THE CONTROL TEST OF INVESTOR LIABILITY IN LIMITED PARTNERSHIPS*

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Limited liability for investors is a major attraction of the limited partnership. The retention of this limited liability depends on the extent of the rights and powers exercised by the limited partners. Limited liability is lost if the limited partners exercise control over the enterprise in which they have invested. Unfortunately, the determination of what activities amount to "control" has proved to be a very difficult matter. Guidelines have not been established and much uncertainty exists.

The whole purpose of limited partnership legislation is to limit the liability of passive profit-sharing investors in business enterprises.[1] Limited liability is granted to such investors on the basis that no public policy requires a person who invests in a business to be fully personally liable if he has not held himself out as being generally liable nor been any part of the cause of a loss suffered by third parties dealing with or affected by that business.[2] To ensure that investors are and remain passive in so far as third parties are concerned, they are expressly prohibited from taking part in the control of the business. The following discussion considers the extent to which this prohibition on control restricts the rights and powers that limited partners may safely exercise.

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* In its original form this article dealt with the control test of investor liability for both limited partnerships and business trusts. The limited partnership and business trust are structurally similar and, not surprisingly, the tests for investor liability in each case are virtually identical in terms of rationale and application.

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1. In this regard, it has been questioned whether this legislation makes any improvement on the existing common law. *See* J.A. Crane, "Are Limited Partnerships Necessary?" (1933) 17 *Minn. Law Rev.* 351. As to the nature and use of limited partnership legislation, *see generally* Ehrcke, W.F. and Wertschek, R., "An Introduction to Limited Partnerships" (1980-1981) 39 *Advocate* 381; Peterson, R., "Public Limited Partnerships in Real Estate Syndications" (1973-74) 12 *W. Ont. Law Rev.* 81; Powers, R.G., "Limited Partnerships in the Alberta Oil and Gas Industry" (1978) 16 *Alta. Law Rev.* 153. Early commentary on American limited partnership legislation is found in Burdick, F.M., "Limited Partnerships in America and England" (1908) 6 *Mich. Law Rev.* 525; Lewis, W.D., "The Uniform Limited Partnership Act" (1917) 65 *U. of Pa. Law Rev.* 715; Crane, J.A., "Are Limited Partnerships Necessary?" (1933) 17 *Minn. Law Rev.* 351; "The Limited Partnership" (1936) 45 *Yale Law J.* 895 (Comment); Katz, W., "A Common Fallacy Respecting Limited Partnerships" (1945) 20 *S. Bar J.* 105, Chel, F.W., "The Limited Partnership" (1954-55) 2 *U.C.L.A. Law Rev.* 105; Caudill, J.W. and Fendler, O., "The Uniform Limited Partnership Act" (1954) 59 *Comm. Law J.* 5; Nadler, C.E., "The Limited Partnership Under the Uniform Limited Partnership Act" (1960) 65 *Comm. Law J.* 71. For more recent commentary on American limited partnership legislation, *see* notes 45 and 101.

2. *See* the Official Comment to the Uniform Limited Partnership Act in *Uniform Laws Annotated* (1969) Vol. 6 at 562-565. Limited liability, in every other legal relationship, is a natural consequence of that relationship. Individuals, corporations, principals and trustees are all fully liable because it was they who incurred the obligation. Shareholders, agents and beneficiaries are, correspondingly, not liable or not liable beyond their contributions so long as the necessary legal relationship is maintained in fact. Limited partners must be prevented from taking part in control in order that there be no derogation from the general rule that a person is fully personally liable for the obligations he has actually incurred or for which he is responsible.

I. THE LEGISLATION

The limited partnership legislation of both Alberta[3] and Ontario[4] grants specific rights and powers to limited partners. Because these rights and powers are expressly granted they cannot amount to participation in control under such legislation[5] even if they might otherwise.[6] In both provinces a limited partner has the right to inspect the partnership books, demand full information on all matters affecting the partnership, acquire a formal account of partnership affairs, dissolve the partnership by court order, receive a share of the profits or other income and obtain the return of his contribution.[7] Further, a limited partner may make loans to and transact other business with the partnership,[8] assign his partnership interest,[9] consent to the continuation of the partnership upon the retirement, death or mental incompetence of one of the general partners (and, in Ontario, the dissolution of a corporate general partner)[10] and give written authority to any person to sign on his behalf any document referred to in the legislation.[11] In addition to these rights and powers the consent or ratification of the limited partners is required in each specific instance when the general partner does any act in contravention of the certificate (or, in Ontario, the partnership agreement), does any act which makes it impossible to carry on the ordinary business of the partnership, consents to a judgment against the partnership, possesses partnership property or assigns any rights in specific partnership property for other than a partnership purpose, admits a person as a general partner, admits a person as a limited partner unless the right to do so is given in the certificate or continues the business of the partnership on the death, retirement or mental incompetence of a general partner unless the right to do so is given in the certificate.[12] The Ontario legislation adds that limited partners may, from time to time, examine into the state and progress of the partnership business, advise as to partnership management, act as a contractor for or an agent or employee of the partnership or general partner and act as a surety for the partnership.[13]

So long as limited partners are content with those rights and powers specifically provided for by legislation their limited liability will be assured.[14] However, once additional rights and powers are given to the

3. The Partnership Act, R.S.A. 1980, c. P-2.
4. The Limited Partnerships Act, 1980, R.S.O. 1980, c. 241.
5. This would be so even absent the specific exemption found in s. 63 of the Alberta Act and s. 12 of the Ontario Act.
6. Many, if not all, of the matters dealt with in s. 55 of the Alberta Act and s. 7 of the Ontario Act would amount to participation in control if decided by limited partners absent statutory permission.
7. Alta., s. 57, 58; Ont., ss. 9, 10. These rights are clarified in the remainder of the applicable Act.
8. Alta., s. 59; Ont. s. 11(1).
9. Alta., s. 65; Ont., s. 17.
10. Alta., s. 66; Ont., s. 20.
11. Alta., s. 77; Ont., s. 29.
12. Alta., s. 55; Ont., s. 7.
13. S. 11(2).
14. Subject to compliance with specific provisions of both Acts imposing full liability. *See* Alta., ss. 53, 73, 74 and Ont., ss. 5, 27, 28.

limited partners their retention of limited liability becomes less certain. The statutory provisions applicable for the purpose of determining limited partner liability exposure are,[15] in Alberta:

> 63. A limited partner does not become liable as a general partner unless, in addition to exercising his rights and powers as a limited partner, he takes part in the control of the business.

and, in Ontario:

> 12. (1) A limited partner is not liable as a general partner unless, in addition to exercising his rights and powers as a limited partner, he takes part in the control of the business.
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> (2) For the purposes of subsection 1, a limited partner shall not be presumed to be taking part in the control of the business by reason only that the limited partner exercises rights and powers in addition to the rights and powers conferred upon the limited partner by this Act.

The first point to be made with respect to these statutory provisions is that the clarification of s. 12(1) found in s-s.2 of the Ontario legislation, although helpful, is probably unnecessary.[16] The reason for the inclusion of s. 12(2) is to prevent an inference being drawn that the statutory enumeration of limited partner rights and powers is intended to be exhaustive.[17] This, it is submitted, is an excess of caution as no such inference is properly extracted once s. 12(1) is fully analyzed. The test for liability under s. 12(1) (and sec. 63 of the Alberta Act) is participation in control and not the exercise of rights and powers beyond those provided by legislation. The test of participation in control involves a question of fact and is independent of the mere exercise of limited partner rights and powers. Additional rights and powers are only factors in the determination of participation in control. The exercise of additional rights and powers may amount to participation in control but that question is to be answered upon an application of the control test; it is not answered merely by finding that such rights and powers are not given by statute. This is well illustrated by a simple example in which a limited partner has under the partnership agreement the right to vote on the appointment of an inspector who is to inquire into and report on the conduct of the general partners. This additional right, when exercised, cannot amount to participation in control under any reasonable view of the control concept. The word "control" is not meaningless.[18] It contemplates at least some ability to act in or have an effect on the partnership business. No such ability is given by this particular right. That being so, s. 12(1) cannot dissolve the limited liability of this limited partner. This is the clear result under s. 12(1) and

15. These provisions are almost verbatim copies of s. 7 of the American Uniform Limited Partnership Act, *supra* n. 2 at 582 (s. 7 is set out at note 46, *infra*). Note that the British Columbia provision is somewhat different. S. 64 of the B.C. Partnership Act, R.S.B.C. 1979, c.312, states that "A limited partner is not liable as a general partner unless he takes part in the management of the business."

16. S. 12(2) is probably based on the similar provision in the new Revised Uniform Limited Partnership Act of the United States. *See* the 1979 Cummulative Annual Pocket Part of *Uniform Laws Annoted* (1969) Vol. 6. The 1976 revision of the 1916 model limited partnership legislation was substantial but was largely bypassed by Ontario in its 1980 Act in favour of uniformity with other Canadian jurisdictions that had earlier adopted the 1916 model.

17. Given the particularity with which limited partner rights and powers are described in the statutes, it is certainly arguable that the draftsmen may have considered them to be adequate. In any event, as described in subsequent text, the words of the control prohibition do not allow the feared inference to be drawn.

18. The *Webster's New World Dictionary* (2nd ed., 1970) defines 'control' as a verb "to exercise authority over; direct; command" and as a noun "the act or fact of controlling; power to direct or regulate; ability to use effectively".

there is nothing in the remainder of the legislation to suggest otherwise.[19]

A second point is that these control provisions presumably require an actual exercise of rights and powers that amount to participation in control. Further, it would seem that "takes part in the control" means participation either alone or as part of a controlling group (e.g. as an active member of a partnership executive committee[20] or together with all the other limited and general partners). These considerations underline the factual nature of the control test.

Although there are a number of interpretive problems with these control provisions[21], the most serious one is the exact meaning to be attached to the phrase "takes part in the control of the business". There is no clarification of this phrase[22] nor is there a definition of the word "control". No Canadian case has interpreted these provisions[23] and case law dealing with the creation of a *de facto* general partnership is not helpful.[24] The draftsman of a limited partnership agreement has only this single phrase to guide him in determining what rights and powers the limited partners may exercise without becoming liable as general partners. The resulting uncertainty as to permissible limited partner rights and powers is said to be the greatest single defect in such legislation.[25]

It is here submitted that these control provisions are more certain than would first appear. The immediately following discussion interprets these provisions utilizing an analysis of the underlying policy considerations.

II. POLICY

In resolving the control-liability issue the most important considerations will be the policies involved and the extent to which they are given effect by the control provision.[26] From a consideration of policy it should be possible to extract guidelines or tests which establish when participation in control occurs.

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19. In fact s-s. 12(1) is the only provision of the Act applicable when additional rights and powers of limited partners are being considered in connection with participation in control.

20. In *Rathke* v. *Griffith* (1950) 218 P (2d) 757, 18 A.L.R.(2d) 1349, a limited partner was not liable as a general partner as a result of being named to the management committee of the firm because he never acted in that capacity.

21. For example, it is not clear what the extent of the limited partner's liability is. Does he continue to be liable as a general partner even after he has ceased to take part in control? Another example is the meaning of the words "his rights and powers as a limited partner." Does this mean only his statutory rights and powers or all his rights and powers? Unfortunately, in this instance either interpretation will provide the same final result.

22. All that is clear is that the mere exercise of additional rights and powers is not by itself a participation in control.

23. *See* part IV, *infra.*

24. *See* H.J. Knowles, *Partnership* (1978) at 1-1 to 1-16. This case law is primarily concerned with determining if the statutory elements of a partnership exist in any particular set of circumstances. Control, as such, is not a deciding test of partnership liability. *See* S. Rowley, "The Influence of Control in the Determination of Partnership Liability" (1927-1928) 26 *Michigan Law Rev.* 290.

25. Crane, J.A. and Bromberg, A.R., *Law of Partnership* (1968) at 147.

26. There are practically no authoritative statements on the policies the legislation is intended to implement (*See* quote at n. 48).

The two extremes in the statutory scheme of limited partner involvement are clear-cut. At one extreme those limited partners with no involvement at all in the partnership have limited liability. This is the position at common law of profit-sharing lenders[27] as well as the position of limited partners under the legislation. At the other extreme those partners with full control have full personal liability in accordance with usual general partnership law. Between these extremes is a continuum of increasing limited partner rights and powers:

No involvement _____ Full control
(limited liability) (unlimited liability)

[Rights and powers increase in number and importance from left to right]

At some point along the continuum a certain amount or kind of limited partner activity[28] will result in a loss of limited liability. This particular point is determined by two competing policies implicit in limited partnership legislation.[29]

The policy favouring increased rights and powers for limited partners is that of investment protection. The separation of management and benefit effected by limited partnership legislation demands at least a minimum level of protection in addition to the structural protection provided by the unlimited liability and fiduciary duties of general partners.[30] Whatever further degree of protection consistent with the limited partnership concept that a limited partner can acquire is to be encouraged.

This policy of investment protection is pursued by investors with a strong bargaining position in the case of private limited partnerships and by securities regulators in the case of public limited partnerships.[31] In the latter case, although enhanced protection may make an investment more attractive and marketable, promoters and general partners will usually shy away from giving limited partners too much of an opportunity to interfere in the business. Regulators, on the other hand, must not discount the interests of third parties when extracting additional investment protection. In every case the pursuit of investment protection must stop short of endangering the limited liability of the investors.

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27. *Supra* n. 1.

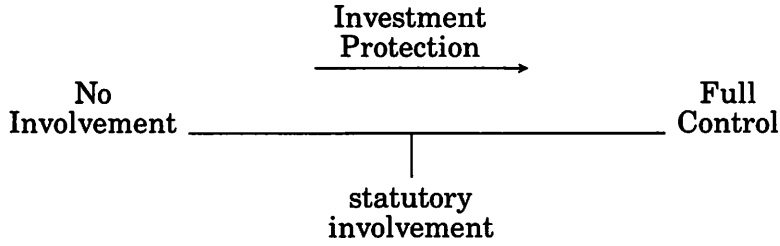
28. Strictly speaking, the amount of limited partner rights and powers should not be determining. The kind of rights and powers exercised is the key matter. Amount, however, will undoubtedly make the difference in a close case.

29. Limited liability is the reason for the legislation. The remaining policies determine what circumstances justify its retention.

30. The present level of limited partner protection provided by statute may well be inadequate to prevent general partner self-dealing and conflicts of interest. Legislative remedies might include provisions for enhanced disclosure and review, rights of dissent and appraisal, valuations in certain circumstances (*eg.* asset transactions with related persons), limited partner derivative actions, experience and net worth requirements for general partners and eligibility requirements for investors.

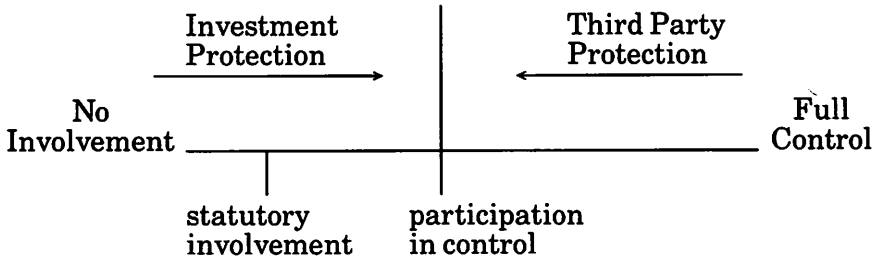
31. The rights and powers to be given limited partners in a public offering is presently a matter of negotiation between the promoter and regulators. Generally speaking, regulators would like limited partners to have the same basic rights as non-voting shareholders.

The primary manifestation of this policy is found in the limited partnership legislation itself with its enumerated rights and powers. The expressly permitted limited partner involvement is indicated by a distinctive point on the continuum (disregarding, for illustrative purposes, any "control" aspect of this statutory involvement). The arrow describes the direction of operation of policy.



Of course, the ultimate in collective investment protection is for the limited partners to have full control over partnership affairs either directly or through the general partner. This, however, would create a *de facto* general partnership. Obviously there is another policy consideration that arises out of the grant of limited liability to limited partners which circumscribes the operation of the policy of investment protection.[32] Since limited liability is a protection against third parties this competing policy must be the protection of the interests and expectations of third parties.[33]

The policy of third party protection is given a definite application in limited partnership legislation.[34] Of all the various statutory protections for third parties the prohibition on control is the most significant in restricting limited partner rights and powers. In fact, the control prohibition describes the point at which the policy of third party protection begins to have legal impact. However that point is defined (i.e. whatever is the test for control), it determines when rights and powers of limited partners must be deferred in the interests of third parties.



32. It will be pointed out in subsequent text that individual investment protection is enhanced by restricting the group rights of limited partners. Specifically, the control prohibition avoids oppression problems. *See* n. 42 *infra*, and accompanying text.

33. These two policies do not always compete. Some forms of limited partner investment protection will also assist third parties (*eg.* disclosure, minimum capital requirements).

34. Statutory protections include the filing of public documents and amendments (Alta., ss. 51, 69; Ont., ss. 3, 18), reliance provisions (Alta., ss. 53, 73; Ont., ss. 5, 27), solvency tests (Alta., ss. 58, 59, 61; Ont., ss. 10, 11, 14), waiver relief and recaptive provisions (Alta., ss. 62; Ont., ss. 15), limited partner control prohibitions (Alta., ss. 63; Ont., ss. 12), priority on dissolution (Alta. ss. 72, Ont., ss. 23) and inspection rights (Ont., ss. 30).

It becomes clear that on the continuum of limited partner rights and powers there is an area between statutory involvement and participation in control in which the policy of investment protection can be given full effect.[35] Further, it is also clear that the two policies of investment protection and third party protection are statutorily balanced at the point of participation in control.[36] It remains to be determined exactly what that point means.

The statutory prohibition on limited partner control is not merely the arbitrary cost of limited liability. The connecting factor between limited liability and the control prohibition is risk aversion. Limited partners are effectively prevented from taking part in control because of the difference in risk aversion the legislation implicitly assumes to arise out of the different liability exposure of limited and general partners.[37] General partners have an inherent check on the manner in which they conduct their business affairs. The fact that their personal fortune is at risk motivates them to make sensible and productive business decisions. Limited partners, on the other hand, have a much reduced check on their risk-taking tendencies once granted limited liability. If limited partners could retain this direct limited liability and yet still participate in the control of the business the result would be contrary to the general policy rule that every person, corporate or otherwise, is liable for obligations he, she or it is actually responsible for. That is: no third party, unless he agrees to it, is bound to accept the possible consequences of the risk aversion that accompanies a limitation of liability. The control prohibition, therefore, is necessary in order to maintain this policy.[38] A third party is only to be subjected to the risk aversion of the general partners.

If the risk aversion of limited partners is not to affect third parties then limited partners must be prevented from being able to affect the security of third parties, namely the partnership assets.[39] In other words, limited partners must not be allowed to prejudice third parties by applying their risk aversion to the employment of partnership assets. In the result, the test of control must be third party prejudice.[40] Prejudice, in

35. Falling within this area would be limited partner rights (in the partnership agreement) to hold meetings, receive regular reports and financial statements, appoint an inspector, approve or appoint the partnership auditor, obtain asset valuations in certain circumstances and approve general partner excursions into unrelated businesses.

36. Making allowance for the degree of control exercised by a limited partner through their statutory approval rights.

37. Risk aversion is a character trait that is measured only with difficulty. Indeed, it is not always true that personal risk aversion varies with the amount at stake. The legislation, however, does not require its measurement. It assumes that there can be a difference between the limited and general partners and negates the need to determine that a difference actually exists.

38. Professor Gower points out that shareholders protections (*qua* investor and member) and third party protections are the fundamental bases for corporate laws. It is the limited liability of shareholders that demands copious provisions for the protection of third parties. *See* L.C.B. Gower, "Whither Company Law" (1981) *U.B.C. Law Rev.* 385 at 389.

39. The security of third parties consists of the assets set out on the partnership balance sheet, key employees and, arguably, the identity and ability of the general partner(s).

40. Apart from what is perhaps the classic article in this area (A.L. Feld, "The Control Test for Limited Partnerships" (1968-1969) 82 *Harv. L. Rev.* 1471) the prejudice test has

this sense, means the possibility of prejudice rather than actual prejudice. It means that partners without full personal liability can have no way in which to affect third parties other than as allowed by statute. If limited partners can affect the partnership assets they can possibly prejudice third parties. The control prohibition prevents this possibility. The legislation assumes prejudice from limited partner participation in control and makes unnecessary a determination of whether or not there is actual harm to third parties or an actual difference in risk aversion between limited and general partners.

This test is relatively easy to apply. Whenever a limited partner exercises rights and powers which affect partnership assets he is dealing with the security from which third parties expect payment. It does not matter whether any particular exercise of a right or power renders an increase or decrease in the value of the assets. The fact of exercising such a right or power indicates that the limited partner has participated in control contrary to the condition on which he retains limited liability. The certainty of this test should encourage the use of the limited partnership wherever it is truly the appropriate vehicle.[41]

There is a peculiar attraction to the existing statutory balance of policies at the point of limited partner participation in control. By disallowing limited partner involvement past this point the statutory scheme has avoided the problem of oppression of the minority.[42] If limited partners as a group have no part in control there can be no abuse of the minority by the majority. Thus the need to regulate the relationships of limited partners *inter se* does not exist. Indirectly, then, the control prohibition itself provides a degree of investment protection not readily apparent on its face.

The determination of participation in control can be assisted by this result. If it is found that limited partners have oppressed each other through the exercise of their rights and powers it will probably be possible to find prejudice to third parties. That is, if limited partners oppress each other they must, as a group, have some ability to manage their investment and thus to affect the security of third parties. Accordingly, the occurrence of limited partner oppression *inter se* is an indication that limited partners are participating in control.

All of the above indicates that the general partner is a very important actor in the limited partnership legislative scheme. Only the general partner can manage the affairs of the partnership and, accordingly, both limited partners and third parties look to the general partner for their profit and protection. Thus, it is the general partner who should receive the greatest attention from regulatory authorities in their efforts to

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been virtually ignored by commentators in discussions on the definition of control (*see* n. 45, *infra*). In the Feld article, the test was recognized as probable but criticized as being too restrictive and not really intended by the American legislation. These criticisms, it is submitted, are unwarranted. The test may be conservative but, in view of the various policies, it is proper and intended.

41. As the test can be readily extracted from the legislation it cannot be safely ignored when providing for limited partner rights and powers.

42. Abuse of limited partners by general partners is not, strictly speaking, a case of oppression. General partner malfeasance is to be prevented or remedied through enforcement of the fiduciary duty. *See* Scamell, E.H. and Banks, R.C.I., *Lindley on Partnership* (14th ed., 1979) at 526, 528.

protect both limited partners and third parties. Internal regulation in the form of unlimited liability and the fiduciary duty between partners already exists. Additional statutory protection, including enhanced and regular disclosure, minimum capital requirements, compliance orders and limited partner derivative actions, is possible if thought necessary.[43]

III. THE AMERICAN EXPERIENCE

Section 7 of the 1916 Uniform Limited Partnership Act (ULPA)[44] of the United States, the model for the Alberta and Ontario control provisions, has been the subject of controversy ever since the limited partnership became a more popular business vehicle in the United States in the 1950's.[45] The exact wording of s.7[46] is familiar:

> 7. A limited partner shall not become liable as a general partner unless, in addition to exercising his rights and powers as a limited partner, he takes part in the control of the business.

The assumptions on which the ULPA is based are described in its Official Comment[47] as follows:

> The draft herewith submitted proceeds on the following assumptions:
>
> First: No public policy requires a person who contributes to the capital of a business, acquires an interest in the profits, and some degree of control over the conduct of 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.
>
> Second: That persons in business should be able, while remaining themselves liable without limit for the obligations contracted in its conduct, to associate with themselves others who

43. *Supra* n. 30 at 42.

44. *Uniform Laws Annotated,* West Publishing Co. (1969) Vol. 6 at 561.

45. Chel, F.W., "The Limited Partnership" (1954-1955) 2 *U.C.L.A. Law Rev.* 105; Jacobs, F.D., "Activities Making a Limited Partner Liable as a General Partner" (1957) 56 *Mich. L. Rev.* 285; Feld, A.L., "The Control Test for Limited Partnerships" (1969) 82 *Harv. L. Rev.* 1471; Roegge, *et al.*, "Real Estate Equity Investments and the Institutional Lender: Nothing Ventured, Nothing Gained" (1971) 39 *Fordham L. Rev.* 579; Walker, R.J., "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" (1973) 26 *Okla. L. Rev.* 289; Slater, K., "'Control' in the Limited Partnership" (1974) 7 *John Marshall Journal* 416; Stanford, D.L., "Foreign Limited Partnerships: A Proposed Amendment to the Uniform Limited Partnership Act" (1974) 47 *So. Cal. L. Rev.* 1174; Kravotil, R. and Werner, R.J., "Fixing Up the Old Jalopy – The Modern Limited Partnership Under the ULPA" (1975) 50 *St. John's Law Rev.* 51; Brodsky, E., "Tax Shelter Litigation: Participating in Control of the Partnership" (1976) 176 *N.Y.L.J.* 1; Augustine, *et al.*, "The Liability of Limited Partners Having Certain Statutory Voting Rights Affecting the Basic Structure of the Partnership" (1976) 31 *Bus. Lawyer* 2087; Feldman, B., "The Limited Partner's Participation in the Control of the Partnership Business" (1976) 50 *Conn. Bar J.* 168; Coleman, G.W. and Weatherbie, D.A., "Special Problems in Limited Partnership Planning" (1976) 30 *Southwestern L.J.* 887; Pierce, M.K., "Limited Partner Control and Liability Under the Revised Uniform Limited Partnership Act" (1979) 32 *Southwestern L.J.* 1301; Banoff, S.I., "Tax Distinctions Between Limited and General Partners: An Operational Approach" (1979-80) 35 *Tax Law Rev.* 1; Brumder, M.E., "Investor Protection and the Revised Uniform Limited Partnership Act" (1980) 56 *Wash. Law. Rev.* 99; Donnell, J.D., "An Analysis of the Revised Uniform Limited Partnership Act" (1980) 18 *Amer. Bus. Law J.* 399; Burr, S.I., "The Potential Liability of Limited Partners as General Partners" (1982) 67 *Mass. Law. Rev.* 22. *See* especially the opinion of the Michigan attorney-general described in (1981) 27 *Wayne Law Rev.* 562 at 562-564. Canadian comment on s. 7 of the ULPA is found in Ehrcke and Wertschek, *supra* n. 1 at 387-389. Further commentary dealing with the control problems of corporate general partners and with the new control provision of the revised Uniform Limited Partnership Act (*supra* n. 16) is found in notes 76 and 101, *infra,* respectively.

46. Unif. Laws Ann., *supra* n. 44 at 582.

47. *Id.* at 562-565.

> contribute to the capital and acquire rights of ownership, provided that such contributors do not compete with creditors for the assets of the partnership.[48]

The first assumption above is sometimes taken as support for the proposition that the control prohibition incorporates a requirement of reliance. It is argued that this part of the Comment indicates that limited partners can take some degree of control in excess of the statute and not lose their limited liability unless third parties have relied on their unlimited liability.[49] This, it is submitted, is a misinterpretation of the words of the Uniform Law Commissioners.[50] The Comment describes the basis for the scheme of the whole Act; it does not set out the test for control.

There is only one way in which the words of the Commissioners can be reconciled with the express prohibition on limited partner participation in control found in sec. 7. This interpretation is that the phrase "some degree of control" must refer only to the statutory rights and powers of limited partners, particularly the rights of approval over certain acts of the general partners.[51] These approval rights are granted in respect of what are, for the most part, control matters.[52] They provide a certain amount of investment protection but they do so by detracting from the ability of the general partners to administer or change the business of the partnership as they see fit.[53] When these rights are exercised the limited partners participate in control along with the general partners. As it is, the ULPA allows this "degree of control" and that is what the Commissioners are describing.

If there can be no "degree of control" in excess of the statute then no question of reliance arises because third parties cannot be prejudiced.[54] What then is the meaning of the phrase "provided creditors have no reason to believe at the times their credits were extended that such person was so bound"? It is again pointed out that this Comment describes the ULPA as a whole. This particular phrase describes ss. 5 and 6 which impose liability on a limited partner whose name appears in the partnership name or who knew the partnership certificate contained a false statement and a third party has relied on the apparent state of affairs.[55] The phrase does not describe the control provision because that

48. *Id.* at 564.

49. Pierce, *supra* n. 45 at 1305-1306, 1309; Feldman, *supra* n. 45 at 171; Stanford, *supra* n. 45 at 1195. These commentators recognize the interests of third parties but find no injury absent reliance. Such a position discounts or ignores the difference in risk aversion between limited and general partners. *See also* Feld *supra* n. 45 at 1979, for the argument that such control as does not induce "reasonable reliance" by third parties is permissible.

50. *See* Kravotil and Werner, *supra* n. 45 at 58, for what, it is submitted, is the correct meaning of the phrase "some degree of control". *See* the following text herein.

51. Unif. Laws Ann., *supra* n. 44 at 586.

52. Subsections 9(a), (b), (c), (d) and (e) would all have an impact on third parties. One of the more obvious examples would be where the general partner wishes to confess a judgment but the limited partners disapprove.

53. The impact of this limited partner involvement is lessened by being structured as approval rights over matters initiated by the general partner(s). Similar matters, initiated and determined solely by limited partners, would undoubtedly contravene the control prohibition.

54. Reliance will only be relevant in cases of holding out or misrepresentation. *See* n. 63 *infra.*

55. Unif. Laws Ann., *supra* n. 44 at 580-581.

provision is self-contained and devoid of any reference to knowledge or reliance. It is doubtful that the absence of a reliance element in this provision can be attributed to a less vigorous draftsmanship that assumed control would be defined in terms of reliance.[56] Reliance is absent for the simple reason that third party prejudice can occur below a level of limited partner activity that induces reliance. It is submitted that the Official Comment describes exactly what the ULPA states in various of its sections and that it does not provide an alternative wording of the control provision.

American commentators have also attempted to justify a "degree of [limited partner] control" by pointing out that the underlying purpose of the ULPA is to "prevent instances of unwarranted imposition of general liability on limited partners."[57] This statement of collateral purpose is undeniable given the history of limited partnership legislation prior to the ULPA. American courts in the nineteenth century tended to view limited liability as a privilege conditioned on absolutely strict compliance with the existing legislation.[58]

> The fact that any minor infractions of or derivations [sic] from the statutory provisions would either prevent a limited partnership from being formed, or subject the "limited" partner to unlimited liability, despite proper formation of the limited partnership, naturally rendered the limited partnership a hazardous means of obtaining limited liabilty and therefor discouraged its employment. Thus interpreted, it was apparent that the statutes would have to be changed if the limited partnership was to be made an attractive form of non-corporate business organization.

The ULPA seeks to avoid the harsh results of some of the earlier cases by, *inter alia*,[59] providing that the partnership is formed if there is substantial compliance in good faith with the requirements of swearing and filing the partnership certificate,[60] that a person who mistakenly believes he is a limited partner can avoid general liability by renouncing his interest in the partnership once he discovers his mistake[61] and that the Act is not to be strictly construed.[62] In fact, the ULPA imposes general liability on limited partners in only three situations: when the limited partner's name appears in the partnership name, when the limited partner knew a statement in the partnership certificate to be false or when the limited partner participated in the control of the business.[63]

The ULPA does much to reduce the liability exposure of limited partners. It is doubtful, however, that the draftsman intended to allow greater

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56. As suggested by Feld, *supra* n. 45 at 1480. Lewis, *supra* n. 1 at 715, said of the drafting of the ULPA – "every sentence being hammered out by round table discussions" and "many hours [were devoted to] a full discussion of the general principles on which the act is based, and to the working of each section".

57. Walker, *supra* n. 45 at 292; Feld, *supra* n. 45 at 1479.

58. "The Limited Partnership" (1936) 45 *Yale Law Y.* 895 at 899; *See also* the American authorities in n. 1, *supra.*

59. *See* Lewis, *supra* n. 1, for a discussion of the differences between the ULPA and the previous Acts. *See also* Caudill and Fendler, *supra* n. 1; Nadler, *supra* n. 1; and Simon, D.J., and Lee, D.A., "The Substantial Compliance Doctrine: Preserving Limited Liability Under the Uniform Limited Partnership Act" (1980) 13 *U.C. Davis Law Rev.* 924.

60. Unif. Laws Ann., *supra* n. 44 at 568, s. 2(2).

61. *Id.* at 594, s. 11.

62. *Id.* at 617, s. 28(1). The Alberta and Ontario legislation is also remedial, as provided by each province's Interpretation Act (R.S.A. 1980, c. I-7, s. 10; R.S.O. 1980, c. 219, s. 10).

63. *Id.* at 580-582, ss. 5, 6 and 7. *See Vulcan Furniture Manufacturing Corp.* v. *Vaughn* (1964) 168 So.(2d) 760.

limited partner control than is expressly provided by the ULPA (of course, additional rights and powers short of control are permissible). To find otherwise would detract from the admitted interests of third parties and raise uncertainty as to the extent of permissible limited partner participation in control.[64] The control prohibition is absolute by its terms and if it were not intended to be so some substantial comment to that effect might have been expected. In response to those commentators who stress the remedial nature of the ULPA it may be said that there is no "unwarranted" imposition of general liability when a third party has been subjected to the risk aversion of a limited partner.

It is submitted that there can be no question of what "degree of control" is permissible – there can be none in excess of the statute. The only question is, what is the meaning of "takes part in the control of the business"?

American jurisprudence on the control prohibition is not extensive,[65] but until recently it had been relatively consistent.[66] Until 1974 the courts had utilized a literal interpretation of the control prohibition[67] and approached each fact situation on an *ad hoc* basis.[68]

> An analysis of each of the cases reveals that they were decided on their own facts and are of little use in forming rules or standards. In each case, it was not the position of the limited partner that was stated as permissible, but the actual role and degree of participation that each had in relation to the general partner. A reading of those cases reinforces the belief of this Court that the determination must be made on an ad hoc basis, and while employment may not be conflicting with the status of a limited partner, the "control" that the partner has in the day-to-day functions and operations of the business is the key question. Does the limited partner have decision-making authority that may not be checked or nullified by the general partner?

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64. Third party reliance is offered as the test of the extent of limited partner involvement when it is argued that "some degree of control" in excess of the statute is permitted. Actual reliance, however, cannot be the test if "control" in excess of the statute is prohibited. Reliance would only be an element in a holding out or representation by limited partners that they are generally liable.

65. The lack of cases is sometimes attributed to lawyer conservatism, due to the uncertainty of the control prohibition, in advising clients setting up limited partnerships. More likely, this conservatism is probably due to the apparent certainty of the control prohibition.

66. The total case law on s. 7 of the ULPA consists of approximately twenty cases. *Holzmann* v. *De Escammilla* (1948) 195 P (2d) 833; *Rathke* v. *Griffith* (1950) 218 P (2d) 757; *Silvola* v. *Rowlett* (1954) 272 P (2d) 287; *Grainger* v. *Antoyan* (1957) 313 P (2d) 848; *Bergeson* v. *Life Insurance Corp. of America* (1958) 170 F. Supp. 150, *revd.* in part (1959) 265 F.(2d) 227; *Plasteel Products Corp.* v. *Helman* (1959) 271 F.(2d) 354; *J.C. Wattenbarger & Sons* v. *Sanders* (1963) 30 Cal. Rptr. 910; *Executive Hotel Associates* v. *Elm Hotel Corp* (1964) 245 N.Y.S. (2d) 929; *Filesi* v. *United States* (1965) 352 F.(2d) 339; *Weil* v. *Diversified Properties* (1970) 319 F. Supp. 778; *Trans-Am Builders, Inc.* v. *Woods Mill, Ltd.* (1974) 210 S.E.(2d) 866; *Gast* v. *Petsinger* (1974) 323 A.(2d) 371; *Delaney* v. *Fidelity Lease Limited* (1975) 526 S.W.(2d) 543; *Frigidaire Sales Corp.* v. *Union Properties, Inc.* (1976) 544 P.(2d) 781; *Fiske* v. *Moczik* (1976) 329 So.(2d) 35; *Stone Mountain Properties, Ltd.* v. *Helmer* (1976) 229 S.E.(2d) 779; *Western Camps, Inc.* v. *Riverway Ranch Enterprises* (1977) 138 Cal. Rptr. 918; *Mursor Builders Inc.* v. *Crown Mountain Apartment Associates* (1978) 467 F. Supp 1316; *The Outlet Company* v. *Wade* (1979) 377 So.(2d) 722. See also *Lichtyger* v. *Franchard Corp.* (1966) 223 N.E.(2d) 869; *Freedman* v. *Tax Review Bd. of Philadelphia* (1968) 243 A.(2d) 130; *Riviera Congress Associates* v. *Yassky* (1966) 277 N.Y.S.(2d) 386; *Sloan* v. *Clark* (1966) 223 N.E.(2d) 893; *Garrett* v. *Koepke* (1978) 569 S.W.(2d) 568; *Evans* v. *Galardi* (1976) 128 Cal. Rptr. 25.

67. The literal interpretation of the control prohibition is variously called the "plain-meaning", "power" or "control" test. *See* Standford, *supra* n. 45 at 1192-1194; Coleman and Weatherbie, *supra* n. 45 at 899; Pierce, *supra* n. 45 at 1306-1309.

68. *Gast* v. *Petsinger* (1974) 323 A.(2d) 371 at 375.

The few cases decided subsequently have departed from each other on the issue of whether or not third party reliance is a further necessary element in the imposition of general liability.[69] The two cases which established the controversy were decided within six months of each other on virtually identical facts. In both *Delaney* v. *Fidelity Lease Limited*[70] and *Frigidaire Sales Corp.* v. *Union Properties, Inc.*[71] the question was whether limited partners were liable under the control provision by reason of being the directors, officers and shareholders of the sole corporate general partner.

In *Delaney,* the Texas Supreme Court determined that this use of the corporate fiction was an attempt to circumvent the statute:[72]

> It was alleged by plaintiffs, and there is summary judgement evidence, that the three limited partners controlled the business of the limited partnership, albeit through the corporate entity. The defendant limited partners argue that they acted only through the corporation and that the corporation actually controlled the business of the limited partnership. In response to this contention, we adopt the following statements in the dissenting opinion of Chief Justice Preslar in the court of civil appeals:
>
> "I find it difficult to separate their acts for they were at all times in the dual capacity of limited partners and officers of the corporation. Apparently the corporation had no function except to operate the limited partnership and Appellees were obligated to their other partners to so operate the corporation as to benefit the partnership. Each act was done then, not for the corporation, but for the partnership. Indirectly, if not directly, they were exercising control over the partnership. Truly 'the corporation fiction' was in this instance a fiction."
>
> Thus, we hold that the personal liability, which attaches to a limited partner when "he takes part in the control and management of the business," cannot be evaded merely by acting through a corporation.

To this the court added an express denial that reliance was required in order to impose liability.

> The defendant limited partners also contend that the "control" test enumerated in Section 8 of Article 6132a for the purpose of inflicting personal liability should be coupled with a determination of whether the plaintiffs relied upon the limited partners as holding themselves out as general partners. Thus, they argue that, before personal liability attaches to limited partners, two elements must coincide: (1) the limited partner must take part in the control of the business; and (2) the limited partner must have held himself out as being a general partner having personal liability to an extent that the third party, or plaintiff, relied upon the limited partners' personal liability. See *Vulcan Furniture Mfg. Corp.* v. *Vaughan,* 168 So.2d 760 (Fla.Dist.Ct.App. 1964); *Silvola* v. *Rowlett,* 129 Colo. 522, 272 P.2d 287 (1954); *Rathke* v. *Griffith,* 36 Wash.2d 394, 218 P.2d 757 (1950). They observe that there is no question in this case but that the plaintiffs were in no way misled into believing that these three limited partners were personally liable on the lease, because the lease provided that the plaintiffs were entering into the lease with "Fidelity Lease, Ltd., a limited partnership acting by and through Interlease Corporation, General Partner."
>
> We disagree with this contention. Section 8 of Article 6132a simply provides that a limited partner who takes part in the control of the business subjects himself to personal liability as a general partner. The statute makes no mention of any requirement of reliance on the part of the party attempting to hold the limited partner personally liable.[73]

In *Frigidaire,* the Washington Court of Appeal refused to impose general liability using the following words:[74]

> [The court quoted that part of the Official Comment of the ULPA discussed earlier herein and then continued]
>
> A limited Partner is made liable as a general partner when he participates in the "control" of the business in order to protect third parties from dealing with the partnership under the

69. *See* notes 70-74 and 87-97 and accomanying text.

70. (1975) 526 S.W.(2d) 543.

71. (1976) 544 P (2d) 781.

72. *Supra* n. 70 at 545.

73. *Id.*

74. *Supra* n. 71 at 785.

> mistaken assumption that the limited partner is a general partner with general liability. See Feld, The "Control" Test for Limited Partnerships, 82 *Harv. L. Rev.* 1471, 1479 (1969). If a limited partnership certificate pursuant to RCW 25.08.020(2) is properly prepared and filed and the limited partner does not participate in the control of the business, it is unlikely that third parties will be misled as to the limited liability of the limited partners. The underlying purpose of the control prohibition of RCW 25.08.070 is not furthered, however, by prohibiting limited partners from forming a corporation to act as the sole general partner in a limited partnership. A third party dealing with a corporation must reasonably rely on the solvency of the corporate entity. It makes little difference if the corporation is or is not the general partner in a limited partnership. In either instance, the third party cannot justifiably rely on the solvency of the individuals who own the corporation.
>
> We hold that limited partners are not liable as general partners simply because they are active officers or directors, or are stockholders of a corporate general partner in a limited partnership.

The decision in this case is said to have recognized a reliance test of limited partner liability, contrary to the holding in *Delaney*. Whether or not this is so, the reliance test has received further judicial consideration and the issue is now fairly raised.[75] Accordingly, an examination of the test will be made once *Frigidaire* is further analyzed.

The decision in *Frigidaire* is said to be general authority for the proposition that limited partners are not liable unless their activities *qua* limited partners induce in third parties a reasonable reliance on their unlimited liability.[76] Such a proposition is based on the court's holding that the rationale or purpose of the control prohibition is to protect third parties from dealing with the partnership under the mistaken assumption that the limited partner is a general partner with general liability,"[77] and on the comments made in the article cited by the court.[78] The case itself, however, was not concerned with the activities of a limited partner in his status as limited partner. In fact, it is arguable that the words of the court deny that limited partner participation in control *qua* limited partner is permissible. In any event a reading of the whole case clearly indicates that the court restricted its consideration of reliance to a corporate context. What the court did decide was that in the case of a corporate general partner, so long as the corporate status of the general partner is maintained and the limited partners do not otherwise participate in control, there could never be a mistaken assumption by a third party that a limited partner had general liability. This result follows from the fact that a third party dealing with a corporation must look only to the solvency of the corporation and is not entitled to rely on the liability of its members. Thus, the court declined to pierce the veil because the ostensible purpose of the control provision had not been frustrated.[79]

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75. *See* notes 87-97 and accompanying text.
76. Commentators are not in total agreement on the utility and effect of the *Delaney* and *Frigidaire* decisions. *See* the commentators in n. 67, *supra*, and the case comments on these decisions at (1974-75) 6 *Texas Tech Law Rev.* 1171 (lower court decision in *Delaney*); (1975-76) 7 *Texas Tech Law Rev.* 745; (1975) 29 *Southwestern Law J.* 791; (1978) 53 *Wash. Law Rev.* 775; (1978) 31 *Okla. Law Rev.* 997; (1978) 47 *Cincinnati Law Rev.* 355; (1979) 55 *N. Dakota Law Rev.* 271. *See also* (1970) 24 *Southwestern Law J.* 285.
77. *Supra* n. 74.
78. The Feld article is cited in most of the recent decisions and by virtually all commentators. It is trite to say that the author has had a dramatic impact on the law in this area.
79. This is also the reasoning in *Western Camps, Inc.* v. *Riverway Ranch Enterprises* (1977) 138 Cal. Rptr. 918. *See also Evans* v. *Galardi* (1976) 128 Cal. Rptr. 25.

The court, in effect, is applying a prejudice test. It is saying that because third parties deal with a particular legal person having a unique character (and asset base) they have no reason to complain subsequently. They have not been prejudiced when that corporation alone or in combination with other general partners has full control over the partnership business. They have not been subjected to unanticipated participation in control by a person other than, and with a different risk aversion than, the general partner.[80]

It is unfortunate that the court in *Frigidaire* concluded that the rationale of the control prohibition is to prevent third parties from mistakenly assuming that the limited partner is a general partner with general liability. As discussed previously this rationale is not supported by the authority offered in the case.[81] It is submitted that the decision provided a correct result (veil not pierced) for the right reason (purpose or rationale of control prohibition not frustrated) but in consideration of an incorrect rationale (prevention of third party reliance). The rationale that is consistent with the terms of the ULPA is that the control prohibition is intended to prevent third party prejudice.[82] This rationale and the test it provides have the advantage of explaining the legitimacy of a corporate general partner made up of limited partners without at the same time being generally applicable to justify limited partner participation in control *qua* limited partner. The matter of corporate general partners will be returned to later.

In *Delaney* the court expressly denied the existence of a reliance test. *Frigidaire* and other cases are taken to have approved a reliance test. It is now relevant to examine the nature, authority for and value of such a test. As described by its proponents the reliance test is not an objective determination of when reliance is reasonable, whether or not the third party actually relied.[83] Rather, the test is said to require both actual participation in control by limited partners (so that third party reliance is reasonable) and actual reliance by third parties.[84] The reliance test is not an attempt to define "takes part in the control of the business". Reliance is an element that is added in order to reduce the number of instances where general liability will be imposed on limited partners. Without a reliance element liability is only imposed if limited partners participate in control. With a reliance element liability is only imposed if

80. *See* n. 38 *supra* and text.

81. *See* notes 48-56 *supra* and text.

82. *See* the discussion of policy in part II.

83. Although this is the type of test which Feld (*supra* n. 45 at 1479) envisaged:

> A third construction of the control test, and the most persuasive, is to measure it by the most logical rationale for holding the limited partner liable: to prevent third parties from mistakenly assuming that the limited partner is a general partner and relying on his general liability. This rationale is suggested by the Commissioners' notes and is repeated in an article by one of the draftsmen. Under this view of the control test, only activities which conceivably could induce reasonable reliance, such as supervision of the partnership's day-to-day activities, should produce general liability.

Even the Feld test is subject to various of the criticisms which follow in the text; notably, the absence of legislative or judicial sanction and the fact that third party prejudice occurs prior to a reliance level of limited partner activity.

84. Feldman, *supra* n. 45 at 179-180; Pierce, *supra* n. 45 at 1309. *See also Delaney* v. *Fidelity Lease Limited* (1975) 526 S.W.(2d) 543 at 545.

limited partners participate in control and third parties thereafter assume that these partners have general liability. This test is offered in order to allow that which is patently prohibited – participation in control.

There is no justification in either the ULPA or its Official Comment for such a test of liability. The control provision stands alone for the purpose of determining limited partner liability due to involvement in the partnership. Its prohibition on participation appears absolute, not being modified by any reference to a reliance element. Given the detail of the Act and the fact that it only imposes liability in three specific instances it can be assumed that the draftsmen would have provided for a reliance element if it had been intended.[85] The Official Comment to the ULPA is invariably offered as support for a reliance test. Whatever is the legal status of this "Official Comment", it has previously been pointed out that this control – reliance interpretation is doubtful.[86] The Comment is a description of the whole Act and is not simply an alternative wording of the control prohibition.

The reliance test reduces the liability exposure of limited partners to a question of estoppel. It imposes liability whenever a limited partner, by his words or conduct, represents that he is liable as a general partner and a third party relies on that representation. This would be so, however, even in the complete absence of the control prohibition. That is, even if the statute allowed certain limited partners to have limited liability but did not prevent their participation in control, they would still be liable as normal partners if that is what they represented themselves to be. Thus, if the test of liability was intended to be reliance there would have been no need for the control provision at all.

Commentators insist that authority for a reliance test is found in a number of the pre-1975 cases.[87] In fact, however, in only one of these cases was reliance in connection with the control provision actually a factor in the decision.[88] In the 1950 decision in *Rathke* v. *Griffith*[89] the Supreme Court of Washington considered the absence of third party reliance to be a factor, but not the test, in determining liability. The court took great comfort in the fact that two other courts (dealing with a different action against Griffith), in possession of substantially the same evidence, had refused to find Griffith generally liable.[90] No subsequent decision has cited this case as authority for a reliance test. It is interesting to note that both *Delaney*[91] and *Frigidaire*[92] cite *Rathke* and yet in *Delaney* the

85. *See* n. 64 *supra* and text.

86. *See* notes 48-56 *supra* and text.

87. *See* Pierce, *supra* n. 45 at 1308-1309; Stanford, *supra* n. 45 at 1195-1197; Feldman, *supra* n. 45 at 188-208.

88. In *J.C. Wattenbarger & Sons* v. *Sanders* (1963) 30 Cal. Rptr. 910, the court treated the matter before it as a question of holding out rather than a potential contravention of the control prohibition. Reliance is obviously a consideration in such a case. None of the other pre-1974 cases (other than *Rathke, infra* n. 89) make any mention of reliance and the implication of reliance drawn out of them by commentators is, at best, tenuous.

89. (1950) 218 P (2d) 757.

90. *Id.* at 764.

91. (1975) 526 S.W.(2d) 543 at 545.

92. *Supra* n. 71 at 783.

reliance test is expressly denied while in *Frigidaire* the court did not rely on *Rathke* in coming to the narrow conclusion it did. More recent decisions have not provided any considered support for a reliance test. In *Western Camps* v. *Riverway Ranch Enterprises*[93] the court followed the narrow ratio of *Frigidaire* that the veil of a corporate general partner will not be pierced if its corporate status has been properly maintained. In *Mursor Builders* v. *Crown Mountain Apt. Assoc.*[94] the corporate status of the general partner was not maintained. The court imposed liability notwithstanding that third parties did not rely on the limited partners general liability. In doing so, the court recognized a difficulty with the reliance test when it stated that "third party reliance is not the sole criterion. Some meaning must be given to the language embodied in [the control provision]".[95] In *Outlet Company* v. *Wade*[96] the court absolved the limited partner with the words "there was no evidence that appellant relied or had a right to rely on the individual credit of the appellee".[97] The extent of the court's elaboration on this statement was a reference to a secondary account of the Official Comment of the ULPA. Accordingly, other than the laconic judgement in *Outlet,* there is no judicial authority for a generally-applicable reliance test of limited partner liability.

The reliance test, it would appear, is no test at all. Taken to its logical conclusion, it allows for the utter defeat of the statutory scheme. Under this test a limited partner could participate in full control or exercise sole control and yet not be liable because, even though his participation is detected, no third party has actually relied on his general liability, and this notwithstanding that such limited partner must actually have been the cause of the third party loss.[98] In these situations the control prohibition has become meaningless.

The reliance test would also involve a difficult problem of compliance. The only way for a limited partner who participates in control (on the strength of the reliance test) to ensure his limited liability is to inform every third party dealing with the partnership of his "status" and thereby prevent third party reliance on his general liability. This will demand an extraordinary degree of attention and care on the part of the limited partner in order to protect himself. If he fails to give notice to all he will be made liable to any third party who knows of his control activities and has consequently assumed that he is generally liable. Thus, the reliance test imposes an unusual burden of compliance on a limited partner without at the same time guaranteeing his limited liability. As such, the test is a trap for the unwary and a considerable cost to the vigilant.

The underlying basis for the reliance test is that, in the absence of

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93. (1977) 138 Cal. Rptr. 918.

94. (1978) 467 F. Supp. 1316.

95. *Id.* at 1333.

96. (1979) 377 So.(2d) 722.

97. *Id.*

98. The limited partner, arguably, could not be made liable under agency principles (undisclosed principal being liable on a contract made by his agent) because he is not liable unless he contravenes one of the liability sections of the ULPA (*i.e.,* s. 1 of the ULPA states that "The limited partners as such shall not be bound by the obligations of the partnership.") *See* s. 8 of the Ont. Act and s. 56 of the Alta. Act.

third party reliance on the general liability of a limited partner, there is no detriment to third parties (or none of which, apparently, they should be allowed to complain). However, third parties are entitled to know who they actually deal with and who it is that has control over their security. That this a general public policy is evidenced by the law of agency where both an agent and his undisclosed principal are liable on a contract properly entered into by the agent.[99] This is an especially important consideration where the difference between the apparent and actual controller is not only personality but legal liability as well. Prejudice arises out of both the unexpected identity and liability exposure of a limited partner involved in control.

In the result, it is submitted that a reliance test (1) cannot be extracted from the ULPA or case law, and (2) does not adequately protect the interests of third parties or limited partners. All of the discussion above would be equally applicable to the Alberta and Ontario control provisions.

To complete this discussion of the American experience it must be noted that the American Uniform Law Commissioners have recently offered for adoption by the states a new control provision that purports to reduce the uncertainty of the 1916 control provision. Article 303 of the 1976 revised ULPA[100] states that:

> 303. [Liability to Third Parties]
>
> (a) Except as provided in subsection (d), a limited partner is not liable for the obligations of a limited partnership unless he is also a general partner or, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business. However, if the limited partner's participation in the control of the business is not substantially the same as the exercise of the powers of a general partner, he is liable only to persons who transact business with the limited partnership with actual knowledge of his participation in control.
>
> (b) A limited partner does not participate in the control of the business within the meaning of subsection (a) solely by doing one or more of the following:
>
> (1) being a contractor for or an agent or employee of the limited partnership or of a general partner;

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99. Fridman, G.H.L., *The Law of Agency* (2nd ed., 1961) at 174, 181.

100. Uniform Laws Ann. (1979 Supp.), *supra* n. 16 at 128-129. The Commissioners' comment on this section (there is further comment on the control section in the Commissioners' Prefatory Note, at 117) reads as follows:

> Commissioners' Comment
>
> Section 303 makes several important changes in Section 7 of the prior uniform law. The first sentence of Section 303(a) carries over the basic test from former Section 7 – whether the limited partner "takes part in the control of the business" – in order to insure that judicial decisions under the prior uniform law remain applicable to the extent not expressly changed. The second sentence of Section 303(a) reflects a wholly new concept. Because of the difficulty of determining when the "control" line has been overstepped, it was thought unfair to impose general partner's liability on a limited partner except to the extent that a third party had knowledge of his participation in control of the business. On the other hand, in order to avoid permitting a limited partner to exercise all of the powers of a general partner while avoiding any direct dealings with third parties the "is not substantially the same as" test was introduced. Paragraph (b) is intended to provide a "safe harbor" by enumerating certain activities which a limited partner may carry on for the partnership without being deemed to have taken part in control of the business. Paragraph (d) is derived from Section 5 of the prior uniform law, but adds as a condition to the limited partner's liability the fact that a limited partner must have knowingly permitted his name to be used in the name of the limited partnership.

Legislative changes of this nature had been made earlier by individual states (*infra*, n. 115). The 1976 ULPA had been adopted by ten states by the end of 1981 (Banoff, S.I. "Can Tax Practitioners Support the Revised ULPA" (1982) 60 *Taxes* at 97).

(2) consulting with and advising a general partner with respect to the business of the limited partnership

(3) acting as surety for the limited partnership;

(4) approving or disapproving an amendment to the partnership agreement; or

(5) voting on one or more of the following matters:

(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;

(v) the removal of a general partner.

Much discussion on this provision is found in the American literature.[101] It remains to be seen what the effect of this new liability test will be.

IV. EARLY CANADIAN CONTROL CASES

Canadian jurisprudence on limited partnership legislation is both sparse and of little assistance in determining limited partner liability under the control provision. The majority of cases are well over a century old and all were decided under legislation substantially different from that presently in force in Alberta and Ontario. Most of the cases find limited partners generally liable because of a failure to strictly comply with the particular statute.[102] These cases are probably one of the main reasons the limited partnership has not, until recently, been a very popular business vehicle in Canada.[103]

The only cases on limited partner control were all decided in 1857 and all in respect of a single unfortunate limited partnership.[104] This limited partnership, Donald Bethune and Co., was formed in 1849, under the brand new limited partnership legislation of Upper Canada,[105]for the purpose of owning and operating steamboats. Bethune was the sole general partner and there were eighty-two limited partners. Five of the limited partners were elected to a committee to advise the general partner on the conduct of the business.

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101. Donnell, *supra* n. 45 at 407-409; Brumder, *supra* n. 45 at 120-123; Kessler, R.A., "The New Uniform Limited Partnership Act: A Critique" (1979) 48 *Fordham Law Rev.* 159 at 164-167; Pierce, *supra* n. 45 at 1314-1328; Aslanides, P.C. *et al.*, "Limited Partnerships – What's Next and What's Left" (1978) 34 *Bus. Lawyer* 257 at 265-266; Shapiro, R.M., "The Need for Limited Partnership Reform: A Revised Uniform Act" (1978) 37 *Maryland Law Rev.* 544 at 577-558; Sell, W.E., "An Examination of Articles 3, 4 and 9 of the Revised Uniform Limited Partnership Act" (1978) 9 *St. Mary's Law J.* 459 at 462-467; O'Neil, F.H., "Comments on Recent Developments in Limited Partnership Law" [1978] *Wash. U. Law Q.* 669 at 679-681.

102. *Slingsby Manufacturing Co.* v. *Geller* (1907) 6 West. L.R. 223; *Benedict* v. *Van Allen* (1859) 17 U.C.Q.B. 234 (C.A.); *Watts* v. *Taft* (1858) 16 U.C.Q.B. 256 (C.A.); *Whittemore* v. *Macdonnell* (1857) 6 U.C.C.P. 547 (C.A.); *Patterson* v. *Holland* (1858) 7 Gr. 1 and also at 6 Gr. 414.

103. Another reason would be the ease of incorporation. *See also* Currie, A.W., "The First Dominion Companies Act" (1962) 28 *Can. J. of Econ. and Pol. Science* 387 at 390. The recent popularity of the limited partnership is due primarily to its conduit nature for tax purposes.

104. *Davis* v. *Bowes* (1857) 15 U.C.Q.B. 280 (C.A.); *Hutchison* v. *Bowes* (1857) 15 U.C.Q.B. 156 (A.C.); *Whittemore* v. *McDonnell* (1857) 6 U.C.C.P. 547 (C.A.) (as an alternative ground); *Bowes and Hall* v. *Holland* (1857) 14 U.C.Q.B. 316 (C.A.).

105. An Act to Authorize Limited Partnerships in Upper Canada, 12 Vic., c. 75 (1849).

Initially, Bethune alone managed the business while seeking the advice of the committee on some important matters. However, in late 1853 Bethune left the country in order to avoid his creditors. Bethune had never paid any part of his own agreed contribution and had applied to his own use a considerable portion of the partnership funds.

Prior to his departure, Bethune had given one George Holland a power of attorney to manage the partnership business in his absence. Holland, however did not manage the business on his own. He resorted to the committee on many questions and the committee obliged by making decisions for him. The members of the committee, both individually and collectively, made decisions in respect of the purchase of boats, the raising of funds, free fares for some passengers, the painting of the boats, the routes and hours of departure of the boats and various other matters.

All of the 1857 control cases determined that these activities of the limited partners vitiated their limited liability by reason of sec. 14 of the Act.[106]

> XIV. And be it enacted, That a special partner may from time to time examine into the state and progress of the partnership concerns, and may advise as to their management; but he shall not transact any business on account of the partnership, nor be employed for that purpose as Agent, Attorney or otherwise; and if he shall interfere, contrary to these provisions, he shall be deemed a general partner.

As is readily evident from the facts, there was here an active management of partnership affairs by limited partners. Accordingly, the decisions are of no help in determining what limited partner activities will attract general liability.

Finally, virtually all of the Canadian cases on limited partnerships are manifestations of the application of the rule that legislation in derogation of the common law is to be strictly complied with. The present legislation of Alberta and Ontario, however, seeks to mitigate the harshness of a strict compliance requirement through a number of provisions.[107] In addition, the legislation is deemed remedial by the provincial Interpretation Acts.[108] Thus, the loss of limited liability through technical infractions and minor compliance defects is much less likely to occur. On the other hand, there is nothing remedial about the control prohibition given that it describes the essential attribute of a limited partner. It can only be construed to give effect to its sole purpose – the protection of third parties.

V. LIMITED PARTNER RIGHTS AND POWERS

The test of liability under the control provision, as described herein, is whether or not a limited partner deals with or makes a decision affecting the assets of the partnership (i.e. the primary security of third parties).[109] This test prevents the possibility of third parties being prejudiced by the reduced liability exposure of limited partners. What limited partner rights and powers are permitted by this test?

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106. *Id.*, s. 14.

107. *See* notes 59-63, *supra*, and text in respect of the ULPA provisions.

108. R.S.A. 1980, c. I-7, s. 10; RSO 1980, c. 219, s. 10.

109. *See* part II, *supra*.

There is little difficulty conjuring up rights and powers that would constitute participation in control when exercised by limited partners. Examples would include the right or power to borrow, give security, extend credit, make distributions, enter into contracts, satisfy debts and claims[110] and make investment and policy decisions. All of these rights and powers directly affect the assets and operations of the partnership. They are the rights and powers of management.

It is also possible to list a variety of rights and powers that do not affect partnership assets and which therefore should not attract general liability. Examples would include the right or power to request and hold meetings, receive regular reports and financial statements,[111] appoint an inspector, approve a change of auditors, obtain asset valuations in certain circumstances and approve general partner (but not partnership) excursions into other businesses.

Other rights and powers require some explanation as to why they do or do not contravene the control prohibition under a third party prejudice test.

The power to hire and fire is allowable depending on whether or not the employees involved can properly be considered assets of the firm. If the employees are the major or perhaps only asset of the partnership the power is prohibited in order to prevent the possibility of prejudice to third parties. It would not be a control power where the employees involved are support staff and the power is exercised in a limited partner's capacity as employee (eg. office administrator).[112]

It has been said[113] that the right to advise (and consult with) the general partner could be a control right depending on the weight the advice carries.[114] This is doubtful, however, because such advice need never be acted on by a general partner. The fact that advice may carry great weight or even amount to a command is not an attribute of the right itself. Any inordinate impact that particular advice might have would arise from factors external to the right. The right to advise is just that, it is not a right to command. If *de facto* commands are made they are made contrary to the right to advise. Further, one who intends to control does not need a formal right to advise; he will do so informally. Nor must the right be found to be a control power in order to impose liability on a limited partner. If the advice is commanding then the general partner

110. Note that the unanimous consent or ratification of the limited partners is required before a general partner has any authority to consent to a judgment against the limited partnership (Alta., RSA 1980, c. P-2, s. 55(c); Ont. R.S.O. 1980, c. 241, s. 7(c).

111. The statutory right to information is a demand right. There is no requirement that disclosure be made on a regular basis (Alta. R.S.A. 1980, c. P-2, s. 57(b); Ont. R.S.O. 1980, c. 241, s. 9(b)).

112. Limited partners can be employees of the limited partnership so long as they remain subject to the control of the general partner. *See Silvola* v. *Rowlett* (1954) 272 P (2d) 287; *Grainger* v. *Antoyan* (1957) 313 P (2d) 848, *Gast* v. *Petsinger* (1974) 323 A.(2d) 371 and Brumder, *supra* n. 45 at 117-118. Ontario s. 11(2)(b) expressly provides that a limited partner may be an employee of the partnership or general partner. There is no corresponding Alberta provision.

113. Feld, *supra* n. 45 at 1477. *See* Brumder, *supra* n. 45 at 116, for the conclusion that the right to advise is permissible under the American case law.

114. Ont. s. 11(2)(a) expressly allows limited partners to advise as to the management of the partnership. There is no corresponding Alberta provision. Previous legislation of both provinces expressly provided for a right to advise (*e.g.*, *see* n. 106 *supra*).

can be found to be the agent of the limited partner for the purpose of controlling the business.

The right of limited partners to terminate the partnership by a percentage vote is a control right.[115] This is ultimate control by limited partners over partnership assets. It is not difficult to see how the exercise of this right can prejudice third parties. It may be that at the relevant time the partnership liabilities exceed assets and all partnership income is servicing partnership debt. The general partner may have no intention to quit but the limited partners decide to dissolve anyway (and forego the return of their contribution). Here it is the wrong persons (i.e. limited partners) who have determined that a third party (and general partner) will suffer loss if the deficiency cannot be made up by the general partner.

There is no substance in the argument that a limited partner's right to dissolve the partnership is only an adjunct or alternative to the statutory right of limited partners to dissolve the partnership by court order and therefore is implicitly within the legislative scheme (i.e. an allowable degree of control).[116] Such an argument ignores the stated requirement of

115. The right to terminate the partnership is one of a number of rights that have been given to limited partners in various American states through amendments to the relevant control provision (*see* Slater, *supra* n. 45 at 419-420 and Stanford, *supra* n. 45 at 1197-1198). An example is the provision set out in the California Corporations Code, *West's Annotated California Codes* (1977) s. 15507:

> 15507-(a) 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.
>
> (b) A limited partner shall not be deemed to take part in the control of the business by virtue of his possessing or exercising a power, specified in the certificate, to vote upon matters affecting the basic structure of the partnership, including the following matters or others of a similar nature:
>
> (I) Election or removal of general partners.
>
> (II) Termination of the partnership.
>
> (III) Amendment of the partnership agreement.
>
> (IV) Sale of all or substantially all of the assets of the partnership.
>
> (c) The statement of powers set forth in subdivision (b) shall not be construed as exclusive or as indicating that any other powers possessed or exercised by a limited partner shall be sufficient to cause such limited partner to be deemed to take part in the control of the business within the meaning of subdivision (a).

116. Augustine, *et al.*, *supra* n. 45 at 2102; Walker, *supra* n. 45 at 294. Walker states that:

> The ULPA grants the limited partners the right to seek judicial dissolution of the partnership. It is not unreasonable to assume, however, that this method of dissolution is not exclusive and that the partnership agreement can grant the limited partners the right to dissolve without court assistance. Under limited partnership statutes prior to the ULPA, a limited partner was a partner in every respect except that his liability was limited. His death or withdrawal dissolved the partnership without causing "interference" problems. Even during the time when the thrust was against limited liability, the limited partners' ability to dissolve the partnership was not thought to disadvantage creditors. Especially since it has been held that, in the absence of statutory bar, the partners may "include in the partnership articles any agreement they wish," granting limited partners the right to effect dissolution without going to court seems reasonable and represents very little change from their present status.

To this it may be answered that: 1) the death or withdrawal of a limited partner obviously cannot cause "interference" or "control" problems; 2) no authority is offered in support of the statement about the early thoughts on dissolution by limited partners; and 3) the partners may make any agreement they like so long as limited partners do not participate in control.

judicial approval. In any event, there is no implicit support in the legislation for such a right. Limited partnership legislation is specific as to both the dissolution and continuation of a limited partnership. The Alberta statutory scheme is as follows: the term of a limited partnership is to be set out in the certificate required to be filed.[117] This term can be defined by events (eg. the bankruptcy of the general partner) or it can be unlimited.[118] The term of the partnership can be ended prematurely (partnership dissolved) or extended (partnership continued) only by an amendment to the certificate requiring the consent of all the partners.[119] If all partners do not consent an application may be made to the court which may direct the amendment.[120] The amendment is only effective to amend the certificate when it is filed.[121] If a statement in the certificate is false or rendered false by subsequent action and no amendment to the certificate is filed then every partner who knew the statement to be false will be generally liable to any third person who suffered loss as a result of relying on the statement.[122] A general partner alone can only dissolve the partnership by court order[123] or by his retirement, death or mental incompetency (and there are no other general partners which all the limited partners agree to let continue the business).[124] A general partner cannot otherwise dissolve the partnership without the consent of all the limited partners because he has no authority to do (1) any act in contravention of the certificate or (2) any act which makes it impossible to carry on the ordinary business of the limited partnership.[125] Thus, a general partner cannot use the general partnership dissolution provisions to dissolve a limited partnership (eg. by giving notice of his intention to dissolve the partnership).[126] In fact, the general partnership dissolution provisions are wholly inapplicable to a limited partnership (except that dissolution by court order is incorporated into the limited partnership dissolution scheme) by necessary inference since the matters dealt with there are expressly provided for in limited partnership dissolution provisions.[127] A limited partner can only dissolve the partnership when his contribution is not returned on demand[128] or by court order[129] or, indi-

117. Partnership Act, R.S.A. 1980, c. P-2, s. 51(2)(d).
118. *Id.*, s. 69(1)(i).
119. *Id.*, ss. 69(1)(h) and (i) and 55(b).
120. *Id.*, s. 70.
121. *Id.*, s. 71.
122. *Id.*, s. 73.
123. *Id.*, s. 57(c).
124. *Id.*, s. 66.
125. *Id.*, s. 55. *See Newburger, Loeb & Co. Inc.* v. *Gross* (1973) 365 F. Supp. 1364 at 1369, where the court concluded that the analogous ULPA provision did not allow variation by the partners. The termination of the business was a matter to be decided by all the partners.
126. *Id.*, ss. 35, 36.
127. For example, under the general partnership provisions (s. 36) a partnership is dissolved by the death or bankruptcy of a partner subject to an agreement between the partners. Dissolution by the death of a general partner is also provided for under the limited partnership dissolution provisions (s. 66). The death or bankruptcy of a limited partner does not cause dissolution as neither event could affect the operation of the partnership or the interests of the other partners.
128. *Id.*, s. 61(4).
129. *Id.*, s. 57.

rectly, by amending the term of the partnership along with all the other partners.[130] No provision dissolves the partnership on the death, retirement or mental incompetency of a limited partner and it is not plausible that a limited partner could dissolve the partnership by giving notice of his intention to do so.[131] As a final point, it is to be noted that dissolution by court order is provided for primarily to protect partners from the incapacity or objectionable conduct of other partners.[132] The court, however, may also dissolve where it is just and equitable to do so and it would seem unlikely that the court would refuse to do so if a substantial number of partners (eg. a majority) requested it.

All of the above provisions infer, if they do not demand, that a limited partnership is only to be dissolved with the consent of all the partners or by court order. It is submitted that Alberta limited partnership legislation, as it relates to dissolution, is comprehensive (no implicit support for other modes of dissolution), exclusive (the control prohibition prevents dissolution in any other way) and is designed to provide maximum protection to all parties (through unanimous consent, judicial dissolution and the control prohibition). The Ontario legislation differs in some particulars but neither does it implicitly support the right as suggested.[133]

The right of the limited partners to amend or to approve the amendment of the partnership agreement is not usually objectionable.[134] In most every case the amendment accomplishes nothing by itself. It only enables something to be done. If what is done amounts to participation in control or otherwise attracts general liability then it, rather than the right to amend, is the cause. An example would be where the limited partners amend the partnership agreement to prohibit the general partner from making any contracts having a value in excess of $1,000 without their approval. Nothing has attracted general liability to this point. However, when the limited partners thereafter exercise their right to approve a contract they are participating in control. General liability is then imposed because of the right to approve and not because of the right to amend. The same point is made by an American commentator on the ULPA control provision:[135]

> Simply amending the partnership agreement should not impose general liability (unless, of course, the amendment accomplishes something such as a violation of ULPA Sections 5 or 6), just as merely being entitled to exercise certain rights does not cause Section 7 liability. The amendment would have to give a new right or power which, if exercised, would constitute a Section 7 violation. If, for instance, an amendment allowed the limited partners to select a general manager and they in fact did so, Section 7 would probably be violated. If it simply eliminated previously permitted general partner abuses, such as self-dealing, there is probably no Section 7 violation.

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130. *Id.*, ss. 69(12)(h) and (i).

131. This is additional evidence that the general partnership dissolution provisions are not applicable to limited partnerships.

132. *Supra* n. 117, s. 38.

133. The most notable difference is that there is no requirement to define a term (whether fixed or indefinite) for the partnership in the filed declaration. *See* s. 3(2) of the Ont. Act., *supra* n. 4.

134. *See* Walker, *supra* n. 45 at 294; Augustine, *et al.*, *supra* n. 45 at 2102.

135. Walker, *supra* n. 45 at 294.

There is, however, one circumstance where the right to amend may amount to participation in control – where the partnership agreement provides for a specific matter and the amendment thereto alone would affect partnership assets. That is, no further limited partner act is required in order to effectively deal with the partnership assets. An example of this would be where the specified investment policy of the partnership is amended by the limited partners and no further act would be required in order for limited partners to affect the employment of the assets.[136]

Finally, it is to be noted that the Alberta legislation requires a notice to amend the filed partnership certificate to be signed by all the partners.[137] This requirement will often be satisfied in the normal course by the general partner signing on behalf of the limited partners using the signing authority he has likely collected from each of them.[138] In Ontario, a declaration of change need only be signed by one general partner in most cases.[139]

The right to remove (and, necessarily, to replace) a general partner is a control right under a prejudice test and probably under any other test of control.[140] This much appears to be conceded by commentators.[141] When limited partners exercise this right they affect the management of the partnership assets which are the primary security of third parties. The right to remove is the right to determine who is to manage the business and thus how it is to be managed. Through it, the limited partners could make significant changes to the operation and personality of the partnership. This may not be direct control over partnership assets but, clearly, it is ultimate control. Like any other right of dismissal, it asserts such ultimate control when it is exercised.

Various reasons have been offered by American commentators as to why the exercise of a right of removal should not be sufficient to cause the imposition of general liability. These reasons require some examination.

To begin with, it is argued that the American cases on the control prohibition – "impliedly if not expressly" – indicate that day-to-day control is what is required before limited liability will be lost.[142] It is said that the "extraordinary control" of the right to remove is outside such day-to-day control. The cases, however, cannot be so restricted because they have generally dealt with relatively one-sided fact situations and have eluci-

136. *See* the text accompanying n. 162, *infra.*

137. *Supra* n. 117, s. 69(2)(b).

138. *Id.*, s. 77. The signing authority provided for here was intended to facilitate such mundane but administratively costly amendments as the admission of a new limited partner or the continuation of the partnership upon the death, retirement or mental incompetence of a general partner. Note that these matters can be provided for in advance in the partnership certificate (s. 55(f), (g)). It is doubtful that this signing authority could be used to validate an amendment that involved a participation in control. *See also* Coleman and Weatherbie, *supra* n. 45 at 917.

139. *Supra* n. 4, s. 18.

140. The right to remove is another right that has been provided for by legislative amendment in a number of jurisdictions (*see* n. 115, *supra*) and is excepted from the ambit of the control prohibition in the 1976 ULPA (*see* n. 100, *supra*).

141. Walker, *supra* n. 45 at 294-295; Augustine, *et al.*, *supra* n. 45 at 2101; Slater, *supra* n. 45 at 184-185; Kratovil and Werner, *supra* n. 45 at 58.

142. Walker, *supra* n. 45 at 295; Augustine, *et al.*, *supra* n. 45 at 2104; Slater, *supra* n. 45 at 427.

dated no particular guidelines when doing so.[143] All that the cases determine is that general liability will be imposed for day-to-day control. To this it might be added that (1) nothing stops an "extraordinary control" right being used day-to-day to effect active control and (2) the control prohibition makes no distinction between different "types" of control.

The case that is usually offered for the proposition that only day-to-day control will attract general liability is *Weil* v. *Diversified Properties.*[144] The action in this case was instituted by a general partner (Weil) seeking to have his limited partners declared generally liable (along with himself) for the debts of the partnership. The court said that the position of the limited partners *vis-à-vis* third parties was not before it and, as between the limited partners and the general partner, the former could only be made liable if they had breached the partnership agreement. The court dismissed the action because the advice the limited partners gave to the partnership managers was not day-to-day management as contemplated by the partnership agreement:[145]

> Whatever may be the obligations of the limited partners as against creditors or third parties, Weil may not prevail against them if they have not breached the terms of the agreement.[146]
>
> Weil has not by a preponderance of the evidence established any violation by the limited partners of terms of the agreement with him, which at the very most is all that Weil can complain of in his effort to have the limited partners declared general partners. Since the partnership agreement was not violated by the limited partners, Weil has no cause of action and his request for the appointment of a receiver and an accounting will be denied. The provisions of the Limited Partnership Act are primarily designed to protect creditors. So long as the provisions of the agreement were followed, no partner can complain.

At most, this case only indicates that giving advice is not a participation in control. It does not even remotely suggest that "control" short of "day-to-day" control is permissible. The inference is to the contrary.

Indeed, to the extent that the right to remove has been considered by the cases, the suggestion is that the right is objectionable. In *Plasteel Products Corporation* v. *Helman*[147], the limited partners selected the general sales manager who had joint control with the general partner over financial aspects of the business. The court, however, did not find the limited partners generally liable because the general sales manager was subject to being dismissed by the general partner. Obviously the court considered the right of one person to remove another who partly controlled the business a relevant and superior control right. Further, in *Freedman* v. *Tax Review Bd. of Philadelphia*[148], the court clearly intimated that the right of removal would attract general liability.

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143. *See* the cases in n. 66 *supra.* Note particularly the comments in *Executive Hotel Associates* v. *Elm Hotel Corp* (1964) 245 N.Y.S.(2d) 929 at 933 (the court would have imposed liability when a limited partner sued to recover rent owed to the partnership: such could not be considered day-to-day control) and *Sloan* v. *Clark* (1966) 223 N.E.(2d) 893 at 895 (a limited partner "is only permitted a limited, if any, voice in the administration of the partnership"). *See also Millard* v. *Newmark & Company* (1966) 266 N.Y.S.(2d) 254. Note the decision in *Consortium Management Company* v. *Mutual America Corp.* (1980) 271 S.E.(2d) 488, where a right of removal was exercised. No third party was involved and the control issue was not discussed nor was it relevant.

144. (1970) 319 F. Supp. 778. The case is cited by Walker, *supra* n. 45 at 295 (n. 35) and referred to by Augustine, *supra* n. 45 at 2103 and Slater, *supra* n. 45 at 427.

145. (1970) 319 F. Supp. 778 at 781.

146. *Id.* at 783.

147. (1959) 271 F.(2d) 354.

148. (1968) 243 A.(2d) 130.

As a second reason, it is said to be relevant that the legislation (*i.e.*, the ULPA) contemplates some degree of control and that the right does not induce third party reliance on limited partner control.[149] It was previously pointed out that the degree of control contemplated must have been the control expressly permitted by the statute[150] and that reliance is not the test of liability.[151] Further, it is doubtful that the right to remove the general partner would not induce third party reliance especially, for example, in a limited partnership with few limited partners.

Third, it is argued that because third party expectations of particular general partner control are entirely defeated by the retirement of a general partner there can be no complaint when the same result is achieved through the power to remove.[152] This argument is inapplicable since it is not the maintenance of a particular general partner array which the third party is entitled to rely on but rather the non-interference of limited partners in the partnership business. The right to remove entails interference by limited partners. Retirement, being internal to the general partner and a risk to which all parties are always subject, does not.

Fourth, it is argued that the right to remove the general partner is consistent with or complementary to the various rights of limited partners to determine the identity of the general partner array that will manage the partnership business.[153] It is said that because the identity of general partners is so important to limited partners, and recognized as such by these provisions, the right to remove the general partner cannot or should not attract general liability. This reasoning, however, draws exactly the opposite inference which the specificity of the legislation demands. The legislation sets out that limited partners are to approve the admission of any new general partner[154] and that they must consent before the partnership can be continued by the remaining general partners upon the death, retirement or mental incompetency of a general partner.[155] Both of these decisions must be unanimous. This is a clear recognition of the importance of the identity of general partners to *all* the limited partners. This, however, is as far as the legislation goes. There can be little doubt that the draftsmen of the legislation must have considered the removal right in their deliberations. Given the detail of the legislation as it relates to the identity of the general partner and its absolute prohibition on limited partner control, it must be assumed that

149. Slater, *supra* n. 45 at 427; Augustine, *et al.*, *supra* n. 45 at 2101. Note that Augustine points out in n. 43 that California considered the permitting of statutory voting rights to be a clarification rather than an alteration of existing law. In fact, however, the changes were *deemed* to be a clarification and a continuation of existing law and that the changes "shall not be construed as constituting changes therein" (*See* the Historical Note in s. 15502 of the California Corporations Code, *supra* n. 115).

150. *See* notes 51-56 *supra*, and accompanying text.

151. *See* notes 83-97 *supra*, and accompanying text.

152. Feldman, *supra* 45 at 184.

153. Walker, *supra* n. 45 at 295; Augustine, *et al.*, *supra* n. 45 at 2101; Slater, *supra* n. 45 at 427.

154. Alta., s. 55(e); Ont., s. 7(e); ULPA, s. 9(e). The admission of a general partner is a matter to be decided by all the limited partners. This section is not subject to variation by the partners. *Newburger, Loeb & Co. Inc.* v. *Gross* (1973) 365 F. Supp. 1364 at 1369-1370.

155. Alta., ss. 55(g), 66; Ont., ss. 7(g), 20; ULPA, ss. 9(g), 20.

the right would have been provided for if it had been intended. It was not provided for probably because it was considered an undue amount of control and because it was feared that it would be used *in terrorem* to effect daily control. Limited partners were not left without a remedy however. If a general partner is incompetent, or wherever it is just and equitable, the court may dissolve the partnership at the request of any single limited partner.[156] The inference to be drawn from these provisions is that the statutory scheme dealing with the identity of general partners is (as in the case of dissolution) comprehensive, exclusive and designed to provide maximum protection to all parties.

The right to approve the sale of all or substantially all the assets of the partnership is not contrary to the control prohibition, in the usual case,[157] for a rather unexpected reason.[158] It is allowable because it is expressly, albeit indirectly, provided for by the legislation. Under the limited partnership legislation of both Alberta and Ontario, a general partner has no authority, without the consent of *all* the limited partners to the *specific* act, to do any act which makes it impossible to carry on the ordinary business of the limited partnership.[159] That being so the statutes must be taken to have expressly provided for that degree of limited partner control which is manifested in the right to approve a sale of all the assets. In such a case, the right to approve a sale will not attract general liability because the sale cannot be done without limited partner approval. On the other hand, the legislation requires the unanimous consent of the limited partners to the specific act. Any percentage vote less than 100 per cent will therefore be ineffective to safely accomplish the sale. Any partner who disagrees may seek an injunction enforcing his right to prevent the sale. A court would find it very difficult to refuse the requested injunction.[160] In the result, the right is not usually affected by the control prohibition but neither is it effective unless approval is unanimous. The above reasoning would also apply to a right to approve dissolution.[161]

The right to consider and approve a material change in the fundamental investment policy of the partnership is a control right because the limited partners thereby directly affect the employment of the partnership assets. Changing or refusing to change investment policy determines what investments will be made with partnership capital. This change could not be made by amendment to the partnership agreement because the amendment (or approval of the amendment) by itself would

156. Alta., ss. 57(c) and 38; Ont. s. 9(c).

157. That is, wherever a sale of assets would make it impossible to carry on the ordinary business of the partnership. An exchange of assets would not therefore be in the same position. An approval of an exchange would be a participation in control. *See also* M. Staples, "Can a Limited Partner Enjoin the Sale of All, or Substantially All, of the Limited Partnership Assets in View of Delaney v. Fidelity Lease Ltd.?" (1975-76) 17 *S. Tex. Law J.* 243.

158. Augustine, *et al.*, *supra* n. 45 at 2102, seek to justify this right by analogy to the right to have dissolution by court order. This analogy argument, it is submitted, can have no more success than the other offered analogies already discussed.

159. Alta., s. 55(b); Ont. s. 7(b). *See Newburger, Loeb & Co. Inc.* v. *Gross* (1973) 365 F. Supp. 1364 at 1369, where it is stated that, except as provided therein, the matters in these approval sections are not subject to variation by the parties (*eg.*, not less than 100 per cent consent or ratification is required).

160. *See Newburger, Loeb & Co. Inc.* v. *Gross, supra* n. 159. *See also* Staples, *supra* n. 157.

161. But not to the bare right of limited partners to dissolve the partnership on their own.

result in participation in control.[162] It is to be noted that the general partner alone could not make any change to the investment policy set out in the partnership agreement because he is bound by the terms of that agreement. This, however, does not mean that the investment policy of the partnership can never be changed. All that need be done is to give the general partner a veto power over changes in investment policy initiated by limited partners. This means giving the limited partners the right to amend the investment policy of the partnership by some percentage vote subject to the approval of the general partners (i.e. in effect, giving the limited partners a right to *advise* the general partners).

As an aside, it is relevant to point out what would appear to be a substantial anomaly or loophole in the legislation. It is found in the provision stating that a general partner has no authority to do an act in contravention of the certificate (or, in Ontario, the partnership agreement) without the consent of all the limited partners to that specific act.[163] This provision would appear to allow limited partners to legitimately exercise full control over the partnership business where the certificate (or partnership agreement) prohibits the general partner from doing virtually anything. In the face of such a bare and extensive prohibition, the general partner would be required by the legislation to seek the consent of the limited partners for most everything he did. The complete self-defeat of the legislation in this fashion suggests that there must be some limitation on this provision. Upon consideration it would seem that this approval right of limited partners was only meant to be exercised in respect of the matters which are specifically required to be set out in the filed public document.[164]

Ontario, as pointed out in parentheses in the preceding paragraph, has not framed this approval right in terms of the filed declaration. Instead, the right is in relation to the partnership agreement. Whether or not general prohibitions can be included in an Alberta certificate,[165] they can clearly be included as terms of a partnership agreement. Thus, complete limited partner control could be provided for in this manner.[166] In order to prevent such a self-defeating interpretation of this legislation, it must be concluded that, apart from the matters required by statute to be included in the public document, no approval that would otherwise be a participation in control can be effected through this particular provision.

The last matter to be dealt with in this part is the position of the Alberta and Ontario Securities Commissions with respect to limited partner rights and powers. As set out in A.S.C. Policy 3-14[167] and O.S.C. Policy 3-25,[168] the Commissions expect certain rights to be given limited

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162. *See* text accompanying n. 136, *supra.*

163. Alta., s. 55(a); Ont. s. 7(a).

164. Alta., s. 51(2); Ont., s. 3(2).

165. It would seem that other matters could be set out in the certificate since there is no suggestion otherwise and the legislation provides that certain other information may be set out therein (*eg.*, the right to admit additional limited partners).

166. Most effectively, of course, where the number of limited partners is small (because of the unanimity requirement).

167. *Also see* A.S.C. Policy 3-19, for the experience and net worth requirements of oil and gas program sponsors.

168. *See also* O.S.C. Policy 3-26.

partners in order to provide them with additional investment protection. The extent of these additional protections is a matter of negotiation with the Commission staff – the underlying regulatory rationale being to provide limited partners with similar rights to corporate shareholders. The trouble with this rationale, of course, is that it does not by itself recognize the limitations imposed by the control prohibition which is not a feature of corporate law.

A number of the rights which are currently found in virtually all limited partnership agreements are potentially liability-attracting rather than investment-protecting as described above. Other rights are ineffective as between the partners. These rights should therefore be retracted or altered (eg. to require unanimity) as the case may be. The Securities Commissions might be expected to agree to these changes in view of, if nothing else, the uncertainty that exists at present. Very harsh consequences may follow from what is perhaps a misdirected regulatory scheme. Regulatory efforts would be better directed at the limited partnership vehicle and the general partner alone.[169]

VI. CORPORATE GENERAL PARTNERS

The use of the corporate form to reduce the liability exposure of general partners has been briefly discussed in part III in connection with the American cases on the control provision. As pointed out there,[170] the prejudice test of control indicates that there is no justification for piercing the corporate veil merely because limited partners are involved in the corporate general partner. This part will expand on those comments.

Historically, at least in the United States, there existed some doubt as to whether or not a corporation could be a partner at all.[171] Even though this doubt was probably unwarranted, the question is now irrelevant since corporate legislation invariably gives a corporation the power to be a partner.[172] In addition, the legislation of both Alberta[173] and Ontario[174] accommodates corporate general partners. By permitting corporations to be general partners the provincial legislatures have effectively provided for a vehicle with complete limited liability for all its natural participants. In the case of the corporate general partner, this limitation on liability is one level more remote than that of limited partners. The corporation is fully liable but its shareholders are not. The ability to utilize corporate general partners has undoubtedly improved the commercial viability of limited partnerships.

Corporate general partners raise no control problems when there are no limited partners involved in their structure. Thus the control issue, in

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169. *See* n. 30, *supra.*

170. *See* text at n. 80.

171. P.R. Johnson, The Corporation as Managing Partner in a Limited Partnership (1979) 55 *N. Dakota Law Rev.* 271 at 275-279 and the Annotation at 60 A.L.R.(2d) 917.

172. The power was often given expressly (*eg.*, the Companies Act, R.S.A. 1980, c. C-20, s. 20(1)(e).). Now the power follows from the fact that a corporation will usually have the powers of a natural person.

173. Alta., s. 50(2) states that "persons" can be partners. Under the Interpretation Act, R.S.A. 1980, c. I-7, a "person" includes a corporation.

174. Ont. s. 1(c) defines "person" to include a corporation.

this context, will rarely arise for large public limited partnerships since general partner officers and shareholders will usually have no or only a nominal interest as a limited partner. It will arise, however, when a small group of persons use the limited partnership as an alternative vehicle through which to achieve limited liability while still retaining control over the business.[175] The issue will arise because of appearances. Whether or not any third party can properly complain about this appearance is the present question.

When a general partner is a corporation it is possible that its directors, officers and shareholders might also be limited partners. Immediately the question arises whether limited partner involvement in the corporate general partner is contrary to the control prohibition. On its face, the control prohibition does not apply because it is the corporation, and not the limited partners, controlling the partnership business. The argument is then made that this is an attempt to circumvent the statute through the use of the corporate fiction and that therefore the corporate veil must be pierced.[176]

Piercing the veil is a matter to be dealt with independently of mere appearance.[177] There must be a reason to pierce and this involves considering the purpose of the control provision. When the corporate veil is pierced it must be because the mischief the provision seeks to prevent is again made possible and not merely that the wording of the provision appears to have been thwarted.

The purpose of the control prohibition is to prevent limited partners prejudicing third parties. Limited partners must not be able to take part in control because they do not have the same inherent check on their business conduct as do general partners (*i.e.,* general liability). The possibility of the risk aversion of limited partners affecting third parties is the mischief which the control provision prevents.

Consider the limited partnership in which all the limited partners are also the only directors, officers and shareholders of the sole corporate general partner. The corporate general partner here has a specific risk aversion determined by its own directing mind and will. This risk aversion is an existing fact which a third party can be assumed to have considered when he dealt with the partnership and which (to personify) he has agreed to let manage his security. So long as the control separation between limited and general partners is maintained, a third party will only be subjected to the peculiar risk aversion of the general partner. That being so, a third party cannot complain of the involvement of limited partners in the corporation because he has never been affected by the risk aversion of some person other than the general partner. The mischief which the control provision prevents, partnership assets being affected by persons other than general partners, remains prevented. The policy of third party protection, as implemented by the legislation, is not thwarted.

175. The primary reason for choosing the partnership over the corporation is the conduit tax scheme of the former.

176. The American discussion on corporate general partners is found in the commentaries cited in n. 76, *supra.*

177. *See generally* J.W. Dunford, "The Corporate Veil in Tax Law" (1979) 27 *Can. Tax J.* 282. See how to avoid being pierced in D.H. Barber, "Piercing the Corporate Veil" (1981) 17 *Willamette Law Rev.* 371.

One perceived problem with corporate general partners is that they tend to be undercapitalized. This, however, is a difficulty with corporations generally and, in that regard, is a problem that can be remedied directly through minimum capital requirements.[178] Undercapitalization can be a factor in piercing the corporate veil but it is unlikely by itself to be sufficient reason to do so. Probably the quickest way to lose the benefit of the corporate fiction is to ignore it. If the shareholders ignore the corporate form a court will do so as well. These, of course, are additional considerations and do not impact directly on the question of whether or not limited partners can be involved in the corporate general partner.

It is submitted that there is no reason to pierce the veil of a corporate general partner simply because the limited partners are its directors, officers or shareholders. There is no actual circumvention of the purpose of the control prohibition which could support a disregard of the corporate form.

VII. CONCLUSION

It is submitted that the limited partnership legislation of Alberta and Ontario sets out a prejudice test of "control". Giving effect to both the terms of the legislation and the underlying policies, the test would impose liability whenever a limited partner can affect the partnership assets. In view of the rationale of the control prohibition, this test is not unreasonable. It is also a certain test that allows objectionable rights and powers to be identified in advance.

Limited partnerships, in so far as limited partner control is concerned, are relatively inflexible vehicles. This is because limited partner participation in control is simply inimical to the concept of the limited partnership.

Limited partner investment protection is said to justify the discounting and overriding of third party interests until an apparently more reasonable level of protection is obtained. It is doubtful, however, that the control prohibition is pliant enough for this purpose. Limited partner rights of the sort contemplated by securities regulators, for example, are properly only provided for by legislation. There are policy decisions to be made in each case and that is the function of the legislature.

There is clearly room for clarification, if not perhaps fundamental change, in connection with limited partnership legislation. If nothing else, the control prohibition should be altered to specifically describe the precise test of limited partner liability. The 1976 ULPA is one approach but even its cumbersome terms could be improved upon.[179] Until such time as there is such legislative change it is submitted that the prejudice test of control must govern the nature of permissible limited partner rights and powers.

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178. For a recent discussion of the problem of undercapitalization and other abuses of the corporate form, *see* M. Whincup, "Inequitable Incorporation – the Abuse of a Privilege" (1981) 2 *The Company Lawyer* 158.

179. *See* notes 100-101, *supra.*