

BEFORE THE FAIR POLITICAL PRACTICES COMMISSION

In the Matter of: )  
 )  
 Opinion Requested by: )  
 Steven F. Nord )  
 City Attorney )  
 City of Merced )

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No. 83-004  
 Oct. 4, 1983

BY THE COMMISSION: We have been asked the following question by Steven F. Nord, City Attorney for the City of Merced:

if he becomes a limited partner with two general partners in a real estate venture, may he participate as city attorney in decisions having a material financial effect on his general partners either personally or in other businesses in which they are involved?

CONCLUSION

As City Attorney of Merced, Mr. Nord must disqualify himself from making, participating in making, or using his official position to influence, any decision which will reasonably and foreseeably have a material financial effect on one or both of his general partners either personally or through some other business activity.

FACTS

Two real estate brokers (Smith and Jones) - who are active in land use issues and development in Merced, have invited Mr. Steven Nord, the city attorney, who is directly involved in the city's land use decisions, to join them as a limited partner in a land development project. The two real estate brokers will be the general partners, with full and complete control over the operations of the partnership. In addition to Mr. Nord, there will be three other limited partners. The capital investment of the four limited partners

will entitle each to a 12-1/2% interest (totaling 50% in the aggregate). Mr. Nord has stated that his capital investment will put him in at "up to \$50,000." The two general partners (Smith and Jones) will each have a 25% interest (also totaling 50%). The four limited partners will contribute their 50% share in the form of a piece of raw land which they jointly purchase. For their 50% share the two general partners will develop that raw land with an apartment complex, supplying the construction material, equipment, financing, permits and their managerial and development skills.

Mr. Smith and Mr. Jones are involved in many land-use matters which involve decision-making by the City of Merced. Mr. Nord has participated in such decisions on numerous occasions in the past in his capacity as City Attorney. If he invests in the partnership, he is concerned about his future involvement in land-use decisions which affect Messrs. Smith and Jones, in their capacities as agents for others or in projects where their involvement is as principals either individually or acting as a business entity.

#### ANALYSIS

Before analyzing the conflict of interest implications of Mr. Nord's question it is helpful to have a basic understanding of limited partnerships.

#### The Nature of Limited Partnerships

A limited partnership, unlike a corporation, is not a separate legal entity, but instead is an association of persons.<sup>1/</sup> The partners have a trustee-type relationship with one another with respect to the partnership endeavor.<sup>2/</sup> A managing partner particularly is held to be under a duty analogous to that of a trustee or fiduciary, and he or she must

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<sup>1/</sup> Bedolla v. Logan & Frazer (1976) 52 Cal. App. 3d 118; 125 Cal. Rptr. 59. However, a limited partnership may be sued under the firm name. Code of Civil Procedure Section 388(a).

<sup>2/</sup> Koyer v. Willmon (1907) 150 Cal. 785, 787; 90 P. 135; Perelli-Minetti v. Lawson (1928) 205 Cal. 642, 647; 272 P. 573.

conduct the business in the interest of the partnership.<sup>3/</sup> The fiduciary character of the relationship is limited, however, to matters connected with the partnership enterprise.<sup>4/</sup>

A limited partnership consists of one or more general partners plus one or more limited partners. The limited partners are not bound by the obligations of the partnership, thus their liability is "limited." The general partners are liable without limit for any obligations contracted by the partnership in the conduct of its business. The general partners have full control over the management of the firm. Limited partners are specifically prohibited from exercising control of the firm and to do so will cause them to lose the limitation of their liability. The limited partner's name may not be used in the partnership's name.

It has been said that:

The primary object of ... limited partnerships was to encourage those having capital to become partners with those having skill, by limiting the liability of the former to the amount actually contributed to the firm.<sup>5/</sup>

The general partner is personally responsible for the debts and obligations of the firm, as in the case of ordinary partnerships, without regard to the amounts contributed by him or her to the firm capital. The liability of the general partner for the debts of the firm has been held to be personal and joint, and to extend not only to his or her interest in the partnership but to all his or her private property. The common

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<sup>3/</sup> 68 Corpus Juris Secundum, Partnership Sec. 76, pp. 517-18.

<sup>4/</sup> Id. at 516-517.

<sup>5/</sup> White v. Eiseman (1892) 134 NY 101, 31 NE 276, 277. A loan of money does not constitute a limited partnership where the agreement provides for the repayment of the loan and security thereon, and where there is to be no sharing of profits and losses. Richardson v. Carlton (1899) 109 Iowa 515, 80 NW 532.

law treats the general partner--as if he or she were, in fact, the partnership.<sup>6/</sup>

In conclusion, a limited partnership involves an investment by the limited partners which is entrusted to the entrepreneurial skills of the general partner, who is charged with the sole discretion and authority to manage the investment by conducting the partnership business. In most limited partnership agreements the general partner is given almost total discretion over distribution of profits, which represent the return to the limited partners on their investment in the firm. Generally, the limited partners cannot retrieve their capital contribution to the firm until the partnership is wound up or unless they transfer their interest (if permitted by the agreement and by their copartners).

#### The Political Reform Act

The Political Reform Act (the "Act")<sup>7/</sup> provides that a public official may not make or participate in making an official decision which will have a material financial effect upon his or her financial interests. What constitutes a financial interest for a public official is set forth in Section 87103, and includes:

(a) Any business entity in which the public official has a direct or indirect investment worth more than one thousand dollars (\$1,000).

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(d) Any business entity in which the public official is a director, officer, partner, trustee, employee, or holds any position of management.

Before a conflict of interest can arise requiring disqualification a financial interest must be present. Once formed the partnership will constitute a financial interest of Mr. Nord since he will have an investment in the partnership of

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<sup>6/</sup> 68 Corpus Juris Secundum, Partnership Sec. 471, pp. 1022-23; Sec. 477, p. 1025-26.

<sup>7/</sup> Government Code Sections 81000-91014. All statutory references are to the Government Code unless otherwise indicated.

more than \$1,000 (Section 87103(a)) and he will be a partner in the entity (Section 87103(d)). As a result, Mr. Nord will have to disqualify himself from making, participating in making or using his official position to influence, any decision of the City of Merced which will have a reasonably foreseeable material financial effect<sup>8/</sup> on the partnership or the partnership property<sup>9/</sup> which effect is distinguishable from the effect which the decision will have on the public generally.<sup>10/</sup>

Mr. Nord's question to us goes beyond the foregoing basic conflict of interests analysis. Because both of the general partners (Smith and Jones) are active in many other real estate matters in Merced, often involving the participation of Mr. Nord in his role as City Attorney, he is concerned about his participation in those other matters when the decisions will have a reasonably foreseeable material financial effect upon either Smith or Jones, or both, or other partnerships or businesses in which they may be involved.

Fundamental to the resolution of this issue is the question of whether to "pierce or not to pierce" through the partnership veil and thereby consider Mr. Nord's relationship to the general partners. We have not to date considered that question in the context of the partnership relationship.

However, in two Commission Opinions, Lumsdon, No. 75-205, 2 FPPC Opinions 140, and Kahn, No. 75-185, 2 FPPC Opinions, 151, we have "pierced through the corporate veil" and treated the controlling (majority) shareholder as one with his closely-held corporation.<sup>11/</sup> While both of those opinions

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<sup>8/</sup> "Material financial effect" is defined by Commission regulation, 2 Cal. Adm. Code Section 18702.

<sup>9/</sup> Mr. Nord was aware of this disqualification requirement when he requested our opinion in this matter. We reiterate this conclusion here only for purposes of clarity.

<sup>10/</sup> "Public generally" is defined in Commission regulation, 2 Cal. Adm. Code Section 18703.

<sup>11/</sup> The Supreme Court of the United States has held that "the corporate form may be disregarded in the interests of justice when it is used to defeat an overriding public policy." Bangor Punta Operations, Inc. v. Bangor & Aroostock R. Co., 417 U.S. 703, 713 (1974).

dealt with this issue in the campaign context, the reasoning in the opinions is equally valid as to the conflicts of interest aspects of the Act. The Lumsdon reasoning was essentially ratified by the Legislature when it adopted the Levine Bill (AB 1040, Ch. 1049, Stats. 1982), now Section 84308. Subdivision (c) of that section provides that a majority shareholder of a closed corporation is subject to the same disclosure and prohibition requirements as the corporation in the context of campaign contributions giving rise to conflicts of interest.

In the corporate context, the controlling shareholder in a close corporation is one who holds a majority of the stock. Since corporate control is based ultimately on stock voting rights, a shareholder who holds the majority of the votes effectively holds control.<sup>12/</sup>

In the limited partnership situation, a single general partner is clearly controlling in every sense of the word. Where there are two general partners, control is shared between them, with each having full legal authority to bind the firm by his or her actions, yet with each having the ability to negate or stymie the other's actions. Consequently, each theoretically has control. In practice, one may be the "managing general partner" and exercise full control, in which case there would be only one controlling general partner.

We conclude that in the application of the overriding public policy of the Political Reform Act, with its clear intention to prohibit conflicts of interest arising from financial relationships, we should "pierce through" the partnership legalism and hold that an investment by Mr. Nord in the partnership is also an investment in the controlling general partners, Smith and Jones.<sup>13/</sup> Consequently, Smith and Jones each constitute a financial interest of Mr. Nord and he must

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<sup>12/</sup> In the case of large, publicly-held corporations, a much smaller percentage of ownership may enable a shareholder to be considered "controlling." Since many small shareholders never vote their stock, the holder of a significant block can wield substantial control at shareholder meetings.

<sup>13/</sup> This conclusion would not be altered by the new California Revised Limited Partnership Act (Corporations Code Sections 15611, et seq.) which has been adopted in California (Chapter 1223, Stats. 1983) and will become operative July 1, 1984.

disqualify himself as to decisions which will have a reasonably foreseeable material financial effect upon either or both of them as individuals, whether the effect is on them directly or as agents for others.

This conclusion is based upon the fact that it is the skill of the general partner that is being invested in by a limited partner. The limited partner entrusts his or her capital to the management of the general partner. In doing so, the limited partner is really investing in the general partner. This is particularly so where there is only one general partner who has complete control over the management of the firm. As suggested above, where, as here, there are two general partners who share equally in the management of the firm, the investment should be considered as being vested equally in both of them. Consequently, an investment of more than \$2,000 in the firm would constitute an investment of more than \$1,000 in each controlling general partner. This investment concept is limited to controlling general partners.<sup>14/</sup>

Some limited partnerships are quite large in terms of numbers of limited partners and are open to the public through brokerage firms and other investment counselors. These investments are subject to the corporate securities laws if the number of investors will exceed 35 or if the investors (limited partners) do not have a preexisting personal or business relationship with the controlling persons (general partners). Corporations Code Section 25102(f). In such instances, it is not likely that the individual limited partner is investing in the general partner as an individual even if there are only one or two general partners. Consequently, the investment concept enunciated above will be confined to those limited partnerships which are similar to a close corporation.<sup>15/</sup>

In addition to the investment concept, we hold that any other business entity in which either Smith or Jones or both act

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<sup>14/</sup> Where control of the limited partnership is vested in three or more general partners, theoretically none would hold a controlling position, and hence there would be no investment by a limited partner in any of them unless one or two were designated as managing general partner(s), effectively giving them full control.

<sup>15/</sup> Corporations Code Section 158 defines a close corporation as having no more than 35 persons as shareholders.

as a controlling general partner or controlling shareholder is an "otherwise related business entity" (within the meaning of Section 82034) with respect to the limited partnership involving Mr. Nord. Section 82034, which defines the term "investment" utilizes the term "parent, subsidiary or otherwise related business entity." While the term is utilized in determining whether a business is "doing business in the jurisdiction," it is clear from the context that it applies to the whole conflict of interest area. Thus, disqualification is required when the effect of a decision will be on the "parent, subsidiary or otherwise related business entity." Consequently, Mr. Nord must also disqualify himself as to those City of Merced decisions which will reasonably and foreseeably have a material financial effect on those "related business entities" which either Mr. Smith or Mr. Jones or both, control. Because we have not yet adopted regulations defining the term "otherwise related business entity" and because this is our first opinion on this point, staff is hereby directed to prepare appropriate regulations to define the term.

#### Summation

To recapitulate, it may be helpful to set forth the parameters of our holding. We have determined that where a limited partner has invested money in a limited partnership which has two or fewer controlling general partners (where the pro rata share of the investment as to each controlling general partner exceeds \$1,000) then the limited partner has an investment in each controlling general partner within the meaning of Section 87103(a).<sup>16/</sup> This is limited to "close" limited partnerships where there are 35 or fewer partners with a preexisting relationship between the general partners and the limited partners. These are partnerships which are exempted from the securities laws by Corporations Code Section 25102(f).

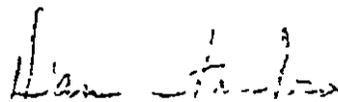
Where a limited partnership has a controlling general partner who is the controlling general partner in another

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<sup>16/</sup> This does not apply between two limited partners in the same partnership, nor does a general partner have an investment in a limited partner (although the limited partner may be a source of income as the result of his or her investment). However, it would apply as between two general partners in a regular partnership or in a limited partnership so long as the requisite level of investment exists.

partnership or limited partnership or the controlling shareholder in a corporation, the second partnership or corporation is a "related business entity" to the first limited partnership. Consequently, financial effects of a decision upon the second entity will be treated as if they were financial effects upon the first.

Adopted by the Commission on October 4, 1983.  
Concurring: Commissioners Conrad, Lemons, Stanford and Ziffren. Absent: Commissioner Metzger.



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Dan Stanford  
Chairman