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INVESTOR PROTECTION AND THE REVISED UNIFORM LIMITED PARTNERSHIP ACT

I. INTRODUCTION

Increased use of the limited partnership[1] form of business organization over the past 20 years has proven the 1916 Uniform Limited Partnership Act[2] (1916 ULPA) inadequate for modern business conditions. In 1976, the Commissioners on Uniform State Laws (the Commissioners) approved a Revised Uniform Limited Partnership Act (1976 ULPA)[3] designed to modernize the old Act.

The 1976 ULPA is a definite improvement over the 1916 ULPA.[4] The new Act, however, makes only slight changes in one of the important and problematic parts of the old Act—the role of limited partners. As it is likely that a number of legislatures will consider adoption of the 1976

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1. Limited partnerships are partnerships offering limited partner-investors the opportunity to limit their liability to the amount of their investment. General partners are generally liable and have exclusive management power. In the last 20 years, the tax advantages available to limited partnerships (*see* note 36 *infra*) have led to the growth of large limited partnerships operating in such areas as real estate, farming, mineral development and entertainment. *See generally* A. BROMBERG, CRANE AND BROMBERG ON PARTNERSHIP 143–51 (1968); Aslanides, Cardinali, Haynsworth, Lane & Niesar, *Limited Partnerships—What's Next and What's Left?*, 34 BUS. LAW. 257 (1978).

2. UNIFORM LIMITED PARTNERSHIP ACT, *reprinted in* 6 UNIFORM LAWS ANN. 559 (1969) [hereinafter cited as 1916 ULPA]. The 1916 ULPA has been adopted in forty-nine jurisdictions.

The limited partnership is a statutory form of business organization. Prior to adoption of the 1916 ULPA, most states had provided for limited partnerships. The need for a uniform law arose primarily from the rigid interpretations of state limited partnership acts by most courts. *See* notes 8–16 and accompanying text *infra*.

3. REVISED UNIFORM LIMITED PARTNERSHIP ACT, *reprinted in* 6 UNIFORM LAWS ANN. 127 (Supp. 1979) [hereinafter cited as 1976 ULPA].

4. Most commentators agree that the 1976 ULPA is a substantial improvement over the 1916 ULPA. Some of the most notable changes are the provision for foreign limited partnerships (art. 9), the provision for centralized filing of partnership certificates (§ 206), and the provision for partner derivative suits (art. 10). The 1976 ULPA also modernizes and clarifies provisions of the 1916 ULPA.

The 1976 ULPA is discussed favorably in the following comments: Aslanides, *et. al.*, *supra* note 1 (the 1976 ULPA will resolve many of the problems of forming and operating limited partnerships); Shapiro, *The Need for Limited Partnership Reform: A Revised Uniform Act*, 37 MD. L. REV. 544 (1978) (comparing the 1976 ULPA with the Maryland version of the 1916 ULPA, Shapiro finds the new Act thoughtful and progressive; it modernizes and clarifies while maintaining the basic character of the limited partnership); Symposium, *Limited Partnership Act*, 9 ST. MARY'S L.J. 479 (1978) (the 1976 ULPA modernizes and clarifies the 1916 ULPA). *See also* Hecker, *Limited Partners' Derivative Suits Under the Revised Uniform Limited Partnership Act*, 33 VAND. L. REV. 343 (1980) (provision for partner derivative suits is important and positive). *But see* Kessler, *The New Uniform Limited Partnership Act: A Critique*, 48 FORDHAM L. REV. 159 (1979) (The 1976 ULPA is not that much better than the 1916 ULPA; it lacks clarity, many of the policy changes are dubious; certificate requirements remain burdensome, central filing will be too expensive for the state, and the provisions for partner derivative suits fail to provide adequate procedural safeguards. To remedy these flaws would render the 1976 ULPA nonuniform). *See also* Hecker, *The Revised Uniform Limited Partnership Act: Provisions Affecting the Relationship of the Firm and its Members to Third Parties*, 27 KAN. L. REV. 1 (1978) (the 1976 ULPA, although it succeeds in streamlining certificate requirements and clarifying control, lacks overall clarity; the changes made by the 1976 ULPA are dubious as they affect third parties).

ULPA in the near future,[5] this comment is written to provide guidance in the area of the limited partner's role. After examining the role of the limited partner as it has evolved within the structure of the 1916 ULPA, this comment discusses changes made by the 1976 ULPA and recommends three changes in the new Act.

First, the control limitation should be narrowed to apply only to the limited partner who exercises control substantially the same as a general partner. Second, general partners should be required to regularly disclose certain partnership information. Third, the act should require limited partner approval of extraordinary transactions and of all transactions involving a general partner conflict of interest. With these changes, the act will more fully reflect modern ideas about investor protection and the reality of the substantial risks inherent in many limited partnership activities.

II. THE 1916 UNIFORM LIMITED PARTNERSHIP ACT

The limited partner's role under the 1916 ULPA is restricted both by the extensive powers granted the general partners and by specific limitations on activities of the limited partners. The 1916 ULPA gives general partners control over virtually all aspects of partnership operations.[6] The Act provides only minimal restraints on general partner decisions, even in transactions that alter the partnership's activities or basic structure.[7] It contains no direct restraints on general partner self-dealing. At the same time, the 1916 ULPA threatens the limited partner who exercises "control" of the partnership with general liability for partnership obligations.

5. The Internal Revenue Service has indicated that limited partnerships formed under the 1976 ULPA will, like those formed under the 1916 ULPA, normally qualify for partnership tax treatment. Proposed Amendment to Treas. Reg. § 301.7701-2 (as circulated to interested parties, but not yet published in *Federal Register*). *See* note 36 *infra*. It is likely that the 1976 ULPA will now receive rapid acceptance in state legislatures. As of this writing Arkansas, Connecticut, Minnesota and Wyoming have adopted the 1976 ULPA. Telephone Interview with National Conference of Commissioners on Uniform State Laws (Oct. 27, 1980).

6. Section 9 of the 1916 ULPA provides that: "A general partner shall have all the rights . . . and liabilities of a partner in a partnership without limited partners . . . ." Section 18(e) of the UNIFORM PARTNERSHIP ACT, 6 UNIFORM LAWS ANN. 213 (1969) [hereinafter cited as UPA] states: "All partners have equal rights in the management and conduct of the partnership business."

One commentator states: "Despite the fact that ordinarily both the limited partner and the shareholder enjoy limited liability, there is an enormous difference in the quantum of power permissible to each. In the limited partnership virtually all power is vested in the general partners." Taubman, *Limited Partnerships*, 3 CORP. PRAC. COMMENTATOR 15, 24 (1962).

7. *See* notes 17–21 and accompanying text *infra*.

A. Historical Context

Prior to 1916, most states had limited partnership acts. Under these acts, the limited liability of limited partners was treated as a privilege and conditioned on exact compliance with statutory requirements.[8] State statutes often included complex filing requirements[9] and bars to limited partner participation in the conduct of the business.[10] A defective limited partnership was treated as a general partnership.[11] As a result, limited partnerships were not widely used; investors who sought limited liability preferred the corporate form.[12]

In drafting the 1916 ULPA, the Commissioners sought to change this.[13] Their primary concern was to ensure that limited partners could, under the new Act, have "the same sense of security from any possibility of unlimited liability as the subscribers to the shares of a corporation."[14]

The 1916 ULPA was drafted to suit the typical limited partnership of the time, one that was relatively small and consensual.[15] Such partnerships offered built-in protections. The partners normally negotiated the partnership agreement. The limited partners often knew the general partners and were able to evaluate their character and experience. Limited partners often had direct contact with the partnership business and were aware of its progress and problems. Furthermore, the general partner usually participated in the partnership as an owner. Since general partner re-

8. *See* Comment to § 1, 1916 ULPA, 6 UNIFORM LAWS ANN. 563 (1969); Caudill and Fendler, *The Uniform Limited Partnership Act*, 59 COM. L. J. 5 (1954); Lewis, *The Uniform Limited Partnership Act*, 65 U. PA. L. REV. 715 (1917); Note, *Partners and Limited Partners Under the Uniform Acts*, 36 HARV. L. REV. 1016 (1923); Comment, *The Limited Partnership*, 2 U.C.L.A. L. REV. 105 (1954); Comment, *The Limited Partnership*, 45 YALE L.J. 895 (1936).

9. *See, e.g.*, 1868 Kansas Sess. Laws, § 9, ch. 74; 1822 N.Y. Laws, § 8, ch. 244; PIERCE'S WASH. CODE ANN. tit. 377, §§ 7, 9 (1912).

10. *See, e.g.*, 1868 Kansas Sess. Laws, § 16, ch. 74; CAL. CIV. CODE § 2501 (1880) (current version at CAL. CORP. CODE § 15525 (West 1977)); PIERCE'S WASH. CODE ANN. tit. 377, § 11 (1912).

11. In re Merrill, 17 F. Cas. 82 (C.C.N.D.N.Y. 1874) (No. 9,467); Sheble v. Strong, 128 Pa. 315, 18 A. 397 (1889).

12. Henningsen v. Barnard, 117 Cal. App. 2d 352, 359, 255 P.2d 837, 841 (1953); 6 U.L.A., *supra* note 8, at 563–64; Caudill and Fendler, *supra* note 8; 36 HARV. L. REV., *supra* note 8; Crane, *Are Limited Partnerships Necessary?*, 17 MINN. L. REV. 351 (1933).

13. 1916 ULPA, *supra* note 2, at § 11.

14. Lewis, *supra* note 8, at 723.

15. "[T]he limited partnership was conceived to accommodate only a few limited partners . . ." A. BROMBERG, *supra* note 1, at 146.

Small, consensual partnerships apparently dominated until recently. One observer states that small limited partnerships predominated in California until 1968 when new securities regulations geared to transferable limited partner interests in larger partnerships were adopted. Hrusoff and Cazares, *Formation of the Public Limited Partnership*, 22 HASTINGS L. J. 87 (1977). In his study of 345 limited partnerships registered in Oregon in 1960, Bayse found that only nine involved total investments in excess of $100,000 and only four had more than fifteen limited partners. Bayse, *A Survey of the Limited-Partnership Form of Business Organization*, 42 OR. L. REV. 35, 59 (1962).

wards resulted from partnership success rather than from salary, fees, or other returns, there was a continuity of interest between the general and the limited partners.[16] The 1916 ULPA should be read with this background in mind.

B. Limited Partner Rights Under the 1916 Act

1. Approval Rights

The 1916 ULPA requires limited partners to sign both the partnership certificate and all amendments thereto.[17] The latter requirement has been routinely circumvented in practice by the appointment by limited partners of an attorney-in-fact authorized to approve amendments.[18]

The Act provides that for certain amendments specific limited partner consent is necessary. The two most important of these are: first, that specific limited partner approval is required for admission of a new general partner;[19] second, that unless otherwise provided in the partnership certificate, specific consent is required to continue the partnership after withdrawal of a general partner.[20]

In addition, the general partner cannot, without limited partner approval, do any of the following:

> (a) Do any act in contravention of the certificate, (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, . . . (f) Admit a person as a limited partner, unless the right so to do is given in the certificate. . . .[21]

2. Access to Partnership Information

Accurate information is a prerequisite to investor oversight. The 1916 ULPA requires general partners to provide true and full information about the partnership on reasonable demand.[22] The limited partners have the right to have the partnership books kept at the partnership's place of busi-

16. UPA, *supra* note 6, § 18(f) provides: "No partner is entitled to remuneration for acting in the partnership business. . . ." This rule applies to general partners in the absence of an agreement to the contrary. It creates continuity of interest among the partners in the sense that partnership success is the only source of return for both the general and the limited partners. In contrast, a general partner benefits from receiving higher fees at the expense of the partnership and the limited partners.

17. 1916 ULPA, *supra* note 2, at §§ 2, 25.

18. See D. AUGUSTINE & R. LOWELL, REAL ESTATE SYNDICATIONS 88 (1972).

19. 1916 ULPA, *supra* note 2, at § 9(1)(e).

20. 1916 ULPA, *supra* note 2, at § 9(1)(g).

21. 1916 ULPA, *supra* note 2, at § 9.

22. 1916 ULPA, *supra* note 2, at § 10(a),(b).

ness and the right to inspect and copy them.[23] However, the 1916 ULPA does not require any disclosure except on demand of a limited partner. Therefore major changes in or problems with the partnership may go undisclosed.

3. *Access to the Courts*

The 1916 ULPA provides that generally a limited partner is not a proper party to a partnership suit.[24] However, the 1916 ULPA gives limited partners the same right as general partners to petition a court for an accounting and dissolution of the partnership.[25] In addition, the 1916 ULPA provides limited partners with a special right to seek judicial dissolution of the partnership if they fail to receive a distribution to which they are entitled under the Act.[26] Partners in a limited partnership are protected by section 21 of the Uniform Partnership Act dealing with the fiduciary duties of partners.[27] Section 21 provides:

> Every partner must account to the partnership for any benefit, and hold as trustee for it any profits derived by him without the consent of the other partners from any transaction connected with the formation, conduct, or liquidation of the partnership or from any use by him of its property.[28]

Section 21 has sometimes permitted limited partners to recover in court for partnership losses resulting from general partner self-dealing.[29]

C. *Restricting Limited Partner Participation—The Control Section*

The relative powerlessness of limited partners under the 1916 ULPA is reinforced by section 7—the control section. Section 7 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."[30]

The passive role of limited partners under the 1916 Act reflected the then-popular view that limited liability is a privilege.[31] Given this view,

23. *Id.*
24. "A contributor, unless he is a general partner, is not a proper party to proceedings by or against a partnership except where the object is to enforce a limited partner's right against or liability to the partnership." 1916 ULPA, *supra* note 2, at § 26.
25. 1916 ULPA, *supra* note 2, at § 10(2)(b),(c).
26. 1916 ULPA, *supra* note 2, at § 16(4).
27. Section 6 of the UPA, *supra* note 6, incorporates the UPA into the 1916 ULPA.
28. UPA, *supra* note 6, at § 21.
29. *See* notes 55–61 and accompanying text *infra*.
30. 1916 ULPA, *supra* note 2, at §7.
31. *See* note 8 *supra*.

some limitation on control was probably a necessary element of an act that would be acceptable to state legislatures. In addition, section 7 was designed to protect the reasonable expectations of creditors who relied on the liability of an active limited partner.[32]

The 1916 ULPA nowhere defines control.[33] The drafters apparently saw section 7 as consistent with some limited partner involvement. Their Comments to the Act state that:

> 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 the 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.[34]

While this comment permits control so long as it does not create reliance, section 7 does not mention reliance.[35] As a result, interpretation has been difficult.

The 1916 ULPA grants limited partners minimal approval rights and no routine access to partnership information. The primary power available to limited partners is recourse to the courts. Section 7 has operated to restrict limited partner efforts to maintain firsthand contact with partnership activities. It is clear that, under the 1916 ULPA, the limited partner is to be a passive investor.

III. THE EVOLUTION OF THE LIMITED PARTNERSHIP—THE 1916 UNIFORM LIMITED PARTNERSHIP ACT AS APPLIED

A. *Modern Limited Partnerships*

One of the greatest changes in the modern use of the limited partnership is the organization of limited partnerships designed to take advantage of special tax features available to businesses that qualify for partnership

32. The concern with creditor protection embodied in section 7 is discussed in Coleman & Weatherbie, *Special Problems in Limited Partnership Planning*, 30 Sw. L.J. 887, 897 (1976).

33. Control is mentioned, but not discussed, in the Official Comment to section 1 of the 1916 ULPA, *supra* note 2. It is not defined there or in the act itself. There is no comment to section 7.

34. 1916 ULPA, *supra* note 2, at § 1, Official Comment.

35. This is more significant because other sections providing general liability for limited partners condition this result on the reliance of the complaining third party. See *id.* § 6 (liability to those who suffer loss through reliance on false statements in the certificate) and *id.* § 5 (liability for any wrongful use of limited partner's name in partnership name to those without actual knowledge of limited liability of limited partner).

tax treatment.[36] Some of these "tax shelter" partnerships are very large.[37]

The combination of partnership taxation, limited liability for investors, and control vested in the general partners has proven attractive for operation of a wide range of businesses.[38] While today a significant number of limited partnerships continue to fit the 1916 model of a smaller face-to-face structure with a negotiated agreement, many limited partnerships are relatively impersonal combinations of managing general partners and uninvolved limited partner-investors. The general partner will often organize the proposed partnership activity and structure; only then does he or

36. Under the so-called Kintner regulations, Treas. Reg. § 301.7701-3(b) (1960), limited partnerships organized under the 1916 ULPA are classified as partnerships rather than as associations taxable as corporations. Tax classification of limited partnerships is discussed in the following articles: Note, *Tax Classification of Limited Partnerships: The IRS Bombards the Tax Shelters*, 52 N.Y.U. L. REV. 408 (1977), Fisher, *Classification Under Section 7701—The Past, Present, and Prospects for the Future*, 30 TAX LAW. 627 (1977). *See also* Note, *Tax Classification of Limited Partnerships*, 90 HARV. L. REV. 745 (1977). For a discussion of classification under the 1976 ULPA see, Haims & Strock, *Federal Income Tax Classification of Limited Partnerships Formed Under the Revised Uniform Limited Partnership Act*, 9 ST. MARY'S L.J. 489 (1978).

Partnership tax classification can offer substantial advantages to investors, particularly investors in businesses with tax losses, since partnership losses are passed through to the partners and may be deducted from gross income they receive from other sources, at least to the extent the partner is "at risk." Certain types of businesses offer substantial opportunities for tax losses; in some of these, special tax provisions create opportunities to increase tax losses or to obtain them earlier than otherwise possible. Examples are the accelerated depreciation available to some real estate ventures, I.R.C. §167(j), (k) (1980), and the option of amortizing a partnership's organization and syndication expenses over five years, I.R.C. § 709(b) (1980). Partnership taxation also allows income which would be classified as capital gains to the partnership to be treated as capital gains by the partners.

The Tax Reform Act of 1976, Pub. L. No. 95-455, §§ 201-14, 90 Stat. 1520 (1976) (codified in scattered sections of the I.R.C.) limits the tax shelter opportunities offered by the Code. Substantial tax shelter opportunities remain, however, particularly in real estate. Tax lawyers are busy exploring possible ways to expand tax shelter opportunities within the new limits. See 34 BUS. LAW., *supra* note 1, at 281-305 for a discussion of the practical impact of the Tax Reform Act of 1976.

Regarding partnership taxation and the effect of the Tax Reform Act of 1976, see Wiesner, *Tax Shelters—A Survey of the Impact of the Tax Reform Act of 1976*, 33 TAX L. REV. 5 (1977); *Tax Shelters: The Decline of the Limited Partnership*, 28 CORP. J. 99 (1978). *See also* Long, *Real Estate Partnerships Under the New Tax Law*, 7 REAL EST. REV. 30 (Spring 1977).

37. A collection of the prospectuses and other materials of a number of large limited partnership offerings may be found in 1 NOTABLE SYNDICATIONS (S. Roulac ed. 1972). The development of larger, less personal limited partnerships is discussed in Hrusoff & Cazares, *supra* note 15.

38. The opportunity to combine limited liability with the tax sheltering opportunities of partnership taxation is the essential attraction of tax shelter partnerships. For many businesses, however, the limited partnership form may be attractive if substantial profits are not anticipated. In particular, this structure may appeal to entrepreneurs since it permits them to obtain equity funds without sacrificing control.

When a business is profitable, however, particularly if it intends to retain earnings, corporate taxation is preferable since corporate income is taxed at low corporate rates in the year realized and is taxed to the shareholder only when distributed. Partnership profits, on the other hand, are taxed to the partners in the year they are realized whether or not they are distributed.

she seek investors. The partnership agreement is not negotiated.[39] And the investor may know little about the proposed area of partnership activity. A limited partnership statute should be designed to meet the needs of the full range of limited partnerships.

Tax-oriented limited partnerships are trouble prone. Typical investment activities, such as real estate and mineral exploration, are complex and risky.[40] Often business risks are compounded by heavy borrowing, which adds a substantial element of financial risk.[41] The projects are often hard to evaluate.[42] Investors are apt to focus on potential tax savings and may fail to consider adequately the weakness of the underlying business

39. Roulac compares partnership agreements in larger limited partnerships to adhesion contracts. Roulac, *Resolution of Limited Partnership Disputes: Practical and Procedural Problems*, 10 REAL PROP., PROB. & TR. J. 276, 280 (1975). The typical structure of real estate partnerships is described in Hacker & Rotunda, *Sponsors of Real Estate Partnerships as Brokers and Investment Advisors*, 23 U.C.L.A. L. REV. 322, 324–26 (1975).

40. See discussion and references in Murdock, *Tax Sheltered Securities: Is There a Broker-Dealer in the Woodwork?*, 25 HASTINGS L.J. 518, 527–30 (1974). *See also* SECURITIES AND EXCHANGE COMMISSION, REPORT OF THE REAL ESTATE ADVISORY COMMITTEE TO THE SECURITIES AND EXCHANGE COMMISSION, (Doc. 723–95731, Oct. 12, 1972) [hereinafter cited as THE DICKEY REPORT].

41. "Investments made by numerous tax shelter partnership programs are highly leveraged with a view toward improving the rate of return on the equity capital contributions of the limited partners. . . . Use of high leverage vastly increases the risk associated with mortgage-financed real estate operations, especially that of foreclosure, if sufficient funds cannot be generated to cover such financing." THE DICKEY REPORT, *supra* note 40, at 69. *See, e.g.*, 1 NOTABLE SYNDICATIONS, *supra* note 37, at 7 (proposed 90% leveraging in "American Housing Partners" prospectus); Hayes & Harlan, *Caveat Emptor in Real Estate Equities*, 50 HARV. BUS. REV. 86, 88–90 (1972). A partner can deduct losses only to the extent of that partner's tax basis (and not more in one year than the actual capital invested). Since leverage can increase the investor's tax basis in the partnership, leverage can make a partnership more attractive from a tax shelter point of view. The Tax Reform Act of 1976 limited this shelter for non-real estate ventures. *See* note 36 *supra*.

42. "The salesman of real estate securities is purveying a commodity more intricate than most securities. Even a sophisticated investor may have difficulty in evaluating the tax aspects of an offering, or the factors of risk and promoters' benefits . . . ." SECURITIES AND EXCHANGE COMMISSION, SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. No. 95, 88th Cong., 1st Sess., pt. 1, at 588 (1963) [hereinafter cited as SPECIAL STUDY]. The difficulties are aggravated by "extremely optimistic" projections and sales materials. THE DICKEY REPORT, *supra* note 40, at 35–37. *See also*, T. ANDERSON, OIL PROGRAM INVESTMENTS, 80–102 (1972); Creamer & Deutschman, *FHA Syndications Under the Microscope*, 2 REAL EST. REV. 10–11 (Fall 1972) (discussing the difficulties of evaluating conventional real estate proposals).

activity.[43] Failure of the partnership business[44] or of the promoter-general partner[45] is common.

In addition, limited partnerships are fertile ground for self-dealing and conflicts of interest.[46] Promoters often are involved in more than one limited partnership and may also be principals in businesses doing business with the partnership.[47] The interrelationships may become extremely

43. "Wittingly or unwittingly, fiscal policy has focused investors' attention so single-mindedly on the tax-saving opportunities in real estate development that investors tend to neglect the basic project economics." Hayes & Harlan, *supra* note 41, at 94.

As a result, investors are routinely urged to pay attention to the basic soundness of the proposed business. *See, e.g.*, D. AUGUSTINE & R. LOWELL, *supra* note 18, at 370. Mosburg concludes that the "market appeal of tax shelter offerings will see many poorly structured and poorly managed ventures purchased by the investing public." Mosburg, *Regulation of Tax Shelter Investments*, 25 OKLA. L. REV. 207, 238 (1972). In discussing fraudulent energy offerings, the S.E.C. states that investors are often induced to invest on "the basis of false statements or omissions concerning . . . the risks associated with the investments [and] the experience of the issurers' principals. . . . One of the major inducements to investors is the purported availability of special tax benefits." SECURITIES AND EXCHANGE COMMISSION, 45TH ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION 38 (1979) (citations omitted) [hereinafter cited as 45TH ANNUAL REP.].

44. *See, e.g.*, Blattberg v. Weiss, 61 Misc. 2d 564, 306 N.Y.S.2d 88 (Sup. Ct. 1969) (inability to fully lease partnership office building led to mortgage foreclosure); Dycus v. Belco Industries, Inc., 569 P.2d 553 (Okla. Ct. App. 1977) (partnership hotel proved unprofitable); Watson v. Limited Partners of WCKT, Ltd., 570 S.W.2d 179 (Tex. Civ. App. 1978) (builder organized a limited partnership to buy and rent four-plexes he had built; the partnership experienced continuing losses and finally in winding up the partnership the four-plexes were sold at a trustees sale. The buyer? The general partner-builder.).

45. Of course, general partner failure often causes partnership failure. *See, e.g.*, Glantz v. Cohan, 364 So. 2d 54 (Fla. Dist. Ct. App. 1978) (failing general partners were unable to meet commitments to the limited partnership; as a result, the partnership failed); Allen v. Steinberg, 244 Md. 119, 223 A.2d 240 (Ct. App. 1966) (corporation used partnership assets to try to meet its obligations, and this led to partnership failure); McGlynn v. Schultz, 90 N.J. Super. 505, 218 A.2d 408 (Super. Ct. Ch. Div. 1966), *aff'd*, 95 N.J. Super. 412, 231 A.2d 386 (Super. Ct. App. Div. 1967) (failing corporate general partner siphoned off partnership funds to try to keep corporation afloat); Mist Properties Inc. v. Fitzsimmons Realty Co., 228 N.Y.S. 2d 406 (Sup. Ct. 1962) (corporation allegedly used proceeds from loan secured by partnership property for corporate purposes; inability to make resulting mortgage payments resulted in foreclosure and sale of partnership property).

46. *See* D. AUGUSTINE & R. LOWELL, *supra* note 18, at 170; Little & Drasner, *The Tax Shelter: A Reappraisal*, 10 J. MAR. J. OF PRAC. AND PROC. 67, 83 (1976). The Dickey Report states:

> Promoters of real estate securities appear to be exposed to more conflicts of interest than do traditional corporate promoters. . . .
>
> The structure of the typical real estate syndication does offer significant opportunities for self-dealing, and there are few controls (for example, independent directors and stockholder approval) comparable to corporate democracy. In real estate offerings, those who are managing the business have a direct monetary interest in the way the funds are used; the promoters themselves run the business and rarely have the constraint of outside directors. In addition, because of partnership law restrictions on the activities of the limited partner, the limited partners cannot act as effective regulators.

THE DICKEY REPORT, *supra* note 40, at 40–41.

47. Promoters typically develop a business opportunity and organize a limited partnership to finance it. They typically act as general partner, though a promoter affiliate may play this role. In a real estate development, a promoter might identify an appropriate property, obtain an option on it, generate construction plans, and obtains bids and financing commitments. At some point in this pro-

complex. For example, limited partnerships may be formed to finance assets used in other general partner ventures. General partner affiliates may manage or develop partnership property[48] or lease partnership assets for use in another business.[49] The resulting conflicts of interest create fertile ground for abuse. General partners may agree to pay themselves or their affiliates excessive fees for services.[50] Or they may sell assets to the

cess, the promoter develops a prospectus which presents the plan, insofar as it is then known, to potential investors. A limited partnership is formed and investors become its limited partners. Because the promoter is more of an organizer than an employee, the promoter can readily organize and manage more than one partnership at a time. Thus, unlike the typical small operating business, management of the partnership is not a full time undertaking and the general partner can readily participate in more than one partnership and at several levels of a real estate undertaking at one time. (There are of course many variations.)

For an example of the complex roles that a promoter may play, see Homestake Mining Co. v. Mid-Continent Exploration Co., 282 F.2d 787 (10th Cir. 1960). There Homestake, the general partner, mined uranium. Mid-Continent, the limited partnership, was formed to construct a mill to process uranium, including uranium mined by the general partner. Mid-Continent was to mill "custom ore" mined independently, as well. Homestake later created another limited partnership, Sapin, to engage in uranium mining and processing in the same area.

The conflict of interest problems in this series of transactions were substantial. In court, questions were raised about Homestake's alleged use of Mid-Continent's assets to develop Sapin, and about the diversion of "custom ore" by Homestake from Mid-Continent to Sapin. Other issues included Homestake's secrecy in organizing Sapin and the question of whether Sapin was organized to take advantage of a partnership opportunity which was Mid-Continent's, or alternatively, whether Homestake had a duty to offer limited partners in Mid-Continent the opportunity to invest in Sapin.

48. *See, e.g.*, Lichtyger v. Franchard Corp., 18 N.Y.2d 528, 223 N.E.2d 869, 277 N.Y.S.2d 377 (1966). In that case, the partnership was structured to pay the general partner a fixed fee for managing the partnership hotel, which was leased to Sheraton. The suit arose when the general partner allegedly renegotiated the lease and thereby reduced partnership income without affecting general partner earnings. *See also* Lerman v. Tenney, 295 F. Supp. 780 (S.D.N.Y. 1969), *aff'd*, 425 F.2d 236 (2d Cir. 1970) (partnership was formed to acquire, modernize, and lease an office building).

49. This kind of limited partnership enables a business to obtain outside financing for a major investment. The partnership generates tax losses through asset depreciation while generating a cash flow from lease payments. The limited partners thus receive tax losses, cash distributions, and an equity interest in the asset, which may appreciate in value, especially if real estate is involved.

For example, in Elle v. Babbitt, 259 Or. 590, 488 P.2d 440 (1971), the corporate general partner organized a limited partnership to buy a pipe mill and lease it back to the corporation. In Allen v. Steinberg, 244 Md. 119, 223 A.2d 240 (1966), the partnership purchased land from a developer to be leased back to the developer, who happened also to be a general partner affiliate, for development of housing and a shopping center.

50. The Dickey Report notes "the complexity of existing compensation arrangements, the abuses therein in the offering of real estate interests, and the high level of compensation to management in relation to the risk they assume, as opposed to the public investor." THE DICKEY REPORT, *supra* note 40, at 48. *See also* SPECIAL STUDY, *supra* note 42, at 578; Comment, *Public Limited Partnerships in Northwest Real Estate Syndication*, 7 WILLAMETTE L.J. 74, 74–82 (1971).

partnership[51] or lease partnership assets[52] at terms unfavorable to the partnership.

Concern about these and other problems became acute in the early seventies.[53] One result was a host of new securities rules, guidelines, and

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51. Probably the most basic, widespread and dangerous abuse involved in [real estate syndication] is the selling of properties to syndications at inflated prices or subject to inflated or unfeasible financing arrangements. . . . This is caused generally by the syndicator's several conflicts of interest, the techniques used to package the tax shelter, and the conflict between these techniques and intrinsically sound investment objectives.

THE DICKEY REPORT, *supra* note 40, at 44. See also materials cited at note 53 *infra*.

In Bassan v. Investment Exchange Corp., 83 Wn. 2d 922, 524 P.2d 233 (1974), the general partner purchased land, then sold it to the partnership for profits which ranged from 33% to 280% over a period of 5 years. The court held that, in respect to the sale under review, the profits made by the general partner (44%) were excessive. Finding that the limited partners had not consented to these profits, the court held that the transaction breached the general partner fiduciary duty to the limited partners. The case is noted in 50 WASH. L. REV. 977 (1975).

52. *See, e.g.*, Riviera Congress Ass'n v. Yassky, 18 N.Y.2d 540, 223 N.E.2d 876, 277 N.Y.S.2d 386 (1966). In 1961 the general partners organized the partnership to purchase a hotel to be leased to a manager. The hotel was leased to a series of general partner affiliates. (Ultimately, the lease was assigned to the owner partnership, which, unable to pay itself rent payments, ceased making promised distributions to the limited partners). The court found that the limited partners had consented to the self-dealing. Hence, the court held there was no general partner liability to the investors unless the trial court on remand found a lack of good faith by the general partners.

In McGlynn v. Schultz, 90 N.J. Super. 505, 218 A.2d 408 (Super. Ct. Ch. Div. 1966), *aff'd*, 95 N.J. Super. 412, 231 A.2d 386 (Super. Ct. App. Div. 1967), the corporate general partner proposed to acquire a shopping center, transfer it at a profit to a limited partnership it organized, and then to lease it from the partnership on terms which would give the limited partners a return of 9–10% on their investment. The plan was to purchase the center for $400,000 cash (and a mortgage of about $1,450,000) and to sell it to the partnership for approximately $320,000 profit. (The general partners were held liable for use of partnership funds for non-partnership purposes, a breach of their obligation as trustee. After using all the partnership's money, the corporation went bankrupt, leaving the partnership with nothing).

In discussing conflicts of interest in oil and gas investments, T. ANDERSON, *supra* note 42, at 57–60, points out the benefits that sponsors can obtain by selling land to a partnership while retaining adjoining land. Exploration by the partnership can provide the sponsor with a free estimate of resource potential on adjoining land. Success will dramatically increase the value of sponsor's adjoining land at no cost to the sponsor. A number of similar scenarios are discussed.

53. *See* THE DICKEY REPORT, *supra* note 40; Heyman and Parnall, *Use (or Abuse) of the Limited Partnership in Financing Real Estate Ventures in New Mexico*, 3 N.M. L. REV. 251 (1973); Mosburg, *supra* note 43; Note, *Proposed Regulation of Limited Partnership Investment Programs*, 6 U. MICH. J. L. REF. 465 (1973); Comment, *Regulation of Real Estate Syndications: An Overview*, 49 WASH. L. REV. 137 (1973); Comment, *supra* note 50.

For earlier materials dealing with these concerns, see SPECIAL STUDY, *supra* note 42, at 575–91 (Real Estate Securities); Berger, *Real Estate Syndication: Property, Promotion, and the Need for Protection*, 69 YALE L.J. 725 (1960).

In the early 1970's there was a great deal of regulatory activity as well. *See* materials cited at note 54 *infra*.

Concern with these problems has continued. *See* recent regulatory activities cited in note 54 *infra*. *See also* 45th ANNUAL REP., *supra* note 43, at 38–39 (Enforcement Program: Energy Related Cases); R. HAFT & P. FASS, TAX SHELTERED INVESTMENTS 3–40 (4 Securities Law Series, rev. 1980); Little & Drassner, *supra* note 46.

regulations[54] directed to the problems of larger limited partnerships.

Any revision of limited partnership statutes should reconsider the limited partner's role in light of the current use and structure of limited partnerships. Limited liability is no longer viewed as a special privilege; the need of passive investors for some protections is now widely recognized. These changes create new flexibility to meet the problems of the investor in the modern limited partnership.

B. *Expanding Protection for Limited Partners*

1. *Through the Courts*

As the 1916 model of the typical limited partnership fit fewer and fewer actual limited partnerships, limited partners sought to stretch the available remedies to solve new problems. Where there were clear abuses by general partners, courts were often willing to expand the existing remedies.[55] The general partner's statutory fiduciary duty[56] does not encompass many of the aspects of a fiduciary's duties at common law.[57] Noting the similarity of the limited partner's position to that of a corporate shareholder, the courts have sometimes expanded the general partner's fiduciary duty

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54. *See* S.E.C. GUIDE 60, PREPARATION OF REGISTRATION STATEMENTS RELATING TO INTERESTS IN REAL ESTATE LIMITED PARTNERSHIPS, *reprinted in* 4 R. HAFT & P. FASS, *supra* note 53, at Appendix C; The Oil and Gas Investment Act of 1972. S. 3884, 92d Cong., 2d Sess., 118 CONG. REC. 26964 (1972); MIDWEST SECURITIES COMMISSIONERS ASS'N, STATEMENT OF POLICY REGARDING REAL ESTATE PROGRAMS, (adopted by Midwest Security Commissioners Ass'n on Feb. 28, 1973, amended Feb. 26, 1974, July 22, 1975 and adopted by the North American Securities Administrators Association (NASAA) on April 15, 1980), *reprinted in* [1980] 1 BLUE SKY L. REP. (CCH) ¶ 4821 [hereinafter cited as MIDWEST POLICY]; MIDWEST SECURITIES COMMISSIONERS ASS'N, GUIDELINES FOR REGISTRATION OF PUBLICLY-OFFERED CATTLE-FEEDING PROGRAMS, (adopted Feb. 28, 1973) *reprinted in* [1980] 1 BLUE SKY L. REP. (CCH) ¶ 4811 [hereinafter cited as CATTLE-FEEDING GUIDELINES]; NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION GUIDELINES FOR THE REGISTRATION OF OIL AND GAS PROGRAMS (adopted Sept. 22, 1976, amended Oct. 12, 1977 and Oct. 31, 1979), *reprinted in* [1980] 1 BLUE SKY L. REP. (CCH) ¶ 4582 [hereinafter cited as NASAA OIL AND GAS GUIDELINES]; WASH. ADMIN. CODE ch. 460.32A (1979); Real Estate Programs, CAL. ADMIN. CODE, tit. 10, §§ 260.140.-110–119.1 (adopted (June 20, 1973), and Oil and Gas Interests, CAL. ADMIN. CODE, tit. 10, §§ 260.140.120–131.9 (adopted Dec. 6, 1974).

55. *See, e.g.*, Miller v. Schweickart, 405 F. Supp. 366 (S.D.N.Y. 1975); Lichtyger v. Franchard Corp. 18 N.Y.2d 528, 223 N.E.2d 869, 277 N.Y.S.2d 377 (1966); Millard v. Newmark & Co., 24 App. Div. 2d 333, 266 N.Y.S.2d 254 (1966).

For an excellent discussion, see Note, *Procedures and Remedies in Limited Partners' Suits for Breach of General Partner's Fiduciary Duty*, 90 HARV. L. REV. 763 (1977).

56. UPA, *supra* note 6, at § 21.

57. A corporate director has a duty of loyalty to the corporation, Guth v. Loft, 5 A.2d 503, 510–11 (Del. 1939), and a duty to exercise care in performing the duties of director. Litwin v. Allen, 25 N.Y.S.2d 667, 677–78 (Sup. Ct. 1940). These duties have been incorporated into the corporate codes of many jurisdictions. *See, e.g.*, the suggested provision in ABA-ALI MODEL BUS. CORP. ACT § 35 (1953).

by analogy to the duties of corporate directors.[58] In addition, courts often have permitted limited partners to initiate partner derivative and representative suits.[59] However, some courts have refused to broaden the statutory rights.[60] Others have raised substantial procedural barriers.[61] As a result, limited partner remedies are unreliable.

2. *Through Legislation and Regulation*

Some legislatures have sought to increase limited partner power by permitting them to vote on such matters as:

(a) Election, removal, or substitution of general partners, including, but not limited to, transfer of a majority of the voting stock of a corporate general partner.
(b) Termination of the partnership.
(c) Amendment of the partnership agreement.
(d) Sale of all or substantially all of the assets of the partnership.[62]

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58. Allen v. Steinberg, 244 Md. 119, 223 A.2d 240, 246 (Ct. App. 1966) (fiduciary duty extends to disclosure at time of investment); Lichtyger v. Franchard Corp., 18 N.Y.2d 528, 536, 223 N.E.2d 869, 873, 277 N.Y.S.2d 377, 383 (1966) ("no basis or warrant for distinguishing the fiduciary reltionship of corporate director and shareholder from that of general partner . . . [t]he principle is the same—those in control of a business must deal fairly with the interests of the other investors."); Huffington v. Upchurch, 532 S.W.2d 576 (Tex. 1976) (partnership opportunity doctrine).

See Note, *Fiduciary Duties of Partners*, 48 IOWA L. REV. 902 (1963). *See also* T. AUGUSTINE & R. LOWELL, *supra* note 18, at 167–74; Coleman & Weatherbie, *supra* note 32, at 915–17; 90 HARV. L. REV. 763, *supra* note 55.

59. Klebanow v. New York Produce Exchange, 344 F.2d 294 (2d Cir. 1965); Smith v. Bader, 458 F. Supp. 1184 (S.D.N.Y. 1978) (applying California law; California law permits partner derivative suits); Lichtyger v. Franchard Corp., 18 N.Y.2d 528, 223 N.E.2d 869, 277 N.Y.S.2d 377 (1966) (partner representative); Riviera Congress Ass'n v. Yassky, 18 N.Y.2d 540, 223 N.E.2d 876, 277 N.Y.S.2d 386 (1966) (partner derivative suit).

See generally Note, *Standing of Limited Partners to Sue Derivatively*, 65 COLUM. L. REV. 1463 (1965). A few states have amended their limited partnership acts to permit limited partner derivative suits. *E.g.*, DEL. CODE ANN. tit. 6, § 1732 (1979); N.Y. PARTNERSHIP LAW § 115-a to -c (McKinney Supp. 1968); OR. REV. STAT. § 69.475 (1979).

60. Lieberman v. Atlantic Insurance Co., 62 Wn. 2d 922, 385 P.2d 53 (1963) (limited partner not a proper party to sue for partnership insurance proceeds).

61. Blattberg v. Weiss, 61 Misc. 2d 564, 306 N.Y.S.2d 88 (Sup. Ct. 1969) (court stated that although the partnership had no assets, limited partners must seek a judicial accounting prior to suing for a return of contribution. The decision was handed down five years after the foreclosure and sale of the partnership property from which limited partners sought recovery, claiming that mortgage was improper.) Riviera Congress Ass'n v. Yassky, 18 N.Y.2d 540, 548, 223 N.E.2d 876, 880, 277 N.Y.S.2d 386, 392–93 (1966) (in suits for breach of fiduciary duty, limited partner knowledge or consent is a defense.) Mist Properties v. Fitzsimmons Realty Co., 228 N.Y.S.2d 406 (Sup. Ct. 1962) (limited partner consent to mortgage of partnership property for non-partnership purpose is binding against third parties.)

62. WASH. REV. CODE § 25.08.070 (1979) (*enacted* 1972 Wash. Laws, 1st Ex. Sess. ch. 113 sec. 2). *See also* CAL. CORP. CODE § 15507 (West 1977); NEV. REV. STAT. § 88.080 (1973); OR. REV. STAT. § 69.280 (1979). Delaware has amended section 7 to permit limited partners to exercise approval rights granted in the partnership agreement. DEL. CODE ANN. tit. 6, § 1707 (1974).

These voting powers, however, exist only if they are also granted to limited partners in the partnership certificate. Often they are not.[63]

State and federal securities regulators have established rules and regulations addressing the special needs of investors in tax-shelter programs.[64] These rules establish explicit disclosure requirements for common types of tax shelter investments.[65] They set experience and net worth requirements for general partners[66] and eligibility requirements for investors.[67] They regulate self-dealing through prohibitions of certain types of

63. In part this is due to concern that voting rights may lead to section 7 liability for limited partners. *See* note 73 *infra*.

64. *See* note 54 *supra*.

65. In addition to substantial pre-investment disclosure requirements, the regulations typically require continuing reporting throughout the life of the partnership. For example California requires quarterly unaudited financial reports and quarterly reports containing other pertinent information about the partnership as well as an annual report that should include audited financial statements, a report of activities, and a comparison of performance with prior projections. CAL. ADMIN. CODE, tit. 10, § 260.140.116.3 (1977); MIDWEST POLICY, *supra* note 54, at § VII C.

Washington has regulations covering sales efforts, WASH. ADMIN. CODE § 460.32A.185 (1977); prospectuses, WASH. ADMIN. CODE § 460.32A.195 (1977); required disclosure of sponsor experience, WASH. ADMIN. CODE § 460.32A.196 (1977); use of projections in sales materials, WASH. ADMIN. CODE § 460.32A.245 (1977). Other provisions require ongoing reporting, WASH. ADMIN. CODE § 460.32A.160 (1977), including reports on any real property acquired in the preceding quarter, WASH. ADMIN. CODE § 460.32A.245 (1977).

66. Typically, limited partnership promoters must have a net worth greater than or equal to the lesser of either 5% of the value of all offerings sold in the preceding 12 months plus 5% of the present offering, or $1,000,000. *E.g.*, WASH. ADMIN. CODE § 460.32A.015 (1977): CAL. ADMIN. CODE, tit. 10, § 260.140.111.2 (1974); NASAA OIL AND GAS GUIDELINES, *supra* note 54, at § II B; MIDWEST POLICY, *supra* note 54, at § II B.

The Internal Revenue Service has taken the position that a corporate general partner must have a net worth of at least 10–15% (depending on offering size) of the offering for a program to obtain an advance ruling that it will be taxable as a partnership. Rev. Proc. 72–13, 1972–1 C.B. 735.

Real estate program sponsors and general partners are normally required to have two years of relevant experience. They, or any affiliates, if they propose to provide services to the program, must either have four years of experience providing that service or demonstrate adequate experience and knowledge to provide the service. *E.g.*, CAL. ADMIN. CODE, tit. 10, § 260.140.111.1 (1974); MIDWEST POLICY, *supra* note 54, at § II A.

In oil programs, the general partner must have three years of relevant experience and four years experience in any type of service provided to the program. *E.g.*, CAL. ADMIN. CODE, tit. 10, § 260.-140.122.1 (1974); NASAA OIL AND GAS GUIDELINES, *supra* note 54, at § II A.

67. Investor eligibility requirements are intended to ensure that investors can bear the risks of the investment and can benefit from the tax shelter offered. Mosburg, *supra* note 43, at 531. California premises its investor requirements on the lack of liquidity of most tax shelter offerings and on their tax orientation. CAL. ADMIN. CODE, tit. 10, § 260.140.112.1 (1974).

It is commonly recommended that real estate program investors have a net worth of $75,000 or net worth of $20,000 and an annual gross income of $20,000 (net worth measured exclusive of home, furnishings, and auto). *E.g.*, CAL. ADMIN. CODE, tit. 10, § 260.140.112.5 (1973); MIDWEST POLICY, *supra* note 54, at § III B 2 c.

NASAA recommends that oil and gas program investors have a net worth of $225,000 or a net worth of $60,000 and an annual income of $60,000 (net worth measured exclusive of home, furnishings, and auto). NASAA OIL AND GAS GUIDELINES, *supra* note 54, at § IV B 2 c. California requires either a net worth of $200,000 or a net worth of $50,000 and a marginal income tax rate of 50% or more. CAL. ADMIN. CODE, tit. 10, § 260.140.123.2 (1974).

dealings and through ceilings on general partner remuneration.[68] They set standards for asset transactions between the partnership and the sponsor.[69] They deal with conflicts of interest,[70] assessments,[71] and fiduciary duty.[72] They require partnerships to give limited partners voting rights.[73]

68. The Midwest Policy sets a standard of reasonableness for general partner/sponsor compensation and suggests limits for various types of compensation, including program participations. The sponsor and affiliates may provide only certain services, primarily property management, and only at the market rate. MIDWEST POLICY, *supra* note 54, at §§ IV and V E. Washington sets ceilings for acquisition services, WASH. ADMIN. CODE § 460.32A.057 (1977); for program management, WASH. ADMIN. CODE § 460.32A.030 (1977); and for commissions on property resale, WASH. ADMIN. CODE § 460.32A.057 (1977).

The NASAA Oil and Gas Guidelines require that organizational and offering expenses must be reasonable and, with management fees, may not exceed 15% of the offering; they limit total general partner compensation. NASAA OIL AND GAS GUIDELINES, *supra* note 54, at § V.

69. California prohibits sale of assets from real estate sponsors to a partnership at more than cost unless there has been a material change, such as passage of two or more years or successful rezoning, which would increase the property value. Sales or leases by the partnership to the sponsor are prohibited except for market rate, fully disclosed lease-backs. CAL. ADMIN. CODE, tit. 10, § 260.140.114.1(b) (1974). Similar limits are recommended in both the MIDWEST POLICY, *supra* note 54, at § V A, and the NASAA OIL AND GAS GUIDELINES, *supra* note 54, at § VI A.

Washington permits sales, leases, and loans between a limited partnership and the partnership's sponsor only if such a plan is fully disclosed at the outset of the partnership. WASH. ADMIN. CODE § 460.32A.045 (1977).

70. Most of the regulations include conflict-of-interest sections. Besides limiting sales and leases, *supra* note 69, and fees and services, *supra* note 68, between sponsor and partnership, they may prohibit loans to the sponsor, prohibit sponsor benefits derived from owning adjoining land whose value is increased by the partnership program, and prohibit rebates; in all cases they require full disclosure. *See, e.g.*, MIDWEST POLICY, *supra* note 54, at § V; NASAA OIL AND GAS GUIDELINES, *supra* note 54, at § VI.

71. Because some operating programs have required investors to make increased investments, sometimes coupled with substantial penalties for failure to make them, the regulations normally limit both amounts that may be demanded and penalties that may be imposed. Real estate programs are often limited to demanding only amounts needed to cover taxes or other government assessments. CAL. ADMIN. CODE, tit. 10, § 260.140.116.8 (1977); MIDWEST POLICY, *supra* note 54, at § VII H. California prohibits forfeitures for failure to make added investments. CAL. ADMIN. CODE, tit. 10, § 260.140.116.9 (1973).

Oil and gas programs are limited to seeking a total of 100% of the initial investment, of which 25% may be mandatory. CAL. ADMIN. CODE, tit. 10, § 260.140.128.8 (1974); NASAA OIL AND GAS GUIDELINES, *supra* note 54, at § VIII E.

72. Some regulations state a broad sponsor fiduciary duty. *See, e.g.*, MIDWEST POLICY, *supra* note 54, at § IX A; NASAA OIL AND GAS GUIDELINES, *supra* note 54, at § VI B 2,5. Some limit the effect of exculpatory clauses. *See, e.g.*, CATTLE-FEEDING GUIDELINES, *supra* note 54, at § I F.

73. The regulations usually require that certain "partner democracy" provisions be included in the partnership agreement of registered partnerships. Typically, 10% of the limited partners may call a partnership meeting. Notice of such meetings is required. The general partner must provide access to a current list of limited partners. The limited partners must be given the right, by majority vote, to: (1) amend the partnership agreement, (2) dissolve the program, (3) remove the general partner and elect a new general partner, and (4) approve or disapprove the sale of all or substantially all of the partnership assets. The agreement must specify a method for valuation of the partnership interest of a removed general partner. *See, e.g.*, CAL. ADMIN. CODE, tit. 10, §§ 260.140.116.1, 260.140.116.2 (1977); MIDWEST POLICY, *supra* note 54, at §§ VII A and B.

In oil partnerships these rights must be provided, and in addition the limited partners must have the

The effectiveness of these regulations in curbing abuses is uncertain. Furthermore, many tax shelter investments are designed to be exempt from registration requirements and, hence, from most of the regulations.[74]

C. Interpretation of the Control Section

Section 7 has been one of the most heavily criticized sections of the 1916 ULPA.[75] While few cases interpreting section 7 have found limited partners to be generally liable for exercising control, the language courts have used in a number of cases has raised fears that limited partners might become generally liable merely for exercising reasonable investor supervision. Section 7 has created a lack of certainty and an element of unpredictability in partnership planning. It is a liability trap for the unwary. At the same time, by threatening a heavy penalty for the limited partner who exercises excessive control, the section has discouraged the careful limited partner from acting to resolve the partnership's financial or managerial crises. Seeking to circumvent section 7 problems, some limited partnerships have been structured to permit limited partners to control a corporate general partner. Recent decisions making these limited partners generally liable have made this a risky approach. The problems created

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power to vote to replace a withdrawing general partner and the right to cancel contracts for services made between the partnership and the sponsor or affiliates. NASAA OIL AND GAS GUIDELINES, *supra* note 54, at §§ VIII A, F.

The voting rights requirements are conditioned on conformity with state law. Because it is uncertain whether these rights might constitute control in violation of section 7 of the 1916 ULPA, *supra* note 2, their enforcement has been weak. *See* Augustine, Fass, Lester & Robinson, *The Liability of Limited Partners Having Certain Statutory Voting Rights Affecting the Basic Structure of the Partnership*, 31 BUS. LAW. 2087 (1976); Comment, *Can Rights Required to be Given Limited Partners Under New Tax Shelter Investment Regulations Be Reconciled with Section 7 of the Uniform Limited Partnership Act?*, 26 OKLA L. REV. 289 (1973).

74. The SEC noted that "[i]t is impossible to state definitely how much the public has invested in real estate investment partnerships, corporations, and trusts, since a *major portion of the public offerings have been made locally in intrastate offerings*. Such offerings are exempted from registration under the Securities Act of 1933. . . ." SPECIAL STUDY, *supra* note 42, at 576 (emphasis added). This remains true. *See* Comment, *Real Estate Limited Partnerships and Allocational Efficiency: The Incentive to Sue for Securities Fraud*, 63 VA. L. REV. 669, 670 n.10 (1977).

75. "The Section of the Uniform Limited Partnership Act that has caused the most difficulty is Section 7. . . ." Freidberg, *Limited Partnerships: A Non-Tax Analysis*, 32 N.Y.U. INST. FED. TAX. 1363, 1366 (1974). The most serious problem in drafting a limited partnership agreement is determining what "control" under section 7 is. Coleman & Weatherbie, *supra* note 32, at 897.

The leading article critically analyzing section 7 is Feld, *The "Control" Test for Limited Partnerships*, 82 HARV. L. REV. 1471 (1969). *See also* Feldman, *The Limited Partner's Participation in the Control of the Partnership Business*, 50 CONN. B.J. 168 (1976); Comment, *"Control" in the Limited Partnership*, 7 J. MAR. J. OF PRAC. AND PROC. 416 (1973); Comment, *Limited Partner Control and Liability Under the Revised Uniform Limited Partnership Act*, 32 SW. L.J. 1301 (1979).

by section 7 have tended to discourage use of the limited partnership form of business organization.[76]

Under section 7, the courts have considered three aspects of limited partner participation in limited partnerships: participation as limited partners, participation as partnership employees, and participation as officers or directors of a corporate general partner.

1. Participation as a Limited Partner

The relevent cases have all permitted some limited partner involvement. In some cases quite extensive limited partner participation has been permitted. However, dicta suggest a lack of consistent approach and a danger that liability might be assessed for rather slight participation. This has created continuing uncertainty.

Most courts have permitted limited partners to consult with and advise the general partner,[77] although at least one court has suggested that where advice carries great weight, the advising limited partner may be found to exercise control.[78] Limited partners have been permitted to exercise powers given in the partnership agreement to approve extraordinary transactions[79] and asset sales.[80] Similarly, a limited partner agent was permitted to share some authority with the general partner where his participation could be terminated by the general partner.[81]

A number of courts have permitted limited partners to bring derivative suits on behalf of the partnership.[82] However, some courts have stated that this limited partner participation was control in excess of that permitted a limited partner and would make the suing limited partner generally liable.[83]

Several courts have suggested that extensive limited partner participa-

76. "Neither the Act nor the decisions under it are very helpful on the critical question of how much review, advisory, management selection, or veto power a limited partner may have without being regarded as taking part in control. The resulting uncertainty is probably the greatest drawback of the limited partnership form." A. BROMBERG, *supra* note 1, at 147 (citations omitted). *See also* 32 Sw. L.J., *supra* note 75, at 1313.

77. Grainger v. Antoyan, 48 Cal. 2d 805, 313 P.2d 848 (1957); Silvola v. Rowlett, 129 Colo. 522, 272 P.2d 287 (1954) *(en banc);* Trans-Am Builders, Inc. v. Woods Mill, Ltd., 133 Ga. App. 411, 210 S.E.2d 866 (1974); Gast v. Petsinger, 228 Pa. Super. 394, 323 A.2d 371 (1974).

78. 323 A.2d at 375.

79. *Id.*

80. Stone Mountain Properties, Ltd. v. Helmer, 139 Ga. App. 865, 229 S.E.2d 779 (1976).

81. Plasteel Products Corp. v. Eisenberg, 170 F. Supp. 100 (D. Mass. 1959) (alternative holding), *aff'd on other grounds, sub nom.,* Plasteel Products Corp. v. Helman, 271 F.2d 354 (1st Cir. 1959).

82. *See* note 59 *supra.*

83. Bedolla v. Logan & Frazer, 52 Cal. App. 3d 118, 125 Cal. Rptr. 59 (1975); Executive Hotel Associates v. Elm Hotel, 41 Misc. 2d 354, 245 N.Y.S.2d 929 (Civ. Ct. 1964).

tion may be permitted in a partnership crisis, distinguishing such activity from day-to-day management.[84] In *Garrett v. Koepke,*[85] where limited partners marshalled and distributed partnership assets after the general partner resigned, the court decided that even if this was undue control, the limited partners were not thereby liable for debts incurred prior to their participation in management.[86]

Holzman v. De Escamilla[87] is the only case holding limited partners liable under section 7 for their activities as limited partners. In *Holzman,* the limited partners controlled partnership finances, overruled the general partner as to crop decisions, and finally replaced the general partner with a paid manager. Here the "limited partners" clearly controlled the partnership's affairs.

A few cases have emphasized creditor protection, finding that when a creditor knew that the limited partner was a limited partner, there was no reason to assess liability.[88] In *Rathke v. Griffith*[89] the court held that excessive control had not been exercised although the limited partner was a member of the partnership board (but never served in that capacity), had helped negotiate a partnership loan agreement and a contractor's contract, and had signed warranty deeds, loan agreements, leases, and a contract on behalf of the partnership. The court gave great weight to the fact that there was no evidence that the creditor knew of any of these acts of control.[90]

2. *Participation as an Employee*

Cases considering limited partners as employees have generally held that limited partners may be employed by the partnership so long as they lack final authority in such areas as hiring or credit extension and do not control partnership finances.[91] Courts examine each case closely to see

84. Weil v. Diversified Properties, 319 F. Supp. 778 (D.D.C. 1970); Trans-Am Builders, Inc. v. Woods Mill, Ltd., 133 Ga. App. 411, 210 S.E.2d 866 (1974).

85. 569 S.W.2d 568 (Tex. Civ. App. 1978).

86. The court decided that there was no liability even if conrol had been exercised since, in any case, the credit was extended before control was exercised. *Id.* at 571.

87. 86 Cal. App. 2d 858, 195 P.2d 833 (1948).

88. Silvola v. Rowlett, 129 Colo. 522, 272 P.2d 287 (1954) (*en banc*).

89. 36 Wn. 2d 394, 407–08, 218 P.2d 757, 764 (1950).

90. "[I]t is not alleged that respondent ever relied on Mr. Griffith's position as a general partner, or in fact ever understood that Mr. Griffith was anything other than a limited partner." *Id.* at 408, 218 P.2d at 764.

91. Grainger v. Antoyan, 48 Cal. 2d 805, 313 P.2d 848, 850 (1957) (Limited partner acted as new car sales manager; court emphasized that he did not hire or fire; he ordered new cars with general partner authorization, and co-signed checks only when requested to do so by the office manager in the general partner's absence. Held, no control); Silvola v. Rowlett, 129 Colo. 522, 272 P.2d 287, 290 (1954) (*en banc*) (Limited partner ran repair shop: although he bought parts and advised the general

that the limited partner does not in fact exercise substantial independent control.[92]

3. *Participation as an Officer or Director of a Corporate General Partner*

Several recent cases have considered whether a limited partner who controls the partnership as an officer or director of the corporate general partner should become personally liable.[93] Some courts have held that the purpose of section 7 is creditor protection. These courts have refused to assess liability where control was exercised through a corporate general partner since in that case there was no basis for creditor reliance.[94] Two courts have refused to read in a reliance requirement and have found liability.[95] In both cases considerations favoring disregard of the corporate entity entered into the court's decision.[96] Because of this split in approach, exercise of control through a corporate general partner is risky under section 7.

IV. THE 1976 UNIFORM LIMITED PARTNERSHIP ACT

A. *Limited Partner Rights*

While the 1976 ULPA makes a number of changes in provisions affecting limited partners, the rights granted under the Act are not substantially different from those granted under the 1916 ULPA. Approval rights have been reduced somewhat while access to the courts has been facilitated.

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partner he was not authorized to extend credit except to those persons he knew personally, and the general partner controlled partnership finances. Held, no control).

92. Gast v. Petsinger, 228 Pa. Super. 394, 323 A.2d 371, 375 (1974) (two of the limited partners served as consultants to a highly technical partnership business; court reversed the trial court's grant of summary judgment for these limited partners, holding that the facts must be examined to ascertain whether the limited partners had decision-making authority that could not be checked or nullified by the general partner).

93. A number of recent casenotes discuss these cases and the problems they create. *See* Note, *The Corporation as Managing Partner in a Limited Partnership*, 55 N.D. L. REV. 271 (1979); 31 OKLA. L. REV. 997 (1978); 47 U. CIN. L. REV. 355 (1978); 53 WASH. L. REV. 775 (1977).

94. Western Camps, Inc. v. Riverway Ranch Enterprises, 70 Cal. App. 3d 714, 729–30, 138 Cal. Rptr. 918, 926–27 (1977); Frigidaire Sales Corp. v. Union Properties, Inc., 88 Wn. 2d 400, 404–05, 562 P.2d 244, 246–47 (1977) (*en banc*).

95. Mursor Builders, Inc. v. Crown Mountain Apartment Associates, 467 F. Supp. 1316, 1333–34 (D. V.I. 1978); Delaney v. Fidelity Lease, Ltd., 526 S.W.2d 543, 545 (Tex. 1975).

96. In *Delaney*, the court emphasized that the corporate general partner had been formed specifically to manage the limited partnership and had no independent existence. 526 S.W.2d at 545. In *Frigidaire*, the Washington court distinguished *Delaney* on this basis. 88 Wn. 2d at 403, 562 P.2d at 246. In *Mursor*, the limited partners had intermingled personal, corporate, and partnership finances. 467 F. Supp. at 1333.

1. *Approval Rights*

The 1976 ULPA requires all initial partners to sign the partnership certificate.[97] Unlike the old Act, the 1976 ULPA does not generally require limited partner signature on amendments[98] and explicitly permits approval by an attorney-in-fact.[99]

The 1976 ULPA retains the requirement that limited partners specifically approve the appointment of any new general partner[100] and the continuation of the partnership after general partner withdrawal.[101] In addition, the new Act requires specific approval by any new limited partner of the certificate amendment making him or her a partner[102] and by any limited partner for an amendment increasing the contribution of that partner.[103] Despite these two new provisions, the limited partner's right to approve amendments is reduced by the revised Act.

2. *Access to Partnership Information*

Though the 1976 ULPA requires little disclosure, it somewhat increases limited partner access to partnership information. The Act specifies that a general partner shall provide true and full information about both the partnership business and the financial condition of the partnership upon reasonable demand.[104] The old Act provided that limited partners had the right to have the partnership books kept in the partnership's place of business and to inspect and copy them.[105] The 1976 ULPA provides that a full list of all partners, a current certificate as amended, the current written partnership agreement, all tax returns and reports, and any partnership financial statements shall be so available.[106] Furthermore, amendments to the partnership certificate shall be promptly mailed or delivered to the limited partners.[107] This ensures notice of certain changes in the partnership structure.

3. *Access to the Courts*

The 1976 ULPA continues to provide limited partners with the same

97. 1976 ULPA, *supra* note 3, at § 204(a)(1).
98. *Id.* at § 204(a)(2).
99. *Id.* at § 204(b).
100. *Id.* at § 401.
101. *Id.* at § 801(3).
102. *Id.* at § 204(a)(2).
103. *Id.*
104. *Id.* at § 305.
105. 1916 ULPA, *supra* note 2, at § 10(1)(a). *See* notes 22–23 and accompanying text *supra*.
106. 1976 ULPA, *supra* note 3, at § 105.
107. *Id.* at § 209.

right as general partners to seek an accounting or judicial dissolution.[108] However, the limited partner who fails to receive a rightful distribution can no longer seek dissolution; instead, under the 1976 ULPA, he has the same remedies as a creditor.[109] Aside from this modification which eliminates an unduly harsh remedy, one which could be disastrous to the other partners, the right to dissolution is probably slightly increased after substantial rewriting in the provisions governing dissolution.[110]

The new Act, like the old, incorporates section 21 of the Uniform Partnership Act dealing with fiduciary duties of partners.[111]

A new power granted to limited partners under the 1976 Act is the right to bring partner derivative suits on behalf of the partnership.[112] These suits were not authorized by the old Act, though most courts when faced with the question did allow limited partners to initiate such suits.[113] The section permitting partner derivative suits contains few procedural requirements.[114] As a result, the right to bring derivative actions is more readily available under the 1976 ULPA than it is under most corporate law provisions for shareholder derivative suits.[115] The provision permitting partner derivative suits will protect limited partners when general partners wrongfully fail to prosecute a partnership claim.

B. Limitations on Control

Recognizing the criticisms of section 7 of the 1916 ULPA, the Commissioners drafted a substantially expanded control provision in section 303 of the 1976 ULPA. Unfortunately, their efforts failed to solve many of the problems created by the old section. The overall effect of the new section, like the old, is to obstruct most limited partner participation in limited partnerships. In fact, the new control section probably narrows the control that a limited partner may exercise. While the new provisions are generally clearer than the old, they do not clarify the liability of the limited partner who seeks to resolve a partnership crisis or who exercises control of a limited partnership through a corporate general partner.

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108. *Id.* at § 802.

109. *Id.* at § 606.

110. *See* Shapiro, *supra* note 4, at 567–69.

111. *See* 1976 ULPA, *supra* note 3, at § 1005 ("In any case not provided for in this Act the provisions of the Uniform Partnership Act govern.").

112. *Id.* at §§ 1001–1004. *See generally* Hecker, *supra* note 4.

113. *See* notes 17–21 and accompanying text *supra*.

114. *See* Hecker, *supra* note 4, at 361–74. The 1976 ULPA also permits a successful plaintiff to recover expenses. 1976 ULPA, *supra* note 3, at § 1004.

115. *See, e.g.*, WASH. REV. CODE § 23A.08.460 providing *inter alia* for award of expenses, including attorney fees, to successful defendants and providing for security for such awards.

1. Section 303(b)—Defining Control

Section 303(b) modifies the control provisions of the new Act by creating a "safe harbor" of defined activities that will not be deemed control in violation of section 303(a). Sections 303(b)(1), (2), and (3) permit activities generally sanctioned by existing case law. Specifically a limited partner may be an employee, contractor, or agent of the partnership;[116] may advise and consult with the general partner;[117] and may act as surety.[118] Section 303(b)(4) permits limited partners to approve or disapprove amendments to the partnership agreement.[119]

Section 393(b)(5) permits partnerships to grant limited partners the right to vote on five matters basic to the structure of the limited partnership. These are:

> i. the dissolution and winding up of the limited partnership;
> ii. the sale, exchange, lease, mortgage, pledge, or other transfer of all or substantially all of the assets of the limited partnership other than in the ordinary course of its business;
> iii. the incurrence of indebtedness by the limited partnership other than in the ordinary course of its business;
> iv. a change in the nature of the business; or
> v. the removal of a general partner.[120]

This section is similar to amendments of the 1916 ULPA presently effective in several states.[121]

Since subsection 5 is only permissive, it is likely that many limited partnership agreements will not give limited partners these voting powers. However, the section will have a substantial impact on those limited partnerships which are required to register under securities rules and regulations[122] since many of these regulations require that limited partners be given certain of these voting rights.[123] Section 303(b)(5) will ensure that limited partners may exercise these rights without the threat of general liability.

Section 303(b) is effective in eliminating some of the uncertainty as to the extent of permissible control. However, section 303(b) does not au-

116. 1976 ULPA, *supra* note 3, at § 303(b)(1).
117. *Id.* at § 303(b)(2).
118. *Id.* at § 303(b)(3).
119. *Id.* at § 303(b)(4). This power was implied in the 1916 ULPA since limited partner approval of amendments was required by that act. *See* text accompanying notes 17 and 18 *supra*.
120. 1976 ULPA, *supra* note 3, at § 303(b)(5).
121. *See* note 62 and accompanying text *supra*.
122. *See* text accompanying notes 64–74 *supra*.
123. *See* note 73 *supra*.

thorize any limited partner oversight of partnership affairs except the giving of advice. It does not go far enough to permit reasonable investor control.

2. Section 303(a)—The New Control Provision

Section 303(a) restates the control test of section 7 to provide two levels of liability for limited partners who exercise control in excess of that permitted under the Act. Under section 303(a), a limited partner becomes generally liable if his control is "substantially the same as the exercise of the powers of a general partner."[124] The limited partner who exercises control less than that of a general partner can become liable "only to persons who transact business with the limited partnership with actual knowledge of his participation."[125]

According to the Comments to the section, the provision for general liability where a limited partner exercises control that is "substantially the same as" that of a general partner is intended "to avoid permitting a limited partner to exercise all of the powers of a general partner while avoiding any direct dealings with third parties. . . ."[126] Arguably only a limited partner who acts as a general partner in all but name should become generally liable under this clause. For example, the limited partner who actually participates in and controls day-to-day decisions and activities would become generally liable.[127] On the other hand, a limited partner who exercises indirect control, for instance through selection of an employee of the partnership who shared financial control with the general partner, would not be exercising day-to-day management and should fall outside the clause.[128] Such a narrow reading would provide reasonable predictability for partners and for their counsel.[129]

Limited partner liability to "persons who transact business with the limited partnership with actual knowledge of his control" provides an additional basis for limited partner liability. This clause is apparently intended to protect creditors and other third parties.[130] However, by its wording it sweeps very broadly and could lead to liability in many situations where there has been no liability under section 7. For example, a

124. 1976 ULPA, *supra* note 3, at § 303(a).

125. *Id.*

126. Commissioners' Comments to section 303, 6 UNIFORM LAWS ANN. 141 (Supp. 1980).

127. This is in accord with court interpretation of section 7 of the 1916 ULPA. *See* text accompanying notes 75–76 *supra*.

128. This, too, is in accord with results under section 7. *See* Plasteel Products Corp. v. Helman, 271 F.2d 354 (1st Cir. 1959).

129. The few cases where liability was imposed under section 7 involved control which meets this test. *See* notes 87 and 95 and accompanying text *supra*.

130. *See* 32 Sw. L.J., *supra* note 75, at 1323.

limited partner who participates in obtaining partnership credit could be found to have exercised control beyond his rights as a limited partner.[131] Clearly the lender would actually know of this participation and a court might find that the limited partner was liable to that lender even in the absence of evidence of actual reliance. Similarly, the participation of limited partners in trying to salvage a struggling partnership might well lead to general liability under this clause.[132] It appears that the "actual knowledge" test will, like section 7, lead to uncertainty, a lack of predictability in planning, and excessive limited partner passivity.[133]

V. PROPOSED CHANGES IN THE 1976 UNIFORM LIMITED PARTNERSHIP ACT

The 1976 ULPA should be amended to resolve the limited partnership problems discussed. The 1976 ULPA, like the 1916 ULPA, encourages the limited partner to seek judicial resolution of partnership problems. Yet often the courts cannot provide the best remedies;[134] indeed, seeking a judicial remedy will often exacerbate problems. Modifications of the 1976 ULPA should permit limited partners some opportunities for direct resolution of partnership problems. Such a resolution will generally be quicker, less expensive, and more direct than litigation; it avoids both the harm to relationships that frequently results from recourse to the courts and the continuing damage that results from delays.

A. *Permitting Reasonable Participation—Limiting the Control Provisions*

The control section should be altered to allow reasonable limited partner participation in the partnership. The reluctance to grant limited liability and concern with protection of creditors justified section 7 in 1916.[135] Today, however, both of these considerations have lost their weight. Apparently, the Commissioners retained the control provisions as part of their plan to "retain the special character of limited partnerships as com-

131. As the limited partner did in Rathke v. Griffith, 36 Wn. 2d 394, 218 P.2d 757 (1950). *See* note 89 and accompanying text *supra*.

132. Again leading to possible liability where there was none under section 7. *See* notes 84–86 and accompanying text *supra*.

133. The same general conclusion was reached in Comment, *Limited Partner Control and Liability Under the Revised Uniform Limited Partnership Act*, 32 Sw. L.J. 1301 (1979).

134. Judicial remedies may be particularly inadequate in the tax shelter context because the investor who obtains damages loses the tax shelter benefits that made the investment attractive. For a discussion of this problem, see Comment, *Real Estate Limited Partnerships and Allocational Efficiency: The Incentive to Sue for Securities Fraud*, 63 VA. L. REV. 669 (1977).

135. *See* notes 8–16 and accompanying text *supra*.

pared with corporations."[136] However, this purpose, without more, does not justify the cost in terms of investor protection. The actual differences between limited partnerships and corporations have diminished significantly.[137] There is a substantial overlap in the organizational characteristics of the two forms which fits with a general tendency to promote economic growth through greater flexibility in business structures.

In retaining the control provision, the Commissioners probably sought to ensure partnership tax treatment for limited partnerships organized under the revised Act. Under the Treasury regulations which differentiate between partnerships and associations taxable as corporations,[138] limited partnerships formed under the 1916 ULPA always qualify as partnerships. The Commissioners sought to assure the same result under the 1976 ULPA.[139] Certainty regarding tax treatment is of such great importance that, at the recommendation of the Commissioner,[140] no legislature adopted the 1976 ULPA until the Internal Revenue Service officially stated that partnership tax treatment would be accorded limited partnerships organized under the new Act.[141]

One basis for automatic tax categorization as a partnership is the determination that limited partnerships lack the corporate characteristic of limited liability.[142] Ordinarily, the general liability of the general partner establishes that the partnership does not have limited liability for tax purposes. However, where the general partner has no assets and is a mere dummy for the limited partners, there may be limited liability in fact.[143] The control provisions operate in this situation to make the limited partners generally liable. If the control provision did not have this effect, then the presence or absence of limited liability would be a factual determination—the result which the Commissioners sought to avoid. To avoid this case-by-case determination, it is adequate to retain the provision imposing liability where a limited partner exercises control "substantially the same as" that of a general partner.

There is no adequate reason, however, for also retaining the second test, the "actual knowledge" test. This test's apparent purpose is not tax classification but creditor protection. Creditor interests are provided for by the new requirement that limited partnerships shall have "limited part-

136. Commissioners' Comment to 1976 ULPA, 6 U.L.A. *supra* note 8, at 127 (Supp. 1980).
137. *See* Hrusoff & Cazares, *supra* note 15, at 100–01.
138. Treas. Reg. § 301.7701–2 (1960).
139. *See* Caveat, 6 UNIFORM LAWS ANN. 148 (Supp. 1980).
140. *Id.*
141. *See* note 5 *supra*.
142. Treas. Reg. § 301.7701–2(a), (d) (1960).
143. Treas. Reg. § 301.7701–2(d)(2) (1960).

nership'' in their name.[144] The lender, thus put on notice, can ascertain who is personally liable and seek additional security or guarantees if necessary.[145] Other doctrines exist to protect the creditor who is misled.[146] And even if additional protection is needed, a far narrower provision would provide it.

Alternatively a more narrowly drafted creditor-protection clause could make limited partners liable only to those third parties who reasonably believe the limited partner to be a general partner and rely on this belief in dealings with the partnership. As drafted, the actual knowledge test can heavily penalize limited partner participation even though that participation is to the partnership's advantage and is appropriate for protection of the limited partner's investment. There is no reason for this harsh result if the third party was not misled and did not in fact rely on the limited partner's apparent liability.

B. *Access to Partnership Information—A Duty to Disclose*

A statutory duty to disclose information about the partnership upon investment,[147] annually, and when conflicts of interest or substantial unforeseen events or changes in partnership operations occur, would significantly increase limited partner ability to exercise reasonable control of the limited partner investment. A duty to disclose partnership information may effectively curb some managerial abuse.[148] By ensuring early notice of partnership difficulties, such a duty will increase the likelihood of salvage of the partnership business. Where a general partner fails to disclose information, this will serve as a red flag both to the limited partners (if they learn about it) and, if there is litigation, to the courts.

At the least it is appropriate to require an annual report of the progress of the partnership.[149] Additional disclosure should be required whenever

144. 1976 ULPA, *supra* note 3, at § 102(1).

145. This protection is believed to be adequate for corporate creditors.

146. Examples include the contract concepts of reliance and collateral estoppel.

147. Rule 10b–5 requires disclosure at the time investors are sought, even for unregistered offerings. 17 C.F.R. § 240.10b–5 (1980).

148. This is one of the rationales underlying the disclosure emphasis of federal securities regulation. *See* Marsh, *Are Directors Trustees?*, 22 BUS. LAW 35, 50–51 (1966).

149. Little and Drasner state:

> Once the sale is over, the typical limited partner customarily does not enjoy the flow of information and attention that generally has come to be accorded to the corporate investor. There is no newspaper which reflects the day-to-day fluctuations in the value of his investment. Annual reports and periodic reports, when they are furnished, tend to be sketchy and confined largely to financial information. Relatively few general partners concern themselves, to any significant extent, with follow-up literature and an informational flow to the limited partners. Moreover, few partnerships furnish limited partners financial and other data covering the operations of the general partner.

substantial deviation from the partnership's initial plan occurs. Disclosure of any proposed transaction that involves a general partner conflict of interest should also be required.

Such provisions would have advantages: They clarify disclosure requirements which are now somewhat uncertain; they enable limited partners to keep apprised of the affairs of the partnership in a routine and orderly manner; and they clarify for both the courts and the general partner the extent of the general partner's duty.

Are these requirements so burdensome that they will discourage entrepreneurs from using the limited partnership form of operation? While these requirements will be somewhat burdensome, in the well-run partnership they will simply involve a duty to communicate to the limited partners information which is available for managerial purposes already. The requirements would discourage two types of partnership.

First, they would correctly discourage the sloppy and ill-controlled partnership. It is one thing for an entrepreneur to be sloppy with his or her own money. It is quite another for a general partner to be sloppy with funds over which the limited partner-investors have little or no control, and which they have placed irrevocably in the general partner's hands.[150]

Second, they would discourage the partnership organized for general partner advantage to such a degree that limited partners probably would object if they knew. It is unlikely that such objections would occur when general partner remuneration is essentially fair; however, when remuneration *is* fair, it should be possible for the general partner to demonstrate that fact. Some particularly complicated partnerships might run into problems in trying to disclose proposed arrangements. However, by and

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Little & Drasner, *supra* note 46, at 90–91.

There appears to be a substantial need to require continuing disclosure. "The failure of many privately placed tax shelter partnerships to provide their investors with [quarterly and annual] reports has been considered by the NASD and blue sky authorities to be one of the areas for potential abuse in these types of securities." Hacker & Rotunda, *supra* note 39, at 340–41. *See* note 65 *supra* (discussing disclosure requirements).

150. The transferability of limited partnership interests is usually restricted. Many partnership agreements contain provisions requiring general partner approval of any transfer; these provisions are intended to establish the characteristic of limited transferability for tax classifications. *See* Treas. Reg. § 301.7701-2(e) (1960). Probably more important is the lack of a ready market. This results from the tax consequences of transfer, THE DICKEY REPORT, *supra* note 40, at 10–11, as well as from the difficulties of valuation and the lack of trading, which affect any untraded business interest. Hrusoff and Cazares, *supra* note 15, at 116–17.

Of course, when the right of removal of the general partner is granted to the limited partners, as it can be under the 1976 ULPA and under some present limited partnership acts, *see* note 62 *supra*, the limited partners do have the ultimate possibility of removal. However, in practice this will be difficult to effect in most cases. *See, e.g.*, Roulac, *supra* note 39. Normally a limited partner is tied in to a partnership very much as a minority shareholder is tied in to a closely held corporation.

large, provisions for disclosure will probably discourage those partnerships where arrangements are in fact unfair.

C. *Limited Partner Power*

Limited partners need the power to disapprove general partner actions primarily in two situations. First, limited partners should be able to limit or control extraordinary general partner actions not proposed at the time of partnership formation. Second, limited partners should be able to exercise authority to limit or control partnership transactions in which the general partner has a conflict of interest.

In designing reforms that will provide these powers, a legislature faces two constraints. First, reforms must avoid all provisions that will bring into question automatic classification of limited partnerships as partnerships for tax purposes. Second, reforms must be designed to avoid making the limited partnership vehicle too clumsy or too unrewarding to be attractive to potential promoter-general partners. While there are many problems in designing an appropriate method for limited partner control of self-dealing and of extraordinary events, the need for such control is too great to ignore.

Three general approaches are available for protecting investors. The first is a flat prohibition of transactions involving general partner conflict of interest. This was the early approach to conflicts of interest in corporations.[151] This is also the approach adopted by some of the security regulations applicable to limited partnership ventures.[152] A second approach has been to grant investors removal power. This is the basic approach of corporate law provisions permitting investors to periodically vote for the board of directors. Such power may be granted by agreement of the partners under the 1976 ULPA.[153] It is also provided for in some securities regulations applicable to limited partnerships.[154] The third approach is to require specific limited partner approval of all transactions involving a general partner conflict of interest.

Each of these approaches has its advantages and disadvantages. A flat prohibition of transactions involving a conflict of interest is probably not workable.[155] Removal powers, while giving substantial power, may be excessive in situations where the partnership is otherwise healthy; and it

151. *See* Marsh, *supra* note 148, at 36–39.

152. *See* note 69 *supra*.

153. *See* text accompanying notes 116–123 *supra*.

154. *See* note 73 *supra*.

155. If enforced, such a rule would eliminate tax shelter limited partnerships as they presently exist. The rigidity of such a rule would be a strong disincentive to the use of the limited partnership form of organization.

will be ineffective where the partnership is failing. Implementing removal power will be difficult both in terms of creating an appropriate opportunity to exercise it and in terms of fairly compensating both outgoing and incoming general partners.[156]

Although approval powers can easily become unduly cumbersome, they appear to offer the best solution. This approach parallels the requirement of some securities regulations and corporate law proposals requiring approval of transactions involving a conflict of interest by disinterested trustees[157] or directors.[158] Approval powers are accorded under the 1916 ULPA[159] and are consonant with the character of limited partnerships. An approval provision should require unanimous approval; in the past, voting provisions providing for less than unanimous limited partner action created tax classification problems.[160] To avoid making the process impossibly cumbersome, a revised provision could require limited partner approval of transactions involving general partner conflict of interest or extraordinary partnership events combined with permission for larger limited partnerships to substitute an equivalent voting provision.

VI. CONCLUSION

Since the 1916 ULPA was drafted, the typical limited partnership has changed from a small, consensual organization to a relatively large, impersonal, and risky tax-oriented organization. This change has resulted in substantial problems of partnership failure and general partner abuse. Despite these admitted problems, the 1976 ULPA makes few changes that address them.

156. For a discussion of these problems, *see* Roulac, *supra* note 39.

157. This is now a proposed requirement for real estate investment trusts. MIDWEST SECURITIES COMMISSIONERS' ASS'N, STATEMENT OF POLICY ON REAL ESTATE INVESTMENT TRUSTS, (adopted July 16, 1970), *reprinted in* [1980] 1 BLUE SKY L. REP. (CCH) ¶ 4801 B.

158. ABA-ALI MODEL BUS. CORP. ACT § 41 (a) (1953). Alternatively, the MBCA permits shareholder approval, *id.* at § 41 (b), or any transaction "fair and reasonable to the corporation." *Id.* at § 41(c).

159. *See* text accompanying notes 17–29 *supra*.

160. *See* Haims and Strock, *supra* note 36, at 496–97.

Legislators should consider modifying the 1976 ULPA to deal with these problems. Three areas of change are recommended. First, the control provision, which subjects a limited partner to loss of limited liability for excessive exercises of control, should be greatly narrowed. Broader liability should result only when a limited partner exercises "control substantially the same as" that of a general partner. Any additional provision for limited partner liability should be premised on reasonable creditor reliance. A modified act should also take a position on the liability of limited partners controlling a corporate general partner.

Second, general partners should have a duty to provide information about the partnership to the limited partners. A modified act should establish requirements for disclosure at the time of investment and annually thereafter; it should also require that the general partner disclose both extraordinary partnership events and transactions involving conflicts of interest.

Last, limited partners should be given power to respond directly to partnership crises and to control general partner self-dealing. This power could take a number of forms. Probably the approach most consistent with both the tax regulations and the special character of the limited partnership is to grant limited partners the power to approve extraordinary partnership actions and transactions involving a general partner conflict of interest.

These recommendations should prove tax neutral. They provide means of resolving partnership problems without resort to the courts and in a manner consistent with the basic nature of the limited partnership.

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