

**LESSONS FROM THE RISE OF THE US LIMITED
LIABILITY PARTNERSHIP**

Regulating Risk-taking in the Large Professional Firm

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Abstract: The limited liability partnership has been heralded as a cost-effective way of doing business for professional firms that seek to reduce the personal liability risk of partners who are not directly involved in negligent acts or wrongdoing. The LLP business form has been adopted by all US states and has proved widely popular for lawyers and accountants/auditors in reducing vicarious and joint and several liability exposure for the rendering of professional advice. The LLP structure allows professional firms to retain the benefits of the partnership structure, such as tax breaks and ease of operation, while reducing the personal liability of individual partners for torts and negligent acts committed by other partners. This paper examines the rise of LLPs statutes in the US by analysing the LLP statutes of three states that have proved prominent in recent litigation involving professional firms performing services in a negligent or reckless manner. The paper suggests that the liability protections of the US LLPs have not reduced risk, but simply shifted it onto customers, pensioners and the investing public. The liability limitation provisions of the US LLPs create a disincentive for professional firms to adopt effective risk management systems to control negligence and malfeasance within the professional firm. The paper suggests that the UK LLP statute addresses some of these issues because it requires LLPs to operate in a transparent manner, but the courts have yet to determine the extent of protection against personal liability that will be available to members not directly involved in negligence or wrongdoing. Future research should examine the implementation of the UK LLP statute and whether it can address the needs of business without increasing risks for consumers, employees and the investing public.

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1. Introduction

The corporate scandals at Enron, WorldCom and other major US companies have raised concern not only regarding issues of corporate accountability and responsibility but also of the role of the professional firms who negligently and recklessly advised and facilitated questionable transactions for these companies that resulted in massive losses for investors, employees and pensioners. Indeed, the conviction of Andersen Consulting for securities fraud, conspiracy to defraud and false statements in May 2002 demonstrated the integral role played by professional firms in the most notorious corporate scandals in recent American history. Andersen's criminal and reckless conduct resulted in excess of \$200 million dollars in losses for investors in Enron and similar losses at other publicly traded companies whom Andersen had advised. Moreover, Andersen's misconduct has resulted in many thousands of creditors' claims against the firms it audited being discharged or substantially diminished in US bankruptcy proceedings. Andersen's behaviour was not isolated, as many US auditing and law firms have been sued for damages and restitution based on principles of third party civil liability by the defrauded investors of companies which were advised by these firms. US federal regulators and state attorneys general have also brought numerous civil and criminal actions against professional firms for fraud and malpractice in rendering services to publicly traded companies that were later shown to have committed fraud and malfeasance.

Most of the professional firms subject to civil and criminal actions in the aftermath of Enron were registered as Limited Liability Partnerships (LLPs) under US state law. Although a number of factors are responsible for the fraudulent practices and reckless behaviour of US corporate enterprises during the 1990s, this paper argues that the limitations on vicarious and joint and several liability in the LLP firms which advised these companies contributed to the misconduct that caused substantial losses. Indeed, the 1990s witnessed not only a Wall Street stock market boom but also the passage of statutory limitations on civil liability for partnerships in each of the fifty US states. These liability limitation statutes allowed professional firms to opt for a form of partnership structure that would substantially limit each individual partner's exposure to joint and several liability in cases of negligence, recklessness, or fraud. These statutes were known as Limited Liability Partnership statutes

(LLPs) which, among other things, protected partners from personal liability if they did not participate directly in another partner's misdeed or fraud. Although these statutes have provided substantial benefits for professional firms by reducing their liability exposure to tort claims, this paper argues that US LLP statutes have facilitated the shifting of operational risk away from the firms that produce the risk onto the public at large, which includes customers, investors and other stakeholders.

This paper does not seek to establish a cause and effect relationship between the fraud and market abuse that has been endemic to corporate America *and* the increasing use of limited liability partnerships by professional firms. Rather, it suggests that the adoption of LLPs under US state law has enabled large professional firms to reduce their liability exposure to malpractice claims without taking countervailing risk mitigation measures within the firm to reduce the incidence of fraud and malpractice in the provision of service. This paper suggests that the US LLP statutes are inappropriate legal vehicles through which to render professional services because they foster inadequate incentive structures to mitigate operational risk. In this context, operational risk takes the form of professional malpractice, fraud and other bad acts. It creates a cost that becomes a negative externality for the rest of society when firms are allowed to shift the cost of such risk onto the public at large. This is an inefficient result that requires regulation to ensure that as much of this risk as possible is borne by the professional firms that create such risk. Further, this paper argues that the LLP structure has undermined the duty of good faith amongst partners to absorb the total cost of doing business within the LLP by creating incentives to disavow the work of other partners who have allegedly committed negligent acts in rendering professional services. That the emergence of the LLP as the legal form of choice for large professional firms in the US is not part of some general, evolutionary movement towards new limited liability vehicles, but has resulted entirely from political pressure from professional firms for limited liability in respect of their activities and from their unwillingness to adopt the corporate form. The widespread adoption of the LLP form by many professional firms has resulted in an increased number of creditor and negligence claims against professional firms.

The paper will then contrast the US LLP with the UK LLP legislation to suggest that although the UK LLP does not accomplish some of its statutory objectives, its corporate structure and its guarantee of regulatory oversight ensures a lower level of risk exposure for customers, creditors, and the investing public. Accordingly, the UK LLP statute is better positioned to serve as a model for other jurisdictions considering adoption of LLP statutes, while the US model is inappropriate for governments that seek to place the onus of risk prevention on

those parties who create the risk, and not on innocent members of the public who look to professional firms to stand behind the quality of their work.

The paper discusses the evolution of US partnership law and examines the pressures that led to introduction of the LLP in the US. The paper then analyses the LLP statutes of three representative states – Texas, Delaware and Illinois – and outlines the statutory requirements and liability limitations in these statutes. The paper will then generally discuss the UK Limited Liability Partnership Act 2000.¹ It is suggested that the UK LLP is more appropriate for other jurisdictions considering whether to adopt LLP statutes. Finally, policy arguments pro and con regarding the US LLP statutes will be discussed with some suggestions for future research.

2. US Partnership Law – *A Primer*

The general partnership has traditionally been the entity of choice to do business by lawyers, accountants and auditors, and in many jurisdictions these professionals have, until recently, been largely restricted from practising under any other legal form. For lawyers, this restriction was based upon the belief that a corporate structure was not suitable to the practice of law. Despite the passage of legislation permitting lawyers to practice law in other forms, the partnership remains the established form of organization for the practice of law. This paper attempts to analyse the evolving structure of US partnership law from a practitioner's perspective with a focus on the development of the limited liability partnership. Indeed, throughout the 1990s, the most important aspect of US partnership law has been the emergence of the limited liability partnership as the preferred business entity through which lawyers and other professionals have chosen to conduct their affairs.

Partnership as a form of business organization is far from new. The Uniform Partnership Act (UPA) was adopted in 1914 as a codification of US common law principles² and set forth standards regarding the nature of the partnership, relations of partners to third parties, relations of partners to one another, the property rights of partners, and the termination of a partnership.³ Partnership legislation enacted in Delaware is almost identical to that of the UPA.⁴ One of the most attractive elements of the general partnership is flow-through taxation. Under this principle, partnership profits are not subject to an entity level tax.⁵ There is no tax imposed until the profits are received by one or more partners as income. The partner's income is then taxed as personal income.⁶ In this manner, general partnerships avoid the double tax that corporate entities are required to pay. Another attractive aspect of the general partnership is its flexibility. No formal written agreement is required to form a partnership. This

makes a general partnership very easy to create and maintain. In addition, there are very few aspects of the partnership structure that cannot be altered by agreement.

These benefits, however, come at the expense of personal liability. Under partnership law, each partner is exposed to unlimited personal liability for both the misconduct of his or her partners, as well as any debts of the partnership to the extent that either exceed the assets of the partnership. Therefore, should a general partnership be burdened with a financial obligation that exceeds the wealth of the firm, every partner in that firm stands to lose not only his or her own economic interest in the partnership, but also any personal assets that partner may have accumulated throughout the course of his or her life.

3. The Evolution of US Partnership Law

The National Conference of Commissioners on Uniform State Laws first considered a uniform law of partnership in 1902. Although early drafts had proceeded along the mercantile or "entity" theory of partnerships, later drafts were based on the common-law "aggregate" theory. The resulting Uniform Partnership Act ("UPA"), which embodied certain aspects of each theory, was finally approved by the Conference in 1914. The UPA governs general partnerships, and also governs limited partnerships except where the limited partnership statute is inconsistent. The UPA has been adopted in every state other than Louisiana and has been the subject of remarkably few amendments in those states over the past eighty years.

In January of 1986, an American Bar Association subcommittee issued a detailed report that recommended extensive revisions to the UPA.⁷ The ABA Report recommended that the entity theory "should be incorporated into any revision of the UPA whenever possible."⁸ In 1987, the Conference appointed a Drafting Committee to Revise the Uniform Partnership Act and held its initial meeting in January of 1988. A first reading of the Committee's draft was completed at the 1990 Annual Meeting in Milwaukee and a second reading was completed at San Francisco in 1992. The Revised Uniform Partnership Act (1992) was adopted unanimously by a vote of the states on 6 August 1992. In 1993, the Drafting Committee recommended numerous revisions to the Act that were adopted later that year at the ABA Annual Meeting in Charleston, South Carolina. This Act was renamed the Uniform Partnership Act (1993).

Subsequently, the Drafting Committee approved a final round of changes, which were adopted unanimously by the Conference in 1994. The Revised Act was approved by the American Bar Association House of Delegates in August,

1994. The Uniform Partnership Act (1994) ("Revised Act" or "RUPA") gives supremacy to the partnership agreement in almost all situations.⁹ The Revised Act is, therefore, largely a series of "default rules" that govern the relations among partners in situations they have not addressed in a partnership agreement. The primary focus of RUPA is the small, often informal, partnership. Larger partnerships generally have a partnership agreement addressing, and often modifying, many of the provisions of the partnership act.

The RUPA enhances the entity treatment of partnerships to achieve simplicity for state law purposes, particularly in matters concerning title to partnership property. RUPA, however, does not apply the entity doctrine in all circumstances. The aggregate approach is retained for some purposes, such as partners' joint and several liability. The Drafting Committee spent significant effort on the rules governing partnership dissolutions. RUPA's basic thrust is to provide stability for partnerships that have continuation agreements. Under the UPA, a partnership is dissolved every time a member leaves. The Revised Act provides that there are many departures or "dissociations" that do not result in a dissolution.

Under the Revised Act, the withdrawal of a partner is a "dissociation" that results in a dissolution of the partnership only in certain limited circumstances. Many dissociations result merely in a buyout of the withdrawing partner's interest rather than a winding up of the partnership's business. RUPA defines both the substance and procedure of the buyout right.

Article 6 of the Revised Act covers partner dissociations; Article 7 covers buyouts; and Article 8 covers dissolution and the winding up of the partnership business.¹⁰ The Revised Act also includes a more extensive treatment of the fiduciary duties of partners. Although RUPA continues the traditional rule that a partner is a fiduciary, it also makes clear that a partner is not required to be a disinterested trustee. Provision is made for the legitimate pursuit of self-interest, with a counterbalancing irreducible core of fiduciary duties.

Another significant change introduced by RUPA is a provision for the public filing of statements containing basic information about a partnership, such as the agency authority of its partners. Because of the informality of many partnerships, and the inadvertence of some, mandatory filings were eschewed in favour of a voluntary regime. It was the Drafting Committee's belief, however, that filings would become routine for sophisticated partnerships and would be required by lenders and others for major transactions.

Another innovation is found in Article 9. For the first time, the merger of two or more partnerships and the conversion of partnerships to limited partnerships (and the reverse) is expressly authorized, and a "safe harbor" procedure for effecting such transactions is provided. Moreover, under the provisions of the RUPA, general partnership law will no longer govern limited partnerships. Under RUPA, limited partnerships are not "partnerships" within the RUPA definition. Second, UPA Section 6(2), which provides that the UPA governs limited partnerships in cases not provided for in the Uniform Limited Partnership Act (1976) (1985) ("RULPA"), has been deleted. No substantive change in result is intended, however. Section 1105 of RULPA already provides that the UPA governs in any case not provided for in RULPA, and thus the express linkage in RUPA is unnecessary. Structurally, it is more appropriately left to RULPA to determine the applicability of RUPA to limited partnerships. It is contemplated that the Conference will review the linkage question carefully, although no changes in RULPA may be necessary despite the many changes in RUPA.

4. The US Limited Liability Partnership

In 1995, the Commissioners on Uniform State Laws appointed a Drafting Committee to add provisions to the Reform Uniform Partnership Act (RUPA) to authorize the creation of a new form of general partnership called a limited liability partnership (LLP). The American Bar Association and most state bar associations had begun lobbying for LLP legislation beginning in the late 1980s in response to the major scandals that had caused the collapse of the US savings and loan industry. The savings and loan scandal resulted in the US government providing a \$980 billions bailout of the industry which primarily involved paying off depositors of failed savings and loans through the federal deposit insurance scheme. Under federal law, regulators were allowed to pursue senior management of the failed savings and loans along with their legal and accounting advisers for fraud, recklessness, or negligence in providing advice to failed S&Ls. Many law firms and accounting firms became insolvent because of civil judgments that arose from wrongful acts in providing negligent advice to poorly-managed (and in many cases fraudulently managed) financial institutions. As a result, the American Bar Association, most state bar associations, and the accounting and auditing professions began a massive lobbying campaign throughout the US to obtain amendments to state partnership law that would limit the liability of partners in professional firms who were not directly involved in such abuses. By 1996, the lobbying campaign had succeeded with over forty states adopting LLP legislation that dramatically reduce the scope of liability of partners who were not directly involved in malpractice and other torts or contract claims.

Industry lobbyists had also succeeded in lobbying the National Conference of Legislatures, which amended the Reform Uniform Partnership Act (RUPA) in 1996 to allow LLPs. The LLP amendments to RUPA deal with four major issues: (1) scope of a partner's liability shield; (2) the voting requirement to become an LLP; (3) the effect of becoming an LLP on the partnership agreement; and (4) the annual filing requirement.¹¹ All fifty states have now adopted some version of the LLP amendments to the RUPA. In most US states, LLP status is only available to certain designated professions such accountants, auditors, lawyers and doctors.

Before we examine the LLP statutes of Texas, Delaware, and Illinois, it should be emphasised that there are two schools of thought regarding the nature of the LLP. The first school sees the LLP as a subtle variation of the classic general partnership. Legal scholars from this school have described LLPs as "a new-fangled version of the classic general partnership, not a new business entity".¹² This view holds that the LLP is a general partnership with a few important modifications"; and as "just a form of general partnership". The other school sees LLPs as an entirely new business entity. Members of this school have described LLPs as "new entities that combine the features of a general partnership with limited liability" and as "the most radical departure yet" from accepted partnership liability principles.

The proponents of the US LLP depicted it as part of a general, evolutionary movement towards new limited liability vehicles that seek to allow agents to bargain around risk exposures in a manner that results in efficient contracting amongst all parties exposed to risk. The reality, however, is that LLP statutes were adopted directly in response to political pressure from professional firms seeking limited liability in respect of their activities and from their unwillingness to incorporate.

a. The Scope of a Partner's Liability Shield

The amendments to add LLP provisions to RUPA include a new Section 306(c) providing for a corporate-styled liability shield which protects partners from vicarious personal liability for all partnership obligations incurred while a partnership is a limited liability partnership. The complete liability shield comports with the modern trend among the states. Most states, however, have adopted a partial liability shield protecting the partners only from vicarious personal liability for all partnership obligations arising from negligence, wrongful acts or misconduct, whether characterized as tort, contract or otherwise, committed while the partnership is an LLP. The Act does not alter a partner's liability for personal misconduct and does not alter the normal

partnership rules regarding a partner's right to indemnification from the partnership (Section 401(c)). Therefore, the primary effect of the new liability shield is to sever a partner's personal liability to make contributions to the partnership when partnership assets are insufficient to cover its indemnification obligation to a partner who incurs a partnership obligation in the ordinary course of the partnership's business.

The ability to limit liability for the malpractice and misdeeds of one's co-owners, while retaining the simplicity of operation and favourable tax treatment of a partnership, makes the LLP attractive to businesses using a UPA partnership. For professionals using a traditional partnership, the protection from malpractice liability provided by an LLP greatly outweighs the expense of maintaining the registration. With respect to the types of businesses and professions that can register as LLPs, the language of the LLP provisions of the UPA does not expressly prohibit any particular business or profession from registering as a LLP.¹³

b. Voting Requirement to Become an LLP

The Act includes a new Section 1001(b) which provides that the decision to become an LLP is a major partnership event equivalent to an amendment of the partnership agreement. Therefore, the required vote equals the vote required to amend the partnership agreement. When the agreement is silent on these matters, the required vote would be unanimous. Where the agreement includes several amendment votes depending on the nature of the amendment, the required vote is that which considers contribution obligations since those obligations are the most affected by the amendments. Most states currently consider the required vote to become a limited liability partnership to be an ordinary partnership decision requiring only a majority consent.

In becoming an LLP, each partner should consider a personal liability calculus. Where partnership assets are insufficient to indemnify a partner for an LLP obligation, each partner forfeits a right to receive contributions from other partners in exchange for being relieved of the obligation to contribute to the personal liability of other partners. This calculus will be different for each partner and will vary, for example, depending on the size and business of the partnership, the number of partners, the amount of insurance, and the relative risk of each partner's business practice compared to fellow partners. To adequately consider these varying interests, the Act adopts the vote required to amend the partnership agreement in special and general cases.

c. Effect of Becoming an LLP on the Partnership Agreement

The last sentence in new Section 306(c) provides that when a partnership becomes an LLP, the resulting liability shield applies notwithstanding inconsistent provisions of the partnership agreement existing immediately before the vote to become an LLP was taken. When the partners vote to become an LLP, they obviously intend to sever their personal responsibility to make contributions to the partnership when partnership assets are insufficient to cover partnership indemnification obligations to a partner. A partner's contribution obligation may be enforced not only by a partner (Sections 401 and 405) but also by a partner's creditors (Section 807(f)). In essence, the new Section 306(c) automatically "amends" the partnership agreement to remove personal liability for contribution obligations that may exist under the terms of the partnership agreement as it exists immediately before the vote. The partners, however, are not prohibited from thereafter amending the partnership agreement again to re-establish contribution obligations (see Section 103(b)).

d. Annual Filing Requirement

The Act includes new Section 1001(d) which provides that a partnership's status as an LLP remains effective until it is revoked by a vote of the partners or is cancelled by the Secretary of State under new Section 1003(c) for the failure to file an annual report or pay the required annual fees. Most states provide that unless an LLP timely files an annual registration statement, its LLP status is "automatically" terminated but may be resurrected prospectively only with a subsequent corrective filing. Under this view, an operating partnership may have significant "gaps" in its shield which is further complicated by sourcing rules necessary to determine when a partnership obligation belongs to the shielded LLP or the unshielded partnership.

As with corporations and limited liability companies, the Act preserves the LLP status and the partners' liability shield unless the LLP status is revoked by the partners or cancelled by the Secretary of State. In the latter case, potential gaps in the liability shield are cured with a retroactive resurrection of the LLP status if a corrective filing is made within two years (Section 1003(e)).

Due to the concerns over malpractice litigation and inadequate insurance, interest in limited liability for professionals is at an all time high.¹⁴ Although limited liability protection was available to law firms through the Limited Liability Company, procedural and structuring problems tended to turn lawyers away.¹⁵ In fact some view the LLP as a reaction to prior structuring difficulties

of the LLC. The introduction of LLP legislation in various state legislatures has resulted in a great deal of heated debate.¹⁶ One of the major concerns with the LLP has always been how to deal with a LLP that has several branch offices in different jurisdictions. It was primarily in an effort to address this concern that LLP statutes spread so rapidly throughout the US.¹⁷ Moreover, some commentators view most LLP statutes as providing significant protections for professionals operating in large partnerships against vicarious liability but without providing the necessary protections for customers and creditors. Regardless of their merits, LLP statutes have now been adopted in every US state.

5. The UK Limited Liability Partnership – *An Overview*

The adoption of the UK Limited Liability Partnership Act 2000 was a response to lobbying by professional firms, such as auditors, accountants and solicitors, whose primary goal was to reduce their liability exposure for tort claims arising from malpractice of other partners. Unlike the US legislation, the UK Parliament refused to accept the professional firms' argument that the LLP legal form should only be available to certain regulated groups of professionals (Freedman, 2001). Some of the reasons against such an exclusive application of the LLP form was that it was difficult to provide a clear definition of 'professional' that would satisfactorily answer complaints of non-level playing fields between potential competitors. The legislation was thus extended so that any two people could establish a LLP with the result that UK law does not permit the exclusive application of the LLP form to professionals. The rationale for the UK LLP as an alternative business structure has been analysed by scholars and practitioners (Freedman, 2001, Birds, 2000, Ward, 2001, Freedman & Finch, 1997).

The UK LLP has some similarities with the US LLP in that it combines tax transparency with limited liability without requiring the usual formalities found in corporation law designed to reduce agency costs by, for instance, protecting the interests of shareholders against managers. Section 6 governs the liability of LLP members. A contract with the partnership is entered into with members acting as agents, so that individual members will be bound only if there is also a contract with them personally. The general principles of agency will apply in determining who may bind the partnership. Generally, the partnership will be liable to third parties in tort. The objective of the UK LLP is to protect LLP members who are not personally negligent or directly involved in wrongdoing. Parliament did not specifically provide in the statute (nor would it accept secondary legislation) whether there would be a separate cause of action against

an individual member in tort. This will be left to the courts to decide on a case-by-case basis.¹⁸

Many proponents support the LLP as an effective legal vehicle for small business that combines the benefits of limited liability with the organisational flexibility of partnership (Birds 2000). Freedman observes, however, that although this new legal form has been made available to all firms (not just professionals), it does not take into account the needs of small businesses. The complexity of the LLP legislation creates much uncertainty, especially with respect to liability issues. Also, the much heralded tax benefits of the LLP under US law are not so apparent under UK tax law, as the possibilities for tax advantages may not be so clear in the case of private limited companies. Where the LLP does provide tax advantages *vis-à-vis* other small UK businesses, the lack of tax neutrality may distort commercial decision making.

6. State Limited Liability Partnership Acts

The LLP is a business entity that bears a close resemblance to the Limited Liability Company. Like the LLC, the LLP combines the fundamental aspects of the general partnership with the corporate characteristic of limited liability. Yet, unlike the LLC, the LLP is bound by the large body of already existent general partnership law, in so far as the partnership law is not in conflict with the provisions of the state LLP statute. Under the original LLP concept as seen in the Texas statute, partners are subject to the same benefits, duties, and obligations as general partners except that there is no longer any personal liability for negligence or misconduct in which they were not directly involved. For example, the LLP may protect partners from misconduct such as securities law violations, broaden sanctions for vexatious claims, and malpractice claims, but only when the claim or claims exceed the assets and insurance of a firm. It is important to remember that the liability protection provided by LLP statutes is personal liability protection rather than liability protection for the firm itself. As with corporate entities, a partner's interest in the LLP itself is not protected. The so-called "shield of limited liability" only comes into play after the firm assets have been dissolved.

Because of the rapid spread of LLPs, the state statutes governing them often differ substantially. The most important difference is in the area of liability protection. Legal scholarship has divided LLP statutes into two groups: first generation statutes and second generation statutes.¹⁹ LLP statutes fit into one of these two categories based on the types of vicarious liability for which they offer protection. First generation statutes relieve partners of vicarious liability for the negligence or misconduct of others in the firm as long as they were not

personally involved. First generation statutes do nothing, however, to alter a partner's liability for any ordinary business debts of the partnership. The Texas LLP statute is a typical first generation statute. Second generation statutes create a much greater shield from liability than do first generation statutes. Because the first generation statutes do not provide liability protection from ordinary business transactions, they are not fully "bullet-proof." In 1994, however, Minnesota passed an LLP statute that did grant liability protection from ordinary business debts.²⁰ Since then, all but eight of the forty-nine states that have enacted LLP statutes have followed suit.

Under these second generation statutes, partners are shielded from all entity-level debt. An important point to reiterate is that, regardless of whether the statute in question is a first generation or a second generation, lawyers will always remain personally liable for their own negligence and misconduct. This stems in part from ABA ethical requirements that dictate that lawyers must remain individually liable for their own conduct. In addition, there is the general agency principle that an actor is responsible for his or her own actions and is not relieved of liability merely because he or she was acting on behalf of another entity. LLP statutes also customarily provide that supervising partners who were aware, or should have been aware, of negligent activity or misconduct remain personally liable for any ensuing consequences. Under common law, supervisory liability is based upon a showing that a special relationship existed between the supervisor and the tortfeasor and that the supervisor in question was negligent in his supervision. State LLP statutes often vary or are ambiguous as to whether supervisors who were not negligent in their supervision may be found personally liable. Some states do not provide for any form of supervisor liability.²¹

Other than restrictions that may exist on the use of LLPs by non-professionals, the LLP is simple and user-friendly, both procedurally and structurally. The transition from general partnership to LLP status is easy, and can be accomplished with a minimal amount of paperwork and expense. Firms must simply file an application, satisfy the minimum capital requirement, and pay the registration fee. Partnership agreements do not have to be rewritten, nor is it necessary to form a governing board. Registration is often good for one year, and LLPs must frequently re-register every year.

There is often a minimum capital requirement for LLPs that varies by jurisdiction. Firms typically satisfy this requirement by maintaining an insurance policy that covers professional malpractice claims. In some states, it is also possible to satisfy the requirement by setting aside an identical amount of funds in a bank account specifically reserved to settle malpractice claims

against the firm. LLPs, just like general partnerships, are directly managed by the partner owners, unless otherwise agreed. Consequently, each partner in an LLP maintains the power to bind the partnership, unless the default rule is altered.²² In addition, termination of an LLP is an important issue to address when drafting the LLP agreement, as LLPs can be dissolved with relative ease unless modified by agreement.

Given the purported additional insulation from vicarious liability afforded by LLP's, a question is whether a firm's malpractice insurance premiums or availability of insurance be affected by adoption of one entity over another? Arguably, different structures, providing different levels of liability coverage to partners, should affect how insurers rate the risk. Insurers, however, continue to set rates and determine insurability according to traditional means. This is logical since the amount of insurance for the entity usually does not vary depending on the form of the entity. Moreover, the exposure for non-intentional conduct remains the same for the individual lawyers who committed the wrongful conduct. The benefit for the insurer is that the individuals who were not involved in the transaction no longer have an incentive to press for a settlement to avoid personal liability.

7. Texas

The first LLP statute was enacted in Texas in 1991 as an outgrowth of the savings and loan crisis of the 1980s.²³ Texas suffered substantial economic problems arising from bank failures. The Federal Deposit Insurance Corporation (FDIC) and the Resolution Trust Corporation (RTC) brought a significant number of civil actions against the lawyers and accountants who had represented failed financial institutions. Many of Texas's largest and most prestigious law firms and accounting firms found themselves facing insolvency because of large settlements and judgments resulting from the savings and loan crisis. Under basic partnership principles and Texas law, partners in a law or accounting firm are personally liable for any debts that exceed the assets of the firm. Needless to say, massive settlements against some of the state's largest firms had a dramatic impact on the legal and accounting communities in Texas. Professional firms began to lobby the legislature seeking to obtain legislation that would provide the same level of liability protection for partnerships as corporate entities.

In 1991, the Texas legislature adopted legislation specifically drafted to provide law firms with a greater measure of protection. The Texas legislation was designed to apply to both professional and non-professional partnerships and shields partners from vicarious liability for professional malpractice. Under the

Texas LLP statute, a partner is not personally liable for "debts and obligations of the partnership arising from errors, omissions, negligence, incompetence, or malfeasance ... by another partner or a representative of the partnership not working under the supervision or direction" of the partner.²⁴ The Texas statute, however, did not limit individual liability for a partner's own negligent actions,²⁵ nor did it eliminate liability for the ordinary business obligations of the partnership, such as creditor claims.

In fact, it is interesting to note that the Texas LLP statute provides the inverse of the protection that most state professional corporation (PCs) statutes provide. Under the Texas LLP statute, partners remain vicariously liable for ordinary business obligations of the firm, but are granted liability protection with regard to the professional malpractice of others representing the firm.²⁶ By contrast, most State PC statutes provide the opposite: limited liability for the ordinary business obligations of the entity and unlimited personal liability for the professional malpractice of one's colleagues.

An LLP under Texas law is essentially a specialized form of a general partnership. The Texas statute treats LLP's under a section of the Texas Uniform Partnership Act, not in a section distinct from existing business entities. Thereby, the LLP is not a new entity, but a new form of partnership, which has been used by professionals for many years. Thus, the tax-related problems encountered by a truly new entity such as the Limited Liability Company are not present.

Soon after the Texas LLP statute was enacted, the IRS issued a ruling that LLPs would be taxed as partnerships.²⁷ Since then, LLPs have experienced exponential growth. During the first year, more than 1200 law firms adopted LLP status, including many of the state's largest and most prestigious firms. Over the next three years that number increased to almost 1600. The New York LLP statute, adopted in 1994, achieved a similar level of popularity.²⁸ Although the litigation arising out of the savings and loan crisis was the impetus for LLP legislation in Texas, after enactment of the LLP legislation malpractice actions against professional firms have now become common.²⁹ The increase in this type of litigation has been primarily directed against both law and accounting firms. During a two year period between 1991 and 1992, both the legal and accounting professions faced judgments in excess of \$1 billion.³⁰

Unfortunately, malpractice insurance cannot alleviate all concerns. Massive verdicts and settlements often exceed a firm's insurance coverage by a substantial amount, thereby often exposing partners who were not directly involved in the malpractice or fraud to unlimited personal liability. For

example, in 1992, Jones, Day, Reavis & Pogue of Cleveland settled claims arising out of a failed savings and loan for \$51 million, though they only had \$19.5 million in insurance coverage.³¹ In 1993, the New York firm of Kaye, Scholer, Fierman, Hays & Handler settled a similar \$275 million claim for \$41 million.³² Yet this amount still exceeded the available insurance by \$16 million. Notably, since both settlement agreements were structured as to allow for instalment payments over a period of years, neither resulted in a forced liquidation of the law firm. In addition, insurance does not cover a law firm's inability to meet their ordinary business obligations such as lease agreements.

LLP statutes treat the limitation of liability in slightly different ways. In some states, statutes have been enacted that either expressly or impliedly recognise foreign LLP's. Because LLP statutes are such a recent development, the liability issues surrounding these statutes have not been resolved. As mentioned above, partners in a Texas LLP are not individually liable for "debts and obligations of the partnership arising from errors, omissions, negligence, incompetence, or malfeasance" that occur through the acts of a fellow partner or agent of the LLP. Although the language appears broad, there is no specific provision regarding contract claims. As a result, Texas courts have not interpreted LLP statutes as applying to contract claims with the result that Texas LLP's offer less liability protection than either PC's or LLC's. An obvious consequence is that plaintiffs will attempt to plead their claims in contract. A further area of concern involves malpractice actions. The wording of the statute and the term "malfeasance" seems to encompass malpractice claims arising in tort, though there is uncertainty concerning claims brought under other theories.

The Texas statute contains language about when a partner shall be shielded from liability, and also details when liability attaches. Specifically, there are four situations when a partner can be liable for the misconduct of another partner or representative. First, a partner can be liable when the other person is "working under the supervision or direction of the first partner" when the misconduct occurred. The statute provides no definition of what is "supervision or direction," but the notes thereto state that the supervision probably would have to be "fairly specific" for liability to attach, and that those involved in "general supervision" would be within the contemplated scope of protection. In addition, the notes hint that firms with well-outlined internal responsibilities will better protect their partners. Second, a partner can be liable for another's acts when a partner is "directly involved in the specific activity" that leads to the imposition of liability. This provision follows the principle, previously discussed, that one may not be shielded from one's own acts. Third, a partner is liable when the partner "had notice or knowledge" of the improper acts, and failed to "take reasonable steps to prevent or cure" them.³³ Finally, the Texas

statute provides that the protection from liability does not affect a partner's joint and several liability for any causes other than those specified. Nor does the protection afforded affect the liability of the partnership to pay its debts out of partnership property, or the manner that process is served on the partnership.

Regarding undercapitalised/uninsured LLPs, the question arises how Texas courts will decide cases involving LLPs that are under capitalised and under insured. Although there are no cases on point, Louisiana courts have addressed the issue of thinly-capitalised or under-insured insurance companies by "piercing the corporate veil".³⁴ The question then arises what the courts will do when a partners set up a partnership that has insufficient capital to cover tort claims? Similarly, in the employment realm, another question arises regarding how courts will apportion liability when an employee of a LLP causes injury to a third party and the partnership is cast in judgment.

In Texas there is not such a question because the Texas Legislature has made it mandatory, in some instances, that LLPs have a minimum of \$100,000 in insurance coverage.³⁵ This insurance policy assures innocent third party victims redress against the partnership itself. The partnership is, in this way, held accountable for it actions even if the individual partners are not. In addition, as discussed above, Texas law does not allow a partner who is in a supervisory position to limit his liability from the acts of employees in his care.³⁶ The statute does allow a partner who has no control over an employee to escape responsibility for the actions of that employee. But, it holds someone in a supervisory position accountable to innocent third persons. The partner held accountable will be liable to a third party victim for any debts that may arise after the partnerships insurance is exhausted.

These two legislative provisions assure third party victims of some type of relief if, and when, negligence or intentional wrongdoing occur. In Texas, LLPs will not be allowed to cause damage to a third party, while their individual partners hide behind a statutory veil of limited liability.³⁷ Texas does not put its courts in a situation where they may need to "pierce the partnership veil".³⁸ In Louisiana the situation is quite different. The Legislature has not made it mandatory for insurance to be carried or that individual partners be held accountable for the acts of employees in their control. In Louisiana, a LLP's employee can injure a third party and only the employee and the partnership will be held accountable.³⁹ The individual partners escape personal liability and an innocent third party will be left without any redress. By not forcing the partners of LLPs to be accountable for the actions of their employees, the partners will be allowed to hide behind the actions of the employees. The statute lends itself to the perpetration of wrongful acts by partners.

8. Delaware

In 1993, Delaware enacted a statute that protects a partner from partnership debts "arising from negligence, wrongful acts, or misconduct" during the partnership business.⁴⁰ In Delaware, an LLP is formed by filing an application with the Office of the Secretary of State.⁴¹ The application must be executed by a "majority in interest of the partners or by [one] or more partners authorized to execute an application" and must include the name of the partnership, the address of its principal office, and "a brief statement of the business in which the partnership engages."⁴² In addition, the partnership name must contain the words "Registered Limited Liability Partnership" or the abbreviation "L.L.P." Registration is good for one year and may be renewed by the filing of an application for renewal.

Unlike Louisiana, Delaware's LLP statute contains a minimum insurance requirement. A Delaware LLP must either carry at least \$1 million of liability insurance "of a kind that is designed to cover the kinds of negligence, wrongful acts, and misconduct for which liability is limited," or show that it has set aside the same amount of funds for the purpose of satisfying judgments against the partnership. With regard to liability protection, Delaware is a full shield jurisdiction and provides protection typical of second generation statutes. A partner in a registered Delaware LLP is free of personal liability for "any debt, obligation or other liability of or chargeable to the partnership ... whether arising in contract, tort or otherwise" as long as that partner was not personally negligent or the supervisor of someone who was personally negligent. This liability protection further extends to any potential indirect liability "by way of indemnification, contribution, assessment or otherwise." Thus, partners in a Delaware LLP will not be held personally liable, nor will they be forced to contribute to the partnership, for the malpractice actions of their colleagues as long as they were not personally involved. Furthermore, partners will not be personally liable for the ordinary business obligations of the firm, such as leases and guarantees.

Several important issues regarding aspects of liability protection remain unresolved under Delaware's LLP statute. For example, regarding supervisor liability, the statute states that partners of an LLP remain personally liable for the negligence or misconduct of those under their "direct supervision and control." Under this standard, a plaintiff need not establish that a partner was somehow negligent in his or her supervision, but only that a partner was exercising a supervisory role when the negligent act or misconduct occurred. This begs the question as to what constitutes "direct supervision and control." Is the mere fact that a partner was ultimately responsible for a certain client case

or a specific matter sufficient to create unlimited personal liability? Probably not. A court applying basic common law agency and control principles would almost definitely require some form of intimate involvement with the conduct in question before imposing vicarious liability. For example, while an executive committee of a medium to large LLP firm exercises supervision and control over the general business and operation of the firm, such supervision and control will most likely not be "direct" enough to expose such partners to personal liability. Conversely, partners who supervise the day-to-day activities of one or more attorneys on a matter, would certainly fall within the bounds of the statutory language.

Regarding prior contractual obligations and misconduct, the uncertainty involves whether or not the partners of a Delaware LLP will remain personally liable for prior misconduct or pre-existing contractual obligations. The Delaware statute states that partners in an LLP are not liable "for any debt, obligation or other liability of or chargeable to the partnership or another partner or partners, whether arising in contract, tort or otherwise, while the partnership is a registered limited liability partnership." This language creates an issue, however, as to whether partners in a Delaware LLP remain exposed to personal liability for obligations arising prior to the firm's registration as an LLP. Take, for example, the situation where a general partnership enters into a commercial lease in 1990. The partnership registers as a Delaware LLP in 1997, and then defaults on the lease the following year. The landlord now wishes to hold the partners in the LLP personally liable. Would partners in this LLP be potentially exposed to personal liability for the firm's contractual obligations? Probably yes. For public policy reasons, a court would likely hold that partners in a Delaware LLP remain exposed to personal liability for all pre-existing obligations. To hold otherwise would adversely affect creditors and would seem fundamentally unjust. Some states, most notably Minnesota, have adopted language that makes it clear that partners in an LLP only receive protection from those partnership obligations incurred after the partnership registers as an LLP. To truly avoid any ambiguity on this issue the Delaware General Assembly should, and most likely will amend Chapter 15 to include language similar to that of the Minnesota LLP statute.

Another important issue that remains unresolved is the type of notice that must be given to clients and creditors when a general partnership converts to an LLP. Although there is no case law directly on point, there is some case law pertaining to general partnerships that convert to corporations. The general consensus in these cases is that in order to receive the typical protection from personal liability that comes with the corporate form, the newly formed entity must provide adequate notice to all clients and creditors that they are no longer

dealing with a general partnership. It would follow, therefore, that a general partnership that converts to a Delaware LLP must give similar notice to its clients and creditors. But what constitutes adequate notice? In several cases, the addition of "Inc." to a new entity's name was not sufficient notice to a creditor. Similarly, in other cases, the filing of a certificate of assumed name or even a certificate of incorporation was also deemed insufficient to put a pre-existing creditor on notice. In light of these holdings, the safe thing for law firms to do would be to write a letter to their clients and creditors briefly explaining the firm's change to LLP status and how this change affects the personal liability of the partners.

a. Liability Protection and Pass-Through Taxation

The Delaware LLP essentially offers the best aspects of every business entity combined into one. It offers personal liability protection from all entity level debts, while at the same time allowing pass-through taxation. Although this is the same protection and treatment offered by an LLC, it is substantially greater with respect to all other business forms. For example, the professional corporation does not provide any protection for the negligent actions or misconduct of one's colleagues, as it only provides limited liability for ordinary business obligations. Although limited partnerships allow limited partners to take advantage of limited liability, general partners remain personally liable for all partnership debt.

b. Procedural and Structural Flexibility

The Delaware LLP also offers a great deal of procedural and structural flexibility. This includes significant freedom with regards to profit sharing, as well as structural flexibility. This flexibility may not be greater than that provided by the general partnership, but it is significant compared to other forms. PCs are highly restricted in their manner of profit sharing, and under the limited partnership form, limited partners may not participate in control of the business. In Delaware, the LLP is a highly popular business entity through which professionals can provide services.

By contrast, in many other states, the decision whether to become a LLP is fraught with uncertainty concerning the extent and scope of liability protections afforded by LLPs. In fact, many LLP statutes offer less liability protection than corresponding statutes for professional corporations and limited liability companies. The lack of language regarding contract claims makes this apparent. However, LLPs do offer protection far beyond that of a general partnership, and without the difficulties that can accompany a partnership's change to a

professional corporation or an LLC. The existing LLP statutes require only that a partnership register the partnership with the secretary of state, pay a fee and include a designation that it is an LLP in the firm's name. Other than statutes in Louisiana and North Carolina, there is a requirement for insurance, such as an escrow account covering claims for which the partners are not jointly liable.

The ease of creation associated with LLP's is a major advantage for a general partnership seeking protection from liability. The LLC's potential problems with tax treatment and state authorization for professionals to use the form are absent, since both issues are well settled regarding partnerships. As with the LLC, there is uncertainty of the need for the approval by legal authorities to practice as LLP's. Also, the same potential problems exist regarding recognition of limited liability in suits brought in other states.

As with the Texas law, no provision is made for claims arising in contract. The statute also says that a partner will be personally liable for his own acts, and for those "under his direct supervision and control." Regarding whether other states will recognise the limited liability of the LLP, Delaware addressed the issue by including language in the statute that Delaware law should control. Another jurisdiction may accept the provision as a matter of comity, but is not bound to do so. Nevertheless, if the "Big 6" accounting firms take advantage of the Delaware LLP legislation, as expected, then other states will seriously consider enacting similar legislation. The presence of similar legislation in the forum state increases the likelihood that the law of the state of the attorneys' residence will be followed.

9. Illinois

This section discusses the law governing the operation, taxation, and dissolution of limited liability partnerships and of foreign limited liability partnerships with a special focus on the LLP legislation in Illinois.⁴³ Under the Illinois LLP legislation, a general partnership is the only entity that is allowed to register as an LLP. Unlike other Illinois business organizations, no entity begins its existence as an LLP. The would-be LLP must already exist as a partnership.⁴⁴ The partnership must apply to the Secretary of State to be registered as an LLP.⁴⁵ The name of the partnership must include one of the following designations as its last words or letters: "Registered Limited Liability Partnership," "L.L.P.," or "LLP."⁴⁶

a. Operation and Termination of LLP

Unlike other Illinois business organizations, the LLP is not required to make a separate filing to correct the information on its registration when an organizational change occurs, such as a change in the number of partners or the registered agent.⁴⁷

As an offshoot of the UPA partnership, the LLP retains standard partnership operation features. No formal meetings or resolutions are required for the partnership to act. As with any UPA partnership, the partners are free to make whatever management arrangements best suit their particular needs, including operating their venture with or without a written partnership agreement.

Regarding termination, the Illinois LLP can be terminated in the same manner that any other UPA partnership can be terminated, e.g., by the death or withdrawal of a partner from the partnership. The LLP can also lose its registered status without ending its existence as a partnership either by the voluntary withdrawal from registered status by the majority in interest of its partners or by the expiration of its registered status if it is not renewed annually.⁴⁸ The position that the LLP provisions occupy within the framework of the UPA implies that when an LLP loses its registered status, it automatically returns to its former status as a UPA partnership.

b. Partnership Income Tax Treatment

Since a LLP is essentially a UPA partnership, it has only part of one of the four characteristics that lead to corporation income tax treatment: a partial limitation on personal liability for entity debts.⁴⁹ This one characteristic is insufficient to alter its essential nature as a UPA partnership. The LLP enjoys partnership pass-through treatment for income tax purposes.⁵⁰ As a UPA partnership, the LLP is subject to the same filing requirements as any other partnership.

c. Scope and Effect of Liability Limitations

As UPA partnerships, LLP partners are jointly and severally liable for any loss or injury caused to any person by "any wrongful act or omission of any partner acting in the ordinary course of the business of the partnership, or with the authority of his co-partners."⁵¹ Partners in an LLP enjoy a rather broad protection from liability for the misdeeds of their partners. Apart from this protection, the standard liability problems of a UPA partnership remain. The Illinois legislation states:

[A] partner in a registered limited liability partnership is not liable, directly or indirectly, including by way of indemnification, contribution, assessment or otherwise, for debts, obligations, and liabilities of or chargeable to the partnership, whether arising in tort, contract or otherwise, arising from negligence, wrongful acts, omissions, misconduct, or malpractice, committed while the partnership is a registered limited liability partnership and in the course of the partnership business by another partner or an employee, agent, or representative of the partnership.⁵²

A partner in an LLP cannot be held personally liable for the negligence or misconduct of other partners or for the negligence or misconduct of partnership agents or employees not under that partner's direct supervision and control.⁵³ A partner in an LLP is expressly liable for his own negligence and misconduct and for the negligence and misconduct of any other person under his direct supervision and control. But the statute does not address the issue of the personal liability of partners for those debts arising from the misdeeds of the partnership itself.

d. Litigation Concerns

For most purposes, Illinois statutory and case law will treat an LLP as any other UPA partnership. The well-litigated area of partnership law will provide answers to the majority of the issues that the partners of an LLP may encounter. The only deviation the LLP provisions make from the UPA is the limitation the LLP creates on a partner's vicarious liability for the torts of other partners and certain partnership employees. The LLP provisions of the UPA are so new for most states that there are no reported decisions dealing directly with the operation and effect of the LLP's unique limited liability provisions.

The Illinois LLP legislation appears to adopt a limited shield for partners against the vicarious liability of other partners or the partnership entity itself. For example, the language of the statute provides a shield against liabilities arising from the misdeeds of one's partners and certain employees.⁵⁴ Regarding employee negligence, the LLP provisions would protect the partner who did not have direct supervisory responsibility over the acts of the negligent employee. For example, if a premises liability accident were caused by the failure of a partnership employee to keep an area free of debris, the LLP provisions would protect the personal assets of those partners who did not exercise direct supervision and control over the negligent employee.⁵⁵ Only the personal assets of those partners who had direct supervision and control of the negligent employee would be available to satisfy the judgment against the partnership.

Regarding entity negligence, if an accident were to occur through the neglect of no particular partner or partnership employee, would the LLP provisions provide any partner with protection? The LLP provisions make no mention of debts arising from the negligence of the entity itself. If the legislature had intended to provide such protection in addition to the liability limitations that it expressly set forth, it had every opportunity to state such protections expressly. Assuming that no particular tortfeasors could be identified, it seems likely that LLP status would not protect the personal assets of any of the partners.⁵⁶

The issue of direct supervision and control is addressed in section 205/15(c), which makes a partner liable for the debts incurred by the partnership for the misdeeds of partnership employees acting under that partner's "direct supervision and control." The term "direct supervision and control" is never defined in the LLP provisions of the UPA. It seems clear that a partnership employee who works directly for a particular partner and who is answerable only to that partner for the performance of a job would be classified as being under that partner's direct supervision and control. The distinction between which partner directly supervises and controls and which does not becomes much less clear when an employee works directly for, and is answerable to, two partners. No response to this dilemma is found in the LLP provisions.

e. Limited Liability Partnerships in Bankruptcy

The Bankruptcy Reform Act of 1994 changed Chapter 7 liquidation rights to allow the protections provided by state LLP laws to be carried into the bankruptcy courts:

If there is a deficiency of property of the estate to pay in full all claims which are allowed in a case under this chapter concerning a partnership and with respect to which a general partner of the partnership is personally liable, the trustee shall have a claim against such general partner to the extent that under applicable nonbankruptcy law such general partner is personally liable for such deficiency.⁵⁷

In Illinois, the applicable nonbankruptcy law would be the LLP provisions of the UPA, which, in tandem with the Bankruptcy Code, provide the partner in an LLP continued protection from vicarious liability upon the liquidation of the partnership in bankruptcy.⁵⁸ This Bankruptcy Code provision does not broaden the scope of the liability limitation; the ordinary debts and obligations of the partnership are still chargeable against the personal assets of LLP partners to the extent that the assets of the bankruptcy estate partnership are insufficient.

f. Foreign Limited Liability Partnerships

An LLP already formed in another jurisdiction may enjoy the protection of Illinois' LLP provisions by registering with the Secretary of State.⁵⁹ As with a domestic LLP, the registration application for a foreign LLP must be signed either by the majority in interest of the partners or by one or more partners authorized to execute the application.⁶⁰ As with a domestic LLP, a foreign LLP can also simply update the changed information on the annual renewal of its registration with no additional filing fee required for the changes themselves.

10. The LLP and Public Policy Considerations

The LLP was created because of concerns about the fundamental fairness of unlimited personal liability for the actions of one's partners. Logically, it seems harsh to punish one partner for the acts of another that he or she may not even know. Under traditional partnership rules, however, a partner is liable for the conduct of others even though most partners in a large firm have no real ability to supervise or control every other partner. Moreover, much debate has arisen over efforts to determine the value of the LLP. Valid concerns have been raised by both sides. Those in favour of LLPs stress the fact that law firms today are structurally much different than they were even a generation ago. These firms are becoming increasingly larger in size, and are consequently becoming more difficult to effectively monitor. The theory of joint and several liability certainly does not seem as realistic in the modern law firm setting as it once did. LLP proponents also stress the fact that limited liability does not prevent recovery against law firms, it merely prevents recovery against the personal assets of innocent partners.

Opponents of the LLP believe that innocent unsophisticated clients and the investors of public companies which LLPs advise will be adversely affected by limitations on joint and several liability. It can be argued that attorneys and auditors, and not their clients or members of the investing public, should bear the real economic cost of their business. This is because attorneys and auditors are in a better position to prevent malpractice from occurring in the future, so it is most efficient for professionals to bear the financial risk. They also note that in the case of the large, multi-office professional firm, the major argument against joint and several liability for all partners in a firm arises from the desire to protect the so-called *innocent* partner who was not directly involved in another partner's negligent acts, and therefore should be insulated from such liability. This argument loses its force, however, when one considers that the so-called *innocent* partner is quite willing to accept the benefits of the economies of scale produced by large office practices (ie., increased revenue per

partner) and that the corresponding cost of such increased profits per partner should be enhanced risk management processes within the large firm to reduce the occurrence of malpractice and fraud. The so-called *innocent* partner is in the best position (as opposed to customers and the investing public) to ensure that adequate monitoring processes are adopted in large, multi-office operations to reduce operational risk within the large firm.

Moreover, it should be noted that not all LLPs are large, and therefore smaller professional firms do not face the same obstacles of monitoring a large business and thus are better positioned to oversee the activities of fellow partners in today's firm environment.⁶¹ Also, a rather more controversial assertion can be made that if professional firms of any size find it too costly, or are simply unable, to monitor effectively the activity of its attorneys/auditors to a necessary extent that the partners feel comfortable with the notion of unlimited personal liability, then perhaps the existence of those firms contravene public policy. Perhaps, these firms should be eliminated altogether and the partners should not be seen as sympathetic victims. Furthermore, the resources of large firms may actually make it easier to monitor the professionals' activities.

In addition, critics of the LLP form caution firms against acting hastily in adopting LLP status, arguing that it may not be as beneficial as it first seems. Many are particularly wary of the relative newness and uncertainty of the entity. They believe that firms should not switch until any unforeseen ambiguities that may arise are resolved. In particular, critics cite ambiguities over the scope of supervisory liability under the LLP statute. Ambiguities are not likely to exist, however, and even if they do arise, they are unlikely to adversely affect the partners of the LLP. Although LLPs have yet to be tested in court, LLPs still have the body of partnership law to rely upon. Even in situations where the LLP statute may be unclear, as in the area of supervisor liability, a look at common law principles should make it possible to determine the basic standard to be imposed. Even in a "worst case scenario," for example, where a court construes "direct supervision and control" in a very liberal manner, the LLP form still offers undeniably greater protection than the general partnership.

Another concern is how clients will react to a law firm attempting to shield its partners from personal liability, and whether public relations problems are likely to ensue. Although common sense dictates that this may be a potential problem, one author disagrees, stating that many firms that have adopted the LLP have had little or no problem with client disapproval. According to this author, most clients are not aware of the substantive difference between the various business entities; and the clients who are usually react favourably. A third concern is that, by removing the threat of personal liability, attorneys will

be less apt to police one another's conduct, thereby causing a potential increase in malpractice litigation. LLP proponents, however, argue that because limited liability does not protect a partner's economic interest in the firm, it is still in every partner's best interest to prevent malpractice to the best of his or her ability. As one LLP proponent stated, "[L]awyers who need the threat of having their bank accounts attached or their homes auctioned before they'll care about the professional behaviour of their partners can't be trusted under any circumstances."

A final concern is that LLPs may create a conflict of interest among firm partners by having the members of one practice group more at risk for personal liability than others. Some areas of the law, such as complex corporate transactions and securities regulation, pose a heightened risk for professional malpractice. Yet, it is often these same areas that are the most financially lucrative for a law firm. Before the advent of limited liability, all partners shared in both the risks as well as the financial benefit of high risk practices. The LLP has somewhat altered this scenario by potentially decreasing the risk of vicarious liability for the partners who do not personally participate in high risk practice areas. In light of this, partners who practice in high risk areas and who bring in more money to the firm may expect to receive an increased share of the profits commensurate with this increased risk. Similar concerns may be raised by partners who supervise more than others.

11. Conclusion

It is the contention of this paper that the professional nature of law and accounting practice and its obligations to the public interest require that each professional partner be civilly responsible for his [or her] professional acts. A special relationship exists not only between the lawyer and accountant and their clients, but between the lawyer and accountant and other professional members of their firm. For instance, when a client engages the services of a lawyer the client has the right to expect the fidelity of other members of the firm. It is inappropriate for the lawyer to be able to play hide and seek in the shadows and folds of the corporate veil and thus escape the responsibilities of professionalism.

The potential problems voiced by critics of the LLP certainly warrant consideration by lawmakers in any jurisdiction contemplating the adoption of a LLP statute. Indeed, the United Kingdom's Limited Liability Partnership Act 2000 attempts to address some of the weaknesses of the US LLPs by regulating the LLP under the Companies Act 1985 and the Insolvency Act 1986 in an effort to provide full disclosure of the finances and accounts of LLPs so the

public will be on notice as to their financial status. Moreover, liquidators in bankruptcy will be able to claw back distributions made to members within two years before a LLP becomes insolvent or is placed under administration. However, third parties will be prejudiced because there will be a strong corporate veil protecting LLP members from vicarious liability deriving from the negligence or misconduct of other LLP members and from contractual obligations and debts incurred on behalf of the LLP by members acting as agents for the LLP. This broad shield against vicarious liability will impose an onerous burden on consumers and creditors who would otherwise be able to seek redress from other partners in the firm.

Many law and economics scholars have argued that the LLP statutes create optimal negotiating structures for agents to bargain around the risks inherent in partnership default (Ribstein, 1999). However, there is a wide gulf between the theoretical model used by law and economics scholars in which all persons are sophisticated and the real world in which we live where most individuals may not even know what a default rule is, much less that it might be in their interest to seek to negotiate a special deal to change it in the unlikely event that something unexpected happens. Moreover, while it is true that in most cases sophisticated contract claimants can protect themselves from the risk of partnership default by having individual partners execute guarantees of performance or agreements to assume liability in the event of default, the real problem is with unsophisticated, smaller enterprises or clients who may do business with the LLP.

This paper seeks to serve as a basis for future research that will adopt law and economics concepts and other relevant theories to analyse the need for regulation of small and large professional firms that perform advisory services in financial markets. An important aspect of such research should address the extent to which statutory limitations on joint and several liability create a more efficient mechanism for allocating risk within and outside the firm. Theoretical approaches that emphasise the value of individual autonomy in bargaining for certain risk allocations should also respect the general statutory objectives of consumer and investor protection. Equally important, economic efficiency and justice considerations will be served by shifting the cost of risk prevention to those who are most capable of bearing the cost of prevention.

Notes

¹ Limited Liability Partnership Act 2000, 2000 c. 12 ('LLP Act').

² Robert W. Hamilton, *Cases and Materials on Corporations Including Partnerships and Limited Partnerships* (6th ed. 1998).

- ³ Carol Goforth, "Limiting Liability of General Partners in LLPs: An Analysis of Statutory Alternatives" (1996) 75 *Or. L. Rev.* 1139, 1141-42.
- ⁴ Allison L. Bergman, "Covering Your Assets: Missouri's New Limited Liability Partnership Law", (1995) 63 *UMKC L. Rev.* 679, 679.
- ⁵ Jennifer J. Johnson, "Limited Liability for Lawyers: General Partners Need Not Apply", (1995) 51 *Bus. Lawyer* 85, 88.
- ⁶ I.R.C. s. 702.
- ⁷ See UPA Revision Subcommittee of the Committee on Partnerships and Unincorporated Business Organizations, Section of Business Law, American Bar Association, Should the Uniform Partnership Act be Revised?, 43 *Bus. Law.* 121 (1987) ("ABA Report").
- ⁸ *Id.* at 124.
- ⁹ See Uniform Partnership Act ss. 29-43, 6 U.L.A. 125 (1995).
- ¹⁰ See generally Donald J. Weidner & John W. Larson, The Revised Uniform Partnership Act: The Reporters' Overview, 49 *Bus. Law.* 1 (1993).
- ¹¹ See Uniform Partnership Act ss 29-43, 6 U.L.A. 125 (1995).
- ¹² Bergman, *supra* note 4, at 679
- ¹³ For example, both §22(14) of the Illinois Medical Practice Act of 1987 and §44(e) of the Illinois Dental Practice Act have been amended effective January 1, 1996, and August 11, 1994, respectively, to make it clear that both physicians and dentists are permitted to use the LLP.
- ¹⁴ See Goforth, 75 *Or. L. Rev.* at 1158.
- ¹⁵ See John Richards, "Illinois Professional Service Firms and the Limited Liability Partnership: Extending the Privilege to Illinois Law Firms", (1996) 8 *DePaul Bus. L. J.* 281, 283.
- ¹⁶ *Ibid.*
- ¹⁷ See Hamilton, *supra* note 2, at 1075.
- ¹⁸ LLP Act, Explanatory Note pp 15-16.
- ¹⁹ See discussion in Goforth above.
- ²⁰ See Minn. Stat. Ann. s. 323.14 (West 1998).
- ²¹ See Colo. Rev. Stat. Ann. s. 7-60-115(2)(a) (West 1998).
- ²² See Larry E. Ribstein, 'Possible Futures for Unincorporated Forms, (1996) 64 *U. Cinn. L. Rev.* at 334.
- ²³ See Darryl Van Dutch, "Some Firms Hesitate to Adopt L.L.P.", *Nat'l L. J.*, May 5, 1997, at A1.
- ²⁴ Tex. Rev. Civ. Stat. Ann. Art. 6132b-3.08(a)(2)(West Supp. 1998).
- ²⁵ *Ibid* art. 6132b-3.08(a)(2)(A).
- ²⁶ *Ibid.* art. 6132b-3.08(a)(2)(A)-(B).
- ²⁷ Private Letter Ruling, 92-29-016 (Apr. 16, 1992).
- ²⁸ See Richards, *supra* note 15, at 283.

- ²⁹ See generally, Ronald E. Mallen & Jeffrey M. Smith, (4th ed. 1996) *Legal Malpractice* ss. 7.10-7.12).
- ³⁰ See "Some Law Firms Were Hit by Massive Suits", *Nat'l L.J.*, Dec. 26, 1994, at C11.
- ³¹ Lee Bernton & Joann S. Lublin, "Seeking Shelter: Partnership Structure is Called into Question as Liability Risk Rises", *Wall St. J.*, June 10, 1992, at A1.
- ³² Michael Osprey, "The Lessons of Kaye, Scholer: Am I My Partner's Keeper?", *Am. Law.*, May 1992, at 3, 81.
- ³³ See Appendix B for provisions of Texas LLP Statute.
- ³⁴ *George A. Hormel and Company v. Ford*. 486 So.2d 927 (La. App. 1st Cir. 1986).
- ³⁵ TEX. CIV. STAT. ANN. art. 6132b § 45-C (West Ann. 1993).
- ³⁶ TEX. CIV. STAT. ANN. art. 6132b § 45 (West Ann. 1993).
- ³⁷ TEX. CIV. STAT. ANN. art. 6132b. § 15(2) (West Ann. 1993).
- ³⁸ *Harris v. Best of America, Inc.*, 569 So.2d 992 (La. 1985), Louisiana courts have listed the following criteria to justify "piercing the corporate veil": (1) commingling of corporate and shareholder funds; (2) failure to follow statutory formalities required for incorporation and the transaction of corporate affairs; (3) undercapitalization; (4) failure to provide separate bank accounts and bookkeeping records; (5) failure to hold regular shareholder and director meetings.
- ³⁹ LA. REV. STAT. ANN. § 9:3431(A).
- ⁴⁰ Del. Code Ann. tit. 6 ss 1501-1543 (Supp. 1999).
- ⁴¹ Del. Code Ann. tit. 8, s. 619 (Supp. 1998).
- ⁴² The application must also be accompanied by a registration fee of \$100 for each partner.
- ⁴³ See the Illinois legislation at 805 ILCS 205/1, et seq. Moreover, the Illinois LLP statute adopts the six separate sections of the UPA that create the distinguishing features of the LLP: 805 ILCS 205/8.1 - 8.5 and 205/15.
- ⁴⁴ 805 ILCS s. 205/8.1(a).
- ⁴⁵ 805 ILCS 205/8.1(a).
- ⁴⁶ 805 ILCS 205/8.2.
- ⁴⁷ 805 ILCS 205/8.1(g). Rather, the LLP simply updates the changed information on the annual renewal of its registration on Form RLLP-8.1-RA(D), with no additional filing fee required for the changes themselves.
- ⁴⁸ 805 ILCS 205/8.1(f).
- ⁴⁹ 805 ILCS 205/15(b).
- ⁵⁰ Treas.Reg. §1.7704-2.
- ⁵¹ 805 ILCS 205/13.
- ⁵² 805 ILCS 205/15(b).

⁵³ 805 ILCS 205/15(b).

⁵⁴ 805 ILCS 205/15(b).

⁵⁵ 805 ILCS 205/15(c).

⁵⁶ 805 ILCS 205/15.

⁵⁷ 11 U.S.C. §723(a).

⁵⁸ See Walter A. Effross et al., *The Bankruptcy Reform Act of 1994: Something for Everyone*, 94 *Am.Bankr.Inst.J.* 1, 17 (1994)

⁵⁹ 805 ILCS 205/8.1(c). The application for foreign LLPs, Form RLLP-8.1(F), is supplied by the Secretary of State's Office. See sample form at §8.34. In addition to the information included

in the domestic registration application (see §8.7), Form RLLP-8.1(F) also requires the inclusion of the original state or country of jurisdiction.

⁶⁰ 805 ILCS 205/8.1(b). 805 ILCS 205/8.1(b). Completed registration applications are filed with the Uniform Partnership Section of the Department of Business Services of the Office of the Illinois Secretary of State. 805 ILCS 205/8.1(a). In Illinois, the filing fee for a foreign LLP is a flat \$500, regardless of the number of partners. A fee of \$300 is required to accompany each annual renewal of the firm's registration on Form RLLP-8.1-RA(F). 805 ILCS 205/8.1(c).

⁶¹ See discussion in Goforth, *supra* note 2, at 1156.

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