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THE LIABILITY OF LIMITED PARTNERS FOR THE DEFAULTED LOANS OF THEIR LIMITED PARTNERSHIPS

THOMAS J. HALL AND JANICE A. PAYNE

Several legal theories may allow lenders to pierce the shield of limited liability and recover partnership debts from limited partners.

A central tenet of limited partnership law is that limited partners are not personally liable for their partnership's obligations. Faced with this general prohibition, should lenders abandon any consideration of recovery against individual limited partners for the defaulted loans of their limited partnerships? Absolutely not. While the principle of limited liability will form a limited partner's first line of defense to an action seeking recovery on partnership obligations, lenders have at their disposal several legal theories that may allow them to pierce the shield of limited liability and recover partnership debts from the limited partners themselves.

First, a lender should consider whether it is possible to recover against a limited partner pursuant to the so-called "control rule."¹ The control rule

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provides that a limited partner can be liable for partnership obligations if he “participates in the control” of the business of the partnership.² Although the control rule was eliminated in the most recent amendments to the Uniform Limited Partnership Act, it remains the law in many states.

Second, a lender may be able to recover on a limited partnership’s defaulted loan by suing to enforce the limited partners’ obligations to contribute capital to the partnership. Limited partnership law generally allows a lender to enforce such capital contribution obligations where the lender has reasonably relied on them in extending credit to the partnership. This rule seeks to protect the legitimate expectations of creditors by giving them a direct right of recovery against limited partners.

Finally, limited partnership law sometimes recognizes a lender’s right to sue the limited partners to recover distributions that were made to them when the limited partnership was insolvent or in the zone of insolvency, or to recover returned capital contributions to the extent necessary to satisfy partnership obligations. In jurisdictions that recognize this right, an action to recover such distributions or returned capital contributions may be asserted by the lenders themselves, obviating the need for a bank to rely on the partnership to pursue such claims.

THE UNIFORM LIMITED PARTNERSHIP ACT

The Uniform Limited Partnership Act, or “ULPA,” was first promulgated in 1916 as part of an effort to codify and standardize commercial law, including the law of limited partnerships.³ Since then, nearly every state has adopted ULPA in one form or another.⁴ Notwithstanding its name and the widespread adoption of ULPA, limited partnership law is not entirely uniform. State legislatures can, and do, modify the provisions of ULPA as they see fit, and the periodic amendments to ULPA are not always adopted by states.⁵ In addition, judicial interpretation of the state versions of ULPA sometimes varies among jurisdictions.⁶ Accordingly, a lender should always consult the statutes and case law of the appropriate jurisdiction — usually the state in which the partnership was formed⁷ — to determine the specific rights and obligations of the limited partners and the partnership’s creditors.⁸ For purposes of this article, unless otherwise noted, we will be referring to the

1985 version of ULPA, as that is the version that is in effect in the majority of states.⁹

LIMITED PARTNER LIABILITY UNDER THE “CONTROL RULE”

Until 2001, ULPA recognized that a limited partner could be personally liable for partnership obligations when it participated in the control of the business of the partnership.¹⁰ This principle of liability arising from a limited partner’s control of partnership business was scaled back in each succeeding iteration of ULPA until it was finally eliminated completely in the 2001 amendments.¹¹ The 2001 version of ULPA unequivocally provides that a “limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise...solely by reason of being a limited partner, *even if* the limited partner participates in the management and control of the limited partnership.”¹²

Despite the elimination of the control rule in the most recent promulgation of ULPA, it remains the law throughout the country in those states that have not yet adopted the 2001 amendments or that have not otherwise dispensed with the control rule.¹³ Thus, in many states, lenders may still reach the personal assets of those limited partners that participate in the control of the partnership business.

To trigger liability under the control rule, a lender must be able to show both that the limited partner “participate[d] in the control of the business” of the partnership *and* that the lender “reasonably believ[ed], based upon the limited partner’s conduct, that the limited partner [was] a general partner.”¹⁴ To further limit the scope of liability under this provision, ULPA also identifies several “safe-harbor” activities that are deemed not to constitute control of the partnership.¹⁵ For example, a limited partner who is a contractor, employee or agent of the limited partnership, a general partner or officer, director or shareholder of a corporate general partner, or a surety or guarantor of the limited partnership is not considered to have participated in the control of partnership business.¹⁶ Nor will a limited partner be deemed to have participated in the control of the partnership by consulting with and advising the general partner regarding the business of the partnership or

proposing, approving or disapproving certain partnership matters.¹⁷ Likewise, pursuing a derivative action on behalf of the limited partnership does not constitute control of the partnership's business.¹⁸

In light of these statutory safe-harbor provisions, a lender seeking to impose liability on a limited partner based on its control of the partnership will need to show more than conduct that is merely advisory or purely administrative. Although there is no bright-line test to determine what conduct will suffice to impose personal liability on a limited partner, courts faced with this question have held that control is adequately demonstrated where the limited partner "openly and publicly took an active part in the management and control of the [partnership] business,"¹⁹ the limited partner controlled the direction of and had final "say-so" on all major decisions concerning the partnership's business,²⁰ the limited partner had decision-making authority that could not be "checked or nullified by the general partner,"²¹ the limited partner had absolute power to withdraw funds from partnership accounts without the "knowledge or consent of the general partner,"²² and the limited partner had control over the distribution of profits.²³ Ultimately, the determination of whether a limited partner's conduct amounts to control over the business affairs of the partnership is a fact-intensive question, which requires "consideration of the purpose of the partnership, the administrative activities undertaken, the manner in which the entity actually functioned, and the nature and frequency of the limited partner's purported activities."²⁴

Liability under the control rule, however, will not lie if a lender can only prove that the limited partner participated in the control of the partnership business. A lender must also demonstrate that he reasonably believed that the limited partner was a general partner. The case *Megatech Inc. v. NSD Acquisitions LP*²⁵ provides an example of the kind of facts that will demonstrate such reliance. In that case, the court found that the limited partner was jointly and severally liable for the partnership's obligations to the plaintiff where the partnership leased employees from the limited partner, the limited partner and partnership had the same fax number, and the letter terminating the partnership's business relationship with the plaintiff was written on the limited partner's stationery, sent by an entity doing business as the limited partner, and made no mention of the partnership. On these facts, the court

concluded that the plaintiff could have reasonably believed that the limited partner was the “controlling entity or general partner.”²⁶

CREDITOR ENFORCEMENT OF A LIMITED PARTNER’S CAPITAL CONTRIBUTION OBLIGATIONS

A lender may also be able to recoup outstanding partnership obligations through an action to enforce the limited partner’s capital contribution obligations to the partnership. Often times, when a limited partner makes an initial capital contribution, it also agrees to make future capital contributions up to a set amount and subject to whatever conditions or limitations are provided for in the partnership agreement or certificate of limited partnership. These capital contribution obligations can be compromised, e.g., modified or eliminated, only by the “consent of all partners,” unless otherwise provided in the partnership agreement.²⁷ Such a compromise, however, is not effective as to third parties who advanced credit in reliance on the obligation.²⁸

Specifically, Section 502 of ULP provides that a creditor who “extends credit or otherwise acts in reliance” on a limited partner’s capital contribution obligations may enforce that obligation.²⁹ A creditor’s right to enforce the limited partner’s capital contribution obligations is unaffected by any compromise of the obligations subsequent to the extension of credit.³⁰ The creditors’ rights set forth in Section 502 reflect a desire to protect partnership creditors and recognize that the obligation to contribute capital is more than just a “bilateral agreement” between individual limited partners and the partnership, but something on which third parties rely when transacting business with the partnership.³¹

Although there is limited case law addressing the exceptions to a limited partner’s liability under Section 502, it is fair to say that these exceptions are “few and they are narrow.”³² Generally, limited partners will only be excused from making their promised capital contributions if a condition to such payment as expressed in the partnership agreement or certificate of limited partnership has not been satisfied.³³ And, of course, a limited partner cannot be required to contribute capital in excess of its commitment. One court applying a state analog of Section 502 also has suggested that contribution obligations may be excused — even as to partnership creditors — where there has

been a “profound failure of consideration such as repudiation of, or fraud incident to, the essentials of the venture to which the [partnership] was made.”³⁴ Courts, however, have also made clear that a “material breach of the limited partnership agreement — including mismanagement or unauthorized acts of the general partners, or disappointed expectations — would not excuse a limited partner’s commitment to contribute additional capital” and thus, does not constitute a valid defense to a Section 502 claim.³⁵ One court went even further, holding that proof of the general partner’s fraudulent activities in connection with the partnership did not excuse the limited partner’s capital contribution obligations and did not provide an adequate defense to a creditor’s claim under Section 502 when the fraud had not resulted in a total failure of consideration.³⁶

To have a valid claim under Section 502, the creditor must have relied on the capital contribution obligation.³⁷ While there is not much guidance as to what will constitute adequate reliance, some courts have found reliance simply by virtue of the fact that the capital contribution obligations were contained in a publicly filed certificate of partnership.³⁸ A lender, however, will want to take extra steps to demonstrate its reliance on the capital contribution obligations. Evidence of such reliance may include references in the lender’s credit files to the capital contribution obligations as a source of repayment of the loan, references to the capital contribution obligations in the credit agreements or solicitation materials, communications with the general partner and limited partners regarding the basis on which the loan will be repaid, review of the partnership’s books and records, such as capital account and financial statements, or execution of an undertaking pursuant to which the general partner agrees to issue, and/or the limited partners agree to make, capital contributions to repay the debt.

In the case *In re LJM2 Co-Investment, L.P. Limited Partners Litigation*, the authors prosecuted a claim on behalf of a litigation trust under Delaware’s version of Section 502. In that case, a group of lenders (the beneficiaries of the trust) had extended financing to an Enron-related partnership called LJM2 Co-Investment, L.P. As a condition to the extension of credit, LJM2’s general partner was required to execute a “General Partner Undertaking,” pursuant to which the general partner was obligated to issue capital calls to the extent necessary to cure a payment default.³⁹ When a capital call was

issued to repay the credit facility, rather than making the required capital contribution, certain of the limited partners sought to avoid that obligation by removing the general partner and amending the partnership agreement to compromise both the outstanding capital call and future capital calls.⁴⁰

In response to the Section 502 claim, the limited partners contended that the capital call was validly compromised and that, in any event, the lenders could not have reasonably relied on the capital contribution obligations because of language in the loan documents and partnership agreement.⁴¹ Specifically, the limited partners argued that the loan documents demonstrated that the loan was recourse only to the partnership and that provisions in the partnership agreement disclaimed any liability to the partnership's creditors and made clear that the capital contribution obligations were merely conditional and subject to compromise at any time.⁴²

The court rejected the limited partners' arguments and ruled that the purported amendment was ineffective because, although the statutory default rule required unanimous consent to alter the capital contribution obligations, the attempted amendment had only been approved by a majority of the limited partners.⁴³ With respect to reliance, the trust argued that the partnership and subscription agreements were replete with references to the limited partners' capital contribution obligations and that this, together with the credit agreement and the General Partner Undertaking, created a situation in which the lenders could rely on the capital contribution obligations.⁴⁴ The court agreed with the trust, holding that the trust had adequately pled reasonable reliance.⁴⁵

RECOVERY OF DISTRIBUTIONS AND RETURNED CAPITAL CONTRIBUTIONS

A lender may also be able to satisfy outstanding partnership debt through an action to recover (1) distributions that were made by the partnership when it was insolvent or in the zone of insolvency, or (2) capital contributions returned to limited partners to the extent they are needed to repay partnership obligations.⁴⁶ Section 607 of ULP provides that a partner may not receive a distribution from a limited partnership to the extent that, after "giving effect to the distribution, all liabilities of the limited

partnership...exceed the fair value of the partnership assets."⁴⁷ Under Section 608 of ULPA, a limited partner is liable for any return of its capital contribution that is later needed to pay partnership obligations incurred before the distribution.⁴⁸ The 2001 amendments to ULPA impose additional conditions on recovery under these sections, providing that a limited partner is only liable to the limited partnership for unlawful distributions or returns of capital contributions if that partner knew that the distribution or return was made wrongfully, either in violation of the partnership agreement or of ULPA.⁴⁹

Some courts have recognized a creditor's right to bring claims under these ULPA provisions directly against limited partners.⁵⁰ For example, in *Neuner v. C.G. Realty Capital Ventures-I, L.P.*, the creditor had purchased a shopping center from a limited partnership and had loaned the partnership \$300,000 to construct additional space in the center.⁵¹ After the sale, the general partner distributed the sale proceeds to the limited partner and then "absconded with the partnership's funds," leaving it defunct. The court recognized the right of the creditor to bring a claim to recover the distributions.⁵²

The *Neuner* court's rationale for giving the creditor standing to recover the distributions was twofold. First, to limit the right of recovery to the partnership would deny the creditor relief "where there is not the slightest hint that the legislature desired to exonerate limited partners from liability."⁵³ Second, allowing the creditor to bring a claim under these sections would not impose any additional liability on the limited partners or alter the limited partners' rights and obligations.⁵⁴

As with a limited partner's obligation to contribute capital, there also may be limits on a creditor's right to recover under Sections 607 and 608. In *Sender v. Simon*, the court refused to allow a creditor to bring a claim to recover distributions from the limited partners where the partnership was deemed to be a complete sham.⁵⁵ The court explained that the issue was not whether a defrauded partner is liable to a third party creditor of the partnership, but whether the limited partner is liable to the sham partnership itself. The court reasoned that the defrauded limited partner was not liable to the sham partnership since to "suggest otherwise would be to further an illegitimate scheme."⁵⁶

It is important to note that there is a dearth of case law interpreting

Sections 607 and 608 and, thus, it is far from certain that a particular court would recognize a creditor's right to recover under these provisions. Nevertheless, the limited case law available suggests that these claims are viable and lenders should explore whether it is appropriate to pursue recovery on such a theory based on the particular facts and law of their situation.

NOTES

¹ See Carter G. Bishop, *The New Limited Partner Liability Shield: Has the Vanquished Control Rule Unwittingly Resurrected Lingering Limited Partner Estoppel Liability as Well as Full General Partner Liability?* 37 Suffolk U. L. Rev. 667, 669 (2004).

² Unif. Ltd. P'ship Act § 303 (amended 1985); Unif. Ltd. P'ship Act § 303 (1976) (a limited partner can be liable if he "takes part in the control of the business..."); Unif. Ltd. P'ship Act § 7 (1916).

³ See Alan R. Bromberg & Larry E. Ribstein, *Partnership*, § 11.02(b) (2005).

⁴ All states except Louisiana have adopted ULPA. See J. William Callison & Maureen A. Sullivan, *Partnership Law and Practice: General and Limited Partnerships* § 18.1 (2004); see also Unif. Ltd. P'ship Act Refs. & Annos (1976).

⁵ See Michael K. Pierce & Jill E. Fisch, *Overview of Substantive Law Governing General Partnerships, Limited Partnerships, and Limited Liability Companies*, SJ029 ALI-ABA 1, 5 (April-May 2004).

⁶ *Id.*; see generally Gavin L. Phillips, Annotation, *Liability of Limited Partner Arising from Taking Part in Control of Business Under Uniform Limited Partnership Act*, 79 A.L.R. 4th 427 at § 1(a) (2004).

⁷ Paul Coltoff et al., 68 C.J.S. *Partnership* § 404 (June 2004); Unif. Ltd. P'ship Act § 901(a) (2001); Unif. Ltd. P'ship Act § 901(a) (amended 1985).

⁸ See Phillips, *supra* note 6.

⁹ See Callison & Sullivan, *supra* note 4, at n.7. The states that have adopted the 1985 amendments to the Uniform Limited Partnership Act are: California, Colorado, Connecticut, Delaware, District of Columbia, Florida, Georgia, Hawaii, Indiana, Kansas, Kentucky, Maryland, Minnesota, Mississippi, Missouri, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, Oregon, South Carolina, South Dakota, Texas, Utah, Virginia, Washington and West Virginia. *Id.*

¹⁰ See Unif. Ltd. P'ship Act § 303 (amended 1985); Unif. Ltd. P'ship Act § 303 (1976). Unif. Ltd. P'ship Act § 7 (1916); see also Bishop, *supra* note 1, at 668-69.

- ¹¹ Bishop, *supra* note 1, at 669-70.
- ¹² See Unif. Ltd. P'ship Act § 303 (2001) (emphasis added).
- ¹³ See *supra* note 9 (listing states that adopted the 1985 version of ULPA); see, e.g., Del. Revised Ltd. P'ship Act § 17-303(a); Cal. Revised Ltd. P'ship Act § 15632(a); N.Y. McKinney's P'ship Law § 121-303(a); Ill. Revised Unif. Ltd. P'ship Act § 210-303; Fla. Stat. § 620.129.
- ¹⁴ See Unif. Ltd. P'ship Act § 303(a) (amended 1985).
- ¹⁵ Unif. Ltd. P'ship Act § 303(b) (amended 1985).
- ¹⁶ Unif. Ltd. P'ship Act § 303(b)(1), (3) (amended 1985).
- ¹⁷ Unif. Ltd. P'ship Act § 303(b)(2), (6) (amended 1985).
- ¹⁸ Unif. Ltd. P'ship Act § 303(b)(4) (amended 1985).
- ¹⁹ *Filesi v. United States*, 352 F.2d 339, 341 (4th Cir. 1965) (applying Maryland law).
- ²⁰ *Hommel v. Micco*, 76 Ohio App. 3d 690, 696, 602 N.E.2d 1259, 1262 (1991) (applying Ohio law).
- ²¹ *Gast v. Petsinger*, 228 Pa. Super. 394, 402, 323 A.2d 371, 375 (1974).
- ²² *Holzman v. De Escamilla*, 86 Cal. App. 2d 858, 860, 195 P.2d 833, 834 (1948).
- ²³ *Brooke v. Mt. Hood Meadows Oreg. Ltd.*, 81 Or. App. 387, 393, 725 P.2d 925, 929 (1986).
- ²⁴ 59A AM. JUR. 2D *Partnership* § 879 (2004).
- ²⁵ *Megatech Inc. v. NSD Acquisitions LP*, Nos. 99-2344, 99-2345, 2000 WL 718392, at *4-5 (4th Cir. June 5, 2000).
- ²⁶ *Id.*
- ²⁷ See Unif. Ltd. P'ship Act § 502(c) (2001); Unif. Ltd. P'ship Act § 502(c) (amended 1985); Unif. Ltd. P'ship Act § 17 (1916).
- ²⁸ Unif. Ltd. P'ship Act § 502(c) (2001); Unif. Ltd. P'ship Act § 502(c) (amended 1985); see, e.g., *Int'l Investors v. Bus. Park Fund*, 991 P.2d 219, 224 (Alaska 1999) (applying 1976 version of ULPA) (limited partners are not only answerable to the partnership for unpaid contributions; creditors have right to enforce liabilities or unpaid contributions).
- ²⁹ Unif. Ltd. P'ship Act § 502(c) (2001); Unif. Ltd. P'ship Act § 502(c) (amended 1985); Unif. Ltd. P'ship Act § 17 (1916).
- ³⁰ See Unif. Ltd. P'ship Act § 502(c) (2001); Unif. Ltd. P'ship Act § 502(c) (amended 1985).
- ³¹ *Partnership Equities, Inc. v. Marten*, 15 Mass. App. Ct. 42, 44-45, 443 N.E.2d 134, 136 (1982).
- ³² *Id.*

³³ See Unif. Ltd. P'ship Act § 502(c) (2001); Unif. Ltd. P'ship Act § 502(c) (amended 1985); Unif. Ltd. P'ship Act § 17 (1916); see also *FDIC v. Nanula*, 898 F.2d 545, 550 (7th Cir. 1990); Partnership Equities, 443 N.E.2d at 136; *Chemical Bank of Rochester v. Haskell*, 68 A.D.2d 347, 351, 417 N.Y.S.2d 541, 545 (4th Dep't 1979).

³⁴ *Partnership Equities*, 443 N.E.2d at 136.

³⁵ *In re Securities Group* 1980, 74 F.3d 1103, 1109 (11th Cir. 1996); Partnership Equities, 443 N.E.2d at 138 (the court compared the limited partners to the stockholders of a business corporation and found that “[m]ismanagement or unauthorized acts of the corporate officers...or disappointed expectations cannot be set up to defeat collection of a stock subscription”).

³⁶ *In re Securities Group*, 74 F.3d at 1108-09; see also *Partnership Equities*, 443 N.E.2d at 136-37 (court held that breach of a term of the partnership agreement by the general partners did not excuse payment of the capital contributions by the limited partners).

³⁷ Unif. Ltd. P'ship Act § 502(c) (2001); Unif. Ltd. P'ship Act § 502(c) (amended 1985).

³⁸ *Partnership Equities*, 443 N.E.2d at 135-36; *In re Securities Group*, 74 F.3d at 1107-08.

³⁹ *In re LJM2 Co-Investment, L.P. Ltd. Partners Litig.*, 866 A.2d 762, 768 (Del. Super. Ct. 2004).

⁴⁰ *Id.* at 769.

⁴¹ *Id.* at 772, 777-79, 782-83.

⁴² See generally *id.* at 772, 782-83.

⁴³ *Id.* at 779-780.

⁴⁴ *Id.* at 782-83.

⁴⁵ *Id.* at 782.

⁴⁶ Unif. Ltd. P'ship Act §§ 508, 509 (2001); Unif. Ltd. P'ship Act §§ 607, 608 (amended 1985); Unif. Ltd. P'ship Act § 16(1)(a) (1916); see also Unif. Ltd. P'ship Act § 607 (amended 1985); Unif. Ltd. P'ship Act § 16(1)(a) (1916).

⁴⁷ Unif. Ltd. P'ship Act §§ 607 (amended 1985); Unif. Ltd. P'ship Act § 16(1)(a) (1916).

⁴⁸ Unif. Ltd. P'ship Act § 608 (amended 1985); John C. Ale, *Partnership Law for Securities Practitioners* § 3:16 (2004) (“RULPA defines a return of a contribution to be a distribution that reduces the fair value of the partnership’s assets below the value of the contributions previously made and not returned”).

⁴⁹ Unif. Ltd. P'ship Act §§ 508, 509 (2001); see also Del. Ltd. P'ship Act § 17-607(b).

⁵⁰ See, e.g., *Neuner v. C.G. Realty Capital Ventures-I, L.P. (In re Sharps Run Assoc., L.P.)*, 157 B.R. 766, 774 (Bankr. D.N.J. 1993) (creditor has standing under New Jersey limited partnership statute to recover limited partner distributions); *Retzke v. Larson*, 166 Ariz. 446, 448, 803 P.2d 439, 441 (Ct. App. 1990) (creditor could pursue garnishment proceeding to recover improper distributions to limited partner); *Henkels & McCoy, Inc. v. Adochio*, 906 F. Supp. 244, 249-50 (E.D. Pa. 1995) (creditor has standing under New Jersey limited partnership statute to recover returned capital contributions); *Sender v. C & R Co.*, 149 B.R. 941, 948-49 (D. Colo. 1992) (creditor has standing under Colorado limited partnership statute to recover distributions and returns of capital contributions); *Kesterson Foods v. Scott*, 932 S.W.2d 935, 939 (Tenn. Ct. App. 1996) (creditor could bring suit against limited partner to recover wrongful return of capital contribution); see generally *Whitley v. Klauber*, 51 N.Y.2d 555, 576 (N.Y. 1990) (creditor had standing under New York limited partnership statute to recover funds necessary to discharge liabilities to creditor).

⁵¹ *Neuner*, 157 B.R. at 771.

⁵² *Id.* at 771-72.

⁵³ *Id.* at 774; see also *Henkels*, 906 F. Supp. at 249-50.

⁵⁴ *Neuner*, 157 B.R. at 774.

⁵⁵ *Sender v. Simon*, 174 B.R. 601, 604 (D. Colo. 1994) *disagreeing with Sender v. C & R Co.*, 149 B.R. 941 (D. Colo. 1992) (the court found that the partnership was a Ponzi scheme, "i.e. a fraudulent arrangement in which an entity makes payments to investors from monies obtained from later investors rather than from any profits of the underlying business venture").

⁵⁶ *Id.*