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# Imposing Liability for "Control" Under Section 7 of the Uniform Limited Partnership Act

Norman Abrams

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# Imposing Liability for "Control" Under Section 7 of the Uniform Limited Partnership Act

*Norman Abrams\**

*The Uniform Limited Partnership Act as adopted in 1916 is currently law in forty-nine states. Section 7 of the Act protects limited partners from general liability unless they take part in control of the business. The author considers the four separate tests for control that have been developed by courts and commentators. Finding each of them unsatisfactory, he proposes an "effects" test based solely on causation as a fairer and more valuable approach. Applying this test, the author evaluates several types of activities which typical limited partners may wish to undertake, including shareholder powers. In 1976 the National Conference of Commissioners on Uniform State Laws recommended that states adopt a revised version of the Uniform Limited Partnership Act. The 1976 version adopted one of the four control tests evaluated by the author and specifically granted limited partners shareholder powers. Mr. Abrams' analysis of the purpose and function of the control rule raises several questions concerning the viability of this approach. He concludes that this legislation is difficult to reconcile with the proposed effects test and with the principles incorporated by the framers into the original Act.*

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## Imposing Liability for "Control" Under Section 7 of the Uniform Limited Partnership Act

### INTRODUCTION

THE CONTROL RULE contained in section 7 of the original Uniform Limited Partnership Act (ULPA) remains today, more than sixty years after it was drafted,<sup>1</sup> one of the more perplexing aspects of limited partnership law. Section 7 is entitled "Limited Partner Not Liable to Creditors" and provides that: "A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business."<sup>2</sup> The ULPA does not offer a definition of control, and cases and commentators have

1. The original Uniform Limited Partnership Act [hereinafter cited as ULPA (1916)] was drafted in 1916 by the National Conference of Commissioners on Uniform State Laws. 6 U.L.A. III (1969). It has been adopted in substantial part in 49 states plus the District of Columbia and the Virgin Islands. 6 U.L.A. 94 (Supp. 1978). In 1976, the Conference promulgated a revised version of the Act [hereinafter cited as ULPA (1976)]. 6 U.L.A. 114 (Supp. 1978).

2. ULPA § 7 (1916).

failed to provide a meaningful framework against which limited partners may measure the boundaries of permissible participation.

One reason the problem has remained unresolved for so many years is that few cases dealing with control have actually come before the courts. As a result, courts dealing with the issue have reached no agreement on firm rules, leading commentators to conclude that equitable considerations applied on a case-by-case basis, rather than clear principles, have been the primary determinants of litigation on control.<sup>3</sup> To add to this uncertainty, the cases and commentaries interpreting them suggest no less than four distinct tests for defining control. Two of these look to the nature of the limited partner's participation in the operations of the enterprise. Of these, one can be termed a "quantitative power" test.<sup>4</sup> It takes into consideration every contact the limited partner had with the enterprise to determine if his participation was such that he might be characterized as having exercised powers reserved to general partners. If so, he will be held liable as a general partner under section 7. The second is a refinement of the first. It can be described as a "day-to-day powers" test.<sup>5</sup> Under this test a limited partner will be held liable if an evaluation of his participation indicates that he assumed day-to-day responsibility for managing partnership affairs.

The other two tests may be generally characterized as reliance tests. Neither attempts to determine the character of the limited partner's participation in partnership affairs. Instead, under these tests, a limited partner will become generally liable to partnership creditors if he appeared to be a general partner. The first of these is the traditional specific reliance test.<sup>6</sup> A creditor must demonstrate that he associated with the enterprise because he believed that the limited partner was a general partner and that this belief was induced by words or acts of the limited partner or of others acting with his approval. If so, the limited partner will be liable to that creditor on any obligation owed him by the partnership as if

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3. Feld, *The "Control" Test for Limited Partnerships*, 82 HARV. L. REV. 1471, 1476 (1969); Note, *Foreign Limited Partnerships: A Proposed Amendment to the Uniform Limited Partnership Act*, 47 S. CAL. L. REV. 1174, 1193-95 (1974); Comment, *Control in the Limited Partnership*, 7 J. MAR. J. PRAC. & PROC. 416, 424 (1975); 56 MICH. L. REV. 285, 286 (1957).

4. See, e.g., *Holzman v. DeEscamilla*, 86 Cal. App. 2d 858, 860, 195 P.2d 833, 834 (1948).

5. See, e.g., *Gast v. Petsinger*, 228 Pa. Super. Ct. 394, 323 A.2d 371 (1974).

6. E.g., *Delaney v. Fidelity Lease Ltd.*, 517 S.W.2d 420, 425 (Tex. Ct. App. 1974) *rev'd*, 526 S.W.2d 543 (Tex. 1975); Note, *supra* note 3, at 1195; 6 TEX. TECH. L. REV. 1171, 1175 (1975).

he were a general partner. Under this rule a limited partner might be personally liable to some creditors and not to others.

The second reliance test is actually an estoppel test.<sup>7</sup> Under this standard, a creditor must demonstrate that the limited partner's actions were such that an objective observer might reasonably have concluded that the limited partner appeared to be a general partner. The necessity of proving actual reliance is eliminated. A creditor could recover from a limited partner if he had been unaware of the limited partner's existence at the time he dealt with the partnership, or even if he had known that the limited partner was a limited partner and had no reason to assume otherwise.

The inability of courts and commentators to agree on a single control test<sup>8</sup> has meant that a limited partner has no way of knowing what form of participation in partnership affairs a court might choose to characterize as control. Only by opting to forego any form of active involvement in a limited partnership can a limited partner assure his limited liability. Perhaps the chilling effect created by this uncertainty, more than anything else, explains the paucity of cases relating to control.<sup>9</sup>

It is not at all clear, however, that the draftsmen of the ULPA intended to restrict limited partners to such a minimal role in partnership activities. Indeed, the draftsmen sought to attract investors by creating a form of partnership organization in which investors could participate with the confidence that they would not face unreasonable risks of general liability to partnership creditors.<sup>10</sup> It

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7. Feld, *supra* note 3, at 1480.

8. A. BROMBERG, CRANE & BROMBERG ON PARTNERSHIP 147 (1968); Note, *supra* note 3, at 1192-93; Comment, *supra* note 3, at 419.

9. Comment, *supra* note 3, at 419.

10. ULPA § 1, Official Comment, at 562 (1916); Lewis, *The Uniform Limited Partnership Act*, 65 U. PA. L. REV. 715, 723 (1917). The common law recognized no distinction between those who merely invested in an enterprise and those who actively managed its affairs. Against creditors both were held to be partners in the enterprise and were personally bound to the full extent of the enterprise's obligations. ULPA § 1, Official Comment, at 562-63 (1916). As a result, partnership participation was effectively limited to those individuals interested in taking a direct role in the conduct of the enterprise. This meant that the amount of capital available for the use of the business was only as large as those amounts which the managers themselves were able to contribute. Few, if any, investors were willing to jeopardize the security of their entire estate by placing a portion of it in the hands of another. The limited partnership was designed to provide partnerships with new sources of working capital by freeing investors from the burdens of general liability. *Id.* at 562; Lewis, *supra* at 723.

The ULPA was not the first statutory effort to limit partnership liability. For a discussion of the history of limited partnerships, see F. TROUBAT, *THE LAW OF COMMANDATARY AND LIMITED PARTNERSHIPS IN THE UNITED STATES* 17-112 (1853). The first limited part-

seems unlikely that the drafters could have believed that investors would be willing to place their capital under the complete control of a general partner without being able to exercise at least some of the powers enjoyed by corporate stockholders. There is no reason to assume that a small amount of control exercised occasionally at a broad policy level would place too great a restriction on a general partner's freedom to run the partnership.

Several provisions of the ULPA grant certain express powers to limited partners. Section 9 provides the limited partners with a collective veto power to override various acts undertaken by general partners which may have a significant effect on the structure or continued viability of the partnership.<sup>11</sup> Section 10 gives the limited partner the rights to inspect and copy the partnership

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nership act was enacted by New York in 1822, and many other states soon adopted legislation modeled on the New York scheme. ULPA § 1, Official Comment, at 563 (1916).

These first-generation statutes, however, failed to attract investors in significant numbers because the limited liability they provided could be too easily lost. A limited partner was considered to be a common law partner who was protected from court application of common law rules of liability by legislative edict. *Id.* Individuals acquired this protection when the partnership which they were about to join met the exact requirements established by the state. Failure to satisfy any statutory condition deprived the partnership of this protective cloak extended by the legislature, and creditors were free to move against all participants as if they had been partners in a simple partnership all along, even though the creditor had not demonstrated reliance on the error. In *Smith v. Argall*, 6 Hill 479 (Sup. Ct. 1844), *aff'd*, 3 Denio 435 (N.Y. 1846), for example, a limited partner was held liable as a general partner because the amount of his contribution was incorrectly shown in one of two newspaper notices the limited partnership was required to publish on formation. The error was due to a printer's error. The creditor did not have to prove reliance.

Frequently limited partner status hinged on technicalities having little, if any, reasonable relationship to the basis of the claims being asserted or the good faith of the parties involved. In *Haggarty v. Foster*, 103 Mass. 17, 19 (1869), *noted in Lewis*, *supra* note 10, at 721, the court observed: "It is wholly immaterial that the transaction at the time was honestly intended and understood by the parties to be sufficient; that the securities actually transferred afforded the means by which their cash value was in fact subsequently realized; or that creditors were not actually defrauded." For other examples of cases requiring strict statutory compliance, see *Holiday v. Union Bag & Paper Co.*, 3 Colo. 342 (1877); *Pierce v. Bryant*, 87 Mass. (5 Allen) 91 (1862); *Richardson v. Hogg*, 38 Pa. 153 (1861).

A number of courts, however, adopted a more liberal approach to interpreting the early limited partnership acts. These courts avoided imposing liability for technical errors. See *Manhattan v. Laimbeer*, 108 N.Y. 578, 15 N.E. 712 (1888); *accord*, *Crouch v. First Nat'l Bank*, 156 Ill. 342, 40 N.E. 974 (1895); *Buch v. Allen*, 145 N.Y. 488, 40 N.E. 236 (1895); *Levy v. Lock*, 47 How. Pr. 394 (N.Y. 1874); *Johnson v. McDonald*, 2 Abb. Pr. 290 (N.Y. 1855).

11. Specifically, § 9 provides:

(1) A general partner shall have all the rights and powers and be subject to all the restrictions and liabilities of a partner in a partnership without limited partners, except that without the written consent or ratification of the specific act by all the limited partners, a general partner or all of the general partners have no authority to:

(a) Do any act in contravention of the certificate,

books, to demand "true and full information" concerning partnership affairs, to obtain a court decree ordering a dissolution of the partnership, and to share in partnership profits.<sup>12</sup> The question that must be answered is: What implied powers does the act permit limited partners to exercise without overstepping the bounds of the section 7 control test? Courts and commentators agree that the ULPA grants implied powers to limited partners,<sup>13</sup> but the four control tests they have developed do not adequately delineate the scope of these implied powers.

This article examines the four existing tests and proposes a fifth, which may be characterized as an "effects" or a "wasting assets" test. Like the quantitative power test and the day-to-day powers test, the "effects" test looks to the nature of the limited partner's participation in the affairs of the partnership. It avoids, however, any attempt to characterize that participation as either an exercise of powers granted to general partners or as an exercise of powers reserved for limited partners. The test instead analyzes the effects of any management decision made by a limited partner on the ability of the partnership to satisfy obligations owed to third parties. A limited partner will be liable as a general partner under this test if he has exercised his own independent judgment on behalf of the partnership with the result that the enterprise has insufficient assets to meet creditor obligations.<sup>14</sup> Finally, the article considers the consequences of applying an effects test to a number of activities which a limited partner might typically consider undertaking. Special attention is given to certain activities

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(b) Do any act which would make it impossible to carry on the ordinary business of the partnership,

(c) Confess a judgment against the partnership,

(d) Possess partnership property, or assign their rights in specific partnership property for other than a partnership purpose,

(e) Admit a person as a general partner,

(f) Admit a person as a limited partner, unless the right so to do is given in the certificate,

(g) Continue the business with partnership property on the death, retirement or insanity of a general partner, unless the right so to do is given in the certificate.

ULPA § 9 (1916).

12. *Id.* § 10.

13. Courts have consistently refused to impose § 7 liability, even though limited partners performed acts not explicitly authorized by statute. *See, e.g., Weil v. Diversified Properties*, 319 F. Supp. 778, 782 (D.D.C. 1970). *Compare* *Feld*, *supra* note 3, at 1481-82 *with* *Note*, *supra* note 3 at 1209-10 *and with* 26 OKLA. L. REV. 289, 294-96 (1973).

14. The "effects" test proposed here is in accord with the analysis of the case law dealing with § 7 contained in 26 OKLA. L. REV. 289 (1973): "In every case found, general liability was imposed on the ground of interference by the limited partners to the extent that it was they, and not the general partners, who had been responsible for impairing creditors' security." *Id.* at 293 (footnotes omitted).

which are similar to those exercised by shareholders in a corporation. Several states have amended section 7 to grant limited partners such "shareholder" powers. These powers are evaluated in terms of the effects test and the policies underlying the original statute.

## I. EXISTING TESTS FOR CONTROL UNDER SECTION 7

### A. *The Quantitative Power Test*

The quantitative power test derives from an analysis of the earliest section 7 cases decided under the ULPA. One of the first cases to deal explicitly with the problem of control was *Holzman v. DeEscamilla*.<sup>15</sup> The general partner was a tenant farmer who had formed a limited partnership with two investors to cultivate his land. Within a year the partnership became insolvent, and the creditors sought to recover from the limited partners. The court held that the limited partners had exercised control and were liable as general partners. It noted that the limited partners often decided what crops were to be planted, sometimes against the wishes of the general partner, DeEscamilla.<sup>16</sup> Particularly telling was the fact that the general partner could not write checks on the enterprise without the cosignature of one of the two limited partners. "Either Russell or Andrews," the court observed, "could take control of the business from DeEscamilla by refusing to sign checks for bills contracted by him and thus limit his activities in the management of the business."<sup>17</sup>

A similar analysis was used by the courts in two subsequent cases to determine whether a limited partner could be held generally liable. In each instance, the court looked to the limited partner's participation in the affairs of the partnership. In *Silvola v. Rowlett*,<sup>18</sup> a creditor of a partnership, which operated an auto dealership, brought an action against the limited partner when the venture went into bankruptcy. Although the limited partner acted as a foreman in the repair shop and advised the general partner from time to time on enterprise affairs,<sup>19</sup> the court concluded that final decisions on all matters were made by the general partner. "[S]ole control and management," the court noted, "rested with the

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15. 86 Cal. App. 2d 858, 195 P.2d 833 (1948).

16. *Id.* at 860, 195 P.2d at 834.

17. *Id.*

18. 129 Colo. 522, 272 P.2d 287 (1954).

19. *Id.* at 528, 272 P.2d at 290-91.



[general partner],” and “the activities of the [limited partner] were at all times subject to such control.”<sup>20</sup> The implication of this holding is that the limited partner was not personally responsible for wasting partnership assets and consequently, should not be held liable to partnership creditors.

In *Grainger v. Antoyan*,<sup>21</sup> the limited partner served as the sales manager of the partnership and as such sold new cars and had limited charge of that department.<sup>22</sup> The court examined the extent of the limited partner’s participation and concluded that he did not conduct himself in a manner which would make him liable as a general partner. The court found that the evidence “clearly demonstrates that defendant had no control over prices, purchases, the extension of credit, wages, salaries, employment, or the funds of the . . . firm, and that he in fact did not take part in the control of the . . . firm’s business.”<sup>23</sup>

These early cases caused considerable difficulty for both courts and commentators<sup>24</sup> since the cases appear to turn on the nature of the limited partner’s participation in the enterprise. The courts made no express attempt to seek any causal relationship between the limited partner’s participation and the harm suffered by creditors, although this element is present in each case. The cases suggest instead that courts were measuring the extent of a limited partner’s participation.<sup>25</sup> The implication is that at some point the sum of the limited partner’s acts in the partnership crossed an imaginary line between controlling and noncontrolling participation. The courts seem to have been looking to some quantitative test of control.<sup>26</sup>

The quantitative test has proven to be impractical because of the difficulty of measuring participation. For example, how many acts are needed to constitute control? What kinds of acts are significant? Has a partner performed an act of control if he insists that the general partners purchase a particular kind of typewriter for the partnership offices? If so, how is this to be compared to another act in which a limited partner forces the general partner to plant crops ill-suited to the climate as in *Holzman*? In addition,

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20. *Id.* at 528, 272 P.2d at 290.

21. 48 Cal. 2d 805, 313 P.2d 848 (1957).

22. *Id.* at 808, 313 P.2d at 850.

23. *Id.* at 813, 313 P.2d at 853.

24. *See, e.g.,* *Gast v. Petsinger*, 228 Pa. Super. Ct. 394, 402, 323 A.2d 371, 375 (1974); *Feld*, *supra* note 3, at 1475-77.

25. Note, *supra* note 3, at 1195.

26. *Id.*

the same act can mean entirely different things in different circumstances. A limited partner who plants a particular crop on a 200 acre plot will have greater effect on partnership affairs if the partnership farms only 200 acres than he will if it farms ten times that acreage. Every partnership is unique. On the basis of this fact alone, it has been suggested that any effort to establish a consistent measure of control is doomed to failure.<sup>27</sup>

One commentator suggests that the characterization of types of participation may offer a solution.<sup>28</sup> Thus, it might be possible to conclude that a limited partner has exercised control if he has done "anything which would affect the partnership's relations to third parties."<sup>29</sup> This approach helps identify the kind of acts on which one might base liability, but only restates the basic question. At what point can an act be said to affect third parties? How direct must the effect be?<sup>30</sup> How extensive must the effect be? A limited partner affects third parties if he buys a typewriter. Is he to become generally liable to all creditors because he affected this one third party? If not, the same measurement problem arises. Thus, this approach offers little increased predictability.

The danger of a quantitative test is that it will operate to force courts to rely almost entirely on equitable considerations. It offers no definitive reason for concluding that a certain amount of power is permissible but that a little more is not. To avoid case-by-case determinations, courts would have to adopt the kind of arbitrary, technical distinctions the draftsmen of the ULPA explicitly set out to avoid.<sup>31</sup> Line drawing might mean that liability would be imposed even though no justifiable explanation for doing so could be found. Such a rule, one commentator observed, would be "incompatible with the [drafters'] emphasis on the presumption in favor of limited liability in the absence of a reason for holding the partner generally liable."<sup>32</sup>

### B. *The Day-to-Day Powers Test*

In the wake of the initial efforts to resolve the "control" di-

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27. *Gast v. Petsinger*, 228 Pa. Super. Ct. 394, 402, 323 A.2d 371, 375 (1974); *Feld*, *supra* note 3, at 1477; *Comment*, *supra* note 3, at 424.

28. *See* *Feld*, *supra* note 3, at 1477-78.

29. *Id.*

30. *Feld* seems to overlook the possibility of a limited partner affecting third parties indirectly. He suggests, for example, that under this view limited partners could determine general partner salaries but could not restrict their directorial activities. *See id.* at 1478.

31. *See id.* at 1479.

32. *Id.*

lemma, courts in two cases<sup>33</sup> attempted to refine the quantitative test by developing what may be characterized as a day-to-day powers test. As in the quantitative power cases, the courts which employed the day-to-day powers analysis looked to the limited partner's role in partnership operations. But the courts attempted to avoid the problem of measuring the limited partner's participation as a method of determining general liability. Instead, under the day-to-day powers test, a limited partner exercises control sufficient to subject himself to section 7 liability if his participation constitutes the day-to-day exercise of power over the operation of partnership affairs on a continuous basis.

In *Weil v. Diversified Properties*,<sup>34</sup> the general partner in a real estate venture sued the limited partners to establish their general liability to partnership creditors. The limited partners had taken away his day-to-day control when the partnership was on the verge of insolvency. The court held that the partners were bound by the terms of the agreement which provided that "day-to-day management of the business of [the] partnership"<sup>35</sup> was reserved to the general partner. The court also concluded that the limited partners did not subject themselves to general liability when they attempted to salvage the business of the partnership because their actions did not amount to the normal day-to-day course of business activities within the meaning of the partnership agreement.<sup>36</sup> By the time the general partner gave up his responsibility for management of the partnership to the limited partners, "funds coming in were far from sufficient to meet current obligations, and no partnership account was being accumulated."<sup>37</sup> The court concluded that "this clearly was not a normal day-to-day business question; it involved the very ability of the enterprise to survive."<sup>38</sup> The implication is that by the time the limited partners intervened, there was really nothing left over which normal day-to-day control could be exerted.

It is reasonable to assume that if the case had come before the court on the complaint of one of the partnership creditors the court would have held much the same way:

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33. *Weil v. Diversified Properties*, 319 F. Supp. 778 (D.D.C. 1970); *Gast v. Petsinger*, 228 Pa. Super. Ct. 394, 323 A.2d 371 (1974).

34. 319 F. Supp. 778 (D.D.C. 1970).

35. *Id.* at 781.

36. *Id.* at 782-83.

37. *Id.*

38. *Id.*

Certainly common sense dictates that in times of severe financial crisis all partners in such an enterprise, limited or general, will become actively interested in any effort to keep the enterprise afloat and many abnormal problems will arise that are not under any stretch of the imagination mere day-to-day matters of managing the partnership business. This is all that occurred in this instance.<sup>39</sup>

A similar analysis was undertaken in *Gast v. Petsinger*,<sup>40</sup> where the limited partners served as engineering consultants on a number of partnership projects. A creditor sued, claiming that this participation was sufficient to establish general liability. As in *Weil*, the partnership agreement vested control of day-to-day operations in the general partner.<sup>41</sup> This was, the court observed, "[c]onsistent with statutes regulating limited partnership . . ."<sup>42</sup> The case was remanded to determine whether the limited partners, who formally were serving only as consultants, had sufficient influence to control day-to-day operations:

It is not apparent from the face of the record that the technical skills and training of [the limited partners] did by virtue of their retention as "Project Managers" place them in a position where their "advice" did influence and perhaps, control the decision of the General Partner, whose particular expertise is unknown.<sup>43</sup>

If the general partner were incapable of making informed business judgments concerning partnership affairs and were deferring instead to the decisions of the limited partners, then they would have been subject to general liability. As the court noted: "The 'control' a partner has in the day-to-day functions and operations of the business is the key question. Does the limited partner have decisionmaking authority that may not be checked or nullified by the general partner?"<sup>44</sup>

The *Gast* court seemed to suggest that occasional consultation by a limited partner is permissible under the control rule. This would provide a limited partner with much more certainty as to the kind of control he could exercise under the ULPA than would a quantitative test. It would also seem to assure limited partners more freedom to participate in the partnership decisionmaking process. The rule implied in *Weil*, on the other hand, may be less

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39. *Id.*

40. 228 Pa. Super. Ct. 394, 323 A.2d 371 (1974).

41. *Id.* at 397-98, 323 A.2d at 373.

42. *Id.* at 398, 323 A.2d at 373.

43. *Id.*

44. *Id.* at 402, 323 A.2d at 375.

extensive. The court's emphasis on the fiscal crisis which precipitated the intervention of the limited partners would suggest that such action is permissible only in unique circumstances. Under this approach occasional participation without a showing of absolute necessity might subject a limited partner to general liability.

A test which conditions general liability solely on the exercise of day-to-day powers, as the court adopted in *Gast*, would provide a much more workable standard for establishing liability than the less refined quantitative powers test. If a limited partner assumes powers that are usually attributable to a general partner on an ongoing basis, he will become generally liable. If, however, he exercises authority only occasionally, his limited liability will likely remain unimpaired. Problems might arise when a court has to determine when participation has become frequent enough to constitute day-to-day control, but for the most part the range of uncertainty would be less extensive than under a purely quantitative test.

This test has a number of disadvantages, however. It would seem to lead to a just result in the case of the limited partner who insisted that the partnership buy a particular typewriter. Read literally it would also seem to protect the limited partners in *Holzman*, if the one and only decision they interjected into enterprise operations was their choice of a particular crop. Suppose, for example, a limited partnership is formed to purchase and operate real estate properties. The partnership agreement provides that purchases are to be made by majority vote of all partners, both limited and general. Over a period of five years the partnership acquires two apartment houses. The investments turn out to be unwise. It is questionable whether the limited partners would be held to have exercised control under the tests of either *Weil* or *Gast*. Yet it seems hard to deny that they are as responsible for creditor losses as the general partners. Confronted with these facts, the *Gast* court would probably be less likely to interpret section 7 as it did. It would be clearly inequitable to deny a creditor the right to recover against a limited partner who made occasional management decisions but had not assumed ongoing day-to-day control if those decisions played some role in the subsequent insolvency of the partnership. The day-to-day powers test, therefore, would seem to confer broader powers on the limited partners than the draftsmen may have intended.

A problem shared by both the day-to-day powers test and the quantitative powers test is that neither considers the relationship

between the limited partner's activities and the creditor's losses. A creditor might recover from a limited partner whose participation had not affected the creditor in any way. On the other hand, a creditor might be denied recovery even though the limited partner's activities were directly responsible for the losses he has suffered. The result in either instance would be arbitrary and inequitable.

This problem arises because both tests operate on the assumption that a limited partner who exercises the kind of powers usually reserved to general partners is effectively a general partner and should be treated like one. However, it is submitted that the rules for determining the creditors to whom a general partner will be liable should not apply to a limited partner who controls. A general partner in any partnership is liable to all those who transact business with the enterprise while he is associated with it.<sup>45</sup> While the decisions made by a general partner who joins an operating partnership can have a devastating effect on the ability of prior creditors to recover on partnership obligations outstanding at the time he becomes a general partner, the Uniform Partnership Act (UPA) limits his liability to prior creditors to the amount of any contribution he makes to the partnership.<sup>46</sup>

If a limited partner who exercises control is treated as if he joined the partnership on the day he began to exercise control, he would also be liable to prior creditors only to the extent of his contribution to the partnership. This result would seem to be improper for two reasons. First, if new general partners were liable to prior creditors, partnerships would find themselves hard-pressed to obtain needed management skills. The exigencies of commerce require that an enterprise be able to obtain managers capable of responding to changing conditions and markets. The UPA rule recognizes this fact. The same rationale should not serve to limit the liability of a limited partner who participates in control. His participation comes only by virtue of his investment association with the enterprise. There is no reason to believe that he brings with him any special skills, managerial or otherwise, that are likely to benefit the partnership or its creditors. Thus, the need for special encouragement and protection is gone.

Second, the UPA approach can be justified by the fact that a general partner is treated as if he exercises management authority

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45. UPA §§ 15, 17, 36 (1914); ULPA § 9 (1916).

46. UPA § 17 (1914).

on a continuous basis whether or not he actually does so. To escape liability to future creditors, he must cease all association with the partnership. A limited partner, on the other hand, is in a position to exercise management powers whenever he chooses, maintaining a passive position at all other times without having to disassociate himself from the enterprise. Thus, a limited partner, unlike a general partner, is in a position to exercise a single act of control. If the UPA rule were applied to this limited partner, he might, by his single act, bankrupt the partnership without incurring personal liability.

In fact, it can be argued that prior creditors have dealt with the enterprise on the understanding that, because an individual has claimed the status of a limited partner in the filing certification or elsewhere, he would not be managing partnership affairs. Of all the individuals in the world who might assume control of a partnership, a creditor has at least some right to expect that those who specifically represented that they would not assume control can be relied upon not to do so. To deny a creditor the right to recover from a limited partner whose decisions prevented recovery from the partnership would seem to be contrary to the equitable principles the draftsmen sought to infuse into the ULPA.<sup>47</sup>

On the other hand, if prior creditors are permitted to recover, a limited partner will be treated as if he had become a general partner before he began to exercise control. Unless liability is linked to some form of causation, there is no other way to determine at what point this liability arose.

Such logic would prevent a court from disallowing the claims of subsequent creditors. This, too, could produce an inequitable result. Subsequent creditors should not be permitted to argue that they have been harmed by activities undertaken before they decided to transact business with a particular enterprise. Otherwise, once a limited partner exercises control, he might discover that he has subjected himself to liability to all subsequent creditors of the partnership, even though he may have ceased active participation and even though any effects of his participation may long since have been rendered benign. Having once exercised control, he could never be sure his liability to future creditors would cease until he terminated his association with the partnership altogether. This would be true even though his control may have caused the partnership no harm. It may even have benefited the partnership

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47. See ULPA § 1, Official Comment (1916).

and improved opportunities for creditor recovery. Partnership insolvency may come several years later. It may be entirely unrelated to anything the limited partner may have done, but unless a court is willing to look directly at the relationship between particular acts of control and the harm they have caused, inequitable consequences may result.

### C. *The Specific Reliance Test*

The search for a defensible rule has led a number of courts<sup>48</sup> and commentators<sup>49</sup> to conclude that the draftsmen might have intended section 7 to protect creditor reliance. General liability would arise whenever the acts of a limited partner have given a creditor a reasonable basis for concluding that he is actually a general partner. Since the creditor has a right to assume that all general partners are generally liable, the limited partner has a duty to make sure that he has given no one cause to adopt such an erroneous belief.

Reliance considerations are referred to in the official commentary to the ULPA,<sup>50</sup> although not specifically in connection with section 7. In two of the early control cases, courts indicated a willingness to entertain reliance claims. In *Silvola v. Rowlett*,<sup>51</sup> the defendant limited partner had been employed as a foreman in the partnership repair shop and had purchased parts without the knowledge or consent of the general partner. Nonetheless, the court determined that the limited partner had not taken part in control, reasoning that the plaintiff could not have relied on the limited partner being generally liable because he had had actual knowledge of the defendant's limited partner status. In *Rathke v. Griffith*,<sup>52</sup> the limited partner had cosigned several documents with the general partners and had negotiated contracts with third parties on two occasions. These activities, the court concluded, had been conducted under the direction of the general partners. The limited partner's testimony that he had never "in any sense managed the affairs of the concern or had the power to initiate and control execution of policy"<sup>53</sup> was uncontradicted. The court

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48. *E.g.* *Silvola v. Rowlett*, 129 Colo. 522, 272 P.2d 287 (1954); *Rathke v. Griffith*, 36 Wash. 2d 394, 218 P.2d 757 (1950).

49. Feld, *supra* note 3, at 1476; Note, *supra* note 3, at 1195-97.

50. ULPA § 1, Official Comment (1916).

51. 129 Colo. 522, 272 P.2d 287 (1954).

52. 36 Wash.2d 394, 218 P.2d 757 (1950).

53. *Id.* at 407, 218 P.2d at 764.



added: "[I]t is not alleged that respondent ever relied on Mr. Griffith's position as a general partner, or in fact even understood that Mr. Griffith was anything other than a limited partner."<sup>54</sup>

More recently, the Washington Supreme Court held that in the absence of actual reliance a creditor could not recover from limited partners who controlled a partnership by acting as directors of the corporate general partner.<sup>55</sup> By contrast, the Texas Supreme Court has on similar facts expressly rejected reading a reliance standard into section 7,<sup>56</sup> observing that "[t]he statute makes no mention of any requirement of reliance on the part of the party attempting to hold the limited partner personally liable."<sup>57</sup>

Commentators were quick to perceive the advantages of a reliance standard for section 7 control.<sup>58</sup> The simple justice of the principle is undeniable. Reliance is after all one of the basic equitable tools of the common law. Then, too, the principle of reliance seems to correspond with the essential outlook of the ULPA draftsmen. As has been observed, the entire drafting process can be characterized as an attempt to eliminate the arbitrary decisions of pre-ULPA courts and infuse notions of equity into the interpretations of limited partnership problems.<sup>59</sup> Creditor reliance is the basic thrust of many sections of the ULPA,<sup>60</sup> and it is specifically identified as an underlying principle of the statute in the draftsmen's Official Comment to section 1.<sup>61</sup>

Most appealing to commentators, however, was recognition of the fact that investing partners would enjoy more freedom to participate in enterprise management if a reliance standard was read into section 7 than they would under a more arbitrary quantitative power test.<sup>62</sup> It seemed to offer a limited partner, as a quantitative

54. *Id.* at 408, 218 P.2d at 764.

55. *Frigidaire Sales Corp. v. Union Properties, Inc.*, 88 Wash.2d 400, 562 P.2d 244 (1977). The court noted, however, that the use of an inadequately capitalized corporate general partner might be an independent basis on which to find individual liability. *Id.* at 404, 562 P.2d at 246-47. *But see Delaney v. Fidelity Lease Ltd.*, 526 S.W.2d 543 (Tex. 1975) (control by limited partners as directors of corporate general partner does not avoid § 7 liability).

56. *Delaney v. Fidelity Lease Ltd.*, 526 S.W.2d 543 (Tex. 1975).

57. *Id.* at 545.

58. Feld, *The "Control" Test for Limited Partnerships*, 82 HARV. L. REV. 1471, 1478-80 (1969); 56 MICH. L. REV. 285 (1957).

59. *See Lewis, supra* note 10.

60. *See, e.g., ULPA §§ 5-6* (1916).

61. ULPA § 1, Official Comment (1916).

62. *See Feld, supra* note 58, at 1479.

test could not, some ability to predict whether the acts he was undertaking were the type that might subject him to general liability under the control rule. Because a reliance standard looks to the relationship between the limited partner and particular creditors, a limited partner need never fear that his participation in and of itself might be considered control.

There are, however, a number of strong arguments against reading a reliance standard into the control test of the ULPA. A reliance standard would provide limited liability for a limited partner acting as an undisclosed principal. Thus, even where the limited partner would be liable under any objective standard,<sup>63</sup> he would be able to manage the enterprise behind the cloak of his limited partner status and avoid general liability.

A second objection to a reliance interpretation is that section 7, as the Texas court observed, makes no mention of reliance.<sup>64</sup> Yet a limited partner's general liability in several other sections of the ULPA is made specifically dependent upon a showing of reliance.<sup>65</sup> If the draftsmen intended to impose a reliance standard for measuring control, one would expect to find evidence of their intent in the specific terminology of section 7. Professor Alan Feld has suggested that this oversight can be attributed to the fact that "the ULPA is the product of a less rigorous tradition of draftsmanship, which saw no need to spell out the precise meaning of the control test."<sup>66</sup> This "realistic answer" is unpersuasive and even Feld seemed to reject it.<sup>67</sup> If the draftsmen neglected to include a reliance standard in section 7 because of tradition, how can one explain the obvious care they took to spell it out elsewhere? In fact, the more plausible conclusion is that one of the reasons the draftsmen saw no need to define control is that they did not intend control to turn on the presence of reliance.

Related, and possibly more telling, is the fact that application of a reliance test to the control rule of section 7 does not correspond with the common sense meaning of the word. The dictionary, that great source of common sense meanings, informs us that one who has control has the power to direct and regulate.<sup>68</sup> Introduction of a reliance element into control rule adjudications

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63. See text accompanying notes 15-43 *supra*.

64. 526 S.W.2d at 545.

65. ULPA §§ 5-6 (1916).

66. Feld, *supra* note 58, at 1480.

67. *Id.*

68. WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 496 (unabr. version 1970).

would seem to sidestep the obvious intent of the draftsmen. Taken to its logical extreme, it would mean that a limited partner could exercise day-to-day control without running the risk of general liability as long as no one except the general partners were aware of his activities. At the other extreme, if everyone were aware of his limited status, the rule would permit a limited partner to run every aspect of the business without running the risk of general liability. No commentator has been willing to carry section 7 this far.

#### D. *The Estoppel Test*

Consequently, some commentators have found themselves in the uncomfortable position of endorsing two separate tests for the same rule.<sup>69</sup> On one hand, they recognize that one who controls an enterprise in the sense that he directs its affairs and regulates its activities should be liable to creditors. On the other hand, they are unwilling to deny the principle that one who induces another to deal with an enterprise to that person's detriment should assume the responsibility for his loss. The problem, of course, is that it is hard to accept the notion that a single rule in a logically drafted statute could have been intentionally designed to facilitate two distinct interpretations serving two separate, though admittedly related, purposes.

Recognizing this problem, Feld attempted to reconcile the two tests into a single logical construct.<sup>70</sup> He suggested that the draftsmen may have designed section 7 to function on an estoppel, rather than on a specific reliance, basis. Feld reasoned that the draftsmen omitted a reliance test from section 7 because they were looking not to specific incidents of reliance but to the kinds of participation on which reliance might reasonably be based. Under this view a limited partner would be held generally liable to a creditor if he controlled the day-to-day affairs of the enterprise because his activities, if known to a creditor, would have been sufficient to lead him to believe that the limited partner was actually representing himself as a general partner. When such conduct could be shown, the limited partner would be estopped from asserting that a particular creditor was unaware of his participation

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69. See Note, *Foreign Limited Partnerships: A Proposed Amendment to the Uniform Limited Partnership Act*, 47 S. CAL. L. REV. 1174, 1193 (1974); 26 OKLA. L. REV. 289, 293 (1973).

70. Feld, *supra* note 58, at 1480. Other commentators have apparently failed to perceive that estoppel and actual reliance are not identical. See Note, *supra* note 69, at 1195-96; 26 OKLA. L. REV. 289, 293 (1973).

in the enterprise and therefore could not be said to have relied on his general liability.<sup>71</sup>

Feld's approach is ingenious. It creates a single test capable of serving both concerns. However, the Feld test poses a number of problems. Suppose a limited partner orders a typewriter for the enterprise on his own accord. He tells the typewriter salesman that he is a general partner in the partnership. Under a specific reliance test he would be liable to the typewriter company but not to any other partnership creditor. Should all partnership creditors be permitted to recover even if the limited partner never makes another partnership decision? Feld insisted that individual creditors need not demonstrate specific reliance. They need only demonstrate that "liability-creating activities" can be attributed to the limited partner.<sup>72</sup> Yet it would be hard to deny that recovery by any other creditor on these facts alone would be arbitrary and unfair. And if these activities are not sufficient to establish a reason to impose liability, how much "liability-creating" conduct is necessary? In addition to measurement problems, the test also raises creditor identification problems. Feld suggested that any creditor can recover if he can show that a limited partner acted as if he were a general partner.<sup>73</sup> Thus, one act or series of acts undertaken at a particular point in time, after which the limited partner ceased to perform any management role in the partnership, would be sufficient to subject him to liability to all future creditors. This would follow even though the decision he may have made could not be said to have harmed them in any way. The consequence is to convert the best features of the reliance test, fairness and simplicity, into the worst feature of the quantitative power test, open-ended liability.

The final and possibly most significant argument against adopting either the specific reliance test or the estoppel test for determining control under section 7 is that to do so would duplicate another provision of the statutory scheme capable of providing creditors with the same protection. This conclusion, however, is not readily obvious from analysis of the ULPA. In fact, nothing in the ULPA, except possibly section 7, would protect a creditor who erroneously concluded that a particular partner was a general partner.<sup>74</sup> This has led commentators<sup>75</sup> to conclude that the drafts-

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71. Feld, *supra* note 58, at 1480.

72. *Id.*

73. *Id.*

74. *Cf.* ULPA §§ 5, 6 (1916) (sections expressly providing for general liability for

men must have meant section 7 to serve this purpose. The assumption implicit in this approach is that the ULPA incorporates within its provisions an independent, internally coherent scheme of statutory regulation. Yet the statute itself indicates that the draftsmen intended the ULPA to function in conjunction with the UPA.<sup>76</sup>

The ULPA expressly provides that the relations between partners must be understood in the broad context of both statutes.<sup>77</sup> Section 1 of the ULPA states that a limited partnership is a partnership composed of both general partners and limited partners. The Official Comment to section 1 indicates that the draftsmen conceived of limited partners as being members of the partnership, not partners, in spite of their name.<sup>78</sup> Section 9 of the Act provides in part that "a general partner shall have all the rights and powers and be subject to all the restrictions and liabilities of a partner in a partnership without limited partners. . . ."<sup>79</sup> The obvious purpose of the ULPA is to provide a framework for creating limited partners and for resolving problems that may arise from their relations with general partners and with creditors. At the same time, it is clear that the draftsmen contemplated that limited partnership problems concerning general partners exclusively or the relationship between general partners and partnership creditors were to be resolved within the framework of the UPA. Thus, one may reasonably conclude that, where the problem at issue involves an individual who may be either a limited partner or a general partner or both, the draftsmen intended to provide courts with recourse to the provisions of both statutes as needed to obtain equitable resolution of the controversy.

The draftsmen state in the Official Comment to section 1 of the ULPA that a limited partner in a partnership may become a general partner in the same manner that any individual may become a partner in an enterprise.<sup>80</sup> Thus, when a controversy arises because a limited partner has begun to act like a general partner, it is not unreasonable to look to the UPA for the proper rule of

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limited partners who commit formal errors in the formation of a limited partnership that could induce reasonable reliance or support estoppel).

75. *E.g.*, Feld, *supra* note 58, at 1479 (citing Lewis, *The Uniform Limited Partnership Act*, 65 U. PA. L. REV. 715, 723 (1917)).

76. ULPA § 1 (1916).

77. *Id.* § 9.

78. *Id.* § 1, Official Comment.

79. *Id.* § 9.

80. *Id.* § 1, Official Comment, § 12.

law. Section 16(1) of the UPA specifically deals with the rights of creditors who have transacted business with an individual on the mistaken assumption that he is a partner in an enterprise or with an enterprise on the mistaken assumption that a particular individual was generally liable for the obligations of the enterprise. Section 16, entitled "Partner by Estoppel," provides:

(1) When a person, by words spoken or written or by conduct, represents himself, or consents to another representing him to any one, as a partner in an existing partnership or with one or more persons not actual partners, he is liable to any such person to whom such representation has been made, who has, on the faith of such representation, given credit to the actual or apparent partnership, and if he has made such representation or consented to its being made in a public manner he is liable to such person, whether the representation has or has not been made or communicated to such person so giving credit by or with the knowledge of the apparent partner making the representation or consenting to its being made.

(a) When a partnership liability results, he is liable as though he were an actual member of the partnership.

(b) When no partnership liability results, he is liable jointly with the other persons, if any, so consenting to the contract or representation as to incur liability, otherwise separately.<sup>81</sup>

There is nothing in either the UPA or the ULPA which would preclude application of UPA section 16(1) to a situation in which a limited partner takes on the appearance of a general partner. As the Official Comment to section 1 of the ULPA seems to indicate, there is nothing in his status as a limited partner which could be said to confer a special privilege of nonliability. Nor is there anything arising from his special contractual relationship with the enterprise that would seem to dictate the necessity of a special provision in the ULPA to protect creditors who act on the mistaken assumption that he is something other than a limited partner. Therefore, it seems unlikely that the draftsmen, who had just completed the UPA,<sup>82</sup> would have had any reason to duplicate their prior efforts or could be said to have intended to do so.

There is nothing in the UPA that would enable a creditor to recover from a limited partner whose business judgment was responsible for the insolvency of the partnership. Under the UPA, if

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81. UPA § 16(1). This approach appears to have been adopted in *J.C. Wattenberger & Sons v. Sanders*, 191 Cal. App.2d 857, 13 Cal. Rptr. 92 (1963), although it has been cited as a case reading reliance into § 7. See Note, *supra* note 69, at 1195.

82. The UPA was adopted in 1914. See 6 UNIFORM LAWS ANN. 5 (1969).

no question of reliance is at issue, a creditor may recover from an individual only by demonstrating that he participated as a partner in the enterprise.<sup>83</sup> To do this he must convince a court that an arrangement existed among the individuals in question making each the agent of the other.<sup>84</sup> This may be achieved by presenting evidence of a written or oral agreement to this effect or by demonstrating that an implied contract can be inferred from the manner in which the affairs of the enterprise were conducted.<sup>85</sup> If a limited partner participates in the partnership in a manner authorized by the terms of the partnership agreement, the provisions of the UPA alone will be of little assistance to a creditor, regardless of whether his participation assumes the indicia of control over enterprise affairs. The creditor will be unable to point to any agreement, written or oral, in which participants could be said to have agreed to share the risk of any losses occasioned by the operations of the enterprise. Nor will he be able to point to any course of conduct which can be said to demonstrate the existence of any arrangement other than that contemplated by the partnership agreement. By granting individuals the right to distribute risk so that some enjoy limited liability while others do not, the ULPA creates a situation in which the status of a limited partner serves to protect him from the justified, reasonable claims a creditor would otherwise seek to assert under the UPA.<sup>86</sup> Indeed, if one concludes that section 7 of the ULPA was designed to protect creditors' reliance, creditors will lose the right to protect themselves from a limited partner whose conduct in the enterprise, unbeknownst to them, destroyed the partnership's ability to meet its contractual obligations.

That the draftsmen of the ULPA intended to protect creditors from limited partners who manage partnership affairs is clear. In the Official Comment to section 1, the draftsmen listed two basic assumptions which they intended to incorporate into limited partnership arrangements:

First: No public policy requires a person who contributes to the capital of a business, acquires an interest in the profits, and some degree of control over the conduct of his business, to become bound for the obligations of the business; provided creditors have no reason to believe at the times their credits were extended that such person was so bound.

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83. UPA §§ 7, 15.

84. *Id.* §§ 6, 7, 9.

85. *Id.* § 7.

86. *See* ULPA § 7 (1916). *See generally id.* § 1, Official Comment.

Second: That persons in business should be able, while remaining themselves liable without limit for the obligations contracted in its conduct, to associate with themselves others who contribute to the capital and acquire rights of ownership, provided that such contributors do not compete with creditors for the assets of the partnership.<sup>87</sup>

Commentators favoring a reliance interpretation of section 7 have noted the draftsmen's statement in the first assumption that creditors should be able to recover from those who erroneously lead them to believe they are generally liable for partnership obligations.<sup>88</sup> No commentator, however, has considered section 7 in terms of the draftsmen's second assumption. One element of this assumption is that "persons in business should be . . . liable without limit for the obligations contracted in its conduct. . . ."<sup>89</sup> One who merely contributes capital to a venture is not a "person in business," but if he contributes capital and makes decisions affecting the conduct of partnership affairs, he is a "person in business" as much as any general partner. His status as a limited partner should not protect him from the obligations his conduct has created.

This means that creditors have two separate rights. They can rely on those who represent themselves as being generally liable. And, under the second assumption, creditors can also recover from those who manage the partnership whether or not they ever made representations to anyone. Since creditors can recover on a reliance claim under UPA section 16(1), the statutory scheme would be sufficient to provide both forms of protection envisioned by the draftsmen if section 7 is given its common sense meaning.<sup>90</sup> By contrast, if section 7 is interpreted simply as a reliance provision, a significant loophole would be created. When a limited partner imposes his own business judgment on partnership affairs, he should be liable to those creditors whose ability to recover from the enterprise is thereby impaired. No other provision of either the UPA or the ULPA is suited to this task. If it is read out of section 7, it is read out of the statutory scheme entirely.

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87. *Id.* § 1, Official Comment.

88. *See, e.g.*, Feld, *supra* note 58, at 1479 & n.30; Note, *supra* note 69, at 1175-76 & n.8.

89. ULPA § 1, Official Comment (1916).

90. *See* text accompanying note 68 *supra*.



## II. THE EFFECTS TEST

### A. *The Rule and Its Justification*

Simply stated, an effects test would make limited partners generally liable to those creditors who have been harmed because of limited partner participation in partnership affairs. In applying the test, a court would have to examine what a limited partner had actually done and ask whether those activities, either alone or in conjunction with the activities of other partnership participants, could be said to have caused the harm suffered by partnership creditors.

This test looks to the nature of the limited partner's partnership activities, without attempting to characterize them as more—or less—characteristic of those undertaken by general partners. Because it derives its basic premises from the common sense meaning of section 7, it adopts the most significant element of the quantitative and day-to-day powers tests.<sup>91</sup> The test also functions to prevent a limited partner from secretly controlling partnership affairs without risking liability for the consequences. In this way the two major weaknesses of the specific reliance test are avoided.<sup>92</sup> And yet by introducing a causation element, the rule offers courts the same benefits previous courts sought by utilizing a reliance factor in their deliberations. Like reliance, causation is a tool of historically proven value with which courts are familiar and which they know how to use. Like reliance, it is grounded in the essentially equitable notion that those whose acts or omissions bring harm to another should bear the burden for the damage that results.

There is at least as much justification for introducing causation into section 7 as for introducing reliance. Read independently of the rest of the statute, the control rule of section 7 seems to make no distinction between acts of control which harm creditors and those which do not. A different result obtains, however, when section 7 is interpreted in light of the express dictates of section 28(1). Section 28 is entitled "Rules of Construction" and states that "[t]he rule that statutes in derogation of the common law are to be strictly construed shall have no application to this act."<sup>93</sup> In effect, this provision instructs courts to interpret the statute in a manner that will avoid arbitrary determinations. In other words, a

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91. *Id.*

92. See text accompanying notes 63, 68 *supra*.

93. ULPA § 28(1) (1916).

participant in a limited partnership should not be held liable unless he has done something to justify such a result. Therefore, in interpreting section 7, a court should consider whether the activities of the limited partner have produced any injury to partnership creditors. If not, the imposition of liability would be arbitrary.

A significant advantage of the effects test is that it would produce the same results as those reached by courts applying the quantitative power test and the day-to-day powers test while avoiding the difficulties of those tests. In *Holzman v. DeEsamilla*,<sup>94</sup> which involved a farming operation,<sup>95</sup> the limited partners were held liable as general partners because they were making the business decisions which led the partnership to insolvency. If the limited partners had exercised their powers wisely, the enterprise would have prospered, and no one would ever have challenged them for the control they exerted. But the business fell apart, and the decisions made by the limited partners had a more than insignificant effect on the subsequent insolvency of the partnership.<sup>96</sup> Creditors who might otherwise have been fully paid out of the accumulated assets of a prosperous enterprise were harmed as a result of the actions of the limited partners. Thus, the right granted them by the court to recover from the limited partners can be considered neither undeserved nor arbitrary.

In both *Silvola v. Rowlett*<sup>97</sup> and *Grainger v. Antoyan*,<sup>98</sup> cases involving auto dealerships,<sup>99</sup> courts refused to impose liability on the limited partners once they concluded that the general partners in each instance had made all business decisions affecting their respective enterprises.<sup>100</sup> The responsibility for the insolvency of those ventures was theirs; in neither case could the limited partner have been said to have done anything to harm partnership creditors. In *Gast v. Petsinger*,<sup>101</sup> the court stated that the limited partners would be liable if, in the guise of consultants, they actually directed partnership affairs.<sup>102</sup> If so, they as much as anyone else played a part in causing the insolvency of the partnership. In *Weil*

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94. 86 Cal. App.2d 858, 195 P.2d 833 (1948).

95. See generally text accompanying notes 15-17 *supra*.

96. 86 Cal. App.2d at 860, 195 P.2d at 834.

97. 129 Colo. 522, 272 P.2d 287 (1954).

98. 48 Cal.2d 805, 313 P.2d 848 (1957).

99. See generally text accompanying notes 18-26 *supra*.

100. See *id.*

101. 228 Pa. Super. Ct. 394, 323 A.2d 371 (1974). See notes 40-43 *supra* and accompanying text.

102. *Id.* at 403, 323 A.2d at 375.

*v. Diversified Properties*,<sup>103</sup> the court refused to extend general liability to limited partners who acted to salvage a failed business.<sup>104</sup> Here, by the time the limited partners became involved, all damage that could be done had been done, so that the acts of the limited partners could not be said to have harmed third parties extending credit to the venture.

Another advantage of the effects test over the quantitative or day-to-day powers tests is that it offers greater predictability. When liability is made dependent on the effects of acts rather than on their size or nature, the measurement and comparison problems created by the earlier tests are eliminated. A limited partner is instead given a reasonable basis against which to evaluate different forms of participation. Thus, a single consistent standard can be applied to every act or group of acts. The limited partner is assured that if the act or acts he is about to undertake are unlikely to contribute to the insolvency of the partnership, he faces little risk of liability. Of course, there is a point at which it may be unclear whether a particular act or series of acts is or is not likely to have a greater than insignificant effect on partnership solvency. The conservative limited partner will have to avoid that ambiguous area. However, it is a significantly smaller area of uncertainty than would exist under a quantitative test.

In addition, the effects test would provide a basis for identifying creditors to whom a limited partner would be liable. It would permit prior creditors to recover under section 7 and provide a rational means for determining when liability should properly cease. If the act is of a kind that poses some risks for the enterprise, and that act, once undertaken, proves to be beneficial or at least not harmful, a limited partner will know that a court a year or more in the future will not subject him to liability because of that act. If the limited partner insists that the general partner plant watermelons and the crop produces enough profits to pay off partnership creditors, but the partnership becomes insolvent for other reasons two years later, no creditor will be able to claim that the limited partner's earlier participation made him liable as a general partner under section 7. The partnership might have made more money by planting a different crop, but that is a matter for the general partner and the limited partner to resolve between themselves. If all obligations to creditors are met, they have no cause

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103. 319 F. Supp. 778 (D.D.C. 1970); see text accompanying notes 34-39 *supra*.

104. 319 F. Supp. at 783.

for complaint. If the watermelon crop proves unsuccessful and the partnership becomes insolvent, prior creditors will be able to recover from the limited partner because his decision was responsible for the losses they incurred when the partnership ceased to pay its bills.

Under the rule proposed here, a fact finder would have to resolve two questions. The first pertains to the nature of the limited partner's participation in enterprise affairs. The fact finder would have to conclude that the limited partner's association with the enterprise included participation in the decisionmaking processes by which the nature and extent of enterprise operations and commitments were determined. Before general liability could be established, however, the fact finder would also have to be convinced that, given the scope and character of the limited partner's decisionmaking role, it had not insubstantially contributed to the insolvency of the enterprise.

Finally, as a basic matter, it should be observed that an individual who assumes the status of a general partner has agreed to assume personal responsibility for protecting creditor interests. An individual who becomes a limited partner assumes no such responsibility. At the same time, however, a creditor who deals with a partnership which contains limited partners has a right to expect that they will not exercise management authority. If a limited partner subsequently exercises management powers over enterprise affairs, his participation, no matter how short-term or extended, significant or insignificant, will have some effect on the profitability of the enterprise. If his participation increases the profitability of the enterprise, the creditor will not be harmed. If his participation reduces the profitability of the partnership, the creditor will still suffer no harm. He will not be harmed unless and until the effects of his participation are such that the enterprise is no longer in a position to satisfy its outstanding obligations.<sup>105</sup>

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105. It should be noted that in certain areas courts have been reluctant to consider the effects of business decisions. The business judgment rule applicable to corporate directors, for example, has evolved because courts have refused to examine the effects of business judgments made by directors. W. FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 1039 (rev. perm. ed. 1975). If a director acts in good faith on the basis of his own honest, independent evaluation of the facts, no stockholder will be permitted to hold him responsible for the consequences. *Id.* There are, however, important differences between the effects test proposed here and a rule that would hold directors liable for poor judgment. First, an effects test would be easier to apply than a poor judgment test. Under the latter the court would have to determine if the judgment was a reasonable one given the

## B. *The Scope of Permissible Participation Under an Effects Test*

Limited partner participation in partnership affairs can assume many forms. By examining, in light of the effects test, a number of the more typical forms of business activity a limited partner might undertake, it is possible to determine the extent to which the test would enable a limited partner to exercise power in a partnership without subjecting himself to general liability under section 7.<sup>106</sup>

### 1. *The Limited Partner as an Employee*

If case law is any indication, a limited partner may often be an employee of the partnership.<sup>107</sup> Under an effects test, activities undertaken by a limited partner on behalf of the enterprise would

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circumstances at the time it was made. The court would then have to determine whether the decision had actually reduced stockholder profits. Since such a suit could be brought against the director of an ongoing corporation as well as an insolvent one, a court would have to try to unravel the effects of this particular decision from those of all other decisions to see if it had caused losses. It would then have to measure the dollar amount of such losses so damages could be ascertained.

By contrast, a court would not be called on to apply an effects test unless a limited partnership in which limited partners are alleged to have exercised managerial authority became insolvent. Litigation would normally arise only once in the life of a limited partnership, and even then only under particular circumstances. A court would have to decide only whether the limited partner's participation had a detrimental effect on partnership viability that was not insignificant. If so, the limited partner has contributed to the insolvency of the partnership and would be liable to creditors for the full amount of partnership obligations. The court would not have to decide whether the judgment he exercised was reasonable. The court would not have to separate its effects from the hundreds of others made in an ongoing enterprise, and it would not have to apportion a monetary value on the particular damage done.

Second, the application of an effects test would promote the purposes of the legislative scheme of the ULPA whereas a poor judgment test would undermine many corporate law principles. In the latter situation, a rule that made directors liable to stockholders for the adverse consequences of each of their decisions would discourage them from taking any actions that seemed at all risky. Yet stockholders elect directors to take the kind of risks necessary to produce a profit. Creditors do not elect limited partners, and for the most part they have every reason to assume that limited partners are not exercising their own business judgments. Creditors also do not have any interest in partnership profits. The partnership is simply indebted to them for a set amount, and their interest extends only to seeing that the partnership acts responsibly to better assure their return. An effects analysis, undertaken by the courts, would therefore serve as an effective check on limited partner excesses and preserve creditors' rights in a manner that is both equitable in result and predictable in operation. Causation issues are complex, but not insurmountable. There is no reason to assume that the facts of every § 7 case will necessarily be ambiguous. None of the cases cited in this article would seem to pose serious causation problems. The causation element of an effects test may be a burden, but it is unlikely to be an unfamiliar one.

106. See note 105 *supra*.

107. *E.g.*, *Gast v. Petsinger*, 228 Pa. Super. Ct. 394, 323 A.2d 371 (1974).

not subject him to general liability if he did not participate in making the business decisions which determined how he should act. Thus, a limited partner could be employed as an agent of the limited partnership if the ultimate judgments concerning the obligations to be assumed and the activities to be performed by the enterprise are made by others. This view is consistent with the position taken by the courts. In both *Silvola* and *Grainger* the limited partners were employees of their respective limited partnerships.<sup>108</sup> Neither exercised any power to commit the enterprise to third parties, and the courts concluded they had not controlled within the meaning of section 7.<sup>109</sup> In *Rathke v. Griffith*,<sup>110</sup> the limited partner signed several documents and conducted negotiations on two occasions representing the enterprise. The documents were also signed by the general partners, and the court concluded that, though he might have had authority to conduct negotiations, the final decisions to commit the enterprise one way or the other had been made by the general partners.<sup>111</sup>

The same logic would enable a limited partner to advise the general partners on partnership affairs. If the limited partner has no power to impose his own business judgments on the determination of enterprise policy, the responsibility for the decisions actually made is not his. The power of ultimate determination remains with the general partners.<sup>112</sup>

The rule would also protect limited partners who have succeeded in imposing valid limitations on the general partner's freedom of action in the terms of the partnership agreement.<sup>113</sup> For example, suppose the limited partner insisted that the agreement provide that the enterprise grow watermelons exclusively.<sup>114</sup> In such cases the limitation has been freely entered into by contract. Though the limited partner may have wanted this restriction, the general partner was free to refuse it if he concluded that it would be unwise to assume general liability on such terms. The ultimate

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108. *Grainger v. Antoyan*, 48 Cal. 2d 805, 313 P.2d 848 (1957); *Silvola v. Rowlett*, 129 Colo. 522, 272 P.2d 287 (1954).

109. 48 Cal. 2d at 813, 313 P.2d at 853; 129 Colo. at 528, 272 P.2d at 290-91.

110. 36 Wash. 2d 394, 218 P.2d 757 (1950).

111. *Id.* at 406, 218 P.2d at 764.

112. *See Grainger v. Antoyan*, 48 Cal. 2d 805, 313 P.2d 848 (1957); *Gast v. Petsinger*, 228 Pa. Super. Ct. 394, 323 A.2d 371 (1974); *Rathke v. Griffith*, 36 Wash. 2d 394, 218 P.2d 757 (1950).

113. Of course, if the limited partner has acted in violation of § 7, he would not be protected simply because the action was authorized by the partnership agreement.

114. *See* ULPA §§ 2(1)(a)(II), 3 (1916).

responsibility thus lies with the general partner, and a subsequent creditor has no basis for recovering from anyone else.<sup>115</sup>

## 2. *The Limited Partner as an Officer or Director of a Corporate General Partner*

A major question arises when an individual who is a limited partner also serves as a director of a corporate general partner which, were it his only connection with partnership affairs, would shield him from general liability to creditors of the firm. If he exercises an important role in deciding the course of partnership affairs and the partnership becomes insolvent, should he be generally liable because he is a limited partner who has exercised control of partnership affairs, or should his limited liability continue unimpaired because he is protected in his corporate capacity?

Several courts have recently dealt with this problem. The UPA permits a corporation to be a partner in a partnership,<sup>116</sup> and the ULPA makes no distinction between a partner under the UPA and a general partner in a limited partnership.<sup>117</sup>

In *Delaney v. Fidelity Lease, Ltd.*,<sup>118</sup> the Texas Court of Civil Appeals concluded that limited partners in such situations do not violate the control rule of section 7. The Texas Supreme Court overturned the Court of Civil Appeals, holding the limited partners generally liable for exercising control.<sup>119</sup> Soon thereafter the Washington Supreme Court in *Frigidaire Sales Corporation v. Union Properties, Inc.*<sup>120</sup> adopted the view of the Texas Court of Civil Appeals on similar facts.<sup>121</sup>

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115. This position is also in accord with the holding of *Plasteel Prods. Corp. v. Helmann*, 271 F.2d 354 (1st Cir. 1959). There the partnership agreement provided that the general partner would have to obtain the approval of the partnership general manager before making any enterprise commitments. The general manager was an employee, not a general partner. But the named general manager was the father of the beneficiaries of a trust that was a limited partner in the enterprise. *Id.* at 355. The general partner was free to fire the general manager at any time, but once he left the employ of the partnership, it was obligated to buy out the interest of the trust. *Id.* Creditors sued all the limited partners under § 7. The court concluded that the only evidence of participation attributed to the trustee-limited partner was the signing of the partnership agreement. Beyond that the limited partners had assumed no role in partnership affairs. *Id.* at 356. They could not be said to have affected the viability of the enterprise as against subsequent creditors.

116. UPA §§ 2, 6 (1914).

117. See ULPA §§ 1, 2 (1916).

118. 517 S.W.2d 420 (Tex. Civ. App. 1974), *rev'd*, 526 S.W.2d 543 (Tex. 1975).

119. 526 S.W.2d 543 (Tex. 1975), *rev'g* 517 S.W.2d 420 (Tex. Civ. App. 1974).

120. 88 Wash.2d 400, 562 P.2d 244 (1977).

121. Compare 517 S.W.2d at 425 with 544 P.2d at 782.

In *Delaney*, the defendants argued that their status as the sole officers, directors, and stockholders of the corporate general partner insulated them "from personal liability arising from their activities or those of the corporation."<sup>122</sup> But because the limited partners were using a corporation to circumvent the dictates of section 7, the Texas Supreme Court felt justified in disregarding the corporate fiction.<sup>123</sup>

The Washington Supreme Court criticized the Texas Supreme Court for its willingness to "pierce the corporate veil." The Washington court argued in *Frigidaire* that the corporate fiction is not to be disregarded without a "showing of any fraud, wrong or injustice perpetrated upon the creditor. . . ."<sup>124</sup> Without this, the court argued, the corporate officers and directors *qua* corporate officers and directors did not act improperly, and justification for "piercing" was absent.<sup>125</sup>

By "piercing," the Texas Supreme Court sought to achieve the result it would have obtained if it had applied section 7 directly. The applicability of such an approach, however, is limited. One commentator has observed that liability imposed under a "piercing" theory may have different results than might liability imposed under section 7.<sup>126</sup> If, in *Delaney*, all stockholders and officers were not limited partners, disregard for the corporate fiction would have subjected them to general liability as well. If the case were decided solely on section 7 grounds, then only the participating limited partners would be personally liable.

The Texas Supreme Court need not have dealt with this issue as it did. Corporate status may well protect an officer or director from personal liability for his activities on behalf of the corporation. Corporate status will not protect him, however, if a corporate participant assumes an independent duty to creditors of the corporation. For example, if a corporate officer agrees to be personally liable for any obligations the corporation is unable to satisfy, he may not subsequently assert that his corporate status precludes the

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122. 526 S.W.2d at 546.

123. *Id.* It may also be significant that the court considered unsettled the question whether a corporation can ever serve as a general partner in a limited partnership under Texas law, *id.*, even though Texas has adopted the UPA and the ULPA. TEX. STAT. ANN. 6132a, 6132b (1970 & Supp. 1978).

124. 544 P.2d at 785.

125. *Id.*

126. Dennis, *Limited Partnership—Limited Partners Who Control Corporate General Partner are Subject to Personal Liability as General Partners*, 7 TEX. TECH. L. REV. 745, 751 (1976).



imposition of personal liability. Thus, there is no reason why an individual who becomes a limited partner under the ULPA cannot be held to have committed himself to be generally liable if he exercises control in any capacity. When a limited partner becomes a corporate director, that should not eliminate his liability under limited partnership law. Instead, his acts should simply have significance under two separate sets of legal rules. The Texas Supreme Court could have held that an individual who assumes the status of a limited partner has agreed not to participate in the decisionmaking processes of the partnership in which he has an interest. If he does exercise management authority, the fact that his participation is under the guise of a separate legal capacity should make no difference. Just as employment status cannot, by itself, shield one from liability under section 7,<sup>127</sup> neither should one's position as a corporate director. For this reason, the contrary holding of the Washington Supreme Court in *Frigidaire* was simply wrong.

### 3. *The Limited Partner as an Independent Contractor*

A similar situation may arise when a limited partner deals with the partnership as an independent contractor. In *Gast v. Petsinger*,<sup>128</sup> for example, the limited partners were consultants to the partnership.<sup>129</sup> The court held that if the limited partners had controlled the partnership through their position as consultants, they violated the rule of section 7.<sup>130</sup> An individual's assumption of one legal relationship with a partnership should not extinguish obligations assumed in another capacity.

### 4. *The Limited Partner Who Reallocates Control*

A limited partner should also be liable in certain cases where it may appear that he did not contribute to the insolvency of the partnership. Consider, once again, the facts of *Holzman*.<sup>131</sup> There, the limited partners were making all the business decisions of the enterprise. Assume that, instead of being the inept farmers they proved to be, they were actually quite skilled, and the partnership

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127. See, e.g., *Plasteel Prods. Corp. v. Helmann*, 271 F.2d 354 (1st Cir. 1959); section II(B)(1) *supra*.

128. 228 Pa. Super. Ct. 394, 323 A.2d 371 (1974).

129. *Id.*

130. *Id.* at 402, 323 A.2d at 375.

131. See 86 Cal. App.2d 858, 195 P.2d 833 (1948). See also text accompanying notes 15-16 *supra*.

was prosperous. It became insolvent, however, after the general partner absconded with all the partnership funds.

Under either the quantitative power test or the day-to-day powers test, the limited partners would be liable to partnership creditors since they had controlled partnership affairs. If a court were applying the effects test, the limited partners would, no doubt, attempt to avoid liability by arguing that they had not stolen the funds and thus had done nothing to cause the partnership's insolvency. But since they assumed responsibility for all partnership activities, the limited partners were responsible for adequately protecting the funds from theft or at least insuring against such a contingency. The same would be true if the villain turned out to be the partnership accountant or another third party. The limited partners may have been negligent in failing to provide adequate protection for their assets. They may have exercised poor business judgment in entrusting their finances to an accountant who subsequently proved unreliable. The fact that the general partner turned out to be the one who stole the funds makes the limited partners no less responsible. They controlled the business. They should have taken whatever steps were necessary to prevent loss of their assets.

The effects test also would not protect a limited partner who exercises significant ongoing authority in some areas but who allows others to run other aspects of the business. Even if the insolvency of the partnership is directly attributed to the management activities of others, the result should be the same as in the example above. Suppose the partners divided responsibility so that the general partner alone was responsible for monies received from partnership creditors. Creditors could not claim in that event that the limited partners were responsible for overseeing the security measures required to protect the liquid assets of the partnership, but the limited partners did participate in the decision by which responsibility for different areas of partnership activity were divided in derogation of the general partner's statutory right to manage the partnership.<sup>132</sup> The ULPA protects a limited partner as long as he leaves the running of the partnership to others. Once he starts taking an active role in partnership affairs, he becomes responsible for the consequences of the decisions he makes. He cannot isolate himself from liability by limiting his sphere of decisionmaking to a single area of endeavor and ignoring what his

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132. ULPA § 9 (1916); *see* UPA §§ 9-14 (1914).

fellow partners do. If his decision to rely on others is wrong, he has made a bad judgment and should not be protected from his own bad judgments at the expense of partnership creditors.

##### 5. *The Limited Partner Who Exercises Sporadic Control*

Under the effects test occasional participation in the decision-making activities of the partnership may be sufficient to constitute control if any of the acts at issue has had a deleterious effect on the ability of creditors to recover from the partnership. For example, if the sole act of the limited partners in *Holzman* had been to insist, over the objections of the general partner, that watermelons be planted, they would be liable if the crop was so unsuccessful that the enterprise was unable to meet its commitments. If in *Rathke v. Griffith*,<sup>133</sup> the limited partner had participated in making a number of policy decisions relating to the negotiations he conducted or the documents he signed, the fact finder would have had to determine whether the compounded effects of these acts, considered either as a single continuous exercise of authority or as individual events, had contributed to the losses suffered by enterprise creditors.

##### 6. *The Limited Partner Who Takes Control During Emergencies*

The decision in *Weil v. Diversified Properties*<sup>134</sup> implies that in certain emergency circumstances a limited partner may interject his own business judgments into partnership affairs without subjecting himself to general liability under section 7.<sup>135</sup> The efforts of the limited partners in that case were designed to save what could be saved of the failing enterprise. The implication of the decision is that liability should not be imposed since the real harm had already been done and the limited partners were acting in a manner that would benefit creditors as well as themselves. If section 7 is interpreted as an effects test, a limited partner would be free to exercise his business judgment as he sees fit, but he would always become liable to all creditors who may be harmed by his participation. Thus, the automatic safe harbor that may arguably be found in *Weil* would be denied under an effects test.

A rule that permits participation in emergencies assumes that the limited partners have something special to contribute in such

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133. 36 Wash.2d 394, 218 P.2d 757 (1950).

134. 319 F. Supp. 778 (D.D.C. 1970).

135. *Id.* at 782.

situations. Indeed, in *Weil*, the limited partners exercising control possessed a great deal of specialized expertise.<sup>136</sup> Moreover, the situation was so desperate that nothing could be done.<sup>137</sup> In a more typical case, however, it is likely that one or the other or both of these elements will be absent. Assuming that a real business emergency arises, there is little reason to assume that the average limited partner will be capable of doing more good than harm. Nor is there reason to believe that limited partners will have a special ability to determine when an emergency has arisen or that limited partners will act only when the situation has become hopeless. Thus a principled basis for such an "emergency rule" is hard to find.

In addition, such a doctrine would be difficult to administer. A court faced with this problem would have to define what a crisis is and determine whether one existed at the time the limited partners interfered. If none existed but the limited partners acted out of honest belief and their participation seriously impaired the financial condition of the partnership, a court would have two choices. A holding in favor of the limited partners would mean that limited partners would be free to exercise control whenever they honestly believe the enterprise to be in trouble. This would seem to be contrary to the notion that creditors can deal with a partnership confident that it will be responsibly managed at all times. When limited partners interfere and assume control because they erroneously believe a crisis exists, they are by definition acting irresponsibly under the statute.<sup>138</sup> Alternatively, if a court holds for the creditors after a limited partner took over the business on the erroneous belief that an emergency existed, this would mean that limited partners could not interfere without sacrificing their limited liability unless a genuine crisis had occurred. Limited partners would be encouraged to participate whenever they perceive that an emergency has arisen, but they would be held liable if their perception proves to be erroneous. This requires them to make a business judgment they may be ill-equipped to make, but they will know that if they pass that hurdle they will be able to do whatever they think best without fear of general liability. Under an effects test, a court would not look to the factors encouraging limited partner participation. Instead, the single issue would be causation and the court would examine the actual management decisions

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136. The most active of the limited partners, Baer, was a Certified Public Accountant. *Id.* at 779.

137. *Id.* at 784.

138. See ULPA §§ 7, 9 (1916).

made by the limited partners under the circumstances. Thus, limited partners would be on continual notice that if they decide to participate, they should be very confident about their business abilities before they take any action that might affect the viability of the partnership.<sup>139</sup>

### 7. *The Limited Partner Who Brings a Derivative Action*

Under the view of control proposed here, a limited partner should be able to bring a derivative action on behalf of the enterprise without running any significant risk of incurring general liability. Yet there is authority that a limited partner risks liability in such instances since he is making decisions affecting the enterprise that are otherwise reserved to the general partners.<sup>140</sup> The New York Legislature, responding to this problem, has specifically exempted limited partners from any general liability that might arise from such participation.<sup>141</sup> Bringing the suit itself is unlikely to harm the enterprise, and as with any derivative suit, a court will usually determine whether the action is in the interests of the enterprise as a whole before allowing it to go forward.<sup>142</sup> If the action is lost, the enterprise will not be worse off. If it is won, the assets of the enterprise will increase. In either circumstance, therefore, a creditor would have no claim against a limited partner under section 7 if it is interpreted as an effects test. The New York statute is merely a restatement of that result.

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139. Under an effects test, a limited partner may act without hesitation if he knows in advance that the act he is about to undertake is one which cannot harm creditors of his partnership. *Weil v. Diversified Properties, Inc.*, 319 F. Supp. 778 (D.D.C. 1970), in which the court characterized the limited partners' participation as an effort to refinance the enterprise, furnishes an example of such an act. Thus, if a limited partner limits his participation to negotiations between prior creditors and potential sources of new capital, his activities can hardly be said to have harmed prior creditors, whether or not refinancing is achieved. If a refinancing effort is successful, however, the limited partner may be liable to those extending replacement credit unless agreement has been reached holding him harmless.

140. *Bedolla v. Logan*, 52 Cal. App. 3d 118, 125 Cal. Rptr. 59 (1975); *Executive Hotel Assocs. v. Elm Hotel Corp.*, 41 Misc. 2d 354, 245 N.Y.S.2d 929 (Civ. Ct.), *aff'd mem.*, 43 Misc. 2d 153, 250 N.Y.S.2d 351 (Sup. Ct. 1964); *accord*, *Millard v. Newmark & Co.*, 24 App. Div. 2d 333, 266 N.Y.S.2d 254 (1966). For a discussion of limited partner derivative actions, see Note, *Procedures and Remedies in Limited Partners' Suits for Breach of the General Partner's Fiduciary Duty*, 90 HARV. L. REV. 763, 770-77 (1977).

141. N.Y. PARTNERSHIP LAW §§ 115-a to 115-c (McKinney Supp. 1977-78).

142. G. HORNSTEIN, CORPORATION LAW AND PRACTICE § 717 (1959).

## 8. *The Limited Partner Who Exercises Shareholder Voting Powers*

The number of limited partners who find themselves exercising direct authority over partnership affairs is probably fairly small. The typical limited partner is likely to be a bona fide investor with little interest in actual management. Of more immediate concern to him is whether his limited status will be endangered if he attempts to exercise powers similar to those reserved to shareholders in a corporation. The emergence of public limited partnerships has increased concern in this area, and the uncertainty surrounding the scope of section 7 has led several states to amend section 7.<sup>143</sup> These amendments create exceptions to the application of the control rule, but they do not attempt any specific definition of control. Under these amendments, limited partners may vote on "matters affecting the basic structure of the partnership" without subjecting themselves to general liability.<sup>144</sup> The revisions state that structural matters include election and removal of general partners, termination of the partnership, amendment of the partnership agreement, and sale of all or substantially all partnership assets.<sup>145</sup>

Power over what these amendments characterize as structural matters, however, can be utilized to exercise considerable, if indirect, control over less structural, more operational matters. The possible consequences of this indirect authority have long been recognized in corporation law,<sup>146</sup> and the freedom of stockholders to exercise these powers is strictly limited by statute. For example, shareholders usually have the power under state corporation law to initiate procedural changes in corporate by-laws, although they may surrender it to the directors,<sup>147</sup> but substantive changes relating to the certificate of incorporation cannot be initiated by shareholders.<sup>148</sup> Shareholder approval is required, but only after

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143. *E.g.*, CAL. CORP. CODE § 15507 (West 1977); DEL. CODE tit. 6, § 1707 (1974); NEV. REV. STAT. § 88.080 (1973); OR. REV. STAT. § 69.280 (1977); WASH. REV. CODE ANN. § 25.08.070 (Supp. 1977); *see* ULPA § 303(b) (1976).

144. *E.g.*, CAL. CORP. CODE § 15507(b) (West 1977).

145. *Id.*

146. *See, e.g.*, *Charlestown Boot & Shoe Co. v. Dunsmore*, 60 N.H. 85 (1880); *Continental Securities Co. v. Belmont*, 206 N.Y. 7, 99 N.E. 138 (1912); *Matter of Auer v. Dressel*, 306 N.Y. 427, 118 N.E.2d 590 (1954).

147. *E.g.*, DEL. CODE tit. 8, § 109 (Cum. Supp. 1977); MD. CORP. & ASS'NS. CODE ANN. § 2-109(b) (1975); TEX. BUS. CORP. ACT ANN. art. 2.23 (Vernon Supp. 1978). Under the Model Act, power to amend the by-laws rests with the directors unless reserved to the shareholders by the articles. MBCA § 25.

148. *E.g.*, DEL. CODE tit. 8, § 242 (1975).

the changes have been recommended by the directors. The sale of all or substantially all of the assets of a corporation requires stockholder approval but, like the power to amend the charter, can only be exercised on the recommendation of management.<sup>149</sup> Stockholders do have the power to dissolve the corporation of their own initiative but only by unanimous vote.<sup>150</sup> Otherwise, directorial action is a prerequisite.<sup>151</sup> The amended limited partnership statutes seem to place no similar limitations on partnership arrangements. Consequently, the limited partners can initiate any of these changes at any time. The effect of the amendment is to give investors in limited partnerships substantially more control over these areas than that exercised by stockholders. This is true even though limited partners must share ownership of the enterprise with its managers and even though general partners, unlike corporate managers, always face unlimited personal liability for partnership obligations. These provisions may make limited partnerships more attractive to investors, but they also deprive general partners of a great deal of their freedom to conduct the business affairs of the partnership as they deem best.<sup>152</sup> Of even greater significance is the fact that the amended versions of section 7 grant limited partners the power to remove general partners.<sup>153</sup> While this power may be viewed as analogous to the power of shareholders to remove directors,<sup>154</sup> the amendments provide no special protection for minority voting interests and are somewhat anomalous where the manager involved is also an owner of the enterprise who faces liability beyond that of a corporate manager. Indeed, it seems unlikely that the drafters of the original ULPA ever envi-

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149. *E.g.*, *id.* § 271.

150. *E.g.*, *id.* § 275(c).

151. *E.g.*, *id.* § 275(a), (b).

152. The amendments, of course, permit only limited partners to negotiate for these powers, but application by state securities commissions of the Midwest Securities Commissioners' Statement of Policy would assure that limited partners in public limited partnerships, at least, will enjoy these powers. *See* Midwest Securities Commissioners Association, Statement of Policy Regarding Real Estate Programs § 7B, I BLUE SKY L. REP. (CCH) ¶ 4821 (adopted Feb. 28, 1973, amended Feb. 26, 1974, July 22, 1975) (requires the partnership agreement to include provisions allowing removal of the general partner, election of a new general partner by vote of limited partners, amendment of the limited partnership agreement, and approval or disapproval of the sale of all or substantially all the assets, unless state law is inconsistent).

153. *E.g.*, CAL. CORP. CODE § 15507(b)(1) (West 1977); DEL. CODE tit. 6, § 1707(b)(3) (1974); NEV. REV. STAT. § 88.080(2)(a) (1973); OR. REV. STAT. § 69.280(2)(a) (1977); WASH. REV. CODE ANN. § 25.08.070(2)(a) (Supp. 1977).

154. *E.g.*, CAL. CORP. CODE §§ 303, 304 (West 1977); N.Y. BUS. CORP. LAW § 706 (McKinney 1963).

sioned that a limited partner should be able to exercise such a power.<sup>155</sup>

The presence of these powers in a partnership agreement together with the statutory assurance that their exercise will not subject limited partners to general liability provide investors with considerable authority over general partners even if never exercised. The general partners know that their tenure as managers or the existence of the business in the form contained in the initial partnership agreement depends on the continued approval of the limited partners, assuming, as is usually true, that the non-managers have a greater interest in the partnership than its managers. The general partners, therefore, must conduct enterprise affairs in a manner calculated to earn the approval of enterprise investors. If the limited partners ever dismissed the original general partners and elected replacements, the new general partners would likely be even more dependent on limited partner approval than their predecessors. Nothing could offer greater proof of the limited partners' intent to oversee carefully the conduct of partnership affairs than their decision to replace those whose conduct they questioned.

Consequently, provisions in a partnership agreement granting limited partners these powers, even if never exercised, would seem to be contrary to the basic principles of the original ULPA. They provide limited partners with a powerful weapon that can be used to exercise control with the assurance that limited liability will be maintained whatever the consequences of their acts. The effects test, by contrast, would provide no such guarantee. If a creditor can demonstrate that the limited partners ever threatened to exercise any of their powers, he may be able to convince a fact finder that the limited partners had forced the general partners to implement their business judgment in the conduct of partnership affairs. If so, they have managed the enterprise just as effectively as if they themselves were general partners and would be generally liable for the adverse consequences of their acts under the interpretation of the test proposed here. In *Holzman*, for example, the court never indicated how the limited partners obtained the au-

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155. See Lewis, *The Uniform Limited Partnership Act*, 65 U. PA. L. REV. 715, 717 (1917):

[G]eneral partners secure the additional funds necessary for the prosecution of the business, and yet remain in control of the business; while if a corporation is formed, all the contributors to the capital stock acquire the right to take part in the management to the extent of a right to vote for the board of directors.



thority they exercised.<sup>156</sup> If the amended version of section 7 had been adopted by California at the time of the case, the limited partners might have escaped liability by simply voting to amend the partnership agreement to convert it from a farming enterprise to an enterprise organized to farm watermelons.<sup>157</sup> The same situation might arise in a public real estate limited partnership if one or two limited partners were in a position to persuade a number of others that a particular piece of property was best suited to meet their needs. It is questionable whether the amended section 7 would protect unsecured creditors from the damage limited partners could effectuate in this way.

If the limited partners actually dismiss the general partners and take charge of enterprise operations on their own, their liability to subsequent creditors under either version of section 7 would probably be the same. Their responsibility for the future prosperity of the enterprise should be no different than where they share decisionmaking authority with the general partners.<sup>158</sup> Their liability to prior creditors, however, would be different. Section 7, as amended, would treat the limited partners as new general partners whose liability does not exceed their actual contributions to the enterprise.<sup>159</sup> Under the original control rule, as interpreted here, however, the limited partners would remain limited partners but would be liable to prior creditors if the enterprise subsequently became insolvent, since the creditors suffered from the interference of the limited partners who they reasonably assumed would not be interjecting their personal business judgments into the course of partnership affairs.

If the limited partners dismiss the general partners and simply elect others to replace them, they would not be liable to any creditors under the amended version of section 7. Under the original version, however, they would face liability to some creditors if an effects test were adopted by the courts. The decision to change general partners is an exercise of business judgment by the limited partners concerning the proper conduct of the enterprise, and consequently, they would be liable to those adversely affected by their

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156. 86 Cal. App. 2d at 858, 195 P.2d at 833.

157. In addition, it is arguable that the limited partners could impose their will on a recalcitrant general partner by simply threatening to exercise their powers of removal or dissolution and still maintain limited liability. A court, however, might view the threatened exercise of a legitimate power as different from its actual exercise.

158. See section II(B)(1) *supra*.

159. UPA § 17 (1914).

actions.<sup>160</sup>

### III. CONCLUSION

As conceived by the draftsmen in 1916, the limited partnership statute was designed to provide an individual who possessed managerial skills and little or no capital the opportunity to own a portion of an investor-backed enterprise.<sup>161</sup> More importantly, the draftsmen allowed him as much control over the business of the partnership as he could negotiate. To assure responsible management, they preserved creditors' rights against partners in partnerships without limited partners.<sup>162</sup> To protect both general partners and creditors, they extended creditors' rights of recovery not only to general partners but also to limited partners whenever the business judgment of the latter might be applied to decide the course of enterprise affairs.<sup>163</sup> The express purpose of the draftsmen was to enable individuals with small businesses to acquire new capital without having to sacrifice some of their powers by having to incorporate to attract investors.<sup>164</sup> The effects test proposed here seeks to maintain the fundamental relationships between the parties and yet provides a workable, predictable standard for determining when the limited partner should be held accountable for being something more than a partnership investor.

The amended versions of section 7, however, substantially alter the equilibrium among manager, investor, and creditor established by the original Act. The amendment gives general partners less authority over the enterprise than they would have had by incorporating. It provides limited partners with substantially more control than they would have been able to exercise as stockhold-

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160. This would most likely relate to prior creditors. If obligations to them are outstanding when the replacement occurs, their ability to recover will be largely dependent on the skills of the new management team the limited partners have chosen. If the partnership is solvent at the time the change is made and subsequently becomes insolvent, the limited partners may not be able to demonstrate that their role had an insubstantial effect on the business activities of the enterprise. If the venture is insolvent at the time the new general partners assume control, and if the assets of the partnership, if dissolved, would be insufficient to meet creditor obligations, then the most creditors could hope to receive from the enterprise would be the value of its assets. If the new management is unable to save the venture, the most harm the creditors can be said to suffer is loss of this amount. Therefore, the liability of the limited partners should not exceed the value of partnership assets when they replace the general partners.

161. See Lewis, *supra* note 155, at 717-19.

162. ULP A § 9 (1916); see *id.* § 1, Official Comment.

163. *Id.* § 7; see *id.* § 1, Official Comment.

164. *Id.* § 1, Official Comment.

ers. It may force general partners to assume liability for the consequences of decisions made by others and may deny creditors the security they once enjoyed of knowing that those actually managing the enterprise will be accountable for their acts.

The adoption of this amendment by several state legislatures raises serious questions about the purpose and continued viability of the limited partnership as a form of business organization. Support for the amendment is motivated by a very real concern for the protection of investors, but the enterprise it creates is devoid of internal logic or coherent structure. As limited partnerships increase in size, they become more and more like corporations. Problems that may arise among participants or between participants and third parties can best be solved by applying rules establishing powers and duties parallel to those imposed on corporation relationships. This amendment is an inevitable step in that direction. As long as federal tax incentives encourage partnership organization,<sup>165</sup> public limited partnerships will continue to exist.

These facts create a serious dilemma for state legislatures. They are charged with the responsibility of facilitating economic prosperity in their respective states. In order to encourage the kinds of business endeavors public limited partnerships currently pursue, each legislature must retain as many aspects of traditional limited partnership law as possible. The greater the resemblance between limited partnership law and corporation law, the more likely it is that the Internal Revenue Service will finally persuade Congress to tax limited partnerships like corporations.<sup>166</sup> At the same time, legislatures have a duty to enact laws that are rational and equitable. This consideration dictates just the opposite result. The solution lies with Congress. Until it is willing to recognize that tax incentives are more closely related to particular kinds of business endeavors and not the form in which they are organized, the inconsistencies and inequities of the modern limited partnership will only become more pronounced.

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165. Because partnerships are not taxed as separate entities they are used to pass through losses to offset individual income. I.R.C. § 704(d).

166. *See* I.R.C. § 7701.