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## LIMITED PARTNER DERIVATIVE SUITS

HAROLD GILL REUSCHLEIN\*

*Dean Reuschlein's article gives a general discussion of the limited partnership form in contrast to the general partnership and the corporation. He carefully reviews the historical development of these different business organizations and then analyzes the origins of the revised Act's article 10 and the implications it holds for the limited partnership in the future. He urges adoption of the Act.*

—Brockenbrough Lamb, Jr.

Despite the ancient lineage of the limited partnership or an institution analogous thereto,<sup>1</sup> the limited partnership as we know it is completely and entirely a creature of statute.<sup>2</sup> When the Uniform Partnership Act was in the drafting stage the proponents of treating the partnership as an aggregate of persons rather than as a legal

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1. The first known business form analogous to the limited partnership existed as early as 1146 in the civil law countries. J. CRANE & A. BROMBERG, *LAW OF PARTNERSHIP* § 26 (1968); Comment, *Regulation of Foreign Limited Partnerships*, 52 B.U.L. REV. 64 (1972); see Ames v. Downing, 1 Bradf. Surr. 321, 329 (N.Y. 1850); 8 W. HOLDSWORTH, *HISTORY OF ENGLISH LAW* 195 (1926); F. TROUBAT, *THE LAW OF COMMENDATORY AND LIMITED PARTNERSHIPS IN THE UNITED STATES*, at 11-112 (1853); Lobinger, *The Natural History of the Private Artificial Person: A Comparative Study in Corporate Origins*, 13 TUL. L. REV. 41, 56 (1938). Known as the "commenda," this medieval limited partnership allowed one to invest in trading operations and share in the profits without risking more than what was invested. 8 W. HOLDSWORTH, *HISTORY OF ENGLISH LAW* 195 n.6 (1926) (investor called commendator and the trader called commendatarius).

This business form was codified in the civil law country of France in 1807. C. COM. arts. 23-29 (France 1807). It was called "societe en commandite." *Id.* Louisiana adopted the French form into its civil law in 1808. LA. CIV. CODE art. 17 (1808); Comment, *Partnership in Commendam—Louisiana's Limited Partnership*, 35 TUL. L. REV. 815 (1961). The current Louisiana partnership in commendam is found at LA. CIV. CODE ANN. arts. 2839-51 (West 1952).

2. See Ames v. Downing, 1 Bradf. Surr. 321 (N.Y. 1850); Millard v. Newmark & Co., 266 N.Y.S.2d 254 (App. Div. 1966); see Comment, *The Limited Partnership*, 45 YALE L.J. 895, 897 (1936). The first acts were adopted in New York (1822), Connecticut (1822) and Pennsylvania (1936). See 3 J. KENT, *COMMENTARIES ON AMERICAN LAW* 36 (1884).

entity carried the day.<sup>3</sup> When the Uniform Limited Partnership Act, ULPA (1916), was being conceived, the same judicial premise applied.<sup>4</sup> This in and of itself serves to explain the absence of a provision authorizing derivative suits by limited partners. Therefore the new article 10 of the proposed ULPA (1976) presents an important addition to the law of limited partnerships.<sup>5</sup>

#### BEFORE THE PROPOSED ARTICLE 10

As we are painfully aware from the debates during the period when the Uniform Partnership Act was in the drafting stage, the mighty locked horns over the merits of "entity" versus "aggregate" as the fundamental theory upon which the Uniform Partnership Act was to travel.<sup>6</sup> Despite the dominance of the aggregate theory of partnership in the Uniform Partnership Act, entity notions nevertheless permeate the Partnership Act in a number of significant areas.<sup>7</sup> The absence of any provision for suits in the firm name, is indicative of the preference for the aggregate theory. However, various statutes and procedural rules have largely rendered the omission innocuous.<sup>8</sup>

As indicated, the limited partnership is a creature of statute. The

3. Crane, *The Uniform Partnership Act—A Criticism*, 28 HARV. L. REV. 762, 763 (1915); Lewis, *The Uniform Partnership Act—A Reply to Mr. Crane's Criticism*, 29 HARV. L. REV. 158, 191 (1916). See also Crane, *Uniform Partnership Act and Legal Persons*, 29 HARV. L. REV. 838 (1916); Note, *The Partnership As a Legal Entity*, 41 COLUM. L. REV. 698 (1941).

4. The Committee of the National Conference of Commissioners on Uniform State Laws charged with drafting the UPA, served also as the committee to draft the ULPA. Lewis, *The Uniform Limited Partnership Act*, 65 U. PA. L. REV. 715 (1916).

5. The text of article 10 is set out, together with a discussion of its several provisions, *infra* p. 522.

6. Dean James Barr Ames argued that the uniform act should treat the partnership as a juristic entity, separate and distinct from the natural persons who might happen to be its member partners. This approach, reasoned Ames, would make the legal concept of a partnership square with the commercial concept of a partnership. But when Dean William Draper Lewis assumed the chief draftsman's duties, the new Partnership Act was irrevocably committed to proceed upon the classic common law theory that a partnership is not an entity but an aggregation of persons bonded together contractually as members to carry on "as co-owners a business for profit." UNIFORM PARTNERSHIP ACT § 6(1).

7. See *id.* § 8(3), 8(4) (dealing with conveyances and acquisition of title to property); *id.* § 9(1) (recognizing the partner as an agent of the partnership). There are various procedural statutes permitting persons carrying the business as partners to sue or be sued in their partnership name. See also UNIFORM LIMITED PARTNERSHIP ACT § 1, Commissioners' note (1916) [hereinafter cited as ULPA (1916)].

8. Under FED. R. CIV. P. 17(b) and TEX. R. CIV. P. 28, all partnerships, both general and limited, are capable of being sued in the firm name. Similar treatment is found in N.Y. CIV. PRAC. ACT § 222a and PENN. R. CIV. P. 2128.

need for an institution permitting a right to share in profits with limited liability for losses has existed since the development of mercantile activity in Western Europe during the Middle Ages.<sup>9</sup> The first limited partnership act was adopted by New York in 1822.<sup>10</sup> Within the next thirty years the important commercial states had followed New York's example.<sup>11</sup> In 1916, the Uniform Limited Partnership Act was offered to the states. Today every state has enacted a limited partnership statute.

The early limited partnership acts originated during a period when there was reluctance to accept this new form, and the court, therefore, construed the statute strictly as being in derogation of common law.<sup>12</sup> Strict attention was paid to the statutory requisites and any failure to meet these requisites would result in the limited partner being stripped of his limited liability and treated instead as a general partner.<sup>13</sup> This failure to meet the requirements included any participation by the limited partner in the management of the business, rendering the limited partner generally liable as a general partner.<sup>14</sup>

It must be remembered that during this period corporate charters were not easy to obtain and corporations were not of general commercial significance so that an analogy between the limited partners and the stockholder was seldom employed.<sup>15</sup> In view of this, it is not surprising to find fairly recent cases in a number of jurisdictions to the effect that only a general partner could qualify as a proper party

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9. See note 1 *supra*. During this period merchants were not held in high esteem and the monied classes consisted for the most part of nobles and clergy who could not engage directly in trade. *Ames v. Downing*, 1 Bradf. Surr. 321, 330 (N.Y. 1850); Comment, *Partnership in Commendam—Louisiana's Limited Partnership*, 35 TUL. L. REV. 815, 816-17 (1961). The limited partnership form gave them the opportunity to secretly invest in trading ventures and collect huge profits without being personally liable and without being publically associated with traders and merchants. This early form of limited partnership put to use great riches not otherwise being used and caused tremendous growth of commerce which eventually raised the stature of the merchant class. *Id.*

10. 1822 N.Y. Laws, ch. 244.

11. Lewis, *The Uniform Partnership Act*, 65 U. PA. L. REV. 715, 720 (1916).

12. J. CRANE & A. BROMBERG, *LAW OF PARTNERSHIP* § 26, at 143 n.22 (1968).

13. See, e.g., *Pierce v. Bryant*, 87 Mass. (5 Allen) 91, 93 (1862); *Fifth Ave. Bank v. Colgate*, 24 N.E. 799, 801 (N.Y. 1890); *Richardson v. Hogg*, 38 Pa. 153, 156 (1861); 56 MICH. L. REV. 285, 286 (1957). Through time the courts came to treat the limited partner more favorably so as to accomplish the purpose of the statute. *White v. Eiseman*, 134 N.Y. 101, 103, 31 N.E. 276, 277 (1892).

14. *Millard v. Newmark & Co.*, 266 N.Y.S.2d 254, 259, 261 (1966); *Executive Hotel Assocs. v. Elm Hotel Corp.*, 245 N.Y.S.2d 929, 933 (Civ. Ct. 1964); ULPA § 7 (1916); see note 77 *infra* and accompanying text.

15. See H. HENN, *LAW OF CORPORATIONS* 17-18 (2d ed. 1970).

to maintain a suit on behalf of or to defend an action against a limited partnership. In *Oil and Gas Ventures, Inc. v. Cheyenne Oil Corp.*<sup>16</sup> the Court of Chancery of Delaware, applying New Jersey law held that: "[I]t would appear that in a case of limited partnership only a general partner is a proper party to a proceeding on behalf of or against such a partnership unless the purpose of the suit is to enforce a limited partner's right against or liability to the partnership."<sup>17</sup>

The classic case permitting a limited partner to maintain a derivative suit is *Klebanow v. New York Produce Exchange*.<sup>18</sup> In *Klebanow* the limited partnership of Ira Haupt & Co., a New York brokerage house, had gone bankrupt. After finding that they were unable to meet their financial obligations, the general partners entered into an agreement with their creditors and the New York Stock Exchange, whereby they assigned to the latter all their rights and powers over their assets. The assignees were to act as the receiver of Ira Haupt & Co. and accomplish the liquidation of the limited partnership. The limited partners brought this suit alleging violation of the Clayton Act,<sup>19</sup> claiming that the liquidating partner was unable, and because of a conflict of interest, his assigns were unwilling to bring suit. The defendants contended that the plaintiffs as limited partners had no standing to sue and no capacity to bring suit. Their contention was supported by section 115 of the New York Partnership Law which indicated that this cause of action would belong to the general partners.<sup>20</sup> The district court<sup>21</sup> and the court

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16. 202 A.2d 282 (Del. Ch. 1964).

17. *Id.* at 284-85; *accord*, *Vulcan Furniture Mfg. Corp. v. Vaughn*, 168 So. 2d 760, 763 (Fla. Dist. Ct. App. 1964); *Lieberman v. Atlantic Mut. Ins. Co.*, 385 P.2d 53, 56 (Wash. 1963); ULPA § 26 (1916).

18. 344 F.2d 294 (2d Cir. 1965), *rev'g*, 232 F. Supp. 965 (S.D.N.Y. 1964).

19. 15 U.S.C. § 15 (1970). Section 15 authorizes a suit by any person injured by anything forbidden in the antitrust laws. *Id.* The court of appeals in *Klebanow* held that the partnership rather than the partner was the one injured. *Klebanow v. New York Produce Exch.*, 344 F.2d 294, 296 (2d Cir. 1965).

20. At the time of this case, N.Y. PARTNERSHIP LAW § 115 (McKinney 1948), *as amended* by N.Y. PARTNERSHIP LAW § 115 (McKinney Supp. 1976) was identical to ULPA § 26 (1916) which reads: "A contributor, unless he is a general partner, is not a proper party to proceedings by or against a partnership, except where the object is to enforce a limited partner's right against or liability to the partnership." *Id.*

FED. R. CIV. P. 17(b) was held applicable and therefore New York law was controlling in both the district court, *Klebanow v. New York Produce Exch.*, 232 F. Supp. 965, 968 (S.D.N.Y. 1964), *rev'd*, 344 F.2d 294 (2d Cir. 1965), and the court of appeals, *Klebanow v. New York Produce Exch.*, 344 F.2d 294, 297 (2d Cir. 1965).

21. *Klebanow v. New York Produce Exch.*, 232 F. Supp. 965 (S.D.N.Y. 1964), *rev'd*, 344 F.2d 294 (2d Cir. 1965).

of appeals<sup>22</sup> held that this statute did not bar a limited partner from bringing a derivative action.<sup>23</sup>

The district court, however, held that a limited partnership is not an entity and no action can be brought on its behalf.<sup>24</sup> This rationale is questionable and was said to be in conflict with Federal Rule of Civil Procedure 17(b) by the court of appeals.<sup>25</sup> The district court analogized the position of a limited partner to that of a creditor rather than that of an owner of the property of the limited partnership.<sup>26</sup> By analogy, therefore, the limited partner was barred from bringing this suit because a creditor could not bring an action.<sup>27</sup> This reasoning flies in the teeth of the commissioners' statement in the comment to section 1 of the ULPA (1916) which gives the limited partner rights nearly equivalent to those of an owner.<sup>28</sup> In *Klebanow* the assignment of management was to the creditors and as long as the limited partnership had sufficient assets to satisfy their claims, those in control of the partnership, namely the creditors, had no motive to prosecute a partnership claim. A creditor is only concerned with the payment of the debt owed to him, not the future earnings of the firm.<sup>29</sup>

In commenting on two New York cases<sup>30</sup> allowing intervention by limited partners in existing suits when it was claimed that the general partners were not protecting the partnership interests, the district court stated that the facts under consideration were so different from those in the New York cases that the precedent was of doubtful

22. *Klebanow v. New York Produce Exch.*, 344 F.2d 294 (2d Cir. 1965).

23. *Id.* at 298 (stated that this situation was not foreseen by legislature); *Klebanow v. New York Produce Exch.*, 232 F. Supp. 965, 967 (S.D.N.Y. 1964), *rev'd*, 344 F.2d 294 (2d Cir. 1965).

24. *Klebanow v. New York Produce Exch.*, 232 F. Supp. 965, 968 (S.D.N.Y. 1964), *rev'd*, 344 F.2d 294 (2d Cir. 1965); *see* 50 IOWA L. REV. 954, 956 (1965). It is not inconsistent with either the nature of the limited partnership nor the purpose for which it was created to hold that the limited partnership exists as a legal entity. The purpose of the limited partnership is in fact advanced through a holding that the limited partnership is an entity by providing additional protection for the investor. *Id.* at 957. "[T]he application of the entity theory by the court in the instant case appears to be rather tenuous." *Id.* at 957.

25. *Klebanow v. New York Produce Exch.*, 344 F.2d 294, 299 (2d Cir. 1965).

26. *Klebanow v. New York Produce Exch.*, 232 F. Supp. 965, 967 (S.D.N.Y. 1964), *rev'd*, 344 F.2d 294 (2d Cir. 1965).

27. *Id.* at 967.

28. The comment to ULPA § 1 (1916) refers to limited partners as "others who contribute capital and acquire rights of ownership."

29. 50 IOWA L. REV. 954, 959 (1965).

30. *Executive Hotel Assocs. v. Elm Hotel Corp.*, 245 N.Y.S.2d 929 (Civ. Ct. N.Y. 1964); *Cooper Prods. Co. v. Twin Bowl Co.*, 148 N.Y.L.J. 8 (Sup. Ct. 1962).

utility.<sup>31</sup> Judge Tyler distinguished these cases on the ground that they involved existing law suits and said that even if they are not distinguishable they are not in accord with "significant provisions of the New York Partnership Law as construed by the appellate courts of this state."<sup>32</sup> The cases, however, would seem to have involved sufficiently similar considerations to give the New York precedent some persuasive value.<sup>33</sup>

Rather than allow the limited partners to sue derivatively, the district court held that another remedy was available to the limited partners in that they were entitled by law to a judicial dissolution of the partnership.<sup>34</sup> Judicial dissolution is not a satisfactory remedy for the limited partner who is concerned with the future earnings of the firm. In the *Klebanow* situation, therefore, judicial dissolution of the partnership was an inadequate remedy, and the only remedy likely to redress the injury to the limited partners was a derivative action.<sup>35</sup>

The court of appeals reversed the district court opinion and allowed the limited partners' derivative action.<sup>36</sup> The court of appeals reasoned that where there is a violation of the Clayton Act<sup>37</sup> and the business is conducted by a partnership, it is the partnership rather than the partner who is the "person" injured.<sup>38</sup> The court, as a necessary step to holding that the partnership had the capacity to

31. *Klebanow v. New York Produce Exch.*, 232 F. Supp. 965, 968-69, (S.D.N.Y. 1964), *rev'd*, 344 F.2d 294 (2d Cir. 1965).

32. *Id.* at 969. To substantiate this statement of New York law the court only cited to the Washington case of *Lieberman v. Atlantic Mut. Ins. Co.*, 385 P.2d 53 (Wash. 1963).

33. 50 IOWA L. REV. 954, 959 (1965).

34. *Klebanow v. New York Produce Exch.*, 232 F. Supp. 965, 968 (S.D.N.Y. 1964) (citing N.Y. PARTNERSHIP LAW § 99 (McKinney 1948)), *rev'd* 344 F.2d 294 (2d Cir. 1965), which is analogous to ULPA § 10(c) (1916)).

35. 50 IOWA L. REV. 954, 959 (1965). An effort by the limited partners to compel the general partners to bring the action would not have succeeded because the general partners had assigned their interest to the defendants. The defendants, as assignees, would not have brought the suit against themselves. "[I]t is obvious that as long as the partnership has sufficient capital to satisfy their [creditors'] claims, those in control of the partnership would have no interest in prosecuting a partnership cause of action . . . [T]he protection being afforded the limited partners by those in control of the firm would be clearly inadequate." *Id.* at 959.

36. *Klebanow v. New York Produce Exch.*, 344 F.2d 294, 299 (2d Cir. 1965), *rev'g*, 232 F. Supp. 965 (S.D.N.Y. 1964).

37. 15 U.S.C. § 15 (1970).

38. *Klebanow v. New York Produce Exch.*, 344 F.2d 294, 296 (2d Cir. 1965). Section 15 of the Clayton Act, 15 U.S.C. § 15 (1970), authorizes a suit to be brought by "any person who shall be injured in his business or property by reason of anything forbidden in the antitrust laws." *Id.*

sue, implicitly held that the limited partnership was a legal entity.

The defendants claimed that the situation of the limited partner was analogous to that of a creditor. This theory which was accepted by the district court is based on the fact that both the creditor and limited partner lack property rights, both are barred from using their name in the firm title, and both have priority in the distribution of assets.<sup>39</sup> But there are significant differences. The creditor normally does not have a right to inspect the firm's books as he wishes, as does the limited partner.<sup>40</sup> Also, the creditor has priority over the limited partner in distribution of the assets.<sup>41</sup> As noted above, the comment to section 1 of the ULPA (1916) indicates that the limited partner has some rights of ownership and does not view his interest as that of a creditor.<sup>42</sup>

The partnership agreement of Ira Haupt & Co. set up a trust relationship upon dissolution of the firm with the general partners as trustees for the limited partners.<sup>43</sup> The plaintiffs argued that the assignment of the managing partners' duties to persons whose interests interfered with prosecution of the firm's claims would warrant the plaintiff's derivative action as *cestui que trust*.<sup>44</sup> It is well settled that a *cestui que trust* may sue to enforce a claim on behalf of the trust estate when the trustee has acted wrongfully.<sup>45</sup> The court denied the claim of express trust but found that a fiduciary duty in favor of the limited partners had been created.<sup>46</sup> The limited partners therefore, were analogous to the beneficiaries of a trust.<sup>47</sup> Using this analogy, the court could find no logical reason why a beneficiary should be allowed to sue yet under the circumstances deny this right to a limited partner.<sup>48</sup>

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39. *Klebanow v. New York Produce Exch.*, 344 F.2d 294, 297 (2d Cir. 1965).

40. *Id.* at 297.

41. *Id.* at 297.

42. See note 28 and accompanying text *supra*.

43. *Klebanow v. New York Produce Exch.*, 344 F.2d 294, 297 (2d Cir. 1965).

44. *Id.* at 297.

45. *Id.* at 297; *Bonham v. Coe*, 292 N.Y.S. 423 (App. Div.), *aff'd mem.*, 12 N.E.2d 566 (N.Y. 1937); *Brooklyn Free Kindergarten Soc'y v. Elbran Realty Corp.*, 7 N.Y.S.2d 531 (App. Div. 1938); see Note, 35 *FORDHAM L. REV.* 731, 736 & nn. 46-48 (1967); *RESTATEMENT (SECOND) OF TRUSTS* § 282(2) (1959). "Upon improper refusal by a fiduciary, equitable principles permit the beneficiary to bring a derivative suit to protect his interest in the entity." Comment, 40 *N.Y.U. L. REV.* 1174, 1177 & n.22 (1965).

46. *Klebanow v. New York Produce Exch.*, 344 F.2d 294, 297 (2d Cir. 1965).

47. *Id.* at 297. In the first suit allowing corporate shareholders to sue derivatively, the directors were held to be trustees for the stockholders who were seen as beneficiaries. *Robinson v. Smith*, 3 Paige Ch. 222, 232 (N.Y. 1832).

48. *Klebanow v. New York Produce Exch.*, 344 F.2d 294, 297 (2d Cir. 1965).



In the connected case of *Klebanow v. Funston*,<sup>49</sup> a federal district court said, "I have no difficulty with the proposition that the plaintiffs as limited partners have standing to sue derivatively and that their position is analogous to that of a cestui que trust where the trustee cannot or will not enforce the cause of action running to him for the benefit of the cestui que trust."<sup>50</sup> This was the sole basis used by the court to sustain the limited partners' capacity to sue.

The trust theory has previously been applied to other business situations.<sup>51</sup> It has from the beginning been a basis for allowing the corporate shareholder to sue derivatively.<sup>52</sup>

More convincing is the analogy of the limited partner to the corporate shareholder. This analogy was quickly accepted by the *New York Produce Exchange* court.<sup>53</sup> Both the corporate shareholder and the limited partner share in the profits, both are subordinated to the general creditors, both have limited liability, and both exist solely because of statutory authorization.<sup>54</sup> The corporate shareholder has some control over management through his vote. The limited partner also has some control over management with his power to veto the admission of new partners, examine the books when he wishes, and obtain full information on all matters affecting the partnership.<sup>55</sup> The limited partnership like the corporation involves a separation of management from the investor. This separation offers many opportunities for abuse. For these reasons American courts have viewed the rights of the limited partner as analogous to those of the corporate shareholder.<sup>56</sup> In 1953, in the case of *Ruzicka v. Rager*,<sup>57</sup> the New York Court of Appeals held that the limited partner was in a position analogous to that of a corporate shareholder.<sup>58</sup>

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49. 35 F.R.D. 518 (S.D.N.Y. 1964).

50. *Id.* at 520; see G. BOGERT, TRUSTS AND TRUSTEES, § 869, at 69-71 (2d ed. 1962); 2 A. SCOTT, TRUSTS, § 282.1 (1st ed. 1939).

51. Comment, *Standing of Limited Partners to Sue Derivatively*, 65 COLUM. L. REV. 1463, 1480 (1965).

52. *Id.* at 1480.

53. *Klebanow v. New York Produce Exch.*, 344 F.2d 294, 297 (2d Cir. 1965).

54. *Id.* at 297.

55. *Id.* at 297.

56. *Id.* at 297; *Miller v. Schweickart*, 405 F. Supp. 366, 369 (S.D.N.Y. 1975) (no more than ordinary shareholders with a title); *Ruzicka v. Rager*, 111 N.E.2d 878, 881 (N.Y. 1953) (quasi-shareholder status); *Sweitzer v. Wisconsin Dept. of Revenue*, 222 N.W.2d 662, 665 (Wis. 1974) (similarly analogous); Comment, *Standing of Limited Partners to Sue Derivatively*, 65 COLUM. L. REV. 1463, 1478 (1965) (closely resemble); 50 IOWA L. REV. 954, 961 (1965) (position similar to that of the shareholder).

57. 111 N.E.2d 878, 881 (N.Y. 1953).

58. *Id.* at 881.

In stating that the limited partner has limited liability, the court referred to the "quasi-corporate aspects of a limited partnership and the quasi-shareholder status of a limited partner."<sup>59</sup>

In the corporate experience, when a breach of the fiduciary duty brings intolerable results, the solution is the derivative action.<sup>60</sup> This fiduciary duty is not lessened by a change in organizational form of the firm.<sup>61</sup> There is likewise no need for different requirements to bring the derivative suit.

The court of appeals held that the limited partner's priority over the general partner on dissolution does not necessitate a finding of a creditor interest, but the limited partner's rights more closely resemble those of a preferred stockholder whose right to sue derivatively has already been established.<sup>62</sup> The limited partner is similar to the preferred shareholder in that both have priority over the other owners upon dissolution and both are subordinate to the general creditor's rights.<sup>63</sup> The court of appeals in the *Klebanow* case after drawing the analogy of the limited partner to the preferred stockholder, said, "[i]ndeed, it makes considerably greater sense to clothe the instant appellants with whatever descriptive phrase is necessary to enable them to sue on behalf of the partnership than to entertain derivative suits by persons owning a few shares in giant corporations, especially if the shares are non-participating redeemable preferred."<sup>64</sup> It appears that the court of appeals felt that the words used in section 115 of the New York Partnership Law must be construed liberally. Judge Friendly quoted a United States Supreme Court case saying, "[i]n reading the language we must remember that 'Legislative words are not inert, and derive vitality from the obvious purposes at which they are aimed.'"<sup>65</sup>

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59. *Id.* at 881.

60. Comment, *Standing of Limited Partners to Sue Derivatively*, 65 COLUM. L. REV. 1463, 1479 (1965). In the same circumstances as the *Klebanow* case, corporate shareholders would be permitted to bring a derivative suit on behalf of the entity "when the corporation has refused upon proper demand to bring the suit or when such demand would be futile under the circumstances." 50 IOWA L. REV. 954, 960 (1965).

61. *Miller v. Schweichart*, 405 F. Supp. 366, 369 (S.D.N.Y. 1975). "The form of the enterprise does not diminish the duty of fair dealing by those in control of the investments." *Id.* at 369.

62. *Klebanow v. New York Produce Exch.*, 344 F.2d 294, 297 (2d Cir. 1965); see *Ashwander v. Tennessee Valley Auth.*, 297 U.S. 288 (1936); Comment, *Standing of Limited Partners to Sue Derivatively*, 65 COLUM. L. REV. 1463, 1473, 1479 & n.110, 1480 (1965).

63. *Klebanow v. New York Produce Exch.*, 344 F.2d 294, 297 (2d Cir. 1965).

64. *Id.* at 297-98.

65. *Id.* at 298 (quoting *Griffiths v. Helvering*, 308 U.S. 335, 355 (1939)). "In a situation not covered by the statute, a court is authorized to apply general rules of law and equity."

To grant relief by way of a derivative action, it is necessary for the court to find that the limited partnership is an entity.<sup>66</sup> Many of the cases since *Klebanow* have allowed the limited partner to sue derivatively. One case, *Millard v. Newmark & Co.*,<sup>67</sup> decided soon after *Klebanow* did not allow the limited partner to bring a derivative action.<sup>68</sup> In the *Millard* case the limited partners brought an action against the general partners for alleged misrepresentations and fraud. The court conceded that the limited partnership was an entity,<sup>69</sup> but reasoned that since the limited partnership form did not exist in common law and exists statutorily, the limited partner has only those rights granted to him by statute or partnership agreement.<sup>70</sup> It was stated, "Only a general partner is authorized to act in behalf of the partnership."<sup>71</sup> Although a limited partner has been compared to a corporate shareholder, "the legislature has not seen fit to endow him with the status of a shareholder, or to confer upon him the rights, powers and obligations of a shareholder."<sup>72</sup> The court said, "[T]he legislature which created the limited partnership took great care to enumerate the rights, privileges and benefits accruing to a limited partner."<sup>73</sup> With this strict interpretation of the statute the court held that neither the derivative suit nor the class action should be allowed and that the proper remedy is a direct action to redress the individual wrong to each limited partner.<sup>74</sup> Each "suffered a separate wrong and has a separate cause of action."<sup>75</sup> This interpretation would flood the courts with litigation.

The majority cited *Executive Hotel Associates v. Elm Hotel Corp.*,<sup>76</sup> to support the theory that a limited partner suing on behalf

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Comment, 40 N.Y.U. L. REV. 1174, 1177 (1965). See ULPA § 29 (1916). Since shareholders would be able to protect their investment through a derivative suit, a limited partner should also be able to do so. 50 IOWA L. REV. 954, 961 (1965).

66. Comment, *Standing of Limited Partners to Sue Derivatively*, 65 COLUM. L. REV. 1463, 1481 (1965). The author further notes that there are two distinct types of entities, an artificial person created by statute and an entity recognized by the courts of equity. *Id.* at 1481. This latter approach has been used in the corporate sphere where the courts have recognized the de facto corporate entity when the situation so warranted. *Id.* at 1481.

67. 266 N.Y.S.2d 254 (App. Div. 1966).

68. *Id.* at 259.

69. *Id.* at 259.

70. *Id.* at 259.

71. *Id.* at 259.

72. *Id.* at 259.

73. *Id.* at 260.

74. *Id.* at 260.

75. *Id.* at 260.

76. 245 N.Y.S.2d 929 (Civ. Ct. N.Y. 1964).

of the corporation was exercising such control over the management as to make himself a general partner with unlimited liability.<sup>77</sup> This would defeat the main purpose of the limited partnership, that of encouraging investment. The choices available to the limited partner of meekly acquiescing in a general partner's misappropriation of partnership funds, protecting his limited liability or bringing an action on behalf of the limited partnership and subjecting himself to unlimited liability is a Hobson's choice. "Certainly, no investor can be said to have bargained for mismanagement of his firm."<sup>78</sup>

The court in the *Millard* case dismissed briefly the *Klebanow* opinion as being primarily a decision based on policy considerations.<sup>79</sup> Instead the majority relied on *Mannaberg v. Herbst*<sup>80</sup> to show that "the wrong is done not to the firm but to each partner separately and that each not only may but must sue alone for such damage as he has sustained."<sup>81</sup>

Judge Rabin filed a strong dissent<sup>82</sup> in which he would have allowed the limited partners to "sue derivatively for the benefit of the partnership where general partners have through wrongdoing, injured the partnership."<sup>83</sup> Judge Rabin noted that in *Mannaberg* the plaintiffs were not seeking to maintain a derivative suit and that the business form there involved was not a limited partnership.<sup>84</sup> The dissent also noted that the recent cases sustaining the right of a limited partner to bring a derivative action were not troubled by *Mannaberg*.<sup>85</sup>

77. *Millard v. Newmark & Co.*, 266 N.Y.S.2d 254, 259, 261 (App. Div. 1966). Section 7 of the ULPA (1916) reads: "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. ULPA § 7 (1916). The court in *Executive Hotel Assocs. v. Elm Hotel Corp.*, 245 N.Y.S.2d 929 (Civ. Ct. N.Y. 1964) (construing N.Y. PARTNERSHIP LAW § 96 (McKinney 1948) which is identical to ULPA § 7), held that by bringing a suit on behalf of the partnership, the limited partner had taken part in the control of the business and was thus liable as a general partner. *Id.* at 933.

78. Comment, *Standing of Limited Partners to Sue Derivatively*, 65 COLUM. L. REV. 1463, 1479 (1965).

79. *Millard v. Newmark & Co.*, 266 N.Y.S.2d 254, 262 (App. Div. 1966).

80. 45 N.Y.S.2d 197 (Sup. Ct.), *aff'd without opinion*, 47 N.Y.S.2d 100 (App. Div.), *aff'd*, 56 N.E.2d 255 (N.Y. 1944).

81. *Millard v. Newmark & Co.*, 266 N.Y.S.2d 254, 262 (App. Div. 1966), *quoting*, *Mannaberg v. Herbst*, 45 N.Y.S.2d 197, 199 (Sup. Ct. 1944).

82. *Millard v. Newmark & Co.*, 266 N.Y.S.2d 254, 262 (App. Div. 1966) (dissenting opinion).

83. *Id.* at 263.

84. *Id.* at 264.

85. *Id.* at 264.

After citing *Ruzicka v. Rager*,<sup>86</sup> Judge Rabin said, "Investment in a business enterprise is not fully encouraged unless there be given to the investor an adequate remedy to enable him to protect that investment from wrongful acts which weaken the financial structure that supports it."<sup>87</sup> "[U]nless we allow the derivative suit, the limited partner has no adequate remedy."<sup>88</sup>

In *Riviera Congress Associates v. Yassky*<sup>89</sup> a limited partner was allowed to sue derivatively.<sup>90</sup> The court held that the plaintiffs were "authorized to sue as limited partners on behalf of the partnership entity to enforce a partnership claim when those in control of the business wrongfully decline to do so."<sup>91</sup>

Section 115-(a) of the New York Partnership Law allows a limited partner to bring an action "in the right of a limited partnership to procure a judgment in its favor."<sup>92</sup> The section requires that the plaintiff be a limited partner "at the time of bringing the action, and that he was such at the time of the transaction of which he complains or that his status as substituted limited partner devolved on him" by law or partnership agreement.<sup>93</sup> This requirement clearly anticipates section 1002 of the revised ULPA. Like the revised Act, the New York law requires that the plaintiff "set forth with particularity the efforts of the plaintiff to secure the initiation of such action by the general partner or partners, or the reasons for not making such effort."<sup>94</sup>

In 1975, the Court of Special Appeals of Maryland in *McCully v. Radack*<sup>95</sup> held that limited partners could intervene in a foreclosure proceeding if they could meet certain requirements.<sup>96</sup> In this case the limited partnership had purchased and operated a marina. The limited partnership entered into a deed of trust agreement and later defaulted. The trustees instituted foreclosure proceedings and the marina was sold at an auction. The limited partners sued complaining that all assets were not included in the accounting and that an

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86. 111 N.E.2d 878 (N.Y. 1953).

87. *Millard v. Newmark & Co.*, 266 N.Y.S.2d 254, 267 (App. Div. 1966) (dissenting opinion).

88. *Id.* at 264.

89. 277 N.Y.S.2d 386, 223 N.E.2d 876 (N.Y. 1966).

90. *Id.* at 391, 223 N.E.2d at 879.

91. *Id.* at 391, 223 N.E.2d at 879.

92. N.Y. PARTNERSHIP LAW § 115-a(1) (McKinney Supp. 1976).

93. *Id.* § 115-a(2).

94. *Id.* § 115-a(3).

95. 340 A.2d 374 (Md. Ct. Spec. App. 1975).

96. *Id.* at 380.

allegedly exorbitant legal fee had been charged against the partnership assets. The Maryland court held that "limited partners may intervene in a commercial transaction, such as a deed of trust foreclosure, when there are strong allegations and proof that the third party has wrongfully acted in concert and collusion with the general partner to the detriment of the limited partnership."<sup>97</sup> The court allowed the plaintiffs to intervene in a commercial transaction which would normally be under the exclusive domain of the general partners as managers. Whether to allow a deed of trust foreclosure or not is normally a decision for the management, and the courts historically have been hesitant about interfering with the internal affairs of a business entity.<sup>98</sup> While a refusal to bring an action on a claim benefiting the firm is a clear breach of a fiduciary duty, the commercial transaction here may not clearly be a breach of trust.

Enough has been said to indicate that enlightened courts have felt it quite necessary to permit a limited partner, in an appropriate situation, to bring a derivative action, either under state statutes anticipating article 10 of the revised ULPA or without benefit of statutory authorization of any kind. They have rationalized such action by drawing an analogy between a limited partner and a stockholder in a corporation—or drawing upon the less convincing analogies between *cestui que trust* and the limited partner or between a creditor and the limited partner.

#### ARTICLE 10

Article 10 of the revised Act brings the treatment of limited partners into the realm of commercial reality. It is a recognition of the enlightened position which the better reasoned cases had already

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97. *Id.* at 380.

98. In the early corporate derivative suit of *Foss v. Harbottle*, 67 Eng. Rep. 189 (Ch. 1843), the Chancellor limited this new form by requiring that the injury be one that could not be redressed by the shareholders themselves. The judiciary sought to balance the minority stockholder's lack of remedy with the policy of having the corporation resolve its own disputes. *Id.* at 202-05.

Another factor was the court's desire not to open the floodgates of litigation to any stockholder with a grievance. See Prunty, *The Shareholders' Derivative Suit: Notes on Its Derivation*, 32 N.Y.U. L. Rev. 980 (1957). Prunty also suggests that a shareholder may be able to circumvent the defense that the grievance is one which can be settled within the corporation on the theory that the injurious action of the directors was *ultra vires*. This is due to the fact that the majority cannot authorize or ratify an act beyond the grant of authority of the organization. *Id.* at 984.

embraced—regarding the limited partner as essentially an investor analogous to the stockholder in a corporation. The article is divided into four sections.

Section 1001 authorizes a derivative action by the limited partner whenever the general partners refuse to bring suit or a successful attempt to have them sue is unlikely. This is analogous to the provision of rule 23.1 of the Federal Rules of Civil Procedure that allows a derivative action to be brought by "one or more shareholder or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it."<sup>99</sup> Thus article 10, like rule 23.1 recognizes the derivative nature of the action. It is interesting to note that rule 23.1 alone is broad enough in scope, permitting the derivative suit to be brought not only by members of a corporation but also by members of an "unincorporated association," which term includes a limited partnership.

Section 1002 of the revised Act states that:

In a derivative action, the plaintiff must be a partner at the time of bringing the action and (1) at the time of the transaction of which he complains or (2) his status as a partner had devolved upon him by operation of law or pursuant to the terms of the partnership agreement from a person who was a partner at the time of the transaction.

Here again it is interesting to note the "proper plaintiff" provisions of rule 23.1 which prescribes that "the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law." Again it is to be noted that rule 23.1 is not limited to shareholder plaintiffs but deals with "member" plaintiffs (such as limited partners) as well. Rule 23.1 also requires that the complaint allege "(2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have." This directive would, of course, be applicable when the limited partner brings his action in a federal court.

Section 1003 requires that "the complaint shall set forth with particularity the effort of the plaintiff to secure initiation of the action by a general partner or the reasons for not making the effort." This section is strikingly similar to the pleading requirements of rule 23.1 which recites that "[t]he complaint shall also allege with par-

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99. FED. R. CIV. P. 23.1.

ticularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort." Here too it is clear that rule 23.1 in its pleading provisions encompasses not only shareholders in a corporation but "members" of an association, such as a limited partnership.

Section 1004 requires that:

If a derivative action is successful, in whole or in part, or if anything is received by the plaintiff as a result of a judgment, compromise or settlement of an action or claim, the court may award the plaintiff reasonable expenses, including reasonable attorney's fees, and shall direct him to remit to the limited partnership the remainder of those proceeds received by him.

This section emphasizes what has long been recognized doctrine with respect to shareholders derivative actions, i.e. that the suit be one to redress a wrong to the corporation, the results of a judgment in favor of the plaintiff belong to the corporation. Section 1004 recognizes that the derivative suit brought by a limited partner is brought in the right of the partnership and the fruits of recovery belong to the limited partnership. To this section 1004 adds the obviously equitable award of reasonable expenses including counsel fees to the limited partner plaintiff.

#### AFTERGLOW

If the revised ULPA, including its article 10, is adopted, hopefully in all of the fifty states, it will lay to rest the matter of the limited partner's right to sue derivatively on behalf of the limited partnership. Further, it will instantiate the salutary solutions reached by the better reasoned decisions antedating proposed article 10 or the law of each adopting jurisdiction. In so doing the adoption of the revised statute will bring the law governing limited partnerships into conformity with the views of the commercial world, which has long viewed the limited partnership as an entity and the limited partner primarily as an investor analogous to the shareholder in a corporation.