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Limitation of Liability of Limited Partners While Affording Control of Partnership Affairs to Limited Partners.

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ARTICLES

LIMITATION OF LIABILITY OF LIMITED PARTNERS WHILE AFFORDING CONTROL OF PARTNERSHIP AFFAIRS TO LIMITED PARTNERS

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I. INTRODUCTION

A limited partnership consists of one or more general partners and one or more limited partners.[1] The general partners manage the business and are personally liable for the obligations of the limited partnership.[2] Limited partners invest capital in the limited partnership and share in the profits of the business, but their liability is limited to the amount of capital they invest.[3] If the limited partners exercise control over the business, however, the limited partners may forfeit their limited liability and be liable as general partners.[4]

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1. TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 1.02(6) (Vernon Supp. 1990). " 'Limited Partnership' means a partnership formed by two or more persons under the laws of Texas and having one or more general partners and one or more limited partners." *Id.*; *see also* J. CRANE & A. BROMBERG, LAW OF PARTNERSHIP § 26 (1968). "A limited partnership is formed by compliance with statutory requirements. It consists of (a) general partners, who manage the business and have the same liability as in an ordinary partnership, and (b) limited partners, who take no part in management, share profits, and do not share losses beyond their capital contributions to the firm." *Id.*

2. Freedman v. Tax Review Bd., 243 A.2d 130, 133 (Pa. Super. Ct. 1968). A limited partnership consists of one or more partners with unlimited liability who will manage the partnership and one or more partners with limited liability who have invested capital but have no management right and whose liability is limited to their investment. *See id.*

3. *Id.*

4. TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(a) (Vernon Supp. 1990).

> A limited partner is not liable for the obligations of a limited partnership, unless the limited partner is also a general partner or, in addition to the exercise of the limited partner's rights and powers as a limited partner, the limited partner participates in the control of the business. However, if the limited partner does participate in the control of the business, the 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.

Id.; *see also* Plasteel Prods. Corp. v. Helman, 271 F.2d 354, 356 (1st Cir. 1959) (limited partner not participating in control not liable as general partner); Holzman v. De Escamilla, 195 P.2d 833, 834 (Cal. Dist. Ct. App. 1948) (limited partner active in management liable as general partner); Grainger v. Antoyan, 313 P.2d 848, 853 (Cal. 1957) (limited partner not exercising

In the last century, the law of limited partnerships has been modified and revised[5] to keep up with the evolving uses of the business entity.[6] For the most part, the revisions and modifications came about by states adopting the Uniform Limited Partnership Act of 1916 (U.L.P.A. or Uniform Act) and later the Revised Uniform Limited Partnership Act of 1976 (R.U.L.P.A. or Revised Uniform Act), which was further amended in 1985.[7] Texas did not adopt the

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control not liable as general partner). *See generally* J. CRANE & A. BROMBERG, LAW OF PARTNERSHIP § 26 (1968) (limited partner subject to liability of general partner by taking part in business).

5. *See* TEX. REV. CIV. STAT. ANN. art. 6132a, comment p. 21 (Vernon Supp. 1990). Due to the intricacies and the popular tax treatment of limited partnerships, the law governing limited partnerships needed revision and modernization from time to time. *See id.*; *see also* AMERICAN LAW INSTITUTE, RESOURCE MATERIALS: PARTNERSHIPS 34-35 (6th ed. 1985). Limited partnerships were first used during the twelfth century in the commercial areas of Italy. *Id.* at 34. Later, the system was carried over to France and eventually arrived in the United States by way of the French influence in Louisiana and Florida. The limited partnership has always been a creature of statute. The first United States limited partnership statute was adopted in New York in 1822. *Id.* Other states soon adopted statutes similar to New York's. *Id.* at 35. For the next 96 years the use of limited partnerships was stifled due to courts believing the statutes were in derogation of common law and thereby strictly construing the statutes. *See* Andrews v. Schott, 10 Pa. 47, 51-52 (1848) (court held limited partners liable for having word "company" in their name, which was prohibited by statute). Therefore, the commissioner for uniform state laws, in 1916, made a proposal that the states adopt the Uniform Limited Partnership Act (U.L.P.A.). *See* AMERICAN LAW INSTITUTE, RESOURCE MATERIALS: PARTNERSHIPS 35 (6th ed. 1985). The underlying theory of the U.L.P.A. is that investors should be able to invest their money in a limited partnership and rely on the knowledge and skill of others in investing, without risking liability. *Id.* In 1976, the national conference of commissioners on uniform state laws extensively modernized the 1916 act and recommended that the states enact the Revised Uniform Limited Partnership Act (R.U.L.P.A.). *Id.*; *see also* Albert & Schwartz, *Texas Revised Limited Partnership Act*, 50 TEX. B. J. 148, 148 (Feb. 1987). In 1985, the commissioners modified the R.U.L.P.A. to adopt certain improvements that states had made to the 1976 revised uniform act. *See id.*

6. *E.g.*, TEX. REV. CIV. STAT. ANN. art. 6132a-1 (Vernon Supp. 1990); *see also* Albert & Schwartz, *Texas Revised Limited Partnership Act*, 50 TEXAS B. J. 148, 148 (Feb. 1987). In the early 1900's, limited partnerships were primarily used by businesses which had only a few partners and were closely held. *Id.* Since the early 1900's, limited partnerships have been used more widely and for many different types of transactions. An area where limited partnerships have often been used is for real estate and oil and gas investments. Limited partnerships are often used in such areas since they have a favorable tax treatment. *Id.* Today, limited partnerships are sold and traded extensively, some even being traded actively on stock exchanges. *See* TEX. REV. CIV. STAT. ANN. art. 6132a-1, comment p. 44 (Vernon Supp. 1990).

7. *See* Uniform Limited Partnership Act, 6 U.L.A. 561 (1916); Revised Uniform Limited Partnership Act, 6 U.L.A. 226 (1985) (amended 1983 and 1985); *see also* AMERICAN LAW INSTITUTE, RESOURCE MATERIALS: PARTNERSHIPS, 34-35 (1985). In 1916, the commissioner for uniform state laws recommended that states adopt the U.L.P.A. *Id.*; *see also* Coleman, *Proposed Amendments Texas Uniform Limited Partnership Act*, 40 TEX. B. J. 46, 47 (Jan. 1977). There was an increased use of limited partnerships, since courts were no longer as

U.L.P.A. until 1955.[8]

As adopted, the Texas Uniform Act of 1955 was practically identical to the national Uniform Limited Partnership Act.[9] The law in Texas remained unchanged until 1977, when the Texas legislature began making revisions.[10] Texas legislators, feeling the need to modernize the state's limited partnership law, enacted the Texas Revised Limited Partnership Act (T.R.L.P.A., or the Texas Revised Act), which took effect September 1, 1987.[11]

Two overriding objectives of the Texas revised act are protection of limited partners and flexibility.[12] The Texas Revised Act differs substantially from its predecessors in many areas, such as formation, amendments, cancellation, liability, indemnification, mergers, and

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willing to hold them in derogation of the common law. *See id. See generally* Albert & Schwartz, *Texas Revised Limited Partnership Act*, 50 TEX. B. J. 148, 148 (Feb. 1987) (states adopted U.L.P.A., then adopted R.U.L.P.A., some modified the R.U.L.P.A. to make further modernizing improvement).

8. *See* Uniform Limited Partnership Act, ch. 133, 1955 Tex. Gen. Laws 471, *repealed by* Texas Revised Uniform Limited Partnership Act, TEX. REV. CIV. STAT. ANN. art. 6132a-1 (Vernon Supp. 1990).

9. *Compare* Uniform Limited Partnership Act, ch. 133, 1955 Tex. Gen. Laws 471, *repealed by* Texas Revised Uniform Limited Partnership Act, TEX. REV. CIV. STAT. ANN. art. 6132a-1 (Vernon Supp. 1990) *with* 6 U.L.A. 561 (1916). *See generally* Albert & Schwartz, *Texas Revised Limited Partnership Act*, 50 TEX. B. J. 148 (Feb. 1987). The Texas Uniform Act as first adopted was almost exactly like the national uniform limited partnership act. *See id.*

10. *See* TEX. REV. CIV. STAT. ANN. art. 6132a (Vernon 1970 & Supp. 1988) (discussing 1977 and 1979 amendments). *See generally* Albert & Schwartz, *Texas Revised Limited Partnership Act*, 50 TEX. B. J. 148, 153 n.4 (Feb. 1987). The gist of these changes "included an extended definition of who may become a general or limited partner (§ 2A), an expansion of safe harbor activities of limited partners without taking control of the business of a limited partnership (§ 8), provisions for qualification of foreign limited partnerships (§ 32), as well as other provisions." *Id.*

11. *See* TEX. REV. CIV. STAT. ANN. art. 6132a-1, comment p. 22 (Vernon Supp. 1990). As limited partnership law kept changing, the T.U.L.P.A. became outmoded. *Id.* The Texas Revised Limited Partnership Act was modeled for the most part on Delaware's Revised Limited Partnership Act of 1985 and the Revised Uniform Limited Partnership Act as amended in 1985, which was created by the national conference of Commissioners for Uniform State Laws. The Texas version differs from Delaware's act and the R.U.L.P.A. only where the committee members to the T.R.L.P.A. thought there could be improvements in form or substance. *Id.*; *see also* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 13.02 (Vernon Supp. 1990). The T.R.L.P.A. replaces the T.U.L.P.A. However, preexisting limited partnerships may be governed under the T.U.L.P.A. for a five-year transition period, unless the partners elect to adopt the T.R.L.P.A. before the five-year period expires. *See id.*

12. TEX. REV. CIV. STAT. ANN. art. 6132a-1, comment p. 22 (Vernon Supp. 1990). Among the T.R.L.P.A. objectives are modernization, comprehensiveness, coherence, and clarification. The two overriding objectives are limited partner protection and flexibility. *Id.*

consolidation.[13] The liability section of the Texas limited partnership statute is a chief concern of limited partners contemplating entrance into a limited partnership.[14]

This article will examine the liability provisions of section 3.03 of the Texas Revised Act, compare it with other uniform limited partnership acts, and attempt to ascertain the amount of control a limited partner can exercise over the partnership today without risking unlimited liability as a general partner. The pertinent text of these Acts is contained in the appendices following this article. This article will further discuss what factors should control limited partner liability and will recommend certain revisions in the legal tests for such liability.

II. TEXAS LIMITED PARTNER LIABILITY FOR EXERCISING CONTROL

A. *Historical Overview*

Texas limited partnership law, prior to the 1955 adoption of the Uniform Act, seemed to prohibit the limited partner from exercising any control over the partnership business.[15] Likewise, after Texas' enactment of the Uniform Act, a limited partner was prohibited from exercising any control over the business.[16] If the limited partner was

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13. *Compare* TEX. REV. CIV. STAT. ANN. art. 6132a, §§ 1-33 (Vernon 1970 & Supp. 1990) *with* TEX. REV. CIV. STAT. ANN. art. 6132a-1, §§ 1.01-13.03 (Vernon Supp. 1990). *See generally* Albert & Schwartz, *Texas Revised Limited Partnership Act*, 50 TEX. B. J. 148, 148-154 (Feb. 1987) (brief analysis of the significant changes between T.R.L.P.A. and T.U.L.P.A.).

14. *See* TEX. REV. CIV. STAT. ANN. art. 6132a, § 8 (Vernon Supp. 1990) (unlimited liability if limited partner exercises control over the business) (text is located in appendix B of this article); *see also* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03. (Vernon Supp. 1990) (unlimited liability if control exercised) (text is located in appendix A of this article). *See generally* Comment, *Limited Partner Control and Liability Under the Revised Uniform Limited Partnership Act*, 32 SW. L.J. 1301 *passim* (1978). Because a limited partner's limited liability can be lost if the limited partner exercises control over the business, a determination of how much control may result in liability is of prime importance for attorneys and limited partners. *See id.*

15. *See* TEX. REV. CIV. STAT. ANN. art. 6110-6132 (Vernon 1962) (art. 6100-6132 repealed, however, provisions appear in historical note). "General partners only shall be authorized to transact business and sign for the partnership and to bind the same." *Id.* From a strict reading of art. 6110-6132, and an absence of case law on the subject, it is not clear whether the limited partner would suffer liability as a general partner for exercising control over the partnership. *See id.*

16. *See* TEX. REV. CIV. STAT. ANN. art. 6132a, § 8 (Vernon 1970 & Supp. 1990). A limited partner shall have limited liability, unless the limited partners exercise control over the partnership business. *Id.*

found to have exercised control over the business, the limited partner no longer enjoyed limited liability.[17]

Problems arose because, although the Uniform Act prohibited limited partners from exercising control over the business, it provided no definition of what constituted control.[18] In *Delaney v. Fidelity Lease Ltd.*,[19] the Texas Supreme Court held that a third-party creditor did not have to rely on the belief that the limited partner was a general partner in order to hold a limited partner liable for exercising control over the business.[20] After *Delaney*, limited partners were still in doubt as to the threshold and extent of their risk.[21]

The 1979 amendment to section 8 of the Uniform Act provided a limited partner with some clarification of the limited partner's liability.[22] The amendment also provided a list of activities in which limited partners could participate without violating the provision against

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17. *See id.*; *see also* Coleman, *Proposed Amendments Texas Uniform Limited Partnership Act*, 40 TEX. B. J. 46, 47 (Jan. 1977). The drafters of the 1919 U.L.P.A., which Texas adopted with little change, were confronted with three conflicting policy considerations: 1) the policy of a limited partner having limited liability, 2) the policy of creditors being able to protect themselves when dealing with limited partnerships, and 3) the policy of allowing limited partners to have some control and supervision over their investment. *Id.* The drafters were able to balance the first two conflicting policy interests by providing that a general partner has unlimited liability for the debts and obligations of the partnership. However, the third policy interest of allowing limited partners some control over their investment was not accomplished in any form in the 1916 U.L.P.A. *Id.*

18. TEX. REV. CIV. STAT. ANN. art. 6132a, § 8 comment (Vernon Supp. 1990). Before the 1979 amendment, section 8 created one of the least clear issues of partnership law because it provided no definition and gave no indication of what constituted "taking part in the control of the business." *Id.* This section left limited partners in doubt as to when and to whom they may become liable. *Id.*

19. 526 S.W.2d 543 (Tex. 1975).

20. *See id.* (no statutory requirement of reliance). The court rejected the limited partners' contention that the creditor must have relied on the limited partners' personal liability, and held that § 8 of the T.U.L.P.A. simply states that limited partners who take "part in the control of the business" subject themselves to unlimited liability. *Id. Delaney* was overruled by the 1979 amendments to the T.U.L.P.A., which added a reliance test. *Id.*

21. TEX. REV. CIV. STAT. ANN. art. 6132a, § 8 comment (Vernon Supp. 1990). Prior to the 1979 amendment, section 8 provided limited partners with an unclear sense of what constituted control over the partnership business. *Id.*

22. TEX. REV. CIV. STAT. ANN. art. 6132a, § 8(a) (Vernon Supp. 1990). The 1979 amendment provided that a limited partner may be liable as a general partner, if "he takes part in the control of the business," however, the amendment added the phrase that a limited partner will only be liable "to a person who transacts business with a partnership reasonably believing that the limited partner is a general partner." *Id.*; *see also* TEX. REV. CIV. STAT. ANN. art. 6132a, § 8 comment (Vernon Supp. 1990). The 1979 amendment overruled the Texas Supreme Court case of *Delaney v. Fidelity Lease Ltd.*, 526 S.W.2d 543 (Tex. 1975), by adding the reliance test. *Id.*

exercising control over the business and subjecting themselves to liability.[23]

B. *The Texas Revised Act Section 3.03(a) Compared to the Texas Uniform Act Section 8(a)*

The Texas 1987 Revised Limited Partnership statute has expanded limited partners' freedom to control their investment and has decreased their risk of liability.[24] The Texas Revised Act is similar to the old uniform act in that under the new act, limited partners may become fully liable if they exercise control over the business.[25] Both acts state that a limited partner can be liable only to one who conducts business with the limited partnership and reasonably believes that the limited partner is a general partner.[26] Nevertheless, the revised act further requires that the reasonable belief that the limited partner is a general partner be "based on the limited partner's conduct."[27]

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23. TEX. REV. CIV. STAT. ANN. art. 6132a, § 8(b) (Vernon Supp. 1990).

24. *Compare* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b) (Vernon Supp. 1990) *with* TEX. REV. CIV. STAT. ANN. art. 6132a, § 8(b) (Vernon Supp. 1990). The official comment states: "section 3.03(b) expands TULPA section 8(b) 'safe harbor' list of activities that a limited partner may carry on with respect to the partnership without being deemed to take part in the control of the business." TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03 comment (Vernon Supp. 1990).

25. *Compare* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(a) (Vernon Supp. 1990) (liability as general partner if engages in control of the business) *with* TEX. REV. CIV. STAT. ANN. art. 6132a, § 8(a) (Vernon Supp. 1990) (liability as a general partner if exercise control over business).

26. *Compare* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(a) (Vernon Supp. 1990) (liable only to persons who do business with partnership and reasonably believe limited partner is general partner) *with* TEX. REV. CIV. STAT. ANN. art. 6132a, § 8(a) (Vernon Supp. 1990) (liable as general partner only to person who conducts business with partnership and reasonably believes limited partner is general partner).

27. TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(a) (Vernon Supp. 1990). Another difference is that the revised act § 3.03(a) includes, by reference to 3.03(d), the potential for unlimited liability of limited partners for knowingly allowing their names to be used for the partnership, unless they have specifically complied with an earlier section in the revised act. *Id.* This difference is more form than substance, since the old uniform act has a similar provision in § 6(b) rather than in § 8. Section 6(b) of the old uniform act provides that "a limited partner whose name appears in a partnership name contrary to the provisions of paragraph (a) is liable as a general partner to partnership creditors who extend credit to the partnership without actual knowledge that he is not a general partner." TEX. REV. CIV. STAT. ANN. art. 6132a, § 6(b) (Vernon 1962). *Cf.* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(a) (Vernon Supp. 1990). One substantive difference in the new act is a requirement that for the limited partners to incur general partner liability due to the use of their names, the limited partners must "knowingly" allow their name to be used, while under the old act the limited partners

C. *The Texas Revised Act Section 3.03(b) Compared to the Texas Uniform Act Section 8(b)*

Generally, the Texas Revised Act and the old uniform act are similar in that they both list numerous safe harbor provisions.[28] Safe harbor provisions are statutorily-prescribed powers that a limited partner may possess and exercise without being deemed to have taken part in the management of the business.[29]

All of the safe harbor provisions in section 8(b) of the previous Texas Uniform Act are repeated in section 3.03(b) of the revised act.[30] However, section 3.03(b) of the revised act has expanded the safe harbor list of section 8(b) of the Texas Uniform Act, allowing limited partners to engage in a greater variety of activities without being deemed to have participated in the control of the business.[31] Both the Texas Revised Act and the previous uniform act allow a limited partner to do such things as advise and consult with a general partner and act as a surety, contractor, endorser, or agent for the general partner or the partnership.[32] When one of the general partners is a corpora-

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did not necessarily have to be aware that their names were being used by the limited partnership. *Compare* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(d) (Vernon Supp. 1990) *with* TEX. REV. CIV. STAT. ANN. art. 6132a, § 6(b) (Vernon 1970). The new revised act also provides that limited partners shall be liable for the obligations of the partnership if the limited partners are also general partners. TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(a) (Vernon Supp. 1990); *see also* TEX. REV. CIV. STAT. ANN. art. 6132a, § 8(a) (Vernon Supp. 1990). Section 8 of the old uniform act does not include liability for a limited partner unless that individual is also acting as a general partner. TEX. REV. CIV. STAT. ANN. art. 6132a, § 8 (Vernon 1970). Although the old uniform act did not expressly state that limited partners were liable as a general partners if they were also general partners, they would have general partner liability regardless, since all general partners "are liable jointly and severally for all debts and obligations of the partnership . . . ." TEX. REV. CIV. STAT. ANN. art. 6132a, § 15 (Vernon 1970).

28. *Compare* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b)(1)-(8) (Vernon Supp. 1990) *with* TEX. REV. CIV. STAT. ANN. art. 6132a, § 8(b)(1)-(5) (Vernon Supp. 1990).

29. *See* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03 comment (Vernon Supp. 1990) (comment refers to list of activities a limited partner may perform regarding partnership without "taking part" in control of business); *see also* JRY Corp. v. Le Roux, 464 N.E.2d 82, 88 n.10 (Mass. App. Ct. 1984). The court states that safe harbors are a list of activities which a limited partner may perform without risking liability as a general partner. *Id.*

30. *Compare* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b)(1)-(8) (Vernon Supp. 1990) *with* TEX. REV. CIV. STAT. ANN. art. 6132a, § 8(b)(1)-(5) (Vernon Supp. 1990).

31. TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03 comment (Vernon Supp. 1990). The official comment states: "section 3.03(b) expands the TULPA § 8(b) 'safe harbor' list of activities that a limited partner may carry on with respect to the partnership without being deemed to take part in the control of the business." *Id.*

32. *Compare* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b)(1) (Vernon Supp. 1990)

tion, both acts allow a limited partner to act as director, shareholder or corporate officer of that general partner.[33] Both acts allow a limited partner to approve, through vote or individually, matters that are material to the partnership and which are stated in the certificate of limited partnership.[34] Such matters include the dissolution of the partnership, amendment of partnership bylaws, and exchange of the assets of the partnership when the exchange is not within the partnership's ordinary course of business.[35]

In addition to the safe harbor provisions of both acts, the revised act has increased and broadened the list by allowing a limited partner

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(not participating in control of business if acting as employee, contractor, agent of partnership or general partner, or director, stockholder, or officer of corporate general partner) *with* TEX. REV. CIV. STAT. ANN. art. 6132a, § 8(b)(3)(4) (Vernon Supp. 1990) (limited partner not exercising control over business when acting as agent, employee, contractor of general partner or limited partnership, or acting as director, shareholder, or officer of a general partner who is a corporation). Section 3.03(b)(2) of the revised act is similar to section 8(b)(1) of the old act. *Compare* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b)(2) (Vernon Supp. 1990) (limited partners not controlling business by advising or consulting a general partner, including matters related to limited partnership business) *with* TEX. REV. CIV. STAT. ANN. art. 6132a, § 8(b)(1) (Vernon Supp. 1990) (limited partners are not exercising control over the business when advising and consulting general partners as to nature of partnership business). Section 3.03(b)(3) of the revised act is similar to section 8(b)(2) of the old act. *Compare* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b)(3) (Vernon Supp. 1990) (limited partner not exercising control in guaranteeing obligation of partnership, providing collateral, or acting as guarantor, endorser or surety for partnership) *with* TEX. REV. CIV. STAT. ANN. art. 6132a, § 8(b)(2) (Vernon Supp. 1990) (limited partner not engaging in control of business for providing collateral, or acting as surety, endorser, or guarantor for obligations of partnership).

33. *Compare* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b)(1) (Vernon Supp. 1990) *with* TEX. REV. CIV. STAT. ANN. art. 6132a, § 8(b)(3)(4) (Vernon Supp. 1990).

34. *Compare* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b)(8) (Vernon Supp. 1990) (list of various activities a limited partner may approve, propose, or vote by majority or otherwise) *with* TEX. REV. CIV. STAT. ANN. art. 6132a, § 8(b)(5) (Vernon Supp. 1990) (list of various activities that, if stated in certificate and are material matters, the limited partner may approve by vote or otherwise).

35. *Compare* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b)(8)(A)-(C) (Vernon Supp. 1990) (limited partner not exercising control over business by proposing or voting on such activities as dissolving or winding up partnership, incurring debt, or refinancing debt of partnership, or selling or exchanging assets of partnership) *with* TEX. REV. CIV. STAT. ANN. art. 6132a, § 8(b)(5)(A)-(C) (Vernon Supp. 1990) (limited partner not conducting business by approving matters stated in partnership certificate such as dissolving or winding up partnership, sale or exchange of assets of partnership other than in ordinary course of business). Section 3.03(b)(8)(H) of the revised act is similar to section 8(b)(5)(B) of the old act. *Compare* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b)(8)(H) (Vernon Supp. 1990) (limited partners will not be exercising control over business for approving or proposing an amendment to partnership agreement) *with* TEX. REV. CIV. STAT. ANN. art. 6132a, § 8(b)(5)(B) (Vernon Supp. 1990) (limited partner will not be engaged in control of business for approving an amendment to partnership agreement).

to become a member of a general partnership that is a partner in the limited partnership without the risk of liability.[36] The revised act allows a limited partner to: (i) call, attend, participate in, or request a meeting between limited or general partners,[37] (ii) wind up the limited partnership pursuant to section 8.04,[38] (iii) bring a derivative action or any other action permitted by law,[39] and (iv) serve on limited partnership committees.[40] The revised act also enables limited partners to approve, disapprove, or propose by vote or any other manner, any combination of the following: (i) a change in the limited partnership's nature; (ii) matters concerning general partners, such as removing, admitting, or retaining them; and (iii) matters involving a transaction or a possible or actual conflict of interest.[41] If the limited partnership qualifies under the federal Investment Company Act of 1940,[42] limited partners may participate in electing directors and trustees of the investment company limited partnership and in handling investment

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36. *See* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b)(1) (Vernon Supp. 1990). This section states that a limited partner will not be liable as a general partner for also being a member of a general partnership which is a partner in the limited partnership. *Id.*

37. TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b)(4) (Vernon Supp. 1990).

38. TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b)(5) (Vernon Supp. 1990).

39. TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b)(6) (Vernon Supp. 1990).

40. TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b)(7) (Vernon Supp. 1990).

41. TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b)(8)(E)-(G) (Vernon Supp. 1990). The Partnership Law Committee of the Business Law Section of the State Bar of Texas has proposed various amendments to the revised Act. *See* 27 STATE BAR OF TEXAS BULLETIN OF THE BUSINESS LAW SECTION 1 (June 1990). These amendments will be submitted to the legislature during the 1991 legislative session. *See id.* There are only a few proposed changes that would affect the imposition of general partner liability on limited partners. Those changes would expand limited partners' safe harbor activities to include: (i) settling or terminating derivative litigation; (ii) electing to continue the partnership's business after dissolution; (iii) acting as permitted under Securities and Exchange Commission rules promulgated under the Investment Company Act of 1940; and (iv) voting on mergers. *Id.* at 2.

42. *See* 15 U.S.C. § 80a-3 (1981). The federal Investment Company Act of 1940 defines an investment company as:

> any issuer which- (1) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities; (2) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or as been engaged in such business and has any such certificate outstanding; or (3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

Id.

advisory and underwriting contracts.[43] Limited partners may also participate in approving auditors and in handling any other matters that the Investment Company Act of 1940 requires to be approved by holders of beneficial interests in the investment company.[44] The revised act also allows limited partners to approve, disapprove, or propose: (i) indemnification of a general partner pursuant to article 11 of the new revised act;[45] (ii) any other matters stated within the partnership agreement;[46] and (iii) to exercise any other right or power provided elsewhere in the revised act.[47]

D. *The Texas Revised Act Section 3.03(a), (b) Compared With Revised Uniform Act Section 3.03(a), (b)*

Section 3.03 of the Texas revised act is similar to section 3.03 of the revised uniform act as amended in 1985.[48] The Texas Revised Act underwent several changes, however, by adding safe harbor provisions. Limited partners are not deemed to be exercising control over the business (i) for being a member of a general partnership that is a partner in the limited partnership,[49] (ii) for providing security in the form of collateral so that the limited partnership may borrow,[50] or (iii) for participating in meetings with both limited and general part-

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43. *See* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b)(8)(I) (Vernon Supp. 1990). This subsection provides that a limited partner is not liable as a general partner for

> proposing, approving, or disapproving, by vote or otherwise, one or more of the following matters: . . . if the limited partnership is qualified as an investment company under the federal Investment Company Act of 1940 (15 U.S.C. § 80a-1 et. seq. [(1981 & Supp. 1990)]): (i) electing directors or trustees of the investment company; (ii) approving or terminating investment advisory or underwriting contracts; (iii) approving auditors; (iv) and acting on any other matters that the Investment Company Act of 1940 . . . requires to be approved by the holders of beneficial interest in the investment company.

Id.

44. *See id.*

45. TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b)(8)(J) (Vernon Supp. 1990).

46. TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b)(8)(K) (Vernon Supp. 1990).

47. TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b)(8)(L) (Vernon Supp. 1990).

48. *Compare* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03 (Vernon Supp. 1990) *with* Revised Uniform Limited Partnership Act § 3.03, 6 U.L.A. 282 (1985 & Supp. 1987). Sections 3.03(a) of both acts are identical. Sections 3.03(b) of both acts are similar, but the Texas Revised Act provided some additional safe harbors. *See id.*

49. TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b)(1) (Vernon Supp. 1990).

50. *See* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b)(3) (Vernon Supp. 1990) (limited partners not conducting business by acting as surety, guarantor, or endorser, or providing collateral for partnership).

ners.[51] The Texas Revised Act also adds provisions related to investment companies governed by the federal Investment Company Act of 1940.[52] Finally, the Texas Revised Act differs from the revised uniform act in that it has provided that limited partners may propose or approve any other activity that is stated within the partnership agreement.[53]

III. CASE LAW CONSTRUING PERMISSIBLE CONTROL

A. *Generally*

There is relatively little case law construing the amount of control a limited partner may exercise, and the case law that does exist fails to delineate how much control is permissible.[54] The lack of case law may be due to the fact that lawyers advise limited partners to act cautiously regarding the degree of control exercised, thereby limiting the opportunity for litigation.[55]

The case law that does exist is ambiguous on the issue of how much control a limited partner may exercise without incurring liability. The ambiguity of existing case law is at least partially due to a tendency by courts to decide control cases on an ad hoc basis.[56] Since state versions of the Revised Uniform Act are new, there is even less case law construing these modern acts. These revised acts do, however, clarify which activities a limited partner may participate in and to whom a limited partner may be liable.[57] Due to the lack of statu-

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51. TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b)(4) (Vernon Supp. 1990).

52. *See* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b)(8)(I) (Vernon Supp. 1990).

53. TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b)(8)(K) (Vernon Supp. 1990).

54. *See* Abrams, *Imposing Liability for "Control" Under Section 7 of the Uniform Limited Partnership Act*, 28 CASE W. RES. 785, 787 (1978). The author stated that cases failed to provide any meaningful definition of what control meant under the Uniform Limited Partnership Act, and one reason for this is that there have been relatively few cases before the courts. *See id.*; *see also* Comment, *Limited Partner Control and Liability Under the Revised Uniform Limited Partnership Act*, 32 SW. L.J. 1301, 1306 (1979).

55. *See* Comment, *Limited Partner Control and Liability Under the Revised Uniform Limited Partnership Act*, 32 SW. L.J. 1301, 1306 (1979).

56. *See* Gast v. Petsinger, 323 A.2d 371, 375 (Pa. Super. Ct. 1974). The actual degree of limited partner participation should be determined on an ad hoc basis. *See id.*; *see also* Comment, *Limited Partner Control and Liability Under the Revised Uniform Limited Partnership Act*, 32 SW. L.J. 1301, 1306 (1979).

57. *See* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(a),(b) (Vernon Supp. 1990). Section 3.03(a) provides that a limited partner will only be liable to those who conduct business with the partnership, and who reasonably believe based on the limited partner's conduct, that the limited partner has the status of a general partner. *Id.* Section 3.03(b) provides a list

tory definitions and interpretive case law, however, there is still uncertainty as to how much participation in the business is permissible. Cases defining the exercise of control generally apply two different tests: the control test;[58] and the reliance test.[59] The following discussion provides an indication of how the courts have applied these two tests.

B. *The Control Test*

Most courts have used the control test to analyze how much control the limited partner may possess.[60] Generally, if the limited partner may initiate business without the approval of the general partner, the limited partner is participating in the control of the business and is subject to general partner liability.[61]

One of the earliest cases that clearly used the control test was *Holzman v. De Escamilla*.[62] In *Holzman*, the limited partnership was in the business of farming.[63] The limited partners had the power to decide which crops to plant, to withdraw funds out of the partnership

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of activities and powers which a limited partner may engage in or possess without risking liability by exercising control over the business. *See id.*

58. Comment, *Limited Partner Control and Liability Under the Revised Uniform Limited Partnership Act*, 32 SW. L.J. 1301, 1306 (1979).

59. *Id.*

60. *See id.*; *see also* Plasteel Prods. v. Helman, 271 F.2d 354, 356 (1st Cir. 1959) (limited partner with power to hire sales manager and make certain financial decisions not exercising control over business since general partner could discharge sales manager); Mursor Builders v. Crown Mcuntain Apt. Assoc., 467 F. Supp. 1316, 1333-34 (D.V.I. 1978) (limited partners who were officers of corporate general partner, commingled personal funds, kept incomplete financial records, and failed to maintain corporate identity were subject to general partner liability regardless of creditor reliance); Weil v. Diversified Properties, 319 F. Supp. 778, 782 (D.D.C. 1970) (limited partner giving general financial advice when partnership in financial distress not exercising control over business); Grainger v. Antoyan, 313 P.2d 848, 853 (Cal. 1957) (limited partner who was sales manager did not control prices, credit, purchases, salaries, or employment, thus not exercising control over business); Holzman v. De Escamilla, 195 P.2d 833, 834 (Cal. Dist. Ct. App. 1948) (limited partners with power to write checks, decide which crops to plant, and power to fire general manager exercised control over business); Trans-Am Builders, Inc. v. Woods Mill, Ltd., 210 S.E.2d 866, 867-69 (Ga. Ct. App. 1974) (limited partners discussing with general partners partnership business and visiting job site not exercising control over business especially when partnership in financial distress). *See generally* Basile, *Limited Liability for Limited Partners: An Argument for the Abolition of the Control Rule*, 38 VAND. L. REV. 1199, 1205-06 (1985). In the majority of reported decisions the courts determined limited partners were liable as general partners when their involvement became too extensive. *Id.*

61. Coleman & Weatherbie, *Special Problems in Limited Partnership Planning*, 30 SW. L.J. 887, 899 (1976).

62. 195 P.2d 833 (Cal. Dist. Ct. App. 1948).

63. *See id.* at 834 (partnership raised vegetables and trucked crops).

without the consent of the general partner, and to require the general partner to resign.[64] The combination of these factors led the court to hold that the limited partners took part in the control of the partnership business.[65]

Another early case embracing the control test was *Bergeson v. Life Insurance Corp. of America*.[66] In *Bergeson*, the limited partners were directors of an insurance company.[67] A shareholder brought a derivative action against the corporation, alleging that the corporation was issuing stock to the directors and officers but receiving nothing in return.[68] The court held the limited partners liable as general partners, stating that the business of the partnership was running the insurance corporation, thus the limited partners actively participated in the control of the business.[69]

Other cases applying the control test have held that being a sales manager or selecting a sales manager for the partnership business did not constitute exercising control over the business.[70] In *Plasteel Products Corp. v. Helman*,[71] a creditor alleged the limited partners should be liable as general partners because they had the power to select the general sales manager.[72] The court did not hold the limited partners

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64. *Id.* The court stated that the limited partners dictated which crops were to be planted. They had absolute control over the partnership funds. The limited partners had the power to have the general partner to resign. The court held that these powers were sufficient for the limited partners to be exercising control over the partnership, and thus liability was imposed. *Id.*

65. *Id. See generally* Abrams, *Imposing Liability for "Control" Under Section 7 of the Uniform Limited Partnership Act*, 28 CASE W. RES. 785, 791 (1978) (discussing *Holzman).*

66. 170 F. Supp. 150 (D. Utah 1958), *rev'd on other grounds*, 265 F.2d 227 (10th Cir. 1959), *cert. denied*, 360 U.S. 932 (1959).

67. *See Bergeson*, 170 F. Supp. at 153 (defendants were former directors of Life Insurance Corp. of America).

68. *See id.* at 153-154 (corporation received nothing for stock worth $40,300).

69. *See id.* at 158-59 (D. Utah 1958). The court's actual holding was based on the fact that the limited partnership did not comply with the partnership statute, thus there was no partnership. *See id.* However, the court went on to state that even if the partnership would have been formed, liability would have still been imposed. The limited partners participated in the control of the business, since the only business was the management of the corporation. *See id. See generally* Comment, *Limited Partner Control and Liability Under the Revised Uniform Limited Partnership Act*, 32 SW. L.J. 1301, 1307 (1979) (discussing *Bergeson*).

70. *See* Plasteel Prods. Corp. v. Helman, 271 F.2d 354, 356 (1st Cir. 1959) (limited partners not exercising control for selecting sales manager, since general partner had discretion over sales mangers employment); *see also* Grainger v. Antoyan, 313 P.2d 848, 850 (Cal. 1957) (limited partner sales manager held as not exercising control over business).

71. 271 F.2d 354 (1st Cir. 1959).

72. *Id.* at 356.

liable as general partners for exercising control over the business, because the general partner had the discretionary power to terminate the general sales manager at any time.[73]

The California Supreme Court, in *Grainger v. Antoyan*,[74] did not impose unlimited liability on a limited partner who was a sales manager for the limited partnership.[75] The court held that the limited partner did not exercise control over the business because he had no control over prices, purchases, salaries or the extension of credit to customers.[76]

Courts have also held that a limited partner's financial advice to the general partners, in an attempt to protect his investment, did not constitute control over the business.[77] In *Weil v. Diversified Properties*,[78] a federal district court held that a limited partner did not exercise control over the business by giving the general partner financial advice when the partnership was in financial distress.[79] Likewise, in *Trans-Am Builders, Inc. v. Woods Mill, Ltd.*,[80] a Georgia court of appeals held that limited partners discussing the partnership business with general partners at the job site were not liable as general partners.[81] The court further stated it is less likely that limited partners will be deemed to control the business when the limited partnership is in financial distress.[82]

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73. *Id. See generally* Comment, *Limited Partnership Control and Liability Under the Revised Uniform Limited Partnership Act*, 32 SW. L.J. 1301, 1307-1308 (1979) (discussing *Plasteel*).

74. 313 P.2d 848 (Cal. 1957).

75. *Id.* at 850. The defendant sales manager had an office, had men working under him, and was in charge of selling new cars. *Id.*

76. *Id.* at 853. *See generally* Abrams, *Imposing Liability for "Control" Under Section 7 of the Uniform Limited Partnership Act*, 28 CASE W. RES. 785, 792 (1978) (discussing *Grainger*).

77. *See, e.g.*, Weil v. Diversified Properties, 319 F. Supp. 778, 782 (D.D.C. 1970); Trans-Am Builders, Inc. v. Woods Mill, Ltd., 210 S.E.2d 866, 868-69 (Ga. Ct. App. 1974).

78. 319 F. Supp. 778 (D.D.C. 1970).

79. *See id.*, at 782. The court stated that common sense would tell one that a limited partner will become more actively involved when there is a financial crisis, and that it is a stretch of the imagination to consider such activities as day-to-day matters. *Id. See generally* Abrams, *Imposing Liability for "Control" Under Section 7 of the Uniform Limited Partnership Act*, 28 CASE W. RES. 785, 796 (1978) (discussing *Weil*).

80. 210 S.E.2d 866 (Ga. Ct. App. 1974).

81. *Id.* at 868-69. The court stated that "it would be unreasonable to hold that a limited partner may not advise with the general partner and visit the partnership business, particularly when the project is confronted with a severe financial crisis." *Id.* at 869.

82. *Id.* at 868.

The Texas Supreme Court, in *Delaney v. Fidelity Lease Limited*,[83] embraced the control test and held that reliance by a third party was unnecessary to hold a limited partner liable.[84] The *Delaney* Court strictly construed the statute; stating that, since reliance was not within the statute, it was not to be a factor for imposing liability.[85] However, the 1979 amendment to section 8 of the Texas Uniform Act overruled *Delaney*, and expressly provided a reliance test.[86]

C. *The Reliance Test*

Courts using the reliance test analyze whether the activities exercised by the limited partner would reasonably justify a third party's belief, and reliance upon that belief, that the limited partner was a general partner.[87] The justification for the reliance test is protection of "third parties from dealing with the partnership under the mistaken assumption that the limited partner is a general partner with general liability."[88]

The concept that a third party must rely on a limited partner's activities and, thus, believe the limited partner is a general partner, was first introduced by the Supreme Court of Washington in *Rathke v. Griffith*.[89] In *Rathke*, the defendant Griffith was a limited partner

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83. 526 S.W.2d 543 (Tex. 1975).

84. *Id.* at 545. The court stated that the statute makes a limited partner liable simply for exercising control over the partnership business, and reliance is not mentioned in the statute. Therefore, a third party seeking to hold a limited partner liable as a general partner for exercising control over the partnership business need not demonstrate that he relied on the limited partner in any way. *Id.*

85. *Id.*

86. *See* TEX. REV. CIV. STAT. ANN. art. 6132a, § 8(a) comment (Vernon Supp. 1990). The 1979 amendment added that a limited partner was only liable to a third party who conducts business and reasonably relies on the belief that the limited partner was a general partner. *Id.* The official comment states that "[section] 8(a) overrules the holding in *Delaney v. Fidelity Lease Ltd.* . . . that there is no creditor reliance test." *Id.*

87. Feld, *The "Control" Test for Limited Partnerships*, 82 HARV. L. REV. 1471, 1479 (1969). Only activities which would reasonably induce a third party to rely on the belief that a limited partner is a general partner will impose unlimited liability on the limited partner. *Id.* An activity such as supervision of the daily activities may cause such reliance. *Id.*

88. Frigidaire Sales Corp. v. Union Properties, Inc., 544 P.2d 781, 785 (Wash. 1975), *aff'd*, 562 P. 2d 244 (1977). *See generally* Basile, *Limited Liability for Limited Partners: An Argument for the Abolition of the Control Rule*, 38 VAND. L. REV. 1199, 1209 (1985) (discussing the specific reliance test).

89. 218 P.2d 757 (Wash. 1950); *see also* Comment, *Limited Partnership Control and Liability Under the Revised Uniform Limited Partnership Act*, 32 SW. L.J. 1301, 1308 (1979). (third party reliance was first introduced in *Rathke*).

who cosigned several documents and was a member of the board of directors of the firm.[90] Griffith testified that he was never involved with the management or the operation of the limited partnership business.[91] Griffith's testimony was not controverted by the plaintiff in any way.[92] The court refused to hold Griffith liable as a general partner and stated: "It is not alleged that respondent ever relied on Mr. Griffith's position as a general partner, or in fact ever understood that Mr. Griffith was anything other than a limited partner."[93]

The reliance concept was also present in *Silvola v. Rowlett*,[94] where the defendant limited partner was a former repair shop foreman and had purchased parts without the approval of the general partners.[95] The *Silvola* court held that the defendant limited partner did not exercise control over the business; the plaintiff was also an employee of the partnership and had actual knowledge that the defendant was a limited partner.[96]

Other courts have held the plaintiff must believe and rely upon the belief that the limited partner is a general partner at the time of the transaction with the limited partnership, however, such belief and reliance is irrelevant once the transaction with the limited partnership is complete.[97] In *Vulcan Furniture Mfg. Corp. v. Vaughn*,[98] a Florida court of appeals stated that a limited partner is not liable as a general partner, unless the limited partner takes part in control of the business and there is reasonable reliance by the third party at the time of the

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90. *See Rathke*, 218 P.2d at 764. Mr. Griffith was named as a director but testified that he never functioned as a director, and this evidence was not controverted. Mr. Griffith's signature was also on two warranty deeds and a number of other documents executed by Mr. Griffith. *Id.*

91. *Id.*

92. *Id.*

93. *Id.* at 764; *see also* Comment, *Limited Partnership Control and Liability Under the Revised Uniform Limited Partnership Act*, 32 SW. L.J. 1301, 1308 (1979).

94. 272 P.2d 287 (Colo. 1954).

95. *Id.* at 289. For a period of time the limited partner, Rowlett, worked as repair shop foreman but later discontinued the service so he could take care of other business. *Id.*

96. *Id.*; *see also* Abrams, *Imposing Liability for "Control" Under Section 7 of the Uniform Limited Partnership Act*, 28 CASE W. RES. 785, 799-800 (1978) (*Silvola* court refused to impose general liability on limited partner since plaintiff had actual knowledge).

97. *See, e.g.*, Vulcan Furniture Mfg. Corp. v. Vaughn, 168 So.2d 760, 764 (Fla. Dist. Ct. App. 1964) (limited partner not liable as general partner unless plaintiff reasonably relies at time of transaction); J.C. Wattenbarger & Sons v. Sanders, 30 Cal. Rptr. 910, 914 (Cal. App. 1963) (plaintiff must be aware of, believe in, and rely on belief that limited partner is general partner before transaction is complete with limited partnership).

98. 168 So. 2d 760 (Fla. Dist. Ct. App. 1964).

transaction.[99] In *J.C. Wattenbarger & Sons v. Sanders*,[100] the activity alleged to have constituted control over the business did not come to the plaintiff's attention until after completion of the transaction with the defendant.[101] The court held there could have been no belief that the defendant was a general partner.[102]

The concept of reliance was implicitly present in *Filesi v. United States*.[103] The court in *Filesi* held that the limited partner, who took an active and open role in the management of the business, was liable as a general partner.[104] The court did not expressly state that reliance was necessary; however, the court implied that such public acts of management would be enough to cause one to rely on the belief that the individual was a general partner.[105]

The Supreme Court of Washington, in *Frigidaire Sales Corp. v. Union Properties, Inc.*,[106] held that reliance by a plaintiff is a prerequisite to recovery from limited partners who are directors of a corporate

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99. *See id.* at 764. The court stated that no public policy requires a limited partner to be liable as a general partner "provided creditors had no reason to believe at the times their credits were extended that such person was so bound." *Id.*

100. 30 Cal. Rptr. 910 (Cal. App. 1963).

101. *Id.* at 914. The court stated:

> Reliance upon an actual or apparent representation of partnership is an essential element to be proven and respondent points out that the record shows that the certificate of fictitious name did not come to the attention of any of appellant's officers until the middle or latter part of July, at a time when the transactions which are the subject of the action were almost completed.

Id. See generally Comment, *Limited Partner Control and Liability Under the Revised Uniform Limited Partnership Act*, 32 SW. L.J. 1301, 1308-1312 (1979) (discussing cases utilizing the reliance test).

102. *J.C. Wattenbarger & Sons*, 30 Cal. Reptr. at 914. The court stated that the determinative question is "whether the acts and conduct of an individual were factually and legally sufficient to lead another person to believe he was a copartner and assumed responsibility as such." *Id.*; *see also* Comment, *Limited Partnership Control and Liability Under the Revised Uniform Limited Partnership Act*, 32 SW. L.J. 1301, 1308-1312 (1979) (discussing different applications of the reliance test).

103. 352 F.2d 339 (4th Cir. 1965).

104. *Id.* at 341. Filesi was the manager of the business and was to receive as a salary 50% of the partnership's profits. The court stated that "it is clear from the evidence generally and from Filesi's own testimony that he openly and publicly took an active part in the control of the business." *Id.* Therefore, the court held that the district court's finding of liability was correct. *Id.*

105. *Id.*; *see also* Comment, *Limited Partnership Control and Liability Under the Revised Uniform Limited Partnership Act*, 32 SW. L.J. 1301, 1309 (1979). Discussing the *Filesi* case, the author stated that the "implication was that the limited partner's behavior would lead others to a reasonable belief that the limited partner was a general partner." *Id.*

106. 562 P.2d 244 (Wash. 1977).

general partner.[107] In *Western Camps, Inc. v. Riverway Ranch Enterprises*,[108] a California court of appeals agreed with the *Frigidaire* court.[109] The *Western Camps* court stated that a third party dealing with the limited partnership must reasonably rely on the solvency of the limited partner.[110]

More recently, a Missouri court of appeals, in *General Elec. Credit Corp. v. Stover*,[111] embraced the reliance test.[112] The plaintiff claimed that it would not have purchased a customer account had it not been for the defendant limited partner signing a security agreement.[113] The court stated that the determinative question was whether the defendant's signing of the agreement induced the plaintiff to rely on the defendant's personal liability.[114]

IV. THE EFFECT OF THE TEXAS REVISED ACT

The Texas Revised Act makes limited partnerships more attractive to investors.[115] This is accomplished by providing limited partners

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107. *Id.* at 247. The court stated that finding respondents liable as general partners would require them to totally ignore the corporate entity in which the limited partners were directors and officers and strictly apply the literal words of the statute. The court refused to find such liability when the petitioners knew that they were dealing with the corporate entity and not the respondent individually. *Id.*; *see also* Abrams, *Imposing Liability for "Control" Under Section 7 of the Uniform Limited Partnership Act*, 28 CASE. W. RES. 785, 800 (1978). Discussing the *Frigidaire* case, the author stated that the court held "in the absence of actual reliance a creditor could not recover from limited partners who controlled a partnership by acting as directors of the corporate general partner." *Id.*

108. 138 Cal. Rptr. 918 (Cal. Ct. App. 1977).

109. *Id.* at 927.

110. *Id.* In applying the *Frigidaire* principles the court stated that the plaintiff knew that the limited partner was a principle of the corporate general partner, therefore, there was no reasonable reliance that the limited partner would be personally liable as a general partner. The court also stated that there needs to be reasonable reliance on the solvency of the entity with which the plaintiff is dealing. *Id.* at 926-927.

111. 708 S.W.2d 355 (Mo. App. 1986).

112. *Id.* at 361. The court stated that the dispositive question was whether the plaintiff had reason to believe that the limited partner would be personally liable. *Id.*

113. *Id.* The plaintiff put forth evidence at trial that it would not have purchased the customer accounts nor extended credit had it not been for the limited partner's signature. *Id.*

114. *Id.* at 362. The court stated that the question is "whether the Stover [limited partner] signature induced GE Credit to extend credit on reliance that as to the two transactions, Stover would be personally bound on those obligations." *Id.* The court also held that this was a fact determination, and the trial court's ruling would not be overturned. *Id.*

115. *See* TEX. REV. CIV. STAT. ANN. art. 6132a-1, comment p. 22 (Vernon Supp. 1990). Due to the advanced uses of limited partnerships, the T.U.L.P.A. became outmoded. The T.R.L.P.A.'s purposes are to modernize and clarify, but the two primary objectives of the act are to provide limited partners with more protection and flexibility. *Id.*

with more control over their investment and more protection from liability.[116] Although the revised act provides more certainty than the old uniform act, some uncertainties remain.[117]

The revised act allows limited partners to be more certain of their liability threshold.[118] Limited partners are more certain of their risk of liability because the reliance test has been made more stringent, which will probably decrease significantly the number of potential plaintiffs able to recover from limited partners.[119] Section 3.03(a) has been made stricter by requiring that a limited partner's activities form the basis of the plaintiff's reasonable belief that the limited partner is a general partner.[120] Section 3.03(a) restricts limited partner liability based on control of partnership business to situations in which (i) the limited partner is operating outside section 3.03(b) safe harbors, and (ii) the third party seeking to establish such liability reasonably relies on a belief, based upon the activities of the limited partner, that the limited partner is a general partner.[121]

From a limited partner's perspective, the desirability of such a reliance test as compared to a straight control test is evident in the *Holzman* case previously discussed. There, the limited partners were held liable as general partners because they dictated what crops to plant, controlled the funds of the farming operation, and terminated the

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116. *Id.* The flexibility of T.R.L.P.A. allows attorneys leeway to tailor limited partnership agreements which will have the "financial, control, tax" and other results desired. *Id.*

117. Basile, *Limited Liability for Limited Partners: An Argument for Abolition of the Control Rule*, 38 VAND. L. REV. 1199, 1217 (1985). The author, discussing section 303 of the R.U.L.P.A., which is almost identical to The Texas Revised Act section 3.03, stated that "even a watered down version of the control rule leads inevitably to ambiguity." *Id.*

118. TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(a) comment (Vernon Supp. 1990). Sections 3.03(a) and 3.03(b) have been made broader and more protective so a limited partner will not suffer unlimited liability when it is inappropriate. *Id.*

119. Basile, *Limited Liability for Limited Partners: An Argument for Abolition of the Control Rule*, 38 VAND. L. REV. 1199, 1215 (1985). The author stated that the requirement that the plaintiff's reasonable belief be based upon the limited partner's activities should substantially reduce the number of potential plaintiffs. *Id.*

120. TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(a) (Vernon Supp. 1990). The plaintiff must conduct business with the limited partnership and the limited partner's conduct must be the basis for the plaintiff's reasonable belief that the limited partner is a general partner. *Id.*; *see also* Basile, *Limited Liability for Limited Partners: An Argument for Abolition of the Control Rule*, 38 VAND. L. REV. 1199, 1215 (1985).

121. *See* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 303(a),(b). Section 3.03(b) enumerates specific activities which a limited partner may participate in without being subject to liability. *Id.*

general partner.[122] Under a reliance test, however, the limited partners would not be liable for such acts unless (i) the plaintiff conducted business with the limited partnership, (ii) the plaintiff reasonably believed the limited partners were general partners, and (iii) the plaintiff's reasonable belief was based on the limited partner's activities.[123]

Uncertainty for limited partners persists under the Texas Revised Act, however, because it is hard to determine what constitutes "participating in the control of the business" under the reliance test.[124] From the cases applying the reliance test in other jurisdictions, some basic principles emerge: (i) the plaintiff must allege he believed the limited partner was a general partner;[125] (ii) the plaintiff must have had this belief prior to entering into the transaction with the partnership;[126] (iii) the plaintiff must have relied upon such belief;[127] (iv) the plaintiff must not have had actual knowledge that the limited partner was not a general partner;[128] and (v) the plaintiff's reliance should

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122. Holzman v. De Escamilla, 195 P.2d 833, 834 (Cal. App. 1948). The Court held that the limited partners "took part in the control of the business," and thus had general partner liability. *Id.*

123. *See* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(a) (Vernon Supp. 1990). Limited partners are only liable as general partners if they exercise control over the business, and then they are only liable to ones who transact business with the partnership, and reasonably believe from the limited partners activities that the limited partner is a general partner. *Id.*

124. Basile, *Limited Liability for Limited Partners: An Argument for Abolition of the Control Rule*, 38 VAND. L. REV. 1199, 1228 (1985). For approximately 70 years, the control rule has been a part of limited partnership law and courts have been unable to interpret the control rule so counsel for investors can accurately assess the risk of liability. *Id.* The author stated that § 3.03(a) of the new revised act may make assessing the risk of liability more certain, but complained it was unnecessary since the control rule is either unnecessary or elusive. The author claimed it was unnecessary because § 16(1) of the Uniform Partnership Act provides that if one holds himself out as a general partner, he will be liable as a general partner. *Id.* The author stated that if § 3.03(a) means more than § 16(1) of the Uniform Partnership Act then § 3.03(a) is very confusing. *Id.* at 1222.

125. Rathke v. Griffith, 218 P.2d 757, 764 (Wash. 1950). The court, in refusing to hold the defendant limited partner liable, stated that the plaintiff never even alleged or understood that the defendant was not a limited partner. *See id.*

126. J.C. Wattenbarger & Sons v. Sanders, 30 Cal. Reptr. 910, 914 (Cal. App. 1963). The court stated that reliance is an essential element and it cannot be established when the plaintiff does not learn of the limited partner's participation until after the transaction is complete. *Id.*; *see also* Vulcan Furniture Mfg. Corp. v. Vaughn, 168 So. 2d 760, 764 (Fla. Dist. Ct. App. 1964) (reasonable belief should be at the time of the transaction).

127. Frigidaire Sales Corp. v. Union Properties, Inc., 562 P.2d 244, 247 (Wash. 1977) (refusing to find liability without showing of reliance by the plaintiff). *See also* Abrams, *Imposing Liability for "Control" Under Section 7 of the Uniform Limited Partnership Act*, 28 CASE W. RES. 785, 800 (1978) (discussing *Frigidaire*).

128. *See* Silvola v. Rowlett, 272 P.2d. 287, 289-291 (Colo. 1954) (refusing to find general

have been based upon the financial capacity of the limited partner.[129] Finally, if the limited partner's activities induced the plaintiff to believe the limited partner was a general partner, then the limited partner will be held liable as a general partner.[130] As a practical matter, if the limited partner takes an active and open role in the management of the partnership business, the cases tend to impose liability as a general partner.[131]

The Texas Revised Act, as previously demonstrated, has significantly increased the number of safe harbors in which a limited partner can participate without risking unlimited liability.[132] The increased safe harbor provisions make a limited partnership more attractive to limited partners because they can have greater assurance of limited liability.[133]

The most interesting safe harbor provision provides that a limited partner may approve or propose, by vote or any other manner, any "matter stated in the partnership agreement."[134] A literal reading of this section would allow limited partnership agreements which permit limited partners to exercise complete control over the partnership while still being protected against unlimited liability, without regard to creditor reliance.[135]

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partner liability when plaintiff had actual knowledge that defendant was limited partner); *see also* Abrams, *Imposing Liability for "Control" Under Section 7 of the Uniform Limited Partnership Act*, 28 CASE W. RES. 785, 799 (1978) (discussing *Silvola*).

129. *See* Western Camps, Inc. v. Riverway Ranch Enters., 138 Cal. Reptr. 918, 927 (Cal. Ct. App. 1977) (plaintiff needs to rely on limited partner's solvency).

130. *See* General Elec. Credit Corp. v. Stover, 708 S.W.2d 355, 361 (Mo. App. 1986) (issue was whether limited partners, by signing document, induced plaintiff to believe limited partners were general partners).

131. *See, e.g.*, Filesi v. United States, 352 F.2d 339, 341 (4th Cir. 1965) (limited partner liable when taking open, active and public role in management of business). *See also* Comment, *Limited Partnership Control and Liability Under the Revised Uniform Limited Partner Act*, 32 SW. L.J. 1301, 1309 (1979) (discussing implication of *Filesi* case).

132. *Compare* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b) (Vernon Supp. 1990) *with* TEX. REV. CIV. STAT. ANN. art. 6132a, § 8(b) (Vernon Supp. 1990).

133. *See* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b) (Vernon Supp. 1990). This section lists safe harbor activities which a limited partner can confidently participate in without fear of being deemed to be exercising control over the business and thereby subject to general partner liability. *Id.*

134. TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b)(8)(K) (Vernon Supp. 1990).

135. *See id. But see* TEX. REV. CIV. STAT. ANN. art. 6132a-1 § 3.03, comment p. 43 (Vernon Supp. 1990). Although the "safe harbor" list in section 3.03(b) is not exclusive and allows other activities, a limited partner will still face liability if the third party reasonably believes that the limited partner is a general partner. *See id.*

A healthful sense of caution, however, leads one to doubt whether that interpretation would prevail in a hotly litigated case, since it could eliminate all situations in which a limited partner would have unlimited liability.[136] An extreme application of the provision would frustrate the act's emphasis on creditor reliance. Evidence that the drafters did not intend such an application is found in a Senate floor statement of the chairman of the committee that drafted the Texas version of the revised act. He noted that safe harbors under the revised act did not come close to allowing limited partners to control the day-to-day activities of the partnership.[137] One interpretation is that this safe harbor provision was meant to cover activities that are not listed in other safe harbor provisions, are specifically enumerated in the partnership agreement, and are not ordinary, daily business activities.[138]

States that have adopted the revised uniform act's version of this section require that the matter be "material" or "related to the partnership agreement" in order to be safe from liability.[139] Omission of these terms increases the certainty of liability limits, since there is no

136. *See* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b)(8)(K) (Vernon Supp. 1990). If the drafter of the partnership agreement could foresee and include activities which the limited partner would want to exercise, the limited partner would be within the safe harbor and immune from general liability, even though he was operating in daily business activities and there was third party reliance. *Id.*

137. *Texas Revised Limited Partnership Act: Hearings on Tex. S.B. 563 Before Economic Development Comm.*, 70th Leg. tape 1 (Mar. 23, 1987) (testimony of Steve Waters, chairman of the State Bar of Texas partnership law committee of the section on corporation, banking and business law). Mr. Waters stated that the safe harbors did not substantively allow partners to do anything other than what they could have done under the old uniform act. Mr. Waters also stated that the safe harbors did not come close to allowing limited partners to get involved in the day-to-day functions of the limited partnership business. *Id.*

138. TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b)(8)(K) (Vernon Supp. 1990); *see also Texas Revised Limited Partnership Act: Hearings on Tex. S.B. 563 Before the Economic Development Comm.*, 70th Leg. tape 1 (Mar. 23, 1987) (testimony of Steve Waters, chairman of the State Bar of Texas partnership law committee of the section on corporation, banking and business law).

139. *See* Basile, *The 1985 Delaware Revised Uniform Limited Partnership Act*, 41 BUS. LAW. 571, 581 (1986); *see also* TEX. REV. CIV. STAT. ANN. art. 6132a, comment p. 9 (Vernon Supp. 1990) (table of jurisdictions which have adopted 1916 version of Uniform Limited Partnership Act); TEX. REV. CIV. STAT. ANN. art. 6132a-1, comment pp. 23-24 (Vernon Supp. 1990) (table of jurisdictions which have adopted the Revised Uniform Limited Partnership Act of 1976). This provision seems to leave things wide open, provided that the activities were enumerated in the partnership agreement. That is no doubt because it is difficult to foresee the specific activities in which a limited partner may need to engage, and thus one must be careful when delineating what activities a limited partner may wish to participate in.

longer the possibility that courts may retrospectively determine that certain activities were not "material" or "related to the partnership agreement."[140] Thus the Texas Revised Act allows a limited partner greater certainty regarding powers stated in the partnership agreement than does the uniform act.[141]

This section is a good tool for drafting limited partnership agreements. The lawyer can attempt to foresee the specific activities in which a limited partner may wish to engage and enumerate those activities in the agreement.[142] As with many tools, however, carelessness with it may lead to undesirable results.

The Texas Revised Act not only increased the number of safe harbor provisions; it also broadened those present in the old uniform act.[143] The old uniform act allowed limited partners to approve "material matters stated in the certificate."[144] Under this provision, the old uniform act listed such activities as dissolution, amending the partnership agreement, selling assets, and incurring debt.[145] The old act also stated that the sale of assets or the incurrence of debt could not be in the "ordinary course of business."[146] The Texas Revised Act does not require such acts to be material, and neither does it require that they be listed in the partnership agreement.[147] Additionally, the revised act does not require the sale of assets or the incurrence of debt to be "other than in the ordinary course of business."[148] Therefore, limited partners will no longer have to wonder, when selling an asset or incurring debt, whether such an act is in the ordinary course of business. This broadening should decrease the risk to limited partners; there is no longer the risk that courts will inter-

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140. Basile, *The 1985 Delaware Revised Uniform Limited Partnership Act*, 41 BUS. LAW. 571, 581 (1986).

141. *Id.* "The 'materiality' requirement created the theoretical risk that a court would decide in retrospect that a matter on which a limited partner had voted was not 'material' enough to be protected by the safe harbor provision. Further, the 'related to the business' requirement could have excluded certain matters, such as the approval of charitable contribution by the partnership . . . ." *Id.*

142. *See* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b)(8)(K) (Vernon Supp. 1990).

143. *Compare* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b) (Vernon Supp. 1990) *with* TEX. REV. CIV. STAT. ANN. art. 6132a, § 8(b) (Vernon Supp. 1990).

144. *See* TEX. REV. CIV. STAT. ANN. art. 6132a, § 8(b)(5) (Vernon Supp. 1990).

145. *Id.*

146. *Id.*

147. TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b)(8) (Vernon Supp. 1990).

148. TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(b)(8)(B), (C) (Vernon Supp. 1990).

pret a specific act as not "material" or not in the "ordinary course of business."

V. ANALYSIS

The increase in certainty afforded limited partners by the Texas revised act is desirable.[149] Certainty in the effects of one's business relationships builds confidence that can result in increased willingness to undertake business ventures. The resulting prosperity inures to the benefit of society and is an end that the law should encourage.

A. *The Interests of Limited Partners*

Given the desirability of increased certainty in business relationships, can the remaining uncertainties as to limited partner liability under the Texas Revised Act be further reduced or eliminated without adverse effect? In addressing this question, some commentators have questioned why state legislatures continue to revise the control rule when it has been the subject of uncertainty for over seventy years.[150] One proposed alternative is to drop all the control restrictions on limited partners and require limited partners to be identified by name.[151] The intent is to provide the third party creditor with

149. TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(a) (Vernon Supp. 1990). This section strengthened the reliance test by requiring that a potential plaintiff reasonably believe, "based on the limited partner's conduct, that the limited partner is a general partner." *Id.*

150. Basile, *Limited Liability for Limited Partners: An Argument for the Abolition of the Control Rule*, 38 VAND. L. REV. 1199, 1128-29 (1985). The author states that the control rule has not been understood for approximately 70 years, and should be abolished. The author further states that the fault does not lie with the courts, but rather with the drafters, who have given the courts an impossible task. *Id.*

151. Comment, *Limited Partner Control And Liability Under The Revised Uniform Limited Partnership Act*, 32 SW. L.J. 1301, 1326 (1979). One alternative to the RULPA is to do away with all control restrictions for limited partnerships. Creditors would not necessarily be harmed by such a move, since most creditors are aware of limited partnerships. Also, requiring limited partners to identify themselves would be an added protection to those who deal with the limited partners. *Id.* Florida is one jurisdiction which requires that limited partners identify themselves. *Id.* at 1326. Florida's statute also requires that "the name of every limited partnership shall contain the word (Limited) or its abbreviation (Ltd.) with a conspicuous sign exhibiting this name at every place of business." FLA. STAT. ANN. § 620.05(1) (West 1977). Texas does not have the requirement that limited partners be identified by their name. The Texas Revised Act does require that the certificate of limited partnership "contain the words 'Limited Partnership,' 'Limited,' or the abbreviation 'L.P.' or 'Ltd.' as the last words or letters of its name . . . ." TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 1.03 (Vernon Supp. 1990). Texas does impose general partner liability on those limited partners who do not conform with § 1.03, and are aware of the non-conformance. Before liability will be imposed,

knowledge that he is dealing with a limited partner.[152] Therefore, the third party creditor would not extend credit on a false assumption that the limited partner will have general partner liability.[153]

If one analogizes limited partnerships to a close corporation, one will see that they are similar, except that close corporation investors may participate in the control of the business.[154] If public policy does not require close corporation investors to relinquish control of their investment to limit their liability, why should that policy require it as to limited partnership investors?[155]

If the law were to change, lawyers for limited partnerships would

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however, the third party creditor must have no actual knowledge that the limited partner is not a general partner. TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 3.03(d) (Vernon Supp. 1990).

152. TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 1.03 (Vernon Supp. 1990); *see also* J. CRANE & A. BROMBERG, LAW OF PARTNERSHIPS 145 (1968). The authors point out that "[t]here is no requirement that a limited firm so identify itself in its name or dealings, although this would be the most effective way of communicating its status to third persons trading with it." *Id.*

153. *See* J. CRANE & A. BROMBERG, LAW OF PARTNERSHIPS 145 (1968).

154. *See* Comment, *Limited Partner Control And Liability Under The Revised Uniform Limited Partnership Act*, 32 SW. L.J. 1301, 1326 n.142 (1979). "Both close corporation shareholders and limited partners are similar in that they enjoy the corporate characteristics of limited liability. They are different in the respect that close corporation shareholders also enjoy the right to participate actively in the control and management of their business." *Id.*; *see also* H. HENN & J. ALEXANDER, LAW OF CORPORATIONS § 257 (3d ed. 1983). The authors distinguished ordinary corporations and close corporations, stating that in a close corporation, the shareholders often participate in the management of the business. *Id.* When analogizing limited partners to close corporation shareholders, one must consider article 12.37 of the Texas Business Corporations Act. Generally, this section provides that when shareholders manage a corporation pursuant to a shareholders agreement, then they may be held responsible for their managerial acts to the extent that corporate directors would be responsible for such acts. TEX. BUS. CORP. ACT. ANN., art. 12.37(A) (Vernon Supp. 1990).

155. Comment, *Limited Partner Control And Liability Under The Revised Uniform Limited Partnership Act*, 32 SW. L.J. 1301, 1326 (1979). The author notes that, at one time, combining limited liability with control over one's investment was against public policy. *Id.* That is no longer the case, which is evidenced by closed corporations and non-recourse financing. *Id.* Section 8(b) provides that a limited partner is not considered to:

> take part in the control of the business by virtue of possessing or exercising a power to: (1) Consult with and advise the general partners as to the conduct of the business. (2) Act as a surety, guarantor, or endorser for obligations of the partnership or provide collateral for its borrowing. (3) Act as a contractor, agent, or employee of the partnership or of a general partner. (4) Act as an officer, director, or shareholder of a corporate general partner. (5) Approve, individually or by a majority of the limited partners (by number, financial interest, or as otherwise provided in the certificate), material matters that are state in the certificate, such as: (A) Dissolution and winding up of the partnership. (B) Amendment of the partnership certificate or agreement. (C) Sale, exchange, lease, mortgage, pledge, or other transfer of all or substantially all of the assets of the partnership

no longer have to contend with the unclear issue of what constitutes control under the reliance test. Neither would they have to predict whether a limited partner's activities would fit within a safe harbor provision. Thus, if the control restrictions were abolished, limited partnerships would become simpler and more attractive to prospective limited partners.

B. *The Interests of Third Party Creditors*

Is that the end of the inquiry? While certainty of result is a desirable goal in business relationships, the limited partners are not the only parties whose need for certainty must be considered. Third party creditors have as much need for and claim to certainty in their dealings as do limited partners. If the control rule were abolished entirely, a third party creditor might receive an unpleasant surprise regarding the non-liability of the partner with whom the creditor was dealing.

The Texas Revised Act addresses this issue by providing that a creditor can recover against a limited partner where the creditor reasonably believed the limited partner was a general partner, based on the limited partner's conduct. When presented with such a reasonable belief based on conduct of the limited partner, it is hard to argue that the limited partner should escape liability.

On the other hand, because the determination of the belief and its basis and reasonableness will often be made by a jury, uncertainty exists for both the limited partner and the creditor. An ideal system would ensure that no party who is acting reasonably would ever be surprised. The alternative of abolishing the control test altogether and requiring notice of limited partner status would be more desirable if the notice could be reliably furnished in a meaningful way.

Constructive notice based upon a listing filed for record in a public office provides certainty to limited partners and to such creditors who are sophisticated and diligent enough to discover the notice. It does not reliably afford notice to everyone. Constructive notice, because it is a legal fiction, should be restricted to situations where actual notice is not reasonably achievable.

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other than in the ordinary course of business. (D) Incurrence, renewal, or refinancing of a debt by the partnership other than in the ordinary course of business.

TEX. REV. CIV STAT. ANN. art. 6132a, § 8(b) (Vernon Supp. 1990).

C. *Resolution of Competing Interests*

What is the best possible notice that can reasonably be achieved? That is, perhaps, best answered by treating separately the various categories of liabilities that might arise. An easily dealt with division of liabilities is as follows: (i) non-contractual liabilities, (ii) written contractual liabilities, and (iii) oral contractual liabilities.

As to non-contractual creditors, the issue seems relatively clear. Non-contractual creditors seldom have settled expectations or reliance interests regarding whose pocket they will be permitted to reach. As a consequence, constructive notice such as that discussed in section B above should be reasonable protection for the interests involved.

As to creditors under written agreements, at least as to partners who sign the agreements, the issue also seems relatively clear. To have the benefit of ironclad limited liability, the limited partner should be required to designate himself expressly as a limited partner when signing the contract. If the limited partner fails to so designate his capacity, then the test for liability should revert to the "reasonable belief" test set forth in section 3.03(a) of the Revised Act.

Many written agreements will not be signed by all the partners, of course. Partners who do not sign will not have the opportunity to designate themselves expressly as limited partners as opposed to general partners. But a creditor's claim of reliance upon the credit of a non-signing partner should be afforded less sympathy than his reliance upon the credit of a signing one. Non-signing limited partners ought to have the benefit of a presumption of non-liability. Creditors should be able to overcome that presumption only upon clear and convincing evidence of conduct relied upon by the creditor, which conduct is inconsistent with the standards of section 3.03 of the revised act.

As to creditors under oral agreements, the issue is more difficult. To avoid a swearing match over what the creditor was or was not actually told by the limited partner regarding the partner's status, one must elect between a constructive notice system or the system set out in section 3.03 of the revised act. While this is an issue over which reasonable minds can easily differ, the system contained at section 3.03 seems to be carefully devised to weigh the competing issues. To the extent that it yields a less fair result than an arbitrary system of constructive notice, it would only be because of the vagaries and expense of litigation.

D. *Incidental Effects*

One area that may be affected incidentally by this proposal is the tax treatment of limited partnerships. It is well established that a limited partnership, as other unincorporated associations, may be taxed as a corporation, depending upon whether the partnership demonstrates certain major corporate characteristics.[156] Among those charateristics is centralization of management.[157] If centralization of management is found to exist, it increases the likelihood that a partnership may be taxed as a corporation, a result seldom desired.[158] To the extent that, in a given partnership, the freedom advocated here actually results in less centralization of management, then it may be easier to establish that the partnership should be taxed as a partnership rather than a corporation. Thus, the freedom advocated here may occasionally have the serendipitous effect of preserving challenged tax benefits.

Another area that may be affected interestingly is securities law. Generally speaking, limited partnership interests are regarded as securities.[159] That is because the restricted role that limited partners are permitted to play usually and necessarily requires them to rely upon the efforts of others to generate their profits.[160] The freedom advocated here, however, raises the prospect that some limited partners may not be relying primarily upon the efforts of others to achieve a return on their investments. In such circumstances, the affected lim-

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156. Treas. Reg. § 301.7701-2 (1990) (setting forth distinguishing characteristics of corporations and partnerships). For an important analysis of the issues involved in reaching the substance of an entity's nature, whatever its form, *see* Morrissey v. Commissioner, 296 U.S. 344, 349 (1935) (analyzing whether an entity having the form of a trust should be taxed as a trust or as an association).

157. Treas. Reg. § 3-1.7701-2(a)(1)(iv) (1990). The other characteristics that are pertinent to distinguishing corporations from partnerships are continuity of life, free transferability of interests, and limited liability. Treas. Reg. § 301.7701-2(a)(2) (1990).

158. Treas. Reg. § 301.7701-3 (1990).

159. *See* Securities Act of 1933, 15 U.S.C. § 77b(1) (1988). Although the extensive list contained in that definition does not explicitly mention limited partnership interests, limited partnership interests usually contain the characteristics of investment contracts, which are explicitly listed. *Id.*; *see also*, Siebel v. Scott, 725 F.2d 995, 999 (5th Cir. 1984), *cert. denied*, 467 U.S. 1242 (1984); S.E.C. v. Murphy, 626 F.2d 633, 640-41 (9th Cir. 1980).

160. *See Murphy*, 626 F.2d at 640-41 (limited partnership is security because it involves investment in common enterprise with profits coming from efforts of others); *see also* SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946) (test is whether scheme involves investment of money in common enterprise with profits to come solely from efforts of others).

ited partnership interests may not be securities.[161] Whether that result is achieved will depend upon the facts of each situation, however, and practitioners who must decide whether securities compliance is an issue in their case should be cautious about client representations regarding the active role limited partners may be expected to assume.

VI. CONCLUSION

The Texas Revised Act makes limited partnerships more appealing to investors. Limited partners now have more control through their ability to participate in more and broader safe harbor activities. Limited partners can predict the imposition of general partner liability more accurately because the reliance test has been made more explicit. Although the revised act is an improvement over the prior law in Texas, there are still areas that can be litigated, thereby introducing uncertainty regarding the ultimate rights and obligations limited partners may have as against third party creditors.

Those litigation-related uncertainties may be further reduced, albeit not eliminated, by treating the different categories of liabilities differently as discussed above. This differentiation seems best designed to provide the degree of notice justified by the scope of the creditors' dealings with the partners. Creditors should have no claim to limited partners' personal assets unless, when they decided to do or continue to do business with the partnership, they actually and reasonably relied upon the possibility of reaching those assets. Limited partners should not have their personal assets jeopardized by a technical rule violation that actually and reasonably misled no one. Enhancing certainty even further regarding limited partner liability, both for limited partners and creditors, should further enhance the value of limited partnerships as business vehicles.

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161. Rodeo v. Gillman, 787 F.2d 1175, 1178 (7th Cir. 1986). In the *Rodeo* case, it was alleged that a transaction had been structured as a purchase of limited partnership interests solely to preserve attractive mortgage financing, with the true intent of the parties being to purchase various parcels of real property. *Id.* at 1176. *See generally* Comment, *Are Limited Partnership Interests Securities? A Different Conclusion Under the California Limited Partnership Act*, 18 PAC. L.J. 125, 159-163 (1986).

APPENDIX A
TEXAS REVISED LIMITED PARTNERSHIP ACT
TEX. REV. CIV. STAT. ANN. ART. 6132a-1

LIABILITY TO THIRD PARTIES

Sec. 3.03. (a) Except as provided by Subsection (d) of this section, a limited partner is not liable for the obligations of a limited partnership unless the limited partner is also a general partner or, in addition to the exercise of the limited partner's rights and powers as a limited partner, the limited partner participates in the control of the business. However, if the limited partner does participate in the control of the business, the 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.

(b) For the purposes of this section, a limited partner does not participate in the control of the business by virtue of the limited partner's having or acting in one or more of the following capacities or possessing or exercising one or more of the following powers:

(1) acting as a contractor for or an agent or employee of the limited partnership or of a general partner, an officer, director, or stockholder of a corporate general partner, or a partner of a partnership that is a general partner of the limited partnership;

(2) consulting with or advising a general partner on any matter, including the business of the limited partnership;

(3) acting as surety, guarantor, or endorser for the limited partnership, to guarantee or assume one or more specific obligations of the limited partnership, or to provide collateral for borrowings of the limited partnership;

(4) calling, requesting, attending, or participating in a meeting of the partners or the limited partners;

(5) winding up a limited partnership under Section 8.04 of this Act;

(6) taking any action required or permitted by law to bring or pursue a derivative action in the right of the limited partnership;

(7) serving on a committee of the limited partnership or the limited partners; or

(8) proposing, approving, or disapproving, by vote or otherwise, one or more of the following matters:

(A) the dissolution and winding up of the limited partnership;

(B) the sale, exchange, lease, mortgage, assignment, pledge, or

other transfer of, or granting of a security interest in, an asset or assets of the limited partnership;

(C) the incurring, renewal, refinancing, or payment or other discharge of indebtedness by the limited partnership;

(D) a change in the nature of the business of the limited partnership;

(E) the admission, removal or retention of a general partner;

(F) the admission, removal, or retention of a limited partner;

(G) a transaction or other matter involving an actual or potential conflict of interest;

(H) an amendment to the partnership agreement or certificate of limited partnership;

(I) if the limited partnership is qualified as an investment company under the federal Investment Company Act of 1940 (15 U.S.C. Section 80a-1 et seq.):

(i) electing directors or trustees of the investment company;

(ii) approving or terminating investment advisory or underwriting contracts;

(iii) approving auditors; and

(iv) acting on any other matters that the Investment Company Act of 1940 (15 U.S.C. Section 80a-1 et seq.) requires to be approved by the holders of beneficial interests in the investment company;

(J) indemnification of a general partner under Article 11 of this Act;

(K) any other matter stated in the partnership agreement; or

(L) exercising a right or power granted or permitted to limited partners under this Act and not specifically enumerated in this subsection.

(c) The enumeration in Subsection (b) of this section does not mean that having or acting in other capacities or possessing or exercising other powers by a limited partner constitutes participation by that limited partner in the control of the business of the limited partnership.

(d) A limited partner who knowingly permits that limited partner's name to be used in the name of the limited partnership, except under circumstances permitted by Subdivision (1) of Section 1.03 of this Act is liable to creditors who extend credit to the limited partnership without actual knowledge that the limited partner is not a general partner.

(e) This section does not create rights of limited partners. Those

rights may be created only by the certificate, partnership agreement, or other sections of this Act.

APPENDIX B
TEXAS UNIFORM LIMITED PARTNERSHIP ACT
TEX. REV. CIV. STAT. ANN. ART. 6132a

LIABILITY OF LIMITED PARTNER

Sec. 8. (a) A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business, and then only to a person who transacts business with the partnership reasonably believing that the limited partner is a general partner.

(b) A limited partner does not take part in the control of the business by virtue of possessing or exercising a power to:

(1) Consult with and advise the general partners as to the conduct of the business.

(2) Act as a surety, guarantor, or endorser for obligations of the partnership or to provide collateral for its borrowing.

(3) Act as a contractor, agent, or employee of the partnership or of a general partner.

(4) Act as an officer, director, or shareholder of a corporate general partner.

(5) Approve, individually or by a majority of the limited partners (by number, financial interest, or as otherwise provided in the certificate), material matters that are stated in the certificate, such as:

(A) Dissolution and winding up of the partnership.

(B) Amendment of the partnership certificate or agreement.

(C) Sale, exchange, lease, mortgage, pledge, or other transfer of all or substantially all of the assets of the partnership other than in the ordinary course of business.

(D) Incurrence, renewal, or refinancing of a debt by the partnership other than in the ordinary course of business.

(c) The statement of the powers set forth in Subsection (b) of this section is not exclusive and does not indicate that any other power possessed or exercised by a limited partner is sufficient to cause the limited partner to be considered to take part in the control of the business within the meaning of Subsection (a) of this section.

(d) This section does not create rights of limited partners. Those

rights may be created only by the certificate, partnership agreement, or other sections of this Act.

APPENDIX C
UNIFORM LIMITED PARTNERSHIP ACT § 7

§ 7. LIMITED PARTNER NOT LIABLE TO CREDITORS

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.