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# Liability of a Limited Partner

## Provisions of Law in different Countries

A Brief Overview in 2008

Many businesses are conducted in form of a corporation defined as "partnership". The partnership is registered in accordance with the provisions of the Partnerships Ordinance (Revised Version) 5735-1975, and acts subject to the provisions and decisions passed.

Clause 1 of the aforesaid Ordinance contains a definition of the term "limited partner" –

***A person who, on joining the partnership, brought capital in form of money or property estimated in an explicit amount, so as not to be responsible for the obligations of the partnership in excess of the amount he invested in the partnership, as said;***

According to this definition, a person defined as limited partner in an Israeli partnership, is responsible for the obligations of the partnership to the extent of his investment only. This will protect the investor from imposing a responsibility on him for debts of the partnership, should the project fail to work out.

As we learn, matters are handled differently in different countries, when entities from different countries join together to run a business in some other country.

As long as the business runs well, everything is all right, however, if the business fails, the responsibility of each of the partners for the debts incurred is examined. A partner who thought to be a "limited partner", feels sure that his responsibility for the debts of the partnership is limited to his investment and that he cannot be approached with additional financial requests to cover the debts of the partnership.

When handling one of those projects, we examined the legal status in some of the countries relevant to the project under examination. We found different references in different countries to the question of responsibility of a limited partner for the debts of the partnership.

As the principles found are of interest, it seems to be appropriate to mention here a summary of the results of the examinations made in respect of the legal status existing in different countries.

It is emphasized, however, that contents of this paper does not constitute a legal opinion concerning the law applicable in the relevant foreign countries, but rather a warning to any Israeli joining a foreign partnership for project management abroad. Such Israeli would be well advised to examine carefully the meaning of his "limited partner" status, should the business turn out to be a failure**. Otherwise, he will find himself examining this subject after the failure occurred, and receiving substantial financial demands to cover the relative part of the debts of the partnership, which failed.**

**The Legal Situation in England:**

The partnership laws in England are based on the provisions of the Partnership Act of 1890, published in The Public General Acts passed in the 53rd and 54th year of the reign of Her Majesty Queen Victoria.

As far as I understand, these provisions are still valid, at least at the time the partnership, being the subject of the examination, was established. It was not found that the above Act had been cancelled. When studying the provisions of this Act, it appears that no provisions for limiting the responsibility of a partner in the partnership existed at that time, which would have been similar to the limitation applying to a limited partnership, while the provisions of Clause 9 of the Act determine shared responsibility (jointly) for each of the partners in the partnership. In certain cases, the partner bears full responsibility for certain debts.

It is worth mentioning that we found that, in Scotland, whenever the partnership is encumbered with debts, the partners (jointly and severally) bear shared responsibility and even full responsibility.

With the development of trade and the need for more sophisticated tools, special provisions of law were determined to limit the responsibility of each of the partners for the debts of the partnership and thus, in fact, the limited partnership was created. (It should be mentioned that, according to the following survey, the first limited

partnership was established by the American legislator, who, as early as in the year 1822, enacted a directive limiting the responsibility of a limited partner in a limited partnership).

We found that the English legislator enacted a law in the year 1907 – The Limited Partnership Act 1907, which was published in The Public General Acts passed in the 7th year of the reign of His Majesty Kind Edward the VII.

We found that the provisions of the Partnership Act of 1890 apply, mutatis mutandis, also to limited partnerships, as long as there is nothing in these provisions to contradict the Limited Partnership Act of 1907 – see in this matter Clause 7 of the Limited Partnership Act of the year 1907, as well as Halsbury's Laws of England, 4th edition, reissue, Vol. 35, Par. 213.

In Clause 6 of the Limited Partnership Act of 1907, following detailed and interesting provisions were found relating to the conduct of a limited partner:

**6.** **(1)** ***A limited partner shall not take part in the management of the partnership business, and shall not have power to bind the firm:***

***Provided that a limited partner may by himself or his agent at any time inspect the books of the firm and examine into the state and prospects of the partnership business, and may advise with the partner thereon.***

***If a limited partner takes part in the management of the partnership business, he shall be liable for all debts and obligations of the firm incurred while he so takes part in the management as though he were a general partner.***

**(2)** ***A limited partnership shall not be dissolved by the death or bankruptcy of a limited partner, and the lunacy of a limited partner shall not be a ground for dissolution of the partnership by the court unless the lunatic's share cannot be otherwise ascertained and realized.***

**(3)** ***In the event of the dissolution of a limited partnership, the general partners shall wind up its affairs, unless the court orders otherwise.***

**(4)** ***Repealed.***

(5) ***Subject to any agreement expressed or implied between the partners.***

a) ***Any difference arising as to ordinary matters connected with the partnership business may be decided by a majority of the general partners***

b) ***A limited partner may, with the consent of the general partners, assign his share in the partnership, and upon such an assignment, the assignee shall become a limited partner with all the rights of the assignor***

c) ***The other partners shall not be entitled to dissolve the partnership by reason of any limited partner suffering his share to be charged for his separate debt***

d) ***A person may be introduced as a partner without the consent of the existing limited partners***

e) ***A limited partner shall not be entitled to dissolve the partnership by notice***

It shall be noted that the English scholars expressed their views concerning the above Clause 6, since the violation of the provisions thereof might create full responsibility for the limited partner:

***"This is the principal practical disadvantage of a limited partnership as compared to a limited company"***

See *Halsbury's Laws of England, 4th Edition, reissue, Vol. 35, Para. 214, footnote 7.*

**The Legal Situation in Canada:**

In the framework of our research of the legal situation in Canada, we found a summary reference to the legal situation in England, which, in the opinion of the Canadian scholars, is as follows:

***"A limited partner is precluded from having any power to "bind the firm". The limited liability status of limited partners is the key feature, which differentiates the limited partnership from the general partnership. The evolution of limited liability for the limited partner essentially created a substantially different legal relationship. Early statutes, using the broad concept of not taking part in the management of the business, severely limited the capability of the limited partners to even monitor the status of their business investment. A fundamental change between early legislation and current legislation is the change from a concept of taking part in "management" of the business to taking part in "control" of the business. This would appear to provide an argument that some participation in management is permitted, provided that participation does not amount to control. The historical basis of general liability, agency concepts and protection of creditor interests as they relate to business firms provide a useful contact for assessing the "control" prohibition.***

See: **A Practical Guide to Canadian Partnership Law, Alison R. Manzer, Par. 9.130, p. 6-9.**

History of the limited partnership in Canadian legislation starts as early as in the year 1849, in the framework of the *"Act to Authorize Limited Partnerships in Upper Canada".*

For a historical survey of the different versions of legislation in the Canadian provinces see *Manzar, Par. 9.190 to 9.240.* However, in the opinion of the author on pages 8-9, no significant differences were found, but as far as our research is concerned, we did find significant differences.

In the Province of Ontario, the provisions of the "Limited Partnership Act R.S.O 1990 c.L-13" apply.

For our research, let us look at the provisions in Paragraph 10 of the above Act.

***10. A limited partner has the same right as a general partner,***

***a) to inspect and make copies of or take extracts from the limited partnership books at all times;***
***b) to be given, on demand, true and full information concerning all matters affecting the limited partnership, and to be given a complete and formal account of the partnership affairs; and***
***c) to obtain dissolutions of the limited partnership by court order. R.S.O. 1980, c. 241, s. 9.***

Furthermore, the provisions in Paragraph 13 of the above Act:

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

***(2) For the purpose of subsection (1), a limited partner shall not be presumed to be taking part in the control of the business by reason only that the limited partner exercises rights and powers in addition to the rights and powers conferred upon the limited partner by this Act. R.S.O. 1980, c. 241, s.12.***

We found that the law in Ontario, in fact, refers to the doctrine of "control" for canceling the limitation of responsibility of the limited partner "*the limited partner takes part in the control of the business"* (hereinafter: **"Control Test"**).

In other provinces, somewhat different provisions were found. Reference is made to the provisions of Paragraph 64 of the law in British Columbia:

***"A limited partner is not liable as a general partner unless he takes part in the management of the business"***

(Taking part in the management of the business – hereinafter: ***The Management Test")***

It may be presumed that the law in British Columbia, in fact, aggravates the position of the limited partner, since the prohibition of "*taking part in the management*" is more extended than the prohibition of "taking part in the control".

We found, however, that in the Province of Manitoba, they have a provision – Paragraph 63 – imposing responsibility on the limited partner towards a third party, with whom he had been in contact on behalf of the partnership and who was unaware of the fact that he was a limited partner. (Hereinafter: **"The Reliance Test"**).

When examining the judicial decision in Canada concerning the distinction between taking part in the control or taking part in the management and between realizing the right to consult, no guidelines were found. See *Manzer, Par. 9.740*, pages 9-35.

However, we did find judicial decision on subjects related to claims of the Plaintiff concerning the management of partnership matters, viz.:

As far as taking part in management is concerned, see: *Hutchison v. Bowes (1857) 14 UCQB 316 (C.A.)*

> ***"Upon the testimony of Holland we think it is clear the defendant, Mr. Bowes, did not confine himself "to examining into the state and progress of the partnership concerns, and advising as to their management", which he might have done without making himself liable as a general partner, but that he did, as well as the other members of the committee, "transact business on account of the partnership", thereby interfering in such matter as under the 14th clause of the act subjects him to be deemed a general partner. The Committee was nothing less than a committee of management, of which Mr. Bowes was for considerable time the chairman. They did more than advise, they directed and acted, and while they did that they could not escape the consequences of interfering in the transaction of the business by calling themselves an advising committee."***

Concerning circumstances not justifying negation of the limitation of responsibility see: Haughton Graphic Ltd. v. Nixon (1969) 9 DLR (3d) 232 (H.C.J.). This was about mentioning the names of limited partners appearing on a deed of sales signed by the partnership).

> ***"The Act has received little judicial consideration and none at all since the early part of the present century… and each case will presumably have to be decided upon its own facts… the mere fact that the limited partners have permitted their names to be used in a conveyance to the partnership does not afford any evidence that they are taking part in the control of the business…"***

As concerns taking part in the control of partnership business, in the framework of the Reliance Test, see:

Haughton Graphic Ltd. v. 33 (B.L.R.) 125 (Ont. H.C.) p. 13 1:

> ***"The evidence, however, is all to the contrary. Zivot admitted that he was the directing mind of Printcast, that he was responsible for it, and he managed it… Marshall was one of those directly under Zivot who made many of the managerial decisions in the areas of sales and administration. Zivot signed cheques on behalf of Printcast, Marshall also had the authority to do so. In fact, Zivot and Marshall were in complete control of Printcast."***

> ***"It is simply a question of whether or not the limited partner took part in the control of the business and this question becomes largely a quantitative matter."***

> ***"In addition… I was referred also to a Canadian article, "The Control Test of Investor Liability in Limited Partnership"… This article recognizes that the reliance test is not part of the definition of taking part in control of the business but rather that reliance is an element that is added to the control test in order to reduce the number of instances where general liability will be imposed upon limited partners. The author offers the additional test in order to allow that which is patently prohibited by the legislation, i.e. participation in control by a limited partner: see pp. 317 and 318."***

And concerning the responsibility of the holder of a position in a corporation, who is the unlimited partner, an interesting reference was given (requiring an in-depth examination) as follows:

> ***"Finally, I was submitted on behalf of the defendants that to hold them liable in this case means that a person who is an officer or director (or I suppose a senior employee) of the corporate general partner in a limited partnership would always be fixed with unlimited liability for the debts of the limited partnership by virtue of control of the corporate general partner. This conclusion does not logically follow. The section only applies to a person who, in addition to being an officer, director, senior employee, or other directing mind of the corporate general partner, seeks also to take advantage of personal limited liability as a limited partner in the limited partnership. In other words s.63 applies only if two conditions are met. Once is that the person be a limited partner and the second is that he take part in the control of the business of the limited partnership. The section does not apply to someone whose sole role in, and connection with, the limited partnership is that of an officer, director or other controlling mind of the general partner."***

In Manzer's book, Par. 9.1450, the clear signs of taking part in the control of partnership business were examined, which could be summarized as follows:

- Taking part in decision enforcing the policy of the partnership will not negate a limitation of responsibility.
- However, taking part in determining the policy, might negate a limitation of responsibility
- Realization of a lawful right in the relationship between the partners will not cause a negation of the limitation of responsibility
- However, the realization of a lawful right, in a manner, which might have an influence on the right of a third party, could bring about a negation of the limitation of responsibility (this doctrine is sometimes called "**The Test of a Risk to a Third Party"**).

Regarding the distinction between the different doctrines, it was found that the article cited in the judgment passed in the Nixon case, received response and criticism in the paper written by Eric Apps titled:

> ***"Limited partnerships and the 'control' prohibition: Assessing the liability of limited partners"***
> The Canadian Bar Review, Vol. 71, p. 552

An in-depth study of the three papers mentioned above displays to the reader a comprehensive and exhaustive review of the various doctrines, while comparing the Canadian judicial decision with that of the United States by extensively using interesting tables and charts.

To summarize the situation in Canada, it should be noted that in the judicial decisions we found only little reference to an interpretation of the provisions of the law relevant to the distinction between examinations of the partnership business and consulting allowed and between prohibited interfering with management or control.

There is no dispute between Canadian scholars that it concerns a factual, quantitative criterion, permitting the court to determine the necessity of depriving the limited partner of his limited responsibility under the circumstances of the case.

**The Legal Situation in the United States**

The first legislation regulating the subject of the limited responsibility of a partner in a limited partnership dates back to the year 1822, in the State of New York, i.e. 80 years before the English legislation. This legislation was based on the French Civil Codex of 1807. The responsibility of partners in a partnership was imposed upon partners, who were

***"transacting business on account of the limited partnership"***

At a later stage, the United States adopted, in fact, the concept of prohibiting a limited partner from holding control in the partnership business, similar to the development in England.

The matter of the main legislation to this effect is to be found in the provisions of section 7 of the Uniform Limited Partnership Act, 1916, which is cited here:

> ***"A limited partner shall not become liable as a general partner unless, in addition to exercising his rights and powers as a limited partner, he takes part in the control of the business."***

Here, too, the scholars stated that judicial decisions on this subject are few. One of the presumptions for it is the lack of the unwillingness of lawyers to advise their clients to establish a limited partnership due to the "uncertainty of the control test". See in this matter footnote 65 in the paper written by Flanningan, mentioned above in the section dealing with the legal situation in Canada.

Also, the Reliance Test was dealt with in judicial decisions in the United States, and in two cases, contradicting judicial decisions were passed and the matter was not decided, **at least to the best of my non-binding understanding.**

However, in one of the aforesaid judicial decisions, we found explicit reference to a limited partner holding office in a general partnership, being a corporation. See –

*Frigidaire Sales Corp. v. Union Properties Inc. (1976) 544 P (2d) 781*

> ***"A third party dealing with a corporation must reasonably rely on the solvency of the corporate entity. It makes little difference if the corporation is or is not the general partner in a limited partnership. In either instance, the 3rd party cannot justifiably rely on the solvency of the individuals who own the corporation.***
>
> ***We hold that limited partners are not liable as general partners, simply because they are active officers or directors, or are stockholders of a corporate general partner in a limited partnership."***

Flanningan concluded from this that in case of a general partner being a corporation, as long as its status as a corporation of the general partner is maintained, and the limited partners do not take part in the control in some other way, a third party will not be able to mistakenly assume that the limited partner in fact is responsible as general partner.

**Summary**

A limited partnership gives rise to difficulties, which might constitute a disadvantage as compared to a limited corporation. The risk of implying full responsibility upon the limited partner, who is concerned about his investment and is found to be interfering in the management or in control or in case of a third party relying on the strength of the limited partner, resulted in only limited use of a limited partnership, and consequently, there are only few legal rulings in cases related to the special nature of the limited partnership.

It was found that the provisions of the law not allowing limited responsibility to a limited partner are similar in different countries.

Furthermore, it appeared that judicial decisions found were specific to a case tried before a judicial authority. Though lacking any similarity between the different doctrines shown in this survey, it appeared that the courts were reciting factual elements brought before them in the framework of legal proceedings, on basis of which they were allowing or not allowing a limited partner limiting responsibility.

Therefore, any person being invited to take part in a foreign partnership dealing with a project in another country, and such person feeling certain that he will enjoy the status of a "limited partner", would be well advised to seek legal advice in the respective country concerning the possibilities of denying limited responsibility and imposing responsibility for the debts of the partnership over and beyond the funds he invested.

Based on the legal advice given, it should be considered in advance whether the "limited partner" status is, in fact, the most suitable status for the interested person to function in the framework of the project. This will spare him many problems in future, substantial legal costs and sometimes even payment of heavy debts.

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