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I. INTRODUCTION

The long-existing need for a form of business association that permits an investor to contribute capital and receive a share of the profits while remaining free from both management responsibility and personal liability in excess of the amount invested[1] is being met in the United States principally by two forms of business organization—the corporation and the limited partnership. Limited partnerships, which can be traced back to the *commenda* of the middle ages,[2] first received statutory recognition in this country in New York in 1822.[3] Because of the strict requirements contained in early statutes, and their strict construction by the courts,[4] limited partnerships did not come of age until the Uniform Limited Partnership Act was promulgated in 1916 by the National Conference of Commissioners on Uniform State Laws.[5] Since that time the 1916 Act has been adopted in forty-nine states, the District of Columbia, and the Virgin Islands.[6]

The fact that limited partnerships, unlike corporations, are not usually treated as separate legal entities for federal income tax purposes[7] and the advent of sophisticated tax shelter planning over the

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1. A. BROMBERG, CRANE AND BROMBERG ON PARTNERSHIP § 26, at 143 (1968).
2. *Id.*
3. 1822 N.Y. LAWS, ch. 244.
4. Lewis, *The Uniform Limited Partnership Act*, 65 U. PA. L. REV. 715, 720-23 (1917).
5. UNIFORM LIMITED PARTNERSHIP ACT, 6 UNIFORM LAWS ANN. 561 (originally drafted in 1916) [hereinafter cited as 1916 Act].
6. 6 UNIFORM LAWS ANN. 93 (Supp. 1979). Louisiana, because of its legal heritage, has not adopted the 1916 Act but recognizes the civil law equivalent of the limited partnership, the partnership in commendam. LA. CIV. CODE ANN. arts. 2839-2851 (West 1952 & Supp. 1978).
7. I.R.C. §§ 701-702. If a limited partnership has too many corporate characteristics, however, it may be treated as a corporation for tax purposes. For discussions of the problem of tax classification of limited partnerships, see 1 Z. CAVITCH, BUSINESS ORGANIZATIONS § 9.03 (1978); Note, *Tax Classification of Limited Partnerships*, 90 HARV. L. REV. 745 (1977); Note, *Tax Classification of Limited Partnerships: The IRS Bombards the Tax Shelters*, 52 N.Y.U.L. REV. 408 (1977).

past two decades have caused a tremendous growth in the number, size, and economic importance of limited partnerships. Previously, most limited partnerships were enterprises with relatively few limited partners who often were associated closely with the general partner or partners either personally, professionally, or geographically. Because of the tax benefits and limited liability available to members of the limited partnership, this pattern has changed. During the early 1970s much of the risk capital invested in speculative fields such as real estate, oil and gas, timber, equipment leasing, motion pictures, and cattle was channeled through limited partnerships, with interests marketed publicly to thousands of passive investors throughout the country.[8] While the Tax Reform Act of 1976[9] and the Revenue Act of 1978[10] limited some of the special tax benefits previously available in these fields of investment, one of the largest—real estate syndications—emerged relatively unscathed.[11]

As is the case with publicly held corporations, ownership is separated from control in the modern limited partnership. Unlike corporations, however, this separation results not only from the dispersion of ownership among thousands of investors, but also from the theoretical nature of a limited partnership. By definition, a limited partner is a passive investor. This requirement is enforced by section 7 of the 1916 Act, which imposes unlimited liability as the price for participation in control.[12] This statutory disjunction of ownership and control is an integral part of what was thought to be a delicate balance achieved by the 1916 Act. The general partners could secure additional funds for the business yet remain firmly in control, while the limited partners could be sure of the active interest and care of the general partners by reason of the latter's unlimited personal liability for obligations of the business.[13] As limited partnerships evolved, small enterprises with close personal relationships among the members became large, sophisticated concerns with hundreds of members, and this balance has broken down. Moreover, the necessarily passive nature of the limited partners' role has invited mismanagement and self-dealing by general partners.[14]

8. *See* Roulac, *Resolution of Limited Partnership Disputes: Practical and Procedural Problems,* 10 REAL PROP., PROB. & TR. J. 276, 279-80 (1975); Glasser, *Gimme Shelter: Reform of Real Estate Tax Shelters,* 7 U. MICH. J.L. REF. 267, 268 (1974).

9. Pub. L. No. 94-455, 90 Stat. 1520 (1976) (codified in 26 U.S.C.).

10. Pub. L. No. 95-600, 92 Stat. 2763 (1978) (codified in scattered sections of 26 U.S.C.).

11. *See* I.R.C. § 465(c)(3)(D); Wiesner, *Tax Shelters—A Survey of the Impact of the Tax Reform Act of 1976,* 33 TAX L. REV. 5, 49-69 (1977) (predating the Revenue Act of 1978).

12. 1916 Act § 7. Section 9 specifically vests control in the general partners. *Id.* § 9.

13. Lewis, *supra* note 4, at 717.

14. *See, e.g.,* Executive Hotel Assocs. v. Elm Hotel Corp., 41 Misc. 2d 354, 245 N.Y.S.2d

In the corporate context such conduct by directors or officers, if it resulted in harm to the corporation, properly would be the subject of a shareholders' derivative suit. Such a suit is a procedural device permitting one or more shareholders to prosecute a claim on behalf of the corporation if the directors are unwilling or unable to do so, a not uncommon occurrence if the directors, themselves, are the potential defendants. The existence of a similar procedural device in the limited partnership context is less widely recognized. It has been developing intermittently in the courts of several states but has been codified in only two.[15]

In 1976 the National Conference of Commissioners on Uniform State Laws promulgated a revised Uniform Limited Partnership Act "intended to modernize the prior uniform law while retaining the special character of limited partnerships as compared with corporations."[16] The 1976 Act addresses the problem of divorce of ownership from control in two principal ways, one substantive and one procedural. First, although it continues the prohibition on taking part in control of the business,[17] it provides that limited partners may be given and may exercise voting rights with respect to certain fundamentally important matters, including the removal of a general partner, without being deemed to be participating in control.[18] Second, it expressly recognizes the right of a limited partner to institute

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929 (Civ. Ct.), *aff'd mem.*, 43 Misc. 2d 153, 250 N.Y.S.2d 351 (Sup. Ct. 1964).

15. DEL. CODE ANN. tit. 6, § 1732 (1974); N.Y. PARTNERSHIP LAW §§ 115-a to -c (McKinney Supp. 1978-1979).

16. UNIFORM LIMITED PARTNERSHIP ACT, Prefatory Note, 6 UNIFORM LAWS ANN. 117 (Supp. 1979) [hereinafter cited as 1976 Act].

17. *Id.* § 303(a).

18. The matters with respect to which limited partners may possess voting rights are: (1) dissolution and winding up of the partnership; (2) disposition of all or substantially all of the partnership assets other than in the ordinary course of business; (3) incurrence of indebtedness by the partnership other than in the ordinary course of business; (4) change in the nature of the business; aud (5) removal of a general partner. *Id.* § 303(b)(5). The securities administrators of several states, concerned about the potential for abuse by general partners, have begun to require that limited partner interests offered for sale in their states carry voting rights that essentially correspond to those enumerated in section 303(b)(5). *E.g.*, CENTRAL SECURITIES ADMINISTRATORS COUNCIL, GUIDELINES FOR THE REGISTRATION OF COMMODITY POOL PROGRAMS § V B (January 24, 1978), 1 BLUE SKY L. REP. (CCH) ¶ 4877; NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, GUIDELINES FOR THE REGISTRATION OF OIL AND GAS PROGRAMS § VIII F (September 22, 1976, amended, October 12, 1977), 1 BLUE SKY L. REP. (CCH) ¶ 4589; MIDWEST SECURITIES COMMISSIONERS ASSOCIATION, STATEMENT OF POLICY REGARDING REAL ESTATE PROGRAMS § VII B (February 28, 1973, amended, February 26, 1974, amended, July 22, 1975), 1 BLUE SKY L. REP. (CCH) ¶ 4821. It should be noted that § 302 of the 1976 Act permits limited partners to be given voting rights on any matter or matters, but to the extent that such voting rights exceed those enumerated in § 303(b)(5) possession or exercise may constitute participation in control. 1976 Act § 302 & Comment.

a derivative action on behalf of the partnership in certain circumstances.[19]

The purpose of this Article is to examine the provisions of the 1976 Act that authorize limited partners' derivative suits. This examination necessarily must begin by tracing the development of derivative suits under the 1916 Act. With this background established the Article will proceed to analyze the relevant provisions of the 1976 Act.

II. Derivative Suits Under the 1916 Act

As previously noted, the virtually complete operating control given to general partners by the 1916 Act, together with the evolution of limited partnerships from small, personalized concerns to large, impersonal enterprises with hundreds of limited partners, has created a situation rife with opportunities for self-dealing and other misconduct by general partners. *Executive Hotel Associates v. Elm Hotel Corp.*[20] unfortunately may not be an altogether atypical example. Executive was a limited partnership with 168 limited partners. Its only asset was a long-term lease on a hotel building, for which it had paid $400,000. Elm was the corporate tenant of the building under a sublease with Executive. The same individual was both the president and major shareholder of Elm and the sole general partner of Executive. Elm defaulted on its obligation to pay rent, and when some of the limited partners complained, this individual, acting as general partner of Executive, released Elm from the obligation to pay over $51,000 in rental arrearages. He also modified the sublease by substantially reducing future rent and releasing certain property deposited with Executive as security. He subsequently created a new corporation, of which he was president and sole shareholder, and, again acting as general partner of Executive, assigned the underlying leasehold to this new corporation. "At this point," said the court, "the property which launched the limited

19. 1976 Act §§ 1001-1004. There currently is some question whether, under the provisions of the 1916 Act, a limited partner's institution of a derivative action constitutes participation in control of the business in violation of § 7. *See* text accompanying notes 66-78 *infra*. While the 1976 Act does not address this issue with the specificity that some might desire, a fair construction of the Act requires the conclusion that institution of such a suit is not participation in control. In addition to the reasons supporting such a conclusion under the 1916 Act, *see id.*, § 303(a) of the 1976 Act expressly provides: "[A] limited partner is not liable for the obligations of a limited partnership unless he is also a general partner or, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business." Since the 1976 Act itself, unlike the 1916 Act, gives a limited partner the right to sue derivatively, filing suit merely would be "the exercise of his rights and powers as a limited partner."

20. 41 Misc. 2d 354, 245 N.Y.S.2d 929 (Civ. Ct.), *aff'd mem.*, 43 Misc. 2d 153, 250 N.Y.S.2d 351 (Sup. Ct. 1964).

partnership was completely gone—and indeed Executive Hotel Associates was bare and denuded of the single asset for which it paid $400,000 and which gave it birth."[21]

It is clear that the fiduciary duties applicable to partners in a general partnership also apply at least to the general partners of a limited partnership.[22] It is equally clear that conduct such as that just described is a breach of those duties. The problem, of course, is enforcement. Since the general partners control the business and ordinarily will be disinclined to institute litigation against themselves, those they control, or those with whom they are in collusion, the question becomes one of what, if anything, the limited partners can do. The following discussion will describe various courts' attempts to deal with this problem within the framework of the 1916 Act.

A. *Limited Partnership as an Entity*

The very essence of a derivative suit is the conscription and assertion by one person of a cause of action technically belonging to another person. Therefore, recognition of the possibility of a derivative suit in the limited partnership context requires the conclusion that, for some purposes at least, such partnerships are juridical entities separate and distinct from their members.

The committee drafting the Uniform Partnership Act had to decide whether to adhere to the common-law view of a partnership as a mere aggregation of individuals or to adopt the theory that a partnership is a separate entity similar to a corporation. They chose the former, and the Uniform Partnership Act, now the governing law in most jurisdictions,[23] proceeds on that basis.[24] The same committee drafted the 1916 Act[25] with the result that limited as well as general partnerships usually are analyzed in terms of the aggregate theory.[26] This predisposition has led some courts to conclude that it is theoretically impossible for a limited partner to maintain a derivative action on behalf of the partnership because there is no entity for the plaintiff-partner to represent.[27]

21. 41 Misc. 2d at 358, 245 N.Y.S.2d at 932.

22. *E.g.*, Riviera Congress Assocs. v. Yassky, 18 N.Y.2d 540, 547, 223 N.E.2d 876, 879, 277 N.Y.S.2d 386, 392 (1966); Roulac, *supra* note 8, at 287-91.

23. *See* 6 UNIFORM LAWS ANN. 1 (Supp. 1979).

24. UNIFORM PARTNERSHIP ACT, Commissioners' Prefatory Note, § 6(1) (1914).

25. Lewis, *supra* note 4, at 715.

26. 1916 Act §§ 1, 29; *see* Donroy, Ltd. v. United States, 301 F.2d 200 (9th Cir. 1962); Bedolla v. Logan & Frazer, 52 Cal. App. 3d 118, 125 Cal. Rptr. 59 (Ct. App. 1975).

27. Klebanow v. New York Produce Exch., 232 F. Supp. 965, 968 (S.D.N.Y. 1964), *rev'd*, 344 F.2d 294 (2d Cir. 1965); *see* Millard v. Newmark & Co., 24 A.D. 2d 333, 338, 266 N.Y.S.2d 254, 260 (1966).

The conclusion is not a necessary one. It is based on an "all or nothing" analysis that fails to recognize that even under the Uniform Partnership Act and the 1916 Act partnerships are treated as entities for some purposes. For example, title to real property may be acquired in the partnership name;[28] a distinction is made between property belonging to the partnership and a partner's interest in the partnership;[29] the death of a limited partner does not dissolve a limited partnership;[30] and the death of a general partner of a limited partnership will not work even a technical dissolution if the remaining general partners rightfully continue the business.[31]

The possibility that a limited partnership could be treated as an aggregate of individuals for some purposes but as an entity for procedural purposes formed the basis for the holding of the New York Court of Appeals in *Ruzicka v. Rager*[32] that, in a suit brought on behalf of the partnership, neither general nor limited partners were subject to counterclaims founded on personal transactions. While recognizing that partnerships normally are not considered to be entities, the court stated as follows:

> It is to be remembered that we are here concerned with a *limited* partnership. There is good reason for regarding such a partnership as a distinct entity for the purposes of pleading. Limited partnerships were unknown to the common law and, like corporations, are "creature[s] of statute". Statutes permitting limited partnerships are intended to encourage investment in business enterprise by affording to a limited partner a position analogous to that of a corporate shareholder.[33]

Although that court did not have to determine the viability of a limited partner's derivative suit, its analysis clearly laid the groundwork for future decisions by emphasizing that for some purposes limited partnerships and limited partners are more similar to corporations and shareholders than to general partnerships and general partners. Subsequent decisions that sought to formulate effective procedures for the protection of limited partners have built on this analysis and consequently have not considered the aggregate theory

28. UNIFORM PARTNERSHIP ACT § 8(3).
29. *Id.* §§ 25-26; 1916 Act § 18.
30. 1916 Act § 21.
31. *Id.* § 20.
32. 305 N.Y. 191, 111 N.E.2d 878 (1953).
33. *Id.* at 197-98, 111 N.E.2d at 881 (emphasis in original) (citation omitted).
34. *See* Klebanow v. New York Produce Exch., 344 F.2d 294 (2d Cir. 1965); Riviera Congress Assocs. v. Yassky, 18 N.Y.2d 540, 223 N.E.2d 876, 277 N.Y.S.2d 386 (1966); Lichtyger v. Franchard Corp., 18 N.Y.2d 528, 538-39, 223 N.E.2d 869, 875, 277 N.Y.S.2d 377, 385-86 (1966) (Burke, J., concurring); Millard v. Newmark & Co., 24 A.D. 2d 333, 342-43, 266 N.Y.S.2d 254, 265 (1966) (Rabin, J., dissenting in part); Comment, *Standing of Limited Partners to Sue Derivatively,* 65 COLUM. L. REV. 1463, 1481-84 (1965).

to be an insurmountable obstacle.[34] The finding of an entity, however, was only the first step toward resolution of the ultimate question.

B. Lack of Statutory Authority

The only judicial remedies that the 1916 Act specifically grants to limited partners are the right to a formal accounting and the right to seek judicial dissolution of the partnership.[35] Some courts, adopting a conservative attitude toward the judicial function, have viewed these remedies as exclusive, thus precluding recognition of a derivative suit for either damages or equitable relief.[36] Such a view demonstrates not only conservatism but a myopic sense of history. Shareholders' derivative suits, now a matter widely regulated by statute or court rule, had their origin in courts of equity without the aid of empowering legislation.[37] The early case of *Foss v. Harbottle*,[38] while holding that a derivative suit could not be maintained on the facts there presented, summarized the rationale for allowing such suits under some circumstances as follows:

> If a case should arise of injury to a corporation by some of its members, for which no adequate remedy remained, except that of a suit by individual corporators in their private characters, and asking in such character the protection of those rights to which in their corporate character they were entitled, I cannot but think that . . . the claims of justice would be found superior to any difficulties arising out of technical rules respecting the mode in which corporations are required to sue.[39]

As the rationale stated in *Foss* is dependent on the inadequacy of other remedies, it becomes necessary to examine the adequacy of the limited partners' remedies of dissolution and accounting. Although a breach of fiduciary duty may give a limited partner a cause of action for judicial dissolution,[40] this remedy often will be akin to throwing out the baby with the bath water. It usually will bring an end to the enterprise, and may force a sacrifice of going concern value. It also does not provide a method for redress of past injuries. For these reasons a limited partner who wishes to have the business continued will rarely find judicial dissolution a satisfactory remedy, and it should not bar a derivative suit in an appropriate situation.[41]

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35. 1916 Act § 10(1)(b), (c).

36. Klebanow v. New York Produce Exch., 232 F. Supp. 965, 968 (S.D.N.Y. 1964), *rev'd*, 344 F.2d 294 (2d Cir. 1965); Millard v. Newmark & Co., 24 App. Div. 2d 333, 336-37, 266 N.Y.S.2d 254, 258-59 (1966).

37. Comment, *supra* note 34, at 1467-70.

38. 2 Hare 461, 67 Eng. Rep. 189 (Ch. 1843).

39. *Id.* at 492, 67 Eng. Rep. at 203.

40. 1916 Act §§ 10(1)(c), 29; UNIFORM PARTNERSHIP ACT § 32(1)(c), (d).

41. Klebanow v. New York Produce Exch., 344 F.2d 294, 299 (2d Cir. 1965); Comment,

An accounting proceeding, the traditional partnership remedy for breaches of fiduciary duty,[42] also will be inadequate in many cases. Its major legal inadequacy derives from the fact that it is founded on the existence of a fiduciary duty and therefore normally may not be maintained against persons who are not partners but into whose hands partnership assets may have fallen.[43] Its major practical inadequacy stems from the inability of the moving limited partner to recover his or her counsel fees.[44] In the context of a modern limited partnership, in which the stake of each individual limited partner often will be relatively small in comparison to potential litigation expenses, this inability may mean that wrongs to the partnership perpetrated by the general partners or those with whom they are in collusion will go uncompensated unless a limited partner is allowed to proceed derivatively. Faced with such a choice, a number of courts have had no difficulty in permitting a derivative suit unaided by specific statutory authority.[45]

Searching for a theoretical basis for such an action, these courts have analogized the position of a limited partner to that of a trust beneficiary and to that of a corporate shareholder. Generally, as a matter of trust law, if a third party tortiously damages the trust property or breaches a contract made with the trustee on behalf of the trust, the right to enforce any resulting cause of action resides exclusively with the trustee.[46] If the trustee refuses to enforce the cause of action and such refusal is not improper, no legal or equitable relief is available to the beneficiaries.[47] If, however, such refusal is improper, it will constitute a breach of trust, and the beneficiaries may maintain a suit in equity against the trustee to compel him or her to assert the underlying cause of action against the third party.[48]

supra note 34, at 1480.

42. 1916 Act §§ 10(1)(b), 29; UNIFORM PARTNERSHIP ACT § 21(1); Alpert v. Haimes, 64 Misc. 2d 608, 315 N.Y.S.2d 332 (Sup. Ct. 1970).

43. A. BROMBERG, *supra* note 1, § 26, at 149; Comment, *supra* note 34, at 1480.

44. Millard v. Newmark & Co., 24 A.D. 2d 333, 336, 266 N.Y.S.2d 254, 258 (1966).

45. Klebanow v. New York Produce Exch., 344 F.2d 294 (2d Cir. 1965); Klebanow v. Funston, 35 F.R.D. 518 (S.D.N.Y. 1964); Riviera Congress Assocs. v. Yassky, 18 N.Y.2d 540, 223 N.E.3d 876, 277 N.Y.S.2d 386 (1966); Executive Hotel Assocs. v. Elm Hotel Corp., 41 Misc. 2d 354, 245 N.Y.S.2d 929 (Civ. Ct.), *aff'd mem.*, 43 Misc. 2d 153, 250 N.Y.S.2d 351 (Sup. Ct. 1964); *cf.* Kobernick v. Shaw, 70 Cal. App. 3d 914, 139 Cal. Rptr. 188 (Ct. App. 1977) (limited partners permitted to maintain cross-complaint in suit against partnership); Linder v. Vogue Invs., Inc., 239 Cal. App. 2d 338, 48 Cal. Rptr. 633 (Dist. Ct. App. 1966) (limited partners permitted to intervene to defend suit against partnership); McCully v. Radack, 27 Md. App. 350, 340 A.2d 374 (Ct. Spec. App. 1975) (limited partners permitted to intervene in proceeding to foreclose deed of trust executed by partnership).

46. 4 A. SCOTT, THE LAW OF TRUSTS § 282 (3d ed. 1967).

47. *Id.* § 282.1.

48. *Id.*

Originally, the beneficiaries could do no more than this, but in order to avoid the necessity of two suits (one by the beneficiaries against the trustee and a second by the trustee against the third party) modern trust law permits the beneficiaries to join the third party in the suit against the trustee and to assert the underlying cause of action on their own behalf.[49] Since the analogy of a shareholder to a trust beneficiary formed the theoretical underpinnings of the early shareholders' derivative suit decisions,[50] it is not surprising to find courts returning to this familiar ground when faced with similar questions concerning limited partners' rights.[51]

The shareholder analogy seems equally compelling. Originating with *Ruzicka v. Rager*,[52] it received perhaps its best exposition by Judge Friendly, writing for the Second Circuit in *Klebanow v. New York Product Exchange*:[53]

> [I]n the main, a limited partner is more like a shareholder, often expecting a share of the profits, subordinated to general creditors, having some control over direction of the enterprise by his veto on the admission of new partners, and able to examine books . . . . That the limited partner is immune to personal liability for partnership debts save for his original investment, is not thought to be an "owner" of partnership property, and does not manage the business may distinguish him from general partners but strengthens his resemblance to the stockholder; and even as to his preference in dissolution, he resembles the preferred stockholder.[54]

This analysis seems correct. A limited partner is an equity participant in an enterprise controlled by others.[55] Such enterprises most commonly are organized either as corporations or as limited partnerships. If, for extraneous reasons, the latter form of association is adopted, the procedural rights of its passive investors, when faced with abuse by those in control, should be no less as limited partners than as shareholders.

C. *Section 26*

Another major stumbling block to limited partners' derivative suits under the 1916 Act is section 26, which provides: "A contribu-

49. *Id.*

50. Prunty, *The Shareholders' Derivative Suit: Notes on Its Derivation*, 32 N.Y.U.L. Rev. 980, 986-88 (1957).

51. Decisions relying on the trust beneficiary analogy in support of a limited partner's right to sue derivatively include the following: Klebanow v. New York Produce Exch., 344 F.2d 294, 297-98 (2d Cir. 1965); Klebanow v. Funston, 35 F.R.D. 518, 520 (S.D.N.Y. 1964); Riviera Congress Assocs. v. Yassky, 18 N.Y.2d 540, 547-48, 223 N.E.2d 876, 879-80, 277 N.Y.S.2d 386, 392 (1966).

52. 305 N.Y. 191, 111 N.E.2d 878 (1953).

53. 344 F.2d 294 (2d Cir. 1965).

54. *Id.* at 297.

55. 1916 Act § 1, Comment; 40 N.Y.U.L. Rev. 1174, 1177-78 (1965).

tor, unless he is a general partner, is not a proper party to proceedings by or against a partnership, except where the object is to enforce a limited partner's right against or liability to the partnership."[56] A derivative suit brought by a limited partner would seem to fall within the literal wording of the section. The limited partner would be a party, the plaintiff; the proceedings would be against the partnership, as nominal defendant; and the object would not be to enforce the limited partner's personal right against the partnership, but rather to enforce the partnership's right against the general partners or third parties.[57] Thus, even assuming that a limited partnership is an entity on whose behalf a derivative suit properly could be brought, section 26 could be read as an absolute prohibition of such actions.[58] Read in this manner, section 26 would be perceived as reinforcing the legislative balance between unlimited liability and control on the part of general partners and limited liability and passivity on the part of limited partners.[59]

On the other hand, section 26 can be given meaning and the legislative balance can be preserved on the basis of a narrower reading. First, section 26 could be viewed in part simply as a procedural restatement of a limited partner's limited liability.[60] Thus, unless a limited partner has violated some other liability-producing section,[61] he or she is not a proper party to proceedings *against* the partnership.[62] With respect to proceedings instituted *by* the partnership, section 26 simply may mean that limited partners need not join as plaintiffs,[63] and in fact that they may not join if the general

56. 1916 Act § 26.

57. By relying on the trust beneficiary analogy it might be argued that a limited partner's derivative suit is not prohibited even by tbe literal language of § 26. That is, the essence of the suit is the enforcement of the limited partner's right to have the partnership properly managed. The primary defendants are the general partners who improperly have refused to institute litigation on the underlying cause of action, whether or not they also are the ultimate wrongdoers. The primary relief sought is an order compelling the assertion of such cause of action, and tbe mere fact that third parties may be joined as defendants to avoid the necessity of two suits does not change tbe fact tbat the limited partner is asserting wbat is essentially a personal right. The suit, tberefore, sbould be covered by the express exception in § 26. *See* Bedolla v. Logan & Frazer, 52 Cal. App. 3d 118, 128, 125 Cal. Rptr. 59, 67 (Ct. App. 1975).

58. Millard v. Newmark & Co., 24 A.D. 2d 333, 336, 266 N.Y.S.2d 254, 259 (1966); Lieberman v. Atlantic Mut. Ins. Co., 62 Wash. 2d 922, 927, 385 P.2d 53, 56 (1963).

59. *See* Millard v. Newmark & Co., 24 A.D. 2d 333, 337, 266 N.Y.S.2d 254, 260 (1966).

60. 1916 Act § 1: "The limited partners as such sball not be bound by tbe obligations of tbe partnership."

61. *E.g., id.* §§ 5, 6, 7, 15, 16, 17.

62. Vulcan Furniture Mfg. Corp. v. Vaughn, 168 So. 2d 760 (Fla. Dist. Ct. App. 1964); *see* Klebanow v. New York Produce Exch., 344 F.2d 294, 298(2d Cir. 1965); Linder v. Vogue Invs., Inc., 239 Cal. App. 2d 338, 340-41, 48 Cal. Rptr. 633, 635 (Dist. Ct. App. 1966).

63. Klebanow v. New York Produce Exch., 344 F.2d 294, 298 (2d Cir. 1965); Oil & Gas Ventures, Inc. v. Cheyenne Oil Corp., 41 Del. Ch. 596, 601-02, 202 A.2d 282, 285 (ch.), *aff'd,* 42 Del. Ch. 100, 204 A.2d 743 (Sup. Ct. 1964); Comment, *supra* note 34, at 1475.

partners are pursuing the litigation actively.[64] If the general partners have refused to pursue the cause of action, and if such refusal is wrongful, the legislative balance already will have broken down, and section 26 need not be construed as an absolute bar to a suit instituted by one or more limited partners. In such a case, however, the legislative policy underlying the 1916 Act would seem to require at least that the limited partners' standing be dependent upon a demonstration that the general partners' refusal to proceed was improper.[65]

D. Section 7

The final issue arising in decisions under the 1916 Act is whether a limited partner's institution of suit on behalf of the partnership constitutes participation in control of the business within the meaning of section 7. That section provides: "A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business."[66] Only a few cases specifically address this question, and none can be regarded as conclusive. For example, one opinion states, without analysis, that merely bringing suit violates section 7;[67] another case assumes the same result;[68] and a third expressly reserves decision on the issue.[69]

The resolution of this issue requires an analysis of section 7. In general, there is a split of authority regarding whether section 7 impliedly embodies a reliance element. That is, some courts and commentators believe that a limited partner who participates in control of the business should only incur personal liability if the activity reasonably could be construed by creditors as indicative of general rather than limited partner status.[70] Others read section 7

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64. Klebanow v. New York Produce Exch., 344 F.2d 294, 298 (2d Cir. 1965); Riviera Congress Assocs. v. Yassky, 18 N.Y.2d 540, 547, 223 N.E.2d 876, 879, 277 N.Y.S.2d 386, 391 (1966); Comment, *supra* note 34, at 1475; 40 N.Y.U.L. REV. 1174, 1176 (1965).

65. Klebanow v. New York Produce Exch., 344 F.2d 294, 299 (2d Cir. 1965); McCully v. Radack, 27 Md. App. 350, 360, 340 A.2d 374, 380 (Ct. Spec. App. 1975).

66. 1916 Act § 7.

67. Executive Hotel Assocs. v. Elm Hotel Corp., 41 Misc. 2d 354, 358-59, 245 N.Y.S.2d 929, 933 (Civ. Ct.), *aff'd mem.*, 43 Misc. 2d 153, 250 N.Y.S.2d 351 (Sup. Ct. 1964).

68. Bedolla v. Logan & Frazer, 52 Cal. App. 3d 118, 128, 125 Cal. Rptr. 59, 66 (Ct. App. 1975).

69. McCully v. Radack, 27 Md. App. 350, 360, 340 A.2d 374, 380 (Ct. Spec. App. 1975).

70. Western Camps, Inc. v. Riverway Ranch Enterprises, 70 Cal. App. 3d 714, 728-30, 138 Cal. Rptr. 918, 926-27 (Ct. App. 1977); Delaney v. Fidelity Loase Ltd., 517 S.W.2d 420, 425 (Tex. Civ. App. 1974), *rev'd*, 526 S.W.2d 543 (Tex. 1975); Frigidaire Sales Corp. v. Union Properties, Inc., 88 Wash. 2d 400, 405-06, 562 P.2d 244, 247 (1977), *aff'g* 14 Wash. App. 634, 641, 544 P.2d 781, 785 (1975); Rathke v. Griffith, 36 Wash. 2d 394, 407-08, 218 P.2d 757, 764 (1950); Feld, *The "Control" Test for Limited Partnerships*, 82 HARV. L. REV. 1471, 1479-80

literally, refusing to imply an element of deception or reliance. They therefore hold that a limited partner who participates in control will become liable as a general partner regardless of whether the conduct could have been misleading to outsiders.[71] This view can be supported on either of two bases. First, section 7 may be considered a sanction designed to protect the management prerogatives of the general partners from unwarranted interference by limited partners.[72] Alternatively, section 7 may be founded on the notion that a limited partner who participates in control is equally responsible with the general partners for loss or dissipation of the firm's assets. Thus, in case of insolvency of the firm (the principal time that personal liability is important), a limited partner who shares control ought to share liability to creditors.[73]

Under any interpretation, institution of a derivative suit by a limited partner should not be held to constitute participation in control. It is hard to imagine how this conduct, which presumably would not be engaged in on a recurring basis and in which the limited partner's status would be disclosed, could lead outsiders reasonably to believe that the limited partner actually was a general partner.[74] Although the general partners might consider it to be an interference with their right to control, if restricted to appropriate cases the derivative suit would have to be categorized as a warranted rather than an unwarranted interference.[75] Again, if restricted to appropriate cases, the suit may well result in enhancing, not dissipating, the partnership's assets.[76] In addition, the cases actually finding a violation of section 7 all have involved acts of control much more extensive and continuous than the mere maintenance of a derivative suit.[77] Finally, to allow a limited partner to

(1969); Feldman, *The Limited Partner's Participation in the Control of the Business*, 50 CONN. B.J. 168, 171-74, 181 (1976); *see* Silvola v. Rowlett, 129 Colo. 522, 526, 272 P.2d 287, 289 (1954).

71. Delaney v. Fidelity Lease Ltd., 526 S.W.2d 543, 545 (Tex. 1975), *rev'g* 517 S.W.2d 420 (Tex. Civ. App. 1974); *see* Holzman v. De Escamilla, 86 Cal. App. 2d 858, 195 P.2d 833 (1948).

72. 40 N.Y.U.L. REV. 1174, 1178-79 (1965).

73. Hecker, *The Revised Uniform Partnership Act: Provisions Affecting the Relationship of the Firm and Its Members to Third Parties*, 27 KAN. L. REV. 1, 47-52, (1978); 26 OKLA. L. REV. 289, 293 (1973).

74. Note, *Procedures and Remedies in Limited Partners' Suits for Breach of the General Partner's Fiduciary Duty*, 90 HARV. L. REV. 763, 776 (1977).

75. *Id.* at 777; 40 N.Y.U.L. REV. 1174, 1179 (1965).

76. 40 N.Y.U.L. REV. 1174, 1179 (1965).

77. Filesi v. United States, 352 F.2d 339 (4th Cir. 1965) (dictum); Plasteel Prods. Corp. v. Eisenberg, 170 F. Supp. 100 (D. Mass.), *aff'd on other grounds sub nom.* Plasteel Prods. Corp. v. Helman, 271 F.2d 354 (1st Cir. 1959);Bergeson v. Life Ins. Corp. of America, 170 F. Supp. 150 (D. Utah 1958) (dictum), *aff'd in part and rev'd in part on other grounds*, 265 F.2d 227 (10th Cir.), *cert. denied*, 360 U.S. 932 (1959); Holzman v. De Escamilla, 86 Cal. App. 2d

maintain a derivative suit when general partners have breached their duties, but only at the price of violating section 7, would put the limited partner to a choice that would be inconsistent with the basic policy of the 1916 Act—that of encouraging investment in this form of enterprise.[78]

III. Recognition of Derivative Suits by the 1976 Act

Following the lead of Delaware[79] and New York,[80] section 1001 of the 1976 Act provides as follows:

> A limited partner may bring an action in the right of a limited partnership to recover a judgment in its favor if general partners with authority to do so have refused to bring the action or if an effort to cause those general partners to bring the action is not likely to succeed.[81]

It should be noted that this provision not only recognizes limited partners' derivative suits but also establishes the conditions under which they may be instituted. These conditions, in turn, are reinforced by the pleading requirements of section 1003.[82] The following discussion will focus first on identification of a cause of action as derivative rather than direct,[83] and then will proceed to a consideration of questions concerning exhaustion of remedies and standing that are raised by sections 1001 and 1003.

A. *Derivative and Direct Causes of Action*

Once a jurisdiction recognizes the possibility that a derivative suit may be instituted by a limited partner it becomes necessary to distingnish between causes of action accruing to the partnership as a business entity and those accruing directly to one or more limited partners as individuals. The distinction is necessary not only for theoretical reasons but also because of the differing procedural requirements applicable to derivative suits and individual or class actions,[84] and because any money judgment recovered in a deriva-

858, 195 P.2d 833 (1948); Gast v. Petsinger, 228 Pa. Super. Ct. 394, 323 A.2d 371 (1974); Delaney v. Fidelity Lease Ltd., 526 S.W.2d 543 (Tex. 1975).

78. 40 N.Y.U.L. Rev. 1174, 1179 (1965).

79. Del. Code Ann. tit. 6, § 1732 (1974).

80. N.Y. Partnership Law §§ 115-a to -c (McKinney Supp. 1978-1979).

81. 1976 Act § 1001.

82. *Id.* § 1003: "In a derivative action, the complaint shall set forth with particularity the effort of the plaintiff to secure initiation of the action by a general partner or the reasons for not making the effort." For a discussion of these requirements, see text accompanying notes 94-113 *infra*.

83. As used in this Article, a direct cause of action refers to one that accrues to one or more limited partners as individuals.

84. *See* Alpert v. Haimes, 64 Misc. 2d 608, 610, 315 N.Y.S.2d 332, 335 (Sup. Ct. 1970). *Compare, e.g.,* Fed. R. Civ. P. 23 *with id.* 23.1 *and* 1976 Act §§ 1001-1004.

tive action is not the individual property of the plaintiff but must be remitted to the partnership.[85] Thus, it seems clear that the action must be brought in the proper form.

New York, having recognized limited partners' derivative suits since 1966, already has a developing body of case law concerning this issue that should prove useful in other jurisdictions in which the 1976 Act may be adopted. As previously discussed, limited partners' derivative suits originated, at least in part, on the basis of an analogy between a limited partner and a corporate shareholder. The body of corporate law dealing with characterization of a cause of action as either direct or derivative, therefore, would seem to provide a logical starting point for the partnership analysis. This, in fact, is the route the New York courts have taken:[86] the cases reveal the use of a conceptual test in which the primary inquiries are to whom the defendant's obligation runs and who has suffered the direct and primary injury flowing from breach of that obligation.[87]

For example, *Riviera Congress Associates v. Yassky*[88] involved a suit against a tenant to recover unpaid rent under a lease in which a limited partnership was lessor. Once the court accepted the partnership as an entity for purposes of analysis, it correctly concluded that the cause of action belonged to the partnership and thus could be asserted by limited partners on a derivative basis. The court further noted that suit on such a cause of action *must* be brought by the partnership or someone entitled to act on its behalf.[89] Similarly, in *Silver v. Chase Manhattan Bank,*[90] a limited partnership was the sole shareholder of a corporation that had deposited funds with the defendant bank. A class action instituted by a limited partner on behalf of himself and all other limited partners, alleging that the bank improperly had disbursed the corporation's funds, was dismissed because the cause of action, if any, belonged to the corporate depositor.[91] The court, however, granted leave to replead the case as a derivative action.[92]

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85. 1976 Act § 1004.

86. Alpert v. Haimes, 64 Misc. 2d 608, 610, 315 N.Y.S.2d 332, 335 (Sup. Ct. 1970); Blattberg v. Weiss, 61 Misc. 2d 564, 569-70, 306 N.Y.S.2d 88, 94 (Sup. Ct. 1969).

87. Alpert v. Haimes, 64 Misc. 2d 608, 609-11, 315 N.Y.S.2d 332, 335-36 (Sup. Ct. 1970); *see* Silver v. Chase Manhattan Bank, 44 A.D. 2d 797, 797, 355 N.Y.S.2d 387, 388 (1974) (per curiam).

88. 18 N.Y.2d 540, 223 N.E.2d 876, 277 N.Y.S.2d 386 (1966).

89. *Id.* at 546-47, 223 N.E.2d at 879, 277 N.Y.S.2d at 391.

90. 44 A.D. 2d 797, 355 N.Y.S.2d 387 (1974) (per curiam).

91. *Id.*, 355 N.Y.S.2d at 388.

92. It would seem that the cause of action would be doubly derivative. That is, the limited partner would be asserting derivatively the partnership's right to bring a shareholders' derivative suit on behalf of the corporation. *See generally* Painter, *Double Derivative Suits and Other Remedies With Regard to Damaged Subsidiaries,* 36 IND. L.J. 143 (1961).

As is true in any situation involving mutually exclusive categories, close questions regarding the characterization issue will arise and arguably incorrect results will be reached. *Alpert v. Haimes*[93] is one example. There the court held that causes of action based on the general partners' allegedly fraudulent sale of *partnership property* and diversion of the proceeds could be maintained directly by limited partners in a class action. The court reasoned that such conduct, if proven, would constitute breach of a fiduciary duty owed to the limited partners *as individuals*. At the same time, the court held that a cause of action for unpaid rent could be maintained only derivatively because the tenants' obligations ran exclusively to the limited partnership. The court thus appeared to recognize the limited partnership as an entity with respect to some causes of action but not with respect to others.

Such ambivalence on the aggregate-entity issue may make the difficulty in characterization even greater in the limited partnership context than it is in the corporate context. One hopes that these problems will be alleviated as courts become more experienced in handling limited partners' derivative suits under the 1976 Act.

B. Exhaustion of Remedies and Standing

Section 1001 of the 1976 Act permits a limited partner to bring a derivative suit "if general partners with authority to do so have refused to bring the action or if an effort to cause those general partners to bring the action is not likely to succeed."[94] Section 1003 provides that the complaint in a derivative action "shall set forth with particularity the effort of the plaintiff to secure initiation of the action by a general partner or the reasons for not making the effort."[95] Taken together, these sections allow a limited partner to institute a derivative action in either of two situations: (1) if he or she has made an effort to secure the suit's initiation by the general partners and they have refused; or (2) if such an effort has not been made, the plaintiff has specified in his or her complaint the reasons why it should be excused because of the unlikelihood of success. Sections 1001 and 1003 apparently are patterned after the provisions in the Delaware and New York versions of the 1916 Act that authorize limited partners' derivative suits.[96] These provisions, in turn, are similar to Rule 23.1 of the Federal Rules of Civil Procedure (and its

93. 64 Misc. 2d 608, 315 N.Y.S.2d 332 (Sup. Ct. 1970).

94. 1976 Act § 1001.

95. *Id.* § 1003.

96. DEL. CODE ANN. tit. 6, § 1732(c) (1974); N.Y. PARTNERSHIP LAW § 115-a(3) (McKinney Supp. 1978-1979).

state law counterparts), which requires in a shareholders' derivative action that the complaint "allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort."[97]

1. Exhaustion of Intraenterprise Remedies

The requirement that a shareholder generally make a demand on directors as a condition precedent to bringing a derivative suit has been viewed as a requirement that the plaintiff exhaust his or her intracorporate remedies. That is, the plaintiff in a derivative suit is asserting not an individual right but one belonging to another legal entity. Because the cause of action belongs in the first instance to the corporation, and because management of the corporation is vested in its board of directors, it is both theoretically and practically justifiable to require the plaintiff to request that the corporation assert its right on its own behalf before allowing him or her to file a complaint that conscripts the cause of action.[98] These same justifications apply in the case of a limited partnership. The 1976 Act continues the norm that control of the business and affairs of a limited partnership rests primarily with the general partners.[99] The limited partners' derivative suit is an exception to this scheme that should be resorted to only when it is clear that the normal management processes have broken down, a fact that usually cannot be determined unless the general partners have refused a request that they take action.

If it is a foregone conclusion, however, that the general partners will refuse the would-be plaintiff's request, the request will be excused on the basis that it would be a futile act. While section 1003 requires that the complaint "set forth with particularity" the reasons why the request was not made, it does not attempt to detail the reasons that will constitute a legally sufficient excuse. This probably was a wise choice on the part of the drafters because it not only will allow the law regarding excuses to develop, but will allow it to develop consistently with a given state's law regarding excuses for a shareholder's failure to make a demand on corporate directors. Examples of situations in which demand has been excused in the corporate area, and which seem readily transferable to the limited partnership situation, include: conflict of interest on the part of the

97. FED. R. CIV. P. 23.1.

98. 3B MOORE'S FEDERAL PRACTICE ¶¶ 23.1.15[4], 23.1.19, at 23.1-92 (2d ed. 1978).

99. 1976 Act § 403.

directors; control of the directors by the alleged wrongdoer; and previously expressed director opposition to the suit.[100]

2. Standing to Sue Derivatively

Assuming that the general partners have refused a demand to institute the suit, or that demand has been excused as futile, the question remains whether the limited partner is, or should be, automatically entitled to maintain the action. The question essentially is one of standing, and the prestatutory cases upholding the limited partners' right to sue derivatively all have emphasized that the general partners' refusal must be wrongful. In *Klebanow v. New York Produce Exchange*[101] the court stated:

> We would indeed expect that the New York courts would require strong allegations and proof of disqualification or wrongful refusal by the general partners before allowing a limited partner to sue on the partnership's behalf—a mere difference of opinion would be nowhere near enough.[102]

The reason for the requirement that the general partners' refusal to sue be wrongful in order to confer standing on the limited partner again is to preserve the integrity of the norm vesting control of the partnership's affairs in the general partners. The decision whether it is sound policy to institute litigation normally should be made by those to whom the statute gives control. Unless the limited partner can demonstrate a reason transcending "a mere difference of opinion," he or she should not be permitted to circumvent the general partners' decision on this question to any greater extent than on any other question of business policy.[103] If, however, those in control of the partnership's affairs are prevented from making an unbiased decision because of a conflict of interest[104] or because they are under the control of the alleged wrongdoer,[105] not only should demand be excused, but if made and refused the limited partner should be permitted to proceed with the action. Additionally, even if the general partners are truly independent, there may be exceptional cases in which their refusal to pursue a clear cause of action

100. Comment, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. CHI. L. REV. 168, 173-82 (1976).

101. 344 F.2d 294 (2d Cir. 1965).

102. *Id.* at 299; *accord*, Riviera Congress Assocs. v. Yassky, 18 N.Y.2d 540, 547, 223 N.E.2d 876, 879, 277 N.Y.S.2d 386, 391 (1966); *cf.* McCully v. Radack, 27 Md. App. 350, 360, 340 A.2d 374, 380 (Ct. Spec. App. 1975) (allowing limited partners to intervene in a foreclosure proceeding).

103. *See* Comment, *supra* note 100, at 192.

104. Riviera Congress Assocs. v. Yassky, 18 N.Y.2d 540, 223 N.E.2d 876, 277 N.Y.S.2d 386 (1966).

105. Klebanow v. New York Produce Exch., 344 F.2d 294 (2d Cir. 1965).

is so unwarranted that such a refusal, itself, would constitute a breach of duty.[106] In such cases refusal by the general partners should not be held to preclude standing on the part of the limited partners.[107]

Sections 1001 and 1003 of the 1976 Act do not contain an express requirement that the general partners be disqualified from making an independent judgment or that their refusal to institute the action be wrongful. Section 115-a of the New York Partnership Law, which presently governs the right of limited partners to sue derivatively in New York, is also silent on this point.[108] In *Wien v. Chelsea Theater Center,*[109] a limited partner brought a derivative suit against the officers of a labor union challenging the legality of a provision in a collective bargaining agreement between the union and the limited partnership. Although the general partners were named as defendants, it does not appear that they were accused of wrongdoing other than causing the partnership to enter into the agreement. The defendants moved to dismiss the complaint on the basis, *inter alia,* that the limited partner lacked standing. They argued that in addition to demand and refusal it must be demonstrated that the refusal was improper, that there is a general consensus among the partners that the suit should be brought, that the general partners consent to the suit, or that the general partners are unable to bring the action themselves. The court denied the motion to dismiss on the grounds that section 115-a does not contain a requirement that the general partners be disqualified or that their refusal to bring the action be wrongful, and that the purpose of the section was to afford limited partners the same rights as shareholders to sue derivatively.[110]

The ultimate holding of the *Wien* case is unclear. It can be read as completely disposing of the standing issue. If this reading is correct the decision is subject to criticism on three bases. First, it gives an unwarranted exclusivity to section 115-a; second, it fails to recognize the existence of a standing requirement in shareholders' derivative suits; and third, it thus distorts the statutory balance of power in limited partnerships. On the other hand, the case can be read more narrowly as merely holding that the standing issue cannot be

106. *Cf.* Groel v. United Elec. Co., 70 N.J. Eq. 616, 61 A. 1061 (Ch. 1905) (shareholders' derivative suit).

107. For a thorough discussion of the standing requirement in the context of shareholders' derivative suits, see Comment, *supra* note 100, at 191-98.

108. *See* N.Y. PARTNERSHIP LAW § 115-a (McKinney Supp. 1978-1979).

109. 91 Misc. 2d 226, 397 N.Y.S.2d 865 (Sup. Ct. 1977), *rev'd on other grounds,* 66 A.D. 2d 741, 411 N.Y.S.2d 316 (1978).

110. *Id.* at 228, 397 N.Y.S.2d at 867.

resolved without at least a limited evidentiary hearing.[111] If this interpretation is correct, the court's failure to grant judgment for the defendants on the pleadings is not necessarily inconsistent with the existence of a requirement that the general partners be disqualified from making an independent judgment or that their refusal to sue be wrongful.

As stated above, if *Wien* holds that a limited partner will have standing merely on the basis of an allegation that the general partners have refused to bring the action, the decision gives an unwarranted exclusivity to the provisons of section 115-a. Whatever the law in New York, one hopes that the absence of an explicit disqualification or wrongful refusal requirement in sections 1001 and 1003 will not result in such a construction under the 1976 Act. Typical provisions permitting shareholders' derivative suits do not contain such an express requirement,[112] but this has not prevented the courts from insisting that a shareholder demonstrate his or her standing to maintain the action.[113] Certainly, there is nothing in the 1976 Act to prevent the imposition of a disqualification or wrongful refusal requirement. In fact, such a requirement would further the policy of the Act: control would remain primarily in the general partners but limited partners would have a remedy for extraordinary cases. Sections 1001 and 1003, therefore, should be interpreted to require the plaintiff-limited partner to demonstrate his or her standing to maintain the action. Thus, unless the general partners are for some reason (such as conflict of interest) prevented from making an unbiased judgment on the question whether to institute litigation, not only should demand not be excused, but if made and refused the limited partner ordinarily should be barred from maintaining the action.

IV. Proper Plaintiff—Membership Requirements

Section 1002 of the 1976 Act imposes two major requirements regarding the times at which the plaintiff in a derivative suit must be a partner. It provides:

> In a derivative action, the plaintiff must be a partner at the time of bringing the action and (1) at the time of the transaction of which he complains or (2) his status as a partner had devolved upon him by operation of law or pursuant to the terms of the partnership agreement from a person who was a partner at the time of the transaction.[114]

111. *See* McCully v. Radack, 27 Md. App. 350, 360, 340 A.2d 374, 380 (Ct. Spec. App. 1975); Comment, *supra* note 100, at 198-200.

112. *See* Fed. R. Civ. P. 23.1.

113. *See, e.g.*, Swanson v. Traer, 249 F.2d 854 (7th Cir. 1957).

114. 1976 Act § 1002.

These requirements, apparently patterned after the Delaware and New York versions of the 1916 Act,[115] raise a number of constructional and other problems. The following discussion will focus first on the requirement that the plaintiff be a partner at the time he or she brings the action, next on the requirement that the plaintiff have been a partner at the time of the transaction of which he or she complains, and finally on issues that may arise if the action is brought in federal court.

A. *Partner at the Time of Suit*

As previously stated, section 1002's requirement that the plaintiff be a partner at the time he or she brings the action appears to be patterned after analogous provisions of Delaware and New York law.[116] It also is similar to statutes governing shareholders' derivative suits in some states.[117] The reason for such provisions is that the shareholder's standing to assert the corporation's cause of action is based upon his or her proprietary interest in the corporation, and thus upon his or her indirect pecuniary interest in the cause of action.[118] Courts in other states have felt that this idea is implicit in the nature of a derivative suit and have imposed a "shareholder at the time of the suit" requirement without the aid of an explicit statute or court rule.[119] Because this same reasoning applies to limited partnerships, section 1002 properly restricts would-be derivative plaintiffs to those with an indirect proprietary stake in the litigation.

It should be noted, however, that section 1002 requires only that the plaintiff be a partner at the time of "bringing" the action; it does not require expressly that the plaintiff remain a partner throughout the continuance of the litigation. The prevailing corporate view appears to be that maintenance of shareholder status throughout the course of the litigation is necessary to maintenance

115. *See* DEL. CODE ANN. tit. 6, § 1732(b) (1974); N.Y. PARTNERSHIP LAW § 115-a(2) (McKinney Supp. 1978-1979). It should be noted that unlike the Delaware and New York laws, § 1002 does not require that the plaintiff be a limited partner at the relevant times. Instead, it uses the term "partner," which includes both limited and general partners. 1976 Act § 101(8). Thus, § 1002 would seem to permit suit by one who was a general partner at the time of the challenged transaction but who subsequently lost that status, became a limited partner, and retained the latter status at the time of bringing the suit.

116. The value of these provisions to the present analysis is limited, however, by their never having been interpreted by the courts of their respective states.

117. *E.g.*, GA. CODE ANN. § 22-615(a) (1977); N.Y. BUS. CORP. LAW § 626(b) (McKinney 1963).

118. Tenney v. Rosenthal, 6 N.Y.2d 204, 211, 160 N.E.2d 463, 466, 189 N.Y.S.2d 158, 163 (1959) (dictum).

119. *E.g.*, Dann v. Chrysler Corp., 40 Del. Ch. 103, 174 A.2d 696 (1961).

of the action. If the plaintiff disposes of all his or her shares after filing the complaint but before judgment, the action has been held to abate, at least as to that particular plaintiff.[120] Such holdings are in accord with the theory that it is the proprietary nature of the plaintiff's interest that is the technical foundation of his or her right to assert the cause of action. Interpreting section 1002 to require partner status only when the complaint is filed would run counter to this theory, which is equally applicable to limited partnerships. This would permit the anomaly of a lawsuit controlled by one with no financial interest in its outcome. In short, there is every justification for interpreting section 1002 the way its corporate law counterparts have been construed, and for requiring the plaintiff to remain a partner throughout the course of the litigation.[121]

B. Partner at Time of Alleged Wrong

1. General Rule

With two exceptions, to be discussed below, section 1002 also provides that the plaintiff must have been a partner at the time of the transaction of which he or she complains.[122] This provision, which will be referred to as the contemporaneous membership rule, again appears to be patterned after the Delaware and New York versions of the 1916 Act. All three statutes reflect an incorporation into limited partnership law of the contemporaneous ownership rule applicable to shareholders' derivative suits in a majority of states and in the federal courts.[123]

This requirement of ownership contemporaneous with the alleged wrong, originating in the Supreme Court's decision in *Hawes*

120. *E.g.*, Heit v. Tenneco, Inc., 319 F. Supp. 884 (D. Del. 1970); Harff v. Kerkorian, 324 A.2d 215 (Del. Ch. 1974), *rev'd on other grounds*, 347 A.2d 133 (Del. Sup. Ct. 1975) (dictum); Tenney v. Rosenthal, 6 N.Y.2d 204, 160 N.E.2d 463, 189 N.Y.S.2d 158 (1959) (dictum); Gleicher v. Times-Columbia Distrib., Inc., 283 A.D. 709, 128 N.Y.S.2d 55 (1954) (per curiam); Sorin v. Shahmoon Indus., Inc., 30 Misc. 2d 429, 220 N.Y.S.2d 760 (Sup. Ct. 1961); Johnson v. Baldwin, 221 S.E. 141, 69 S.E. 585 (1952).

121. It would seem that a partnership interest, however small, would be sufficient for purposes of § 1002. *Cf.* H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS § 361 (2d ed. 1970) (size of stock ownership immaterial). For this reason, and because § 1004 permits an award of fees to the attorney of a successful plaintiff, it could be argued that, as a practical matter, the relevant financial interest in the outcome of the case is that of the plaintiff's attorney rather than that of the plaintiff. Therefore, it should make no difference whether the plaintiff continues as a partner throughout the course of the litigation. This argument, however, is equally applicable to the narrow requirement that the plaintiff be a partner at the time of filing the complaint. Thus, under even the most restrictive interpretation of § 1002, it must be considered as having been rejected by the drafters of the 1976 Act.

122. 1976 Act § 1002.

123. H. HENN, *supra* note 121, at § 362; Harbrecht, *The Contemporaneous Ownership Rule in Shareholders' Derivative Suits*, 25 U.C.L.A. L. REV. 1041, 1043 (1978).

v. Oakland,[124] has been justified on three bases. The first, relevant only to litigation in the federal courts, is that it prevents transfer of shares to a willing nonresident in order to create diversity jurisdiction.[125] The second and most commonly proffered reason is that the rule is designed to prevent persons from purchasing shares after the fact solely for the purpose of instituting derivative litigation.[126] The concern underlying this rationale presumably is that such "purchased lawsuits" are likely to be pressed more for their nuisance value than to redress real wrongs. The third justification is that a plaintiff who had no proprietary interest in the enterprise at the time the wrong occurred simply has suffered no injury.[127] Although one might argue that the contemporaneous ownership or membership rule is an inappropriate vehicle to implement the policies underlying these reasons,[128] such arguments are beyond the scope of this Article. The following discussion will proceed on the premise that inclusion of a contemporaneous membership rule in the 1976 Act is justifiable from a policy standpoint and will concentrate on problems raised by the manner in which it has been drafted.

By generally requiring the plaintiff to have been a partner "at the time of the transaction of which he complains," section 1002 adopts almost verbatim the language of the original contemporaneous ownership rule enunciated by the Supreme Court in *Hawes v. Oakland.*[129] Since most provisions regulating shareholders' derivative suits also use this formulation,[130] courts and commentators may draw upon an already existing, voluminous body of interpretive case law.

Not surprisingly, the crucial issue raised by this language is the determination of when a transaction has occurred. In many cases resolution of the question will be straightforward. For example, if a general partner fraudulently misappropriates partnership assets in January, and the plaintiff does not become a partner until June, the plaintiff's suit would seem to be barred by the contemporaneous membership rule. In analogous corporate cases, however, shareholders sometimes have sought to avoid the impact of the contempora-

124. 104 U.S. 450 (1882).

125. *See, e.g., id.;* Quincy v. Steel, 120 U.S. 241 (1887).

126. *See, e.g.,* Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541 (1949) (dictum); Dimpfell v. Ohio & Miss. Ry., 110 U.S. 209 (1884); Hirshfield v. Briskin, 447 F.2d 694 (7th Cir. 1971).

127. *See, e.g.,* Goldherg v. Ball, 305 Ill. App. 273, 27 N.E.2d 575 (1940); Home Fire Ins. Co. v. Barber, 67 Neb. 644, 93 N.W. 1024 (1903).

128. *See* Harbrecht, *supra* note 123, at 1060-66.

129. 104 U.S. 450, 461 (1882).

130. *See, e.g.,* FED. R. CIV. P. 23.1; DEL. CODE ANN. tit. 8, § 327 (1974); N.Y. BUS. CORP. LAW § 626(b) (McKinney 1963).

neous ownership rule by arguing, in effect, that the original wrong continues as long as it remains unremedied. Therefore, while the *acquisition* of their shares postdates the original transaction, the plaintiffs' *ownership* of shares is contemporaneous with a wrong done to the corporation. Such arguments generally have failed because the courts have realized that, if accepted, they would all but eliminate the requirement of contemporaneous ownership.[131]

In other cases, pinpointing the time of a transaction may be more difficult. For example, a general partner may lease property from the limited partnership under a long term lease at an unfairly low rental. Or, a general partner may sell property to the limited partnership at an excessive price on an installment basis. In these sorts of cases the plaintiff may become a partner after the original bargain is struck but while its obligations are being performed. The argument of a continuing wrong has considerably more appeal in such circumstances and has been accepted by some courts in shareholders' derivative suits.[132] Other courts, however, reject the argument on the basis that the continuing performance is vulnerable to attack only if the original bargain is vulnerable, and consideration of the latter issue is barred by the contemporaneous ownership rule.[133] Because of this sharp division of authority over language virtually identical to that of section 1002, one may expect a less than uniform interpretation of this provision of the 1976 Act.

2. Exceptions to the Rule

As noted above, section 1002 contains two exceptions to the contemporaneous membership rule. Even if the plaintiff in a limited partners' derivative suit was not a partner at the time of the alleged wrong, the action still may be maintained if "his status as a partner . . . devolved upon him by operation of law or pursuant to the terms of the partnership agreement from a person who was a partner at the time of the transaction."[134] Like the contemporaneous member-

131. *See, e.g.,* Weinhaus v. Gale, 237 F.2d 197 (7th Cir. 1956); Henis v. Compania Agricola de Guatemala, 116 F. Supp. 223 (D. Del. 1953), *aff'd,* 210 F.2d 950 (3d Cir. 1954) (alternative holding); McQuillen v. National Cash Register Co., 22 F. Supp. 867 (D. Md. 1938), *aff'd,* 112 F.2d 877 (4th Cir.), *cert. denied,* 311 U.S. 695 (1940); Newkirk v. W.J. Rainey, Inc., 31 Del. Ch. 433, 76 A.2d 121 (1950); Weinstein v. Behn, 65 N.Y.S.2d 536 (Sup. Ct. 1946), *aff'd,* 272 A.D. 1045, 75 N.Y.S.2d 284 (1947) (alternative holding).

132. *See, e.g.,* Lawson v. Krock, 17 Fed. R. Serv. 2d 700 (4th Cir. 1973) (per curiam); Palmer v. Morris, 316 F.2d 649 (5th Cir. 1963); Hoff v. Sprayregan, 52 F.R.D. 243 (S.D.N.Y. 1971) (alternative holding).

133. *See, e.g.,* Lowell Wiper Supply Co. v. Helen Shop, Inc., 235 F. Supp. 640 (S.D.N.Y. 1964); Levitan v. Stout, 97 F. Supp. 105 (W.D. Ky. 1951); Goldie v. Yaker, 78 N.M. 485, 432 P.2d 841 (1967); Chaft v. Kass, 19 A.D.2d 610, 241 N.Y.S.2d 284 (1963) (per curiam).

134. 1976 Act § 1002(2).

ship rule itself, the exception for devolution by operation of law originated with *Hawes v. Oakland,*[135] and is substantially similar to its corporate law counterparts.

Strictly defined, devolution by operation of law refers to the passing of property without any intentional or voluntary act by either the previous or new owner.[136] If this definition were rigidly applied, few methods of acquisition other than by intestate succession would qualify. Corporate cases, however, have tended to apply the exception with some flexibility. Thus, the acquisition of stock pursuant to the terms of a will has been viewed as a taking by operation of law even though the transaction technically is a private donative act of the testator or textatrix.[137] In *Salter v. Columbia Concerts, Inc.,*[138] the court summarized its rationale as follows:

> So far as the question for decision here is concerned, no real distinction is found between intestate and testate succession. In each case the critical event from which the succession springs is death, an event over which the decedent has no control. What follows in the disposition of the property left by him is as much the operation of law in the one case as in the other.[139]

These courts have tended to focus on the purpose of the contemporaneous ownership rule as preventing speculation in litigation, and, finding the danger absent in a transfer of shares occasioned by death, have held the acquisition to be within at least the spirit of the exception.[140]

Voluntary inter vivos transfers, however, generally have been held to fall outside the scope of the operation of law exception. For example, acquisition of shares from the grantor by trustees of a

135. 104 U.S. 450, 461 (1882).

136. Whitaker v. Whitaker Iron Co., 249 F. 531, 536 (4th Cir.), *cert. denied,* 248 U.S. 564 (1918); McQuillen v. National Cash Register Co., 22 F. Supp. 867, 872 (D. Md. 1938), *aff'd,* 112 F.2d 877 (4th Cir.), *cert. denied,* 311 U.S. 695 (1940).

137. Phillips v. Bradford, 62 F.R.D. 681, 685 (S.D.N.Y. 1974); McQuillen v. National Cash Register Co., 22 F. Supp. 867, 872 (D. Md. 1938), *aff'd,* 112 F.2d 877 (4th Cir.), *cert. denied,* 311 U.S. 695 (1940); Salter v. Columbia Concerts, Inc., 191 Misc. 479, 77 N.Y.S.2d 703 (Sup. Ct. 1948).

138. 191 Misc. 479, 77 N.Y.S.2d 703 (Sup. Ct. 1948).

139. *Id.* at 481, 77 N.Y.S.2d at 705.

140. In *Hirshfield v. Briskin,* 447 F.2d 694 (7th Cir. 1971), the plaintiff acquired shares from her husband's estate pursuant to an agreement settling a dispute over ownership of the shares. The court, in holding the operation of law exception to be applicable, stated:

> The transfer to her of tbe shares was not in all respects solely and perfectly a result of the operation of law, and some element of bargain or consent was present. Yet we think her acquisition sufficiently approximated a devolution by operation of law and did not present the sort of occurrences involving speculation, champerty, or collusion to confer jurisdiction, which Rule 23.1 seeks to preclude.

Id. at 698 (footnote omitted). *See also* Helfand v. Gambee, 37 Del. Ch. 51, 136 A.2d 558 (1957) (acquisition of shares pursuant to corporate reorganization for which plaintiff had voted held to be by operation of law).

revocable inter vivos trust has been held to be a taking by contract and not by law.[141] Although the problem of speculation in litigation may not be present on the facts of a particular case, such holdings seem to be based on the fear that a rule extending the exception to circumstances in which both the timing of the transfer and the identity of the transferee are within the control of private parties simply would be too dangerous a door to open.

These corporate law cases may be indicative of how the operation of law exception will be interpreted in the limited partnership context. The matter is slightly more complicated, however, for while a transfer of corporate shares will carry with it a transfer of shareholder status, a transfer of a limited partner's interest in the partnership will not necessarily make the transferee a limited partner.[142] Under the 1976 Act, after the initial formation of the limited partnership, there are five ways in which a person may acquire the status of a limited partner. First, a person who acquires a partnership interest directly from the limited partnership may become a limited partner upon compliance with the applicable provisions of the partnership agreement, or, if none, upon the unanimous written consent of the partners.[143] Second, a person who acquires a partnership interest from an existing partner may become a limited partner if the transferor, pursuant to authority contained in the certificate of limited partnership, possesses and exercises the power to give his or her assignee the right to become a limited partner.[144] Third, a person who acquires a partnership interest from an existing partner may become a limited partner upon the unanimous consent of the other partners.[145] Fourth, the executor, administrator, guardian, or conservator of a deceased or incompetent partner may exercise all of the partner's rights for the purpose of settling or administering the partner's estate.[146] Fifth, a person who acquires a partnership

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141. Stephenson v. Landegger, 337 F. Supp. 591 (S.D.N.Y. 1971), *aff'd*, 464 F.2d 133 (2d Cir.), *cert. denied*, 409 U.S. 1039 (1972); Myer v. Myer, 271 A.D. 465, 66 N.Y.S.2d 83 (1946), *aff'd*, 296 N.Y. 979, 73 N.E.2d 562 (1947).

142. *See* 1976 Act § 702.

143. *Id.* § 301(a)(1).

144. *Id.* §§ 301(a)(2), 704(a).

145. *Id.* § 704(a).

146. *Id.* § 705. It would appear from the wording of § 705 that the partner's personal representative merely possesses the partner's rights but does not become an actual partner. Although for many purposes the distinction will be purely academic, it could have a significant practical impact under § 1002. If the deceased or incompetent partner was not a partner at the time of an allegedly wrongful transaction, and if his or her personal representative merely possesses the partner's rights, then suit will be barred by the contemporaneous membership rule of § 1002. If, however, the personal representative is deemed to become an actual partner by operation of law, and if such status is not required to devolve from one who was a

interest from the estate of a deceased or incompetent partner who had the power to grant his or her assignee the right to become a limited partner may become a limited partner if the personal representative of the deceased or incompetent partner exercises such power.[147]

Of the five methods by which a person may acquire the status of a limited partner, the first three are simply outright, voluntary purchases that do not even approximate a devolution by operation of law; all three easily could involve the kind of speculation in litigation that the contemporaneous membership rule presumably was designed to prevent. As such, they appear to fall outside the scope of the exception. The fourth method, acquisition by the personal representative of a deceased or incompetent partner would seem to be the clearest case of a devolution by operation of law since it involves a transfer of status triggered by an involuntary and unpremeditated event and impelled primarily by the provisions of the 1976 Act itself.[148]

The fifth method, acquisition by a person from the estate of a deceased or incompetent partner pursuant to a grant by the partner's personal representative, is somewhat more difficult because such a transfer requires a voluntary act by the personal representative. In the case of a deceased partner, however, the element of volition will be more theoretical than real. The requirement of an affirmative grant to an assignee of the right to become a limited partner derives from the traditional view that partnerships are consensual relationships whose members are free to choose their associates. Thus, an assignee of a partnership interest generally will not have the right to become a limited partner unless the other partners consent.[149] This consent may be given either specifically, after the assignment, or generally, in advance of the assignment through inclusion in the certificate of limited partnership of a provision giving the partners authority unilaterally to make their assignees limited partners.[150] If the certificate contains such a provision the concept of *delectus personae* is largely fictional; the requirement of an affirmative grant of the right to become a limited partner is largely vestigial. If a partner in such a limited partnership dies, testate or intestate, his or her personal representative normally would exercise

partner contemporaneous with the wrong, then suit will not be barred. For a discussion of the latter issue, see text accompanying notes 151-62 *infra*.

147. 1976 Act § 705.

148. *See id.*

149. *Id.* §§ 702, 704(a).

150. *Id.* §§ 301(a)(2), 704(a). Such provisions generally will be included in the certificates of large, commercial limited partnerships.

the power, granting the right to become a limited partner to the person succeeding to the partnership interest. In fact, the personal representative might even have a fiduciary duty to exercise such a power so that the legatee or heir could enjoy fully the property interest to which he or she succeeded. In this situation the analogy to testate or intestate succession to corporate stock is close if not compelling. For this reason, and because this situation generally would not present the danger of speculation in litigation, it should be held that the legatee or heir acquired his or her status as a limited partner by operation of law.

A person who acquires his or her status as a limited partner through an assignment from and grant by the guardian or conservator of an incompetent partner should be treated differently. Incompetency, unlike death, will not operate to transfer equitable title to the underlying partnership interest. Therefore, a person succeeding to the interest will do so only by reason of a voluntary and intentional assignment of the interest by the incompetent partner's personal representative. Such an assignment with a grant of the right to become a limited partner is as much an outright sale as a similar transaction engaged in by the original partner himself or herself. Since the danger of fostering speculative litigation is equally present in both cases, neither should be held to be a devolution by operation of law.

A final issue concerning the devolution by operation of law exception is whether the devolution must be from a person who was a partner at the time of the transaction that is the subject of the litigation. As noted above, section 1002 requires that the plaintiff in a derivative suit have been a partner at the time of the transaction or that "his status as a partner . . . devolved upon him by operation of law or pursuant to the terms of the partnership agreement from a person who was a partner at the time of the transaction."[151] Because the section is not punctuated and is devoid of any commentary from the drafters, it is possible to interpret the final clause either as modifying both methods of devolution or as modifying only devolution pursuant to the partnership agreement. In order to consider this question it first is necessary to determine what devolution "pursuant to the terms of the partnership agreement" means.

"Partnership agreement" is defined in the 1976 Act as "any valid agreement, written or oral, of the partners as to the affairs of a limited partnership and the conduct of its business."[152] Limited

151. *Id.* § 1002(2).
152. *Id.* § 101(9).

partnership agreements drafted under the 1916 Act commonly include provisions regulating the assigument of partnership interests and the ability of an assignee to assume the status of a limited partner.[153] This practice seems compatible with the 1976 Act and presumably will continue. With respect to assignments, section 702 specifically states: "Except as provided in the partnership agreement, a partnership interest is assignable in whole or in part."[154] As already noted, however, a simple assignment does not give the assignee the right to become a limited partner.[155] The assignee may become a limited partner only if the assignor gives him or her that right or if all other partners consent.[156] If the assignor's power to give that right is restricted or conditional, the restrictions or conditions, as well as the power itself, must be stated in the certificate of limited partnership.[157] This is not to say that such power, restrictions, or conditions could not *also* be stated in the partnership agreement, but it does seem that the validity of provisions appearing *only* in the partnership agreement could be questioned. With this in mind, section 1002's reference to devolution pursuant to the terms of the partnership agreement, and its concurrent failure to mention devolution pursuant to the terms of the certificate of limited partnership, would seem to indicate that voluntary assignments which include the grant of a right to become a limited partner are not within the intended scope of the exception to the contemporaneous membership rule.[158]

Another provision sometimes included in limited partnership agreements is one giving the partnership, other partners, or designated third parties the option to purchase a partner's interest upon the occurrence of a stated event such as death, incapacity, or withdrawal from the partnership.[159] Because the focus of both this Article and section 1002 is the limited partners' derivative suit, purchases by the partnership will not be considered in the following discussion.

To the extent that the partnership agreement gives an option

153. *See, e.g.*, 1 J. RABKIN & M. JOHNSON, CURRENT LEGAL FORMS WITH TAX ANALYSIS Forms 2.01 ¶ 7(b), 2.09 ¶ 9, 2.12 ¶ 14, 2.12A Art. XVI, 2.13 Art. 13, 2.13A Art. IX, 2.14 Art. XIV (1979).

154. 1976 Act § 702. The introductory phrase was included to make it clear that the partnership agreement can restrict assignability. *Id.* Comment.

155. *Id.* § 702.

156. *Id.* §§ 301(a)(2), 704(a).

157. *Id.* §§ 201(a)(7), 301(a)(2).

158. *Compare* DEL. CODE ANN. tit. 6, § 1732(b) (1974); N.Y. PARTNERSHIP LAW § 115-a(2) (McKinney Supp. 1978-1979).

159. *See, e.g.*, 1 J. RABKIN & M. JOHNSON, *supra* note 153, Forms 2.11 Art. VII, 2.12A § 14.4, 2.19 Art. V.

to purchase a partner's interest to a person other than an existing partner, it would be necessary, for purposes of section 1002, that the certificate of limited partnership contain authority for the selling partner, or his or her personal representative, to grant the purchaser the right to become a limited partner.[160] The provisions in the agreement creating the option would not be inconsistent with or superfluous to this authority, but simply would describe the circumstances under which the option-holder would have a right to purchase. Therefore, such a person arguably could be one whose status as a partner devolved upon him or her at least primarily "pursuant to the terms of the partnership agreement."

Generally, however, the option will run to existing partners, as a common purpose of such an option is to preserve each participant's proportionate interest in the enterprise. If one of the purchasing partners wished to institute a derivative action challenging a transaction that was complete before he or she became a partner, he or she might attempt to claim the benefit of the devolution pursuant to the partnership agreement exception on the basis of the additional partnership interest acquired under the option. Since the exception is phrased in terms of the devolution of *status* as a partner, a claim of this sort is open to attack. If a person already is a partner, that *status* will exist independently of, and will not be enhanced by, the exercise of an option to acquire another partner's *interest.* The purchasing partner, therefore, would appear to be outside the scope of the exception. For policy purposes, however, a purchase by an existing but noncontemporaneous partner is substantially equivalent to a purchase by an outsider, and, therefore, it will be assumed that the objection relating to pre-existing status is not insurmountable.

Assuming, then, that devolution "pursuant to the terms of the partnership agreement" refers to the situation in which an outsider (for example, a family member) or an existing but noncontemporaneous partner purchases another partner's interest pursuant to an option granted by the partnership agreement, it becomes necessary to consider why the drafters wished to confer standing on the purchaser only if the seller was a partner at the time of the alleged wrong. Since we are dealing with an exception to the contemporaneous membership rule it seems appropriate to re-examine the possible purposes of the rule itself.

Three principal rationales have been offered to justify the analogous shareholders' contemporaneous ownership rule—prevention

160. *See* 1976 Act §§ 301(a)(2), 704(a)(1).

of suits in federal courts on the basis of collusively obtained diversity jurisdiction; prevention of the litigation of purchased grievances; and the theory that a shareholder who had no interest at the time of the alleged wrong has suffered no injury and thus has no equitable basis for asserting the corporation's cause of action. Prevention of a collusive transfer to obtain diversity jurisdiction obviously is inapplicable to a provision in proposed uniform state legislation and need not be discussed further.

Preventing unscrupulous persons from purchasing for the sole or chief purpose of instituting a derivative suit is the most commonly advanced reason for the corporate contemporaneous ownership rule, and it is probable that similar considerations prompted section 1002's contemporaneous membership rule. It seems unlikely that one purchasing pursuant to an option in a partnership agreement would do so just to file a suit, as the option would offer little opportunity for this type of speculation. First, the event that gives rise to the option will not be in the control of the purchaser, and, in the case of death or incapacity, will not even be in the control of the seller. Second, the purchaser normally will be a person with a previous relationship either to the seller or to the limited partnership, one whose identity will be prescribed in advance in the agreement, either specifically or by class. Thus, an exception to the rule of contemporaneity for this sort of purchaser seems appropriate. But even assuming there is a possibility for speculative abuse in this situation, requiring the seller to have been a partner at the time of the challenged transaction would afford no additional protection, as there is no necessary correlation between a seller's status and a purchaser's motives. If this analysis is correct, it would follow that the requirement of contemporaneous membership by the former partner was not designed to prevent this sort of speculation in litigation. This conclusion, in turn, would support a construction of the requirement as being applicable both to devolution pursuant to the partnership agreement and to devolution by operation of law.[161]

A related type of abuse, requiring cooperation between the seller and purchaser, could occur under a partnership agreement containing an option exercisable upon the withdrawal of a partner. In this situation a partner who could not institute a derivative action personally because he or she lacked the necessary status at the time of the transaction could withdraw, permitting the option-

161. The provisions governing shareholders' derivative suits in some jurisdictions unambiguously require that shares devolving by operation of law pass from a contemporaneous owner. *E.g.*, CAL. CORP. CODE § 800(b)(1) (West 1977); GA. CODE ANN. § 22-615(a)(1) (1977); MASS. GEN. LAWS ANN. ch. 156B, § 46 (West 1970).

holder to acquire his or her partnership interest (and if an outsider, status as a new limited partner) for the purpose of bringing the derivative suit.[162] This sort of collusive transfer would be prevented by the requirement that the seller be a contemporaneous partner, and so could justify that requirement in section 1002. Under this analysis the requirement would not be construed as applying to devolutions by operation of law because of their distinguishing involuntary character. Of course, under this analysis the requirement of seller contemporaneity would be overly broad because it also would apply to transfers pursuant to the partnership agreement that approximate devolutions by operation of law, such as options triggered by death or incapacity rather than withdrawal. In addition, the coalition of elements necessary for an actual collusive transfer of the type described probably would not occur very often. For these reasons, although the requirement has the effect of preventing these transfers, it seems unlikely that this is its primary goal.

Finally, it is possible that the requirement of seller contemporaneity is based on the injured party rationale. If the seller was a partner at the time of the alleged wrong, he or she personally suffered an indirect injury and would have an equitable basis for asserting the partnership's cause of action. An option-holder purchasing pursuant to the partnership agreement from such a partner could be viewed as succeeding to the seller's status as an injured party as well as to his or her status as a partner. Thus, although no subsequent purchasers will have suffered an injury personally, those who purchase from a contemporaneous partner could be thought to have a greater equitable basis for instituting a derivative action than those who purchase from a noncontemporaneous partner. Under this analysis, of course, no rational distinction could be made between those who take pursuant to the partnership agreement and those who take purely by operation of law, with the result that the transferor contemporaneity requirement would be construed as modifying both methods of devolution.

If this view is correct, then section 1002 actually consists of a combination of two of the traditional rationales for the contemporaneous ownership rule. Its general rule prevents speculation in litigation by giving standing only to those who were partners at the time of the challenged transaction. The two exceptions to this rule seem designed to permit suit by noncontemporaneous partners only if they became partners in a manner not readily susceptible to speculative activity. In addition, the general rule could be seen as em-

162. *See* Harbrecht, *supra* note 123, at 1059 & n.75.

bodying the notion that only those who have suffered an indirect injury as a result of the alleged wrong should have standing to assert the partnership's cause of action. The requirement that a noncontemporaneous partner acquire his or her status from a contemporaneous partner seems most logically supportable if it applies to both exceptions on the basis of the injured party rationale, and thus reinforces this reading of section 1002.

C. *Potential Conflict with Federal Rule 23.1*

A final problem raised by section 1002 is its potential conflict with Rule 23.1 of the Federal Rules of Civil Procedure insofar as that Rule applies to a limited partners' derivative suit instituted in federal court on the basis of diversity jurisdiction. If Rule 23.1 is broad enough to encompass derivative suits brought on behalf of limited partnerships as well as those brought on behalf of corporations, then to the extent that its provisions respecting contemporaneity differ from those of section 1002 such a conflict appears inevitable.[163]

163. It is possible that the 1976 Act may have the indirect and unintended effect of drastically curtailing federal diversity jurisdiction with respect to limited partnerships. The general rule in suits involving unincorporated associations is that the citizenship of each member of the association is relevant for purposes of determining whether complete diversity exists between plaintiffs and defendants. United Steelworkers v. R.H. Bouligny, Inc., 382 U.S. 145 (1965); Great Southern Fire Proof Hotel Co. v. Jones, 177 U.S. 449 (1900); Chapman v. Barney, 129 U.S. 677 (1889). At present, there is a division of authority on the question whether the citizenship of limited partners in limited partnerships formed under the 1916 Act must be considered under this general rule. The leading case holding that limited partners' citizenship need not be considered is Colonial Realty Corp. v. Bache & Co., 358 F.2d 178 (2d Cir.), *cert. denied,* 385 U.S. 817 (1966). In that case Judge Friendly based his decision principally on § 26 of the 1916 Act, which provides that, "A contributor, unless he is a general partner, is not a proper party to proceedings by or against a partnership, except where the object is to enforce a limited partner's right against or liability to the partnership." 1916 Act § 26. Since limited partners were not proper parties to proceedings by or against limited partnerships, he reasoned, their citizenship was irrelevant for purposes of diversity jurisdiction. 358 F.2d at 183-84. Judge Friendly avoided the effect of his holding in Klebanow v. New York Produce Exch., 344 F.2d 294 (2d Cir. 1965), that limited partners could maintain a derivative suit on behalf of the partnership, by noting that New York subsequently had held to the contrary in Millard v. Newmark & Co., 24 A.D.2d 333, 266 N.Y.S.2d 254 (1966). 358 F.2d at 184 n.7. The leading case requiring that limited partners' citizenship be considered is Carlsberg Resources Corp. v. Cambria Sav. & Loan Ass'n, 554 F.2d 1254 (3d Cir. 1977). In a strong dissent Judge Hunter urged adoption of the *Colonial Realty* rule, but indicated that his views might be different if the relevant state law permitted limited partners to sue derivatively. After noting the holding in Riviera Congress Assocs. v. Yassky, 18 N.Y.2d 540, 223 N.E.2d 876, 277 N.Y.S.2d 386 (1966), which overruled *Millard* and authorized derivative actions in New York, he stated:

> That procedure has been adopted by the New York legislature, as well as by Delaware, and is a 1976 proposed revision to the Uniform Limited Partnership Act. If such derivative suit were brought in diversity, then it might be appropriate to look at the citizenship of the limited partners.

554 F.2d at 1265 n.10.

Rule 23.1, in pertinent part, provides:

> In a derivative action brougbt by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his sbare or membership thereafter devolved on him by operation of law . . . .[164]

It is clear from the language quoted that the Rule establishes the conditions precedent for derivative suits by members of unincorporated associations as well as those by shareholders of corporations. The existing case law provides little guidance on the question whether limited partnerships are unincorporated associations for purposes of Rule 23.1. At least one decision assumes without discussion that they are,[165] and this result is consistent with the general usage of that term in the context of federal civil procedure.[166] Thus, Rule 23.1 would seem at least potentially applicable in limited partners' derivative suits brought in federal court. If the basis of federal jurisdiction is diversity of citizenship the question arises whether the federal court will apply Rule 23.1 or section 1002 of the 1976 Act as the proper standard of contemporaneity.

Based upon the experience in shareholders' derivative suits the answer to some extent may depend upon which of the two standards is the stricter. The general rule of section 1002 requiring contemporaneous membership is virtually identical to that of Rule 23.1. Section 1002, however, provides more exceptions, allowing suits by noncontemporaneous partners who acquired their status either by operation of law or pursuant to the partnership agreement, while Rule 23.1 would permit suit only by the former.

The tendency of the federal courts, when confronted with a situation in which state law would permit a shareholder to sue derivatively but Rule 23.1 would not, has been to apply the stricter Federal Rule.[167] These decisions, in effect, hold the matter to be purely

164. FED. R. CIV. P. 23.1.

165. *In re* King Resources Co. Sec. Litigation, 420 F. Supp. 610 (D. Colo. 1976).

166. FED. R. CIV. P. 17(b)(1) uses the phraseology "partnership *or other* unincorporated association" (emphasis added). "Unincorporated association" has been held to mean the same thing under *id.* 23.2 as under 17(b)(1), *see* Lee v. Navarro Sav. Ass'n, 416 F. Supp. 1186 (N.D. Tex. 1976); Suchem, Inc. v. Central Aguirre Sugar Co., 52 F.R.D. 348 (D.P.R. 1971), and thus to include partnerships. Pyle v. Arthur Andersen & Co., 16 Fed. R. Serv. 2d 634 (D. Or. 1972). As discussed in note 163, *supra*, limited partnerships specifically have been held to be unincorporated associations for jurisdictional purposes. Carlsberg Resources Corp. v. Cambria Sav. & Loan Ass'n, 554 F.2d 1254 (3d Cir. 1977).

167. *E.g.*, Elkins v. Bricker, 147 F. Supp. 609 (S.D.N.Y. 1956); Kaufman v. Wolfson, 136 F. Supp. 939 (S.D.N.Y. 1955); Perrott v. United States Banking Corp., 53 F. Supp. 953 (D. Del. 1944); Winkelman v. General Motors Corp., 44 F. Supp. 960 (S.D.N.Y. 1942);

procedural rather than substantive.[168] Although the precise issue has never been decided by the Supreme Court, this result is supported by *Hanna v. Plumer*,[169] in which the Court stated:

> When a situation is covered by one of the Federal Rules, the question facing the court is a far cry from the typical, relatively unguided *Erie* choice: the court has been instructed to apply the Federal Rule, and can refuse to do so only if the Advisory Committee, this Court, and Congress erred in their prima facie judgment that the Rule in question transgresses neither the terms of the Enabling Act nor constitutional restrictions.[170]

It is further supported by dictum in *Cohen v. Beneficial Industrial Loan Corp.*,[171] to the effect that Rule 23.1 is applicable in a federal diversity case even if the relevant state law contains no similar provision.[172]

In another respect, however, section 1002 may be stricter than Rule 23.1. The operation of law exception in the 1976 Act can be construed to require devolution from a contemporaneous partner while Rule 23.1 contains no such restriction. It is more difficult to predict what a federal court would do in a situation in which the plaintiff would be barred from suing in state court but would not be barred in federal court if Rule 23.1 rather than section 1002 were applied.

In *In re Penn Central Transportation Co.*,[173] the court, reversing a prior ruling,[174] held that a shareholder was barred from suing derivatively by New York's contemporaneous ownership rule even though the suit would not have been barred under the court's interpretation of Rule 23.1. It reasoned that the New York rule was substantive and so must be applied in a federal diversity case under the principle of *Erie Railroad v. Tompkins*.[175] In support of its conclusion, the court relied on *Cohen v. Beneficial Industrial Loan Corp.*,[176] which held that state security for expenses provisions were applicable in federal court because they are substantive rather than procedural in nature.

Piccard v. Sperry Corp., 36 F. Supp. 1006 (S.D.N.Y.), *aff'd*, 120 F.2d 328 (2d Cir. 1941); Lissauer v. Bertles, 37 F. Supp. 881 (S.D.N.Y. 1940); Summers v. Hearst, 23 F. Supp. 986 (S.D.N.Y. 1938).

168. Arguments that the contemporaneous ownership rule is substantive can be made. *See* 3B MOORE'S FEDERAL PRACTICE ¶ 23.1.15[2] (2d ed. 1978); 7A C. WRIGHT & A. MILLER, FEDERAL PRACTICE AND PROCEDURE § 1829 (1972); Harbrecht, *supra* note 123, at 1046-50.

169. 380 U.S. 460 (1965).

170. *Id.* at 471 (footnote omitted).

171. 337 U.S. 541 (1949).

172. *Id.* at 556.

173. 354 F. Supp. 759 (E.D. Pa. 1972).

174. 341 F. Supp. 845 (E.D. Pa. 1972).

175. 304 U.S. 64 (1938).

176. 337 U.S. 541 (1949).

While *Cohen* can be distinguished on the basis that its rationale is rather strictly limited to security for expenses statutes, the *Penn Central* court nonetheless may have reached the correct conclusion.[177] As pointed out in *Hanna v. Plumer,*[178] forum-shopping is one of the chief concerns of *Erie* and its progeny. It would appear that failure to apply the stricter state requirement "would have so important an effect upon the fortunes of one or both of the litigants that . . . it would be likely to cause a plaintiff to choose the federal court."[179] The *Penn Central* view also seems in harmony with the Supreme Court's discussion in *Angel v. Bullington*[180] of a somewhat analogous question involving a state door-closing statute. The Court there stated:

> The essence of diversity jurisdiction is that a federal court enforces State law and State policy. If North Carolina has authoritatively announced that deficiency judgments cannot be secured within its borders, it contradicts the presuppositions of diversity jurisdiction for a federal court in that State to give such a deficiency judgment. North Carolina would hardly allow defeat of a State-wide policy through occasional suits in a federal court. What is more important, diversity jurisdiction must follow State law and policy. A federal court in North Carolina, when invoked on grounds of diversity of citizenship, cannot give that which North Carolina has withheld.[181]

Whether this approach will be followed with respect to section 1002's requirement of devolution from a contemporaneous partner remains to be seen. The problem almost certainly will arise if the 1976 Act receives widespread acceptance among the states.[182]

V. EXPENSES

Once again reverting to the Delaware and New York models,[183] the drafters of the 1976 Act expressly have provided for the recovery by a successful derivative plaintiff of his or her expenses, including attorney's fees. Section 1004 provides:

177. *See* Harbrecht, *supra* note 123, at 1050-52.
178. 380 U.S. 460 (1965).
179. *Id.* at 468 n.9.
180. 330 U.S. 183 (1947).
181. *Id.* at 191-92.
182. Conflicts similar to those discussed in the text also may arise in state courts in those states having a general rule of civil procedure broad enough to cover derivative suits brought by limited partners. *E.g.,* DEL. CH. CT. R. 23.1; MASS. R. CIV. P. 23.1. In such instances the conflict probably would be resolved in favor of § 1002 on the basis of the maxim that specific provisions control over more general ones. The potential for such conflicts, however, may influence state legislatures to modify § 1002 so that it will conform to their various individual general rules of procedure.
183. *See* DEL. CODE ANN. tit. 6, § 1732(d) (1974); N.Y. PARTNERSHIP LAW § 115-a(5) (McKinney Supp. 1978-1979).

> If a derivative action is successful, in whole or in part, or if anything is received by the plaintiff as a result of a judgment, compromise, or settlement of an action or claim, the court may award the plaintiff reasonable expenses, including reasonable attorney's fees, and shall direct him to remit to the limited partnership tbe remainder of those proceeds received by him.[184]

The final clause of section 1004 indicates that the primary source for payment of the plaintiff's expenses is the fund, if any, he or she has recovered on behalf of the limited partnership. This procedure is in accord with the practice in shareholders' derivative suits and finds theoretical justification in the nature of a derivative action. Since the cause of action asserted belongs to the limited partnership, and since its successful prosecution presumably benefits the partnership, it is thought fair to impose on the partnership the burden of paying the expenses connected with the suit.[185] The practical justification for imposition of this burden is that it encourages litigation of meritorious claims by limited partners whose personal stake in the outcome necessarily is indirect and often will be small compared to the costs involved.[186]

It should be noted that the award of attorneys' fees and other expenses is discretionary and is limited to amounts that the court determines to be reasonable. These limitations apparently stem from a competing concern that a provision permitting payment of the plaintiff's litigation expenses may encourage the pressing of specious as well as meritorious claims.[187] Because section 1004 encompasses dispositions by way of settlement or compromise as well as by judgment, this concern may be justified.[188]

In determining a reasonable fee for the plaintiff's attorney, courts will have the benefit of a substantial amount of corporate precedent. A number of factors are considered relevant, including: "(1) the amount recovered for the corporation; (2) the time fairly required to be spent on the case; (3) the skill with which the services were performed; (4) the novelty and complexity of the issues; (5) the standing of the attorneys; and (6) the contingent nature of the fee."[189] Although it has been stated that the amount recovered is the

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184. 1976 Act § 1004.

185. *See* 3B MOORE'S FEDERAL PRACTICE ¶ 23.1.25, at 23.1-143 to -144 (2d ed. 1978).

186. *See* 7A C. WRIGHT & A. MILLER, *supra* note 168, § 1841 at 443.

187. *See* 3B MOORE'S FEDERAL PRACTICE ¶ 23.1.25, at 23.1-146 (2d ed. 1978).

188. For a discussion of the compromise or settlement of derivative suits under the 1976 Act, see text accompanying notes 200-11 *infra*.

189. Newman v. Stein, 58 F.R.D. 540, 542 (S.D.N.Y. 1973); *accord*, Ramey v. Cincinnati Enquirer, Inc., 508 F.2d 1188 (6th Cir. 1974), *cert. denied*, 422 U.S. 1048 (1975); Angoff v. Goldfine, 270 F.2d 185 (1st Cir. 1959); Mesh v. Goldfield Corp., 60 F.R.D. 595 (S.D.N.Y. 1973).

most important of these factors,[190] and while some older cases seem to restrict the awarding of plaintiff's expenses to situations in which the litigation has produced a fund against which they may be taxed,[191] the modern trend is to allow such expenses whenever the litigation has substantially benefitted the corporation.[192] The theory of these cases is that because successful vindication of a corporate right benefits all shareholders, all ought to share in the expense. If the suit has not resulted in the creation of a fund, this cost-spreading may be accomplished by an order directing the corporation to pay the plaintiff's reasonable expenses.[193] Section 1004, by disjunctively referring to success *or* receipt of funds by the plaintiff, not only seems to permit but also to contemplate similar holdings in limited partners' derivative suits.

It also seems clear from section 1004's reference to compromises and settlements that the suit need not proceed to final judgment. This provision furthers the policy favoring resolution of disputes by settlement and is in accord with current corporate law.[194] Section 1004, however, may go farther. Its use of the terminology "compromise or settlement of an action or claim" may indicate an intent to adopt the rule of *Dottenheim v. Emerson Electric Manufacturing Co.*,[195] that if the requisite corporate or partnership benefit is present, it is not even necessary for the plaintiff formally to have commenced the derivative action.[196]

Finally, after giving the court discretion to award a successful plaintiff his or her reasonable expenses and attorney's fees, section 1004 instructs the court to direct him or her to remit the remainder of the proceeds, if any, to the limited partnership.[197] At first glance, this mandate does not seem remarkable. Since the underlying cause of action was that of the limited partnership, the balance of any proceeds received ordinarily should redound to its benefit. In some situations, however, strict adherence to the concept of the limited

190. Newman v. Stein, 58 F.R.D. 540, 542 (S.D.N.Y. 1973).

191. *See* Giesecke v. Pittsburgh Hotels, Inc., 180 F.2d 65 (3d Cir. 1950); Wolfes v. Paragon Refining Co., 74 F.2d 193 (6th Cir. 1934).

192. *E.g.*, Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970); Ramey v. Cincinnati Enquirer, Inc., 508 F.2d 1188 (6th Cir. 1974), *cert. denied*, 422 U.S. 1048 (1975).

193. Mills v. Electric Auto-Lite Co., 396 U.S. 375, 392-97 (1970).

194. *E.g.*, Green v. Transitron Elec. Corp., 326 F.2d 492 (1st Cir. 1964); Republic Nat'l Life Ins. Co. v. Beasley, 73 F.R.D. 658 (S.D.N.Y. 1977); Milstein v. Werner, 58 F.R.D. 544 (S.D.N.Y. 1973).

195. 77 F. Supp. 306 (E.D.N.Y. 1948).

196. The corresponding provisions of the Delaware and New York statutes contain similar language. DEL. CODE ANN. tit. 6, § 1732(d) (1974); N.Y. PARTNERSHIP LAW § 115-a(5) (McKinney Supp. 1978-1979).

197. 1976 Act § 1004.

partnership as injured party may prove inefficient or even unjust. For example, if a general partner flagrantly misappropriates partnership assets, remains in control, and is likely to continue this conduct in the future, a direct pro rata recovery by the limited partners may be preferable to placing the proceeds of the derivative suit in jeopardy by remitting them to the partnership. Individual pro rata recovery on a derivative cause of action, while exceptional, is not unknown in the corporate sphere.[198] The Delaware and New York counterparts of section 1004 make specific provision for such a possibility,[199] and perhaps it would have been wiser for the drafters of the 1976 Act to have modified their mandate in a similar fashion.

VI. Judicial Supervision of Settlements

The final sentence of Rule 23.1 states that a derivative suit "shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs."[200] This provision, the substance of which has been adopted by statute or court rule in a number of states,[201] contains two separate requirements—judicial supervision of the dismissal or compromise of a derivative suit; and notice to other shareholders or members.

The requirement of judicial supervision serves two related purposes. First, it is designed to prevent the settlement of a meritorious claim by an out-of-court payment to the plaintiff and his or her attorney to the exclusion of the corporation and other shareholders. Second, it is intended to discourage institution of a vexatious or "strike" suit in hope of such a payment.[202] The notice requirement not only gives other shareholders whose interests may be affected the opportunity to be heard, but in so doing, gives the court a broader perspective regarding the merits of the proposed settlement.[203]

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198. *See, e.g.,* Perlman v. Feldmann, 219 F.2d 173 (2d Cir.), *cert. denied,* 349 U.S. 952 (1955); Grenier, *Prorata Recovery by Shareholders on Corporate Causes of Action as a Means of Achieving Corporate Justice,* 19 Wash. & Lee L. Rev. 165 (1962).

199. Del. Code Ann. tit. 6, § 1732(d) (1974): "This subsection shall not apply to any judgment rendered for the benefit of injured limited partners only and limited to a recovery of the loss or damage sustained by them." N.Y. Partnership Law § 115-a(5) (McKinney Supp. 1978-1979) is similar.

200. Fed. R. Civ. P. 23.1.

201. *E.g.,* Colo. R. Civ. P. 23.1; Del. Ch. Ct. R. 23.1; Mass. R. Civ. P. 23.1; N.Y. Bus. Corp. Law § 626(d) (McKinney 1963).

202. 3B Moore's Federal Practice ¶ 23.1.24[1] (2d ed. 1978); 7A C. Wright & A. Miller, *supra* note 168, § 1839 at 427-28.

203. Cohen v. Young, 127 F.2d 721 (6th Cir. 1942), *cert. denied,* 321 U.S. 778 (1944).

Although New York has enacted similar requirements specifically with respect to limited partners' derivative suits, Delaware has not.[204] The drafters of the 1976 Act, following Delaware's lead, have omitted any direct requirement of judicial supervision of a compromise or settlement with notice to the other partners. The primary policy justification for such an omission appears to be that fairness may require the plaintiff to be free to settle a derivative action because if it ultimately is unsuccessful he or she personally must pay the costs of the litigation.[205] On the other hand, in light of the strong policy considerations supporting judicial supervision and notice, denial of the right to settle out of court may not be too great a burden for plaintiffs to bear.[206] This seems particularly true in view of the absence of any requirement in the 1976 Act that the plaintiff fairly and adequately represent the interests of other partners similarly situated.[207]

As a practical matter, it may be that most settlements of limited partners' derivative suits will be judicially supervised.[208] Two reasons support this conclusion. First, defendants usually will wish to be free of the threat of future suits by the partnership or by other limited partners on the same cause of action. Unless the statute of limitations is about to run, they can achieve this goal only through the res judicata effect of a court-approved settlement.[209] Additionally, the plaintiff's motive for an out-of-court settlement that amounts to a private payoff is undercut substantially by section 1004's requirement that the remainder of any proceeds received by him or her be remitted to the partnership.[210] In light of this explicit statutory directive, a plaintiff clearly would be accountable to the partnership for the amount received by him or her in an out-of-court settlement, provided that the facts of the suit and its settlement were known to the other limited partners.[211]

VII. CONCLUSION

Commercially, the limited partnership has come of age. Recog-

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204. *See* N.Y. PARTNERSHIP LAW § 115-a(4) (McKinney Supp. 1978-1979); Rodgers v. Sound of Music Co., 74 Misc. 2d 699, 343 N.Y.S.2d 672 (Sup. Ct. 1972); *see also* DEL. CODE ANN. tit. 6, § 1732 (1974).

205. 3B MOORE'S FEDERAL PRACTICE ¶ 23.1.24[2], at 23.1-136 (2d ed. 1978).

206. *See id.*

207. *See also* FED. R. CIV. P. 23.1.

208. It has heen stated that the court having jurisdiction in a derivative action has inherent power to provide for the conduct of the proceedings, including the power to require that notice be given to absent shareholders or members. *Id.*, Advisory Committee Note.

209. H. HENN, *supra* note 121, at §§ 374, 376.

210. 1976 Act § 1004.

211. *See* Clarke v. Greenherg, 296 N.Y. 146, 71 N.E.2d 443 (1947).

nizing this, the National Conference of Commissioners on Uniform State Laws promulgated the 1976 Act "to modernize the prior uniform law."[212] Of the sixty-four separate sections contained in the 1976 Act the four relating to limited partners' derivative suits ultimately may prove to he the most significant. The law relating to these actions is of critical importance to limited partners but, with the exceptions of Delaware and New York, it presently is developing in only a few jurisdictions and on a slow, sporadic, case-by-case basis. Sections 1001 through 1004 are designed to remedy this situation by providing a comprehensive set of rules governing the initiation and conduct of derivative suits by limited partners. This is no small accomplishment, and any criticism of the fine-tuning of these rules should not obscure this basic fact.

Some, if not all of these sections, of course, present problems of construction that will require resolution by the courts. Perhaps the thorniest of these lurk in the contemporaneous membership rule of section 1002. Ambiguous drafting coupled with an uncertain policy basis for the rule and its two exceptions create a situation in which both nonuniform interpretation and collision with Rule 23.1 of the Federal Rules of Civil Procedure are possible. In addition, in a comprehensive scheme governing derivative suits one would expect to find a section that explicitly reflects the modern trend requiring judicial supervision of compromises and settlements with provision for adequate notice to the other limited partners. The 1976 Act regrettably addresses this issue only indirectly in section 1004. Nevertheless, the simple recoguition of the right of a limited partner to sue derivatively is such an important contribution to limited partnership law that it far outweighs these and other shortcomings in the mechanics controlling exercise of the right.

212. 1976 Act, Prefatory Note.