LIMITED PARTNER LIABILITY:
A RESPONSE

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Introduction

The rights which limited partners may exercise without imperiling their limited liability was recently addressed in this journal by Mr. Eric Apps.¹ Using my 1983 article as his foil,² he explores the operation of the statutory control test that conditions liability on whether or not a limited partner “takes part in the control of the business”.³ His purpose is to “suggest a framework for the interpretation of the control prohibition . . . which provides a more appropriate reconciliation of the expectations of investors, managers and creditors than the existing legal regime as currently understood”.⁴ For him, this more appropriate reconciliation implies or requires an increased latitude for limited partner control over the affairs of the partnership.

My original analysis was explicitly grounded in public policy.⁵ It is a standard legal principle that actors bear the cost of the adverse consequences of their conduct.⁶ The purpose of this rule is to regulate risk-taking. To the extent actors are insulated from the full cost of their risk-taking, they

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⁴ Apps, loc. cit., footnote 1, at p. 614.
⁵ Flannigan, loc. cit., footnote 2, at pp. 306-321.
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have an incentive to take greater risks. There is no legal relationship or structure that allows this to occur, or to occur without some compensating adjustment. Thus, the general law of contract and tort operate on the basis of this risk regulation policy, as does the derivative general law of partnership. The doctrine of vicarious liability applies this policy in the employment and agency contexts. On the same basis, the corporation is made liable for its conduct to the full extent of its property. Shareholders are granted a qualified limited liability, but because of this change in the default liability rule, the corporation is subjected to extensive statutory regulation.

It is this public policy of risk regulation that requires the ascription of general liability to limited partners who control. The actor who exercises control (either alone or as part of a group) determines the level of risk associated with a particular enterprise. That level has traditionally been that which corresponds to risk-taking constrained by the knowledge of general responsibility. If limited partners could control while still retaining their limited liability, this constraining factor would not operate, and their risk-taking would be insulated or unregulated.

Apps takes issue with my policy analysis and seeks to replace it with a different approach. By the process of analogy, he would assimilate the positions of limited partners and shareholders. His thesis 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


8 It is qualified because the corporate veil may be pierced or the shareholder may be found to be a principal in an agency relationship with the corporation. See R. Flannigan, Corporations Controlled by Shareholders: Principals, Agents or Servants? (1986-87), 51 Sask. L. Rev. 25 (reprinted (1990); 5 Sec. & Corp. Reg. Rev. 66).


Separation of ownership and control demands copious provisions for the protection of the members against the controllers (the managers and directors); limited liability demands copious provisions for the protection of creditors; and the possibility of a public offering demands copious provisions for the protection of the public as potential investors. Hence the length and complications of company law. (Emphasis added).

10 In the vicarious liability context, see Flannigan, loc. cit., footnote 7, at pp. 31-35.

11 Control, in this context, means the ability to take risks. That is only possible where a limited partner has the ability to affect the employment of the partnership assets. Accordingly, the test for permissible limited partner rights is whether or not they allow the limited partner to affect the employment of the partnership assets. This definition corresponds with the common understanding of what it means to control. Any rights which offend this test of control are objectionable unless they are otherwise sanctioned by the legislation.
prohibition is currently perceived to impose”.\textsuperscript{12} Apps, it will become apparent, does not deny the control test all scope of application. His object, rather, is to contain it within what he regards as narrower boundaries. He believes this to be justified by his corporate analogy, in which context he understands there to be a greater degree of investment protection.

Before responding to the details of Apps’s arguments, a number of preliminary observations are in order. The first is that the discussion in my original article understated the significance of the risk regulation policy. There I identified voluntary creditors as the group prejudiced by limited partner control.\textsuperscript{13} In fact, there are two other parties to consider. Subsequently, in the vicarious liability,\textsuperscript{14} business trust\textsuperscript{15} and corporate agency\textsuperscript{16} contexts, I have explained how insulated or unregulated risk-taking increases the probability of loss to involuntary creditors (tort victims). The jurisprudence in each of these contexts indicates that those who control will be held generally liable. This represents an additional application of the risk regulation policy. Apps omits any consideration of involuntary creditors.

The other party is the general partner in a limited partnership. General partners are fully liable for the debts of the partnership. They are therefore uniquely affected by the unregulated risk-taking of limited partners. They are the first to bear the loss from that risk-taking. That is why, where general partners are something more than corporate shells, they would be reluctant to agree to limited partner control. Contrast, in this respect, the position of corporate directors who, like shareholders, have a qualified limited liability and are therefore not similarly affected by shareholder control. This represents an initial conceptual difficulty with the corporate analogy. Apps does mention “managerial autonomy” in his discussion, but he does not develop that notion to any extent, nor does he address this particular consideration.\textsuperscript{17} Apps seems to assume that, but for the control test, limited partners would be able to extract from the general partner significant powers to control the business. However, where the general partner is a non-trivial entity (as we must assume), the prospect of bearing the costs of an insulated risk set is a substantial disincentive to part with control. Thus, the effect on the general partner indicates that independent limited partner control rights are not fairly

\textsuperscript{12} Apps, \textit{loc. cit.}, footnote 1, at p. 614.
\textsuperscript{13} Flannigan, \textit{loc. cit.}, footnote 2, at pp. 308-309.
\textsuperscript{14} Flannigan, \textit{loc. cit.}, footnote 7.
\textsuperscript{16} Flannigan, \textit{loc. cit.}, footnote 8.
\textsuperscript{17} \textit{E.g.}, Apps, \textit{loc. cit.}, footnote 1, at pp. 614, 633.
imposed on a mandatory basis and would be difficult to acquire on a permissive basis.\(^\text{18}\)

The control test responds to all three of these risk-taking effects (on voluntary creditors, involuntary creditors and general partners). At the same time, the statutory regime does not require that limited partners forego all control. They are granted a degree of negative control in the form of veto rights over a number of significant matters. In this way, and others, limited partners are provided with investment protection. Any proposal to alter this statutory accommodation by increasing the permissible scope of limited partner control would have to address explicitly the various risk-taking effects.

The second observation is that this issue also arises in the business trust context. The question is again what rights the investors (beneficiaries) may exercise without losing their limited liability. As in the case of the limited partnership, a control test is utilized. The issue has been the subject of an extended debate between myself and Mr. Maurice Cullity.\(^\text{19}\) The trust argument is also premised on the operation of the risk regulation policy. Cullity does not expressly contest this policy, although his conclusion that beneficiaries can exercise virtually complete control is inconsistent with it. Instead, he argues that the control test is not supported by the Anglo-Canadian jurisprudence. With this I disagree. Apart from that, as will appear, our discussion has some relevance to the limited partnership question. The initial implication for Apps, however, is to give rise to a further concern over the appropriateness of the corporate analogy he employs. The business trust is virtually identical, in terms of structure, to the limited partnership.\(^\text{20}\) This suggests, if we are to use the analogy technique, that the business trust would be a more suitable model.

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\(^{18}\) Apps, ibid., at p. 645, states that management (the general partner) uses "the liability threat as a means of unilaterally altering the balance of power in such negotiations [over limited partner rights] in its favour". This is understandable (assuming the general partner is not genuinely concerned with the liability exposure of the limited partners) once it is realized that the general partner is the first to bear any loss occasioned by the insulated risk-taking of the limited partner.

\(^{19}\) The most recent contribution to the debate is R. Flannigan, Beneficiary Liability and the Wise Old Birds. This paper was presented at the First International Conference on Equity held in Jerusalem in June 1990, and is published in book form in Equity and Contemporary Legal Development (Hebrew University, Jerusalem), pp. 275-301.

The final preliminary observation is perhaps of greatest interest to those lawyers who must negotiate or draft the terms of limited partnership agreements. The argument Apps makes is a normative one. He recognizes that his interpretation of the control test is different from the "existing legal regime as currently understood". This is confirmed by his rejection of Haughton Graphics Ltd. v. Zivot as "quite simply a bad case with little persuasive merit". This case, which ended only when the Supreme Court of Canada declined leave to appeal, is the only modern Canadian decision on limited partner liability. The result of the case is potentially a restrictive one for limited partners, but it is neither an untenable nor unprecedented decision. The laconic critique offered by Apps hardly demonstrates that the conclusion of the three courts involved was perverse. If anything, the decision merely manifests the judicial (and public) discomfort with insulated risk-taking. It is clear, in any event, that Apps is arguing for what the law should be, not what it is. His position is that the control test bears another, more appropriate, interpretation. That is what we now proceed to investigate. However, given that this is admitted to be a normative claim, it would be an imprudent solicitor who insisted on the kinds of limited partner rights Apps is advocating.

I. Origins and Jurisprudence

Apps begins his historical review of the English experience with the flat assertion that the limited partnership is "a hybrid or intermediate form of business organization deriving its origins from the long established legal principles applicable to both partnerships and corporations". It is unclear, in the first instance, how this claim supports the assimilation of the position of limited partners to that of shareholders rather than, obviously, that of general partners. Apart from that, it should be apparent that the "hybrid" and "assimilation" arguments are in fact opposed to one another. The assertion of hybrid status is an assertion of novelty or difference. It presumes that the legislature intended to create something sui generis. It follows that assimilation back or across to one of the supposed bracketing (parent) structures is a flawed analytical strategy. The proper approach is to analyze the limited partnership on its own terms. When this is done, the legal structure of the limited partnership is understood to be the natural con-

21 Apps, loc. cit., footnote 1, at p. 614.
23 Apps, loc. cit., footnote 1, at p. 633.
24 The decision would be a restrictive one if it absolutely prevented limited partners from being directors, officers and shareholders in a corporate general partner. It is not clear that it has this effect. (See Flannigan, loc. cit., footnote 2, at pp. 315-316, 332-334, for a discussion of the American cases and an analysis of the problem).
25 Apps, loc. cit., footnote 1, at p. 615.
sequence of the application of the risk regulation policy to the control positions of the respective parties. As I have elsewhere demonstrated, this is consistent with the legal structure of every other traditional form of business organization.26

Apps initially proposes to develop our understanding of the appropriate scope of the control test by reviewing "the evolution of the principle of investor liability as it applies to both the partnership and the corporation."27 In this he does not succeed. The relevance and significance of the historical factors are either poorly understood or simply not developed. For example, the observation Apps makes with respect to investor liability in corporations prior to the advent of general incorporation legislation is that limited liability was illusory where the corporate charter allowed calls to be made to satisfy the corporation's debts. He follows this with the statement that "intermediate entities, such as the joint stock and deed of settlement companies, showed many of the attributes of the corporation", but were "hybrid business forms" because they were treated as partnerships for liability purposes.28 His conclusion is that the law "did not differentiate between undertakings carrying on business as partnerships, co-partnerships, joint stock companies, deed of settlement companies, or even corporations" and that "liability issues were intimately interrelated for all business firms".29 The point of all this, however, is not established. On the face of it, the only implication seems to be that a primitive legal regime does not make liability distinctions. However, even this is inconsistent with Apps' general thesis. The corollary is that a more advanced legal regime would make such distinctions. It would not, in particular, simply assimilate liability consequences through the device of analogy.

The main difficulty with this particular analysis is Apps' failure to appreciate that his conclusion is unremarkable. The organizational features which Apps characterizes as corporate attributes (delegated management, transferable shares) were in fact available to, and utilized by, partnerships.30 Not being peculiar or fundamental to a particular legal structure, these attributes did not alter the partnership status of joint stock or deed of

27 Apps, loc. cit., footnote 1, at p. 615.
28 Ibid., at p. 616.
29 Ibid., at p. 617.
30 It was thought by some that the "Bubble Act" ((1720), 6 Geo. 1, c. 18) had made partnerships with freely transferable shares illegal. This was not clear, however, and even while the statute was in force, free transferability was openly provided for. The repeal of the statute in 1825 (6 Geo. 4, c. 91) laid to rest the idea that partnership shares could not be made freely transferable. This was judicially confirmed in a number of cases. See Garrard v. Hardey (1843), 5 Man. & G. 471, 134 E.R. 648 (C.P.); Harrison v. Heathorn (1843), 6 Man. & G. 81, 134 E.R. 817 (C.P.).
settlement companies. Consequently, the law did not distinguish between “partnership, co-partnership, joint stock companies, [or] deed of settlement companies” because there was no distinction to be made. They were all partnerships. The corporation was also a “partnership” in this liability sense because, under the call provisions, the shareholders had *contracted* for general liability. It was only when call provisions were eliminated from corporate charters that the different default liability rule for shareholders distinguished the corporation from the partnership. Accordingly, when understood in this way, Apps’ analysis has no implication of any kind (in his favour) for the “appropriate scope” of the control test.

Apps winds up his discussion of the English “evolution of the principle of investor liability” by glossing over the introduction of general incorporation legislation, incorrectly characterizing the significance of *Cox v. Hickman*, and merely noting the statutory introduction of the limited partnership in England in 1907. Nothing is developed in a way that reveals the proper scope of the control test. Nevertheless, he concludes that “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”. Unfortunately, the content of these insights remains unclear.

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33 The practise of providing for calls in corporate charters had been confirmed in the 1825 statute (6 Geo. 4, c. 91) that repealed the “Bubble Act”. The second section of the statute stated that “it shall and may be lawful, in and by such Charter, to declare and provide, that the Members of such Corporation shall be individually liable, in their Persons and Property, for the Debts, Contracts and Engagements of such Corporation ... and the Members of such Corporation shall thereby be rendered so liable accordingly”. Implicit in this provision is the conclusion that the elimination of call provisions left the members with limited liability.


35 (1860), 8 H.L.C. 268, II E.R. 431 (H.L.). The House of Lords confirmed that profit-sharing was not necessarily conclusive of partnership. Profit-sharing, however, did establish a *prima facie* case that required evidence of some other relationship (such as debtor/creditor) in order to be rebutted. This is a fundamentally different conclusion from the one Apps asserts (loc. cit., footnote 1, at p. 617), “that mere participation in profits was not sufficient, in and of itself, to give rise to liability as a partner”. See the extended discussion of *Cox v. Hickman* in Flannigan, loc. cit., footnote 15, at pp. 76-88.

36 The statutory limited partnership was first introduced in North America by the State of New York in 1822 (N.Y Laws 1822, at p. 259). The first Canadian legislation was enacted for the colony of Upper Canada in 1849 (12 Vict., c. 75). Civil law jurisdictions had recognized the form of the limited partnership from at least the twelfth century.

37 Apps, loc. cit., footnote 1, at p. 619.
The historical record is actually relatively straightforward. The corporation and limited partnership were originally created to serve different purposes. This is confirmed by the fact that the discussion, and subsequent enactment, of both general incorporation and limited partnership legislation occurred contemporaneously in the nineteenth century in England and the United States.\textsuperscript{38} Clearly the legislatures believed they were creating \textit{different} legal structures with \textit{different} practical functions. They created these structures, in each case, by altering the legal treatment of the general partnership. In England, the demand for general incorporation legislation came primarily from the larger partnerships (joint stock companies) with delegated management and transferable shares.\textsuperscript{39} Once it was decided to allow incorporation generally, the method adopted was simply to require these organizations to register their constituting document (the deed of settlement) with the office of the Registrar.\textsuperscript{40} Initially only entity status was granted, creating a corporation with general liability for its members.\textsuperscript{41} Shortly thereafter, however, shareholders were granted limited liability.\textsuperscript{42} This resulted in the modern legal form of the registration corporation.\textsuperscript{43}

The creation of the limited partnership was similarly realized by modifying the legal structure of the general partnership. The evident intention was to make available a legal form through which general partnerships could fund their undertaking by obtaining capital from outside investors in return for a share of the residual claim (net profits).\textsuperscript{44} This was first attempted with Bovill's Act,\textsuperscript{45} and then concluded with the limited partnership legislation.\textsuperscript{46} It involved altering the general partnership form to provide limited liability to investors who shared in profits but remained passive.

\textsuperscript{38} See Gower, \textit{op. cit.}, footnote 34, c. 3.

\textsuperscript{39} And that was the type of organization for which the legislation was intended. See P.W. Ireland, \textit{The Rise of the Limited Company} (1984), 12 Inter. J. Soc. Law 239.

\textsuperscript{40} It must be understood that, while the procedure was simple, incorporation brought with it an extended degree of public regulation.

\textsuperscript{41} An Act for the Registration, Incorporation and Regulation of Joint Stock Companies (1844), 7 & 8 Vict., c. 110. The initial refusal to allow limited liability was probably more a reflection of the fact that this was essentially regulatory, rather than facilitative, legislation.

\textsuperscript{42} An Act for Limiting the Liability of Members of Certain Joint Stock Companies (1855), 18 & 19 Vict., c. 133.

\textsuperscript{43} An Act for the Incorporation and Regulation of Joint Stock Companies and Other Associations (1856), 19 & 20 Vict., c. 45. The 1856 Act incorporated the 1844 and 1855 statutes and instituted the modern non-provisional procedure of registering the memorandum and articles of association (today, the articles of incorporation and bylaws).

\textsuperscript{44} Incorporation was mandatory for partnerships with more than twenty members. Smaller partnerships were permitted to incorporate, but the regulatory requirements, along with the expense of incorporation, were disincentives.

\textsuperscript{45} Partnership (Amendment) Act, 1856, 28 & 29 Vict., c. 86.

\textsuperscript{46} Limited Partnerships Act, 1907, 7 Edw. 7, c. 24.
in the conduct of the business. In this sense, the corporation and limited partnership shared a common (rather than a derivative or serial) origin.

The changes that occurred created distinct legal structures. The main conceptual difference was in the status of the two types of investors. The corporate legislation assumed the shareholders to be the principals of the business. This had been their status in the joint stock company where, in general meeting, they elected governors or “directors” to pursue the undertaking on their behalf. This arrangement was incorporated into the new legislative regime as the basic formal structure, with the shareholders becoming the “owners” of the interposed corporate entity. The limited partnership legislation proceeded on a different basis. The general partners were regarded as the principals of the business. Limited partners were understood to be mere contributors of equity capital with little or no desire (or invitation) to interfere in the conduct of the enterprise. Their contribution was risked in reliance on the commercial ability of the general partners and in exchange for the same limited liability that made corporate investments attractive. In this respect, limited liability appears to have been primarily intended to benefit the general partners (rather than the outside investor *per se*) who feared that outside investment would otherwise flow exclusively to corporations. Essentially the legislation sought to attach a protected capital source to what were otherwise independent undertakings operated by principals with open responsibility.

As it has turned out, the effect of the legislation in the one case was to offer a degree of control along with a relatively secure limited liability; in the other, limited liability was contingent on the continued passivity of the investor. It will be appreciated that this made the corporation a more attractive vehicle even to the passive investor, who could be accommodated within its structure, because of the general preference for a less conditional limitation of liability and because the statutory regulation involved was applied primarily at the corporate, rather than the shareholder, level. Thus, although created subsequently in England, the limited partnership failed to improve on the corporation in its designed function as an investment structure. This is why the limited partnership, in all jurisdictions, has been a rarely used form of organization. It has only been used where externalities, primarily tax shelter considerations,^{47} are sufficiently attractive.^{48} This

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^{47} The traditional advantage has been the flow-through of tax deductions or credits to the individual partners. In the corporation, these are absorbed at the corporate level. The difference is premised on the “aggregate” status of the partnership and “entity” status of the corporation. In this regard, if flow-through taxation is generally permissible, query whether it should be available through types of securities rather than types of business organization.

^{48} See R.C. Banks, Lindley and Banks on Partnership (16th ed., 1990), p. 736. A more recent attraction is its use as a takeover defence. Disincorporation into a limited partnership can entrench management. This use engages the larger controversy over the appropriateness of takeover defences.
historical record, in any event, does not provide any support for Apps' thesis that the positions of shareholders and limited partners should be assimilated. Rather, it establishes the converse, that these forms are, and were intended to be, distinct legal structures. They are, in effect, distinct legal conclusions. The fact that one of them has effectively served the capitalization purposes intended for the other does not compel their theoretical or practical standardization.

The modern history of the limited partnership in the United States began in 1916 when the Uniform Limited Partnership Act (ULPA) was drafted and subsequently adopted by most states. This statute, which also employed the passive investor model, contained the control test now found in the Canadian legislation. The application of this provision by the American judiciary has been relatively consistent in terms of the approach taken. Apps nevertheless purports to establish the need for reform of the control test by finding fault with the judicial analysis. In his view, "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 the decided cases". He does not, however, substantiate this claim with an analysis of the cases. In one sense, it is clear that "the determination must be made on an ad hoc basis". The test is de facto control and the application of that test involves investigating the particular circumstances of a given case (the ad hoc aspect) in order to determine whether the powers actually exercised constitute control beyond that permitted by the legislation. Apps' objection to this approach sits uneasily with his salutary insistence that the analysis of the control test be contextual.

The ad hoc approach has in fact generated "principles of consistent application". We see this in the analysis of Frederick Kempkin, whom Apps regards as having offered "the most sensible way to harmonize the various competing jurisprudential and policy issues". Kempkin also advocates the corporate analogy and he identifies three types or levels of decisions made in corporations. "Structural" decisions are those for which shareholder approval is usually required and include "altering the articles, merger and consolidation in most cases, dissolution, the share contract and the like". "Business policy" decisions are the matters determined, in theory, by the board of directors, involving "dividend policy, investment

50 Apps, loc. cit., footnote 1, at p. 621.
53 Apps, loc. cit., footnote 1, at p. 629.
policy, types of product, pricing, employee benefits, and many others".55
"Ministerial" decisions, made by officers and employees of the corporation,
are concerned with implementing the policy decisions made by the board
of directors. All of these types of decisions are also made in limited
partnerships. In that context, as Kempkin sees it, a number of principles
can be extracted from the cases. The first is that ministerial decision-making
does not attract general liability for limited partners. Business policy decision-
making, on the other hand, does attract liability. I agree with Kempkin
that these are proper conclusions. With respect to structural decision-making,
however, we disagree, at least to the extent that "structural" decisions amount
to control decisions. Kempkin believes that limited partners can participate
in structural decisions. However, he does not find this in the case law,
which in fact suggests otherwise.56 Rather, he looks to the statute (the
1975 version of the ULPA) and to the powers explicitly granted to limited
partners, some of which are structural powers.57 Thus, his conclusion is
unsurprising. Obviously limited partners may exercise the powers granted
to them by the statute. This does not imply, however, that limited partners
can freely exercise other control powers. These specifically identified powers
are simply statutory exceptions to the general operation of the control
test. This leaves us with yet another principle. Together, the three principles
are that limited partners may exercise ministerial powers, but not business
policy or structural control powers unless they are specifically enumerated
in the statute. The American jurisprudence on the ULPA is consistent
with these principles.

The other issue that had attracted a good deal of attention in the
United States was whether or not "reliance" was a further condition for
the imposition of general liability under the ULPA. I addressed this question
in my earlier article and found no statutory, and little judicial, support
for the reliance thesis and no compelling rationale for its operation.58
Nevertheless, the raising of the issue in the 1960s, along with other factors,
led to calls for reform of the uniform legislation.

The ULPA was substantially revised in 1975 and then again in
1985.59 The 1975 changes to the control provision purported to increase
marginally the latitude for limited partner control. However, this was done
in a complex and contradictory fashion, and without a general and
disinterested debate on the implications of increasing limited partner
control, and was generally condemned by academic commentary. The

55 Ibid.
56 Flannigan, loc. cit., footnote 2, at pp. 322-331.
57 Kempkin, loc. cit., footnote 52, at pp. 455-456.
58 Flannigan, loc. cit., footnote 2, at pp. 315-320.
59 Revised Uniform Limited Partnership Act (1976) with the 1985 Amendments,
6 Uniform Laws Annotated (1991 Supp.).
1985 changes were also regarded as insufficiently considered.\textsuperscript{60} As it is, Canadian lawyers need not concern themselves with the difficulties associated with these revisions for they are not applicable here, either directly or indirectly. In that respect, Apps is simply wrong when he states that the limited partnership statute adopted in Ontario in 1980\textsuperscript{61} "drew heavily on the statutory framework established under the revised ULPA".\textsuperscript{62} In fact, in the interests of uniformity, Ontario copied (with very few changes) the Alberta legislation, which, in turn, had been copied from the 1916 ULPA in 1968.\textsuperscript{63} This means that there has been no legislative acceptance in Canada of what Apps regards as "a presumption favouring expanded [control] powers" for limited partners.\textsuperscript{64} This is specifically confirmed by the substantial identity of the control provisions in the three statutes.\textsuperscript{65}

This is where Apps ends his discussion of the origins of the limited partnership and the case law interpreting the scope of the control test. His object had been to support his thesis that limited partners should be entitled to exercise voting rights beyond the constraints the control test is currently understood to impose. Apps, however, does little more than recount the historical events, and then sometimes inaccurately. His analysis simply fails to develop in any deep or even pragmatic way the supposed implications of these events for his thesis.

This brings us to the present day and Apps' discussion of the existing Canadian legislation. Before turning to that discussion, however, it is worth addressing an argument concerning what constitutes modern public policy in this context. Apps refers to one commentator's view that control liability is unfair because, as he puts it, "although appealing from a sense of redistributive justice, [it] seems inconsistent with prevailing social and legal attitudes about the regulation of business firms".\textsuperscript{66} He cites the commentator's statement 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

\begin{footnotesize}
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\item Apps appears to share this assessment of the details of the revised control provision, \textit{loc. cit.}, footnote 1, at pp. 624-627.
\item S.O. 1980, c. 48.
\item Apps, \textit{loc. cit.}, footnote 1, at p. 632.
\item An Act to Amend the Partnership Act, S.A. 1968, c. 76,
\item Apps, \textit{loc. cit.}, footnote 1, at p. 632.
\item The few differences between the Alberta and Ontario statutes with respect to permissible limited partner rights are described and explained in my original article, \textit{loc. cit.}, footnote 2.
\item Apps, \textit{loc. cit.}, footnote 1, at p. 626.
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context defies comprehension”. This view, which is but the most simplistic form of analogy argument, rests on a refusal or inability to investigate how public policy might be implemented in different ways in different structures. It represents a superficial assessment of public policy generally and the corporate legal regime in particular. General responsibility for one’s conduct, as I have already indicated, is indeed a “bedrock principle” of the common law. Its specific application in the business organization context is illustrated by the general liability of sole proprietors, general partners and corporations themselves. Its partial formal modification for shareholders, who are liable to the extent of their contribution, is obtained in exchange for an extensive regulatory regime intended to ameliorate its effects in other ways. Even then, shareholders are held generally liable at common law for their de facto control of the corporation’s business. Moreover, the directors (and officers) of the corporation, who actually manage the business, are personally liable for their managerial conduct in numerous ways. These include liability for negligence, employee wages, taxes, competition offences, environmental offences, breaches of statutory solvency tests and breaches of fiduciary obligation. Thus, in almost every important respect, managerial power is associated with personal liability. This is the true “prevailing social and legal attitude” towards the regulation of business firms.

II. Assessing the Legislation

Apps first examines the existing Canadian legislation for the purpose of demonstrating that its content has been informed by “legal principles . . . fundamental to both corporations and partnerships”. This is intended, paradoxically, to support his corporate analogy thesis. His method is simply to list a number of limited partnership “principles” that are supposedly


68 As a practical matter, influential shareholders are often generally liable because they are required by creditors to secure personally, in one way or another, the significant obligations of the business. This applies to both individual and corporate shareholders and to both large and small corporations. Parent corporations, for example, will often be required to guarantee the liabilities of their subsidiaries. Arranging this security is one way in which the actors contractually re-establish the basic constraint on risk-taking. The prevalence of these security arrangements suggests that the constraint is widely perceived by voluntary creditors to be desirable. Shareholders themselves might offer personal security as a device to signal and bond their disciplined risk-taking.

69 Flannigan, loc. cit., footnote 8.


71 Apps, loc. cit., footnote 1, at p. 634. (Emphasis in the original).
reflective of corporation or partnership principles.72 None of this justifies in any evident way the use of the corporate analogy.

Apps also asserts that the corporate analogy is supported by the "broad range of activities" limited partners can participate in under the legislation.73 These activities are identified as the right to examine into the state of the partnership business and to be creditors, guarantors, employees and advisors.74 Although the relevance of these latter capacities is unclear, the argument Apps seems to be making at this point is that the current legal positions of limited partners and shareholders are similar. However, even assuming the alleged similarity (on matters unrelated to control), how this supports the different argument that the position of limited partners should be further assimilated (on the matter of control) to that of shareholders is never developed.

The one observation Apps does make is that these types of activities "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".75 Nothing in the analysis, however, supports the implicit suggestion that limited partners can assume the same role as shareholders. Apart from that, Apps here appears to have incorporated another radical proposition into his approach. He states that he would "go further than the analysis of Kempkin and suggest that the control prohibition prevents limited partners from making decisions which are the preserve of the board of directors and senior management".76 He appears to have concluded that limited partners cannot participate in either the "business policy" or "ministerial" decisions described by Kempkin. This is a startling proposition. The claim that limited partners cannot perform ministerial functions (make decisions which implement business policy) is a highly restrictive view of limited partner involvement and is directly contradicted by the American cases.77 Apps and I have reversed positions at this point. Nothing in the

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72 Apps' list, ibid., at p. 634, is as follows:
Limited partnerships formed under the LPA have a qualified continued existence. Limited partnerships are entitled to use the acronym "Limited", but only in the name "Limited Partnership". The interest of the limited partner in the property and assets of the partnership is personal property. 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". Limited partners have continuing obligations in the event that they have not contributed the full amount of their capital to the limited partnership. The interests of limited partners are freely transferable. The ability of limited partners and general partners to receive distributions from the limited partnership is subject to solvency requirements.

73 Apps, ibid.

74 See Flannigan, loc. cit., footnote 2, at p. 304, for a comprehensive description of the rights and powers granted to limited partners under the Alberta and Ontario statutes.

75 Apps, loc. cit., footnote 1, at p. 635. (Emphasis in the original).

76 Ibid. (Emphasis in the original).

77 See Kempkin, loc. cit., footnote 52, at pp. 453-454.
risk regulation policy requires that limited partners should be made generally liable, unless their conduct is tortious, for purely ministerial functions.\textsuperscript{78} Apps himself offers no justification for his view. In this instance, his corporate analogy (as he interprets it) has driven him to assert an implausible restriction on limited partners. This is perhaps the danger of applying analogy stripped of policy content.

Apps' next objective is to establish the relationship between the control test and limited partner rights. As I indicated in my earlier article, it is clear that limited partners can negotiate rights in addition to those expressly granted in the legislation.\textsuperscript{79} However, the control test requires that additional rights must be such that they do not allow limited partners to participate in control. This was the substance of my analysis. Apps bypasses this and focuses on my observation that the veto right over acts in contravention of the partnership certificate (in Ontario, the partnership agreement) appeared to be a potential loophole through which limited partners could exercise full control over the partnership business.\textsuperscript{80} He incorrectly characterizes this as the premise from which I proceed to argue that certain kinds of voting rights would amount to participation in control. The actual premise, as my analysis indicates, is the risk regulation policy. Unsanctioned rights are objectionable because they allow limited partners to apply their insulated risk set to the employment of partnership assets.

Apps argues that my analysis ignores the history and content of the legislation. In his view, the control test was designed to regulate "individual" conduct while the veto rights must be regarded as "class" rights.\textsuperscript{81} This novel dichotomy is simply asserted. Its sources in the legislation are not identified, nor is its justification explained. In fact, I am aware of no legislative or judicial support for this view. It is a distinction Apps has fabricated in an effort to support what he insists is the proper relationship between the control test and limited partner rights.

Nevertheless, having fashioned his tools (the corporate analogy and the individual/class dichotomy), Apps proceeds to apply them to define control in the limited partnership context. He states first that a limited partner can exercise voting rights concerning the matters in the veto provision only if "sufficient voting power to carry the day" is not possessed.\textsuperscript{82} This is an odd proposition. Apparently the veto provision, while allowing collective (but unrelated) majority control, prevents individual control (along with the control restriction). That, however, is not what the veto provision

\textsuperscript{78} The primary illustration of this is the general law of agency. The authorized agent is only liable for personal tortious conduct.

\textsuperscript{79} Flannigan, \textit{loc. cit.}, footnote 2, at pp. 309, 323.

\textsuperscript{80} \textit{Ibid.}, at p. 331.

\textsuperscript{81} Apps, \textit{loc. cit.}, footnote 1, at p. 636.

\textsuperscript{82} \textit{Ibid.}, at p. 638.
actually states.\textsuperscript{83} It is a true veto power. This means that the ability to "carry the day" never arises. Accordingly, contrary to Apps' argument, the veto provision is not required to contain its own supposed potential excesses.

The odd manner in which Apps understands the veto provision to operate appears to be a consequence of his belief that limited partners can exercise veto rights by majority vote. His analysis incorporates this belief at a number of points,\textsuperscript{84} but he does not explain it until the end of his article.\textsuperscript{85} He argues that, by consenting to the terms of a partnership agreement containing majority (or special majority) voting rights, 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".\textsuperscript{86} From this he concludes that the exercise of majority approval rights "does not thus give rise to a [veto provision] 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 [the veto provision]".\textsuperscript{87} The flaw in this argument is readily apparent. Apps has simply ignored the control test. The terms of the partnership agreement clearly do not override the mandatory operation of that test.\textsuperscript{88} Thus, if limited partners exercise control rights that are provided in the partnership agreement, but which are not sanctioned by the statute, they will be held generally liable. The veto provision is irrelevant to this

\textsuperscript{83} Section 8 of the Ontario statute, supra, footnote 3, (section 55 of the Alberta statute, \textit{ibid.}) reads as follows:

7. A general partner in a limited partnership has all the rights and powers and is subject to all the restrictions and liabilities of a partner in a partnership without limited partners except that, without the written consent to or ratification of the specific act by all the limited partners, a general partner has no authority to,

(a) do any act in contravention of the partnership agreement [certificate, in Alberta];
(b) do any act which makes it impossible to carry on the ordinary business of the limited partnership;
(c) consent to a judgment against the limited partnership;
(d) possess limited partnership property, or assign any rights in specific partnership property, for other than a partnership purpose;
(e) admit a person as a general partner;
(f) admit a person as a limited partner, unless the right to do so is given in the partnership agreement; or
(g) continue the business of the limited partnership on the death, retirement or mental incompetence of a general partner or dissolution of a corporate general partner, unless the right to do so is given in the partnership agreement.

\textsuperscript{84} Apps, \textit{loc. cit.}, footnote 1, at pp. 638, 641, 644, 645.
\textsuperscript{85} \textit{Ibid.}, at p. 646.
\textsuperscript{86} \textit{Ibid.}
\textsuperscript{87} \textit{Ibid.} (Emphasis in the original).
\textsuperscript{88} The partnership agreement is not in any sense illegal because it provides for unsanctioned control rights. The effect of the control test is only to attach general liability for an exercise of those rights.
unless, of course, it sanctions the particular right. It does not do so unless it is an approval right and is formulated to require "the written consent or ratification of the specific act by all the limited partners". Accordingly, while limited partners can freely exercise any non-control rights by majority vote, they cannot exercise control rights at all, either individually or as a class, unless the rights satisfy the statute or the limited partners are willing to accept the associated social constraint of general liability.

It is perhaps worth emphasizing here that the general and limited partners are free to contract for whatever control arrangement they believe serves their respective interests. The risk regulation policy does not negate this contractual freedom. It does, however, prescribe different default liability consequences, vis-à-vis third parties, for the different control arrangements that might be negotiated. This is done in the public interest to regulate the source of the subsequent risk-taking, wherever that source has been located by the terms of the negotiated arrangement. Risks (even great risks) may be freely taken, but only where the risk-taker is constrained by open responsibility for the losses which may render the undertaking insolvent. In this way, the risk regulation policy disciplines risk-taking, without restricting either its location or nature. The limited and general partners themselves remain bound by the terms of their agreement and can enforce it against each other whether or not it provides for limited partner control.

The remainder of Apps's analysis in this section only begs the question. In his view, "the fact that limited partners as a class are collectively able to influence the management and direction of the limited partnership [which appears to be control] . . . should not, in and of itself lead to a conclusion of control" unless it amounts to control over "business policy". This statement assumes that control other than business policy control is permissible. That, however, is precisely the issue to be decided. Apps adds nothing substantive when he expresses difficulty in seeing how "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". I would have no difficulty with rights which fit that description. However, this picture does not portray the kinds of rights that are at issue here.

Part of Apps' difficulty in this part of his analysis is his formalistic understanding of the basic legal notion of control. I have elsewhere examined the various statutory and common law uses of the control concept. That

89 Supra, footnote 83.
90 Apps, loc. cit., footnote 1, at pp. 638-639. (Emphasis in the original).
91 Ibid., at p. 639.
examination demonstrates that particular control usages have been justified in and by their context. The kind of analysis involved requires an appreciation of the different ways in which control can be achieved and the particular purpose for which a control test is deployed. Apps does not get beyond the formal corporate control context and, in that respect, remains constrained by the limitations of his analogy thesis.

Apps eventually comes to discuss the risk regulation foundation for the control test. He discusses its application only to voluntary creditors, not recognizing its significance for involuntary creditors. His first reaction is that this policy of liability for control is tautological. It is perhaps his phrasing of the policy ("responsibility for liability") that suggests this to him. Of course, the policy is that risk-taking must be regulated by responsibility for its adverse consequences. Internalizing the cost of the consequences (the ascription of liability) is the mechanism through which that regulation is achieved. This establishes what is generally acknowledged to be a primary social constraint on human (and corporate) conduct.

Apps finds my creditor protection analysis "suspect", initially, because of my concern that securities regulators not endanger the limited liability of limited partners by insisting on the inclusion of problematic voting rights in the partnership agreement. However, his only observation in this regard is that "minimum capital and other requirements" would protect the interests of both limited partners and creditors. I agree that minimum capital requirements are intended to have that effect. However, a minimum capital requirement has nothing to do with control. In the same paragraph, Apps observes that the veto provision allows general and limited partners, acting in concert, to "make a host of decisions particularly adverse to a creditor without any input from him". But obviously the issue is not about creditor input. Moreover, the veto provision provides for control in restricted instances, it does not have the scope implied by Apps' "host of decisions". Other than that, however, Apps is perfectly right. The statute permits limited partners to affect the employment of partnership assets to this extent. But that is where it draws the line. Further investment protection is to be secured in other ways.

Apps argues that creditors protect themselves through their assessment of the creditworthiness of the general partner and limited partnership and deal with the risks involved by negotiation. This argument fails to account for involuntary creditors. Apart from that, it fails to recognize that creditors are concerned with who makes the important decisions and the extent

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93 Apps, loc. cit., footnote 1, at p. 640, footnote 132.
95 Apps, loc. cit., footnote 1, at pp. 640-641.
96 Ibid., at p. 641. (Emphasis in the original).
97 Ibid.
to which those persons are bonded by value at risk. Creditors will often seek to arrange or enhance this bonding through contractual arrangements with *those who control*. Apps also seems to think that creditors are protected because general and limited partners "cannot take any personal benefit unless the liabilities of the limited partnership to third parties are satisfied". This is an empty argument because, in practice, the only time the limited liability of limited partners will be questioned is when the limited partnership and general partner are insolvent.

In Apps's view, 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". He states that it would be difficult to quantify relative levels of "risk adversity". But this is only an assertion of empirical failure and, in any event, does not deny the qualitative difference between regulated and unregulated risk-taking. Apps also believes that an equally credible argument can be made that "the risk sets of general and limited partners are exactly the opposite of what I have indicated, given that general partners are often corporations and that a substantial part of the limited partnership's capital is contributed by limited partners." This too is a flawed argument. The corporation's capital is distinct from the partnership capital. As a general partner, the full amount of the corporation's capital is available to creditors. The limited partners are not fully liable in this way. Thus, the risk set of the corporate general partner is regulated by its open financial responsibility while the risk set of limited partners is not. It is also beside the mark to indicate, as Apps does, that "assessments of risk are meaningless without the correlative assessment of returns" and that creditors are powerless to prevent limited and general partners together taking significant risks for high returns. The relevant fact is that, according to their relative risk sets, limited partners would tend to take greater risks at a given return. More fundamentally, the concern is not the level of risk actually engaged (whatever the return). Rather, it is that the taking of the risk is not regulated by responsibility for its consequences.

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99 Others might frame the issue as who is better able to bear or distribute the loss. The risk regulation policy operates (until its utility is exhausted) in advance of a loss-bearing or loss distribution analysis and places the loss with the limited partners. See generally Flannigan, *loc. cit.*, footnote 7.
100 Apps, *loc. cit.*, footnote 1, at p. 641.
103 It is irrelevant that some general partners may be shell corporations. We cannot premise the standard operation of the control test on the possibility of judgment-proof corporate general partners.
104 Apps, *loc. cit.*, footnote 1, at p. 642.
The conclusion Apps reaches at this point in his analysis is that the control test has “very little to do with creditors” and therefore, presumably, risk regulation. However, nothing in his discussion has established this. Instead, his critique tends rather to confirm the risk regulation policy. Not conceding this, of course, Apps must provide some kind of explanation for the existence of the control test. His argument, based on “reasonable creditor reliance”, is that the control test and the name liability provision are “nothing more 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”.

These common law doctrines are regarded by Apps as having a narrow scope of application. That is not the case. Partnership status is established by profit-sharing and either loss-sharing or some participation in control. All of these factors apply to limited partners. Thus, at common law, a limited partnership would almost certainly be characterized as a general partnership. This would occur, moreover, for very limited levels of control, or even no control at all, under the silent partner doctrine, which operates on general principles of partnership. The threshold for partnership status is actually very low in terms of the connections required to meet it. In this sense, the silent partner doctrine goes even further than the control test itself (which at least requires control) in creating general liability. Accordingly, how all this transfers into the statutory context, as a codification, is not clear and Apps has not offered an explanation. It appears to offer only the promise of confusion.

Another difficulty with this view of the legislation is Apps’ “reasonable creditor reliance” rationale. While this can explain liability for holding out, it obviously has nothing to do with the tort and contract liability of silent partners. Voluntary creditors have only relied on the status representation of the disclosed partner and that is why, in Apps’ reliance sense, the disclosed partner is liable. The silent partner, on the other hand, has made no representation to the creditor. Here the reason for both contractual and tortious liability is that the creditor has been subjected to the risk taking of the silent partner. This is simply another manifestation of the risk regulation principle.

The main difficulty with Apps’ argument, however, is that the words of the control test do not restrict (or expand) its scope in the fashion he suggests nor is there any indication in the legislative history of the

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105 Ibid.
106 Ibid., at pp. 642-643.
108 See Pooley v. Driver (1876), 5 Ch. D. 458 (Ch. D.).
109 What is the “reliance” basis for the liability of the disclosed partner to involuntary creditors?
provision to that effect. Apps' argument, which now pursues a "partnership analogy", does not by itself require that we read these common law parameters into the text of the control test.110

III. Defining and Justifying Limited Partner Rights

It is Apps' view that limited partners should be entitled to exercise a greater degree of control over the partnership business. Given that the consequences of this argument are significant, we might have expected him to define that greater control with some care by explicitly identifying which particular matters could be the subject of limited partner voting rights. He has done this in only a partial and ambiguous fashion.111 Apps describes these matters in abstract terms in different ways. In his corporate analogy, they are "those powers which are functionally equivalent to those of shareholders".112 With reference to Kempkin's classification, they are "structural" rights.113 Finally, according to Apps, they are "fundamental changes in the business direction or philosophy" of the partnership.114 When it comes time to describe the actual concrete rights implied by these abstractions, however, Apps is a bit coy. He specifically refers only to the right to remove the general partner and the right to approve extraordinary asset sales. He does not describe which particular matters (other than extraordinary asset sales) would amount to "fundamental changes". This offers little comfort to those who, in practice, must identify specific permissible rights.

The one right for which Apps is most insistent is in fact the most objectionable. An unfettered right to remove is generally regarded by the judiciary as a powerful control instrument.115 The right secures a comprehensive ability to affect the partnership business. It is perhaps the single most effective way to acquire control over the ordinary course (business policy) of the business operation. The scope of control it provides is congruent with the scope of control exercised by the person subject to removal, in this case, the whole of the partnership undertaking. It is a powerful device,

110 Apps offers no evidence to support his argument that the legislation simply codified the common law silent partner and holding out doctrines. Instead, admitting that it is speculation on his part, he proposes, loc. cit., footnote 1, at p. 643, footnote 138, an empirical analysis of the cases "to test this [codification] thesis".

111 The ambiguity in Apps' discussion is illustrated by two paragraphs (at pp. 643-644), in which he describes a variety of rights I had analyzed in my original article. His only comment is that "in circumstances where the partnership agreement provides for alternative methods of dealing with these issues Flannigan's analysis encounters difficulties" (at p. 643). It is unclear whether Apps would regard all of the enumerated rights as permissible.

112 Ibid., at p. 639.

113 Ibid.

114 Ibid., at p. 644.

in this respect, because it is effective in *terrorem*. Its mere existence is sufficient to cause the general partner to accede to what the limited partners suggest or “advise”. Rarely is it necessary to even threaten its exercise. I have explained this in detail elsewhere.\(^{116}\)

The need to secure “managerial accountability” is the main justification Apps offers for allowing limited partners an unfettered right to remove the general partner.\(^{117}\) The difficulty with this justification, at least in the way Apps understands it, is that it is inappropriate in the limited partnership context. The basic premise underlying the legislation is that the general partner carries on business as a principal, financed in part by capital contributed by passive limited partners. An unfettered right to remove is inconsistent with this premise. It is the power to discipline the general partner. Its effect is to establish a relationship of subordination between the parties. The assumption behind the demand for such a right is that it is the limited partners who are the principals, and the general partner merely their agent. This is not an assumption that can be accommodated within the limited partnership form, unless, of course, the limited partners are willing to accept the general responsibility of principals. The legislative structure was instead fashioned in contemplation of the passive investor who relies on the integrity of the general partner and, failing that, on

\(^{116}\) Flannigan, *loc. cit.*, footnote 15, at pp. 112-124.

\(^{117}\) For example, *loc. cit.*, footnote 1, at pp. 614, 639, 644. Apps also believes greater powers are justified because of the “inequality of bargaining power limited partners face” and the “monitoring costs for limited partners of ensuring proper management in the absence of such prophylactic rules” (at p. 644). But Apps does not develop these supposed justifications. They are merely asserted. In fact, there is no basis for the inequality of bargaining power argument. Investors in limited partnerships are typically wealthy individuals or organizations seeking certain tax advantages. In this respect, to the extent that inequality of bargaining power is given some legal significance in the doctrine of unconscionability, the position of limited partners will rarely, if ever, come close to satisfying the threshold level of situational disadvantage. There is also no basis for the monitoring cost argument Apps advances. The absence of control rights simply does not have the effect of creating or increasing monitoring costs. Such costs are incurred in any event, and for monitoring reasons. It will be appreciated, moreover, that nothing in the risk regulation policy prevents limited partners from exercising extensive monitoring powers.

Apps suggests one other ostensible justification in the course of his analysis. Although it is not entirely clear, Apps appears to regard it as fundamentally important that the limited and general partners have negotiated what they believe to be a satisfactory basis for their relationship. As Apps states it, *ibid.*, at pp. 648-649; limited partners should be able to vote on those matters “which they and the general partner have contractually agreed should be subject to review” unless, significantly, it amounts to ordinary course control. It should be apparent that this justification does not take into account the interests of either voluntary or involuntary creditors, who are not party to the partnership bargain. As well, Apps himself would refuse to give effect to the partnership bargain where it provided limited partners with ordinary course control. In this respect, the justification only begs the question since, even for Apps, some other factor determines the extent of its application.
enforcement of the fiduciary obligation requiring the general partner to act in the investor's best interest.

The same view is taken by the United States' Treasury Department when determining whether or not a particular limited partnership possesses sufficient "association" characteristics (specifically, centralized management) to cause it to be taxed in the same way as a corporation. The 1983 Treasury ruling on this subject states that "[a]n unrestricted power to remove a general partner ... tends to show that the general partner is managing the partnership in a representative capacity rather than on the partner's own behalf". The department would only accept the right in a very limited form. The revenue regulations now state that a "substantially restricted right of the limited partners to remove the general partner (for example, in the event of the general partner's gross negligence, self-dealing or embezzlement) would not itself cause the partnership to possess centralized management". The nature of these restricted circumstances is such that control of the business is not facilitated by the removal power. The control potential in these circumstances is insignificant. Constrained in this way, the right to remove does not detract from the principal status of the general partner.

The view that an unfettered right to remove attracts general liability also informs Canadian commercial practice. Some partnership agreements exclude the right entirely. A few imprudently incorporate the completely unfettered right. The majority contain the right, but only in restricted form. Usually this involves making the exercise of the right conditional upon the bankruptcy or dissolution of the general partner or upon the general partner's breach of the partnership agreement. These circumstances are again such as to indicate that, at least ostensibly, the control issue is not engaged. The right has been qualified in such a way as to strip it of

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118 The term "association" refers to "an organization whose characteristics require it to be classified for purposes of taxation as a corporation rather than as another type of organization such as a partnership or trust". Regulations on Procedure and Administration, 26 C.F.R., para. 301.7701.2(a).


120 Regulations on Procedure and Administration, supra, footnote 118, para. 301.7701-2(c).

121 It will be appreciated that individual partnership agreements usually contain a variety of provisions that potentially raise the control issue. Accordingly, an assessment of the actual control arrangement must be a comprehensive exercise. Part of that assessment will involve recognizing attempts to disguise limited partner control. Thus, one partnership agreement, which in form appeared to restrict the right to remove, gave the limited partners the exclusive right to appoint additional general partners at any time and required multiple general partners to act by majority vote. This would allow the limited partners to remove the incumbent general partner from the control of the business. The in terrorem quality of the combined provisions, like the bare right to remove, can be used to exercise de facto control, and if so used, would expose the limited partners to general liability.
its coercive power, rendering it insignificant from a control perspective, while offering a measure of investment protection. This leaves the general partner with the principal status the legislation both assumes and requires.

The absence of a right to remove, it must be appreciated, does not mean that managerial accountability is absent. The major concern with persons who are trusted to act in the interests of others (for example, trustees, directors, general partners), is that they will act opportunistically by shirking, appropriating assets or otherwise diverting value away from the trusting party. The traditional legal response to this possibility is the imposition of a fiduciary obligation. I have elsewhere explained in detail how this obligation is applied throughout the law to maintain the integrity of trusting relationships. The general rule is that the trusted party cannot profit from the fiduciary office. In the present context, this means that the general partner's personal interest in the undertaking cannot be preferred over that of the limited partners (or other general partners). Fiduciary status also requires the trusted party to maintain an even hand amongst those to whom the obligation is owed. This requires the general partner to treat limited partners of the same class equally and limited partners of different classes fairly.

Apps discusses the fiduciary obligation only to deny its value for his purposes. In his view, "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". Apps' denial that the fiduciary obligation is sufficiently comprehensive indicates the sense in which he employs the "managerial accountability" phrase. It is not limited to general partner opportunism. His idea is apparently that full accountability can only be achieved if significant partnership decisions are reviewable by the limited partners. The difference here may be illustrated by reference to one of Apps' remarks. As he sees it, if 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) [sic] without the limited partners' consent". The argument here might have been that limited partners can be oppressed

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124 Ibid., at p. 613.
125 Ibid., at p. 644. (Emphasis in the original).
by fundamental changes that are structured in such a way as to favour the general partner. However, the fiduciary obligation would apply to that kind of abuse. The obligation is comprehensive in this respect. It applies to any form of managerial opportunism or self-service. But this is not Apps’ argument. Rather, his concern is that these decisions are made without limited partner consent, even where they are treated equally or (for different classes) fairly by the general partner when the decision is implemented. Essentially, Apps is equating investment protection with investment control. Limited partners are protecting their investment, in this sense, through their ability to second guess the decisions of the general partner. This is the effect of the right to remove. However, as we have seen, this kind of investment protection conflicts with the presumed principal status of the general partner and allows the insulated risk set of the limited partners to affect third parties.

Most of the other rights Apps would permit limited partners, although not specifically identified, appear to be included within his description of approval rights over “fundamental changes in the business direction or philosophy” of the partnership. As it is, the existing legislation explicitly takes into account the prospect of fundamental change in both a mandatory and permissive way. The legislation provides for negative control over the matters enumerated in the veto provision, a number of which are illustrations of fundamental change. Subsection (b), which states that a general partner has no authority to “do any act which makes it impossible to carry on the ordinary business of the limited partnership”, is of particular interest. It would appear to prevent such fundamental changes as a merger or the sale of substantially all of the partnership assets. The limited partners individually have this control whether or not they could otherwise negotiate it.

The permissive way in which the legislation deals with fundamental changes begins with the bargain made between the limited and general partners. If the limited partners believe their interests are served by restraining the general partner’s ability to make fundamental changes in the “business direction and philosophy” of the partnership, they can negotiate an objects clause that carefully describes the partnership business. This description would be included in the filed statutory declaration or certificate that creates the limited partnership. Thereafter, the general partner could not institute a fundamental change in the nature of the business carried on without first obtaining the unanimous consent of the limited partners. This is required by the veto provision which states that the general partner has no authority

126 The Supreme Court of Canada has not always appreciated the significance and scope of the fiduciary constraint. See R. Flannigan, Fiduciary Obligation in the Supreme Court (1990), 54 Sask. L. Rev. 45.

127 Alberta: The Partnership Act, supra, footnote 3, s. 55(b); Ontario: The Limited Partnership Act, ibid., s. 8(b).
to “do any act in contravention of the partnership agreement [or, in Alberta, the certificate].”

Proceeding without consent would be both a breach of statute and a breach of contract.

In these two respects, the current legislation goes a long way towards meeting Apps’ demand for fundamental change rights. At the same time, however, because the legislature recognized that insulated control affected other parties (voluntary and involuntary creditors, general partners), it chose not to extend limited partner control beyond these matters. That is the purpose of the control test. In this way, taking into account all the applicable interests, the legislature defined a specific scope within which limited partners could regulate fundamental change initiated by the general partner. If a proposed fundamental change is not governed by the terms of the veto provision, the alternative for limited partners who disagree is either to sell their interest or seek dissolution of the partnership, both of which are provided for in the legislation. As I indicated in my original article, this regime also has the effect of preventing a majority of limited partners from oppressing the minority. This is because they are either not entitled to control or because the control they are permitted has a unanimity requirement.

Apparently, however, even this statutory accommodation is insufficient for Apps. He appears to regard this scope of limited partner control as unnecessarily restrictive, although it is unclear what additional rights he would permit. He would also object to the unanimity requirement, although it is again unclear why, in the limited partnership context, unanimity is inappropriate. In any event, to alter this regime, he would have to offer a plausible argument for its reform. He would have to describe the precise nature of any additional rights and explain how their availability establishes a more appropriate balance amongst all of the affected parties. This he has not done.

Conclusion

Apps has not justified his thesis in substantive policy terms. It is not enough to assert that limited partners should be in the same position as corporate shareholders. That is only a conclusion requiring an independent justification. The proposition is in fact a dangerous one for those who employ this vehicle. It may have the effect of destroying the tax shelter function for

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128 Alberta: The Partnership Act, *ibid.*, s. 55(a); Ontario: The Limited Partnership Act, *ibid.*, s. 8(a).

129 The exit option will be restricted if there is no real market for the units (presumably this will be reflected in the price of the unit). Limited partners can increase their exit options *ex ante* by negotiating for redeemable units or dissent and appraisal rights or by investing only in the listed units of public limited partnerships.

which limited partnerships are today most often used. Assimilating the two structures may lead to the taxation of the limited partnership as a corporation, as has recently occurred in the United States for publicly traded limited partnerships.\(^\text{131}\) The only plausible theoretical justification for taxing corporations and limited partnerships differently is that they are different structures.\(^\text{132}\) The limited partnership is a vehicle through which general partners with general liability can offer limited liability to passive equity investors. The corporate structure contemplates a greater degree of investor control, but this is premised on a different conception of the status of the investor and carries with it a greater degree of public regulation. There are tradeoffs involved here. Apps has not established that these tradeoffs are meaningless.

The limited partnership, at least in the liability sense, is a contextualized business organization. It accommodates whatever \textit{de facto} relationship the parties choose to negotiate. If limited partners choose to arrange principal status for themselves, they will be treated as such and bear the corresponding general responsibility. If they instead create a relationship akin to a trust, they will secure the associated limited liability. When understood in this way, the function of the control test becomes apparent. It determines the point at which a person will be regarded as a principal, rather than a passive beneficiary of a principal’s effort. We can then appreciate why a right to remove, or extended control rights over fundamental changes, should result in general responsibility. These kinds of rights are the rights of principals. Apps’ attempt to shift the point of operation of the control test is objectionable for precisely this reason. “Managerial accountability”, as he employs that phrase, is the accountability owed to a principal. It is that very accountability (or control) which, in turn, generates the open responsibility of a principal to third parties.

None of the foregoing, it must be appreciated, forecloses a reassessment and revision of the current limited partnership legislation. The existing regime is a construction which we are free to alter as we see fit. The question here is whether Apps has established a basis for reform of the control test. I do not believe he has done so. He has not demonstrated the practical need for reform, he has not proposed a definite plan of reform (that is, specific permitted rights), he has not accounted for all the parties


\(^{132}\) The entity/aggregate distinction (see supra, footnote 47), is a legal abstraction that has little to do with the real economic bases of tax obligation. Arguably, however, different taxation regimes would be justified if the social costs of each organizational form were different. The loss externalization associated with limited liability, which is ultimately a cost to the state, would justify a greater tax burden on limited liability structures (to recoup the state’s greater expenditure). The difference in the liability features of the corporation and limited partnership might theoretically justify a further distinction in their respective tax burdens.
affected by reform and, most important, he has not established that the risk regulation basis of the legislation is misconceived. A bare appeal to "investment protection" is all that he offers. Without justification, that is but unhelpful rhetoric. Nevertheless, it may still be worthwhile for an appropriate law reform agency to consider whether or how the position of limited partners might be clarified having regard to the other interests involved. My concern is only that we understand how the existing legislation reflects extant public policy and that we not depart from this legislative scheme until we are satisfied that a more precise implementation of that public policy is possible or we are convinced that the public attitude towards insulated risk-taking outside the regulated corporate law context has somehow changed in a demonstrable way. My own sense is that a strict application of the fiduciary obligation will do more to protect limited partners than any specific tinkering with their permissible control rights.