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Formation of the Public Limited Partnership

By Ronald R. Hrusoff* and Carlos A. Cazares**

In searching for tax-saving methods, taxpayers have utilized many devices. One that has always generated a great deal of interest is the limited partnership. A limited partnership created under the Uniform Limited Partnership Act must file an information return, but unlike a corporation, it pays neither federal nor state income tax. Instead,
partners, both general and limited, are taxed directly upon the profits in proportion to their interest in the partnership, or as otherwise provided for in the partnership agreement. The liability of a limited partner, but not of a general partner, is limited to the amount of his investment.

California was slow to recognize public limited partnerships. As late as 1961, an appellate court quoted with approval the following language from an article written by William Dahlquist:

\[\text{[I]n bona fide limited partnerships, there is the right of delectus personarum, the right to determine membership. No partner is admitted without unanimous approval of every other partner. . . . Memberships are never indiscriminately offered at random to the public at large.}\]

For many years California’s Commissioner of Corporations actively discouraged the use of large limited partnerships, except for private offerings to sophisticated investors. With the promulgation of the regulations under the Corporate Securities Law of 1968, the policy was reversed, making possible the creation of publicly held limited partnerships. Any type of business may be conducted through a limited partnership unless prohibited by statute. Nevertheless, with


6. Compare CAL. CORP. CODE § 15015 (general partners liable on obligations of partnership) with CAL. CORP. CODE § 15501 (limited partners not bound by obligations of partnership).


10. CAL. CORP. CODE §§ 25000-804.


12. Stowe v. Merrilees, 6 Cal. App. 2d 217, 44 P.2d 368 (1935). In approximately half of the jurisdictions, some restrictions are imposed. 2 S. ROWLEY, ROWLEY ON PARTNERSHIP § 53.3 (2d ed. 1960). California, for example, prohibits limited part-
a few exceptions, large public limited partnerships have only been used in oil and gas explorations, feed lots, and real estate ventures. The evolution of the public limited partnership has been a stumbling process, and due in part to the 1969-1970 stock market collapse, not an entirely painless one.

The legal problems connected with the formation of the public limited partnership go beyond the fundamental statutory requisites for lawful existence. Although problems such as the use of a limited partner's name as part of the partnership name, the amount of control over the operation of the partnership to be given the limited partners, and formation by substantial compliance with the California Limited Partnership Act are important, they are not the primary points of concern for one creating a public partnership. Increasingly more complex problems are emerging as public limited partnerships become larger and more sophisticated. The ordinary formation problems are overshadowed by questions concerning taxation, partnership investment policies, fees paid to promoters and managers, and the transferability of limited partnership interests. This article will focus primarily on these questions.

I. Formation

A limited partnership must have at least one general and one limited partner. It can be formed, according to California Corporations Code sections 15501 and 15502, by substantial compliance with the requirements set out therein. The requirements are satisfied when

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13. E.g., Prospectus for Six Flags Over Texas Fund, Ltd., at 3 (June 12, 1969) (a $5,950,000 limited partnership for the operation of an amusement park).
15. E.g., Prospectus for Circle One Cattle Fund, at 4 (Nov. 20, 1969); Prospectus for Western Feed Cattle Fund, Inc., at 5 (March 24, 1970).
17. CAL. CORP. CODE § 15505(1). See text accompanying notes 35-36 infra.
18. Id. §§ 15502(1)(a)(XV), 15507. See text accompanying notes 60-61 infra.
19. Id. § 15502(2). See text accompanying notes 63-65 infra.
20. See text accompanying notes 70-151 infra.
21. See text accompanying notes 170-76 infra.
22. See text accompanying notes 177-93 infra.
23. See text accompanying notes 194-207 infra.
24. CAL. CORP. CODE § 15501.
25. Id. § 15502(2).
two or more persons\(^{26}\) sign, acknowledge,\(^{27}\) and record\(^{28}\) a limited partnership certificate in the county of the principal place of business, and in each county in which title to real estate is held.\(^{29}\)

The California Limited Partnership Act requires that the certificate contain 15 separate items.\(^{30}\) Failure to substantially comply with these requirements may cause a limited partner to lose his preferred status as to creditors and to be deemed a general partner.\(^{31}\) As there is no prohibition against including non-required provisions,\(^{32}\) a frequent practice is to entitle the limited partnership agreement "Articles of Agreement and Certificate of Limited Partnership," and to record the entire document. This procedure has two advantages. First, it eliminates the expense of preparing and executing a second instrument. Second, it eliminates the possibility of inadvertently omitting a required provision from either the certificate or the agreement. Where the partnership is closely held, however, the parties may not desire the entire agreement to become a public document; for this reason they may wish to record only the certificate. In public partnerships, the offering circular or prospectus will disclose all facets of the proposed venture, including a summary of the agreement, if not the agreement itself.\(^{33}\)


\(^{27}\) The requirements for a valid acknowledgment are set forth in \textit{Cal. Civ. Code} §§ 1180-207. As a practical matter, acknowledgment has become synonymous with notarization. New York does not require acknowledgment, but does require that the certificate be published in a newspaper. \textit{N.Y. Partnership Law} § 91(1)(b) (McKinney 1948).


\(^{29}\) The code does not require a written partnership agreement; thus, it is theoretically possible to have an oral agreement with the certificate serving as a memorandum of the agreement. \textit{Cf.} Calada Materials Co. v. Collins, 184 Cal. App. 2d 250, 7 Cal. Rptr. 374 (1960).


\(^{32}\) See discussion in Feld, \textit{The "Control" Test for Limited Partnerships}, 82 Harv. L. Rev. 1471, 1482 (1969).

\(^{33}\) For excellent forms see Prospectus for Burnham Properties Ltd., at 1-14,
Corporations Code section 15502(1) (a) sets forth, in paragraphs I to XV, the statements required in the limited partnership certificate. They are briefly summarized below.

Paragraph I of the Corporations Code section 15502(1) (a) requires that the partnership name be specified. The name need not contain any special identifying symbols such as "Ltd." or "Limited." The partnership, however, is prohibited from using the surname of a limited partner unless it is also the surname of a general partner, or prior to the time the named individual became a limited partner, the business had been carried on under a name in which his surname appeared. If a limited partner's name is improperly used in the partnership name, the limited partner will be liable as a general partner to anyone who extends credit to the partnership without actual knowledge that the limited partner is not a general partner.

Paragraph II requires a brief statement describing the character of the business. Following the pattern of corporate articles, the business is generally described as broadly as possible. Most real estate partnership agreements specify the properties to be developed or operated and then, as a catch-all, state that the partnership is allowed to invest in any other real estate.

Paragraph III requires that the principal place of business of the partnership be specified and Paragraph IV requires disclosure of the name, residence and status—general or limited—of each member of the partnership.

Paragraph V requires the certificate to state the "term for which the partnership is to exist." The term may be stated as a specified number of years, as ending on a given date, or as indefinite. If the partnership invests in real estate, the term may be no shorter than the term of any mortgage obligation.


34. An additional array of rules has been imposed by California's Commissioner of Corporations. CAL. AD. CODE tit. 10, §§ 260.140.110-115 (1968). For detailed discussions of the technical requirements, see 2 Z. CAVITCH, BUSINESS ORGANIZATIONS § 39.05 (1965); 2 S. ROWLEY, ROWLEY ON PARTNERSHIPS §§ 53.1-2 (2d ed. 1960).

35. CAL. CORP. CODE § 15505(1).

36. Id. § 15505(2). The more frequent problem arises when either the general partner or a limited partner represents to a creditor that one or more limited partners will guarantee certain partnership obligations. E.g., Donroy Ltd. v. United States, 301 F.2d 200 (9th Cir. 1962); Hayward Tamkin & Co. v. Carpenteria Inv. Co., 265 Cal. App. 2d 617, 624-25, 71 Cal. Rptr. 462, 467 (1968).

37. CAL. AD. CODE tit. 10, § 260.140.112(d) (1968). See also CAL. BUS. & PROF. CODE § 10290.
Paragraph VI requires disclosure of the amount of cash or property contributed by each limited partner. If property is contributed in lieu of cash, the value of the property for partnership purposes will be determined by the agreement and not by the actual value of the property. The value set forth in the agreement, however, must be established in good faith; the parties are prohibited from stating a value which they know to be false. An interest in the partnership for services rendered may be given to a general, but not to a limited partner. In other words, cash or the beneficial interest in the property must be conveyed, transferred or assigned unconditionally by the limited partner, or on his behalf, to the partnership.

Paragraph VII requires the certificate to state the amount and time of any additional contributions expected from each limited partner. If unimproved or minimum income land is involved, there should be a detailed provision for assessability of the partners in order to pay the balance of the purchase price and other expenses such as taxes and operating costs. In most cases, the maximum assessment is disclosed; however, partnership interests have been offered in which the investor may be called upon to make additional capital contributions in undetermined amounts. In one offering the limited partners could be called upon for contributions whenever operating capital fell below $10,000. This type of provision is totally unworkable because the investor has no way of anticipating his future outlays. The preferred method is to have a schedule specifying maximum contributions.

The regulations provide that in the event a limited partner fails to pay his assessments, his interest may not be forfeited. It may, however, be reduced or subordinated to the partnership interests meeting

43. E.g., Prospectus for Jasmin Groves Co., at 4 (Nov. 20, 1968) (additional $5,000 per year, not exceeding $15,000 overall).
the assessment. In addition, the regulations suggest that the defaulting partner’s interest, after appraisal, may be sold to the partnership or to the remaining partners.

Paragraph VIII requires a statement as to the “time, if agreed upon, when the contribution of each limited partner is to be returned.” Absent such a statement, a limited partner is entitled to the return of his contribution after he has given “six months’ notice in writing to all other members . . . .”47 If capital is withdrawn, the certificate must be amended to reflect the change in the amount of contributed capital.48

Paragraph IX requires that the certificate state the “share of the profits or the other compensation by way of income which each limited partner shall receive by reason of his contribution.” Where the promoters receive promotional interests, detailed restrictions are imposed by the regulations.49

Paragraph X requires a statement covering “[t]he right, if given, of a limited partner, to substitute an assignee as a contributor in his place, and the terms and conditions of the substitutions.” Unless the agreement provides to the contrary, the consent of all other partners is necessary.50 In small closely held ventures, it is not uncommon for transferability to be limited by a provision granting the remaining limited partners or the general partner the right of first refusal.51 The regulations specifically endorse such provisions.52 The large public partnership agreements often contain language requiring the consent of the general partner in order to transfer a limited partnership interest.53 The principal reason for such a restraint is to provide one of the criteria necessary to insure that the partnership will not be deemed an “association” for income tax purposes; for if it were so characterized, it would be taxed under rules applying to corporations.54 Consent will generally be given freely, unless the partnership has covenanted with the California Commissioner of Corporations to consent only to trans-

47. CAL. CORP. CODE § 15516(2)(c).
48. Id. § 15516(1)(c).
49. See text accompanying notes 177-93 infra.
50. CAL. CORP. CODE § 15519(4).
51. For a typical provision, see Prospectus for Six Flags O.er Texas Fu.d, Ltd., at 20 (June 12, 1969).
52. CAL. AD. CODE tit. 10, § 260.140.112(c) (1968).
53. See, e.g., Prospectus for Burnham Properties Ltd., at 8 (Nov. 12, 1969); Prospectus for Jasmin Groves Co., at 6 (Nov. 20, 1968).
fers to persons meeting certain financial tests. To insure itself a public market, one recent partnership offered freely assignable participations in a limited partnership interest held by a single limited partner. A ratable portion of the limited partnership interest is transferable to the holder of a participation at his election, subject to obtaining the consent of the general partners.

Paragraph XI requires that "[t]he right, if given, of the partners to admit additional limited partners" be stated.

Paragraph XII requires disclosure of any agreement that grants one or more limited partners "priority over other limited partners, as to contributions or as to compensation by way of income." Absent such a provision, each limited partnership unit will be equal to all other units.

Paragraph XIII requires that the certificate disclose whether a provision has been made for the automatic continuation of the business upon the death, retirement or insanity of a general partner. Absent such a provision, the partnership automatically terminates unless all remaining partners, general and limited, consent to the continuation of the partnership.

Paragraph XIV requires disclosure of "[t]he right, if given, of a limited partner to demand and receive property other than cash in return for his contribution."

Paragraph XV requires the certificate to declare the right, if given, of the limited partners to vote upon matters affecting the basic structure of the partnership; such matters include the election or removal of general partners, the termination of the partnership agreement, and the sale of all, or substantially all, of the assets of the partnership. The regulations specifically require that a majority of the limited partners be given the power to remove the general partner.

55. See text accompanying notes 202-03 infra.
57. Id. at 34.
60. CAL. CORP. CODE §§ 15502(1)(a)(XV), 15507(b); cf. CAL. AD. CODE tit. 10, § 260.140.110(b) (1968).
61. CAL. AD. CODE tit. 10, § 260.140.110(a) (1968). In the event participation
As noted above, a limited partnership is also formed by substantial compliance, in good faith, with the various certificate requirements. Considerable leeway is allowed. However, failure to file a certificate or to file a copy of the certificate in a county where the partnership does business constitutes a lack of substantial compliance.

In the event the certificate contains a false statement, anyone suffering a loss due to reliance upon such a statement may recover his loss from any partner, limited or general. But to be held liable, a partner must have known of the false statement at some time prior to the date the statement was relied upon, and must have failed to cause the certificate to be amended to reflect the true state of affairs.

Each time an additional partner is admitted or a person is substituted as a limited partner, the certificate of limited partnership must be amended. To do so each of the limited partners must sign the amended certificate. In large partnerships this is an impossible burden. For this reason, in 1967 the California Corporations Code was amended to provide that if the partnership certificate permits and the partnership has 25 or more limited partners, the amendment need only be signed by the selling limited partner, the substituted limited partner, interests are sold, a majority of the holders of participation interests should be given the power to instruct the limited partner to remove the general partner. See text accompanying notes 56-57 supra & 202-03 infra.

The amount of allowable participation in the administration of the limited partnership by the limited partners is treated in Linder v. Vogue Inv., Inc., 239 Cal. App. 2d 338, 48 Cal. Rptr. 633 (1966); Sloan v. Clark, 18 N.Y.2d 570, 223 N.E.2d 893, 277 N.Y.S.2d 411 (1966); and Lichtyger v. Franchard Corp., 18 N.Y.2d 528, 223 N.E. 2d 869, 277 N.Y.S.2d 377 (1966). Although there has been some liberalization in the past 20 years, limited partners will still be accorded the status of general partners if they take part in discussions determining business policy to any substantial degree. In those partnerships where the general partner is a financially irresponsible corporation controlled by certain limited partners, their limited liability might be lost. See Feld, The "Control" Test for Limited Partnerships, 82 Harv. L. Rev. 1471 (1969); Note, Activities Making a Limited Partner Liable as a General Partner, 56 Mich. L. Rev. 285 (1957).

62. See text accompanying note 25 supra.
64. See Giles v. Vette, 263 U.S. 553 (1923).
68. Id. § 15525(1)(b).
and the general partner. At this writing, some dispute exists as to whether each limited partner must execute the original certificate. Certain title companies have taken the position that this is necessary or the certificate will not be validly issued. The partnerships have found this position objectionable; consequently, the title companies have recently agreed to reconsider their position.

II. Tax Ramifications

The primary motivation for organizing a venture as a limited partnership is to obtain partnership treatment for federal income tax purposes. Contemporary ventures making use of this organizational form are predicated on attracting capital from investors who want the losses as well as the gains to flow directly to them as individuals. Under the current tax laws, one other vehicle—the real estate investment trust—could be used by a large public venture to minimize the income tax liability of the investor while limiting his liability to the amount of his investment. A brief comparison of the two organizational forms is necessary to understand the reasons for the increasing popularity of the public limited partnership.

A. Real Estate Investment Trust v. Limited Partnership: A Comparison

A real estate investment trust offers an investor the opportunity to invest in a managed portfolio of real estate equities or mortgages.

69. Id. § 15525.5.
70. Massachusetts Business Trusts have existed for quite a few years; however, real estate investment trusts as we know them are a creature of statute which came into existence in 1960 with the enactment of Internal Revenue Code sections 856 through 858. See generally Dawson, The Real Estate Investment Tax, 40 TEXAS L. REV. 886 (1962); Roberts & Shapiro, Real Estate Investment Trusts, N.Y.U. 19TH INST. ON FED. TAX. 1047 (1961); Roeder, Requirements for Qualification of Real Estate Investment Trusts, N.Y.U. 20TH INST. ON FED. TAX. 631 (1962); Real Estate Investment Trusts (BUREAU OF NATIONAL AFFAIRS TAX MANAGEMENT PORTFOLIO 20-0), Good recent material is somewhat sparse, but includes Les & Green, Real Estate or Opportunity, Commercial & Financial Chronicle, July 9, 1970, at 15; Kelly, Real Estate Investment Trusts After Seven Years, 23 Bus. LAW. 1001 (1968); Thomas, Misplaced Trust?, Barron’s, July 7, 1969, at 3.

71. California also has real estate investment trust provisions. CAL. CORP. CODE §§ 23000-03; CAL. REV. & TAX. CODE § 24413.

72. Real estate investment trusts, historically, have invested either in equities or in mortgages. See Prospectus for B.F. Saul Real Estate Investment Trust, at 3 (Dec. 18, 1969); Prospectus for Continental Mortgage Investors, at 2 (Feb. 18, 1970). The most recent trusts tend to invest in both equities and mortgages. Prospectus for Connecticut General Mortgage and Realty Investment, at 2 (March 17, 1970). In addition, trusts have been formed for specialty projects such as the purchase of the
Provided it meets various statutory tests, the trust will receive a deduction equal to the earnings it distributes to the holders of shares of beneficial interest (shareholders). That portion of the distributed earnings that arose as long-term capital gain will retain its desirable status as long-term capital gain for purposes of taxing the recipient shareholders; the remainder is to be reported as ordinary income on the shareholders' returns.

To qualify as a real estate investment trust under the California regulations, the trust must have a minimum capital of at least $100,000. According to the federal tax law and regulations, beneficial ownership must be vested in not less than 100 persons, and no more than 50 percent of the shares representing beneficial interests may be held by five or fewer persons during the last half of the trust's taxable year. These shares must be held during at least 335 days of the trust's taxable year, or during a proportionate part of any taxable year of less than 12 months duration.

At the close of each quarter of the trust's taxable year, at least 75 percent of the value of the trust's assets must be comprised of real estate, cash or cash equivalents, and government securities. For purposes of this requirement, the term real estate is defined to include mortgages and interests in other real estate investment trusts. Of the remaining 25 percent, not more than 5 percent of the assets may be invested in the securities of any single entity, and the trust may not hold more than 10 percent of the voting stock of any corporation. At no time may the trust hold property primarily for sale to customers in the ordinary course of its trade or business.


72. INT. REv. CODE OF 1954, § 857(b)(2)(C); CAL. REv. & TAX. CODE § 24413.
75. CAL. AD. CODE tit. 10, § 260.140.93 (1969). The Midwest Securities Commissioners Ass'n, Statement of Policy on Real Estate Investment Trusts ¶ E (July 16, 1970), in 1 BLUE SKY L. REP. ¶ 4801 [hereinafter cited as Midwest Commissioners' Policy], requires a minimum capitalization of $200,000 or 10 percent of the net assets of the trust upon completion of the public offering, whichever is less.
76. INT. REv. CODE OF 1954, § 856(a)(5).
78. INT. REv. CODE OF 1954, § 856(b).
79. Id. § 856(c)(5)(A).
80. Id. § 856(c)(6)(B).
81. Id. § 856(c)(5)(B); Treas. Reg. § 1.856-2(d)(2) (1962).
At least 75 percent of the gross income of the trust must be derived from real estate in the form of rent, mortgage interest, capital gain, distributions from and sales of interests in other real estate investment trusts, and refunds of real estate taxes.\(^8\) To complicate the matter, an additional 15 percent of income must be derived from these same sources or from dividends, interest, or capital gain from the sale of stock or securities.\(^4\) Finally, if 30 percent or more of its gross income comes from the sale of stock or securities held for less than 6 months or from the sale of real property held for less than 4 years, it will not be considered a real estate investment trust for that taxable year.\(^5\) Rents are defined in such a manner as to exclude all amounts received where the trust furnishes or renders services to tenants, or manages or operates the property directly rather than through an independent contractor.\(^6\) Further, rents received from any entity of which 10 percent or more is owned by the trust are also excluded.\(^7\)

After electing to be taxed as a real estate investment trust, the trust will not be taxed on the portion of its taxable income that is distributed (including capital gains) in those years in which it distributes at least 90 percent of its income.\(^8\) The undistributed portion will be taxed to the trust at regular corporate rates.\(^9\) Distributions to individual shareholders do not qualify as dividends entitled to the $100 dividend exclusion,\(^0\) nor do they qualify as dividends entitled to the 85 percent corporate dividends received deduction.\(^1\)

There are no provisions passing net operating losses through to the shareholders; thus, depreciation in excess of income cannot be used to offset other income of the shareholders. Except for capital gains distributed in the year realized, distributed income loses its original distinctive character upon distribution.\(^2\)

Real estate investment trusts may be unlimited in the size of their portfolios or the number of shareholders; they may be leveraged

\(^8\) INT. REV. CODE OF 1954, § 856(c)(3).
\(^4\) See id. § 856(c)(2).
\(^5\) Id. § 856(c)(4).
\(^7\) INT. REV. CODE OF 1954, § 856(d)(2)(B).
\(^8\) Id. § 857(a)(1).
\(^9\) Id. § 857(b)(1).
\(^0\) Id. §§ 116(b)(3), 857(c).
\(^1\) Id. §§ 243(c)(3), 857(c).
through borrowings or the issuance of debt securities; and they may be merchandised with attractive warrant provisions, or in conjunction with convertible debentures. After an uncertain beginning in 1961 and 1962, they have recently become extremely popular—more than 100 were on the market as of August 1, 1970.

The limited partnership, in contrast to a real estate investment trust, is not hampered by percentage and holding period limitations on the type of income that must be earned. Unless prohibited by state law, a limited partnership may engage in any legal business, and thereby receive all of its income from rentals, dividends, or from the operation of a business. No portion of the partnership earnings need be distributed; flexibility of management is thereby insured.

A partnership is not taxed on the income generated by its business activities. Rather, the partners are taxed directly on partnership income in proportion to their interests or as otherwise determined by the partnership agreement. Selecting the partnership organizational form not only avoids a tax at the operational level, but more importantly, it allows business losses, including depreciation, to flow through to the individual investor. Partnership earnings taxed to

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93. At one time the Association of Midwestern Security Commissioners would not clear an issue with debt exceeding 300 percent of the net assets of the trust. The Midwest Securities Commissioners Ass'n, Proposed Statement of Policy on Real Estate Investment Trusts ¶ D (Feb. 20, 1970). Under the new policy statement, however, they only require that the aggregate borrowings be "reasonable" in relation to the net assets of the trust and that the maximum amount of such borrowings in relation to net assets be described in the prospectus. Midwest Commissioners' Policy ¶ D, supra note 75.


97. Compare text accompanying note 85 supra.

98. Compare text accompanying notes 83-84 supra.

99. Compare text accompanying note 88 supra.

100. Compare text accompanying note 89 supra.


102. INT. REV. CODE OF 1954, § 702; Treas. Reg. § 1.702-2 (1956). In certain extremely limited situations, a Subchapter S corporation could also be an advantageous organizational form for federal income tax purposes. To qualify under Subchapter S, however, the corporation cannot have more than 10 shareholders and cannot receive more than 20 percent of its income from rents; thus, its usefulness to ventures involving public offerings is negligible. See INT. REV. CODE OF 1954, §§ 1371-78.
the partners in the years earned may subsequently be distributed to those partners or to new partners without a second tax being incurred.\textsuperscript{103}

A real estate investment trust has three serious drawbacks not shared by a limited partnership. First, since losses may not be passed through to the shareholders,\textsuperscript{104} the benefit of excess depreciation is lost.\textsuperscript{105} Second, since 90 percent of its income and gain must be distributed,\textsuperscript{106} the shareholders' investments cannot be accumulated and reinvested. Third, the ability of the trust to invest in assets other than real estate is severely limited.\textsuperscript{107}

B. The Association Problem

As the limited partnership concept has matured, partnership agreements have assumed characteristics commonly associated with the corporate form of organization.\textsuperscript{108} Freely tradeable partnership interests, centralized management, and limited liability have become the hallmarks of progressive limited partnerships.\textsuperscript{109} As the resemblance between limited partnerships and corporations grows stronger, however, the tax ramifications of selecting a particular organizational form become less predictable.

State law is not definitive in determining how an organization will be treated for federal income tax purposes.\textsuperscript{110} Thus, a limited partnership that meets all the state requirements for partnership status might still be subject to corporate taxation if it is deemed to be an "association" rather than a partnership under the Internal Revenue Code.\textsuperscript{111} It will be treated as an association if it more nearly resembles

\textsuperscript{103} Compare Treas. Reg. § 1.857-4(a) (1962).
\textsuperscript{104} See text accompanying note 92 supra.
\textsuperscript{105} Compare text accompanying note 102 supra.
\textsuperscript{106} See text accompanying note 88 supra.
\textsuperscript{107} See text accompanying notes 79-87 supra.
\textsuperscript{108} Partnerships have always been treated as an aggregate of their partners; however, there is some indication that limited partnerships are being treated as separate entities. Compare Puerto Rico v. Russell & Co., 288 U.S. 476 (1933), Klebanow v. New York Produce Exch., 344 F.2d 294 (2d Cir. 1965), and Ruzicka v. Rager, 305 N.Y. 191, 111 N.E.2d 878 (1953), with Donroy, Ltd. v. United States, 301 F.2d 200 (9th Cir. 1962).
\textsuperscript{110} Treas. Reg. § 301.7701-1(c) (1965).
\textsuperscript{111} Compare Int. Rev. Code of 1954, § 7701(a)(3) (including "associations" among those organizations used to define the term "corporations"), with § 761 (defining meaning of the term "partnerships"). For a discussion of the "association" problem, see Driscoll, The Limited Partnership and the Association Question, U. So.
a corporation than an ordinary partnership. The characteristics of an association were developed in the case law and are now set down with particularity in the regulations.\textsuperscript{112} Despite the specificity of the characteristics annunciated in the regulations, the actual determination of whether any given partnership is an association requires a careful case by case approach—seeking substance rather than form.

(1) \textit{The Landmark Cases}

\textit{Morrissey v. Commissioner,}\textsuperscript{113} decided in 1935, is the landmark case in which the United States Supreme Court set forth principles that have become the basis for the current “association test” or, perhaps more accurately, the “association tests.” Although the \textit{Morrissey} case involved a trust, the opinion established a number of criteria to be used in determining whether or not an organization of any sort might be taxable as an association.

In \textit{Morrissey}, the trust was created as a vehicle for investing in and subsequently managing real estate holdings. Eventually, 920 people owned beneficial interests in the corpus of the trust. Interests were represented by transferable certificates for shares, and the liability of each investor was limited to his initial investment. Technically, the investor-beneficiaries had “no say” in managing the affairs of the trust, but the trust agreement provided that trustees could convene a meeting to make reports to the shareholders. At the meeting, shareholders could vote on proposals and make recommendations, but only in an “advisory” capacity.\textsuperscript{114}

The Treasury Department argued that the structure and activities of the trust made it taxable as an association. The Supreme Court upheld this position. The Court, in a substance-over-form approach, enumerated the relevant characteristics of an association: (1) holding title as an entity; (2) centralized management through representatives of the members of the association; (3) continuity of life despite death or sale or transfer; and (4) limitation of the individual investor’s liability.\textsuperscript{115} It emphasized that none of the individual characteristics

\textsuperscript{112} Treas. Reg. § 301.7701-2 (1965).
\textsuperscript{113} 296 U.S. 344 (1935).
\textsuperscript{114} The Morrissey trust was very close to the modern real estate investment trust. \textit{See} \textbf{Int. Rev. Code} \textbf{of} \textbf{1954}, §§ 856-58.
\textsuperscript{115} 296 U.S. at 359.
was of itself a test for association status; rather, the determination was based on the totality of facts and circumstances. Overlapping of some of the criteria used to distinguish between corporations, trusts, and partnerships soon became apparent. Courts attempting to apply the *Morrissey* tests were perplexed as to which of the criteria should make up the total test for the respective organizational forms.

In *Glensder Textile Company*\(^{116}\) the Board of Tax Appeals examined the characteristics set forth in *Morrissey* as they related to an organization set up to comply with the Uniform Limited Partnership Act. The government, relying specifically on *Morrissey*, argued that Glensder Textile Company, a limited partnership, should be taxed as an association. Its contention was that the partnership possessed all the characteristics enumerated in *Morrissey*. The Board followed an analytical approach that first looked to what the state law permitted and then to the actual partnership agreement to determine if, on the facts, the organization was an association.

The Board held that although in a limited partnership the general partners have "centralized control," their situation is not automatically analogous to that of a corporate director.\(^{117}\) Of greater concern to the Board was whether the general partners were mere agents of the limited partners. For assurance that the general partners were acting on their own, for their own interests, and not as agents of the limited partners, the Board looked for "substantial assets" risked by the general partners themselves in the venture.\(^{118}\)

The decision also held that the continuity of existence, which stemmed from a reservation in the certificate enabling the surviving general partners to continue the business on the death, retirement, or incapacity of a general partner, was not analogous to the chartered life of a corporation.\(^{119}\) Nor did the mere reservation of a power allowing the limited partner to transfer his whole interest convince the Board that free transferability existed. The Board acknowledged the reservation of the power, but noted, "It does not appear . . . that such transfers were contemplated, for no mechanics were provided for the ready transfer of interests through certificates representing shares in the partnership."\(^{120}\) *Glensder*, by applying selected criteria from *Morrissey* to an organization formed under the Uniform Limited Partnership Act,

\(^{116}\) 46 B.T.A. 176 (1942).
\(^{117}\) Id. at 185.
\(^{118}\) Id. at 183.
\(^{119}\) Id. at 185-86.
\(^{120}\) Id. at 186.
was setting forth principles which eventually emerged as the current Treasury Regulations.

(2) The Regulations

The current Treasury Regulations attach the "association" label to any kind of organization that, because its characteristics so closely resemble a corporation, is considered by the Internal Revenue Service (IRS) to be a corporation for tax purposes. The regulations state:

There are a number of major characteristics ordinarily found in a pure corporation which, taken together, distinguish it from other organizations. These are: (i) Associates, (ii) an objective to carry on business and divide the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of interests.121

No single characteristic is determinative; classification as an association will depend upon the facts in the individual case. IRS assertions that the organization should be treated as an association are proper only if the organization "more nearly resembles a corporation than a partnership or trust."122

Some of the major characteristics of a corporation are common to trusts and others are common to partnerships. Naturally, characteristics common to both partnerships and corporations are not material in distinguishing between these entities. The determination of whether a business organization is to be treated for tax purposes as a partnership or as a corporation depends on such distinguishing characteristics as whether there exists centralization of management, continuity of life, free transferability of interests, and limited liability.123 A partnership must possess a majority of the above corporate characteristics before it will be classified an association.124 A detailed examination of each characteristic is necessary for a full understanding of the problem faced by the contemporary limited partnership.

(a) Continuity of life

The regulations provide that

[a]n organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member

121. Treas. Regs. § 301.7701-2(a) (1960).
122. Id. § 301.7701-2(a)(1) (1960).
123. Id. § 301.7701-2(a)(2) (1960).
124. Id. § 301.7701-2(a)(3) (1960).
will not cause a dissolution of the organization . . . .

The test for continuity of life focuses on the continuing "identity" of the organization. The death, insanity, or personal bankruptcy of a shareholder does not cause a corporation to dissolve; the corporation has a separate identity from its shareholders. The removal, resignation, or incapacity of a general partner, however, ends the partnership.

Local law may allow the partners to enter into an agreement to continue the business after the removal or withdrawal of a general partner. Such an agreement, however, does not create the same kind of immortality possessed by a corporation. The existence of the partnership entity is still in a real sense contingent. Under the Uniform Limited Partnership Act, any general partner may withdraw and dissolve the partnership at any time, and thereby change the identity of the organization. In fact, the regulations provide that a limited partnership subject to a statute corresponding to the Uniform Limited Partnership Act lacks continuity of life.

A common provision in many limited partnerships is the right of the limited partners to remove a general partner. This provision furnishes a useful method of protecting a limited partnership from the possibility of acquiring the corporate characteristic of continuity of life.

(b) Centralized Management

Centralized management is defined as "a concentration of continuing exclusive authority to make independent business decisions on behalf of the organization which do not require ratification by members of such organization."

The term "management" means broad power to enter into binding agreements in the name of the organization. It is not intended to apply to "ministerial tasks" or to those acts of an agent performed at the direction of his principal.

The type of power necessary to constitute centralized management is that power held by a trustee or a board of directors. The regulations state that "limited partnerships subject to a statute corresponding to the Uniform Limited Partnership Act, generally do not have centralized

125. Id. § 301.7701-2(b)(1) (1960).
127. Id. § 15038(2)(b).
128. Id. §§ 15031(1)(b), 15509(1).
management, but centralized management ordinarily does exist in such a limited partnership if substantially all the interests in the partnership are owned by the limited partners."\(^{132}\) The more capital contributed by the limited partners and the more widely held the partnership interests become, the closer the organization comes to having "centralized management."

(c) Limited Liability

"An organization has the corporate characteristic of limited liability if under local law there is no member who is personally liable for the debts of or claims against the organization."\(^{133}\) In the typical limited partnership conforming to the Uniform Limited Partnership Act, personal liability exists with respect to each general partner. The regulations specifically require, however, that the general partners have "substantial assets," over and above their investment, that can be reached by a creditor of the organization.\(^{134}\) If the general partner is a corporation, it must have substantial assets beyond its interest in the partnership. If these tests are not met, the IRS deems that the liability of the limited partner is not limited.\(^{135}\) In many instances the public limited partnership will be unable to meet this test.\(^{136}\)

(d) Free Transferability

"An organization has the corporate characteristic of free transferability of interests if each of its members or those members owning substantially all of the interests in the organization have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization."\(^{137}\) To constitute free transferability in the corporate sense, the individual must be able to transfer all attributes of his interest in the organization. Thus, free transferability of interests is not present if a limited partnership agreement allows a partner to transfer his right to share in the partnership profits, but not his right to be a limited partner.\(^{138}\) Further, if either the limited partnership agreement or local

132. Id. § 301.7701-2(c)(4) (1960).
133. Id. § 301.7701-2(d)(1) (1960).
134. Id. § 301.7701-2(d)(2) (1960).
135. Id.
136. See, e.g., Prospectus for Burnham Properties Ltd., at 7 (Nov. 12, 1969).
138. Investment Properties Associates, with freely transferable participation interests, has attempted to resolve this problem by allowing a participation holder to
law provides that the transfer of a partnership interest dissolves the old partnership and that the remaining general partners have a right to approve or to disapprove the new partner, then free transferability in the corporate sense does not exist.

(3) Internal Revenue Service Policy: A Change?

At this date it is fairly easy to structure a public limited partnership in a manner that will pass muster. To some extent this is due to a nonaggressive approach by the IRS in this area. There is, however, some indication that this policy is changing. Of importance, and no doubt on the mind of some potential investors, is the recent change of position by the IRS with regard to the line of professional corporation cases following United States v. Kintner. The IRS announcement appears to have brought an end to a long and losing battle for the government; however, it may provide a basis for the IRS to attack the "partnership" tax status of public limited partnerships.

In Kintner a group of doctors operating as a professional association (a partnership under the local law) argued that their organization should be taxed as a corporation for federal income tax purposes. The court carefully examined the articles of the organization and determined that it possessed enough of the requisite corporate characteristics to qualify for corporate tax treatment. In reaching its decision, the court admonished the IRS for its inconsistent stand, stating:

The Government's contention here goes counter not only to the policy of the Internal Revenue Department, which, at all times, declines to be bound by State law, but also to the latest Treasury regulation on the subject which reads: "The term 'association' is not used in the Internal Revenue Code in any narrow or technical sense. . . . It is immaterial whether such organization is created by an agreement, a declaration of trust, a statute, or otherwise." The IRS refused to accept the Kintner decision and continued to tax

become a limited partner on his demand. As a practical matter few, if any, holders will desire to become partners as they would receive no additional benefit and would then have a non-liquid security. Prospectus for Investment Properties Associates, at 34 (Dec. 4, 1969).

140. 216 F.2d 418 (9th Cir. 1954).
142. 216 F.2d at 423.
professional associations as partnerships—in spite of the fact that many states enacted legislation permitting physicians, lawyers, and other professionals to incorporate. Finally, after losing case after case in circuit after circuit, the IRS conceded defeat in August 1969.\footnote{143}

During the battle it was incumbent upon the IRS to maintain a consistent position with respect to what the government deemed to be an association. It would have been intolerable to argue that “association” should be construed narrowly when the taxpayer was seeking certain tax advantages of a professional corporation and liberally when the IRS was seeking to impose the corporate tax on the earnings of the limited partnership. In order to assert that professional corporations should be denied corporate status for tax purposes, the IRS, to be consistent, had to refrain from taxing limited partnerships as corporations.

Thus, the IRS concession of defeat makes the position of public limited partnerships somewhat problematical. Despite the fact that an organization qualifies under local law as a limited partnership, the government can now use the Kintner rationale to argue that the need for uniformity in the federal tax system requires that these vehicles be taxed as associations. The Kintner “battle” left in its wake numerous pages of dictum that are explicit in their advocacy of a loose and nontechnical construction of the term “association.”\footnote{144} A serious loss of revenue because of a significant increase in limited partnerships might well lead the government into a campaign against limited partnerships similar to the one undertaken against the professional corporation.

It is not necessary for a limited partnership to obtain permission from the IRS to be classified as a partnership for tax purposes. In light of the aforementioned developments, however, it is advisable. Public limited partnerships are designed to amass large amounts of capital, and as their need for capital increases, the base of potential investors necessarily broadens. Informing a potential investor of a favorable IRS ruling to the effect that the limited partnership will not be taxed


144. In Kintner the court quotes the regulations to the effect that “the term ‘association’ is not to be used in the Internal Revenue Code in any narrow or technical sense.” 216 F.2d at 423.”}
as an association is undoubtedly a strong selling point. Such a ruling affords the limited partnership an extremely desirable type of protection. For this reason both Burnham Properties and Investment Properties Associates obtained revenue rulings. While it is technically possible for the IRS to retroactively revoke a private ruling, in practice it is rarely done.

To obtain a ruling the applicant must set forth explicitly the facts of the proposed venture. A ruling will not be given for a hypothetical venture. In addition to all the relevant facts, the applicant, according to IRS policy, must make certain representations concerning the ownership structure of the proposed venture. If the general partner is a corporation, the IRS also demands the applicant's assurance that the limited partner will not own "directly or indirectly, individually or in the aggregate, more than 20% of the stock of the corporate general partner or any of its affiliates, as defined in § 1504(a) of the Code." It will further require that the general partner's net worth available for creditors at least equals the greater of $250,000 or 10 percent of the total amount raised by the offering.

III. The Limited Partnership as a Security

Before limited partnership interests may be marketed, they must be registered under one or more federal and state provisions. If interests in a partnership organized to deal in real estate are sold to no

145. Prospectus for Burnham Properties Ltd., at 6 (Nov. 12, 1969).
147. INT. REV. CODE OF 1954, § 7805(b); E. GOODRICH, L. REDMAN, & J. QUIGGLE, PROCEDURE BEFORE THE INTERNAL REVENUE SERVICE 181 n.27 (1965).
148. GOODRICH, REDMAN & QUIGGLE, supra note 147, at 175.
150. Corporation as Sole General Partner of Limited Partnership, supra note 149.
152. If offered to no more than 25 persons and sold to no more than 10, limited partnership interests are exempt from qualification under the California Corporate Securities Law. CAL. CORP. CODE § 25102(f); CAL. AD. CODE tit. 10, § 260.102.2 (1969). They are probably also exempted from registration by section 4(1) of the Securities Act of 1933, 15 U.S.C. § 77d(2) (1964), so long as the purchaser is a sophisticated investor and has been provided with sufficient information to allow him to make an intelligent determination of the value of the security he is offered. See Securities & Exch. Comm'n v. Ralston Purina Co., 346 U.S. 119 (1953); United States v. Hill, 298 F. Supp. 1221 (D. Conn. 1969).
more than 100 California residents, and a registration statement has not been filed with the Securities and Exchange Commission (SEC) under the Securities Act of 1933, the issue may be qualified with the Real Estate Commissioner. 153 Those issues sold to more than 100 California residents must be qualified with the Corporations Commissioner, 154 but not with the SEC so long as all requirements of the intrastate exemption are met. 155 If it is offered in two or more states, a registration statement must be filed with the SEC under the Securities Act of 1933, 156 and qualified by coordination with the Corporations Commissioner. 157

All of the larger public limited partnerships are qualified either with the Corporations Commissioner under the intrastate exemption or are registered with the SEC. Although the structure of the partnership will to a great extent govern the type of registration, there nevertheless exists some degree of flexibility as to which type of registration is to be used.

Intrastate offerings have certain advantages. They involve few delays in bringing an issue to market. 158 They allow the use of financial projections, photographs, and renderings in presenting the issue to the public. 159 The offering circular may be xeroxed, mimeographed or printed on long, short or colored paper. 160 The securities may be sold

153. Compare CAL. BUS. & PROF. CODE §§ 10251(a), 10260(e) with § 10271.
154. See CAL. CORP. CODE § 25100(e).
157. CAL. CORP. CODE § 25111.
158. With reasonable luck an issue can be prepared and qualified in California in 4 to 6 weeks, while it may take 3 to 4 months to get it through the SEC, absent cursory review.
159. Inasmuch as the SEC quarrels over projections and photographs as being nonrepresentative, they are seldom used. In recent California intrastate offerings, however, some extremely imaginative presentations have been made. E.g., Offering Circular for Country Club Apartments (June 26, 1970) (drawings); Offering Circular for One Wilshire Co. (July 13, 1970) (projections); Offering Circular for Westwood Investment Company (May 11, 1970) (photographs and financial projections).

It is rumored that certain partnerships registered with the SEC have circulated projections to California residents along with the prospectus after it had become effective. These projections have been approved by California's Commissioner of Corporations under CAL. AD. CODE tit. 10, § 260.302 (1968).
160. The Offering Circular for Westwood Investment Company (May 11, 1970) had a cover printed in burnt orange; the all time extreme, however, was achieved by
through real estate seminars or may be marketed on television.161

Among the disadvantages of using the intrastate exemption to make a public offering, at least in California, is the lack of a provision for a preliminary offering circular or "red herring"—presale of the issue using letters of interest is thereby prevented.162 Technical requirements of the SEC further complicate the use of the exemption. For example, the partnership must be conducting substantial operational activities in the state of incorporation.163 This does not mean that the partnership cannot have activities in two or more states nor does it mean that a portion of the proceeds cannot be used in a second state. The question of what portion of the proceeds could be so used has never been tested; however, if the partnership employed 75 percent of the proceeds in its home state, it would seem to have utilized a substantial portion there.164

The greatest problem with an intrastate offering is insuring that it is sold only to residents of one state.165 If the inadvertent sale of even one share, unit, or participation interest is made, the exemption is lost for the entire offering. In those offerings limited to persons evidencing a substantial net worth and making a minimum purchase of $3,000 to $5,000, the margin of profit for each sale allows verification of the purchaser's residence.

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161. CAL. AD. CODE tit. 10, § 260.302 (1968), permits advertising which has been preapproved by the Commissioner of Corporations; SEC Release No. 4434 (Dec. 13, 1961) makes it clear that the SEC will permit an advertisement going to residents of two or more states so long as sales will be made only to residents of a single state. TeleMart Enterprises, Inc. raised over a million dollars by offers made exclusively on television. For a humorous article by TeleMart's counsel describing the offering, see Augustine & Hrusoff, The Screaming Yellow Prospectus, Dicta, Sept. 1970, at 10 (San Diego B. Ass'n pub.).

162. If a limited partnership is registered with the SEC, the "red herring" may be circulated throughout California before the issue is qualified. In fact, the California Commissioner of Corporations may be responsible for many of the changes made in the final prospectus. There is no logical reason why the same procedure could not be followed with an intrastate offering, thereby enabling the underwriter to obtain some indication of the market's response to the issue before signing the underwriting agreement. By allowing this procedure, there would be fewer "best efforts" intrastate offerings and more "firm" underwritings.


A further problem may arise with overzealous securities salesmen. There have been instances where the salesman, rather than lose an order, has purchased the security in the name of a nominee and shortly thereafter transferred it to a nonresident owner.\(^\text{166}\) This causes the whole issue to lose the intrastate exemption. Once securities come to rest in the hands of permanent investors, however, there are no hazards in making transfers to nonresidents.\(^\text{167}\) Since determining when the securities have come to rest is subjective, and differs with each individual investor, many issuers insist that investors refrain from transferring their interests for a year after the offering closes. There is some authority that the SEC will abide by a 1 year holding period.\(^\text{168}\) Shorter transfers in special circumstances—for example, where the distribution involves no securities salesmen—have been used in the past.\(^\text{169}\)

In the event the partnership is offered nationally, Blue Sky Law problems may be encountered in three general areas: investment policies, management and promotional fees, and transferability of partnership interests.

A. Partnership Investments

Historically, limited partnerships formed for the purchase of real estate have purchased a single parcel which is described in the prospectus or offering circular in detail.\(^\text{170}\) Blue Sky Commissioners have come to expect this type of presentation. Burnham Properties, a public limited partnership offering, broke from tradition and announced that it would invest in an undescribed portfolio of real estate.\(^\text{171}\)

In California neither the Corporations Code nor the regulations prohibits undefined real estate investments; however, such offerings are not looked upon with favor. Marsh and Volk point out that

\[\text{[t]he Commissioner normally will not authorize the offer and}\]

\(^\text{166.}\) E.g., Armstrong, Jones & Co. v. SEC, 421 F.2d 359 (6th Cir. 1970); Stadia Oil & Uranium Co. v. Wheelis, 251 F.2d 269 (10th Cir. 1957); Brooklyn Manhattan Transit Corp., 1 S.E.C. 147 (1935).


\(^\text{168.}\) Brooklyn Manhattan Transit Corp., 1 S.E.C. 147 (1935).


\(^\text{170.}\) See, e.g., Offering for One Wilshire Co. (July 13, 1970); Prospectus for Jasmine Groves Co., at 3 (Nov. 20, 1968).

sale of limited partnership interests in a "blind pool" where there is no specific property proposed to be acquired by the real estate syndicate and the formation of the syndicate is solely for the purpose of raising funds to acquire unspecified property at some time in the future.\textsuperscript{172}

New York prohibits such offerings by statute.\textsuperscript{173} As many offerings have some percentage of the proceeds uncommitted, it is the authors' understanding that the Bureau of Condominium, Theatre and Syndication Financing in the New York Attorney General's Office (the agency responsible for administering the statute) has implemented the statute by unofficially requiring that two-thirds of the offering be committed to identified properties. Real estate investment trusts meet this requirement by purchasing construction loan participations from commercial banks—frequently at lower yields than would be available if the trusts were able to invest the proceeds of the offering in new loans.\textsuperscript{174}

Theoretically, there should be no greater objection to a limited partnership investing in a portfolio of undisclosed real estate than there would be to a new mutual fund investing in an undisclosed securities portfolio, or to a real estate investment trust investing in an unknown portfolio of real estate mortgages or equities.\textsuperscript{175} For this reason, Burnham Properties adopted the approach used by real estate investment trusts. It contracted to purchase participations in bank construction loans maturing over a 10-month period with $14,000,000 of the $20,-000,000 proceeds\textsuperscript{176} of its offering. The California Commissioner of Corporations found this procedure acceptable; however, the New York Attorney General did not, and for this reason, partnership interests were not offered in New York.

B. Management and Promotional Fees

The second problem is that of insider fees. The California Corporations Commissioner and several of the Blue Sky Commissioners are concerned that the total amount of compensation paid to promoters be

\textsuperscript{172} H. Marsh & R. Volk, Practice Under the California Corporate Securities Law of 1968, at 318 (1969) [hereinafter cited as Marsh & Volk].


\textsuperscript{174} Thomas, Misplaced Trusts?, Barron's, July 7, 1969, at 3, col. 3.

\textsuperscript{175} The one valid distinction could be the lack of liquidity of the investment. In the event a shareholder of either a mutual fund or a real estate investment trust becomes dissatisfied with the manager's selection of investments, he can immediately sell his interest. Until recently, this alternative was not open to a limited partner. See text accompanying notes 194-204 infra.

\textsuperscript{176} Prospectus for Burnham Properties Ltd., at 4-5 (Nov. 12, 1969).
The problem is especially nebulous because only the most rudimentary guidelines exist. Although there are a good many variations, fees to "insiders" may generally be divided into three classifications: advisory fees; indirect benefits, such as real estate brokerage fees, insurance commissions, and property management fees; and actual promotional interests.

In a large partnership, as in a real estate investment trust, the general partner or advisor, if one is used, is entitled to a fee for seeking out and managing the investments. In Burnham Properties the fee was 1/2 of 1 percent of gross assets plus an incentive of an additional 1/8 of 1 percent to 3/8 of 1 percent of gross assets, depending on the amount of the return on capital. One or two Blue Sky Commissioners have suggested that there is no reason why the means of computing the fee should not be the same as that used by the bulk of the real estate investment trusts. Such a fee might amount to 1/10 of 1 percent of the average book value of the invested assets per month and, as an incentive, an amount equal to 10 percent of the net capital gains plus 10 percent of the amount by which net profits exceed 8 percent per annum of the net worth of the partnership. But in no event should the fee exceed the greater of: 1.5 percent of the average net assets of the partnership, net assets being defined as total invested assets at cost less total liabilities excluding depreciation reserves; or 25 percent of the net income of the partnership, excluding provision for depreciation and realized capital gains and losses and extraordinary items, and before deducting advisory and servicing fees and expenses—but in no event shall this amount exceed 1.5 percent of the total invested assets of the partnership. At one time two schedules, one for equity trusts and one for mortgage trusts, were proposed. This gave rise to the inference that partnerships might adopt the equity schedule. In explaining the new statement of policy, however, Thomas Nelson, Chairman of the Policy Committee, made it clear that the new rules not only were not binding on partnerships but that the Midwest Commissioners had no policy regarding partnerships.

180. Midwest Commissioners' Policy ¶ C, supra note 75.
In many partnerships, the general partner is given a promotional interest. This interest may be as high as 25 percent if no selling commission is granted, or 10 percent if there are selling expenses. In the event the promoters receive such an interest, California Corporation Code section 15523 requires that the limited partners shall have their entire capital contribution returned before the general partners realize anything from their promotional interest. The regulations carry this rule one step further by providing:

A subordinated interest should provide that a six percent per annum cumulative payment from net profit (calculated without any regard to accelerated depreciation) on invested capital must be made to the limited partners before any additional distribution of such net profit is made to both limited and general partners in accordance with the profit-sharing formula of the agreement.

There is no further statutory support for this regulation.

The regulation would be difficult to apply, however, if a portion of the capital gains were to be distributed over a series of years without being characterized as a return of capital. As a consequence, it seems to have been ignored on occasion. The requirement would be reasonable if the limited partners and the general partner (who has not contributed cash) shared in partnership income. However, in those situations where the limited partners receive all income and the general partner receives a minimal advisory fee plus a share in the capital gain, there is no rational basis for the requirement.

As the agreement may properly allocate depreciation disproportionately among partners, Investment Properties Associates granted 50 percent of the depreciation to the promoters (general partner and special limited partner) who had contributed approximately 25.5 percent of the capital, thereby substantially increasing the benefit received by them from the partnership.

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184. Id. See Offering Circular for Pauma Valley Properties, Ltd., at 7 (Aug. 11, 1970), for an example of the regulation without modification.
185. Coordinated Growth Properties allowed the promoters 5 percent of the profits and losses without regard to the 6 percent test. Offering Circular for Coordinated Growth Properties, at 12 (July 8, 1969).
186. Jasmin Groves adopted a modified version of the Commissioner’s formula. The limited partners will receive a cash payment equal to 15 percent on their investment before the general partner receives anything; however, once the 15 percent is paid, the general partner receives a payment up to 20 percent of the operating income with any excess going to the limited partners. The general partner also receives 20 percent of all capital gain from the sale of real estate. Prospectus for Jasmin Groves, at 15 (Nov. 20, 1968).
The "promoters may also receive management fees for actual services . . ." Many promoters will manage the property and charge the partnership an appropriate fee. Typically, the manager is paid a percentage of gross rentals or a percentage of invested gross assets. Five percent is a normal fee. In addition, the promoter will receive commissions for insuring the partnership property.

In some cases promoters have received substantial fees for these services. In an attempt to control real or imagined abuses in real estate investment trusts, the Midwest Commissioners are requiring that a majority of the trustees be independent of the manager and a majority of the trustees approve all contracts with the manager. It would be unreasonable to assume that similar restrictions will not be placed on partnerships.

If the promoter is in the real estate business, and he almost always is, he will desire to receive real estate commissions for property he sells to the partnership or property owned by the partnership which is listed for sale. There is no reason why the promoter should not be allowed to earn listing fees once a decision has been made to sell a given parcel of partnership property, for the property will be listed with multiple brokers and in all likelihood will not be sold by the promoter.

Frequently, a real estate broker, to make a sale, will form a limited partnership in order to purchase the property. If the terms of the transaction are fully disclosed, the SEC has no choice but to allow the offering. In California, where such offerings are common, the commission must be reasonable for the offering to be qualified.

Certain promoters have carried this concept to extreme. Marsh and Volk point out:

Transactions have come to the attention of the Department of Corporations wherein the promoter has entered into an escrow to acquire property for a purchase price, for example, of $500,000, and makes a $25,000 deposit in escrow. The promoter then forms the real estate syndicate to acquire the property for $750,000 and opens a second escrow through which the syndicate will acquire the property from the promoter. Through the device of "back-

190. Prospectus for M.D.D.S. Realty Co., at 7 (Sept. 15, 1969). In 97-Woodruff Apartments, the manager was allowed a 4 percent fee. Offering Circular of 97-Woodruff Apartments Co., at 7 (July 16, 1969).
191. Midwest Commissioners' Policy ¶ B, supra note 75. The general partner has always had a problem in that he and the manager are identical in interest. This problem can be solved if the general partner is a corporation, a majority of whose directors are independent of the advisor, which in turn is a separate entity.
to-back escrows”, the promoter receives $250,000 cash profit in connection with the transaction. The Department of Corporations will, with rare exception, view such a transaction as unfair, unjust, and inequitable to the purchasers who had limited partnership interests in the subsequent syndication. 193

C. Transferability of Partnership Shares

The third and most difficult problem is the “so-called” California legend—the requirement that each partnership agreement or partnership certificate contain a legend or statement printed on it that the security may not be transferred to a new purchaser without the acquiescence of the Commissioner. 194 Although the rules do not say so, the restriction only applies if the purchaser resides in California. In many instances the Commissioner will readily consent to the transfer upon joint application by the seller and prospective purchaser. Even in the best situations, however, free transferability is hampered. It goes without saying that a non-legended security is more marketable than a legended issue, especially if the stock is to be sold to nonresident investors who are totally unfamiliar with legended securities.

The Commissioner's regulations specifically provide that “a legend condition . . . will normally be imposed on the limited partnership interests.” 195 No reason is given for singling out limited partnerships for restrictive treatment, although Marsh and Volk suggest that the legend is imposed because of the “inherent non-liquid nature of limited partnership interests.” 196 In the typical limited partnership, the restriction may also be justified because of the lack of diversification among the type or location of the partnership investments or because the limited partner may be assessed to meet mortgage payments. Another reason could be to alert the investor that he is buying into a highly speculative venture. This would be true if the partnership is formed for oil and gas exploration, the management is new and untried, or the promoters are unknown. 197

193. Marsh & Volk 315-16.
194. Cal. Ad. Code tit. 10, § 260.141.10 (1968) provides that the Commissioner of Corporations may impose a legend whenever “securities are issued pursuant to a limited offering qualification and (a) a variation from the standards normally imposed in an open qualification is approved by the Commissioner based upon the characteristics of the particular purchasers or their close relationship with the issuer and the Commissioner determines that there is a substantial danger that subsequent transfers of such securities might be unfair, unjust or inequitable to the subsequent purchasers thereof . . . .
196. Marsh & Volk 317.
197. It can also be argued that limited partners do not have the right to elect an
In a situation where partnership interests in large scale diversified real estate partnerships are offered by an underwriter heading a syndicate, several of the reasons for imposing a legend condition evaporate. At the outset, a registration will have been filed with the SEC, and the partnership will be subject to the reporting requirements imposed under the Securities and Exchange Act of 1934. The requirement that a partnership submit itself to initial investigation by the SEC as well as to subsequent annual reporting does not insure that it is a worthwhile investment; however, this additional scrutiny does produce a better quality offering.

If partnership interests are offered in $5,000 or $10,000 units, the secondary market may be somewhat thin. Nevertheless, the market for $20,000,000 of limited partnership interests is probably considerably broader than the market for a $500,000 corporate equity issue which is not subject to a legend condition. Although the underwriter (for tax or other reasons), may not desire or be able to make a market in the traditional sense, it will be in a position to execute trades on a matching of buy and sell orders. In those instances where assignments of participation interests in the limited partner's holding are offered in minimum units of $10, $15, or $20, and the underwriter stands ready to make a public market in these interests, there is no logical reason why a legend should be imposed.

The Commissioner has relaxed his standards in two recent offerings. In both Jasmin Groves and Burnham Properties, partnership interests were offered without a legend, conditioned upon the initial offering being limited to a restricted class of purchasers and upon the representation by the general partner that no one would be allowed to become annual slate of officers. However, a majority in interest may have the power, according to the partnership agreement, to remove the general partner, to amend the partnership agreement, to dissolve the partnership, and to block the sale or pledge of substantially all the partnership assets. See Cal. Corp. Code § 15507. As such, their voting rights are almost as meaningful as those possessed by the shareholders of a public corporation.

20. Traditionally, the market maker maintains a position in the security and will buy any amount offered for sale, even in the absence of corresponding buy orders.
21. See, e.g., Prospectus for Investment Properties Associates (Dec. 4, 1969). It is submitted that under basic contract principles allowing free assignment of the benefits of a contract, the general partner would be hard pressed to refuse payment of pro rata earnings to an assignee failing to meet the minimum standards regardless of the representations made to the Corporations Commissioner. Nevertheless, there is no question but that the assignee could be denied the right to become a substituted limited partner.
a substituted limited partner unless he met the standards imposed upon the initial purchaser. In Jasmin, the investor was required to have net assets of $200,000 or to be in the 50 percent tax bracket;\textsuperscript{202} in Burnham the investor was merely required to have net assets of $50,000.\textsuperscript{203}

With the enactment of the Real Estate Syndicate Act, the legislature (with the support of the Corporations Commissioner) transferred jurisdiction over certain limited partnerships investing solely in real estate to the Real Estate Commissioner.\textsuperscript{204} Those owned beneficially by more than 100 persons,\textsuperscript{205} and those for which a registration statement had been filed under the Securities Act of 1933\textsuperscript{206} remain under the jurisdiction of the Corporations Commissioner.\textsuperscript{207} As this will remove all of the small, non-underwritten limited partnerships from the jurisdiction of the Corporations Commissioner, it is submitted that those partnerships registered with the SEC should be treated in the same manner as corporate stock issues. This is especially so if the underwriter can guarantee that a dissatisfied investor has a market in which he can dispose of his partnership interest.

Conclusion

Despite the inconveniences of the organizational form, tax problems, and difficulties with Blue Sky Commissioners, the number of public limited partnerships are increasing. In many respects they are still in a state of flux. On the one hand, there exist such ventures as Westwood Investment Company, a $400,000 intrastate offering for the purchase of a single apartment complex. On the other hand are offerings such as Jasmin Groves, Burnham Properties and Investment Properties.

Today, partnerships are fumbling with two basic problems—diversity and liquidity of investment. As a greater number of large issues come to market, each containing a series of properties, the aversion to a large non-described portfolio will vanish as it did with mutual funds. The problem of liquidity is somewhat more difficult to solve.

One group of promoters is attempting to create liquidity by pro-
viding some form of redemption. One Wilshire Company\textsuperscript{208} and Pacific Area Real Estate Fund, Ltd.\textsuperscript{209} will attempt to redeem those units offered them. Efforts in this direction encounter two stumbling blocks. First, the partnership must constantly value its holdings, a problem not dissimilar to a mutual fund valuing its portfolio of "lettered" stock for purposes of establishing redemption values. And second, the partnership could face a severe task in maintaining sufficiently liquid funds to redeem those units offered it. Further, if units are to be continuously redeemed, the partnership must continue to sell units or it will soon pay out all its capital by way of redemptions. A continuous influx of capital may be equally troublesome as it will create difficulties in portfolio management.

The second group is attempting to establish a market for limited partnership units. The trading of $5,000 or $10,000 units, although difficult, is not impossible. In fact, most debentures trade in $5,000 units. The more workable solution, however, is to have one limited partner who has purchased the entire offering sell assignments of portions of his interest. These assignments need not be recorded every time a transfer is made and they can be traded in units as low as $10.

It can reasonably be expected that once solutions are found to the two remaining problems, limited partnerships will become as common as real estate investment trusts. Five years from now it would not be surprising to see Wells Fargo or the Bank of America bring out a $100,000,000 limited partnership for investment in an unspecified portfolio of real estate.

\textsuperscript{208} Offering Circular of One Wilshire Co., at 4 (1970).
