office, as a director for his personal benefit at the expense of the stockholders.²⁴

On the facts alleged, the operative conduct (redemption of the minority's shares at a grossly inadequate price) occurred at the director level.²⁵ However, Transamerica, the controlling shareholder, so dominated and controlled the directors that the court characterized the relationship as one of agency.²⁶ Thus, the court concluded that the liability flowing from the directors' dereliction was rightly imposed on Transamerica, which, because of its control, legally constituted the board of directors of the corporation.²⁷

The Delaware Supreme Court took this same approach, albeit in abbreviated form, in *Sinclair Oil Corp. v. Levien*.²⁸ Sinclair owned ninety-seven percent of the stock of Sinven, one of Sinclair's several subsidiaries.²⁹ The Chancellor had found as a fact that Sinven's directors were not independent of Sinclair, but rather were "officers, directors, or employees of corporations in the Sinclair complex."³⁰ The court therefore held that "[b]y reason of Sinclair's domination" of the Sinven board, Sinclair owed Sinven a fiduciary duty.³¹

Because of the reality that the kind of domination and control found in *Zahn* and *Sinclair* will almost invariably exist in the context of parent and subsidiary corporations, the analysis became even more abbreviated and rarefied in the 1990s. Section 1.10 of the *Principles of Corporate Governance* defines a "controlling shareholder" as a person who *either* (1) owns and has the power to vote a majority of the outstanding voting stock; or (2) *otherwise* exercises a controlling influence over the management or policies of the corporation or the transaction or conduct in question by reason of the person's position as a shareholder.³² Four

24. *Id.* at 45.

25. *Id.* at 39–40, 45–46.

26. *Id.* at 40, 46.

27. *Id.* at 46.

28. 280 A.2d 717 (Del. 1971).

29. *Id.* at 719.

30. *Id.*

31. *Id.*

32. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 1.10(a) (1994).

points are apparent from this bifurcated definition. First, if the person is a majority shareholder, the person is conclusively deemed to be a controlling shareholder subject to fiduciary obligations. Second, if the person owns less than an absolute majority of the voting stock, controlling shareholder status is a question of fact. Third, the question of fact is whether, notwithstanding ownership of less than a majority block, the person “otherwise” exercises a controlling influence over the corporation’s “management or policies.” Thus, the basis of both parts of the definition continues to be traditional fiduciary principles: whether the person has power to act, directly or indirectly by means of agents, in a discretionary, managerial capacity with respect to the property of others. The only difference is that in one case controlling influence is conclusively presumed and in the other it must be established as a fact.³³

Delaware case law has also evolved to a similar majority-versus-less-than-majority distinction in its analysis of controlling shareholder fiduciary duties. For example, the court in *Kahn v. Lynch Communication Systems, Inc.* held that a shareholder became a fiduciary only if the shareholder owned a majority interest or exercised control over the corporation’s business affairs.³⁴ The focus continues to be on a dominating relationship over corporate conduct and affairs, either by means of majority stock ownership or proof of actual domination and control of the board of directors.³⁵

On the other hand, if no director or officer conduct is involved—that is, if the controlling shareholder is simply acting strictly as a shareholder—respondeat superior is inapplicable because there is no breach by the inferior. In these situations, the general rule has been, and continues to be, that the controlling shareholder is not subject to

33. *Id.* Section 1.10(b) assists a plaintiff in the latter instance by raising a rebuttable presumption of control over management or policies if the person owns or controls more than twenty-five percent of the voting stock.

34. 638 A.2d 1110, 1113 (Del. 1994).

35. *See id.* at 1114. The *Kahn* court stated:

Alcatel held a 43.3 percent minority share of stock in Lynch. Therefore, the threshold question . . . was whether, despite its minority ownership, Alcatel exercised control over Lynch’s business affairs. Based upon the testimony and the minutes of the . . . Lynch board meeting, the Court of Chancery concluded that Alcatel did exercise control over Lynch’s business decisions.

Id. *But see* Williams v. Geier, 671 A.2d 1368, 1378 & n.22 (Del. 1996) (indicating that domination and control must be alleged and proven even in cases of majority ownership). Without much regard for the niceties, Kansas courts have not hesitated to impose fiduciary duties on controlling shareholders where circumstances have warranted. *E.g.*, Richards v. Bryan, 879 P.2d 638 (Kan. Ct. App. 1994) (in holding for oppressed minority shareholder of subsidiary corporation, court failed to differentiate between acts of parent corporation and acts of its shareholders, who were also directors of subsidiary).

fiduciary responsibilities. As stated by the Tenth Circuit Court of Appeals:

In other words, a dominant or majority stockholder does not become a fiduciary for other shareholders by reason of mere ownership of stock. It is only when one steps out of the role as a stockholder and acts in the corporate management . . . that he assumes the burden of fiducial responsibility.³⁶

B. Partnerships

Traditionally, the near-universal rule has been that partners in general partnerships are in a fiduciary relationship to the partnership and to the other partners. In *Meinhard v. Salmon*, Justice Cardozo likened partners to trustees and famously held them to “the punctilio of an honor the most sensitive.”³⁷ The reason is that each partner is an agent of the partnership and, unless otherwise agreed, each has an equal right to participate in the management and conduct of its business.³⁸ As such, each partner possesses the kind of discretionary managerial authority that is the hallmark of fiduciary status in a business setting.

36. *McDaniel v. Painter*, 418 F.2d 545, 547 (10th Cir. 1969) (applying Kansas law). The rule that, with certain narrow exceptions, a controlling shareholder is free to transfer the controlling block of shares at a premium without having to share the offer or the premium with the minority is perhaps the best example of this proposition. *See id.* (noting that a controlling block of shares should command a premium because it is more valuable than minority stock); *Ritchie v. McGrath*, 571 P.2d 17, 23 (Kan. Ct. App. 1977) (finding no breach of fiduciary duty, even though sale occurred in secret); PRINCIPLES OF CORPORATE GOVERNANCE § 5.16.

37. 164 N.E. 545, 546 (N.Y. 1928).

38. KAN. STAT. ANN. §§ 56a-301, -401(f) (2005); *see also* REVISED UNIF. P'SHIP ACT § 404 cmt. 1 (1997) (“[T]he law of partnership reflects the broader law of principal and agent, under which every agent is a fiduciary.”). What has just been said is equally applicable to both general and limited liability partnerships, and for that reason it is important that limited liability partnerships be distinguished from limited partnerships. Limited liability partnerships are an innovation of the 1990s, and except with respect to the personal liability of the partners, a limited liability partnership is, in most respects, identical to a general partnership. It is formed under and governed by the same statute as a general partnership, and its partners play the same role in managing its business and affairs. *See* KAN. STAT. ANN. § 56a-101(e) (defining the term “limited liability partnership”); *id.* § 56a-306(a) (establishing the general rule that partners are jointly and severally liable for partnership obligations); *id.* § 56a-306(c) (establishing the rule that joint and several liability does not apply to limited liability partnerships); *id.* §§ 56a-1001 to -1004 (2005 & Supp. 2012) (addressing specific aspects of limited liability partnerships). Limited partnerships are a completely different form of business organization. They have a much longer history, they are governed by a separate statute, and, by definition, they have two kinds of partners who typically play very different roles in the partnership. *See id.* § 56-1a101(e)–(g) (2005) (defining “general partner,” “limited partner,” and “limited partnership”); *id.* § 56-1a203 (limiting the liability of limited partners); *id.* § 56-1a253 (establishing rights and obligations of general partners).

When Kansas adopted the Revised Uniform Partnership Act in 1998,³⁹ it codified partners' fiduciary duties, exclusively and preemptively, as follows: "The only fiduciary duties a partner owes to the partnership and the other partners are the duty of loyalty and the duty of care set forth in subsections (b) and (c)."⁴⁰ Unfortunately, subsection (e) of the same section muddies the water by providing that "[a] partner does not violate a duty or obligation . . . *merely because* the partner's conduct furthers the partner's own interest."⁴¹ The drafters of the Revised Uniform Partnership Act explained that subsection (e) embodies the notion that a partner is not literally a trustee and is not held to the same standards as a true trustee. Rather, subsection (e) attempts to strike a balance between a partner's rights as an owner and principal and the partner's duties as an agent and fiduciary.⁴² In *Welch v. Via Christi Health Partners, Inc.*,⁴³ the Kansas Supreme Court seized on subsection (e) as an affirmative statutory authorization for partners to pursue their own self interests. This made them something less than fiduciaries, and certainly distinguished them from corporate directors and officers, whom the court characterized as true trustees.⁴⁴ Arguably, *Welch* does not strike the balance the drafters were attempting to achieve and reverses the rule generally followed elsewhere in the United States that partners' fiduciary duties, if anything, are stricter than those of their corporate counterparts.⁴⁵

Limited partnerships, by definition, have two kinds of partners: general and limited.⁴⁶ Unless otherwise agreed, general partners have the same rights and powers, and they are subject to the same restrictions and liabilities, as partners in a general partnership.⁴⁷ Therefore, the general partners are agents of the limited partnership, control management of its business, and are subject to the same fiduciary duties as partners in a general partnership.⁴⁸ Because, on the facts, *Welch* involved the general

39. See *supra* note 4.

40. KAN. STAT. ANN. § 56a-404(a).

41. *Id.* § 56a-404(e) (emphasis added).

42. REVISED UNIF. P'SHIP ACT § 404 cmt. 5.

43. 133 P.3d 122 (Kan. 2006).

44. See *id.* at 138. In the course of its opinion, the court quoted some of the drafters' commentary but was forced to delete as inconsistent the drafters' citation of *Meinhard v. Salmon*. Compare *Welch*, 133 P.3d at 140–41, with REVISED UNIF. P'SHIP ACT § 404 cmt. 1.

45. See, e.g., *Donahue v. Rodd Electrotype Co.*, 328 N.E.2d 505, 515–16 (Mass. 1975).

46. KAN. STAT. ANN. § 56-1a101(e)–(g).

47. *Id.* § 56-1a253.

48. See *id.* § 56-1a604; see also *Newton v. Hornblower, Inc.*, 582 P.2d 1136, 1143, 1146 (Kan. 1978) (imposing a strict fiduciary duty on the corporate general partner).

partner of a limited partnership, this means a significantly diluted fiduciary duty.⁴⁹

Limited partners typically are passive investors who do not participate in management, and who, for that reason, ordinarily are not in a fiduciary relationship with the limited partnership or the other partners.⁵⁰

C. Limited Liability Companies

In Kansas and elsewhere, limited liability companies have two management paradigms. The statutory default rule provides for decentralized, partnership-like management by the members, with each member being an agent of the limited liability company and having voting rights in proportion to the member's interest in profits.⁵¹ For this reason, the conventional wisdom has been that the members occupy a fiduciary relationship to the limited liability company and to each other similar to that of partners in a pre-*Welch* general partnership.⁵²

A limited liability company's operating agreement, however, may provide for centralized management by vesting managerial authority in one or more managers.⁵³ In such a case, the managers (whether or not

49. *Newton* imposed a strict fiduciary duty on the corporate general partner of a limited partnership. *Id.* *Welch* does not purport to overrule, or even mention, this aspect of *Newton*, possibly because of the statutory change in the interim between the two decisions. Ironically, however, in *Newton* the directors of the general partner were also named as defendants, and *Welch* cites the case as illustrative of the strict fiduciary standard to which Kansas holds corporate directors and officers. *Welch*, 133 P.3d at 139.

50. See KAN. STAT. ANN. § 56-1a202(a) (providing that limited partners' special rights may be set forth in a partnership agreement); *id.* § 56-1a202(b) (permitting limited partners to be granted voting rights by a partnership agreement); *id.* § 56-1a203(a) (establishing the general rule of limited liability for limited partners); see also *In re Villa W. Assocs.*, 193 B.R. 587, 593 (Bankr. D. Kan. 1996) (comparing limited partners' passive status to that of corporate shareholders).

51. KAN. STAT. ANN. § 17-7693(a) (2007). Revisions to the Kansas Revised Limited Liability Company Act would, if enacted, delete the sentence vesting contracting authority in the members of a member-managed limited liability company. H.B. 2398, 3-8, § 26, Kan. H.R., 2013 Sess. (Kan. 2013). Nevertheless, the same result would be reached by means of KAN. STAT. ANN. § 17-76,135, which provides that the rules of law and equity govern in cases not provided for in the Kansas Revised Limited Liability Company Act. That reference includes the common law of agency, which, as recently restated, indicates that members of a member-managed limited liability company have the same agency powers as partners in a general partnership. RESTATEMENT (THIRD) OF AGENCY § 3.03 cmt. e(2) (2006).

52. See, e.g., *Maillet v. Frontpoint Partners, L.L.C.*, No. 02 Civ. 7865(GBD), 2003 WL 21355218, at *3 (S.D.N.Y. June 10, 2003) (denying, under Delaware law, defendant's motion for summary judgment that posited members in a limited liability company do not owe a fiduciary duty); *Cimarron Feeders v. Bolle*, 17 P.3d 957, 964 (Kan. Ct. App. 2001) (finding the trial court appropriately compared rules governing partnership duty to that of limited liability companies).

53. KAN. STAT. ANN. § 17-7693(a).

they are also members) would be agents of the limited liability company,⁵⁴ and it was commonly accepted that they would be subject to fiduciary duties akin to those of corporate directors and officers.⁵⁵ The nonmanaging members, whose positions would be analogous to that of shareholders or limited partners, generally would not be subject to fiduciary obligations.⁵⁶ However, to the extent that a majority or controlling member exercised a dominating influence over the managers, such member would be subject to vicarious fiduciary duties on the same basis as a majority or controlling shareholder.⁵⁷

Recently, an element of uncertainty has been injected into this relatively settled and uncontroversial understanding of fiduciary duty. As discussed in Parts III.C and IV.C, in Kansas an operating agreement may expand or restrict members' and managers' fiduciary duties,⁵⁸ and in Delaware the agreement may eliminate such duties entirely.⁵⁹ In January 2012, the Delaware Court of Chancery issued its opinion in *Auriga Capital Corp. v. Gatz Properties, LLC*.⁶⁰ In *Auriga*, the limited liability company's operating agreement affirmatively imposed fiduciary duties on its manager that were analogous to those of corporate directors.⁶¹

54. *Id.* § 17-7693(b)(2); *see also supra* note 51. House Bill 2398 would also delete the statutory language in section 17-7693 making managers agents of the limited liability company. H.B. 2398, *supra* note 51, § 26. However, as is the case with members, reference to agency law will yield the same result.

55. *See, e.g., Carson v. Lynch Multimedia Corp.*, 123 F. Supp. 2d 1254, 1264 (D. Kan. 2000) (rejecting manager immunity for breach of fiduciary duties); *VGS, Inc. v. Castiel*, No. C.A. 17995, 2000 WL 1277372, at *4 (Del. Ch. Aug. 31, 2000), *aff'd*, 781 A.2d 696 (Del. 2001) (finding that managers owe a fiduciary duty to the limited liability company). As is true in the corporate context, *see supra* note 18, if a limited liability company is insolvent, its managers must manage the company with a view to the interest of its creditors. *E.g., Blackmore Partners, L.P. v. Link Energy LLC*, No. Civ. A. 454-N, 2005 WL 2709639, at *6 (Del. Ch. Oct. 14, 2005).

56. *Coventry Real Estate v. Developers Diversified Realty Corp.*, 84 A.D.3d 583, 584 (N.Y. App. Div. 2011) (finding that under Delaware law in a manager-managed limited liability company only managers and controlling members are fiduciaries; nonmanaging minority members are not); *cf. KAN. STAT. ANN. § 17-7693(b)(1)* (providing that in a manager-managed limited liability company, no member acting solely in the capacity of a member is an agent of the limited liability company). House Bill 2398, if enacted, would repeal subsection 17-7693(b). H.B. 2398, *supra* note 51, § 26. The REVISED UNIF. LTD. LIAB. CO. ACT § 409(g) (2006), which has not been enacted in Kansas, addresses the point specifically, and provides that in a manager-managed limited liability company managers are subject to fiduciary duties of loyalty and care but members are not.

57. *See Carson*, 123 F. Supp. 2d at 1258–59; *see also Solar Cells, Inc. v. True N. Partners, LLC*, No. Civ. A. 19477, 2002 WL 749163, at *4 (Del. Ch. Apr. 25, 2002) (finding that a member subject to fiduciary duty must act in good faith).

58. KAN. STAT. ANN. § 17-76,134(c)(2).

59. DEL. CODE ANN. tit. 6, § 18-1101(c), (e) (West 2011). House Bill 2398, if enacted would follow Delaware in authorizing complete contractual waiver of fiduciary duties. H.B. 2398, *supra* note 51, § 57.

60. 40 A.3d 839 (Del. Ch.), *aff'd*, 59 A.3d 1206 (Del. 2012).

61. *Id.* at 857–58.

Before ultimately holding that the manager had breached the contractual duty of loyalty, and in response to the manager's argument that he owed no fiduciary duties whatsoever, Chancellor Strine engaged in an extensive analysis of whether Delaware law itself imposed default fiduciary duties that would apply in the absence of relevant provisions in an operating agreement. The basic analysis was straightforward and convincing: (1) "inequitable action does not become . . . permissible simply because it is legally possible";⁶² (2) the Delaware act, like that of Kansas, incorporates the rules of law and equity in cases not provided for in the statute; (3) the statute allows parties to contract around (and out) of fiduciary duties, which suggests that such duties exist by default in the absence of contractual modification (or elimination); (4) under traditional equitable principles the manager of a limited liability company qualifies as a fiduciary because the manager is vested with discretionary power to manage the business; (5) fiduciaries owe the fiduciary duties of loyalty and care; and (6) therefore, the Delaware Limited Liability Company Act (DLLCA) starts with the default that managers owe enforceable fiduciary duties.⁶³

On appeal, the Delaware Supreme Court affirmed on the basis of the manager's contractual fiduciary duties.⁶⁴ Having so held, however, the court went on to chastise the Chancellor for engaging in "improvident and unnecessary" dictum "without any precedential value" about an issue as to which "reasonable minds could differ."⁶⁵ Although the Delaware Supreme Court clearly was concerned about what it perceived as the Chancellor's bootstrapping use of previous Court of Chancery opinions,⁶⁶ its scathing rebuke creates doubt about its view of the substantive merit of his conclusion.⁶⁷

62. *Id.* at 849 (quoting *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437, 439 (Del. 1971)) (internal quotation marks omitted). Chancellor Strine misquoted *Schnell* as "inequitable action does not become *legally* permissible simply because it is legally possible." *Id.* (emphasis added).

63. *Id.* at 849–52. Although the dispute involved only the fiduciary duties of a manager in a manager-managed limited liability company, the same analysis would apply to members in a member-managed limited liability company. *See id.* at 850 n.34.

64. *Gatz Props., LLC v. Auriga Cap. Corp.*, 59 A.3d 1206, 1213 (Del. 2012).

65. *Id.* at 1218.

66. *See id.* at 1219 n.70.

67. *See id.* at 1220 ("We remind Delaware judges that the obligation to write judicial opinions on the issues presented is not a license to use those opinions as a platform from which to propagate their individual world views on issues not presented.").

III. DUTY OF CARE

A. Corporations

It is generally recognized that there are two functionally different aspects to directors' managerial roles. The *Corporate Director's Guidebook* explains them as follows:

Directors have a responsibility to act in the best interests of the corporation and its shareholders. To do so, they must focus on maximizing the value of the corporation for the benefit of its shareholders. Directors fulfill this responsibility through two primary board functions: decision-making and oversight. The board's decision-making function generally involves considering and, if warranted, approving corporate policy and strategic goals and taking specific actions such as evaluating and selecting top management, approving major expenditures and transactions and acquiring and disposing of material assets. The board's oversight function involves monitoring the corporation's business and affairs including, for example, financial performance, management performance, compliance with legal obligations and corporate policies, and evaluating and designing appropriate risk management structures.⁶⁸

Correspondingly, there are two distinctly different bases on which a plaintiff might allege a breach of duty of care. As stated by the Delaware Court of Chancery in *In re Caremark International Inc. Derivative Litigation*:

Director liability for a breach of the duty to exercise appropriate attention may, in theory, arise in two distinct contexts. First, such liability may be said to follow from a board decision that results in a loss because that decision was ill advised or "negligent." Second, liability to the corporation for a loss may be said to arise from an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss.⁶⁹

Accordingly, because the policies and method of analysis differ, the following discussion considers these two contexts separately. The *Caremark* court noted that "[t]he first class of cases will typically be subject to review under the director-protective business judgment rule."⁷⁰

68. CORPORATE LAWS COMM., ABA BUS. LAW SECTION, CORPORATE DIRECTOR'S GUIDEBOOK 11 (6th ed. 2011) [hereinafter CORPORATE DIRECTOR'S GUIDEBOOK].

69. 698 A.2d 959, 967 (Del. Ch. 1996) (emphasis omitted).

70. *Id.*

1. Decision-Making: The Business Judgment Rule

If directors have made a good faith, informed, honest, and unselfish business decision, most courts are reluctant to second-guess the decision simply because it turns out badly. This judicial deference is known as the business judgment rule, and, when applicable, it protects directors' decisions that fall short of constituting waste: a decision that is so one-sided that no person of ordinary, sound judgment could conclude that the corporation has received adequate consideration; the rare, unconscionable case in which directors irrationally squander or give away corporate assets; or a decision that cannot be attributed to any rational business purpose.⁷¹ In Delaware and Kansas, the rule operates as "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."⁷² Thus, the initial burden is on the party challenging the decision to rebut the presumption by demonstrating that at least one of its preconditions is lacking.

Of course, the easiest way for a plaintiff to rebut the business judgment presumption is to show the directors have a self-dealing financial interest in the subject matter of their decision.⁷³ Such situations implicate the classic duty of loyalty, with the result that the burden of proof is on the directors to establish the entire fairness of the transaction.⁷⁴ Alternatively, the plaintiff can attempt to establish lack of good faith,⁷⁵ or that the directors have been grossly negligent in failing to inform themselves of all material information reasonably available to them before making their decision.⁷⁶ If the plaintiff rebuts the business judgment rule in either of these ways, what standard of review applies and which party has the burden of proof?

In *Cede & Co. v. Technicolor, Inc.*, the Delaware Supreme Court held that rebuttal of the business judgment rule on the basis that the decision was uninformed shifted the burden of proof to the directors to

71. *E.g.*, *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 74 (Del. 2006); PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 1.42. (1994).

72. *E.g.*, *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000); *accord* *Becker v. Knoll*, 239 P.3d 830, 834 (Kan. 2010).

73. *E.g.*, *Fliegler v. Lawrence*, 361 A.2d 218, 221 (Del. 1976).

74. *See infra* Part IV.A.2 (discussing self-dealing corporate transactions).

75. *See infra* Part IV.A.1 (discussing the requirement of good faith in the corporate context).

76. *E.g.*, *Smith v. Van Gorkom*, 488 A.2d 858, 872–73 (Del. 1985), *overruled on other grounds by Gantler v. Stephens*, 965 A.2d 695 (Del. 2009).

demonstrate the entire fairness of the transaction.⁷⁷ This holding was unprecedented at the time and was subjected to the criticism that it inappropriately applied the stringent duty of loyalty standard of review, along with its shifted burden of proof, to a duty of care factual situation.⁷⁸ The *Cede* court created further doctrinal controversy by *equating* the duty to reach an informed decision with the “duty of care” rather than treating it as a mere subset of the broader duty of care in the decision-making context.⁷⁹ For example, one commentator stated:

Notice how the court puts the cart before the horse. Directors who violate their duty of care do not get the protections of the business judgment rule; indeed, the rule is rebutted by a showing that the directors violated their duty of “due care.” This is exactly backwards.⁸⁰

Another argued that the result was a substantive truncation of the duty of care.⁸¹ Not only was this reading of *Cede* correct, it is precisely what the court intended. In other words, after *Cede* the “duty of care” in the decision-making context has become purely procedural—an inquiry into whether the directors’ *decisional process* was grossly negligent.⁸²

As a policy matter, the business judgment rule flows from and reinforces the statutory allocation of power and functions within a

77. 634 A.2d 345, 350–51, 361 (Del. 1993), *modified*, 636 A.2d 956 (Del. 1994). For a discussion of the standard of review and burden of proof in cases involving lack of good faith, see *infra* Parts III.A.3, IV.A.1.

78. *E.g.*, Lyman Johnson, *Rethinking Judicial Review of Director Care*, 24 DEL. J. CORP. L. 787,788–801 (1999).

79. *See Cede*, 634 A.2d at 366–68.

80. Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 94–95 (2004) (footnote omitted).

81. Johnson, *supra* note 78, at 803–05.

82. Any doubt on this point was eliminated three years later in the *Caremark* opinion, in which the court expressed an extreme view of the strictly procedural nature of the duty of care, as follows:

What should be understood, but may not be widely understood by courts or commentators who are not often required to face such questions, is that compliance with a director’s duty of care can never appropriately be judicially determined by reference to *the content of the board decision* that leads to a corporate loss, apart from consideration of the good faith *or* rationality of the process employed. That is, whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through “stupid” to “egregious” or “irrational”, provides no ground for director liability, so long as the process employed was either rational or employed in a *good faith* effort to advance corporate interests. To employ a different rule—one that permitted an “objective” evaluation of the decision—would expose directors to substantive second guessing by ill-equipped judges or juries, which would, in the long-run, be injurious to investor interests. Thus, the business judgment rule is process oriented and informed by a deep respect for all *good faith* board decisions.

In re Caremark Int’l Inc. Derivative Litig. 698 A.2d 959, 967–68 (Del. Ch. 1996) (footnotes omitted). For further discussion, see *infra* Part IV.A.1.

corporation: shareholders elect directors, but directors, not shareholders, manage the business.⁸³ As long as directors are acting in good faith, on an informed basis, and free from a disabling conflict of interest, they should be free from having their decisions second-guessed by minority shareholders, judges, and juries acting with disavowed, but nevertheless real, hindsight. Business necessarily involves risk, and risk and potential profit are directly related. Over time, riskier decisions produce greater profit, even after factoring in losses, than do more conservative decisions. The business judgment rule recognizes this and attempts to free directors from the fear of personal liability if a decision that appeared to be a reasonable risk at the time turns out badly. A contrary rule that imposed liability on the basis of ordinary negligence, or even gross negligence, with respect to the *substance* of a decision would create an incentive for directors to pursue the least risky, most conservative of the options available to them, to the disadvantage of their shareholders generally.⁸⁴

2. Monitoring and Oversight

It is a fact of life that as the size of a corporation and its business grows, direct hands-on management by the board becomes more difficult. This practical reality is recognized explicitly by the statutory norm that provides “[t]he business and affairs of every corporation shall be managed by *or under the direction of* a board of directors.”⁸⁵ Thus, it is both necessary and appropriate that the board delegate, formally or informally, many of its managerial functions and responsibilities to board committees and to the corporation’s senior executives.⁸⁶ To the extent that direct decision-making authority has been so delegated, the role of the board becomes one of oversight or monitoring of the performance of the delegates in managing the business.

83. *E.g.*, KAN. STAT. ANN. §§ 17-6301(a), -6501(b) (2007); *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) *overruled on other grounds by* *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009); *see also* RESTATEMENT (SECOND) OF AGENCY § 14C cmt. a (1958).

84. *See, e.g.*, *Joy v. North*, 692 F.2d 880, 885–86 (2d Cir. 1982), *superseded by statute*, CONN. GEN. STAT. ANN. § 33-724; *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 746 (Del. Ch. 2005), *aff’d*, 906 A.2d 27 (Del. 2006); *see also* WILLIAM A. KLEIN, JOHN C. COFFEE, JR. & FRANK PARTNOY, *BUSINESS ORGANIZATION AND FINANCE* 241–50 (11th ed. 2010) (discussing risk and return).

85. KAN. STAT. ANN. § 17-6301(a) (emphasis added).

86. *See, e.g., id.* § 17-6301(c) (providing for delegation of duties to committees); *id.* § 17-6302(a) (providing for delegation of duties to officers); PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS §§ 3.01, 3.02(c), 4.01(b) (1994) (same).

Depending on the size of the corporation and the complexity of its business, such oversight and monitoring may include: (1) reviewing performance of the business and its operating, financial, and other plans, objectives and strategies; (2) establishing and monitoring information reporting systems concerning the corporation's compliance with applicable laws, administrative regulations, and ethical obligations; (3) understanding the corporation's risk profile and overseeing its risk management programs; (4) understanding the corporation's financial statements and monitoring operation of its internal controls and compliance with disclosure policies and requirements; (5) selecting, setting goals for, reviewing the performance of, establishing the compensation of, and replacing when necessary the corporation's senior executives; and (6) developing succession plans for the corporation's senior executives.⁸⁷

In performing its functions, the board is entitled to rely on the information, opinions, reports and statements of its committees, the corporate officers and employees, and outside experts, provided such reliance is in good faith and there are no circumstances that should put the directors on notice that reliance is unwarranted or that further inquiry is called for.⁸⁸ Moreover, the board's good faith, informed, and disinterested decisions as to the specifics regarding implementation of its oversight functions are subject to the protection of the business judgment rule.⁸⁹ Thus, breach of the directors' duty of care in this context essentially involves "an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss."⁹⁰

In such instances, the primary legal question concerns the standard of review to which directors will be subjected. On one hand, because an unconsidered failure to act will not be reviewed under the business judgment rule, one might logically expect liability to be predicated on simple or ordinary negligence, and that is the position taken by the American Law Institute.⁹¹ After all, the policy of encouraging wealth maximization through rationally based risk taking is not implicated when

87. CORPORATE DIRECTOR'S GUIDEBOOK, *supra* note 68, at 13; *see also Caremark*, 698 A.2d at 968–70 (discussing director liability for failure to monitor).

88. KAN. STAT. ANN. §§ 17-6301(e), -6422; *Van Gorkom*, 488 A.2d at 874–75; PRINCIPLES OF CORPORATE GOVERNANCE §§ 4.01(a), (b), 4.02, 4.03.

89. *Caremark*, 698 A.2d at 970; *see also* Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984) (stating that a conscious decision to refrain from acting may be a valid exercise of business judgment), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

90. *Caremark*, 698 A.2d at 967 (emphasis omitted).

91. PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(a), (c), cmt. c.

directors have not made a conscious business decision of any sort.⁹² On the other hand, the existing Delaware precedent indicates that something more than ordinary negligence, or even gross negligence, is the appropriate standard in cases involving failure to monitor as well as in cases falling under the business judgment rule. Thus, the Delaware Supreme Court in *Graham v. Allis-Chalmers Manufacturing Co.* stated the standard as follows:

In the last analysis, the question of whether a corporate director has become liable for losses to the corporation through neglect of duty is determined by the circumstances. If he has *recklessly* reposed confidence in an *obviously* untrustworthy employee, has *refused or neglected cavalierly* to perform his duty as a director, or has *ignored* either *willfully* or through inattention *obvious* danger signs of employee wrongdoing, the law will cast the burden of liability on him.⁹³

More recently, the Delaware Court of Chancery restated the standard of liability as requiring “*lack of good faith* as evidenced by sustained or systematic failure . . . to exercise reasonable oversight.”⁹⁴

These decisions are supported, explicitly or implicitly, by the view that the policy of the law should be to encourage qualified people to assume directorships by freeing them from fear of liability for all but the most egregious breaches of fiduciary duty.⁹⁵ This policy is also the basis of statutory provisions in both Delaware and Kansas that permit the adoption of exculpatory charter provisions that free directors from liability for monetary damages for breach of duty of care but not for

92. *Id.* § 4.01(c) cmt. c. states:

There is, however, no reason to provide special protection where no business decision making is to be found. If, for example, directors have failed to oversee the conduct of the corporation’s business . . . by not even considering the need for an effective audit process, and this permits an executive to abscond with corporate funds, business judgment rule protection would be manifestly undesirable. The same would be true where a director received but did not read basic financial information, over a period of time, and thus allowed his corporation to be looted. In these and other “omission” situations, the director or officer would be judged under the reasonable care standards of § 4.01(a) and not protected by § 4.01(c).

93. 188 A.2d 125,130 (Del. 1963) (emphasis added).

94. *Caremark*, 698 A.2d at 971 (emphasis added). *Stone v. Ritter*, 911 A.2d 362 (Del. 2006), expressly approved the *Caremark* standard.

95. The *Caremark* court articulated this policy as follows:

[A] demanding test of liability in the oversight context is probably beneficial to corporate shareholders as a class, as it is in the board decision context, since it makes board service by qualified persons more likely, while continuing to act as a stimulus to good faith performance of duty by such directors.

698 A.2d at 971 (emphasis omitted).

breach of duty of loyalty or for acts or omissions lacking in good faith.⁹⁶ The widespread adoption of such provisions has shifted the focus in oversight cases from care to good faith. Indeed, although *Caremark* purports to be a duty of care case, it enunciates a standard sounding in lack of good faith for exactly that reason. Unfortunately, the common failure of opinions to articulate clearly the interdependence of the standard of culpability and the presence of exculpatory provisions makes analysis in cases lacking such exculpatory provisions difficult. In the final analysis, *Graham*, a pre-exculpatory provision decision that nevertheless requires a state of mind that is equivalent to lack of good faith, should supply the answer.⁹⁷

In *Speer v. Dighton Grain, Inc.*,⁹⁸ also a pre-exculpatory provision opinion, the Kansas Supreme Court stated the standard of care as “that measure of attention, care, and ability which the ordinary director and officer of corporations of this kind would be reasonably and properly expected to bestow upon the affairs of the corporation.”⁹⁹ Yet the directors’ failure to monitor the activities of a dishonest vice president, even after specifically being warned by the corporation’s outside auditor, was so extreme that the case was tried and argued on appeal as involving gross negligence.¹⁰⁰ For the reasons discussed in Part III.A.3, immediately below, it is highly likely that Kansas will follow Delaware in adopting lack of good faith as the standard.

3. Exculpatory Charter Provisions

In the 1985 decision of *Smith v. Van Gorkom*,¹⁰¹ the Delaware Supreme Court shocked the corporate world by holding that disinterested but grossly uninformed directors who approved a disadvantageous merger were not entitled to the protection of the business judgment rule and thus faced the prospect of an adverse multimillion dollar personal judgment. The reaction of the Delaware legislature was swift. In 1986 it amended its corporation law to add section 102(b)(7).¹⁰² That section

96. DEL. CODE ANN. tit. 8, § 102(b)(7) (West 2011); KAN. STAT. ANN. § 17-6002(b)(8) (2007); see also Parts III.A.3, IV.A.1 (discussing exculpatory provisions and good faith).

97. See 188 A.2d at 130.

98. 624 P.2d 952 (Kan. 1981).

99. *Id.* 955–56.

100. *Id.*

101. 488 A.2d 858 (Del. 1985), *overruled on other grounds by* *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009).

102. Ch. 289, §§ 1–2, 65 Del. Laws 544 (Del. 1986) (codified at DEL. CODE ANN. tit. 8, § 102(b)(7) (West 2011)). The Delaware Supreme Court has described section 102(b)(7) as “a

permits a corporation's certificate of incorporation to contain a provision limiting or eliminating a director's personal liability for monetary damages for breach of fiduciary duty, with the exception of liability for: (1) breach of duty of loyalty; (2) acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law; (3) unlawful distributions; or (4) any transaction from which the director received an improper personal benefit. In other words, the statute permits a provision in the certificate of incorporation that eliminates personal liability for money damages for breach of the duty of care.¹⁰³ Kansas followed suit by amending its statute to adopt an identical provision the following year.¹⁰⁴

The purpose of these statutes is to permit shareholders affirmatively to “encourag[e] capable persons to serve as directors of corporations by providing them with the freedom to make risky, good faith business decisions without fear of personal liability.”¹⁰⁵ That is, the policy is the same as that underlying the business judgment rule, but it is clear that

thoughtfully crafted legislative response to our holding in *Van Gorkom*.” *Emerald Partners v. Berlin*, 787 A.2d 85, 96 (Del. 2001).

103. Technically, the statute permits only limitation or elimination of the damages remedy, not the underlying duty of care itself. *Emerald Partners*, 787 A.2d at 92; *see also Malpiede v. Townson*, 780 A.2d 1075, 1095 (Del. 2001). As a practical matter, one would not expect to encounter many cases outside of the mergers and acquisitions context in which a plaintiff sought to enjoin a breach of the duty of care. *Malpiede* itself is instructive. There, the plaintiffs originally sought to enjoin the disputed merger, but the court refused to issue a temporary restraining order, the merger closed, and the case devolved into an action for damages. *Malpiede*, 780 A.2d at 1081–82.

104. Ch. 88, § 1, 1987 Kan. Sess. Laws 536 (codified at KAN. STAT. ANN. § 17-6002(b)(8) (2007)). *Kansas Heart Hospital, L.L.C. v. Idbeis*, 184 P.3d 866 (Kan. 2008), among other things, concerned the question whether a board of directors' interpretation of a corporate bylaw was entitled to judicial deference under the business judgment rule. The defendants attempted to rebut application of the rule by focusing on the decisional process employed by the board, arguing that it was grossly negligent in the same way as that in *Van Gorkom*. In partial response, the court cited *Van Gorkom* as “superseded by statute.” *Kan. Heart Hosp.*, 184 P.3d at 887. That is simply not the case. True, the legislative response to *Van Gorkom* was enactment of section 102(b)(7), but the statute is not self-executing. *Van Gorkom* would be decided exactly the same way today in the case of a corporation without an exculpatory provision in its charter. More to the point, the statute does not authorize corporations to repeal the duty of care; it only speaks to the damage remedy for breach of the duty. Finally, the business judgment rule continues to shield a multitude of *decisions* from judicial second-guessing totally apart from the question of directorial *liability* for having made the decision. In fact, the court was asked to use it in that transactional sense in *Kansas Heart Hospital*, which did not involve an attempt to impose damage liability on the directors. For that reason, section 102(b)(7) and its Kansas counterpart were completely irrelevant to the case, but the question whether the directors' decisional process was grossly negligent, thus rebutting application of the business judgment rule, was completely relevant. As to that issue, *Van Gorkom* has not been superseded and should not have been represented as such.

105. *Prod. Res. Grp., L.L.C. v. NCT Grp., Inc.*, 863 A.2d 772, 793 (Del. Ch. 2004); *accord Emerald Partners*, 787 A.2d at 90 (stating that section 102(b)(7) frees directors to take business risks without worrying about negligence lawsuits); *Malpiede*, 780 A.2d at 1095 (same).

exculpatory clauses will also insulate directors from claims that they have failed to monitor adequately management of the business.¹⁰⁶

Delaware views these exculpatory provisions as “in the nature of” affirmative defenses,¹⁰⁷ with the result that failure to assert them amounts to a waiver.¹⁰⁸ If properly asserted, however, they require dismissal of a complaint that pleads nothing more than a breach of the duty of care.¹⁰⁹

B. Partnerships

Nationally, before promulgation of the Revised Uniform Partnership Act, there was a division of authority regarding the standard of care to which partners were held in managing the business. The traditional view, to which Kansas subscribed, imposed liability on partners for ordinary negligence with respect to both their business decisions and their supervisory activities.¹¹⁰ The modern trend elsewhere, however, looked to corporate law and applied a slightly more plaintiff-friendly version of the business judgment rule. The effect was to adopt a gross negligence standard,¹¹¹ at least as to partners’ business decisions that turned out badly.¹¹²

106. *Prod. Res.*, 863 A.2d at 798.

107. *Emerald Partners v. Berlin*, 726 A.2d 1215, 1223 (Del. 1999). This seemingly harmless and accurate characterization has caused a not insignificant amount of confusion. *See Emerald Partners*, 787 A.2d at 89–98 (analyzing the effect of 102(b)(7)); *Malpiede*, 780 A.2d at 1094–96, n.71; E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992–2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1433–36 (2005).

108. *McMullin v. Beran*, 765 A.2d 910, 926 (Del. 2000).

109. *Malpiede*, 780 A.2d at 1093–94.

110. In *Carlin v. Donegan*, 15 Kan. 495 (1875), the Kansas Supreme Court reversed the trial court for instructing the jury that liability could be predicated only on a showing of gross negligence. *Id.* at 500. Although *Carlin*’s age might cast doubt on its present viability, it has not been overruled and has been cited as authority for this point as recently as 1987. *In re Novak*, 97 B.R. 47, 60 (Bankr. D. Kan. 1987). In *Insley v. Shire*, 39 P. 713 (Kan. 1895), a lack of supervision allowed employees to embezzle partnership funds. *Id.* at 715. The court articulated a standard of “reasonable diligence” and held that losses caused by culpable neglect were chargeable against the guilty partners. *See id.* at 717.

111. Until relatively recently, the conventional wisdom was that the corporate business judgment rule would not insulate the substance of a decision that amounted to gross negligence. *E.g.*, *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985), *overruled on other grounds* by *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009); *Aronson v. Lewis*, 473 A.2d 805, 812 n.6 (Del. 1984), *overruled on other grounds* by *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000); PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(c) & cmt. f (1994). However, the advent of exculpatory charter provisions and the concomitant focus on good faith or the lack thereof, combined with *Cede*’s contraction of the duty of care to a purely procedural inquiry,

When Kansas enacted the Revised Uniform Partnership Act,¹¹³ it codified this modern trend, as follows:

A partner's duty of care to the partnership and the other partners in the conduct and winding up of the partnership business is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.¹¹⁴

This standard of care, of course, brings partnership law closer to that applicable to corporate directors. Although it is true that the policy of encouraging qualified persons to serve as independent directors is inapplicable, the policy of freeing business persons to make profit-maximizing decisions is equally applicable, with a slightly different twist.

One of the hallmarks of partnership law is the norm that partners share profits and losses.¹¹⁵ If this norm is combined with a standard of care that is breached only by gross negligence or worse conduct, then losses caused by a partner's ordinary negligence will be borne by all partners like any other loss, rather than being allocated exclusively to the acting partner. If all partners are active in the business and subject to similar risks in their management activities, they probably would prefer this result to one that visited the consequences of ordinary negligence solely on the actor.¹¹⁶

If partners want a more stringent standard of care, they are free to provide for it in their partnership agreement.¹¹⁷ They may also reduce

have had the effect of expanding the business judgment rule's protective umbrella to encompass gross negligence, leaving only waste unprotected. *See supra* note 71 and accompanying text.

112. *E.g.*, *Bane v. Ferguson*, 890 F.2d 11, 14 (7th Cir. 1989) (applying Illinois law); *Shlomchik v. Richmond 103 Equities Co.*, 662 F. Supp. 365, 373-74 (S.D.N.Y. 1986) (applying New York law); *Master Garage, Inc. v. Bugdanowitz*, 690 P.2d 879, 882 (Colo. App. 1984); *Rosenthal v. Rosenthal*, 543 A.2d 348, 354 (Me. 1988). *See generally* 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 (2005) (examining the business judgment rule as applied to unincorporated business organizations).

113. Ch. 93, 1998 Kan. Sess. Laws 393 (effective Jan. 1, 1999) (codified at KAN. STAT. ANN. §§ 56a-101 to -1305 (2005 & Supp. 2012)).

114. KAN. STAT. ANN. § 56a-404(c) (2005). General partners of limited partnerships are subject to the same duty of care because of the linkage between the partnership act and the limited partnership act. *Id.* §§ 56-1a253(a), (c), -1a604.

115. Unless otherwise agreed, partners share profits and losses equally. *Id.* §§ 56a-103(a), -401(b). This sharing is typically accomplished by means of partners' accounts, which are credited with each partner's share of profits and charged with the partner's share of losses. *Id.* § 56a-401(a).

116. Donald J. Weidner & John W. Larson, *The Revised Uniform Partnership Act: The Reporters' Overview*, 49 BUS. LAW. 1, 22-23 (1993).

117. KAN. STAT. ANN. § 56a-103(a); REVISED UNIF. P'SHIP ACT § 103 cmt. 6 (1997).

the statutory standard as long as the reduction is not unreasonable.¹¹⁸ The drafters of the Revised Uniform Partnership Act state that “provisions releasing a partner from liability for actions taken in good faith and in the honest belief that the actions are in the best interests of the partnership” are authorized, but that a provision “absolving partners of intentional misconduct is probably unreasonable.”¹¹⁹ This indicates fairly clearly that an analogy to the corporate exculpatory provisions discussed above is not inappropriate.¹²⁰ Such an analogy would disallow partnership exculpation of both intentional misconduct and knowing violations of the law.¹²¹ On the other hand, a partnership agreement that immunizes partners from the consequences of gross negligence would be permissible.

Whether that immunity could be extended to recklessness is problematic. Arguably, recklessness might be seen as simply a very extreme form of negligence. However, to the extent recklessness is seen as involving a conscious disregard of a known duty or an undue risk of harm, it is qualitatively different and more culpable than even very gross negligence. As discussed below, it would amount to a lack of good faith that could not be protected either by a corporate charter or by analogy, a partnership agreement.¹²²

118. KAN. STAT. ANN. § 56a-103(b)(4).

119. REVISED UNIF. P'SHIP ACT § 103 cmt. 6.

120. See *supra* Part III.A.3.

121. Compare KAN. STAT. ANN. § 17-6002(b)(8)(B) (2007) (stating that articles of incorporation may not eliminate or limit a director's liability for bad faith acts, intentional misconduct, or a knowing violation of law), with *id.* § 56a-404(c) (2005) (stating that a partner's duty of care is limited to refraining from grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law).

122. *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 67 n.111 (Del. 2006) (noting bad faith includes “reckless indifference to or a deliberate disregard of the interests of the whole body of stockholders” (quoting *Allaun v. Consol. Oil Co.*, 147 A.2d 257, 261 (Del. Ch. 1929)). See *infra* Part IV.A.1 for further discussion of good faith in the context of corporate charter exculpatory clauses. The Delaware partnership and limited partnership statutes differ radically from their uniform and Kansas counterparts, in that the Delaware statutes permit partnership agreements to eliminate completely any and all liability for breach of fiduciary duties. DEL. CODE ANN., tit.6, §§ 15-103 (d), (f), 17-1101(d), (f) (West 2011). For this reason, Delaware partnership precedent is not helpful in resolving the extent to which Kansas partnership agreements may modify the statutory duty of care. Similar contractual waiver provisions appear in Delaware's limited liability company act, section 18-1101(c), (e), and will be discussed *infra* Part IV.C. House Bill 2398, if enacted, would amend the Kansas Revised Limited Liability Company Act (KRLCA) to mirror Delaware law in this respect. H.B. 2398, *supra* note 51, § 57.

C. Limited Liability Companies

Unlike partnership law, there is no statutory duty of care applicable to the members and managers of Kansas limited liability companies.¹²³ Nevertheless, in *Carson v. Lynch Multimedia Corp.*,¹²⁴ the court implicitly imported the Delaware corporate business judgment rule into the law of Kansas limited liability companies, but held it inapplicable to managers' actions taken for reasons wholly unrelated to the business.¹²⁵ In addition, in *Blackmore Partners, L.P. v. Link Energy LLC*,¹²⁶ the Delaware Court of Chancery applied the classic corporate business judgment rule in granting summary judgment for the defendant managers of a limited liability company in the face of a challenge to their decision to sell the company's assets.¹²⁷ Similarly, the court in *Minnesota INVCO of RSA #7, Inc. v. Midwest Wireless Holdings LLC*,¹²⁸ applied the business judgment rule to shield the decision of a limited liability company's managers to initiate an amendment of the operating agreement to repeal members' rights of first refusal in order to facilitate a merger that would benefit all members proportionately.¹²⁹

This readiness to analyze decision-making in manager-managed limited liability companies by reference to corporate law leaves little doubt that courts will take the same approach with reference to the oversight function.¹³⁰ Section 17-7697 of the Kansas Revised Limited Liability Company Act (KRLCA) reinforces this conclusion.¹³¹ Like its

123. Compare UNIF. LTD. LIAB. CO. ACT § 409(c), (h) (1996) (codifying members' and managers' duty of care as limited to refraining from grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law), with REVISED UNIF. LTD. LIAB. CO. ACT § 409(c), (g)(1) (2006) (codifying members' and managers' duty of care as that which a person in a like position would reasonably exercise under similar circumstances and in a manner the person reasonably believes to be in the best interests of the company, subject to the business judgment rule).

124. 123 F. Supp. 2d 1254 (D. Kan. 2000).

125. *Id.* at 1260; cf. *VGS, Inc. v. Castiel*, No. C.A. 17995, 2000 WL 1277372, at *5 (Del. Ch. Aug. 31, 2000), *aff'd*, 781 A.2d 696 (Del. 2001) (holding business judgment rule inapplicable to managers' decision amounting to bad faith breach of duty of loyalty). See generally Miller & Rutledge, *supra* note 112 (discussing the business judgment rule in the context of unincorporated business organizations).

126. No. Civ. A. 454-N, 2005 WL 2709639 (Del. Ch. Oct. 14, 2005).

127. *Id.* at *5 (citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds* by *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000)).

128. 903 A.2d 786 (Del. Ch. 2006).

129. *Id.* at 797-98.

130. See *In re Regional Diagnostics LLC*, 372 B.R. 3, 30 (Bankr. N.D. Ohio 2007) (applying Delaware law and denying a motion to dismiss a claim alleging a bad faith failure to exercise oversight).

131. KAN. STAT. ANN. § 17-7697 (2007).

corporate counterparts,¹³² it protects a member or manager who relies in good faith on a limited liability company's records and on other information, opinions, reports, or statements of its other members, managers, officers, employees, or committees, or of any other person who has been selected with reasonable care, as to matters the member or manager reasonably believes are within the person's professional or expert competence.¹³³ It is important to note, however, that the statute requires "good faith" reliance.¹³⁴

It is also apparent that members and managers of Kansas limited liability companies can contract out of the duty of care at least to the same extent as corporate directors and partners in partnerships. The KRLCA postulates that its policy is to give maximum effect to freedom of contract and the enforceability of operating agreements.¹³⁵ Moreover, it affirmatively provides that to the extent a member or manager has fiduciary or other duties and liabilities, such duties and liabilities may be expanded or restricted by the operating agreement, and the member or manager will not be liable for acting in good faith in reliance on the operating agreement.¹³⁶ A similar provision in Delaware's statute validated an operating agreement that exculpated a limited liability company's managers from damage awards based on breach of their duty of care.¹³⁷ As such, the agreement replicated Delaware and Kansas corporate law.¹³⁸

132. *Id.* §§ 17-6301(e), -6422; *see also supra* note 88 and accompanying text (discussing statutes).

133. KAN. STAT. ANN. § 17-7697.

134. *See Auriga Capital Corp. v. Gatz Props., LLC*, 40 A.3d 839, 874 n.154 (Del. Ch.) ("A fiduciary cannot select an unqualified advisor instead of a qualified one . . . and then claim he was guided by his expert sherpa [sic]."), *aff'd*, 59 A.3d 1206 (Del. 2012).

135. KAN. STAT. ANN. § 17-76,134(b).

136. *Id.* § 17-76,134(c).

137. *Blackmore Partners, L.P. v. Link Energy LLC*, No. Civ. A. 454-N, 2005 WL 2709639, at *8 (Del. Ch. Oct. 14, 2005).

138. *See supra* Part III.A.3. Delaware has since radically liberalized its partnership, limited partnership, and limited liability company statutes to permit complete elimination of fiduciary duties. *See infra* Part IV.C. House Bill 2398, if enacted, will amend the KRLCA to comport with Delaware law in this regard. H.B. 2398, *supra* note 51, § 57.

IV. DUTY OF LOYALTY

A. Corporations

1. Good Faith

The classic statement of the business judgment rule is that “[i]t is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”¹³⁹ In 1993, the Delaware Supreme Court in *Cede & Co. v. Technicolor, Inc.*,¹⁴⁰ stated that, to rebut the presumption of the business judgment rule, “a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the *triads* of their fiduciary duty—good faith, loyalty or due care.”¹⁴¹ It was not entirely clear whether the *Cede* court actually intended to break with the past and recast good faith as a third fiduciary duty, separate and independent from loyalty and care, or whether it merely intended good faith as a synonym for loyalty.¹⁴² Nevertheless, several additional Delaware decisions at least verbally embraced the concept of a triad of fiduciary duties of good faith, loyalty, and due care.¹⁴³ Whether viewed as a separate fiduciary duty, a synonym for loyalty, or a bridge or overarching concept that connects care and loyalty,¹⁴⁴ the primary practical importance of good faith was and is that breaches of the duty of care are subject to exculpation under a section 102(b)(7) charter provision, whereas bad faith conduct is not.¹⁴⁵

139. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by* *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

140. 634 A.2d 345 (Del. 1993). This is the same court that confined the duty of care in the decision-making context to an inquiry into the board’s decisional process and held that rebuttal of the business judgment rule shifts the burden of proof to the directors to establish entire fairness. *See supra* notes 77–82 and accompanying text.

141. *Cede*, 634 A.2d at 361.

142. *See* John L. Reed & Matt Neiderman, “Good Faith” and the Ability of Directors to Assert Section 102(b)(7) of the Delaware General Corporation Law as a Defense to Claims Alleging Abdication, Lack of Oversight, and Similar Breaches of Fiduciary Duty, 29 DEL. J. CORP. L. 111, 119–20 (2004) (discussing the possible misunderstanding).

143. *E.g.*, *Emerald Partners v. Berlin*, 787 A.2d 85, 91 (Del. 2001); *McMullin v. Beran*, 765 A.2d 910, 917, 918, 920 (Del. 2000); *Emerald Partners v. Berlin*, 726 A.2d 1215, 1221, 1223 (Del. 1999).

144. *See* Reed & Neiderman, *supra* note 142, at 119–24 (discussing different interpretations of good faith); Hillary A. Sale, *Delaware’s Good Faith*, 89 CORNELL L. REV. 456, 463–64 (2004) (discussing emerging good faith doctrine); Veasey & Di Guglielmo, *supra* note 107, at 1449–51 (discussing whether good faith is a separate duty).

145. DEL. CODE ANN. tit. 8, § 102(b)(7)(ii) (West 2011). KAN. STAT. ANN. § 17-6002(b)(8)(B)

The duty of loyalty traditionally has been confined to situations in which a director, officer, or controlling shareholder has a pecuniary, self-dealing conflict of interest with the corporation or minority shareholders.¹⁴⁶ Because Delaware General Corporation Law section 102(b)(7) and Kansas General Corporation Code section 17-6002(b)(8) exclude *both* breaches of duty of loyalty *and* conduct not in good faith from exculpation,¹⁴⁷ good faith finds its most significant application in situations that do not involve loyalty as traditionally cast. In other words, the concept of good faith is most important with respect to non-self-dealing director decisions that are so beyond the pale that they are explainable only on the basis of bad faith, or in cases that involve such sustained and systematic lack of oversight that they amount to complete abdication of all directorial responsibility.¹⁴⁸

Thus, for thirteen years, two doctrinally consequential questions—the precise content of good faith and whether it was a third, independent fiduciary duty—lacked conclusive answers. In 2006, the Delaware Supreme Court answered both questions in rapid succession.

The most definitive judicial examination of good faith to date is *In re Walt Disney Co. Derivative Litigation*,¹⁴⁹ which involved the employment and subsequent termination without cause of Michael Ovitz as Disney's second in command. Ovitz's tenure at Disney was a brief fourteen months and, pursuant to his employment agreement, his termination netted him approximately \$130 million in cash and stock options. Several shareholders brought derivative actions against the Disney directors attacking the decisional processes that resulted in Ovitz's employment and termination. The gravamen of the complaint was that the board's compensation committee and full board violated their respective duties of good faith by making material decisions without either adequate information or deliberation.¹⁵⁰

(2007) is to the same effect. See discussion *supra* Part III.A.3.

146. See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (discussing when the business judgment rule can apply), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971) (same); *Veasey & Di Guglielmo*, *supra* note 107, at 1451 (noting that the preferable approach is to treat good faith and loyalty separately because self-dealing is unnecessary for a good faith violation).

147. DEL. CODE ANN. tit. 8, § 102(b)(7)(i), (ii); KAN. STAT. ANN. § 17-6002(b)(8)(A), (B).

148. See *Veasey & Di Guglielmo*, *supra* note 107, at 1451; see also *Reid & Neiderman*, *supra* note 142, at 124–40 (discussing extensively both types of cases.).

149. 906 A.2d 27 (Del. 2006).

150. *Id.* at 35.

There are three critically important parts to the *Disney* opinion. The first is entitled “The Due Care Determinations,” and concerns applicability of the business judgment rule to the employment decisions made by the board and compensation committee.¹⁵¹ It is important to understand why this discussion is even relevant, given Disney’s section 102(b)(7) charter provision that exculpated the directors from money damage liability for breach of duty of care. The reason is that the business judgment rule *presumes* the board (and committee) acted on an informed basis in the good faith and honest belief that the action taken was in the best interest of the company. This presumption is sufficient to satisfy the requirement that the directors initially produce evidence of good faith.¹⁵² If the business judgment rule is rebutted, the burden of proof shifts to the directors to establish the entire fairness of their decision-making process and the decision resulting from it.¹⁵³ Plaintiffs may rebut the business judgment rule by making a prima facie showing of: breach of the duty of care (gross negligence in the decisional process), bad faith, or conflict of interest. It is easier for plaintiffs to make a prima facie showing of lack of due care (gross negligence in the decisional process) than to make a prima facie showing of either bad faith or conflict of interest (unless, of course, such a conflict exists on the facts). Therefore, the plaintiffs attempted to establish breach of duty of care (gross negligence in the decisional process) as a threshold matter to get the case tried under the strict review standard with the burden of proof on the defendants to establish the fairness of the employment contract and their good faith in approving it.¹⁵⁴ The plaintiffs argued that the compensation committee and full board were grossly negligent in making material decisions without adequate information or deliberation. The chancellor found that the committee’s and board’s decisional processes, while far from constituting best practices, did not amount to gross negligence, and the supreme court affirmed on the basis of the limited scope of appellate review of findings of fact.¹⁵⁵

The second, and most important part of the *Disney* opinion is entitled “The Good Faith Determinations.”¹⁵⁶ Undeterred by their lack of success regarding due care, the plaintiffs argued that the compensation committee’s and full board’s decisions were not made in good faith

151. *Id.* at 52–62.

152. *See supra* notes 107–09 and accompanying text.

153. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 350, 361 (Del. 1993).

154. *Disney*, 906 A.2d at 52–53.

155. *Id.* at 55–60.

156. *Id.* at 62–68.

because they were made without adequate information and deliberation. Having failed to establish gross negligence, it is hardly surprising that the plaintiffs were also unable to establish bad faith by equating it to gross negligence. In addition to being factually deficient, the plaintiff's case was legally deficient under the chancellor's nonexclusive definition of bad faith: "intentional dereliction of duty, a conscious disregard for one's responsibilities," and "intentional[] fail[ure] to act in the face of a known duty to act."¹⁵⁷ The legal correctness of this definition prompted an extended discussion of good faith by the supreme court.

The court began by observing that there are at least three categories of fiduciary behavior that might be labeled as bad faith. The first, at one end of the spectrum, is subjective bad faith—conduct motivated by an actual intent to do harm.¹⁵⁸ This category is so self-evident it merited no further consideration. The second, at the opposite end of the spectrum, is lack of due care (gross negligence), as asserted by the plaintiffs. The court unequivocally concluded that gross negligence could not be equated with bad faith, because to do so would be to eviscerate section 102(b)(7), the whole point of which is to permit exculpation of duty of care breaches but not acts and omissions lacking good faith.¹⁵⁹ This left a third category that fell in between the first two and is what the chancellor's definition intended to capture. The court explained why this category must constitute a violation of the duty to act in good faith, as follows:

[T]he universe of fiduciary misconduct is not limited to either disloyalty in the classic sense (*i.e.*, preferring the adverse self-interest of the fiduciary or of a related person to the interest of the corporation) or gross negligence. Cases have arisen where corporate directors have no conflicting self-interest in a decision, yet engage in misconduct that is more culpable than simple inattention or failure to be informed of all facts material to the decision. To protect the interests of the corporation and its shareholders, fiduciary conduct of this kind, which does not involve disloyalty (as traditionally defined) but is qualitatively more culpable than gross negligence, should be proscribed. A vehicle is needed to address such violations doctrinally, and that doctrinal vehicle is the duty to act in good faith.¹⁶⁰

157. *Id.* at 63, 67.

158. *Id.* at 64.

159. *Id.* at 64–66. The court also relied on section 145 of the Delaware General Corporation Law, which the court read as permitting indemnification of litigation expenses incurred by reason of a duty of care violation but not for a violation of the duty to act in good faith. *Id.* at 66.

160. *Id.*

In so holding, however, the court declined to address whether the duty to act in good faith was a third fiduciary duty, independent of both care and loyalty.¹⁶¹

Because the business judgment rule had not been rebutted, the third major part of the *Disney* opinion, entitled “The Waste Claim,” involved its actual application and a final attempt by the plaintiffs to prove that a severance payment of \$130 million for less than a year and a half of unsatisfactory work was waste and therefore outside the protection of the business judgment rule.¹⁶² The court began by defining “waste” as an exchange that is “so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration,” an “unconscionable case where directors irrationally squander or give away corporate assets,”¹⁶³ and a decision that cannot be “attributed to any rational business purpose.”¹⁶⁴ The court then rejected the argument that Ovitz’s severance package amounted to waste. The payment of \$130 million was contractually required and therefore could not be waste unless the contractual provisions that required it themselves constituted waste. Moreover, the contract was not waste, because Ovitz appeared to be a good hire at the time, and the compensation features were necessary to induce him to relinquish his lucrative position at his privately owned Hollywood talent agency. Therefore, the terms of the employment contract were not irrational.¹⁶⁵

Although the court did not make the point explicitly, it is clear that waste is bad faith conduct. Logically, if this were not so, waste would be exculpable and there would have been no need to decide the merits of whether the severance package amounted to waste. In addition, waste, as defined by the court, is certainly qualitatively more culpable than gross negligence and yet does not involve disloyalty as classically defined. As such, it falls into that middle ground that the court identified as requiring proscription by means of the duty of good faith. Finally, in a footnote, the court cited “reckless indifference to or a deliberate disregard of the interests of the whole body of stockholders” as an example of bad faith.¹⁶⁶ The necessary conclusion is that waste constitutes bad faith

161. *Id.* at 67 n.112.

162. *Id.* at 73–75.

163. *Id.* at 74 (quoting *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000)).

164. *Id.* (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)).

165. *Id.* at 74–75.

166. *Id.* at 67 n.111 (quoting *Allaun v. Consol. Oil Corp.*, 147 A.2d 257, 261 (Del. Ch. 1929)).

conduct and thus falls outside the protection of both the business judgment rule and section 102(b)(7) exculpatory provisions.¹⁶⁷

If *Disney* involved director decision-making and an explication of conduct not in good faith, *Stone v. Ritter* applied the *Disney* analysis in the oversight context and ended speculation about whether good faith was a separate, freestanding fiduciary duty.¹⁶⁸ *Stone* was decided shortly after *Disney* and involved an alleged violation of the directors' duty to be active monitors of the corporate executives' and other employees' management of the business. Specifically, the derivative complaint charged that the directors had utterly failed to implement any internal information and reporting system that would have enabled them to learn that employees were engaging in conduct that violated federal money-laundering laws, with the result that the corporation was required to pay \$50 million in fines and civil penalties.¹⁶⁹ Liability in this situation previously had been enunciated by the Delaware Court of Chancery in *In re Caremark International Inc. Derivative Litigation*,¹⁷⁰ as follows:

Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation . . . only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.¹⁷¹

In *Stone*, the Delaware Supreme Court expressly adopted the *Caremark* articulation of the necessary preconditions for director oversight liability. Either: (a) the directors utterly failed to implement any information and reporting system; or (b) having implemented such a system, consciously failed to monitor or oversee its operation, thus disabling themselves from being informed of risks or problems requiring their attention. The court further stated that this standard was an example of lack of good faith as described in *Disney*: intentionally failing to act in the face of a known duty to act, demonstrating a conscious disregard of duty.¹⁷²

167. *In re Citigroup S'holder Derivative Litig.*, 964 A.2d 106, 139 n.113 (Del. Ch. 2009) (relying on the chancery decision in *Disney* for the proposition that waste is nonexculpable bad faith conduct).

168. 911 A.2d 362 (Del. 2006).

169. *Id.* at 364–66.

170. 698 A.2d 959 (Del. Ch. 1996).

171. *Id.* at 971; *see also supra* notes 93–97 and accompanying text.

172. *Stone*, 911 A.2d at 370.

The primary doctrinal importance of *Stone* is that it answered the question left open by *Disney*, expressly holding that good faith is not a third, independent fiduciary duty under Delaware law. The court explained:

It is important, in this context, to clarify a doctrinal issue that is critical to understanding fiduciary liability under *Caremark* as we construe that case. The phraseology used in *Caremark* and that we employ here—describing lack of good faith as a “necessary condition to liability”—is deliberate. The purpose of that formulation is to communicate that a failure to act in good faith is not conduct that results, *ipso facto*, in the direct imposition of liability. The failure to act in good faith may result in liability because the requirement to act in good faith “is a subsidiary element[,]” i.e., a condition, “of the fundamental duty of loyalty.” It follows that because a showing of bad faith conduct, in the sense described in *Disney* and *Caremark*, is essential to establish director oversight liability, the fiduciary duty violated by that conduct is the duty of loyalty.

This view of a failure to act in good faith results in two additional doctrinal consequences. First, although good faith may be described colloquially as part of a “triad” of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty. Only the latter two duties, where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly. The second doctrinal consequence is that the fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith. As the Court of Chancery aptly put it . . . “[a] director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation’s best interest.”¹⁷³

Although the contours of the “new” duty of loyalty, and the place of good faith in it, continue to be developed by a steady stream of decisions,¹⁷⁴ *Stone* represents the logical conclusion of a thirteen-year

173. *Id.* at 369–70 (footnotes omitted). See generally Leo E. Strine, Jr. et al., *Loyalty’s Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629 (2010) (employing a historical, etymological, and policy-oriented analysis to conclude that the basic definition of the duty of loyalty is the obligation to act in good faith to advance the best interests of the corporation).

174. See, e.g., *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 243–44 (Del. 2009) (finding that court of chancery erroneously employed duty of care analysis to directors’ decision to authorize merger when relevant standard was good faith); *In re Goldman Sachs Group, Inc. S’holder Litig.*, No. 5215–VCG, 2011 WL 4826104, *16, *19 (Del. Ch. Oct. 12, 2011) (defining waste as a board decision so egregious or irrational that it could not have been based on a valid assessment of the corporation’s best interests and therefore constituting bad faith, and declining to extend

process that began with *Cede*'s reaction to the enactment of section 102(b)(7) and the ubiquitous presence of exculpatory charter provisions adopted pursuant to its authority. In addition to overzealously positing a triad of fiduciary duties, *Cede* reduced the duty of care to an inquiry into the board's decisional process¹⁷⁵ and held that if the business judgment rule is rebutted because that process was grossly negligent, the case would be tried under the entire fairness standard with the burden of proof on the directors to establish that their decision was made in good faith and in the best interests of the corporation.¹⁷⁶ In so holding, the *Cede* court was amazingly prescient, because after *Disney* and *Stone*, monetary liability is predicated on lack of good faith, which sounds in loyalty. In the decision-making context, if the plaintiff rebuts the business judgment rule in any of the three applicable ways,¹⁷⁷ the case appropriately is tried under the entire fairness loyalty standard. If the business judgment rule is not rebutted the plaintiff must show waste, which is a decision so reckless and irrational that it is explainable only on the basis of bad faith, which again is a loyalty breach. Thus, there is no longer a substantive duty of care, and there is no need for one. If, on the other hand, the factual situation is one of oversight, it has been clear since *Caremark* that the standard is lack of good faith, which after *Stone*, also is the duty of loyalty.

2. Self-Dealing Contracts and Transactions

“Self-dealing” should not be understood as a prejudgment of the merits or even as a necessarily derogatory or pejorative term. Rather, in the present context, it is simply descriptive of a factual situation in which a corporate fiduciary (director, officer, or controlling shareholder) appears on both sides of a contract or transaction with the fiduciary's corporation, or otherwise receives an exclusive or disproportionate

Caremark/Stone oversight duties to an affirmative duty to monitor risk); *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 136 (Del. Ch. 2009) (same); *In re Tyson Foods, Inc. Consol. S'holder Litig.*, 919 A.2d 563, 593 (Del. Ch. 2007) (holding that “spring-loaded” stock options may involve indirect deception of shareholders, and therefore may constitute a bad faith breach of the duty of loyalty); *Ryan v. Gifford*, 918 A.2d 341, 357–58 (Del. Ch. 2007) (holding that “backdated” stock options constitute conduct that is disloyal to the corporation and therefore is an act in bad faith).

175. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 366–68 (Del. 1993).

176. *Id.* at 350, 361.

177. *See supra* notes 73–76 and accompanying text.

financial benefit from the transaction.¹⁷⁸ Quite literally, “self-dealing” means “dealing with oneself.”

Under normal circumstances, the business judgment rule raises a presumption that in making a business decision the directors of a corporation were informed of all material information reasonably available to them and that they acted in the good faith and honest belief that the decision was in the corporation’s best interest.¹⁷⁹ Consequently, the burden is on the party challenging the decision to establish facts that either rebut the presumption or demonstrate that the decision was so egregious that it amounted to waste.¹⁸⁰

The situation is much different, however, if the decision is to authorize a self-dealing contract or transaction. Because, by definition, a corporate fiduciary receives or expects to receive a benefit that is not available to other similarly situated shareholders, the transaction is inherently suspect as one in which the fiduciary may be profiting at the expense of the corporation or other shareholders. Thus, at common law, a director’s self-dealing contract or transaction, if challenged, is not subject to review under the deferential business judgment rule.¹⁸¹ Instead, its merits are subject to strict judicial scrutiny under the so-called entire fairness standard, with the burden of proof on the interested director or directors to establish good faith and the intrinsic fairness of the transaction from the corporation’s standpoint.¹⁸²

A major Delaware common law exception to the fairness rule involves disinterested shareholder ratification. That is, if the self-dealing transaction is submitted to a shareholder vote, and if, after disclosure of

178. See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971). There is a significant body of Delaware case law dealing with the duties of corporate directors in the context of hostile takeovers. The transactions in such cases usually do not involve self-dealing in that the directors do not have a personal financial interest in the transaction that is adverse to the corporate interest. The directors typically do, however, have a personal interest in protecting their directorships, and that interest may well be at odds with the shareholders’ interest in maximizing the value of their shares via the hostile offer. Complicating matters further, the directors have a duty to protect the corporation from threats to good business policy and effectiveness. Because of these competing considerations, a complex hybrid analysis has developed that is beyond the scope of this Article. For an excellent exposition of Delaware law as applied in Kansas, see *Burcham v. Unison Bancorp, Inc.*, 77 P.3d 130, 147–51 (Kan. 2003), and authorities cited therein. See also Annette Simon, Note, *MM Companies, Inc. v. Liquid Audio, Inc.: An Attempt to Clarify the Blasius-Unocal Framework*, 52 U. KAN. L. REV. 1153 (2004) (analyzing the further complications involved if the directors’ response to the takeover threat disenfranchises the corporation’s shareholders).

179. *Aronson*, 473 A.2d at 812.

180. *Id.*; see also *supra* Part III.A.1.

181. *Aronson*, 473 A.2d at 812.

182. *E.g.*, *Newton v. Hornblower, Inc.*, 582 P.2d 1136, 1145–47 (Kan. 1978).

all material facts, the holders of a majority of the voting shares held by persons who are not interested in the transaction vote to approve it, the taint of interest is removed. The effect of such a disinterested ratification is to shift the standard of review back to the business judgment rule with the burden of proof on the party attacking the transaction to show waste—that no person of ordinary sound business judgment would view the terms as a fair exchange.¹⁸³

The policy underlying the disinterested shareholder ratification exception is quite sensible and straightforward. The business judgment rule is premised on the proposition that the interest of the corporation and its shareholders is best served by permitting the board of directors to make informed, good faith, honest, and unselfish business decisions free from being second-guessed by courts at the behest of minority shareholders.¹⁸⁴ However, if those decisions are potentially selfish rather than unselfish, the interest of the corporation and its shareholders requires the added protection of scrutiny of the merits (second-guessing) by a disinterested, fully informed party (the court). If, however, the transaction has already been scrutinized and approved by disinterested, fully informed parties (the disinterested shareholders) further scrutiny by the court would be redundant. In other words, this exception views fairness as a *process of scrutiny by disinterested, fully informed observers*, and equates scrutiny by disinterested shareholders with scrutiny by a disinterested judge.

The Delaware legislature approved the view that fairness is a process of informed scrutiny by a disinterested party or parties and took it one step farther when it recodified its corporate law in 1967. Unfortunately, as is true with many innovations in their first generation, there were defects.

Although there are minor grammatical and stylistic differences, section 144 of the Delaware General Corporation Law and section 17-6304 of the Kansas General Corporation Code are substantively identical. Section 144 provides,

- (a) No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the

183. *E.g.*, *Gottlieb v. Heyden Chem. Corp.*, 91 A.2d 57, 58–59 (Del. 1952).

184. *See supra* Part III.A.1.

meeting of the board or committee which authorizes the contract or transaction, or solely because any such director's or officer's votes are counted for such purpose, if:

- (1) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or
- (2) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or
- (3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders.

(b) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or of a committee which authorizes the contract or transaction.¹⁸⁵

A complicated, interrelated, and somewhat disingenuous line of Delaware cases has construed section 144 to have the following effects. First, good faith, informed approval by a majority of the disinterested directors cures the self-dealing aspect of the transaction, and it will be reviewed under the business judgment rule with the burden of proof on the party attacking the transaction to show waste.¹⁸⁶ In other words, section 144(a)(1) adds a third category of disinterested observers eligible to scrutinize carefully a self-dealing transaction: the disinterested directors. As long as they are truly disinterested, not dominated or controlled by the interested director or directors, and act in good faith,

185. DEL. CODE ANN. tit. 8, § 144 (West 2011); accord KAN. STAT. ANN. § 17-6304 (2007).

186. *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 906 A.2d 114, 120 (Del. 2006); *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 365–66 & n.34 (Del. 1993); *Oberly v. Kirby*, 592 A.2d 445, 466–67 (Del. 1991); *Marciano v. Nakash*, 535 A.2d 400, 404–05 & n.3 (Del. 1987); *Cooke v. Oolie*, No. Civ. A. 11134, 2000 WL 710199, at *13 & n.41 (Del. Ch. May 24, 2000). Note that section 144(a)(1) does not require a disinterested majority of the whole board. All that is necessary is a majority of the disinterested directors, no matter how many or few. See, e.g., *Cooke*, 2000 WL 710199, at *13 n.41 (finding that approval of loans by disinterested directors, who were two of four total directors, cleansed taint of interest of two other directors and permitted invocation of business judgment rule). The point is especially important because of ill-considered dictum to the contrary concerning section 17-6304(a)(1) of the Kansas General Corporation Code in *Oberhelman v. Barnes Inv. Corp.*, 690 P.2d 1343, 1349–50 (Kan. 1984).

their scrutiny is considered to be an adequate substitute for scrutiny by a judge.¹⁸⁷

Second, good faith, informed approval by the holders of a majority of the voting shares held by disinterested parties also cures the self-dealing aspect of the transaction, and it will be reviewed under the business judgment rule with the burden of proof on the attacking party to show waste.¹⁸⁸ In essence, Delaware courts interpret section 144(a)(2) as codifying the common law disinterested shareholder ratification rule even though the statute does not explicitly require the shareholder vote to be disinterested. This lapse in statutory drafting is a major defect in section 144. Although approval by *disinterested* shareholders may be an adequate substitute for judicial approval such that the business judgment rule may be invoked, few would agree that strict judicial scrutiny for entire fairness should be foreclosed by the affirmative vote of *interested* shareholders. The Delaware courts have solved this problem by judicial legerdemain that amounts to superimposing a requirement of shareholder disinterest on section 144(a)(2).¹⁸⁹ Happily, the Kansas Supreme Court has willingly, if somewhat awkwardly, followed suit.¹⁹⁰

187. See *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 756 n.464 (Del. Ch. 2005); *Cooke*, 2000 WL 710199, at *13 n.41.

188. *Cede & Co.*, 634 A.2d at 366 n.34; *Marciano*, 535 A.2d at 405 n.3; cf. *Fliegler v. Lawrence*, 361 A.2d 218, 221–22 (Del. 1976) (holding that although section 144(a)(2) does not expressly require a disinterested shareholder vote, the statute does not cure the loyalty taint or remove the case from the strict fairness standard if the vote is interested). Note that, as with the director vote, an absolute disinterested majority is not necessary. All that is required is the affirmative vote of a majority of the issued and outstanding shares held by shareholders who are disinterested. *In re PNB Holding Co. S'holders Litig.*, 2006 WL 2403999, at *15 (Del. Ch. Aug. 18, 2006); see also *Fliegler*, 361 A.2d at 221.

189. At common law in the nineteenth century, a director's self-dealing contract was *absolutely voidable*, totally without regard to fairness or unfairness, *solely* because a director stood on both sides of the transaction. Harold Marsh, Jr., *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35, 36–39 (1966). By the middle of the twentieth century this rule had evolved into the familiar modern common law rule, under which a self-dealing contract is *conditionally voidable* unless shown by the interested director to be entirely fair to the corporation. *Id.* at 43–44. In *Fliegler v. Lawrence*, the defendants noted the absence of an express disinterest requirement in section 144(a)(2) and argued that the statute *validated* a self-dealing transaction even if the shareholder ratification was interested. 361 A.2d at 222. The court's response was to focus on the introductory language of section 144(a) rather than the shareholder ratification procedure in subsection (a)(2). *Id.* Reading subsection (a) literally, the court concluded that the legal effect of statutory compliance was merely to move the case out of the nineteenth century rule of absolute voidability and into the twentieth century fairness rule. *Id.* That is, *Fliegler* held that compliance with section 144 merely "provides *against invalidation* of an agreement '*solely*' because such a director or officer is involved." *Id.* (emphasis added). Thus, notwithstanding the interested shareholder ratification, it was still incumbent on the directors to establish common law fairness. *Id.* Eleven years later, in *Marciano v. Nakash*, the court effectively rewrote the *Fliegler* holding, as follows: "[S]ection 144 *validation* of interested director transactions is not deemed exclusive, as *Fliegler* clearly holds." 535 A.2d 400, 404 (Del. 1987) (emphasis added). The court then surreptitiously added the disinterest requirement to subsection (a)(2) in its now-famous footnote

Gantler v. Stephens,¹⁹¹ however, has injected an element of uncertainty as to the effect of some disinterested shareholder votes. *Gantler* involved a charter amendment to adopt a reclassification proposal in which a majority of the directors were personally interested. As required by statute, the amendment was put to a shareholder vote,¹⁹² in which a majority of the shares held by disinterested persons were voted in favor. The Delaware Court of Chancery held that because the reclassification was an interested transaction, it initially was not entitled to business judgment deference.¹⁹³ However, the disinterested shareholder vote “ratified” the proposal and reinstated the business judgment rule as the standard of review.¹⁹⁴ The Delaware Supreme Court reversed, holding that the lower court erred in two ways. First, the court drew a bright-line distinction between cases in which a shareholder vote is *statutorily required to authorize* an action or transaction—such as a charter amendment, long-form merger, or transfer of all or substantially all assets—and those in which a shareholder vote is a voluntary additional layer of independent approval that is not statutorily required.¹⁹⁵ Only the latter are “classic” cases of shareholder “ratification.”¹⁹⁶ Second, the court held that the proxy statement furnished to the shareholders in connection with the vote was materially misleading, thus precluding the vote from being fully informed.¹⁹⁷ Therefore, the court concluded that “the approving shareholder vote did not operate as a ‘ratification’ of the challenged conduct in any legally meaningful sense.”¹⁹⁸

A casual reading of *Gantler* leads to the conclusion that a statutorily required shareholder vote, even if disinterested, will be sufficient to authorize the subject transaction but will not have the additional effect of “cleansing” director interest and permitting invocation of the business

three: “[A]pproval by fully-informed disinterested directors under section 144(a)(1), or disinterested stockholders under section 144(a)(2), permits invocation of the business judgment rule and limits judicial review to issues of gift or waste with the burden of proof on the party attacking the transaction.” *Id.* at 405 n.3.

190. *Oberhelman*, 690 P.2d at 1349–50.

191. 965 A.2d 695 (Del. 2009).

192. DEL. CODE ANN. tit. 8, § 242(b)(1) (West 2011); KAN. STAT. ANN. § 17-6602(c)(1) (2007).

193. *Gantler v. Stephens*, No. 2392-VCP, 2008 WL 401124, at *15 (Del. Ch. Feb. 14, 2008), *rev’d*, 965 A.2d 695 (Del. 2009).

194. *Id.* at *19, *23.

195. *Gantler*, 965 A.2d at 713.

196. *Id.*

197. *Id.* at 712.

198. *Id.* at 713.

judgment rule. Only “classic” ratification in which the disinterested shareholder vote is not statutorily required can have that effect. This interpretation of the opinion is reinforced by the fact that the court voluntarily reached out to decide this point and also by the court’s care in excepting from its apparent holding statutory disinterested shareholder ratification under section 144(a)(2), the whole point of which is to cure conflicts and permit application of the business judgment rule.¹⁹⁹

On the other hand, the opinion offers no explanation of the policy reason that would underlie such a drastic substantive change in the law. The situation is even more puzzling when one considers that Justice Jacobs, author of the *Gantler* opinion, co-authored an article eight years previously that was a ringing, policy-based endorsement of disinterested, but statutorily required, shareholder votes as curative of conflicts in long-form mergers.²⁰⁰ For these reasons, and because the materially misleading proxy statement is a completely independent basis for reversal, it is possible that the *Gantler* court was merely making a clarifying semantic distinction, rather than an outcome-determinative substantive distinction, between disinterested shareholder votes that are statutorily required and those that amount to “classic” ratification. A very careful parsing of the opinion makes this reading at least more than fanciful. Chancellor Strine, one of Justice Jacobs’s co-authors, agrees.²⁰¹

A third possible reading that reconciles the conflict would distinguish between statutorily required shareholder votes that coincidentally achieve approval by a majority of the voting shares held by disinterested persons (as was the case in *Gantler*) and those in which the transaction, in addition to the statutory vote, is *also specifically targeted and conditioned* on approval by a majority of the disinterested shares. In the latter case, the “classic” ratification feature of a voluntary additional layer of independent shareholder approval would be present, albeit in the broader context of a statutorily required vote. This reading preserves the ultimate cleansing effect of long-standing doctrine,²⁰² while

199. *Id.* at 713 n.54.

200. William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1306-08 (2001).

201. *In re S. Peru Copper Corp. S’holder Derivative Litig.*, 52 A.3d 761, 793 n.113 (Del. Ch. 2011) (“The key is not what you call it, but rather preserving the utility of a long-standing doctrine of our law.”), *aff’d sub nom.* *Ams. Mining Corp. v. Theriault*, 51 A.3d 1213 (Del. 2012).

202. *See In re PNB Holding Co. S’holders Litig.*, 2006 WL 2403999, at *14 (Del. Ch. Aug. 18, 2006) (stating that in the context of an interested director merger, as opposed to a controlling shareholder merger, it is not necessary that the disinterested shareholder vote be made the subject of a separate nonwaivable condition).

responding to the court's concern that, to be effective, ratification must be specifically focused.²⁰³

Finally, only if the self-dealing transaction is neither approved by a majority of the disinterested directors nor by the holders of a majority of the voting shares held by disinterested parties is it required that the transaction be carefully scrutinized for both procedural and substantive fairness by the court.²⁰⁴ As under the common law, the burden of proof to demonstrate fairness under section 144(a)(3) is on the party seeking to uphold the transaction.²⁰⁵

Delaware, however, distinguishes self-dealing contracts or transactions with a controlling shareholder,²⁰⁶ which technically are not covered by statute. Because control carries with it the potential for oppression, even disinterested directors or shareholders may feel pressured in a way that prevents them from being able to safeguard the corporate interest adequately. Therefore, their approval is not viewed as a substitute for close judicial scrutiny of the merits of the transaction. That is, entire fairness remains the exclusive standard of review. At most, in a controlling shareholder self-dealing transaction, approval by disinterested directors or disinterested shareholders may shift the burden of proof to the party attacking the transaction to demonstrate its unfairness.²⁰⁷

203. See *Gantler*, 965 A.2d at 713.

204. In Delaware and Kansas the fairness test is termed "entire fairness" to emphasize that there must be a finding of both fair dealing and a fair deal. See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983) (describing the elements of fair dealing and fair deal); *Becker v. Knoll*, 239 P.3d 830, 835 (Kan. 2010) (quoting *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 52 (Del. 2006); *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993)).

205. See *Marciano v. Nakash*, 535 A.2d 400, 405 n.3 (Del. 1987); *Fliegler v. Lawrence*, 361 A.2d 218, 221–22 (Del. 1976); *Oberhelman v. Barnes Inv. Corp.*, 690 P.2d 1343, 1350–51 (Kan. 1984).

206. See *supra* Part II.A (discussing the fiduciary status of controlling shareholders).

207. *Kahn v. Tremont Corp.*, 694 A.2d 422, 428–29 (Del. 1997); *Kahn v. Lynch Commc'n Sys.*, 638 A.2d 1110, 1115–18 (Del. 1994). A parallel, but inconsistent, line of Delaware decisions recognizes an exception to universal application of the entire fairness standard when a controlling shareholder makes a tender offer for the minority's shares that it does not already own, followed by a short-form merger in which any nontendering minority shareholders are cashed-out at the same price. *Glassman v. Unocal Exploration Corp.*, 777 A.2d 242, 247–48 (Del. 2001); *Solomon v. Pathe Commc'ns Corp.*, 672 A.2d 35, 39–40 (Del. 1996); *In re Aquila Inc. S'holders Litig.*, 805 A.2d 184, 190–91 (Del. Ch. 2002); *In re Siliconix Inc. S'holders Litig.*, No. Civ. A. 18700, 2001 WL 716787, at *6–8 & n.26 (Del. Ch. June 21, 2001). This disparate treatment is explainable, at least conceptually, on the basis that the tender offer is a transaction solely between the controlling shareholder and the individual minority shareholders of the subsidiary. Therefore, there is no duty to offer a "fair" price as long as the offer is not coercive and the controlling shareholder accurately furnishes all material information to the minority shareholders. *Solomon*, 672 A.2d at 39–40. If the shares tendered, when added to the shares already owned, raise the controlling shareholder's ownership of the subsidiary to at least ninety percent, it may merge the subsidiary into itself, and

Moreover, even a shift in the burden of proof is not automatic. The attempt must be to replicate an arm's-length transaction, which requires that the independent directors, ideally constituted as a separate negotiating committee, be given real bargaining power. The controlling shareholder must not dictate the terms of the transaction.²⁰⁸ As a practical matter, this requirement typically necessitates proof of how the independent committee actually functioned, which leads to the conundrum that the burden of persuasion cannot be allocated in advance of the trial. Recognizing this problem, and that a shift in the burden of

cash-out the remaining minority, by a simple resolution of its board of directors. There is no necessity of any action by either the board of directors or the minority shareholders of the subsidiary. DEL. CODE ANN. tit. 8, § 253 (West 2011); KAN. STAT. ANN. § 17-6703 (2007). Because the legislature specifically designed the short-form merger statute to obviate the necessity of any dealing between the parent and subsidiary, the fair dealing prong of entire fairness is inapplicable. Thus, any potential unfairness can relate only to price, for which, absent fraud or illegality, appraisal is the exclusive remedy. *Glassman*, 777 A.2d at 247–48. Nevertheless, at the policy level, the problem of inherent controlling shareholder oppression that underlies *Lynch* is equally present in the tender offer/short-form merger cases. Recognizing this similarity, the Delaware Court of Chancery first modified the *Solomon/Glassman* line of cases by requiring that: (1) the tender offer is subject to the nonwaivable condition that at least a majority of the minority shares are tendered; (2) the controlling shareholder commits in advance to a short-form merger at the same price if it acquires ninety percent or more of the subsidiary's shares; (3) the controlling shareholder makes no retributive threats; and (4) the independent directors of the subsidiary are given sufficient discretion and time to react to the tender offer by hiring their own advisors, providing a recommendation concerning the offer to the minority shareholders, and disclosing adequate information for the minority to make an informed judgment. *In re Pure Res., Inc. S'holders Litig.*, 808 A.2d 421, 445 (Del. Ch. 2002). More recently, the same court proposed unifying the *Lynch* and *Solomon/Glassman* lines. If a long-form cash-out merger is *both*: (1) negotiated and approved by a special committee of independent subsidiary directors; *and* (2) conditioned on an affirmative vote of the holders of a majority of the minority shares, then the business judgment rule presumptively should apply. Otherwise, the entire fairness standard would remain applicable. Similarly, if a first-step tender offer is *both*: (1) negotiated and recommended by a special committee of independent subsidiary directors; *and* (2) conditioned on the affirmative tender of a majority of the minority shares, then the business judgment rule again should presumptively be applicable to the tender offer and a second-step cash out merger at the same price. Otherwise, the entire fairness standard would apply. *In re CNX Gas Corp. S'holders Litig.*, 4 A.3d 397, 412–13 (Del. Ch. 2010); *In re Cox Commc'ns, Inc., S'holders Litig.*, 879 A.2d 604, 606–07 (Del. Ch. 2005). The Delaware Supreme Court has yet to rule on this development. Its most recent opinion reaffirms the vitality of *Lynch* in regard to a long-form merger with a defectively functioning independent committee and without a majority of the minority shareholder approval condition. *Ams. Mining Corp. v. Theriault*, 51 A.3d 1213, 1240 (Del. 2012). Even more recently, Chancellor Strine created the opportunity for a definitive Delaware Supreme Court ruling, at least as to the *Lynch* line. In *In re MFW Shareholders Litigation*, C.A. No. 6566-CS, 2013 WL 2436341 (Del. Ch. May 29, 2013), he held that a long-form parent–subsidiary cash-out merger that in fact was *both* (a) negotiated by a fully empowered special committee of independent directors of the subsidiary *and* (b) subject to the nonwaivable condition of approval by a fully informed majority of the minority shareholders of the subsidiary, was subject to review under the business judgment rule rather than the entire fairness standard. Chancellor Strine distinguished the *Lynch*, *Tremont*, and *Theriault* holdings as involving, at most, only one of the two cleansing mechanisms, leaving him free to decide the case as one of first impression.

208. *Tremont*, 694 A.2d at 429; *Lynch*, 638 A.2d at 1117–18.

persuasion is only a modest benefit in a trial with a preponderance of the evidence standard of proof, the Delaware Supreme Court recently held that “if the record does not permit a pretrial determination that the defendants are entitled to a burden shift, the burden of persuasion will remain with the defendants throughout the trial to demonstrate the entire fairness of the interested transaction.”²⁰⁹ Consequently, in the controlling shareholder context, negotiation and approval by disinterested directors and approval by fully informed disinterested shareholders have been reduced to “best practices” that proponents of a transaction will use to establish a fair process, and inferentially, a fair price.²¹⁰

3. Use of Corporate Assets, Corporate Opportunities, and Competition

Basic concepts of duty of loyalty embodied in agency law require that an agent refrain from using a principal’s property for personal purposes, usurping a business opportunity that rightfully belongs to the principal, or competing with the principal while the agency relationship is ongoing.²¹¹ These duties are closely related and frequently overlap, such that an agent may breach more than one of them in a single course of conduct. For example, an agent may use her principal’s property to usurp a business opportunity of the principal, and then utilize that opportunity to compete with the principal.²¹²

Corporate directors’ and officers’ fiduciary duties in this context generally track agency law precisely. Thus, use of corporate property for personal benefit constitutes self-dealing and therefore is a breach of the duty of loyalty unless such use is authorized by a majority of the disinterested directors, the holders of a majority of the shares held by disinterested persons, or is otherwise fair and beneficial to the corporation.²¹³ Similarly, a director or officer may not compete with her corporation during her affiliation unless the competition is authorized,

209. *Theriault*, 51 A.3d at 1243.

210. *Id.* at 1244.

211. See RESTATEMENT (THIRD) OF AGENCY §§ 8.02 & cmt. d, 8.04, 8.05(1) (2006).

212. *Id.* § 8.05 cmt. b.

213. *Becker v. Knoll*, 239 P.3d 830, 835 (Kan. 2010) (“If the plaintiffs in the present case made a prima facie showing of self-dealing then the burden of proof shifted to Knoll to prove that his employment of Morehouse was entirely fair to the corporation.”); PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.04 (1994); see also *Schmidt v. Farm Credit Servs.*, 977 F.2d 511, 515 (10th Cir. 1992) (discussing use of corporate property pursuant to Kansas law); *Branding Iron Motel, Inc. v. Sandlian Equity, Inc.*, 798 F.2d 396, 401–02 (10th Cir. 1986) (same).

after full disclosure, by disinterested directors or shareholders.²¹⁴ However, severance of the relationship severs the former director's or officer's ongoing fiduciary duties. Therefore, absent a valid covenant not to compete, the former director or officer may freely compete with the corporation, but may not use confidential information derived from the former relationship.²¹⁵

At least from the standpoint of litigated cases, the most problematic of the three related duties is that concerning corporate opportunities. Part of the difficulty stems from failure to recognize that there are two separate issues involved. First, under what circumstances is a prospective business opportunity properly characterized as belonging, at least equitably, to the corporation? This question is crucial, because unless one can conclude that a business opportunity is a *corporate* opportunity there is no self-dealing conflict of interest. That is, unless the opportunity is at least equitably that of the corporation, the director or officer who takes it will not be receiving a benefit *from* the corporation that other, similarly situated shareholders are not receiving.²¹⁶ Second, assuming an opportunity is a corporate opportunity, under what circumstances is a director or officer justified in taking the opportunity for herself?

As to the first issue, there are two widely recognized definitions or tests. The oldest and narrowest is known as the "interest or expectancy" test. It restricts corporate opportunities to those in which the corporation has an existing legal or equitable property interest or at least an expectancy growing from an existing right.²¹⁷

*Guth v. Loft, Inc.*²¹⁸ casts a broader net. It is probably the best-known American corporate opportunity case, and it is widely cited for establishing the "line of business" test. Actually, *Guth* enunciates two somewhat related and overlapping tests, the application of which depends on whether the opportunity came to the director or officer in her "individual" or "official" capacity, as follows:

It is true that when a business opportunity comes to a corporate officer or director in his individual capacity rather than in his official

214. PRINCIPLES OF CORPORATE GOVERNANCE § 5.06.

215. *Parsons Mobile Prods., Inc. v. Remmert*, 531 P.2d 428, 432-33 (Kan. 1975); RESTATEMENT (THIRD) OF AGENCY § 8.05 & cmt. c.

216. See *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 722 (Del. 1971) (explaining that unless an opportunity is a corporate opportunity, there is no self-dealing).

217. See *Lagarde v. Anniston Lime & Stone Co.*, 28 So. 199, 201 (Ala. 1900) (distinguishing corporate opportunities from noncorporate opportunities).

218. 5 A.2d 503 (Del. 1939).

capacity, and the opportunity is one which, because of the nature of the enterprise, is not essential to his corporation, and is one in which it has no interest or expectancy, the officer or director is entitled to treat the opportunity as his own, and the corporation has no interest in it, if, of course, the officer or director has not wrongfully embarked the corporation's resources therein.

.....

On the other hand, it is equally true that, if there is presented to a corporate officer or director a business opportunity which the corporation is financially able to undertake, is, from its nature, in the line of the corporation's business and is of practical advantage to it, is one in which the corporation has an interest or a reasonable expectancy, and, by embracing the opportunity, the self-interest of the officer or director will be brought into conflict with that of his corporation, the law will not permit him to seize the opportunity for himself.²¹⁹

Although the *Guth* court included the interest or expectancy element under both facets of its corporate opportunity doctrine, it interpreted that element as being present if the corporation had an urgently pressing need for the opportunity even if there was no preexisting property interest or contractual expectancy.²²⁰ Delaware has since watered the element down even more, in effect asking whether the opportunity was one in which the corporation was "interested" or constituted an activity in which it "expected" to engage.²²¹

The two leading Kansas cases have not had to come to grips with, or even recognize as a separate issue, the appropriate test for a corporate opportunity. The reason is that both, on the facts, involved opportunities in the same line of business as that of the corporation and in which the corporation had an existing interest or expectancy.²²²

219. *Id.* at 510–11.

220. *Id.* at 514.

221. *See Broz v. Cellular Info. Sys., Inc.*, 673 A.2d 148, 156–57 & n.8, 159 (Del. 1996) (interpreting *Guth*).

222. *See generally* *Newton v. Hornblower, Inc.*, 582 P.2d 1136, 1147–49 (Kan. 1978) (involving appropriation of opportunities to expand existing motel business); *Parsons Mobile Prods., Inc. v. Remmert*, 531 P.2d 428, 435 (Kan. 1975) (concerning two corporations manufacturing specialized vehicles). The American Law Institute has proposed a new, bifurcated definition of corporate opportunities that distinguishes between outside directors on one hand and inside directors and other officers on the other. The first part of the definition applies to all directors and officers and focuses on how the person becomes aware of the business opportunity. In general terms, if the director or officer learns of a business opportunity because of her connection with the corporation (i.e., in the person's official capacity or through the use of corporate information or property), the opportunity is considered a corporate opportunity. *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* § 5.05(b)(1) (1994). The second part of the definition applies only to inside directors and other officers and adopts an expanded, flexible line of business test. *Id.* § 5.05(b)(2).

The second issue, after a business opportunity has been identified as a corporate opportunity, involves the circumstances under which a director or officer may take personal advantage of the opportunity without breaching the duty of loyalty. In Kansas, the test is the familiar one of good faith and fairness, with the burden of proof on the director or officer.²²³

As has been discussed, the law of directors' and officers' self-dealing contracts and transactions has evolved into a tripartite analysis in which "fairness" may be determined alternatively by a majority of the disinterested directors, the holders of a majority of the voting shares held by disinterested parties, or a disinterested judge.²²⁴ Unfortunately, in the factual context of corporate opportunities, a director or officer may simply appropriate the opportunity without first offering it to the corporation. In such a case, there is no alternative forum outside the courtroom in which to test the fairness of the fiduciary's conduct.

The American Law Institute has attempted to ameliorate this situation by requiring directors and officers invariably to offer all corporate opportunities to the corporation.²²⁵ If the corporation accepts the offer, that is the end of the matter. If the corporation rejects the offer, we can look at the corporate decision-makers who participated in the rejection. If the rejection was by a majority of the informed, disinterested directors, or the informed, disinterested shareholders, and the rejection was within the broad parameters of the business judgment

Limiting this broader definition to inside directors and other officers reflects a policy decision to encourage qualified persons to serve as outside directors as a matter of good corporate governance. In other words, section 5.05(b) attempts to strike a balance that protects the corporate interest while still allowing unaffiliated persons sufficient freedom in their other activities that they will not be deterred from becoming outside directors. Section 5.05 has proven to be quite popular with the courts of other jurisdictions. *See, e.g.,* Ne. Harbor Golf Club, Inc. v. Harris, 661 A.2d 1146, 1150–52 (Me. 1995) (using section 5.05 in finding corporate opportunity); Demoulas v. Demoulas Super Mkts., Inc., 677 N.E.2d 159, 180–82 (Mass. 1997) (same); Klinicki v. Lundgren, 695 P.2d 906 (Or. 1985) (same).

223. *Newton*, 582 P.2d at 1146–47.

224. *See supra* Part IV.A.2.

225. PRINCIPLES OF CORPORATE GOVERNANCE § 5.05(a)(1). Note that the director or officer is not required to offer to the corporation *all* business opportunities that come to her, but only those that constitute *corporate* opportunities. *See id.* § 5.05(b); *see also supra* note 222 (providing the definition of a corporate opportunity). Of course, whether a business opportunity constitutes a corporate opportunity may be difficult for the director or officer to determine *ex ante*. Adding to the difficulty is the realization that the corporation may accept the offer, thus precluding any potential profit by the director or officer. Nevertheless, that is what duty demands, and all doubts should be resolved in favor of offering the opportunity to the corporation. *Id.* Section 5.05(e), however, provides a safety valve in cases in which failure to offer stems from a good-faith belief that the opportunity was not a corporate opportunity, by permitting a delayed offer not later than a reasonable time after suit is filed.

rule, the director or officer is free to take the opportunity.²²⁶ If, however, the rejection was interested, the director or officer has the burden of proving that her appropriation was fair to the corporation.²²⁷ Because this articulation rationalizes the law governing corporate opportunities with that governing directors' and officers' self-dealing contracts and transactions, it has become popular in other jurisdictions and is worthy of serious consideration by the Kansas judiciary.²²⁸

Finally, note section 122(17) of the Delaware General Corporation Law, which provides as follows:

Every corporation created under this chapter shall have power to:

.....

(17) Renounce, in its certificate of incorporation or by action of its board of directors, any interest or expectancy of the corporation in, or in being offered an opportunity to participate in, specified business opportunities or specified classes or categories of business opportunities that are presented to the corporation or 1 or more of its officers, directors or stockholders.²²⁹

Because this section refers to renunciation of business opportunities by a corporation's board of directors, and does not require the director action to be disinterested, it could be read to alter radically the duty of loyalty with respect to corporate opportunities. This is neither the intent nor the effect of section 122(17). The section appears in Subchapter II of the Delaware General Corporation Law,²³⁰ which contains seven sections

226. *Id.* § 5.05(a)(2), (a)(3)(B)–(C), (c). Disinterested shareholder approval is even easier to obtain under the American Law Institute formulation than it is under Delaware law. All that is necessary is a majority of the shares *actually voted* by disinterested parties, *id.* § 1.16, rather than a majority of the total number of issued and outstanding shares *held* by disinterested parties (whether or not present and voting). *See supra* note 188 (describing and offering authority for the Delaware rule.).

227. PRINCIPLES OF CORPORATE GOVERNANCE § 5.05(a)(2), (a)(3)(A), (c).

228. *See, e.g.*, *Ne. Harbor Golf Club, Inc. v. Harris*, 661 A.2d 1146, 1150 (Me. 1995) (adopting the American Law Institute standards, the Principles of Corporate Governance, regarding usurpation of corporate opportunity); *Demoulas v. Demoulas Super Mkts., Inc.*, 677 N.E.2d 159, 180 (Mass. 1997) (discussing usurpation of corporate opportunity under the *Principles of Corporate Governance*); *Klinicki v. Lundgren*, 695 P.2d 906, 920 (Or. 1985) (adopting the *Principles of Corporate Governance* standards). Although Delaware has specifically declined to hold that corporate opportunities must always be offered to the corporation, it has stated that such an offer, followed by rejection, constitutes a “safe harbor” for the director or officer. *Broz v. Cellular Info. Sys., Inc.*, 673 A.2d 148, 157–58 (Del. 1996).

229. DEL. CODE ANN. tit. 8, § 122(17) (West 2011). Section 17-6102(17) of the Kansas Statutes is substantively identical.

230. DEL. CODE ANN. tit. 8, ch. I, subch. II.

that legislatively confer certain powers on corporate entities but do not purport to regulate the substantive use or operation of those powers. That section 122(17) is not intended to affect the duty of loyalty with respect to corporate opportunities is made abundantly clear by its legislative history, which provides as follows:

The subsection is intended to eliminate uncertainty regarding the power of a corporation to renounce corporate opportunities in advance It permits the corporation to determine in advance whether a specified business opportunity or class or category of business opportunities is a corporate opportunity of the corporation rather than to address such opportunities as they arise. The subsection does not change the level of judicial scrutiny that will apply to the renunciation of an interest or expectancy of the corporation in a business opportunity, which will be determined based on the common law of fiduciary duty, including the duty of loyalty.²³¹

That is, section 122(17) speaks only to the legal power of a corporation to renounce or reject business opportunities. It does not speak to the overarching equitable fiduciary duties, including the duty of loyalty, that constrain the use of that legal power. In the now-famous words of the Delaware Supreme Court, “inequitable action does not become permissible simply because it is legally possible.”²³²

B. Partnerships

1. Good Faith

Because Kansas law codifies the duties of care and loyalty as the exclusive fiduciary duties of partners,²³³ it is clear that good faith is not a separate, freestanding fiduciary duty. It is equally clear that, unlike corporate law described above,²³⁴ good faith is not an integral part of an expanded duty of loyalty. This is so because subsections (1) through (3) of section 56a-404(b) require partners only to refrain from specific conduct involving a pecuniary conflict of interest with the partnership.²³⁵

231. S. 363, 140th Gen. Assem. 7–8 (Del. 2000).

232. *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437, 439 (Del. 1971).

233. KAN. STAT. ANN. §§ 56a-404(a)–(c) (2005); *see also* DEL. CODE ANN. tit. 6, § 15-404(a)–(c). These provisions also apply to general partners of limited partnerships by reason of KAN. STAT. ANN. §§ 56-1a253(a), (c), -1a604.

234. *See supra* Part IV.A.1.

235. KAN. STAT. ANN. § 56a-404(b) limits a partner’s duty of loyalty to: (a) accounting and holding as trustee for the partnership any property, profits, or benefits derived from the business or use of partnership property; (b) refraining from dealing with the partnership as or on behalf of an

Therefore, the kinds of nonpecuniary fiduciary misconduct visualized by the Delaware court in *Disney* and *Stone* as bad faith breaches of the duty of loyalty²³⁶ must be dealt with in Kansas partnership law under the rubric of duty of care, which specifically prohibits “reckless conduct, intentional misconduct, or a knowing violation of the law.”²³⁷

Nevertheless, in addition to the fiduciary duties of care and loyalty, each partner owes the partnership and the other partners a statutory obligation of good faith and fair dealing in discharging any duties or in exercising any rights under either the Kansas Uniform Partnership Act (KUPA) or the partnership agreement.²³⁸ Unlike a fiduciary duty, the obligation of good faith and fair dealing is contract based rather than status based.²³⁹ The difference is important, because the contractual doctrine is narrowly limited to situations in which an agreement is silent as to a matter, but it is clear from what was expressed that the parties would have agreed to proscribe the conduct complained of had they thought to negotiate the matter.²⁴⁰ Thus, although the language may be the same, the obligation of good faith and fair dealing is much narrower in application than the equity-based fiduciary duty of loyalty. As such, it is beyond the scope of this Article.

2. Pecuniary Conflicts of Interest

As with the duty of care,²⁴¹ current Kansas law exclusively and comprehensively codifies partners’ duty of loyalty to the partnership and to each other, as follows:

adverse party; and (c) refraining from competing with the partnership.

236. See *supra* Part IV.A.1.

237. KAN. STAT. ANN. § 56a-404(c); see also *supra* notes 118–22 and accompanying text.

238. KAN. STAT. ANN. § 56a-404(d). Once again, this provision applies equally to general partners of limited partnerships because of the linkage between the statutes governing the two forms of partnership. See *id.* §§ 56-1a253(a), (c), -1a604.

239. REVISED UNIF. P’SHIP ACT § 404 cmt. 4 (1997). The obligation of good faith and fair dealing is derived from RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981). *Id.* Kansas case law applies the Second Restatement’s implied covenant of good faith and fair dealing in every contract except those relating to employment at will. *Kan. Baptist Convention v. Mesa Operating Ltd. P’ship*, 864 P.2d 204, 210–12 (Kan. 1993). Thus, the interpretation of the common law doctrine will inform the meaning of the statutory doctrine.

240. *Nemec v. Shrader*, 991 A.2d 1120, 1127 n.20 (Del. 2010). See generally Paul M. Altman & Srinivas M. Raju, *Delaware Alternative Entities and the Implied Contractual Covenant of Good Faith and Fair Dealing Under Delaware Law*, 60 BUS. LAW. 1469 (2005) (discussing Delaware cases involving application of the covenant of good faith and fair dealing).

241. See *supra* Part III.B.

(b) A partner's duty of loyalty to the partnership and the other partners is limited to the following:

(1) To account to the partnership and hold as trustee for it any property, profit, or benefit derived by the partner in the conduct and winding up of the partnership business or derived from a use by the partner of partnership property, including the appropriation of a partnership opportunity;

(2) to refrain from dealing with the partnership in the conduct or winding up of the partnership business as or on behalf of a party having an interest adverse to the partnership; and

(3) to refrain from competing with the partnership in the conduct of the partnership business before the dissolution of the partnership.²⁴²

In broad outline, this statement of the duty of loyalty tracks corporate law and, in that respect, is consistent with pre-statutory case law in Kansas.²⁴³ However, for the first time in American legal history, partnerships under KUPA and statutes like it are legal entities, separate and distinct from the partners.²⁴⁴ This radical departure from the aggregate theory, coupled with human frailty, has resulted in some growing pains that partially account for the result in *Welch v. Via Christi Health Partners, Inc.*²⁴⁵

242. KAN. STAT. ANN. § 56a-404(b). These duties apply equally to general partners of limited partnerships. *Id.* §§ 56-1a253(a), (c), -1a604; *Welch v. Via Christi Health Partners, Inc.*, 133 P.3d 122, 136 (Kan. 2006). Two other subsections of section 56a-404 might seem to conflict with the duty of loyalty in subsection (b). Subsection (e) provides that “[a] partner does not violate a duty or obligation under this act or under the partnership agreement merely because the partner’s conduct furthers the partner’s own interest.” KAN. STAT. ANN. § 56a-404(e). This provision is discussed *supra* at notes 41–44 and accompanying text. Subsection (f) provides that “[a] partner may lend money to and transact other business with the partnership, and as to each loan or transaction the rights and obligations of the partner are the same as those of a person who is not a partner, subject to other applicable law.” *Id.* § 56a-404(f). Although this provision may appear to be in direct conflict with the prohibition in subsection (b)(2) against self-dealing transactions, it actually assumes compliance with the duty of loyalty, and its focus is on the status of a partner-creditor vis-à-vis outside creditors of the partnership. *See* UNIF. LTD. P’SHP ACT § 112 & cmt. (2001) (authorizing a partner to transact business with the limited partnership and enjoy the same rights as a nonpartner but explaining that the provision has no impact on a general partner’s duty of loyalty). For further discussion, see Edwin W. Hecker, Jr., *The Kansas Revised Uniform Partnership Act*, J. KAN. B. ASS’N, Oct. 1999, at 16, 32–33.

243. *See* *Newton v. Hornblower, Inc.*, 582 P.2d 1136 (Kan. 1978) (employing an identical analysis to duty of loyalty claims against corporate directors and officers and the general partner of a limited partnership).

244. KAN. STAT. ANN. § 56a-201(a).

245. 133 P.3d 122 (Kan. 2006).

This important decision involves a transaction in which a shell limited liability company was merged into a functioning limited partnership with the limited partners being cashed out and replaced by new investors. The general partner of the limited partnership controlled both constituent entities, engaged an appraiser to determine the merger price, fixed the terms of the merger, unilaterally amended the partnership agreement to lower the default unanimous vote requirement for mergers to a level that allowed it to control the vote, informed the limited partners that it would vote in favor of the merger regardless of how they voted, and unilaterally approved the merger without a single limited partner voting in favor.²⁴⁶ After engaging their own expert to value their limited partnership interests, approximately half (both in number and interest) of the limited partners brought suit against the general partner, alleging that the merger price was unfairly low.²⁴⁷ The plaintiffs claimed they were dissociated partners entitled to a statutory buyout at a price determined under section 56a-701 of KUPA,²⁴⁸ and alternatively, that they were entitled to an equitable entire fairness hearing based on the general partner's breach of duty of loyalty. The district court granted summary judgment for the general partner on both counts, and the supreme court affirmed.²⁴⁹

The portion of the court's opinion concerning the statutory buyout is obsolete due to changes in the controlling mixed entity merger statutes since the decision. The important point, however, is that the court concluded no statutory buyout rights were available to the plaintiffs,²⁵⁰ and that situation still remains true.²⁵¹ Unfortunately for the plaintiffs, their breach of fiduciary duty claim fared no better. The court began its analysis by emphasizing section 56a-404(e), which provides that a partner does not violate a duty "merely because the partner's conduct furthers the partner's own interest."²⁵² The court read this statement as an affirmative statutory authorization for partners to pursue their own self-interest, which made them less than fiduciaries and certainly distinguished them from corporate directors, whom the court

246. *Id.* at 125–27.

247. *Id.* at 126.

248. KAN. STAT. ANN. § 56a-701.

249. *Welch*, 133 P.3d at 127, 145.

250. *Id.* at 136.

251. For a discussion of the statutory changes, see Edwin W. Hecker, Jr, *The Kansas Business Entity Transactions Act*, J. KAN. B. ASS'N, Sept. 2011, at 21, 22–23.

252. KAN. STAT. ANN. § 56a-404(e) (emphasis added).

mischaracterized as true trustees.²⁵³ Undeterred, the plaintiffs argued that the general partner violated section 56a-404(b)(2) by acting “as or on behalf of a party having an interest adverse to the partnership.”²⁵⁴ In other words, by being in control of both parties to the merger agreement, the general partner was on both sides of the bargaining table. As such, it could not be expected to negotiate with itself on an arm’s-length basis to achieve the best price possible for the limited partnership and its limited partners. After reiterating that use of the term “fiduciary” was misleading and inappropriate because partners are permitted to pursue their own self-interest, the court acknowledged that the interests of both the general partner and the shell limited liability company were adverse to the limited partners.²⁵⁵ The statutory language of all three subsections of section 56a-404(b), however, prohibited only interests adverse to the *partnership* itself as a *separate entity*.²⁵⁶ Although the general partner was on both sides of the transaction, the court found no evidence that the general partner’s interest was adverse to the limited partnership or that the limited partnership, as an *entity*, was harmed by the transaction.²⁵⁷ Moreover, the mere fact that the limited liability company was the other constituent entity to the merger did not necessarily mean that its interest was adverse to the limited partnership. The court relied on the fact that the limited liability company was a shell with a two-week lifespan, created solely for purposes of the cash-out merger, as evidence that its interest could not have been adverse to the limited partnership.²⁵⁸ In other words, the limited liability company’s interest was not adverse because it had no interest.

The court’s and counsels’ preoccupation with the three entity-focused operative subparagraphs of section 56a-404(b) perhaps caused it to devote insufficient attention to subsection (a) and the introductory wording of (b) itself, which provide:

(a) The *only* fiduciary duties a partner owes to the partnership *and the other partners* are the duty of loyalty and the duty of care set forth in subsections (b) and (c).

253. *Welch*, 133 P.3d at 138.

254. *Id.* at 141; KAN. STAT. ANN. § 56a-404(b)(2). The plaintiffs also argued that the general partner violated section 56a-404(b)(1) by misappropriating a partnership opportunity. That argument is weaker on the facts and presents no issues in addition to those raised by the section 56a-404(b)(2) argument. Accordingly, it is not discussed further.

255. *Welch*, 133 P.3d at 142.

256. KAN. STAT. ANN. § 56a-404(b) (emphasis added).

257. *Welch*, 133 P.3d at 142.

258. *Id.*

(b) A partner's duty of loyalty to the partnership *and the other partners* is *limited* to the following:

[Subparagraphs (1)–(3), which speak *only* to the duty of loyalty owed to the *partnership entity*.]²⁵⁹

Read literally, this language states that a partner's duty of loyalty to the other partners is limited to the following: none. In other words, subsection (a) makes clear that the statute preempts the field, leaving no room for default common law fiduciary duties. Subsection (b) then "limits" the statutory duty of loyalty to its three subparagraphs, none of which affirmatively impose a duty that runs to the other partners. If the statute means what it says, the necessary conclusion is that partners no longer owe a duty of loyalty directly to the other partners, as opposed to the partnership.²⁶⁰ If the *Welch* court had more clearly articulated this point, it would have made unnecessary the court's undue reliance on subsection (e) for the proposition that partners are not true fiduciaries, a proposition that has the unfortunate potential of living on to dilute the strength of the loyalty partners owe to the partnership. It also would have made unnecessary the court's equally unfortunate, and inconsistent, discussion of applicability of the corporate law duty of loyalty, which is considered next.

259. KAN. STAT. ANN. § 56a-404(a)–(b) (emphasis added).

260. If the Kansas statute had not preempted the field, the result might have been different. For example, the analogous provisions of the California Uniform Partnership Act state that: "(a) [t]he fiduciary duties a partner owes to the partnership and the other partners are the duties of loyalty and care set forth in subdivisions (b) and (c)"; and "(b) [a] partner's duty of loyalty to the partnership and the other partners *includes* [entity-focused duties essentially the same as those in Kansas]." CAL. CORP. CODE § 16404(a)–(b) (West 2006) (emphasis added). By eliminating "only" in subsection (a) and substituting "includes" for "limited" in subsection (b), the statute makes clear the intent *not* to preempt judicially recognized default fiduciary duties. Thus, in *Perretta v. Prometheus Development Co.*, on facts substantially the same as those in *Welch*, the court reached a very different result. 520 F.3d 1039 (9th Cir.) (applying California law), *withdrawn after reh'g on other grounds*, 527 F.3d 853 (9th Cir. 2008). Recognizing the self-dealing nature of a limited partnership cash-out merger, the court summarily rejected the general partner's contention that the case should be reviewed under the deferential business judgment rule. *Id.* at 1044 n.5. Unlike the Kansas Supreme Court, the Ninth Circuit did not believe that California's version of section 56a-404(e) was a legislative disavowal of a partner's fiduciary status. Nor did it believe the California equivalent of section 56a-404(b)(2), which narrowly focused only on loyalty to the partnership as an entity, excluded consideration of harm to the individual partners that constitute the entity. *See id.* at 1044. Accordingly, it held that the self-dealing nature of the merger required that the general partner bear the burden of establishing complete good faith and fairness. *See id.* at 1049; *see also* *Cole v. Kershaw*, No. Civ.A. 13904, 2000 WL 1206672 (Del. Ch. Aug. 15, 2000). *Cole* involved a self-dealing cash-out merger of a general partnership into a limited liability company. The parties conceded application of the entire fairness test and, relying on *Weinberger*, the court found the merger lacking in both procedural and substantive fairness. *Id.* at *9.

As a last resort, the plaintiffs argued that both Kansas and Delaware corporate cash-out merger cases supported their duty of loyalty claim. In response, the court relied on *Weinberger v. UOP, Inc.*²⁶¹ for the proposition that, in addition to self-dealing, the plaintiffs must show fraud, misrepresentation, or other misconduct before they are entitled to an equitable duty of loyalty entire fairness hearing.²⁶² The court appeared not to care that *Weinberger* announced this proposition in the broader context of an opinion holding that cashed-out minority shareholders had an enhanced statutory appraisal remedy that normally would be adequate and therefore exclusive—a situation quite different than that of the plaintiff limited partners. It also failed to note that this aspect of *Weinberger* has not been followed in Delaware controlling shareholder cases at least since 1994.²⁶³ Finally, the court gave no indication it realized that controlling shareholders, like partners, are owners and therefore not true trustees, but who nevertheless have the burden of proving entire fairness to the cashed-out minority.²⁶⁴ In sum, the lesson of *Welch* is clear—if partners want fiduciary duties that are owed to each other as well as to the partnership entity, they affirmatively must include contractual duties to that effect in their partnership agreement.²⁶⁵

From the defense perspective, it should be clear that, although stated as absolutes, KUPA's statutory duty of loyalty rules should be construed to permit validation of conduct that technically violates their strict prohibitions if the partner carries the burden of proving good faith and fairness.²⁶⁶ Moreover, as developed above,²⁶⁷ "fairness" may consist of extrajudicial scrutiny and approval, by informed disinterested parties, of conduct that otherwise would violate the duty of loyalty. This concept is codified by KUPA, which provides that "all of the partners or a number or percentage specified in the partnership agreement may authorize or

261. 457 A.2d 701 (Del. 1983).

262. *Welch*, 133 P.3d at 143–45.

263. See, e.g., *Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110 (Del. 1994) (holding that the entire fairness standard applies to controlling shareholder self-dealing transactions with no requirement of additional misconduct); see also *supra* notes 206–10 and accompanying text.

264. See *supra* Parts II.A, IV.A.2.

265. See, e.g., KAN. STAT. ANN. § 56a-103(a), (b)(3) (2005) (the partnership agreement may not eliminate the duty of loyalty but it may expand the duty).

266. See *Newton v. Hornblower, Inc.*, 582 P.2d 1136, 1146 (Kan. 1978) (noting that the party seeking to sustain the transaction must make "an affirmative showing of fairness and good faith" by "clear and satisfactory evidence"); *supra* note 242 and cases cited therein; cf. REVISED UNIF. LTD. LIAB. CO. ACT § 409(b)(2), (e) (2006) (providing explicitly that a showing of fairness is a defense to a claim that a member or manager acted as or on behalf of an adverse party).

267. See *supra* Part IV.A.2.

ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty.”²⁶⁸ Under the statutory default requirement of unanimity, such authorization or ratification necessarily would include a majority (all) of the disinterested partners. If the partnership agreement provides for approval by a lesser number or percentage, care should be taken to make such a requirement explicit.²⁶⁹

In addition, although a partnership agreement may not completely eliminate the duty of loyalty, it may identify in advance specific types or categories of activities that do not violate the duty, provided the identification is not manifestly unreasonable.²⁷⁰ For example, an exculpatory provision in a real estate partnership agreement that authorizes the partnership to employ one of the partners who is a real estate agent and further authorizes the partner to retain standard commissions on partnership transactions undertaken by the partner should be permissible as not manifestly unreasonable.²⁷¹

C. Limited Liability Companies

1. Good Faith

As in the corporate context,²⁷² limited liability company law now views good faith as an integral part of the duty of loyalty, either by reason of an operating agreement’s adoption of corporate fiduciary standards or by reason of default fiduciary duties.²⁷³ Thus, a manager’s conduct of an auction sale of a limited liability company by means of a process the court characterized as a sham designed to squeeze out minority members was a bad faith breach of the manager’s duty of loyalty.²⁷⁴ So too was conscious disregard of a known duty to act, such as intentional failure to exercise oversight responsibilities by consciously ignoring warnings of accounting irregularities and weakness in internal

268. KAN. STAT. ANN. § 56a-103(b)(3)(ii).

269. The absence of such a specific limitation was a matter of contention in *Perratta v. Prometheus Dev. Co.*, 520 F.3d 1039 (9th Cir.), *withdrawn after reh’g on other grounds*, 527 F.3d 853 (9th Cir. 2008).

270. KAN. STAT. ANN. § 56a-103(b)(3)(i).

271. REVISED UNIF. P’SHP ACT § 103 cmt. 4 (1997).

272. *See supra* Part IV.A.1.

273. *Gatz Props. LLC v. Auriga Capital Corp.*, 59 A.3d 1206 (Del.) (contractual corporate fiduciary duty of loyalty), *aff’g on other grounds*, 40 A.3d 839 (Del. Ch. 2012) (limited liability company default duty of loyalty).

274. *Auriga Capital Corp. v. Gatz Props. LLC*, 40 A.3d 839, 873–75 (Del. Ch.), *aff’d*, 59 A.3d 1206, (Del. 2012).

controls.²⁷⁵ Similarly, a business decision by disinterested managers that is so egregious that it amounts to waste can be found to have been made in bad faith and for that reason fall outside the protection of the business judgment rule.²⁷⁶ More generally, managers' acts done in technical compliance with the law governing limited liability companies but for the purpose of diluting a member's equity amount to disloyal bad faith breaches of fiduciary duty.²⁷⁷

2. Pecuniary Conflicts of Interest

There is ample Delaware precedent applying "classic" corporate directors' loyalty concepts to managers of limited liability companies. For example, in *William Penn Partnership v. Saliba*,²⁷⁸ the operating agreement did not purport to modify fiduciary duties, and the parties agreed that the managers therefore owed traditional duties of care and loyalty to the members.²⁷⁹ By standing on both sides of the sale of the limited liability company's sole asset, the managers had the burden of proving the entire fairness of the transaction.²⁸⁰ In addition, Delaware routinely applies the entire fairness standard that governs self-dealing corporate mergers to analogous situations involving limited liability companies.²⁸¹ However, approval of a self-dealing transaction by an informed majority of the disinterested managers obviates the necessity of a fairness inquiry and insulates the transaction under the business judgment rule.²⁸² Finally, traditional application of the duty to account for profits from misappropriation of entity property and nonconsensual

275. See, e.g., *Reg'l Diagnostics, LLC v. Zelch*, 372 B.R. 3, 30–37 (Bankr. N.D. Ohio 2007) (applying Delaware law and relying on *Stone v. Ritter*, 911 A.2d 362 (Del. 2006)).

276. See, e.g., *Blackmore Partners, L.P. v. Link Energy LLC*, No. Civ. A. 454-N, 2005 WL 2709639, at *8 (Del. Ch. Oct. 14, 2005) (“[T]he subjective bad faith of directors may be inferred from corporate actions which are ‘so egregious as to be afforded no presumption of business judgment protection.’” (quoting *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000))).

277. See, e.g., *Solar Cells, Inc. v. True N. Partners, LLC*, No. Civ. A. 19477, 2002 WL 749163, at *4 (Del. Ch. April 25, 2002); *VGS, Inc. v. Castiel*, No. Civ. A. 17995, 2000 WL 1277372, at *4–5 (Del. Ch. Aug. 31, 2000), *aff'd*, 781 A.2d 696 (Del. 2001).

278. 13 A.3d 749 (Del. 2011).

279. *Id.* at 756.

280. *Id.*

281. See, e.g., *Solar Cells, Inc.*, 2002 WL 749163, at *4–6; *VGS, Inc.*, 2000 WL 1277372, at *4–5 (explaining that the entire fairness standard must be applied to the proposed mergers).

282. See *Blackmore Partners, L.P. v. Link Energy LLC*, No. Civ. A. 454-N, 2005 WL 2709639, at *7 (Del. Ch. Oct. 14, 2005).

competition also has been applied to managers of limited liability companies.²⁸³

As has previously been mentioned,²⁸⁴ KRLICA states that its policy is to give maximum effect to freedom of contract and to the enforceability of operating agreements.²⁸⁵ More specifically, it provides that to the extent a member, manager, or other person has duties and liabilities, including fiduciary duties, to the limited liability company or to another member or manager, such duties and liabilities may be expanded or restricted by the operating agreement.²⁸⁶ Moreover, any such member, manager, or other person acting under an operating agreement will not be liable for good faith reliance on the operating agreement.²⁸⁷ These provisions obviously emphasize the contractual nature of limited liability companies and are especially relevant to the nature and scope of fiduciary duties. A sampling of the many judicial opinions concerning the effect of operating agreements on fiduciary duties provides useful insight.

In *Lynch Multimedia Corp. v. Carson Communications, L.L.C.*, an operating agreement provided that opportunities in the limited liability company's line of business that came to a member from certain designated sources or that existed in specified geographical areas must first be offered to the company and rejected before being pursued individually by the member.²⁸⁸ It also stated that members and managers could engage in other businesses of any nature without being deemed to have violated any duty to the limited liability company or to the other members.²⁸⁹ The court held that these provisions were authorized by the statute and that the contractual duties supplanted any more generalized common law duties relating to business opportunities or competition.²⁹⁰

The operating agreement in *Gatz Properties, LLC v. Auriga Capital Corp.*²⁹¹ provided that:

Neither the Manager nor any other Member shall be entitled to cause the Company to . . . enter into any additional agreements with affiliates on terms and conditions which are less favorable to the Company than

283. Phillips v. Hove, No. 3644-VCL, 2011 WL 4404034, at *24-25 (Del. Ch. Sept. 22, 2011).

284. See *supra* text accompanying notes 104-06.

285. KAN. STAT. ANN. § 17-76,134(b) (2007).

286. *Id.* § 17-76,134(c)(2).

287. *Id.* § 17-76,134(c)(1).

288. 102 F. Supp. 2d 1261, 1264 (D. Kan. 2000).

289. *Id.* at 1262-63.

290. See *id.* at 1265.

291. 59 A.3d 1206 (Del. 2012).

the terms and conditions of similar agreements which could then be entered into with arms-length third parties, without the consent of a majority of the non-affiliated Members²⁹²

The court interpreted this language as the contractual equivalent of the entire fairness standard of conduct and judicial review, with the burden of establishing the fairness of the transaction on the manager.²⁹³ Moreover, had the manager conditioned the transaction on the approval of an informed majority of the nonaffiliated members, the transaction would not have been subject to, or reviewed under, that standard.²⁹⁴

In *Solar Cells, Inc. v. True North Partners, LLC*, the operating agreement recognized the potential for conflicts of interest between the controlling member and managers appointed by it and the limited liability company and its other member.²⁹⁵ In the event of such a conflict, the agreement provided that neither the managers nor the controlling member would have any liability as long as the managers acted in the good faith belief that their decision was in the best interest of the company.²⁹⁶ In a suit by the other member to *enjoin* an allegedly unfair self-dealing merger, the court held the provision in the operating agreement to be inapplicable because it only purported to limit *liability* rather than to waive completely the traditional duty of loyalty.²⁹⁷

The *Solar Cells* case raises the question whether the current Kansas statutory language that permits fiduciary and other duties to be “expanded or restricted” by the operating agreement²⁹⁸ is sufficiently broad to authorize a complete waiver of the duty of loyalty and other fiduciary duties. In *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*,²⁹⁹ which involved identical language in Delaware’s then limited partnership statute, the Delaware Supreme Court expressed doubt whether total abolition of fiduciary duties was authorized. It noted that the language of the statute did not expressly refer to “elimination” of fiduciary duties. In addition, the court observed that the historic approach of Delaware courts had been to scrutinize searchingly the efforts of fiduciaries to escape fiduciary duties.³⁰⁰ In 2004, the Delaware

292. *Id.* at 1212–13.

293. *Id.* at 1213.

294. *Id.*

295. No. Civ. A. 19477, 2002 WL 749163, at *3 (Del. Ch. Apr. 25, 2002).

296. *Id.* at *4.

297. *Id.*

298. KAN. STAT. ANN. § 17-76,134(c)(2) (2007).

299. 817 A.2d 160 (Del. 2002).

300. *Id.* at 167–68.

legislature responded to the dictum in *Gotham Partners* by amending its partnership act,³⁰¹ limited partnership act,³⁰² and limited liability company act³⁰³ expressly to permit expansion, restriction, or elimination of fiduciary and other duties and liability for the breach thereof. However, no agreement may eliminate the implied contractual covenant of good faith and fair dealing or limit or eliminate liability for a bad faith breach of the implied covenant.

Although amendment of the DLLCA and other unincorporated business entity statutes to authorize complete contractual waiver of fiduciary duties but not the implied contractual covenant of good faith and fair dealing seems dramatic, it merely highlights in bold relief the ongoing evolution of the Delaware law governing those entities toward ever greater emphasis on contract and correspondingly less emphasis on equitable concepts of fiduciary duty. An exhaustive examination of this phenomenon is beyond the scope of this Article,³⁰⁴ but perhaps one illustration will be helpful.

*Fisk Ventures, LLC v. Segal*³⁰⁵ involved a limited liability company with a carefully negotiated operating agreement that contained a supermajority vote requirement giving each of two primary classes of members a veto power over most actions.³⁰⁶ Thus, little could be done unless both cooperated. Not surprisingly, a paralyzing deadlock developed, and the leader of one of the two classes accused the other class of breaching the operating agreement, breaching the implied covenant of good faith and fair dealing, and breaching fiduciary duties.³⁰⁷ In deciding whether to grant a motion to dismiss for failure to state a claim, the court began its analysis by searching for a duty:

The *sine qua non* of pleading an actionable breach is demonstrating that there was something to be breached in the first place. In other words, before the Court can start worrying about whether or not there was a breach, the Court needs to determine that there was a *duty*. In the

301. DEL. CODE ANN. tit. 6, § 15-103(b)(3), (f) (West 2006 & Supp. 2013).

302. *Id.* § 17-1101(d), (f) (West 2011).

303. *Id.* § 18-1101(c), (e).

304. See, e.g., Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 4 (2007) (“I conclude that parties to contractual entities such as limited partnerships and limited liability companies should be free—given a full, clear disclosure paradigm—to adopt or reject any fiduciary duty obligation by contract. Courts should recognize the parties’ freedom of choice exercised by contract and should not superimpose an overlay of common law fiduciary duties . . .”).

305. No. 3017–CC, 2008 WL 1961156 (Del. Ch. May 7, 2008), *aff’d*, 984 A.2d 124 (Del. 2009).

306. *Id.* at *2.

307. *Id.* at *6.

context of limited liability companies, which are creatures not of the state but of contract, those duties or obligations must be found in the LLC Agreement or some other contract.³⁰⁸

Because the veto power was a carefully bargained-for right, the court concluded that its exercise could not support a claim for breach of either the express terms of the operating agreement or the implied covenant of good faith and fair dealing.³⁰⁹ More importantly for present purposes, the court also failed to find a fiduciary duty. The operating agreement proactively stated that “[n]o Member shall have any duty to any Member of the Company except as expressly set forth herein. . . .”³¹⁰ After noting the DLLCA’s permission to expand, restrict, or eliminate fiduciary duties, the court concluded:

Pursuant to this provision, the Genitrix LLC Agreement eliminates fiduciary duties to the maximum extent permitted by law by flatly stating that members have no duties other than those expressly articulated in the Agreement. Because the Agreement does not expressly articulate fiduciary obligations, they are eliminated.³¹¹

Fisk is important as much for the first passage quoted above as for the second, because after Delaware’s statutory amendment it is no longer an open question whether fiduciary duties can be eliminated; the only question is whether, in a given case, they have been. On the other hand, absent contractual modification or waiver, the existence of default fiduciary duties is still a matter of debate. In the first passage, then-Chancellor Chandler, author of the *Fisk* opinion, gives a clear indication of his belief. As has been noted in Part II.C, his successor, Chancellor Strine takes the opposite view.³¹²

These matters should be of more than passing local interest in Kansas, because of House Bill 2398, introduced in the 2013 Kansas Legislative Session. This bill updates the KRLCA generally to keep

308. *Id.* at *8 (footnotes omitted).

309. *See id.* at *8–11.

310. *Id.* at *9.

311. *Id.* at *11.

312. *See Auriga Capital Corp. v. Gatz Props., LLC*, 40 A.3d 839, 849 (Del. Ch.) (“[T]he LLC Act starts with the default that managers of LLCs owe enforceable fiduciary duties.”), *aff’d*, 59 A.3d 1206 (Del. 2012); *see also supra* Part II.C. *Feely v. NGAOCG, LLC*, No. 7304–VCL, 2012 WL 6840577 (Del. Ch. Nov.28, 2012), decided after the Delaware Supreme Court opinion in *Auriga*, adopted the *Auriga* Chancery’s view confirming the existence of default fiduciary duties. The operating agreement did not provide for the modification or elimination of fiduciary duties, so the question whether they existed was squarely presented. Because the Supreme Court opinion had not ruled that default duties did not exist, *Feely* felt free to follow the Chancery opinion as a matter of stare decisis. *Id.* at *9–10.

pace with developments of the last thirteen years, including a section that adopts the 2004 Delaware amendments that authorize contractual waiver of fiduciary duties but not waiver of the implied covenant of good faith and fair dealing.³¹³

V. CONCLUSION

At the outset, this Article stated its goal as an attempt to survey generally the law of fiduciary duties as applied to Kansas corporations, partnerships, and limited liability companies, and to illustrate the extent to which corporate analysis and precedents are being applied (or not applied) in the context of these other forms of business organization. On the corporate front, due to the widespread adoption of exculpatory charter provisions, there has been a major realignment of fiduciary duty law, with the duty of loyalty being expanded beyond its classical financial conflict of interest bounds to include nonpecuniary misconduct not in good faith.³¹⁴ With respect to partnerships, the Kansas Supreme Court, interpreting both statutory and decisional law, has downgraded significantly the fiduciary status of partners.³¹⁵ Finally, particularly in Delaware, limited liability companies have assumed a contract-based personality that promises to make them an ever more unique and useful alternative to corporations. A legislative proposal currently pending, if enacted, will continue Kansas's tradition of following Delaware's lead.³¹⁶

While this Article does not purport to be completely comprehensive or exhaustive, one hopes that it is sufficiently thorough to serve as a starting point for further investigation of these developments.

313. H.B. 2398, *supra* note 51, § 57. Because there was insufficient time in the 2013 session for both houses of the Kansas Legislature to act on H.B. 2398, it has been held over for the 2014 session. For a comprehensive and thoughtful analysis of the issues, see Scott Gordon Wheeler, Comment, *LLC Fiduciaries: Where Has All the Good Faith Gone?*, 59 U. KAN. L. REV. 1063 (2011).

314. *See supra* Part IV.A.1.

315. *See supra* Part IV.B.2.

316. *See supra* Part IV.C.2.