Indiana Law Journal

Volume 71 | Issue 1 Article 7

Winter 1995

# It's Nothing Personal: The Public Costs of Limited Liability Law Partnerships

N. Scott Murphy
*Indiana University School of Law*

# It's Nothing Personal: The Public Costs of Limited Liability Law Partnerships

N. SCOTT MURPHY*

"[T]he actions of a partner you don't even know, working in an office on the other side of the country, could cost you your house and force your kids to go to public school."[1]

"It's a partner's worst nightmare: Her fellow partner has been accused of malpractice . . . . The firm's malpractice insurance won't cover the claim. The firm's assets won't cover the claim. Soon the feds will be coming after the partners' personal assets. Soon the feds will be coming after her house, her boat, her Lichtenstein hanging on the wall."[2]

## INTRODUCTION

Terror at the prospects of public school for one's kids and losing a pricey piece of art sounds more like material for a lawyer joke than grounds for legislative action. But statehouses around the nation are treating such horrors as a mandate to rewrite the book on partnership liability, and with it the rules governing the American law firm.

The limited liability partnership ("LLP") or registered limited liability partnership ("RLLP"), as it is known in some states, demonstrates the most radical departure yet from traditional notions of member liability for law partnerships.[3] In the past, the overwhelming majority of law firms operated as general partnerships, entailing unlimited liability for all partners. This made each partner in a firm personally liable for the malpractice of the firm's other partners, even malpractice of which the partner was unaware.[4]

The LLP allows a law firm to obtain limited liability, which lets firm partners avoid much of the personal exposure to malpractice claims against their colleagues which came with the territory of traditional law partnerships. Not only do LLPs offer limited liability, they offer it without losing pass-through taxation for the firm, and without noticeable changes to the partnership's structure or operation. Thus LLPs offer law firms a number of advantages not available with other enterprise forms.[5]

---

* J.D. Candidate, 1996, Indiana University School of Law-Bloomington; B.J., 1993, University of Missouri-Columbia. I thank Professor Alysa C. Rollock for her guidance and constructive comments on earlier drafts of this Note. I also thank Professor Roger B. Dworkin for advising my formulation and research of the tort law principles contained in this Note. Finally, I thank my parents, Russell N. and Scarlett Y. Murphy, for their love and support, and my lady, Stacy E. Notaras, for her grace, guidance, and love throughout my work.

1. Michael Orey, *The Lessons of Kaye, Scholer: Am I My Partner's Keeper?*, AM. LAW., May 1992, at 3, 81.

2. Thom Weidlich, *Limiting Lawyers' Liability: LLPs Can Protect Assets of Innocent Partners*, NAT'L L.J., Feb. 7, 1994, at 1.

3. Edward A. Adams, *Firms Expected to Make Switch to New Format: Limited Liability Partnerships See Restricting Exposure*, N.Y. L.J., July 14, 1994, at 1.

4. *Id.*

5. These forms include the general partnership, the limited partnership, the professional corporation, the traditional C corporation, and, most recently, the limited liability company ("LLC"). *See infra* part I.C.

Available in eighteen states and the District of Columbia,[6] the LLP is the upstart sibling of the limited liability company ("LLC"), now available in all but a handful of jurisdictions.[7] LLP statutes have not yet been tested in court,[8] but they have won legions of supporters among the American bar and media, who trumpet the LLP as a long-overdue protection for "innocent" law partners.[9] Similarly, legal scholars have given substantial consideration to the LLP as a positive opportunity for law firms.[10]

---

6. As of Janurary 1, 1995, eighteen states and the District of Columbia had enacted LLP statutes. The following are the statutory sections describing the nature of a partner's liability in a limited liability partnership: ARIZ. REV. STAT. ANN. § 29-215 (1994); CONN. GEN. STAT. § 34-53 (1995) (effective Jan. 1, 1996); DEL. CODE ANN. tit. 6, § 1515 (Supp. 199.4);19. CODE ANN. § 41-146 (1995); ILL. ANN. STAT. ch. 805, para. 205/15 (Smith-Hurd 1995); IOWA CODE § 486.15 (1995); KAN. STAT. ANN. § 56-315 (1994); KY. REV. STAT. ANN. § 362.220 (1994); LA. REV. STAT. ANN. § 9:3431 (West Supp. 1995); MD. CODE ANN., CORPS. & ASS'NS § 9-307 (1994); MINN. STAT. ANN. § 323.14 (West 1995); N.Y. PARTNERSHIP LAW § 26 (McKinney Supp. 1995); N.C. GEN. STAT. § 59-45 (Supp. 1994); OHIO REV. CODE ANN. § 1775.14 (Anderson Supp. 1994); S.C. CODE ANN. § 33-41-370 (Law. Co-op. Supp. 1994); TEX. REV. CIV. STAT. ANN. art. 6132b, § 3.08 (West 1994 & Supp. 1995); UTAH CODE ANN. § 48-1-46 (1995); VA. CODE ANN. § 50-15 (Michie 1994). For a convenient compilation of full-text LLP statutes, see *Limited Liability Partnership Statutes*, *in* 12 STATE LIMITED PARTNERSHIP LAWS (Michael A. Bamberger & Arthur J. Jacobson eds., 1995).

7. Forty-six states and the District of Columbia had passed LLC statutes as of January 1, 1995. LLC laws have been proposed in the remaining four states: Hawaii, Massachusetts, Pennsylvania, and Vermont. For a convenient collection of full-text LLC statutes, see *Limited Liability Company Statutes*, *in* 8-11 STATE LIMITED PARTNERSHIP LAWS, *supra* note 6.

8. Christi Harlan, *Texas and Louisiana Move to Shield Personal Assets of Law-Firm Partners*, WALL ST. J., Mar. 13, 1992, at A4; Weidlich, *supra* note 2, at 1.

Courts have addressed, with mixed results, the issue of whether professional corporation statutes, which offer limited liability for shareholders, may properly extend similar protection to lawyers for their co-partner's malpractice. *See* First Bank & Trust Co. v. Zagoria, 302 S.E.2d 674, 675 (Ga. 1983) ("However, there is no clear authority enunciating whether such a limitation of liability exists for a professional corporation organized for the purpose of practicing the legal profession."). The Georgia Supreme Court in *Zagoria* also stated:

> By enacting the professional corporation statute the legislature performed a useful and constitutional act. A professional corporation has numerous legitimate business purposes. By conducting a law practice through the structure of a professional corporation, its shareholders realize the advantages of more orderly business operations, greater ease in acquiring, holding and transferring property, and more continuity of its existence. Additionally, a professional corporation affords to its shareholders insulation against liability for obligations which do not arise as a result of a breach of a lawyer's obligation to his client or an act of professional malpractice. The shareholders of a professional corporation have the same insulation from liability as shareholders of other corporations with respect to obligations of a purely business and nonprofessional nature. However, the influence of the statute upon the professional corporation cannot extend to the regulation of the law practice so as to impose a limitation of liability for acts of malpractice or obligations incurred because of a breach of a duty to a client.

*Id.*.

9. Weidlich, *supra* note 2, at 1, 38; *see also* Harlan, *supra* note 8, at A4 ("The Louisiana law 'was designed to put some sanity back into these lawsuits' against bank and thrift advisers, says David Willenzik, a New Orleans lawyer who helped draft it.") (citations omitted); Lisa Isom-Rodriguez, *Limiting the Perils of Partnership*, AM. LAW., July-Aug. 1993, at 30. Specifically, Isom-Rodriguez said:

> These days big-firm partners are looking to registered limited liability partnerships . . . with an enthusiasm perhaps more appropriately reserved for the Holy Grail, says Michael Bohnen, a partner at Boston's 117-lawyer Nutter, McClennen & Fish, who has written an LLP bill that is pending in the Massachusetts legislature. The Grail may have promised the ultimate wisdom, but LLPs . . . promise to protect a partner's personal assets from claims leveled against another partner down the hall, or on the other side of the world.

*Id.*

10. *See* W. Philip Clinton & Douglas N. Currault II, *The Birth of Two Business Entities: Limited Liability Companies and Registered Limited Liability Partnerships*, 40 LA. B.J. 289, 292 (1992) ("[C]learly Louisiana attorneys must now consider the LLC and RLLP whenever advising clients starting a business or reconsidering their original choice of business format."); Terrence A. Oved, *New York State Limited Liability Partnerships*, N.Y. ST. B.J., Mar.-Apr. 1995, at 38, 73 (noting advantages of LLPs and predicting that LLPs will "surface as the dominant form of organization for professionals"); Brian L. Schorr & Sylvia Wong, *Limited Liability Company Law, Part Two*, N.Y. L.J., July 14, 1994, at 1, 4 ("New York's law should prove to be an attractive statute for organizing an LLC or a professional LLP."); *A Report to the Illinois Supreme Court Rules Committee by the Chicago Bar Association: Eliminate the Vicarious Liability of Attorneys*, CBA REC., Sept. 1994, at 24.

Similar praise has been given to the limited liability company. *See, e.g.*, Curt C. Brewer IV, *North Carolina's Limited Liability Company Act: A Legislative Mandate for Professional Limited Liability*, 29 WAKE FOREST L. REV. 857 (1994); David L. Cameron, *Strike Up the Band: The Limited Liability Company Comes to Oregon*, 30 WILLAMETTE L. REV. 291

While most authors have praised the LLP, little attention has been paid to the negative implications of law firms using LLP statutes.[11] This Note fans the neglected ember of cautionary scholarship on the LLP law firm, specifically in the area of legal malpractice. Using tort law principles of deterrence, loss prevention, and loss spreading, it argues that law firms, by converting from general partnerships to LLPs, will foster legal malpractice, transfer malpractice risk to inefficient loss preventors, and transfer malpractice costs to inefficient loss spreaders. For simplicity's sake, this Note uses various model acts, as well as the Texas Revised Limited Liability Partnership Act, as references.[12]

This Note consists of four parts. Part I sets forth concepts helpful to the understanding of LLPs, including (a) the basic characteristics of the LLP as compared to other enterprise forms, (b) the history behind LLP statutes, and (c) the advantages likely to make LLPs more attractive to law firms than other enterprise forms. Parts II, III, and IV set forth three societal costs implicated in allowing use of the LLP form by law firms. Part II argues that LLPs will breed malpractice by discouraging lawyers from co-monitoring. Part III argues that the LLP, by shifting the cost of underinsured legal malpractice from firms to clients, will force clients to act as malpractice watchdogs, a role for which they are ill-equipped. Part IV argues that the LLP, by shifting the cost of underinsured legal malpractice from firm partners to clients, will impede the efficient spreading of malpractice costs.

## I. THE EMERGENCE OF THE LLP LAW FIRM

This Part explains basic concepts necessary to understand LLPs and their appeal to law firms. It approaches this task from a definitional, historical, and comparative angle. Part I.A. presents the basic characteristics of the LLP, focusing heavily on the characteristic of limited liability and its appeal to law firms. Part I.B. traces the history behind the

---

(1994); Robert E. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375 (1992) ("There is no question that LLCs can fill an important gap as an alternative business form."); Demetrios P. Koutrodimos, *LLCs Can Protect Members and Provide Flexible Operations*, 52 TAX'N FOR ACCT. 30 (1994); Jimmy G. McLaughlin, *The Limited Liability Company: A Prime Choice for Professionals*, 45 ALA. L. REV. 231 (1993); Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L.Q. 417, 473 (1992) (arguing that "the partnership form has been preserved by legal rules that make limited liability costly" and that "[t]hese rules are normatively unjustified"); David C. Worrell & Marci A. Reddick, *The Indiana Business Flexibility Act (Limited Liability Companies)*, 27 IND. L. REV. 919 (1994).

11. For one exception, see Thomas A. Denker, *Lawyers and Limited Liability for Arizona's Professionals: Deliverance or Damnation?*, 37 ARIZ. L. REV. 355 (1995).

12. Acts referred to in this Note include: TEX. REV. CIV. STAT. ANN. art. 6132b, § 3.08 (West 1994 & Supp. 1995); UNIF. PARTNERSHIP ACT (1994); UNIF. PARTNERSHIP ACT (1914); UNIF. LTD. PARTNERSHIP ACT (1985); REVISED MODEL BUSINESS CORP. ACT (1984); REVISED MODEL PROFESSIONAL CORP. ACT (1984); Draft Unif. Ltd. Liability Co. Act (1993) *reprinted in* 8 STATE LIMITED PARTNERSHIP LAWS, *supra* note 6.

In 1992, the National Conference of Commissioners on Uniform State Laws adopted a new Uniform Partnership Act commonly referred to as the Revised Uniform Partnership Act. In 1994, they made further changes and the name of the Act became the Uniform Partnership Act (1994). This 1994 Act is still referred to as the Revised Uniform Partnership Act. *See* UNIF. PARTNERSHIP ACT (1994) (historical notes).

Note that unlike the Uniform Limited Liability Company Act for LLCs, no formal model limited liability partnership act has been promulgated for LLPs. The Texas Act was selected for reference in this Note because Texas was the first state to enact a registered limited liability partnership act. Many states which have enacted or which are in the process of enacting LLP statutes have patterned their statutes after the Texas Act. Texas also is the first state to receive a private letter ruling from the IRS granting its state's LLPs partnership status for tax purposes. *See* Priv. Ltr. Rul. 92-29-016 (Apr. 16, 1992); Weidlich, *supra* note 2, at 1.

Other statutes which promise to be influential include New York's LLP act. N.Y. PARTNERSHIP LAW § 26 (McKinney Supp. 1995); *see* Schorr & Wong, *supra* note 10, at 1, 4 ("[New York's law] may well be considered a 'model' LLC and LLP statute. It reflects some of the most current thinking on the subject and provides an LLC's or a professional LLP's organizers with a package of features and options not yet available in other state statutes.").

American law firm's rendezvous with the LLP, demonstrating the philosophic metamorphosis of many firms from a traditionalist distaste for nonpartnership status to their present exodus to the LLP "promised land." Part I.C. attempts to explain *why* so many more law firms are choosing to adopt the LLP form, given their past rejection of other nonpartnership forms.

### *A. Characteristics of the LLP*

Though LLP statutes in those states which have passed them differ, common characteristics exist which may be illustrated through examination of the first LLP statute ever passed, the Texas Registered LLP Act. This Part focuses primarily on the LLP's attribute of limited liability. Limited liability means that an enterprise member, merely by virtue of her membership, will not be held personally liable for acts of the enterprise (including acts of other enterprise members), beyond the amount of her individual investment.[13] In contrast, unlimited liability means that a member of an enterprise,[14] by virtue of her membership, is personally liable for the acts of the enterprise, including acts of other enterprise members taken within the context of the enterprise's operation.[15]

Texas allows any enterprise presently existing as a general partnership[16] to be registered as an LLP by its members. Attainment of LLP status requires miniscule procedures under the Texas Act. A general partnership can transfer to the LLP form by merely filing an application with the Secretary of State containing the partnership's name, its address, number of partners and an "in-brief" description of the partnership business, along with a payment of $200 per partner and proof of firm ownership of a malpractice insurance policy over $100,000.[17] The Texas Act requires no further action, though the LLPs must update their registration annually through renewal filings.

---

13. The classic example is the limited liability afforded to a shareholder of a large publicly held corporation. Suppose A owns 10 shares of General Motors stock, for which A paid $100. A GM automobile assembly line worker negligently overlooks an engine defect which later causes the engine to explode and injure the owner. While GM's corporate assets may very well be subject to a substantial tort claim by the car owner, the individual GM stockholder will lose no more than his original $100 investment. As an example, see Stewart v. Coffman, 748 P.2d 579, 581 (Utah Ct. App. 1988) ("[S]hareholder insulation from such liability has been a cornerstone of corporate law in the United States since the nineteenth century. Virtually every state has a statute . . . which limits a shareholder's liability to the cost of the shares held.") (footnote omitted in original); *see also* Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 89-90 (1985).

14. "Enterprise" is used in this Note as a catch-all phrase to indicate all of the various entities or collectives recognized by law. Liability for a member of one type of enterprise, such as a partnership (members are commonly called "partners"), depending on the law of the relevant jurisdiction, may or may not differ from liability for a member of another type of enterprise, such as a limited partnership (general partners and/or limited partners), corporation (shareholders), LLC (shareholders), or LLP (partners).

15. The classic example is the unlimited liability of partners in a traditional general partnership law firm. Suppose A, a probate attorney and partner in XYZ law firm, takes a day off from work. That same day, B, a products liability lawyer and also partner in XYZ, forgets to file an appeal to a $120 million judgment against XYZ client Willy Pharmaceuticals for heart problems developed by a group of plaintiffs after 20 years of using a prescription drug engineered by Willy. Willy sues XYZ and demonstrates that an error by the trial court would have won the case for Willy on appeal, earning Willy a $120 million malpractice judgment. XYZ's malpractice insurance policy allows maximum recovery of $100 million. B's personal assets are worth $5 million. The law of partnership requires A, and all other XYZ partners, to pay the rest out of their personal assets.

Recent cases recognizing unlimited liability for partners in general partnerships are common. *E.g.*, Georgou v. Fritzhall, 145 B.R. 36, 36-37 (Bankr. N.D. Ill. 1992); Bank of Denver v. Southeastern Capital Group, 763 F. Supp. 1552, 1560 (D. Colo. 1991); McVaney v. Baird, 466 N.W.2d 499, 501, 506 (Neb. 1991); Clients' Sec. Fund of N.Y. v. Gradeau, 526 N.E.2d 270, 273 (N.Y. App. Div. 1988); Roach v. Mead, 722 P.2d 1229 (Or. 1986).

16. *See infra* part I.C.1 (examining the characteristics of the general partnership).

17. TEX. REV. CIV. STAT. ANN. art. 6132b, § 10.03.

In exchange for the LLP's conformance with its registration requirements, Texas grants an LLP's members limited liability. The Texas LLP Act reads in part as follows:

> (a) Liability of Partner.
> (1) A partner in a registered limited liability partnership is not individually liable for debts and obligations of the partnership arising from errors, omissions, negligence, incompetence, or malfeasance committed while the partnership is a registered limited liability partnership and in the course of the partnership business by another partner or a representative of the partnership not working under the supervision or direction of the first partner unless the first partner:
> (A) was directly involved in the specific activity in which the errors, omissions, negligence, incompetence, or malfeasance were committed by the other partner or representative; or
> (B) had notice or knowledge of the errors, omissions, negligence, incompetence, or malfeasance by the other partner or representative at the time of occurrence and then failed to take reasonable steps to prevent or cure the errors, omissions, negligence, incompetence, or malfeasance.[18]

The Texas Act thus grants each partner personal immunity from liability for obligations of their partnership which arise from the errors, omissions, negligence, incompetence, or malfeasance of her co-partners unless that partner participated in or supervised the malpractice.[19] In other words, the Texas Act grants partnership members limited liability. Limited liability is an appealing attribute to law firm partners for several reasons. First, self-interest leads firm partners who are assumedly risk-adverse to seek out methods to reduce risk of personal loss,[20] and the Texas Act offers one way to reduce this risk. Second, scholars and the media continue to report the increasing size and frequency of malpractice claims and judgments, leading many partners to feel a need to further insulate their personal assets.[21] Third, the increasing size of firms and specialization within them have led more firm partners to view their personal risk as higher with so many partners acting as agents for their firm.[22]

### *B. History of the LLP Law Firm*

For centuries, lawyers were unable to obtain limited liability. One author examined the changing tide that came near the middle of the 20th century.

> Prior to the 1960's, no state allowed professionals to incorporate. Therefore, all professionals, including lawyers, worked under the broad personal-liability rules governing partnerships and sole proprietorships.
>
> Resistance to allowing attorneys in particular to practice in the corporate form was based upon two general types of concerns: (1) the possibility that the corporation itself might interfere with the professional relationship between each client and the attorney handling his case, and (2) the possibility that lawyers could avoid malpractice liability. However, these "traditional" concerns over the ethical implications of allowing lawyers to incorporate got pushed aside in the 1960's and 1970's, as other considerations

---

18. *Id.*

19. As a general rule, a lawyer would violate the Model Rules of Professional Conduct if she attempted to contract with a client to limit her personal liability for her own acts of malpractice. *See* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.8(h) (1994).

20. *See* STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW 206-08 (1987).

21. *See, e.g.*, Denker, *supra* note 11, at 359; Manuel R. Ramos, *Legal Malpractice: The Profession's Dirty Little Secret*, 47 VAND. L. REV. 1657, 1658-81 (1994).

22. SUSAN SAMUELSON, LAW FIRM MANAGEMENT: A BUSINESS APPROACH § 8.2, at 8:17-8:23 (1994) (detailing sharp growth in size of and specialization within law firms); Adams, *supra* note 3, at 1; Weidlich, *supra* note 2, at 1, 38.

prompted professionals to lobby state courts and legislatures for the right to incorporate.

> The right to enjoy limited liability was not the only advantage which professionals stood to gain from being allowed to practice in the corporate form; other benefits also attended the act of incorporation. The most significant of these benefits was the lenient tax treatment [of qualified corporate retirement plans] which corporations received, and it was the desire to allow professionals to take advantage of these tax benefits which led states to permit professional incorporation. Today, every American jurisdiction provides for the incorporation of professionals.[23]

Despite the advent of professional corporation statutes, the vast majority of law firms remained in the general partnership realm.[24] Then, in the early 1980's, Congress answered then-President Ronald Reagan's call for large-scale tax reform by passing the Economic Recovery Tax Act of 1981 and the Tax Equity and Fiscal Responsibility Act of 1982.[25] To the partnership's benefit, these two acts equalized the tax treatment of corporations and partnerships.[26] With favorable tax treatment no longer a motivation for incorporation, limited liability remained the only significant benefit to forming a professional corporation.

Meanwhile, the IRS was poised to change its long-standing approach to classifying entities for federal tax purposes. In the past, the IRS had classified entities with limited liability for all members as a corporation for tax purposes.[27] The IRS' classification of limited liability business structures as corporations meant that all income earned by the business was taxed twice, once at the "entity" level and again at the shareholder level.[28] Income of partnerships, on the other hand, was not taxed at the "entity" level.[29] As a result, along with fees and filings and the annoyance of owner-manager corporate role-playing,[30] double taxation was another price to be paid for limited liability.

An opportunity for the IRS to revise its approach came with the LLC. Born in Germany and with long-established acceptance throughout Europe and Latin America, LLC statutes began to emerge in the United States in the mid-1980's.[31] In 1986, only two states,

---

23. Denker, *supra* note 11, at 358 (citations omitted).

24. *See* SAMUELSON, *supra* note 22, § 2.2.4, at 2:11 ("Despite the substantial advantages of incorporation, only 19 of the 250 largest law firms have incorporated their practices."); Oved, *supra* note 10, at 38 ("Historically, general partnerships have been the preferred form utilized by most law firms.").

25. Economic Recovery Act, Pub. L. No. 97-34, 95 Stat. 172 (1981) (codified as amended in scattered sections of 26 U.S.C.); Tax Equity and Fiscal Responsibility Act, Pub. L. No. 97-248, 96 Stat. 324 (1982) (codified as amended in scattered sections of 26 U.S.C.).

26. Denker, *supra* note 11, at 359.

27. Keatinge, *supra* note 10, at 382-83.

28. CLAIRE M. DICKERSON, PARTNERSHIP LAW ADVISER 9 (1991). This principle is commonly known as "double taxation."

29. Professors Cary and Eisenberg state:

> The critical [taxation] difference between corporate and partnership taxation is that a corporation is normally taxed as an entity while a partnership is not . . . . [P]artnership income is treated on a conduit basis . . . . [I]ncome is treated as if it had been personal income realized by the partners as individuals, not to the partnership as a separate entity.

WILLIAM L. CARY & MELVIN A. EISENBERG, CORPORATIONS: CASES AND MATERIALS 95 (6th ed. 1988); *see also* DICKERSON, *supra* note 28, at 9.

30. Steven C. Bahls, *Application of Corporate Common Law Doctrine to Limited Liability Companies*, 55 MONT. L. REV. 43, 50 (1994) ("Owners of closely owned businesses often regard the formality required by business organization statutes as unnecessary red tape or as 'Mickey Mouse' requirements imposed by the government."); Isom-Rodriguez, *supra* note 9, at 30, 32.

31. For a history of LLC statutes outside the United States, see Ervin O. Anderson, *Government Policies and Legal Factors*, *in* JOINT INTERNATIONAL BUSINESS VENTURES 214, 216-17 (Wolfgang G. Friedman & George Kalmanoff eds., 1961).

For a more expansive discussion of the history, purpose, and predicted effects of LLC statutes in the United States, see Keatinge, *supra* note 10, and McLaughlin, *supra* note 10.

Wyoming and Florida, had passed statutes recognizing such entities, without much attention paid by the rest of the nation.[32] At first, the IRS balked at the limited liability aspect of the LLC, promising to deny it partnership classification, and with that, close the door to conduit-entity taxation: "The Internal Revenue Service believes that the term 'partnership' can apply only to an organization some member of which is personally liable under applicable local law for debts of the organization. Since a limited liability company does not satisfy this condition, it cannot be classified as a partnership."[33]

But in 1988, the IRS classified a Wyoming LLC as a partnership for tax purposes, despite the presence of limited liability for members.[34] The IRS' modern approach to taxing various business entities was recently explained:

> The unincorporated organization will be taxed as a corporation if it has more corporate characteristics than noncorporate characteristics. The characteristics considered by the IRS as indicative of corporate status are: "(i) associates, (ii) an objective to carry on business and divide the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of interests."
>
> The first two characteristics, associates and an objective to carry on business and divide the gains, are common to both partnerships and corporations; therefore, these characteristics do not enter into the analysis. The IRS considers the presence of the four remaining characteristics of continuity of life, centralization of management, limited liability, and free transferability of interests in determining whether an LLC is classified as a corporation or a partnership. Consequently, practitioners must be certain that a newly created LLC has more noncorporate than corporate characteristics.[35]

Suddenly, under the IRS' new approach, double taxation was no longer a "cost" of limited liability.[36] Law firms could now obtain limited liability *and* conduit taxation by complying with LLC statutes.

By mid-1995, forty-seven states and the District of Columbia had adopted LLC statutes.[37] Though LLC supporters touted their statutes as crucial to fostering business growth,[38] it would not be the next budding Henry Ford or Bill Gates in need of venture

---

32. Wayne M. Gazur & Neil M. Goff, *Assessing the Limited Liability Company*, 41 CASE W. RES. L. REV. 387, 389-91 (1991). Wyoming enacted the first LLC statute in 1977. WYO. STAT. §§ 17-15.102 (1995); Ribstein, *supra* note 10, at 425. Florida followed in 1982. *See* FLA. STAT. ANN. §§ 608.401-.416 (West 1993 & Supp. 1995); McLaughlin, *supra* note 10, at 231.

33. Classification of Limited Liability Companies: Notice of Proposed Rulemaking, 45 Fed. Reg. 75,709 (1980) (to be codified at 26 C.F.R. § 301) (proposed Nov. 17, 1980).

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

35. C. Timothy Spainhour, Note, *Limited Liability Companies in Arkansas: The Knowns and Unknowns*, 16 U. ARK. LITTLE ROCK L.J. 27, 35 (1994) (citations omitted) (quoting Gary Schwarcz & Aaron H. Sherbin, *The Limited Liability Company: A New Entity for Michigan Businesses?*, 71 MICH. B.J. 650, 652 (1992)); *see also* Keatinge, *supra* note 10, at 382-83 (explaining IRS' traditional tax classification of limited liability entities as corporations).

36. The Draft Uniform Limited Liability Company Act states:

> § 304. Liability to Third Parties.
>
> (a) Except as otherwise provided in this [Act], the debts, obligations, and liabilities of a limited liability company, whether arising in contract, tort, or otherwise, shall be solely the debts, obligations and liabilities of the limited liability company. A member or manager of a limited liability company shall not be obligated personally for any such debt, obligation, or liability of the limited liability company solely by reason of being a member or acting as a manager of a limited liability company.

Draft Unif. Ltd. Liability Co. Act § 304(a) (1993), *reprinted in* 8-11 STATE LIMITED PARTNERSHIP LAWS, *supra* note 6; *see also* Bahls, *supra* note 30, at 52-53 (discussing LLC's as resolution to entity-seeking dilemma).

37. For a convenient collection of full-text LLC statutes, see *Limited Liability Company Statutes*, *in* 8-11 STATE LIMITED PARTNERSHIP LAWS, *supra* note 6.

38. *See* Jeffrey A. Tannenbaum, *States Are Sanctioning New Form of Business*, WALL ST. J., July 17, 1992, at B1 ("In creating LLCs, legislators are aiming to please business owners concerned about liability and hoping to attract new business to their states.").

capital who took advantage of LLC statutes.[39] Rather, much of the response to LLC statutes came from professional organizations, including law firms seeking reduced liability.[40] The fact that law firms were among the businesses that most utilized the LLC was particularly ironic, as few would argue that law firms had any growth difficulties during the prior two decades.[41] Nonetheless, law firm adoption of the LLC form appeared somewhat similar to law firm adoption of the professional corporation form: by mid-1995, more than four hundred law firms nationwide had become LLCs.[42]

In the midst of the wildfire adoption of LLC statutes, Texas quietly took the LLC concept one step further in 1991, by passing the Registered Limited Liability Partnership Act along with an LLC statute.[43] Soon thereafter, the IRS made a private letter ruling stating that Texas LLPs would be taxed as partnerships.[44] LLP statutes caught on in a manner similar to LLC statutes; by January 1995 they were available in eighteen states and the District of Columbia.[45] Law firm adoption of the LLP form appears to have taken the wind out of law firms' attraction to the LLC. For example since the LLP's emergence in Texas, more than five hundred Texas law firms have adopted the form, while practically no Texas law firms have adopted the LLC form.[46]

### *C. Appeal of the LLP Form to Law Firms*

The LLP form offers advantages over alternative limited liability structures available to law firms in the past. As discussed below, these alternative forms present disadvantages that prevented most firms from abandoning the partnership form earlier, while the LLP promises to lead many more firms away from the partnership form in pursuit of limited liability.

---

39. *See* Peter Blackman, *Limited Liability Option: Experts Weigh the Pros and Cons of Converting*, N.Y. L.J., Aug. 25, 1994, at 5, 5 ("No one expects there to be a rush to convert existing businesses (other than professional partnerships) to the new available structures.") (parenthetical in original); *see also* Thomas M. Wells & Anthony Pantano, *Corporations Should Stand Pat as Partnerships Shift to LLCs*, N.J. L.J., Apr. 11, 1994, at 10.

40. After only one year of nearly nationwide adoption of LLC statutes in state legislatures, Martindale-Hubbell Law Directory listed 526 law firms registered as LLCs. Search of LEXIS, MARHUB library, USBIO file (Oct. 27, 1995) (search is the following: "', LLC' or ', L.L.C.' or ', a Limited Liability Company'") [hereinafter LEXIS LLC search].

41. SAMUELSON, *supra* note 22, § 8.4, at 8:17.

42. The Martindale-Hubbell Law Directory lists 526 law firms registered nationwide as LLCs, a quasi-nationwide option for little more than a year. *See* LEXIS LLC search, *supra* note 40; *supra* text accompanying note 37. In contrast, the Directory lists 11,520 firms registered nationwide as professional corporations, with professional corporations available nationwide since the 1970's. Search of LEXIS, MARHUB library, USBIO file Oct. 27, 1995) (search is the following: "', PC' or ', P.C.' or ', a Professional Corporation'"). If we assume nationwide adoption of the professional corporation in 1970, the appearance of 11,520 professional legal corporations by 1995 implies an average annual formation/conversion rate of about 460 firms per year. If we assume the LLC form has been available nationwide for one year, the appearance of 526 LLC law firms by 1995 appears, at least initially, to follow a growth rate somewhat similar to that of the professional corporation. The key word may be "initially": with the recent emergence of the LLP option, we may never know the true extent of law firms' preference for the professional corporation over the limited liability company.

43. *See* TEX. CIV. STAT. ANN. art. 1528n, § 11.07, art. 6132b, § 15 (West Supp. 1995). Legislative history indicates that the LLC statute and the LLP statute were enacted simultaneously. In addition, Texas amended its LLC statute in 1993 to include professionals. Weidlich, *supra* note 2, at 1, 38.

44. Priv. Ltr. Rul. 92-29-016 (Apr. 16, 1992) ("[The] LLP will be classified as a partnership for federal tax purposes."); Weidlich, *supra* note 2, at 38 ("[T]he extent of the Internal Revenue Service's commentary on the subject has been one private-letter ruling finding that Texas' LLPs would be treated as partnerships.").

45. *See* statutes cited *supra* note 6.

46. The Martindale-Hubbell Law Directory for Texas lists 1082 professional corporations, 537 limited liability partnerships, and only one limited liability company. Searches of LEXIS, MARHUB library, TXDIR file (Oct. 27, 1995) (searches are the following: "', LLC' or ', L.L.C.' or ', a Limited Liability Company' and 'Professional Biographies Section'"; "', LLP' or ', L.L.P.' or ', a Limited Liability Partnership' and 'Professional Biographies Section'"; "', PC' or ', P.C.' or ', a Professional Corporation' and ', Professional Biographies Section'").

### 1. The LLP v. The General Partnership

The partnership has for decades been the most common form among law firms.[47] Like the LLP, the general partnership requires no formal written agreement: it is easy to create, customize, and maintain.[48] However, a general partnership imposes unlimited liability on all partners,[49] in accordance with the aggregate theory of partnership, the partner's duty of loyalty, and principles of agency.[50] The minimal procedural burden of filing for LLP status instead of remaining a general partnership seems easily compensated by the benefits of limited liability.

---

47. *See* Eddy J. Rogers, *Has Your Firm Thought About Incorporating?*, 50 TEX. B.J. 1194, 1194 (1987).

48. CARY & EISENBERG, *supra* note 29, at 94 ("[A] general partnership can be organized and maintained with little or no formalities or filing fees.").

49. This is true both under the Uniform and Revised Uniform Partnership Acts. The Revised Uniform Partnership Act provides:

> § 306. Partner's Liability
> (a) Except as provided in subsection (b), all partners are liable jointly and severally for all obligations of the partnership unless otherwise agreed by the claimant or provided by law.

UNIF. PARTNERSHIP ACT § 306 (1994).

Not all jurisdictions have adopted the Revised Uniform Partnership Act, but the original Uniform Partnership Act similarly provides:

> § 15. Nature of Partner's Liability
> All partners are liable
> (a) Jointly and severally for everything chargeable to the partnership under sections 13 [wrongful acts of partners] and 14 [misappropriation by partners].
> (b) Jointly for all other debts and obligations of the partnership; but any partner may enter into a separate obligation to perform a partnership contract.

UNIF. PARTNERSHIP ACT § 15 (1914) (alterations added).

Several commentators consider the Revised Uniform Partnership Act to have abandoned the aggregate theory of partnership in favor of the entity theory. *See* John W. Larson et al., *Partnership Law: Revised Uniform Partnership Act Reflects a Number of Significant Changes*, 10 J. PARTNERSHIP TAX 232, 233 ("[The Revised Uniform Partnership Act] contains a number of changes that unequivocally adopt the entity theory."). But it should be noted that the Revised Act of 1994, though defining a partnership as an entity, retains the aggregate characteristic of unlimited liability for partners, a critical characteristic in comparing traditional partnerships and LLPs. *See* UNIF. PARTNERSHIP ACT § 201 (1994) (defining partnership as entity); *see id.* § 306(a) (addressing liability of partners); *see also* ROBERT W. HILLMAN, LAW FIRM BREAKUPS 110 (1990) [hereinafter HILLMAN, BREAKUPS] (arguing that aggregate elements, such as joint liability, are likely to remain a part of Revised Uniform Partnership Act); ROBERT W. HILLMAN, HILLMAN ON LAWYER MOBILITY §§ 4:3 to 4:4, 4:6 to 4:7 (1994) (noting that despite language implying adoption of entity view of partnership, Revised Act retains the aggregate element of shared losses among partners).

50. Scholars have cited a number of possible reasons why partners have unlimited liability. First, the aggregate theory of partnership views the partnership as a collective of individuals; each partner acts as an agent for her partners. DICKERSON, *supra* note 28, at 8.

A second reason often given for unlimited liability for partners, especially in law firms, is that partners are assumed to owe one another a high duty of loyalty. Therefore, both the benefits and the burdens of any individual partner are assumed to be ratified by each of the other partners. *See* UNIF. PARTNERSHIP ACT § 404(a)-(c) (1994); UNIF. PARTNERSHIP ACT §§ 18, 21 (1914); *see also* Committee on Professional Ethics & Conduct of the Iowa State Bar Assoc. v. McClintock, 442 N.W.2d 607, 608 (Iowa 1989) (noting that "[m]ost law partnerships are founded upon a total trust and confidence among the partners"); Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928) ("Joint adventurers, like copartners, owe to one another,while the enterprise continues, the duty of the finest loyalty.").

A third justification for unlimited liability for members of a general partnership is that partners are best suited to be held liable for the acts of the partnership; their investment of resources in the venture generally makes them the most motivated and best situated to maximize partnership earnings and minimize partnership debts. *See generally* SHAVELL, *supra* note 20, at 170 ("If . . . the principal can observe and control the actor's level of care, then imposition of vicarious liability will induce the principal to compel the actor to exercise optimal care.").

### 2. The LLP v. The Limited Partnership

A limited partnership consists of one or more general partners and one or more limited partners. The limited partner retains limited liability exposure, and is restricted to the limited partner's investment in the business; the general partner retains unlimited liability similar to a partner in a general partnership.[51] Limited partnerships have the pass-through tax treatment advantage of the partnership.[52] However, insulation of the limited partner from liability for acts of the partnership beyond the limited partner's investment is contingent upon the limited partner's refraining from active management of the business.[53] While modern limited partnership acts have expanded the range of activities in which a limited partner may engage without incurring unlimited liability,[54] this range is still insufficient to make the entity of much use to law firms, whose partners are usually active and controlling participants in a law firm's operation.[55] In contrast, the LLP offers the same liability protection as a limited partnership, without the same restriction on the partner's activity with respect to the partnership operation.

### 3. The LLP v. The Professional Corporation

Despite the advent of professional corporation statutes in the 1970's, offering firms limited liability and a number of corporate tax advantages,[56] most law firms did not leave the partnership realm for professional corporation form.[57] First, partners feared that adopting a corporate status would offend the public and injure their client goodwill by implying a reduced concern for client interests.[58] Second, malpractice claims were

---

51. The Uniform Limited Partnership Act reads in part:

> [A] limited partner is not liable for the obligations of a limited partnership unless he [or she] is also a general partner or, in addition to the exercise of his [or her] rights and powers as a limited partner, he [or she] participates in the control of the business.

UNIF. LTD. PARTNERSHIP ACT § 303 (1985) (alterations in original). Conversely, § 403 reads:

> (a) Except as provided in this [Act] or in the partnership agreement, a general partner of a limited partnership has the rights and powers and is subject to the restrictions of a partner in a partnership without limited partners.
>
> (b) Except as provided in this [Act], a general partner of a limited partnership has the liabilities of a partner in a partnership without limited partners to persons other than the partnership and the other partners. Except as provided in this [Act] or in the partnership agreement, a general partner of a limited partnership has the liabilities of a partner in a partnership without limited partners to the partnership and the other partners.

*Id.* § 403 (alterations in original).

52. *Compare* Keatinge, *supra* note 10, at 382 *with* CARY & EISENBERG, *supra* note 29, at 95.

53. UNIF. LTD. PARTNERSHIP ACT § 303 (a)-(b) (1985).

54. *Id.* § 305.

55. SAMUELSON, *supra* note 22, at 2:12 (describing the law partnership as "the ultimate cooperative organization, a marriage of equals").

56. As explained in part I.B., the tax advantages of professional corporation statutes, indeed traditional C corporation statutes as well, chiefly the favorable treatment afforded to qualified corporate retirement plans, were eliminated with congressional tax reform legislation in the early 1980's. *See* text accompanying *supra* notes 24-26. Without the tax advantages available in the 1970's, double taxation of corporate income arguably makes professional corporation statutes even more onerous to law firms today than twenty years ago.

57. SAMUELSON, *supra* note 22, § 2.12, at 2:12 ("Despite the substantial advantages of incorporation, only 19 of the 250 largest law firms have incorporated their practices."(footnote omitted)).

58. *Id.* § 2:11n.10 ("[Law firms'] work product was so important and the capitalization of their businesses was so small that unlimited liability was necessary, it was thought, to provide adequate protection for clients."); Martha Middleton, *Larger Law Firms Ponder Corporate Step*, 67 A.B.A. J. 693 (1981); Steven Brill, *Ways & Means: To P.C. or Not to P.C.*, AM. LAW., Feb. 1981, at 10-11; Weidlich, *supra* note 2, at 1, 38 (quoting A.B.A. LLC Subcommittee Chairman Robert R. Keatinge in saying that "[t]here's a sort of knee-jerk reaction to anything that limits the liability of

relatively infrequent and rarely of much financial substance, and thus did not warrant a fundamental change in the firm's structure.[59] Third, professional corporation statutes entailed a number of formational and operational burdens.[60] Finally, many firms' members simply preferred the traditional image of a law partnership and of being a "partner":

> Tradition dictates that when lawyers and accountants decide to mold a firm, they should form a partnership. Despite the liability exposure, professionals have long cherished the financial reward and status of "making partner." This tradition is a major reason why partnerships prevail in the professional arena. . . . Nevertheless, partnerships (even with their unlimited personal liability to partners) remain the most popular choice among professionals fashioning a firm.[61]

Another scholar commented that "customs and rituals have evolved over time that are almost as important as the legal technicalities. Indeed, 'making partner' is the closest experience to tenure outside ivory towers."[62]

### 4. The LLP v. The LLC

As its closest cousin, the LLC offers law firms nearly every advantage that LLPs offer. Most importantly, the LLC allows decentralized management (which the limited partnership lacked), pass-through taxation (which the professional corporation lacked), and limited liability (which the general partnership lacked). However, law firms appear to prefer the LLP over the LLC.[63] This preference likely is due to a lack of comfort with the LLC linked to factors similar to those which prevented law firms from utilizing professional corporation statutes: (1) aesthetic distaste for abandoning the partnership form and (2) a desire to avoid procedural complexity.

#### a. Aesthetics

Many law firm partners are deciding against conversion to the LLC form because they fear a public perception of impropriety and lack of professionalism, much like their concerns about professional corporation statutes. Many firm partners fear that a client greeted by an "attorney-shareholder" might perceive the attorney as more interested in dividends than in the client's interests.[64] An LLP law firm, however, greets the public as a partnership—in its formal decisionmaking, in its organizational structure, even in the legal name it advertises to the public—albeit one with the initials "L.L." preceding the "P." for "Partnership" on its letterhead.[65] Also, though the availability of LLC statutes

---

a professional").

59. Ramos, *supra* note 21, at 1661.

60. Harlan, *supra* note 8, at A4 ("For years, most states have offered law firms . . . the chance to become professional corporations, gaining many liability protections. But such corporations carry tax burdens and reporting requirements that can make them unattractive.").

61. Thomas W. Van Dyke & Paul G. Porter, *Limited Liability Partnerships: The Next Generation*, 63 J. KAN. B. ASS'N., 16, 18.)

62. SAMUELSON, *supra* note 22, at 2:12.

63. *See supra* note 47 and accompanying text.

64. *See* Weidlich, *supra* note 2, at 1, 38.

65. *Id.*; *see* Tex. Rev. Civ. Stat. Ann., art. 6132b, § 3.08(c) (West Supp. 1995).

to lawyers varies,[66] LLP statutes generally have law firm use explicitly in mind.[67] This aids in the perception of firm partners that their adoption of the LLP form is socially endorsed. Clients and the public aside, many attorneys also receive a subjective benefit in self-esteem that they get from retaining the partnership designation for their law firm.[68]

### b. Procedural Complexity

In order to take advantage of the LLC's form, law firms must follow procedures similar to those required under traditional corporate statutes.[69] But unlike LLC statutes, the Texas Act allows attainment of LLP status with miniscule procedural requirements. In addition to offering the substantive benefits of limited liability and pass-through taxation, the Texas Act eliminates practically all the burdensome structural and filing requirements contained in former corporate statutes:[70]

> Part of the problem with limited liability business structures is that the most widely available forms—*professional corporations and limited liability companies*—are the least attractive options for large law firms. It takes a considerable amount of work to convert from a general partnership to these other structures, including rewriting the firm's partnership agreement, forming a board of directors, and appointing officers. . .
>
> Limited liability partnerships, on the other hand, don't have these disadvantages. Where state law allows LLPs, any . . . general partnership can register as an LLP by simply filling out a form with the secretary of state and paying a nominal annual fee per partner. A firm does not have to create a board of directors, and may not even need to rewrite its partnership agreement.[71]

While legal complexities[72] may seem unlikely to scare a law firm, whose members deal with legal rules daily, law firms may respond to the law differently as a "client" (namely, a business choosing an operational form) than as counsel to other businesses seeking entity forms.

---

66. Brewer, *supra* note 10, at 870 ("Professionals wishing to operate as LLCs initially face the traditional hurdle of obtaining an explicit provision in state LLC laws allowing professionals to operate as LLCs."); *see also* McLaughlin, *supra* note 10, at 244 ("[S]tates that have since enacted LLC acts have responded in a variety of fashions.").

67. *See e.g.*, David B. Rae, *Limited Liability Partnerships: The Time to Become One is Now*, HOUS. LAW., Jan.-Feb. 1993, at 47 ("[I]t appears that the [Texas LLP] law was enacted with professional partnerships in mind . . . ."); *id.* at 47 n.3 ("Originally, [Texas] LLPs were limited only to professional partnerships.").

68. *See also* SAMUELSON, *supra* note 22, § 2.2.4, at 2:12 (noting that in law firms,"'making partner' is the closest experience to tenure outside ivory towers"); Van Dyke & Porter, *supra* note 61, at 18.

69. *See* REVISED MODEL BUSINESS CORP. ACT §§ 1.20-.27, 1.40-.41, 2.01-.06, 16.20-.22 (1984); Draft Unif. Ltd. Liability Co. Act §§ 101-112, 201-206, 304(a) (1993), *in* 8 STATE LIMITED PARTNERSHIP LAWS, *supra* note 6.

70. TEX. REV. STAT. ANN., art. 6132b, § 3.08(b), (c), (d) (West Supp. 1995); REVISED MODEL BUSINESS CORP. ACT §§ 1.20-.27, 2.01-.06, 16.20-.22 (1984).

71. Isom-Rodriguez, *supra* note 9, at 30; *see also* CARY & EISENBERG, *supra* note 29, at 94 ("Organizing a corporation . . . is a complex matter, normally requiring an attorney's services and filing fees."); Blackman, *supra* note 39, at 5 ("[M]ost [firms] will probably opt for an LLP format because of the greater ease of formation . . . .").

72. *See* Van Dyke & Porter, *supra* note 61, at 17-18. Specifically, Van Dyke and Porter state:

> [A]s a consequence of its swift introduction into the legal and business communities, the courts and IRS have yet to answer some key questions about this hybrid business entity. These unanswered questions, in part, have frustrated the use of the limited liability company as a business entity.
>
> In many states . . . the limited liability company statutes allow for flexibility in drafting so as to permit the LLP to be classified for tax purposes as either a corporation or a partnership. For this reason, drafting the limited liability company organizational documents requires a knowledge of "association" taxation. A drafter must have a firm grasp of the "corporate characteristics" which must be lacking in order for a limited liability company to be treated as a partnership for federal tax purposes. Drafting organizational documents can thus be fraught with dangers to the unwary.

*Id.*

LLP statutes offer law firms all of the LLC's substantive benefits–active member management, pass-through taxation, and limited liability–plus (1) the procedural benefits of boilerplate filing and "business as usual" operation and (2) the image-preservation and self-assurance of retaining a legal designation of "partnership." These advantages have led far more law firm partnerships into the limited liability arena under LLP statutes than with past alternatives, such as the limited partnership and the professional corporation. Any change in behavior that would be caused by an *individual* law firm's conversion from unlimited to limited liability will therefore occur in greater numbers of firms, multiplying the *aggregate* effect on the practice of law and on legal clients.

### 5. The LLP v. The C Corporation

The traditional C corporation, like the LLP, possesses the characteristic of limited liability.[73] Legislatures have always granted limited liability to corporate shareholders to encourage their funding of enterprise. Skilled managers, lacking the monetary resources to fund ventures, were thereby paired with investors who were unwilling to risk their personal liability:

> Legislatures grant limited liability to owners of corporations in order to facilitate business formation in their states. As early as the 1800s, Jacksonian liberals made persuasive arguments that a state's failure to grant limited liability to corporate owners would drive capital to other states. Similar arguments are still made to legislatures today to encourage legislatures to enact limited liability legislation. . . .
>
> . . . Following the Industrial Revolution, capital-intensive businesses required increasing amounts of capital. In addition, the Industrial Revolution created a demand for workers with more specialized skills. Often workers with the necessary specialized skills could not accumulate the capital necessary to operate a post-Industrial Revolution business. As a result, those contributing the capital necessary to operate the business were not necessarily those with the specialized skills necessary to operate the business. Granting limited liability to those who contributed capital encouraged investment, because investors could invest without risking their full net worth. While investors are often willing to risk their entire net worth to businesses they operate, investors, absent limited liability, are not willing to invest in businesses that they do not operate or closely monitor. With limited liability, owners are free to invest in diverse enterprises without the need of incurring the excessive costs necessary to monitor each enterprise closely.[74]

This policy of protecting "unskilled, absent investors" seems inapplicable to close corporations, since their owners have control over the actions of the corporation as compensation for the risks of unlimited liability.[75] Nonetheless, as a general rule, close

---

73. REVISED MODEL BUSINESS CORP. ACT § 2.02 cmt. 3e (1984) ("The basic tenet of modern corporation law is that shareholders are not liable for the corporation's debts by reason of their status as shareholders.").

74. Bahls, *supra* note 30, at 55-56 (footnotes omitted); *see also* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1924-26 (1991) (suggesting that limited liability in tort has been the prevailing rule for corporations in the United States, as elsewhere, for more than a century, creating incentives for excessive risk-taking by permitting corporations to avoid the full costs of their activities). *See generally* Paul Halpern et al., *An Economic Analysis of Limited Liability in Corporation Law*, 30 U. TORONTO L.J. 117, 118 (1980) (setting out arguments on each side of the issue of limited liability for corporations).

75. *See* Robert W. Hillman, *Limited Liability and Externalization of Risk: A Comment on the Death of Partnership*, 70 WASH. U. L.Q. 477, 484 (1992) (criticizing Professor Ribstein's article, Ribstein, *supra* note 10, for using the same limited liability justification for public corporations as for close corporations); *see also* 1 F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS § 1.10, at 47 (1994) ("[L]imited liability serves an additional role for public corporations not usually applicable for close corporation: it encourages the development of a public market for stocks, facilitating the free transferability of shares.").

corporations, and thus owners of close corporations, like their traditional C corporation counterparts, enjoy limited liability as well.[76] However, all C corporations are taxed both at the entity level and at the shareholder level, unlike the LLP.[77] In addition, corporations require a formal agreement and compliance with a host of specific statutory requirements, such as formal incorporation, periodic filings, and payment of various fees.[78] Many formalities are advisedly observed even after incorporation, in order for shareholders in a corporation to avoid personal liability via piercing of the corporate veil.[79] Comparison between the C corporation and the LLP may seem a less worthy endeavor for the purposes of law firms, as no state allows attorneys to utilize traditional corporate statutes. Nevertheless, assuming arguendo that law firms could incorporate through traditional means, such a move would involve formation and operational burdens similar to LLCs and professional corporations, and tax burdens similar to professional corporations.

In sum, the LLP offers law firms at least one advantage over every alternative business entity form available to law firms. LLPs possess limited liability (lacked by the partnership), active member management (lacked by the limited partnership), pass-through taxation (lacked by the professional corporation), and aesthetic simplicity (lacked by the LLC). As Parts II, III, and IV argue, however, the notion of LLPs as the "best of all possible worlds"[80] for law firm partners comes at a considerable cost to the public.

## II. HOW LLP LAW FIRMS WILL FOSTER LEGAL MALPRACTICE

This Part will argue that allowing the use of the LLP form will breed malpractice. Limited liability will encourage lawyers to avoid co-monitoring. Thus, as more lawyers fail to prevent their colleagues' mistakes, the occurrence of malpractice will increase.

### *A. The Deterrence Principle*

The deterrence principle of tort law owes much of its support to the economic analysis of tort law, which gained prominence in 1961 with the publication of Guido Calabresi's first article on tort law and Ronald Coase's revolutionary article on social cost.[81] William Landes and Richard Posner recently summarized the deterrence priniciple:

> The germ of the analysis is [Jeremy] Bentham's proposition that people maximize utility in all areas of life. Although this implies that liability rules can be used to affect the level of accidents, Bentham himself did not comment on this implication. A more direct antecedent of the modern economic approach to torts is the concept of social cost, or external cost, notably as articulated by [A.C.] Pigou. Using among other examples that of the locomotive that emits sparks which damage the crops of farmers located along the railroad right-of-way, Pigou noted the potential divergence of social cost from private

76. *See also* REVISED MODEL BUSINESS CORP. ACT § 2.02 cmt. 3e (1984).

77. DICKERSON, *supra* note 28, at 9. This principle is commonly known as "double taxation."

78. REVISED MODEL BUSINESS CORP. ACT §§ 1.20-.27, 2.01-.06, 16.20-.22 (1984); *see also* CARY & EISENBERG, *supra* note 29, at 94.

79. CARY & EISENBERG, *supra* note 29, at 94. Note that the requirement that corporations follow formalities in order to retain limited liability has more truth in law than in fact. Many corporations, especially close corporations, commonly fail to strictly follow corporate requirements. Bahls, *supra* note 30, at 50 .

80. VOLTAIRE, CANDIDE *passim* (Lowell Bair trans. & ed., Bantam Classic ed., 1959) (1759).

81. *See* Guido Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 YALE L.J. 499 (1961); Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

> cost. The crop damage, he argued, is not a private cost to the railroad; and only private costs determine behavior. But it is a social cost because the farmer is a member of society, as is the railroad. Therefore, unless some means were found to force the railroad to internalize the cost, there would be too much or too careless railroading.[82]

Drawing on ideas first introduced by Calabresi and Coase and later embraced in Posner's writings, the deterrence principle seeks to assign liability in a manner that encourages people to act efficiently and thereby avoid injury to others.[83] By deterring conduct which causes accidents, accidental harms to society are reduced. Today deterrence is a primary justification for tort liability rules,[84] including those in the area of professional malpractice.[85]

### *B. Effect of a General Partnership-to-LLP Conversion on Co-monitoring*

Limited liability law partnerships will discourage co-monitoring among firms' lawyers because limited liability gives less incentive than unlimited liability for lawyers to co-monitor. In a general partnership, a lawyer will be held liable for any acts of malpractice by her firm, including acts of her colleagues, whether or not the lawyer was involved in the particular act of malpractice.[86] This increases the incentive of every lawyer to take actions[87] to reduce the possibility of mistakes by colleagues.[88]

However, an LLP law firm partner cannot be held liable for any acts of her co-partners unless that partner participated in or supervised the malpractice.[89] A lawyer's insulation from liability for acts of other lawyers in a limited liability law partnership could arguably reduce the motivation of lawyers to actively monitor fellow attorneys. In addition, since lawyers are held liable only for acts which they are in some sense

---

82. WILLIAM M. LANDES & RICHARD A. POSNER, THE ECONOMIC STRUCTURE OF TORT LAW 7, 31-53 (1987) (citations omitted).

83. *See generally* GUIDO CALABRESI, THE COSTS OF ACCIDENTS (1970); Richard A. Posner, *A Theory of Negligence*, 1 J. LEGAL STUD. 29 (1972) [hereinafter Posner, *A Theory of Negligence*]; Richard A. Posner, *Killing or Wounding to Protect a Property Interest*, 14 J.L. & ECON. 201 (1971) [hereinafter Posner, *Killing or Wounding to Protect a Property Interest*].

84. *See, e.g.*, RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 2 cmt. a (Tentative Draft No. 1, 1994) (listing "creating safety incentives" as the first rationale for product liability doctrines).

85. LANDES & POSNER, *supra* note 82, at 11 ("[T]here is widespread agreement that the imposition of tort liability on professionals (for example, in the form of medical malpractice), and on business and other enterprises, does affect behavior, does deter—some think too much!").

86. UNIF. PARTNERSHIP ACT § 306(a) (1994); UNIF. PARTNERSHIP ACT § 15 (1914).

87. *See* discussion *infra* part III.C. (discussing various actions taken by law firms to prevent malpractice).

88. *Developments in the Law—Lawyers' Responsibilities and Lawyers' Responses*, 107 HARV. L. REV. 1547, 1672 (1994) [hereinafter *Developments*]:

> Under an unlimited liability regime, attorneys are personally liable for the professional misdeeds of their law partners when neither the wrongdoer nor the law firm can pay a malpractice judgment. This arrangement . . . deters wrongdoing by imposing strong third-party monitoring incentives. Vicariously liable partners have both their personal assets and the reputation of the firm at stake. Thus, partners are more likely to monitor each other's work.

*Id.* (footnotes omitted); *see also* Alan O. Sykes, *The Economics of Vicarious Liability*, 93 YALE L.J. 1231, 1246 (1984). Professor Sykes states:

> Under vicarious liability . . . an enterprise cannot evade judgments as long as the principal and the agent together have sufficient assets to cover them. . . . [W]hen vicarious liability forces the enterprise to "internalize" the full cost of its actions, the result is a socially efficient level of loss-avoidance investment by the agent and a privately (and socially) efficient level of risk sharing between the principal and the agent.

*Id.*

89. TEX. REV. CIV. STAT. ANN., art. 6132b, § 3.08 (West Supp. 1995).

"connected with,"[90] the insulation from vicarious liability that LLP statutes create will encourage lawyers to take steps to separate themselves from potential connection to malpractice. Such steps might include informal fragmentation among law firm attorneys,[91] as each lawyer begins to understand that while she will share in the profits of every partner's success, she will not share in paying the price of the mistakes of those partners with whom she does not work.[92] In short, the fewer partners a lawyer works with, the lower the potential liability to which she will be exposed.

Other implications of the LLP form include the increased departmentalization of law firms, since LLP firms would have an interest in encouraging formal fragmentation among its lawyers by instituting liability damage control.[93] Such formal departmentalization would heighten even further the informal fragmentation caused by lawyers' awareness of limited liability. Such a rift would be especially likely to occur between partners in high-risk practice areas, such as corporate securities, and low-risk practice areas, such as insurance defense. This is because partners with the highest risk would perform the type of work most likely to be perceived by their lower risk counterparts as dangerous to "touch." Lower risk practitioners would feel most inclined to avoid contact with high-risk partners, in order to minimize their exposure to increased personal liability.[94]

### *C. Effect of Decreased Co-monitoring on Malpractice*

The decreased monitoring which limited liability encourages among a law firm's partners will result in an increase in malpractice. As fewer lawyers within a firm consult with and "check up" on one another, the quality of legal service that each lawyer provides becomes more and more dependent on the *individual* aptitude of each lawyer.[95] The increased solitude among a law firm's partners heightens the likelihood of a legal oversight formerly avoidable through co-monitoring and peer consultation. This common sense notion—that no individual is infallible—finds support in the disproportionate number of malpractice judgments against solo practitioners versus multilawyer firms.[96]

---

90. Obviously, under an unlimited liability regime, all the "connection" one needs is membership in the partnership. Under limited liability, this is a more vague question. *See id.*

91. Dennis E. Curtis, *Old Knights and New Champions: Kaye, Scholer, the Office of Thrift Supervision, and the Pursuit of the Dollar*, 66 S. CAL. L. REV. 985, 1016 ("[T]he separate groups in the various firms might not cooperate with each other as efficiently as they do now (even though they might inhabit the same building as they currently do)."); Weidlich, *supra* note 2, at 38 ("[T]here are cultural questions as well. Some people fear that partners won't have as much impetus to draw their wagons around a colleague who's been accused of wrongdoing once their own assets are safe.").

92. *See also* Curtis, *supra* note 91, at 1016; Weidlich, *supra* note 2, at 1. *Compare* REVISED UNIF. PARTNERSHIP ACT § 306(a) (1994) (holding all partners jointly and severally liable for all obligations of the partnership) *with* UNIF. PARTNERSHIP ACT § 15 (1914) (allowing partners in an unlimited liability partnership to enter into a separate obligation to perform a partnership contract).

93. *See* Adams, *supra* note 3, at 2.

94. *Id.* Specifically, Adams states:

> [Each] partner would no longer be equally likely to pay should a huge malpractice liability come due. The LLP form could drive a wedge between partners who handle large corporate transactions, where risks of large malpractice costs are greatest, and partners in a less risk-prone department such as trusts and estates
> ....

*Id.*

95. *See* SHAVELL, *supra* note 20, at 170-75 (discussing how vicarious liability of principal affects agent's level of care).

96. *See* A.B.A. STANDING COMMITTEE ON LAWYER'S PROFESSIONAL LIABILITY, CHARACTERISTICS OF LEGAL MALPRACTICE: REPORT OF THE NATIONAL LEGAL MALPRACTICE DATA CENTER 31 (1989) (reporting results of study showing that 35% of all malpractice claims were solo practitioners, while 44% were two- to five-lawyer firms); Ramos, *supra* note 21, at 1735 (reporting results of study showing that 38% of all malpractice claims were solo practitioners, while

In short, from the client's point of view, two lawyers' heads are almost always better than one, because it increases the likelihood that either lawyer will catch the other's error, or, through peer consultation, one lawyer will discover the error in time to correct it.

### *D. Response to the Malpractice Deterrence Problem*

LLP proponents have a number of potential responses to the malpractice deterrence problem, each of which suffer from one or more defects.

#### 1. Minimizing Insurance Costs

LLP advocates might first respond to the deterrence problem by arguing that there will be little decrease in monitoring caused by conversion to the LLP form due to the firm's countervailing incentive to avoid rising malpractice insurance costs.[97] LLP advocates might argue that lawyers in LLP firms will maintain their present level of co-monitoring in order to maintain the same level of risk, and thereby keep their insurance premiums from increasing.[98]

There are two responses to this argument. First, it incorrectly assumes that insurance companies either do accurately price or are able to accurately price their premiums based on an individual firm's internal monitoring techniques. It is true that some forms of first-party insurance coverage, such as automobile accident policies, do "merit-rate" insureds by giving credit for factors such as sex, age, and accident record.[99] But in most third-party insurance coverage settings, including professional liability insurance, insurers perform a mere cursory analysis of an insured's risk prior to assigning a policy[100] and fail to substantially monitor changes in the insured's risk during the period of coverage.[101] In the area of legal malpractice insurance, this "hands-off" approach by insurers may be due in part to the wide range of subjective differences in law firm monitoring, thereby

---

50% were two- to five-lawyer firms).

97. Ribstein, *supra* note 10, at 434-35; *see Developments*, *supra* note 88, at 1668-74 (discussing strategies firms may use to lower their malpractice costs).

98. Ribstein, *supra* note 10, at 435.

99. Curiously, the behavioral impact of these "merit-rating" schemes on behavior has been criticized. *See* Daniel W. Shuman, *The Psychology of Deterrence in Tort Law*, 42 U. KAN. L. REV. 115, 155 (1993). Professor Shuman states:

> Even in insurance markets where liability insurance premiums are commonly thought to reflect claims experience, the linkage between safe behavior and insurance premiums is questionable. Although it is commonly assumed that premiums for automobile insurance reflect individual experience including accidents and traffic violations, the rating is largely determined by considerations such as age, gender, and geographic area. If you are young, male, and live in New York, for example, your automobile insurance will be high even if you never experience an accident or receive a traffic ticket. You can remove yourself from this group only by aging, having a sex change, or moving, not by driving more carefully. The influence of a surcharge on drivers who have recently been involved in accidents has not been linked to safer driving.

*Id.* (footnotes omitted); Stephen D. Sugarman, *Doing Away with Tort Law*, 73 CAL. L. REV. 555, 575-77 (1985).

100. Gary T. Schwartz, *The Ethics and the Economics of Tort Liability Insurance*, 75 CORNELL L. REV. 313, 318-19 (1990) ("[M]any lines of 'personal' insurance—including homeowners liability insurance and *professional malpractice insurance*—make no effort to reflect the individual's accident potential.") (emphasis added).

101. HILTON L. STEIN, HOW TO SUE YOUR LAWYER: THE CONSUMER GUIDE TO LEGAL MALPRACTICE 156 (1989). Stein states:

> Another example of risk management involves an insurance application form that is completed by attorneys. All attorneys must check off whether they have a docket control and diary system. The insurance companies, however, do not check on these systems. If the insurance companies did, the lawyers would be forced to engage in risk management by implementing controls. At the present time, lawyers have no incentive to implement controls.

*Id.*

resulting in an insufficiently definable range of risks among firms within the context of monitoring.[102] Legal malpractice insurance companies instead are likely to calculate premiums on more readily measurable factors, including firm size, geographic location, and area of practice.[103] Many legal malpractice insurers do not even make a firm's malpractice claim history a factor in pricing its premiums.[104] Firms and their lawyers thus feel little pressure from an insurer to monitor internally, since the quality of their monitoring does not affect premium prices.[105]

Second, even assuming an effect of co-monitoring on risk that would cause insurers to *supply* insurance at a higher premium rate to an LLP firm, the release from vicarious liability will reduce members' need to *demand* maximum insurance coverage for their firm. Unlimited liability, because it exposes the personal assets of every law partner to a malpractice judgment, creates a greater incentive to fully insure than limited liability.[106]

---

102. Similar explanations have been offered in the medical malpractice area. *See* Shuman, *supra* note 99, at 154-55 ("There is considerable doubt about whether a meaningful and actuarially credible experience rating program can be devised for liability insurance against claims that are as occasional an event to the individual doctor as are malpractice suits.") (quoting THE REPORT OF THE HARVARD MEDICAL PRACTICE STUDY TO THE STATE OF NEW YORK: PATIENTS, DOCTORS & LAWYERS: MEDICAL INJURY, MALPRACTICE LITIGATION, AND PATIENT COMPENSATION IN NEW YORK at 2-8 (1990)); *see also* George L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE L.J. 1521, 1542 (1987) ("The principal reason risks are uninsurable is that insurers are unable to narrow the assortment of risks within a pool.").

The "hands-off" attitude of legal malpractice insurers is reflected in the inaugural issue of a journal published by Attorneys' Liability Assurance Society ("ALAS"), a legal malpractice mutual insurance company:

> ALAS' fundamental philosophy is that its loss prevention program is advisory only, and that inflexible edicts are to be avoided. . . . Each Member Firm is not only permitted, but affirmatively encouraged, to apply ALAS' recommendations with such refinements as it deems fit to its own special circumstances and unique firm culture.

Robert E. O'Malley et al., *Preventing Legal Malpractice in Large Law Firms*, 1 ALAS LOSS PREVENTION J. 2, 2 (1990).

103. *See* Shuman, *supra* note 99, at 154-55. Professor Shuman states:

> There is no evidence that the cost of liability insurance has reduced the rate of accidental injury. . . . Physicians' malpractice insurance premiums, for example, rarely reflect claims experience for an individual practitioner, but instead reflect area of practice specialty and geographic location . . . .
>
> Even in insurance markets where liability insurance premiums are commonly thought to reflect claims experience, the linkage between safe behavior and insurance premiums is questionable.

*Id.* (footnotes omitted). *See also* Richard J. Bonnie, *The Efficacy of Law as a Paternalistic Instrument*, *in* NEBRASKA SYMPOSIUM ON MOTIVATION 1985: THE LAW AS A BEHAVIORAL INSTRUMENT 131, 191 (1985) ("[T]here is no evidence that awareness of the 'cost' of having an accident (in terms of increased premiums) actually motivates people to drive more safely.").

104. STEIN, *supra* note 101, at 155-56 (lamenting the lack of "experience rating" of insureds by legal malpractice industry).

105. Arguably, a firm's malpractice claim record (which *may* influence an insurer's calculation of insurance premiums, *but see id.* at 156) is influenced by the quality of internal monitoring among the firm's lawyers. But this only means that monitoring techniques affect insurance costs, not vice versa. The use of a firm's malpractice claim record *prior to its adoption of the LLP form* will be of limited help in an insurer's calculation of premiums that accurately reflect the firm's internal monitoring techniques *after LLP conversion*. A law firm most likely will experience a rise in insurance premiums only after its conversion to LLP status causes it to decrease monitoring and commit more malpractice. This will cause its malpractice record to show an increased frequency and severity of malpractice claims, and only then will the insurer increase the firm's insurance premium. Only at that time might the firm respond with increased monitoring to improve its malpractice record in an attempt to reduce insurance costs. Though logical in theory, this linkage is unsupported by empirical evidence. Shuman, *supra* note 99, at 154. Shuman states, "There is no evidence that the cost of liability insurance has reduced the rate of accidental injury. . . . Physicians' malpractice insurance premiums, for example, rarely reflect claims experience for an individual practitioner, but instead reflect area of practice specialty and geographic location." *Id.* Even if the link did exist, it would not avoid the cost borne by malpractice victims in the interim between the firm's adoption of the LLP form and the insurer's eventual increase in the firm's premium. Sugarman, *supra* note 99, at 576 (discussing the "lapse" factor involved in experience rating by insurers).

106. Hansmann & Kraakman, *supra* note 74, at 1888-89. Professors Hansmann & Kraakman state specifically:

> [W]ith unlimited liability, a shareholder having personal assets sufficient to cover any tort judgment will have an incentive to purchase full insurance. In turn, such insurance will give the shareholder efficient incentives to internalize costs with respect to both level of care and magnitude of investment.
>
> With limited liability, on the other hand, the shareholder will often have an incentive either to purchase no insurance or to purchase insurance that is insufficient to cover the full range of losses that

In a general partnership, a firm's lawyers will each be affected by firm liability and personal liability. But in an LLP firm, unlike a partnership, a lawyer is not subject to vicarious liability. In other words, the lawyer is not subject to personal liability for professional acts of other partners in the lawyer's firm. This reduced liability affects a firm's *desired coverage*, which helps determine its insurance premiums, just as does its *malpractice risk*.[107] Since lawyers not subject to vicarious liability no longer fear losing their personal assets in a malpractice claim against a fellow lawyer, they will demand less insurance for the firm, and thus the firm will pay less in premiums. Because a firm paying for expensive insurance has more incentive to find ways (such as co-monitoring) to reduce insurance costs than a firm with cheap insurance, LLP firms will have less incentive than traditional partnerships to co-monitor in order to keep premiums down. Even if a law firm's status as an LLP causes it to pay a higher premium to obtain a particular level of coverage, that particular level of coverage will be lower than the firm would demand as a traditional partnership.[108]

### 2. Protecting One's Interest in the Firm

LLP advocates might also argue that an LLP law firm's partners will maintain their former monitoring levels to protect their financial and reputational interests in the firm. This argument raises the question of whether the partners' original investment interest will sufficiently counter their decreased interest in preventing personal liability. However, the desire of law partners for limited liability indicates a philosophical shift away from valuing firm interests and toward valuing personal interests. This argument is consistent with the increased mobility of law firm partners and the rise in law firm

---

> her corporation might cause. Liability insurance sold to businesses invariably has an upper limit on coverage, and it appears that most firms choose a relatively low coverage limit, suggesting that incomplete insurance is a common strategy.

*Id.* (footnotes omitted).

107. Priest, *supra* note 102, at 1545 ("An additional way that risk pools are segregated . . . is by the level of insurance protection desired.").

108. Advocates for limited liability law firms have argued that mandatory insurance requirements will prevent LLP firms from underinsuring. *See In re* Rhode Island Bar Ass'n, 263 A.2d 692, 697 (R.I. 1970) (approving of limited liability for professional corporations). The Rhode Island Supreme Court stated that "[b]ecause of the requirement of mandatory liability insurance, the clients served by the corporation and the members of the public who otherwise deal with the corporation will not suffer by reason of such limited liability." *Id.* However, Professors Hansmann & Kraakman have argued that mandatory insurance cannot sufficiently substitute for unlimited liability. *See* Hansmann & Kraakman, *supra* note 74, at 1927-28. Professors Hansmann & Kraakman argue:

> Coverage-oriented alternatives to unlimited liability include such simple devices as establishing fixed insurance coverage or capitalization levels for firms, which would then be enforced by holding corporate officers or directors personally liable for a breach of the statutory norm. Putting aside for the moment the potential enforcement problems, the obvious difficulty with coverage rules is their inflexibility. No single coverage level would be satisfactory across industries, firms of different sizes, or even production technologies. Moreover, regulators would have great difficulty in acquiring the information necessary to make fine-grained determinations of appropriate coverage levels, particularly since the magnitude of potential tort losses would often change rapidly over time with new technological developments. At best, then, fixed coverage levels would become minimum coverage levels that would be keyed to the smallest and safest firms in the relevant industry grouping. At worst, such levels would become wholly irrelevant to the actual magnitude of tort losses, as clearly happened in the infamous taxi cab cases. In either case, fixed coverage levels would be unlikely to change the basic incentive problems associated with limited liability.

*Id.* at 1927 (footnotes omitted).

Note also that incorporated firms who fail to insure against the cost of mistakes may be subject to the doctrine of piercing the corporate veil. *See* Minton v. Cavaney, 364 P.2d 473 (Cal. 1961). The doctrine uses undercapitalization as one factor in holding shareholders personally liable for the debts of the corporation. William P. Hackney & Tracey G. Benson, *Shareholder Liability for Inadequate Capital*, 43 U. PITT. L. REV. 837, 851 (1982).

breakups in recent years.[109] This implies that firm investment interests will not completely preserve present monitoring levels.

### 3. Danger of Overmonitoring

LLP advocates might respond to the malpractice deterrence problem by arguing that unlimited liability actually breeds malpractice by encouraging too many lawyers in a firm to insist on working on every project.[110] Overmonitoring may breed more mistakes by encouraging lawyers to feel less intimately connected with, and thus less individually responsible for, the quality of their clients' services.[111] In other words, "too many cooks spoil the broth."

But a law office is not a kitchen; implying as much unrealistically simplifies the nature of law practice. Even in small practices, the entire firm is rarely consulted on any particular client or case.[112] In traditional law partnerships, from the boutique to the metropolitan firm, lawyers undertake the bulk of their work individually or in teams. These teams are often arranged by practice specialty and consult periodically with other attorneys within the firm.[113] Though *every* lawyer may not be consulted on *every* client's case, a considerable amount of consultation occurs with most client cases. In most firms, a substantial number of "lawyer's heads" are utilized in the majority of major legal actions taken. Using the kitchen analogy, the practice team may very well play the chef, but junior attorneys likely serve as assistants, peer partners as advisors, and senior partners as the enterprise's owners who either give the "dishes" a personal "taste test" during updates at periodic firm meetings or hear the news, good or bad, from the "critics" (*i.e.*, the clients).

Co-monitoring does not endanger client services. Rather, a custom of teamwork is considered vital to effective work in a law firm. Unlimited liability is arguably responsible for this custom because it encourages lawyers to monitor and interact. Unlimited liability encourages lawyers to supervise more often, scrutinize their colleagues' work more carefully, and employ internal checks to avoid malpractice.[114] Limited liability, on the other hand, reduces monitoring because the rational lawyer shuns teamplay in favor of reclusion.

---

109. *See* HILLMAN, BREAKUPS, *supra* note 49, at 110 (discussing continuing liability of withdrawing partners); Steven Brill, *The End of Partnership?*, AM. LAW., Dec. 1989, at 3.

110. This breed of complaint is common among members of large law partnerships, who cite the difficulties of consulting every partner on every issue and obtaining consensus. SAMUELSON, *supra* note 22, at 2:41.

111. Ribstein, *supra* note 10, at 435 ("Although lawyers may have some additional incentive under unlimited liability to monitor co-partners, this increased monitoring may not be particularly useful, indeed may be counterproductive, to the extent that it involves second-guessing complex professional decisions.").

112. *See* SAMUELSON, *supra* note 22, at 2:12-2:13 ("The legal work itself is done by small teams of partners and associates. Most teams consist of between two and six lawyers, although in a major litigation case the group may be as large as 30.").

113. *See id.* (noting modern trend toward attorney specialization).

114. *Developments*, *supra* note 88, at 1672 (1994); *see* Easterbrook & Fischel, *supra* note 13, at 110; Hansmann & Kraakman, *supra* note 74, at 1882-83; Sykes, *supra* note 88, at 1246.

### 4. Impracticality of Co-Monitoring

LLP advocates might respond to the malpractice deterrence problem with an impracticality argument: the age-old, co-monitoring atmosphere of the traditional law partnership is a thing of the past, replaced by the modern law firm, employing hundreds of associates and partners.[115] Such a mammoth business enterprise, so goes the argument, cannot be expected to monitor or deter the malpractice of every attorney.[116]

There are three problems with the impracticality argument. First, it assumes that all law firms are large. In fact, less than ten percent of all lawyers work in firms of twenty or more attorneys.[117] Such small firms do not boast offices on opposite coasts, partners numbering in the several hundreds, or other burdens which arguably might make co-monitoring more burdensome. For LLP proponents to advocate abandoning rules of liability which are outdated for the few, rather than the many, is questionable.

Second, strong evidence indicates that large firms are in fact *more* able than small firms to co-monitor. A large firm's revenue base allows it to shoulder the considerable overhead cost required to launch and maintain many co-monitoring tools unavailable to smaller firms. These tools include: (a) supervisory personnel structuring, with senior partners who watch partners who watch associates, (b) elaborate training programs for associates and partners, and (c) computer-automated case management, calendering, file storage, and telecommunication.[118]

A third problem with the impracticality argument exists. The position that some large firms cannot monitor their attorneys may imply a larger problem. Perhaps it is the *large law firm*, not co-monitoring, that is "impractical." If large firms are unable to monitor the acts of their attorneys sufficiently to make partners comfortable with the thought of being held liable for the acts of other partners, then perhaps large law firms themselves run counter to public policy.[119] Perhaps the wealth gained from large law firms' economies

---

115. *See* Brill, *supra* note 109, at 3 ("Law firms are so big now that partners not only aren't friends with one another, they often don't know one another.... In short, except for a diminishing minority of quaint holdouts, the days of all-for-one, one-for-all partnership among equally entitled colleagues are over."). Note that Brill tames his obituarial characterization a bit later in his article:

> For while law partnerships may never be the band of loyal friends and colleagues that many once were, the *business of law* demands that they be collectives of professionals who trust one another, who pretty much like one another, and who believe in the collective values and legitimacy of the institution.

*Id.* at 35 (emphasis in original).

116. *Id.* (contrasting the modern institutionalized firm's need to plan for quality control with older firm's ability to do so quickly); *see also* Orey, *supra* note 1, at 81 ("[T]he actions of a partner you don't even know, working in an office on the other side of the country, could cost you your house and force your kids to go to public school.").

117. BARBRA A. CURRAN ET AL., THE LAWYER STATISTICAL REPORT: A STATISTICAL PROFILE OF THE U.S. LEGAL PROFESSION IN THE 1980'S 3 (Table 1.4.3) (1985).

118. William T. Braithwaite, *How Is Technology Affecting the Practice and Profession of Law?*, 22 TEX. TECH. L. REV. 1113, 1129-33, 1144-46, 1147-51 (1991) (discussing the advantages and disadvantages of certain law firm technologies); Jon E. Klemens, Note, *The Future of Technology in Law Firms*, A.B.A. J., July 1989, at 82, 86 (discussing advantages of computer software for electronic mail and messaging, document review, internal and external communications, and access by home computers).

119. *See* David W. Leebron, *Limited Liability, Tort Victims and Creditors*, 91 COLUM. L. REV. 1565, 1577-78 (stating that when the insurance market fails to adequately protect corporate resources from liability, "unlimited liability would serve a valuable regulatory function"); *Developments*, *supra* note 88, at 1668 (acknowledging a "social benefit [in] forcing incompetent lawyers into bankruptcy"); *see also* Hansmann & Kraakman, *supra* note 74, at 1888 (discussing the inviability of small corporations with unlimited liability). Professors Hansmann and Kraakman state specifically:

> Undoubtedly, some small corporations that are viable under limited liability would cease to be so under unlimited liability, since they could not buy adequate insurance and their shareholders would be unwilling to expose personal assets to the risks of a tort judgment. But there is no reason to assume that such small firms *should* exist—that is, that they have positive net social value. In fact, an important advantage of

of scale, economies of scope,[120] and attorney specialization[121] is insufficient to protect clients whose lawyers' malpractice injures them beyond the limits of firm assets and insurance. Such underinsurance scenarios are not rare,[122] and may occur more frequently as law firms grow larger and, as LLP advocates assert, become less able to self-monitor. Perhaps it is not time to "kill all the lawyers,"[123] but instead, to kill all the large law firms.

### 5. Professional Limits

Finally, LLP advocates might respond to the malpractice deterrence problem by arguing that professional rules, such as the Model Code of Professional Responsibility and the Model Rules of Professional Conduct, will prevent lawyers from allowing their colleagues to commit more malpractice.[124] A lawyer has a duty to avoid any interest adverse to the representation of his client, such as choosing to ignore the negligent behavior of a fellow partner.[125] Doing otherwise would create a conflict between the lawyer's interest in minimizing personal liability and the lawyer's duty to represent the interests of clients.

The problem with this argument is that professional rules are neither intended nor capable of preventing malpractice by lawyers, and thus are ineffective substitutes for unlimited liability in deterring malpractice. Disciplinary rules and enforcement procedures governing the legal profession are explicitly not intended to prevent malpractice by law firms. The American Bar Association advocates the Model Rules and Model Code not as bases for malpractice claims, but as guidelines for ethical behavior

---

> unlimited liability is precisely that it would force such firms—which are effectively being subsidized by their tort victims—out of business.

*Id.* (emphasis in original).

120. This is a concept which advances that it is cheaper to produce many related projects (at a large firm) than to produce each project individually.

121. SAMUELSON, *supra* note 22, at 2:17.

122. To begin with, malpractice claims themselves are neither infrequent nor frivolous. An A.B.A. study in conjunction with every major legal malpractice insurer showed that over a five-year period, a third of all malpractice claims resulted in a settlement or judgment for the plaintiff. STANDING COMMITTEE ON LAWYERS' PROFESSIONAL LIABILITY, AMERICAN BAR ASSOCIATION, CHARACTERISTICS OF LEGAL MALPRACTICE: REPORT OF THE NATIONAL LEGAL MALPRACTICE DATA CENTER 3, 41, 141 (1989). Further, incidents of high legal malpractice judgments are not uncommon and may be increasing in frequency. For example, one of the largest recoveries against a Texas law firm was against Jenkins & Gilchrist in Dallas, in which a handful of partners advised a thrift that later failed. The firm settled with regulators in 1989 for $20 million. Harlan, *supra* note 8, at A6. In another example, the firm Kaye, Scholer, Fierman, Hays & Handler exceeded its policy limits when it was forced to pay $20 million to bondholders in 1990 and $41 million to the federal government in 1992 to settle claims arising from its representation of Lincoln Savings & Loan. Adams, *supra* note 3, at 1.

Though the case of Kaye Scholer is the only known example of a large firm facing a malpractice judgment which exceeds its insurance, it is entirely conceivable that a large firm could face a malpractice judgment of $150 million or $200 million in the near future, *id.*, and that such a judgment would exceed the firm's malpractice insurance. *See* Milo Geyelin, *Lawyers and Clients*, WALL ST. J., Sept. 2, 1994, at B3 (noting possibility of partners losing personal assets as a result of a malpractice judgment against another partner); Weidlich, *supra* note 2, at 38 ("[I]t is not unusual for personal assets to be put in harm's way.") (quoting Martin I. Lubaroff of the Wilmington, Delaware firm of Richards, Layton & Finger, P.A.). In addition, it is impossible to know how many law firms have *settled* claims in amounts which exceeded their policy limits or would have if tried in court.

123. WILLIAM SHAKESPEARE, THE SECOND PART OF KING HENRY THE SIXTH act 4, sc. 2.

124. Cornelia H. Tuite, *Partner Liability*, A.B.A. J., Sept. 1990, at 90.

125. *See generally* MODEL RULES OF PROFESSIONAL CONDUCT Rule 8.3 (1994); MODEL CODE OF PROFESSIONAL RESPONSIBILITY EC 5-1 (1980); *id.* EC 5-2.

which, if violated, serve as grounds for reprimand or disbarment.[126] Courts give limited weight to violations of rules of the profession as support for findings of malpractice liability.[127] Second, even when the rules are used in accordance with the ABA's intent in intra-profession disciplinary actions against attorneys, they are not uniformly enforced nor effective in encouraging lawyers to adhere to professional standards.[128] Professional rules will do little to keep the malpractice of lawyers in check upon a law firm's conversion from a general partnership to an LLP form.

This Part has argued that limited liability law partnerships will breed malpractice by discouraging co-monitoring among lawyers. Part III will argue that LLPs shift legal malpractice costs onto clients, who are unable to effectively prevent malpractice.

## III. HOW LLP LAW FIRMS WILL SHIFT MALPRACTICE RISK TO INEFFICIENT LOSS PREVENTORS

LLP law firms will not only foster malpractice by discouraging lawyers from co-monitoring, they will also shift the costs of preventing underinsured malpractice onto clients, who are less capable loss preventors.

### *A. The Loss-Prevention Principle*

The principle of efficient loss prevention, like deterrence, dates back to 1961 with the publication of articles by Ronald Coase and Guido Calabresi.[129] While deterrence guides tort law in discouraging accidents by assigning liability to someone, the loss prevention principle takes things a step further: it guides tort law by deciding *to whom liability most properly applies*. In his article *The Problem of Social Cost*, Coase argued that in assigning legal liability to one of two individuals, the choice is socially irrelevant as long as each individual bears equal transaction costs in avoiding a loss.[130] However, if one

---

126. MODEL RULES OF PROFESSIONAL CONDUCT Scope para. 18 (1994) ("Violation of a Rule should not give rise to a cause of action nor should it create any presumption that a legal duty has been breached. . . . [These Rules] are not designed to be a basis for civil liability."); *id.* Rule 5.1 cmt. ("Whether a lawyer may be liable civilly or criminally for another lawyer's conduct is a question of law beyond the scope of these Rules."); *see also* HILLMAN, BREAKUPS, *supra* note 49, at 100 ("Vicarious liability for the malpractice of other partners . . . is a product of partnership law rather than of the norms of legal ethics."); L. RAY PATTERSON & THOMAS B. METZLOFF, LEGAL ETHICS: THE LAW OF PROFESSIONAL RESPONSIBILITY § 12.01 (3d. ed. 1989) ("The point is made by the bar's persistent position that the breach of a rule of ethics shall not be a basis of liability.").

127. Courts have refused to allow professional rule violations alone to support malpractice judgments. *E.g.*, Beattie v. Firnschild, 394 N.W.2d 107, 110 (Mich. Ct. App. 1986) ("[The Michigan Court of Appeals] has rejected the argument that a violation of the Code of Professional Responsibility is negligence per se, in favor of the proposition that a code violation is rebuttable evidence of malpractice.").

128. PATTERSON & METZLOFF, *supra* note 126, § 2.01 ("[The professional rules] have not been entirely successful. They have not, for example, been vigorously enforced."); Professors Patterson and Metzloff also state:

> [T]he successor ABA codes have not kept pace with the times. The paradox is that even as official ABA policy continues to be to limit the codes of ethics to a disciplinary function, they must compete with other rules from other sources governing the lawyer's conduct. The irony is that having led the way in showing the importance of the ethical conduct of lawyers, the ABA has also shown that the topic is too important to be left to lawyers alone.

*Id.* § 2.01.

In fact, this alleged inaptitude of the legal profession to regulate itself has caused many state officials to call for federal or local regulation of the legal profession. Keatinge et al., *supra* note 10, at 458 ("Congress and federal regulatory agencies [are] attempt[ing] to ensure the accountability of professionals."). Ironically, the advent of LLP law firms, by casting further doubt on the legal profession's ability to serve the public's needs, might make the state's involvement in regulating the conduct of lawyers more likely than ever before.

129. *See* Calabresi, *supra* note 81; Coase, *supra* note 81.

130. Coase, *supra* note 81, at 17-28.

party can prevent loss more efficiently, society is better off assigning liability to that party. The principle became invaluable to legal economists advocating proper cost-shifting in tort law.[131] Calabresi, who published a tidal wave of scholarship following his *Some Thoughts on Risk Distribution and the Law of Torts*,[132] summarized in a 1971 article the loss prevention principle which he had engendered a decade earlier:

> (1) [E]conomic efficiency standing alone would dictate that set of entitlements which favors knowledgeable choices between social benefits and the social costs of obtaining them, and between social costs and the social costs of avoiding them; (2) [T]his implies, in the absence of certainty as to whether a benefit is worth its costs to society, that the cost should be put on the party or activity best located to make such a cost-benefit analysis; (3) [I]n particular contexts like accidents or pollution this suggests putting costs on the party or activity which can most cheaply avoid them; (4) [I]n the absence of certainty as to who that party or activity is, the costs should be put on the party or activity which can with the lowest transaction costs act in the market to correct an error in entitlements by inducing the party who can avoid social costs most cheaply to do so.[133]

As Calabresi explains, while the deterrence goal of tort law may well be served by making a party liable for the cost of an accident, the goal of loss prevention requires that liability rest with the party who can most efficiently avoid the accident. As this Part argues, law firms are far more capable of preventing the occurrence of malpractice than clients, and are, therefore, under the loss prevention principle, the most appropriate bearers of liability.

### *B. The Shift in Malpractice Costs Caused by a Law Firm's General Partnership-to-LLP Conversion*

In a general partnership, a partner is personally liable for the debts and obligations of the law firm, including those of each of her partners.[134] Imagine that the partner negligently handles a client's case, resulting in a malpractice judgment against the firm. If the firm's insurance and assets are altogether insufficient to pay the judgment, the personal assets of all partners, negligent and nonnegligent alike, are subject to collection by the creditor.[135]

In an LLP firm no lawyer can be held personally liable unless she was involved in the act of malpractice, either directly or in a supervisory capacity.[136] If the involved lawyer(s) do not possess sufficient assets to pay a malpractice judgment once firm insurance and assets are depleted, the "innocent lawyers" are protected[137] and the client will be undercompensated.[138] The client, not the law firm, must now respond to the specter of

---

131. LANDES & POSNER, *supra* note 82, at 7, 31-53.

132. Calabresi, *supra* note 81.

133. Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1096-97 (1972).

134. UNIF. PARTNERSHIP ACT § 306(a) (1994); UNIF. PARTNERSHIP ACT § 15 (1914).

135. UNIF. PARTNERSHIP ACT § 306(a) (1994); UNIF. PARTNERSHIP ACT § 15 (1914).

136. TEX. REV. CIV. STAT. ANN., art. 6132b, § 3.08(a) (West Supp. 1995).

137. *Id.*

138. This underinsurance scenario is more likely to occur under limited liability than unlimited liability. Reinier Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 868-69 (1984) ("[T]he personal liability of firm agents—and in particular, of managers and directors—can serve as a partial check on asset insufficiency, that is, on the danger that undercapitalized corporations will abuse their limited assets to evade the compensatory or deterrent policies of liability rules."); Leebron, *supra* note 119, at 1584 ("Limited liability may be inefficient because it allows enterprises to externalize costs and makes activities less risky to investors than to society as

undercompensation.[139] As Parts III.C and III.D explain, clients are less capable of making socially efficient efforts to prevent malpractice.

### C. Law Firms as Malpractice Preventors

Law firms have a number of methods with which to effectively and efficiently prevent malpractice. For instance, lawyers in a particular firm, both by virtue of physical proximity to one another and their custom of practicing in groups,[140] can personally monitor each other's acts.[141] Members of a law firm are held by their profession to remain schooled in competent legal representation.[142] Thus they are relatively well qualified to observe and evaluate the practices of lawyers. Firms commonly enact organizational "safety rules," such as requiring that two or more attorneys read every opinion letter.[143] Most firms have their new associates complete in-house training programs[144] and require

---

a whole."); *see also* Kraakman, *supra*, at 870.

139. *See* Easterbrook & Fischel, *supra* note 13, at 91 ("Limited liability does not eliminate the risk of business failure but rather shifts some of the risk to creditors.").

140. SAMUELSON, *supra* note 22, at 2:12-2:13.

141. Sykes, *supra* note 88, at 1246; *Developments*, *supra* note 88, at 1671. This practice is also consistent with professional rules. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.1 cmt. (1994) ("To maintain the requisite knowledge and skill, a lawyer should engage in continuing study and education. If a *system of peer review* has been established, the lawyer should consider making use of it in appropriate circumstances.") (emphasis added).

The "position to prevent harm" argument has also been used to argue against limited liability in the corporate context where a shareholder becomes closely involved in a venture, such as in a close corporation. When shareholders show an intent to control the affairs of a corporation, it becomes less likely that shareholders will avoid personal liability for the negligent acts of the corporation. A tradeoff emerges: limited liability versus personal control. Professor Bahls states:

> While investors are often willing to risk their entire net worth to businesses they operate, investors, absent limited liability, are not willing to invest in businesses they do not operate or closely monitor. . . . Some commentators have persuasively argued that less justification exists for limited liability of owners in closely held businesses. . . . Courts, recognizing the lesser need to protect shareholders of closely held corporations from liability, have applied the doctrine of piercing the corporate veil almost exclusively to closely held corporations.

Bahls, *supra* note 30, at 56-57; *see also* 1 O'NEAL & THOMPSON, *supra* note 75, § 2.04 ("[C]ourts not uncommonly disregard the separate personality of a close corporation and impose personal liability on the shareholders for corporate contracts or torts."); Halpern et al., *supra* note 74, at 148 ("[A] limited liability regime will, in many cases, create incentives for owners to exploit a moral hazard and transfer uncompensated business risk to creditors, thus inducing costly attempts by creditors to reduce these risks."); Hansmann & Kraakman, *supra* note 74, at 1882 ("The most familiar inefficiency created by limited liability is the incentive it provides for the shareholders to direct the [closely held] corporation to spend too little on precautions to avoid accidents."); Hillman, *supra* note 75, at 486. Specifically, Professor Hillman states:

> [I]t is necessary to consider how and why active involvement with a firm may be relevant to the issue of limited liability. Again, consider just a few possibilities:
>
> Active participation reduces monitoring costs, and therefore the need for limited liability, because shareholders are on the scene and may watch the activities of their co-owners.
>
> Active participation, when tied with a substantial investment, reduces the need for limited liability because the shareholder may not have the same diversification objectives as the passive investor in the publicly held firm.
>
> Active participation may mislead third parties into thinking that owner/managers stand behind the commitments of their firms.
>
> Or, active participation justifies unlimited liability because the power to control carries with it the responsibility for the consequences of the exercise of control.

*Id.*; *see also* SHAVELL, *supra* note 20, at 176 ("[Close corporation] shareholders are more likely to have the requisite knowledge and, if personally liable, the desire to watch over the corporation's activities.").

142. PATTERSON & METZLOFF, *supra* note 126, § 5.01.

143. DICKERSON, *supra* note 28, at 80.

144. *See* William H. Fortune & Dulaney O'Roark, *Risk Management for Lawyers*, 45 S.C. L. REV. 617, 631-37 (1994). Orientational education for lawyers is also encouraged by professional requirements. The Model Rules of Professional Conduct state:

> (a) 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.
>
> (b) A lawyer having direct supervisory authority over another lawyer shall make reasonable efforts to ensure that the other lawyer conforms to the Rules of Professional Conduct.

older attorneys to complete continuing education and competency refresher courses.[145] Firms often devote time and resources toward the internal appointment of supervisory partners.[146] Many firms establish committees to monitor the firm's malpractice risk or appoint a loss prevention partner.[147] Some have gone as far as to retain full-time counsel for this purpose.[148] The ongoing computer revolution allows lawyers to accomplish a number of tasks more efficiently, such as tracking procedural deadlines, reviewing each other's work, and billing clients.[149] Additionally, malpractice records undoubtedly play a role in a firm's selection (or nonselection) of its associates for partnership positions.[150]

In all of these examples, the law firm can take advantage of its members' shared physical proximity, professional skills, work schedules, and financial resources to establish efficient and effective checks against the occurrence of malpractice. Indeed, there seem to be few entities as well-equipped as a law firm to effectively prevent the malpractice of its own members.

### *D. Clients as Malpractice Preventors*

Unlike law firms, clients usually have few methods with which to effectively prevent legal malpractice. Clients usually lack either the physical proximity, the educational skills, or the financial resources to find a good lawyer,[151] much less be an effective watchdog for legal malpractice.[152] Clients usually cannot "comparison shop" among firms according to the quality of their malpractice prevention practices, due to the client's lack of expertise[153] and to restrictions on law practice advertising.[154] Thus, market forces which might be helpful in other merchant consumer contexts[155] are unlikely to be of assistance to the client in encouraging firms to engage in competition based on their malpractice-prevention skills.

Of course, a few alternative prevention options exist for certain classes of clients. For instance, corporate clients often employ internal staff attorneys who possess the requisite

---

MODEL RULES OF PROFESSIONAL CONDUCT Rule 5.1 (1994).

145. *See* Fortune & O'Roark, *supra* note 144, at 631. Continuing education within a firm is also encouraged by professional requirements. *See* MODEL RULES OF PROFESSIONAL CONDUCT Rule 5.1 (1994). The comment to Rule 5.1 states in part:

> The measures required to fulfill the responsibility prescribed in paragraphs (a) and (b) can depend on the firm's structure and nature of its practice. In a small firm, informal supervision and occasional admonition ordinarily might be sufficient. In a large firm, or in practice situations in which intensely difficult ethical problems frequently arise, more elaborate procedures may be necessary.

*Id.* cmt.

146. *See* DICKERSON, *supra* note 28, at 81.

147. Fortune & O'Roark, *supra* note 144, at 631.

148. Jonathan M. Epstein, *The In-House Ethics Advisor: Practical Benefits for the Modern Law Firm*, 7 GEO. J. LEGAL ETHICS 1011, 1029 (1994) (arguing that each firm should have a person or persons responsible for establishing procedures designed to minimize liability).

149. Braithwaite, *supra* note 118, at 1129-33, 1144-51; Klemens, *supra* note 118, at 86.

150. *See generally* SAMUELSON, *supra* note 22, § 2.3.4.3, at 3:45 (noting modern law firms' evaluation and promotion of members based on demonstrated competence).

151. *See* Linda Morton, *Finding a Suitable Lawyer: Why Consumers Can't Always Get What They Want and What the Legal Profession Should Do About It*, 25 U.C. DAVIS L. REV. 283 (1992).

152. This explains why legal malpractice plaintiffs generally need a lawyer to serve as an expert witness to testify that particular conduct by the defendant-lawyer was negligent. STEIN, *supra* note 101, at 129-33.

153. Morton, *supra* note 151, at 284-86.

154. *Id.* at 296-308.

155. Clients have demonstrated some degree of market influence by successfully demanding changes in lawyer services in the area of alternative billing methods. *See* N. Scott Murphy, *The Billable Hour*, IND. BUS. MAG., May 1994, at 37.

skills and time to monitor the actions of the corporation's outside counsel. However, inside counsel suffers the disadvantage of monitoring from outside the work environment of the law firm's attorneys; by virtue of their lack of proximity, they seem inferior in their ability to efficiently or effectively monitor the professional behavior of the firm's members.[156] Another option for some clients is to obtain a personal guarantee from the partners for the firm's services.[157] However, the only clients with a personal-guarantee option at their disposal are those who possess sufficient bargaining power to obtain it. This limits personal guarantees to clients who comprise a substantial portion of the law firm's business. Few clients possess such power. Even assuming arguendo that firm guarantees were available to all clients, such guarantees never give clients any more malpractice protection than that provided by the default rule of unlimited liability in a general partnership. This rule in effect requires all partners to pledge their entire personal worth in the event of any incident of malpractice by a particular partner.[158] Realistically, the vast majority of clients do not have the option of employing advisory counsel or obtaining a firm's guarantee to discourage the occurrence of malpractice. Furthermore, even clients who obtain advisory counsel or firm guarantees experience far greater transaction costs than law firms do in achieving the same level of malpractice prevention.[159]

Most clients lack either the resources to recognize malpractice, or sufficient market power to induce firms to practice additional malpractice avoidance. Though corporate and wealthy clients can often encourage malpractice avoidance through outside monitoring and personal guarantees, such options are usually less effective and always more expensive than options available to law firms. Moreover, as a matter of fairness, these options are not available to all clients, thereby potentially creating an unlevel playing field for private and poor consumers of legal services. The LLP firm, by transferring the cost of underinsured malpractice to clients, shifts the burden of avoiding malpractice to less capable loss preventors.

---

156. Robert E. Rosen, *The Inside Counsel Movement, Professional Judgment and Organizational Representation*, 64 IND. L.J. 479, 510-19 (1989).

157. *See* Easterbrook & Fischel, *supra* note 13, at 113 ("Alternatively, the creditor could ask for prepayment, personal guarantees, or other security.").

The issue of client-firm bargaining also raises the question of whether a malpractice claimant qualifies as a breach of contract creditor or an involuntary tort creditor. Logically, a law firm's contract creditors, such as an office landlord, can factor the risk of nonpayment by the firm through charging higher rates and investigating the firm's creditworthiness. *See* Hansmann & Kraakman, *supra* note 74, at 1919 ("Limited liability for contractual debts simply permits the owners and creditors of a firm to allocate the risks of the enterprise between themselves in whatever fashion is most efficient."). This is not the case for involuntary tort creditors. *Id.* at 1919-20; *see* Leebron, *supra* note 119, at 1601 ("[A]lmost every commentator has paused to note that limited liability cannot be satisfactorily justified for tort victims ('involuntary creditors') and then moved on as though there is nothing to do about this unfortunate wrinkle in the economic perfection of the law." (footnote omitted)).

Do malpractice victims, having had a contractual relationship with the firm prior to the injury, qualify as involuntary creditors? The conclusion of most scholars is that malpractice victims are involuntary creditors because of their inability to contract effectively according to the risk of default by a law firm, due to a lack of foreseeability of the harm, a lack of expertise, and a lack of bargaining power. SHAVELL, *supra* note 20, § 3.2.3 ("customers' knowledge of the quality of most professional services (medical, legal, architectural) is . . . limited"). Professors Hansmann and Kraakman state specifically:

> Tort victims, unlike contract creditors, cannot assess the potential credit-worthiness of a corporation before they are injured, much less insist on compensation for bearing the risk that they will suffer harms that the corporation's assets are insufficient to cover. Consequently, limited liability in tort permits the firm's owners to determine unilaterally how much of their property will be exposed to potential tort claims, thereby inviting opportunism and inefficiency.

Hansmann & Kraakman, *supra* note 74, at 1921. For further discussion, see Leebron, *supra* note 119, at 1601 n.114.

158. UNIF. PARTNERSHIP ACT § 306(a) (1994); UNIF. PARTNERSHIP ACT § 15 (1914).

159. *Developments*, *supra* note 88, at 1671.

### *E. Response to the Malpractice Prevention Problem*

LLP advocates might respond to the malpractice prevention problem by arguing that, under loss prevention principles, subjecting the *negligent partner alone* to personal liability is a better loss prevention rule.[160] Negligent partners are better loss preventors than "innocent" partners because they are in a better position to make cost-effective decisions to prevent malpractice. The negligent lawyer, as direct counsel to the client, is well situated in physical proximity and professional knowledge to take preventive steps to avoid malpractice.[161] In such a position, the negligent lawyer deserves the greatest possible incentive to prevent loss to the client. Accordingly, she should be held solely liable for compensating the injured client for any underinsured malpractice claim.

The problem with this argument is that it compares the loss-preventing abilities of the wrong people; namely, it counterpoises the negligent lawyer against her uninvolved partners, rather than the uninvolved partners against the client victimized by malpractice. LLP advocates note that the LLP form insulates uninvolved partners from the negligent acts of other partners. This seems to assign more liability, and thus a heightened loss-prevention incentive, to the negligent partner in an LLP law firm. At first blush, the policy of assigning liability to the party most capable of preventing harm seems better served by the LLP than by the general partnership. Realistically, however, many general partnership agreements contractually alter the relative contribution duties of partners from the general rule of equal sharing of debts.[162] Many agreements deny each partner indemnification by fellow partners for the partner's negligent acts, thus requiring a negligent partner to suffer alone the cost of an adverse malpractice claim once firm insurance and assets are exhausted.[163] Only after the negligent partner's personal assets are exhausted and the malpractice judgment creditor seeks compensation from an innocent partner, will contribution occur from other partners.[164] In other words, under either the LLP or general partnership rule, the negligent partner will pay first once firm insurance and assets are used up. The remaining difference between the LLP and general partnership is that LLP firms do not offer malpractice creditors the personal assets of the uninvolved partners as a payment source once a negligent partner's assets are gone.

Since LLP statutes often fail to shift underinsured malpractice costs from negligent partners to nonnegligent partners (due to the indemnity provisions of many general partnership agreements), comparing their relative loss prevention skills becomes less relevant in selecting an appropriate rule of liability. Since LLPs *will always* shift underinsured malpractice costs from nonnegligent partners to clients, it becomes highly relevant to compare the preventive abilities of "uninvolved" partners to firm clients. In most cases, a negligent lawyer's fellow partners will be far more able than the client to make cost-effective decisions to prevent malpractice making them better parties to which to assign liability.[165]

---

160. This argument is made by many lawyers who object to unlimited liability. *See* Orey, *supra* note 1, at 81; Weidlich, *supra* note 2, at 1.

161. *See supra* part III.C.

162. UNIF. PARTNERSHIP ACT § 401(b) (1994); UNIF. PARTNERSHIP ACT § 18(a) (1914).

163. *See* MELVIN A. EISENBERG, *Form of Partnership Agreement: §15.06 Indemnification*, *in* CORPORATIONS AND BUSINESS ASSOCIATIONS: STATUTES, RULES, MATERIALS, AND FORMS 10 (1994).

164. *Id.*

165. *See supra* part III.C.

## IV. HOW LLP LAW FIRMS WILL SHIFT MALPRACTICE COSTS TO INEFFICIENT LOSS SPREADERS

Part II of this Note argued that the LLP form will breed malpractice by discouraging members of law partnerships from monitoring co-partners. Part III argued that the LLP form shifts the costs of underinsured malpractice from law firms to clients, despite the relative inability of clients to prevent legal malpractice. This Part will argue that LLPs not only shift malpractice costs onto less capable *loss preventors*, but also shift malpractice costs onto less efficient *loss spreaders*.

### *A. The Loss-Spreading Principle*

Like deterrence and loss prevention, the principle of loss spreading owes much of its development to Legal Economics, aided by the works of Guido Calabresi, Ronald Coase, and Richard Posner.[166] While deterrence and loss prevention assign liability to encourage people to efficiently avoid accidents, the principle of loss spreading assigns liability for accidents which cannot be efficiently avoided.[167] As Professors Fowler Harper, James Fleming, Jr., and Oscar Gray explain: "Accidents and their consequences today pose a serious social problem. Its solution calls for (1) measures that will cut down accidents; and (2) measures that will minimize the bad effects of those accidents that do happen."[168] Loss spreading guides tort law in achieving goal number (2) by assigning liability for a loss to the party that can most efficiently distribute it to other loss bearers.[169] Professor Gary Schwartz recently described three likely characteristics of an efficient loss spreader:

> The defendant may have loss-bearing abilities for a number of reasons. First, the defendant might be a wealthy entity with deep-pocket attributes. Second, the defendant may be a commercial organization that can respond to liability in a loss-spreading way by marginally raising the prices that it charges to large numbers of customers. Third, the defendant, so long as he is minimally solvent, can effectively spread the loss through the purchase of liability insurance.[170]

In general, then, the party who will most cheaply achieve risk minimization, or "risk neutrality," will be the one who has the greatest economic resources or who can spread the loss most effectively, either as a result of the party's status as a commercial enterprise or its ability to obtain insurance.[171]

The goals of loss spreading are not limited to merely distributing losses to the maximum number of loss bearers. The law will also consider a particular audience of loss bearers to determine whether, as a normative matter, they should be expected to pay the

---

166. *See* Calabresi, *supra* note 81; Coase, *supra* note 81; Posner, *A Theory of Negligence*, *supra* note 83; Posner, *Killing or Wounding to Protect a Property Interest*, *supra* note 83.

167. LANDES & POSNER, *supra* note 82, at 13 ("[A]lways bear[] in mind that the economic function of tort law is to optimize rather than minimize the number of accidents.").

168. 3 FOWLER V. HARPER ET AL., THE LAW OF TORTS § 11.5 (2d ed. 1986) (footnotes omitted).

169. James G. Fleming, *The Role of Negligence in Modern Tort Law*, 53 VA. L. REV. 815, 837 (1967); Schwartz, *supra* note 100, at 359-60.

170. Schwartz, *supra* note 100, at 359-60 (footnote omitted).

171. In the professional practice context, similar observations have been made about the medical profession. *See* Glen O. Robinson, *Rethinking the Allocation of Medical Malpractice Risks Between Patients and Providers*, 49 LAW & CONTEMP. PROBS. 173, 181 (1986) (discussing efficient allocation in the context of medical malpractice) ("If there is an economic preference for the [doctor], it must rest on the intuition that physicians are better able than patients either to reduce accident costs or *distribute them efficiently* . . . ." (emphasis added)).

costs incurred by the loss transfer. In his 1967 article, *The Role of Negligence*, Professor Fleming stated the principle beautifully:

> By far the most pervasive catalyst of loss spreading has proved to be liability insurance; for it has made it possible to gear conventional rules of law, without any radical reform of those rules themselves, to the changing needs of a technological society with rising living standards and ever growing expectations of physical and social security. Instead of adverse judgments having a crushing effect on the hapless defendant, his liability insurance at once affords him protection against having to bear the impost singlehandedly and "pools" the risk among all premium payers. Better still, to the extent that tort liability falls on the enterprise as a whole the cost is passed on to its customers as a negligible fraction of the price they are charged for its products.[172]

The manufacturing industry offers a common example of this principle. If a defective car injures a car owner and results in a successful products liability suit, the manufacturer will incur a loss by paying the plaintiff's judgment. But the manufacturer, by raising automobile prices, can pass that loss along to future car buyers. Not only does this spread loss as a *positive* matter (because a loss gets distributed among a larger group of loss bearers), but it is serves the principle of loss spreading as a *normative* matter because many of the loss bearers are car buyers who benefited from cheaper automobile prices that the manufacturer was able to charge because of costs saved in making a defective car, such as inspection costs.[173]

### *B. The Shift in Malpractice Costs Caused by a Law Firm's General Partnership-to-LLP Conversion*

In a general partnership, a partner is personally liable for the debts and obligations of the law firm, including those of each of her partners.[174] If firm insurance and assets are insufficient to pay a malpractice judgment, the personal assets of all other partners are subject to collection by the malpractice creditor.[175] An LLP firm, however, shields its partners from vicarious liability for the negligent partner's acts,[176] and thus, any underinsured malpractice claims which exceed the negligent partner's assets will go uncompensated.[177] The client must shoulder the burden of any excess malpractice. As Parts IV.C and IV.D explain, clients are improper subjects upon which to impose responsibility for spreading malpractice costs.

---

172. Fleming, *supra* note 169, at 837.

173. *See id.* (setting forth this economic theory).

174. UNIF. PARTNERSHIP ACT § 306(a) (1994); UNIF. PARTNERSHIP ACT § 15 (1914).

175. UNIF. PARTNERSHIP ACT § 306(a) (1994); UNIF. PARTNERSHIP ACT § 15 (1914).

176. TEX. REV. CIV. STAT. ANN., art. 6132b, § 3.08 (West Supp. 1995).

177. *See* Easterbrook & Fischel, *supra* note 13, at 91 ("Limited liability does not eliminate the risk of business failure but rather shifts some of the risk to creditors.").

### C. Law Firms as Loss Spreaders

Though much of legal malpractice can be avoided through preventive techniques,[178] some degree of malpractice inevitably occurs.[179] Law firms, however, are able to offset the burden of malpractice claims through loss spreading.

Law firms commonly spread losses incurred through malpractice claims by securing malpractice insurance.[180] Some firms choose to spread losses through self-insurance, either by maintaining a capital reserve to be used in paying malpractice judgments or by merely relying upon firm assets and the personal assets of partners to cover the costs of any malpractice judgment.[181] In any case, the costs of the client's loss (first "spread" across the shared partnership assets of the firm's partners) will presumably be spread among a larger group of individuals, namely the firm's clients, through higher legal fees.[182] Tort law prefers this result, both because the loss is distributed across a *larger number* of loss bearers and because those loss bearers are parties who more likely benefited from lower malpractice costs which the law firm was able to charge by providing negligent legal services.[183]

### D. Clients as Loss Spreaders

Clients have a more limited range of options for spreading the costs of malpractice. Legal malpractice insurers generally do not offer first-party coverage; that is, coverage which would insure *clients* against legal malpractice.[184] In addition, unlike law firms whose partnership form spreads the initial costs of any underinsured malpractice judgments across the personal assets of its partners,[185] if a client is a private individual, no loss spreading can occur; the client's only available option is to self-insure.[186]

In the case of a commercial client, the cost of underinsured malpractice claims can be passed onto customers. For instance, if outside counsel for Microsoft Corporation commits malpractice and underpays the claim, Microsoft can spread its loss across a larger group of loss bearers, namely computer software consumers. But as explained,

---

178. *See* part III.C.

179. Fredric L. Goldfein, *Legal Malpractice Insurance*, 61 TEMP. L. REV. 1285, 1285, 1298 (1988); *see* Gary T. Schwartz, *Reality in the Economic Analysis of Tort Law: Does Tort Law Really Deter?*, 42 UCLA L. REV. 377, 399 (1994) ("Despite the existence of an extensive [medical] malpractice liability system, malpractice seems to be committed quite frequently.").

180. Goldfein, *supra* note 179, at 1285-86; Fortune & O'Roark, *supra* note 144, at 823-33 (discussing history of lawyers moving from "going bare" to recognizing the "obvious" need for insurance).

181. Fortune & O'Roark, *supra* note 144, at 633-34 (discussing the success of "captive" or "bar-related" insurance companies, entities wholly owned by those insured for the purpose of underwriting the insurance of its members); Priest, *supra* note 102, at 1526-27 (discussing various self-insurance techniques chosen by professionals instead of malpractice insurance).

182. *See* Roger J. Bulger & Victoria P. Rostow, *Medical Professional Liability and the Delivery of Obstetrical Care*, 6 J. CONTEMP. HEALTH L. & POL'Y 81, 84 (1990) (linking rising malpractice insurance premiums to rising fees in obstetrical practice).

183. *See* Fleming, *supra* note 169, at 837-38.

184. *See* Chandra D. Lantz, Note, *Triggering Coverage of Progressive Property Loss: Preserving the Distinctions Between First- and Third-Party Insurance Policies*, 35 WM. & MARY L. REV. 1801, 1808-16 (explaining that "[t]hird-party coverage insures against liability to a third party that has suffered loss as a result of the insured's actions," while "[i]n contrast, first-party policies seek to indemnify for losses personally suffered by the insured").

185. UNIF. PARTNERSHIP ACT § 306(a) (1994); UNIF. PARTNERSHIP ACT § 15 (1914).

186. *See* Escola v. Coca-Cola Bottling Co., 150 P.2d 436, 441 (1944) (Traynor, J., concurring) ("The cost of an injury . . . may be an overwhelming misfortune to the person injured, and a needless one, for the risk of injury can be insured by the manufacturer and distributed among the public as a cost of doing business.").

transfer of loss to a *larger* group of loss bearers is only one goal of loss spreading.[187] Another important goal of loss spreading is the transfer of loss to an *appropriate* group of loss bearers.[188] A strong argument can be made that the *clients of Microsoft's law firm*, rather than computer software consumers, are the more appropriate group of loss bearers because they benefited from cheaper legal fees which the law firm charged due to costs the firm saved in practicing law negligently as opposed to nonnegligently.

A law firm is a more appropriate loss spreader of malpractice costs, because it is more often capable of spreading malpractice costs across a larger group of loss bearers. More importantly, law firms are better loss spreaders because they are able to spread malpractice costs across the group of loss bearers who most likely benefited from the firm's malpractice.

### *E. Response to the Loss-Spreading Problem*

LLP advocates might respond to the loss-spreading problem by arguing that under unlimited liability, firms simply are unable to obtain the amount of insurance necessary to sufficiently spread losses, which might bankrupt underinsured firms or force them to refuse to offer certain types of legal services or to represent certain clients.[189] But while some law firms have found themselves unable to obtain insurance,[190] insurance has grown more available in recent years as premiums have leveled off and various "bar-based" and "captive" insurance programs have gained prominence.[191] In any event, insurance is at least *available* to law firms, while it is generally unavailable to clients, making law firms more practical subjects for malpractice liability.[192] In addition, firms have the option of either raising fees or refusing to perform certain high-risk services.[193] If consumers of legal services are unwilling to pay the increase in fees necessary to enable law firms to spread malpractice costs, then perhaps the social costs of having such services outweigh their social benefits.[194]

---

187. *See supra* part IV.A.

188. Fleming, *supra* note 169, at 837.

189. Physicians make a similar argument, claiming to practice defensive medicine in lieu of available medical malpractice insurance. Bulger & Rostow, *supra* note 182, at 83 ("Obstetricians and family physicians increasingly report that they are eliminating the obstetrical portion of their practices or reducing the provision of care to patients who are identifiably at high risk because they fear being sued and do not want to accept the high cost of liability insurance." (footnote omitted)).

190. Goldfein, *supra* note 179, at 1292-93 (discussing rising costs and shrinking availability of legal malpractice insurance); Geyelin, *supra* note 122, at B3 ("[L]iability insurance, particularly for smaller firms, may cover only a fraction of the amount of money at stake in a big transaction.").

191. Fortune & O'Roark, *supra* note 144, at 633-34.

192. The unavailability of first-party legal malpractice insurance for clients—that is, protection against malpractice *suffered*—is in part due to the difficulty of predicting damages likely to be suffered. This unpredictability affects all first-party insurance policies. *See* Lantz, *supra* note 184, at 1808-16. Specifically, Lantz states:

> In general, a first-party insured is able to predict his maximum losses and potential risks during a particular policy period. An insured protected by a liability policy, however, can at best make an educated guess as to potential losses and risks. Whereas direct damage losses can never exceed the value of the insured property, liability claims can be virtually unlimited. As a result, the spectrum of risks and degree of uncertainty is much greater in the context of third-party insurance coverage.

*Id.* at 1814 (footnotes omitted).

193. Curtis, *supra* note 91, at 987-88 ("In many cases, [insurers] have refused to write coverage for claims brought by regulatory agencies, even refusing coverage entirely for thrift representation. These insurance company policies in turn affect what kind of clients law firms are willing to represent.").

194. *See* Leebron, *supra* note 119, at 1577-78 ("In these circumstances, however, unlimited liability would serve a valuable regulatory function."); *Developments*, *supra* note 88, at 1668 (acknowledging "the social benefit of forcing incompetent lawyers into bankruptcy"); *see also* Hansmann & Kraakman, *supra* note 74, at 1888.

## CONCLUSION

A substantial change in a law partner's liability occurs upon conversion from general partnership to LLP status. Many law firm partners have cheered the arrival of this "best of all possible worlds."[195] With LLP statutes apparently more popular than past nonpartnership forms, their negative effect, if any, will be all the greater upon society in the aggregate. Whether state courts will involve themselves in the efforts of law firms to shield personal assets from vicarious tort liability remains to be seen. As this Note has argued, limited liability law partnerships entail three distinct public costs. First, limited liability law partnerships will reduce malpractice deterrence among lawyers. Second, LLP law firms will force clients into the role of malpractice preventors, a role for which they are ill-equipped. Third, LLP law firms will impede the spreading of malpractice costs. Courts should give pause before letting today's legislative obsession with legal malpractice reform lead to deterrence, loss prevention, and loss spreading burdens that may be too difficult for clients to bear.

195. VOLTAIRE, *supra* note 80, *passim*.