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PARTNERSHIPS-LIMITED-FAILURE TO COMPLY WITH STATUTES AS BASIS FOR UNLIMITED LIABILITY

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PARTNERSHIPS—LIMITED—FAILURE TO COMPLY WITH STATUTES AS BASIS FOR UNLIMITED LIABILITY—The recent decision of the Eighth Circuit Court of Appeals in *Kistler v. Gingles*,[1] that a limited partner under the Arkansas Limited Partnership Act fails to avoid unlimited liability if the terms of the statute are not complied with, illustrates the inherent danger of the limited partnership. This statute,[2] which is typical of the limited partnership statutes[3] antedating the Uniform Limited Partnership Act,[4] provides, in part, for an affidavit by one of the general partners stating that the sums which each limited partner proposes to contribute to the enterprise have actually and in good faith been paid into the business in cash by the date of its registration;[5] and that if any false statement be made in the affidavit, all the persons interested in such partnership shall be liable for all the engagements of the firm as general partners.[6] The uncontested facts in the above case show that while the would-be limited partners had not actually paid over in cash their full contributions as had been stated in the affidavit, they were at all times ready, willing, and able to so do. Instead of losing only their initial investment in the enterprise, the investors were held liable for the concern's entire indebtedness as a result of their failure to follow the precise terms of the statute. Herein lies the danger of the limited partnership and the reason this type of business association has been largely neglected in those states not adopting the Uniform Limited Partnership Act.[7]

The purpose of the limited partnership is well stated by the Supreme Court of Connecticut:[8] "... [In the limited partnership] we find a clear general purpose and intent by the legislature to encourage trade by authorizing and permitting a capitalist to put his money into a partnership with general partners possessed of skill and business

[1] (8th Cir., 1949) 171 F. (2d) 912.

[2] Ark. Stat. (Pope, 1937) §§10558-10585.

[3] See BATES, LAW OF LIMITED PARTNERSHIP 21 et seq. (1886) for a comparison of the various state statutes.

[4] See 8 U.L.A., Partnership, §6 (1948) for list of states, 28 in number, which have adopted the Uniform Limited Partnership Act.

[5] Sec. 10565.

[6] Sec. 10566.

[7] Lewis, "The Uniform Limited Partnership Act," 65 UNIV. PA. L. REV. 715 (1917), discusses the defects in existing limited partnership acts causing the Commissioners on Uniform State Laws to adopt the Uniform Limited Partnership Act.

[8] Clapp v. Lacey, 35 Conn. 463 at 466 (1868).

character only, without becoming a general partner or hazarding anything in the business except the capital originally subscribed." The traditional common law partnership association could not be used as such an investment device because of the early doctrine of partnership liability to third persons of anyone who shared the profits of a trade, including lenders of capital who received a share of its profits in place of interest.[9] Although the capitalist can realize his goal of limited liability through investment in a corporation, as a limited partner he has an advantage over the stockholder in a corporation in that he may be sure of the active interest of the general partners, whose functions are similar to those of the directors of a corporation, because such partners, unlike the directors of a corporation, are unlimitedly liable for the partnership's debts. On the other hand, the limited partner has no voice in the management of his capital such as a corporate stockholder has. The advantages of the limited partnership are considerable, and were so recognized by the legislatures as far back as 1822 when New York passed the first limited partnership act.[10] This statute was soon duplicated by other states and by 1888 was in effect in all but three states, closely copied by all, almost verbatim by many.[11] When these statutes were drafted and the limited partnerships formed under them were first subjected to judicial cognizance, the old notion prevailed that one who partook of profits must run the risk of losses. The limited partnership was accordingly considered by the courts as a privilege granted by the legislature to the profit-seeking investor. Therefore, to achieve that privilege, he must meticulously meet the conditions attached to it as set forth in the act.[12] Failure to comply defeated the privilege and the investor was deemed a common law general partner. Another argument[13] advanced for requiring the strictest adherence to the statute was that it was in derogation of the common law and should be exactly construed. Thus, where the investment in an enterprise was made in the form of bonds (worth more than

[9] Grace v. Smith, 2 W. Bl. 998 (1775); Waugh v. Carver, 2 H. Bl. 235 (1793). Cox v. Hickman, 8 H.L. 268, 11 Eng. Rep. 431 (1860) overruled these cases.

[10] N.Y. Laws (1822) p. 259.

[11] BATES, LAW OF LIMITED PARTNERSHIP 21 et seq. (1886).

[12] Holliday v. Union Bag and Paper Co., 3 Colo. 342 (1887); Pierce v. Bryant, 87 Mass. 91 (1862); Maloney v. Bruce, 94 Pa. 249 (1880); Henkel v. Heyman, 91 Ill. 96 (1878).

[13] For criticism of this rule see 36 HARV. L. REV. 1016 (1923).

the subscription called for) instead of in cash as required by statute, the subscriber was declared unlimitedly liable for the concern's debts.[14] Again, where payment was made by check instead of in cash as required, the limited partner found himself unlimitedly liable.[15] Where the investments of the limited partners were recorded jointly, instead of individually, the contributors were held to be liable generally since the statute required each listing to be separated.[16] Consequently, while the policy behind the creation of limited partnerships was to further investment by reducing risk, the attitude of the courts in interpreting the statutes has been to deprive the provisions of any usefulness, except where the association is to contain no more than one limited partner.[17]

To revitalize the limited partnership, the Uniform Limited Partnership Act was approved by the National Conference of Commissioners in 1916. The fundamental philosophy behind the Uniform Act is that no public policy requires a person who contributes capital to a business enterprise to become bound for the obligations of the business.[18] In furthering this policy, section 2 states: "A limited partnership is formed if there has been substantial compliance[19] in good faith with the requirements for formation." Section 11 gives additional protection, stating that "a person who has contributed to the capital of a business conducted by a person or partnership erroneously believing that he has become a limited partner in a limited partnership, is not, by reason of his exercise of the rights of a limited partner, a general partner with the person or in the partnership carrying on the business, or bound by the obligations of such person or partnership; provided that on ascertaining the mistake he promptly renounces his interest in the profits of the business, or other compensation by way of income." Thus, limited liability is not under this act a privilege attaching to the investor only by strict adherence to the statutory scheme. Even if the intended limited partnership is not

[14] Haggerty and Albinola v. Foster, 103 Mass. 17 (1869).

[15] In re Allen's Estate, 41 Minn. 430, 43 N.W. 382 (1889).

[16] Spencer Optical Mfg. Co. v. Johnson, 53 S.C. 533, 31 S.E. 392 (1898).

[17] Commissioners' Note, 8 U.L.A. 3.

[18] Ibid.

[19] The problem of what constitutes substantial compliance remains. The courts have met this question many times in deciding whether a corporation de facto has been formed. The same analysis applies here.

formed because of failure to comply with the regulations set out in the act, unlimited liability does not attach to the profit-seeking investor in the twenty-eight states which have adopted the act, provided he originally acted in good faith in attempting to abide by the requirements, and, on learning he has failed to meet them, promptly disavows his interest in the association.

Since a substantial number of states continue to carry on their books statutes resembling the New York Act of 1822, many investors still run the risks of noncompliance with these older statutes, should they choose to use them to achieve the desired goal of limited liability. There is, however, another alternative, indicated by the wide-spread adoption of the principle laid down in *Cox v. Hickman*,[20] that while profit sharing is a prima facie indicium of partnership it is not conclusive, and one may receive a share of profits, as payment of a debt, or in lieu of interest, without becoming a partner in fact or liable as a partner to third party creditors. This case is a milestone in the history of partnership law, repudiating the concept that the profit sharer in a business is a partner on whom unlimited liability falls. Under this rule, which has been codified in section 7(4) of the Uniform Partnership Act (to be distinguished from the Uniform Limited Partnership Act), one may invest money in return for a share of the profits of an unincorporated enterprise without complying with the statutory steps prescribed in the limited partnership acts, provided he does not participate in the concern's management. Consequently, a person desiring to invest capital in an enterprise in the expectancy of receiving in return a share of its profits is strongly advised to avoid the limited partnership acts in those states which have not as yet adopted the Uniform Limited Partnership Act. Instead he should carefully preserve evidence indicating the fact that he contributed money to the partnership merely for investment purposes without the intention of joining it as a general partner.

But what of the investor who has attempted without success to comply with the older limited partnership statutes? Is the burden of unlimited liability to be placed upon him even though he has conscientiously and in good faith tried to abide by their terms? Certainly the wording of the statutes leaves little hope for nonliability.[21] Never-

[20] 8 H.L. 268, 11 Eng. Rep. 431 (1860).

[21] BATES, LAW OF LIMITED PARTNERSHIP 38 (1886).

theless, the Supreme Court of the United States in *Giles v. Vetter*[22] relieved such an investor of unlimited liability. In this case the parties intended to create among themselves the relationship of limited partners for the purpose of running a stock brokerage office under the Illinois Limited Partnership Act of 1874, but they failed to do so because this act had been replaced by the Uniform Limited Partnership Act the day before they filed their papers. The Uniform Act did not allow limited partnerships in this type of business, thereby removing the possibility that the investors could protect themselves from unlimited liability under it. Moreover, the partnership agreement was not in the form nor filed at the office required by the Uniform Act. When the firm accrued debts, the creditors brought suit, seeking to place the unlimited liability of general partners upon the investors. The Court held not only that the investors were not partners but also that they were not liable as partners, relying on section 7(4) of the Uniform Partnership Act which contains, as said, the codified form of the concepts laid down in *Cox v. Hickman*. Inasmuch as the partners did in fact attempt to abide by the terms of the older limited partnership act, this case is authority for the nonliability of one who enters into an intended limited partnership as a limited partner under the older type limited partnership statute. The court's decision was based upon the Uniform Partnership Act without reference to either the repealed limited partnership act nor its successor, and since the Uniform Partnership Act, section 7(4), is declaratory of the common law, the case is also authority for nonliability in those states which have not enacted it.[23] A wide acceptance of the rule applied in this case would eliminate the dangers inherent in the older statutes, placing an investor in a state which has not adopted the Uniform Limited Partnership Act in the same liability-free position as one in a state in which that act is now the law. Thus by indirect means the policy which originally led the legislatures to pass limited partnership acts could be put to full nationwide practice.

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[22] 263 U.S. 553, 44 S.Ct. 157 (1924).

[23] See 7 U.L.A., Partnership, xv (1949) for a list of states which have adopted the Uniform Partnership Act.