Limited Partners' Liability for Impermissible Control Activity under the Revised California Limited Partnership Statute

Richard M. Buxbaum
Berkeley Law

Craig B. Etlin

Follow this and additional works at: https://scholarship.law.berkeley.edu/facpubs

Part of the Law Commons

Recommended Citation

This Article is brought to you for free and open access by Berkeley Law Scholarship Repository. It has been accepted for inclusion in Faculty Scholarship by an authorized administrator of Berkeley Law Scholarship Repository. For more information, please contact jcera@law.berkeley.edu.
LIMITED PARTNERS' LIABILITY FOR IMPERMISSIBLE CONTROL ACTIVITY UNDER THE REVISED CALIFORNIA LIMITED PARTNERSHIP STATUTE

Richard M. Buxbaum* and Craig B. Etlin†

I. INTRODUCTION

As the modern limited partnership has changed its typical purpose, so the role of the limited partners in the governance of that form of enterprise organization has changed. The tensions between the established legal model and new forms of behavior are reflected in the state of jurisprudence and commentary dealing with the limits on limited partners' control of the firm under the old statute; indeed, this issue was, in our opinion, a major factor in the recent recodification movement.

A. The Concept of Control

The limitation of the limited partners' liability for the obligations of the partnership is only available for the price of giving up "control" to the general partner(s). The corporate analogy offers itself as an appropriate background context for understanding the nature of the "control" concept. The shareholder-director relationship does not provide a perfect analogy, but today it is a better one than an analogy to the trustee-beneficiary relationship which at one time was the preferred frame of reference. The reason for the shift is simple enough: the limited partner

* Professor of Law, University of California, Berkeley; A.B. 1950, Cornell University; LL.B. 1952, Cornell University; LL.M. 1953, University of California, Berkeley.
† Associate, Morrison & Foerster, San Francisco; B.A. 1982, University of California, Los Angeles; J.D. 1985, University of California, Berkeley.
3. A. Bromberg, Crane and Bromberg on Partnerships (1968).
is an investor in an enterprise, and needs to exercise some degree of control, or at least supervision over that investment; the beneficiary is a donee, as well as a stranger to the agreement (between settlor and trustee) structuring the trustee's duties vis-a-vis the beneficiary. The investment-related basis of the limited partner-general partner relationship is best illustrated by the treatment of the former's voting rights, which are the operational reflection of the fact that investment protection is the basis for the very concept of "participation" — i.e., permissible involvement as opposed to impermissible control — of the modern law of limited partnerships.  

B. Background

The concept of "control" itself, as well as the compatibility of the exercise of control and limited liability status, has evolved substantially over the past decades. "Control" means different things for a small, closely-held enterprise and for a large, publicly-held one. The early 20th century image of the limited partnership, perfectly reflected in the original ULPA, is that of a single general partner whose own substantial investment is augmented by the passive capital of a few silent, sleeping or retired partners. Early cases involve retail mercantile establishments and small local producers (often originally sole proprietorships). As to relative capital participation, it tended to be either equal or involve a local, passive investor with an active partner who provided technical or management contributions in lieu of capital.

In this setting, complex, hierarchical governance structures were irrelevant to the function of the enterprise. If limited partners participated in enterprise governance at all, they were likely to do so in a hands-on, shirtsleeve fashion, not through the indirect steering of the general partner by the setting of policy and the monitoring of results. Thus, they were immediately, almost by definition, exposed to the view of third parties and the risk of liability. The separate question of third party reli-

4. The relationship of voting rights with control is illustrated by the 1963 amendment, Act of June 11, 1963, ch. 870, 1963 Cal. Stat. 2110, of section 15507 of the earlier (ULPA) version of the Corporations Code, which added the voting rights demanded by the Commissioner of Corporations not in direct form but as a safe harbor immunity from seas of illegitimate control.


7. See, e.g., Tilge v. Brooks, 124 Pa. 178, 16 A. 746 (1889). The occasionally found passive limited partners typically were local parties prevailed upon to make an investment in a local enterprise; see, e.g., Strang v. Thomas, 114 Wis. 599, 91 N.W. 237 (1902).

8. See this situation in even the relatively recent cases of Grainger v. Antoyan, 48 Cal. 2d 805, 313 P.2d 848 (1957) and Silvola v. Rowlett, 129 Colo. 522, 272 P.2d 287 (1954). See also, e.g., J.
ance was not addressed, not because it was irrelevant normatively but because it was so prevalent factually that its possible normative significance was not perceptible.

There was also no reason to involve limited partners in the governance of the enterprise from the perspective of their own protection. The same factors already mentioned suggest that the limited partnerships on the one hand could rely on the substantial investment by the general partner as an automatic monitor of overall enterprise performance. On the other hand, their proximity to the enterprise and to the general partner permitted direct monitoring of the general partner to the degree necessary when an agent-principal separation of roles arose and created a conflict of interests.

In short, and with all the qualifications that such a simplified analysis of "ideal type" situations brings with it, we can say generally that limited partners' involvement in the running of the enterprise was not as necessary as it is today, but when it occurred it was more visible and more immediate. Today, in contrast, the general partner, typically the promoter of the enterprise or an affiliate of the promoter, runs it more as an agent than as a fellow principal. The investors, even in private syndications, are distant (in part because the enterprise investments may be at a distance). Even less of their fortune, and thus of their interest, may be invested in the partnership than was the case when the local gentry placed some money with an expanding local enterprise. The modern limited partnership is an investment situation that requires the kind of conflict-reducing investor participation with which state securities regulation has made us familiar.

But the nature of that investor participation also has changed. Even if these limited partnerships are more investment-oriented than operational entities, and thus require less complex internal governance structures and less personnel than do industrial enterprises, they do require more internal organization, more internal hierarchy, than did the small mercantile establishment of 1910. This is of course particularly true of the large, public syndicate; but it is to some extent true of the private placement, which may itself be quite large and which in any event often is operated, as one member of the syndicator's "family" of investments, on a pooled basis with centralized managerial and consulting services.9


9. This is well demonstrated by the continuing education materials developed for the field of limited partnership law. See, e.g., ALI-ABA, Comm. on Continuing Professional Educ., Resource Materials - Partnerships (5th ed. 1984).
The limited partners' involvement in management thus is already factually more likely to be indirect and structured along formal lines of voting, than it is likely to be direct — and this is so before legal considerations even apply or become a factor in shaping the relationship. When hands-on involvement in the partnership does occur, it is likely to be in an emergency or salvage context, when the normal governance structure for one reason or another has broken down.\textsuperscript{10}

This background sketch has a purpose beyond its possible validity in explaining the real, historical evolution of the limited partnership: It informs the interpretation of the new statutory approach to the problem of liability for impermissible control behavior of limited partners.

The following brief review of the voting rights specified in the "safe harbor" catalog in section 15632(b) of the California Corporations Code is not intended to exhaust the myriad problems of scope and interpretation generated by this list. For the present, what is important is to understand this list as an expression of the corporate analogue; such an understanding will provide the setting for a more detailed review of the control question.

The overall analysis of this section and of the potential loss of limited liability through participation in control begins with the inner harbor of this safe harbor provision — these very voting provisions — because there is little room for ambiguity or borderline problems in the application of those voting provisions.\textsuperscript{11} We then move on to the outer harbor of the balance of section 15632(b), beginning again with the least ambiguous provisions and moving out to the more problematical ones.

1. The Limited Partners' Right to Vote

Since the first efforts to provide voting rights to limited partners as an element of investor protection, the corporate law form of mandatory shareholder voting rights has served as the implicit if not explicit model. It is instructive to compare these mandatory shareholder voting rights with the safe harbor voting rights of limited partners. This comparison may resolve doubtful issues.


\textsuperscript{11} See generally Augustine, Fass, Lester, & Robinson, The Liability of Limited Partners Having Certain Statutory Voting Rights Affecting The Basic Structure of the Partnership, 31 Bus. Law. 2087 (1976) (exercise of statutory voting rights not subjecting limited partners to general liability). On the special control problem posed by regulations such as CAL. ADMIN. CODE tit. 10, 260.140.116 (1985) which as to certain (real estate) entities seem to require that solely the limited partners vote, without general partner participation, see Coleman & Weatherbie, supra note 10, at 897 n.87.
(a) **Section 15632(b)(5)**

i) Subdivision (5)(A), governing dissolution and winding up of a limited partnership, directly corresponds to section 1900, governing the shareholders' participation in the dissolution of a corporation. As in the latter case, section 15636(f) provides for a simple majority vote, in interest, of the limited partners, in default of a contrary provision in the partnership agreement.**

12. For convenience, we set forth here the entire text of subsection 15632(b), (c), and (d):

(b) A limited partner does not participate in the control of the business within the meaning of subdivision (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, or an officer, director, or shareholder of a corporate general partner.

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 or guaranteeing one or more specific debts of the limited partnership.

4. Approving or disapproving an amendment to the partnership agreement.

5. Voting on or calling a meeting of the partners for one or more of the following matters:
   - The dissolution and winding up of the limited partnership.
   - The sale, exchange, lease, mortgage, pledge, or other transfer of all or a substantial part of the assets of the limited partnership other than in the ordinary course of its business.
   - The incurrence of indebtedness by the limited partnership other than in the ordinary course of its business.
   - A change in the nature of the business.
   - An election to continue the business of the limited partnership after a general partner ceases to be a general partner other than by removal where there is no remaining or surviving general partner.
   - The admission of a general partner or an election to continue the business of the limited partnership after the removal of a general partner where there is no remaining or surviving general partner.

6. Winding up the partnership pursuant to Section 15683.

7. Executing and filing a certificate pursuant to Section 15633 or a certificate of amendment pursuant to Section 15625 or a certificate of dissolution pursuant to paragraph (1) of subdivision (a) of Section 15623 or a certificate of cancellation of certification of limited partnership pursuant to paragraph (1) of subdivision (b) of Section 15623.

8. Serving on an audit committee or committee performing the functions of an audit committee.

(c) The enumeration in subdivision (b) does not mean that any other conduct or the possession or exercise of any other power by a limited partner constitutes participation by the limited partner in the control of the business of the limited partnership.

(d) A limited partner who knowingly permits that partner's name to be used in the name of the limited partnership, except under circumstances permitted by subdivision (b) of Section 15612, is liable for all obligations of the limited partnership to persons without actual knowledge or notice that the limited partner is not a general partner.

13. This cross-reference will be important throughout the discussion of the various safe harbor provisions, since it specifies what might be called the "standard form" contract which applies to the partnership in default of other, explicit treatment in the partnership agreement. For analysis of the
ii) Subdivision (5)(B), governing sale or other transfer of all or a substantial part of the partnership assets other than in the ordinary course of business, is derived directly from section 1001.14

iii) In essence if not in form, subdivisions (5)(F), (H), (I) and (J), to the extent they provide for the removal and admission of a general partner under various circumstances, are directly analogous to the election and removal of directors found in sections 300 and 310 (as augmented by common law precedent).15

iv) Subdivisions (5)(G), (I) and (J), to the extent they provide for an election to continue the business of the partnership after the occurrence of certain dissolution events that otherwise would cause its winding-up and liquidation, by definition have no direct corporate analogy.16 In a structural sense they are nevertheless analogous to certain shareholder decisions (e.g., the extension of corporate existence after expiration of an originally limited period of existence, which is a shareholder not directorial decision).17

v) Subdivision (5)(E), governing approval of a transaction in which the normally competent decisionmakers, the general partners, have a potentially disabling conflict of interests, is derived from that portion of section 310 which permits the substance of such a transaction to be approved by the vote of the disinterested shareholders.18

This curative substitute for general partner decisionmaking is, however, a limited one. The less important limitation arises from the fact that the conflict of interests is that of "the general partners." What if only one, or less than all, have this conflict? Can the partnership agreement safely jump at once to substitute the limited partners? That the plural includes the singular19 is not a full answer in this case, since there is a substantive issue lurking here. If, as we shall assume, the corporate solution to conflict-of-interests transactions provided by section 310

---

14. CAL. CORP. CODE § 1001(a) (West 1977) ("A corporation may sell, lease, convey, exchange, transfer or otherwise dispose of all or substantially all of its assets . . . .").
15. For an analysis of those sections' significance, see 3 H. MARSH, MARSH'S CALIFORNIA CORPORATION LAW, ch. 2 (2d ed. 1983) and references cited id. at 1 n.1.
16. Corporations do not typically exist only for a single and limited purpose; indeed, the concluding paragraph of subsection 202(b) suggests that this would be a highly unusual event.
18. For a review of this section's three curative approaches to conflict-of-interests transactions by directors, see Buxbaum, Conflict-of-Interests Statutes and the Need for a Demand on Directors in Derivative Actions, 68 CALIF. L. REV. 1122 (1980).
should be applied to partnerships by analogy, curative voting procedures less drastic than recourse to the shareholder-like limited partners may be available, in particular the vote of the disinterested general partner or partners though these in ordinary corporate circumstances might be too few to function for the group. There is an even stronger case for action by disinterested general partners than for action by disinterested directors. While a board of directors might have to act collectively to bind the corporation to third parties, in a limited as well as a general partnership each general partner is a plenary agent for the entity; thus, any one disinterested general partner could effect the transaction.

Thus, it could be argued that subdivision (5)(E) should be available only as a last resort; i.e., when no disinterested general partner is available. That is a respectable substantive reason why the subdivision reads as it does: when "the general partners" have a conflict. Yet we see no serious objection to a more cautious provision in the partnership agreement which, seeking to protect the investors from even a remote risk of backscratching among ostensibly disinterested general partners who might otherwise buy each other's real estate at inflated prices for the partnership, requires approval by the limited partners whenever any general partner has a conflict of interests. Since courts generally are sympathetic to this purpose, we suggest that the statute, in providing a safe harbor for voting not only where actual conflicts of interests exist but also in the case of potential conflict, can be viewed as being sufficiently broad to provide a safe harbor for a provision authorizing a limited partnership vote when less than all of the general partners have an actual conflict.

A second problem or limitation of subdivision (5)(E) arises from the fact that it is a part of the voting provision of the safe harbor catalogue, and not an autonomous provision. Thus, it would not cover the case of an agreement which in advance appoints a given limited partner as guest

---

20. Section 310 needs to be read in conjunction with the mandatory quorum provisions of section 307(a)(8); see R. Jennings & R. Buxbaum, Corporations — Cases and Materials 459 (5th ed. 1979).


22. Courts have recognized the problem of reciprocal favors and backscratching; see, e.g., Stoiber v. Miller Brewing Co., 257 Wis. 13, 42 N.W.2d 144 (1950). Compare with this view the specific exculpation (in the one area of reciprocal voting for fellow directors' compensation as executives) now provided by Cal. Corp. Code § 310(a) (West 1977).

23. Indeed, where curative statutes seem to allow interested shareholders to participate, both California and Delaware jurisprudence read into that authorization a separate limiting requirement of fairness. See Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 241 P.2d 66 (1952); Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976).
general partner, simply to make all later-arising, conflict-tainted decisions in an executive sense.

Such a provision would appear to be outside the safe harbor. But what of an agreement which simply places this substitute responsibility in the hands of an already legitimately appointed committee, such as an audit committee (per subdivision (b)(8))? As a smaller group, more flexible and quicker to move than a clumsy mail ballot among hundreds of investors, such a committee would have its advantages. Yet it is not clear that their action, even if by formal internal vote, would be covered by this combination of (b)(5)(E) and (b)(8). Again, a rhetorical rationalization for bringing this situation within the safe harbor exists: The lead-in subdivision (b) speaks not of "the limited partners" who do not "control" by exercising one or more of the safe harbor functions, but of "a limited partner." Thus, even if only a few "vote" for the transaction (indeed, even if only one is selected, in the agreement, to join, say, the only other independent general partner in sharing responsibility for "voting" on the transaction), the provision literally covers such limited partner(s).24

We speak of the partnership agreement as the source for the alternative decision-maker enabling provision, and that is for a reason. We do not find in this (or any other) section any grant of authority to the general partner(s) simply to invoke the substitution of a committee of less than all the limited partners. We do not believe this power exists by virtue of a general partner's plenary agency power;25 and for obvious reasons we do not believe this would be a good idea from the perspective of the limited partners.

vi) Subdivision (5)(D), a vote on a change in the nature of the business of the partnership, has a close corporate analogy, though the issue as such no longer is relevant in the modern corporate context, now that corporate purpose clauses are essentially required to be unlimited.26 Limited partnerships, organized to carry on specific, usually tax-driven investment plans, need to be narrow-purpose; and in the days when that
was typical of corporations as well, shareholder voting to change purposes clauses (technically, by amendment of the articles of incorporation) was the exclusive method of achieving prospective changes of business activity.  

In effect, a vote on the change in the nature of the partnership's business is just a special case of the situation covered in subsection (b)(4), which provides a safe harbor for the amendment of the limited partnership agreement (though to the extent it is effected by a vote of the limited partners, it would have been better placed in the (b)(5) catalogue). Whether we treat change in the nature of the business as an analogue to amendment of the purposes clause of articles of incorporation, or as an amendment of a specific contract, the partnership agreement, we are tempted to say "by definition," is alterable only by its original signatories or their successors in interest.

vii) Only subdivision (5)(C), the incurrence of indebtedness other than in the ordinary course of the partnership's business, has no ready analogue in corporation law. It is, rather, another consequence of the tax-driven nature of most limited partnerships, a nature that dictates treatment of the invested capital pool, plus its originally planned debt leverage, more or less as a closed-end investment activity. As such, it is somewhat analogous to subdivision (5)(D), now in a financial rather than entrepreneurial sense.

(b) Modification of Voting Rights by Agreement

The catalogue of voting rights is reviewed here only as it relates to the concept of "control," and not in the internal sense of reviewing its scope in the context of all investor-manager relationships. Even in the first sense, it should be noted, it is only slightly more mandatory for limited partnerships than is the analogous catalogue for corporations. So far as the new law is concerned, owners can be deprived of most of these voting rights (except for rights to vote on the matters covered by subdivisions (5)(H) and (I))  

by any contrary arrangement in the partnership agreement, just as is the case for corporations. It is true that section 300(c) does not permit contractual exclusion, in the corporate context, of

---

27. Indeed, it was uncertain whether anything less than unanimity of the shareholders could achieve this change; see the discussion of this retrospective-prospective problem in the ultra vires context in R. JENNINGS & R. BUXBAUM, supra note 20, at 131.

28. Though section 15636 begins with the disclaimer that its treatment of limited partners' rights is subject to contrary contract provision, the second paragraph of subsection (f) specifies that as to its treatment of these two specific voting issues ((H) and (I) respectively) no contrary contractual arrangement is permissible. CAL. CORP. CODE § 15636 (West Supp. 1986). The reasons for this apparently anomalous treatment lie in tax law and are described in Buxbaum & Etlin, supra note 13.
certain important shareholder rights (such as the right to petition for dissolution), but none of those protected rights is a voting right.\textsuperscript{29} No voting right other than the right of holders of a special class of stock to vote on changes specifically affecting that class or series\textsuperscript{30}—a point irrelevant in the present context—is mandated by that statute.

Of course, this power of contractual exclusion may be illusory, but that is because of the overriding mandate of securities regulation provisions—for example, as when the Corporations Commissioner refuses to grant a permit to issue the limited partnership units unless these permitted rights are in fact provided.\textsuperscript{31} The partnership statute alone, while it suggests that these voting rights in fact will be provided—since section 15636(f) assumes their availability unless they are explicitly denied—does not require their grant.

\textbf{(c) The General Partner as Co-Principal}

In one sense, however, the corporate analogy breaks down. Directors of a corporation are the elected representatives of their principals, the shareholders. Public policy requires that they act as discretionary agents, not as puppets, and to this day only reluctantly accepts inroads into directorial autonomy made by shareholders.\textsuperscript{32} However, corporation law in general also permits these directors' removal, even without cause, and denies them any direct standing to insist on their position and its perquisites.\textsuperscript{33}

The general partners of a limited partnership ostensibly are in a different position. The law—and often the facts—make them principals, too; there is no suggestion, at least in the law, that they are only the owners' representatives. Rather, what implication there is in the law generally goes the other way: they are the "true" owners, who augment their capital contribution with that of passive participants, and run the pooled enterprise on their joint behalf.\textsuperscript{34} As a result, there is a slight

\textsuperscript{29} The protected statutory provisions are sections 158, 417, 418, 500, 501, 1111, 1201(e), 2009, 2010, 2011, and those of chapters 15, 16, 18, and 22. \textit{CAL. CORP. CODE} § 300(c) (West Supp. 1986).

\textsuperscript{30} This is the strong implication of section 903 of the Corporations Code, which deals with the right of preferred shareholders to vote on certain actions specifically affecting their class or series. \textit{Cf.} the similar conclusions on an analogous statutory cross-reference in Jordan, \textit{The Close Corporation Provisions of the New California General Corporations Law}, 23 \textit{UCLA L. REV.} 1094, 1116-17 (1976) (waiver of certain rights not allowed if such rights affect third parties).

\textsuperscript{31} \textit{See} \textit{CAL. ADMIN. CODE} tit. 10, 260.140.116.2 (1985).

\textsuperscript{32} This well-known debate is summarized in R. \textit{JENNINGS} & R. \textit{BUXBAUM}, \textit{ supra} note 20, at 153-57.

\textsuperscript{33} \textit{Id.} at 225.

\textsuperscript{34} At the least, both federal tax rules and state securities regulation rules require that the general partner demonstrate a substantial net worth before allowing non-associational tax treatment
implication in the statute that the limited partners' participation in the governance of the enterprise is to be limited not only to avoid misleading creditors, but also to honor the primacy of the general partners. This overtone, however, should have no direct bearing on the consequences, as to third parties, of overstepping permissible control rules; rather, it has a direct bearing only on the interpretation of the limits of internal governance as such. This overtone, though, may have an indirect bearing on the potential liability of the limited partners to third parties if those limited partners overstep the boundaries of legitimate internal governance.

2. The Clear Safe Harbor Rules: Section 15632(b)(3), (4), (7) and (8).

(a) Subsection (b)(3): Acting as surety for the limited partnership or guaranteeing one or more specific debts of the limited partnership.

This provision is for the most part clear. The only eventuality not clearly covered is the unlikely case of a limited partner acting as surety directly for a general partner rather than for the partnership. While this transaction sounds strained, it is not out of the question that a creditor would ask for the direct personal guarantee of the general partner before extending credit to the limited partnership, if only to take advantage of the general partnership law's ranking provisions in section 15040(h) to the degree this would still be useful despite the new bankruptcy rule.\(^3\)

In that case, a request that the limited partner stand surety for the general partner is conceivable. It would be marginally safer, therefore, if the limited partner stood surety for the partnership debt in parallel rather than sequential order with the general partner, a preference to which the lender should be indifferent.

It is unclear why the statute refers only to the guarantee of one or more specific debts, rather than to the typical blanket guarantee of all current and future advances provided in many credit extension instruments. Nevertheless, the clear reference to specific, identifiable debts should be regarded as a meaningful one, and thus by clear negative inference the general guarantee agreement is a risky instrument from the perspective of leaving the safe harbor and entering the potentially dangerous sea of control activity.

---

\(^3\) 11 U.S.C § 723 (1982).
(b) Subsection (b)(4): Approving or disapproving an amendment to the partnership agreement.

Since the procedure for passing on amendments is equivalent to the voting process covered in subsection (b)(5), there should be no occasion for interpretation difficulties with this provision. The voting process may take place at a meeting (as implied in the 1984 amendment to subsection (b)(5), permitting the “calling [of] a meeting of the partners”),36 as well as by a round-robin of mail ballots. The process of approving or disapproving an amendment may similarly take place at a meeting or by the use of mail ballots. The use of the singular form of “amendment” in the subsection also should not be construed as preventing simultaneous consideration of two or more amendments: It is the concept of an amendment, not the specific amendment, that is covered by this safe harbor provision.

The initiation or proposal of an amendment to the partnership agreement, however, is not so clearly covered by this subsection of the safe harbor provision. Ordinarily, of course, the savings clause of subsection (c) — that the safe harbor enumeration does not by definition make all other action impermissible control action — should apply to the initiation or proposal of an amendment.37 Alternatively, subsection (b)(2), concerning the advising of the general partner with respect to the business of the enterprise, might cover the initiation or proposal of amendments. Only in a case in which such behavior goes to the same extreme as would put the availability of this (b)(2) immunity in doubt might the (b)(4) immunity also be questionable.38

(c) Subsection (b)(7): Executing and filing certificates under sections 15633, 15625, 15623(a)(1) and 15623(b)(l).

These sections permit limited partners to file certificates of formation, amendment and dissolution when general partners fail to fulfill their obligation to do so.39 Subsection (b)(7) is no more than a self-evident, and perhaps unnecessary, confirmation that conduct specifically authorized by these sections cannot later be characterized as illegitimate control behavior.

36. CAL. CORP. CODE § 15632(b)(5) (West Supp. 1986) (as amended by Act of April 29, 1984, ch. 1903, 1984 Cal. Legis. Serv. 95 (West)).
37. See infra notes 82-85 and accompanying text.
39. For a discussion of these rights, see Buxbaum & Etlin, The Limited Partner’s Filing Rights (forthcoming).
(d) Subsection (b)(8): Serving on an audit committee or committee performing the functions of an audit committee.

The public limited partnership, like the listed or section 12(g) corporation, may be under compulsion of a stock exchange or securities regulators to appoint an audit committee comprised of non-management limited partners to perform what by now are well-defined audit functions. Such service should not in and of itself generate questions of impermissible control behavior, though it is a kind of participation that brings the limited partners into higher visibility both among fellow partners and outside creditors.

The only minor question of interpretation which subsection (b)(8) raises is the overly broad reference to service on a functionally equivalent committee, rather than, as would be more appropriate, performance of equivalent functions. If that functionally equivalent committee also performs other functions, such as those of a nominating or, worse, of an executive committee, this subsection cannot be read to immunize the limited partner's involvement in any other than the audit functions.

A member of an audit committee, of course, may be liable for breach of a duty of care or loyalty in the performance of audit functions, and be held responsible either by fellow investors or even, perhaps, by creditors. That liability is not excused by any safe harbor provision, including subsection (b)(8). Indeed, this duty of care is a species of directorial duty, as the analogous section 309 (especially 309(b)(3)) makes clear. It is unclear whether protections analogous to the safe harbor catalog of section 309(b)(1) and (2) would be available to limited partner

---

40. The provisions of several substantive sections of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1982), applied only to companies whose securities were registered on a national stock exchange. The 1964 amendments, Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565, added a section 12(g) (codified at 15 U.S.C. § 78(g)(1) (1982)) to the statute which extended a registration duty (and through that a duty to comply with the mentioned substantive provisions) to corporations with gross assets exceeding $1,000,000 and with at least one class of equity security held of record by at least 500 persons.

41. The New York Stock Exchange Rule 2495H requires the appointment of audit committees as a condition of listing; and the SEC, while it did not adopt its proposed regulation 13B so requiring, has published an opinion of its General Counsel to the effect that it possesses the authority so to require. Memorandum of General Counsel [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,535 (Mar. 2, 1978).

42. That would be most likely in the case of bankruptcy or reorganization proceedings, in which the trustee has occasionally been granted the power to marshal this kind of corporate claim. See, e.g., Brown v. Presbyterian Ministers Fund, 484 F.2d 998 (3d Cir. 1973); New York Credit Men's Adjustment Bureau v. Weiss, 305 N.Y. 1, 110 N.E.2d 397 (1953).

43. "In performing the duties of a director, a director shall be entitled to rely on information, opinions, reports or statements... prepared or presented by:... (3) A committee of the board
audit committee members in this instance.\textsuperscript{44} We assume that it is, especially as these reliance defenses were known in a general way in the common law before being codified in 1975.\textsuperscript{45}

3. The Complex Safe Harbor Rules: Subsections (b)(1), (2) and (6).

\textbf{(a) Subsection (b)(1): Being a contractor for or an agent or employee of the limited partnership or of a general partner, or an officer, director, or shareholder of a corporate general partner.}

This provision liberally confirms the jurisprudence exemplified for California by \textit{Western Camps, Inc. v. Riverway Ranch Enterprises}.\textsuperscript{46} While the fact situation there, as well as in the leading cases of \textit{Frigidaire Sales Corp. v. Union Properties, Inc.}\textsuperscript{47} and \textit{Delaney v. Fidelity Lease Ltd.},\textsuperscript{48} was atypical, in that the cases involved corporate general partners all of whose shareholders were also all of the limited partners of the limited partnership, it is conceivable that even in the more typical tax-driven limited partnership some of the limited partners might be involved in the corporate general partner structure (not to mention that the corporate general partner or some of its owners or directors also may participate as limited partners). The basic message of the exception is clear: The lim-

\textsuperscript{44} I.e., the right to rely on reports from officers of employees or of counsel, independent accountants and other experts respectively.

\textsuperscript{45} That is not to say, however, that as a committee member with certain primary duties a director has the same recourse to reliance on officers' or experts' reports. Cf. \textit{Stern, The General Standard of Care Imposed on Directors Under the New California General Corporation Law, 23 UCLA L. REV. 1269, 1277-78 (1976)} (discussing the analogous question of whether an inside (i.e., full-time officer) director may be under a job-related higher level of care than an outside director); and see \textit{id.} at 1279 as to the heightened "inquiry notice" of committee members with specific functions.

\textsuperscript{46} 70 Cal. App. 3d 714, 138 Cal. Rptr. 918 (1977).

\textsuperscript{47} 88 Wash. 2d 400, 562 P.2d 244 (1977).

\textsuperscript{48} 526 S.W.2d 543 (Tex. 1975) (legislatively overruled by \textit{Tex. Rev. Civ. Stat. Ann. art. 6132a, § 2A} (Vernon Supp. 1986) as to possible invalidity of arrangement whereby corporation serves as general partner of limited partnership, and by \textit{id.} § 8(a) as to lack of a reliance test); see \textit{generally Wertheimer, Substantive Law and Special Problems of General and Limited Partnerships, in Resource Materials - Partnership 1} (5th ed. 1984) (discussing legislative response to \textit{Delaney} and enactment of an explicit reliance test). These cases and their implications are also discussed in, e.g., Kempin, \textit{supra} note 2, at 457-58, and Coleman & Weatherbie, \textit{supra} note 10, at 900-02. \textit{See generally R. Jennings & R. Buxbaum, supra} note 20, at 51-52 (as to relations between limited partners of failing limited partnerships and creditors).
The provision contains two groups of immunized roles: being contractor for, or agent or employee of, either the limited partnership itself or a general partner thereof, on the one hand; and being an officer, director or shareholder of a corporate general partner on the other. It is an open question whether the limited partner can be an officer of, for example, a non-corporate general partner (such as a proprietorship or business trust); or whether a limited partner can perform one of these roles in a multi-level hierarchy of partnerships (as when the general partner itself is a limited partnership with a "grandparent" corporate general partner). On the whole we are inclined to read the exemption liberally, and to consider these far-fetched but occasionally occurring structures as covered. The fact that the sober imagination of the drafters of the legislation did not match the fevered imagination sometimes found among those who draft investment instruments probably should not in this instance be held against the latter; otherwise, these already prolix statutes would become unmanageable.

One warning found in the Frigidaire case should, however, be recalled. Other legal principles, especially those concerning the disregard of the corporate entity, remain available to claimants against limited partners who participate in these roles (though not, again, because they are limited partners; these principles would apply equally to similar shareholder-actors for the corporate general partner who are not at the same time limited partners). Given California's particularly liberal "disregard" doctrine, and given the typically thin capitalization of corporate general partners now that federal income tax regulations no longer require relatively substantial net worth positions of general partners, this is a realistic danger. While it is beyond the scope of this

49. See supra note 48.
50. See Kempin, supra note 2, at 457; R. JENNINGS & R. BUXTBAUM, supra note 20, at 51.
52. An association purporting to be a limited partnership will not be treated as a limited partnership for tax purposes only when the general partner has no substantial assets other than his interest in the partnership which could be reached by a creditor of the organization and when the general partner is merely a dummy acting as the agent of the limited partners. Treas. Ref. § 301.7701-2(d)(2) (as amended in 1983). In the case of corporate general partners, if the corporate general partner has an interest in only one limited partnership and the total contributions to the partnership are less than $2,500,000.00, the net worth of the corporate general partner must be at least $250,000.00 or 15 percent of the total contributions, whichever is lesser. If the total contributions to the partnership are $2,500,000.00 or more, the net worth of the corporate general partner must be at least 10 percent of the total contributions. These net worth requirements are exclusive of the interest in the listed partnership itself. Rev Proc. 72-13, 1972-1 C.B. 735.
discussion to review alter ego rules generally, it is well within our mission not only to flag this issue but to emphasize that the particular structure and operations of the limited partnership may be particularly vulnerable to the operation of the "disregard" doctrine.

It is true that other parts of section 15632 limit the exposure of a limited partner who transgresses the control barrier to those who detrimentally rely on the apparent general partner status of that person. The analogous limit found in the disregard-of-corporate-entity doctrine, however, is much feeble and less frequently and consistently applied. Not only may contract claimants hold shareholders liable, but the cause of action is being used more often by trustees in bankruptcy or reorganization. This is a context in which the dislike of the windfall element in such a recovery is much less marked (despite the purist stance of such California cases as Stodd v. Goldberger, denying standing to the trustees).

Subsection (b)(1) speaks of a limited partner being a contractor, an agent, an employee, an officer, a director or a shareholder. It is open to debate whether its immunity applies to the limited partner who is, for example, the sole shareholder of the corporate general partner, or the sole managing executive of that general partner. To the extent Frigidaire is followed in its insistence that the only relevant criterion for destroying the immunity of the limited partner-shareholder is the traditional one of disregard of corporate entity (without reference to the circumstances that the corporation is the sole general partner of the limited partnership), it would suggest that the degree of authority held by the person in running the corporation is irrelevant. But this is not a necessary consequence of agreeing to permit the wearing of two hats in the first place; a half-way position is equally conceivable. We confess to a certain degree of unease at the notion that the conditions justifying limited partners' participation could be so totally undermined by an uncompromising two-hats posture. Still, except for a Platonic yen for formal purity, we have no reason to prefer liability to immunity in this case. The rhetorical argument against immunity, if one did wish to go with liability, is easy: The lead-in to subsection (b) speaks of "solely . . . doing . . . the following," and the person who totally controls the destiny of the partnership is "doing" more than "solely" being a director or officer or shareholder of the cor-

53. See infra notes 82-92 and accompanying text.
55. 73 Cal. App. 3d 827, 141 Cal. Rptr. 67 (1977).
corporate general partner. But that is only a rationalization masking a judgment call.

(b) Subsection (b)(2): Consulting with and advising a general partner with respect to the business of the limited partnership.

Much of the case law on the old ULPA section 7 and its control problems involved transactions which in rough form could be gathered under this phrase. The same is true of the surprisingly abundant law review commentary, which in addition struggled with various overarching tests or concepts to capture the elusive boundary at which permissible consultation and advice crossed over into impermissible control activity.

In general, two concepts need to be kept in mind even today, for the statutory definition of "consult and advise" is no more specific than was the definition under section 7 of the ULPA. The first concept is the distinction between authority and representation; the second, the distinction between initiation of and response to the decisionmaking process.

Participation or authority in decisionmaking in situations involving no parties outside of the partnership ("indoor participation") typically has been treated more indulgently by the cases than has the same level of participation when the person so acting represented, or joined the general

56. Compare the analogous treatment of "solely" in the case of interlocking directorates in 1 H. MARSH, supra note 15, at 612.


59. The most significant of which is the question of reliance. All of the literature cited in the preceding footnote addresses this point; one of the fuller case treatments is that of Gast v. Petsinger, 228 Pa. Super. 394, 323 A.2d 371 (1974).
partner in representing, the partnership in discussions and transactions with third parties ("outdoor participation"). In addition, it is a long-standing if conceptually unsatisfactory legal saw that the "mere" right to veto a transaction (or at least to require consultation before it was effected) was less critical than the right to initiate a decision or transaction.

The indoor-outdoor distinction is less critical today, but only for the separate reason that now only those third parties (other than tort and public claimants) who knew of the limited partner's behavior may obtain redress against such a person; see the discussion at page 557 below. Even before the new code was adopted some cases already had displayed more generosity in permitting the challenged limited partner to participate with the general partner even in discussions with third parties, so long as the participation indeed was in discussions only and not in representation. Nevertheless, staying behind such an obvious and easily identifiable line should be counselled in order to avoid even the slightest risk; and it should not be difficult advice to follow, since this kind of public participation is not normally an important element of limited partner activity. A special caveat may be in order for the lawyer of the limited partnership who is also a limited partner thereof.

Whether a general partner who conjures with a limited partner's purported control activity with third parties may expose that limited partner to risk via the doctrine of partnership by estoppel is doubtful, in light of the conditions required to apply section 15632(a) of the California Corporations Code: actual knowledge of the limited partner's participation in control and reasonable belief in general partner status. It is not certain, however, that this double hurdle would be a necessary condition to an estoppel status.

62. See supra note 60.
63. CAL. CORP. CODE § 15016 (West 1977) (§ 16 of the Uniform Partnership Act); CAL. CORP. CODE § 15004(2) (West 1977) (§ 4(2) of the Uniform Partnership Act: "The law of estoppel shall apply under this act.") See generally Painter, Partnership by Estoppel, 16 Vand. L. Rev. 327 (1963) (actual consent required under the Uniform Partnership Act).
64. Kempin, supra note 2, argues that the adoption of an explicit reliance requirement in section 303(a) of the Revised Uniform Limited Partnership Act, and of course in the California version discussed here, limits the estoppel concept to its narrow, traditional version. It should be noted, however, that under a lesser definition of the section 16 estoppel concept, reliance by the person claiming harm is not required so long as the public holding out indeed was public and thus relied on in a general community sense. See Fletcher v. Pullen, 70 Md. 205, 16 A. 887 (1889); cf. R. Jen-
The "invitation-veto" issue is a more central one, though in our opinion it is better recast as a question of the degree to which the general partner by agreement or by brute fact is obliged to follow the limited partner's advice. Some transactions are important and extraordinary enough that not only advice but effectuation power is legitimately granted to limited partners; but those — for example, incurrence of extraordinary debt or a change in the nature of the business — are separately treated in the voting list (page 538 above). This special treatment suggests that the "consult and advise" function is not seen as an inherent or even normally expectable function of limited partner status, but as something special or at least specifically bargained for, or perhaps as something evolving from a particular situation or exigency occurring in the partnership. We would, for example, not expect to see a partnership agreement provision submitting less extraordinary proposed transactions to an advisory or consulting vote of the limited partners, and by the same token we would not characterize such a structure or approach in a partnership agreement as the kind of permissible involvement in decision-making contemplated by subsection (b)(2).

An equally significant problem is the case of the general partner who, for practical economic reasons, cannot afford to refuse the limited partner's advice. That a blanket veto power for the limited partners as to any and all transactions cannot be written into the partnership agreement is, we submit, clear. The problem lies in factual situations which lead to the same veto power without it being apparent in the partnership agreement. It is a factual matter and not much more can be said about it; but in the abstract it seems equally clear that a de facto power is as vulnerable to a finding of impermissible control, and as remote from the safe harbor of subsection (b)(2), as is its contractual equivalent.

Impermissible participation can lead to liability of a type other than

NINGS & R. BUXBAUM, supra note 20 (consent to public representation creating partnership by estoppel). Since California Corporation Code section 15722 explicitly calls for the Uniform Partnership Act to govern in any case not provided for in the limited partnership statute, a minor question can arise as to whether the new reliance requirement indeed is explicit enough not to permit application of this cross-reference (and of the lesser form of estoppel behavior thereunder — as to which, as it happens, there is no relevant California jurisprudence).


66. Kempin, supra note 2, at 454-55; cf. Gast v. Petsinger, 228 Pa. Super. 394, 323 A.2d 371 (1974) (service of limited partners as engineering consultants on partnership projects raised issue of fact as to their possible control); but see Rodeo v. Gillman, 787 F.2d 1175 (7th Cir. 1986) (potential, though not initially exercised, managerial control by limited partners was not sufficient "control" to deem the limited partnership interest not to have been a security at the time sold in the context of alleged securities laws violations, even though actual control was ultimately exercised by limited partners two years after sale).
that arising from control violations; a liability which, it should be stressed, also can arise though the behavior otherwise fell well within subsection (b)(2). Under appropriate circumstances, advice-givers and consultants may be liable both to fellow but passive investors and to third parties, if the advice leads to loss-causing action. Civil liability can arise if the limited partner's behavior qualifies as aiding and abetting a breach of duty by the principal tortfeasor (for example, the general partner or the limited partnership itself). This is especially true if the limited partner-adviser is a professional or an expert, but it should be stressed that a formal professional relationship, let alone a paid one, is not a necessary prerequisite to this result. We stress, again, that fellow investors are among those who may be able to hold an errant limited partner in this fashion. The principles contained in section 309(b) should not be viewed as applicable to corporations alone.

(c) Subsection (b)(6): Winding up the partnership pursuant to Section 15683.

This section permits the limited partners to wind up the affairs of a dissolved limited partnership if no eligible general partner remains available to do so. A first and practically important question of construction is whether subsection (b)(6) can be relied on by the one or more of the limited partners who are selected by their fellow limited partners to carry out winding up, or whether the subsection is only available to all of the limited partners acting collectively. The latter would be a practical nightmare in the case of a public limited partnership, and no good reason suggests itself for such an awkward construction, which would all but read the subsection out of the statute. Also, the same rhetorical argument made at page 540 above (that the introductory language of section 15632(b) speaks of “a limited partner,” rather than “the limited partners” when enumerating the voting behavior that does not trigger control problems) would apply here. Therefore we believe that this exemption

67. This discussion pertains to the duty of care owed by agents or principals, and embodied at least in the case of corporations in California Corporations Code section 309. While the statutory catalog of “reasonable reliance” safe harbors may be more elaborate than its common law precursor (as to this, see Southern Cal. Home Builders v. Young, 45 Cal. App. 679, 188 P. 576 (1920)), the statute nevertheless is little more than a common law restatement and reflects the common law rules applying in essentially identical fashion to other principal-agent relations such as these forms of limited partnership involvement.

68. Section 309(b) describes the circumstances in which a director is entitled to rely on information, reports or statements prepared or presented by other officers or employees. CAL. CORP. CODE § 309(b) (West 1977). The application of this policy to limited partnerships could result in the shifting of liability onto a limited partner who gave bad advice which was subsequently relied upon by the other limited partners or the general partner.
should be available to the limited partner who acts as agent for the enterprise in this unusual situation. In any event, it should be at least possible for the limited partners to appoint a new general partner under the generous enabling provisions of section 15632(b)(5)(J).69

The more practical problem hereunder arises from the extremely flexible definition of "winding up." The abundant case law under the analogous General Partnership Act sections70 contains many examples of a years-long if not decades-long winding-up process;71 yet the overall purpose of this specific immunization suggests that it should not be stretched to cover winding up indefinitely. A limited partnership without a general partner to absorb its excess liabilities is at least a formal and probably also a commercial anomaly. The general partnership situation, in which just such a fully liable person by definition always is available, is not a suitable analogue; in the latter case, the courts can afford to be somewhat relaxed about the length of the process. That is not the case with the limited partnership.72 We therefore would counsel caution, and would especially warn, for example, against a practice of extending the process in order to run an income-producing property to its tax-determined crossover point before liquidating the asset, especially if this would entail renewal of leases, loans, and similar new cycles of risk-producing events.73 The mentioned availability of a substitute general partner as an alternative makes less necessary and to some degree less appropriate the practice of having a limited partner conduct the winding up and liquidation. It hardly needs pointing out that this kind of activity is peculiarly vulnerable to third party claims of reasonable belief in the acting partner's apparent general partner status, and thus of all the discussed forms of control behavior is least likely to enjoy the immunity from liability available even for impermissible control behavior when the

69. This section allows the admission of a general partner when there is no remaining general partner. CAL. CORP. CODE § 15632(b)(5)(J) (West Supp. 1986).

70. CAL. CORP. CODE §§ 15034-35 (West 1977) (§§ 34-35 of the Uniform Partnership Act).

71. See, e.g., Farmers & Merchants Bank of Stuttgart, Ark. v. Harris, 559 F.2d 466 (8th Cir. 1976); Adelman v. United States, 304 F. Supp. 599 (C.D. Cal. 1969), aff'd mem., 440 F.2d 991 (9th Cir. 1971); United Counties Trust Co. v. Podvey, 160 N.J. Super. 244, 389 A.2d 515 (1978). In general partnerships, of course, this issue easily slides over into the question of a tacit acquiescence of the estate of a deceased partner or representatives of a departing one to the continuation of the enterprise under section 40 of the Uniform Partnership Act; see, e.g., Blumer Brewing Corp. v. Mayer, 223 Wis. 540, 269 N.W. 693 (1936).

72. If the dissolution is caused by the planned departure of the sole general partner, and the limited partners do not or under the agreement cannot elect a substitute, the additional complication of who is to effect the winding up can also arise. See, e.g., Roeschlein v. Watkins, 686 P.2d 1347 (Colo. Ct. App. 1983).

reliance requirements of section 15632(a) are not met.\textsuperscript{74} The details of the winding-up process, and the terms of compensation of the partner(s) so engaged, as well as the reciprocal problems of liability to other partners for breach of duty, contribution or indemnification will not be discussed here.


The explicit safe harbor provisions are underpinned by section 15632(c): "The enumeration in subdivision (b) does not mean that any other conduct or the possession or exercise of any other power by a limited partner constitutes participation by the limited partner in the control of the business of the limited partnership."\textsuperscript{75}

Two minor issues of interpretation can be disposed of at the outset. The singular includes the plural;\textsuperscript{76} thus, conduct or possession or exercise of other power or powers, by more than one or even all of the limited partners also is protected under this provision. Secondly, the adverb "necessarily" should be understood as qualifying the verb "constitutes." The provision cannot be read affirmatively to strip the risk of control from all other behavior!

In brief, the subsection is nothing more or less than a minor interpretive guide for the bench and bar, a kind of \textit{ejusdem generis} rule applied to a statute. It suggests, for example, that an assignment for the benefit of creditors (assuming one can be made by the limited partners under section 15681),\textsuperscript{77} while not technically covered by the most likely safe-harbor provisions — section 15632(b)(5)(A) or (B)\textsuperscript{78} — could be saved from the risk that it might constitute participation in control by the ameliorative effects of this interpretive guide. To take an opposite example, however, the already discussed risk that a limited partner may be doing more than just the "consulting and advising" permitted under section 15632(b)(2) cannot be skirted by reference to subsection (c).

We believe and assume that this distinction is clear. It is true that

\textsuperscript{74} These reliance requirements require that for a limited partner to be personally liable to persons transacting business with the partnership those persons must do so with actual knowledge of the limited partner's participation in control and also reasonably believe the partner to be a general partner. \textsc{Cal. Corp. Code} § 15632(a) (West Supp. 1986). See discussion at page 557 below.

\textsuperscript{75} \textsc{Cal. Corp. Code} § 15632(c) (West Supp. 1986).


\textsuperscript{77} This section covers nonjudicial dissolution. \textsc{See Cal. Corp. Code} § 15681 (West Supp. 1986).

\textsuperscript{78} These provisions cover distribution and winding up, as well as the sale, exchange, lease, mortgage or other transfer of all or a substantial part of the partnership assets other than in the ordinary course of business. \textsc{Cal. Corp. Code} § 15632(b)(5)(A), (B) (West Supp. 1986).
the California version differs from RULPA section 303(c), from which it is taken. The former adds the phrase "any other conduct" before "pos-
session or exercise of any other power." This, however, merely applies
the savings clause in subsection (c) to actions that are covered by the safe
harbor catalog of subsection (b) even if, by chance, the partnership agree-
ment does not include them.

C. The Additional Requirement of Reliance

1. Limiting Factors

The text of section 15632(a) provides in relevant part: "If a limited
partner participates in the control of a business . . . , that partner is never-
theless not liable to persons who transact business with the limited part-
tnership unless they do so with actual knowledge of that partner's par-
ticipation in control and reasonably believing that partner to be a gen-
eral partner." While the statement generally reflects what had been a developing
rule even under section 7 of the old ULPA, it carries that development
a good deal further, and is to be understood as a significant cutback of
liability even for impermissible control behavior. The very fact that there
is a difference between this subdivision and the analogous 1976 RULPA
revision already is instructive. The first version of RULPA section
303(a) provided quite a different limitation of liability, one that purports
to be both less far-reaching and more differentiated:

[A] limited partner is not liable for the obligations of a limited
partnership unless . . . , 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.

The differentiation made in the RULPA provision, which is not
present in the California provision, is between situations in which the
limited partner's participation in the control of the business is "substantially the same as the exercise of the powers of a general partner," and those in which the limited partner's participation in control is something lesser.

In the former case (participation on a par with the powers of a general partner), RULPA imposes unlimited liability on the would-be limited partner even in the absence of reliance or actual knowledge by the outside claimant of the limited partner's participation in control. In the second case, however, in which the limited partner's participation falls short of being equivalent to that of a general partner, RULPA imposes unlimited liability on the limited partner only with regard to claims of "persons who transact business with the limited partnership with actual knowledge of his [the limited partner's] participation in control."\(^8\)

The California provision, which RULPA now has been revised to follow, abandons this distinction altogether, and in all cases imposes a higher threshold requirement before an outside claimant can hold a limited partner fully liable for the partnership's debts. Not only must the claimant have transacted business with the partnership with actual knowledge of the limited partner's participation in control (which RULPA originally required only for situations in which the limited partner's participation in control was less than that which would be exercised by a general partner), but California law also requires that the claimant reasonably believed that the overreaching actor is a general partner.

Nominally then, the California provision, when compared with the RULPA provision, not only requires actual knowledge of the control behavior, whether or not the limited partner's participation in control is sufficiently plenary to resemble a general partner's behavior, but, by requiring in all cases a reasonable belief that the overreaching actor is a general partner, the California provision seems to eliminate the risk that less flagrant violations of the control limits can lead to any liability in the first place. Nevertheless, in practice the California version should cause far less difficulty or variation in interpretation, whatever one may think of the underlying policy of eliminating that risk.

That policy, we believe, reflects an interesting legitimization issue. Non-secured creditors — suppliers, wage claimants, etc., — rarely are

\(^8\) This distinction may be eliminated soon. The 1985 meeting of the National Conference of Commissioners on Uniform State Laws considered and recommended a set of amendments to RULPA which, among other changes, would abandon this two-tier distinction and accede to the California one-tier version. See Basile, supra note 58, at 1214-17, and the actual revision as reprinted in 6 ULA Anno. 1987 Supp. at 282. This does not, of course, affect the analysis of the one-tier version propounded in the following text.
"represented" on the typical state bar drafting committee. Secured creditors, typically financial institutions, are.\textsuperscript{85} They have no problem with this reliance limitation, since they are protected by their customary or at least available practice of taking a secured creditor position, and if necessary by other guarantees. To the extent that the syndicators, who are represented, have any position on the matter, it is that of the investors, also represented, who of course want this limitation. Given this situation, only enlightened self-restraint would keep the statutory end product from requiring the utmost in reliance. The questionable element in the provision as drafted is not the general rule of requiring actual knowledge of participation in all contract cases, but the stringent extra hurdle of requiring a reasonable belief in the \textit{conclusory} element of general partner status.

That extra fillip, missing from the original RULPA provision, not only raises a vague worry about the California provision's legitimacy but, given the judiciary's sovereignty over the statute in the particular, simultaneously provokes interpretation questions. There is no denying that California's refusal to follow the early RULPA distinction between participation in control which is tantamount to that of a general partner, and participation which is not, constitutes an actual and substantial difference from that first version of RULPA. Nevertheless, we believe it can be demonstrated that once actual knowledge of a limited partner's impermissible control activity is demonstrated, the additional requirement of reasonable belief in general partner status probably does not represent a true additional hurdle.

An example may make this somewhat cryptic comment clear. Assume control behavior that not only is beyond the explicit safe harbor of section 15632(b) but also falls outside the \textit{ejusdem generis} protection of section 15632(c). Assume also a transacting third party less sophisticated than the prototypical financial institution already mentioned — say a small contractor or a house buyer signing a contract for a home still to be built by the partnership. It seems clear to us that most limited partner behavior which clears the first hurdle to liability — the third party's actual knowledge of the limited partner's participation in control — will clear the second — the third party's reasonable belief in the limited partner's apparent general partner status. In this context, reasonable belief in

\textsuperscript{85} This observation is based on the senior author's participation on a number of state and ABA committees assigned drafting functions. In any event, we are confident that this perception not only is accurate but widely shared. "Represented" is in quotation marks, for obvious reasons. The committee members are appointed at least in part, for just this representativeness; thereafter they of course perform a public function. They rise above their principals, not their principles.
general partner status is a conclusion flowing from the event and from the third party's place on the spectrum of commercial sophistication, not a genuinely or generically independent factual requirement. At most, there is a very limited penumbral range of clearly impermissible control behavior to which the special California variant of the first RULPA reliance requirement may apply. Normally, we believe, this range will instead turn out, in litigation, to be non-existent.

2. The "Transact Business" Condition

It would be a mistake to read this reliance requirement as one that must be met by all injured third parties before they can hold overacting limited partners personally and unlimitedly liable. The reliance requirements do not apply against tort claimants, for example, who seek to hold transgressing limited partners liable for damages not recoverable from the partnership or the general partners. The argument is identical with that found in disregard of corporate entity cases. Tort claimants cannot plan their involvement with the entity or its owners in either case. While there is an element of windfall recovery in the situation, it is more than matched by the prophylactic deterrence principle that puts limited partners at their own peril when transgressing the boundaries of participant control. This arises from a vague but sound sense that the inappropriate behavior has at least a general, if not a close, connection with the capacity of the inappropriately controlled enterprise to do harm.

It is a nicer question whether tort claims by parties transacting business with the partnership, which are based on those transactions, can be brought against controlling limited partners on whom the tort claimant did not rely in the course of those transactions with the partnership. If a partnership employee, for example, claims a wrongful discharge from an at-will employment relationship, should a judgment not satisfied by the entity or its general partner be recoverable from an errant limited partner who exercised control functions (but not as to this transaction)? Does that kind of overstepping limited partner become the entity's agent

86. Thus, modern efforts to stretch analogous common law rules about the standing of tort as against contract claimants in order that such rules can be used to proceed against owners of insolvent entities are beside the point; the statute takes care of the debate, except in marginal cases such as those discussed in the text preceding note 88 infra. The statutory policy paraphrased immediately below already has foreclosed the debate. The newly revised RULPA section, supra note 84, unnecessarily beclouds this issue by its awkward phrasing. The overactive limited partner "is liable only to persons who transact business with the limited partnership reasonably believing, based on the limited partner's conduct, that the limited partner is a general partner." Nonetheless, absent anything in the drafter's Comment to the contrary (id. at 283), we believe that the discussion in the accompanying text applies to the new RULPA version as well.
whose liability depends on general agency law principles as to torts committed by an agent within the scope of his agency?87 What of one of the new family of tortious breach of contract claims?88

We believe that personal liability, without reliance, would be inappropriate in these situations, and thus would apply the "transact business" condition liberally. If the tort claim arises from an earlier transaction between the third party and the partnership (begging the question whether entering at-will employment is "transacting business" — on this we pass), then the claimant in turn should be held to the twin requirements of subsection (a). On the other hand, this too needs to be leavened by common sense. Should the two bystanders hit by the entity's drilling rig and seeking recovery against the overtransacting limited partner be treated differently depending on whether or not they also happened to be limited partners in that entity?

The same immunity might hold true for a fraudulent inducement to contract claim, though once the latter is successfully established it becomes, by definition, a case of not doing business with the partnership;89 it might on appropriate facts be handled as was the previous example of the tort claim — but this is a close case.90 The defrauded parties' excess loss (the part not recovered from the partnership and the general partners) probably cannot be recovered from fully passive limited partners personally, though it may have been their agent who deceived the second-stage investors.91 Whether it should fairly be recovered from controlling overstepping limited partners (again, provided they did not participate in this transaction) begins to resemble the "windfall versus deterrence" equation which, as to traditional personal injury torts, is re-

87. See generally Restatement (Second) of Agency §§ 215-67 (1958) (liability of principal for authorized conduct of agent or conduct by agent incidental to authorized conduct).
89. Cf. e.g., In re Stirling Homex Corp., 579 F.2d 206 (2d Cir. 1978) (claims of allegedly defrauded stockholders subordinated to those of unsecured general creditors; i.e., those doing business with insolvent entity), cert. denied, 439 U.S. 1074 (1979).
90. This discussion is particularly relevant when it is further putative limited partners who make this claim; that is a much more common situation than the occasional trade contractor fraud claim (though these also occur, especially in real estate development construction situations). Furthermore, we are not discussing the question of competition between third-party claimants and allegedly defrauded limited partners. The subordination rules of section 39(b) of the Uniform Partnership Act (section 15039(b) of the California Corporations Code), applicable to the limited partnership case pursuant to section 15722 of the California Corporations Code, clearly bar equal status for the latter.
91. If the limited partner-principals had sufficient inquiry notice of the propensity of the promoter-affiliate of the general partner to behave in this fashion, ordinary vicarious liability rules of the aider-abettor variety might begin to play a role.
solved in favor of the claimants.\textsuperscript{92}

That equation might come out differently in a situation in which limited partner-investors who subsequently bought into a limited partnership because of the impermissible activities of prior limited partner-investors seek to recover from those prior limited partner-investors on the grounds of securities law violations or common-law fraud.

The reliance requirement as currently reflected in California law is in balance. On one hand, it is designed to prevent the holding of limited partners liable for transactions in which the limited partners played too minor a role to mislead a third party. On the other hand, it is designed to insure that a third party who was reasonably misled by impermissible activity of limited partners has proper recourse against them.

\textsuperscript{92} Indeed, in corporation law, analogous situations (e.g., promoters' contracts, defective incorporation problems) typically permit even contract claimants to hold the corporation's owners responsible. \textit{See generally} N. Lattin, \textit{The Law of Corporations} 194-99 (2d ed. 1971) (corporation de facto and corporation by estoppel theories).