# NOTE

## IS THE LIMITED LIABILITY PARTNERSHIP NOW THE ENTITY OF CHOICE FOR DELAWARE LAW FIRMS?

### I. INTRODUCTION

Law firms operate and interact today in an increasingly litigious society,[1] and the threat of vicarious liability to which partners are often exposed due to the misconduct of fellow attorneys is no longer theoretical.[2] In the aftermath of the savings and loan crisis of the late 1980s, many of the law and accounting firms that represented the failed financial institutions faced massive judgments totaling in the billions of dollars.[3]

The first limited liability partnership (LLP) statute enacted in Texas in 1991 was a reaction to the increasing trend of malpractice claims against professionals.[4] Although this statute did not provide protection for the firm itself against professional malpractice claims, it did prevent these types of claims from being satisfied out of the personal assets of innocent partners.[5]

In 1993, Delaware adopted legislation that permitted businesses to form LLPs, making Delaware the third state to enact such a statute.[6] Although professionals were not restricted in their ability to organize under the LLP form, as in some states, attorneys were strictly prohibited from taking advantage until approval was given by the Delaware Supreme Court.[7] Recently, the Delaware Supreme Court has granted this approval, opening the door for Delaware law firms to take similar advantage.[8]

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[1]Allison L. Bergman, *Covering Your Assets: Missouri's New Limited Liability Partnership Law*, 63 UMKC L. REV. 679, 679 (1995).

[2]Jennifer J. Johnson, *Limited Liability for Lawyers: General Partners Need Not Apply*, 51 BUS. LAW. 85, 88 (1995).

[3]*See infra* notes 77-80 and accompanying text.

[4]*See infra* notes 76-77 and accompanying text.

[5]*See* 1991 Tex. Gen. Laws 901, § 84; *infra* note 86 and accompanying text.

[6]*See infra* note 176 and accompanying text. As of July 1998 there were 74 Delaware businesses registered as Delaware LLPs. Search of DELAWARE SECRETARY OF STATE OFFICE statistics (July 1998).

[7]*See infra* notes 177-78 and accompanying text.

[8]*See infra* note 180 and accompanying text. Several firms have already made the switch. Young, Conaway, Stargatt & Taylor (Young, Conaway) was the first major Delaware-based firm to register as an LLP. Joseph M. Nicholson, a partner at Young, Conaway stated that the firm had no hesitations about registering as an LLP. Telephone interview with Joseph M. Nicholson, Partner, Young, Conaway, Stargatt & Taylor (Nov. 12, 1997). Smith, Katzenstein & Furlow and Potter, Anderson & Corroon have also registered as LLPs. Search of DELAWARE SECRETARY OF STATE

This note begins by examining the various business forms that are available to Delaware law firms. It will also give a brief history of the LLP and provide a general examination of its characteristics. The third section will focus on Delaware LLP law and will discuss the extent to which Delaware LLP law differs from LLP legislation enacted in other states. Several issues arising under the Delaware statute, as well as concerns of LLP critics, will also be discussed. Finally, this note concludes that, although the LLP may not be a perfect fit for every Delaware law firm, it offers substantial benefits over any alternative entity and the vast majority of Delaware firms stand to benefit substantially by adopting the LLP structure.

## II. VARIOUS BUSINESS FORMS AVAILABLE TO DELAWARE LAW FIRMS

The Rules of the Delaware Supreme Court restrict the business forms under which attorneys may practice.[9] Attorneys are currently permitted to practice law under the following business forms: general partnership, professional service corporation (PC), limited partnership, limited liability company (LLC), and limited liability partnership (LLP).[10] The following section provides a brief history and discusses the primary characteristics of each of these forms.

### A. *General Partnership*

Historically, general partnership has been the entity of choice among law firms.[11] This trend most likely arose because, until recently, lawyers were largely restricted from practicing under any other form.[12] This prohibition was based upon the belief that a corporate structure was not suitable to the practice of law.[13] Despite the passage of legislation permitting lawyers to practice law in other forms, partnership remains the "time-honored" and established form of organization for the practice of law.[14]

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OFFICE statistics (July 1998). To date, these three are the only Delaware firms to register. *Id.* For a look at foreign LLP law firms registered in Delaware, see *infra* note 189 and accompanying text.

[9]*See infra* text accompanying note 179.

[10]DEL. CT. CODE OF PROFESSIONAL RESPONSIBILITY RULE 67 (1999).

[11]N. Scott Murphy, *It's Nothing Personal: The Public Costs of Limited Liability Law Partnerships*, 71 IND. L.J. 201, 209 (1995).

[12]John Richards, *Illinois Professional Service Firms and the Limited Liability Partnership: Extending the Privilege to Illinois Law Firms*, 8 DEPAUL BUS. L.J. 281, 283 (1996).

[13]Johnson, *supra* note 2, at 92; *see* Murphy, *supra* note 11, at 205-06.

[14]Johnson, *supra* note 2, at 85.

Partnership as a form of business organization is far from new.[15] The Uniform Partnership Act (UPA) was adopted in 1914 as a codification of common law principles which had been in existence for years.[16] The UPA set forth standards regarding the nature of the partnership,[17] relations of partners to third parties,[18] relations of partners to one another,[19] the property rights of partners,[20] and the termination of a partnership.[21] Partnership legislation enacted in Delaware is almost identical to that of the UPA.[22]

One of the most attractive elements of the general partnership is pass-through taxation. Under this principle, partnership profits are not subject to an entity level tax.[23] There is no tax imposed until the profits are received by one or more partners as income.[24] The partner's income is then taxed as personal income.[25] In this manner, general partnerships avoid the double tax that corporate entities are required to pay.[26]

Another attractive aspect of the general partnership is its flexibility. No formal written agreement is required to form a partnership.[27] This makes a general partnership very easy to create and maintain.[28] In addition, there are very few aspects of the partnership structure that cannot be altered by agreement.[29]

These benefits, however, come at the expense of personal liability. Under partnership law, each partner is unlimitedly personally liable for both the misconduct of his or her partners, as well as any debts of the partnership

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[15]Carol R. Goforth, *Limiting the Liability of General Partners in LLPs: An Analysis of Statutory Alternatives*, 75 OR. L. REV. 1139, 1158 (1996).

[16]*Id.*

[17]*See* UNIF. PARTNERSHIP ACT §§ 6-8, 6 U.L.A. 125 (1995).

[18]*See id.* §§ 9-17.

[19]*See id.* §§ 18-23.

[20]*See id.* §§ 24-28.

[21]*See* UNIF. PARTNERSHIP ACT §§ 29-43, 6 U.L.A. 125 (1995).

[22]*Compare* DEL. CODE ANN. tit. 6, §§ 1501-1543 (Supp. 1997), *with* UNIF. PARTNERSHIP ACT §§ 1-43, 6 U.L.A. 125 (1995).

[23]I.R.C. § 701 (1998).

[24]*Id.*

[25]*See id.* § 702.

[26]*See id.* § 11(a). Corporations are generally required to pay a tax on profits. *Id.*

[27]*See* UNIF. PARTNERSHIP ACT § 7, 6 U.L.A. 125 (1995). *Accord* DEL. CODE ANN. tit. 6, § 1507 (establishing rules for determining the existence of a partnership under Delaware law).

[28]Murphy, *supra* note 11, at 209.

[29]*See, e.g.*, UNIF. PARTNERSHIP ACT §§ 18-19, 37, 6 U.L.A. 125 (1995) (establishing that the rights and duties of partners, the place where partnership books are kept, and the right to wind up are subject to the agreements between partners). *Accord* DEL. CODE ANN. tit. 6, §§ 1518-1519, 1537 (Supp. 1997).

to the extent that either exceed the assets of the partnership.[30] 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.[31]

### B. *Professional Corporations*

The professional corporation (PC) is a largely outdated business entity.[32] The first professional corporation statutes were enacted in the 1960s to allow lawyers and other professionals to make use of the corporate form.[33] Today, every state, including Delaware, has its own PC statute.[34] PCs are structured and operated much like a regular corporation.[35] They are also bound by the state's body of corporate law and must abide by the usual corporate formalities.[36]

As horrifying as the thought of unlimited personal liability may seem, it was dissatisfaction with another aspect of partnership law that led to the creation of professional corporations.[37] Despite the favorable pass-through tax status of the general partnership, partners were, up until recently, denied certain personal tax benefits for which corporate employees were eligible.[38] The most significant of these benefits was the lenient tax treatment of qualified corporate retirement plans.[39] By adopting the PC form, attorneys and other professionals were able to take similar advantage.[40]

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[30]UNIF. PARTNERSHIP ACT §§ 13-15, 6 U.L.A. 125 (1995). The Revised Uniform Partnership Act (RUPA) promulgated in 1994 retains this principle. *Accord* DEL. CODE ANN. tit. 6, §§ 1513-15 (Supp. 1997). *See also* DEL. CT. CODE OF PROFESSIONAL RESPONSIBILITY RULE 67(h)(ii) (1999) ("Each shareholder, partner or member of a Professional Organization shall be jointly and severally liable for any liability of the Professional Organization . . . .").

[31]*See* UNIF. PARTNERSHIP ACT §§ 13-15, 6 U.L.A. 125 (1995). *Accord* DEL. CODE ANN. tit. 6, §§ 1513-15 (Supp. 1997); DEL. CT. CODE OF PROFESSIONAL RESPONSIBILITY RULE 67(h) (1999).

[32]*See infra* text accompanying notes 53-55.

[33]Johnson, *supra* note 2, at 92.

[34]*See* ROBERT W. HAMILTON, CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS 164 (5th ed. 1994). *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 601-619 (Supp. 1998). Delaware's PC statute was adopted in 1969.

[35]Johnson, *supra* note 2, at 92-93.

[36]DEL. CODE ANN. tit. 8, § 619 (Supp. 1998).

[37]HAMILTON, *supra* note 34, at 164-65.

[38]Johnson, *supra* note 2, at 92.

[39]Murphy, *supra* note 11, at 206.

[40]*Id.*

As corporate entities, PCs are subject to the same entity level tax as regular business corporations.[41] There is an exception, however, for PCs that elect Subchapter S status.[42] Subchapter S status allows a corporation to avoid the entity level tax and receive pass-through taxation.[43] To qualify for S status, a corporation must have seventy-five members or less[44] and no more than one class of stock.[45] To avoid losing subchapter S status, a PC must be careful not to violate the single class of stock requirement when distributing profits to its shareholders.[46] If more than one class of stock is present, a PC will lose its S status and will be subject to an entity level tax.[47]

Although tax incentives were the primary reason for allowing professionals to incorporate,[48] the PC does provide shareholders with some measure of protection from vicarious liability.[49] Under the basic corporate concept of limited liability, shareholders are not personally liable for ordinary business debts of the PC.[50] The PC statute specifically states, however, that vicarious liability for the professional misconduct of fellow shareholders remains.[51]

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[41]Johnson, *supra* note 2, at 139. *See supra* note 26.

[42]Treas. Reg. § 1.1362-1 (1998). "An election may be made only with the consent of all of the shareholders of the corporation at the time of the election." *Id.* The vast majority of law firms operating as PCs are eligible for and elect subchapter S status.

[43]*Id.*

[44]I.R.C. § 1361(b)(1)(A) (1998). Until recently, S-corporations were restricted to 35 members or less.

[45]*Id.* § 1361(b)(1)(D).

[46]Richards, *supra* note 12, at 298. *See* Johnson, *supra* note 2, at 139.

[47]I.R.C. § 1361(a)(2) (1998).

[48]*See supra* text accompanying notes 37-39.

[49]*See infra* text accompanying notes 50-51.

[50]REV. MODEL BUS. CORP. ACT § 6.22 (Supp. 1998).

[51]DEL. CODE ANN. tit. 8, § 608 (Supp. 1998). *Accord* DEL. CT. CODE OF PROFESSIONAL RESPONSIBILITY RULE 67(h)(ii) (1999); First Bank & Trust Co. v. Zagoria, 302 S.E.2d 674 (Ga. 1983) (holding an uninvolved attorney personally liable for the misconduct of his fellow shareholder).

> The professional nature of the law practice and its obligations to the public interest require that each lawyer be civilly responsible for his [or her] professional acts. A lawyer's relationship to his [or her] client is a very special one. So also is the relationship between a lawyer and the other members of his or her firm a special one. 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.

*Id.* at 675.

Despite favorable tax treatment and a greater degree of liability protection, the vast majority of general partnerships never became PCs.[52] Then, in 1981, Congress passed two pieces of legislation that gave partnerships the same tax incentives that had previously been available only to corporate entities.[53] As a result of this legislation, any tax advantage of switching to PCs has largely disappeared.[54] To quote one law review author, "[M]any professionals now practice in PCs in spite of, rather than because of, the tax consequences."[55]

### C. *Limited Liability Company*

The limited liability company (LLC) is, in many ways, a combination of the partnership and corporate forms.[56] The popularity of LLCs exploded after a 1988 tax ruling held that they would receive the same pass-through tax treatment as partnerships.[57] Statutes permitting the use of LLCs were in place in all fifty states by the end of 1996.[58]

Under the LLC form, members get the advantages of limited liability while retaining the tax status and flexibility of the general partnership.[59] To form an LLC, the investors must file articles of organization with the proper state authority.[60] The investors in an LLC are not referred to as "partners" or "shareholders," but rather as "members."[61] LLCs are usually permitted by statute to engage in any lawful business.[62]

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[52]Murphy, *supra* note 11, at 206. This is most likely due to the level of comfort and familiarity most firms felt towards the partnership form. *See supra* text accompanying notes 11-14.

[53]ECONOMIC RECOVERY ACT, Pub. L. No. 97-34, 95 Stat. 172 (1981); TAX EQUITY AND FISCAL RESPONSIBILITY ACT, Pub. L. No. 97-248, 96 Stat. 324 (1982).

[54]*See* Forest J. Bowman, *The Professional Corporation-Has the Death Knell Been Sounded?*, 3 PEPP. L. REV. 515 (1983).

[55]Johnson, *supra* note 2, at 139.

[56]Goforth, *supra* note 15, at 1150; Beth Duncan, *Choice of Entity: Conversion to Limited Liability Partnerships Is Easy, But The Safety Net They Offer Is Only a Partial One*, BNA'S CORP. COUNSEL WEEKLY, Feb. 8, 1995, at 8.

[57]Johnson, *supra* note 2, at 102. In 1988, the IRS authorized a Wyoming LLC to file as a partnership for tax purposes, despite the existence of limited liability for its members. Rev. Rul. 88-76, 1988-2 C.B. 360.

[58]Goforth, *supra* note 15, at 1150.

[59]Johnson, *supra* note 2, at 124; *see* UNIF. LTD. LIAB. CO. ACT § 303, 6A U.L.A. 454 (1995) ("[T]he debts, obligations, and liabilities of a limited liability company, whether arising in contract, tort, or otherwise, are solely the debts, obligations, and liabilities of the company."). *Accord* DEL. CODE ANN. tit. 6, § 18-303 (Supp. 1998).

[60]*See* UNIF. LTD. LIAB. CO. ACT § 202(a), 6A U.L.A. 443 (1995). *Accord* DEL. CODE ANN. tit. 6, § 18-201(a) (Supp. 1998).

[61]*See* UNIF. LTD. LIAB. CO. ACT § 101, 6A U.L.A. 431 (1995). *Accord* DEL. CODE ANN. tit. 6, § 18-101(11) (Supp. 1998) (defining "member").

[62]*See* UNIF. LTD. LIAB. CO. ACT § 112, 6A U.L.A. 425 (1995).

Historically, the primary disadvantage of the LLC was that its formation required the creation of a new business entity.[63] In many states, including Delaware, this is no longer the case.[64] Yet, the mere fact that LLCs are so new has dissuaded many firms from switching.[65]

### D. *Limited Partnership*

The limited partnership form is identical to general partnership in almost all aspects except the liability of partners and control of the partnership.[66] In a limited partnership, there are two types of partners: general partners and limited partners.[67] Status as a general partner in a limited partnership is identical to partnership status in a general partnership.[68] General partners in a limited partnership, just as in a general partnership,[69] are vicariously liable for any and all financial obligations that exceed the wealth of the partnership.[70] Limited partners, however, are not vicariously liable.[71] In the case of financial difficulty, a limited partner only stands to lose his or her interest in the partnership. The personal assets of a limited partner are not exposed.[72] The drawback to limited partner status, however, is that to avoid personal liability, limited partners may not participate in the control of the business.[73]

Although attorneys have been permitted to form limited partnerships for more than a decade, very few have chosen to do so.[74] Perhaps this is because attorneys do not want to relinquish control and yet do not want to be held vicariously liable.[75] With the advent of limited liability partnerships, the number of general partnership law firms will continue to decrease.

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[63]Darryl Van Duch, *Some Firms Hesitate to Adopt L.L.P.*, NAT'L L.J., May 5, 1997, at A1.

[64]*See* DEL. CODE ANN. tit. 6, § 18-214(g) (1997) ("[T]he converting other entity shall not be required to wind up its affairs or pay its liabilities and distribute its assets and the conversion . . . shall constitute a continuation of the existence of the converting other entity . . . .").

[65]"[S]ome issues such as securities law treatment and various tax issues have not been fully dealt with." Goforth, *supra* note 15, at 1152 (footnote omitted).

[66]*See* REV. UNIF. LTD. PARTNERSHIP ACT § 303(a), 6A U.L.A. 1 (1995).

[67]*Id.* § 101, 6A U.L.A. 61. *Accord* DEL. CODE ANN. tit. 6, § 17-101 (Supp. 1998).

[68]REV. UNIF. LTD. PARTNERSHIP ACT § 101, 6A U.L.A. 61 (1995).

[69]*See supra* notes 30-31 and accompanying text.

[70]REV. UNIF. LTD. PARTNERSHIP ACT § 403(b), 6A U.L.A. 177 (1995).

[71]*Id.* § 303(a), 6A U.L.A. 144.

[72]*Id.*

[73]*Id.*

[74]Johnson, *supra* note 2, at 111.

[75]*See supra* notes 69-73 and accompanying text.

### E. *Limited Liability Partnership (LLP)*

#### 1. History

The first LLP statute was enacted in Texas in 1991[76] as an outgrowth of the savings and loan crisis of the 1980s.[77] Texas was hit particularly hard by the bank failures.[78] A significant number of the law suits brought by the Federal Deposit Insurance Corporation (FDIC) and the Resolution Trust Corporation (RTC) were brought against the lawyers and accountants in Texas who had represented the failed financial institutions.[79] Many of Texas' largest and most prestigious law firms found themselves facing financial ruin in the wake of settlements and judgments resulting from the savings and loan crisis.[80]

Under basic partnership principles and Texas law, partners in a law firm are personally liable for any debts that exceed the assets of the firm.[81] Needless to say, massive settlements against some of the state's largest firms sent shockwaves throughout the Texas legal community.[82] There were complaints that professional partnerships should be able to receive the same level of liability protection as corporate entities.[83]

The 1991 LLP legislation was specifically drafted to provide law firms with a greater measure of protection.[84] The Texas legislation was designed to apply to both professional and non-professional partnerships and shields partners from vicarious liability for professional malpractice.[85] 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

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[76]*See* 1991 Tex. Gen. Laws 901, § 84. For a behind the scenes look at the enactment of Texas LLP statute and a detailed discussion of its legislative history, see Robert W. Hamilton, *Registered Limited Liability Partnerships: Present at the Birth (Nearly)*, 66 U. COLO. L. REV. 1065, 1071-74 (1995).

[77]Ronald E. Mallen, *Ethics/Malpractice Issues: The Professional and Ethical Issues Facing the Attorney-Employee*, *in* THE BEST ENTITY FOR DOING THE DEAL 1996, at 993, 995 (PLI Corp. Law & Practice Course Handbook Series No. B-937, 1996).

[78]Hamilton, *supra* note 76, at 1069. Approximately one-third of the savings and loan failures occurred in Texas. *Id.*

[79]*Id.*

[80]For a vivid description of the problems facing one major Dallas law firm, see Hamilton, *supra* note 76, at 1069-71.

[81]*See supra* text accompanying notes 30-31.

[82]Hamilton, *supra* note 76, at 1071.

[83]Bergman, *supra* note 1, at 681.

[84]Mallen, *supra* note 77, at 995.

[85]*See* 1991 Tex. Gen. Laws 901, § 84.

the partnership not working under the supervision or direction" of the partner.[86] The Texas statute, however, did not limit individual liability for a partner's own negligent actions,[87] nor did it eliminate liability for the ordinary business obligations of the partnership.[88]

Soon after the Texas LLP statute was enacted, the IRS issued a ruling that LLPs would be taxed as partnerships.[89] Since then, LLPs have experienced exponential growth.[90] During the first year, more than 1200 law firms adopted LLP status, including many of the state's largest and most prestigious firms.[91] Over the next three years that number jumped to almost 1600.[92] The New York LLP statute, adopted in 1994, achieved a similar level of popularity.[93] Several other states received as many as 2000 applications for LLP status during the first year it was available.[94]

Although the litigation arising out of the savings and loan disaster was the impetus for LLP legislation in Texas,[95] malpractice actions against professional firms are not a new phenomenon.[96] Over the past few years, however, this type of litigation has experienced a marked increase.[97] Both law and accounting firms have been particularly beset.[98] During the one year

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[86]TEX. REV. CIV. STAT. ANN. art. 6132b-3.08(a)(2) (West Supp. 1998).

[87]*Id.* art. 6132b-3.08(a)(2)(A).

[88]*Id.* art. 6132b-3.08(a)(3)(A). It is interesting that the Texas LLP statute provides the inverse of the protection by most PC statutes. 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. *Id.* art. 6132b-3.08(a)(2)(A)-(B). Most PC statutes, on the other hand, provide for the opposite: limited liability for the ordinary business obligations of the entity and unlimited personal liability for the professional malpractice of one's colleagues. *See supra* text accompanying notes 50-51.

[89]Priv. Ltr. Rul. 92-29-016 (Apr. 16, 1992) ("[The] L.L.P. will be classified as a partnership for federal tax purposes.").

[90]Hamilton, *supra* note 76, at 1065.

[91]*Id.* at 1065.

[92]*Id.* at 1065 n.3.

[93]Richards, *supra* note 12, at 283.

[94]Bergman, *supra* note 1, at 682-83.

[95]*See supra* text accompanying notes 76-83.

[96]*See generally* Ronald E. Mallen & Jeffrey M. Smith, *Legal Malpractice* §§ 7.10-7.12 (4th ed. 1996) (discussing privity and negligent misrepresentation).

[97]Johnson, *supra* note 2, at 87.

[98]Massive verdicts and settlements against large and prestigious law firms are becoming increasingly prevalent. *See, e.g.*, *Some Law Firms Were Hit by Massive Suits*, NAT'L L.J., Dec. 26, 1994, at C11 (discussing several large claims and judgments against law firms in 1994, including: an $84 million jury verdict against Keck, Mahin & Cate of Chicago for securities fraud (later reduced to $68 million); a $52 million claim against Shook, Hardy and Bacon, PC, of Kansas City for racketeering; a $25.5 million verdict against Miller, Canfield, Paddock and Stone, PLC, of Detroit for malpractice; a $20 million claim against Milbank, Tweed, Hadley and McCloy of New York for malpractice; a $17.7 million verdict against Vinson & Elkins, LLP, of Houston for malpractice; and a $7.1 million judgment against Baker & McKenzie for sexual harassment (this

span between 1991 and 1992, both the legal and accounting professions faced judgments of nearly $1 billion.[99]

Unfortunately, malpractice insurance cannot alleviate all concerns.[100] Massive verdicts and settlements often exceed a firm's insurance coverage by a substantial amount,[101] thereby exposing often innocent partners to unlimited personal liability.[102] 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.[103] In 1993, the New York firm of Kaye, Scholer, Fierman, Hays & Handler settled a similar $275 million claim for $41 million.[104] Yet this amount still exceeded the available insurance by $16 million.[105] Notably, since both settlement agreements were structured as to allow for installment payments over a period of years, neither resulted in a forced liquidation of the law firm.[106] In addition, insurance does not cover a law firm's inability to meet their ordinary business obligations such as lease agreements.[107]

Due to the concerns over malpractice litigation and inadequate insurance, interest in limited liability for professionals is at an all time high.[108] Although limited liability protection was available to law firms through the LLC, procedural and structuring problems tended to turn lawyers away.[109] In fact some view the LLP as a reaction to prior structuring difficulties of the LLC.[110]

The introduction of LLP legislation in various state legislatures has resulted in a great deal of heated debate.[111] One of the major concerns with the LLP has always been how to deal with an LLP that has several branch

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judgment was later settled)). For a discussion of recent litigation against accountants, see Goforth, *supra* note 15, at 1141.

[99]Lee Berton & Joann S. Lublin, *Seeking Shelter: Partnership Structure is Called in Question as Liability Risk Rises*, WALL ST. J., June 10, 1992, at A1.

[100]Johnson, *supra* note 2, at 88.

[101]*Id.*

[102]*See supra* text accompanying notes 30-31.

[103]Hamilton, *supra* note 76, at 1085 n.52.

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

[105]*See* Sharon Walsh, *Top Lawyers Leave Kaye, Scholer: OTS Lawsuit, Freeze on Assets Send Partners to Other Firms*, WASH. POST, Sept. 19, 1992, at A8.

[106]*See* Hamilton, *supra* note 76, at 1085 n.52.

[107]Johnson, *supra* note 2, at 88. *See, e.g.*, Bergman, *supra* note 1, at 682 (discussing the bankruptcy plan which required the partners of a major law firm to collectively pay more than $40 million over the course of 10 years).

[108]Bergman, *supra* note 1, at 699; Richards, *supra* note 12, at 283.

[109]*See supra* text accompanying note 63.

[110]*Id.*

[111]*See infra* Part II.E.3.

offices in different jurisdictions.[112] It was primarily in an effort to address this concern that LLP statutes spread so rapidly throughout the country.[113] Regardless of their merits, LLP statutes have now been adopted in every state but Vermont.[114]

### 2. Nature and Characteristics of the LLP

The LLP is a business entity[115] that bears a close resemblance to the LLC.[116] Like the LLC, the LLP combines the fundamental aspects of the general partnership with the corporate characteristic of limited liability.[117] 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.[118] Under the original LLP concept as seen in the Texas statute,[119] 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.[120] For example, the LLP may protect partners from misconduct such as securities law violations, broadened Rule 11 sanctions, and malpractice claims, but only when the claim or claims exceed the assets and insurance of a firm.[121]

It is important to remember that the liability protection provided by LLP statutes is personal liability protection rather than liability protection for

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[112]Hamilton, *supra* note 76, at 1074-75. Under Delaware LLP law, LLPs registered in other jurisdictions are not required to register in Delaware, and will be governed subject to the laws of the state in which they are registered. DEL. CODE ANN. tit. 6, § 1547 (Supp. 1999). *See infra* note 181.

[113]Hamilton, *supra* note 76, at 1075.

[114]*See* VT. STAT. ANN. tit. 11, § 1207 (Supp. 1997).

[115]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" (Bergman, *supra* note 1, at 679); as "a general partnership with a few important modifications" (Goforth, *supra* note 15, at 1144); and as "just a form of general partnership" (Duncan, *supra* note 56)). 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" (*Johnson*, supra note 2, at 106) and as "the most radical departure yet" from accepted partnership liability principles (Murphy, *supra* note 11, at 201).

[116]*See supra* Part II.C. Second generation LLP statutes are becoming more and more like LLCs. Hamilton, *supra* note 76, at 1066, 1095. *See infra* text accompanying notes 133-37.

[117]Johnson, *supra* note 2, at 106.

[118]*Id.* at 109.

[119]TEX. REV. CIV. STAT. ANN. art. 6132b-3.08 (Supp. 1998).

[120]*See id.*; Hamilton, *supra* note 76, at 1067.

[121]Bergman, *supra* note 1, at 679.

the firm itself.[122] As with corporate entities, a partner's interest in the LLP itself is not protected.[123] The so-called "shield of limited liability" only comes into play after the firm assets have been dissolved.[124]

Because of the rapid spread of LLPs,[125] the state statutes governing them often differ substantially.[126] The most important difference is in the area of liability protection.[127] Legal scholarship has divided LLP statutes into two groups: first generation statutes and second generation statutes.[128] LLP statutes fit into one of these two categories based on the types of vicarious liability for which they offer protection.[129]

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.[130] First generation statutes do nothing, however, to alter a partner's liability for any ordinary business debts of the partnership.[131] The Texas LLP statute is a typical first generation statute.[132]

Second generation statutes create a much greater shield from liability than do first generation statutes.[133] Because the first generation statutes do not provide liability protection from ordinary business transactions, they are not fully "bullet-proof."[134] In 1994, however, Minnesota passed an LLP statute that did grant liability protection from ordinary business debts.[135] Since then, all but eight of the forty-nine states that have enacted LLP statutes have followed suit.[136] Under these second generation statutes,

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[122]*See infra* text accompanying notes 123-24.

[123]Richards, *supra* note 12, at 284.

[124]Hamilton, *supra* note 76, at 1076-77. The liability protection of the LLP has been referred to as "death insurance" for innocent partners because it only comes into play upon the collapse of the firm. *Id.* (citing Bart Ziegler, *Top Accountants to Shield Partners from Lawsuits*, WALL ST. J., July 29, 1994, at C15).

[125]*See supra* text accompanying notes 90-94.

[126]Johnson, *supra* note 2, at 107.

[127]*See id.* at 107-110.

[128]*See* Goforth, *supra* note 15, at 1153-54.

[129]*Id.*

[130]*Id.* at 1153.

[131]*Id.*

[132]Goforth, *supra* note 15, at 1153. *See* TEX. REV. CIV. STAT. ANN. art. 6132b, § 15 (Supp. 1998).

[133]Hamilton, *supra* note 76, at 1087.

[134]*See* Goforth, *supra* note 15, at 1153.

[135]*See* MINN. STAT. ANN. § 323.14 (West 1995).

[136]The eight states that continue to have first generation statutes are: Arizona, Iowa, Louisiana, North Carolina, Pennsylvania, South Carolina, Texas, and Utah. *See* ARIZ. REV. STAT. ANN. § 29-215 (West 1998); IOWA CODE ANN. § 486.15 (West Supp. 1998); LA. REV. STAT. ANN. § 9.3431 (West Supp. 1998); N.C. GEN. STAT. § 59-45 (Supp. 1997); 15 PA. CONS. STAT. ANN. § 8204 (West. Supp. 1998); S.C. CODE ANN. § 33-41-370 (Law. Co-op. Supp. 1996); TEX. REV.

partners are shielded from all entity-level debt.[137] 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.[138] This stems in part from ABA ethical requirements that dictate that lawyers must remain individually liable for their own conduct.[139] 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.[140]

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.[141] 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.[142] State LLP statutes often vary or are ambiguous as to whether supervisors who were not negligent in their supervision may be found personally liable.[143] Some states do not provide for any form of supervisor liability.[144]

Other than restrictions that may exist on the use of LLPs by non-professionals,[145] the LLP is simple and user-friendly, both procedurally and structurally.[146] The transition from general partnership to LLP status is easy, and can be accomplished with a minimal amount of paperwork and

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CIV. STAT. ANN. art. 6132b, § 15 (West Supp. 1998); UTAH CODE ANN. § 48-1-12 (Supp. 1998). The National Conference of Commissioners on Uniform State Laws has recommended that all states adopt second generation LLP statutes and become "full-shield" jurisdictions. Van Duch, *supra* note 63, at A1.

[137]Goforth, *supra* note 15, at 1153.

[138]Johnson, *supra* note 2, at 91.

[139]MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.8(h) (1996).

[140]RESTATEMENT (SECOND) OF AGENCY § 343 (1958). *See* Johnson, *supra* note 2, at 91.

[141]DEL. CODE ANN. tit. 6, § 1515(c) (Supp. 1998).

[142]Johnson, *supra* note 2, at 113.

[143]*See, e.g.*, S.C. CODE ANN. § 33-41-370(D) (Law. Co-op. Supp. 1996) (limiting liability to situations where supervisor was "at fault" in supervising).

[144]*See, e.g.*, COLO. REV. STAT. ANN. § 7-60-115(2)(a) (West Supp. 1997); GA. CODE ANN. § 14-8-15(c) (Supp. 1998); IND. CODE ANN. § 23-4-1-15(3) (Michie Supp. 1997); KY. REV. STAT. ANN. art. § 362.220 (Banks-Baldwin Supp. 1997); LA. REV. STAT. ANN. § 9.3431 (West Supp. 1998); UTAH CODE ANN. § 48-1-12 (1998).

[145]*See* Johnson, *supra* note 2, at 107; Bergman, *supra* note 1, at 680 (noting statutes allow veterinarians, doctors, dentists, accountants, lawyers, and corporate joint ventures to take advantage of the LLP form).

[146]*See infra* notes 147-54 and accompanying text.

expense.[147] Firms must simply file an application, satisfy the minimum capital requirement, and pay the registration fee.[148] Partnership agreements do not have to be rewritten, nor is it necessary to form a governing board.[149] Registration is often good for one year,[150] and LLPs must frequently re-register every year.[151]

There is often a minimum capital requirement for LLPs that varies by jurisdiction.[152] Firms typically satisfy this requirement by maintaining an insurance policy that covers professional malpractice claims.[153] 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.[154]

LLPs, just like general partnerships, are directly managed by the partner owners, unless otherwise agreed.[155] Consequently, each partner in an LLP maintains the power to bind the partnership, unless the default rule is altered.[156] In addition, termination of an LLP is an important issue to address when drafting the LLP agreement,[157] as LLPs can be dissolved with relative ease unless modified by agreement.[158]

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[147]Duncan, *supra* note 56. *See also* Mallen, *supra* note 77, at 1000 (claiming that the transition to an LLP is much easier than the transition to an LLC); Bergman, *supra* note 1, at 680 (same); Johnson, *supra* note 2, at 136 (noting the conversion to an LLP is subject to relatively few regulatory requirements).

[148]Goforth, *supra* note 15, at 1145-47. For specific requirements in Delaware, see infra notes 187-89 and accompanying text.

[149]Larry Smith, *LLPs: Politically, a Ripe Time For Firms to Act*, OF COUNS., Aug. 16, 1993, at 2, 2.

[150]Martin I. Lubaroff, *Registered Limited Liability Partnerships — The Next Wave*, INSIGHTS, May 1994, at 23, 27.

[151]*See, e.g.*, DEL. CODE ANN. tit. 6, § 1544(e) (Supp. 1998).

[152]Goforth, *supra* note 2, at 1146. The minimum capital requirement in Texas is only $100,000. TEX. REV. CIV. STAT. ANN. art. 6132b-3.08(d) (Supp. 1999). It has been kept low intentionally so that smaller firms would be able to make use of the LLP without difficulty. Hamilton, *supra* note 76, at 1076. In most states, the minimum requirement is $1 million. *See, e.g.*, DEL. CODE ANN. tit. 6, § 1546(a) (Supp. 1998). Note that some states do not have any minimum capital requirement. *See, e.g.*, LA. REV. STAT. ANN. § 9.3435 (1997).

[153]Goforth, *supra* note 15, at 1146-47.

[154]*Id.*

[155]Larry E. Ribstein, *Possible Futures For Unincorporated Firms*, 64 U. CIN. L. REV. 319, 334 (1996). *See* UNIF. PARTNERSHIP ACT § 18, 6 U.L.A. 125 (1995). *Accord* DEL. CODE ANN. tit. 6, § 1518 (Supp. 1998).

[156]Ribstein, *supra* note 155, at 324. *See* UNIF. PARTNERSHIP ACT § 9, 6 U.L.A. 125 (1995). *Accord* DEL. CODE ANN. tit. 6, § 1509 (Supp. 1998).

[157]*See* Richards, *supra* note 12, at 300.

[158]Subject to any agreement between the parties, a partnership or LLP may be terminated by any one of the following events: (1) the termination of the definite term or particular undertaking specified in the agreement; (2) the express will of any partner when no definite term or particular undertaking is specified; (3) the express will of all the partners who have not assigned their interests;

### 3. Public Policy Considerations of the LLP

The LLP was created because of concerns about the fundamental fairness of unlimited personal liability for the actions of one's partners.[159] Logically, it seems harsh to punish one partner for the acts of another that he or she may not even know.[160] 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.[161]

A great deal of ink has been spilled over the past few years in attempting to determine the value of the LLP.[162] Valid concerns have been raised by both sides. Those in favor of LLPs stress the fact that law firms today are structurally much different than they were even a generation ago.[163] These firms are becoming increasingly larger in size, and are consequently becoming more difficult to effectively monitor.[164] The theory of joint and severable liability certainly does not seem as realistic in the modern law firm setting as it once did.[165] 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.[166]

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(4) the bona fide expulsion of any partner from the business; (5) the death or bankruptcy of any partner; and (6) court ordered dissolution. UNIF. PARTNERSHIP ACT § 31, 6 U.L.A. 771 (1995). *Accord* DEL. CODE ANN. tit. 6, § 1531 (Supp. 1998).

[159]*See supra* text accompanying notes 160-61.

[160]Hamilton, *supra* note 76, at 1102.

[161]Goforth, *supra* note 15, at 1159, 1170.

[162]*See generally* Bergman, *supra* note 1, at 699-700 (stating that states should embrace LLPs to limit expanding liability, but warning against the potential suspicion that may occur in clients); Goforth, *supra* note 15, at 1221 (stating that LLPs help alleviate the unfairness of unlimited partner liability, but have also created confusion); Hamilton, *supra* note 76, at 1103 (stating that current LLP statutes being enacted are unnecessarily reversing the traditional rules of unlimited liability and will bolster the growing mistrust of the legal profession); Johnson, *supra* note 2, at 145 (claiming that law firms can achieve a number of benefits from LLP status, but risk a potentially divisive impact on the law firms' internal dynamics); Murphy, *supra* note 11, at 233 (claiming that law firms with LLP status create a severe public cost, namely, clients' inability to recover for and prevent legal malpractice); Terrence A. Oved, *New York State Limited Liability Partnerships*, 67 N.Y. ST. B.J., Mar.-Apr. 1995, at 38, 73 (arguing that LLPs create tax advantages and liability limitations that make it the best form of organization for business professionals); Ribstein, *supra* note 155, at 367 (stating that LLPs "are appropriate for different types of firms for transaction cost or regulatory reasons"); Richards, *supra* note 12, at 308-09 (claiming LLPs eliminate the unfairness of unlimited personal liability that partners were subject to in traditional partnership agreements).

[163]*See* Lubaroff, *supra* note 150, at 23.

[164]*See* Goforth, *supra* note 15, at 1159.

[165]*See* Richards, *supra* note 12, at 305.

[166]Bergman, *supra* note 1, at 694.

Scholars in opposition to the LLP believe that innocent unsophisticated clients will be adversely affected.[167] It can be argued that attorneys, and not the client or consumer, should bear the real economic cost of their business.[168] This is because attorneys are in a better position to prevent malpractice from occurring in the future, so it is most efficient for attorneys to bear the financial risk.[169]

In addition to asserting their own position, opponents of LLPs have vigorously attacked proponents' attempts to support LLPs.[170] In particular, they address the concern over the fundamental unfairness in allowing unlimited personal liability for innocent partners in the multi-office large firm environment.[171] One commentator points out that not all LLPs are large, indicating that it is not impossible to effectively monitor the activity of fellow partners in today's firm environment.[172] Interestingly, the author also asserts that if large firms are unable to effectively monitor the activity of its attorneys to such a degree that the partners feel comfortable with the notion of unlimited personal lability, then perhaps the existence of those firms contravene public policy.[173] Thus, these firms should be eliminated altogether and the partners should not be seen as sympathetic victims.[174] Furthermore, the resources of large firms may actually make it easier to monitor attorney activity.[175]

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[167]For instance, one such scholar writes:

> 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.

Hamilton, *supra* note 76, at 1094. Another scholar writes:

> 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.

Goforth, *supra* note 15, at 1186.

[168]*See* Murphy, *supra* note 11, at 230.

[169]*See id.* at 223-28.

[170]*See infra* text accompanying notes 171-73.

[171]*See infra* text accompanying notes 172-73.

[172]Murphy, *supra* note 11, at 221.

[173]*Id.*

[174]*Id.*

[175]*Id.*

## III. DELAWARE'S LLP STATUTE

In August of 1993, following a very brief approval process, Delaware became the third state to enact an LLP statute.[176] The Delaware statute did not place any restrictions on the use of LLPs by nonprofessional firms, as some states have done.[177] It did, however, make the use of LLPs by attorneys subject to approval by the Delaware Supreme Court.[178] In Delaware, attorneys have always been restricted by the Delaware Supreme Court Rules to practicing law in specific business forms.[179] In the spring of 1997 the Rules were amended to permit attorneys to practice law in Delaware under the LLP form.[180]

### A. *Provisions of the Delaware LLP Statute*

In Delaware, an LLP is formed by filing an application with the Office of the Secretary of State.[181] The application must be executed by a "majority in interest of the partners or by [one] or more partners authorized to execute an application"[182] 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."[183] The application must also be accompanied by a

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[176]Smith, *supra* note 149, at 2. The "big six" accounting firms were a major force driving the initiation of LLP legislation in Delaware, and in 1994, three of the "big six" firms decided to become LLPs under Delaware law. *See* Hamilton, *supra* note 76, at 1066-67; Mallen, *supra* note 77, at 995.

[177]*See* DEL. CODE ANN. tit. 6, ch. 15 (Supp. 1998).

[178]DEL.CODE ANN. tit. 6, § 1515(d) (Supp. 1998). "The ability of an attorney-at-law, admitted to the practice of law in Delaware, to practice law in a registered limited liability partnership, shall be determined by the Rules of the Supreme Court of this State." *Id.* According to one legal author, "this caveat reflect[ed] [the] apparent tendency among lawmakers to be very careful when it comes to lessening the load of legal practitioners." Smith, *supra* note 149, at 2.

[179]*See* DEL. CT. CODE OF PROFESSIONAL RESPONSIBILITY RULE 67 (1999).

[180]This amendment became effective May 1, 1997. *Id.*

[181]DEL. CODE ANN. tit. 6, § 1544(a) (Supp. 1998). Foreign registered LLPs are not required to register with the Secretary of State's Office. *Id.* § 1547(c). Foreign registered LLP law firms, however, must register with the Delaware Supreme Court. The following out-of-state firms with Delaware branch offices have registered in this manner: McCarter & English of New Jersey; Skadden, Arps, Slate, Meagher & Flom of New York; Blank, Rome, Comisky & McCauley of Philadelphia; Duane, Morris & Heckscher of Philadelphia; Klehr, Harrison, Harvey, Branzburg & Ellers of Philadelphia; Pepper Hamilton of Philadelphia; Saul, Ewing, Remick & Saul of Philadelphia; and Wolf, Block, Schorr & Solis-Cohen of Philadelphia. Martindale-Hubbel Lawyer Locator (visited Aug. 8, 1998) <http://lawyers.martindale.com.marh>.

[182]DEL. CODE ANN. tit. 6, § 1544(b) (Supp. 1998).

[183]*Id.* § 1544(a).

registration fee of $100 for each partner.[184] In addition, the partnership name must contain the words "Registered Limited Liability Partnership" or the abbreviation "L.L.P."[185] Registration is good for one year and may be renewed by the filing of an application for renewal.[186]

Delaware's LLP statute also contains a minimum insurance requirement.[187] 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,"[188] or show that it has set aside the same amount of funds for the purpose of satisfying of judgments against the partnership.[189]

With regard to liability protection, Delaware is a full shield jurisdiction[190] and provides protection typical of second generation statutes.[191] 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.[192] This liability protection further extends to any potential indirect liability "by way of indemnification, contribution, assessment or otherwise."[193] 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.[194] Furthermore, partners will not be personally liable for the ordinary business obligations of the firm, such as leases and guarantees.[195]

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[184] *Id.* § 1544(c). Under the 1997 amendment to § 1544(c), "in no event shall the fee payable for any year with respect to a registered limited liability partnership under this section be more than $120,000." *Id.*

[185] *Id.* § 1545.

[186] DEL. CODE ANN. tit. 6, § 1544(e) (Supp. 1998).

[187] *Id.* § 1546(a).

[188] *Id.*

[189] *Id.* § 1546(d).

[190] *See* DEL. CODE ANN. tit. 6, § 1515(b) (Supp. 1998).

[191] *See supra* text accompanying notes 133-37.

[192] DEL. CODE ANN. tit. 6, § 1515(b) (Supp. 1998).

[193] *Id. See also* Hamilton, *supra* note 76, at 1077-78 (describing contribution and indemnification claims).

[194] For a discussion of what constitutes "direct supervision and control," see *infra* Part III.B.1.

[195] DEL. CODE ANN. tit. 6, § 1515(b) (Supp. 1998).

### B. *Issues Unresolved Under the Delaware Statute*

Several important issues regarding aspects of liability protection remain unresolved under Delaware's LLP statute.

#### 1. Supervisor Liability

The Delaware statute states that partners of an LLP remain personally liable for the negligence or misconduct of those under their "direct supervision and control."[196] 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.[197]

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.[198] 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.[199]

#### 2. Prior Contractual Obligations and Misconduct

The next uncertainty is whether 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*."[200] This language creates an issue, however, as to whether

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[196]*See id.*

[197]*Id.*

[198]Lubaroff, *supra* note 150, at 25.

[199]*Id.*

[200]DEL. CODE ANN. tit. 6, § 1515(b) (Supp. 1998) (emphasis added).

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 firms 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.[201] 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.[202] 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.

### 3. Sufficient Notice

A third 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.[203] 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.[204] 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

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[201]Goforth, *supra* note 15, at 1184. "Numerous public policy arguments can be made that it would be unfair to allow partners in an LLP to cut off the personal liability on which creditors... may have relied. Moreover, it may violate principles of freedom of contract if the LLP legislation is interpreted as retroactively changing the terms of [a] pre-existing contract." *Id.* at 1183.

[202]A partner is not personally liable for obligations "incurred while the partnership is a limited liability partnership." MINN. STAT. ANN. § 323A.3-06 (West Supp. 1998). The statute goes on to clarify that "[a]ll debts and obligations under or relating to a note, contract, or other agreement are incurred when the note, contract, or other agreement is entered into." *Id.*

[203]*See, e.g.*, Conner v. Steel, Inc., 470 P.2d 71 (Colo. Ct. App. 1970); Hill & Co. v. O'Malley, 817 P.2d 660 (Kan. Ct. App. 1991); Guynn v. Brondum, 63 So.2d 821 (Miss. 1953); Horizon Hobby Distribs. v. Gurriero, 613 N.Y.S.2d 550 (N.Y. Sup. Ct. 1994); Mulkey v. Anglin, 25 P.2d 778 (Okla. 1933); Philip Lithographing Co. v. Babich, 135 N.W.2d 343 (Wis. 1965).

[204]*Philip Lithographing*, 135 N.W.2d at 344.

adequate notice? In several cases, the addition of "Inc." to a new entity's name was not sufficient notice to a creditor.[205] Similarly, in other cases, the filing of a certificate of assumed name[206] or even a certificate of incorporation[207] 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.[208]

### C. *Concerns*

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.[209] Many are particularly wary of the relative newness and uncertainty of the entity.[210] They believe that firms should not switch until any unforeseen ambiguities that may arise are resolved.[211] In particular, critics cite ambiguities over the scope of supervisory liability under the LLP statute.[212]

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.[213] Even in situations where the LLP statute may be unclear, as in the area of supervisor liability,[214] a look at common law principles should make it possible to determine the basic standard to be imposed.[215] 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.

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[205]*Conner*, 470 P.2d at 73; *Hill & Co.*, 817 P.2d at 663; *Guynn*, 63 So.2d at 823; *Philip Lithographing*, 135 N.W.2d at 345.

[206]*Horizon Hobby Distribs.*, 613 N.Y.S.2d at 551.

[207]*Mulkey*, 25 P.2d at 780.

[208]For an examination of a clients likely reaction to such a letter, see *infra* notes 216-18 and accompanying text.

[209]*See generally* Murphy, *supra* note 11 (discussing the cost to society posed by the LLP).

[210]*Id.* at 202.

[211]*See* Oved, *supra* note 162, at 41 (discussing various points of uncertainty).

[212]*See supra* Part III.B.1. "It is not hard to imagine that anyone seeking to formulate a claim against an LLP would argue for as broad a definition" as possible. Oved, *supra* note 162, at 41.

[213]*See supra* text accompanying note 118.

[214]*See supra* Part III.B.1.

[215]*Id.*

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.[216] 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.[217] 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 favorably.[218]

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.[219] 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.[220] 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 behavior of their partners can't be trusted under any circumstances."[221]

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.[222] Some areas of the law, such as complex corporate transactions and securities regulation, pose a heightened risk for professional malpractice.[223] Yet, it is often these same areas that are the most financially lucrative for a law firm.[224] Before the advent of limited liability, all partners shared in both the risks as well as the financial benefit of high risk practices.[225] The LLP has somewhat altered this scenario by potentially

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[216]"[C]lients may look askance at any rush by their lawyers to shield themselves behind an LLP." Milo Geyelin, *Lawyers are Moving to Protect Own Assets in Case of a Suit*, WALL ST. J., Sept 2, 1994, at B3.

[217]*See* Oved, *supra* note 162, at 41. Young, Conaway, Stargatt & Taylor LLP does not expect a unfavorable reaction from their clients. Interview with Joseph M. Nicholson, *supra* note 8.

[218]Oved, *supra* note 162, at 41. Clients "are used to seeing unintelligible initials after lawyers' names. . . . From the clients perception, the view may be 'if my lawyer's protecting him/herself, he/she'll probably do a good job protecting me.'" *Id.*

[219]*See* Murphy, *supra* note 11, at 215.

[220]Richards, *supra* note 12, at 296. Practicing in the LLP form "does not preclude the possibility that a malpractice claim could wipe out a partners' interest in the partnership." *Id.*

[221]Smith, *supra* note 149, at 3.

[222]Johnson, *supra* note 2, at 139-40.

[223]Oved, *supra* note 162, at 40. The practice of law in highly regulated areas such as securities law tends to be risky due to a combination of complexity and severe statutory penalties for violations. Johnson, *supra* note 2, at 140.

[224]Johnson, *supra* note 2, at 140.

[225]*See supra* text accompanying notes 30-31.

decreasing the risk of vicarious liability for the partners who do not personally participate in high risk practice areas.[226] 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.[227] Similar concerns may be raised by partners who supervise more than others.[228]

### D. *LLP v. Other Business Forms Available to Delaware Attorneys*

The fact that there are several valid criticisms of the LLP does not significantly detract from the value of the entity compared to most firms. And, although the LLP may not be suitable for all Delaware firms, the majority stand to benefit substantially from this entity.

#### 1. Liability Protection and Pass-Through Taxation

The Delaware LLP essentially offers the best aspects of every business entity combined into one.[229] It offers personal liability protection from all entity level debts,[230] while at the same time allowing pass-through taxation.[231] Although this is the same protection and treatment offered by an LLC,[232] it is substantially greater with respect to all other business forms.[233] The PC 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.[234] Although limited partnerships allow limited partners to take advantage of limited liability, general partners remain personally liable for all partnership debt.[235] General partnership, needless to say, offers no form of liability protection.[236]

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[226]*See supra* text accompanying notes 191-94.

[227]Johnson, *supra* note 2, at 140.

[228]*See* Ribstein, *supra* note 155, at 330-32.

[229]*See infra* text accompanying notes 230-42.

[230]*See supra* text accompanying notes 190-95.

[231]*See supra* text accompanying notes 23-26.

[232]*See supra* text accompanying note 59.

[233]*See infra* text accompanying notes 234-36.

[234]*See supra* text accompanying notes 49-51. In addition if a PC firm does not qualify as an S-corporation under I.R.C. § 1361(b)(1), it will not be subject to pass-through taxation. *Id.*

[235]*See supra* text accompanying notes 68-70.

[236]*See supra* text accompanying notes 30-31.

### 2. Procedural and Structural Flexibility

The Delaware LLP also offers a great deal of procedural and structural flexibility.[237] This includes significant freedom with regards to profit sharing, as well as structural flexibility.[238] This flexibility may not be greater than that provided by the general partnership,[239] but it is significant compared to other forms.[240] PCs are highly restricted in their manner of profit sharing,[241] and under the limited partnership form, limited partners may not participate in control of the business.[242]

## IV. CONCLUSION

The potential problems voiced by critics of the LLP certainly warrant consideration by any firm that is contemplating the adoption of LLP status. No entity is a perfect fit with every firm, and many factors should be considered.[243] Yet, even in light of this, LLP status will greatly benefit the vast majority of Delaware firms that have not yet become LLPs. Texas' legal community has been universally satisfied with the LLP structure for almost seven years, and no complaints have been voiced.[244] The problems cited by critics are not only unlikely to occur on a regular basis, but also are not relevant to, and may not even affect, most firms. Although LLP status may not comport with the goals of all Delaware firms, the majority have nothing to lose and a great deal to gain.

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[237]*See infra* text accompanying notes 238-39.
[238]*See supra* text accompanying notes 27-29.
[239]*Id.*
[240]*See infra* text accompanying notes 241-42.
[241]*See supra* text accompanying notes 41-47.
[242]*See* text accompanying note 81.
[243]Lubaroff, *supra* note 150, at 29.
[244]Oved, *supra* note 162, at 73.