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LIMITED PARTNERSHIPS AND THE "CONTROL" PROHIBITION: ASSESSING THE LIABILITY OF LIMITED PARTNERS

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One of the principal issues associated with the use of the limited partnership is the extent to which limited partners are insulated from liability for the obligations of the partnership. Most Canadian statutes authorizing the use of limited partnerships provide that limited partners who participate in the "control" or "management" of the partnership business will lose their limited liability. The author discusses the limited and relatively restrictive Canadian case law and academic commentary concerning the so-called "control prohibition" and suggests that the adoption of a more expansive interpretation of the permissible scope for participation by limited partners in the conduct of the business of the limited partnership is warranted.

L'une des questions majeures que pose l'usage de la société en commandite est de savoir jusqu'à quel point les commanditaires sont à l'abri des obligations de la société. La plupart des lois canadiennes autorisant l'usage de la société en commandite stipulent que les commanditaires qui prennent part à la gérance ou à la direction de la société perdent leur responsabilité limitée. L'auteur examine la jurisprudence et la doctrine canadiennes concernant l'interdiction frappant les directeurs, toutes deux limitées et relativement restrictives, et suggère que l'adoption d'une interprétation plus large de la participation permise aux commanditaires dans la poursuite des affaires de la société en commandite se justifie.

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Introduction

Although the limited partnership¹ has been part of the Canadian business culture since the early 1800s, it has only recently become a popular form of business organization.² In recent years, limited partnerships have been promoted and marketed, both privately and publicly, in such diverse business activities as oil and gas drilling, real estate syndications, mining operations, film, theatre and television productions, racehorse syndications, mortgage lending, mutual funds, and recreational, hotel and restaurant operations.³

Limited partnerships consist of one or more general partners, who are responsible for the management of the business, and one or more limited partners, who contribute property or assets for a share of profits (and a claim on assets in the event of liquidation). Their relationship is governed by the terms of the partnership agreement, by the partnership and limited partnership legislation of the jurisdiction of organization, and by the common law applicable to partnerships.

While the limited partnership is marketed to investors as a relatively risk free investment vehicle, this is not, in fact, necessarily the case. A shareholder is insulated from the risks associated with the conduct of the corporation's business by the statutory conferral of limited liability.⁴ The principal risk confronting prospective shareholders—the possible loss of their investment—is readily quantifiable. At the same time shareholders retain some measure of control over management, in theory at least,⁵ by the voting franchise which entitles them to elect (and replace) existing management and to approve fundamental changes in the structure or operation of the business.

A limited partner, on the other hand, receives only a qualified limited liability. Under the Limited Partnerships Act of Ontario⁶ and comparable

¹ The limited partnership is the common law counterpart of the "société en commandite", which traces its origins from the civil law traditions of continental Europe. For a discussion of the origins of the limited partnership in Canada, see *infra*, pp. 630 *et seq.*

² This popularity is largely motivated by tax considerations. See P. McQuillan, *Understanding the Taxation of Limited Partnerships* (2nd ed., 1987), p. 59ff.

³ See R.G. Witterick, *The Limited Partnership Vehicle*, in *Packaging Real Estate Limited Partnerships* (1988), p. B-6.

⁴ See, for example, s. 92(1) of the Business Corporations Act, 1982, S.O. 1982, c. 4 (herein the "OBCA") and s. 45(1) of the Canada Business Corporations Act, R.S.C. 1985, c. C-44 (herein the "CBCA").

⁵ For a discussion of the practical effects of "shareholder democracy" see E.V. Rostow, *To Whom and for What Ends is Corporate Management Responsible?*, in E.S. Mason (ed.), *The Corporation and Modern Society* (1959); B. Welling, *Corporate Law in Canada: The Governing Principles* (1984), pp. 297ff and 443ff; T. Hadden, R.E. Forbes and R.L. Simmonds, *Canadian Business Organization Law* (1984), pp. 285-292. See also R. Halpern, M. Trebilcock and S. Turnbull, *An Economic Analysis of Limited Liability in Corporation Law* (1980), 30 U.T.L.J. 117; D.R. Fischel and F.H. Easterbrook, *Limited Liability and the Corporation* (1985), 52 Univ. Chi. L. Rev. 89.

⁶ R.S.O. 1980, c. 241 (hereinafter sometimes the "LPA").

legislation governing limited partnerships in other Canadian jurisdictions limited partners may become as fully liable as general partners, among other reasons,⁷ to the extent that they participate in the "control" or "management" of the business. Unfortunately, the meaning of "control" is not defined under the LPA.

Statutory "safe harbour" provisions⁸ appear to recognize the legitimate expectation of limited partners to exercise some measure of control over the business of the limited partnership and those charged with its management. So too does section 12(2) which states that the limited partner "shall not be presumed to be taking part in the control of the partnership business if he exercises rights and powers *in addition* to the rights and powers conferred on the limited partner by this Act". However, these qualifications do not clarify the scope of the control prohibition with any certainty.⁹

While prospective shareholders may make investment decisions without concern for the liability risks associated with active involvement in management, prospective limited partners must, theoretically at least, assess both the risk of investment loss *and* the risk of assuming additional liability for participating in the control of the business to the extent that they seek to assert a right of involvement in, or a right to review, managerial decisions.

⁷ Under s. 5(2) of the LPA, where a distinctive part of the limited partner's name is used in the firm's name, a limited partner may be held liable as a general partner to any creditor who has extended credit to the limited partnership "without actual knowledge that the limited partner is not a general partner". Limited partners are liable for shortfalls in their agreed capital contribution (s. 15) and for failing to correct inaccuracies of which they are aware in the public filings of the limited partnership (s. 27).

⁸ Under the LPA a limited partner enjoys a number of rights the exercise of which might otherwise be considered to amount to participation in control. These include:

- (a) the right to inspect partnership documents, demand and be given full disclosure of all matters pertaining to the affairs of the partnership and obtain a dissolution of the limited partnership by court order (section 9);
- (b) the right to loan money to and transact other business with the partnership and receive along with creditors a pro-rated share of assets subject to solvency limitations (section 11(1)); and
- (c) the right to examine into the state and progress of the limited partnership business and advise, as to its management, act as a contractor for or agent of the limited partnership or the general partner, and act as a surety for the limited partnership (section 11(2)).

⁹ While it might be argued that the "expectation interest" of the limited partner for managerial accountability is sufficiently recognized by the imposition of fiduciary obligations upon general partners under partnership law and the obligation of general partners to account to limited partners for the conduct of the business, the non-comprehensive nature of such fiduciary obligations, the fact that actions to enforce such obligations typically operate retrospectively rather than prospectively, and the limited availability of remedies (other than the draconian remedy of dissolution) limit the utility of this method of enforcing accountability.

In practice, this assessment is made within the context of the negotiation of the terms of the partnership agreement. Managerial accountability is established under most "standard form" agreements by granting limited partners voting rights on fundamental matters. However, determining the permissible scope of such voting powers is a difficult task given the current uncertainty in Canadian law over the scope of the "control prohibition".

Since the control prohibition insulates general partners from the involvement of limited partners in the business, a legislative intention to curtail the investment expectations of limited partners and to retain some sphere of activity as the exclusive domain of general partners is manifest. This competing claim for managerial autonomy must be considered in the context of the interpretation of the control prohibition. The loss of investor immunity from liability following a contravention of the control prohibition similarly reflects a legislative intention to protect the interests of creditors when limited partners take part in the control of a business. Accordingly, the interpretation of the control prohibition also requires an investigation of the rights and expectations of creditors which are deserving of legal recognition and protection.

The purpose of this article is to suggest a framework for the interpretation of the control prohibition in the context of the conferral and exercise of voting rights by limited partners which provides a more appropriate reconciliation of the expectations of investors, managers and creditors than the existing legal regime as currently understood. Unlike other recent contributions on business organization which seek to account for investor immunity from liability,¹⁰ this article proceeds from the premise that "control" simply acts as a proxy for liability. In that context, this article seeks to establish a functional basis for the interpretation of the appropriate scope of the control prohibition.

The theory put forward is that limited partners should be regarded as occupying positions analogous to those of shareholders, and should be entitled to bargain for voting rights which protect their investment expectations without the constraints the control prohibition is currently perceived to impose. This theory is supported by reference to a comparative analysis of the origins of the limited partnership in English, American and Canadian law, a review of the jurisprudence interpreting the scope of the control prohibition, and an assessment of the LPA as it currently stands. Though the discussion takes place in the context of voting rights, the conclusions also apply to other fact situations involving participation by limited partners in the business where "control" may be an issue.

¹⁰ See, for example, Halpern, Trebilcock and Turnbull, *loc. cit.*, footnote 5; Fischel and Easterbrook, *loc. cit.*, footnote 5.

I. The Limited Partnership under English Law

While the statutory limited partnership is a relatively recent creature of English law, the limited partnership is a hybrid or intermediate form of business organization¹¹ deriving its origins from the long established legal principles applicable to both partnerships and corporations which originated in England and were subsequently adopted in North America. Accordingly, an understanding of the appropriate scope of the control prohibition and the allocation of liability which it contemplates requires an understanding of the evolution of the principle of investor liability as it applies to both the partnership and the corporation.

The issue of investor liability existed long before the industrial revolution of the 1800s. However, the proliferation of business enterprises and the unprecedented scale of expansion of economic activity during this period increased the importance and complexity of legal issues relating to the regulation of business enterprises. A major issue which confronted judges and legislators in England and elsewhere was the appropriate allocation of liability for the obligations of the business firm.¹²

The law of partnership which emerged in this period was derived from the application of the common law of contract and agency—"judge made law"—to business relationships.¹³ The partnership was regarded at law as merely an aggregation of individuals carrying on business for gain. A contractual and agency relationship governed their dealings *inter se*, while principles of agency law dominated their relationship with the community in which they carried on business. Both partners contributing capital and those involved in the partnership business were presumed to be agents for each other. All persons regarded at law as partners were personally liable for the debts of the partnership incurred in connection with its business activities.

Efforts to minimize this liability risk through participating debt or other profit sharing arrangements were constrained by usury laws and by the common law rule that persons sharing in the profits of a venture could be treated as partners even though, as between themselves, they did not intend to create a partnership.¹⁴ The tenuous distinctions often drawn to

¹¹ See F.W. Wegenast, *The Law of Canadian Companies* (1931), p. 10.

¹² For a discussion of the evolution of the principle of limited liability in the corporate context, see L.C.B. Gower, *Gower's Principles of Modern Company Law* (1979), pp. 22-53; Welling, *op. cit.*, footnote 5, pp. 31-96; Hadden, *op. cit.*, footnote 5, pp. 4-44, 141-145; Wegenast, *op. cit.*, footnote 11, pp. 1-27, 334-341. See also Halpern, Trebilcock and Turnbull, *loc. cit.*, footnote 5; Fischel and Easterbrook, *loc. cit.*, footnote 5.

¹³ E.H. Scamell and R.C. Panson Banks, *Lindley on Partnerships* (15th ed., 1984), p. 3.

¹⁴ *Ibid.*, pp. 92-95, citing *Bloxham v. Pell*, cited (1775), 2 Wm. Blacks 999, 96 E.R. 587 (K.B.); *Gilpin v. Enderby* (1822), 5 B. & Ald. 954, 106 E.R. 1441 (K.B.); *Fereday v. Hordern* (1821), Jac. 144, 37 E.R. 804 (Ch.).

determine whether a partnership did exist caused uncertainty for both promoters of business ventures and prospective investors. Conversely, the procedural difficulties creditors encountered in suing individual partners for partnership debts created results which were equally inequitable.¹⁵

The corporation emerged from different traditions of English law, but its evolutionary path paralleled that of the partnership.¹⁶ Although historically a creature of royal prerogative and an instrument of monopoly power, the corporate entity became subject to legislative control as a key instrument of economic development during the 1800s. Corporations were traditionally differentiated from partnerships in certain fundamental respects such as the transferability of their "shares", their separate and legally distinct existence, and the vesting of management of their business affairs in the hands of "governors" or "directors".¹⁷ However, these differences were largely immaterial so far as liability issues were concerned. While their distinct legal existence suggested that shareholders could be insulated from corporate debts,¹⁸ this limitation of liability was also largely illusory. Most charters permitted the corporation to make calls upon its members for contributions of capital to discharge its obligations, and in the event of its failure to do so creditors could proceed directly against shareholders by a process analogous to subrogation.¹⁹

Intermediate entities, such as joint stock and deed of settlement companies, shared many of the attributes of the corporation. However, they too were hybrid business forms since at law they were, in most respects, treated as partnerships.²⁰ Stockholders participating in the profits of these ventures suffered the same exposure to liability as passive investors who had invested in partnerships. Efforts were made to mitigate this exposure through the use of liability exclusion clauses in contracts and constating documents²¹ but such schemes were always "difficult and precarious".²² Insulation from liability was only effectively obtained by the procedural difficulties creditors faced in bringing actions for the recovery of debts owing to them.²³

¹⁵ *Ibid.*, pp. 329-330.

¹⁶ See Gower, *op. cit.*, footnote 12, pp. 22-38; Welling, *op. cit.*, footnote 5, pp. 31-36; Hadden, *op. cit.*, footnote 5, pp. 4-18; Wegenast, *op. cit.*, footnote 11, p. 17-19.

¹⁷ *Ibid.*, p. 28.

¹⁸ See Gower, *op. cit.*, footnote 12, pp. 25-26.

¹⁹ See Gower, *ibid.*, p. 26ff; Welling, *op. cit.*, footnote 5, pp. 87-90; Wegenast, *op. cit.*, footnote 11, p. 333ff.

²⁰ See Wegenast, *ibid.*, p. 4.

²¹ See Gower, *op. cit.*, footnote 12, p. 35.

²² See Wegenast, *op. cit.*, footnote 11, p. 18.

²³ Gower, *op. cit.*, footnote 12, p. 36, observes that in reality unlimited liability, "though a danger to the risk-taker, was often a snare and a delusion rather than a protection to the public and no handicap at all to the dishonest promoter".

Business was thus conducted under a legal regime which did not differentiate significantly between undertakings carrying on business as partnerships, co-partnerships, joint stock companies, deed of settlement companies, or even corporations.²⁴ Liability issues were intimately inter-related for all business firms. The question of investor liability for business obligations was "the chief point in the public mind" by the mid-1800s.²⁵ During this period legislators also sought to come to grips with the proliferation and variety of business forms. Tentative steps were taken to provide for the formal legal recognition of joint stock and deed of settlement trading companies in the 1830s and 1840s.²⁶ Legal rules limiting liability of shareholders for corporate obligations were formalized shortly thereafter, in large part because of the increasing recognition and acceptance of the corporation as a business form.²⁷ The sensible rationale expressed for granting immunity from liability for corporate obligations was that "those who dealt with companies knowing them to be limited had only themselves to blame if they burnt their fingers".²⁸ During this period, the enactment of "limited partnership" legislation was also considered and even recommended by legislative committees, but no steps were taken to implement this recommendation.²⁹

Shortly after the granting of immunity from liability to shareholders, the House of Lords addressed the fundamental issue of investor liability for partnerships, deciding, in the case of *Cox v. Hickman*,³⁰ that mere participation in profits was not sufficient, in and of itself, to give rise to liability as a partner. This result was codified in Bovill's Act.³¹ Given the recent extension of limited liability to corporate shareholders, and contemporaneous discussions about the desirability of limited partnership legislation, this codification was interpreted as providing statutory recognition for the limited partnership as a business form. Bovill's Act was popularly known as "The Limited Partnership Act" and a number of limited partnerships were purportedly created under that statute. Difficulties sub-

²⁴ Gower, *ibid.*, p. 23, observes that during this period "it would be entirely misleading to suggest that there was in any sense a company law; at the most there was an embryonic law of partnership which applied to those companies which had not become incorporated and, with modifications required by the terms of the charter and the nature of incorporation, to those that had".

²⁵ See Welling, *op. cit.*, footnote 5, p. 93.

²⁶ See Gower, *op. cit.*, footnote 12, pp. 39-40; Hadden, *op. cit.*, footnote 5, pp. 16-17.

²⁷ Limited Liability Act, 18 & 19 Vict., c. 133 (U.K.); Companies Act, 1862, 25 & 26 Vict., c. 89 (U.K.).

²⁸ Gower, *op. cit.*, footnote 12, p. 48.

²⁹ *Ibid.*, pp. 43-44.

³⁰ (1860), 8 H.L. Cas. 268, 11 E.R. 267.

³¹ 28 & 29 Vict., c. 26.

³² L.R. Hepburn and W.J. Strain, *Limited Partnerships* (1983), pp. 1-6. See *Syers v. Syers* (1876), 1 App. Cas. 174 (H.L.); *Polley v. Driver* (1876), 5 Ch. D. 458 (M.R.).

sequently arose, however, when investors in such "limited partnerships" were held to be personally liable for their debts.³² Those who had invested in a partnership business were held to be protected only where they "were not in truth associated with *the running* of the business".³³

The continuing confusion in the case law and the relative "success" of the extension of limited liability to shareholders promoted further study and Sir Frederick Pollock, one of England's leading authorities on partnership law, was assigned responsibility for drafting an omnibus bill to both regulate partnerships and permit the formation of limited partnerships. His draft legislation was brought before Parliament four times in the 1880s, and finally enacted in 1890 as the Partnership Act,³⁴ but the provisions drafted by Pollock authorizing the creation of limited partnerships were not adopted.³⁵ The granting of limited liability to corporate shareholders without regard to their participation in management, together with the other advantages of incorporation, provided powerful incentives to choose the corporate business form.³⁶ The affirmation of the separateness of the corporate personality even in closely held companies in the seminal case of *Salomon v. Salomon*³⁷ made the corporate firm the pre-eminent form of business organization.

Legislation was finally approved governing limited partnerships in 1907.³⁸ That legislation provided that limited partners would be insulated from liability provided that they did not take part in the "management" of the business. Although they could "advise" the general partners they were precluded from having any power to "bind the firm".³⁹ While the

³³ Hepburn and Strain, *ibid.*, pp. 1-7. Gower, *op. cit.*, footnote 12, p. 50, notes that *Syers v. Syers*, *supra*, footnote 32, far from protecting creditors who had advanced funds to partnerships on a participating basis "merely worsened their position by making them, in the two most common circumstances, deferred creditors in bankruptcy."

³⁴ See Scamell and Fanson Banks, *op. cit.*, footnote 13, pp. 3-4; Gower, *op. cit.*, footnote 12, p. 50ff.

³⁵ In his commentary on the legislation, F. Pollock, *Pollock on the Law of Partnerships* (3d ed., 1884), p. 135, observed that his limited partnership legislation was experimental and probably useful but "in as much as this matter seems as far as ever from coming to anything practical, I have not thought it worthwhile to give any more consideration to it at present". The enactment of the Companies Act had already led to a dramatic increase in the number of incorporated business ventures at the time the draft limited partnership legislation was under consideration; see Gower, *op. cit.*, footnote 12, p. 49.

³⁶ Gower, *ibid.*, p. 51.

³⁷ [1897] A.C. 22 (H.L.).

³⁸ The Limited Partnerships Act, 1907, 7 Ed. 7, c. 24 (U.K.). For a discussion of the English legislation, see Scamell and Fanson Banks, *op. cit.*, footnote 13, p. 925ff.

³⁹ *Ibid.*, section 6(1). J.B. Miller, *The Law of Partnership in Scotland* (1973), p. 587, observed that "[t]he distinction drawn between actual management and advising . . . is probably a workable one . . . the subsection [s. 6(1)] is clearly concerned only with precluding him [the limited partner] from taking any active step to carry his own views into effect

legislation still commanded some commercial support⁴⁰ it remained, and apparently continues to remain, relatively unused.⁴¹ Nonetheless, the English experience yields two important insights: first, it illustrates the hybrid character of the limited partnership as a business form; second, it serves as a reminder of the intimate links between liability rules, agency concepts, and creditor interests as they relate to business firms. Both of these insights provide a useful contextual basis for assessing the control prohibition.

II. *The Limited Partnership Under United States Law*

The evolution of the law governing business forms in the United States followed similar but not identical paths to that in England. The curtailment of the royal prerogative (for different reasons, of course), the "democratization" of the process of incorporation, the limitations of partnerships as business forms, and the public debate over limited liability were also landmarks in the development of business organization law in the United States.⁴²

The limited partnership, however, was a notable exception. The limited partnership was formally established as a statutorily sanctioned form of business organization by the State of New York in 1822, thirty years prior to its first consideration by English legislators and more than eighty years before similar legislation was formally adopted in England.⁴³ The limited partnership has also enjoyed broader commercial acceptance. As a result American developments provide a rich and informative body of case law and commentary on the control issue. The principal motivation in enacting the legislation was to ensure that passive investors in partnership ventures

and thus limits his right to advising with his partners. He is thus restricted to persuading the general partner or partners to adopt his views and the Act regards the management of the business as the conduct necessary to make these views effective in transactions with third parties, activities from which the limited partner is precluded".

⁴⁰ In Pollock on the Law of Partnerships (15th ed., L.C.B. Gower (ed.), 1952), p. 183, it was noted that public opinion in support of the legislation was "lagging behind the law" since the use of the corporation "involves little more trouble and expense to the members, enables the liability of all to be limited and permits them to take part in the management without forfeiting their freedom from liability".

⁴¹ Hepburn and Strain, *op. cit.*, footnote 32, pp. 1-6. See also Miller, *op. cit.*, footnote 39, p. 584.

⁴² See H.W. Ballantine, Ballantine on Corporations (1946), pp. 13-17, 25-43; N.D. Lattin, Corporations: Cases and Materials (4th ed., 1959).

⁴³ The American legislation was modelled on the provisions of the French Commercial Code of 1807 and has been cited as the first instance in which an American state derived its statutory law from a country other than England. See J.A. Crane, Law of Partnership (1968), p. 1432. The origins of the limited partnership under American law are discussed in *Ames v. Downing*, 1 Bradf. 321 (1850), which is cited in R.K. Wilkie, Limited Partnership Control: A Reexamination of Creditor Reliance (1984-85), 60 Indiana L.J. 515, at p. 516. See also Ballantine, *op. cit.*, footnote 42, pp. 10-12.

could avoid liability for the debts of the partnership to third parties.⁴⁴ Liability for partnership debts was confined by statute to those "transacting business on account of" the limited partnership.

The legislation suffered, however, from both strict interpretation and the hostility of the judiciary to the principle of limited liability.⁴⁵ Limited partners were held liable as general partners in the event of even trivial procedural defects in the organization of the limited partnership as well as in those cases where limited partners became involved in the conduct of its business.⁴⁶ Although judicial acceptance of investor immunity from liability grew in subsequent years,⁴⁷ differing attitudes as to the purpose and scope of the control prohibition⁴⁸ led to demands for a comprehensive statutory restatement of the legislation.

A restatement was proposed in the Uniform Limited Partnership Act in 1916.⁴⁹ The ULPA subsequently served as the model for the remedial legislation adopted by most state legislatures.⁵⁰ The commissioners who drafted the ULPA proposed the adoption of curative provisions to address "procedural" defects pertaining to organization. They also sought to resolve the "substantive" issue of involvement in management by providing that

⁴⁴ See Crane, *op. cit.*, footnote 43, p. 144; S. Rowley, *Rowley on Partnership* (2d ed., 1960), p. 593.

⁴⁵ Crane, *ibid.* See also N. Abrams, Imposing Liability for "Control" Under Section 7 of the Uniform Limited Partnership Act (1978), 28 Case Western L. Rev. 785, at p. 789; R.C. Brown, The Limited Partnership in Indiana (1929-30), 5 Indiana L.J. 421, at p. 422.

⁴⁶ See *Andrews v. Schott*, 10 Pa. 47 (1848); *In re Merrill*, 17 Fed. Cas. 82 (1874); *Manhattan Co. v. Laimbeer*, 108 N.Y. 578 (1888).

⁴⁷ See, for example, *White v. Eisman*, 134 N.Y. 101 (1892); *Chick v. Robinson*, 95 F. 619 (1899); *National Bank v. Bailey*, 147 Pa. 111 (1892); *McKnight v. Ratcliff*, 44 Pa. 156 (1863); *Tilge v. Brooks*, 124 Pa. 178 (1889). In *Continental National Bank v. Strauss*, 137 N.Y. 148, at p. 151 (1893), the court held that control must be "something more than that incidental supervision and advice which a person having capital invested in a concern would naturally give to an enterprise in which perhaps the greater part of his fortune would be invested".

⁴⁸ In *Smith v. Argall*, 6 Hill 479 (1844), the New York Supreme Court held that a creditor relying on procedural defects in organization did not have to establish reliance in order to sustain a claim of investor liability. *Cf. Lawson v. Wilmer*, 3 Phila. 123 (1858) and *R.W. Rayne & Co. v. Terrell*, 33 La. Ann. 812 (1881), where reliance was held to be a necessary prerequisite to establish investor liability. In the latter case the court observed, at p. 815, that it was only where the limited partner "held himself out as a partner, by actively conducting the business, or introducing his name in the partnership style, or declaring his connections, as a general partner, or acted as a general partner, or acted in a manner in which a general partner *only* could act, and third parties were justified to infer and did infer that he was a general partner and acted on that well-founded inference that he could be held responsible to them".

⁴⁹ Uniform Limited Partnership Act, 6 Uniform Laws Annotated, Vol. 6 (West Publishing Co., 1969), p. 561 (herein, as amended, the "ULPA").

⁵⁰ Crane, *op. cit.*, footnote 43, p. 50.

limited partners would not be held liable unless, in addition to the exercise of their rights and powers, they took part in the "control of the business".⁵¹

In drafting the ULPA the commissioners sought inspiration from legal principles being applied to corporations. The control rule was intended to give limited partners "the same sense of security from any possibility of unlimited liability as the subscribers for shares of a corporation".⁵² The commissioners also sought to restrain creditors from exploiting the control rule to make limited partners liable for partnership debts.⁵³

However, the effect of the ULPA was merely to replace the perceived deficiency of the judicial decisions with an ambiguous statutory "control" prohibition. In addition, the reference of the commissioners in the commentary to creditor "reliance" as a touchstone of liability produced conflicting decisions in which the issue of the relationship between "control" and "reliance" was debated.⁵⁴

Numerous American decisions have since dealt with the control rule and limited partner liability.⁵⁵ American judges and many commentators have often suggested that determining the scope of the control prohibition is essentially a factual exercise. Unfortunately, as a result of an essentially *ad hoc* approach by judges to adjudication, considerable difficulties have been encountered in extracting principles of consistent application from decided cases. Those commentators who have attempted to develop a framework for the analysis of the control prohibition have sought to reconcile the results of these cases by reference to two "tests": a "quantitative power" test and a "reliance" test.⁵⁶

The quantitative power test attempts to measure the involvement of the limited partner in the actual operation and conduct of the business of the limited partnership. The difficulty with this test is that fact specific

⁵¹ ULPA, section 7.

⁵² Unif. Laws Ann., Vol. 8 (1922), Commissioners Note to ULPA. See also J. Kent, Commentaries on American Law, Vol. 3 (1826), p. 35. In addition to the legislative history, there is ample American judicial authority for the view that limited partners were regarded from the time of the inception of this business form as occupying a position analogous to that of stockholders in a corporation.

⁵³ In their commentary on the ULPA the commissioners stated, Uniform Laws Annotated, *op. cit.*, footnote 49, p. 564:

The Draft herewith submitted proceeds on the following assumptions: First: No public policy requires a person who contributes to the capital of a business, acquires an interest in the profits, and *some degree* of control over the conduct of the business, to become bound for the obligations of the business; provided creditors have no reason to believe at the times their credits were extended that such person was so bound. (Emphasis added).

⁵⁴ See Wilkie, *loc. cit.*, footnote 43, for a discussion of these cases.

⁵⁵ See the case references in Partnerships, 68 Corpus Juris Secundum, s. 478, p. 1029ff.

⁵⁶ See, for example, J.J. Basile, Limited Liability for Limited Partners: An Argument for the Abolition of the Control Rule (1985), 38 Vanderbilt L.J. 1199.

reasoning based on unarticulated notions of what control "means" tends to produce an unwieldy and unfocused approach to the liability issue.⁵⁷ In many cases where the quantitative power test has been invoked, the factual basis upon which liability was asserted was explored without any serious consideration of the context within which the control prohibition was enacted or any exploration of the relationship between managerial, investor and creditor interests which is generally conceded to be implicit in the allocation of liability it contemplates.

This has proved to be particularly problematic where voting rights are at issue. In *Gast v. Petsinger*,⁵⁸ for example, the Pennsylvania Supreme Court held that the provisions of a partnership agreement which gave the limited partners, *inter alia*, the right to vote to prevent transfers of assets and other acts outside of the ordinary course of business, together with a proviso that management and control of the business was to reside with the general partner, did not exceed "that degree of control which would convert the status of a limited partner to that of a general partner". In adopting this approach, the court left open the possibility that another court could, in another context, regard the exercise of similar or functionally equivalent voting powers, if they effectively led to the "checking" or "nullification" of the managerial powers of the general partner (which voting powers by definition do), as giving rise to a contravention of the control prohibition.⁵⁹

Not surprisingly, these cases tend to reveal a thinly disguised result-oriented reasoning process based only on an examination of the impugned conduct and a clandestine assessment of the equities involved. Unfortunately, this fact specific approach creates an unpredictable framework for subsequent determinations and is thus of limited analytical value.⁶⁰ While the facts may support a conclusion of control in those "easy cases" where limited partners are perceived to have clearly overstepped permitted boundaries of involvement, the absence of a predictable analytical framework creates an unsound commercial basis for structuring limited partnerships in cases at the margin where a debatable issue of relative "quantitative" power may exist. While this test provides a threshold for the determination of

⁵⁷ See and compare the results in *Holzman v. de Escamilla*, 195 P. 2d 833 (1948), and *Grainger v. Antoyan*, 313 P. 2d 848 (1957).

⁵⁸ 323 A. 2d 371, at p. 374 (1974).

⁵⁹ After reviewing the jurisprudence the judge observed that in his view, *ibid.*, at p. 375, "the determination must be made on an *ad hoc* basis . . . the 'control' that [the] partner has in the day-to-day functions and operations of the business is the key question. Does the limited partner have decision-making authority *that may not be checked or nullified by the general partner?*" (Emphasis added).

⁶⁰ In *Weil v. Diversified Properties*, 319 F. Supp. 778, at p. 791 (1970), the court observed, rather unilluminatingly, that "the general principle of these cases appears to be that a limited partner may continue to have an interest and some say in the partnership business without losing his limited liability".

liability, its inherent dependence upon factual inquiries and subjective judgments is not, without some rational basis for making those judgments, particularly useful at the margins.

There are numerous cases where the quantitative power test has been applied, including many where broadly similar levels of limited partner involvement have led to differing results. Further analysis is of little merit.⁶¹ Under the ULPA liability could be found to attach, in general terms, to limited partners who in any fundamental respect appeared to be the controlling minds of the general partner or who occupied a position from which they were able to influence or direct the "day to day" operations of the limited partnership. Courts even went so far as to "pierce the corporate veil" of corporate general partners and find that the limited partners who had organized the general partner were thereby in control of the limited partnership and thus liable accordingly.⁶²

The "reliance" test suffers from many of the same difficulties. Initially, it proceeded from the premise (supported by the commentary to the ULPA⁶³) that the purpose of the control rule was to protect creditors who otherwise might mistakenly assume that a limited partner who "interfered" in the management of the business was a general partner.⁶⁴ The control prohibition was a prophylactic rule required to prevent limited partners from becoming actively involved in the business of the partnership so as to protect the reasonable expectations of creditors who dealt with the partnership. This approach was defended on the basis that permitting limited partners to participate in the control of the limited partnership would encourage creditors to rely on their activity as evidence of their full partnership status and

⁶¹ A summary can be found in Wilkie, *loc. cit.*, footnote 43, Basile, *loc. cit.*, footnote 56, or Rowley, *op. cit.*, footnote 44.

⁶² See *Delaney v. Fidelity Lease Ltd.*, 517 S.W. 2d 420 (1975), but cf. *Frigidaire Sales Corp. v. Union Properties Inc.*, 562 P. 2d 244 (1977), where the court held that the corporate veil should not be pierced since the creditor dealt with the "corporate" general partner of the limited partnership precisely on that basis—surely the more correct result in the absence of a fraud or sham.

⁶³ See, *supra*, footnote 53.

⁶⁴ See Basile, *loc. cit.*, footnote 56, at p. 1208ff, and Wilkie, *loc. cit.*, footnote 43, at p. 523 ff. For example, in the *Lawson* decision (*supra*, footnote 48) the court stated that the "design [of the statute] no doubt was to protect third persons, who were ignorant of the relations between the members of the partnership, and who might be led by the presence and intervention of the special partner, to believe that he was personally liable for the debts of the firm". Similarly, in *Hannover National Bank v. Strrett*, 15 Abb. N. Cas. 334, the court said, at p. 336, that "the interference by transacting business or acting as agent for the firm, upon which the penalty of liability as a general partner is imposed by the statute, means an interference by intrusion into the office of a general partner, and the performance of acts that pertain to the office of the general partner, and which might therefore deceive the public with the idea that he who appears to be, is in fact a general partner". See also *Silvola v. Rowlett*, 272 P. 2d 287 (1954); *Rathke v. Griffith*, 218 2d 757 (1950); *Vulcan Furniture Manufacturing Co. v. Vaughn*, 168 So. 2d. 760 (1964).

corresponding liability. However, some courts held that demonstrated reliance was not a necessary prerequisite for limited partner liability. Other courts accepted the reliance test, but applied it unevenly. The ambiguity of the control prohibition and the absence of any specific *statutory* recognition of creditor reliance as a basis for liability led to great difficulties in determining the scope of a predictable reliance based framework of rules for limited partner liability.⁶⁵

In 1976, in response to these difficulties, a revised ULPA was proposed.⁶⁶ It maintained the control test but sought to restrict reliance based claims by adding that if limited partners' participation was not "substantially the same as" the exercise of the powers of general partners, they would be liable only to creditors who had "actual knowledge of [their] participation in control".⁶⁷ In addition, the revised ULPA incorporated "safe harbour" provisions,⁶⁸ deeming certain activities (including voting on specified matters) not to constitute participating in control. The ULPA also specifically stated that "the possession or exercise of any other powers or rights conferred on the limited partner" did not in and of itself constitute participation in control.⁶⁹

Notwithstanding its remedial intent, this legislative reform merely added more levels of complexity to the control issue. Now it became necessary to determine whether limited partners enjoyed "substantially the same powers" as general partners for purposes of assessing whether control was being exercised. The amendments also provided explicit legislative recognition of the reliance test—a retrograde step in the view of some. Finally, with the incorporation of a non-exhaustive list of "safe harboured" rights and powers, including rights to vote on certain specified matters, the contradiction inherent in the control prohibition was fully laid bare. Limited partners could (apparently) exercise voting powers in addition to those specifically conferred under the ULPA. At the same time, however, voting rights could also now be regarded definitively, at some unknown point, as raising control issues. The efforts of the commissioners to clarify the issue of investor liability instead led to increased criticism of the "control" rule itself and credible arguments favouring its abolition.⁷⁰

⁶⁵ Basile, *loc. cit.*, footnote 56, at p. 1217ff.

⁶⁶ Revised Uniform Limited Partnership Act, 6 Uniformed Laws Annotated, *op. cit.*, footnote 49 (Supp., 1985).

⁶⁷ *Ibid.*, s. 303(a).

⁶⁸ *Ibid.*, s. 303(b). Under the revised ULPA limited partners would be entitled to act as contractors, agents or employees of the limited partnership, consult with and advise the general partners as to its management, vote on matters such as a dissolution, sale of all or substantially all assets, the incurring of debt out of the ordinary course of business, a change in the nature of the business or the removal of a general partner.

⁶⁹ *Ibid.*

⁷⁰ Why fix something that is broken? See Wilkie, *loc. cit.*, footnote 43, and Basile, *loc. cit.*, footnote 56, for a discussion of the recent academic literature on this issue.

American commentators have been critical of the reasoning which led to the incorporation of a specific statutory reliance test and recommend its abolition.⁷¹ One of the most vexing problems facing lawyers advising clients about investments in limited partnerships is advising how much decision-making authority they can reasonably negotiate without losing their immunity from liability, given the "nightmarish interpretative difficulties" posed by the control prohibition. These difficulties are also raised for promoters of public limited partnerships, who must comply with the Securities and Exchange Commission's prescribed "investor protection" policies in order to "blue sky" their offerings, even though those policies may be contrary to the legislation and case law governing the issuer.⁷²

Basile notes that the control rule originated at a time when limited partnerships were generally small business entities consisting of a few members conducting business on a local scale. Protecting the reliance interests of creditors could (arguably) be justified in that context.⁷³ However, he suggests that limited partnerships are now large organizations consisting of many members conducting business on a regional or even national basis. Limited partners are not likely to have the occasion or desire to direct the general partner. More likely, investors are only seeking to exercise control over those decisions that may have a material impact on the value of their investment.

He notes that creditors probably could not demonstrate that the possession or exercise of voting rights caused them to mistake limited partners for general partners, but the risk of being deemed to be in control increases as more and more powers are conferred upon or are subject to limited partner review under the partnership agreement.⁷⁴ The control rule thus merely provides general partners with a convenient means of denying requests by limited partners for additional investor protection. A creditor-based justification of the control rule "implicitly assumes that creditors of limited partnerships form expectations regarding the personal liability of the agents of the partnership with whom the creditor deals",⁷⁵ an assumption that is highly suspect.

Basile argues that the control rule is both unnecessary and unfair. It is unnecessary because in the ordinary course creditors dealing with a limited partnership do so on the basis of its filings, financial resources and operating performance. To the extent that limited partners become involved in the business and activities of the limited partnership they can be caught on the equitable grounds of "holding themselves out" as general

⁷¹ Basile, *ibid.*, at p. 1219ff.

⁷² See, for example, R.J. Haft, *Investment Limited Partnerships and Other Flow Through Vehicles* (1988), pp. 15-35ff.

⁷³ *Loc. cit.*, footnote 56, at p. 1218.

⁷⁴ *Ibid.*, at p. 1221.

⁷⁵ *Ibid.*, at p. 1225.

partners which, as part of the body of general partnership law, is applicable to limited partnerships.⁷⁶ It is unfair because the argument that those who participate in the business of the limited partnership should be personally liable to its creditors, although appealing from a sense of redistributive justice, seems inconsistent with prevailing social and legal attitudes about the regulation of business firms.⁷⁷

The confusion with respect to the control issue was only compounded in August, 1985 when additional amendments were proposed to the ULPA. The "substantially the same as" test for control was abolished. Reliance-based claims were only permissible where reliance resulted from the "conduct" of the limited partner.⁷⁸ Safe harbours, including those relating to voting rights, were expanded.⁷⁹ In particular, section 303(b)6 of the revised ULPA contains a *specific* provision entitling limited partners to vote on those matters related to the business of the limited partnership "which the partnership agreement states in writing must be subject to the approval or disapproval of the limited partners". In effect, then, those negotiating the terms of a partnership agreement can attempt to create

⁷⁶ On this point I disagree with Basile. See *infra*, at p. 643.

⁷⁷ Basile, *loc. cit.*, footnote 56, notes, at p. 1227, that "it is hardly a bedrock principle of American business law that managerial power goes hand in hand with personal liability. . . . Why personal liability should be the price of managerial power in the case of a limited partnership and not in the corporate context defies comprehension".

⁷⁸ Uniform Limited Partnership Act (1985), 6 Uniform Laws Annotated, *op. cit.*, footnote 49 (Supp., 1986), s. 303(a).

⁷⁹ *Ibid.* Section 303(b) provides that a limited partner does not participate in the control of the business within the meaning of subsection (a) solely by doing any of the following:

6. proposing, approving or disapproving, by voting or otherwise, one or more of the following matters:
 - (i) the dissolution and winding up of the partnership;
 - (ii) the sale, exchange, lease, mortgage, pledge or other transfer of all or substantially all of the assets of the limited partnership;
 - (iii) the incurring of debt by the limited partnership other than in the ordinary course of its business;
 - (iv) a change in the nature of the business;
 - (v) the admission or removal of a general partner;
 - (vi) the admission or removal of a limited partner;
 - (vii) a transaction involving an actual or potential conflict of interest between a general partner and the limited partnership or the limited partners;
 - (viii) an amendment to the partnership agreement or certificate of the limited partnership;
 - (ix) *matters related to the business of the limited partnership not otherwise enumerated in this section (b) which the partnership agreement states in writing must be subject to the approval or disapproval of the limited partners;*
 - (x) winding up the limited partnership pursuant to section 803;
 - (xi) *exercising any right or power permitted to limited partners under this Act and not specifically enumerated in this subsection (b).* (Emphasis added).

their own "safe harbours". This assertion of the primacy of the partnership agreement collides with full impact into the statutory control prohibition itself.

The legislative response reflected in the 1976 and 1985 revisions of the ULPA to the uncertainty which has developed in the case law demonstrates the difficulties inherent in legislative reform directed toward remedying perceived deficiencies in specific judicial decisions. Legislative reforms intended to expand the permissible level of limited partner involvement in response to *ad hoc* evolutions in the case law have themselves become confused and unfocused. Such reforms also merely invite courts to justify conveniently future "control" decisions in particular circumstances on the basis that legislative reforms have not yet been implemented.

At the same time the revised ULPA theoretically expands potential control situations by permitting limited partners, through their "safe-harboured" voting powers, to effectively enjoy a veto power over a broad range of "ordinary course" activities of general partners. This process of "reactive" reform runs the risk of subverting the whole legislative scheme since it proceeds simultaneously in two contradictory directions: first, by affirming that the control prohibition remains legally relevant (even, presumably, for voting rights) in some residual manner; and second, by "reforming" the ULPA in a manner which makes the control prohibition incoherent and potentially meaningless.

As the statutory framework has evolved, however, so too has the jurisprudence. More recent American cases have approached the issue of control in a manner which is more sensitive to the interests of investors by analyzing, at least to a limited degree, the nature of the limited partnership, the position of limited partners and the various competing interests of those involved in the conduct of its business.⁸⁰ It has been held, for example, that limited partners can only lose their limited liability if they "have authority to bind the partnership or participate in the *management* or *administration* of the partnership or *conduct* any business, management or administration of the affairs of the partnership".⁸¹ This kind of analysis comes closer to the mark in facilitating the extraction of principles which may be useful in other circumstances.

As a "new generation" limited partnership statute, the revised ULPA adopts and codifies this progressive approach. The broadening of "safe harbour" voting powers and the assertion of the primacy of the partnership

⁸⁰ *Magneson v. C.I.R.*, 753 F. 2d. 1490 (1985); *Kramer v. McDonald's System Inc.*, 396 N.E. 2d. 504 (1979).

⁸¹ *Matter of Pischke*, 11 B.R. 913; *Cromwell v. Commerce and Energy Bank of Lafayette*, 456 So. 2d. 1389 (1984); *Sloan v. Clark*, 223 N.E. 2d. 893 (1966); *Freddman v. Tax Review Board of City of Philadelphia*, 243 A. 2d. 130 (1968); *Hirsch v. duPont*, 396 F. Supp. 1214 (1975).

agreement (which is, after all, the constituent document of the business form), are each consistent with the trend toward greater recognition and acceptance of the limited partnership as a business form—a trend which can (and must) be seen as emerging from both the historical origins of the limited partnership and the evolution of the jurisprudence over the past one hundred years.

The revised ULPA prevents general partners from using the control prohibition as a shield to prevent limited partners from obtaining additional investment protection through the use of their voting power to establish or enforce managerial accountability. It elaborates a non-exhaustive set of circumstances in which the limited partners may vote to approve or disapprove fundamental changes in the business philosophy or structure of the limited partnership without contravening the quantitative dimension of the control prohibition. On the other hand, the control prohibition continues to have residual impact and value where limited partners (either by the scope of their voting powers or through the exercise of such voting powers in tandem with other activities) participate directly in the control of the business.

The reigning in of the reliance test under the revised ULPA to those situations where the reasonable expectations of creditors are deserving of legal recognition and protection also reflects a more coherent underlying principle and policy.⁸² In that context, even if Basile⁸³ overstates the case for the abolition of the control rule, the wide voting powers statutorily conferred on limited partners under the revised ULPA reinforce the view that, whatever conduct continues to be prohibited by the control rule on grounds of reliance, it is difficult to imagine any situation in which third parties, unfamiliar with (and presumably not privy to) the contractual arrangements between the general and limited partners, could suggest that they “relied” on the existence *or* exercise of *voting* rights by limited partners to constitute control. The view that the “control” test requires some active domination over or participation in the actual day-to-day management

⁸² In their commentary on the restatement, the commissioners stated, Uniform Laws Annotated, *op. cit.*, footnote 49, Supp. Pamphlet 1991, p. 241:

[The ULPA now] . . . confine(s) the liability of a limited partner who merely steps over the line of participation in control to persons who actually know of that participation in control. General liability for partnership debts is imposed only on those limited partners who are, in effect “silent general partners”. With that exception, the provisions of the new act that impose liability on a limited partner who has somehow permitted third parties to be misled to their detriment as to the limited partner’s true status *confine that liability to those who have actually been misled*. (Emphasis added).

⁸³ *Loc. cit.*, footnote 56. A reliance-based claim appears reasonable in those specific circumstances where limited partners have become actively involved in the business activities of the limited partnership, mislead creditors about their status and cause creditors to change their position. As I argue, *infra*, at p. 643, Basile’s suggestion that the doctrines of “holding out” or “partnership by estoppel” accomplish this result is not adequate.

of the business and affairs of the limited partnership, and that "exercising voting rights as to extraordinary matters should not constitute control",⁸⁴ both have substantial American academic support.

Another American commentator, F.G. Kempkin,⁸⁵ has recently proposed an analytical approach to the interpretation of the control prohibition which reflects these recent remedial trends in legislative reform while recognizing that the control rule continues to exist and must be considered. His approach is, in my view, the most sensible way to harmonize the various competing jurisprudential and policy issues in a manner which promotes the interests of investors, respects the autonomy of managers and protects the reasonable expectations of creditors. He suggests that the limited partnership must be recognized for what it is: a business form which in many fundamental respects has historically been at common law, and is now statutorily conceded to approximate, the corporation. Accordingly, for purposes of assessing "control", analogies must be drawn between the decision-making apparatus of the corporation and that of the limited partnership.

Kempkin identifies three levels of decision-making in the corporate context: "structural" decisions relating to the articles, by-laws, share contract, mergers, consolidations and dissolutions which typically require shareholder approval in some form; "business policy" decisions that are typically discretionary management decisions within the preserve of the board of directors; and "ministerial" or administrative decisions relating to the implementation of business policy. In Kempkin's view the case law and legislation are most appropriately reconciled by asserting that limited partners have only been held liable where they exercised the kinds of functions ordinarily exercised by the board of directors of a corporation⁸⁶ and that "one may infer from the decided cases that the permissible type of control intended was the exercise of control by shareholders". Kempkin is even prepared to accept the relevance of creditor reliance,⁸⁷ provided that judges

⁸⁴ See Basile, *ibid.*, at p. 1221ff. See also, for example, Kent Slater, Control in the Limited Partnership (1974), 7 John Marshall Journal of Practice and Procedure 416; D. Augustine, P.M. Fass, M.N. Lester and J.F. Robinson, The Liability of Limited Partners Having Certain Statutory Voting Rights Affecting the Basic Structure of the Partnership (1976), 31 Business Law J. 2087; Coleman, Special Problems in Limited Partnership Planning, in Private Real Estate Limited Partnerships (1978), Vol. 1.

⁸⁵ See F.G. Kempkin, The Problem of Control in Limited Partnership Law: An Analysis and Recommendation (1984-85), 22 American B.L.J. 443.

⁸⁶ *Ibid.*, at p. 450ff.

⁸⁷ He observes, *ibid.*, at p. 466:

Whether a limited partner does or does not engage in management is no more a matter of concern of the creditors of the limited partnership than is the managing by owner/managers in a close corporation. It is only when the third party reasonably believes that the limited partner is a general partner, on principles of estoppel that the third party's reasonable expectations are denied. In such a case, the imposition of unlimited liability is right and proper.

adopt an analytical framework which gives sufficient weight to the legitimate expectations and rights of investors and critically assesses claims of reliance made by creditors.

III. *The Limited Partnership Under Canadian Law*

The evolution of the limited partnership in Canada provides an interesting example of the manner in which English, American and French sources of law have each played a role in shaping the Canadian legal mosaic. There is evidence that "sociétés en commandite" were operating in Lower Canada under the French Civil Code in the early years of the 1800s,⁸⁸ and that merchants in Upper Canada were complaining in this period that the availability of this form of organization in Lower Canada was placing them at a competitive disadvantage.⁸⁹ During this period Canadian legislators were confronted with the same issues faced by legislators in other jurisdictions with respect to the appropriate framework for the regulation of business activities, including the debate over investor liability,⁹⁰ and they looked to both American and English experience for inspiration.⁹¹ Limited partnerships were permitted by statute in 1849,⁹² thus predating the adoption of similar legislation in England by almost sixty years. This legislation, modelled on the New York legislation of 1822, was subsequently adopted in the other Canadian jurisdictions.⁹³

Flannigan,⁹⁴ the only Canadian commentator on the control issue to date, provides a summary of the sparse Canadian case law on limited partnerships. He suggests that the early Canadian jurisprudence is unhelpful. The issue of liability was typically addressed in the context of procedural irregularities relating to organization. In such circumstances, as in the United States, courts had a tendency to find liability on the basis of a strict application of the statute.⁹⁵ He speculates that this restrictive interpretation of the law

⁸⁸ See Hadden, *op. cit.*, footnote 5, pp. 23, 105.

⁸⁹ *Ibid.*, p. 23.

⁹⁰ For a discussion of the early Canadian developments, see Hadden, *ibid.*, pp. 18-29; Wegenast, *op. cit.*, footnote 11, pp. 20-27; Welling, *op. cit.*, footnote 5, pp. 36-48, 84-97.

⁹¹ Wegenast, *ibid.*, p. 20, notes that in the early years the American influence was more prevalent but that by the late 1800s the English influence increased.

⁹² An Act to Authorize Limited Partnerships in Upper Canada, 12 Vict., c. 76. The legislation was initially applicable only in Upper Canada and subsequently was extended to Quebec.

⁹³ See Hepburn and Strain, *op. cit.*, footnote 32, pp. 1-10.

⁹⁴ R.D. Flannigan, *The Control Test of Investor Liability in Limited Partnerships* (1983), 21 Alta. L. Rev. 303.

⁹⁵ See, for example, *Slingsby Manufacturing Co. v. Geller* (1907), 6 West. L.R. 223 (Man. C.A.); *Benedict v. Van Allen* (1859), 17 U.C.Q.B. 234 (C.A.); *Watts v. Taft* (1858), 16 U.C.Q.B. 256 (C.A.); *Whittemore v. Macdonell* (1857), 6 U.C.C.P. 547 (C.A.); *Patterson v. Holland* (1858), 7 Gr. 1 (Ch.).

made limited partnerships relatively unattractive when compared with the merging corporate alternative, and thus less utilized.⁹⁶

The only cases on the substantive issue of control all related to the demise of one limited partnership—Donald Bethune & Co.—formed for the purpose of resurrecting, refitting and operating steamboats. Bethune was the sole general partner and the limited partners elected five of their members to a committee to advise the general partner on the conduct of the business. After a period of initial success, the limited partnership run into financial difficulties. Bethune "jumped ship", leaving for England with his own contribution and a considerable portion of the partnership funds. Prior to his departure he designated an individual by power of attorney to act on his behalf. This individual, however, deferred to a committee of limited partners for advice and the members of the committee proceeded, in effect, to make many of his decisions for him.

Flannigan notes that in all of the cases resulting from this "unfortunate affair"⁹⁷ these factual circumstances were so overwhelming that a conclusion of "interference" by the limited partners in the operation of the partnership could not be avoided. Accordingly, in his view the "decisions are of no help in determining what limited partners' activities will attract general liability".⁹⁸

It is suggested, however, that the reasoning in the 1857 decision of *Whittemore v. MacDonell*⁹⁹ is very instructive, since it provides a relatively contemporaneous analysis of the statute as then enacted. In that case, Draper C.J. observed that "the position of special [limited] partners is *very analogous to that of the holders of stock in an incorporated company*".¹⁰⁰ With respect to the issue of liability for interference he stated that the committee members who acted as "directors" should be charged as general partners since they had assumed direction of the business and reduced the nominal general partners to "the position of clerks or employees".¹⁰¹ These views are consistent with the American jurisprudence in the area, the historical origins of the statutory limited partnership and, as will be discussed below, the legislative history and policy of the statute itself.

⁹⁶ Flannigan, *loc. cit.*, footnote 94, at p. 321. Hadden, *op. cit.*, footnote 5, pp. 105-106, notes that the "initial experience of the form was not encouraging and it soon fell into general disuse . . . [since] most traders who might have taken advantage of the legislation preferred to incorporate themselves with full limited liability under the companies statutes".

⁹⁷ *Davis v. Bowes* (1857), 15 U.C.Q.B. 280 (C.A.); *Hutchison v. Bowes* (1857), 15 U.C.Q.B. 156 (C.A.); *Whittemore v. Macdonell*, *supra*, footnote 95; *Bowes and Hall v. Holland* (1857), 14 U.C.Q.B. 316 (C.A.).

⁹⁸ Flannigan, *loc. cit.*, footnote 94, at p. 322.

⁹⁹ *Supra*, footnote 95.

¹⁰⁰ *Ibid.*, at p. 551. (Emphasis added).

¹⁰¹ *Ibid.*, at p. 552. (Emphasis added).

The control prohibition has been contained in the LPA, in some form, since its inception.¹⁰² Initially, limited partners could not "transact business on account of" the partnership. While the general partners thus remained free from the "control" of the limited partners they were liable to account to them "for their management of the business in like manner as other partners".¹⁰³ The legislation remained substantially the same over the next century, but in 1930 was amended to substitute a new control prohibition based on the ULPA of 1916. It provided that limited partners could "examine" and "advise" as to the conduct of the business of the limited partnership but would become liable as general partners if they took part in the "control" of the business.¹⁰⁴ The LPA was repealed in 1980 and the more comprehensive statutory scheme referred to above was introduced.¹⁰⁵ Not surprisingly, the revised legislation once again drew heavily on the statutory framework established under the revised ULPA, providing for defined "safe harbours" and a presumption favouring expanded powers but retaining a "control" rule.

The only relevant recent reported decision with respect to the control prohibition is the case of *Haughton Graphics Ltd. v. Zivot*.¹⁰⁶ In that case the defendant limited partners organized a limited partnership under Alberta law, incorporated a corporation to act as general partner (of which they were officers and shareholders) and subscribed as the sole limited partners. The Ontario High Court had to decide if they could be held liable for the debts of the limited partnership. The defendants were introduced to the plaintiff as officers of the corporate general partner. The plaintiff was also aware of the fact that the partnership was a limited partnership. After the limited partnership went bankrupt the plaintiff sought recovery against the defendants personally. The court held that the defendants were liable to the plaintiff since the evidence clearly established that as a consequence of their role in the management of the general partner the defendants participated in the control of the partnership. This case has been interpreted

¹⁰² Under the Limited Partnerships Act, R.S.O. 1897, c. 138, a "special partner" was permitted under section 16 "from time to time to examine into the state and progress of the partnership business" and might "advise as to its management", but could not "transact any business on account of the partnership or be employed for that purpose as agent or otherwise" and if he did so, he would be "deemed to be a general partner".

¹⁰³ *Ibid.*, s. 15.

¹⁰⁴ The Statute Law Amendment Act, 1930, 20 Geo. V., S.O., c. 21, s. 12(4), repealing and re-enacting in an amended form The Limited Partnership Act, R.S.O. 1927, c. 171, s. 15.

¹⁰⁵ *Supra*, footnote 6. Hadden, *op. cit.*, footnote 5, p. 106, suggests that the reform was necessitated by the tax-driven revival of interest in the limited partnership (see *supra*, footnote 2). He notes that similar amending legislation has been enacted in British Columbia and Alberta, but that the control prohibition in British Columbia prohibits limited partners from taking part in the "management" of the business.

¹⁰⁶ (1986), 33 B.L.R. 125 (Ont. H.C.), *aff'd* (1988), 38 B.L.R. xxxiii (Ont. C.A.), leave to appeal to S.C.C. refused (1988), 38 B.L.R. xxxi. (S.C.C.).

as establishing the proposition that persons acting in the capacity of officer, director (and perhaps even shareholder) of a corporate general partner thereby runs the risk of being held personally liable for the debts of the limited partnership. It is suggested that this is quite simply a bad case with little persuasive merit.¹⁰⁷

IV. *The Relationship between Voting Rights and Control under the LPA*

A. *The Limited Partnership as a Hybrid Business Form*

If the LPA contemplates a notional allocation of rights and responsibilities among the general partner(s) and the limited partner(s) and if this allocation of rights is intended to impact upon the rights of creditors, there must be a context—an appropriate analytical framework—within which the term "control", which is intended to capture this allocation of rights and responsibilities, can be coherently interpreted.

It is suggested that this context should involve the extension of fundamental principles of *both* managerial accountability and managerial autonomy which are applicable to corporate law to the limited partnership as a business form. Some might reject this analogical approach, arguing that it does violence to the integrity of the limited partnership as a separate and distinct legal form. It is suggested, however, that just as principles of partnership law can inform corporate jurisprudence,¹⁰⁸ so too should corporate jurisprudence have a role to play in the interpretation of the LPA—particularly when one considers that the limited partnership is a *hybrid* or intermediate business form.

¹⁰⁷ Based on the facts the plaintiff was not only aware that he was dealing with a limited partnership, but that the general partner of the partnership was a corporation. In view of the absence of any demonstrated reliance on the part of the creditor, and in view of the fact that the creditor was aware that he was dealing with a limited partnership and a corporate general partner, the result only throws into question the rationale for the public filing obligations of limited partnerships, the limitation of liability which corporate shareholders are entitled to rely upon, and also creates unsupportable incentives for creditors not to investigate the persons with whom they deal. If courts intend to interpret the scope of the control prohibition without any inquiry as to the legitimate expectations and obligations of creditors dealing with limited partnerships and to pierce the corporate veil of the general partner, the scope of the control prohibition and the purpose it is intended to serve would be perverted. Surely the more defensible view would be to confine this kind of judicial activism to those (unlikely) situations where persons who are both limited partners and officers, directors or shareholders of a corporate general partner hold themselves out as general partners charged with the management of the limited partnership and fully liable as such, and both mislead creditors as to the incorporated status of the general partner and their own status as limited partners. See *Delaney v. Fidelity Lease Ltd.*, *supra*, footnote 62; *Frigidaire Sales Corp. v. Union Properties Inc.*, *supra*, footnote 62.

¹⁰⁸ In the seminal decision of *Ebrahimi v. Westbourne Galleries Ltd.*, [1973] A.C. 360 (H.L.), a "closely held corporation" was described as a "quasi partnership" in the context of an action seeking its "just and equitable" winding up.

When one assesses the statutory regime of the LPA, taken as a whole, it is evident that the limited partnership borrows heavily from legal principles which have been fundamental to *both* partnerships and corporations from their inception. Limited partnerships formed under the LPA have a qualified continued existence.¹⁰⁹ Limited partnerships are entitled to use the acronym "Limited", but only in the name "Limited Partnership".¹¹⁰ The interest of the limited partner in the property and assets of the partnership is *personal property*.¹¹¹ A limited partnership may have different classes of limited partners with different rights as to the receipt of "return of contribution", "profits" or "as to any other matter".¹¹² Limited partners have continuing obligations in the event that they have not contributed the full amount of their capital to the limited partnership.¹¹³ The interests of limited partners are freely transferable.¹¹⁴ The ability of limited partners and general partners to receive distributions from the limited partnership is subject to solvency requirements.¹¹⁵

The use of the corporate analogy in the interpretation of the "control prohibition" is also supported by analyzing the broad range of activities which the limited partners are specifically entitled to participate in under the LPA. Under section 11 limited partners can be creditors or guarantors. They can be employees, advisors or consultants. They can "examine" the state of the partnership business and "advise" as to its management. The American and Canadian jurisprudence supporting the view that limited partners occupy a position analogous to that of shareholders has already been referred to.

¹⁰⁹ Limited Partnerships Act, *supra*, footnote 6; ss. 3(4) and 20 provide for a qualified continued existence of the limited partnership similar to that contained in partnership legislation.

¹¹⁰ *Ibid.*, s. 5(3). This provision reflects the regulatory approach to corporations in the mid-1800s when the acronym of "Limited" was first introduced as a "red flag" for creditors on the premise that for creditors "forewarned" would be "forearmed".

¹¹¹ *Ibid.*, s. 6(2). This reflects a "corporate" conception of property. See section 41 of the OBCA, *supra*, footnote 4, for example, which states that shares are "personal property". Cf. Scamell and Panson Banks, *op. cit.*, footnote 13, p. 392, on the character of partnership property.

¹¹² *Ibid.*, s. 13. Although this is similar to partnership legislation, the separation of management from investment which is manifested under the LPA, and the fact that the units of limited partners are "personal property" suggest that, in reality, this capital structure would more closely resemble a corporation with different classes of shareholders.

¹¹³ *Ibid.*, s. 15. The analogy to the corporate "call" for additional capital at common law is clear.

¹¹⁴ *Ibid.*, s. 17. The limited partner is entitled to assign his interest "*as he sees fit*", and a substituted limited partner stands in his position. Transferability has historically been the hallmark of share ownership for corporations.

¹¹⁵ *Ibid.*, ss. 10(2), 14 and 23. Compare sections 30, 31, 32, 38 and Part XVI of the OBCA, *supra*, footnote 4, to the same effect. Partnership legislation also contains such restrictions.

These types of activities, when transferred to a corporate context, suggest that the only role the limited partner cannot assume is a role analogous to that of a member of the board of directors or senior management of a corporation who is in a position to determine the conduct of business in the ordinary course, and, to that end, to bind the corporation in its dealings with third parties. In this respect I would go further than the analysis of Kempkin¹¹⁶ and suggest that the control prohibition prevents limited partners from making decisions which are the preserve of the board of directors and senior management and which pertain to the conduct of the day-to-day business of the limited partnership and the transaction of business with third parties.

B. The Relationship Between the Control Prohibition and the Rights of Limited Partners under the LPA

The control prohibition must also be analyzed by reference to those provisions of the LPA which define parameters for the roles of the limited partner and the general partner in more general terms—specifically, the expansive wording of section 12(2)¹¹⁷ and the right of limited partners under section 7 to exercise a veto power over changes in the partnership agreement or other fundamental changes in its business.¹¹⁸

If the conferral of voting rights on limited partners under section 12(2) in addition to section 7 veto rights were contrary to the control prohibition, the scope of the right to "advise" as to the management of the business under section 11 would be problematic since it contemplates limited partner involvement which, particularly for public limited partnerships, can only be made effective through (and would be meaningless without) a voting mechanism to elicit such opinions. The combined effect of sections 11 and 12(2) thus clearly indicates that the grant and exercise of voting power beyond those matters set forth in section 7 under the partnership agreement is legitimate.

¹¹⁶ *Loc. cit.*, footnote 85.

¹¹⁷ S.12(1). A limited partner is not liable as a general partner unless, in addition to exercising his rights and powers as a limited partner, he takes part in the control of the business.

(2) For the purposes of subsection (1), a limited partner shall not be presumed to be taking part in the control of the business by reason only that the limited partner exercises rights and powers in addition to the rights and powers conferred upon the limited partner by the Act.

¹¹⁸ Under section 7, the consent of all the limited partners is required in circumstances where the general partner contravenes the provisions of the partnership agreement, does any act which makes it impossible to carry on the ordinary business of the limited partnership, consents to a judgment against the limited partnership, possesses or assigns partnership property for purposes other than a partnership purpose, admits a person as a general partner (or a limited partner unless the right is conferred under the partnership agreement), or continues the partnership on the death, retirement or mental incompetence of a general partner or insolvency or dissolution of a corporate general partner.

Flannigan suggests, however, that section 12(1)¹¹⁹ and section 7 work at cross-purposes in that the requirement of unanimous approval of limited partners under section 7 to amend the partnership agreement or to sanction acts of the general partner in *contravention* of its terms create the theoretical possibility that the limited partners could negotiate substantial limits on the ability of the general partner to "manage the business and affairs of the partnership" and thereby exercise *de facto* control of the limited partnership without thereby contravening the control prohibition.¹²⁰ From this premise he proceeds to argue that many voting rights typically conferred on limited partners will contravene the control prohibition and suggests that this is a sensible result.¹²¹

It is suggested that this view proceeds from a premise which is fundamentally false. In interpreting the control prohibition one must distinguish between limited partners in their personal capacities as persons (either alone, or in concert with a group of "related" persons be they general partners, other limited partners *or even third parties*) in fact "controlling" the operation of the limited partnership, and limited partners in their capacities as members of a *class* of investors who may exercise rights and powers under the partnership agreement in a manner consistent with the provisions of the LPA.

The apparent "contradiction" arises because Flannigan ignores the fact that the origins and legislative history of the control prohibition, as well as an analysis of the current legislation, indicate that the control prohibition is designed to regulate *individual* (or related group) conduct, while the rights of limited partners which are legislatively guaranteed under section 7 (including the right to veto changes in the partnership agreement) can only reasonably be regarded as class rights. Two *separate* questions must be asked: first, under section 12(1), in what circumstances will a limited partner be held to be participating in "control" of a limited partnership; and second, is there any situation in which a *group of unrelated limited partners*, by the exercise of their voting rights on matters *other than* those specified under section 7, can be held to be in control of the limited partnership. Both questions require an interpretation of the meaning of "control" and the meaning given must be consistent in both contexts in order to establish a coherent basis for the interpretation of the LPA.

¹¹⁹ See *supra*, footnote 117.

¹²⁰ Flannigan, *loc. cit.*, footnote 94, at p. 331.

¹²¹ One example typically given is the use of an extremely restrictive borrowing clause prohibiting the general partner from incurring debt above a nominal level in the ordinary course of business.

C. Defining "Control" in the Context of the LPA

When one considers a definition of "control" it is clear that the term is relational referring to a state which exists between two persons or things.¹²² The definition suggests a situation of one person having the ability to exercise and in fact exercising some degree of influence, authority or restraint over another. However, control only has meaning by reference to a context and an analysis of the context is central to an understanding of whether, in any given circumstance, a case for control can be made out.

The definitions of "control" which are frequently encountered in corporate and securities statutes, for example, are typically drafted in relation to corporations and focus on the relationship between a person (or group of *related* persons) and *the* body corporate. Control is typically contingent upon the exercise by the person of sufficient voting power to elect a majority of the directors. This makes sense given the statutory *context* which establishes (among other things) what it is that the shareholders and directors can do. Majority voting power constitutes "control" since it entitles the holder to elect a majority of the directors who manage the business and affairs of the corporation.

However, once elected directors are charged with certain duties and functions under the statute governing the corporation and its articles and by-laws. Shareholders may not, in the ordinary course, interfere with the exercise of the managerial authority so conferred on the board of directors. They do not "control" the corporation in that sense. The fact that a shareholder is entitled to vote for the election of the board of directors (or its removal) does not, in and of itself, support a conclusion of control unless the shareholder has sufficient votes to carry the day. In that case the shareholder is entitled to the rights, and is subject to the obligations, established under the corporate and securities legislation governing the corporation which specifically take account of, and regulate, the activities of majority or "controlling" shareholders.¹²³

Similarly, the fact that shareholders, as a class who are entitled to vote as an incident of their share ownership, are thus *collectively* able to influence the management and direction of the corporation by virtue of the exercise of their voting rights does not typically lead to a conclusion

¹²² In the Shorter Oxford English Dictionary (3d ed.), control is defined as "the act of controlling, or of checking and directing action; domination, command, sway; a method or means of restraint; to regulate, call to account; to exercise restraint or direction upon the action of". In Black's Law Dictionary (6th ed., p. 328), control is defined as the "[p]ower or authority to manage, direct, superintend, restrict, regulate, govern, administer or oversee".

¹²³ Such regulation would include, for example, disclosure obligations applicable in the ordinary course (insider reports, proxy solicitation regulation) and regulation of activities out of the ordinary course (sales of control, oppression, separate class votes for minority shareholders, etc.).

of control, except in those circumstances where all of the shareholders' acting unanimously (for example, in the case of a unanimous shareholders' agreement among the shareholders of a closely held corporation) have removed managerial powers from the directors. In that case the shareholders as a class can be said to have assumed control of the corporation, not because of their ability to elect the board of directors, but because they have *in fact* assumed that managerial status. In those circumstances, the shareholders, having collapsed the distinction between managerial and investor roles, lose their immunity from liability and become subject to the obligations, duties and liabilities of the directors accordingly.¹²⁴

In the context of the limited partnership, the relationship of *a* limited partner and *the business* of the limited partnership is at issue in assessing "control" under section 12(1). In that context, we know that *a* limited partner, apart from all of the other permitted activities, can exercise voting powers in the manner set forth in section 7. If a limited partner has sufficient voting power to carry the day, then there must be some countervailing power under the legislation to prevent the limited partner from exercising voting power either alone (or in concert with the general partner) in a manner which is detrimental to the other limited partners, limited partnership and the general partner.

That countervailing power is found in two places: section 7, which effectively prevents the majority limited partner (either alone or in concert with the general partner) from abusing the minority limited partners by requiring unanimous consent for fundamental changes in the partnership business or self-dealing between the general partner and the limited partnership; and section 12(1), the "control prohibition", which prevents the majority limited partner by the use of voting power from "interfering", "participating in" or attempting to exert "control" over those managerial functions which the general partner is statutorily permitted to perform. An individual limited partner with less than majority voting power, on the other hand, should not, by the mere exercise thereof, be regarded as having the ability to control the limited partnership under section 12(1) since the mere ability to vote on matters pertaining to the business of the limited partnership does not, in and of itself, support a conclusion of control.

Similarly, the fact that limited partners as a *class* are collectively able to influence the management and direction of the limited partnership by virtue of the voting rights which are conferred on them under a partnership agreement should not, in and of itself, lead to a conclusion of control, unless the limited partners, as a class, in fact remove from the general partner the ability to make those managerial or "business policy" decisions

¹²⁴ See section 108 of the OBCA, *supra*, footnote 4, and section 140 of the CBCA, *supra*, footnote 4.

in the ordinary course of the business which would otherwise be within the mandate of the general partner, thereby collapsing the distinction between managerial and investor roles which is express in the legislation. In such case it would be both just and appropriate to impose on limited partners, as a *class*, the obligations, duties and liabilities of the general partner in a manner analogous to the obligations imposed on shareholders who have entered into a unanimous shareholders' agreement and restricted the powers of the directors to manage the business of the corporation. In the context of the limited partnership, collapsing the distinctions between investors and management should result in the limited partners becoming fully liable as general partners. Section 12(1) should be interpreted accordingly.

It is difficult to see, however, how the conferral upon limited partners, as a class, of voting rights which do not have an impact upon the managerial autonomy of, or otherwise "fetter the discretion of", the general partner in any fundamental sense, but which are designed to preserve managerial accountability and enhance investor protection, offends either the LPA or fundamental principles of public policy to such an extent that limited partners should be held liable.¹²⁵ It would seem reasonable to suggest that limited partners should be permitted to exercise those powers which are functionally equivalent to those of shareholders (*including*, if permitted under the partnership agreement, the ability to remove the general partner). The analogy to permissible levels of shareholder involvement appears to be defensible.

In this context, Kempkin's¹²⁶ suggestion that voting powers on "structural" decisions ought to be permissible must be viewed in light of the fact that, in the corporate context, most "structural" decisions are no longer the result of bargaining between managers and investors but are externally imposed by the "standard form" contract embodied in corporate legislation. However, in the case of a limited partnership, any rights in addition to the limited rights conferred under section 7 of the LPA must flow from the bargaining process. Limited partners must be free to bargain for those rights without fear of losing their immunity from liability.

D. *The Relevance of Creditor Interests*

The traditional argument against limited partners establishing strong prophylactic rules for managerial conduct is based on a perceived need for creditor protection. Flannigan provides a very restrictive view on the permissible scope of limited partner involvement (voting or otherwise) in the business of the limited partnership based on the legislative intent and

¹²⁵ Flannigan, *loc. cit.*, footnote 94, at p. 332, suggests that regulatory efforts designed to promote investor protection (such as the requirements imposed on issuers by securities commissions as to voting requirements) are misguided and inappropriate.

¹²⁶ *Loc. cit.*, footnote 85.

policy rationale he argues undergirds the LPA. He argues that the place along the continuum of rights and powers exercisable by limited partners under their partnership agreement, where "rights" become "control", must be identified by reference to the competing expectation interests of investors and creditors.¹²⁷ Flannigan argues that the control prohibition is the "most significant" statutory provision protecting the interests of creditors since it represents that "point at which the policy of third party protection begins to have legal impact" and thus "determines when rights and powers of limited partners must be deferred to the interests of third parties".¹²⁸

He regards the "connecting factor" between the control prohibition and limited liability encapsulated within section 12(1) as "risk aversion". The general partner makes sensible business decisions because its personal assets are at risk. Limited partners, with less to lose, would be less adverse to risk. If limited partners exercised control with limited liability this would violate the rule that "every person, corporate or otherwise, is liable for obligations he, she or it is actually responsible for".¹²⁹ According to Flannigan, the control prohibition is simply an attempt to maintain the integrity of this rule.

In his view "limited partners must be prevented from being able to affect the security of third parties, namely, the assets of the partnership" to the prejudice, or potential prejudice, of third parties and, accordingly, the test of control must be third party prejudice.¹³⁰ Whenever limited partners exercise rights and powers which "affect partnership assets" they are dealing with the security from which third parties expect payment. Thus, "[o]nly the general partner can manage the affairs of the partnership and, accordingly, both limited partners and third parties look to the general partner for their profit and protection".¹³¹

Leaving aside the fundamental difficulties posed by Flannigan's "rule" of responsibility for liability¹³² the analysis remains suspect. The regulatory policies promoting investor protection which Flannigan suggests are "misguided" impose minimum capital and other requirements on general partners (who are now virtually all corporations) so that the interests of *both* limited

¹²⁷ Flannigan, *loc. cit.*, footnote 94, at p. 306 ff.

¹²⁸ *Ibid.*, at p. 308.

¹²⁹ *Ibid.*, at p. 309.

¹³⁰ *Ibid.*

¹³¹ *Ibid.*, at p. 310.

¹³² The "rule" appears to be tautological and thus uninformative. It seems to suggest that everyone is responsible for what they are responsible for. But is not that what we are trying to decide? Notwithstanding this "rule", is not the absence of *shareholder* or *managerial* responsibility for liabilities *exactly* what our corporate legislation contemplates? And in commercial practice would a general partner be anything *other* than a corporation?

partners and creditors will be protected.¹³³ The LPA also clearly contemplates that a limited partner, together with the general partner, may lawfully exercise voting power "to affect partnership assets". The general partner and the limited partners, acting in concert, could, under section 7, fundamentally alter the partnership business, consent to a judgment against another creditor, transfer partnership assets to third parties, sanction self-dealing by the general partner and make a host of decisions particularly adverse to a creditor without *any* input from him. Thus the assertion that this is what the control prohibition is all about is suspect. Flannigan's analytical tool is not powerful enough to resolve the competing policy considerations adequately.

Creditors *do* look to the general partner for their protection, not only because of the (corporate) general partner's "unlimited liability" (for what it is worth) but because standard business practice dictates that they assess the creditworthiness of the general partner and limited partnership before they deal with them and make the appropriate arrangements. Creditors bargain with limited partnerships, assess risks, take security, impose negative covenants, impose financial and operating performance requirements, specify repayment terms for trade credit, investigate title, and review public filings. In practice, many of the risks associated with dealings between creditors and limited partnerships are addressed and allocated in the context of these negotiations. As *Haughton Graphics Ltd. v. Zivot*¹³⁴ demonstrates, the rationale for a court to interfere in these circumstances is extremely tenuous.

More significantly, creditors can also look to those provisions of the LPA itself which regulate the manner in which the business of the limited partnership is conducted and which allocate the risks of those business activities in a manner favourable to them. The LPA provides in a number of fundamental respects that, *regardless* of what the limited partners or general partners do with the assets of the partnership, they cannot take any personal benefit unless the liabilities of the limited partnership to third party creditors are satisfied.¹³⁵ In this fundamental respect—the expectations of third parties dealing with the limited partnership that their claims will be satisfied—the LPA is in fact quite comprehensive, imposing requirements equivalent to the solvency tests applicable under corporate legislation.¹³⁶

The suggestion that the control prohibition constitutes a statutory recognition of differential risk levels between general partners and limited partners is highly speculative and intuitively problematic. It would likely

¹³³ The Ontario Securities Commission, for example, has imposed fundamental "investor protection" obligations for publicly held limited partnerships. See O.S.C. Policy Statements 5.3 and 5.4.

¹³⁴ *Supra*, footnote 106.

¹³⁵ See, for example, Limited Partnership Act, *supra*, footnote 6, ss. 10(2), 14 and 23.

¹³⁶ See, for example, CBCA, ss. 34(2), 35(3), 36(1), 38(3), 42, 44(1).

be difficult to quantify relative levels of "risk aversity" in a manner sufficiently precise to demonstrate that this argument has any validity. Flannigan's analysis of the relevant incentives for "risky" or "risk adverse" behaviour ignores a number of considerations. An equally credible argument can be made that the risk aversity of general partners and limited partners is exactly the opposite given that corporate general partners incorporated with limited liability are now the norm and a substantial portion of the capital of the limited partnership is contributed by the limited partners. The minimum capital requirements for general partners and other "investor protection" provisions applicable to public limited partnerships, in fact, reflect a regulatory intervention thought necessary to ensure that a general partner soliciting investment contributions has a "risk" level which more closely approximates that of prospective limited partners.

Even if Flannigan's assessments of risks are accurate, assessments of risk are meaningless without the correlative assessments of returns. Limited partners might be more or less aggressive in demanding that the general partner act "risk adversely" depending on the alternative expected returns available to them at various points in time for various levels of risk. General partners might be more or less aggressive in pursuing risky opportunities depending upon the assessments they make of the risks of loss versus the potential returns. *Both* general partners and limited partners acting in concert may be prepared to take significant risks for high returns (by, for example, radically changing the business) and creditors would be *powerless* to do anything about it under the LPA, even on the basis of Flannigan's interpretation of the scope of the control prohibition.

Why then do creditors deal with limited partnerships? For the same reason they deal with any business. Creditors too are willing to take, and do take, certain risks in order to achieve certain expected returns. It is suggested that the risk assessments creditors make and the actual risks they face in dealing with limited partnerships are much less significant than Flannigan suggests. At least creditors know that whatever their exposure may be, in the event of liquidation they will be paid out of the assets of the limited partnership *and* those of the general partner before the limited partners receive anything. In the broad sense, then, section 12(1) has very little to do with creditors.

It does, however, remain relevant in the narrow sense of reasonable creditor reliance, and this extremely *specific* reliance interest should be protected in those *very* limited circumstances where it applies—where individual limited partners are actively involved in the ongoing day to day business activities of the limited partnership, and actually mislead creditors into believing they are unlimitedly liable as a general partner. In that regard, section 12(1) and 5(2), the two principal sections imposing liability on limited partners for "substantive reasons",¹³⁷ are nothing more

¹³⁷ See the discussion, *supra*, at p. 615, and footnote 7.

than a codification of the doctrines familiar to partnership law generally that silent partners and persons who hold themselves out as partners are liable as partners for the debts of the partnership.¹³⁸

Unlike Basile¹³⁹ and Kempkin,¹⁴⁰ who suggest that the control prohibition is unnecessary in this context, given the doctrines of "holding out" and partnership by estoppel, it is suggested that the reasons these prohibitions were necessary was to address the *ambiguity* between the statutory provision under partnership legislation generally that silent partners carrying on business by partners or agents and persons holding themselves out as partners were liable as such, and the specific limitation of liability accorded to limited partners under limited partnership legislation. The introduction of the "control" test was thought necessary to ensure that limited partners who in fact were controlling the management of the partnership "behind the scenes" or holding themselves out as general partners, would not be able to rely on their shield of limited liability under another statute as against the persons who dealt with them as partners. It is in this limited sense that the issue of "control" must be assessed.

Flannigan suggests that the test of limited partner liability must turn on whether the limited partner deals with or has the ability to deal with the assets of the partnership in a manner which is prejudicial to the interests of third parties since this goes to the root of the issue of third party reliance.¹⁴¹ He argues that one must examine the classes of powers conferred on the limited partners under the partnership agreement to determine if they are within this statutory scheme. Flannigan argues that *any* effort by the limited partners to exercise control over the right to borrow, the right to give security, make distributions, enter into contracts, satisfy debts and make investment and policy decisions directly affect the assets and operations of the partnership and are therefore a "control" right beyond the realm of the limited partners.¹⁴²

On the other hand, the exercise of statutory rights and the ability to approve excursions by the general partner (but, strangely, not the limited partnership since this is a "control" right) into other business activities would not contravene the statute.¹⁴³ The right to approve a sale of assets

¹³⁸ For a discussion of the doctrine of partnership by estoppel, see Partnerships Act, R.S.O. 1980, c. 339, s. 15, and Scamell and Panson Banks, *op. cit.*, footnote 13, p. 112ff. For a discussion of the liability of dormant partners, see Scamell and Panson Banks, *ibid.*, p. 287. An empirical analysis of "control" and "holding out" cases could yield interesting results to test this thesis.

¹³⁹ *Loc. cit.*, footnote 56.

¹⁴⁰ *Loc. cit.*, footnote 85.

¹⁴¹ *Loc. cit.*, footnote 94, at p. 323.

¹⁴² *Ibid.*

¹⁴³ *Ibid.*

or other extraordinary transaction is permissible, but only because section 7 requires unanimous approval for any act "which makes it impossible to carry on the partnership business" or which is "in contravention of the partnership agreement". The right of the limited partners to terminate the partnership or remove the general partner constitute "ultimate control" of the partnership assets and are thus "control rights" beyond the authority of the limited partners.

In circumstances where the partnership agreement provides for alternative methods of dealing with these issues Flannigan's analysis encounters difficulties. If, for example, the partnership agreement has a broad "objects" clause and if it provides for extraordinary sales by majority approval, how can this result be justified through his framework? Presumably the "partnership business" (whatever it is) can continue and the partnership agreement has not been contravened so as to give rise to a section 7 voting right. No right to vote thus arises. Conversely, how can limited partners effectively establish managerial accountability if the ultimate sanction, removal of management, is beyond their powers?¹⁴⁴

E. *The Relevance of Oppression*

Flannigan raises a point which goes to the root of my criticism of his analysis. He suggests that the existence of the control prohibition avoids "the problem of oppression of the minority. If limited partners as a group have no part in control there can be no abuse of the minority by the majority. Thus the need to regulate the relationships of the limited partners *inter se* does not exist".¹⁴⁵ I suggest that this comment misses the fundamental point. If Flannigan is correct in asserting that limited partners are not entitled to remove the general partner or have any say in *most* decisions commercially regarded as "fundamental changes", the fact of oppression is a concern not among the limited partners themselves but *between* the limited partners and the general partners who are in a position to control the business and make a host of potentially adverse business decisions "in the ordinary course" (of course) without the limited partners' consent. This *operational* reality is precisely why limited partners, as a *class*, should be entitled to have, *at the very least*, a say in negotiating basic prophylactic rules which define the scope of managerial authority in broad terms, and determining whether there will be fundamental changes in the business direction or philosophy embodied in those rules.

¹⁴⁴ In this context it is worth noting that even if limited partners exercised a right granted under the partnership agreement to remove a general partner, this would not imperil creditors who had dealt with the partnership up to that time since, under the provisions of applicable partnership legislation, the general partner would continue to be liable for obligations incurred during its tenure as general partner. See, for example, sections 15, 18 and 19 of the Partnerships Act, *supra*, footnote 138.

¹⁴⁵ *Loc. cit.*, footnote 94, at p. 310.

The partnership agreement which sets forth the obligations of the general partners to the limited partners is the contractual bargain upon which the investment is made. In terms of investment protection courts must appreciate the inequality of bargaining power limited partners face, the monitoring costs for limited partners of ensuring proper management behaviour in the absence of such prophylactic rules, and the implications this reality has when their "bargain" is made. Courts must recognize and respect the legitimate right of investors to insist that such rules should be permissible without concern over "control" issues (and without management's use of the liability threat as a means of unilaterally altering the balance of power in such negotiations in its favour). Courts must weigh this consideration in the balance when determining whether the limited partners have overstepped the bounds of permitted control. The suggestion by Flannigan that the control prohibition must be interpreted principally by reference to the interests of creditors discounts, to a large extent, a whole range of interests and an equally important relationship subsumed within the "control" debate.

If, on the other hand, Flannigan is wrong as I believe, and such voting rights are legally defensible, then in those situations where one limited partner has sufficient voting power to carry the day the possibility of oppressive conduct must be considered.¹⁴⁶ Fortunately, it is. Section 7, which provides for unanimous consent in order to effect fundamental changes, accomplishes this task. *Each* limited partner has a veto power over *any* action which the majority limited partner may initiate to alter the contractual bargain contained in the partnership agreement; and which adversely affects the minority's investment expectations. Section 12(1) also operates in this context to prevent one limited partner, as an *individual*, from interfering with the general partner's management of the business by preventing the limited partner, through the use of voting power or otherwise, from interfering in the *conduct* by the general partner of the day-to-day business and affairs of the limited partnership without losing limited liability. Taking the analysis one step further, in the case of the limited partnership with *different classes* of limited partners with different rights as to matters permitted under the LPA such as the right to participate in profits, *each* member of *each* class would have a right of veto under section 7 where the general partner and the limited partners of another "class" sought to alter the rights conferred on them under the partnership agreement.

¹⁴⁶ Note that this issue appears to have arisen in the American case of *JRY Corporation v. Lecoux*, 464 N.E. 2d. 8 (1987), where an attempt by the majority limited partner to remove the general partner and appoint its own nominee was successfully opposed by the general partner and the other limited partners on the basis that since no right existed under the partnership agreement permitting this fundamental change in the structure of the partnership, unanimous approval would be required to remove the general partner.

In this context, Flannigan suggests that the rights conferred on limited partners, for example, to consent to "fundamental changes" in the partnership business or "to approve contraventions of the partnership agreement", require *unanimity* under section 7 to be valid and effective. The fact that, as a matter of commercial practice, partnership agreements typically provide for "special majority" approval by limited partners of "fundamental changes" raises an issue unrelated to the concept of control. *In fact it goes to the issue of enforceability from the opposite direction.* He argues that since the LPA requires unanimous action to approve types of actions which would typically be regarded as fundamental changes, the requirement of only majority approval may not in fact go far enough to achieve safely the desired result.¹⁴⁷

The possibility remains open for even one limited partner to challenge the enforceability of such decisions. In my view, however, this does not make sense. By consenting to the terms of the agreement, including the incorporation of provisions permitting changes in business direction or philosophy by "special majority" vote, limited partners are effectively recognizing that as part of the fundamental contract these rights are binding and enforceable and each limited partner is indirectly ratifying actions which may subsequently be taken. Consequently, providing for majority approval as part of the partnership agreement does not thus *give rise* to a section 7 voting right since there has been no departure from the partnership agreement which is an essential pre-condition to the exercise of such rights under section 7. From an investor protection point of view, investors are essentially getting what they bargained for.¹⁴⁸ If, as previously discussed, the change is not provided for in the partnership agreement, the veto power each limited partner enjoys permits the protection of the partner's investment interest.

Unfortunately, however, the LPA does not include any "dissent and appraisal" remedy for those limited partners who do not approve changes implemented by the general partner and a majority of the limited partners. The circumstances in which limited partners may demand the return of contributions are limited to the dissolution of the partnership; the time specified in the agreement for the return of contributions (or, if no time is specified for dissolution or return, on six months notice); or upon the consent of all partners. In addition, the LPA refers only to the "contribution" and does not appear to provide for any means of valuing the investment.¹⁴⁹ Even if the limited partner is entitled to receive the contribution, the failure

¹⁴⁷ *Loc. cit.*, footnote 94, at p. 330. On the same issue, see *Reilly v. Rangers Management Inc.*, 727 S.W. 2d. 527 (1987); *Cunningham v. Consolidated Realty*, 803 F. 2d. 840 (1986).

¹⁴⁸ This approach is consistent with the American jurisprudence. See, for example, *Mist Properties Inc. v. Fitzsimmons Realty Co.*, 228 N.Y. S. 2d. 406 (1962); *Newburger, Loeb & Co. Inc. v. Gross*, 365 F. Supp. 1364 (1973), *aff'd* 563 F. 2d. 1057 (1977).

¹⁴⁹ Limited Partnership Act, *supra*, footnote 6, s. 14(1)(a).

of the limited partnership to pay can only ultimately be addressed by the rather draconian measure of commencing an action for its dissolution.¹⁵⁰ Investors and their counsel should bargain for such a dissent and appraisal remedy.

For purposes of interpreting the control prohibition, it is suggested that a distinction must be drawn between the ability of the general partner to manage the business and affairs of the limited partnership in the ordinary course and bind it in its dealings with third parties and the ability of the limited partners as a class, whether through the exercise of their voting rights or as otherwise provided in the general agreement, to preserve the integrity of their investment in the manner contemplated by the partnership agreement. The business purposes identified in the partnership agreement, and the delineation of the powers of the general partner to conduct that business, represent the bargain on which the investment is made.

Conclusion

The suggestion that the exercise of voting rights should not be permitted except in those very limited circumstances set forth in section 7 is without merit. The suggestion that legislative reform is necessary to provide for the conferral of such rights on limited partners¹⁵¹ is not only unnecessary, given the rather weighty legislative agenda of more significant social and commercial issues, but also potentially confusing and counter-productive in view of recent American experience. In the search for greater predictability, American legislators have only increased the uncertainty with respect to the interpretation of the control prohibition under the ULPA.

It has been said that partnership law is "judge-made law" and that, on balance, it is "a good example of it".¹⁵² There is no reason why the same cannot be said in the case of the limited partnership. Judges are as well equipped as legislators to deal with the legal and policy issues pertaining to the regulation of commercial enterprise, if cases are resolved with a view to the development of a coherent legal framework and with an eye to the positive and negative effects of prevailing commercial practice. The task is perhaps more difficult because the hybrid nature of the limited partnership necessitates the reconciliation of principles of partnership and corporate law which will occasionally cause difficulties.

The LPA as currently enacted embodies a legislative response to this challenge which is remarkable, both in terms of its succinctness and its comprehensiveness. It may fairly be said that the legislation embodies a

¹⁵⁰ *Ibid.*, s. 14(1)(d).

¹⁵¹ *Ibid.* Flannigan, *loc. cit.*, footnote 94, states that the rights being imposed by securities regulators "are properly only provided for by legislation. There are policy decisions to be made in each case and that is the function of the Legislature".

¹⁵² See Scamell and Fanson Banks, *op. cit.*, footnote 13, p. 3.

fair and equitable reconciliation of the expectation interests of the investors and managers who, by contract, commit themselves to a common undertaking, and does so in a manner which effectively protects both the general interest of third party creditors to whom the limited partnership may be indebted and the specific reliance interests of creditors who deal with the limited partnership which are deserving of legal recognition and protection.

To the extent that individual limited partners actually become involved in the management of the day-to-day operations of the limited partnership they should be treated as general partners if they have misled specific creditors who suffer losses in reliance on their apparent status—not only to recognize their reliance, but also because, *vis-à-vis* other limited partners, the individual limited partners have assumed a role in the management of the partnership business for which they are not accountable.

It is possible that the limited partnership will continue to be popular. It may also be the case, however, that for commercial reasons (as a result of changes in tax policy) the limited partnership will soon be relegated to its former status of relative disuse. It would be unfortunate, however, if the same “unsound views of political economy”¹⁵³ which led to its early demise in the mid-1800s resulted, once again, in its drifting into legal oblivion by virtue of an unduly restrictive interpretation of the scope of the control prohibition. It is clear that legislative reform is not on the horizon. It is clear that the conferral on limited partners of voting powers which go beyond the “fundamental rights” provisions of section 7 is a widely accepted aspect of commercial practice.

What is not clear, given the current conservative Canadian views on the scope of the control prohibition, is whether courts will be prepared to hold that the commercial practice is wrong and misguided. It would be unfortunate if the courts decided that limited partners, having enjoyed by contract the right to vote in matters pertaining to the business of the partnership, should be held to be unlimitedly liable to creditors of the limited partnership who probably would have no knowledge of,¹⁵⁴ or interest in, the manner in which the internal affairs of the partnership are governed and who have conducted their own dealings with the limited partnership on the basis of their relationship with, and assessment of, the general partner and limited partnership alone.

The suggestion made in this article is that there is a strong argument, in terms of both law and policy, that limited partners should be entitled to assert, without any risk of additional liability, rights analogous to those rights exercisable by shareholders, including the right to vote on those matters pertaining to the business of the partnership which they and the general partner have contractually agreed should be subject to review, unless

¹⁵³ *Ibid.*

¹⁵⁴ Limited Partnership Act, *supra*, footnote 6, s. 30(4).

the scope of involvement by limited partners, either individually or collectively, is such as to directly infringe upon the managerial autonomy of the general partner to conduct the day-to-day management of the business and affairs of the limited partnership and its dealings with third parties, or to permit limited partners to assume a position in connection with the conduct of the enterprise that causes third parties to be specifically, actually and detrimentally misled as to their true status. A contrary decision would merely reallocate a risk of loss arising in commercial dealings between the limited partnership and its creditors, which is adequately addressed elsewhere in the legislation and which, in all likelihood, creditors of the limited partnership and the general partner and limited partnership had previously allocated among themselves.