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FRANK E. ROEGGE, GERARD J. TALBOT, AND ROBERT M. ZINMAN*

I. THE INSTITUTIONAL LENDER AS A REAL ESTATE ENTREPRENEUR

In recent years there has been much talk about the activity of institutional investors in what are loosely called "joint ventures" in real estate. These investments may include single buildings or large developments located throughout the country. While in the past institutional investors traditionally restricted their real estate investments to fixed return mortgages and sale leasebacks, with changing economic conditions their philosophy also changed, resulting in the joint venture phenomenon. Some of the problems accompanying this change are the subject of this article.

A. "Revolution" in Institutional Thinking

The most important institutional lenders making long term mortgage loans traditionally have been life insurance companies, savings and loan associations, mutual savings banks, and banks as trustees for pension trusts. Commercial banks, which formerly were primarily interested in construction lending, have recently stepped up their long term mortgage lending, while insurance companies have also become active in the construction-lending field.

Life insurance companies constitute the largest element in long term commercial mortgage lending, with broad investment powers (though subject to regulation), and may be considered typical institutional investors. Their development as real estate entrepreneurs may represent the greatest change in attitude and approach to real estate investment by institutional lenders. In three states which are generally considered prominent in the area of life insurance—Massachusetts, New York and New Jersey—first mortgage loans became a permitted form of investment in 1818, 1848.

* Members of the New York Bar. The authors gratefully acknowledge the advice and assistance of their associates, and particularly the assistance of Theodore F. Feldman of the New York Bar.

2. Id.
and 1852, respectively. Somewhat later, investment (or perhaps it should be termed speculation) in real estate with or without statutory authority, became popular. In 1870, one of the most prominent New York insurance companies invested eighty percent of its assets in its home office building. In 1905, the Armstrong Committee, considering abuses by life insurance companies, reported:

[Testimony taken by the committee discloses flagrant abuses in connection with investments in real estate. Under the guise of procuring suitable accommodation for the transaction of business excessive amounts have been expended in the acquisition of land and buildings not necessary in any proper sense for the uses of the corporation, which yield a poor return upon the amount expended. . . . No further purchase of property should be permitted under subdivisions 1 and 2 of section 20 of the Insurance Law or under section 14 of the General Corporation Law without the consent of the Superintendent of Insurance upon his finding that the acquisition is necessary. Section 13 of the General Corporation Law, providing that the Supreme Court might authorize purchases of real property in lieu of similar property disposed of, should be rendered inapplicable to insurance corporations.

This report led directly to the passage of section 100 of the New York Insurance Law of 1909, which was the precursor of the present provision of section 81(7). This section required that the Superintendent of Insurance approve any real estate acquisition other than through foreclosure or other satisfaction of debt. Under the terms of the statute, even ownership of foreclosed properties was expected to be terminated within

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7. At the time, the only statutory authority for the acquisition of real estate by New York life insurance companies was contained in Law of June 24, 1853, ch. 463, § 9, [1853] N.Y. Laws 76th Sess. 890 (repealed 1892), which prohibited an insurance company from purchasing, holding or conveying real estate, except:

"1. Such as shall be requisite for its immediate accommodation in the transaction of business; or"

"2. Such as shall have been mortgaged to it in good faith, by way of security for loans previously contracted . . . ; or,"

"3. Such as shall have been conveyed to it in satisfaction of debts previously contracted in the course of its dealings; or,"

"4. Such as shall have been purchased at sales upon judgments, decrees or mortgages obtained or made for such debts . . . . [A]ll such real estate as may be acquired as aforesaid, and which shall not be necessary for the accommodation of such company in the convenient transaction of its business, shall be sold and disposed of within five years after such company shall have acquired title to the same . . . ." See also text accompanying note 9 infra.

8. For an entertaining discussion of how this came to be, see The New Yorker, Oct. 21, 1961, at 139, 144-45.


five years,\textsuperscript{11} and extensions from the Insurance Department were not automatically granted.\textsuperscript{12} In 1922, the Insurance Law was amended to permit the acquisition of certain housing without the Superintendent's approval.\textsuperscript{13}

In 1946, the New York Insurance Law was changed by adding paragraph (h) to section 81(7),\textsuperscript{14} to permit investment in real estate for the production of income. The law also permitted improvement or development pursuant to an existing program to make the property income-producing. Significantly, properties acquired by foreclosure or deed in lieu thereof and held under subsection 7(c) could be transferred to paragraph (h), and no longer had to be disposed of within five years from the date of acquisition.

About the same time, other states—most notably New Jersey\textsuperscript{15} in 1945, and Massachusetts\textsuperscript{16} in 1947—were adopting similar legislation. Finally, in 1963 the new Michigan constitution and resulting legislation authorized acquisition of real estate for investment,\textsuperscript{17} and in 1967, Texas permitted limited ownership.\textsuperscript{18} Consequently, ownership by life insurers of real estate for investment is permitted, in some form, in every state.

\begin{itemize}
  \item 11. Id. § 20, published as ch. 28, art. 1, § 20 [1909] Consol. Laws of N.Y. 1782 (repealed 1939).
  \item 12. "Such certificate can be obtained by filing in this Department an affidavit by an officer of the company setting forth the fact that diligent efforts to dispose of the property has [sic] been made but without success and that the interest of the company will suffer from a sale at this time." Ruling of New York Insurance Department, Dec. 26, 1912, in 2 G. Dorn, Annotated Insurance Law of New York 320 (1934). Miss Dorn, who was an attorney with the Insurance Department for many years, compiled her own notes and various other material into two unpublished volumes, which can be found in the library of the College of Insurance in New York, New York.
  \item 18. Law of June 17, 1967, ch. 660, § 1, [1967] Texas Gen. Laws 60th Sess. 1753, adding Tex. Ins. Code Ann. art. 3.40-1 (1963). Some restrictions, however, are imposed. For example, the purchase of undeveloped real estate for the purpose of development or subdivision is prohibited. Moreover, a substantial portion of the property must be materially enhanced in value by the construction of durable, permanent-type building and other improvements. Id.
\end{itemize}
From time to time various state statutes have been liberalized as to amount and other limitations.\textsuperscript{19}

While the legislative history of subsection 7(h) in New York shows an intent to permit insurance company investors to acquire and profit from equity acquisitions,\textsuperscript{20} most acquisitions under this subsection were "sale-leasebacks," under which the institution purchased real estate and leased it back to the tenant for a fixed net rent, often with the privilege of renewing at a lower rent. Presumably this renewal at a lower rent reflected the fact that the insurer, through fixed net rent during the initial term, would recover its initial investment plus a return approximately equal to or slightly above the prevailing rate of interest on first mortgages. The slightly higher rate of return reflected the fact that the purchase price of the property acquired in the sale-leaseback arrangement usually would exceed the limitations of two-thirds or three-fourths of the value of the real property which investment statutes frequently imposed upon mortgage lending,\textsuperscript{21} and that rent recovery, unlike foreclosure deficiency judgments, was limited to one year's rent in the event of the tenant's bankruptcy, and three year's rent in the event of reorganization.\textsuperscript{22} Despite the higher rate of return, the result of these early equity acquisitions with a fixed return, coupled with frequently inserted


\textsuperscript{20} "On account of the continued downward trend of interest rates and the consequent dearth of suitable investments which qualify under Section 81, the life insurance companies particularly find it difficult to invest their funds to yield an income sufficient to meet the interest rates assumed in their outstanding contractual obligations. It is expected that the broadening of the classes of reserve investments as proposed will relieve the present investment situation to some extent." Memorandum from Robert E. Dineen, Superintendent of Insurance, to the Governor, March 26, 1946, in Bill Jacket to Law of April 5, 1946, ch. 509 [1946] N.Y. Laws 169th Sess. 1139. The "Bill Jackets" or "Governor's Bill Jackets" contain letters, studies, legal memoranda, and other material—either sent originally to the Governor or submitted to him by his counsel or the committee chairman—urging him to sign or veto a bill. The original jackets are located in the Legislative Reference Library in Albany and, except for a few earlier jackets, generally cover the period from 1921 forward. The collection has now been microfilmed and may be seen at the New York Public Library (42d Street branch) in New York City.

See also the approval of the Committee on State Legislation of the Association of the Bar of the City of New York, and other writings contained in the Bill Jacket.

\textsuperscript{21} See note 35 infra.

\textsuperscript{22} 11 U.S.C. §§ 103, 602 (1964).
limited repurchase options or rejectable offer provisions, was to give the insurer little more economically than it had in conventional mortgage investing.

However, some insurers still had various buildings acquired through foreclosure, and in some cases such properties, after transfer to paragraph (h), were managed by managing agents and became highly profitable. Through efficient operation, higher rents, and perhaps modernization, these properties produced yields far in excess of those obtainable through mortgage lending. In some cases, subsequent sales of such properties also produced substantial capital gains. These properties—and also office building properties built and partially occupied by insurers, who leased to other tenants—proved that equity ownership could be highly profitable to institutional investors.

The number of foreclosed properties suitable for retention was strictly limited, however, and insurance companies were not always the best planners, developers, builders and promoters. Those normally engaged in these activities could be hired for a fee, but perhaps could not be expected to work with the same zest shown in developing properties in which they had a financial interest. In the late forties, the fifties and the early sixties, builders and developers did not view insurance companies as fellow equity participants in the many buildings they were constructing. Hopefully, the insurance company mortgage or purchase price in a sale-leaseback would cover all costs. If not, private sources of funds—generally from high tax bracket individuals investing as limited partners—would fill the gap. This situation prevailed well into the sixties.

Beginning about 1966, however, external factors produced a revolution in real estate development. The most significant of the factors were inflation, high interest rates, tight money, and falling common stock prices.

1. Inflation

While life insurers classically paid claims in fixed dollars, factors such as expenses and dividends caused them to seek protection against infla-
tion not offered by fixed return mortgage loans or sale-leasebacks. Contingent interest or percentage rent were answers, but not total ones. Contingent interest, which is additional interest often based on the income of the property, faced limitations imposed by usury statutes, and by its very nature yielded nothing after maturity of the loan. Percentage rent, which is additional rent also based on such income, offered better possibilities. Many developers, however, did not wish to engage in a sale-leaseback, which involved a sale of the building and loss of income tax benefits. Similarly, institutional investors did not wish to buy only the land, since they would receive no tax benefits from ownership of a non-depreciable asset.

2. High Interest Rates

While in the late sixties interest rates increased to their greatest heights since the Civil War, some state usury statutes were not amended at the same speed at which national interest rates were increasing. Thus, in many jurisdictions mortgage loans, with or without contingent interest, ceased to constitute attractive investments for institutions. On the other hand, where usury laws permitted above average rates, fixed rate mortgage loans generally were non-prepayable for many years and thus constituted a serious burden on developers.

3. Tight Money

The "credit crunch" of 1966 and the general credit situation in 1969-1970 helped produce the so-called "revolution" in institutional thinking. Insurers obtained less money from mortgage prepayments and paid more out in policy loans, and banks and savings and loan associations were subject to a lack of growth in assets or actual disintermediation. Consequently, they limited the number of mortgage loans made and carefully scrutinized each mortgage, unwilling to lend as freely as in the past.

25. Id.
28. Policy loans in 1960 amounted to $5,231,000,000, or 4.4 percent of assets. The comparable figure in 1969 was $13,825,000,000, or 7.0 percent of assets. Institute of Life Insurance, Life Insurance Fact Book 90 (1970) [hereinafter cited as Life Insurance Fact Book].
30. See Fortune, supra note 27, at 92.
Even where financing was available, the gap between the loan amount and the amount of money needed by the builder increased.

4. Falling Common Stock Prices

As this gap increased, the availability of funds from secondary sources (often wealthy individuals seeking tax shelters) was affected by a decline in common stock prices. With the Dow Jones industrial average falling from 989.12 on December 16, 1968\(^{31}\) to 627.46 on May 26, 1970\(^{32}\), many prospective investors could no longer borrow on their stock and, in any case, were not interested in acquiring additional tax losses.

The situation was ripe for change, and change came. Financial institutions, first slowly and perhaps nervously and then in ever greater volume, acquired true equity interests in office buildings, office parks, apartment house developments, industrial parks and other income-producing real estate.\(^{33}\) Some took their equity interests as bonuses for making loans.\(^{34}\) However, unless the loan exceeded the permitted percentage of value,\(^{35}\) either by too generous an appraisal or through the use of a “basket” or “leeway” statute,\(^{36}\) this did not solve the basic problem which led to the “revolution,” i.e., the builder’s shortage of funds. Even with an oversized loan, and without considering the problem of usury,\(^{37}\) his fixed charges would probably be too high. Therefore, more insurers entering the field bought an equity interest at a fair price based upon the value not when the project would be an established success, but reflecting the possibilities, the risks, and the potential at the time of agreement—usually before construction commenced. The equity interest acquired was usually substantial—typically fifty percent.

Some insurance companies apparently went further, giving up mortgage lending and investing their real estate funds only in equity interests. They, of course, obtained the highest leverage. Such investments, how-

33. Life Insurance Fact Book, supra note 28, at 89.
34. See Fortune, supra note 27, at 93.
35. In New York, as in other states, the mortgage loan usually cannot exceed two-thirds, or in certain cases three-fourths, of appraised value. N.Y. Ins. Law § 81(6)(a) (McKinney 1966), as amended, (McKinney Supp. 1970). Under some circumstances, however, mortgages are allowed even with loan-value ratios in excess of three-fourths. See note 36 infra.
36. In New York, the “basket” statute is found in section 81 of the Insurance Law. N.Y. Ins. Law § 81(17) (McKinney Supp. 1970). It allows insurance companies, inter alia, to make loans with loan-value ratios as high as 100 percent, provided all such loans and other investments made under the leeway provision do not, in the aggregate, exceed 3½ percent of the company’s admitted assets.
37. See part III C infra.
ever, were possible only where someone else would make the mortgage loan without an equity investment. Opportunities of this nature were limited, since many institutions were not enthusiastic about making mortgage loans to give leverage to a competitor. Thus developers, at least in very large transactions, tended to seek large life insurers as both mortgage lenders and purchasers of equity interests, and the large life insurers sought large developments where they could invest not only in a mortgage loan, but also in a substantial interest in the equity.

B. Effect of the "Revolution"

The partial shift of institutional funds from fixed return mortgage loans to equity investments did not constitute the entire "revolution." Changes resulting from this shift also comprised a large part of it.

As many life insurers began to acquire common stocks, more institutional investment philosophy also changed. Safety properly remained essential, but the emphasis on what constituted safety shifted. The servant who buried his talent had kept it safe, but he was rebuked by his master. A life insurance loan officer investing throughout 1969 and 1970 in seven percent fixed return mortgage loans would not be praised. While safety lay in part in avoiding or reducing the effect of inflation, it became recognized that for large institutional investors safety should be measured by the whole, not as to each part. For instance, one loan officer might invest $100,000,000 in seven percent "ultra safe" ten year mortgage loans which, ignoring repayment and reinvestment of interest and amortization, would result in $170,000,000 in assets in ten years. On the other hand, another loan officer might put $90,000,000 of his $100,000,000 in slightly less safe eight percent ten year mortgages, and $10,000,000 in related equity interests of far greater risk. Assume that one $5,000,000 mortgage goes into default and shows no return above principal, and that the $10,000,000 equity interests show returns varying from partial loss of principal to a return of forty percent, but an overall return of twenty percent per annum for the ten year period. Again ignoring repayment and reinvestment of interest and amortization, his $90,000,000 will have grown to $158,000,000 and his $10,000,000 to $30,000,000 for a total of $188,000,000. He may have had to think harder, negotiate harder, and worry more, but who is to call his performance "less safe" or call him the less deserving servant?

Furthermore, insurers as equity investors obtained a better understand-

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38. Investments in common stocks increased from $403,000,000 in 1960 to $3,703,000,000 in 1969. Life Insurance Fact Book, supra note 28, at 74.
ing of the developer's problems and his philosophy. One of his needs is speed, and this need alone has accelerated the change toward more prompt decisions and servicing which already was underway in many insurance companies. Coupled with the shift to common stock investments, this has effected a change in the attitude of some insurance company investment officers. Together with the development of new products such as real estate investment trusts, variable annuities and separate accounts, it has led to a new image for insurance companies. Insurers will probably never be the same.

If the insurer has changed, so has the developer. Traditionally somewhat of a rugged individualist who took the institutional investor's money but tried to hold the institution at arm's length, the developer dealt with limited partners who either knew and trusted him or else were unsophisticated in the area. In any event, they were not bothersome to him. The huge institution, however, had different approaches and different philosophies. Its officers wanted to know how much architects and contractors were being paid, and perhaps share in the writing of architectural and construction contracts. They were expense conscious, organization conscious, and conflict conscious. They were interested in the status of the developer's key subordinates. They imposed limits on, or wanted to know the reasons for, transactions with related corporations or persons. All this was perhaps initially galling to him, but he learned that he had a partner with far more to contribute than mere money. It had a wealth of experience in real estate matters, acquired through many decades of good and bad times. It also made available staffs of accounting, architectural, economic and legal experts, and knowledge of the entire country, its customs, possibilities, and economic data. The developer has profited through such relationships, and he, too, will never be the same.

Society has benefited and changed from this increased efficiency. As developers established relationships with large institutions, giving them a steadier source of equity funds, greater stability and counter cyclical influences emerged.41

Perhaps most important, as the large life insurance companies began to invest in real estate equities and common stock, holders of life insurance policies and annuities could effortlessly benefit from balanced investment programs designed to produce safety and yield, while reducing the effect of inflation. This was previously possible only for the rich, who had diversified investment capabilities.

Today some of the external factors that produced the so-called revolu-

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41. When the money market is "tight" and other sources of financing dry up, the institutional investor can often provide both the funds necessary to maintain existing projects and those required for new projects, thus retarding an economic reversal.
tion in real estate development are no longer present. Interest rates are beginning to decline; money is less tight; and common stock prices are rising. Nevertheless, real estate equity investments by institutional lenders have continued. Inflation is still with us; institutional thinking appears to have changed irrevocably; and developers, having learned to live with and having been benefited by institutional lenders as equity partners, continue to seek institutional funds for joint ventures in real estate.

C. The Investment

Investments by institutions in real estate equities vary in form from investor to investor, from developer to developer, and even from transaction to transaction between the same institution and developer. Nevertheless, real estate equity and associated mortgage investments often adhere to a basic structure.

The institution may commit itself to make a mortgage loan to the developer. The commitment is normally for a long term mortgage loan (i.e., financing after the completion of the improvements), but may also include a land loan (to acquire the real estate), a development loan (to prepare the real estate for construction), and a construction loan (for construction of the improvements). In the past, banks have been the traditional source of construction financing, and other institutions have tended to avoid becoming involved with the inherent problems of such undertakings. Nevertheless, in connection with equity investments, even insurance companies have, with increasing frequency, made construction loans or participated in construction loans with banks or other traditional construction lenders. Often the institution, when it does not have the facilities or personnel to effectively protect its interest during the period of development and construction, will not become involved in the equity end of the transaction until completion of the construction. In such situations, development and land loans are often employed during construction in lieu of the equity participation.42

At the time of the long term mortgage loan commitment or commitments, or sometime thereafter, the institution or a subsidiary corporation

42. The developer will often need the amount of the equity contribution prior to the completion of construction. To meet this need, the institutional investor may make a short term land loan in the amount of the prospective equity contribution, secured by a mortgage on the real property. When the developer has complied with the conditions of the equity commitment and the institution or its subsidiary becomes obligated to make the equity contribution, that contribution is used to satisfy the land loan. If the institution or its subsidiary does not take its equity interest until completion of construction, the developer will be getting 100 percent of the tax deductions during the construction period. The value of this additional tax benefit to the developer can be calculated, and offset with interest charged on the land loan.
may commit itself to purchase an interest in the property, subject to mortgages, either immediately or upon substantial completion of construction. This equity interest is normally in the form of an interest in a partnership owning the real estate under a written partnership agreement, or an interest as a tenant in common in the real estate, together with an operating agreement which may or may not constitute the parties partners.

Sometimes the transaction is far more complicated and involves the use of numerous real estate investment techniques. In one such case, the institutional lender purchased the real estate from the developers and leased the property back to the developers (a traditional sale-leaseback). The institutional lender then made substantial loans to the tenant, secured by a mortgage on the leasehold estate (a traditional leasehold mortgage), and then a subsidiary of the institutional investor purchased an interest in the leasehold subject to the mortgage (which may become, in a few years, a "traditional" equity investment).

It should be made clear, however, that the equity interest described above and discussed in this article is not what is sometimes referred to as a "kicker" for a mortgage loan, or as a "piece of the action." These words are anathema to many institutional investors. The interest being discussed is an interest in property purchased primarily as an inflation hedge, at a price based on the estimated future value of the interest fixed by appraisal at the time of commitment, and with which comes the attendant risk of loss and possibility of long term gain normally associated with real estate development.

II. THE VEHICLE

A. The "Joint Venture"

Normally the institutional investor and the developer will own and operate the property through a general or limited partnership, but in common parlance most of the real estate equity investments in which

43. See part IV A infra.


47. See part II B infra.
institutional investors have become involved are referred to as "joint ventures." Articles, and at least one book, have been written with titles such as "Joint Ventures in Real Estate," even though what is discussed therein is a partnership. The term is often used as a verb, as well as a noun, and businessmen will speak of "joint venturing" a particular piece of real estate. Many investment partnerships, the agreements for which provide that they are governed by the particular jurisdiction's Uniform Partnership Act (UPA), use the term "joint venture" or "venture" in their names. In this article, the authors have for convenience often referred to the partnership or other arrangement for the operation of the property as a "joint venture." What is a joint venture? What is the effect of using that term in connection with the agreement between the institution and developer? Does using the term create any special legal relationship between the parties, or affect the rights of third parties?

1. The Meaning of "Joint Venture"

Joint ventures are American in origin and are unknown in English law. At first they were referred to as "joint adventures" rather than "joint ventures," but in recent years "joint venture" seems to have become the preferred term. A substantial body of thought holds that the joint

48. See, e.g., Weaver, supra note 46. The term "joint venture" is, of course, not limited to real estate. It will cover "all situations in which two or more persons or independent firms join forces to achieve some common goal." Pitofsky, Joint Ventures Under the Antitrust Laws: Some Reflections on the Significance of Penn-Olin, 82 Harv. L. Rev. 1007 (1969). Professor Pitofsky, in discussing the organization of new producing and servicing organizations by two or more companies as a form of "quasi-merger," says that the term "joint venture" is a "vague and protean concept . . . of little use in categorizing structure or conduct with particular market consequences." Id. The real estate joint venture, of course, generally bears little or no resemblance to the Penn-Olin type quasi-merger.

The term "joint venture" has become popular also in connection with international business undertakings. See, e.g., Tan Hun Hui, Legal Nature of Joint Ventures in Singapore, 2 Singapore L. Rev. 1 (1970); Conlee, A Developer Discusses Joint Ventures, 29 The Mortgage Banker 59 (May 1969).

49. See Nason, Engaging in Real Estate Equity Investments With Another Party—Use of the Joint Venture Vehicle, 21 Ass'n Life Ins. Counsel Proceedings 1 (1969). See also Aronsohn, The Real Estate Limited Partnership and Other Joint Ventures (to be published in 1 Real Estate Rev. No. 1 (Spring 1971)).

50. See Practising Law Institute, Joint Ventures in Real Estate (Real Estate Transcript Series No. 12 (1970)).

51. "[T]he English law has never recognized joint adventures as an independent relationship but has frequently referred to it as a particularized partnership, sometimes as a 'special' partnership." Mechem, The Law of Joint Adventures, 15 Minn. L. Rev. 644 (1931). As pointed out by Professor Rowley, as early as 1808 it was said that persons were "jointly concerned" in an "adventure," but it was not "until the middle of the last century that courts began to draw a distinction between partnership and joint adventures." 2 S. Rowley, Partnership § 52.1, at 461 (2d ed. R. Rowley & D. Sive 1960), citing Lyles v. Styles, 15 F Cas. 1143 (No. 8625) (C.C.D. Pa. 1808).
venture is but a form of partnership (a joint venture is often referred to as a "partnership for a particular purpose"), while another group feels that a joint venture can create a separate and distinct legal relationship. Both groups, however, agree that there are many points of similarity between a joint venture and a partnership and very few differences of any substance. In a large and still growing body of decisions, many courts have purported to establish that there is such a thing as a joint venture, without successfully arriving at an adequate definition of what it is or how it differs from a partnership.

This does not mean that definitions of a joint venture have not been attempted. According to Professor Rowley, the most popular definition is "a special combination of two or more persons, where in some specific venture a profit is jointly sought without any actual partnership or corporate designation." Professor Rowley states that the second most popular definition is "[a]n association of two or more persons to carry out a single business enterprise for profit." It is interesting to note that the second definition does not differ greatly from the definition of a partnership contained in the UPA, i.e., "an association of two or more persons to

52. "The law of partnership is applied, point for point to all joint adventure controversies, and identical results are reached, under similar circumstances, no matter whether the association is regarded as a partnership or a joint adventure." Mechem, supra note 51, at 666. See Ross v. Willett, 76 Hun. 211, 213, 27 N.Y.S. 785, 786 (Sup. Ct. 1894), where the court stated: "A joint venture is a limited partnership, not limited in a statutory sense as to liability, but as to its scope and duration, and under our law joint adventures and partnerships are governed by the same rules." See also United States v. Wholesale Oil Co., 154 F.2d 745, 747 (10th Cir. 1946), where the court said: "A joint venture is but one form of partnership . . . ."

53. See Comment, Joint Venture or Partnership, 18 Fordham L. Rev. 114 (1949), which states that joint venture and partnership "are separate concepts, serving separate ends and susceptible of independent interpretation in the law." See also 2 S. Rowley, supra note 51, § 52.1, at 461, where it is said: "The ever increasing number of cases in which specific associations are deemed joint adventures, and in which the legal principles said to be applicable to joint adventures, as such, are applied, is ample proof, however, that such a separate body of law does exist, however vague its theoretical outlines may be." See generally Note, Partnership and Joint Venture Distinguished, 33 Harv. L. Rev. 852 (1920).

54. "Due to the fact that in the greater number of instances the law of joint adventure and partnership parallel each other, it may not appear to make any difference whether the relation is designated a joint venture or a partnership." Comment, supra note 53, at 122.

55. "Precise definition of a joint venture is difficult. The cases are of little help since they are generally restricted to their own peculiar facts. 'Each case in which a coadventure is claimed . . . depends of course for its results on its own facts, and owing to the multifariousness of facts, no case of coadventure rises higher than a persuasive precedent for another.'" United States v. Standard Oil Co., 155 F. Supp. 121, 148 (S.D.N.Y. 1957), aff'd, 270 F.2d 50 (2d Cir. 1959), quoting Harris v. Morse, 54 F.2d 109, 113 (S.D.N.Y. 1931).

56. 2 S. Rowley, supra note 51, § 52.1, at 464 (footnote omitted).

57. Id. (footnote omitted).
carry on as co-owners a business for profit." The joint venture definition deletes the words "as co-owners," and substitutes for "a business" the words "a single business enterprise." Thus it removes a term which describes a legal relationship, but adds a requirement that the association be for a limited purpose.

These differences may shed some light on what a joint venture really is or should be. Perhaps the words "joint venture" do not in themselves create or describe a legal relationship at all. Perhaps the words merely describe the purpose or intent of the parties to act in concert with respect to a particular activity or series of activities limited either in time or in scope. The actual legal relationship between the parties or with third parties would be governed by general principles of law, depending upon what the agreement between the parties says, what the parties intend, what their activities are, and what authority or apparent authority they have conferred upon one another.

When Jack and Jill went up the hill to fetch a pail of water, they may have been joint venturers. If their parents had promised them a cookie to share between them for bringing the water back, their activities would seem to fit at least within the most popular definition of a joint venture cited by Professor Rowley. But, although this may have been a joint venture, it is doubtful that anyone would maintain that Jack and Jill were partners and subject to the UPA.

On the other hand, let us assume that Jack and Jill, having reached majority, decide to build and operate the Hilltop Hotel. They enter into an agreement establishing a non-corporate entity called "Hilltop Associates" which will hold title to the real estate, and set forth in the agreement the rights, powers, duties and obligations they each have in connection with the construction and operation of the hotel, with provisions pertaining to the sharing of profits and losses, and requirements to the effect that they each will devote full time to the operation of the hotel. Now Jack and Jill would seem to be partners and subject to the UPA, if that law is in effect in the applicable jurisdiction. However, the words "joint venture" might be an inappropriate description of their enterprise since, if the words "joint venture" mean anything, they probably mean that the parties intend an activity or activities limited in some way as to time or scope. While it is true that this activity is limited to a specific hotel, both Jack and Jill have agreed to devote their full time to the proposed activities for an indefinite period, and thus they may not fit within what was probably intended by the words "specific venture" or "single business enterprise" in the above-mentioned definitions of "joint ven-

58. Uniform Partnership Act § 6(1) [hereinafter cited as U.P.A.].
Nevertheless, whether they are joint venturers or not, their legal relationship would be that of partners.

Between these two extremes, there are any number of combinations, three of which might be as follows:

(a) Suppose Jack and Jill became involved in numerous real estate developments, some together, some individually, and some with third parties. Now they plan to purchase the hill in the name of a non-corporate entity called the "Hilltop Venture," build garden apartments and either operate them through a manager they will hire, or sell the property to a third party after construction—all under the terms of a detailed agreement setting forth, as in connection with the hotel discussed above, their rights and duties. This time, however, the agreement provides that each may engage in any other activities without obligation to the other partner. It would seem that the purpose of the parties is concerted activity limited to a single project, i.e., a joint venture. Their legal relationship within the scope of the venture, however, would probably still be that of partners.

(b) Assume the same facts, except that the property is not owned by the Hilltop Venture but by Jack and Jill as tenants in common, each having an undivided one-half interest. It would seem that they are still joint venturers and, in operating the property, still in the legal relationship of partners. As a matter of fact, prior to the UPA, when partnerships could not hold title to real estate, this would have been the most usual form a partnership would take.

(c) Now assume that Jack, an accountant in state A, and Jill, a nurse in state B, acquire as tenants in common fee title to a hill in state C. The hill is under lease to the United States Army for a radar installation. Jack and Jill agree to hire a real estate management firm as managing agent to collect the rents, pay the taxes and insurance, and forward one-half of the net income to each of them. Possibly they are joint venturers,

59. The definitions seem to be aiming at a limitation as to scope, purpose or time. Bromberg states that a joint venture "is a business association distinguishable from a partnership (if at all) only by narrowness of purpose and scope. A partnership may be formed for a single undertaking, but is usually intended to encompass an indefinite number of transactions within a relatively broad line of business for an indefinite duration." A. Bromberg, Partnership § 35, at 189 (1968). Rowley states: "The principal difference between a partnership and a joint venture is said to be that while a co-partnership is ordinarily formed for the transaction of a general business of a particular kind, a joint venture is usually, but not necessarily, limited to a single transaction." 2 S. Rowley, supra note 51, § 52.14, at 482 (footnote omitted).

60. See part IV A infra.

61. See U.P.A. § 7(2), which states that part ownership, including tenancy in common "does not of itself establish a partnership, whether such co-owners do or do not share any profits made by the use of the property."

62. See id. § 8, Comment.
but they are probably not partners. Their legal relationship would not seem to amount to a partnership arrangement, since they would not seem to have established an association under which either would have the powers normally afforded one partner to bind the other.\(^63\)

A court in situation (c) would want to look at the terms of the relationship in order to determine whether a partnership had been created. The point being made here is that from a legal standpoint a joint venture is what the parties wish to make of it. It can be the same as a partnership, or it can be different. The fact that the words "joint venture" are used should not in itself result in legal consequences. The legal consequences of a joint venture will depend, then, on what the parties have agreed to do, and actually do.

If the above theory is correct, then many of the cases differentiating between a partnership and a joint venture can perhaps be explained on the ground that they were merely determining the rights and liabilities of parties acting in concert, when their relationship did not amount to a partnership.\(^64\) Since this determination would depend on the facts of each case, it would be understandable that the courts could not establish any consistent rules with respect to "joint ventures" as such. There are, however, some differences often enunciated by the courts and commentators as being generally applicable to what might be called non-partnership joint ventures. These differences, which are more often apparent than real, seem to revolve around the fact that any non-partnership joint venture would not be subject to the UPA and its entity-aggregate compromise.\(^65\) For example, in a nonpartnership joint venture, it is said: (i)

\[\text{\(63.\) As pointed out by Mechem, this has sometimes been referred to as a "tenancy-in-common-plus." See Mechem, supra note 51, at 664. Mechem's view was that joint ventures are partnerships. He distinguished cases holding the parties to be joint venturers and not partners as really involving nonpartnership "tenancies-in-common-plus." We would differ with Mechem mainly in semantics and argue that they were nonpartnership joint ventures.}\]

\[\text{\(64.\) It has been said that a corporation can enter a joint venture where it could not enter a partnership, notwithstanding the fact that the joint venture has all the attributes of a partnership. If true, this would seem to constitute a legal distinction between joint ventures and partnerships, under the rationale that a joint venture is limited in time or scope and thus joining a joint venture would not constitute an undue abdication of corporate authority. See H. Ballantine, Corporations § 88 (1946). As indicated in note 173 infra, however, the problem of corporate participation in a partnership is diminishing. Furthermore, in analyzing this question Professor Mechem found "practically no authority for saying that a corporation can engage in a joint adventure where it could not also have engaged in a partnership." Mechem, supra note 51, at 652. He concluded that "It seems improbable that many courts are prepared to hold that the power and authority of a corporation to participate in a joint adventure is substantially different than in the case of partnerships." Id. at 653.}\]

\[\text{\(65.\) See part II B 3 infra.}\]
the venture could not hold title to real estate;\(^{66}\) (ii) the venture would be bound only by ordinary agency rules with respect to one venturer's right to bind the other;\(^{67}\) (iii) the venture might not be "dissolved" on the death or withdrawal of a venturer;\(^{68}\) (iv) the venture may not become a voluntary bankrupt;\(^{69}\) and (v) one venturer could sue the other at law with respect to transactions of the venture.\(^{70}\)

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66. A nonpartnership joint venture would not be subject to the UPA and thus could not take advantage of UPA section 8(3), which permits the partnership to hold title to real property. Title to joint venture property would therefore be held in the name of one venturer on behalf of the joint venture, or in the name of the venturers as tenants in common or joint tenants. See 2 S. Rowley, supra note 51, § 52.33.

67. Here again the cases dealing with joint ventures seem in conflict. See Keyes v. Nims, 43 Cal. App. 1, 9, 184 P. 695, 698 (Dist. Ct. App. 1919), stating in dictum that "[i]n a joint adventure, no one of the parties thereto can bind the joint adventure." This phrase has been quoted as supporting the theory that there is no mutual agency in a joint venture. Compare Goerig v. Continental Gas Co., 167 F.2d 930, 932 (9th Cir. 1948) ("The liability of the joint adventurers in the State of Washington is that of co-partners."), with Bryce v. Bull, 106 Fla. 336, 343, 143 So. 409, 411 (1932) ("[E]ach one of several joint adventurers has power to bind the others in matters which are strictly within the scope of the joint enterprise."). It would seem that in a nonpartnership joint venture, the venturers should be liable to third parties for acts of their coventurers, to the extent they have conferred, by agreement or by their actions, authority on their coventurer to act for them. As pointed out by Bromberg, "[e]ach venturer has authority to act and bind within the . . . actual or apparent scope of the venture." A. Bromberg, supra note 59, § 35, at 193-94; see Restatement (Second) of Agency § 159 (1958).

68. See 2 S. Rowley, supra note 51, §§ 52.37, 52.38.

69. Section 5 of the Bankruptcy Act permits partnerships to file voluntary petitions in bankruptcy and permits involuntary petitions to be filed against partnerships. Bankruptcy Act § 5, 11 U.S.C. § 23 (1964). Such rights would seem inapplicable to nonpartnership joint ventures unless they could be considered "unincorporated companies" within the definition of "corporation." Id. § 1(8), 11 U.S.C. § 1(8) (1964). Compare the discussions of a similar problem in an earlier version of the Bankruptcy Act in Mechem, supra note 51, at 655, and Comment, supra note 53, at 130.

70. Miller v. Walser, 42 Nev. 497, 181 P. 437 (1919). Partners normally must sue in equity for an accounting with respect to transactions of the partnership. See discussion in part IV B 2 infra. Nonpartnership joint venturers, however, may also sue for an accounting. In the Miller case, the court said: "The principal distinction between a partnership and a joint adventure is that . . . [in a joint venture] one party may sue the other at law for a breach of the contract; but this right will not preclude a suit in equity for an accounting." Id. at 513, 181 P. at 442. Many courts, however, hold that with respect to transactions relating to the venture, the venturers cannot sue each other at law during the existence of the venture. See Danelian v. McLoney, 124 Cal. App. 2d 435, 268 P.2d 775 (Dist. Ct. App. 1954), where the court held that the action between former venturers was not barred by the statute of limitations since a "joint venturer has no cause of action for a breach of duty owed to the venturer until the firm has been dissolved and an accounting has been had." Id. at 441, 268 P.2d at 779; see Consolidated Mach. & Wrecking Co. v. Harper Mach. Co., 190 App. Div. 283, 180 N.Y.S. 135 (1st Dep't 1920).

The cases giving venturers the right to sue each other have been explained on the ground
2. "Badges" of Partnership

Regardless of what theory or meaning of "joint venture" is adopted, the parties will be in the legal relationship of partners if their acts and powers constitute them as such. What acts or powers are considered in order to determine whether the relationship justifies the designation of such persons as "partners" has been rather thoroughly discussed in cases, treatises, and law review articles. Section 6(1) of the UPA defines partnership as "an association of two or more persons to carry on as co-owners a business for profit." As explained by Professor Rowley, this definition "outlines all of the requisites of a partnership," the most important of which, according to Professor Bromberg, are co-ownership (including profit sharing and joint controls) and association (including an intention to form a partnership).

The elements of partnership as contained in the UPA definition will not be dwelled upon here, although "each word of the definition requires further explanation and delimitation before, under a given act [sic] of circumstances, a partnership can be determined." It would seem clear that the equity investment contemplated in this article, which includes the exercise of controls by the institutional investor (as well as the developer) over the operation of the property, would constitute the parties general partners in most situations. Thus, regardless of whether the parties are considered to be joint venturers, if they form an association to operate the property, with each having a share of control over the management of the property and each sharing profits and losses, it would be difficult to say that they are not partners and subject to the UPA provisions concerning their legal relationships with each other and third parties.

3. Use of the Term

If, then, the institutional joint venture would in most situations constitute a partnership, is there any advantage to using the term "joint
venture" in the name of the partnership, or in connection with the transaction?

The use of the term joint venture should not change the legal relationships of the parties, even if the theory that a joint venture does not involve legal relationships is not accepted by the courts. If the parties are acting as partners, they most likely will be held to be partners regardless of what they call themselves. However, there still may be some specific advantages to using the "joint venture" term. Since it is the popular name, its use helps to define what is being done, while providing a convenient name to give to a variety of possible structures creating varying legal relationships which may not be fully determined until after extensive negotiations. Also, the use of "joint venture" may afford some protection against unauthorized acts by a partner. As will be discussed in more detail below, each partner is liable for the acts of the other within the scope or apparent scope of the business. Since the use of the term "joint venture" normally implies an intention by the parties to act in concert with respect to an activity or activities limited in time or scope, the fact that these words are contained in the title of the business may tend to make it more difficult for a third party to argue that the partner acting beyond the authority conferred upon him had apparent authority to so act.

B. The Legal Relationship

As has been discussed, whether or not the parties call themselves or are called "Joint Venturers," the legal relationship is usually that of a general or limited partnership. Other forms of investment have been employed, but on the whole they have seemed less desirable.

1. Corporations and Trusts

The corporate form has the advantage of limited liability. However, income tax considerations usually will dictate against its use. In the early years of the real estate equity investment, the project probably will operate at a loss for tax purposes because of the combined effects of low

76. "Except in rare cases where the evidence is conclusive, the issue as to whether or not a partnership exists is a question of fact. . . . It is the substance and not the name or form of the relationship that constitutes the legal relationship of the contracting parties." Seaboard Sur. Co. v. H & R Constr. Corp., 153 F. Supp. 641, 646 (D. Minn. 1957), modified sub. nom. Nelson v. Seaboard Sur. Co., 269 F.2d 882 (8th Cir. 1959).

77. See part IV C 2 infra.

78. See id.

79. See part II C infra.

80. Present always is the "veiled" threat that in some circumstances a court may pierce the corporate entity. The general rule, however, is that "the corporateness—with attendant corporate attributes—will be recognized and will not be disregarded." H. Henn, Corporations § 143, at 204 (1961). For a discussion of the exceptions to this general rule, see part II C infra.
rental income and large deductions for depreciation, mortgage interest, and operating expenses. The use of the corporate form prevents the offsetting of these tax losses against other income of the parties, whereas the partnership vehicle permits the deduction of the losses by the partners from their personal income on a current basis. Once the real estate equity investment crosses into the black for tax purposes, investors using the corporate form must also consider the possibility of taxation at two levels, i.e., the corporation level and the shareholder level when the profits are distributed. This problem may be of much greater concern to the developer (if an individual) than to the institutional investor, since dividends to the institutional investor (even if it is a taxable entity) will qualify for the corporate eighty-five percent "dividends received" deduction. Use of the corporate device in such circumstances could give rise to considerable conflict between the parties as to dividend policy since the individual investor can be expected to favor retention of profits by the corporation and an eventual bail-out at long-term capital gains rates whereas the institutional investor may wish profits distributed as earned.

The problem of double taxation may be mitigated somewhat by having the parties make their investment through the vehicle of bona fide debt as well as stock investment, rather than through stock exclusively. Some of the profits of the corporation are thus paid out as interest deductible by the corporation, rather than as non-deductible dividends.

The parties may also discover that use of the corporate form can result in increased taxation at the state level, depending upon the laws of the particular jurisdiction involved. Even if there was no tax disadvantage, or if the tax disadvantage was acceptable to the institutional investor, the corporate form may nevertheless be precluded by statutes regulating the investments of institutional lenders. These statutes would often prevent the institution from acquiring substantial percentages of the outstanding common stock of the corporate vehicle.

Another possibility is the use of a form of business or other trust.

81. Since the institutional investor is not an individual, an election of "Subchapter S" treatment for the corporation is not available. Int. Rev. Code of 1954, § 1371(a)(2).
82. Id. § 702.
83. Id. § 243(a)(1).
84. Id. § 331.
85. See discussion in part II B 1 infra.
88. Having its origin in Massachusetts, the business trust is a form of unincorporated business organization created by a declaration of trust, under which the management is "conducted by compensated trustees for the benefit of persons whose legal interests are
Here a trustee would own legal title to the property and the beneficiaries, or cestuis-que trust, would be the institutional lender and the developer. Normally in a trust situation the beneficiaries would not be personally liable. As explained by Professor Scott, a trustee "is not empowered to act on behalf of the beneficiaries personally... He may have power to subject the trust property to the claims of third persons, but he is not the agent of the beneficiaries and has no power to subject them to such claims... The trustee is said to be agent for the trust estate and not agent of the beneficiaries." However, if the trust were a "dry" or "passive" trust, under which the beneficiaries exercise control over the trustee in the operation of the property, the beneficiaries might lose their limited liability. Furthermore, "it is exceedingly difficult to make any accurate statement as to what powers may be given to the shareholders without subjecting them to personal liability." While an active and not a "dry" trust might preserve limited liability, the institutional investor, even as represented by transferable certificates of participation, or shares." Comment, Massachusetts Trusts, 37 Yale L.J. 1103, 1105 (1928). See generally G.G. Bogert & G.T. Bogert, The Law of Trusts and Trustees § 291 (2d ed. 1964); Magruder, The Position of Shareholders in Business Trusts, 23 Colum. L. Rev. 423 (1923).

89. 3 A. Scott, The Law of Trusts § 274 (3d ed. 1967). Professor Scott points out, however, that where the trustee, in addition to his duties as trustee, "has undertaken to act for the beneficiaries and under their control, he is also their agent, and as such can subject them to personal liabilities by acts done by him within the scope of the employment." Id. at 2304.

90. "It is uniformly held that, if the cestuis may dictate on questions of the management of the trust, they are liable for the debts. The liability is usually rested on the theory that the organization is not then a trust but a partnership or joint stock association in which the trustees are mere agents." G.G. Bogert & G.T. Bogert, supra note 88, § 294; see Restatement (Second) of Agency § 14B (1958). A joint stock association or joint stock company, referred to by Bogert, wanders somewhere between corporation and partnership, with centralized management, continuity of life, transferability of interest, unlimited liability of the shareholder, and taxation as a corporation. See generally A. Bromberg, supra note 59, § 34. The combination of entity taxation and general liability make the joint stock association inappropriate for institutional real estate equity investments.

91. In business trusts, the holder of the trust certificates, or the cestuis or beneficiaries of the trust, are often referred to as "shareholders."

92. G.G. Bogert & G.T. Bogert, supra note 88, § 297, at 593. Messrs. Bogert indicate that one test generally approved is whether the shareholders "have reserved powers sufficient to enable them as a practical matter to control the business." Id. Judge Magruder felt that shareholders of a business trust might be held to be partners "not because they have some meeting or association together, but because by virtue of powers in the trust deed they may fairly be said to be carrying on the business," Magruder, supra note 88, at 432. It would seem that the power to remove trustees (see Neville v. Gifford, 242 Mass. 124, 136 N.E. 160 (1922)), or to alter or amend the declaration of trust (see Simson v. Klepsstein, 262 F. 823 (D.N.J. 1920)), would render the shareholder liable, although even these conclusions have been subject to some criticism on the ground that the shareholders should not be held to be partners, at least until they really begin to exercise control over management.
beneficiary, may feel that he must exercise some control over management, at least as to major decisions affecting the property and the liabilities of the parties.  

Furthermore, since centralized management is common to both corporations and business trusts, such trusts are generally taxed as corporations, thus raising again the problem of double taxation. The specter of being subjected to double taxation, while losing limited liability as the result of the retention of what the institutional investor considers the barest of controls, has frequently led to avoidance of the trust route. Thus the standard vehicle for equity investments by institutional lenders has become a form of partnership, either limited or general.

2. Limited Partnerships

Sometime during the middle ages, as early as the twelfth century, the first commendator gave money to the first commendatarius, and the limited partnership was born. The commendator received a portion of the profits, usually the major portion, but was not personally liable for the losses. The commendatarius had control over the money and the operation of the business. In Louisiana, a limited partnership is still known as a “partnership in commendam.”

Today the limited partnership is strictly regulated by statute. The Uniform Limited Partnership Act (ULPA), which was drafted by the National Conference of Commissioners on Uniform State Laws and is in force in forty-five jurisdictions (including the major commercial states), is specific in its requirements for the organization of the limited partnership. Basically, the limited partnership is composed of one or more general partners, whose rights and liabilities are very much akin to the partners of a general partnership. Like the commendatarius, they have control over the partnership and its assets. There are also limited

93. See Part IV B 1 infra.
95. “Limited partnerships were first known and recognized in the Italian commercial centers of Pisa and Florence in the twelfth century, as a means for the owners of wealth, primarily the nobles and clergy, to invest their capital without being known or named.” 2 S. Rowley, supra note 51, § 53.0, at 550.
96. See generally A. Bromberg, supra note 59, § 26.
98. The ULPA was approved by the National Conference of Commissioners on Uniform State Laws in 1916. This organization is composed of commissioners appointed by the governors of the respective states. See Uniform Laws Annotated, Uniform Limited Partnership Act III (Master ed. 1969).
100. The general partners’ powers are, however, restricted in a few specific areas. See id. § 9.
partners (one or more) who, like the commendators, reap their share of the profits, suffer no losses beyond their initial investment, and have little or no say about what goes on. It is these elements of the limited partnership which make it both desirable and undesirable as a vehicle for equity investment by the institutional lender.

(a) Control. Limited liability is certainly a desirable end. But ULPA section 7 provides that: "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." The ULPA does not say what constitutes taking part in control of the business, or what the rights and powers of a limited partner are. It does, however, list in section 10 "rights" of a limited partner which can be exercised without losing limited liability under the language of section 7. Section 10 provides that the limited partner has the rights of a general partner to require the maintenance and inspection of partnership books, a formal accounting of partnership affairs, and a dissolution and winding up by court decree. Section 10 also provides that the limited partner has the right to receive a share of the profits, and the return of his contribution as provided in sections 15 and 16. Also, while stating that the general partners have control over the partnership, section 9 provides that general partners must obtain the consent of all the limited partners prior to doing any one of several things—including acting in contradiction of the certificate, doing anything that would make it impossible to carry on the business, confessing judgment for the partnership, or admitting general or limited partners. It would seem that these required consents can be given or withheld by the limited partner, without losing limited liability, as part of the "rights and powers" of the limited partner under section 7.

The limited partner has other rights and powers under the ULPA, such as the right to lend money to the partnership under section 13. But it is not clear whether the rights and powers referred to in section 7 were intended to go beyond those specifically mentioned in the statute. What rights and powers the limited partner may exercise in the partnership agreement, in addition to his slim statutory rights, and still pass muster under section 7 is therefore uncertain. For example, would the right to be consulted on major decisions constitute taking part in the control of the business beyond the rights and powers of limited partners? What about a veto power over purchases or sales of partnership assets? California tried to set some guidelines by amending its ULPA in 1963. The amendments provided that limited partners could vote for the election of general partners, the termination of the partnership, amendments to

101. Id. § 10(2).
102. Id. § 7.
103. Id.
the partnership agreement, and sale of all or substantially all of the partnership assets, without losing limited liability.\textsuperscript{104} Outside of California there seems to be no legislative help, and the cases are too few and do not seem to set any guidelines.\textsuperscript{105} In a recent article,\textsuperscript{106} the problem of control by the limited partner was considered, and that author concluded:

[T]he most persuasive [construction of the control test] is to measure it by the most logical rationale for holding the limited partner liable: to prevent third parties from mistakenly assuming that the limited partner is a general partner and relying on his general liability. . . . Under this view . . . only activities which conceivably could induce reasonable reliance, such as supervision of the partnership's day-to-day activities, should produce general liability.\textsuperscript{107}

This is the most liberal of the possible constructions the author discussed. Yet, with no certainty as to the outcome, he did not feel that counsel could permit a limited partner to engage in a regular practice of giving "advice" to the general partners.\textsuperscript{108}

Thus the institutional investor is torn between trying to protect its assets through limited liability on the one hand, and through taking part in the control of the business on the other. Institutions do not wish to invest money with no voice as to over what is done with it. The fear, however, is that the exercise of any power might be considered control within the meaning of the ULPA.

\textsuperscript{104} Cal. Corp. Code § 15507 (West Supp. 1971); see ch. 870, § 7 [1963] Cal. Stat. 2113, stating that the amendment to section 7 of the ULPA "shall be construed as a clarification and a continuation of existing law and shall not be construed as constituting changes therein."

\textsuperscript{105} See Feld, The "Control" Test For Limited Partnerships, 82 Harv. L. Rev. 1471, 1474-75 (1969). The author states that apart from cases where the limited partners are clearly responsible for the enterprise and thus liable as general partners (e.g., Holzman v. DeEscamilla, 86 Cal. App. 2d 858, 195 P.2d 833 (Dist. Ct. App. 1948)), "there appear to be only three cases in which the courts have had to confront the issue of what and how much a limited partner may do with impunity, and in none have they managed satisfactory descriptions of the standards by which to judge the partners' activities." Id. at 1475. The three cases are Granger v. Antoyan, 48 Cal. 2d 805, 313 P.2d 848 (1957) (auto distributorship sales manager-limited partner who supervised sales people and cosigned checks as convenience to general partner was not exercising control); Silvola v. Rowlett, 129 Colo. 522, 272 P.2d 287 (1954) (foreman-limited partner of auto shop who could purchase parts but not extend credit was not exercising control); and Rathke v. Griffith, 36 Wash. 2d 394, 218 P.2d 757 (1950) (no liability notwithstanding execution of a few documents by the limited partner and unused by-law provision making limited partner a "director").

\textsuperscript{106} Feld, supra note 105.

\textsuperscript{107} Id. at 1479.

\textsuperscript{108} Notwithstanding Plasteel Prods. Corp. v. Heiman, 271 F.2d 354 (1st Cir. 1959), which permitted advice by the limited partner, Mr. Feld stated that "in view of the weight [investing partners'] advice is likely to carry . . . . this relationship may, as a practical matter, give any 'advice' the color of a command in the partnership." Feld, supra note 105, at 1477.
(b) Partnership Assets as Security. Another problem of the limited partnership is found in section 13 of the ULPA. Because of the importance of this section, both in substance and in form, it is set forth in full below:

§ 13. Loans and other business transactions with limited partner.

(1) A limited partner also may loan money to and transact other business with the partnership, and, unless he is also a general partner, receive on account of resulting claims against the partnership, with general creditors, a pro rata share of the assets. No limited partner shall in respect to any such claim

(a) Receive or hold as collateral security any partnership property, or

(b) Receive from a general partner or the partnership any payment, conveyance, or release from liability, if at the time the assets of the partnership are not sufficient to discharge partnership liabilities to persons not claiming as general or limited partners,

(2) The receiving of collateral security, or a payment, conveyance, or release in violation of the provisions of paragraph (1) is a fraud on the creditors of the partnership.\footnote{ULPA. § 13.}

On its face, subsection (1)(a) says that a limited partner may not receive or hold partnership property as collateral security, and subsection (2) says that receiving such security is a fraud on creditors of the partnership. Since the institutional investor, as a limited partner, will also often be a holder of a mortgage on partnership assets, this section, if it means what it seems to say, may have serious consequences.\footnote{Section 13 is not as artfully drawn as it might have been. As a result, it is possible to argue that it only prohibits taking security with respect to a claim that arises in connection with a pre-existing debt, since the section provides that a limited partner may loan money to the partnership but may not receive partnership property as collateral security with respect to a "resulting claim" against the partnership. In this connection see the California amendment to section 13 (see text accompanying note 126 infra), which made the existing language of subsection (1)(a) applicable only on insolvency, and also added an additional clause prohibiting a limited partner from making a loan on the security of partnership property if the partnership is insolvent at the time the secured loan is made. See note 117 infra.}

However, the case law (what there is of it) says that the section does not mean what it seems to be saying. The leading case is Hughes v. Dash.\footnote{309 F.2d 1 (5th Cir. 1962).} In that case the trustee in bankruptcy of the limited partnership sought to have the mortgage, made by the limited partnership to the limited partner, declared null and void as against the trustee, pursuant to the Florida counterpart of section 13 of the ULPA. At the time the mortgage was made, the partnership was solvent. The fifth circuit held that the mortgage was valid and good against the trustee. Judge Bell addressed himself directly to the problem and held that the qualifying language of subsection (1)(b), which prohibits a limited partner from receiving any

\footnote{109. ULPA. § 13.}
\footnote{110. Section 13 is not as artfully drawn as it might have been. As a result, it is possible to argue that it only prohibits taking security with respect to a claim that arises in connection with a pre-existing debt, since the section provides that a limited partner may loan money to the partnership but may not receive partnership property as collateral security with respect to a "resulting claim" against the partnership. In this connection see the California amendment to section 13 (see text accompanying note 126 infra), which made the existing language of subsection (1)(a) applicable only on insolvency, and also added an additional clause prohibiting a limited partner from making a loan on the security of partnership property if the partnership is insolvent at the time the secured loan is made. See note 117 infra.}
\footnote{111. 309 F.2d 1 (5th Cir. 1962).}
payment, conveyance, or release only "if at the time the assets of the partnership are not sufficient to discharge partnership liabilities to persons not claiming as general or limited partners," is also applicable to subsection (1)(a). For convenience, this qualifying language will be referred to as the "insolvency qualification." He relied upon the Official Comment of the Commissioners on Uniform State Laws with respect to this section, which indicates an intention to apply the insolvency qualification to both subsections. In the Comment, the Commissioners state that the limited partner may loan money to the partnership, provided he does not, in respect to such transactions, accept from the partnership collateral security, or receive from any partner or the partnership any payment, conveyance, or release from liability, if at the time the assets of the partnership are not sufficient to discharge its obligations to persons not general or limited partners.4

From the language, punctuation, and grammatical structure of this Comment, it would seem that the statutory problem could have been created by a printer's error. Had subsections (a) and, with the exception of the insolvency qualification, (b) been indented and the insolvency qualification brought out to the margin, the Hughes decision would clearly be correct. Whether a printer's error or not, the Commissioners' Comment does seem to indicate that the "mischief" the drafters were aiming at was that of a limited partner accepting security from an insolvent partnership, and that this was all they intended to prohibit.5

112. Id. at 2.
113. U.L.P.A. § 1, Comment Fifth. The Official Comments can be found following U.L.P.A. § 1, in 6 Uniform Laws Annotated 562 (Master ed. 1960).
114. Id.
115. Last year a New Jersey case supported the Hughes decision. A.T.E. Financial Serv., Inc. v. Corson, 111 N.J. Super. 234, 268 A.2d 73 (Ch. 1970). The New Jersey Superior Court held the insolvency qualification applicable to subsection (a). See also Granger v. Antoyan, 48 Cal. 2d 805, 313 P.2d 848 (1957), where the limited partner held a chattel mortgage on partnership assets. The Supreme Court of California, based upon a review of the evidence, held that the limited partner had not violated § 15513 of the Corporations Code [U.L.P.A. § 13]. Although the court did not discuss the problem of the application of the insolvency qualification to subsection (a), its decision would seem to have assumed it. The Granger case was decided prior to the amendment discussed in note 110 supra.
116. See de Sloovere, Contextual Interpretation of Statutes, 5 Fordham L. Rev. 219 (1936); Frankfurter, Some Reflections on the Reading of Statutes, 47 Colum. L. Rev. 527 (1947).
117. Where a limited partner makes a loan to the partnership and receives contemporaneous collateral security, it is not entirely clear why section 13 of the ULPA should consider this "mischief," even if the partnership is at the time insolvent. Such loan and security would not be considered an unlawful preference under section 60(a) of the Bankruptcy Act, but would seem to constitute a fraudulent conveyance under section 67 of the Bankruptcy Act and under section 8 of the Uniform Fraudulent Conveyance Act (UFCA). See
However, other legislative history, at least in New York, still casts some doubt on this conclusion. In a letter on the stationery of the Commissioners on Uniform State Laws, New York State Board, dated March 21, 1922 and found in the Governor's Jacket on the ULPA, Carlos C. Alden, a New York Commissioner, wrote to the Honorable C. Tracey Stagg, counsel to the Governor, urging approval by the Governor of the ULPA. The letter commented "only on the most important changes which it [the ULPA] will make in our existing law." Section 13 was one of the three sections discussed in the letter. Mr. Alden's comment was as follows: "Under § 13, a limited partner may not secure a preference on partnership assets, upon a loan of money to it, through the taking of collateral security. This is not prevented under our present statute, and seems a proper safeguard to add to our law." Most of the foregoing was also embodied in a memorandum from Mr. Stagg apparently to the Governor, also found in the Governor's Jacket, in which he stated the bill "merits approval." In addition, the Association of the Bar of the City of New York, in approving the bill, used the exact language quoted above from Mr. Alden's letter. Thus there is some indication that the New York drafters of 1922 intended a result somewhat different from that intended by the drafters of the original uniform act, which had been

part II C 3 infra. The giving of security may be the only way to induce such a partner, who is not liable for the debts of the partnership, to infuse new cash into an insolvent enterprise. The limited partner may be the only source of available funds, and it is possible that investment of those funds might greatly benefit both the partners and their creditors by saving the partnership.


120. Prior to the adoption of the ULPA, the New York statute provided that a limited partner could loan money to the partnership and "take and hold the notes, drafts, acceptances and bonds of or belonging to the partnership, as security for [its] repayment." Law of April 14, 1857, ch. 414, § 17, [1857] N.Y. Laws 80th Sess. 836, 837 (repealed 1922). It did not expressly prohibit taking other partnership assets as security.

New York had had a limited partnership law for 100 years prior to the enactment of the ULPA. The first statute was passed in 1822, and became the example for several states. Law of April 17, 1822, ch. 244 [1822] N.Y. Laws 45th Sess. 259 (repealed 1828); see N.Y. Limited Partnership Law § 90, n.1 (McKinney 1948), citing Moorhead v. Seymour, 77 N.Y.S. 1050 (City Ct. 1901), which further traces the New York statute to the French Code with respect to La Societe en Commandite.

121. The Report of the Association of the Bar of the City of New York was prepared by its Committee on the Amendment of the Law of Association and is found in the Governor's Jacket. See note 20 supra.
approved by the General Conference of the Commissioners on Uniform State Laws in 1916.

Another problem revolves around the language of section 13 which states that a limited partner may not "receive or hold as collateral security any partnership property," and also the insolvency qualification which (under the Hughes interpretation) would permit such security "if at the time" the partnership was not insolvent. Assuming that the insolvency qualification does apply, and that a limited partner could receive partnership assets as security if no insolvency existed or was created, what would happen if the solvent partnership later became insolvent? Although the security was undoubtedly to protect against such a circumstance, the emphasized language quoted above would seem to say that a limited partner could not hold the collateral once the partnership became insolvent. This result hardly makes any sense, and the language seems to have been ignored by the cases and commentators. Indeed, subsection (2) makes only the receiving of collateral security in violation of section 13 a fraud on creditors. Thus the penalty provided would not seem applicable to holding security in violation of the section. This apparent inconsistency might indicate that the drafters used the words "or hold" loosely, without fully considering their effect.

Undoubtedly, section 13 of the statute needs some clarification. Some jurisdictions have attempted to do so. Most recently, in 1970, the California legislature amended its statute and provided in a separate subsection that secured loans to the partnership by a limited partner would not be valid if at the time the loan was made the partnership assets were not sufficient to discharge debts to outsiders.

123. Id. § 13(1)(b) (emphasis added).
124. A possible interpretation of the "or hold" language is that the drafters believed a limited partner would, under some circumstances, hold partnership assets for reasons other than security. If such property already held by the limited partner were converted to collateral security, the limited partner would not technically fit within the "receive . . . as collateral security" language. Such an interpretation, however, would not explain the failure to include "or hold" in subsection (2) of section 13.
If, in the applicable state, the taking of security by a limited partner should be held to violate the statute, the penalty provided in section 13 is that the transaction would be a fraud on creditors of the partnership. Thus the mortgage would be invalid as to creditors and the trustee in bankruptcy of the partnership. It follows that the mortgage should remain valid between the parties. Would the limited partner also lose limited liability? Probably not, since the fraud remedy is specified in the section itself, and since in other portions of the ULPA where the drafters intended a loss of limited liability they so specified.

The institutional lender's decision on whether to use a limited partnership may in the end depend upon local interpretations of the ULPA and on the availability of title insurance covering the mortgage. In any event, the complexity of the problems of control and collateral security and the magnitude of the risks appear to have turned some institutional investors from the limited partnership to a general partnership as the vehicle for equity investments.

3. General Partnerships

Many of the problems raised in connection with the limited partnership are avoided by the use of a general partnership, but all problems are not resolved and some additional ones are created. Some of the difficulty is conceptual and involves attempting to determine exactly what constitutes a partnership.

The Uniform Partnership Act defines a partnership as "an association

127. The UFCA has generally been interpreted to render transactions that are fraudulent as to creditors voidable at the option of those creditors. See 37 Am. Jur. 2d Fraudulent Conveyances § 106 (1968). The trustee in bankruptcy is, inter alia, a lien creditor on the day of bankruptcy. See Bankruptcy Act § 70(c), 11 U.S.C. § 110(c) (1964).
129. See, e.g., U.L.P.A. § 5.
130. A senior officer of one major national title company, in discussions with the authors, has indicated recently that his company would consider (on a case by case basis) insurance of mortgages on partnership real estate held by limited partners. If its study of the transaction indicates that the limited partner's mortgage is for a valid business purpose and not to "euchre" general creditors, the company would insure. The California Land Title Association has, however, apparently at least tentatively decided to recommend that the policy insuring a mortgage held by a limited partner contain an exception for the rights of creditors of the partnership. But see text accompanying 126 supra.
131. Others, however, would prefer not to join general partnerships. See, e.g., Groothuis & Cohen, Life Insurance Company Investments in Limited Real Estate Partnerships, 21 Ass'n Life Ins. Counsel Proceedings 433 (1971) (supporting the limited partnership approach). Most institutions which have joined general partnerships have done so through one or more subsidiaries rather than directly. For a discussion of the use of a subsidiary in connection with the limited partnership approach, see part II C 2 infra.
of two or more persons to carry on as co-owners a business for profit.\footnote{U.P.A. § 6(1).} But is a person dealing with an entity or with a group of individuals? This question has been answered often but not always consistently. At least some of the blame rests with the UPA itself.

When the Commissioners on Uniform State Laws, shortly after the turn of the century, focused their attention on the preparation of a uniform partnership act, they selected Dean James Barr Ames as the principal drafter.\footnote{Dean Ames had submitted two drafts before he died in 1910.\footnote{For the history of the Act, see Commissioner's Prefatory Note to Uniform Partnership Act, 6 Uniform Laws Ann. 5-8 (1969).} Had he been able to complete his job, many of the problems faced by the institutional lender in operating under the UPA might have been avoided, for Dean Ames was an advocate of the so-called “entity” theory of partnership—\footnote{Dean Ames would have defined a partnership as “a legal person formed by the association of two or more individuals for the purpose of carrying on a business with a view to profit.” U.P.A. § 1(1) (Tent. Draft No. 2, 1909).} a theory which regards a partnership as having a legal personality separate and distinct from the individual legal personalities of each member.\footnote{Beale, James Barr Ames—His Life and Character, 23 Harv. L. Rev. 325, 326 (1910).} To accomplish his purpose, in 1905 Dean Ames sought and procured the Commissioners’ instructions to draw the Act “‘on the lines of the mercantile [entity] theory of partnership.’”\footnote{Resolution of the Commissioners on Uniform State Laws, Aug. 18, 1905, in 34 A.B.A. Rep. 1082 (1909). Dean William Draper Lewis, who eventually drafted the Uniform Partnership Act, disliked the “entity” theory: “By its advocates it has also been called the ‘mercantile theory,’ on the assumption that business men . . . proceed on the . . . premise on which the theory is based. Such an assumption however, is entirely unwarranted.” Lewis, The Uniform Partnership Act, supra note 135, at 639.} When the “earnest, patient, and thorough . . . scholar”\footnote{Under several state constitutions, a partnership treated as an “out and out” legal entity might be considered a corporation for the purposes of limited liability. Thus in these states “it possibly could not be made lawful for more than double the individual contribution, which, of course, is quite at war with the whole conception of partnership.” Address of Dean James Barr Ames to a meeting of the Commissioners on Uniform State Laws, Aug. 24, 1908, in Report of the Committee on Commercial Law, 34 A.B.A. Rep. 1082 (1909).} died, he had already acknowledged that the “entity” theory was meeting some roadblocks in the form of state constitutions,\footnote{Lewis, The Desirability of Expressing the Law of Partnership in Statutory Form, 60 U. Pa. L. Rev. 93 (1911).} but his final product might have embodied more
of what Coleridge called the "shaping spirit of Imagination"\textsuperscript{140} than does the UPA.

On Dean Ames' death, the Commissioners turned to Dean William Draper Lewis.\textsuperscript{141} Dean Lewis was an advocate of the "aggregate" theory, the underlying idea of which is that "in partnership transactions the individual partners deal directly with each other and with third persons," a theory which "is also called the common law theory of partnership, because ... the courts proceed on [its] underlying assumptions ... ."\textsuperscript{142} Had the Act been redrawn to follow the aggregate theory completely, many of the problems faced today might have been avoided. But apparently the Commissioners had traveled too far on the entity road to turn back all the way. Upon his appointment, Dean Lewis, together with James B. Lichtenberger of the Philadelphia Bar, prepared two drafts, one embodying the "entity" idea and the other embodying the "aggregate" theory. In 1911 the Conference withdrew its 1905 instructions to Dean Ames,\textsuperscript{143} so that the Act could be drafted to combine both theories.

Thus the UPA was conceived and ultimately born with a slightly schizoid personality.\textsuperscript{144} The UPA itself contains numerous provisions.

\textsuperscript{141} "[T]he substance, form and phraseology of the Act are principally the work of Dr. William Draper Lewis and other members of the Philadelphia Bar. To these men is due the fact that this Act adheres to the common law theories and ideas and in great part conforms to the existing law in ... States, rather than to the theories and ideas of the legal fiction of an entity, as originally intended." Lichtenberger, The Uniform Partnership Act, 63 U. Pa. L. Rev. 639 (1915) (footnote omitted).
\textsuperscript{142} Lewis, The Uniform Partnership Act, supra note 135, at 639.
\textsuperscript{143} Said Professor Williston: "[I]t is to be said that we cannot escape from our past legal history satisfactorily by a legislative fiat. We may trim and pare excrescences, and may on new subjects create wholly new legal ideas by statute, but in subjects with a long past, experience seems to show that it is difficult to adopt fundamentally new ideas." Williston, The Uniform Partnership Act, With Some Remarks on Other Uniform Commercial Laws, 63 U. Pa. L. Rev. 196, 207-08 (1915) (emphasis deleted).
\textsuperscript{144} "[T]he only general thing which this draft is based on, as to the question of theory, is really in a sense positive negation of the proposition that you can regard a partnership as a separate legal person. I am quite willing to agree with Professor Williston, however, that we have regarded a partnership as an entity in a great many instances ... but ... the draft has not endowed that entity with a separate legal personality." Remarks of Dr. William Draper Lewis, commenting on the fifth draft of the Uniform Partnership Act, before the 21st Annual Conference of the Commissioners on Uniform State Laws, Aug. 23, 1911, in 36 A.B.A. Rep. 824-25 (1911). The battle between these conflicting theories broke out in print in the following series of articles (listed chronologically): Crane, The Uniform Partnership Act—A Criticism, 28 Harv. L. Rev. 762 (1915); Lewis, The Uniform Partnership Act—A Reply to Mr. Crane's Criticism (pts. 1-2), 29 Harv. L. Rev. 158, 291 (1915); Crane, The Uniform Partnership Act and Legal Persons, 29 Harv. L. Rev. 838 (1916).
which could be based only on the theory that a partnership is an entity, while other provisions are obviously based on the aggregate theory. A partnership under the Internal Revenue Code of 1954 also has a hybrid nature in that the partnership is not considered a taxable entity, although it is treated as an entity for various tax purposes. Other statutes, such as the Bankruptcy Act, and the Uniform Fraudulent Conveyance Act (UFCA) purport to treat a partnership as an entity. The cases often enunciate theories of what a partnership is in order to justify a particular result, and thus the decisions are not always consistent. This inner conflict in the UPA is a basic problem that must be faced in drafting many provisions of the partnership agreement.

Regardless of the confusion as to the nature of the partnership arrangement, it is clear from the UPA that the partners will share equally in profits and losses unless there is agreement to the contrary. They will be personally liable for the debts of the partnership, will have

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145. For example, the partnership may hold title to real property (U.P.A. § 8(3)), and the partner's interest is a personal property interest in the partnership (id. § 26). Each has certain limited rights as a tenant-in-partnership in the partnership property (id. § 25), and a right to participate in management (id. § 24). Assignment of a partner's interest will not cause a dissolution. Id. § 27. When a partnership is dissolved, it continues until "winding up." Id. § 30. A partner's undivided assets are distributed first to his individual creditors (id. § 40), and partnership creditors have priority as to partnership assets. Id. § 40.

146. For example, a partnership will dissolve on the death or withdrawal of a partner (id. §§ 29, 31(4)) under general agency principles. Partners are generally liable for the debts of the partnership.


148. Id. §§ 703, 706, 707(a).


151. Compare Darby v. Philadelphia Transp. Co., 73 F. Supp. 522 (E.D. Pa. 1947), with David v. David, 161 Md. 532, 157 A. 755 (1932). As an example of how confusing the cases are, Bromberg cites McElhinney v. Belsky, 165 Pa. Super. 546, 69 A.2d 178 (1949), as supporting the entity concept (A. Bromberg, supra note 59, § 3, at 28 n.4. But see id. § 3 at 23 n.55.) while Rowley cites the same case as supporting the aggregate concept. S. Rowley, supra note 71, § 1.3, at 23 n.69. The sad thing is that both of these authorities are possibly correct.

152. See part IV infra.


154. Partners are jointly and severally liable for "everything chargeable to the partnership under sections 13 [partner's wrongful act] and 14 [partner's breach of trust]," but "jointly for all other debts and obligations of the partnership . . . ." Id. § 15.
rather broad authority to bind the partnership within the apparent scope of its business, and will have equal rights as to the management of the partnership business.

It is also clear that the partnership may hold title to real property in its name and, since there is no provision in the UPA equivalent to section 13 of the ULPA (which sheds doubt on the ability of a limited partner to have a lien on the partnership assets), it would seem that a partnership, absent fraud, could mortgage its assets to one of its partners. The UFCA and the Bankruptcy Act, in both of which the entity aspects of the partnership relationship predominate, make the conveyance or transfer (including the mortgage) of partnership property or the incurrence of partnership debt to a partner fraudulent as to creditors, if the partnership is or will thereby be rendered insolvent. In determining when a partnership is insolvent for the purposes of the UFCA and the fraudulent conveyances section of the Bankruptcy Act, the value of the separate assets of each general partner in excess of the amount needed to meet claims of his separate creditors is added to the assets of the partnership. Since the assets of most institutional investors probably will be sufficient to satisfy the debts of the institution's creditors and the partnership creditors, it would seem doubtful that loans to the partnership by the institutional general partner, and any mortgages given by the partnership as security, would be fraudulent as to creditors.

While it would seem, therefore, that a mortgage of partnership property held by a partner would be a valid mortgage, the practical benefits of the mortgage are reduced by the following: (a) The partner, being generally liable for all the debts of the partnership, would not seem to obtain any significant advantage vis-à-vis other partnership creditors in being able to foreclose a mortgage, since the proceeds thereof would be subject to

155. Id. § 9.
156. Id. §§ 18(e), 24.
157. Id. § 8(3).
158. See discussion of section 13 of the ULPA in part II B supra.
159. See 1 S. Rowley, supra note 71, § 40(b); 68 C.J.S. Partnership § 104 (1950).
160. The UFCA was originally approved by the National Conference of Commissioners on Uniform State Laws and the American Bar Association in 1918. It is now the law in twenty-five jurisdictions, including New York, California, Pennsylvania, Michigan, Massachusetts and New Jersey. UFCA, 7 Uniform Laws Ann. 423 (Master ed. 1970). The law was drafted for the National Conference of Commissioners on Uniform State Laws by Dean William Draper Lewis (see id. at 424), who was primarily responsible for the UPA.
161. See notes 149 & 150 supra.
claims of all the creditors of the partnership;\textsuperscript{165} and (b) section 40(b) of the UPA provides that partnership liabilities owing to individual partners, other than for capital and profits, are second in rank of priority\textsuperscript{166} in distribution of partnership assets after dissolution of the partnership.\textsuperscript{167} Thus, it would seem that on dissolution no payments may be received by a partner on any obligation of the partnership, secured or unsecured, until all the creditors of the partnership have been paid,\textsuperscript{168} but such obligations and any security therefor, if not fraudulent, would

\textsuperscript{165}Where real estate values are depressed, however, it would seem advantageous to the institution to pay the partnership debts, foreclose its mortgage and hold onto the real estate.

\textsuperscript{166}This may significantly affect the application of the dual priority rule of UPA section 40(i) which, with respect to a partner's separate property, gives separate creditors of an insolvent partner priority over creditors of the partnership. See A. Bromberg, supra note 59, § 93(e). While the reason for the subordination of the partner's claim as creditor in section 40(b) is not entirely clear, Professor Bromberg speculates it is "that partners' claims against their firms are often not, in fact, neatly classified into debt, capital contributions and profits. And even if they were, the books might easily be juggled to convert one into another." Id. § 93(e), at 550. If this theory is correct, there should be no reason to subordinate claims held by partners as mortgagees of the partnership, inasmuch as the mortgage would be of record.

\textsuperscript{167}See Eardley v. Simmons, 8 Utah 2d 159, 330 P.2d 122 (1958). Section 40 states that its rules shall be observed "subject to any agreement to the contrary." In addition to appropriate language in the partnership agreement, it might be argued that the mortgage itself might constitute such an "agreement to the contrary." It would seem, however, that the drafters of the UPA probably intended this language to refer only to agreements affecting rights among the partners, and not rights affecting third parties unless they are parties to such an agreement—especially since the provision has been interpreted as having been written to protect creditors (see Price v. Slawter, 209 Cal. App. 2d 608, 26 Cal. Rptr. 227 (Dist. Ct. App. 1962)) and since it applies to settling accounts "between partners."

\textsuperscript{168}For an early enunciation of this somewhat contradictory rule, see Waterman v. Hunt, 2 R.I. 298 (1852):

"So the firm may, in good faith and for a valuable consideration, give a note to one of the partners . . . ."

"[T] hey may [also] make a valid mortgage to secure its payment.

\ldots . . ."

"But if [the mortgagee] has retained the notes and mortgage until the company had gone into bankruptcy, he could not be permitted to enforce them against the assets of the company, to the exclusion of the company creditors, or pari passu with them. Being himself liable to these creditors he could make no claim until they were paid." Id. at 303-04 (dictum) (emphasis deleted).

Professor Rowley expresses this rule as follows: "Firm property may be mortgaged to one partner and the mortgage is not invalid because of the relationship, although such fact may tend to bear upon the question whether the mortgage was fraudulent. Such mortgage in inferior to the rights of firm creditors." 1 S. Rowley, supra note 71, § 40(b), at 764 (footnotes omitted). However, it is not entirely clear whether "such mortgage" in the last sentence of this quotation refers to any mortgage from a partnership to a partner, or only to a partnership mortgage which is fraudulent. See also 68 C.J.S. Partnership § 104 (1950).
appear valid and enforceable without subordination to partnership creditors before dissolution. Bankruptcy, of course, would constitute a dissolution of the partnership. On the other hand, it might be argued that since the mortgage would normally create a property right in the mortgagor, leaving the mortgagor with an equity of redemption, section 40 was meant to refer only to distribution of the equity of the partnership over and above mortgages, and not to the rights of a holder of a valid mortgage—notwithstanding the fact that he is a partner. Whether the argument would be successful is not clear.

Thus, in the case of a general partnership, the institutional investor can exercise the control over the operation of the partnership it would be unable to exercise as a limited partner. In most cases it could, subject to possible priorities of creditors of the partnership, hold partnership assets as security for loans which would be questionable under the ULPA, while continuing to avoid the double taxation problems inherent in a corporate structure. To obtain these advantages, the institutional investor must give up important protection and limited liability, and wrestle with the complexities of the UPA.

169. U.P.A. § 31(5).


171. The following are some of the arguments which might be advanced:

1. If it is determined that the mortgage to a partner is valid and cannot be set aside as being fraudulent, the only assets the partnership has to which section 40(b) of the UPA can apply would seem to be the value of its property over and above valid liens.

2. Both the UFCA and the UPA were written primarily by Dean William Draper Lewis. In the earlier draft of the UPA, Dean Lewis had inserted a fraudulent conveyances clause similar to the one presently in section 8 of the UFCA. This was section 21(3) in the seventh draft of the UPA. See Crane, The Uniform Partnership Act—A Criticism, 28 Harv. L. Rev. 762, 766 n.87 (1915). Crane notes, without approval, that the section was placed in the UFCA rather than the UPA because “it was felt that it pertained rather to another branch of the law and was out of place in the partnership code.” Id. at 776. Thus, while it is clear that Dean Lewis knew and clearly adverted to the problem of fraudulent conveyances (see Lewis, The Uniform Partnership Act—A Reply to Mr. Crane’s Criticism, 29 Harv. L. Rev. 291, 296-98 (1916)), if section 40 is given a broad interpretation, it would subordinate debts owed to partners to the claims of other creditors and severely restrict the scope of section 8 of the UFCA. It is not clear that this was intended.

3. It is conceptually difficult to understand how a mortgage can be both valid and subordinate to general creditors even in a limited area, or what sense it makes to permit a partner to foreclose a day before bankruptcy but, if he has not foreclosed, to subordinate him to general creditors the day after. Whether or not these arguments have merit, it would appear that the reason for subordination in section 40(b) “appears not to have been scrutinized carefully.” See A. Bromberg, supra note 59, § 93(c). A reasoned clarification of the statute, at least with respect to mortgages held by partners on partnership property, appears to be in order.

172. See part V infra.
C. Direct Versus Subsidiary Investment

Equity investments of institutional lenders have been made either directly in the name of the institution or by a subsidiary corporation of the investor.\textsuperscript{173} State laws regulating institutional investors often restrict the number and type of subsidiaries such investor may have and the purposes for which they may be organized.\textsuperscript{174} If the investment through a subsidiary is permitted, it may nevertheless create significant tax problems. On the other hand, it may help solve some of the other problems that have disturbed institutional investors in this area.

1. Tax Considerations

In deciding whether to participate in a real estate equity investment directly or through a subsidiary, a key consideration for the institutional investor is the effective rate at which net income from the venture will be taxed in the hands of the subsidiary, as compared to the effective tax rate in the hands of the institutional investor if received directly. The subsidiary will normally pay tax on net income at the full corporate rate of forty-eight percent.\textsuperscript{175} If the institutional investor is also in a forty-eight percent tax bracket, the tax considerations are fairly neutral since the institutional investor usually can have the subsidiary's profits re-

\textsuperscript{173} It has often been said that a corporation may not be a partner because a corporation's directors may not share or delegate their management functions. The UPA, however, defines "partnership" as an association of two or more "persons" and defines persons to include corporations. See U.P.A. §§ 2, 6. The UPA provision, however, may not in itself constitute an authorization for corporations to join partnerships. See, e.g., 1935 N.Y. Op. Att'y Gen. 230. In New York, such authority is found in Bus. Corp. Law § 202(a)(15) (McKinney 1963), subject, inter alia, to anything contrary in the certificate of incorporation. Other states may not be so explicit. See H. Ballantine, Corporations § 87 (rev. ed. 1946). In these states, shareholders' approval, or a specific provision in the certificate of incorporation authorizing membership in partnerships, often is sufficient to permit such membership. See generally ABA Committee on Partnerships & Unincorporated Business Associations, May a Corporation Be a Partner?, 17 Bus. Law. 514 (1962).

As explained by Professor Ballantine, even if there is no authority for a corporation to enter into a partnership, the corporation may still incur liability of a partner to third parties. It also has been said that a corporation could enter a partnership if it had sole management of the business, or if the enterprise were denominated a "joint venturo" rather than a partnership. Id. But see note 64 supra.

\textsuperscript{174} For example, with respect to insurance companies, see N.Y. Ins. Law §§ 46(a), 81(9) (McKinney Supp. 1970).

\textsuperscript{175} Int. Rev. Code of 1954, § 11. While in the past the use of a subsidiary created an additional surtax exemption on the first $25,000 of taxable income (id. § 11(d)), the Tax Reform Act of 1969 provides for the gradual elimination of this benefit over the period 1970-1974, with its complete elimination thereafter. Int. Rev. Code of 1954, §§ 1561, 1562, 1564. A life insurance company and its real estate subsidiaries will be entitled to two surtax exemptions. Id. § 1563(b)(2)(D).
mitted to it on a tax-free basis. However, where the institutional investor is taxed at a lower effective tax rate than the subsidiary would be, use of the subsidiary may result in additional tax burdens. Many types of institutional lenders, such as life insurance companies, mutual savings banks, real estate investment trusts, and qualified pension trusts, either do not pay tax on their net investment income or are taxed at an effective rate less than the full corporate rate of forty-eight percent. Thus use of a fully taxable subsidiary can prove disadvantageous from a tax viewpoint.

If business and other non-tax reasons nevertheless dictate the use of a subsidiary, the taxable income of the subsidiary can be reduced by the judicious use of a mixture of both debt and stock investment, rather than stock investment only. The chief concern here is insuring that the debt will be considered as bona fide debt for tax purposes, so that the interest paid by the subsidiary will be deductible from its income. Because of the close relationship of the parties, it is essential that the arrangement reflect as many indicia of true debt as possible. Assuming this is done, there is the additional question of how much debt can be issued without the arrangement being subject to attack on "thin capitalization" grounds. In the past, it has been impossible to say with complete certainty what ratio of debt to equity was immune from Internal Revenue Service attack, since the cases in this area generally have considered thin capitalization as only one of a number of factors to be considered. However, a debt-equity ratio of five-to-one or even ten-to-one (exclusive of mortgages made by the partnership) probably was fairly safe, assuming the investment otherwise had the preponderant characteristics of debt.

This already cloudy area has been further beclouded, at least temporarily, by the Tax Reform Act of 1969, which, in adding section 385 to the Internal Revenue Code, gave broad authority to the Treasury Department to issue regulations setting forth factors which are to be taken into account in determining whether debt or stock is present. Section 385 reads as follows:

Treatment of certain interests in corporations as stock or indebtedness.

(a) Authority to prescribe regulations.—The Secretary or his delegate is authorized

176. See text accompanying notes 191-95 infra.
178. Id. §§ 591-96.
179. Id. §§ 856-58.
180. Id. §§ 401(a), 501(a).
181. Id. § 163.
182. In Fin Hay Realty Co. v. United States, 398 F.2d 694, 696 (3d Cir. 1968), the court listed sixteen criteria for judging whether an investment is debt or equity.
to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness.

(b) Factors.—The regulations prescribed under this section shall set forth factors which are to be taken into account in determining with respect to a particular factual situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists. The factors so set forth in the regulations may include among other factors:

(1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest,

(2) whether there is subordination to or preference over any indebtedness of the corporation,

(3) the ratio of debt to equity of the corporation,

(4) whether there is convertibility into the stock of the corporation, and

(5) the relationship between holdings of stock in the corporation and holdings of the interest in question.184

Since the ratio of debt to equity is one of the factors specifically listed, presumably the regulations will lay down some guidelines in this area. One commentator has taken the rather Draconian view that the regulations should establish a two-to-one debt-equity ratio as the norm.185 Until the proposed regulations are issued, reliance on existing law would appear justified. While there is nothing in section 385 to prevent the regulations from being given retroactive effect, in the interests of fairness the regulations under section 385 should be given prospective effect only.186

The filing of a consolidated return by the institutional investor, if that course is open to it, can be used to nullify the tax disadvantage in utilizing a subsidiary in lieu of direct investment.187 The consolidated return approach is particularly important if the subsidiary has net operating losses which can be offset against the parent's income. In the early years of the subsidiary, this is quite likely to be the case because of the combined effect of accelerated depreciation (if used),188 high start-up expenses, and relatively low rental income. Even with the availability of a three-year carryback and a five-year carryover for net operating losses,189 the tax benefit of the loss deduction could be deferred or even lost entirely in the absence of a consolidation of returns.

Certain types of institutional investors, including life insurance com-

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187. See id. §§ 1501-05.
188. Id. § 167(b).
189. Id. § 172.
companies, real estate investment trusts, and qualified pension trusts, do not have the consolidated return approach available to them.\textsuperscript{190}

Where the subsidiary does have profits, the institutional investor parent, if a taxable entity, will wish to have profits remitted without payment of an additional income tax at its level. The filing of consolidated returns avoids the problem, since intercorporate dividends among the members of the affiliated group are not taxable.\textsuperscript{191} Even if consolidated returns are not filed, the intercorporate dividends normally will qualify for an eighty-five percent dividends received deduction which can be increased to a hundred percent deduction at the election of the parent.\textsuperscript{192} Generally, the only significant price for making the hundred percent election is the foregoing of multiple surtax exemptions,\textsuperscript{193} which are of short-lived value.\textsuperscript{194} Profits which have not been remitted as dividends ordinarily can be recovered by the parent at some time in the future by means of a tax-free liquidation.\textsuperscript{195}

The life insurance company institutional investor, because of its unique tax treatment under the Code,\textsuperscript{196} finds that the use of a real estate subsidiary presents additional problems which other institutional investors do not have. As noted above, the consolidated return approach is not open to the life insurance company, so that net operating losses of the subsidiary cannot be used to offset the parent's income.

Also, where the subsidiary has profits which are taxed and then remitted to the parent as dividends, even with the election of the hundred percent dividends received deduction, there normally will be an effect on the tax incurred by the life insurance company parent. This result occurs because all investment income (including tax-exempt income) is taken into account in a complex statutory formula which determines what portion of the investment income is deemed needed to satisfy obligations to policyholders ("policyholders' share") and is therefore non-taxable, and what portion is free investment income ("company's share") subject to tax.\textsuperscript{197} Briefly, the higher the portfolio rate of return, the greater the policyholders' share. Accordingly, if the tax-free dividends on the subsidiary's stock are at a lower rate than the general portfolio rate, they

\textsuperscript{190} Id. § 1504(b).
\textsuperscript{192} Int. Rev. Code of 1954, § 243.
\textsuperscript{193} Id. § 243(b)(3)(C)(v).
\textsuperscript{194} See note 175 supra.
\textsuperscript{195} Int. Rev. Code of 1954, § 332.
\textsuperscript{196} Id. §§ 801-20.
will depress the overall rate and therefore increase the company's share of investment income. Conversely, if they are at a higher rate than the rate on the balance of the portfolio, the company's share of investment will be decreased.

A further complication arises from the fact that the amount of the life insurance company's assets is a component of the statutory formula and that stocks (and real property) are valued at fair market value for this purpose whereas all other property is valued at adjusted basis. Generally the larger the amount of assets, the higher the company's tax. Since a partnership interest is personal property, it is valued at adjusted basis if held by the insurer directly. However, if the interest is held by a subsidiary, presumably the fair market value of the partnership interest (which may be greater or less than its adjusted basis) will be reflected in the value of the subsidiary's stock. The requirement that the subsidiary's stock be valued at fair market value also raises the possibility that the Internal Revenue Service will not accept whatever valuation of the subsidiary's stock the life insurer uses.

Use of a real estate subsidiary by the institutional investor also has a potential for trouble under section 482 of the Code, which gives the Internal Revenue Service broad power to allocate income, deductions, and the like between two corporations owned or controlled by the same interests. Since the investment personnel of the parent institutional investor normally can be expected to render services for the real estate subsidiary as well, it is important that adequate records be kept of the time spent on subsidiary matters, and that transactions between parent and subsidiary be maintained on an arm's length basis to the extent feasible.

Despite the numerous tax problems and lack of countervailing tax benefits which use of a subsidiary may entail, other business reasons have resulted in the widespread use of subsidiaries by institutional investors.

2. Non-tax Considerations

There are several non-tax considerations that may cause the institutional investor to organize a real estate subsidiary or subsidiaries for equity investments.

First, there are the risks imposed by the general liability feature of a partnership and the ability of one partner to bind the other. As a real estate subsidiary's assets increase and the number of joint ventures multiply, the assets of the subsidiary exposed to liability increase and the

200. See part IV C infra.
protection afforded by the use of a corporate subsidiary decreases. Thus real limited liability, such as that of a limited partner or stockholder, can be achieved in the subsidiary approach only by creating a separate corporate subsidiary for each joint venture. The use of any number of subsidiaries, however, is difficult from a logistic point of view\textsuperscript{201} and may increase the risk of attack on the corporate entity (as discussed below). Even when the institution has only one subsidiary for equity investment, and even when this subsidiary has become a substantial corporation in its own right, institutional investment officers still feel more secure knowing that most of the depositors' or policyholders' money is safe from significant liabilities, however remote.

Second, real estate equity interests have not been a traditional subject for investment by institutions, which still consider such joint ventures somewhat outside their lifestyle and prefer to retain at least a measure of anonymity. There is a justifiable feeling that the association of the large institutional investor's name with a piece of property encourages litigious plaintiffs, produces higher costs, and sometimes causes involuntary involvement in day-to-day operations. There is a fear that even if the action of the partner-developer does not create liability, the institution might be put in a position where its name or reputation could suffer due to acts over which it has no control.

Third, where the institution has become wed to the limited partnership approach, it can make its equity investment through a subsidiary as limited partner without running afoul of the ULPA proscription against a limited partner's taking or holding security.\textsuperscript{202} The control problem would not be resolved\textsuperscript{203} however, making the subsidiary-limited partnership approach advantageous only where the institution wishes to protect the assets of a substantial subsidiary.

Fourth, the institution's mortgage would be protected against subordination to partnership creditors under section 40 of the UPA.

All the desired results of the use of a subsidiary are contingent on the courts respecting the corporate separateness of the subsidiary. The general rule that a corporation is an entity separate and apart from its stockholders and that the stockholders are not liable for the debts of the corporation\textsuperscript{204} is, of course, clear. However, in several areas courts have occasionally "pierced the corporate veil."

\textsuperscript{201} For example, Board of Directors' meetings must be held, books must be kept, tax returns filed etc. This can become extremely expensive and time consuming as the number of subsidiaries grow.

\textsuperscript{202} See part II B 2 supra.

\textsuperscript{203} Id.

\textsuperscript{204} See generally N. Lattin, Corporations, ch. 2 (1959); Berle, The Theory of Enterprise Entity, 47 Colum. L. Rev. 343 (1947).
Generally, disregard of the corporate entity has occurred in situations where the corporation was severely undercapitalized and the creditors were not aware of it; where the shareholders held themselves out as being obligated for the corporate debts; where there was a commingling of assets and a failure to operate the corporation as a corporation, resulting in a general disregard of the corporate entity by the shareholders, directors and officers; when the corporation is a "mere instrumentality" of its parent and the recognition of the corporate entity would work a fraud or injustice; and in other areas where the court found that public policy or considerations of fraud should preclude recognition of the corporate entity.

The danger to the institution would apparently occur if a court were to hold it liable for the debts of the subsidiary, or hold that the subsidiary's debts to the institution were subordinate to the rights of creditors of the subsidiary, either because (i) the subsidiary was undercapitalized; (ii) the corporate entity was disregarded by the institution; or (iii) the subsidiary was a "mere instrumentality" of the parent.

As to undercapitalization, the test is not the total amount of capital but whether the capital is reasonably adequate to meet the corporation's prospective liabilities. The danger would seem to be greatest when the corporation is formed, since the capital in the subsidiary generally will grow as the value of its assets increase, especially where one or just a few subsidiaries are used for many equity investments. In any case, if the capital of the subsidiary bears a reasonable relation to its expected debts, as would normally be the case in the institutional subsidiary situation, it would seem that there should be little ground for disregarding the corporate entity on the basis of under-capitalization.

If the institution is careful about maintaining the distinction between parent and subsidiary, there should be no piercing of the veil on that


206. See Weisser v. Mursam Shoe Corp., 127 F.2d 344 (2d Cir. 1942).

207. Compare Sisco-Hamilton Co. v. Lennon, 240 F.2d 68 (7th Cir. 1957), with Berkey v. Third Ave. Ry., 244 N.Y. 84, 155 N.E. 58 (1926).

208. See generally 1 W. Fletcher, Cyclopedia of Corporations § 41.1 (rev. ed. 1963).

209. See United States v. Milwaukee Refrig. Transit Co., 142 F. 247, 255 (C.C.E.D. Wis. 1905), where the court said: "[A] corporation will be looked upon as a legal entity as a general rule, and until sufficient reason to the contrary appears; but when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud or defend crime, the law will regard the corporation as an association of persons."


account. As to the subsidiary being a "mere instrumentality" of the parent, this basis for piercing the corporate veil seems to have been applied in the situation where the parent has manipulated the subsidiary for its own purposes in a manner which would work a fraud or injustice upon creditors, and normally should not create a problem in the institutional equity subsidiary situation.

Nevertheless, the institution should take every precaution to avoid any of the danger areas associated with piercing the corporate veil, for the failure to do this could have serious consequences.

III. THE COMMITMENT

A joint venture usually begins with a commitment given by a lending institution or its mortgage banking correspondent to a developer. This beginning may be a fleeting provision in the mortgage commitment providing for a joint venture, or there may be a separate formal agreement to create and invest in a joint venture, with the terms of the partnership agreement annexed to or forming a part of the agreement.

A. Mortgage Commitment Provision

Traditionally, commitments, and especially mortgage commitments, are "bankable," i.e., banking institutions will lend construction money in reliance on them, considering themselves thereby reasonably assured of a take-out. This is not to say the commitment must be unconditional. Regulated by federal statutes, national banks may make loans having maturities of no more than thirty-six months to finance the construction of industrial or commercial buildings, where there is a valid and binding agreement entered into by a financially responsible lender to advance the full amount of the bank's loan upon completion of the buildings. The statute does not define the meaning of "valid and binding."

Certainly, standard mortgage commitments are conditioned upon completion of the premises satisfactory title, solvency of the borrower, and perhaps acquisition of certain permits and certificates—all of which

212. In Taylor v. Standard Gas & Elec. Co., 306 U.S. 307, 322 (1939), the Court stated that the instrumentality rule "is not, properly speaking, a rule, but a convenient way of designating the application in particular circumstances of the broader equitable principle that the doctrine of corporate entity, recognized generally and for most purposes, will not be regarded when so to do would work fraud or injustice." Professor Ballantine explained: "The term 'instrumentality' is a word of too uncertain meaning to express any legal test. All corporations are used as business instrumentality.

must usually be met by a date certain. In some events, a bank or its subsidiary could take over and proceed to eliminate the failure of performance. However, a broad condition to mortgage disbursement that the developer and the lending institution have entered into a joint venture agreement, in form and substance satisfactory to the lending institution, is generally too uncertain for a construction lender. Attaching the form of joint venture agreement helps. Also, spelling out the conditions for entering into the joint venture by the institutional lender, making them similar to the conditions for making the mortgage loan, is helpful. The conditions for entering into the venture cannot, however, be entirely met by the performance of the conditions required for making the mortgage loan. Title matters such as junior liens and certain conditions not affecting the lien but imposing civil or criminal sanctions on an owner are examples.\textsuperscript{214}

**B. Separate Commitment**

Many banks making a construction loan prefer elimination from the mortgage commitment of all reference to a joint venture and, for various reasons, the institutional lender may agree. In that event, there will be a separate contract or commitment for a joint venture. Usually the construction lender need not rely on the separate agreement, because the proceeds of the permanent loan will be sufficient to pay off his construction loan. If the loan is insufficient, greater certainty in the contract or commitment, including the form of joint venture agreement, would give better bankability.

On the other hand, in separating the loan commitment from the joint venture agreement, the lending institution has perhaps helped solve one problem while creating another. If the joint venture is not a condition to the making or purchasing of the permanent mortgage loan, can the institution be assured of obtaining the joint venture interest? Most joint ventures are partnerships in form, and thus the interest to be acquired constitutes personal property. According to the general rule, there is no specific performance of an agreement to enter into a partnership,\textsuperscript{215} although in special circumstances some courts have enforced such an agreement.\textsuperscript{216}

\textsuperscript{214} The equity commitment will often contain a condition that there are no liens on the property. While the mortgagee’s interest is unaffected by liens junior to the mortgage, the owner is still subject to them. Similarly, the institution as owner is concerned about building code violations imposing liability on the owner, though as mortgagee it may not be liable.


\textsuperscript{216} For example, in Snodgrass v. Stubbs, 54 A.2d 338 (Md. Ct. App. 1947), after
A possible solution to this problem is to have the mortgage commitment provide that the loan shall be callable if a joint venture is not entered into within a stated period after the institution acquires the mortgage investment. If such a provision were of sufficient certainty, reasonableness and clarity, it should be enforceable.\(^{217}\)

If the interest to be acquired is that of tenant in common, and if all the usual standards of completeness of contract are met, there seems to be no reason why an agreement with the developer should not be specifically enforceable.\(^{218}\)

Of course, the breach of an agreement to enter into or convey an interest in a partnership should constitute grounds for a damage action.\(^{219}\) In addition to recovering actual losses incurred,\(^{220}\) prospective profits might be recovered if they can be ascertained and are not speculative.\(^{221}\) Properly performing his part of the agreement, the plaintiff was granted specific performance and the court ordered that his interest in the real and personal property of the business be conveyed to him. Additionally, in Jones v. Styles, 268 Ala. 595, 109 So. 2d 713 (1959), the court, in overruling a demurer to the complaint, held that it could order "the execution of partnership articles" to form a partnership for an existing insurance business "if necessary to invest a partner with the legal rights for which he had entered into the partnership, although after the articles are executed, the parties cannot be compelled to act under them." Id. at 597-98, 109 So. 2d at 715. See also Whittworth v. Harris, 40 Miss. 483 (1866); Favero v. Wynacht, 371 P.2d 858 (Mont. 1962); 81 C.J.S. Specific Performance §§ 15, 81 (1953).

217. See Hasbrouck v. Van Winkle, 261 App. Div. 679, 27 N.Y.S.2d 72 (3d Dep't 1941), aff'd, 289 N.Y. 595, 43 N.E.2d 723 (1942), where the mortgagee's covenants to build a house on certain property within ten years (and in default thereof, to pay the mortgagee $1,000) were enforceable. The court held that the mortgagee could foreclose upon breach of those covenants. It would seem to follow that covenants to enter into a joint venture within a specified time or, in default thereof, to pay the entire debt, should be enforceable at the mortgagee's option—especially since the debt is supported by independent consideration. Cf. Mills Land Corp. v. Halstead, 184 Misc. 679, 56 N.Y.S. 682 (Sup. Ct. 1945), where the court said that "[a] foreclosure may be based upon the 'non-performance of any act' required by the mortgage." See also 1 C. Wiltsie, A Treatise on the Law and Practice of Real Property Mortgage Foreclosure § 64, at 126 (5th ed. 1939), stating that a "mortgage may provide for foreclosure for the whole debt or for maturity of the whole indebtedness upon the breach of any condition or of a single covenant or condition."

For the validity of acceleration clauses generally, see 1 G. Glenn, Mortgages § 51 (1943); 9 G. Thompson, Real Property § 4744 (1958).


221. Ramsay v. Meade, 37 Colo. 465, 86 P. 1018 (1906); Webster v. Beau, 77 Wash.
spective profits, however, often cannot be proved or are not allowed. In this situation, the measure of damages should be the excess in value of the thing to be conveyed (partnership interest) over the price.222 Just what evidence would determine this is unclear.

C. Usury Considerations

The absence of a requirement for a joint venture in the mortgage commitment, or the absence of any provision making the loan callable unless the institution obtains an interest in the joint venture, helps to solve another problem: usury.

The typical joint venture interest obtained by an institutional investor at the time of making a mortgage loan is purchased for what the parties deem a fair price, determined according to prospects at the time of contracting. Nevertheless, unless the transaction is exempt under local law by reason of corporate, large loan or business purpose exclusions, a usury problem may exist. Anything of value obtained by a lender in connection with the making of a loan, either directly or through a subsidiary, may be considered interest. In one case, the lender received manure from a mortgaged hotel, in addition to interest at seven percent. The manure was held to be interest, making the loan usurious.223 Accordingly, if the joint venture interest is a condition of making the mortgage loan and is worth more than is paid for it, it can be argued that this additional value is consideration for the mortgage loan. Fortunately, most states224 (including New York,225 but apparently not Texas225) permit any additional consideration received to be spread over the life of the loan, as variously


224. “[T]he general rule [is] that in testing a contract for usury ‘the entire period of the loan must be taken into consideration.’” Hershman, Usury and “New Look” in Real Estate Financing, 4 Real Prop. Probate & Trust J. 315, 316 (1969) (footnote omitted).


226. There are no cases construing the present corporate usury statute, which limits interest to 1½ percent per month. Tex. Rev. Civ. Stat. Ann. art. 1302-2.09 (Supp. 1970). However, when the statutory limit was 10 percent per annum, a line of cases held that interest charges could not be spread over the term of the loan. Shropshire v. Commerce Farm Credit Co., 120 Tex. 400, 30 S.W.2d 282 (1930), motion for rehearing overruled, 39 S.W.2d 11 (Tex.), cert. denied, 284 U.S. 675 (1931); Commerce Trust Co. v. Ramp, 138 S.W.2d 531 (Tex. Comm'n App. 1940).
defined. Thus, for example, for a loan of $1,000,000 for ten years at eight percent interest in a state with a ten percent usury limit, the usual rule, absent amortization, would be that a $200,000 bonus in the form of a joint venture interest, if not in cash, would not create usury. Amortization, prepayment, or calling privileges, if exercised, could reduce the permissible additional consideration. Assuming in this example that a joint venture interest was acquired for $100,000, usury would not normally be a problem unless the joint venture interest (1) was required, expressly or impliedly, as a condition to making a loan; and (2) was worth in excess of $300,000, reflecting a gross undervaluation.

If the joint venture is freely entered into and not required in the mortgage commitment, and if the developer is free to sell the interest to others after he obtains his mortgage commitment or even his loan, it is difficult to find that a deficiency in the sales price for the venture interest would constitute a bonus for making the loan, and thus usury. However, a gross undervaluation of the venture interest (e.g., the sale of a $100,000 interest for $100) might shock a court into finding some element of

227. In Manchester Realty Co. v. Kanehl, 130 Conn. 552, 36 A.2d 114 (1944), Chief Justice Maltbie multiplied the highest legal interest rate (12 percent per annum) by the loan amount actually advanced, and further multiplied this by the term of the loan, thereby finding the maximum the lender could charge. Apparently, the lender could receive up to this amount at any time under any plan of payment. In Green Ridge Corp. v. South Jersey Mortgage Co., 211 So. 2d 70 (Fla. Dist. Ct. App.), cert. denied, 219 So. 2d 702 (Fla. 1968), the court held that interest and bonuses should be apportioned “over the period commencing with the date of closing and ending with either the date of the [foreclosure] decree or the original maturity date, whichever is prior in time.” 211 So. 2d at 72. As the court stated: “The test of usury followed in Florida is not based upon the contingencies inherent in a transaction, but upon what actually develops.” Id. at 71. This rule has now been changed by statute so that charges are spread over the stated term of the loan. Law of July 2, 1970, ch. 70-331, § 1, [1970] Fla. Laws Extraord. Sess. 969. See also Pennsylvania Mut. Life Ins. Co. v. Orr, 217 Iowa 1022, 252 N.W. 745 (1934); 91 C.J.S. Usury § 42 (1955).

228. With the usury rate of 10 percent per annum, over the term of the loan as much as $1,000,000 in interest could be charged (10 percent of the loan of $1,000,000, multiplied by the term of 10 years). Thus, over the term, interest at 8 percent ($800,000) plus a $200,000 bonus is allowable.

229. The difference between the fair value (over $300,000) and the price paid ($100,000) is considered additional interest (over $200,000) charged for making the loan. This additional interest, when added to the eight percent (or $800,000 over the term), exceeds the amount allowed ($1,000,000).

230. In Memorial Gardens of Wasatch, Inc. v. Everett Vinson & Associates, 264 F.2d 282 (10th Cir. 1959), under a reversed fact pattern, the borrower alleged that the loan to him was usurious because of the simultaneous land purchase agreement. The court found no usury, holding that the parties intended a land purchase transaction rather than a loan. “The loan was incidental to the sale. In fact, there was no firm agreement to borrow or to loan any sum. [The borrower] was free to arrange for development capital in any way he wished.” Id. at 285.
fraud, coercion, or illegal side agreement, constituting the $99,900 a bonus and hence interest.

If the joint venture is not a condition to the loan, however, the developer may elect not to offer an equity interest to the lender because a third party makes a more attractive offer. If the venture is considered essential by the lender, it might make the venture a requirement of the mortgage, with documentation that will satisfy the construction lender, and take other steps to avoid usury. This is not always a great problem. If the price is fair (as documented by appraisals), if the loan interest rate is sufficiently less than the usury rate, and if the loan amount is far greater than the joint venture contribution (as it usually is), there is a large margin for error. With presumptions against usury, the risk can be minimal, but as the difference between the loan rate and usury rate narrows, the risk increases. The danger is not that a bonus truly exists, but that years later, when the development becomes a great financial success, a judge or jury trying the facts might apply hindsight and find a far higher value for the equity interest than that originally agreed to by the parties. The fact that the mortgage financing gives the equity investment the benefit of leverage can help lead to this result.

In some instances, lenders have sought to be sure of acquiring the desired equity interest by obtaining, at the time of giving a land loan commitment or permanent loan commitment, an option to buy a part interest in the developer's land at a favorable price. By separate agreement, the institution agrees not to exercise its option if a satisfactory joint venture is entered into. This technique has been used to make a joint venture commitment practicable where there was insufficient planning of land use, and consequently insufficient knowledge of the amounts involved. Unfortunately, this technique has several drawbacks.

The option, unlike a contract to enter into a joint venture, would seem to have some value—which might be considered additional interest. Moreover, at least one case has held that such an option is unenforceable as being merely further security for the debt.231

Finally, if the institution is permitted to determine whether it will enter the joint venture after the project has been completed and its value demonstrated, the excess of the value over purchase price may be ordinary taxable income to the institution—a fee paid for making the loan.232

D. Title Insurance

Mortgagees customarily require that title insurance be provided by the borrower in mortgage transactions, or by the seller in sale-leaseback

transactions. Joint ventures create a new problem. Assume a $10,000,000 mortgage on property worth $11,000,000, and the acquisition of fifty percent of the equity for $500,000. There normally would be a $10 million mortgagee policy and an $11 million owner's policy. Also, the latter would normally run to the partnership, where title is held in the partnership name. Two problems result.

(1) Notwithstanding reduced rates for simultaneously ordered insurance, developers resent paying all or even half of its cost. The institution, however, is likely in its commitments to require both policies (i) in order to protect its equity investment, which will become more valuable over the years as a result of amortization payments on the mortgage; and (ii) because the standard form of title policy provides in effect that when the title company pays the institutional mortgagee, it is subrogated to the mortgagee's rights against the mortgagor, which is the institutional mortgagee or its wholly owned subsidiary. This difficulty could be alleviated if the title company could cause a separate owner's policy of $5,500,000 to be issued to the institution (not the partnership) or its subsidiary, limiting the title insurer's subrogation rights under the mortgagee policy to the developer's interest in the partnership. The policy would expressly state that despite the personal property exception in some title policies and the personal property nature of the institution's partnership interest, such interest is insured as though it were real property. However, thus far such insurance, with its conceptual

233. "10. Subrogation Upon Payment or Settlement. Whenever the Company shall have settled a claim under this policy, all right of subrogation shall vest in the Company unaffected by any act of the insured claimant .... The Company shall be subrogated to and be entitled to all rights and remedies which such insured claimant would have had against any person or property in respect to such claim had this policy not been issued, and if requested by the Company, such insured claimant shall transfer to the Company all rights and remedies which such insured claimant would have had against any person or property in respect to such claim had this policy not been issued, and if requested by the Company, such insured claimant shall transfer to the Company all rights and remedies necessary in order to perfect such right of subrogation and shall permit the Company to use the name of such insured claimant in any transaction or litigation involving such rights or remedies. If the payment does not cover the loss of such insured claimant, the Company shall be subrogated to such rights and remedies in the proportion which said payment bears to the amount of said loss, but such subrogation shall be in subordination to the insured mortgage." American Land Title Association Standard Loan Policy, Conditions and Stipulations, para. 10 (1970).

234. In the event of a title defect, the mortgagee's title policy will protect the institution's mortgage investment but not its equity investment, since the institution is in the position of lender rather than owner. If covenants of title are made, or if there is personal liability, the title company may be subrogated to the rights of the mortgagor, and may sue the institution or its subsidiary, qua owner, on its or their covenants.

235. See, e.g., New York Board of Title Underwriters, Title Insurance Policy (Form 100E, rev. eff. 7/1/69), in which Schedule B(7) excludes "[t]itle to any personal property, whether the same be attached to or used in connection with said premises or otherwise."
difficulties, has not been generally available. Even if a title company could issue such a policy—covering by its terms the aforesaid problems raised by subrogation provisions and the personal property nature of partnership interests—appropriate provisions in the partnership or venture agreement would also be required. It should be made clear that the institutional partner is entitled to recover the entire proceeds of the insurance, and that the exercise of subrogation rights by a title insurer against the developer's interest creates no right in the developer against the institution or its interest.

(2) In a policy to a partnership, knowledge of either partner may be attributed to the insured partnership. The standard form of title policy normally provides that the title insurer is not responsible for title defects known to the insured but not on the record and unknown to the title company. Thus, if a separate policy cannot be issued to the institution and the partnership is the insured, the developer's knowledge of the defect may preclude recovery under the policy. Title insurers have thus far been unwilling, and in some states may be unable, to issue nonimputation insurance. Thus, if the partnership is to hold title to the real property, imputation is the risk the institutional investor may have to take.

In considering the problems of title insurance, title to the real estate held by the venturers as tenants in common may be preferred to title held by the partnership. As a tenant in common, the institution can obtain its own policy covering its own undivided interest, without any fear of imputation of the developer's knowledge.

IV. OPERATION OF THE PROPERTY: THE "JOINT VENTURE" AGREEMENT

When the terms of the commitment have been complied with, the institution or its subsidiary becomes obligated to make its equity contribution—normally under a joint venture agreement, the terms of which were agreed to at the time the commitment was executed. Often the joint

236. The American Land Title Association Standard Loan Policy, 1970 form, expressly excludes from its coverage: "3. Defects, liens, encumbrances, adverse claims, or other matters (a) created, suffered, assumed or agreed to by the insured claimant; (b) not known to the Company and not shown by the public records but known to the insured claimant either at Date of Policy or at the date such claimant acquired an estate or interest insured by this policy or acquired the insured mortgage and not disclosed in writing by the Insured claimant to the Company prior to the date such insured claimant became an insured hereunder . . . ." Id., Schedule of Exclusions from Coverage (TO 1691 PNTI (S-70)).

237. In some states, the forms of title policies are fixed by statute and cannot be readily changed. See Tex. Ins. Code Ann. art. 9.07 (1963).

238. See part III B supra.
venture agreement is attached to the commitment as an exhibit. Its negoti-ation is usually extremely difficult and consumes a great deal of time, probably because both parties realize that the project's ultimate success and the safety of the investment may hinge on the outcome of these negoti-uations.239

A. Title to the Real Estate

Prior to the adoption of the UPA, a partnership, being a collection of individuals, could not ordinarily hold title to real property.240 On this point, however, the entity aspects of the UPA became predominant, and section 8(3) of that Act permits title to real estate to be held in the name of the partnership. In states that have not adopted the UPA, the real property must be owned directly by the partners, normally as tenants in common. This technique may also be employed where the UPA is in effect, if it should be considered desirable.

A tenancy in common is, of course, a method of co-ownership of property under which each of the owners has an undivided interest in the entire property.241 Either owner may convey, mortgage, or otherwise transfer his interest to third parties, unless precluded by restrictions in his deed or by agreement with his tenant in common. Upon the death of a tenant in common, his undivided interest will normally pass to his heirs or devisees.242 Absent an enforceable agreement to the contrary, the tenants normally have a right to "partition" (i.e., ask a court to divide) the property, and where an equitable division in kind is unfeasible, the court will normally sell the property and divide the proceeds between the parties in accordance with their respective undivided interests.243 Either party may be a purchaser at such sale.244 The partition procedure is not

239. No attempt is being made to cover all the provisions which may be found in a typical real estate joint venture agreement. Only basic problems and provisions that have caused the most difficulty in negotiations are discussed. Among other things, the compensation (if any) and the duties of the manager should also be spelled out in some detail; the agreement should contain minimum requirements for insurance, including workmen's compensation, comprehensive general liability, all risk builder's, crime, and other such insurance as may be required by the institutional investor; provisions should be written covering accounting and distributions, including requirements for periodic audits by independent certified public accountants; and, where appropriate, there should be inserted provisions giving the institution a preferential right to purchase an interest in surrounding land if such land is acquired by the developer.

240. See F. Mechem, supra note 71, § 153.


242. Id. § 6.10.

243. Id. §§ 6.21, 6.26.

244. See 68 C.J.S. Partition § 184(a) (1950).
disadvantageous to the institutional lender, since presumably the institutional lender will always be in a position to protect its interest on a sale of the property.245

If a tenancy in common is employed, an agreement will be executed providing for the operation and maintenance of the property. The parties will generally have the same authority and powers with respect to such operation as they would in a partnership that has title to the real property. Whether the operating agreement between tenants in common makes the parties partners for the operation of the property will, as discussed above,246 depend on what the agreement says. It would seem that in most cases, if the institutional lender has the controls it normally wishes to have, the agreement will probably create the legal relationship of partners.247

Where title to the real estate is held in the name of the partnership, the partners would each have an interest in the partnership248 which is an interest in personal property.249 Additionally, a partner has certain limited rights in specific partnership property, known as his tenancy in partnership,250 and a "property" right to participate in management.251 Where the partnership assets are interests in real property, the partner's aggregate rights, at least in New York, have been determined to be equivalent to an interest in real estate for the purposes of sections of the law regulating institutional investments, which permit acquisition of real property.252

B. Control and Management; Remedies on Default

1. Control and Management

Once the decision has been made to utilize a general partnership vehicle, the attorney drafting the partnership agreement is faced with a conflict in objectives. The institutional investor, to protect its investment and guard against possible liabilities, desires to exercise control over the

245. Special tax considerations relating to tenants in common as distinguished from partners are discussed in part IV D infra.
246. See part II A 2 supra.
247. Id.
248. U.P.A. § 24(2).
249. Id. § 26.
250. Id. §§ 24(1), 25(1).
251. Id. §§ 18(e), 24(3).
252. For example, the New York Insurance Department, in a letter to an Insurer, stated: "This is to advise you that an investment in an interest in a partnership, joint venture or trust, where the partnership, joint venture or trustee is the record holder of real property or an interest therein, constitutes an investment in real property or an interest thereunder under Section 81(7) (h) [of the New York Insurance Law] . . . ."
operation of the partnership. Between the desire and the exercise, however, falls the shadow, inasmuch as the institutional lender normally has neither the facilities, personnel, time nor expertise to handle the day-to-day operation of the property. Once an investment has been made, the personnel of the institutional lender will normally become involved in the negotiations of other investments, and with each new investment the overall "housekeeping" required of existing investments becomes that much greater. It is nevertheless clear that the institution must be prepared to do more than was required when its main "housekeeping" function involved the mortgagor's monthly payments of interest and principal.

A typical agreement compromising between detailed involvement in day-to-day operations and abdication of all control functions might require the consent of both partners for all "major decisions." "Major decisions" could be defined to include, inter alia, sale, mortgaging, approval of the annual budget, and initiation of new construction programs.


254. A provision on major decisions might provide, inter alia:

"No act shall be taken, sum expended, decision made or obligation incurred by the Venture, Manager, or any Venturer with respect to a matter within the scope of any of the major decisions (hereinafter called "Major Decisions") as enumerated below, unless such of the Major Decisions have been Approved by the Venturers [this phrase normally means approval of all the partners]. The Major Decisions shall include:

"(1) Acquisition of any land or interest therein;

"(2) Financing of the Venture, including but not limited to the financing of the acquisition of the Property, interim and permanent financing of the Improvements and financing operations of the Venture;

"(3) Sale, or other transfer, or mortgaging or the placing or suffering of any other encumbrance on any of the Property or the Improvements or any part or parts thereof;

"(4) Lease or other arrangement involving space in any Improvements if such lease or other arrangement . . . ;

"(5) Terminating or modifying any lease of other arrangement involving space in any of the Improvements . . . ;

"(6) Construction of any Improvements or the making of any Capital Improvements, repairs, alterations or changes . . . ;

"(7) Selecting or varying depreciation and accounting methods, changing the fiscal year of the Venture and making other decisions with respect to treatment of various transactions for bookkeeping or tax purposes, consistent with the other provisions of this Agreement;

"(8) Approval of all construction and architectural contracts and all architectural plans, specifications and drawings prior to the construction of any improvements contemplated thereby;

"(9) Varying or changing any portion of the insurance program required by Company in accordance with Article III hereof;

"(10) Determining whether or not distributions should be made to the Venturers, except as set forth in Section hereof;

"(11) Approving each Budget pursuant to Section hereof;

"(12) Making any expenditure or incurring any obligation by or of the Venture in-
Under this type of arrangement, the partnership can work successfully as long as both partners are in agreement. When they disagree, a method is provided—a buy-sell agreement or right of first refusal—to end the relationship.\textsuperscript{255}

The day-to-day management of the property is then entrusted to a “manager” (often the developer), who is responsible for its operation, but who frequently is permitted to employ a managing agent to do the work. The manager may expend money within the approved budget allocations, and he is normally given a certain amount of discretion beyond authorized budget expenses. He must bring all other expenses and all matters within the area of major decisions to the partners for their determination.

When one of the partners is the manager, and even when a third party is the manager, self-dealing can be a major problem. If the gardening, management, rent collection, repairs, guard service, etc. can be delegated at exorbitant fees to corporations owned or controlled by the manager, even the most successful property may have little profit left for distribution to the partners. If the self-dealing managing agent is a partner, such self-dealing would appear to be in violation of the partner's fiduciary duties to his co-partner,\textsuperscript{256} and a default under the agreement. Where the self-dealing managing agent is not a partner, the overreaching by the

\footnotesize{volving a sum in excess of $\ldots$ for any transaction or group of similar transactions except for expenditures made and obligations incurred pursuant to and specifically set forth in a Budget theretofore Approved by the Venturers; making any expenditure or incurring any obligation which when added to any other expenditure for the Fiscal Year of the Venture exceeds the Budget by \%; or making any expenditure or incurring any obligation which falls into any category or categories of expenditures which in the opinion of Company and its counsel is required by law to have the prior approval of Company or Its Board of Directors;

“(13) Determination of the maximum and minimum working capital requirements of the Venture; or

“(14) Any other decision or action which by any provision of this Agreement is required to be Approved by the Venturers or which materially affects the Venture or the assets or operations thereof.”

255. See discussion of the buy-sell arrangement in part IV E infra.

256. See U.P.A. § 21(1), which makes a partner accountable to the partnership as a fiduciary for “any profits derived by him without the consent of the other partners from any transaction connected with the formation, conduct, or liquidation of the partnership or from any use by him of its property.” See Meinhard v. Salmon, 249 N.Y. 458, 164 N.E. 545 (1928). In this connection, where appropriate the agreement should make it clear that the partners may enter into other real estate transactions without accountability to their partners. Such a clause might provide:

“Nothing in this agreement shall be deemed to restrict in any way the freedom of any party hereto to conduct any other business or activity whatsoever (including the acquisition, development and exploitation of real property) without any accountability to the venture or any party hereto, even if such business or activity competes with the business of the venture.”}
manager can nevertheless amount to a breach of the manager's duty of loyalty to the partnership,257 for which an action would be available.258 However, problems of proof in the area of self-dealing make it advisable that protection also come from the language of the agreement itself and from careful supervision.

It would probably be unacceptable to any developer-manager to have the agreement prohibit his dealing with companies he owns or controls. Such dealings may in fact be a benefit to the project, since the manager would be more familiar with the work of related organizations and probably would have greater control over and confidence in these firms. The problem can be avoided by a simple provision that the manager shall not enter into agreements for goods or services with any related party unless the contract is approved by all the partners.259 Then reasonable contracts can be approved by the institution, and unreasonable ones rejected.

As an alternative, the agreement might provide that the cost of all services and supplies shall not exceed what is reasonable for the area where the property is located. Admittedly, this is a rather indefinite standard. A proven violation of the requirement, however, might subject the manager to certain liabilities for damages, and this should serve as an inhibition on overreaching. As an additional precaution, it may be advisable to require that the manager periodically furnish to the partners a list of related corporations with whom the partnership is dealing. These precautions, however, may in themselves be insufficient, since what is "reasonable" may be the rates set by local organizations based upon routine small

258. Id. §§ 399–409.
259. A "related parties" clause might provide, inter alia:
"The Manager or any Venturer shall not enter into any contract, agreement, lease, or other arrangement for the furnishing to or by the Venture of goods, services or space with any party or entity related to or affiliated with the Manager or any Venturer or with respect to which the Manager or any Venturer has any direct or indirect ownership or control unless such contract, agreement, or arrangement has been approved by the Venturers. By way of illustration and not as a limitation on the scope of the phrase 'related or affiliated with', for the purposes of this section, the following shall be considered related to or affiliated with the Manager or any Venturer:
1. Any corporation, partnership, association or other entity (hereinafter in this Section referred to as 'Entity') owned in whole or in part by the Manager or any Venturer;
2. Any holder of more than ten (10) percent of the issued and outstanding shares of, or any holder of more than a 10% interest in the Manager, any Venturer, or any Entity owned in part by the Manager or any Venturer;
3. Any Entity in which any officer, director, employee, partner or shareholder (or member of the family of any such officer, director, employee, partner or shareholder) of the Manager, any Venturer or any Entity owned in whole or in part by the Manager or any Venturer, has a direct or indirect interest or relationship, which interest or relationship includes, but is not limited to, a partner, employee, agent or stockholder interest or relationship."
transactions. Such rates may be appropriate for small transactions but often they are excessive in larger ones—where rates are frequently negotiated downward. Thus, the institutional lender might be advised to attempt to negotiate the provision giving it the right to approve contracts.

Control over who will serve as manager or managing agent is often considered by institutional investors important to the protection of their investment. Such control can protect the institution not only where a suspected overreaching is difficult to prove, but also during the hiatus between the time major disagreement between the partners arises and the actual disposition of the property.\(^\text{260}\)

A typical agreement which contains such protection might state that the institution consents to the developer serving as manager or managing agent, but that the institution may at any time withdraw its consent. To do this, it will furnish the developer with a list of three managing agents experienced in managing property of the type owned by the partnership in the area where the property is located, from which list the developer may select a replacement manager or managing agent.

Some developers argue that the right to change managers or managing agents should be limited to what might be termed discharges for cause. This, of course, raises problems and delays associated with proving cause, problems which the provision is supposedly inserted to avoid. Other developers desire an equal right to furnish such a list to the institution, and to require discharge of any replacement manager or managing agent. Such a provision has been negotiated into the agreement on occasion, but misuse of these rights could create "turnstile management" to the disadvantage of all parties. The provision has offended some developers—one of whom dubbed it the "Huey, Louie and Dewey" clause because of the suggestion that the institution furnish the names of three managing agents. Nevertheless, many developers have made it clear that they have no objection to the clause. Their stated reasons are (1) their confidence that the job they will do as manager or managing agent will be more than satisfactory to their institutional partner; (2) their certainty that if one partner is dissatisfied with management, the partnership would not work and thus management should be placed in the hands of a third party; and (3) their belief that because of the potential costs involved in obtaining outside management, the institutional partner will not exercise its rights frivolously.

2. Remedies on Default

On default by one of the parties, there are normally several courses of action open to the nondefaulting party.\(^\text{261}\)

\(^{260}\) See part IV E infra.
\(^{261}\) Some agreements will provide for arbitration of disputes under the agreement, or
First, he may invoke any of the terms of the partnership agreement providing for a termination of the partnership. This usually is in the form of the "buy-sell" agreement,262 a right which is normally made available to either party with or without default. In proper cases, he might obtain immediate injunctive relief against a defaulting partner to prevent or stop acts which violate the agreement or are prejudicial to the rights of the other parties.263

Second, if the default constitutes a breach of a partner's duty to the partnership, it may be possible for the nondefaulting partner to bring an action for an accounting under section 22(d) of the UPA. Prior to the UPA, an accounting would normally occur in connection with dissolution of the partnership.264 Under the UPA this is still generally the rule, but section 22 of the UPA now provides, inter alia, that a partner is entitled to an accounting when the "circumstances render it just and reasonable."265 It is in the course of the accounting that adjustment will be made to make the nondefaulting partner whole. Thus, if the developer defaults in providing services to the partnership as manager, it may be that damages can be recovered after an accounting without dissolution.266 Of course, any party may force a dissolution of the partnership pursuant to or in contravention of the partnership agreement.

Third, if the default constitutes a breach of an obligation or duty of one partner to another, as distinct from an obligation of one partner to the partnership, the nondefaulting partner may bring an action directly against the defaulting partner for damages or, where appropriate, restitution or specific performance.267 For example, if the developer does not perform the promised management services to the partnership, an action in damages by the nondefaulting partner against the defaulting partner

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262. See part IV E infra.
263. See generally 2 S. Rowley, supra note 71, § 48.41.
264. See generally 2 S. Rowley, supra note 51, § 47.1. In some circumstances, however, accounting has been permitted without dissolution. See, e.g., Miller v. Freeman, 111 Ga. 654, 36 S.E. 961 (1900).
265. U.P.A. § 22(d). In the Comment to this section, the drafters make it clear that even under the UPA a formal accounting normally may be had only on dissolution. Since each partner has access to the partnership books, formal accounting are not usually necessary. This Comment recognizes, however, that "at particular times and under particular circumstances" an accounting may be had when there is no dissolution.
266. See A. Bromberg, supra note 59, §§ 65(f), 69, 70.
267. Id. § 69.
generally would not lie.\textsuperscript{268} However, if the developer borrows money from
the institution and defaults in payment, the institutional partner may re-
cover that money in a suit directly against the developer-partner.\textsuperscript{269} In
addition, if the real property is held by the partners in their individual
capacity as tenants in common, an action in tort would seem to lie be-
tween the partners for damages to the property of one of them.\textsuperscript{270} It
would seem that in the area of remedies for default, the entity aspects of
the partnership predominate, and therefore it is necessary to determine
in each situation whether the obligation in default is an obligation to the
partnership or an obligation to a partner.

C. Operating Losses, Liabilities, and Profits

When an institutional lender makes a mortgage loan, its greatest risk
is the loss of its investment. The remedy of foreclosure, coupled with
sound appraisals and the cushion provided by statutory loan-to-value
ratios,\textsuperscript{271} makes it unlikely that the institution would lose a substantial
portion of its mortgage investment even if the project is an economic
failure for the developers. When the risk is small so is the gain, and as a
result the institutional lender normally has received a fixed return over a
long period of time.\textsuperscript{272} With equity investments, the institution has an
opportunity to share in the profits of the venture and to protect its de-
positors, policyholders, and stockholders against the risks of inflation;
but with equity investments comes the risk of exposure to liabilities.

1. Operating Losses

There are actually some developers who request the institution to agree
to put up, in addition to its initial capital contribution, all additional
funds that may be necessary over the years to keep the partnership in
business. Obviously, even if the business people in the institution wish to
comply with such a request, they cannot do so without the approval of
the institution's board of directors.\textsuperscript{273} Even its board of directors prob-

\textsuperscript{268} Id.; see, e.g., Miller v. Freeman, 111 Ga. 654, 36 S.E. 961, 962 (1900).
1951).
\textsuperscript{270} See Smith v. Hensley, 354 S.W.2d 744 (Ky. 1962).
\textsuperscript{271} See note 35 supra.
\textsuperscript{272} Due to the pressures of inflation during the past few years, institutional lenders
have shortened the term of loans by approximately ten years, without reducing the period
required for complete amortization of the loan. This leaves a certain amount of unpaid
principal outstanding at the end of the term. This "balloon," as it is often called, can be
refinanced at a then current interest rate, thus helping to reduce the effects of inflation.
Interest rates, however, have not always reflected inflation trends, and this procedure could
backfire on the institution. Contingent interest might help, but usury statutes restrict the
effectiveness of this type of inflation hedge.
\textsuperscript{273} For example, no investment or loan may be made in New York by any domestic
life insurance company unless it has been authorized by the board of directors, or by a
ably could not bind future boards to such an approach to equity investments. On the other hand, when the institution owns property directly in its own name, it would normally incur obligations—e.g., the obligation to pay taxes, make repairs required by law, or make mortgage payments—even where income is insufficient to meet these expenses. Similarly, an institution as joint venture partner should be able to agree to put up its share of additional funds necessary to meet these expenses. This would seem to be as far as the institution could go. Beyond this, the partners would have to decide at the time whether they wish to put more money in, borrow additional funds or dispose of the property at a loss.

2. Liabilities

As a general partner, the institution is liable for the acts of its partner within the scope, or apparent scope, of the venture. The partnership agreement, if carefully drawn, should clearly limit the actual scope of each partner's authority. It is, therefore, "apparent" scope that can cause the problems. Just as an "apparent" horse may not be a horse, so "apparent" scope or "apparent" authority may not be the real scope of the venture, or the real authority conferred upon a partner. Rather, it is what a third party dealing with the venture or a partner would think is the scope of the venture or the authority of the partner. Fortunately, the committee thereof charged with the duty of supervising or making such investment or loan. N.Y. Ins. Law § 78(1) (McKinney Supp. 1970).

274. A board of directors may not delegate its powers of supervision and management, since this may be considered a surrender of its functions. An agreement to invest undetermined amounts of additional funds at any time in the future would seem to encroach upon the power of future boards. In a similar context, Ballantine suggests that "[i]n making arrangements in the nature of a partnership to which a corporation is a party, as in drafting management contracts, it would be well to preserve the ultimate authority of the directors and to make the contract subject to termination upon reasonable notice for cause, and even at the option of the board of directors after a limited time, in order to avoid undue delegation or abdication of control by the directors over the management of the corporate business." H. Ballantine, Corporations § 87 (rev. ed. 1946) (footnote omitted). See also id. § 48.

275. Of course, when a board of directors authorizes a corporation to become a partner, it is, in effect, authorizing it to become liable to third parties for losses. As between the partners, however, the UPA specifies that each partner is required to contribute towards the losses in proportion to his share of the profits, unless there is agreement to the contrary. U.P.A. § 10(a). The institutional investor normally will want such an agreement.


277. The foregoing words are a paraphrase of part of Professor Austin W. Scott's remarks to his classes in connection with "constructive" trusts.

278. In dealing with the partner or venture, a reasonable man might determine the scope of the partner's apparent authority by looking to the partnership agreement, the course of business of the particular partnership, or the course of business of similar partnerships in the locality. A. Bromberg, supra note 59, § 49, at 276.
larger the transaction, the more unreasonable it would seem for a person
to assume without further proof that the transaction is within the scope
of the venture or the authority of the partner. Thus, while a person might
be justified in assuming that the managing partner of the XYZ Joint Ven-
ture had authority to order a steel safe for the rental office, he would be
less justified in assuming the managing partner could purchase, on behalf
of the venture, the steel company and its assets. The picture becomes less
clear when the fact situation is somewhere between these extremes. In
any case, the standards are vague and the risk of liability, however remote,
is always present. If the developer has substantial assets, the institution
may attempt to achieve some protection with an indemnification from the
developer for his acts outside and in contravention of the partnership
agreement. While this is helpful, it cannot eliminate the problem. Thus,
the institution must frequently and thoroughly check on the operation of
the venture in order to protect its interest and guard against liability.

3. Profit

Of course, the object of the venture is to make a profit. Inasmuch as
the interests of the partners might not always be consistent with respect
to when there should be a distribution of the expected profit, such distrib-
utions would normally constitute a "major decision," requiring approval
of all the venturers. Distributions normally are made in accordance with
the respective interests of the parties. However, when an institution puts
up all or most of the cash required, the agreement will often provide for
a cash flow distribution preference in favor of the institution, until all or
substantially all of the initial or subsequent capital contributions of the
venturers are repaid. Subsequently, the distributions will be made in ac-
cordance with the respective interests of the parties.

D. Some Tax Considerations

1. Existence of a Partnership for Tax Purposes

The tax definition of a partnership is an extremely broad one: "[T]he
term 'partnership' includes a syndicate, group, pool, joint venture, or
other unincorporated organization through or by means of which any
business, financial operation, or venture is carried on, and which is not,
within the meaning of this title, a corporation or a trust or estate."

279. Occasionally the institution is asked to enter an existing partnership. This often
occurs when the parties wish to retain the advantage of being the first user of property
already in use (see discussion in part IV D 5 infra). If the institution agrees to enter an
existing partnership, it will be liable "for all the obligations of the partnership arising
before [its] admission," but such liability will be "satisfied only out of partnership prop-
erty." U.P.A. § 17. It therefore would seem that, unless there are countervailing business
reasons for doing so, entering existing partnerships may not ordinarily be desirable.

In addition to a formal partnership organized under the UPA or the ULPA, the definition is broad enough to encompass real estate "joint ventures," as well as tenancies in common of commercial real estate. While some courts have found that a tenancy in common of real estate does not create a partnership for tax purposes, the cases generally have involved individuals who acquired the real property through inheritance and rented it out. Since there was no business motive in the acquisition, the courts were reluctant to find a partnership for tax purposes. However, in the type of arrangement being discussed, the developer and the institutional investor have a clear business purpose to operate the property for profit and to share in its gains and losses. Where the real property is held as a tenancy in common and no formal partnership is established, the parties customarily will have an "operating agreement," which in virtually all respects is the same as a partnership agreement. The Treasury Regulations recognize that such an arrangement can constitute a partnership: "Tenants in common, however, may be partners if they actively carry on a trade, business, financial operation, or venture and divide the profits thereof. For example, a partnership exists if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent." The last clause above seems to indicate that if the property were leased on a net basis, partnership treatment could be avoided. However, the parties normally will not operate the property on such a basis. For the purposes of the following discussion, it will be assumed that a partnership for tax purposes does exist.

2. Contributions to the Partnership

Ordinarily, no gain or loss is recognized when an individual contributes property in exchange for an interest in the partnership. Frequently the developer has held the land on which the commercial building is or will be built for some time, and there has been considerable appreciation in value. By contributing the property to the partnership rather than selling a portion of it to the institutional investor, the developer can defer the gain on the appreciation until a later time. When appreciated property is contributed to the partnership by the developer, the institutional investor normally will want the partnership agreement to provide for a special allocation of the gain upon ultimate disposition of the property. If the property is depreciable, a special allocation of depreciation may also be desirable to reflect the difference between the depreciable basis of the

281. Lulu Lung Powell, 26 CCH Tax Ct. Mem. 161 (1967); Lena Hahn, 22 T.C. 212, petition for review dismissed, 216 F.2d 954 (8th Cir. 1954); In re Estate of Appleby, 41 B.T.A. 18 (1940), aff'd, 123 F.2d 700 (2d Cir. 1941).


property (carried over from the developer) and its higher fair market value at the time of contribution.\textsuperscript{284}

An alternative approach to the problem is to have a sale of the appreciated property by the partner to the partnership. This may be desirable if the property is depreciable, \textit{e.g.}, a building, since a sale, while requiring the partner to recognize gain,\textsuperscript{285} gives the partnership a stepped-up basis for tax purposes,\textsuperscript{286} and avoids the need for special allocation provisions for gain and depreciation. While there may be some risk that the Internal Revenue Service will challenge the sale as a de facto contribution, the Code specifically recognizes that a partner and his partnership can deal on an arm's length basis,\textsuperscript{287} and thus a bona fide sale so intended by the parties should be recognized for tax purposes.\textsuperscript{288}

In some cases, the developer may make no capital contribution at all. He in effect contributes his know-how and skill, and the institutional investor provides all the necessary financing through loans and capital contributions. Where the developer in such a case receives a capital interest in the partnership, it may be considered compensation for services and thus ordinary income to him at some time.\textsuperscript{289} Since the developer is expected to render his services over a substantial period of time, the time of receipt of such income for tax purposes is difficult to predict. Receipt of the income probably can be deferred, and perhaps ordinary income treatment can be avoided altogether, by providing that such capital interest is not transferable, is payable only on liquidation of the partnership, and only after the institutional investor has first recovered all of its capital contributions.

3. Effect of Debt on Basis of Partnership Interest

Generally speaking, a partner's initial tax basis for his partnership interest is equal to the amount of money and the adjusted basis of property he contributes to the partnership.\textsuperscript{290} However, a partner's basis is also increased by his share of partnership liabilities.\textsuperscript{291} This is significant where it is anticipated that losses will occur in the early years of the project (or where losses do in fact occur at any time), since a partner can deduct his share of the losses against other income only to the extent that

\begin{itemize}
  \item \textsuperscript{284} Id. § 704(c)(2).
  \item \textsuperscript{285} Id. § 1002.
  \item \textsuperscript{286} Id. § 1012.
  \item \textsuperscript{287} Id. § 707(a).
  \item \textsuperscript{288} Treas. Reg. § 1.721-1(a) (1956).
  \item \textsuperscript{289} Id. § 1.721-1(b)(1), (2). See also United States v. Frazell, 335 F.2d 487, rehearing denied, 339 F.2d 885 (5th Cir. 1964), cert. denied, 380 U.S. 961 (1965).
  \item \textsuperscript{290} Int. Rev. Code of 1954, § 722.
  \item \textsuperscript{291} Id. § 752(a).
\end{itemize}
he has a positive basis for his partnership interest. Since the property ordinarily will be heavily mortgaged, both the developer (even where he makes no capital contribution) and the institutional investor should have a substantial tax basis for their partnership interests. Where a limited partnership is used, with the developer as general partner and the institutional investor as limited partner, the institutional investor should require that the developer-general partner not be personally liable for the mortgage loan, for the limited partner gets no step-up in basis if the general partner is personally liable. Even where a general partnership is used, it may be advisable either to have both parties personally liable or to have neither liable, so that both will be assured an increase in basis.

4. Special Allocations for Tax Purposes

Unless the partnership agreement provides otherwise, a partner’s share of the various tax items of income, gain, loss, deduction and credit of the partnership is determined in accordance with his share of the taxable income or loss of the partnership. The partnership agreement may, however, provide for special allocation of specific items. This will be recognized for income tax purposes, unless the primary goal of the allocation is the avoidance or evasion of income tax. The regulations list a number of factors to be considered in determining whether the principal purpose of a special allocation is the avoidance or evasion of income tax:

Whether the partnership or a partner individually has a business purpose for the allocation; whether the allocation has ‘substantial economic effect,’ that is, whether the allocation may actually affect the dollar amount of the partners’ shares of the total partnership income or loss independently of tax consequences; whether related items of income, gain, loss, deduction, or credit from the same source are subject to the same allocation; whether the allocation was made without recognition of normal business factors and only after the amount of the specially allocated item could reasonably be estimated; the duration of the allocation; and the overall tax consequences of the allocation.

One special allocation already mentioned is an allocation to take account of contributed property which at the time of contribution has a value in excess of its basis. There may also be other circumstances justifying a special allocation. For example, the institutional investor, for personal liability reasons, may not want to enter into the partnership with the developer until the development is virtually completed. Assume that the institutional investor then contributes fifty percent of the total building

292. Id. § 704(d). If the loss is in excess of such basis, it may be deducted at the end of any partnership year in which this excess is repaid to the partnership. Id.

293. Treas. Reg. § 1.752-1(c) (1956).


295. Id. § 704(b)(2).


and land cost in return for a fifty percent partnership interest. During construction, the developer, as sole owner, ordinarily has an election for tax purposes to treat certain items (such as real estate taxes and interest) either as expenses or as additions to basis. The developer normally will wish to expense these items. This means, however, that the institutional investor will be contributing fifty percent of the total building costs, part of which have already been written off by the developer. The same may be true of depreciation deductions if the property is completed and rented in stages, and the institutional investor does not become a partner until the final stage is finished. In such a case the institutional investor, to protect its position, may wish the partnership agreement (the terms of which are agreed to prior to construction) to provide that in no event will its share of depreciation be less than fifty percent of the total building cost. Because of the bona fide business reasons for the special allocation, it should be recognized for tax purposes. Alternatively, the institutional investor may be able to contractually bind the developer to elect to capitalize these items during construction.

5. Depreciation

The Tax Reform Act of 1969 has somewhat reduced the benefits of accelerated depreciation. Nevertheless, the parties may still wish to use this method if the property meets the requirement that its “first use” commence with the taxpayer. In this case the partnership is considered the taxpayer. Thus, if the partnership is formed and the property is transferred to it after the property is put in use, accelerated depreciation will be lost. There may be a clash of interests if the developer is anxious for accelerated depreciation, while the institutional investor is unwilling to form the partnership during the construction period and run the risks associated with construction. Ordinarily, both partners will have to follow the same method of depreciation for income tax purposes, since the election of the depreciation method is made by the partnership and is binding on each of the partners. If the parties take title to the property as tenants in common, however, and then form the partnership and contribute the property to it, they may treat the property for depreciation purposes (and also for gain or loss purposes) as if it were not partnership property—provided their interests in the capital and profits of the partnership correspond to their undivided interests in the property. If the property is not actually contributed to the partnership, but is merely

298. Id. § 266.
301. Treas. Reg. § 1.167(c)-1(a) (6) (1956).
303. Id. § 704(c).
used by it, the parties also apparently may treat the property as individually owned for depreciation and gain and loss purposes. Since tenants in common are not obligated to use the same method of depreciation, the parties in a partnership arrangement flowing from tenancy in common ownership should have the same right.

E. Dissolution and Termination

All joint ventures eventually will come to an end. A partner may be in need of funds, become a bankrupt, or die. The partners may encounter basic disagreement as to the operation of the property. How the parties meet these situations, and provide for some degree of continuity and order in connection therewith, is the subject of this section.

1. Operating Under the UPA

Any change in the relation of the partners "caused by any partner ceasing to be associated in the carrying on" of the business will cause a dissolution of the partnership. Section 31 of the UPA specifies the causes of dissolution. Under this section, dissolution will occur, inter alia, at the will of any partner pursuant to the agreement or in contravention thereof, on the death of a partner, or on the bankruptcy of a partner. This is consistent with the aggregate theory of partnership. Since the partnership is an association of persons in theory and in the express terms of section 31 of the UPA, no one specific association can exist if a partner ceases to be associated in the carrying on of the business. According to the official Comment to this section:

The relation of partners is one of agency. The agency is such a personal one that equity cannot enforce it even where the agreement provides that the partnership shall continue for a definite time. The power of any partner to terminate the relation, even though in doing so he breaks a contract, should, it is submitted, be recognized.

Thus, notwithstanding the language of the agreement, any partner can force a dissolution of the partnership—subject, of course, to personal liability if his action is a breach of the terms of the agreement. Upon dissolution, any partner who has "not wrongfully dissolved the partnership or the legal representative of the last surviving partner, not bankrupt, has the right to wind up the partnership affairs," unless otherwise agreed. For cause, any partner, his legal representative or an assignee may obtain winding up from the court.

As has been noted, the UPA is a compromise between the entity and
aggregate theories, and here that compromise shines in all its inconsist-
tency. The statutory language just discussed reflects the aggregate theory,
but the entity aspects are not ignored. First, the partnership does not ter-
minate upon dissolution, but continues until winding up. Second, where
dissolution is in contravention of the agreement, the non-defaulting part-
ners may under certain circumstances continue the business. Third,
section 41, by implication, indicates that the business can be continued
in a variety of situations—in certain cases without even an assignment
of a deceased or retired partner's interest. Fourth, sections 17 and
18(g) of the UPA more than imply that admission of a new partner with
the consent of the existing partners may be accomplished without dissolu-
tion. This would seem consistent with the section 29 definition of dis-
solution, which refers only to a change in relation caused by a partner
"ceasing to be associated" with the partnership. And fifth, at least one
authority strongly supports as the better view the theory that "changes
in membership pursuant to agreement do not necessarily cause dissolu-
tion."

Without discussing in any great detail the metaphysics involved in
determining when dissolution occurs, what dissolution is, and how part-
nerships can arise, phoenix-like, from their own ashes, it should be fairly
clear that many institutional investors and developers wish to frame
their agreement so as to avoid these problems.

2. The Language of the Agreement

All of what is said in the agreement is, of course, subject to the UPA
provisions on dissolution and winding up. The developer is not normally
apprehensive that the language of the agreement will not be adhered to
by the institution, not only because of the nature of institutional inves-
tors, but also because the institution or even its subsidiary would pre-
sumably be far from judgment proof. The institution also is not terribly
concerned about the failure of the developer to adhere to the language
of the agreement in this respect, since it presumably will have sufficient
assets to protect itself in any sale under a forced winding up of the
partnership.

The developer will normally wish to be able to transfer all or a portion

311. Id. § 38(2)(b).
312. See id. § 41(3).
313. See A. Bromberg, supra note 59, §§ 73, 78A.
314. Apparently, some institutional investors make no provision in their agreement for
termination of the partnership, but rely on general application of law. Their feeling is that
on termination of the partnership the partners will become tenants in common, and an
action for partition would lie. See part IV A supra.
of his interest to third parties. The institution, while it might permit the transfer of a portion of the developer’s interest, is relying on the expertise of the developer and will normally insist that he retain a substantial economic interest in the partnership for a considerable period of time. A compromise along these lines can normally be worked out. The agreement also may provide that when the time is reached wherein either or both parties can transfer all or a substantial portion of their interests, the nontransferring party will have a right of first refusal. This right protects it from managers or partners with whom it would prefer not to deal. As a practical matter, however, except for the developer’s possible syndication of portions of his interest which, for economic and other reasons, the institution may wish to restrict, sales of interests in partnerships or partial interests in land are not easily consummated and, if consummated, may be at a price somewhat lower than the selling partner’s percentage interest in the partnership would warrant. Thus the parties are more interested in the right to terminate the venture and sell the entire partnership.

If the parties disagree as to major decisions, or if for some other reason they wish the partnership ended, they may usually take advantage of a buy-sell arrangement which is often found in the partnership agreement. Basically, one partner sets a price on the entire partnership or the real estate, and the other partner has the option of either buying the first partner’s interest or selling his interest to the first partner at a pro rata percentage of the price set by the first partner. The developer often raises objection to this on the ground that in a tight money situation he might be unable to raise the money, and thus would be forced to sell at what might be too low a price. The solution is normally to provide a reasonable period of time between exercise of the buy-sell and closing, so that funds can be raised. While the buy-sell appears to be a simple solution, its implementation may cause significant problems. For example, valuation of partnership interests, with contingent obligations and existing contracts, as well as interests in real estate, is difficult; and the

315. To provide some assurance that the formation of the joint venture (or any subsequent sale by the developer of his interest therein) is not subject to registration or regulation under federal or state securities laws, the institutional investor may require an opinion from its counsel as a condition of entering into the joint venture. It may also require an opinion from the developer’s counsel to the same effect, and a representation and warranty from the developer that he has not and will not sell, offer for sale or solicit offers to purchase, directly or indirectly, any portion of his interest in the joint venture to or from any person or entity so as to require registration or qualification of such sale under federal or state securities laws.

316. In a default situation, the defaulting partner is often considered the non-withdrawing partner, giving the option to the nondefaulting partners.
hiatus between exercise of the option and closing can be the source of innumerable problems. Some joint venture agreements will provide, in addition to the buy-sell, that either party may negotiate a sale of the entire assets of the partnership to a third party, provided that the other party is given a right of first refusal.

The developer often wishes his interest transferred to his heirs or representatives upon his death or disability. The institution, however, does not look forward to substituting for the expertise of the developers the inexperience of a host of heirs. The agreement therefore often provides for an appraisal of the property on death or disability, with the institution having the option of obtaining a hundred percent interest by paying the partner's heirs or representatives the appraised value of the deceased or disabled partner's interest; the invocation of the buy-sell as against the estate, under which the estate would have the option of buying the institution's interest or selling its interest to the institution; or the transfer of the deceased partner's interest to his heirs or representatives, but only as limited partners with no control over the operation of the property; or a combination of the foregoing.

Because of the loss of the expertise of the developer, the venture often obtains key-man insurance on the developer's life. The institution must be certain in several states that it does not attempt to designate the insurance company or, if it is an insurance company, that it does not require that it be designated as the insurer, for various reasons, possibly including usury.

When the developer becomes a bankrupt, the situation from the institution's standpoint is similar to the partner's death: i.e., the institution, in view of the fact that the bankruptcy trustee and the institution would probably have different objectives, might not consider the trustee a compatible partner. The solutions, however, are more limited, because the buy-sell or limited partnership approaches might not be enforceable against a trustee in bankruptcy. As successor to the bankrupt partner, the trustee may rely on his rights under the Bankruptcy Act, which requires the nonbankrupt partners to "settle the partnership business as expeditiously as its nature will permit and account for the interest of the general partner or partners adjudged bankrupt," or perhaps, under

317. During this hiatus, the "Huey, Louie and Dewey" clause becomes invaluable. See part IV B 1 supra.

318. Care must be exercised, inter alia, with respect to state laws regulating unfair insurance practices, and possible breaches of the anti-trust laws. As to usury, see Equitable Life Assurance Soc'y of the United States v. Scali, 38 Ill. 2d 544, 232 N.E.2d 712 (1967), which held that such a requirement in a mortgage situation was not usurious.

319. Bankruptcy Act § 5(i), 11 U.S.C. § 23(i) (1964). This section also provides that partnership property shall not be administered in bankruptcy when at least one of the general partners is not bankrupt unless all nonbankrupt general partners consent.
UPA section 37, ask a court for a winding up for cause shown. The appraisal technique previously discussed might be considered both an orderly and expeditious method of settling the partnership business and accounting for the interest of the bankrupt partner. Thus, some agreements may provide that the nonbankrupt partner or partners may elect an appraisal in lieu of winding up the partnership, even though appraisals are difficult and appraisers are known to vary dramatically in their conclusions about the value of the same property. Whatever provision is inserted in the partnership agreement, it will be subject to a possible attempt by the trustee to reject it if he believes it to be burdensome to the estate. In any such case, however, it would seem that the contract which could be rejected would be the partnership agreement and not just a particular provision thereof, so that the trustee, as far as his rights of rejection are concerned, would have to accept the partnership agreement as written or abandon the partnership.

V. Conclusion

While institutional equity investments in real estate are new, while structuring of the joint venture is difficult and complex, and while the risks can be large, it now seems that such equity investments of one form or another will become a significant factor in institutional portfolios.

However, while joint ventures by institutions are new, some legal relationships they create are traditional. Many problems that arise stem from the fact that these legal relationships are employed perhaps in different ways, in different combinations and under different circumstances than they have been previously. All the consequences of this new employment may not yet have been fully ascertained. This article has considered many of the existing problems facing the institutional investor and the present thinking with respect to solutions to those problems. It is expected that over the years new problems will arise, and new solutions to existing problems will become apparent.

Institutional investors have not been in the “joint venture” field long enough to evaluate their profitability and success on the basis of any

320. Such a provision might specify that upon filing of a petition by or against a partner, such partner shall automatically cease to be a member of the partnership and the remaining partners shall then proceed to settle the partnership business and account for the interest of the bankrupt partner. It might then be further provided that in settling the partnership business the nonbankrupt partners could account for the bankrupt’s share, either by an appraisal and payment to the trustee, by a winding up of the partnership and distribution of the assets, or by any other equitable and feasible means.


322. In re Italian Cook Oil Corp., 190 F.2d 994 (3d Cir. 1951).
more than scattered returns. It has become clear that “joint ventures” in real estate are not simple transactions to negotiate or document. The legal, printing and other costs of putting a joint venture together suggest that it may not be feasible for small transactions. Furthermore, projections are not perfect, and the institution is known to be investing in a risk-bearing situation. For example, the institution should know that in a period of business recession or rapid inflation, it may well have to invest far larger sums than were originally projected. While large institutions can easily do this, smaller institutions may find themselves hard pressed to expend large sums to honor commitments and bring joint ventures through troubled times. This, together with the complexity of the transaction, might tempt one to quote Benjamin Franklin when he said: “Great Estates may venture more; Little Boats should keep near shore.”

With the growing sophistication of both the developer and the institutional investor in this area, however, and the growing standardization of philosophy and form, a kind of modus vivendi may soon be realized which may herald the day when neither size of the venturer nor the amount of money involved will act as a deterrent to the creation of institutional joint ventures in real estate.