1998

Limited Partner, Maximum Effect: Rethinking the Risk of Investing in Delaware Limited Partnerships

J. Brooke Hern

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LIMITED PARTNER, MAXIMUM EFFECT: 
RETHINKING THE RISK OF INVESTING IN 
DELAWARE LIMITED PARTNERSHIPS

J. Brooke Hern*

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* Appreciation is owed to Distinguished Professor of Law Alan R. Bromberg of 
  Southern Methodist University School of Law for his generous support and thoughtful 
  insight, and to my wife, Stephanie, for making all things possible.

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LIMITED partnerships offer investors an opportunity to profit from the proficiency, competence, and ability of experienced general partners. In exchange, general partners obtain the financial backing necessary to realize their full potential for business development and expansion. While general partners assume personal liability for the enterprise's debts and actions, they retain almost unfettered control over business decisions without review or effective opposition from limited partners. Conversely, limited partners are liable only to the extent of their investment, but they must turn over control of that investment to the judgment and will of general partners.

Thus, while limited partnerships are grounded in a series of give-and-take exchanges, investing in a limited partnership also requires an unreciprocated leap of faith. Investors must trust that general partners will return to them the benefit for which they bargain. This Comment examines the extent to which limited partners can prevent unanticipated acts of self-dealing that deny the return of profit and assets. The answer to this inquiry has consequences for limited and general partners alike because general partners must earn the investors' trust before they can obtain money from limited partners. A trend away from limited-partnership investment will have dire consequences for entrepreneurs who depend on limited partners to fund business ventures.

This Comment seeks stable ground on which investors can rest before taking a leap of faith in trusting that general partners will protect the financial interests of limited partners. To shed light on what is at risk, this search begins with an analysis of the economic importance of limited partnerships. It continues through the evolution of modern limited-partnership statutes and the on-going debate between concepts of fiduciary duty and freedom of contract. The search concludes with an overview of relevant case law and an attempt to apply that law with the certainty and consistency investors should demand before entering a limited-partnership agreement.

Through the examination of theory, statute, and case law, it is clear that investors should approach with suspicion any limited-partnership agreement that permits self-dealing. As well, it will be evident that investors should be wary of contractual provisions waiving traditional fiduciary duties owed by general partners. Examining the varying degrees of fiduciary protections offered by different jurisdictions, this Comment advises investors to enter into limited-partnership agreements only after a close and thorough examination of the state law governing the agreement. Finally, this Comment shows that investors should avoid limited-partnership agreements governed by Delaware law. It exposes Delaware law as a haven for harmful self-dealing that can leave investors without adequate legal recourse. It shows that the choice of Delaware law, in itself,
suggests that general partners seek freedom from fiduciary limitations and the ability to put their own interests first. Indeed, the absence of basic fiduciary safeguards in Delaware presents a level of risk that far outweighs the benefits offered by the limited partnership.

B. Economic Growth, Private Investment, and Limited Partners: An Overview

Speaking to the nation in his first State of the Union Address, President Kennedy called on Congress to demonstrate the promise and potential of capitalism. “We must show the world what a free economy can do,” he said, “to put unused capacity to work, to spur new productivity, and to foster higher economic growth.” To achieve that goal, the President asked Congress to approve a tax-incentive program that would encourage private-sector investment.2

President Kennedy was not the first or last American leader to pursue this course. Historically, American economic policy has often been directed toward spurring growth by encouraging private investment.3 This strategy continues today in the Clinton Administration. For example, the Clinton economic program includes incentives for investing in “cutting-edge research and development . . . that will create investment-led, technology-driven, economic growth and . . . provide new high-skilled, high-wage jobs.”4 Across the broad spectrum of start-up businesses, limited partners play an important role in launching and sustaining new business ventures. Everyday, in every state throughout the nation, limited partnerships are formed to attract investment dollars.

In Missouri, plans were launched to build a 280-acre discount outlet mall just outside of St. Louis.5 While bulldozers prepared to clear the way for the first 1.2 million square-feet of leasable space, limited partners funded Phase I of the project by investing $199 million in the newly created St. Louis MegaMall, L.P.6

In Texas, investors were called on to raise funds needed to purchase a professional football team and move it to Houston.7 Limited partners were asked to invest a minimum of $1 million to complete a $200-million financing package.8

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2. See id.
6. See id.
8. See id.
Last year, limited partners invested $46 million in a California venture-capital fund targeting local health care and technology-related companies.\(^9\) It was the sixth fund created by the La Jolla-based Sorrento Ventures III, L.P., which had more than $100 million under management in 1996.\(^10\)

During the 1970s and 1980s, limited partnerships attracted an estimated $130 billion from investors.\(^11\) From shopping malls, to football teams, to start-up companies in cutting-edge industries, limited partners were needed to provide capital, help realize entrepreneurial dreams, and capture untapped markets for economic growth and job creation.\(^12\)

These numbers suggest that, for general partners and limited partners alike, limited partnerships are an attractive form of investment. Composed of a combination of one or more limited and general partners, the limited partnership functions much like a general partnership,\(^13\) except that the rights of limited partners are restricted to receiving income from profit and dissolution.\(^14\) While offering limited partners the same limited liability enjoyed by corporate shareholders, limited partners also escape the double taxation and franchise fees that burden corporations. Moreover, by enabling less experienced investors to benefit from the general partners’ expertise, the limited partnership is an opportunity for money and experience to come together and produce profit.\(^15\)

On the other hand, a limited partnership opportunity may present more risk than meets the eye. Investors must look beyond the lure of limited liability, flow-through taxation, and the potential for profit derived from the experience of general partners. By surrendering control, without sufficient fiduciary protections, limited partners cannot be certain of realizing any of the benefits.

C. THE RISK OF HARM FROM SELF-DEALING

While the relationship between a general and limited partner is, by tradition, grounded in concepts of fiduciary duty,\(^16\) recent revisions to partnership law emphasized freedom of contract and the permissible waiver of fiduciary protections, including the duties of care and loyalty and the

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10. See id.
11. See Steve Kam et al., The Market Pricing of Syndicated LPs and the Valuation of FLPs (Family Limited Partnerships), TRUSTS AND ESTATES, Feb. 1, 1996.
14. See id. §§ 1231, 1307.
15. See Mason, supra note 12, at B1.
obligation of good faith and fair dealing. The underlying rationale for this doctrinal shift is that general partners need greater flexibility to take entrepreneurial risks that will yield profit. As a result, limited partners are exposed to an unusual and perhaps hidden danger. Beyond the entrepreneurial risk of loss and failure that accompanies all business investments, limited partners may also face a risk of being squeezed-out and denied the benefit for which they bargain because the enterprise achieves a high level of success. As well, limited partners risk suffering disproportionately from the ill-effects of changing economic circumstances as general partners seek to minimize their own loss by putting their own interests first.

This Comment does not advocate greater protection for limited partners. Indeed, a contractarian approach to business investment may well yield greater economic success than a paternalistic one. Rather, this Comment looks through the eyes of a prospective investor to examine whether the freedom of contract, enjoyed by a general partner, imposes a risk of loss that outweighs the potential for financial gain offered by the limited partnership. The central inquiry is whether a limited partner can adequately protect against the risk of entrusting money to a fiduciary who may well be entitled to engage in conduct that defies traditional concepts of fiduciary duty.

Considering the need for investment by limited partners, the answer to this inquiry is one that affects the general partners' interests as well. "[I]nvestors in limited partnership[s] ... have a limited incentive to invest in entities that broadly and explicitly repudiate a duty of loyalty." Thus, if the risks are too great and investors are well-advised to seek more attractive business ventures, the ill-effects of the contractarian approach will reach the general partners rather than the investors who ultimately pursue other financial opportunities.

The next section explores the history of fiduciary duty in the context of limited partnerships. Tracing early obligations to subordinate the general partners' interests beneath those of limited partners, the section examines the modern debate between the concepts of fiduciary duty and freedom of contract. That debate sets the stage for a discussion of Delaware law and its strong commitment to contractarian principles.

II. HISTORICAL BACKGROUND

A. THE COMMON LAW

Any discussion concerning fiduciary duty must, and typically does, rely

to some extent on *Meinhard v. Salmon.* It was there that Justice Cardozo pronounced that "the rule of undivided loyalty is relentless and supreme" where a party is vested with "exclusive powers of direction" over the affairs of another. Cardozo further held that partners owe a duty characterized "[n]ot [by] honesty alone, but [by] the punctilio of an honor the most sensitive ...."

Without any statutory basis, courts continued to hold general partners liable as "full-fledged fiduciaries" based on the adoption of the law of agency in the Uniform Partnership Act and by analogy to the law governing trusts. Absent from the common law and emerging statutes was a clear standard for evaluating conduct.

**B. The Modern Debate**

Two general views emerged to shape the modern debate over limited partnership law. The first view holds that the relationship between general and limited partners is fiduciary in nature. Under this view, general partners may only engage in self-interested transactions where "the partners clearly understand ex ante" that certain types of self-dealing transactions might occur at the expense of the limited partnership. Limited partners may also give contemporaneous approval for previously unspecified acts of self-dealing. According to Vestal, "[t]his world view forms the foundation of current law as expressed in both the [Uniform Partnership Act] and the common law of partnerships."

The second view holds that a relationship between general and limited partners is contractarian in nature. In contrast to the fiduciary view, the contractarian view requires no advanced understanding on the part of limited partners that a general partner might subordinate the limited partnership's interests; nor does it require any contemporaneous notice of specified acts of self-dealing. Rather, the contractarian view maintains that general partners are free to engage in self-interested transactions, unless the limited-partnership agreement provides otherwise.

20. 164 N.E. 545 (N.Y. 1928).
21. Id. at 547-48.
22. Id. at 546.
25. See Editorial Comments of Prof. Alan R. Bromberg, January 1997 (on file with the author).
28. Id. at 523-24.
29. See id. at 524.
30. Id.
31. See id.
32. See id.
33. See id.
The contractarian view is based on concepts of liability and market forces as mechanisms for regulating behavior and enforcing standards of conduct. Contractarians criticize the fiduciary view as "outmoded" and shortsighted, and suggest that the development of "an optimal corporate contract" depends not on government regulation, but on the discipline demanded by a private market.

C. THE UNIFORM ACTS

To fully explore the significance of Delaware law, it is necessary to first examine the uniform and revised uniform acts that shape the body of law governing limited partnerships. Both the Uniform Partnership Act (UPA) and the Revised Uniform Partnership Act (RUPA) govern relationships between general and limited partners. Each of the acts recognizes a fiduciary duty owed by a general partner to a limited partnership. The Revised Uniform Limited Partnership Act (RULPA) also recognizes that a general partner is accountable to a limited partner as a fiduciary. The revised acts identify a duty of loyalty, a duty of care, and an obligation of good faith and fair dealing. Courts have also upheld a duty of disclosure with respect to information needed by limited partners to make informed decisions.

Even while recognizing fiduciary duties and obligations, RUPA expressly permits a general partner to modify the duties of care and loyalty if the modifications are not "manifestly unreasonable." RUPA also permits a general partner to eliminate the obligation of good faith and fair dealing by creating substitute standards of conduct, but again, only if those standards are not "manifestly unreasonable." What constitutes

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35. Id.
36. See RUPA § 403(a) (granting general partners in a limited partnership the same rights as in a partnership without limited partners).
37. See UPA § 21(a) (a general partner is "accountable as a fiduciary"); RUPA § 404.
38. See RULPA § 403(a) (subjecting general partners of a limited partnership to the same limitations as general partners in a partnership without limited partners).
39. See RUPA § 404(b) (duty to account to the limited partnership, act as trustee of its property, and refrain from competing or acting on behalf of a party "having an interest adverse to the partnership"); In re USA Cafes, L.P. Litigation, 600 A.2d 43, 48 (Del. Ch. 1991); Boxer v. Husky Oil Co., 429 A.2d 995, 997 (Del. Ch. 1981).
40. See RUPA § 404(c) (duty to refrain from conducting the affairs of or winding up the limited partnership in a manner that amounts to gross negligence, recklessness, intentional misconduct, or a knowing violation of the law); Trustees of Gen. Elec. Pension Trust v. Levenson, No. 12014, 1992 LEXIS 43 (Del. Ch. March 3, 1992) (applying the standard of gross negligence developed in Aronson v. Lewis, 473 A.2d 805 (Del. 1984)).
41. See RUPA § 404(d) (A general partner must discharge the duties to the partnership and the limited partners and must exercise any rights granted to the general partner under both RUPA and the partnership agreement consistent with the obligation of good faith and fair dealing.).
43. RUPA §§ 103(b)(3), (b)(4).
44. See id. § 103(b)(5).
"manifestly unreasonable" has not been determined by the courts. In addition, RUPA expressly rejects any presumption that a general partner violates the duties and obligations set forth in either the Act or the partnership agreement "merely because the [general] partner's conduct furthers the [general] partner's own interest."

Both RUPA and RULPA are in effect, to some extent, in almost every state. In light of this widespread acceptance of the revised acts, the next section examines the continuing debate among proponents of contractarian and fiduciary views, and the direction of limited partnership law. It also examines Delaware's version of RULPA and the effect of RUPA on limited partnership law in general. Finally, the next section explores possible alternatives to fiduciary safeguards to determine whether investors can find stable ground on which to base investment decisions as contractarian principles gain influence over the body of limited partnership statutes and decisions.

III. THE DEBATE CONTINUES

A. The Direction of Limited Partnership Law

Since Meinhard v. Salmon, partnership law has adopted neither the fiduciary nor the contractarian view, but has vacillated somewhere toward the middle of these two extremes. In fact, the common law continues to search for that delicate balance between "flexibility and fidelity." While the courts have long held that a general partner clearly owes fiduciary duties to a limited partner, the extent to which a general partner's fiduciary duties may be modified by contract is unclear. Provisions authorizing self-dealing are not "ipso facto impermissible," but are subject to good faith standards. Once again, however, it is unclear exactly what is meant by good faith.

In Riviera Congress Associates v. Yassky, the court approved a self-dealing transaction because a prospectus issued to prospective investors suggested that self-dealing might occur. The court found this was sufficient notice to the limited partners, despite the absence of any expression of notice in the limited-partnership agreement. In so holding, the court demonstrated a willingness to look beyond the four corners of a limited-partnership agreement to condone a general partner's act of self-dealing. In contrast, courts are less willing to consider extrinsic evidence to rem-

45. See Discussion with Prof. Alan R. Bromberg, February 1997.
46. RUPA § 404(e).
47. See Robert B. Robbins, Fiduciary Duties of Directors of Corporate General Partners to Limited Partnerships, CA65 ALI-ABA 87, 92 (1996).
52. See id.
53. See id.; Bromberg & Ribstein, supra note 50, at 6:156-57 n.136.
edy or punish self-dealing acts where the limited-partnership agreement contains seemingly permissive language. For example, in Furman v. Cirr
tito, a federal court upheld a general partner's self-dealing transaction by refusing to consider extrinsic evidence that self-dealing was inconsist
ent with the parties' agreement-in-fact. The court held that the terms of the limited-partnership agreement superseded any fiduciary obligations arising from any prior discussions or agreements.

Thus, even though fiduciary obligations are "more intense" in a limited partnership because the investors are passive, modern courts are influ-
enced by secondary authority that supports greater flexibility to contract away fiduciary obligations owed by general partners to limited partners. Relying on these secondary sources, the Connecticut Supreme Court expressed concern over the imposition of strong fiduciary protections:

We agree with the thrust of these commentaries that, in general, in the context of a commercial limited partnership the fiduciary rela-
tionship must be flexible enough to ensure that partners with diverse interests will be able to craft and rely on a partnership agreement that reflects their common interests. The law should recognize that an overly strict interpretation of partnership loyalty might stifle the limited partnership form, and enable a limited partner to exploit its status as beneficiary to hold a general partner hostage to the partnership.

B. FIDUCIARY DUTIES AND DELAWARE'S "MAXIMUM EFFECT"

There is a historical basis for concluding that fiduciary duties serve as default principles in the absence of express contract provisions permitting self-dealing transactions by a general partner, and these common law principles have been codified in many jurisdictions. While the revised model acts offer general partners relief from these common-law obligations, the Delaware RULPA provides general partners with even greater freedom to engage in self-dealing acts that are harmful to limited partnership interests.

For example, title 6, section 17-1101(c) of the Delaware Code declares it the policy of the Delaware RULPA to give "maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements." As this Comment will demonstrate, Delaware's "maxi-
mum effect" policy is construed broadly against fiduciary-default principles that were prevalent at common law.

While conferring great legal significance upon contractual language written by general partners, the Delaware RULPA also invites general partners to contractually restrict fiduciary obligations owed to the limited

54. 828 F.2d 898, 901 (2d Cir. 1987).
55. BROMBERG & RIBSTEIN, supra note 50, at 6:114.
56. See id. at 6:153-54.
59. DEL. CODE ANN. tit. 6, § 17.1101(c) (West 1997).
partnership. Moreover, the Delaware RULPA provides a safe harbor to shield general partners from liability when they rely in "good faith" on that language as a basis for disregarding fiduciary obligations.

Therefore, when deciding disputes arising from limited-partnership agreements organized under Delaware law, courts are required to give "maximum effect to the principles of freedom of contract," thus allowing general partners to act in a manner inconsistent "with the common law duties of a fiduciary" where the limited-partnership agreement is interpreted as modifying that responsibility.

Further, courts may not violate the safe harbor provision of the Delaware RULPA to reach general partners who act in "good faith" reliance on their agreement, even where the general partner's self-dealing "might otherwise be questionable or impose a stricter standard of scrutiny than the norm." Contrary to contractarian concerns that RUPA and RULPA expanded fiduciary obligations by explicitly recognizing them, the Delaware RULPA has increased the risk of harmful self-dealing by allowing general partners to define the parameters of fiduciary duties in the contractual setting of a limited-partnership agreement.

Critics see a problem with increasing the level of permitted harm without defining that which constitutes "good faith." For the sake of promoting efficiency, critics say, such statutes leave courts with an ambiguous standard of good faith that fails to rise along with the relative power of the general partner. By apparently prohibiting only conduct deemed to be egregious, critics say, such an approach is "at variance with both the continuum and tradition" of limited partnership law.

Consistent with that criticism, some commentators emphasize the relevance of bargaining power and the sophistication of the parties, suggesting that waivers of fiduciary duties should be enforced only "where there is direct and equal dealing between the partners[, ...] the waiver is explicit[,] and there are no equitable reasons for nonenforcement in the given case."
While other states take a more moderate approach to the contractarian-fiduciary debate, Delaware is the only one to expand RULPA to include this unique and far-reaching "maximum effect" policy, thereby giving general partners a higher degree of flexibility and protection from liability. The next section takes a step back to explore RUPA's influence on the contractarian-fiduciary debate more generally. The section also explores RUPA's role in defining fiduciary obligations owed by general partners and looks at the risk and uncertainty that arise for limited partners out of the revised act.

C. THE EFFECT OF RUPA

With respect to RUPA's effect on limited partnership law, there are two competing views: one suggesting that RUPA is a departure from prior law because it weakens fiduciary obligations, and another suggesting that RUPA increases the level of fiduciary duties owed by a general partner. In the course of evaluating the present state of limited partnership law, conclusions as to which analysis is correct may differ among jurisdictions. Limited partnership law is an evolving body of statute and case law, influenced by four model acts—each of which may, to varying degrees, be in effect in a particular jurisdiction.

While RUPA has influenced the direction of limited partnership law, using the revised act as a guide for prospective analysis may offer little certainty for limited partners. Indeed, RUPA is open to criticism for failing to reconcile the principles of fiduciary obligation and freedom of contract. The failure to reconcile these competing principles generates uncertainty and confusion in the search for stable ground on which to base investment decisions. Indeed, Professors Bromberg and Ribstein criticize RUPA's lack of clarity in their analysis of section 404(b)(2):

RUPA § 404(b)(2) provides for a specific duty to refrain from "dealing with the partnership . . . as or on behalf of a party having an interest adverse to the partnership." Because the language of UPA § 21 is included in RUPA § 404(b)(1) without specifying how subsection (b)(2) relates to subsection (b)(1), it is not clear how, if at all, the new provision affects existing law.

Further sources of confusion are subsections 404(e)-(f), which provide, respectively, that a partner does not violate a duty or obligation merely by furthering his own interest and may transact business with the partnership on the same basis as a third party "subject to applicable law." It is not clear how these provisions interact with the rest of § 404. The provisions seem to contradict the duty to act selflessly
Professors Bromberg and Ribstein further observed additional points of confusion concerning the duty of loyalty and obligation of good faith: RUPA is also perverse even in its limited authorization of waivers. RUPA permits "specific types or categories of activities" covered by duty-of-loyalty waivers and agreed "standards" for measuring the performance of the good faith obligation that "are not manifestly unreasonable." . . . These qualifications are so vague that sophisticated planners would be foolish to rely on them, but are sure to enmesh in litigation unfortunate partners who attempt private ordering of fiduciary duties.77

While this analysis warns of uncertainty for general partners, it also forewarns prospective investors considering the limited partnership form of investment. The concept of limited partnership involves relinquishing control of large sums of money and placing trust in a general partner to nurture that investment and return to the limited partner his fair share of the profits. If fiduciary duties are not required to watch over a general partner’s conduct, on what alternative safeguards can limited partners depend to minimize the risk that a general partner might deny them the benefit for which they bargain?

D. Alternatives to Fiduciary Safeguards

One suggestion is that market forces will protect limited partners because "general partners must run the firm carefully to avoid personal liability," thereby lessening the need for limited partners to obtain fiduciary guarantees.78 "[T]his argument fails," according to Ribstein, because personal liability "has little effect on the general partners' incentives to self-deal, for example, by taking partnership opportunities or excessive compensation."79

The sophistication of investors and the availability of expert advice represents another alternative to fiduciary safeguards. However, Ribstein rejects the argument that limited partners are among a more sophisticated class of investors able to understand complex deals and to benefit from the advice of qualified business advisors.80 To the contrary, the complex nature of limited partnership deals may conceal, rather than alert, investors to waivers of fiduciary duties in limited partnerships.81 "The supposed problem is not that investors are unsophisticated, but that there is 'a fundamental problem of asymmetric information' because investors cannot predict the extent of the conduct that the waiver may

76. Id. at 6:116.
77. Id. at 6:161-62.
79. Id.
80. See id. at 305.
81. See id.
permit.”82

The ability to exit a limited partnership might also present an alternative to fiduciary safeguards were it not for the illiquidity inherent in this type of investment. Few limited partnership interests find a ready market, which would allow for the easy or quick transfer of interests.83 Therefore, Ribstein rejects the notion that market forces can effectively guide the conduct of general partners.84

Bound by contract to a self-dealing general partner, limited partners may be trapped without recourse.85 Unable to adequately negotiate for provisions that protect against harmful self-dealing, and unable to transfer their interest to another willing investor, the only alternative left for a limited partner might be the removal of the general partner by vote or court order. Here again, however, limited partners face another obstacle: the high costs inherent in removing a general partner.

To remove a general partner, it is necessary to buy out or compensate the partner for the partner's ownership rights. In addition, the general partner probably will insist ex ante on a right to discharge of the partner's guarantee of partnership debts in the event of removal. This discharge may necessitate satisfying obligations owed to creditors and therefore selling important assets . . . . [T]he partners may need to replace the guarantee lost by removal of the general partner. In particular, if the partnership had only one general partner, it must either replace that partner, dissolve, or continue as a general partnership. Without an effective power to remove the general partners, the limited partners lose an important constraint on the general partners’ actions. As a result, the fiduciary duty constraint becomes more important.86

The history and evolution of limited partnership law offers an unclear picture of how best to safeguard the benefit for which an investor bargains upon entering a limited partnership. In the absence of broad fiduciary language, counsel for an investor would be challenged to draft a limited-partnership agreement that anticipates the many ways general partners may circumvent their fiduciary obligations. The next section of this Comment will examine recent and significant court decisions that continue to shape the law that governs relationships between general and limited partners. The section will also explore circumstances in which unanticipated self-dealing is viewed by courts as bargained-for freedom provided to general partners under limited-partnership agreements. Particular attention should be given to the low level of fiduciary protection afforded under Delaware law, even where disputes are litigated in courts outside of Delaware. These cases serve as notice to investors that

82. Id.
83. See id. at 306.
84. See id.
85. See id. at 309.
86. Id. (citations omitted).
different states offer different levels of fiduciary protection, and that Delaware law provides very little protection from harmful self-dealing.

IV. JUDICIAL DECISIONS

A. The Search for Certainty

While much of the debate over fiduciary duties focuses on contract provisions that permit self-dealing, most limited-partnership agreements lack specificity and only broadly define the rights, duties, and liabilities of a general partner. Where a limited-partnership agreement does not adequately or clearly define the general partner’s fiduciary duties, Delaware courts, in particular, have shifted toward the contractarian view.

In *Froemming v. Gate City Federal Savings & Loan Association*, the court applied general fiduciary duties despite a broad provision in the partnership agreement that permitted Delaware partners to engage in other business and to *benefit from* the partnership without *accounting to* the partnership. However, under current Delaware statutes, *Froemming* may no longer be good law, depending on what the general partner has done.

In 1988, Professors Bromberg and Ribstein observed that “there is some authority for nonenforcement or incomplete enforcement of [waivers relating to a general partner’s duty of loyalty] in the corporate and limited partner context.” In 1995, however, the two commentators noted that “[a recent amendment to the Delaware limited partnership statute [giving maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements] may signal a reversal of this authority.”

Delaware courts, which follow the contractarian approach to a greater degree than other courts, have adopted a factual presumption that general partners standing on both sides of a transaction must certainly have bargained for such a position. Parties may modify “traditional notions
of fiduciary duty” and redefine “the parameters of due care.” Holding that contract terms control in the absence of allegations of fraudulent inducement, the court in In re Cencom Cable Income Partners, L.P. Litigation refused to grant injunctive relief to stop the sale of partnership assets to the general partner, even though the general partner stood on both sides of the transaction. Organized under Delaware law, the partnership agreement obligated the general partner to liquidate the partnership’s assets by a specified date, and it made no express provision for the limited partners to object to the manner in which the general partner fulfilled this obligation. The limited partners also alleged that the general partner failed to disclose material facts relevant to the liquidation provision, but the court did not view those omissions as fraudulent inducements warranting injunctive relief.

Furthermore, Delaware courts assume that limited partners pay discounted prices in exchange for giving a general partner the contractual right to act in conflict with traditional concepts of fiduciary duty. Thus, the court will allow a general partner to stand on both sides of a sale of assets without seeking the most favorable price for the partnership property. Even where a contract provision allowing self-dealing is not reasonable, Delaware does not hold a general partner liable for breach of the duty of loyalty and allows for an effective denial of any benefit for which a limited partner has bargained. The general partner is required only to act with a good faith belief that his conduct is permissible under the limited-partnership agreement. Relying on Delaware law, the court in United States Cellular Investment Co. of Allentown v. Bell Atlantic Mobile System, Inc. held that, under circumstances involving such good faith belief, self-dealing is allowed, and the general partner is “shielded from liability for breach of fiduciary duty” even though self-dealing occurred to the detriment of limited partners. In that case, the plaintiffs’ complaint alleged that the general partner “willfully failed and refused to share the right to provide cellular services in New Jersey” with the limited partners. The Court of Chancery’s decision to dismiss the fiduciary duty claim was upheld on grounds that the complaint merely asserted that the general partner intentionally, rather than knowingly, breached the agreement.

95. Id.
96. See id. at *13.
97. See id.
99. See id.
102. Id. at 504.
103. Id.
104. See id.
Further, in *U.S. West, Inc. v. Time Warner, Inc.*, the court held that limited partnerships are amenable to greater freedom of contract that may include the waiver of fiduciary duties. Absent a defect in the bargaining process, such as fraud, non-disclosure, or manipulation, "explicitly negotiated and validly adopted provisions [waiving fiduciary duties] will be enforced." Thus, it seems that prospective investors are left with a high-level of uncertainty with respect to how a general partner can be restrained from self-dealing. Indeed, recent case law suggests that the most difficult part of a limited partner's burden of proof may be to demonstrate a defect in the bargaining process, which is the only exception noted by the court above.

**B. Applying the Law: More Uncertainty**

1. **The Risk of Fraudulent Inducement**

Consider the following situation. An entrepreneur engaged in a restaurant and hotel business approaches an experienced, out-of-state general partner wishing to establish a riverboat gambling operation. The state legislature recently passed a law allowing for such enterprises, and the entrepreneur is an influential member of the community, capable of obtaining the necessary political support to gain the required local approval. He also has the ability to supply a portion of the seed money needed to start the enterprise, but wishes to work with someone experienced in running casinos.

Both parties understand that, while the entrepreneur will get a small percentage of the business, his primary motive for joining the enterprise is to expand his own restaurant and hotel business by serving the proposed casino. The general partner promises that, in the event of success, the entrepreneur will also obtain hospitality contracts for additional casinos upon expansion of the limited partnership.

The entrepreneur is successful in gaining local political support and subsequent government approval for the new enterprise. The general partner accepts a substantive investment from the entrepreneur, and a Delaware limited partnership is formed. However, when it comes time to sign the limited-partnership agreement, the general partner explains that the portion of the agreement detailing the entrepreneur's hospitality contract will be covered by a second document that has not yet been drafted, and the entrepreneur is asked to sign *the part of the agreement* that is ready.

Despite the absence of a written guarantee and the presence of provisions permitting self-dealing on the part of the limited partner, the entre-

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106. See id. at *69.
107. Id. at *70.
108. See id. at *76.
entrepreneur signs the limited-partnership agreement. The limited-partnership agreement provides the investor with a five-percent interest in the limited partnership and a five-percent interest in the corporate general partner, but it fails to mention the promised hospitality contract, which served as the true basis of the bargain. On the one hand, the entrepreneur has every reason to believe that the general partner is dealing in good faith and has no reason to believe that the general partner would conduct himself in a manner inconsistent with traditional fiduciary concepts. Additionally, the entrepreneur is concerned about upsetting relations with the general partner and does not want to jeopardize the plan under which the entrepreneur will be awarded the hospitality contract for this and future casinos.

Some time passes, and the general partner has yet to offer the second document. The entrepreneur, now a limited partner, is concerned that the general partner may not fulfill his promise. In the meantime, the general partner has welcomed a second general partner into the enterprise.

As new assets are brought in and the limited partnership grows in value, the general partner approaches the entrepreneur seeking a modification of their agreement. The general partner wishes to reduce the entrepreneur's share of the business such that it does not grow in value with any increase in assets. Worried that the general partner may renege on the hospitality contract, which is a comparatively greater concern than the small percentage of the business he owns, the entrepreneur agrees to the modification.

In the end, the general partner decides not to give the hospitality contract to the entrepreneur. The general partner then uses partnership assets to form a new limited partnership with the second general partner for the purpose of expanding the river boat gambling enterprise in other states. The entrepreneur is not invited to participate in the expansion, either as a limited partner or with respect to hospitality services. The general partner has acted in a manner consistent with the limited-partnership agreement.

In this situation, the limited partner has expended time and money to make the enterprise a success. In fact, as an entrepreneur, time spent is money lost. As an attorney, one might see a valid cause of action against the general partner. The general partner appears to have fraudulently induced the limited partner to sign a partnership agreement that includes provisions allowing self-dealing. Throughout the relationship, the general partner held out a proverbial carrot, the hospitality contract, to induce the investor to agree to the terms of the limited-partnership agreement.

Recall that in *U.S. West* the court held that such fraudulent inducement would render any contractual waiver of fiduciary duty invalid and unenforceable. It is, however, difficult to predict how a court would rule on a breach of fiduciary duty claim in this case, due to the lack of clarity in

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109. See *id.* at *70.*
limited partnership law. While one might predict a victory for the entre-
preneur, the facts of this situation met with the opposite result from the
court in Whalen v. Connelly.110 Applying Delaware law, the Iowa
Supreme Court upheld self-dealing provisions of the partnership agree-
ment.111 The general partner effectively contracted his way out of any
fiduciary obligation to disclose interests in competing activities, and was
thus permitted to act contrary to the duty of loyalty.112 The court also
refused to consider the limited partner's claim that he had entered into an
effective "oral partnership" with the general partner, holding that "the
written contract must be viewed as superseding any prior oral agreement
by application of the integration clause and the parol-evidence rule."113

Additionally, the court rejected the limited partner's claim of fraudu-
lent inducement because the alleged representations were addressed in
the integration clause and because the limited partner agreed to modify
the contract at the request of the general partner.114 The court held that
where "a person with knowledge of a potential fraud enters into a new
agreement concerning the same subject matter, he waives his claim to
fraud in the original transaction."115 Ultimately, the decision relied on
the Delaware court's holding in Citadel Holding Co. v. Roven.116

Moreover, the Whalen court emphasized the intent of the parties while
actually using rules of contract construction to ignore the parties' intent,
even though fraud was alleged.117 Such a result seems inconsistent with
the concepts of fair dealing and equal-bargaining power that form the
basis of the contractarian view.

2. The Risk of Changing Circumstances

Inconsistent and unpredictable results can also be found in Adler v. William Blair & Co.,118 where investors were invited to participate in a
limited partnership in order to derive tax benefits. The limited partner-
ship was formed as a source of passive-investment loss to offset taxes
owed on sources of active-investment gain held by investors.119 Under
the partnership agreement, the enterprise would purchase property and
the limited partners would deduct the depreciation expense of that prop-
erty from their personal taxable income.120 In exchange, the general
partners would collect fees for managing the properties.121

110. 545 N.W.2d 284, 292 (Iowa 1996).
111. See id. at 291.
112. See id.
113. Id. at 293.
114. See id. at 294.
115. Id.
117. See Whalen, 545 N.W.2d at 284.
119. See id. at 229.
120. See id.
121. See id.
As with any business venture, the purpose of the limited partnership was to reap profits for the investors. Prior to the Tax Reform Act of 1986, it was profitable for the partnership to acquire rapidly depreciating property.122 With tax reform, however, depreciation expenses could no longer be used to offset tax liability for other sources of income.123

Despite this dramatic change in the federal tax code, the general partner continued to purchase property suffering from declining value in order to profit from the collection of management fees.124 The result was that the limited partners were now tied to a losing investment under a partnership agreement that allowed the general partner to engage in self-interested transactions.125 Because the limited partnership was now a losing enterprise for the limited partners, they lacked any real exit option, as it would be difficult to find another interested investor.

The limited partners filed suit claiming that the general partner breached his fiduciary duty by failing to react to changes in the tax code.126 Indeed, the general partner appears to have committed an egregious breach of the duty of loyalty because his conflict of interest could easily have been resolved by purchasing fee-generating properties benefiting from rising value. Thus, the general partner rejected an option for resolving a conflict between his own interests and the interests of the limited partners, instead consciously and perhaps needlessly harming the limited partners.

The court held that the general partner breached no fiduciary duty.127 The decision was based on factual findings that the limited partners knew, before investing, that the partnership sought to purchase depreciating properties and that the tax code might soon change.128 The court characterized the plaintiffs' complaint as demanding that the general partner "abandon the primary purpose of the partnership in the face of tax law changes."129 Elsewhere in the opinion, however, the court itself recognized that it was not the primary purpose of the enterprise to generate "reasonable Partnership tax losses from straight-line real estate depreciation to offset or 'shelter' a Unit holder's taxable income from other sources."130 According to the court, the "primary investment objective" was to "locate and acquire suitable real estate properties and obtain capital appreciation through an increase in the value of the Properties."131 The court's statements seem to support the limited partner's claim rather than the general partner's defense. For if the primary objective was to acquire suitable property, and the tax code changed the definition of

122. See id. at 230.
123. See id.
124. See id.
125. See id.
126. See id. at 231.
127. See id. at 236.
128. See id.
129. Id.
130. Id.
131. Id. at 235-36 (emphasis added).
“suitable property” making depreciating property no longer suitable, then
the secondary objective of acquiring depreciating property should have
been subsumed by the primary objective of obtaining capital appreciation
through an increase in the value of the properties.

The court’s holding is especially surprising when considered in the con-
text of the Tax Reform Act of 1986, which “contained important changes
[that] profoundly affected the market for limited partnership inter-
est.”132 In a recent article, one group of commentators captured the
plight of limited partners trapped in such investments:

Significantly, active income, which included an individual’s wages,
could no longer be offset by passive losses from [limited partners-
ships]; the lure of using the losses from a limited partnership to offset
other income basically disappeared over the next few years. Yet the
partnerships continued to be managed by general partners interested
in perpetuating their stream of management fees, at the same time
creating passive losses which investors were loath to do anything
[about] due to the potential tax liability from recapturing
depreciation.133

It is reasonable for investors to have assumed that general partners
would react to changing law for the benefit of the partnership, and it is
difficult to imagine how they could have foreseen and prevented such a
risk. True, the limited partners were warned that the tax benefit could be
eliminated by changing law,134 but they received no warning that the gen-
eral partner would purchase properties harmful to their interests. Thus,
the holding in this case leaves the legal environment for limited-partner-
ship investment less clear and less predictable.

3. The Risk of Too Much Profit

The legal environment for investing in limited partnerships is made no
more clear by the holding in Katell v. Morgan Stanley Group, Inc.135 The
court rejected the plaintiffs’ claim that their general partners were in
breach of fiduciary duties when conducting two self-dealing transactions
that benefitted the managing general partners’ affiliates to the financial
detriment of the limited partners. The court “decline[d] to undertake an
independent review of the merits of plaintiffs’ claims,”136 relying instead
on the judgment of a special litigation committee composed of members
of the corporate general partner, which determined that “continuing [the]
derivative action was not in the best interests of the partnership.”137

132. Kam, supra note 11, at 40.
133. Id.
134. See Adler, 648 N.E.2d at 236.
136. Id. at *13.
137. Id. at *5. In so deciding, the court said it would “not linger over all the details
criticized by the Plaintiffs, but base [its] decision on [its] overall impression of the Commit-
tee’s good faith and the reasonableness of its investigation.” Id. at *9.
In 1985, twenty-two limited partners invested $2 million each into the Morgan Stanley Leveraged Equity Fund, L.P. The entity was created under Delaware law by Morgan Stanley and CIGNA Corporation to identify and invest in limited partnership opportunities. The partnership agreement designated Morgan Stanley Leveraged Capital Fund, Inc. (Morgan Stanley LCF) as the managing general partner, and required approval for many decisions from CIGNA LCF, which the agreement also designated as a general partner. Also under the agreement, all investment decisions with respect to leveraged buy-out opportunities required a majority vote of a management committee consisting of three appointees from each general partner. The partnership agreement also allowed for self-dealing transactions by a general partner, but only if one of the general partners had no interest in, and subsequently approved of, the transaction. Thus, an alternative to fiduciary protection in this instance would be the self-interest of the general partner who is disinterested in the transaction. In other words, the disinterested general partner would not normally sacrifice its own interests by approving the other general partner’s self-interested transaction.

The limited partnership invested in two leveraged buy-out opportunities, the Container Corporation of America (CCA) and Silgan Corporation. Later, the general partners sold the partnership’s interest in both corporations to affiliates of Morgan Stanley. As a result, the plaintiffs alleged, the affiliates were able to purchase the companies at a substantial and unfair discount. The court discussed the plaintiffs’ complaint with skepticism due to the level of profit generated by the sale: “Although both transactions produced handsome profits for the limited partners of Fund I, Katell and Desert Equities contend that the returns may have been $15 million greater had Morgan Stanley affiliates not stood on both sides of the transaction.” The court continued to express skepticism in its summary of procedural events:

Plaintiffs were dissatisfied with the price [the limited partnership] received for its shares in the CCA and Silgan transactions. Although [the limited partnership] earned enormous returns on its investments in these companies, Plaintiffs believe that Morgan Stanley unfairly limited their gains by selling the investments to [another of its own limited partnerships] for less than they were worth.

Thus, from the beginning, the court reveals its lack of sympathy for limited partners who demand not just a large measure of profit in return for their investment, but the full measure of the profit for which they bargained. In essence, the court’s language suggests that when a limited partner’s profit becomes sizeable, self-dealing becomes less significant. It

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138. See id. at *1.
139. See id.
140. See id. at *5.
141. Two limited partners who brought the claim against Morgan Stanley and CIGNA.
143. Id. at *4.
seems that the court is creating a sliding scale of justice, whereby a general partner is permitted to siphon-off a portion of the limited partners’ rightful share of the profit. This reasoning gives rise to an important question: Why is a general partner entitled to a disproportionate share of the profit when he assumed no greater entrepreneurial risk than the limited partners?

The court avoids this issue using a judicial slight-of-hand in which it recharacterizes the transaction as one approved by disinterested general partners. While acknowledging that Morgan Stanley stood on both sides of the transaction, the court viewed the sale and purchase as merely “a good way to invest this capital.” Attempting to minimize CIGNA’s interest in the transaction, however, the court reveals CIGNA’s motive as one concerned with self-interest rather than with the interests of the partnership and limited partners: “CIGNA believed that selling the assets . . . was a good way to ‘divorce’ Morgan Stanley. . . . [so it] approved the offers . . . without asking for a higher bid.”

As well, the court’s recharacterization also seems unconvincing in light of other facts in the case. For instance, when the limited-partnership agreement was signed, it did not permit the creation of a special litigation committee to review pending derivative litigation. It was after the complaint was filed that the general partners drafted an amendment to the partnership agreement authorizing the use of a special litigation committee consisting of disinterested appointees to decide whether the plaintiffs’ action should go forward. Without specifying exactly who would be appointed to serve on the committee, the amendment won approval from nineteen of the twenty-two limited partners. However, the general partners then appointed CIGNA as the sole member of the litigation committee. CIGNA employees recommended dismissal, concluding that the plaintiffs’ lawsuit was not in the best interests of the limited partnership. It was only through a series of post-agreement maneuvers that the general partners obtained permission to allow CIGNA to review the complaint, and the general partners’ actions in obtaining that permission seem to fall short of satisfying fiduciary obligations not waived under the original agreement.

Additionally, the court refused to give weight to the ongoing series of disagreements between CIGNA and Morgan Stanley as a motive for CIGNA’s approval of the transaction. The court’s analysis also paid little consideration to CIGNA’s expressed desire to wind up the affairs of the limited partnership and dissolve this aspect of its relationship with Morgan Stanley. In addition, the court dismissed as irrelevant the plaintiffs’ assertion that CIGNA could not act against Morgan Stanley’s best

144. See id. at *5.
145. Id. at *1.
146. Id.
147. See id. at *5.
148. See id. at *6-8.
interest because of "longstanding business ties" between the two companies. The court viewed the companies' ongoing disagreements over the management of the limited partnership as evidence of CIGNA's willingness to act against Morgan Stanley, rather than a motive for CIGNA's approval of an unfair transaction that would free it from the venture.

Further, the court deemed CIGNA's willingness to lose profit along with the limited partners as proof that CIGNA "did not stand to benefit from these transactions at the expense of the partnership." This analysis, however, ignores the strong possibility that CIGNA was willing to pay such a price for its "divorce" from a troublesome partnership with Morgan Stanley, and to ensure that the venture did not destroy a long-standing and profitable relationship between the companies.

Even more bothersome is the court's willingness to ignore the differences between shareholders and limited partners. By applying rulings pertaining to disputes between shareholders and corporate boards of directors, the court used the business-judgment rule to review the actions of a general partner with far greater control and authority than a corporate director. Consistent with Delaware law, the court also extended the Aronson ruling from its original corporate context to find that a general partner, faced with liability, may excuse his own self-interested action by deciding to bar derivative litigation initiated by dissatisfied limited partners. Following the court's reasoning here, it is difficult to imagine how an investor in a Delaware limited partnership could ever be assured of recourse for derivative harm, such as the selling of partnership assets, even where the general partner acts in violation of express provisions of a limited-partnership agreement.

Ultimately, the court found that CIGNA acted in good faith because the employees it appointed to the special litigation committee provided "fresh sets of eyes . . . to review the merits of [the] claim[ ]." Again suggesting that the limited partners should be happy with the return received on their investment, the court discounted the plaintiffs' concern over the bias with which the CIGNA employees came to the investigation:

149. See id. at *7.
150. See id. at *8.
151. Id. at *7.
152. See Bromberg & Ribstein, supra note 50, § 1.01(b)(2), (3).
154. See id. at *12.
155. Meaning "any action brought by one or more limited partners of a limited partnership to enforce a limited partnership's right or to prevent or remedy a wrong to the limited partnership where the general partner . . . fails or refuses to do so." Debra E. Wax, Annotation, Right of a Limited Partner to Maintain Derivative Action on Behalf of Partnership, 26 A.L.R.4th 264, 266 (1983).
It is not surprising that [the CIGNA employees] heard favorable descriptions about deals that brought 50-to-1 and 14-to-1 returns on investment. These men worked in the same division of CIGNA as the persons involved in CIGNA LCF [and the limited partnership], but that does not reflect that CIGNA LCF selected them in bad faith.\textsuperscript{157}

Again, the court is analogizing the special litigation committee to the type used by corporate boards of directors and often composed of disinterested directors. The partnership agreement itself permitted self-dealing "subject to applicable law,"\textsuperscript{158} and Delaware courts apply corporate fiduciary duty principles in the limited-partnership context.\textsuperscript{159}

However, it is important to note a significant distinction between a general partner and a corporate board of directors. The board may, indeed, have a variety of interests among directors, some interested and others disinterested in any given transaction that gains approval. It is therefore possible to obtain an independent evaluation of board action, particularly where the special committee is composed of outside directors. Conversely, a general partner—whether a person or a corporation—is an individual. If that individual is interested or biased, it cannot at once be disinterested and unbiased for the purpose of investigating its own self-dealing. A corporation is a fictional entity created by law. It can only speak and act through corporate employees, officers, and directors.

The court's reasoning is flawed because it fails to adequately weigh this distinction in its application of corporate fiduciary principles in the context of a limited partnership. As a corporation, it is impossible for CIGNA to act as a general partner through employees in its finance division, and then provide a disinterested and unbiased review of its own actions through a special committee composed of other members of its finance division. In other words, it is illogical to suggest that a general partner can independently review his own conduct. Delaware courts, however, clearly disagree.

In the end, the Katell court declined to apply the full measure of the entire fairness test derived from corporate fiduciary principles.\textsuperscript{160} While the second step of the Zapata test is not typically used in the corporate context, the circumstances presented by a corporate general partner reviewing the fairness of its own transaction seems to warrant the independent judicial review prescribed in Zapata. Finding the special committee's investigation to satisfy Zapata's procedural requirements, notwithstanding the procedural deficiencies noted above, the court de-

\begin{itemize}
  \item \textsuperscript{157} Id.
  \item \textsuperscript{158} Id. at *12.
  \item \textsuperscript{159} See id.
  \item \textsuperscript{160} See id. (citing Zapata, 430 A.2d at 798 (creating a two-step analysis allowing the court to first inquire into the independence of the special litigation committee and then to substitute its own business judgment for that of the committee to determine if the transaction was fair)).
\end{itemize}
clined to review the substantive fairness of the transaction approved by CIGNA and Morgan Stanley.161

Examining these facts prospectively, that is from the point of view of a prospective investor, it would be difficult to foresee that a $15 million act of self-dealing could go unchecked. Even while the partnership agreement permitted self-dealing, it did so only if the transaction was approved by the other general partner, and only if that general partner had no interest in the transaction. The prospective investor could reasonably rely on this alternative to broad fiduciary language because the disinterested general partner would, in theory, prevent unfairness and harm to the limited partners.

Looking beyond the debate as to whether CIGNA was interested or disinterested, one conclusion clearly arises from the facts of the case: the court declined to review the substantive fairness of the transaction because it would be forced to conclude that the sale of partnership assets by Morgan Stanley to Morgan Stanley was unfair to the limited partners. Such a result could only be achieved by giving "maximum effect" to the language of the partnership agreement.

In agreeing to permit self-dealing subject to disinterested approval, the limited partners did not intend to allow a general partner to steal their share of the profit. Clearly, the intent behind the provision was to allow self-dealing by a general partner where the transaction did not harm the interests of the limited partners. Ultimately, the Katell court refused to look to the intent behind the provision, causing this alternative to fiduciary protection to fail and resulting in a $15 million loss to the limited partners. It is ironic that Delaware is traditionally heralded as offering a higher degree of jurisprudential certainty, and yet a limited partner's search for certainty in contract is slowed by the unstable landscape drawn by such Delaware decisions.

V. CONCLUSIONS

A. DELAWARE DECISIONS AND THE "MAXIMUM EFFECT"

The preceding cases suggest that the Delaware law is hostile toward fiduciary duty claims filed by limited partners against general partners. It is therefore important to note that Delaware courts have also upheld fiduciary obligations in this context. In In re USACafes, L.P.,162 for example, a Delaware court ignored a long-standing rule shielding directors of corporate general partners from fiduciary duty claims filed by limited partners.163 The court found for the plaintiff, holding that "the directors of corporate general partners are obligated to cause the general partner to satisfy its duty to the limited partner."164

161. See id. at *13.
162. 600 A.2d 43 (Del. Ch. 1991).
163. See id. at 48; Bromberg & Ribstein, supra note 50, at 6:07.
164. Robbins, supra note 47, at 95.
Even while Delaware law recognizes the fundamental concept of fiduciary duty, it has probably gone farther than any other jurisdiction in denying fiduciary duties and in supporting limited-partnership agreements that limit or eliminate them. By giving “maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements,” Delaware law leaves limited partners with virtually no fiduciary protections. This is especially true considering that most limited-partnership agreements are written by general partners or their lawyers, are designed to protect general partners, and are agreed to by limited partners without an opportunity for effective negotiation. Delaware’s “maximum effect” policy derives its legitimacy from traditional freedom-of-contract principles based on equal bargaining power, good faith negotiation, and fair dealing in the trade. It is unclear how such principles are related to the way in which limited-partnership agreements are actually created and signed.

The enforcement component of the “maximum effect” policy raises additional concerns for a limited partner. This is because limited partners must be more careful than other passive investors in entities with active management, such as shareholders in corporations and limited liability companies. After all, general partners are typically self-chosen, have permanent tenure, and have broad powers without the restraint of a collective governing board. Correlatively, limited partners have little or no voting rights, and are thus more vulnerable to losing the benefit for which they bargained to a self-dealing transaction.

From Whalen to Katell, courts interpreting Delaware law have engaged in a legal fiction, pretending that limited partners and general partners enter into agreements that are freely negotiated and represent the agreement-in-fact. Delaware law assumes that investors actually agree to allow general partners to do as they please with assets and profits belonging to the limited partnership. Additionally, Delaware has yet to find a case that exceeds RUPA’s lone restriction on contract provisions that modify fiduciary duties and obligations. One would be hard pressed, indeed, to find a case under Delaware law in which the court found such a provision to be “manifestly unreasonable.”

While contractarians defend Delaware’s “maximum effect” policy against criticism and calls for greater fiduciary protections, the prospective investor must approach a Delaware limited partnership with great hesitation. Putting oneself in the position of the investors in Katell, it is easy to see how prospective concern over the absence of broad fiduciary language and the possibility of harmful self-dealing might be assuaged by

165. See Bromberg, supra note 70.
167. See Bromberg, supra note 70.
168. See RUPA § 103(a)(3) (fiduciary duties may be waived so long as the waiver provision is not manifestly unreasonable).
the requirement that self-dealing transactions be approved by a disinterested general partner. It would be difficult to foresee that the disinterested general partner would choose to take a $15 million loss by approving a self-dealing transaction, or that a court would uphold the approval by characterizing an interested general partner as disinterested for purposes of granting the required approval. Yet, that is precisely what happened in Katell.

Returning to the central inquiry posed by this Comment, it is unclear whether a limited partner can, under Delaware law, adequately protect against harmful self-dealing. Further, the risk of investing in a Delaware limited partnership seems high, given the manner in which the “maximum effect” principle is applied. In effect, it seems virtually impossible to devise a Delaware limited-partnership agreement providing for adequate and effective alternatives to traditional fiduciary protections from acts of harmful self-dealing.

Were all jurisdictions to go as far as Delaware in denying fiduciary duties, an investor would be ill-advised to place funds at risk in a limited partnership under the control of such an unaccountable general partner. In short, choosing not to invest is the best alternative to fiduciary protections that are absent under Delaware limited partnership law. Applied to limited partnerships generally, however, this alternative carries with it serious economic consequences. Start-up companies, entrepreneurs, and even communities rely on the billions of dollars generated through the limited partnership form of investment. Additionally, it would be inaccurate to apply conclusions based on Delaware limited partnership law so broadly to the law in other jurisdictions.

B. Some Jurisdictions Offer Greater Certainty

To be sure, the holding in Adler underscores the influence contractarian principles have had in non-Delaware judicial decisions. There is little certainty offered in a jurisdiction that allows a general partner to ignore a significant change in circumstances by continuing to conduct business in a manner that yields only loss for the limited partners because of that change in circumstances. This is especially true where, as in Adler, the general partner could have chosen alternative investment strategies that would have yielded profit to all investors, rather than just the general partner. Placing oneself in the position of the prospective investor, it would be difficult to foresee that the general partner would violate his fiduciary obligation to put the limited partners' interests above his own. Still, the Illinois court reached a conclusion that is consistent with Delaware decisions: the limited partners agreed to allow self-dealing, even at the expense of their own financial interests.

169. See Kam, supra note 11.
170. See Bromberg, supra note 70.
171. See Adler, 648 N.E.2d at 226 (holding that the general partner did not breach fiduciary obligation).
Not all jurisdictions are so willing to completely abandon traditional notions of fiduciary duties and obligations in favor of an approach that places limited partners at risk. The facts present in both Adler and Katell, for instance, would probably be decided differently under the laws of Missouri and Louisiana.

In contrast to contractarian principles, in Palmisano v. Mascaro, a Louisiana court of appeals invalidated a contract provision because it circumvented the basic fiduciary duties required among partners. There, the partnership agreement allowed a partner to escape liability for acts within the scope of his authority that did not constitute malfeasance or misfeasance. It also gave him sole, uncontrolled authority to decide the terms under which partnership property would be sold.

In Knopke v. Knopke, a Missouri court of appeals invalidated a limited-partnership agreement that gave the general partner “unqualified authority” to make all decisions relating to the financial affairs of the partnership. The partnership agreement, the court held, could not excuse the general partner from fulfilling his obligation to deal honestly with the partnership and limited partners.

Both of these jurisdictions declined to apply Delaware’s “maximum effect” principle to questions arising from express waivers of fiduciary duties in limited-partnership agreements. Traditional principles of fiduciary duty protect the investor’s interest in receiving the benefit for which he bargained. While self-dealing may be authorized under certain conditions, these courts recognize that self-dealing that results in substantial detriment to the limited partnership is certainly not the type envisioned or authorized by the limited-partnership agreement. Furthermore, these courts recognize an obligation on the part of the general partner to exercise authority granted under the agreement consistent with the obligation of good faith and fair dealing. Such rulings offer greater certainty for investors in limited partnerships than does the law of Delaware.

The facts in the Whalen case might also yield different results under New York law. For instance, in Lyall v. Grayco Builders, Inc., a New York court reviewed a provision in the partnership agreement giving a partner the right to work on other projects independently. The court relied on fiduciary principles in holding that the provision did not give the partner the right to divert partnership assets to those other opportunities, much in the same manner as the general partner in Whalen sought to exclude his limited partner from opportunities to expand riverboat gambling operations into other states.

174. See id. at 915.
176. See id. at 470.
177. See Whalen, 545 N.W.2d at 290.
Other states like Texas, Massachusetts and California also provide greater fiduciary protections than those offered under Delaware law. Unlike Delaware, these jurisdictions are more willing to invalidate contract provisions that seem to unreasonably modify traditional concepts of fiduciary obligations. In doing so, these courts reject the legal fiction that general partners and limited partners negotiate and enter into agreements with equal bargaining power. Instead they give greater weight to the manner in which limited-partnership agreements are actually drafted and signed.

Additionally, some jurisdictions offer greater fiduciary protection under state securities laws to limited partnership interests acquired through public offerings. "Blue-sky laws," which are designed to protect "gullible investors" in securities transactions, have been formally and informally adopted by most states to limit a general partner's ability to dilute fiduciary duties. In addition, the Securities and Exchange Commission also requires some disclosure of fiduciary obligations in the context of a public offering.

C. Choosing Predictability Over Uncertainty

The decision to acquire an interest in a limited partnership assumes that the general partner will not act in conflict with the best interests of the investor. Indeed, it seems contrary to sound investment strategy to concede that opportunities and profit might be stolen away by the custodian of the investor's fund. If that is so, an investment is better directed to a venture that carries less legal risk.

As an investor agrees to relinquish control over money, prudence requires him to seek a high level of certainty that the general partner will return the profit for which the investor has bargained. Such certainty requires a fiduciary obligation to put the interests of the investor above

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179. See Wartski v. Bedford, 926 F.2d 11 (1st Cir. 1991) (court used fiduciary principles to restrict a provision in the limited-partnership agreement which broadly permitted the general partner to compete against the limited partnership).

180. See Tri-Growth Centre City, Ltd. v. Sildorf, 265 Cal. Rptr. 330 (1989) (fiduciary principles used to limit contract provision authorizing partners to compete with the partnership).


182. See, e.g., N.A.S.A.A. Rep. (CCH) ¶ 3602 E. (August 1991) (publicly offered real estate program "shall provide that the sponsor shall have fiduciary responsibility for the safekeeping and use of all funds and assets of the program ... [and] the program shall not permit the participant to contract away the fiduciary duty owed to the participant by the sponsor"); N.A.S.A.A. Rep. (CCH) ¶ 2622 H. (November 1991) (oil and gas programs shall not contractually limit any fiduciary duty owed to the participants by the sponsor except to limit the time the sponsor devotes to the program and to allow limited competition by the sponsor).

those of the general partner, even where harmless self-dealing is permitted by the limited-partnership agreement.

In search of certainty, investors should be wary of Delaware limited partnerships. Particularly where the enterprise operates outside Delaware, the general partner’s choice of Delaware law signals a need for caution as to the possibility that the general partner might engage in harmful self-dealing. Just as a general partner might choose Delaware law based on the high degree of flexibility it offers, a prospective limited partner should confine his investment strategy to partnership agreements governed by state laws that tend to uphold fiduciary obligations. Any state that gives “maximum effect” to the language of the agreement offers the general partner an upper-hand over the limited partners. Again, this is because the general partner usually drafts the agreement without substantive input from the limited partners.

An investment strategy that stays clear of Delaware limited partnership law benefits the investor by achieving a higher degree of certainty that fiduciary duties and obligations will be upheld. Such a strategy also benefits the public need for economic growth and development, because investors are more likely to engage in start-up ventures and support entrepreneurial activity under laws that protect their investments from harmful self-dealing.

In this regard, legal advice becomes equally if not more important than financial advice in the selection of a limited-partnership interest. A survey of current legal trends should be conducted before any investment is made, thereby providing a degree of certainty that the general partner is not relieved of basic fiduciary obligations. While the debate between contractarian and fiduciary principles rages on, limited partners must look out for their own investments and their own self-interest. Avoiding Delaware law is a good start.