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Seeking Shelter in the Minefield of Unintended Consequences - The Traps of Limited Liability Law Firms

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Seeking Shelter in the Minefield of Unintended Consequences — The Traps of Limited Liability Law Firms

Susan Saab Fortney*

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* Associate Professor of Law, Texas Tech University School of Law. At the ABA National Conference on Professional Responsibility held May 30 through June 1, 1996, Anthony E. Davis, a risk management expert, suggested that limited liability firms created a "minefield of unintended consequences." I thank him for inspiring the title of this Article. I also thank Curtis J. Berger, William R. Casto, Timothy W. Floyd, Harvey J. Goldschmid, Ronald E. Mallen, and Dean G. Pawlowic for their comments. This Article was written in partial fulfillment of the requirements for the degree of Doctor of the Science of Law in the Faculty of Law, Columbia University.

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I. Introduction

"Where were the professionals?"¹ This infamous question posed by U.S. District Court Judge Stanley Sporkin ignited a national debate on the role of accountants and attorneys in the savings and loan debacle.² Banking regulators embraced this quotation as their rallying cry in malpractice actions against attorneys and accountants.³ Government regulators pursued

1. *Lincoln Sav. & Loan Ass'n v. Wall*, 743 F. Supp. 901, 920 (D.D.C. 1990) (upholding Federal Deposit Insurance Corporation's seizure of Lincoln Savings and Loan Association). Charles Keating, Jr., the chairman and chief executive officer of American Continental Corporation, the parent of Lincoln Savings and Loan Association, testified that he had been so determined to do "the right thing" that he surrounded himself with "literally scores of accountants and lawyers to make sure all the transactions were legal." *Id.* In response to this testimony, Judge Sporkin, U.S. District Court Judge for the District of Columbia and former Chief of Enforcement of the U.S. Securities and Exchange Commission, lamented:

Where were these professionals, a number of whom are now asserting their rights under the Fifth Amendment, when these clearly improper transactions were being consummated? Why didn't any of them speak up or disassociate themselves from the transactions? Where also were the outside accountants and attorneys when these transactions were effectuated?

Id.

2. Numerous commentaries in the popular press and scholarly journals quote Judge Sporkin's blistering criticism. See, e.g., Editorial, *Judgment on Lincoln S&L*, WASH. POST, Aug. 24, 1990, at A26 (editorializing that question of "[w]here were these professionals?" served as "a charge to bar associations and accountancy boards to consider [the] enormous failure of their professional standards to protect both clients and the public"); see also James O. Johnston, Jr. & Daniel Scott Schecter, *Introduction: Kaye, Scholer and the OTS — Did Anyone Go Too Far?*, 66 S. CAL. L. REV. 977, 977 (1993) (using Judge Sporkin's quotation to introduce symposium issue on government regulation and legal ethics).

3. See Mary C. Daly, *Resolving Ethical Conflicts in Multijurisdictional Practice — Is Model Rule 8.5 the Answer, An Answer, or No Answer at All?*, 36 S. TEX. L. REV. 715, 785 (1995) (stating that government regulators invoked refrain of "where were the professionals?" in number of high profile cases against prominent law firms). For example, the Office of Thrift Supervision's press release announcing its enforcement action against the New York-based firm of Kaye, Scholer, Fierman, Hays & Handler stated that the action addressed Judge Sporkin's question. See OFFICE OF THRIFT SUPERVISION, OTS SEEKS \$275 MILLION IN RESTITUTION; FREEZES ASSETS OF LINCOLN'S LAW FIRM (Press Release, Mar. 2, 1992).

claims against hundreds of attorneys and accountants, including those affiliated with prestigious law firms and accounting firms.⁴ These actions, which sought millions in damages and restitution, threatened firm members who practiced in general partnerships because the individual members could be held personally liable if firm assets did not satisfy a malpractice judgment.⁵ Claiming that the potential exposure to these suits was so high and the defense costs so expensive, the professionals and their insurers paid millions of dollars to settle the lawsuits.⁶ Ironically, the malpractice suits against attorneys and accountants successfully galvanized these professionals to obtain protection from future professional liability claims.⁷ Thereafter,

4. See Steve France, *Unhappy Pioneers: S & L Lawyers Discover a "New World" of Liability*, 7 GEO. J. LEGAL ETHICS 725, 726 (1994) (noting that in connection with failed financial institutions, government sued at least twenty-two of largest two hundred law firms in country). By 1995, law firms paid more than \$400 million in settlements. *Id.* A flood of litigation also hit accounting firms. Facing astronomical defense costs, many public accounting firms, like law firms, opted to settle out of court. Julie Faussié, Note, *Limiting Liability in Public Accounting Suits: A Desperate Appeal from a Beleaguered Profession*, 28 VAL. U. L. REV. 1041, 1041, 1043 (1994) (citing interview with principal in accounting firm and ARTHUR ANDERSEN ET AL., THE LIABILITY CRISIS IN THE UNITED STATES: IMPACT ON THE ACCOUNTING PROFESSIONAL, A STATEMENT OF POSITION 2, 3 (1992)). For example, the accounting firm of Ernst & Young agreed to pay \$400 million to settle claims brought by federal banking regulators. Susan Schmidt, *Ernst & Young Pays \$400 Million to Settle Thrift Regulator's Claims*, WASH. POST, Nov. 24, 1992, at A1. The accounting firm of Deloitte & Touche paid the second largest settlement of \$312 million, and KMPG Peat Marwick paid the banking regulators the third largest settlement of \$187 million. Jerry Knight, *Fourth S & L Auditor Settles U.S. Lawsuits — KPMG Peat Marwick to Pay \$187 Million*, WASH. POST, Aug. 10, 1994, at F1. In a report to the U.S. Securities and Exchange Commission, the nation's six largest accounting firms stated that they faced \$30 billion in claims related to failed savings and loan associations. Albert B. Crenshaw, *Accountants Plead for Relief — 6 Biggest Firms Say They Face \$30 Billion in Liability Claims*, WASH. POST, June 12, 1993, at D1.

5. See Thom Weidlich, *Limiting Lawyers' Liability — LLPs Can Protect Assets of Innocent Partners*, NAT'L L. J., Feb. 7, 1994, at 1 (describing "partner's worst nightmare" as when firm's assets and insurance will not cover malpractice claim so that malpractice plaintiff comes after partner's "personal assets . . . her house, her boat, her Lichtenstein hanging on the wall").

6. Ed Hendricks & Mary Berkheiser, *Where Were the Lawyers?*, LITIGATION, Summer 1992, at 30 (explaining that settlements left unanswered important questions of liability and fault).

7. For an account of the different constituencies that supported the LLC movement, see Wayne M. Gazur, *The Limited Liability Company Experiment: Unlimited Flexibility, Uncertain Role*, 58 LAW & CONTEMP. PROBS. 135, 179-81 (Spring 1995). One description of the attorneys' efforts to garner support at the American Bar Association (ABA) Spring 1992 meeting indicated that the LLC was "being shown around this year's Tax Section meeting like a new fighter plane at the Paris Air Show." *Id.* at 180 (citing Charles Davenport et al., *ABA Tax Section Meeting: LLC Boosters Blitz Passthrough Session*, 55 TAX

a question on the whereabouts of professionals could easily be answered — the professionals were actively lobbying state legislatures to limit the vicarious liability of firm partners for the acts and omissions of other firm partners.

These professionals sought legislation that would enable them to limit their vicarious liability without having to organize as professional corporations and risk double taxation. The coalition of professionals and business lobbyists successfully convinced state legislators to adopt legislation providing for limited liability companies and limited liability partnerships (collectively called "limited liability firms"). Because limited liability firms provide liability protection without subjecting firms to double taxation, these new limited liability structures rapidly gained popularity. As described by a partner in a large Boston law firm, big firm partners look at limited liability firms with "an enthusiasm perhaps more appropriately reserved for the Holy Grail."⁸

The flurry of firms to reorganize as limited liability firms reflects the enthusiasm for the new business structures. Within a few years, the limited liability firm movement swept the country.⁹ Those firms that have not yet organized as limited liability firms probably will consider doing so in the future.¹⁰ When they do, there may be little opposition to converting to a limited liability firm because attorneys have wholeheartedly embraced the limited liability firm structure.¹¹

NOTES 1019 (1992)).

8. Lisa Isom-Rodriguez, *Limiting the Perils of Partnership*, AM. LAW., July-Aug., 1993, at 30 (quoting Michael Bohnen, partner at Boston's 117-lawyer firm of Nutter, McClennen & Fish and author of Massachusetts LLP bill).

9. As of December 1995, forty-seven states had enacted LLC statutes and thirty-five states had enacted LLP legislation. John W. Simpson, *L.L.C. and L.L.P. Format Can Benefit Law Firms*, NAT'L L.J., Apr. 1, 1996, at B11. Some states, like Rhode Island, do not permit attorneys to practice as LLCs, and regulators in some states have not determined if attorneys can organize as LLPs. *Id.*

10. Robert R. Keatinge & George W. Coleman, *The Right Entity May Limit Your Liability*, LAW PRAC. MGMT., July-Aug. 1995, at 22. As stated by Robert R. Keatinge, partner of the Denver-based firm of Holland & Hart and chair of the ABA Business Law Section Partnership Committee's Subcommittee on LLCs, the LLC is "clearly the hottest topic in law today, at least when it comes to practice management." Richard C. Reuben, *Added Protection*, A.B.A. J., Sept. 1994, at 54, 55-56.

11. See Peter Blackman, *Limited Liability Option — Experts Weigh the Pros and Cons of Converting*, N.Y. L.J., Aug. 25, 1994, at 5 (noting that "across the board" corporate and tax attorneys hail advent of LLCs and LLPs). A few attorneys express some reservations with the understanding that the limited liability shield only matters when the firm exhausts all assets and faces extinction. *Id.* (quoting Kaye, Scholer partner).

Commentators also herald the coming of the limited liability firm. Even the titles of law review articles reflect how authors have warmly received limited liability firms.¹² Although a plethora of these articles discuss the features and advantages of these limited liability firms, a relatively small number of the articles question the advisability of law firms rushing to reorganize as limited liability firms.¹³ The paucity of articles scrutinizing the limited liability form suggests that commentators have devoted little attention to analyzing the negative implications of attorneys' practicing in limited liability partnerships or limited liability companies.¹⁴ Similarly, in converting their practices to limited liability firms, attorneys may overlook the consequences of abandoning the traditional partnership structure. They may not realize how conversion to a limited liability partnership (LLP) or a limited liability company (LLC) completely transforms the dynamics and culture of law firm practice, creating financial and administrative problems.¹⁵ This Article considers some of the unintended consequences of attorneys' limiting their vicarious liability in limited liability firms. After Part II reviews the forces behind the limited liability movement and the emergence of limited liability law firms, Part III surveys the statutory approaches to limiting vicarious liability in LLCs and LLPs. Part IV then examines possible internal consequences of attorneys' practicing as limited liability firms. Using an economic analysis to evaluate possible outcomes of attorneys' limiting their vicarious liability through limited liability firms, Part V turns to the external effects of the elimination

12. See David B. Rae, *Limited Liability Partnership: The Time to Become One Is Now*, HOUS. LAW., Jan.-Feb. 1993, at 47, 49 (concluding that "[t]here does not appear to be any significant reason for a professional partnership not becoming an LLP"). See generally B. Todd Bailey & Rick D. Bailey, *The Idaho Limited Liability Company: In Search of the Perfect Entity*, 31 IDAHO L. REV. 1 (1994); David L. Cameron, *Strike Up the Band: The Limited Liability Company Comes to Oregon*, 30 WILLAMETTE L. REV. 291 (1994) (singing praises of LLCs).

13. For an insightful analysis of some of the problems of LLPs, see Robert Hamilton, *Registered Limited Liability Partnerships: Present at the Birth (Nearly)*, 66 U. COLO. L. REV. 1065, 1076-87 (1995). Surprisingly, law students have written two other critical pieces. See generally Thomas A. Denker, Note, *Lawyers and Limited Liability for Arizona's Professionals: Deliverance or Damnation?*, 37 ARIZ. L. REV. 355 (1995); N. Scott Murphy, Note, *It's Nothing Personal: The Public Costs of Limited Liability Law Partnerships*, 71 IND. L. J. 201 (1995).

14. Another author made this observation in explaining that most articles praise the advent of limited liability firms. See Murphy, *supra* note 13, at 203.

15. In his testimony criticizing the Texas LLP provisions initially proposed, partnership expert, Professor Alan R. Bromberg, called the proposal a "radical restructuring" of partnership law. Walter Borges, *Partners' Liability Bill Hits Rough House Waters*, TEX. L., May 13, 1991, at 7.

of vicarious liability. After showing how the limited liability rules under LLP and LLC legislation adversely affect incentives to assure quality legal services, Part VI proposes an alternative approach to limited liability that eliminates strict vicarious liability for the acts and omissions of partners, while creating incentives for firms to monitor attorney conduct through reasonable risk management controls. This alternative approach limits attorneys' liability while protecting clients and other members of the public.¹⁶

II. *Genesis of Limited Liability Firms*

A. *Emergence of Limited Liability Companies*

The rush by professionals to organize limited liability firms actually started with a mineral venture in Wyoming. In 1977, Wyoming passed the first LLC statute as special legislation designed to assist a particular mineral concern that wanted to organize a business entity offering limited liability to all equity participants, while avoiding taxation on the entity level.¹⁷ Pursuant to this authority, the mineral concern organized as an LLC and obtained a private letter ruling from the Internal Revenue Service (IRS) that the company would be classified as a partnership.¹⁸ Thereafter, the IRS spent six years studying the issue of classification of unincorporated associations.¹⁹ Following this study, the IRS released Revenue Ruling 88-76, a public revenue ruling concluding that an LLC with limited liability and centralized management under Wyoming law would be classified as a partnership for federal tax purposes.²⁰ This public revenue ruling served as a springboard for other states to jump on the LLC bandwagon.²¹ In an

16. This Article does not analyze the ethical rules that relate to attorneys limiting their vicarious liability. For a discussion of these ethical considerations, see Robert R. Keatinge & George W. Coleman, *Practice of Law by Limited Liability Partnerships and Limited Liability Companies*, 1995 PROF. LAW. SYMP. 5, 12-13.

17. Carol R. Goforth, *The Rise of the Limited Liability Company: Evidence of a Race Between the States, But Heading Where?*, 45 SYRACUSE L. REV. 1193, 1199 (1995).

18. *Id.* at 1200 (citing Priv. Ltr. Rul. 81-06-082 (Nov. 18, 1980)).

19. According to the study, the limited liability feature of LLCs should not, by itself, prevent an LLC from being classified as a partnership. *Id.* at 1202 n.51.

20. Rev. Rul. 88-76, 1988-2 C.B. 360.

21. Statistics illustrate the importance of the public IRS revenue ruling. Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1, 3 (1995). As explained by Professor Ribstein, by 1988, eleven years after the enactment of the Wyoming statute, only Florida had enacted a LLC statute and only twenty-six LLCs were organized in Wyoming. *Id.* By the end of 1994, forty-six other states had adopted LLC statutes and "tens of thousands of LLCs had been formed." *Id.*

attempt to compete for investment capital and tax revenues, "state legislators willingly traded off limited liability in the hope of luring new businesses that might otherwise migrate to states with LLC legislation."²² States did not want to be left behind as other jurisdictions authorized the new business forms.²³

Professionals in coalition with business groups helped push LLC legislation through the states.²⁴ Attorneys and accountants believed that the LLC provided the "best of both worlds" in allowing persons to limit their liability while avoiding disadvantageous corporate taxation.²⁵ In response to professionals' lobbying initiatives, several states, including Alabama, Arkansas, Arizona, Delaware, Georgia, Idaho, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Montana, Nebraska, New Hampshire, Oregon, Utah, Virginia, and Wyoming, explicitly authorized professionals to practice as LLCs.²⁶ Another fifteen states implicitly authorized profes-

22. Karen C. Burke, *The Uncertain Future of Limited Liability Companies*, 12 AM. J. TAX POL'Y 13, 21 (1995). As suggested by Professor Burke: "The recent surge of interest in LLCs raises important issues concerning the role of regulatory and tax constraints on business form, as well as the responsiveness of state legislatures to interest group politics and competition for investment capital." *Id.* at 15.

23. Goforth, *supra* note 17, at 1272 (noting that in "virtually every state, those responsible for drafting and/or enacting LLC legislation cite motives which relate to attracting business and revenue to the state, or avoiding the loss of such business and revenues to other states").

24. See Burke, *supra* note 22, at 20-21 (explaining that combined interests of small business and organized bar groups faced "weak opposition" because LLCs posed no threat to "powerful interest groups"). The "voluminous support" of those groups, outweighed the opposition initially mounted by trial lawyer associations. Goforth, *supra* note 17, at 1279. In some states, like Washington, the trial lawyers convinced the legislature to require that professional LLCs carry a minimum level of malpractice liability insurance. *Id.* at 1281.

25. See Lawrence H. Brenman, *Service Businesses Switch to LLC*, 11 J. PARTNERSHIP TAX'N 167, 168 (1994) (describing major benefits of LLCs to service providers). Prior to the emergence of the LLCs, professionals could only obtain limited liability by organizing as professional corporations subject to taxation at the corporate level, unless the corporation qualified for partnership taxation under Subchapter S of the Internal Revenue Code. State laws which require that all members of professional corporations be licensed in the state of incorporation also prevent multi-state firms from incorporating. See Jimmy G. McLaughlin, *The Limited Liability Company: A Prime Choice for Professionals*, 45 ALA. L. REV. 231, 259 (1993).

26. Alson R. Martin, *Limited Liability Companies (LLCs): The New Game in Town*, in ESTATE PLANNING FOR THE FAMILY BUSINESS OWNER 89, 128 (1994). Maryland, Oregon, and Virginia changed their statute to permit professionals to practice as LLCs after initially adopting legislation explicitly prohibiting professionals from using the LLC form. Allan G. Donn, *The Best Entity for Doing the Deal — Limited Liability Entities for Law Firms*, in THE BEST ENTITY FOR DOING THE DEAL 237, 240 (PLI Corp. L. Practice Course Handbook Series No. 937, 1996) (providing comprehensive listing of state legislation by

sionals to use the LLC form by providing that LLCs could be organized for "any lawful purpose."²⁷ Rhode Island expressly prohibited LLCs from providing professional services.²⁸

B. Emergence of Limited Liability Partnerships

While professionals in other states sought approval to limit their liability through LLCs, Texas attorneys spearheaded a different initiative to limit their liability — the LLP. The LLP initiative grew out of the collapse of real estate and energy prices in the late 1980s and the resultant collapse of Texas financial institutions.²⁹ Following the failure of a number of Texas financial institutions, banking regulators pursued actions against the institutions' officers, directors, and professional advisers, including the institutions' former counsel. These claims captured the attention of the legal community because the amount of alleged damages far exceeded the amount of the insurance coverage carried by the target law firms. Attorneys could not fathom the possibility of their personal, nonexempt assets being subject to execution for judgment arising from their partners' malpractice. This concern spurred attorneys' interest in seeking legislative changes to limit their vicarious liability.

Partners of a twenty-one person Lubbock, Texas law firm originated the idea of changing partnership law to limit professionals' vicarious liability. The first senate bill encompassing this idea obtained a "very negative reception" for a number of reasons, including the facts that it only covered professionals and that it would be considered a "help-a-lawyer-bill."³⁰ Critics also objected to the original bill because it relieved parties of responsibility for the misconduct of persons they directed and supervised, failed to signal to third parties that the new entity limited liability, and

category). For an actual discussion of the different statutory approaches used to authorize professionals to practice as LLCs, see Dirk G. Christensen & Scott F. Bertschi, *LLC Statutes: Use by Attorneys*, 29 GA. L. REV. 693, 695-96 (1995).

27. Christensen & Bertschi, *supra* note 26, at 696 ("Because the practice of a profession by a licensed individual is lawful, these statutes imply that a limited liability company can render professional services.")

28. R.I. GEN. LAWS § 7-16-3 (Supp. 1996) ("Every limited liability company organized under this chapter has the purpose of engaging in any business for which a limited partnership may carry on, except the provision of professional services.")

29. See Hamilton, *supra* note 13, at 1069 (noting that Texas led nation in number of financial institution failures, with more than one-third of nation's banking failures). For a personal account of the events leading to the adoption of the nation's first LLP legislation, see *id.* at 1074.

30. See *id.* at 1073 (acknowledging that author's first reaction to proposed legislation was negative).

failed to provide a substitute source of recovery (i.e., insurance).³¹ After partnership expert Professor Alan R. Bromberg criticized the bill, legislators asked him to propose amendments.³² Professor Bromberg's revisions addressed objections to the bill by:

- (1) Extending the liability limitation to all partnerships,
- (2) Denying protection to partners for misconduct of those working under their supervision or direction,
- (3) Requiring annual registration with the state and inclusion of "L.L.P." or "registered limited liability partnership," in the firm name, and
- (4) Requiring liability insurance in an arbitrary and admittedly often inadequate amount of \$100,000.³³

With these revisions, the proponents of the bill "quietly attached" it to an omnibus bill "that authorized limited liability companies and included significant amendments to existing corporation and partnership statutes."³⁴ Sections of the Omnibus Business Association Act of May 20, 1991 amended and added provisions to the Texas Uniform Partnership Act to create a new type of partnership, a registered LLP.³⁵

The LLP spark that started in a small West Texas town "spread like wild fire" to the rest of the state and throughout the nation.³⁶ The LLP structure appeals to members of professional partnerships because they can continue to function as general partnerships while limiting partners' vicarious liability for other partners' malpractice. Unlike the LLC, the LLP does not require the creation and administration of an entirely new type of busi-

31. ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON LIMITED LIABILITY PARTNERSHIPS AND THE REVISED UNIFORM PARTNERSHIP ACT § 1.01(a), at 3 (1995).

32. Hamilton, *supra* note 13, at 1073-74. In his testimony on the LLP proposal, Professor Alan R. Bromberg identified two problems: "It's not needed, and it's poor public policy." Borges, *supra* note 15, at 7. Professor Bromberg also referred to the bill as "highly discriminatory, in that it protects those who need it least." *Id.* He noted that partners in successful partnerships usually make large incomes, own many personal assets, and can afford insurance. *Id.*

33. BROMBERG & RIBSTEIN, *supra* note 31, § 1.01(a), at 3-4.

34. Hamilton, *supra* note 13, at 1074.

35. Steven A. Waters & Matthew D. Goetz, *Annual Survey of Texas Law — Partnerships*, 45 Sw. L.J. 2011, 2022 (1992).

36. Within two years of the enactment of the Texas LLP legislation, 569 Texas firms elected LLP status. See *Why 569 Texas Law Firms Just Switched to LLP*, LAW OFF. MGMT. & ADMIN. REP., Apr. 1994, at 94-1 (quoting staff attorney with Texas Secretary of State's office). By July 1996, forty-five states had adopted LLP legislation and the remaining states were considering adopting LLP legislation. *An Important Matter for State Bar Members*, W. VA. LAW., July 1996, at 27.

ness entity.³⁷ Moreover, the LLP enables members to continue the tradition of holding themselves out as partners. Citing the advantages of LLPs, attorneys and accountants marshaled support for enactment of LLP legislation.³⁸ Some LLP statutes expressly allow professionals to practice as LLPs while others do not specifically address the ability of professionals to practice as LLPs.

Even in those states that expressly allow professionals to practice as LLPs or LLCs, the appropriate state body that regulates the practice of law must approve attorneys which use a limited liability structure.³⁹ For example, a Nebraska State Bar Association ethics opinion prohibits attorneys from forming LLCs despite the fact that the Nebraska LLC statute expressly authorizes professionals to practice as LLCs.⁴⁰ Thus, as a final hurdle, professionals must obtain approval from the appropriate regulatory authority in order to use a limited liability structure.⁴¹ Otherwise, firm attorneys could be denied the desired liability shield.

37. See Larry Smith, *LLPs: Politically, A Ripe Time for Firms to Act*, COUNSEL, Aug. 16, 1993, at 2 (discussing administrative ease in converting to LLP and other practical advantages of LLPs).

38. The accounting profession, led by the Accountants' Coalition, joined the push for enactment of LLP legislation. Dan L. Goldwasser, *As the Dust Settles*, in ACCT. LIABILITY 1995, at 9, 21-22 (PLI Litig. & Admin. Practice Course Handbook Series No. 526, 1995) (asserting that adoption of LLP and LLC laws, which reduce liability exposure of accountants, "will encourage competent CPAs to practice in large firms in which they have little or no control over the actions of their partners").

39. The ABA and many state bar associations have already concluded that attorneys can limit their liability through LLCs and LLPs. See ABA Comm. on Ethics and Professional Responsibility, Formal Op. 96-401 (1996) (concluding that *Model Rules of Professional Conduct* permit attorneys to practice in limited liability entities provided certain conditions are met). Court opinions rarely cite or rely on these advisory bar association opinions. See CHARLES W. WOLFRAM, MODERN LEGAL ETHICS § 2.6.6 (1986). For a review of the ethics opinions and state rules allowing attorneys to practice law in LLCs, see Christensen & Bertsch, *supra* note 26, at 756-58. A review of the state ethics opinions indicates that some states allow attorneys to practice in LLCs without qualifications. See, e.g., State Bd. of Tex. Professional Ethics Comm'n, Op. 486 (undated) (concluding that no provision in *Texas Disciplinary Rules of Professional Conduct* prohibits attorneys from practicing as LLC). Other states impose additional conditions. For example, Colorado Rule of Civil Procedure 265 requires that equity owners in professional companies remain personally liable for the organization's professional acts, unless the organization itself carries professional liability insurance meeting certain standards. David C. Little, *Changes in the Rule Authorizing Professional Corporations*, COLO. LAW., Mar. 1996, at 67, 68.

40. Nebraska State Bar Ass'n, Ethics Op. 94-1 (1994) (prohibiting Nebraska attorneys from practicing as LLCs until "[state] supreme court enacts rules specifically authorizing [that form of practice]").

41. If a state's highest court concludes that the limited liability structure violates applicable ethics rules or public policy, the court could refuse to recognize the limited liability shield.

III. Statutory Approaches to Limiting Liability

The limited liability shield provided by LLPs and LLCs varies from state to state.⁴² Initially, when Texas adopted the first LLP statute, the key difference between an LLP and an LLC was that an LLP only limited partners' vicarious liability for tort claims, whereas an LLC limited vicarious liability for all claims. More recent LLP legislation drops this distinction by eliminating vicarious liability for both tort and contract claims.⁴³

In rejecting the statutory liability shield, courts could rely on the inherent powers doctrine, which holds "that courts, and only courts, may regulate the practice of law." Charles W. Wolfram, *Lawyer Turf and Lawyer Regulation — The Role of the Inherent-Powers Doctrine*, 12 U. ARK. LITTLE ROCK L.J. 1, 3 (1989-90) (emphasis omitted); see *First Bank & Trust Co. v. Zagoria*, 302 S.E.2d 674, 675-76 (Ga. 1983) (concluding that shareholders in professional corporation cannot limit their vicarious liability). Thirteen years later, in a surprising reversal of position, the Georgia Supreme Court overruled *Zagoria* "to the extent that it states that this court, rather than the legislative enabling act, determines the ability of lawyers to insulate themselves from personal liability for the acts of other shareholders in their professional corporation." *Henderson v. HSI Fin. Servs., Inc.*, 471 S.E.2d 885, 886 (Ga. 1996). This reversal illustrates the difficulty in predicting how courts will handle the statutory liability limits. Referring to the "perpetual state of flux," one commentator warns attorneys against assuming that courts will uphold the liability shield. Debra L. Thill, Comment, *The Inherent Powers Doctrine and Regulation of the Practice of Law: Will Minnesota Attorneys Practicing in Professional Corporations or Limited Liability Companies Be Denied the Benefit of Statutory Liability Shields?*, 20 WM. MITCHELL L. REV. 1143, 1176 (1994).

42. Most states enacted their LLC legislation without the benefit of a uniform or prototype act. Jennifer J. Johnson, *Limited Liability for Lawyers: General Partners Need Not Apply*, BUS. LAW., Nov. 1995, at 85, 102 n.69 (explaining that version of jurisdiction's limited partnership act served as basis for many LLP statutes with certain provisions drawn from general business corporation law). In 1993, the Subcommittee on General Partnerships and Unincorporated Business Associations of the ABA Section on Business Law released a Prototype Limited Liability Company Act (Prototype Act). The Prototype Act is reprinted in BROMBERG & RIBSTEIN, *supra* note 31, app. B. The Prototype Act formed the basis for statutes enacted since the Prototype Act was released. Johnson, *supra*, at 102. Thereafter, in August 1994, the National Conference of Commission on Uniform State Laws approved the Uniform Limited Liability Company Act, which has since been redrafted. UNIF. LIMITED LIABILITY COMPANY ACT (ULLCA), 6A U.L.A. 425 (1995).

43. Compare TEX. REV. CIV. STAT. ANN. art. 6132b-3.08 (West Supp. 1997) (limiting partner's liability for debts and obligations of partnership "arising from errors, omissions, negligence, incompetence, or malfeasance . . . committed by another partner or a representative of the partnership"), with N.Y. PARTNERSHIP LAW § 26(b) (McKinney Supp. 1997) (expanding LLP liability protection to provide that "no partner . . . is liable or accountable, directly or indirectly (including by way of indemnification, contribution or otherwise), for any debts, obligations, or liabilities of, or chargeable to, the registered limited liability partnership or each other, whether arising in tort, contract or otherwise, . . . solely by reason of being such a partner").

LLCs afford owners the same limited liability enjoyed by corporate shareholders along with flow-through partnership tax benefits.⁴⁴ Under all LLC statutes, the LLC remains liable for all company liabilities, including liability resulting from any negligent or wrongful act of its members or employees.⁴⁵ Individual members also remain liable for their own misconduct.⁴⁶ LLC statutes then either implicitly or expressly limit members' vicarious liability for tort claims.⁴⁷ For example, the District of Columbia statute states that "[n]o member of a professional limited liability company shall be so personally liable and accountable merely because of such member's membership interest in the professional limited liability company."⁴⁸ Statutes which implicitly limit liability do so by providing that a member is liable only for that member's own negligence.⁴⁹

Similarly, LLP provisions take different approaches to providing a liability shield. Most states follow the Texas model, adopting LLP legislation that only eliminates vicarious liability for tort claims. Understanding that clever plaintiffs could attempt to plead around such a statutory limit by alleging some malpractice theory of liability other than negligence, some state legislators broadened the liability shield to eliminate vicarious liability for misconduct, whether characterized as tort or contract or otherwise.⁵⁰

44. Johnson, *supra* note 42, at 102. This Article uses the terms "partners" or "members" to refer to owners of LLCs.

45. Brian L. Schorr, *Limited Liability Companies: Features and Uses*, in FORMING AND USING LIMITED LIABILITY COMPANIES 1993, at 196 (PLI Corp. L. Practice Course Handbook Series No. 805, 1993).

46. The Comments to the ULLCA explain that the language in the Act which states that LLC members have no liability for firm obligations "solely" due to their membership status does not relieve a member of liability for the member's own conduct. *See* ULLCA § 303 cmt. Furthermore, agency law holds "actors . . . responsible for their personal actions even when carried out as agents for another entity." Johnson, *supra* note 42, at 91 (citing RESTATEMENT (SECOND) OF AGENCY § 343 (1958)). Finally, ethical rules in every jurisdiction prohibit or restrict attorneys' attempts to limit their liability prospectively. *Id.*

47. Christensen & Bertschi, *supra* note 26, at 701 (referring to appendix that sets forth pertinent portions of various statutes).

48. D.C. CODE ANN. § 29-1314 (1996).

49. By limiting a member's liability to that member's own negligence, a statute "implies that a member that was not involved in the negligent act or omission enjoys limited liability." Christensen & Bertschi, *supra* note 26, at 702.

50. *See, e.g.*, CAL. CORP. CODE § 15015 (West Supp. 1996) (protecting partners from another partner's malpractice, whether claim sounds in tort, contract, or otherwise); DEL. CODE ANN. tit. 6, § 1515(b) (Supp. 1994) (same); FLA. STAT. ANN. § 620.782(1) (West Supp. 1996) (same). In the opinion of one commentator, this statutory language addresses the "diverse character of malpractice claims by providing protection against tort claims and all claims resulting from the provision of professional services, whether arising in tort or

Some of the most recent LLP statutes, such as those enacted in Minnesota and New York, go one step further in providing partners full protection against vicarious liability for all obligations of the firm.⁵¹

A. Provisions Conditioning Limited Liability on Insurance

Another difference in the liability provisions in LLP and LLC statutes relates to insurance requirements. Some LLP and LLC statutes provide that the liability shield only applies if the LLP or LLC carries some requisite amount of insurance coverage.⁵² Other statutes do not condition liability protection on maintaining some level of insurance or providing evidence of financial responsibility.⁵³

The amount of insurance required varies from state to state. For example, the Texas LLP provisions require at least \$100,000 of liability insurance.⁵⁴ Recognizing the skyrocketing costs of litigation and the actual exposure for attorneys and firms, the Delaware statute increases the minimum amount of insurance to \$1,000,000 and California increases the amount to \$100,000 times the number of attorneys in the LLP, up to \$7,500,000.⁵⁵ Although the amount of required insurance coverage varies

contract." Johnson, *supra* note 42, at 109.

51. See, e.g., MINN. STAT. ANN. § 323.14(2) (West Supp. 1997) ("A partner of a limited liability partnership is not, merely on account of this status, personally liable for anything chargeable to the partnership under Sections 323.12 [wrongful acts] and 323.13 [breach of trust], or for any other debts or obligations of the [LLP].").

52. In viewing insurance or asset segregation as a substitute for individual partner liability, the insurance or segregation of assets should be in effect at the time of suit in order for the liability shield to apply. See BROMBERG & RIBSTEIN, *supra* note 31, § 2.06(c), at 53.

53. For example, the New York LLP provisions do not mandate insurance coverage. See N.Y. PARTNERSHIP LAW, Article 8-B practice commentaries, at 111 (McKinney Supp. 1997) ("Unlike some other states . . . New York does not prescribe certain levels of malpractice or other insurance or maintaining certain financial responsibility for a RLLP.").

54. TEX. REV. CIV. STAT. ANN. art. 6132b-45-C(1) (West Supp. 1997). The Texas provisions now allow the following alternative to insurance:

\$100,000 of funds specifically designated and segregated for the satisfaction of judgments against the partnership based on the kinds of errors, omissions, negligence, incompetence, or malfeasance for which liability is limited . . . by

- (i) deposit in trust or in bank escrow of cash, bank certificates of deposit, or United States Treasury obligation; or
- (ii) a bank letter of credit or insurance company bond.

Id.

55. DEL. CODE ANN. tit. 6, § 1546(a) (1993 & Supp. 1994) (requiring at least \$1,000,000 of liability insurance "of a kind that is designed to cover the kinds of . . . misconduct for which liability is limited by § 1515(b) of this title and which insures the

from state to state, legislatively mandated insurance addresses the concern that the elimination of vicarious liability leaves malpractice plaintiffs without recovery in the event of a judgment.⁵⁶ Still, most statutory amounts appear to be inadequate, considering the escalating costs of defense and the size and frequency of malpractice claims.⁵⁷

B. Provisions Relating to Supervisory Liability

The vicarious liability provisions of LLP and LLC statutes also vary in their treatment of supervisory liability for other persons' acts or omissions. Only a few LLC statutes extend a member's personal liability to cover acts or omissions of persons who that member directly supervises or controls.⁵⁸ The vast majority of the LLC statutes do not refer to supervisory liability, effectively limiting a member's personal liability to that member's own conduct.⁵⁹

On the other hand, most LLP statutes provide for some degree of personal liability for the conduct of supervised persons.⁶⁰ LLP statutes use different approaches in recognizing personal liability for supervised persons. Most statutes indicate that the limited liability provisions "do not affect" the liability of partners or members for their own acts or the acts of those they directly supervise.⁶¹ Some suggest this liability by "negative

partnership and its partners"); CAL. CORP. CODE § 15052(a)(2) (West Supp. 1997).

56. As explained by Professor Deborah Rhode, "many valid civil liability claims go unredressed because the lawyer has insufficient insurance or personal assets." Deborah L. Rhode, *Institutionalizing Ethics*, 44 CASE W. RES. L. REV. 665, 697 (1994).

57. Most legal malpractice policies now require that defense costs be subtracted from the limits of liability, thus reducing the amount remaining to pay judgment or settlements. Andrew S. Hanen & Jett Hanna, *Legal Malpractice Insurance: Exclusions, Selected Coverage and Consumer Issues*, 33 S. TEX. L. REV. 75, 148 (1992).

58. See, e.g., ARIZ. REV. STAT. ANN. § 29-846 (1989 & West Supp. 1996); N.Y. LIMITED LIABILITY COMPANY LAW § 1205 (McKinney Supp. 1997).

59. Johnson, *supra* note 42, at 104 n.75 (citing LLC statutes that do not make reference to supervisory liability). One commentator views the question of supervisory responsibility under these statutes as an "evolving issue" to be resolved. See McLaughlin, *supra* note 25, at 245 n.127.

60. See Johnson, *supra* note 42, at 112. Compare Model Rule 5.1(a), which states: "A partner in a law firm shall make reasonable efforts to ensure that the firm has in effect measures giving reasonable assurance that all lawyers in the firm conform to the rules of professional conduct." MODEL RULES OF PROFESSIONAL CONDUCT Rule 5.1(a) (1995) (amended 1996). In discussing Model Rule 5.1, one commentary suggests that LLP statutes incorporate the concept of supervisory responsibility. Robert R. Keatinge et al., *Limited Liability Companies, LIMITED LIABILITY COMPANIES: INTO THE MAINSTREAM*, Q229 A.L.I.-A.B.A. 1, 122 (1994).

61. See Johnson, *supra* note 42, at 112.

inference" from language that gives partners "limited liability for firm debts arising from the acts of others 'not under the direct supervision and control' of the member or partner."⁶² Other statutes expressly state that attorneys "shall be" liable for persons they directly supervise and control.⁶³

Some statutes that recognize supervisory liability do not clarify whether courts should hold the supervisory attorney strictly liable for conduct of supervised attorneys, leaving open the question of whether a plaintiff seeking to hold a supervising attorney personally liable must establish some negligence on the part of the supervising attorney.⁶⁴ Other statutes require a showing of partner negligence or fault, specifying the types of activities that could trigger negligence liability, including supervision and cooperation.⁶⁵ Statutory language also raises questions on the level of "supervision" that gives rise to liability.⁶⁶ As discussed below, these ambiguities may encourage attorneys to avoid any connection to other attorneys' work.

IV. Internal Consequences of Converting to Limited Liability Firms

Traditionally, law firms functioned as general partnerships in which the partnership and its partners were liable for tortious wrongs or contractual breaches committed by one of its members within the scope or apparent scope of the partnership.⁶⁷ The members shared unlimited liability for firm

62. *Id.*

63. *See, e.g.*, N.Y. PARTNERSHIP LAW § 26(c) (McKinney Supp. 1997) (providing that partner in registered limited liability partnership "shall be personally and fully liable and accountable for any negligent or wrongful act or misconduct committed by him or her or by any person under his or her direct supervision and control while rendering professional services on behalf of such registered limited liability partnership").

64. *See* Johnson, *supra* note 42, at 113.

65. BROMBERG & RIBSTEIN, *supra* note 31, § 3.04(a), at 86.

66. Martin, *supra* note 26, at 122.

67. *See* RONALD E. MALLIN & JEFFREY M. SMITH, LEGAL MALPRACTICE § 5.3 (4th ed. 1996) (referring to Uniform Partnership Act (U.L.A. 1914) Sections 13 and 15 and the Uniform Partnership Act (U.L.A. 1992) Sections 305 and 306). Section 79 in chapter four of the proposed *Restatement of the Law Governing Lawyers* being considered by the American Law Institute (ALI) recognizes this general rule of vicarious liability in stating: "Each of the principals of a law firm organized as a general partnership is liable jointly and severally with the firm." RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 79(2) (Tentative Draft No. 12, 1996). Comment (b) following Section 79 explains the rationale for imposing vicarious liability:

Vicarious liability also helps to maintain the quality of legal services, by requiring not only a firm but also its principals to stand behind the performance of other firm personnel. Because many law firms are thinly capitalized, the vicarious liability of principals helps to assure compensation to those who may have claims against the principals of the firm.

debts. This personal liability of members for firm debts provided a basis for various provisions in partnership statutes.⁶⁸ Thus, by eliminating unlimited liability, LLP and LLC legislation alters a fundamental premise underlying traditional partnership practice. This change affects a number of aspects of law firm practice, including the manner in which attorneys conduct themselves before and after malpractice claims arise.

A. Adverse Effect on Attorneys' Willingness to Work with and Supervise Other Firm Attorneys and Employees

Partners in general partnerships pool net cash flows and liability, thus sharing the costs and benefits of the partnership. In traditional partnerships, the unlimited liability shared by partners encourages the partners to participate actively in firm affairs in an effort to control their own personal liability exposure. Active participation takes a number of forms, including acting as supervising attorneys or serving on various committees, such as opinion review or peer review committees.⁶⁹ Such monitoring and consultation promises "[to] improve the quality of services delivered, [to] control liability losses, and [to] enhance the human capital of the partners."⁷⁰ Such measures protect the individual partners, the firm, firm clients, and other third parties⁷¹ who deal with firm attorneys or rely on attorneys' work.⁷²

Id. § 79 cmt. b. To address legislation allowing attorneys to limit their vicarious liability, the comments note that "limited liability is a principle generally accepted for those engaged in gainful occupations, and it may be difficult for a lawyer to monitor the behavior of other lawyers in a large firm." *Id.* The ALI membership declined to approve an earlier version of Section 79 and accompanying comments that recognized a uniform rule holding attorneys vicariously liable: "The ALI has not yet resolved what stand the *Restatement* will take on this issue . . ." *Limited Liability Firms*, LAWS. MAN. ON PROF. CONDUCT (ABA/BNA) § 91:365 (1996).

68. BROMBERG & RIBSTEIN, *supra* note 31, § 1.03(c), at 18-19. A number of statutory provisions "are designed to accommodate the interest of personally liable members who need to control their potential liability, and whose shares in the firm should reflect their contributions of personal assets or credit." *Id.* For example, general partnership statutes provide for equal and direct participation in management, subject to contrary agreement.

69. Some consultation and involvement with other attorneys occurs on a formal basis, such as team work on a project or referral of legal problems to other attorneys. Consultation also occurs on an informal basis, such as sharing ideas and suggestions in a lunch visit or a section meeting.

70. Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327, 335 (1983) (noting that professional services can only be efficiently monitored by other professionals).

71. Third parties who are protected include opposing parties in litigation and investors who rely on an opinion letter issued by the firm. According to the ABA's National Data Center statistics, 13% of all malpractice plaintiffs fall into the category of nonclients. MALLEN & SMITH, *supra* note 67, § 6.2. As firms grow, the percentage of nonclient claims

Conversion to a limited liability firm effectively undermines this incentive for principals to consult, monitor, and supervise one another. By eliminating the risk of personal liability, the limited liability scheme largely removes a significant economic incentive to monitor the conduct of other firm participants.⁷³ In the absence of personal liability, firm principals might still monitor subordinates if they recognized their ethical responsibility to do so.⁷⁴ The threat to firm reputation, insurance, and other assets might also encourage attorneys to monitor other firm players and to participate in risk management activities. Unfortunately, the limited liability scheme could undermine this desire to consult with or to monitor other attorneys because such involvement with other attorneys can destroy the liability shield. Even defenders of limited liability firms recognize these "perverse incentive effects."⁷⁵ As explained by Professors Alan R. Bromberg and Larry Ribstein:

Partners may find that they can best reduce their risk of personal liability if they avoid monitoring that might trigger liability for participating in misconduct. The partner's personal liability for participating in misconduct would exceed their partner's share of the firm's liability. For example, specialists may refuse to learn about cases in which they are not directly involved, and firms may abolish opinion committees. This may hurt both firms and their clients.⁷⁶

increases. *Id.* The number of nonclient claims will continue to increase as duties to third parties expand. For an analysis of the current issues related to injuries to nonclients, see generally Symposium, *The Lawyers' Duties and Liabilities to Third Parties*, 37 S. TEX. L. REV. 957 (1996).

72. In traditional partnerships, quality control measures such as peer review measures provide internal controls on attorney misconduct, whereas unlimited liability exposure acts as an external control. For a discussion of the effects of culture and organizational structure on these internal and external controls, see Susan Saab Fortney, *Am I My Partner's Keeper? Peer Review in Law Firms*, 66 U. COLO. L. REV. 329, 340-344 (1995).

73. See Robert B. Thompson, *The Taming of Limited Liability Companies*, 66 U. COLO. L. REV. 921, 942-43 (1995) (warning that "limited liability can have a perverse impact on sharing work within a firm and on the firm's incentive structure" causing "members [to] dodge high risk transactions or demand higher compensation").

74. The ABA ethics opinion on practice in limited liability firms expressly states that the statutory shield from tort liability does not "free attorneys from supervisory obligations" under applicable ethical rules. See ABA Comm. on Ethics and Professional Responsibility, Formal Op. 96-401 (1996).

75. BROMBERG & RIBSTEIN, *supra* note 31, § 3.04(b), at 88. Different approaches could be used to address these problems. For example, firms could impose specific duties on partners or courts could apply some fiduciary duty. *Id.* (cross-referencing Section 4.04(b) on indemnification and Section 4.05 on fiduciary duties). For a discussion of indemnification problems, see *infra* notes 99-110 and accompanying text.

76. BROMBERG & RIBSTEIN, *supra* note 31, § 3.04(b), at 88.

In short, limited liability provisions not only remove one incentive to monitor and consult with other attorneys, but the provisions also threaten to penalize an attorney for doing so. This may cause firm attorneys to operate more as a confederation of attorneys sharing office space, rather than as a team sharing responsibilities and work.

Legislation, such as LLP provisions that impose supervisory liability, might actually subvert firm structure, growth, and cohesion. As discussed above, most of the LLP statutes make LLP partners "liable not only for their own misconduct, but also for the conduct of others in which they somehow participated or for whom they had some monitoring responsibility."⁷⁷ These provisions could result in a "kind of vicarious liability that is concentrated on particular partners"⁷⁸ leaving those partners "more exposed to liabilities in LLPs than in non-LLP partnerships because only their assets, and not those of [all] other partners, will be available to pay claim[s]."⁷⁹ Recognizing this exposure, partners may shirk supervisory responsibilities rather than subject themselves to the risk of personal liability for the acts or the omissions of others.⁸⁰

The ambiguity of the "supervision and control" provisions further exacerbates their adverse effect.⁸¹ The failure of LLP statutory provisions

77. Larry E. Ribstein, *Possible Futures of Unincorporated Firms*, 64 U. CIN. L. REV. 319, 322 (1996).

78. *Id.* at 330. Professor Larry E. Ribstein suggests that concentrating tort liability on supervising or monitoring partners, rather than "across the board" liability, can be justified on the basis that such partners' connection to the matter might enable them to prevent the harm or misconduct. *Id.* at 330-31.

79. *Id.* at 330 (explaining that this adverse effect "is exacerbated by the fact that supervisory liability is a wrong that claimants can pursue directly against partners even in states that otherwise require plaintiffs with vicarious liability claims first to exhaust partnership assets before seeking recovery out of partners' personal assets"). Malpractice experts Ronald E. Mallen and Jeffrey M. Smith made the same cautionary observation in warning that limited liability structures for those who do not supervise or render any service leave those who do even more exposed than in a general partnership. MALLEN & SMITH, *supra* note 67, § 5.6.

80. In testimony on the original Texas LLP bill, Professor Bromberg indicated that unlike the current law, which encourages supervision, the proposed LLP legislation, which did not include provisions on supervisory liability, would weaken the motivation to supervise associates and staff closely. *See* Borges, *supra* note 15, at 7. Thereafter, Professor Bromberg revised the bill to include the provisions for "supervisory and control" liability." *See* BROMBERG & RIBSTEIN, *supra* note 31, § 1.01(a), at 3.

81. In discussing interpretation problems, Professor Hamilton notes that the shield may easily be described in "abstract terms," but "serious issues of interpretation arise at the margin." Hamilton, *supra* note 13, at 1081. Professor Hamilton uses the Texas statute to illustrate the interpretation problems. *Id.* at 1081-83. Unlike the District of Columbia

to define the meaning of "direct supervision or direction" raises a number of questions, including:

How close does supervision have to be to constitute "direct" supervision? Does it cover the ultimate responsibility that a senior partner or rain-maker in a law firm has for "his" client? Is it limited to the mid-level partner who actually does the work or who supervises associates and more junior partners when they do the work? Does it extend to members of the opinion committee of a law firm who review all formal legal opinions before they are released?⁸²

Although the statutes themselves may not clarify the degree of control that will subject a supervisor or a monitor to personal liability, commentators suggest that the statutes should not be interpreted "to deny the liability shield to someone (such as a managing partner or senior partner) who exercises indirect supervision over all partnership activities or over a particular segment of the partnership's business or who generally directs other partners by establishing policies and procedures or by assigning responsibilities."⁸³ Professor Bromberg's comments following the Texas LLP statutory provision make a similar observation in stating that:

[T]he supervision probably should be fairly specific for the exception to apply. The language does not seem intended to deny the liability shield to someone (such as a managing or senior partner) who exercises only a general supervision over all partnership activity.⁸⁴

Another comment following the Texas LLP provisions states that questions of supervisory control liability "involve fact questions as well as

statute, which imposes liability on partners who had "written notice or knowledge" of negligence or malpractice, the Texas statute extends liability to partners who were aware of negligence or malpractice and failed to take reasonable steps to prevent its occurrence. *Id.* at 1081 n.45. The Texas statute does not provide guidance on what charges partners with notice. *Id.*

82. *Id.* at 1082. Following this list of questions that apply to law firms, Professor Hamilton poses similar questions for accounting firms. *See id.*

83. R. Dennis Anderson et al., *Registered LLPs*, 55 TEX. B.J. 728, 729 (1992) (interpreting Texas LLP provision, which subjects partners to liability when other person works "under the supervision or direction of the first partner at the time the errors, omissions, negligence, incompetence or malfeasance occurred"); *see also* TEX. REV. CIV. STAT. ANN. art. 6132b (West Supp. 1997); Keatinge & Coleman, *supra* note 10, at 27 (expressing "hope" that "liability will be limited to those who have exercised negligent supervision, which is probably direct personal liability for negligence, in any case, rather than personal liability assigned to someone who happens to hold the title of manager or practice group leader").

84. TEX. REV. CIV. STAT. ANN. art. 6132b, § 15 cmt., at 112 (West Supp. 1997) (source and comments about 1991 Amendments by Alan R. Bromberg).

interpretation of the statutory language."⁸⁵ Malpractice plaintiffs' attorneys will attempt to assert claims to raise fact questions on the responsibility of all firm attorneys who had any connection to the matter giving rise to the malpractice claim.⁸⁶ These fact questions eventually will be litigated when plaintiffs assert that partners should be held liable for serving as monitors, managers, or supervisors.⁸⁷

Several statutes that provide for some form of supervisor or control liability do not clarify whether negligence on the part of the supervisor must be established.⁸⁸ If liability can be imposed on a supervisor, manager, or control person without establishing negligence, then liability appears to be a kind of strict liability imposed for serving in a role as a supervisor, monitor, or manager.⁸⁹

Because the statutes leave open many questions relating to supervisory and control liability, risk-averse attorneys⁹⁰ will probably elect to do less

85. *Id.*

86. When questions of interpretation arise, Professors Bromberg and Ribstein caution that "under pressure from plaintiffs' lawyers, courts might expand partners' individual liability for their own misconduct to compensate in part for the elimination of vicarious liability, perhaps by imposing liability on partners who are not involved in the misconduct but who merely learn of it and fail to act on this knowledge." BROMBERG & RIBSTEIN, *supra* note 31, § 3.04(b), at 88.

87. In his comments that follow Texas LLP statutory provisions, Professor Bromberg apparently recognizes the inevitability of resolving the fact questions in litigation when stating that a "firm which has well defined lines and descriptions of responsibility may have an advantage when issues of this sort are litigated." *Id.* In litigation, plaintiffs may seek to name all partners on the theory that the applicable ethical rules require that all members of a firm take steps to insure adequately that all lawyers in a firm comply with requirements of the rules of professional conduct. See Anthony E. Davis, *Limited Liability for Lawyers*, PROF. LAW., Aug. 1995, at 1, 5 (referring to obligations under Model Rule 5.1, with respect to supervising other lawyers, and Model Rule 5.3, with respect to supervising nonlawyer employees). For a discussion of Model Rule 5.1 and a partner's duty to monitor his or her peers, see Fortney, *supra* note 72, at 354-57.

88. Proponents of limited liability firms urge that liability only be imposed on a showing of negligent supervision. See Keatinge & Coleman, *supra* note 10, at 27.

89. See Ribstein, *supra* note 77, at 331 (warning that partners "may refuse to engage in strict liability activities where this will cause them to bear all of the risk, but reap only some of the gain").

90. In many ways, risk-averse partners tend to be superior monitors and supervisors as compared to other partners who tend to be less concerned about liability exposure. Ironically, the persons that will serve as the better monitors and supervisors will probably try to evade any supervisory or monitoring responsibility. In addition, persons with limited nonexempt assets may be less effective monitors than partners with substantial assets at stake. Partners with limited or no personal assets at stake may be willing to accept supervisory or monitoring positions, especially if they receive additional compensation for doing

rather than more and to know less rather than more when it comes to working with peers and subordinates.⁹¹ Similarly, wealthy senior attorneys might avoid acting as monitors, mentors, managers, and supervisors simply because those roles could subject them to personal liability for others' acts or omissions. The reluctance of experienced attorneys to train and supervise associates and junior partners can adversely affect the quality of legal services and may hamper the subordinates' professional growth and undermine their loyalty to the firm.⁹² Finally, attorneys who fear personal liability for the work of others may be less inclined to refer work to other firm attorneys, resulting in a kind of "territorial" hoarding of work by attorneys who may not be the best qualified to handle the work. Once again, this undermines the functioning of a firm as a team of attorneys sharing work and consulting each other in the delivery of legal services.

B. Conflicts Relating to Sharing of Liability and Payment of Debts

A traditional partnership could be viewed as a joint enterprise in which partners share the risks and benefits of that enterprise. This unlimited liability provides an impetus for partners to stand behind any partner sued for professional malpractice.⁹³ Statutory and contractual indemnification and contribution provisions reflect this "all for one, one for all" relationship among partners who share unlimited liability for partnership debts.⁹⁴ The elimination of this unlimited liability can lead to conflicts relating to the payment of malpractice claims and partnership debts, as well as conflicts related to indemnification and contribution.

so. Because these persons have comparatively less at stake, they may permit risky ventures that other partners might prevent.

91. See Deborah A. DeMott, *Our Partners' Keepers? Agency Dimensions of Partnership Relationships*, 58 LAW & CONTEMP. PROBS. 109, 128 (Spring 1995) (explaining that structure of limited liability statutes creates incentive to know less rather than more about fellow professionals' activities within same firm).

92. For a thorough analysis of the importance of supervision and mentoring of subordinate attorneys in law firms, see generally Irwin D. Miller, *Preventing Misconduct by Promoting the Ethics of Attorneys' Supervisory Duties*, 70 NOTRE DAME L. REV. 259, 267-74 (1994). As noted, "ongoing supervision prevents mishaps before they occur and allows opportunities for rectifying any potential problems at early correctable stages." *Id.* at 272.

93. See Weidlich, *supra* note 5, at 1 (referring to concern that limited liability rule will adversely affect firm culture so that partners will not "draw their wagons around colleague who's been accused of wrongdoing").

94. If partners give up the right to seek indemnification from other partners, they could be "exchanging the relationship of 'all for one' for one characterized as 'every man for himself.'" Robert R. Keatinge et al., *Limited Liability Partnerships: The Next Step in the Evolution of the Unincorporated Business Organization*, 51 BUS. LAW. 147, 188 (1995).

When faced with malpractice claims, partners in traditional partnerships, understanding their own personal exposure to liability for any judgment, rally around colleagues accused of malpractice.⁹⁵ In limited liability firms, partners may still support colleagues accused of malpractice, understanding that the firm's assets and reputation are at stake. In the event that malpractice insurance covers the loss, no conflict should arise among the principals. This situation changes, however, when insurance falls short of the amount of the malpractice claim. Serious conflicts can arise between firm attorneys with personal liability for the malpractice claim and the remaining attorneys with no personal liability for the malpractice claim. When firm assets cannot pay all firm obligations, attorneys with personal liability for the malpractice claim would probably prefer that the firm use those assets to pay the malpractice claim. On the other hand, attorneys with no personal liability for malpractice claims would want firm assets used to pay general firm debts, such as lease obligations and line of credit commitments.⁹⁶ This conflict can arise in states in which the LLP statute only limits liability for tort claims.⁹⁷ A similar conflict could arise if contractual creditors dealing with limited liability firms require all firm principals to sign personal guarantees making all principals liable for the partnership's contractual debt. Principals who foresee these potential conflicts could attempt to address the conflicts in their partnership agreement or LLC operating agreement. Despite the terms of agreements governing LLP partners or LLC members, disgruntled partners or members

95. In studying the advisability of converting to an LLP, the LLP evaluation committee for the Houston-based firm of Vinson & Elkins "concerned itself primarily with the larger policy implications . . . [of converting to a limited liability] system that would not require partners to rally around a colleague facing personal liability." Isom-Rodriguez, *supra* note 8, at 32 (quoting Vinson & Elkins LLP evaluation committee chairperson).

96. See Robert R. Keatinge et al., *Limited Liability Companies and Limited Liability Partnerships*, in 1995 LIMITED LIABILITY COMPANIES AND LIMITED LIABILITY PARTNERSHIPS: OPERATIONS AND DRAFTING AFTER REV. PROC. 95-10, at 1, 122 (1995) (explaining that use of firm assets to pay general firm debts can force negligent partner to use separate assets to pay malpractice liability).

97. Under LLP provisions that only extend the liability shield to malpractice claims, partners not involved in the malpractice would prefer that partnership assets be used to satisfy ordinary business obligations because they can be compelled to contribute to satisfy such obligations. See Hamilton, *supra* note 13, at 1079-80. For a discussion and examples of the "opportunistic conduct" that can occur in LLPs between "innocent" partners with no personal liability for malpractice claims and "guilty" partners with personal liability for both their malpractice claim and ordinary partnership obligations, see *id.* As explained by Professor Hamilton, "principles of fraudulent transfer, preferences in bankruptcy, or breach of fiduciary duty may come into play to limit opportunistic conduct" by partners with different agendas. *Id.* at 1079, n.37.

could challenge any decision on the use of assets as a breach of fiduciary duty.⁹⁸

Partners may not recognize that conversion to limited liability structure requires reconsideration of indemnification and contribution provisions in their partnership agreements.⁹⁹ First, partnerships must alter the indemnification and contribution provisions included in the partnership agreement. If partners fail to modify their agreements, a negligent partner who pays a malpractice claim might seek indemnification from the partnership and contribution from other firm partners. If firm partners refuse to contribute to the loss, litigation will probably ensue.

When LLP agreements or LLC operating agreements fail to address indemnification and contribution, the default rules under the Uniform Partnership Act (UPA) and the Revised Uniform Partnership Act (RUPA) provide for indemnification and contribution.¹⁰⁰ In that event, the same conflict could occur between the negligent attorney who seeks indemnification and contribution and the other partners. Once again, the other partners may refuse payment, arguing that requiring contribution amounts to a "back door" imposition of vicarious liability.¹⁰¹

98. See Robert R. Keatinge, *Liability of Members*, PLANNING AND USING LIMITED LIABILITY VEHICLES: LIMITED LIABILITY PARTNERSHIPS, LIMITED LIABILITY COMPANIES, LIMITED PARTNERSHIPS, LIMITED LIABILITY LIMITED PARTNERSHIPS, Q243 A.L.I.-A.B.A. 125, 136 (1996) (noting that question of whether application of assets "would implicate a breach of fiduciary duty to the negligent partner remains to be determined").

99. Keatinge et al., *supra* note 94, at 195 (suggesting that indemnification provisions be revised to provide that partnership, rather than individual partners, will indemnify negligent or responsible partner). Any provision giving rise to an individual obligation to contribute to the partnership for partnership obligations should also be modified or eliminated. See Elizabeth G. Hester, *Keeping Liability at Bay*, BUS. L. TODAY, Jan.-Feb. 1996, at 59, 60 (explaining that modification of contribution and indemnification provisions will "assure that the agreement does not override the protection afforded partners by the [applicable] statute").

100. Section 18(b) of the UPA states: "The partnership must indemnify every partner in respect of payments made and personal liabilities reasonably incurred by him in the ordinary and proper conduct of its business, or for the preservation of its business or property." UNIF. PARTNERSHIP ACT (1914) (UPA) § 18(b), 6A U.L.A. 526 (1995). Section 401(c) of RUPA states: "A partnership shall reimburse a partner for payments made and indemnify a partner for liabilities incurred by the partner in the ordinary course of the business of the partnership or for the preservation of its business or property." REVISED UNIF. PARTNERSHIP ACT (1994) (RUPA) § 401(c), 6A U.L.A. 52 (1995).

101. The application of the indemnification and contribution rules could be viewed as a dilution of LLP protection. Professors Bromberg and Ribstein explained this dilution as follows: "If a partner is liable for her own misconduct and receives indemnification from the firm, the other partners have in effect shared that liability. Similarly, if innocent partners are required to contribute to losses resulting from another partner's misconduct, they are effectively sharing that liability." BROMBERG & RIBSTEIN, *supra* note 31, § 2.08(a), at 61.

Limited liability statutes can address the contribution problem by limiting the obligation of an LLP partner to contribute to the losses of the partnership, to indemnify other partners, and to make contributions upon dissolution.¹⁰² When a limited liability statute does not address contribution and indemnification rights, partners will be left to litigate the question.¹⁰³

Although partners may want to eliminate "across-the-board" indemnification and contribution, in some areas they may determine that indemnification and contribution should be provided in order for partners to assume special risks liability.¹⁰⁴ For example, supervisors, managers, practice leaders, and oversight committee members may require indemnification before serving in positions that could subject them to personal liability for the acts and the omissions of others.¹⁰⁵ Because partners in these positions in limited liability firms face more exposure than they would in traditional partnerships,¹⁰⁶ denying indemnification to them may cause them "to be reluctant to engage in these activities, [or they] may seek alternative types of compensation so that they can, in effect, insure against the risk, or [they] may refuse to be partners in LLPs."¹⁰⁷

102. See Louis A. Mezzullo, *Choice of Entity, QUALIFIED PLANS, PCS, AND WELFARE BENEFITS*, 980 A.L.I.-A.B.A. 1121, 1183-1185 (1995) (reviewing different LLP provisions dealing with indemnification and contribution). Most LLP statutes have adjusted the UPA indemnification and contribution provisions, and the prototype LLP statute adjusted the RUPA indemnification and contribution provision. See BROMBERG & RIBSTEIN, *supra* note 31, § 2.08(a), at 61 n.195.

103. In the event of litigation, the court should construe the indemnification and contribution sections "consistently with the limitation of liability." *Id.* Allowing negligent partners to recover, directly or indirectly, from other partners would appear to be inconsistent with the LLP liability shield. Anderson et al., *supra* note 83, at 733.

104. See Ribstein, *supra* note 77, at 329 (explaining that partners involved in "high-risk activities may demand indemnification from the partnership as a condition of participating in an LLP rather than having to face these liabilities alone"). A New York attorney who participated in the drafting of the New York LLP statute indicated that agreements from partners to contribute to partners handling certain transactions could avoid intrafirm squabbles, while maintaining the tradition of supporting one's partners. Edward A. Adams, *Firms Expected to Make Switch to New Format: Limited Liability Partnerships Seen Restricting Exposure*, N.Y. L.J., July 14, 1994, at 1.

105. See Davis, *supra* note 87, at 6 (describing opinion letter committee members and "rainmakers" as persons who might insist on indemnification).

106. See *supra* notes 78-79 and accompanying text.

107. BROMBERG & RIBSTEIN, *supra* note 31, § 2.09(d), at 66-67. In another article, Professor Larry Ribstein identified problems associated with these additional contracting costs. For example, increasing supervisors' compensation to reflect their "extra litigation risk" may "compromise other objectives in designing partner compensation." Ribstein, *supra* note 77, at 331.

This contractual indemnification also subjects the indemnified partners and the other partners to different risks. First, indemnification means that partners to be indemnified "rather than tort creditors would be left with the risk that assets of [other] partners would be inadequate or unavailable to pay claims."¹⁰⁸ The partner to be indemnified could resort to litigation to recover funds from the other partners. The other partners would carefully scrutinize their agreement to confirm that the indemnification provisions would not cover serious misconduct by the partner seeking indemnification.¹⁰⁹ Finally, the indemnification provisions would need to be qualified so as to avoid triggering an obligation to outside creditors.¹¹⁰

These problems relating to the sharing of liability and payment of claims could be avoided if firms' malpractice insurance policies would pay all costs related to the defense and payment of malpractice claims. Unfortunately, the limited liability structure creates potential conflicts among the partners related to insurance acquisition and use. These conflicts may adversely affect the costs and availability of malpractice insurance coverage.

C. *Adverse Effects on the Cost and Availability of Malpractice Insurance*

Attorneys may not realize that converting to limited liability structure impacts different aspects of professional liability insurance, starting with the annual decision to secure malpractice coverage. First, attorneys may mistakenly think that conversion to a limited liability firm diminishes the need for professional liability insurance.¹¹¹ Even attorneys who understand that malpractice insurance should be purchased to protect firm assets (and the assets of the persons accused of malpractice) may elect policies with lower limits of liability than they would want in a traditional firm in which partners share unlimited personal liability. In determining the amount of coverage, attorneys involved in activities that pose higher risk of personal liability, such as securities attorneys and section supervisors, may prefer higher limits of liability than less exposed attorneys.¹¹²

108. Ribstein, *supra* note 77, at 331.

109. BROMBERG & RIBSTEIN, *supra* note 31, § 2.09(d), at 67.

110. *Id.*

111. See Kirsten L. Christophe, *Continuing Protection: Converting to a Limited Liability Structure Raises Key Insurance Issues*, A.B.A. J., Sept. 1995, at 92 (referring to this belief as "common misperception").

112. Ribstein, *supra* note 77, at 332 (explaining that attorneys exposed to higher levels of risk "may insist on maintaining higher levels of insurance or on [the firm] retaining more cash than the less exposed partners would prefer"). To illustrate the conflict between these

Assuming that the firm resolves conflicts on purchasing the policy, the limited liability structure can cause insurance conflicts after a person makes a malpractice claim. Facing a malpractice claim, partners in traditional firms circle the wagons and marshal a unified defense.¹¹³ This generally enables the firm and the target attorneys to hire the same defense counsel because their interests are aligned.¹¹⁴ As a result, partners in traditional partnerships seldom file cross claims against one another.¹¹⁵ The limited liability structure changes the alignment of the partners so that "liability of one" no longer amounts to "liability for all."¹¹⁶ In a limited liability firm, partners sit in different positions. Those partners involved in client representation risk personal liability while the statutory limited liability provisions protect other partners if the court upholds the liability shield.¹¹⁷ Even partners with personal liability exposure can be divided.

two groups of partners, Professor Hamilton used the example of a two-partner firm in which one partner practices in the area of trusts and estates and the other partner handles mergers and acquisitions. See Hamilton, *supra* note 13, at 1084.

113. Although "[i]t often is desirable to present a united front against a professional liability claim through a common defense on behalf of the firm and all its partners," some observers theorize that the limited liability shield may divide partners. See Christophe, *supra* note 111, at 92.

114. Professional liability policies name the firm as the insured and extend coverage to all professionals and employees associated with the firm. Debra A. Winiarski, *Walking the Fine Line: A Defense Counsel's Perspective*, 28 TORT & INS. L.J. 596, 607 (1993). Typically, the insurer will hire the same defense attorney to represent the firm and firm attorneys named as codefendants. *Id.* at 607-08 (describing conflicts analysis that defense counsel complete before accepting joint representation of codefendants).

115. The filing of cross claims would serve no purpose because current partners in traditional partnerships will be held liable for all partnership debts and obligations. See RUPA § 306(a) (providing that "all partners are liable jointly and severally for all obligations of the partnership unless otherwise agreed by the claimant or provided by law").

116. See John J. Soughan, *Professional Responsibility and Law Firm Management: Issues from an Insurer's Point of View* 10 (1996) (unpublished manuscript) (on file with *Washington and Lee Law Review*) (noting that traditionally liability for one is, in a sense, liability for all resulting in "uniformity of interest as between partners and even extended to the firm and the carrier").

117. The courts may not recognize the liability shield for a number of reasons. For example, some statutes, such as the Texas LLP statute, require the registered LLP to maintain "at least \$100,000 of liability insurance of the kind that is designed to cover the kinds of errors [and] omissions . . . for which liability is limited" under the statute. TEX. REV. CIV. STAT. ANN. art. 6132b-3.08(d)(1)(A) (West Supp. 1997). Depending on the circumstances, a court may need to construe and apply this language to determine if the liability shield applies. To illustrate the construction problems, Professor Hamilton poses a number of questions including the following:

[W]hat happens if an act of negligence or malpractice is covered . . . under the

Consider the example of a malpractice claim arising out of a tax shelter opinion which failed to disclose that a tax attorney with the firm would earn commissions on the cash proceeds generated by tax shelter sales.¹¹⁸ In that event, the tax attorney and the members of the committee who approved the opinion could share personal liability. The committee members might file cross claims against the tax attorney, asserting that the tax attorney failed to inform them of the tax attorney's contingent interest. Because the positions of the committee members and the tax attorney clearly conflict, the individual attorneys and the firm should not be represented by the same defense counsel.¹¹⁹ Rather, committee members would probably demand

statutes but is excluded from coverage by a restriction or exception in the liability insurance policy? Since the insurance proceeds are not available to the plaintiff in that case, may she ignore the shield of limited liability and go after the innocent partners? The language, "of a kind that is designed to cover the kinds of negligence, wrongful acts, and misconduct for which liability is limited" indicates that a complete overlap between coverage and the shield of limited liability is not required, but no one really knows.

Hamilton, *supra* note 13, at 1083. As indicated, questions may arise as to whether the firm's insurance policy satisfies the statutory requirements. If the policy does not, the court could deny the liability shield, sorely disappointing attorneys who relied on such a shield.

118. Because investors could view the pecuniary interest as a material fact reflecting on the firm's independence, the opinion letter should have disclosed the commission arrangement. See John P. Freeman, *Current Trends in Legal Opinion Liability*, 1989 COLUM. BUS. L. REV. 235, 275-76 (recommending disclosure of any personal interest which reasonable person would consider important in subject matter of opinion).

119. The interests of the committee members and the tax attorney not only conflict on defense of the claim, they also could conflict because of the application of one or more insurance policy exclusions. For example, the fraud exclusion under the policy could apply if the plaintiff established that the tax attorney defrauded the plaintiff in not disclosing the bankruptcy. If the committee members did not engage in the fraud, they could be protected under the "innocent partner" provision typically found in legal malpractice policies. The innocent partner protection extends coverage to any insured who neither personally participated in fraudulent, criminal, or dishonest conduct nor remained passive after learning of any such act or omission. Robert W. Minto, Jr. & Marcia D. Morton, *The Anatomy of Legal Malpractice Insurance: A Comparative View*, 64 N.D. L. REV. 547, 573-74 (1988). If a policy does not provide innocent partner protection, the fraud exclusion may eliminate coverage for all partners even if the plaintiff alleges that certain partners acted negligently in failing to supervise and mitigate their partners' criminal acts. See *Continental Cas. Co. v. H.S.I. Fin. Servs., Inc.*, 466 S.E.2d 4, 6 (Ga. 1996) (concluding that claim that law partners acted negligently in supervising and mitigating fellow partner's criminal act "aris[es] out of" any dishonest, fraudulent, criminal, or malicious act" within meaning of insurance policy's fraud exclusion). But see *Continental Cas. Co. v. McDowell & Colantoni, Ltd.*, 668 N.E.2d 59, 64-65 (Ill. App. Ct. 1996) (concluding that "dishonesty" provision in law firm's professional liability insurance policy did not exclude claim alleging law firm negligently failed to supervise its trust account and thereby allowed firm member to misappropriate client funds).

a separate defense.¹²⁰ The multiple defenses would reduce the amount available to pay the claim because legal malpractice policies now include the amount of defense costs in the coverage limits.¹²¹ Depending on the size of the claim and the amount of damages sought, the interests of the insured attorneys might conflict on application of the amount remaining under the policy. The committee members might want the insurer to use the remaining amount to fund a settlement for them. At the same time, the tax attorney could insist that the insurer devote the remaining policy amount to defense. In the event of such a conflict, an insurance company could seek court intervention to resolve the dispute. This conflict not only divides firm attorneys, but reduces the amount of insurance remaining to pay the plaintiff following judgment or settlement.

These conflicts and other issues associated with the limited liability structure will force insurers to rethink their approach to underwriting legal malpractice insurance. Historically, insurers developed attorneys' professional liability policies for partnerships.¹²² Legal malpractice insurance experts Ronald E. Mallen and Jeffrey M. Smith suggest that different structures, providing different levels of liability protection to partners, should affect how insurers rate the risk.¹²³ Although the limited liability structure may not change the maximum amount of the insurers' exposure under a policy, conflicts like those discussed above may cause insurers to spend more to defend claims. In addition, insurers will increase premiums if their claims experience indicates that limited liability firms tend to relax internal controls. As explained by one risk management expert, insurers may differentiate premiums between firms with and without limited liability status on the theory that "if their individual assets are not at risk, members of firms with limited liability will have far weaker incentives than those retaining joint and several liability to adopt effective risk management

120. As a general rule, insurers that insure "codefendants whose interests conflict must retain independent counsel for each insured or permit each insured to do so at its expense." Douglas R. Richmond, *Lost in the Eternal Triangle of Insurance Defense Ethics*, 9 GEO. J. LEGAL ETHICS 475, 494 (1996). An attorney who attempts to represent codefendants with an actual or a potential conflict may violate the applicable disciplinary rules prohibiting such representation and may be sued for malpractice. *Id.* at 495.

121. As explained by one legal malpractice insurance expert, mounting separate defenses may deplete any retention (or deductible) more quickly and may also serve to reduce amounts available under the insurance policy to pay the actual claim. Soughan, *supra* note 116, at 12.

122. *Id.* at 10.

123. MALLEN & SMITH, *supra* note 67, § 5.6, at 372 (explaining that insurers continue to determine insurability according to traditional means on assumption that type of entity does not affect amount of insurance for entity).

within their practices."¹²⁴ In traditional partnerships, the risk of unlimited liability provides an impetus for all firm partners to support internal controls to prevent malpractice.¹²⁵ If the elimination of unlimited vicarious liability causes firms to be lax, insurers will adjust their premiums to reflect their increased exposure.¹²⁶ As the cost of insurance increases, partners in limited liability firms may elect to carry lower limits of insurance or the minimum amount required under some statutes.¹²⁷ This leads to conflicts among partners and externalization of costs to aggrieved clients and other tort victims.

V. External Consequences of Eliminating Vicarious Liability

Attorneys readily acknowledge that their interest in limited liability firms stems from a desire to limit their vicarious liability without forgoing taxation as a partnership.¹²⁸ If courts recognize the statutory limits on vicarious tort liability, attorneys will obtain the limited liability protection they seek. At the same time, members of the legal profession, state legislatures, and the public may not fully appreciate or acknowledge the unforeseen consequences of eliminating vicarious liability in limited liability firms. As discussed above, conversion to limited liability firms can adversely

124. Anthony E. Davis, *Limited Liability for Lawyers*, N.Y. L.J., Nov. 6, 1995, at 3, 5. In addition to the risk of increased premiums, Mr. Davis describes another risk associated with the underwriting of limited liability firms that relates to insurers' concerns over the financial viability of their insureds. Insurers who are concerned that firms will not or cannot pay the policy deductible may require that firms provide additional information on their financial condition. *Id.* Firm partners may not expect such intrusive inquiry into firm finances.

125. For a discussion of the importance of internal controls in insurers' underwriting investigations, see Geoffrey C. Hazard, *How Firms Avoid Risk*, NAT'L L. J., May 9, 1994, at A21.

126. Limited liability firms could radically change underwriting practices if claims experience for limited liability firms causes insurers to write malpractice policies for individual firm attorneys rather than for the entire firm.

127. In recent years, carriers have increased premiums for attorneys' professional liability insurance. See Note, *Developments in the Law — Lawyers' Responsibilities and Lawyers' Responses — Lawyers' Responses: Shifting the Costs of Liability*, 107 HARV. L. REV. 1651, 1652 (1994). This trend will continue, if not worsen, if carriers learn that the limited liability structure exposes firms and, correspondingly, the carriers to increased malpractice exposure. If carriers determine that limited liability firms appear to be too risky, they could refuse to underwrite them.

128. See *Eliminate the Vicarious Professional Liability of Attorneys*, CHI. BUS. ASS'N REC., Sept. 1994, at 24 (recommending that Illinois Supreme Court's rules be amended to eliminate vicarious liability of attorneys who are co-owners of law firms operating as professional corporations and limited liability companies).

affect internal firm affairs. The blanket elimination of vicarious liability can also adversely affect clients and other persons dealing with firms. The external consequences of eliminating vicarious liability merit further examination. This examination of the possible outcomes requires consideration of the basic tenets underlying vicarious tort liability.

A. Traditional Justifications for Imposing Vicarious Liability

Traditional tort principles and economic theory intersect in their justifications for imposing vicarious liability. Under tort law, vicarious liability deliberately allocates risk to the principal as a cost of doing business through agents as a policy rule.¹²⁹ The principal, rather than the injured tort victim, stands in the best position to absorb losses, "to distribute them, through prices, rates or liability insurance, to the public, and so to shift them to society."¹³⁰ Thus, vicarious liability provides a powerful incentive for principals to engage in careful selection, instruction and supervision of personnel, and to take "every precaution" to see that they conduct the enterprise safely.¹³¹ In short, the traditional justification for vicarious liability embodies principles of risk allocation and harm avoidance through deterrence.

B. Economic Justifications for Imposing Liability

1. Deterrence

The principles of risk allocation and deterrence also provide economic justifications for imposing tort liability.¹³² First, the general deterrence approach imposes liability in a manner that encourages people to act efficiently and thereby to avoid injury to others.¹³³ In the context of accidents,

129. See W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 69, at 500 (5th ed. 1984) (referring to vicarious liability within context of employers and their employees engaged in enterprise).

130. *Id.* § 69, at 500-01.

131. See *id.* § 69, at 501.

132. As early as 1929, William O. Douglas planted the seeds for economic analysis of tort law in an essay using an economic perspective to analyze the doctrine of respondeat superior. See William O. Douglas, *Vicarious Liability and Administration of Risk*, 38 YALE L.J. 584, 584-85 (1929). The economic analysis of tort law blossomed in the 1960s and the 1970s with the work of various scholars, most notably Guido Calabresi and Richard A. Posner.

133. In his seminal work analyzing the economics of accident law, Guido Calabresi distinguished the "specific deterrence" approach, which seeks collectively to target specific acts or activities thought to cause accidents, with the "general deterrence" approach, which decides the costs of activities and lets "the market determine the degree to which, and the

this general deterrence approach operates to reduce accident costs by creating incentives to engage in safer activities and thereby reducing accidents.¹³⁴ Using this approach, people are free to choose whether they would rather engage in certain activities and pay the costs to do so or engage in safer activities.¹³⁵ In making this choice, economists assume that people act rationally in their own self-interest. As rational actors, individuals weigh the costs of harmful conduct against the costs of avoiding the harm. When the risk of liability causes actors to engage in safer activities, tort rules effectively deter or discourage dangerous activity.

Some tort scholars question the capacity of law to deter certain types of torts.¹³⁶ With respect to professional malpractice, a 1987 treatise by William M. Landes and Judge Richard Posner refers to the "widespread agreement that the imposition of tort liability on professionals . . . does affect behavior, does deter — some think too much!"¹³⁷ Since that publication, empirical data suggest that the threat of tort liability discourages professionals from engaging in tortious conduct. In the context of medical professionals, studies reveal that the threat of liability clearly affects the behavior of doctors in encouraging the adoption of risk management programs, resulting in a reduction in the basic number of malpractice incidents.¹³⁸ According to the data obtained in a Harvard study, the rate of negligent patient injuries in New York hospitals was thirty percent less than it would have been were there no liability for medical malpractice.¹³⁹

ways in which, activities are desired given such costs." GUIDO CALABRESI, *THE COSTS OF ACCIDENTS* 68-69, 95 (1970).

134. *See id.* at 73 (explaining that some people who would engage in relatively dangerous activities at prices that did not reflect costs, will shift to safer activities if costs are reflected in prices).

135. *See id.* at 69. Because of the role the market plays in placing losses on activities that engender them, Guido Calabresi calls "general deterrence" the market approach. *See id.*

136. For an evaluation of the "realistic objections" to the claims about tort law's deterrence efficacy, see Gary T. Schwartz, *Reality in the Economic Analysis of Tort Law: Does Tort Law Really Deter?*, 42 *UCLA L. REV.* 377, 381-87 (1994).

137. WILLIAM M. LANDES & RICHARD A. POSNER, *THE ECONOMIC STRUCTURE OF TORT LAW* 11 (1987). In this discussion, Professor Landes and Judge Posner acknowledge that although there had been little "systematic study of the deterrent effect of tort law, what empirical evidence there is indicates that tort law deters, even where . . . liability insurance is widespread." *Id.* at 10.

138. *See* Schwartz, *supra* note 136, at 401-03 (reviewing examples of how threat of liability has caused medical providers to practice "defensive medicine" and to implement risk management programs to improve providers' claims experience).

139. Paul Weiler, a member of the Harvard study team, drew this conclusion, extrapolating from the Harvard data. *See id.* at 404-05.

Reports relating to New Zealand's experience in abolishing its tort system and replacing it with a compensation program for all personal injuries also indicate that tort law provides a significant amount of deterrence.¹⁴⁰ Reportedly, "informed observers believe that the elimination of liability has led to laxer standards of medical care."¹⁴¹ Even the former administrator of the New Zealand compensation program acknowledged that "people fear that there is a lack of any deterrent element."¹⁴² This information suggests that the threat of malpractice claims deters harmful conduct by encouraging precautions in the delivery of professional services.¹⁴³

Within the context of a law firm, the deterrence principle applies to the conduct of different organizational players. First, the risk of tort liability should discourage individual attorneys from engaging in tortious activity. The risk of enterprise liability being imposed on the firm motivates firm managers to institute malpractice avoidance measures.¹⁴⁴ Finally, the risk of vicarious liability being imposed on all partners in a traditional partnership encourages partners to monitor one another's conduct.¹⁴⁵ In short, vicarious liability provides an incentive for attorneys to institute malpractice avoidance measures and to monitor the conduct of their peers.

The elimination of partners' vicarious liability guts the most powerful incentive for law firm members to invest in monitoring and malpractice prevention measures. First, members of limited liability law firms may not concern themselves with the harm to others that would generate liabilities

140. See *id.* at 420-22. Professor Schwartz distinguishes between "the strong form of deterrence argument — which assumes that tort law does in fact deter as thoroughly as economic models suggest — and the more 'moderate' form of the argument — which assumes that tort law provides a significant amount of deterrence." *Id.* at 378. Professor Schwartz concludes that information from New Zealand and other evidence relating to the deterrence value of tort law supports the moderate form of the deterrence argument, but not the stronger version. See *id.* at 423.

141. *Id.* at 420 (quoting Patricia M. Danzon, *Malpractice Liability: Is the Grass on the Other Side Greener?*, in *TORT LAW AND THE PUBLIC INTEREST* 176, 203 (Peter H. Shuck ed., 1991)).

142. *Id.* at 421 (quoting Margaret Vennell, *International Workshop, Beyond Compensation: Dealing with Accidents in the Twenty-First Century, Brief Country Reports: New Zealand*, 15 U. HAW. L. REV. 568, 571 (1993)).

143. Increases in the number and success of legal malpractice claims and in the size of damage awards have compelled "the profession to pay greater attention to ensuring competence." RICHARD L. ABEL, *AMERICAN LAWYERS* 9 (1989).

144. For example, by imposing sanctions against law firms, Rule 11 of the Federal Rules of Civil Procedure deters misconduct by encouraging firms to monitor individual attorneys. See Jeffrey A. Parness, *The New Federal Rule 11: Different Sanctions, Second Thoughts*, 83 ILL. B.J. 126, 129 (1995).

145. See Fama & Jensen, *supra* note 70, at 335 (recognizing importance of pooling of net cash flows and liability in encouraging mutual monitoring and consulting).

beyond the amount they contributed to the firm.¹⁴⁶ Moreover, limited liability statutes actually create disincentives to firm members functioning as a team with firm-wide responsibility for client representation. As suggested above, involvement in a case could result in an attorney losing the liability shield. Practically speaking, this limited liability regime will cause attorneys to become more insular in their representation of clients, shunning supervisory or monitoring responsibilities within the firm. As rational actors, attorneys will avoid liability by shutting their eyes, intentionally avoiding involvement in the work of their peers and associates. Supporters of LLP and LLC legislation advocate the limited liability rule, referring to the difficulty of monitoring in large law firms. Basically, they assert that unlimited liability should be eliminated because size makes monitoring difficult in large firms.¹⁴⁷ This argument ignores the deterrent effect of unlimited liability in encouraging firms to implement safety precautions and risk management measures, such as opinion review committees.¹⁴⁸ The argument assumes that monitoring requires second-guessing and direct involvement in other attorneys' work. This argument also assumes that all law firms are large and that size excuses the implementation of monitoring and safety measures.¹⁴⁹ As explained by one commentator: "[S]trong evi-

146. See Robert B. Thompson, *Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise*, 47 VAND. L. REV. 1, 14 (1994) (asserting that limited liability in corporate enterprise may result in enterprise not sufficiently investing in safety and overinvesting in hazardous activities, resulting in scenarios in which "enterprise will not bear all of its costs").

147. See, e.g., Michael J. Lawrence, Note, *The Fortified Law Firm: Limited Liability Business and the Propriety of Law Incorporation*, 9 GEO. J. LEGAL ETHICS 207, 211, 222 (1995) (asserting that growth of law firms, with increased specialization, departmentalization, and branch offices, make monitoring "improbable, if not physically impossible"). One commentator even suggests that monitoring can result in undue interference in professional relationships between individual attorneys and their clients. See Stephen E. Kalish, *Lawyer Liability and Incorporation of the Law Firm: A Compromise Model Providing Lawyer-Owners with Limited Liability and Imposing Broad Vicarious Liability on Some Lawyer-Employees*, 29 ARIZ. L. REV. 563, 572-73 (1987). In responding to this "undue interference" argument, one author explains "that the legal profession is threatened less by overly-cautious [attorneys] than by [attorneys] who, not being subject to extensive monitoring by the owners of their firm, might represent their clients incompetently." Denker, *supra* note 13, at 366. Recognizing the difficulties in monitoring, liability rules should encourage, rather than discourage, monitoring. For a discussion of how the LLP and the LLC statutes discourage monitoring, see *supra* notes 69-92 and accompanying text.

148. Internal review committees, policies, and procedures help to prevent maverick or inexperienced attorneys from violating professional standards. See Lawrence G. Baxter, *Reforming Legal Ethics in a Regulated Environment: An Introductory Overview*, 8 GEO. J. LEGAL ETHICS 181, 212 (1995).

149. But see Milton R. Wessel, *Institutional Responsibility: Professionalism and Ethics*, 60 NEB. L. REV. 504, 513 (1981) (asserting that large institutional practice "should not be

dence indicates that large firms are in fact more able than small firms to co-monitor . . . [and] to shoulder the considerable overhead cost required to launch and maintain many co-monitoring tools unavailable to smaller firms."¹⁵⁰ Unlike smaller firms, which can more easily rely on informal controls and face-to-face interaction, larger firms need more bureaucratic controls, such as firm policy manuals and administrative committees.¹⁵¹

Finally, the assertion that monitoring should be excused in large firms assumes the value of large law firms compared to smaller firms.¹⁵² The large law firm in which partners share unlimited liability provides "one stop" expertise and an internal, bonded referral market."¹⁵³ From the client's perspective, the value of one-stop shopping may not be enough to

granted an exemption from responsibility simply because their members are independent licensed professionals").

150. Murphy, *supra* note 13, at 221. Comonitoring tools include supervisory personnel structuring and training programs for all firms attorneys, as well as computer case management, file storage, telecommunications, docket control, and conflict control systems. *See id.*

151. *See* Geoffrey C. Hazard, *The Issue of Firm Size*, NAT'L L. J., Oct. 24, 1994, at A21; *see also* Geoffrey C. Hazard, *Size Creates Tension*, NAT'L L. J., Nov. 21, 1994, at A21 (explaining that elaborate administrative controls, such as conflicts systems, keep large firms functioning). Administrative committees, calendaring systems, conflicts systems, supervision arrangements, and other measures that control malpractice are institutional measures. *See* John Leubsdorf, *Legal Malpractice and Professional Responsibility*, 48 RUTGERS L. REV. 101, 143 (1995) (arguing that vicarious liability ensures that partners will institute and enforce such measures).

152. As suggested by one critic of limited liability law firms: "Perhaps it is the large law firm, not co-monitoring, that is 'impractical.' . . . Perhaps the wealth gained from large law firms' economies of scale, economies of scope, and attorney specialization is insufficient to protect clients whose lawyers' malpractice injures them beyond the limits of the firm assets and insurance." Murphy, *supra* note 13, at 221-22. In bemoaning the "dramatic increase in the number of malpractice cases and settlement and jury verdicts against the largest and best known law firms in the country," Robert E. O'Malley, Loss Prevention Counsel of Attorneys' Liability Assurance Society, the insurer of the nation's largest law firms, explains that "large law firms are the [malpractice] problem these days." *Eighth Annual Judicial Conference of the United States Courts of Appeals for the Federal Circuit*, 133 F.R.D. 245, 283 (1990). Mr. O'Malley reported that "large, well-known law firms" paid the four largest settlements of legal malpractice claims in the last five years. *Id.* at 283-84. The settlement amounts of \$55 million, \$40 million, \$27 million, and \$20 million represented the limits of liability under the applicable malpractice policy in all cases except one. *Id.* at 284.

153. Marc Galanter & Thomas Palay, *The Many Futures of the Big Law Firm*, 45 S.C. L. REV. 905, 909 (1994). "One stop" expertise means that a single entity can assist clients with multifaceted problems. *See id.* Firm assets and reputation, coupled with the personal liability of firm partners, act as a kind of bond insuring the performance of services by firm attorneys to whom work is referred. *See id.* at 910.

justify eliminating the deterrent value of holding attorneys liable for acts or omissions of other attorneys within the scope of firm business.¹⁵⁴ As firms grow, vicarious liability becomes more important because each firm attorney "wields the prestige of the firm" and clients rely on firm reputation.¹⁵⁵

2. Risk Allocation and Externalization Problems

Limited liability defenders tend to discount the importance of firm attorneys' assuming responsibility for monitoring their peers. With most clients, such monitoring can only be effectively conducted by other attorneys because of the "inherent asymmetry of knowledge about the product."¹⁵⁶ The disparity in the relative positions of firm attorneys and firm clients relates to the risk distribution principle. Applying this principle, liability for loss should be assigned to a party who can prevent loss more efficiently. In the case of legal malpractice, firm members sit in a better position than clients and other tort victims to prevent malpractice by firm attorneys.¹⁵⁷ Attorneys can institute various measures such as docket

154. Large law firms may not provide efficiency through the "economies of scale." Because personnel costs clearly account for the largest firm expenditure, firms do not realize significant savings as they grow. Moreover, because attorney fees charged by larger firms tend to be higher than fees charged by smaller firms, nothing indicates that any savings realized from "economies of scale" results in lower attorney fees.

155. See Leubsdorf, *supra* note 151, at 142. In explaining the importance of monitoring in large firms, Professor John Dzienkowski notes:

[C]lients of small firms are more likely to seek an individual lawyer in a firm rather than signing on with the firm itself because of the firm's reputation. In the large firm, partners are not likely to work with all of the other lawyers on a regular basis, and are more likely focused on work within their section or practice or perhaps in one or two related areas of practice. Further, new associates are more likely to work for a number of partners all of whom may be too busy to provide proper supervision and guidance.

John S. Dzienkowski, *Legal Malpractice and the Multistate Law Firm: Supervision of Multistate Offices: Firms as Limited Liability Partnerships; and Predispute Agreements to Arbitrate Client Malpractice Claims*, 36 S. TEX. L. REV. 967, 976-77 (1995).

156. Jack Carr & Frank Mathewson, *The Economics of Law Firms: A Study in the Legal Organization of the Firm*, 33 J.L. & ECON. 307, 309 (1990) (explaining that in market for complex professional services, "inherent asymmetry of knowledge" arises because "professionals supplying the good are knowledgeable [whereas] consumers demanding the good are uninformed"). Because consumers understand their disadvantage, "they seek assurance from the market in the form of commitments for honest delivery of services." *Id.* at 309-10.

157. In addition to clients suing for malpractice, nonclients such as third party beneficiaries and opposing parties in transactions can recover on malpractice claims, such as fraud claims. These nonclients generally cannot "monitor" the conduct of attorneys who do not represent them. Nevertheless, they can be hurt by law firm's externalization of costs.

control and conflict check systems to avoid and detect problems. As compared to most of their clients and other third parties, firm members' superior knowledge of procedural and substantive law, coupled with their access to information, enables them to prevent malpractice more efficiently than clients. Although some sophisticated clients may be able to monitor their attorneys, most clients must choose attorneys before they render services, and "most clients are not repeat players."¹⁵⁸

Firm partners stand to benefit from activities of other firm members and agents. This justifies the imposition of vicarious liability on principals because principals benefit through their agents' acts and should bear, jointly and severally with agents, the liability created by agents' misdeeds.¹⁵⁹ On the other hand, a limited liability rule allows firm principals to avoid costs associated with acts or omissions of other firm actors by allowing the firm principals to externalize the costs of doing business. If the assets of individual tortfeasors and firm assets do not cover the amount of tort claims, the firm principals shift the cost of doing business to clients and other tort victims.¹⁶⁰ In this sense, tort liability can be viewed as a "cost of the enter-

158. ABEL, *supra* note 143, at 154 (describing market failure). Abel states: "The only clients who can effectively police the quality of representation they receive are large corporations, which increasingly are using in-house counsel to supervise the quality and cost of services rendered by law firms." *Id.* at 152. Some sophisticated clients such as clients represented by corporate counsel might only retain firms who maintain certain levels of insurance. Less sophisticated clients who do not understand the limited liability structure of firms will continue to rely on firm reputation. "It is also foolish to believe that the majority of clients will understand what the designation at the end of the law firm name means in practice." Dziekowski, *supra* note 155, at 985, n.82 (suggesting that state law require that limited liability firms disclose effect of liability shield on clients' ability to sue firm principals). In June 1996, I studied business people's perceptions of law firms and law practice by surveying members of the Austin, Texas Chamber of Commerce. Of the sixty respondents, 91.27% (fifty-five persons) did not understand the effect of law firms practicing as LLPs or LLCs (study results on file with *Washington and Lee Law Review*). Business people who are members of a Chamber of Commerce are presumably more sophisticated consumers of legal services than members of the general population. This study indicates that unsophisticated consumers of legal services may continue to rely on firm reputation because they do not understand the effect of attorneys' practicing in limited liability firms.

159. See DeMott, *supra* note 91, at 119 (referring to "benefit principle" as one justification for imposing vicarious liability on principal for misdeeds of another partner).

160. In some situations, such as cases involving attorney theft or misappropriation of client funds, the amount of the loss might be shifted to a bar-administered client security fund. Most client security fund programs restrict the amount of recovery and the conditions for recovery. In discussing the limitations of such bar-administered programs, Professor Charles W. Wolfram explains: "Elaborate proof requirements are typically imposed, and all funds limit, some quite severely, the size of individual claims and the cumulative claims against any one lawyer that will be compensated." WOLFRAM, *supra* note 39, § 4.8, at 183.

prise that limited liability transforms into an externality borne by persons not associated with it."¹⁶¹ With externalization, "[l]iability that is avoided does not disappear into a black hole; it falls onto another person."¹⁶² In the case of limited liability law firms, liability falls on the shoulders of tort victims when firm and tortfeasor assets do not satisfy tort claims. Therefore, limited liability allows firms to shift to others some of the costs of economic activity, resulting in economic inefficiency and offending one's sense of fairness.¹⁶³

Limited liability creates a moral hazard in allowing participants in limited liability firms to reap the benefits of risky activities and not bear all of the costs.¹⁶⁴ For example, law firm partners may recruit a rainmaker who generates risky securities work with millions of dollars of fees for the firm. Depending on the compensation system the firm uses, firm partners will share to some degree in the revenue the rainmaker generates. At the same time, the members of a limited liability firm do not expect to be personally liable for any claims made in connection with the risky securities work. Moreover, firm members may intentionally avoid any monitoring or involvement with the securities attorney, fearing that any connection to the work will destroy their limited liability shield. Thus, limited liability encourages excessive risk taking and offsets the economic incentive for parties to prevent harm to others.¹⁶⁵ As explained below, this results in a shifting of costs to tort creditors when the assets of the firm and the tortfeasor do not satisfy creditors' claims.¹⁶⁶

161. Phillip I. Blumberg, *Limited Liability and Corporate Groups*, 11 J. CORP. L. 573, 616 (1986).

162. Thompson, *supra* note 146, at 2.

163. See William A. Klein & Eric M. Zolt, *Business Form, Limited Liability, and Tax Regimes: Lurching Toward a Coherent Outcome?*, 66 U. COLO. L. REV. 1001, 1036 (1995) (noting that some commentators have defended limited liability by asserting that limited liability's economic benefits, including encouraging economic investment and growth, outweigh its adverse effects). Such justification for limited liability does not apply to limited liability law firms.

164. See Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 103-04 (1985) (explaining that critics of limited liability focus on moral hazard in advocating substantial modification of limited liability doctrine).

165. See David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1586 (1991).

166. For an LLC proponent's response to the general externalization problem, see Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L.Q. 417, 438-50 (1992).

This shifting of liability presents a real risk because of the capitalization of law firms.¹⁶⁷ Law firms, large and small alike, tend to be thinly capitalized compared to the amount of firm revenues.¹⁶⁸ Apart from the amount of malpractice insurance that firms maintain and the amount of accounts receivable, law firms normally do not hold significant assets subject to execution following a judgment. Contract creditors such as lenders often require a security interest in the accounts receivable and hard assets.¹⁶⁹ In addition, creditors and other sophisticated persons who contract with limited liability law firms and professional corporations commonly require that firm members sign personal guarantees. When faced with tort liability for only some members and contract liability guaranteed by all members, firm members will probably give priority to paying the contract creditor.¹⁷⁰ This leaves a tort victim holding a judgment against a law firm and individual tortfeasors.¹⁷¹ To the extent that the nontortfeasing members made contributions to the firm, they fund firm liabilities. Members can reduce their expense for tort damages by minimizing their investment in the firm. In this sense, limited liability

167. An analysis of the impact of a limited liability rule must consider the particular nature of law firms as a service industry and the capitalization of law firms.

168. See Frederick W. Lambert, *An Academic Visit to the Modern Law Firm: Considering a Theory of Promotion-Driven Growth*, 90 MICH. L. REV. 1719, 1728 (1992) ("The law firm exists as a very thinly capitalized entity that typically renders services for cash that is due upon presentation of a statement. It distributes profits periodically and generally does not retain significant earnings. It might accurately be described as a conduit for cash.") (reviewing MARC GALANTER & THOMAS PALAY, *TOURNAMENT OF LAWYERS: THE TRANSFORMATION OF THE BIG LAW FIRM* (1991)). One commentator predicts that the capitalization level of firms will decrease as firms will require less working capital and less long-term capital. Howard L. Mudrick, *Rethinking Capitalization in the 1990s*, TEX. LAW., Nov. 9, 1992, at 28, available in LEXIS, News Library, TXLAWR File.

169. Leebron, *supra* note 165, at 1637 ("Secured creditors who have obtained a valid lien under state law have priority over unsecured creditors, including tort victims, up to their security.").

170. Even in the absence of personal guarantees, the same results can occur in states in which the statutory liability shield only covers malpractice-type claims, rather than all claims. These statutes give "partners an incentive to protect their own wealth by paying contract claims first out of partnership assets, leaving nothing for the tort-type creditors." BROMBERG & RIBSTEIN, *supra* note 31, § 3.03, at 83. For an analysis for the "opportunistic conduct" by classes of partners with different financial exposure, see *supra* notes 95-98 and accompanying text. For a discussion of the fiduciary duty questions raised by the use of firm assets and distributions to firm attorneys, see Deborah A. DeMott, *Fiduciary Preludes: Likely Issues for LLCs*, 66 U. COLO. L. REV. 1043, 1046-49 (1995).

171. See Burke, *supra* note 22, at 34 (suggesting that limited liability rule in LLCs may leave "less powerful" voluntary creditors, such as employees and suppliers, in same position as involuntary tort creditors).

actually creates incentives to do business through thinly capitalized firms.¹⁷²

Debt financing and the possibility of bankruptcy exacerbate the "perverse incentives" to externalize costs.¹⁷³ When faced with a large judgment, firm members could vote to dissolve the firm. In bankruptcy, secured creditors would enjoy absolute priority over tort victims.¹⁷⁴ Thus, a higher ratio of debt to equity further limits firms' tort liability. Once the firm files for bankruptcy, partners could simply form a new law firm, leaving the tort creditor with an uncollectible judgment against the bankrupt law firm and the individual tortfeasors.¹⁷⁵

This scenario can be avoided if the principals take steps to maintain sufficient insurance or assets in order to satisfy malpractice claims. Unfortunately, the limited liability structure may result in firms carrying lower levels of insurance than they would carry under an unlimited liability regime. Unlimited liability creates strong incentives for firm owners to purchase insurance sufficient to cover tort judgments because the owners do not want their personal assets subjected to execution in the event of an insurance shortfall. In an unlimited liability firm, malpractice insurance protects attorneys against personal liability for uninsured tort claims and protects tort victims who have claims covered under the firm's malpractice policy. The limited liability structure reverses the situation, creating

172. In encouraging attorneys to do business through thinly capitalized firms, the limited liability rule effectively punishes firms that invest in insurance and malpractice prevention measures. For an insightful analysis of the consequences of limited liability for closely held firms, see Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1882-94 (1991) (advocating abandonment of limited liability for corporations).

173. See *id.* at 1884.

174. See *id.* (explaining that under prevailing priority rule for distributions of assets in bankruptcy, tort claimants come after secured creditors and then share pro rata with debtor's general creditors). In order to minimize the externalities and inefficiencies, Professor David W. Leebron advocates changing these priorities to give tort claimants priority over both secured and unsecured financial creditors. Leebron, *supra* note 165, at 1650. If secured creditors hold an equity position in the debtor firm, the secured creditors' claims may be subordinated to other creditors if the debtor firm is undercapitalized. The U.S. Supreme Court articulated this rule in *Taylor v. Standard Gas & Electric Co.*, 306 U.S. 307, 323-24 (1939), known familiarly as the "Deep Rock" case because the undercapitalized subsidiary in the case was named Deep Rock Oil Corporation.

175. A judgment creditor may attempt to hold the new law firm responsible under a theory of successor liability. In a recent case, the Texas Court of Appeals refused to hold a limited liability partnership law firm responsible for the tortious acts of the predecessor law firm. See *Medical Designs, Inc. v. Shannon, Gracey, Ratliff & Miller, L.L.P.*, 922 S.W.2d 626, 628 (Tex. App. 1996, writ denied).

incentives for owners to purchase either no insurance or the minimum amount of insurance required by law. Ironically, supporters of limited liability law firms used the rising costs of malpractice insurance to justify the elimination of vicarious liability.¹⁷⁶ As discussed above, the limited liability structure may actually increase the cost of insurance, resulting in limited liability law firms carrying lower levels of insurance than traditional law firms would carry.¹⁷⁷

A reduction in the amount of malpractice coverage increases the likelihood that limited liability law firms will not afford compensation for injuries sustained by conduct of firm attorneys, thus frustrating the compensation purpose of tort law.¹⁷⁸ This compensation principle also justifies imposition of vicarious liability. Vicarious liability enhances the assets out of which parties can be compensated.¹⁷⁹ On the other hand, limited liability increases the probability that there will be insufficient assets to pay creditors' claims.

In analyzing liability controls on corporate malfeasance, Professor Reinier H. Kraakman argues that asset insufficiency can lead to under-enforcement of legal norms.¹⁸⁰ As explained by Professor Kraakman,

176. This justification for limited liability structure indicates that supporters of limited liability firms believe that statutory liability limits should be provided to attorneys as protection against personal liability because law firm insiders do not want to pay the higher costs required to purchase traditional insurance. For a discussion of rising insurance costs as a force driving the limited liability movement, see Mark Rosencrantz, Comment, *You Wanna Do What? Attorneys Organizing as Limited Liability Partnerships and Companies: An Economic Analysis*, 19 SEATTLE U. L. REV. 349, 371-73 (1996).

177. See *supra* notes 122-27 and accompanying text; see also Note, *supra* note 127, at 1673 (discussing insurance as liability-shifting mechanism and concluding that partners may fail to insure at optimal levels without liability incentive to invest in covering tort risks). Firms that do not maintain adequate insurance and capital to cover tort claims may face increases in the cost of credit from voluntary creditors who adjust the cost of credit in response to the increased risk. See FRANK H. EASTERBROOK & DANIEL R. FISCHL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 107-08 (1991).

178. See KEETON ET AL., *supra* note 129, at 6 ("The purpose of the law of torts is to adjust these losses, and to afford compensation for injuries sustained by one person as the result of the conduct of another.") (quoting Cecil A. Wright, *Introduction to the Law of Torts*, 8 CAMBRIDGE L.J. 238 (1944)); see also CALABRESI, *supra* note 133, at 27-28 (terming compensation function of accident law as "secondary accident cost reduction goal" in that "it does not come into play until after earlier primary measures to reduce accident costs have failed").

179. See DeMott, *supra* note 91, at 121.

180. In the context of corporate malfeasance, "asset insufficiency" arises when the "firm's assets cannot cover the tort damages for a firm's delicts." Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 869 (1984). In the locution of Professor Kraakman, "sanction insufficiency" and "enforcement

personal liability of firm participants can serve as a "partial check on asset insufficiency, that is, on the danger that undercapitalized [firms] will abuse their limited assets to evade the compensatory and deterrent policies of liability rules."¹⁸¹ Personal liability provides incentives for firm participants to prod the firm into covering its potential liability.¹⁸²

In an attempt to deal with the problem of asset insufficiency, some states require that limited liability firms maintain a minimum amount of insurance or adequate capitalization.¹⁸³ This approach can result in over- or under-provision for tort risks.¹⁸⁴ Rather than mandating a certain level of insurance or capitalization, firm attorneys should be allowed to select the strategy for covering risk through insurance, self-insurance, and internal risk management activities.¹⁸⁵

VI. *Alternative Approach to Limited Liability*

The previous discussion shows that limited liability firms create a number of problems, including risk externalization and asset insufficiency. Nevertheless, attorneys insist that they should not be held jointly and severally liable for others' acts and omissions. The following proposal urges a modified approach to limited liability, providing a partial shield

insufficiency" also lead to the underenforcement of legal norms. *See id.* at 867-68. Sanction insufficiency occurs when the "legal system cannot charge a price high enough to deter firm delicts." *Id.* In the case of attorneys practicing in limited liability firms, sanction insufficiency arises when monetary sanctions and civil liability imposed against individual attorneys and their firms does not deter attorney misconduct. Enforcement insufficiency occurs when "the legal system cannot even detect or prosecute a significant proportion of offenses." *Id.* at 868. Given the limitations of the attorney disciplinary systems and other external controls on attorney conduct, enforcement insufficiency demands enhanced and broader civil liability for attorney misconduct.

181. *Id.* at 868-69 (referring to undercapitalized corporations).

182. *See id.* at 871. In describing statutory insurance requirements as an "unsatisfactory compromise" to deal with externalization problems, Professor Ribstein stated:

Because firms vary widely in size and riskiness, minimum statutory insurance will be either too much or too little for most firms. Even if legislators could determine an appropriate minimum amount, they would also have to regulate such terms as deductibles, exclusions, co-insurance, and the use of proprietary insurers. In the end, the costs of micromanaging firms' insurance are likely to exceed the benefits to creditors.

Ribstein, *supra* note 77, at 333-34.

183. *See supra* notes 52-55 and accompanying text.

184. *See* Kraakman, *supra* note 180, at 874.

185. *See id.* (arguing that managers stand in best position to select "optimal strategy for covering risk").

to principals while protecting the consuming public. The proposal creates incentives designed to encourage malpractice avoidance and to safeguard against externalization of risk and asset insufficiency. At the same time, the proposal allows firm principals the freedom to choose how they want to capitalize, manage, and insure firm risks. The limited liability shield should apply only if firm members can show that the firm acted reasonably in implementing measures to control the risk that gave rise to liability.¹⁸⁶ When the amount of malpractice insurance and firm assets do not adequately cover a malpractice judgment, then the firm members can avoid personal liability by showing that the firm implemented reasonable measures and procedures to control the conduct that caused the loss.¹⁸⁷ Therefore, firm members can escape personal liability if they can affirmatively show that they acted reasonably in managing risk.¹⁸⁸

186. Cf. Kansas Bar Ass'n Ethics Op. 94-03 (June 28, 1994), in NATIONAL REPORTER ON LEGAL ETHICS & PROFESSIONAL RESPONSIBILITY KS:OPINIONS:50, KS:OPINIONS:55 (1994) (concluding that Kansas attorneys may practice in LLPs provided that they adhere to principles of vicarious liability set forth in Model Rules 5.1 and 5.3).

187. The federal securities laws use a similar approach in providing for a due diligence defense for implementation of compliance programs. For example, Section 20(a) of the Securities and Exchange Act of 1934 provides a defense for controlling persons who can show that they "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." 15 U.S.C. § 78t(a) (1994). As explained in one commentary:

The essence of this defense is that, notwithstanding the violation, the employer exercised due care in supervising its employee. To succeed in this defense, the employer would have to demonstrate that it had an adequate system of supervision and internal controls in place at the time of the violation, and that it diligently enforced that system.

Lawrence J. Zweifach & Claire R. Telecki, *Compliance Procedures: Preventing and Mitigating Criminal and Civil Liability of Corporate Defendants*, in SECURITIES LITIGATION 1993: CURRENT STRATEGIES AND DEVELOPMENTS 209, 216 (PLI Litig. & Admin. Practice Course Handbook Series No. 479, 1993). For a recent analysis of the effect of corporate compliance programs, see Kevin B. Huff, Note, *The Role of Corporate Compliance Programs in Determining Corporate Criminal Liability: A Suggested Approach*, 96 COLUM. L. REV. 1252, 1254 (1996) (recommending that evidence of compliance program be considered with other relevant evidence).

188. This approach is analogous to the concept of "enterprise causation," in which imposition of liability on the enterprise turns on whether the enterprise could have prevented wrong. For a discussion of the implications of enterprise causation, see Alan O. Sykes, *The Boundaries of Vicarious Liability: An Economic Analysis of the Scope of Employment Rule and Related Legal Doctrines*, 101 HARV. L. REV. 563, 571-75 (1988). For example, in a sexual harassment case, employer's liability could be predicated on the employer's negligence in failing to adopt a policy against harassment. See *id.* at 604-05 (discussing *Meritor Sav. Bank v. Vinson*, 477 U.S. 57, 71-75 (1986)).

Using this approach, asset insufficiency creates a presumption of unlimited liability. Firm members can then plead limited liability as an affirmative defense and attempt to show that they acted reasonably in implementing measures and precautions to avoid the problem.¹⁸⁹ In the event that no reasonable precautions could have prevented the loss, firm members could plead limited liability as an affirmative defense and then avoid personal liability if they can carry the burden of showing that implementation of reasonable procedures would not have prevented the plaintiff's injury.¹⁹⁰

If the firm members do not act reasonably in attempting to control the risk, they share personal liability if the amount of malpractice insurance and other firm assets do not satisfy the amount of a tort judgment.¹⁹¹ Rather than holding firm members personally liable for the amount of the outstanding judgment, courts should determine each member's share of the liability on a pro rata basis.¹⁹² Using a pro rata approach, a member's

189. Fact questions related to limited liability for members should be resolved by factfinders in a bifurcated trial. In the first phase of the bifurcated trial, the factfinder determines whether the plaintiff should recover on the plaintiff's claims. If firm partners plead limited liability as an affirmative defense, the factfinder in the second phase of the trial could consider evidence related to law firm implementation of reasonable malpractice prevention controls. The second trial need not be conducted if the amount of the judgment would be covered by insurance or other firm assets. As in punitive damage cases, in which the factfinder hears evidence relating to the amount of punitive damages in a separate trial, the factfinder would hear in a separate trial evidence related to firm procedures and malpractice prevention efforts.

190. Under current statutes, partners can assert the liability shield as an affirmative defense. For example, to invoke the liability protection under the Texas LLP provision, partners should plead limited liability as an affirmative defense and then carry the burden of proving that the partnership qualifies as an LLP, i.e., that it has complied with the statutory registration, name, and insurance requirements. Thereafter, the burden shifts to the plaintiff to show that some statutory exception applies, thereby removing the liability shield. See Anderson et al., *supra* note 83, at 729.

191. In basing liability on failure to implement measures to control risk, this approach could be viewed as "modified fault" theory based on a "duty to monitor" one's peers. If firm members fail to meet that duty, they could be subject to liability for the acts or omissions of other firm members. For a discussion of law firm partners' duty to monitor, see Fortney, *supra* note 72, at 348-61. As attorneys reorganize as limited liability firms, courts may expand the duty to supervise. See Thompson, *supra* note 73, at 942.

192. In advocating the abandonment of limited liability for corporate shareholders, Professors Henry Hansmann and Reinier Kraakman support an alternative approach to liability in which shareholders share proportionate liability for claims that exceed corporate assets. See Hansmann & Kraakman, *supra* note 172, at 1932-33. Under a proportionate liability rule, if a corporation lacks sufficient assets to satisfy claims, claimants have the right to recover from each shareholder an amount proportionate to the shareholder's equity interest in the corporation. See Joseph A. Grundfest, *The Limited Future of Unlimited*

individual percentage of the liability will be based on the amount of total compensation and distributions that each principal received for the last five years. With this approach, an individual's percentage of responsibility should correspond to the percentage of total firm remuneration that the individual received. This approach proportionately places liability on persons who received remuneration from the firm. To the extent that distributions prevent firms from retaining earnings and purchasing insurance to respond to liability losses, distributions can deplete assets otherwise available to satisfy tort judgments. In that event, the potential problem of asset insufficiency can be remedied by imposing personal liability on members in proportion to their compensation. In short, law firm members who receive the most compensation from the firm will carry proportionally greater responsibility and bear the costs if the firm does not implement reasonable measures to control malpractice. Finally, the implementation of reasonable controls also satisfies attorneys' obligations under state ethical rules, which are based on Model Rule 5.1¹⁹³ and the recently adopted New York disciplinary rule requiring law firms, as well as firm partners, "to make reasonable efforts to ensure that all firm lawyers conform to the disciplinary rules."¹⁹⁴

A simple malpractice case illustrates how the proposal would work. Assume that a litigation associate fails to file a timely answer, resulting

Liability: A Capital Markets Perspective, 102 YALE L.J. 387, 388 (1992). For a discussion of the procedural obstacles that may frustrate the implementation of a proportionate liability scheme, see generally Janet Cooper Alexander, *Unlimited Shareholder Liability Through a Procedural Lens*, 106 HARV. L. REV. 387 (1992).

193. Model Rule 5.1(a) provides that a "partner in a law firm shall make reasonable efforts to ensure that the firm has in effect measures giving reasonable assurance that all lawyers in the firm conform to the Rules of Professional Conduct." MODEL RULES OF PROFESSIONAL CONDUCT Rule 5.1(a) (1996). Ethics expert Michael Franck believes that Model Rule 5.1 imposes an ethical duty on all partners to set up practices and procedures to insure compliance with the rules of professional responsibility. See Jerome Fishkin, *Ethics Liability for Acts and Omissions of Partners*, in 5 LEGAL MALPRACTICE REP. 10, 11-12 (1996) (reviewing cases holding attorneys ethically culpable for misdeeds of their partners). For a commentary on partners' duty to monitor compliance with ethical rules, see ABA, ANNOTATED MODEL RULES OF PROFESSIONAL CONDUCT 423 (3d ed. 1996).

194. Although the New York rule appears to be similar to Model Rule 5.1, the New York rule goes one step further in imposing liability on law firms, stating that a "law firm shall adequately supervise, as appropriate, the work of partners, associates and nonlawyers who work at the firm." N.Y. COMP. CODES R. & REGS. tit. 22, § 1205(c) (1996). In adopting this rule, New York became the first in the nation to impose professional discipline on law firms. See Ann Davis, *N.Y. Makes Firms Liable*, NAT'L L.J., June 10, 1996, at A6.

in a multi-million dollar judgment against a firm client. When the client sues the firm and the partners, courts could hold firm partners liable if the amount of malpractice insurance and other firm assets would not cover the judgment. In that event, the firm partners could avoid personal liability if they affirmatively plead the liability shield and show that they acted reasonably in implementing measures to control the risk, such as a docket control system. If the firm partners could not show that they acted reasonably in attempting to prevent the litigation malpractice, then courts could hold firm partners personally liable in proportion to their compensation.¹⁹⁵

Unlike the current liability scheme under LLP and LLC legislation that encourages externalization by undercapitalized firms, this approach creates incentives which promise to benefit firm members, as well as clients and other third parties who deal with the firm. First, the pro rata approach to imposing liability encourages firm members with the most at stake to influence firm decisions relating to insurance and malpractice avoidance. If these firm members understand that they will be personally liable in the event of asset insufficiency, they are more likely to support the purchase of malpractice insurance. Second, the scheme encourages all firm partners to support the implementation of reasonable measures to avoid malpractice. In particular, the pro rata approach puts pressure on the most influential and highly compensated firm members to orchestrate the implementation of malpractice controls.

While this approach provides incentives for firms to purchase insurance and to implement procedures to control risk, the scheme still gives firm principals the freedom to choose how they want to handle the costs of malpractice.¹⁹⁶ Unlike legislation that conditions the liability shield on the firm's maintaining a certain level of insurance or capitalization, this approach gives firm members the ability to choose how they want to handle the matter, changing the basic incentive problems associated with

195. Another example involves a malpractice claim arising out of business transactions with firm clients. If firm insurance and assets do not cover the amount of the malpractice judgment, firm partners could be personally liable unless they show that they acted reasonably in controlling the risk by adopting policies prohibiting business transactions with clients and prohibiting the use of firm letterhead for personal business dealings. On the other hand, firm partners could be held liable if they failed to implement a conflicts system to detect business transactions with clients and permitted the firm partner to use firm bank accounts for depositing investor funds.

196. For example, firm attorneys may elect to implement internal controls when insurance policies exclude certain types of claims, such as claims brought by federal banking regulators.

the current limited liability scheme.¹⁹⁷ For example, rather than purchasing an indemnity policy, a firm may self-insure. On the other hand, firm members who do not want to implement malpractice avoidance controls may elect not to do so, understanding that the cost may be personal liability in the event that firm insurance and assets fall short of satisfying a tort judgment.

Although this approach still exposes attorneys to some risk of personal liability, it eliminates the possibility of strict vicarious liability for the acts or omissions of another partner. Attorneys should prefer this pro rata liability over joint and several liability because it relates an individual partner's costs of participating in the law firm directly to benefits the individual receives from the enterprise.

VII. Conclusion

After opening with the lament, "Where were the professionals?," this Article explored attorneys' efforts to seek shelter from vicarious liability. Law firm attorneys welcomed the advent of LLPs and LLCs, viewing them as a panacea for malpractice liability for the conduct of other firm actors. In the flurry to reorganize as LLPs and LLCs, attorneys have ignored or dismissed problems and adverse consequences of these new liability structures. As illustrated above, the current limited liability rules can negatively impact firm insiders and persons who deal with the firms. Empirical evidence must be obtained to gauge how these new liability forms will actually affect attorney perspectives, conduct, and responsibilities to clients. Considering the possible internal and external consequences of firms' converting to LLPs and LLCs, this Article ends by asking: "Where is the profession and professionalism in the new landscape of limited liability law firms?"

First, attorneys should recognize the uncertainty surrounding these new liability structures.¹⁹⁸ Without the guidance of an established body of

197. For a critique of coverage-oriented reforms as alternatives to unlimited liability, see Hansmann & Kraakman, *supra* note 172, at 1927. In addition to enforcement problems, coverage-oriented reforms appear to be inflexible and geared toward the smallest firms. For example, the Texas LLP legislation requiring that firms maintain at least \$100,000 insurance coverage enables small firms to afford the purchase of insurance, but falls short of requiring a meaningful level of insurance for larger firms.

198. Even Professor Larry Ribstein, a supporter of limited liability structures, recognizes that the "future of LLCs is uncertain." Ribstein, *supra* note 21, at 47-48 (noting that unanswered questions relate to lack of uniformity in LLC statutes and whether other business forms will supersede LLC structure). Other authors express similar sentiments. See Daniel S. Goldberg, *The Tax Treatment of Limited Liability Companies: Law in Search*

law to resolve problems, courts may resolve disputes using established corporate and partnership doctrine.¹⁹⁹ Courts also may extend or modify traditional rules to fit the new liability structures. For example, courts must determine if aggrieved persons should be able to pierce the LLC veil and hold LLC members jointly and severally liable.²⁰⁰ Given the lack of uniformity in LLP and LLC legislation, interstate problems and conflicts of law questions will inevitably arise.²⁰¹ Although commentators have suggested an approach courts should use in resolving these problems,²⁰² attorneys should appreciate the risks associated with practicing in limited liability firms.

of Policy, 50 BUS. LAW. 995, 1017 (1995) (concluding that "[j]udgment will have to be reserved . . . until both the immediate fate and long-term effects of the [LLC] changes are known").

199. In discussing the uncertainty surrounding LLCs, Professor Wayne M. Gazur predicted that the "LLC's future will be marked by legislative, judicial, regulatory, and practitioner experimentation with the new entity, revisiting issues already settled in other contexts. The law relating to the long-standing forms of business organization will not be irrelevant, because LLC law will develop through a heavy emphasis on analogy." Gazur, *supra* note 7, at 138.

200. Although corporate rules applicable to piercing the corporate veil have been developed through common law, LLC statutes may adapt the corporate rules to LLCs. Robert R. Keatinge & George W. Coleman, *Professional Practices*, PLANNING AND USING LIMITED LIABILITY VEHICLES: LIMITED LIABILITY PARTNERSHIPS, LIMITED LIABILITY COMPANIES, LIMITED PARTNERSHIPS, AND LIMITED LIABILITY LIMITED PARTNERSHIPS, Q243 A.L.I.-A.B.A. 203, 228 (1996). One author predicts that the courts in states whose statutes do not explicitly adopt corporate law rules will still pierce the "limited liability company veil" if the courts find policy reasons for doing so. See Dennis S. Karjala, *Planning Problems in the Limited Liability Company*, 73 WASH. U. L.Q. 455, 464 (1995).

201. For an analysis of the conflict of law issues raised by interstate LLC transactions, see Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375, 449-456 (1992) and P. John Kozyris, *The Conflicts-of-Laws Aspects of the New American Business Entity: The Limited Liability Company*, 43 AM. J. COMP. L. 417, 417-25 (1995). See also Dzienkowski, *supra* note 155, at 987-88 (discussing forum shopping as problem that partners in multistate law firms will encounter in attempting to rely on statutory liability shields).

202. See Hester, *supra* note 99, at 62; Martin I. Lubaroff, *Registered Limited Liability Partnerships: The Next Wave*, in FORMING AND USING LIMITED LIABILITY COMPANIES AND LIMITED LIABILITY PARTNERSHIPS 1994, at 503, 536 (PLI Corp. L. Practice Course Handbook Series No. 836, 1994) (asserting that under full faith and credit and comity principles, another state should respect partners' election to form their partnership under, and to be governed by, laws of certain state). For a review of recent cases that address jurisdictional issues, see Marilyn B. Cane & Helen R. Franco, *Limited Liability in Registered Limited Liability Partnerships: How Does the Florida RLLP Measure Up?*, 20 NOVA L. REV. 1299, 1309-10 (1996).

Second, attorneys should understand that the new liability structures do not provide an impervious shield against liability. Courts in their exercise of inherent authority to regulate the legal profession may reject the liability shield and refuse to allow firm attorneys to externalize the costs of law firm practice.²⁰³ In regulating the legal profession, a court could narrow the liability shield using an approach such as the one proposed in Part VI of this Article. Even if courts recognize statutory liability limits, plaintiffs may attempt to avoid liability limits by fashioning claims that fall outside the statutory language. Therefore, conversion to a limited liability firm may not provide the shelter that attorneys desire. Finally, attorneys should consider the negative impact on attorneys practicing in LLPs or LLCs. As discussed above, the limited liability structure dramatically alters the dynamics of law firm practice. No longer do attorneys approach representation and firm problems with an "all for one, one for all" mentality.²⁰⁴ Instead, practitioners risk personal liability if they become involved in the work of other attorneys or firm employees. Through this transformation, attorneys no longer function as a team with collective responsibility; rather, they coexist as a confederation of individuals sharing office space.²⁰⁵ This abandonment of collective responsibility threatens the quality of legal services and risks unraveling the thread that holds together firm attorneys.

Rather than seeking shelter through limited liability structures that lead attorneys to dodge responsibility for their colleagues and subordinates, professionals should adopt structures promoting collective responsibility in serving clients.²⁰⁶ Such an approach helps attorneys appreciate that the

203. See *supra* note 41.

204. From the feminist perspective, limited liability in law firms undermines the "webs of interconnectedness" and destroys a sense of group responsibility. As explained by one feminist scholar: "Tort law should begin with a premise of responsibility rather than rights, of interconnectedness rather than separation, and a priority of safety rather than profit or efficiency." Leslie Bender, *A Lawyer's Primer on Feminist Theory and Tort*, 38 J. LEGAL EDUC. 3, 31 (1988).

205. For a discussion of the differences in a confederation style and a team approach to group law practice, see MARY ANN ALTMAN & ROBERT I. WEIL, AN INTRODUCTION TO LAW PRACTICE MANAGEMENT 41-46 (2d ed. 1987).

206. See Deborah L. Rhode, *Ethical Perspectives on Legal Practice*, 37 STAN. L. REV. 589, 646-47 (1985) (urging that "the profession fashion structures within and across employing institutions that can encourage collective support and sense of responsibility for normative concerns"). By assuming collective responsibility, firm attorneys recognize that bureaucratic failings and collective decisions play a significant causal role in unethical conduct in law firms. See Ted Schneyer, *Professional Discipline for Law Firms?*, 77 CORNELL L. REV. 1, 20 (1991) (referring to organizational roots of unethical conduct in firms).

"contours of professionalism"²⁰⁷ must include client interests.²⁰⁸

For years, professionalism crusaders have railed against the decline of professionalism as evidenced by litigation incivility.²⁰⁹ This conceptualization of professionalism could be viewed as inwardly directed, focusing on attorneys' dealings with one another.²¹⁰ Similarly, the movement of attorneys to limit their liability amounts to an inwardly directed initiative, protecting attorneys at the expense of clients and other malpractice victims.²¹¹ Instead of elevating their self-interests above client interests and the public interest, attorneys must "redirect their work organizations to better achieve professional ideals" of accountability and competency.²¹² The legal community should "turn from lamenting the decline of professionalism to the more important work of improving the delivery of legal services."²¹³

207. One commentator asserts that limited liability will change the "contours of professionalism" and undermine the "traditional defenses of professional privilege" such as self-regulation. John Flood, *Megalaw in the U.K.: Professionalism or Corporatism? A Preliminary Report*, 64 IND. L. J. 569, 588, 591 (1989).

208. See Peter A. Joy, *What We Talk About When We Talk About Professionalism: A Review of Lawyers' Ideals/Lawyers' Practices: Transformations in the American Legal Profession*, 7 GEO. J. LEGAL ETHICS 987, 1004 (1994) (book review) (arguing that scholarship and bar reports on professionalism fail to discuss society's needs and expectations of attorneys, essentially leaving public out of professionalism debate). By taking steps to ensure the quality of services, the legal profession earns the privilege of self-regulation. See ABEL, *supra* note 143, at 151 (explaining that "professions claim the privilege of self-regulation on the ground that they not only correct misconduct but also ensure the quality of the services they render").

209. As suggested by the Chief Justice of the Delaware Supreme Court, Honorable E. Norman Veasey, the concern over professionalism extends beyond the concern over civility, but should focus on the "aspects of professionalism which relate to competence, public service, intellectual honesty, candor, independence, and the businesslike approach to the profession." E. Norman Veasey, *Professionalism and Pragmatism — The Future: A Message from the Chief Justice of Delaware*, 11 DEL. LAW. 13, 13 (1993).

210. For a thoughtful critique of the professionalism crusader's concern over incivility and litigation abuse, see generally Roy Atkinson, *A Dissenter's Commentary on the Professionalism Crusade*, 74 TEX. L. REV. 259 (1995).

211. In some states, such as North Carolina, the debate over allowing attorneys to limit their liability through LLCs revolved around "professionalism, or the notion that professionals are entrusted with significant public duties." Curt C. Brewer, IV, Comment, *North Carolina's Limited Liability Company Act: A Legislative Mandate for Professional Limited Liability*, 29 WAKE FOREST L. REV. 857, 885-86 (1994).

212. See Robert L. Nelson, *Of Tournaments and Transformations: Explaining the Growth of Large Law Firms*, 1992 WIS. L. REV. 733, 749 (reviewing MARC GALANTER & THOMAS PALAY, *TOURNAMENT OF LAWYERS* (1991)).

213. Russell G. Pearce, *The Professionalism Paradigm Shift: Why Discarding Professional Ideology Will Improve the Conduct and Reputation of the Bar*, 70 N.Y.U. L. REV. 1229, 1276 (1995).

Unlike the current approaches to limited liability that undermine firm-wide accountability and collective responsibility for competency, the proposed limited liability rule protects clients as well as attorneys. By conditioning limited liability on attorneys' reasonable efforts to implement malpractice avoidance measures, the proposal couples professionalism with protection. If firm attorneys act professionally in attempting to control malpractice, they earn a shield against joint and several liability. In short, this alternative approach to limited liability protects firm attorneys if they make reasonable efforts to protect clients. Such an approach promises to serve attorneys, their clients, and the legal profession.

NOTES
