

THE DAILY RECORD

WESTERN NEW YORK'S SOURCE FOR LAW, REAL ESTATE, FINANCE AND GENERAL INTELLIGENCE SINCE 1908

CivilLITIGATION

Protect limited partners' investments

In this post-meltdown era, the news media and case reporters are full of stories about lawsuits by investors alleging fraud, breach of fiduciary duty and other misconduct by the people who managed their now-worthless investments.

Litigators representing those investors have advanced both traditional and novel legal theories in support of their efforts to compel the responsible parties to pay for the losses. Although some lawsuits arise from exotic and sophisticated investment schemes, others involve a more traditional form of investment, the limited partnership.

A limited partnership is an unincorporated association that can serve as the vehicle for straightforward or complex business ventures. A limited partnership often is used to put together an investment in real estate, for example. A person or entity intending to control the venture and serve as the general partner seeks out investors who become the limited partners. A limited partner's expected return on his or her investment often is a combination of tax benefits related to pass-through losses in the venture's early stages and a share of the profits.

Under New York's Revised Limited Partnership Act — applicable to limited partnerships formed after July 1, 1991 — a limited partner's status is more like that of a corporate shareholder than that of a partner in a New York general partnership. Under RLPA §121-303(a), a limited partner is not responsible for the liabilities of the limited partnership unless he or she also is a general partner or participates in the control of the business.

The limitation of liability provided by RLPA §121-303(a) can be a double-edged sword for a limited partner, because its bar against participation in the control of the business leaves him or her vulnerable to harm caused by the misconduct of an unscrupulous general partner. The relationships between the general partner, the limited partnership itself and the individual limited partners are addressed generally in RLPA, but the Act essentially defers to the limited partnership's written agreement on governance issues, such as the sharing of profits and losses (§121-503), the sharing of distributions (§121-504), the withdrawal of a limited partner (§121-603), and the assignability of a limited partnership interest (§121-702). RLPA §121-108 authorizes a partner to lend money to, borrow money from, and

transact other business with, the limited partnership.

The RLPA also restricts a limited partner's ability to obtain financial and operational information from the general partner. Section 99(1) of the original Limited Partnership Act afforded a limited partner the same rights as a general partner to "have on demand true and full information of all things affecting the partnership, and a formal account of partnership affairs whenever circumstances render it just and reasonable," but the RLPA now makes it more difficult for a limited partner to stay informed of the status of his or her investment and the general partner's activities. RLPA §121-106(b) provides a relatively restricted list of the information a limited partner is entitled to review as a matter of right, "subject to reasonable standards as may be set forth in the partnership agreement or otherwise established by the general partners."

In many ventures, the prospective general partner offers the potential limited partner a written agreement that restricts, to the maximum extent permitted by the RLPA, the limited partner's rights of withdrawal, assignability and access to information. It is also often true that the general partner is more likely to engage in business transactions with the limited partnership — including borrowing money from the limited partnership — than the non-participating limited partners. The limited partnership agreements we see in our litigation practice make it extremely difficult to remove a general partner, generally specifying no grounds for removal short of fraud. In other words, a general partner bent on mischief often has the opportunity to misbehave under the belief he or she never will be punished.

The best time for a limited partner to protect against potential general partner misconduct is when the investment is made. The limited partner's attorney should insist that the limited partnership agreement require the general partner to provide limited partners with, at minimum, copies of annual tax returns. Knowledge is power, and returns contain key information about distributions received, assets bought and sold, and transactions in limited partnership interests. A general partner's refusal to agree to share such information is a red flag that should not be ignored.

Of course, a litigator asked to represent a limited partner in a

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Daily Record
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dispute with a general partner often is presented with a one-sided agreement of the type I've described. That means an uphill but winnable battle, especially when the general partner is highly motivated to block inquiry into his or her activities, and can use the limited partnership's funds to pay lawyers, permitted by RLPA §121-1004, at least until judgment is entered establishing misconduct. The litigator may have to start with a proceeding under RLPA §121-106(b) to force the general partner to disgorge basic but critical business records such as tax returns and banking records. The documents enable litigators to follow the money and may support claims against the general partner based on the uncovered misconduct.

A general partner is a trustee who owes the limited partnership and the individual limited partners the highest fiduciary duties. See RLPA §121-403(c) and Partnership Law §43(1). A general

partner breaches those fiduciary duties by misappropriating or commingling funds or through self-dealing, and is liable for the harm caused by any breach.

Evidence of a general partner's breach of fiduciary duties would support an action for equitable relief, such as an accounting and the imposition of a constructive trust on any ill-gotten gains. It also would support a derivative action under RLPA §121-1002 or a dissolution proceeding under RLPA §121-802.

A litigator should choose the form of proceeding and requested remedies based on the client's objectives but, whatever the choice, proof of the general partner's breach of fiduciary duties can be used as a powerful weapon for the protection of a limited partner's investment.

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