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Proposed Regulation of Limited Partnership Investment Programs

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PROPOSED REGULATION OF LIMITED PARTNERSHIP INVESTMENT PROGRAMS

Although the limited partnership is not a new development in American law, the popularity of this type of enterprise organization has increased dramatically in recent years, particularly as a vehicle for investment in real estate and oil and gas syndication. Investors desiring maximum return on venture capital have discovered that certain limited partnership investment programs can offer them "flow through" tax shelter advantages, substantial capital leverage, and limited liability, while saddling them with virtually no management responsibility. Unfortunately, general partners have simultaneously discovered the windfalls available through exploitation of nonmanaging limited partners. This exploitation is achieved by means of abusive practices typically including adhesion contracts, general partners' engaging in...
conflicts of interest, and misleading promotional and statistical presentations.\(^5\)

Limited partners have long been admonished to scrutinize potential investments;\(^6\) this advice is often ignored, however, by investors eager to reap quick profits. Furthermore, the proliferation of limited partnership interests in a single enterprise diffuses the focus of investor vigilance and increases the potential for undetected abuses. Thus a need for regulation, either governmental or private, has developed. Currently the Uniform Limited Partnership Act and blue sky laws provide some control of limited partnership abuses at the state level. On the interstate level, the Midwest Securities Commissioners Association, the National Association of Securities Dealers, and the Securities and Exchange Commission (SEC) have programs or proposals which address these abuses.\(^7\) This article analyzes these existing and proposed programs in terms of the competing interests of general and limited partners.

I. ADVANTAGES OF THE LIMITED PARTNERSHIP FORMAT OVER THE CORPORATE FORMAT

The motivation for investing venture capital in a limited part-

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\(^6\) Francis Troubat, in one of the earliest definitive works on the American limited partnership, recognized the necessity for care in selecting a general partner:

Do you know your intended general partner? Have you read his soul and compassed the calibre of his mind? Disaster will be sure to attend you, if you fall into the hands of a man who is without a deep sense of probity, and without the judgment and talent adequate to manage your property for your mutual benefit.

F. TROUBAT, THE LAW OF COMMANDATARY AND LIMITED PARTNERSHIPS IN THE UNITED STATES I (1853).

\(^7\) Midwest Securities Commissioners Association, Statement of Policy Regarding Real Estate Limited Partnership, CCH 1972 BLUE SKY L. REP. NO. 458 [hereinafter cited as MSCA]; NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., TAX SHELTERED PROGRAMS, PROPOSED ARTICLE III, SECTION 33 OF RULES OF FAIR PRACTICE AND PROPOSED REGULATIONS TO BE ADOPTED PURSUANT THERETO (1972) [hereinafter cited as NASD]; SEC PROPOSED LEGISLATION, REGULATION OF OIL AND GAS PROGRAMS, CCH 1972 FED. SEC. L. REP. NO. 428 [hereinafter cited as SEC]. The NASD is an organization of over-the-counter securities dealers which regulates itself under the supervision of the SEC. Established by the Maloney Act (Section 15A of the Securities Exchange Act of 1934, 15 U.S.C. § 78o(3) (1970)) in 1938, the NASD offers members participation in investment banking and over-the-counter securities business on a preferential basis in exchange for their adherence to standards of ethical conduct established by the NASD. The SEC may review and overrule any NASD rule and may suspend or revoke its registration if it fails to enforce compliance with those rules. CCH 1971 NASD MANUAL ¶¶ 101, 102, 107.

The MSCA is an association of state securities administrators of the twenty-four member states. A policy statement of the MSCA represents the consensus of the administrators of member states and is not binding on the individual member state unless it is expressly adopted or followed by the individual state. CCH 1969 BLUE SKY L. REP. ¶ 4751.
nership rather than in a corporation arises from the fact that the former can offer tax shelter advantages and capital leverage as well as limited liability.

A. Income Tax Advantages

In the corporate setting revenues may be taxed twice: as income to the corporation and as dividend income to the shareholder upon distribution. A limited partnership, however, is treated as a conduit through which income passes for taxation at the individual level. Therefore, the limited partner avoids the double taxation that distributed earnings of the enterprise suffer in the corporate setting, and he may deduct his share of the partnership expenses against his individual income from whatever source.

A very valuable framework of large deductible expenses may be developed from accelerated depreciation on buildings purchased or built by real estate syndications, or through prepaid drilling expenses in oil and gas programs. By being offset against gross income, these deductible expenses can shelter the cash flow generated from an enterprise. The enterprise may in fact be profitable, although on paper it generates no taxable earnings.

Moreover, if initial deductible expenses are sufficiently high that a loss is generated, the amount of the loss may be set off against an investor's income from other sources. Finally, even upon bankruptcy, which can occur even though the partnership is solvent, the limited partner loses only his investment and is entitled to an ordinary loss deduction in the amount of the adjusted basis of his investment.

\[\text{INT. REV. CODE OF 1954, §§ 1, 11, 61. The validity of this comparison assumes that the participants in a real estate or oil and gas investment program would distribute all profits and thereby incur double taxation. Although this enterprise could take the form of a Subchapter S corporation, id. §§ 1371-1379, the availability of this option is restricted to groups of ten or fewer members. Since the proposals to be evaluated herein are concerned primarily with programs of greater size, see notes 52 and 53 infra, it is not particularly useful to compare the advantages of limited partnerships and Subchapter S corporations.}\]

\[\text{INT. REV. CODE OF 1954, § 701.}\]

\[\text{id. §§ 702, 703.}\]

\[\text{id. § 167.}\]

\[\text{id. § 263(c).}\]

\[\text{In other words, the cash receipts earned, while less than total expenses on paper, may exceed actual out-of-pocket expenditures.}\]

\[\text{INT. REV. CODE OF 1954, §§ 702, 703. A more complete description of the tax advantage may be found in Content, Tax Aspects of Real Estate Syndications, in Institute of Continuing Legal Education, Creative Real Estate Financing 145, 158 (1968).}\]

\[\text{If all the general partners are adjudged bankrupt, the partnership will also be adjudged bankrupt. See 11 U.S.C. § 23(i) (1970).}\]
partnership interest even though it exceeds the amount of his capital account on the partnership books.\textsuperscript{16}

There are, however, countervailing considerations. Cash flow distributed in excess of a limited partner's basis\textsuperscript{17} will result in income taxable to him,\textsuperscript{18} and partnership losses in excess of the investor's basis are not currently deductible\textsuperscript{19} although they may be recognized upon sale of the partnership interest.\textsuperscript{20} Furthermore the tax shelter effect suffers from the limitations on the kinds of real estate which can be depreciated at an accelerated rate,\textsuperscript{21} from the recapture of depreciation under Section 1250,\textsuperscript{22} and from the additional surtax on the accelerated depreciation as a tax preference item.\textsuperscript{23} While new residential rental property may be depreciated at a rate of 200 percent declining balance\textsuperscript{24} and low income rental housing may be fully depreciated in five years,\textsuperscript{25} nonresidential property can be depreciated at a maximum of 150 percent declining balance.\textsuperscript{26} Furthermore upon disposition of this property, the accelerated portion of the depreciation (above straight line) must be recognized as gain to the limited partner.\textsuperscript{27}

Although these restrictions would seem to suggest the elimination of the substantial tax shelter benefits of the limited partnership, careful advance planning will preserve significant tax savings if the sale of a partnership interest is coordinated with the point where cash flow and Section 1250 recapture will result in the least taxable income.\textsuperscript{28}

B. Capital Leverage

An investor who purchases an interest in a partnership under a


\textsuperscript{17} The basis for a partner's interest in a partnership is his basis in the property he contributes plus his share of the partnership liabilities. Each partner's basis is increased annually by his distributive share of the enterprise's income and reduced annually by distributions received from the partnership and by his distributive share of partnership losses. \textit{See Int. Rev. Code of 1954}, § 705.

\textsuperscript{18} \textit{Id.} § 751.

\textsuperscript{19} \textit{Id.} § 704(d).

\textsuperscript{20} \textit{Id.} § 704(d); \textit{Treas. Reg.} § 1.752-1(e) (1956).


\textsuperscript{22} \textit{Id.} § 1250.

\textsuperscript{23} \textit{Id.} §§ 56–58. In 1969 Congress defined certain advantages as tax preference items and for succeeding taxable years imposed a surtax of 10 percent on the excess of these items over an amount determined under a statutory formula, \textit{id.} § 57. Among these tax preference items are accelerated depreciation on real property, \textit{id.} § 57(a)(2), and percentage depletion. \textit{id.} § 57(a)(8).

\textsuperscript{24} \textit{Id.} § 167(j)(2).

\textsuperscript{25} \textit{Id.} § 167(k).

\textsuperscript{26} \textit{Id.} § 167(j)(1).

\textsuperscript{27} \textit{Id.} § 1250.

\textsuperscript{28} \textit{See} Content, \textit{supra} note 14, at 165, 166, for a detailed graphic explanation of how to accomplish the coordination of sale within minimum tax expense.
deferred payment option may benefit from capital appreciation much the same way he might when buying stock on margin. One author has given the following explanation of the leverage feature:

Leverage results when an individual acquires his limited partnership “interest” under an agreement resembling an installment contract. His initial contribution is usually to a pro rata share of the down payment on the purchase price of the land, plus related expenses. Subsequent contributions made periodically are used to pay the balance owing on the property. Assuming the fair market value of the land appreciates quickly and the land is sold before the full purchase price is paid, the limited partner realizes a substantial profit upon his minimum investment.29

The leverage advantage in interstate programs is subject, at least in the immediate future, to a fatal restriction established by the Federal Reserve Board’s interpretation of Section 7(a) of its Regulation T,30 which in effect prevents a broker/dealer from arranging credit on terms more favorable than he himself could grant to his customers if he sold partnership units on a periodic payment basis.31 Any utilization of deferred payments is effectively restricted to intrastate programs which undoubtedly will increase in economic significance as these programs respond to the availability of the intrastate exemption in the Securities Act of 193332 to escape not only Regulation T but also planned federal regulation by the SEC.33

C. Limited Liability

Under the Uniform Limited Partnership Act, a limited partner is liable for limited partnership losses only to the extent of his investment.34 General partners too may achieve limited liability

29 Braislin, supra note 5, at 79.
30 12 C.F.R. § 220.7(a) (1970) reads:
A creditor may arrange for the extension or maintenance of credit to or for any customer of such creditor by any person upon the same terms and conditions as those upon which the creditor, under the provisions of this part, may himself extend or maintain such credit to such customer, . . .
31 “The act [Section 7(c) of the Securities and Exchange Act of 1934] and § 220.7(a) also provide in substance that any such broker or dealer shall not arrange for any extension or maintenance of credit on unregistered securities.” 12 C.F.R. § 220.109 (1972).
33 See SEC, supra note 7.
34 ULPA § 1. This limited liability, however, may be lost if the limited partner’s name appears in the partnership name (id. § 5(2)), if the limited partner knows of a false statement in the certificate which is relied upon by another party to his detriment (id. § 6), or if the limited partner takes part in the control of the business (id. § 7).
by incorporating the general partner, thus eliminating all individual liability of any participant in the enterprise. Such an arrangement, however, may be subject to attack by the Internal Revenue Service. Treasury Regulations state that if an organization qualifies as a limited partnership under local laws it may be classified for tax purposes either as an ordinary partnership or as an association. If classified as the latter the program will be given corporate tax treatment.35

II. POTENTIAL ABUSES BY GENERAL PARTNERS

The reverse side of the advantages of limited partnership is the potential for general partners to abuse this form of enterprise organization to the detriment of limited partners. These abuses

However a person believing himself to be a limited partner does not become subject to general partner liability if he promptly renounces his interest in the partnership profits. See id. § 11. Notwithstanding Section I an investor should be sure that the general partner's liability to creditors is not effectively passed to him through the device of mandatory assessments couched in the language of the program contract. For a further discussion of the mandatory assessment, see note 37 infra.

35 In analyzing an organization's status the Internal Revenue Service applies a four-part test. If it finds that more than two parts of the test are satisfied, the entity will be characterized and taxed as a corporation. The four corporate characteristics constituting the elements of the test are as follows:

(1) Centralized Management — An organization has centralized management if any person (or any group of persons which does not include all the members) has continuing exclusive authority to make management decisions necessary to the conduct of the business for which the organization was formed. A limited partnership which has a substantial portion of its interest held by nonmanaging limited partners obviously does have centralized management. Treas. Reg. § 301.7701-2(c)(1) (1960).

(2) Limited Liability — An organization has the corporate characteristic of limited liability if under local law there is no member who is personally liable for the debts of or claims against the corporation. To prevent the partnership from being attributed with the corporate characteristic of limited liability, a corporation acting as the general partner must have substantial assets other than those in the partnership program. Treas. Reg. § 301.7701-2(d)(1) (1960). The Commissioner has specifically defined what is meant by a corporation having substantial assets. If the limited partnership has total contributions of $2,500,000, the corporate general partner must have a net worth equal to the lesser of 15 percent of contributions or $250,000. If the total program contributions exceed $2,500,000, the corporation must have a net worth of at least 10 percent of contributions. In addition the limited partners in aggregate may not own either directly or indirectly more than 20 percent of the corporation. Int. Rev. Svc. Rev. Proc. 72-13, 1972-2 INT. REV. BULL. 26.

(3) Continuity of Life — An organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization. Thus a partnership does not have continuity if it ceases to exist upon the death of the general partner or at any other specific point in time. Treas. Reg. § 301.7701-2(b)(1) (1960).

(4) Free Transferability — An organization has the corporate characteristic of free transferability of interests if each of its members who collectively own substantially all of the interests in the organization has the power, without the consent of other members, to substitute for himself a person who is not a member of the organization. A requirement that the general partner must approve all transfers of interest by limited partners provides sufficient restraint to avoid this element of the test. Treas. Reg. § 301.7701-2(e)(1) (1960).
can be categorized as arising from unequal bargaining power conducive to adhesion contracts, from manipulation of management power, and from other miscellaneous causes related to misstatement or withholding of information.\textsuperscript{36}

\section*{A. Abuse by Contracts of Adhesion}

The popularity of limited partnerships has led to mass-marketing techniques for these programs generating reduction in the price of individual partnership interests and a concomitant increase in the number of investors. This development enhances the bargaining position of the general partner, and exploitation of this favorable position is illustrated in some of the terms common in limited partnership agreements. Mandatory assessment clauses conditioned upon cost overruns or other misfortune are a typical example.\textsuperscript{37} A clause of this nature effectively insulates the general partner from the risk of loss from his own poor management. In effect it is the investor's waiver of his limited liability. Penalty provisions dictating loss of future participation rights or outright forfeiture of partnership interest have been included to encourage compliance with such mandatory assessment clauses.\textsuperscript{38} Another manifestation of the abuse of the general partner's bargaining power is the blind pool limited partnership arrangement. In a blind pool, the limited partnership agreement imposes no limitation on the specific usage of the funds invested. This gives the general partner the broadest possible discretion and is recognized as among the highest risk ventures in the tax shelter area because it permits the general partner to invest in any assets he desires, thus giving him the opportunity to invest the funds of others in assets he owns either directly or indirectly.

\section*{B. Manipulation of Management Prerogatives}

Conflicts of interest may also precipitate abuses by general partners effected through their control of the management process. As one commentator has explained, the general partner

\textsuperscript{36} The discussion which follows is by no means exhaustive; it does however provide a perspective from which to evaluate recent regulatory proposals of private and public officials. Since the general partner often performs the functions of syndicator, promoter, and broker, all of whom have an identity of interests distinct from that of the limited partners, references to any party associated with the limited partnership other than limited partners should be construed as synonymous with a reference to the general partner in the discussion of these proposed regulations.

\textsuperscript{37} The assessment clause typically enables management to obtain on demand an additional amount of capital from the limited partner beyond his subscription commitment.

\textsuperscript{38} Braislin, supra note 5, at 89.
purchasing and selling land or other assets for the partnership can often manipulate purchase and sale prices. If the property is sold to the limited partnership by a land company affiliated with the general partner, he can determine the total price that the investors will be obligated to pay. If this price is more than the land company paid, the difference represents income to the land company and the general partner. Moreover, the general partner can also control the price of land as it leaves the limited partnership. For example, if the general partner authorized a purchase from the land company at a high estimated value and sale to the (affiliated) development company at a low estimated value, the limited partnership would show a relatively small profit and the limited partners would be deprived of their fair share of the land value appreciation. In addition, those investors who depend on leverage, expecting the property to be sold before more than a fraction of their monetary obligation accrues, can be sorely disappointed by the general partner who continues to hold the land, forcing the investors to make continuing contributions.

Property transfers involving affiliates give rise to other aspects of self-dealing. General partners are frequently compensated by fees or commissions for locating, negotiating for, and acquiring land as well as for acting as a real estate agent when land is sold. When an affiliate is the other party in these transactions, however, the general partner is actually dealing with himself and in reality has not earned these fees.

C. Miscellaneous Abuses

In addition to the specialized problems afflicting tax shelter investment programs discussed above, limited partnerships are also subject to common varieties of corruption, including kickbacks from associates to whom the managers distribute the partnership's contracted work, partnership loans without interest to the general partner which may subsequently be forgiven, and failure to report to the participants the program's financial position, its activities, or its tax status. These abuses arise from the remoteness of the unsupervised general partner from the limited partners, dissipating the limited partner's return on investment and crippling his efforts to invest knowledgeably.

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39 Id. at 81.
40 Id.
III. CURRENT RESPONSES TO ABUSIVE PRACTICES

A. Intrastate Regulation

At the state level limited partnerships have been regulated at least since the advent of the Uniform Limited Partnership Act (ULPA). Although the ULPA in conjunction with the Uniform Partnership Act (UPA) injects some uniformity into the law governing limited partnerships, it nevertheless suffers from confinement to the limitations of state jurisdiction. Furthermore, the statute itself was not directed toward the abuses discussed above. Except for the fiduciary duty imposed by Section 21 of the UPA, no part of the UPA-ULPA scheme purports to regulate general partner compensation. While the ULPA makes clear that the limited partner is liable for unpaid installments toward his partnership interest, it fails to restrain the general partner from cancelling the limited partner's equitable interest (consisting of his in-
stallment payments to date) by penalties or forfeiture.45 Loans to limited partners are regulated but no comparable restriction is placed on loans to the general partner.46 Finally, the act imposes no disclosure requirements on the general partner, although limited partners may obtain financial information upon demand.47

State schemes for securities regulation similarly suffer from the problems of jurisdictional boundaries, lack of uniformity, and, additionally, obsolescence. As one commentator has noted, the novelty of limited partnership investment programs and the inapplicability of traditional standards used to evaluate investment securities has meant that most blue sky administrators may fail to control elements of the general partner’s compensation plan and his financial interest in the enterprise.48

B. Interstate Proposals

The security industry’s response to the need for regulation of limited partnerships on an interstate level is manifested primarily in three regulatory schemes. The Midwest Securities Commissioners Association (MSCA) has drafted a set of guidelines for real estate limited partnerships which it proposes to recommend for enforcement by member states.49 The National Association of Securities Dealers (NASD) has developed a program of regulation which would be binding on its over-the-counter dealers.50 Finally, the federal government, through the SEC, has proposed a federal regulatory scheme for oil and gas programs.51 Presumably the NASD and SEC regulatory schemes do not apply to entities which come within an exemption to the registration requirements

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45 ULPA § 17; see also text accompanying notes 37–38 supra.
46 ULPA § 13.
47 Id. § 10(1)(b).
48 Mosburg, Regulation of Tax Shelter Investment, 25 Okla. L. Rev. 207, 217 (1972): [I]n the critical area of promoter compensation and promotional interest, only California had established rules, and even California’s rules had been developed prior to the evaluation of “second generation” programs that saw a substantial change in the structure of program format and participation formula. (footnotes omitted). For California’s rules, see 10 Cal. Admin. Code §§ 260.140.111–124 (1971).
49 MSCA, supra note 7.
51 SEC, supra note 7.
of the Securities and Exchange Act. Likewise, while the MSCA proposal mentions no exemptions, it too may be avoided by resort to statutory exemptions provided by the securities laws of member states. Nevertheless, these proposals would apply to limited partnership arrangements dealing with larger numbers of investors (generally over twenty-five for the NASD and MSCA proposals, and over thirty-five for the SEC proposal) who are likely to have smaller average investments. Indeed such investment programs are more likely to need administrative scrutiny than entities composed of fewer limited partners investing larger sums who are presumably more capable of protecting themselves.

1. **Insuring Competent and Responsible Management**—The three regulatory schemes can be usefully compared in terms of their approaches to the areas of abuse which plague limited partnerships. In order to insure responsible management and investor influence each of the three schemes has established minimum requirements for participation by general partners and has created voting rights for limited partners. The MSCA proposal requires that a general partner have three years experience in his area of operation, and have a net worth of $50,000 or 15 percent of the first $2,500,000 raised in the program plus 10 percent of all assets in excess of $2,500,000. These provisions are designed to guarantee skill and solvency on the part of the general partner. In blind pool programs (nonspecified property syndications) the requirements are more stringent. A general partner must have five years experience and must have investable funds of $1,000,000. Moreover the investor must purchase in units of $5,000 for blind pool offerings and $2,500 on all other offerings.

In addition, the prospective limited partner presumably will face appropriate investor suitability standards related to the character of the particular program. These latter provisions are intended to insure that only comparatively sophisticated investors who can evaluate risk and absorb loss are involved in these investment....

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53 For example, Indiana exempts offerings to a group of twenty or fewer, IND. STAT. ANN. § 23-2-1-2(b)(10) (1972). In Michigan the figure is fifteen persons, MICH. COMP. LAWS ANN. Sec. 451.802(b)(9) (Supp. 1972). In Ohio the number is twenty-five persons, OHIO REV. CODE ANN. § 1707.03(M)(2) (Supp. 1972).

54 MSCA, supra note 7, § II. A.

55 Id. § II.B.

56 Id. § VI. B.

57 Id.§ VI. A.

58 Id. § III. D.

59 Id. §§ III. A. B.
programs. To facilitate an analysis of the partnership enterprise the MSCA proposal additionally establishes a program of full disclosures.\textsuperscript{60}

The NASD proposal requires the general partner to have five years experience and a net worth of 10 percent of contributions or $100,000, whichever is more.\textsuperscript{61} In addition, oil and gas programs must have a minimum public sale of $250,000.\textsuperscript{62} The NASD also requires disclosure of financial and tax data;\textsuperscript{63} if tax disclosures are not made, investors are permitted to withdraw from all except oil and gas programs.\textsuperscript{64} The NASD also requires a $5,000 minimum investor purchase\textsuperscript{65} but only for oil and gas programs, and imposes on the broker the responsibility of requiring that limited partners have a net worth of $50,000 and have incomes that are taxed at a marginal rate of at least 50 percent.\textsuperscript{66}

The SEC proposal sets no minimum investment requirements for limited partners although it authorizes registered securities associations to set such limits;\textsuperscript{67} it does establish, however, a requirement that the program collect a total of $250,000 before operation can begin.\textsuperscript{68} The minimum net worth requirement for general partners is set at the greater of (a) $250,000 or (b) the lesser of either $1,000,000 or 5 percent of total contributions.\textsuperscript{69} In addition the SEC proposal prohibits participation by general partners convicted of a felony or misdemeanor involving similar activity within the previous ten years.\textsuperscript{70}

While the NASD and SEC proposals call for the use of escrow or custodial accounts to protect proceeds during initial collection,\textsuperscript{71} the MSCA depends upon a fiduciary duty similar to that enunciated in Section 21 of the UPA for protection of the limited

\textsuperscript{60} See text accompanying notes 123–35 infra.
\textsuperscript{61} NASD, supra note 7, §§ 2(a), (b).
\textsuperscript{62} Id. § 2(c)(1).
\textsuperscript{63} If the tax benefits described in the prospectus cannot be demonstrated by a favorable ruling from the Internal Revenue Service, the investor may withdraw his capital. Id. §§ 2(e)(1), (2).
\textsuperscript{64} All funds received must be placed in escrow until a favorable ruling or counsel’s opinion is received. Id. § 2(e)(2).
\textsuperscript{65} Id. § 2(f).
\textsuperscript{66} Id. §§ 5(b)(2), (3). These sections require that the broker/dealer limit sales of program units to customers, who, after giving effect to all of their tax sheltered investments, are reasonably anticipated to be in a 50 percent federal tax bracket. It is not entirely clear under the wording of these provisions whether an investor with $50,000 gross income but no taxable income would meet this standard. The more likely presumption, however, is that such an investor does in fact qualify under these sections.
\textsuperscript{67} SEC, supra note 7, § 19(a)(1).
\textsuperscript{68} Id. § 12(2).
\textsuperscript{69} Id. § 13(a)(1).
\textsuperscript{70} Id. § 8.
\textsuperscript{71} NASD, supra note 7, § C; SEC, supra note 7, § 12.
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Also each proposal provides specific voter rights ranging from a simple removal power in all three proposals to a power to make fundamental policy determinations in the SEC proposal. These three regulatory schemes are also directed at countering specific abuses which arise from partnership agreements of adhesion, in particular mandatory assessments and penalties for subsequent nonpayment. The MSCA's answer to this problem is to limit the general partner's capacity to compel limited partners to contribute beyond their initial investments, the maximum permissible assessment being an amount equivalent to the increase in taxes or other governmental obligations on the property. The proposal also requires that the general partner employ only fair and equitable remedies in the event of default by a limited partner. Reasonable penalties may take the form of reducing the limited partner's proportionate interest in the partnership, subordinating his interest to that of nondefaulting partners, or forcing sale of his interest; his interest, however, shall not be subject to forfeiture. Finally, the scheme entirely prohibits assessments for blind pools.

The similar approaches of the NASD and SEC limit mandatory assessments to 15 percent of the limited partner's investment. These proposals also prohibit the use of unfair remedies as penalties for failing to meet assessments. In addition, the NASD prohibits the jeopardizing of the defaulting limited partner's right to invest in future optional development wells (oil and gas), as the partnership develops these new wells, without disclosure and requires full disclosure of potential assessments.

These measures regulating the general partner's experience, net worth, and capitalization are apparently intended to insure that the general partner is competent, financially responsible, and sol-

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72 The general partner shall have fiduciary responsibility for the safekeeping and use of all funds and assets of the syndicate, whether or not in his immediate possession or control, and... he shall not employ... such funds or assets in any manner except for the exclusive benefit of the syndicate.

MSCA, supra note 7, § IX. A.

73 For removal of the general partner, each program requires a simple majority of outstanding shares to constitute a successful removal vote. MSCA, supra note 7, § VII. B; NASD, supra note 7, § 3(a); SEC, supra note 7, § 13(b).

74 The SEC proposal requires a majority vote to authorize the general partner to borrow or loan money, to make assessments, and to purchase or sell securities, real estate, or commodities. SEC, supra note 7, § 11(b)(2).

75 See text accompanying notes 37–38 supra.

76 MSCA, supra note 7, § VII. G.

77 Id. § VII. H.

78 Id. § VI. F.

79 NASD, supra note 7, § 2(i); SEC, supra note 7, § 9(e).

80 NASD, supra note 7, § 2(k).
vent. However, the programs differ in their usage of these devices. First, while the MSCA and NASD each require a level of experience for general partners, the SEC does not. Second, both the NASD and SEC demand a minimum total capitalization in order to avoid early failures resulting from inadequate financing, but the MSCA requires minimum capitalization only for blind pools. Each of these omissions creates significant deficiencies in their respective programs. Requiring experience provides some assurance of competence; demanding minimal capitalization assures financial vitality, at least initially. Each element should be included in any effective regulatory scheme.

In addition to provisions designed to insure responsibility and competence on the part of the general partner, each scheme includes restrictions which eliminate the possibility of investment by those who cannot safely bear the risk of loss. The SEC establishes no investor suitability standards, but instead authorizes registered security associations to set such standards. The MSCA establishes no explicit suitability standards but imposes the responsibility for generating them on the broker. The NASD proposes to limit the investor's access to the market by erecting both investor income and net worth barriers.

The propriety of these barriers is questionable, however, when reviewed in the complete framework of the securities statutes. As Professor Loss has observed of the Securities Act of 1933, "Congress did not take away from the citizen 'his inalienable right to make a fool of himself.' It simply attempted to prevent others from making a fool of him." The proposals of the NASD and the MSCA contemplate restrictions which contradict this basic policy of securities law. The SEC proposal itself would allow strict investor suitability standards to be imposed. Arguably con-

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81 MSCA, supra note 7, § III. In its original proposal dated May 18, 1972, the MSCA barred participation in blind pool programs unless the investor had an income of at least $35,000 and a net worth of $20,000. Midwest Securities Commissioners Association, Statement of Policy Regarding Real Estate Limited Partnership, CCH 1972 Blue Sky L. Rep. No. 445.


83 The initial choice between philosophies of regulation did not include controls on investor access to the market, but was limited to a penalty for the broker's fraud or in the alternative a requirement upon him of full disclosure.

Having come at long last to the point of legislating, Congress was faced with a choice of conflicting philosophies. The diehards wanted to settle for a fraud act . . . Others, taking an in-between position, contended for a disclosure law . . . .

. . . At any rate, President Roosevelt chose the disclosure philosophy. And it was that which won out and which seems now quite firmly entrenched so far as the Securities Act of 1933 is concerned.

Id. at 121-22, 127.
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sistency with the federal securities law demands only that full disclosure be made and that no restrictions be imposed on the investor. Even the minimum investment prerequisite established by the NASD and MSCA seems contradictory to federal securities law policy; the restriction, however, is less burdensome than suitability standards.

2. Management Manipulation and Conflicts of Interest—The second area of potential general partner abuse, self-dealing and conflicts of interest, has also been confronted by each regulatory scheme. General partner overcompensation is attacked in the MSCA scheme by restricting compensation to an amount calculated at competitive local rates for services actually rendered. Section IV of the proposal further spells out in schedule form exactly what rates will be acceptable. Moreover the MSCA proposal allows general partner compensation only for brokerage, property management, and partnership management services, and specifically prohibits kickbacks and rebates.

The NASD regulatory scheme incorporates a similar compensation schedule, differentiating among the rates allowed for oil and gas, real estate, and all other programs. The scheme prohibits unfair and unreasonable compensation in general and specifically prohibits kickbacks, fees on dissolution of the partnership, and real estate commissions on the purchase of property from affiliates of the general partner. In addition, to prohibit the general partner's absorbing all cash flow the NASD proposal requires that selling fees be held in escrow until the limited partners recapture their total initial investments, limits real estate fees to a single payment, and establishes the same competitive local rate standard as the MSCA. Finally, the NASD sets specific percentage limitations on fees for certain facets of the operation of

84 See notes 58 and 65 and accompanying text supra.
85 See note 83 supra.
86 In addition to the general "reasonable" fees requirements, the MSCA specifically limits the general partner's compensation for partnership management and promotional services as follows:

1) interest in profits—25 percent of the undistributed amounts remaining after the investors receive 100 percent of their investments plus a 6 percent return, or

2) (a) cash flow—10 percent of cash flow after payment of 7 percent of investor capital, and

(b) proceeds from property sales—15 percent after 100 percent investor recovery plus 6 percent return and

(c) management fees must be based on cash flow. MSCA, supra note 7, § IV.
87 Id. § IV.
88 Id. § V. F.
89 See generally NASD. supra note 7, § 7.
90 Id. § 7(a).
91 Id.
both oil and gas\textsuperscript{92} and real estate programs.\textsuperscript{93} The NASD characterizes these regulations as being drafted to recognize and follow existing industry practices whenever possible unless the public interest requires otherwise.\textsuperscript{94}

The SEC approach is entirely different. Rather than regulate compensation rates directly, the SEC would require that fees be regulated by contract, delegating the authority to regulate the areas of sales literature, sales charges, suitability, and classification of management compensation to the NASD.\textsuperscript{95}

Each proposal recognizes that some conflicts of interest may be tolerated as long as controls against abuse are imposed. In confronting the conflicts of interest problem, the MSCA specifically prohibits loans to the general partner,\textsuperscript{96} acquisition of property in other programs in which the general partner has an interest,\textsuperscript{97} and exclusive employment of the syndicator to purchase or sell property for the program.\textsuperscript{98} Additionally the general partner is prohibited from making a profit on loans to the program.\textsuperscript{99} The MSCA does, however, permit the partnership to purchase or lease property in which the general partner has an interest as long as the transaction, if fully disclosed,\textsuperscript{100} occurs at the time of partnership

\textsuperscript{92} Compensation for general partners in oil programs, is limited as follows:
(1) $33\frac{1}{3}$ percent working interest or net profit in a lease after payout;
(2) $\frac{1}{16}$ overriding royalty interest convertible after payout into a working interest or net profits interest with a maximum of 25 percent;
(3) $\frac{1}{18}$ overriding royalty interest in addition to working interest or a net profits interest after payout with a maximum of 20 percent;
(4) 40 percent reversionary interest in the wells if no interest on development funds advances by the sponsor is charged to the participants or the program. Payout occurs when the proceeds from production attributable to a particular well equal the sum of all costs. NASD, supra note 7, §§ 1(z), 7(b). An overriding royalty interest is an interest in oil and gas produced or in the proceeds from the sale of oil and gas, free of operating expenses but subject in some cases to production taxes and transportation charges. Id. § 1(x). A working interest is an operating interest entitling the holder to a share of production under an oil and gas lease which carries with it the obligation to bear a corresponding share of all costs associated with the production of income. Id. § 1(uu). A reversionary interest is an interest in a program the benefits of which accrue in the future upon the occurrence of some event, commonly payout. Id. § 1(ll).

\textsuperscript{93} NASD real estate compensation limitations are as follows:
(1) administration fees—$\frac{1}{2}$ of 1 percent of gross assets or 2$\frac{1}{2}$ percent of equity whichever is less;
(2) promotional services—25 percent of cash flow;
(3) sale of property—only limit is that participants must receive total investment first;
(4) leasing fees—prohibited;
(5) financing of same property—only one fee may be charged for financing any one piece of property. NASD, supra note 7, § 7(c).

\textsuperscript{94} Id. at 23.

\textsuperscript{95} SEC, supra note 7, at 13.

\textsuperscript{96} MSCA, supra note 7, § V. A(3).

\textsuperscript{97} Id. §§ V. A(4), H.

\textsuperscript{98} Id. § V. F.

\textsuperscript{99} Id. § V. I(1).

\textsuperscript{100} Id. § V. A. (1)(a).
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formation and is priced at or below fair market value as independently appraised. In addition, sales or leases to the general partner must involve a guaranteed leaseback on terms no more favorable than would be offered others.

The NASD similarly prohibits only some general partner conflicts of interest. The theory is that if abuses are regulated, conflicts of interest which may be beneficial to the partnership can be tolerated. The NASD prescribes two controls over permissible conflicts: disclosure of conflicts in the prospectus, and application of a price to property transactions between the partnership and an affiliate of the general partner which reflects cost or fair market value, depending on the nature of the program and the date relative to partnership formation of general partner acquisition.

Those conflicts which the NASD finds impermissible include (1) sales of property between programs with the same general partners, (2) renting of program property to general partners as principal or prime tenants except under a guaranteed leaseback term, and (3) sales of professional services such as legal and accounting services. Although an oil and gas general partner cannot own property adjacent to the program's property, such an arrangement is legitimate for real estate programs if disclosed in the prospectus. Finally no sales of property or services are legitimate to blind pools unless specifically disclosed.

The SEC prohibits transfers of property between the general partner and the program except those transfers which provide the program with the advantage of cost or fair market value pricing, whichever is lower. The program in addition must report to the limited partners the details of these transfers. Pursuing further possibilities of abuse, the SEC prohibits the acquisition by an oil and gas program of participation units in another oil and gas program.

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101 Id.
102 Id. § V. A(1)(b).
103 Id. § V. A(2).
104 NASD, supra note 7, at 13.
105 Id. § 4(a).
106 Id. §§ 4(a)(1), (2), (3). If the general partner acquired the property after formation of the program it must be sold to the partnership at the lower of cost or fair market value.
107 Id. § 4(b)(3).
108 Id. § 4(b)(1).
109 Id. § 4(b)(2).
110 Id. § 4(b)(4).
111 Id. § 4(b)(5).
112 SEC. supra note 7, § 18(a)(1).
113 Id. § 18(a)(2).
program, and bars the general partner from drilling for his own account on partnership land.

Although the MSCA, NASD, and SEC share similar attitudes toward toleration of controlled conflicts of interest, their approaches to general partner compensation are divergent in two respects. The proposals disagree as to the propriety of regulating rates of compensation in the first instance; and secondly, if regulation is deemed appropriate, they chose dissimilar modes of effecting that regulation. The necessity for external regulation to supercede free enterprise bargaining mechanisms proceeds from the ineffectiveness of those devices in adequately protecting one contracting party from abuse by another. The existence and tenor of these three regulatory proposals suggests that the bargaining process is not as effective a device as it should be in protecting the interests of limited partners. Both the NASD and MSCA proposals abandon attempts at rejuvenating the bargaining device and substitute specific percentage maximum fees which the general partner may not exceed. In contrast, the SEC does not address the topic of rate determination directly anywhere in the proposed statute. It does, however, insure the parties’ opportunity for bargaining by requiring management contracts to be accepted by a majority of the limited partners.

The federal government has endorsed the policy of reliance on industry self-regulation in controlling mutual fund management fees, which in many respects is analogous to regulating fees for blind pool limited partnership management. In developing an appropriate test to assure reasonable mutual fund management fees in the Investment Company Amendments Act of 1970, the Congress expressly disclaimed any intent to regulate rates directly. Notwithstanding the analogy, Congress might not choose to rely on the bargaining process if faced with the higher risk limited partnership situation. If the bargaining process is not

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114 Id. §§ 10(a), (b).
115 Id. § 18(e).
116 See text accompanying notes 86–95 supra.
117 SEC, supra note 7, § 13(b).
118 Mutual fund management companies invest the funds of institutional investors which represent shareholders who are in much the same position as limited partners. The management company invests the funds in common stocks at their professional discretion, just as the general partner of a blind pool program invests in real estate. See generally Investment Company Amendments Act of 1970, Act of December 14, 1970, Pub. L. No. 91-547, 84 Stat. 1413.
119 Id.
120 "Your committee recognizes the fact that the investment advisor is entitled to make a profit. Nothing in the bill is intended to imply otherwise.... It is not intended to introduce general concepts of rate regulation as applied to public utilities. S. Rep. No. 91-184, 91st Cong., 2d Sess. 6 (1969)."
acceptable, alternative means of regulation must be evaluated in terms of their capacity to effect the policy of insuring reasonable fees for general partners.

The SEC’s reinforcement of the bargaining process no doubt will be less effective as program sizes swell to accommodate greater numbers of investors and general partners become more remote. The influx of investors precipitates a seller’s market where contracts become standardized, units of partnership interests are offered on a take-it-or-leave-it basis, and bargaining ceases.

In contrast, the MSCA and NASD fixed percentages provide absolute standards which the general partner cannot ignore, but they virtually guarantee that the maximum fees will also become minimum fees. The increasingly independent general partner in the face of a disorganized group of limited partners can be expected to contract for maximum permissible fees. An alternative would be to redefine the fiduciary duty of general partners as the standard of good faith conduct in respect to management fees, as was contemplated in the Investment Company Amendments Act of 1970 with the courts empowered to determine when the duty is breached. Absent definitive standards, however, this alternative imposes a burden on the courts which at the threshold bespeaks inconsistent decisions. Combining the NASD/MSCA maximum rate concept with the SEC reinforcement of the bargaining process would stimulate the parties to bargain, but would safeguard participants from a bargaining failure by the imposition of uniform maximum limits. Both the NASD and MSCA, however, would probably need to condition the use of this standard upon consistency with state law, as the power to approve management fees may be construed as a violation of the ULPA Section 7 control test.

3. Miscellaneous Abuses—Nondisclosure of program financial data, activity data, and tax status rulings militates against a participant’s capacity to bargain meaningfully and invest intelligently. Each of the three proposals specifically details the information which the general partner must disclose. In addition to those disclosures already discussed, both the NASD and MSCA put

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121 15 U.S.C. § 80a-35(b) (1970) reads in part: [T]he investment advisor of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services. An action may be brought under this subsection by the Commission or by a security holder.

122 See notes 138–43 and accompanying text infra.

123 See text accompanying notes 63 and 105 supra.
restrictions on the content of projected income literature. Furthermore, each requires full disclosure of tax status through a ruling of the Internal Revenue Service or opinion of counsel. The MSCA requires the actual issuance of a favorable tax ruling before a program’s units can be freely transferable, while the NASD would permit an investor to withdraw entirely upon a subsequent unfavorable ruling. The MSCA also demands that reports be given to the limited partners of all the program’s activities and interests, that details of general partner compensation be disclosed, that all records be accessible at reasonable times, and that audited financial statements be distributed. Similarly, the NASD would require quarterly reporting of all relevant facts including program progress information, revenue receipt and disbursement information, annual audited financial statements, and reports containing relevant tax information.

Although it requires the disclosure of property transfers in which a conflict of interest inheres, the SEC has no provision specifying what financial data must be disclosed. Instead the oil program must transmit to its participants only information and financial data which the Commission may have prescribed.

Section 2(c)(I) requires that any sales literature referring to federal tax treatment should reference an IRS ruling or counsel’s opinion.
bargaining process, an effective regulatory scheme should explicitly include generous reporting requirements. In this regard the SEC proposal establishes an insufficient minimum, forcing the investor to depend on the Commission to promulgate further reporting requirements.

While all programs require disclosure of program tax status, conflicts of interest, and periodic financial statements, the NASD and SEC proposals omit important information. The MSCA makes the most complete demands, requiring disclosure of virtually everything regulated in its proposal, including tax status, general partner net worth, conflicts of interest, property descriptions, pending suits, financial statements, and income projections. The NASD likewise has a strong disclosure program, but it omits important areas such as general partner net worth and experience, pending suits, and description of partnership property. The SEC fails explicitly to require disclosure of general partner net worth and experience, income projections, property descriptions, and general partner compensation. Under the SEC proposal, unless the Commission establishes comprehensive disclosure requirements, the investor is privy to the least information; consequently the proposal is unlikely to prevent fraud or to enable the investor to bargain intelligently.

IV. COLLATERAL EFFECTS

Although the purpose of these proposals is to regulate potential program abuses, some provisions might precipitate the loss of certain investment program advantages. For example, the provisions in each of the proposals permitting the removal of a partner or requiring his employment to be approved by vote of the limited partners as well as the SEC's provisions allowing investors to vote on fundamental policy decisions endanger the investor's limited liability.

Section 7 of the ULPA protects a limited partner from general liability unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in control of the business. Thus any interference with or participation in the conduct or control of the partnership business may transform the limited partner into a general partner for purposes of expanding liability. The essen-

136 MSCA, supra note 7, § VII. B(3); SEC, supra note 7, § 13; NASD, supra note 7, § 3(a) (1). See note 73 and accompanying text supra.
137 SEC, supra note 7, § 11; see note 74 supra.
tial question in any such determination is, of course, what constitutes control. The ULPA in Section 9 permits limited partners to veto (1) any act contravening the partnership certificate which defines the participants' rights inter se, (2) any act making it impossible to carry out the ordinary business of the partnership, (3) confession of judgment, (4) use of partnership property for other than a partnership purpose, (5) admission of another general or limited partner, or (6) continuation of the business after the general partner dies, unless the certificate provides otherwise.\footnote{ULPA § 9.} It is unclear whether power to remove current partners is sufficiently different from the permissible power to veto new ones so as to justify the imposition of general liability. Moreover, in a recent New York case, \textit{Riviera Congress Associates v. Yassky},\footnote{48 Misc.2d. 282, 264 N.Y.S.2d. 624, (Sup. Ct. 1965) \textit{aff'd}, 18 N.Y.2d. 540, 223 N.E.2d. 876, 277 N.Y.S.2d. 386 (1966).} the court permitted the limited partners to sue in behalf of the partnership itself and in effect replace the general partner where the general partner failed to collect rental payments from an affiliated tenant in the partnership's building. The court reasoned that the statute, New York's version of the ULPA,\footnote{N.Y. PARTNERSHIP LAW §§90-119 (McKinney 1948), \textit{as amended}, (McKinney Supp. 1972).} which bars limited partners as improper parties in a suit in behalf of the partnership, is intended to restrain the limited partners from interfering with the rights of general partners to carry on the business of the partnership. Thus where the general partner has failed to carry on the business of the partnership, the limited partners may, without loss of limited liability, step in to collect overdue rent. \textit{Yassky}, however, says nothing about replacement of a general partner who is "carrying on the business" to the limited partners' dissatisfaction.

In deciding whether a removal power constitutes substantial control\footnote{California has confronted this limited liability question squarely and has statutorily created a right in the limited partner to elect or remove general partners as long as voting powers appear in the partnership certificate. \textit{CAL. CORP. CODE} § 15507 (West 1963).} prohibited by Section 7 of the ULPA, one commentator suggests the following test: powers which include the right to initiate matters and decide them entirely within the group of limited partners constitute substantial control; powers confined to approval of actions of the general partner are no greater than shareholders usually have and are not very substantial.\footnote{Bromberg, \textit{supra} note 3, at 147.} Clearly
removal of a general partner against his will is more substantial control than approval of his actions. Indeed, it is disapproval carried to the farthest limit. In contrast, another commentator, after reviewing alternative constructions of the control test concludes that the test should be measured

by the most logical rationale for holding the limited partner liable: to prevent third parties from mistakenly assuming that the limited partner is a general partner and relying on his general liability. . . . Under this view of the control test only activities which conceivably could induce reasonable reliance, such as supervision of the partnership’s day to day activities, should produce general liability.144

This conclusion is reached notwithstanding the absence of any specific reference to creditor’s reliance as a basis for liability in Section 7, although the draftsmen do have this reference in Section 5 prohibitions against using the limited partner’s name in the partnership name. Under this latter test, a removal power would hardly fall into the routine business activity of the partnership. In any event, all three proposals have recognized the problem and have moved to avoid it. Both the MSCA and NASD condition the inclusion of voting rights on their consistency with limited liability under state law.145 If state law clearly prohibits the removal power, the limited partnership must operate without it. On the other hand, the SEC simply preempts state law,146 presumably avoiding the problem altogether.

If in fact the MSCA and NASD voting proposals do conflict with state law, the dissatisfied limited partner is stripped of some of his self-help remedies and is relegated to civil suit for breach of fiduciary duty under Section 21 of the UPA. Furthermore, if the validity of the removal power remains undecided in the state of partnership formation, the NASD and MSCA escape clauses may be impotent in protecting the investor’s limited liability. Where limited partners are sued by creditors and the state court ultimately holds that the removal power does indeed violate the law, the NASD and MSCA cannot retroactively extract the removal clauses from the existing certificate.

144 Feld, supra note 138, at 1479.
145 MSCA, supra note 7, § VII. B; NASD, supra note 7, § 3.
146 SEC, supra note 7, §§ 13(c), 11(d).
V. Conclusion

With the revival in popularity of the limited partnership and the discovery of several unique means of exploiting it, interstate bodies both governmental and private have roles to play in discouraging abuse of limited partnerships. This is especially true in view of the inadequacy of the ULPA and existing blue sky regulations in confronting the problem. Existing regulatory proposals vary considerably, however, in their effectiveness and collateral consequences.

The MSCA proposal attempts generally to insure the solvency and competency of general partners while strengthening the bargaining power of limited partners through disclosure requirements, eliminating assessments and forfeitures, and attacking conflicts of interest without unduly restricting the investor's access to the market with its minimum investment amounts and suitability requirements. Its primary deficiencies appear to be potential jeopardy to the limited partner's limited liability which the voting removal power may entail and the inflexible standards restricting the parties' actual capacity to bargain about general partner compensation.

Directly remedying the fewest abuses, the NASD proposal sufficiently strengthens the bargaining power of the limited partner and demonstrates an enlightened approach to conflicts of interest, separating useful conflicts from unacceptable ones. Unfortunately, the NASD proposal, like the MSCA proposal, restricts the parties' rights to contract for general partner compensation and may jeopardize the investor's limited liability through the removal voting privilege. In addition, the NASD severely restricts the investor's access to the market with income, net worth, and other suitability requirements.

Midway between the other two in terms of effective control of abuses, the SEC proposal attacks the bargaining process problem with strict forfeiture and assessment controls. Although the Commission's proposal provides for use of the bargaining process in the determination of general partner fees, it fails to establish a ceiling to prevent fees from reaching an unreasonable level in the event of bargaining failure. Notwithstanding its conflicts of interest provisions for fair prices on sales or purchases of program property and the prescribed disclosures required in that regard, its other disclosure provisions are insufficient to insure the transmission of essential information to the investor. Finally, although the SEC does not directly limit investor access to the market with
suitability requirements, it authorizes registered securities associations to do so.

A model proposal might incorporate the following elements as being the most desirable characteristics of the three proposals. First, to insure competency, solvency, and responsibility in management, the proposal should establish minimum general partner net worth and experience requirements. In addition it should require a sufficient minimum capitalization to support the funding requirements of the intended program.

Second, to preserve the limited partner’s investment equity, an ideal program should prohibit assessments except to meet tax increases, and restrict nonpayment penalties to fair, nonforfeiture provisions. In addition, to promote investor sophistication, the model should demand disclosure by the general partner of the program’s high-risk potential. The proposal should not, however, erect barriers to investment defined in terms of investor income level and net worth or minimum investment amount, if it is to reflect prevailing securities law policy.

As a fourth item, to insure that a reasonable compensation level for general partners is achieved but not exceeded, the proposal should establish rate determination procedures which both promote participant bargaining and define a ceiling above which fees cannot climb. Likewise, to preserve the benefits of selected conflicts of interest while avoiding the collateral abuses, a fifth program element should establish specific procedures and cost guides for partnership transactions where the general partner has an adverse financial interest.

Moreover, to enhance the investor’s bargaining position, the model should require generous disclosure of partnership financial statements, cash flow statements, general partner conflicts of interest, general partner compensation, partnership tax status stated in opinions and rulings, and comparisons of projections to actual investment results. Finally, to avoid collateral loss of limited liability while insuring the responsiveness of the general partner to limited partner interests, the proposal should also include a general partner removal power, exercisable by the limited partner and supplemented by an opinion of counsel as to its consistency with state law.

Legislation and guidelines designed to protect the limited partner from unscrupulous general partners must additionally avoid jeopardizing tax and limited liability advantages adhering to the limited partnership organizational form. To erect general partner restrictions at the expense of program advantages would neces-
sarily discourage investors from utilizing a flexible device which is becoming an increasingly important element in the financing of real estate, oil and gas, and other high-risk but important industries.

—Ivan J. Schell