COMMENTS

The Professional Liability Crisis and the Need for Professional Limited Liability Companies: Washington's Model Approach

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> Litigation and its threat have begun to metastasize to virtually every sector of the economy. Retailers sue manufacturers, franchisees sue franchisers, commercial tenants sue office and mall developers, and everyone sues accountants.[1]

> People never used to sue lawyers, just doctors . . . . But (now) they are suing lawyers.[2]

> Ambulance chasers used to be confined to automobile accidents[.] Now . . . business accidents are a lot more valuable.[3]

I. INTRODUCTION

There is currently a crisis in this country,[4] involving the liability of professionals—lawyers and accountants in particular[5]—to clients,

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1. WALTER K. OLSON, THE LITIGATION EXPLOSION 7 (1991).

2. L.M. Sixel, *Limited Liability Shelters Business Partners*, THE HOUS. CHRON., Apr. 26, 1992, at Business 1.

3. David C. Walters, *Liability Crisis Threatens Auditors*, CHRISTIAN SCI. MONITOR, Dec. 28, 1992, at Economy 9.

4. *See* Thomas McCarrol, *Who's Counting*, TIME, Apr. 13, 1992, at 48 ("[T]he accounting profession is facing the most serious liability crisis in its history."); *see generally* OLSON, *supra* note 1, at 317-24.

5. This Comment is limited to the discussion of issues relating to lawyers and accountants. These two professions have been in the limelight of late because of the voluminous amount of litigation against them. Although doctors are also currently being sued at an alarming rate, the issues raised there are extremely different from those raised by lawyers and accountants, as the injuries in a medical malpractice case are generally physical in nature, while lawyers and accountants (usually) only cause financial injury when they are negligent.

investors, and regulators. Professionals are being subjected to lawsuits at an alarming rate,[6] a large proportion of which have sprung out of the savings and loan debacle.[7] Although some of the litigation is justified, many of the suits are warrantless wastes of precious judicial resources.[8]

The accounting profession has been hit the hardest by the outbreak in lawsuits,[9] but lawyers are quickly becoming targets as well.[10] The litigation trend has already had several detrimental effects upon the accounting profession,[11] including exorbitant increases in insurance costs, cutbacks by firms in high risk areas, and failures of national accounting firms.[12] These same consequences will fall upon the attorneys in this country if something is not done to change the current system.

Several remedies are available to solve this problem, including reform of the joint and several liability standard[13] and reinstatement

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6. *See* McCarrol, *supra* note 4, at 48 (discussing litigation against accountants); Alison L. Cowan, *Settlements Alarming Auditors and Lawyers*, N.Y. TIMES, Apr. 1, 1992, at D5 (discussing lawsuits against lawyers and accountants).

7. McCarrol, *supra* note 4, at 48 (noting that roughly two thirds of recent litigation stems from the Savings and Loan scandal).

8. For example, Rule 10b-5, *see infra* notes 71-76 and accompanying text, is often used by investors to hedge against investment loss. *See* 138 CONG. REC. S12,599 (daily ed. Aug. 12, 1992) (statements of Sen. Domenici); 138 CONG. REC. E2463 (daily ed. Aug. 12, 1992) (statements of Rep. Tauzin); *see also* Greenfield v. U.S. Healthcare, 146 F.R.D. 118 (E.D. Pa.) (sanctioning plaintiffs for litigation abuses), *aff'd*, 22 F.3d 1274 (3d. Cir. 1993); Kennedy v. Josephenthal, & Co., 635 F. Supp. 399, 405 (D. Mass. 1985) (sanctioning plaintiff's attorney for bringing needless litigation), *aff'd*, 814 F.2d 798 (1st Cir. 1987).

9. *See* Norman B. Arnhoff, *Professional Liability of Accountants*, N.Y. L.J., Jan. 11, 1990, at 1, 2.

10. *See* Andrew Leigh, *Now It's the Lawyers Getting Hit With Liability Suits*, INVESTOR'S DAILY, Mar. 19, 1992, at 10. Although this Comment focuses upon the problems with excessive litigation arising against attorneys involved in banking and securities law, attorneys practicing in other fields are not immune from the problems discussed here. First, *all* attorneys in a partnership are personally liable for the negligent act of one lawyer representing a bank or corporation that proposes a stock offering. Most firms that practice in banking and corporate law also have attorneys engaged in other legal fields, all of whom will feel the bite of a lawsuit against one of their partners. Second, malpractice suits are prevalent in all areas of the law. *See, e.g.*, OLSON, *supra* note 1, at 317-24. Lawsuits against attorneys arising from the savings and loan debacle and securities transactions are merely two examples of areas where litigation has risen to new heights in recent years.

11. *See* Arthur Anderson & Co. et al., *Liability Crisis in the United States: Impact on the Accounting Profession*, J. ACCT., Nov. 1992, at 19 [hereinafter Arthur Andersen].

12. *See infra* Part III.

13. *See generally* J.D. LEE & BARRY A. LINDAHL, MODERN TORT LAW: LIABILITY AND LITIGATION §§ 19.01-.08 (rev. ed. 1988) (discussing joint and several liability standard); *see also* ARNOLD S. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10B-5 § 260.03[j] (2d. edition 1992).

of the privity requirement regarding audited financial statements.[14] However, this Comment focuses upon the need for a change in the status quo of unlimited liability of professionals through use of the partnership entity,[15] which mandates that each partner's interest in the partnership and her personal assets be available to creditors.[16]

A new entity, the limited liability company (LLC), provides an answer to the unlimited liability problem of professionals. First introduced in Wyoming in 1977,[17] LLC legislation has been codified in forty-eight states (including the District of Columbia),[18] and is being considered by each remaining state in one form or another.[19] Washington passed its LLC statute in April, 1994, and it became effective on October 1, 1994.[20]

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14. Traditionally, an accountant was liable only to those with whom she was in "privity" of contract, or any known beneficiary at the time of the undertaking. *See* Ultramares v. Touche, 174 N.E. 441 (N.Y. 1931). However, in many jurisdictions this doctrine has been eliminated. *See, e.g.*, Rosenblum, Inc. v. Adler, 461 A.2d 138 (N.J. 1983).

15. Most firms currently practice in either partnership or sole proprietorship form. *See* 1 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, LIMITED LIABILITY COMPANIES § 15.05, at 15-6 n.20 (1992).

16. UNIF. PARTNERSHIP ACT § 15 (1914).

17. Act of March 4, 1977, ch. 155, 1977 Wyo. Sess. Laws 512. The Wyoming Act is now codified at WYO. STAT. §§ 17-15-101 to -143 (Supp. 1994).

18. ALA. CODE § 10-12 (Supp. 1994); ALASKA STAT. § 10.50 (Supp. 1994); ARIZ. REV. STAT. ANN. §§ 29-601 to -847 (Supp. 1994); ARK. CODE ANN. § 4-32 (Michie Supp. 1993); 1994 Cal. Adv. Legis. Serv. 1200 (Deering); COLO. REV. STAT. § 7-80 (1994); 1993 Conn. Pub. Acts 267 (Reg. Sess.); DEL. CODE ANN. tit. 6, § 18 (1993); 1994 D.C. Stat. 138; FLA. STAT. ch. 608.401-.514 (West 1993 & Supp. 1995); GA. CODE ANN. § 14-11 (Supp. 1994); IDAHO CODE §§ 53-601 to -672 (Supp. 1993); ILL. COMP. STAT. ANN. ch. 805, act 180 (Smith-Hurd Supp. 1995); IND. CODE § 23-18 (Michie Supp. 1994); IOWA CODE ANN. § 490A (West Supp. 1993); KAN. STAT. ANN. § 17-7601 to -7652 (Supp. 1993); KY. REV. STAT. ANN. § 275 (Michie/-Bobbs-Merrill 1994); LA. REV. STAT. ANN. §§ 12:1301-1369 (West 1994); ME. REV. STAT. ANN. tit. 31, §§ 601-762 (West 1994); MD. CODE ANN., CORPS. & ASS'NS § 4A (Supp. 1994); MICH. COMP. LAWS ANN. §§ 450.4101-.5200 (West 1994-95); MINN. STAT. § 322B (1993); 1994 Miss. Laws 402; MO. ANN. STAT. § 347.010-.187 (Vernon Supp. 1994); MONT. CODE ANN. § 35-8 (1993); NEB. REV. STAT. § 21-26 (Supp. 1993); NEV. REV. STAT. § 86 (1993); N.H. REV. STAT. ANN. § 304-C (Supp. 1993); N.J. REV. STAT. § 42:2B (West 1994); N.M. STAT. ANN. § 53-19 (Michie Supp. 1993); N.Y. LIM. LIAB. CO. LAW (1994); N.C. GEN. STAT. § 57C (1993); N.D. CENT. CODE § 10-32 (Supp. 1993); OHIO REV. CODE ANN. § 1705 (Anderson 1992); OKLA. STAT. tit. 18, § 2000-2060 (West 1994); OR. REV. STAT. § 63 (1993); 1994 Pa. Laws 106; R.I. GEN. LAWS § 7-16 (1993); 1994 S.C. Acts 448; S.D. CODIFIED LAWS ANN. § 47-34 (Supp. 1994); TENN. CODE ANN. § 48-201 to -248 (1994); TEX. REV. CIV. STAT. ANN. art. 1528n (Supp. 1994); UTAH CODE ANN. § 48-2b (Supp. 1994); VA. CODE ANN. § 13.1-1000 to -1073 (Michie 1993); WASH. REV. CODE § 25.15 (1994); W. VA. CODE § 31-1(A) (Supp. 1994); WIS. STAT. ANN. §§ 183.0102-.1305 (West 1994); WYO. STAT. § 17-15 (Supp. 1994).

19. *See* John Cunningham, *The New Era in Corporate Law: New N.H. Business Organization Law is an Option Many have to Consider*, N.H. BUS. REV., July 23, 1993, at 2.

20. WASH. REV. CODE § 25.15 (1994).

Of the states that have enacted LLC statutes, thirty-nine have specifically provided for professionals within the legislation, including Washington. At this time, three states prohibit professionals from becoming LLCs (including California and Oregon),[21] thirty-six allow them to do so,[22] and the remainder of the states omit any mention of use by professionals.[23]

This Comment argues that every state should allow professionals to take advantage of LLC statutes, as Washington has done. Such action will provide protection for accountants and lawyers from the wave of litigation that has surfaced in recent times and to restore an element of confidence to these professions. This Comment further asserts that allowing professionals to use LLC statutes is not only consistent with the duties peculiar to the accounting and legal professions, but also a *necessary* step when viewed in light of the policies of fairness, efficiency, and public protection.

Initially, Part II of this Comment describes the litigation crisis in this country and the sources of and reasons for the crisis. Part III

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21. OR. REV. STAT. § 63.074(2) (1993); R.I. GEN. LAWS § 7-16-3 (1992); 1994 Cal. Adv. Legis. Serv. 1200 § 93 (Deering).

22. ALA. CODE § 10-12-4(s) (Supp. 1994); ARIZ. REV. STAT. ANN. §§ 29-841 to -847 (Supp. 1993); ARK. CODE ANN. § 4-32-103(d) (Michie Supp. 1993); 1993 Conn. Legis. Serv. 267 (West); 1994 D.C. Stat. 138; FLA. STAT. ch. 621.02 (West Supp. 1995); GA. CODE ANN. § 14-11-1107(f) (Supp. 1993); IDAHO CODE § 53-605(2) (Supp. 1993); IND. CODE ANN. § 23-18-2-2 (Burns Supp. 1994); IOWA CODE ANN. §§ 490A.1501-1519 (West Supp. 1994); KAN. STAT. ANN. § 17-7604(q) (Supp. 1994); KY. REV. STAT. ANN. § 275.005 (Michie/Bobbs-Merrill Supp. 1994); LA. REV. STAT. ANN. §§ 12:1301-02 (1993); MD. CODE ANN., CORPS. & ASS'NS § 4A-203(9) (Supp. 1994); ME. REV. STAT. ANN. tit. 31, § 611 (West 1994); MICH. COMP. LAWS ANN. §§ 450.4901-.4910 (West Supp. 1994); MINN. STAT. ANN. §§ 319A.03, 322B.12 (West Supp. 1995); 1994 Miss. Laws 402; MONT. CODE ANN. §§ 35-8-1301 to -1307 (Supp. 1993); MO. ANN. STAT. §§ 347.015, .035 (Vernon Supp. 1994); NEB. REV. STAT. § 21-2603(15) (Supp. 1993); N.H. REV. STAT. ANN. § 304-D (Supp. 1993); N.Y. LIM. LIAB. CO. LAW § 1201 (1994); N.C. GEN. STAT. § 57C-2-01(C) (1993); N.D. CENT. CODE § 10-31-03.1 (Supp. 1993); OHIO REV. CODE ANN. § 1705.03(6) (Anderson Supp. 1994); OKLA. STAT. ANN. tit. 18, §§ 2001, 2002 (West Supp. 1995); 1994 Pa. Laws 106; 1994 S.C. Acts 448; S.D. CODIFIED LAWS ANN. §§ 47-13A-1, 13B-1 (Supp. 1994); TENN. CODE ANN. §§ 48-248-101, -202 (Supp. 1994); TEX. REV. CIV. STAT. ANN. art. 1528n, § 1101 (West Supp. 1995); UTAH CODE ANN. § 48-2b-105(1)(r) (1994); VA. CODE ANN. §§ 13.1-1100 to -1123 (Michie 1993 & Supp. 1994) WASH. REV. CODE § 25.15.045 (1994); WYO. STAT. § 17-19-103(b) (1994).

23. Some states that omitted any mention of professionals have recognized use of LLCs by professionals in other areas of statutory law. For example, Colorado's accountancy statute allows for accounting practices to become LLCs. *See* COLO. REV. STAT. § 12-2-102 (Supp. 1994). The Colorado Supreme Court has also modified rule 265 of the Colorado Rules of Civil Procedure to allow attorneys to practice as LLCs. *See* COLO. REV. STAT. ANN. R. CIV. P. 265. (effective Nov. 1, 1991); Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375, 459 (1992) (noting amendment by Colorado Supreme Court). This change, without a corresponding statutory amendment, may present a problem in the future. *See* Keatinge, *supra*, at 459 n.639.

discusses the current and potential future effects of the crisis if it is not addressed by lawmakers. Part IV introduces the LLC as a remedy for the effects of excessive litigation, describes the Washington LLC Act as it applies to professionals, shows how various statutes have addressed the issue of LLC use by professionals, and demonstrates how the LLC fits within the ethical codes of the legal and accounting profession. Part V of this Comment then illustrates how the LLC will help to remedy the litigation crisis, while Part VI shows why the LLC is a proper entity for professionals, and asserts that the Washington LLC act provides an ideal compromise between the interests of professionals and consumers. Finally, Part VII concludes that the LLC can provide professionals with much needed relief from the perils of excessive litigation, but that in order to do so, every state must follow Washington's lead and pass or amend legislation to permit professionals to utilize LLCs.

II. THE CRISIS

Lawsuits against professionals are at an all-time high.[24] This Part describes the various aspects of this crisis. Section A describes how it has hit the accounting profession; section B does the same with regard to attorneys; section C illustrates the sources of the crisis, while section D explains why professionals have come under such intense legal scrutiny over the last three years.

A. *Accountants*

The accounting profession has been hit the hardest by the explosion in litigation,[25] and the crisis has been termed "the premier threat to the profession."[26] As one commentator recently noted, "[t]he problems with the accounting profession . . . can be summed up in one word: liability."[27] In addition, a prominent figure in the profession has stated that, "[the profession's] liability burden is more than five times that of the manufacturers seeking product liability

24. *See* Arthur Andersen, *supra* note 11, at 22 (giving statistics which illustrate that litigation against accountants is at highest point ever); OLSON, *supra* note 1, at 317-24 (noting the increasing litigation against attorneys).

25. *See* McCarrol, *supra* note 4, at 48.

26. David R. Sands, *Accountants around the Globe See Rise in Professional Liability Suits*, WASH. TIMES, Oct. 20, 1992, at C3.

27. Matt Roush, *Liability Is No. 1 Issue for Accountants*, CRAIN'S DETROIT BUS., Jan. 25, 1993, at 8.

relief."[28] Some of the most prominent cases against accountants include:

- a $400 million settlement between Ernst & Young and federal thrift regulators;[29]

- a $338 million judgment recently levied against Price Waterhouse by an Arizona jury;[30]

- a $200 million verdict against Coopers & Lybrand by a jury in Texas;[31]

- an agreement by Arthur Andersen to pay $22 million to settle private lawsuits regarding its part in the Lincoln Savings and Loan Failure;[32] and

- the recent $312 million settlement reached between federal regulators and Deloitte & Touche in an action in which the government sought $1.4 billion in damages from the firm.[33]

In relation to revenue, litigation costs for accounting firms have risen from 7.7% in 1990,[34] to 9.0% in 1991,[35] to a high of 14.3% in 1992.[36] Furthermore, the number of suits filed against accountants has increased each year over the past ten years.[37] A recent survey reports that between 1987 and 1991, ninety-six percent of accounting firms with over fifty members experienced an increase in their liability exposure.[38] The industry as a whole now faces over thirty billion dollars in pending lawsuits.[39]

The most disturbing factor is that, although the largest firms are most often mentioned with regard to the crisis,[40] smaller firms are

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28. FEDERAL DOCUMENT CLEARING HOUSE CONGRESSIONAL TESTIMONY, Aug. 10, 1994, at *7, *available in* LEXIS, News Library [hereinafter CONGRESSIONAL TESTIMONY] (statement of J. Michael Cook, Chairman and CEO, Deloitte & Touche, LLP).

29. Geoffrey F. Aronow, *Accountants Lead the Latest Charge for Liability Reform*, INSIGHTS, Feb. 1993, at 17.

30. *Id.*

31. *Id.*

32. *Id.*

33. *See* Jerry Knight, *Fourth S&L Auditor Settles U.S. Lawsuits*, WASH. POST, Aug. 10, 1994, at F1; Larry Black, *Failure of Deloitte Talks Raises Spectre of Ruin; Record Professional Negligence Settlement with US Government Feared Over Savings and Loan Scandal*, INDEPENDENT, June 19, 1993, at 19.

34. Arthur Andersen, *supra* note 11, at 20.

35. *Id.*

36. Albert B. Crenshaw, *Accountants Plead for Relief; 6 Biggest Firms Say They Face $30 Billion in Liability Claims*, WASH. POST, June 12, 1993, at D1.

37. *See* Alan Breznick, *More Firms Suit Up for Legal Struggles*, CRAIN'S N.Y. BUS., Jan. 27, 1992, at 33.

38. Arthur Andersen, *supra* note 11, at 20.

39. *Id.*

40. *See id.*; Aranow, *supra* note 29 (listing several recent cases against Big Six firms).

feeling the pains of litigation as well. A recent survey showed that firms outside the six largest experienced a two-thirds increase in litigation between 1987 and 1991, and have seen a 300 percent increase in liability premiums since 1985.[41]

B. *Attorneys*

Although accountants clearly lead the liability race,[42] attorneys are not far behind.[43] Enormous verdicts against attorneys have become commonplace in recent years,[44] and a large number of suits arising from the savings and loan crisis have been filed against attorneys.[45] Two of the more well known cases have involved the lawyers working with the failed Lincoln Savings and Loan: the Kaye Scholer settlement of $41 million in the face of a freeze on its assets by the Office of Thrift Supervision,[46] and the $24 million that Cleveland megafirm Jones Day Reavis & Pogue paid out to settle its portion of the damage resulting from the now infamous thrift's failure.[47]

Indeed, law firms are beginning to experience the effects of the litigation. As one expert noted, "[t]hey're laying people off, and now they're faced with significant cash outlays, and I think you may see more partnerships dissolve just because they're not going to be able to pay the bills."[48] The statistics support this statement: 100 of the largest law firms in this country eliminated between five and ten percent of their partnership positions between 1990 and 1992,[49] and an estimated 256 lawsuits arising from the savings and loan scandal remained to be filed against attorneys at the end of 1992.[50] One partner of a New York firm summed up the current state of the

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41. Arthur Andersen, *supra* note 11, at 20-21.

42. Arnhoff, *supra* note 9, at 2.

43. *See* Andrew Leigh, *Now It's the Lawyers Getting Hit with Liability Suits*, INVESTOR'S DAILY, Mar. 19, 1992, at 10; Jennifer E. King, *Recent Malpractice Suits Driving up the Cost of Lawyers' Liability Insurance*, ILL. LEGAL TIMES, Nov. 1992, *available in* LEXIS, Legnew Library, ILT File; Donna K. H. Walters, *New Liability Twist has Lawyers, Accountants Scurrying*, L.A. TIMES, Mar. 29, 1992, at D1.

44. *See* King, *supra* note 43 (discussing megaverdicts against large law firms).

45. *See id.* at *3.

46. Harvey L. Pitt & Dixie L. Johnson, *Freeing Corporate Professional Advisers from the Threat of RICO Liability*, N.Y. L.J., Mar. 15, 1993, at Outside Counsel 1.

47. King, *supra* note 43, at *1; Lee Berton & Joann S. Lublin, *Partnership Structure Called in Question as Liability Risk Rises*, WALL ST. J., June 10, 1992, at A9.

48. Cowan, *supra* note 6, at D8.

49. *See* Berton & Lublin, *supra* note 47, at A1, A9.

50. King, *supra* note 43, at *3 (according to one expert's estimate).

profession: "You have to be out of your mind to be a partner in a law firm today."[51]

C. *Sources of the Crisis*

1. Savings and Loan Failures

a. *Introduction*

Much has been made of the banking scandal of the '80s and the bailout and cleanup of the '90s,[52] and for good reason. Approximately 550 thrift institutions have failed[53] as a result of the overly aggressive (and frequently fraudulent) practices employed by those institutions, and the estimates of the cost to the taxpayer to clean up the mess continue to grow,[54] running between $200 and $500 billion.[55] Because of these failures, and because few officers and directors of the failed thrifts have any assets remaining,[56] the federal government has become preoccupied with identifying a "meaningful class of deep pockets on whom to affix responsibility for these woes."[57] Thus, regulators and judges have turned toward professionals to answer for their contribution[58] and more.[59]

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51. Berton & Lublin, *supra* note 47, at A1, A9. Although, on its face, this statement may seem a bit overreaching (indeed, it was made by a partner at Kaye, Scholer), the principle underlying the remark is valid: All partners in law firms organized as partnerships are *personally* liable when *one* banking or securities lawyer makes a negligent error. *See supra* notes 10 and 13. Because nearly all large firms have at least one bank and several large corporations for clients, every partner in those firms puts her house on the line with every opinion letter written. The mere fact that one partner may practice in estate planning does not protect him from paying his portion of a $30 million judgment against a banking partner.

52. *See* Alison L. Cowan, *Big Law and Auditing Firms to Pay Millions in S&L Suit*, N.Y. TIMES, Mar. 31, 1992, at A1, D21; Harvey L. Pitt and Dixie L. Johnson, *The Banking Scandal: A New Era of Standards for Professionals?*, N.Y. L.J., Apr. 23, 1992, at Outside Counsel 1.

53. *American Professions; On the Defensive*, ECONOMIST, Mar. 14, 1992, at 90.

54. Pitt and Johnson, *supra* note 52, at 1.

55. *See* David B. Newdorf, Comment, *Inside Fraud, Outside Negligence and the Savings and Loan Crisis: When Does Management Wrongdoing Excuse Professional Malpractice?*, 26 LOY. L.A. L. REV. 1165, 1170 n.23 (1993) (showing estimates at $200 billion and $500 billion).

56. *See id.* at 1168 (noting that the only "deep pockets" left are the insurers of the professionals).

57. Pitt and Johnson, *supra* note 52, at 1.

58. *See id.*; *see also* Lincoln Sav. & Loan Ass'n v. Wall, 743 F. Supp. 901, 920 (D.D.C. 1990) ("Where were these professionals . . . when these clearly improper transactions were being consummated? Why didn't any of them speak up or disassociate themselves from the transactions? Where also were the outside accountants and attorneys when these transactions were effectuated?")

59. The doctrine of joint and several liability is often applied in the Savings and Loan cases, which allows for any party responsible for a portion of the loss to bear the entire amount of the damages proven.

Three agencies have been given congressional power to enforce the cleanup process through litigation. These agencies include the Resolution Trust Corporation (RTC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS).[60] Each of these agencies has filed a significant number of lawsuits against professionals.[61] The only "deep pockets" remaining when a thrift fails are the professional malpractice insurers and the professional firms themselves.[62]

The involvement of professionals in the banking scandal is a complex issue that often spans several legal doctrines. The issues involved may be simplified and illustrated by a hypothetical situation involving thrift misconduct.

b. A Hypothetical Thrift Failure[63]

In a typical thrift failure, the officers and or directors of the institution have attempted to increase the profits of the institution by directly investing depositors' funds in risky real estate ventures. However, an extreme downturn in the market for real estate has caused the value of the property to sink far below the amount paid for it by the thrift. In fact, often the decrease in the value of the property greatly exceeds the amount of capital put up by the institution, causing the thrift to be insolvent. Rather than report this condition to the appropriate federal agency, the officers of the thrift then embark on even more speculative measures, offering to purchase land from an investor who will in turn purchase the original property that the thrift had purchased. Both sides do so for more than market value, without any cash input from either side. To close the deal, the thrift agrees to loan the investor a portion of the purchase price on a nonrecourse basis.[64]

This entire second transaction is in violation of federal law,[65] but the officers of the thrift have covered this up by making all of the transactions through dummy corporations.[66] The transactions have

60. *See* Newdorf, *supra* note 55, at 1165 n.1, 1170 n.21.

61. *See id.*

62. *Id.* at 1170.

63. This hypothetical is derived from David B. Newdorf's article, appearing in the Loyola of Los Angeles Law Review. *See id.* at 1166.

64. For an example of a similar land transaction, see *id.* at 1170 n.19.

65. Banks are limited both in the amount they may lend as a percent of capital, *see* 12 U.S.C. § 84(a)(2) (1988) (ten percent limit), and in the amount they may lend to insiders, *id.* at § 375(b)(1) (1988) (same terms as noninsiders).

66. A "dummy" corporation is one "formed for sham purposes and not for conduct of legitimate business . . . ." BLACK'S LAW DICTIONARY 502 (6th ed. 1990).

been conducted by two separate law firms, so that neither one would suspect the overall nature of the deal. If either firm had looked below the surface, the dummy corporations would have been discovered. The deals produce a huge profit for the thrift, and because they appeared to be arms-length transactions, the accountants approved the amount on the financial statements.

However, when the real estate market worsens, both the thrift and the investor default on the outstanding loans. This wipes out any capital the thrift had, leaving a negative net worth. The Federal Savings and Loan Insurance Corporation (FSLIC)[67] then pays off the depositors from the federal insurance fund and closes the institution. The agencies come after the professionals involved, alleging that both the lawyers and accountants must have turned a blind eye to the fraudulent activity.

The agency typically alleges several causes of action against both the attorneys and the accountants, including: professional negligence, breach of fiduciary duty, negligent misrepresentation, unjust enrichment, aiding and abetting management in violations of legal and fiduciary duties, fraud and deceptive trade practices.[68] The key allegation is professional negligence; the agency asserts that the professionals involved were negligent in failing to discover the fraudulent activity, and that this negligence proximately caused the losses of the savings and loan.[69]

The above scenario generally describes what happened to many of the failed thrifts across this country[70] and gives a fairly accurate description of the nature of the professional involvement in the savings and loan crisis. However, that debacle has been only one of the primary sources of litigation against professionals.

2. Start Up Companies/Securities Litigation

The next largest source of litigation against lawyers and accountants is casually referred to as 10b-5 litigation.[71] The term "10b-5" refers to rule 10b-5,[72] promulgated by the Securities and Exchange

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67. The FSLIC has now been absorbed into the FDIC. *See* Newdorf, *supra* note 55, at 1170 n.21.

68. *See id.* at 1173-74 n.47.

69. *Id.*

70. *Id.* at 1166.

71. *See* Arthur Andersen, *supra* note 11, at 23 (noting that 10b-5 suits represent nearly one-third of the current litigation against the accounting profession); Adam F. Ingber, *10b-5 or not 10b-5?: Are the Current Efforts to Reform Securities Litigation Misguided?*, 61 FORDHAM L. REV. S351, S356-58 (1994).

72. 17 C.F.R. § 240.10b-5 (1994).

Commission to implement section 10(b) of the Securities Exchange Act of 1934, dealing with fraudulent securities offerings.[73]

In a typical 10b-5 case, investors purchase securities of a new or existing corporation. Attorneys and accountants are involved with the prospectus for the offering in several ways.[74] The accountant's most common responsibility is the audit of the financial statements.[75] Not surprisingly, many companies whose securities are put on the market do not perform to the expectations of the investors, and an action is brought against the accountants and/or the attorneys for the failure to disclose certain information about the company that would have caused the investors not to purchase the securities.[76]

There are many sources of litigation against professionals. The number of lawsuits stemming from the savings and loan crisis and the increase in securities litigation are just two highly publicized examples of what has become a very large problem in this country. The more crucial question is one that underlies the above information: Why are the professionals feeling the greatest weight of the litigation arising from these situations?

D. *Why Sue Professionals?*

There are several reasons that the enormous number of suits arising out of both the savings and loan situation and 10b-5 litigation are filed against professionals. This section briefly discusses each of those reasons.

One reason asserted by some courts is that professionals may obtain malpractice insurance to cover any judgment or settlement. As the court in *Rosenblum, Inc. v. Adler*[77] indicated: "Independent auditors have apparently been able to obtain liability insurance covering these risks or otherwise to satisfy their financial obligations. We have no reason to believe that they may not purchase malpractice insurance policies that cover their negligent acts . . . ."[78] The court went on to note that the accountants could pass the cost of the insurance on to their customers, who could in turn pass the cost on to the entire consuming public.[79]

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73. 15 U.S.C. § 78(j) (1988).

74. *See* Lawrence R. Bard, *A Distinct-Responsibility Approach to Accountant's Primary Liability Under Rule 10b-5*, 61 GEO. WASH. L. REV. 193, 203 (1992).

75. *Id.* (describing audit function).

76. *See id.* at 204.

77. 461 A.2d 138 (N.J. 1983).

78. *Id.* at 151.

79. *Id.* at 153 (citing Palsgraf v. Long Island R.R., 162 N.E. 99, 100 (N.Y. 1928)).

Another reason professionals are sued so frequently is because they may be held liable for mere negligence, while the client corporation's officers and directors are often protected by the business judgment rule, which incorporates a standard of gross negligence.[80] Thus, there are circumstances where the professionals involved will be liable, while the direct wrongdoers are exculpated.[81]

Professionals are also being sued because they are the only solvent parties remaining when the thrift or business goes under.[82] Indeed, the larger professional firms often have a substantial amount of capital built up.[83] The targeting of the assets and insurance coverage of these firms is referred to as the "deep pocket" theory.[84]

The "deep pocket" reasoning leads, in turn, to the issue of joint and several liability.[85] Under this doctrine, even though the professionals may be only ten percent responsible for the loss, they must pay the entire amount of damage if found negligent.[86] This encourages plaintiffs to sue only the professionals because their pockets are usually the deepest.

Yet another reason professionals are being sued at record highs is because the public is looking for someone upon whom it can affix blame. The low public perception of professionals makes them an easy target.[87] The public outrage over the savings and loan debacle has only fueled the increase of lawsuits against professionals, and these lawsuits help satisfy the public's desire for retribution.[88] Indeed, "lawyer bashing" has become a national pastime as evidenced by a recent beer commercial where cowboys rope lawyers instead of bulls.[89] This perception has been furthered by the judiciary, who are of the opinion that the professionals are in large part responsible for the

80. *See* Richard A. Booth, *Fiduciary Duty and the Former Partner*, 48 BUS. LAW. 315, 315 n.2 (1992).

81. *See id.*

82. *See* Ron Cooper, *Accountant Malpractice Claims Rising*, BUS. FIRST-LOUISVILLE, Jan. 28, 1991, at *3 (*available in* LEXIS, News Library, Busdtl File).

83. *See* Roush, *supra* note 27, at 8.

84. *See* Cooper, *supra* note 82, at *3.

85. *See supra* notes 10 and 13 (discussing joint and several liability standard).

86. *Id.*

87. *See* Robert Rice, *Business and the Law: Tied up in Claims for Damages-US Lawyers are Concerned at the Growing Trend to Sue Them When Financial Institutions Fail*, FIN. TIMES, Oct. 19, 1993, at 18 (describing lawyer television commercial); Newdorf, *supra* note 55, at 1170-71.

88. *See* Pitt and Johnson, *supra* note 52, at 1.

89. *See* Rice, *supra* note 87, at 18.

savings and loan crisis.[90] Many professionals have described this viewpoint as "scapegoatism."[91]

A final reason that professionals have been sued is that some professionals have performed at a severely substandard or even fraudulent level,[92] making it even easier for the thrifts and start-up companies to deceive investors and regulators. In such cases, the professionals deserve whatever damages they incur.[93] However, these situations represent the exception rather than the rule. In the majority of situations, fraudulent activities of thrift management, often undetectable by the professionals involved, has been the primary cause of bank failures.[94]

In sum, when professionals are negligent and have not been deceived by the client, they deserve to pay for the damage that they have proximately caused. However, bringing lawsuits against attorneys and accountants either because they have significant assets and insurance or for retributive purposes is unfair, especially where professionals are responsible for only a minimal portion of the total damage. This practice will devastate both the accounting and legal professions if it is not properly addressed.

III. THE EFFECTS OF THE CRISIS IF LEFT UNCHECKED

This Part details the potential effects of the litigation crisis. Several of the statistics and arguments included in this Part are derived from a recent study[95] provided by the big six accounting firms[96] to several federal agencies and members of Congress. Although the arguments presented will, in most cases, reflect the effects of litigation from an accountant's standpoint, the impact on the legal profession would likely follow a similar path. Therefore, most of the arguments will be put in terms of professionals in general, rather than simply

90. *See, e.g.*, Lincoln Sav. & Loan Ass'n v. Wall, 743 F. Supp. 901, 913, 920 (D.D.C. 1990) (blaming failure on professionals' failure to act).

91. *See* Timothy D. Naegele, *Rabid Regulators Want Your Hide*, AM. BANKER, May 27, 1992, at 4 (attributing professional liability suits to "scapegoatism").

92. *See* McCarrol, *supra* note 4, at 49 (discussing GAO study finding evidence of substandard professional performance); Arthur Andersen, *supra* note 11, at 21 (acknowledging some poor performance).

93. *See* Arthur Andersen, *supra* note 11, at 21.

94. *See, e.g.*, Newdorf, *supra* note 55, at 1169.

95. Arthur Andersen, *supra* note 11, at 19.

96. The Big Six accounting firms are the six largest in this country and worldwide. They include Arthur Andersen, Ernst & Young, Deloitte & Touche, Coopers & Lybrand, Price Waterhouse, and KPMG Peat Marwick.

accountants. Any effects that are especially peculiar to one profession or the other will be noted.

A. *Insurance*

One consequence of the litigation explosion that has already begun to materialize is the increase in the cost of professional malpractice insurance.[97]

Accounting firms with over fifty members have experienced a 300 percent increase in insurance premium costs since 1985.[98] Law firms are experiencing similar inflation; it now costs between $5,000 and $12,000 per attorney, per year in some areas to insure a firm against malpractice liability.[99] These premiums continue to rise at around twenty percent per year.[100]

As premiums and deductibles increase, total coverage decreases. The median deductible for accounting firms today is $240,000.[101] This is almost six times the median figure in 1985.[102] Deductibles for the largest firms now exceed $25 million for the first loss.[103] However, obtaining the same level of coverage is becoming increasingly difficult.[104] While firms could obtain $200 million in coverage in the past, they are lucky to obtain half of that amount now.[105]

An even more disturbing trend is that many firms, especially the small to medium size firms, are "going bare," meaning that they operate without insurance.[106] This occurs for two reasons: first, as noted above, the cost of liability insurance is spiraling out of control; second, many insurers simply will not cover professionals (accountants in particular) because of the enormous amount of risk and uncertainty involved.[107] According to a recent survey, forty percent of firms outside of the Big Six do not currently have insurance.[108] This development injures plaintiffs the most, as an adequate recovery is no longer an option when one of these firms is sued.

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97. See Walters, *supra* note 43, at D1; Arthur Andersen, *supra* note 11, at 20.
98. Arthur Andersen, *supra* note 11, at 20.
99. *See* Walters, *supra* note 43, at D7.
100. King, *supra* note 43, at *2.
101. Arthur Andersen, *supra* note 11, at 20.
102. *Id.* ($42,000).
103. *Id.*
104. *See* Cowan, *supra* note 6, at D8.
105. *Id.*
106. *See* Gene R. Barrett, *New AICPA Chairman Sees a Bright Future for the Profession*, J. ACCT., Dec. 1992, at 86, 87.
107. McCarrol, *supra* note 4, at 50.
108. Arthur Andersen, *supra* note 11, at 20-21.

B. Changing Clients and Methods

Another consequence of excessive litigation is that professionals are now seeking new ways to reduce their risk.[109] This strategy is played out in several ways. These include avoidance of high-risk clients and industries, implementation of client screening, and requiring all work to be subject to additional checks. Each of these effects, while injurious to professionals, will cause even further deleterious consequences upon the professions, the financial marketplace, and the economy.

One risk reduction method is the avoidance of high-risk industries.[110] In the survey mentioned in the previous section, accounting firms were asked whether the current litigious environment had affected the services they offer. Fifty-six percent of those firms answered that they had reduced or eliminated their practice in high-risk industries, including financial institutions, real estate, and high technology companies.[111] Companies making initial public offerings made up another area of substantial cutbacks by accounting firms. These companies are particularly vulnerable to 10b-5 litigation due to the volatility of their stock prices.[112] The United States Supreme Court recognized this problem in a recent case: "[E]xcessive litigation can have ripple effects. For example, newer and smaller companies may find it difficult to obtain advice from professionals. A professional may fear that a newer or smaller company may not survive and that business failure would generate securities litigation against the professional . . . ."[113] However, these firms provide a great deal of innovation and worldwide competition for this country. They are also the firms that are most in need of quality professional services.[114]

Another method of risk management that accounting firms have employed is the reduction or elimination of services they offer. This means that the audit, which has historically been the life-blood of an accounting practice,[115] may be a thing of the past. The aforementioned survey showed that seventy-nine percent of the responding firms

109. *Id.* at 22.
110. *Id.*
111. *Id.*
112. *Id.*
113. Central Bank v. First Interstate Bank, 114 S. Ct. 1439, 1454 (1994).
114. *See* Andersen, *supra* note 11, at 22.
115. The audit provides sixty percent of the total revenue of accounting firms. McCarrol, *supra* note 4, at 49.

are cutting back on the services they offer, and some are abandoning audits altogether.[116]

These methods of risk reduction create significant problems. If firms will not be audited because of the risk, then investors will not put their capital into that company. If the high-risk company is audited by a smaller, and possibly less qualified firm, there is greater opportunity for fraudulent practices to occur.[117] If the former occurs, then "[f]inancial markets could grind to a halt . . . . Investors are not going to invest unless they see that stamp of approval."[118] If the latter occurs, the savings and loan debacle could repeat itself.

The other risk reduction methods mentioned above, client screening and extra checking of all work, primarily increase the cost of accounting and legal services in general. The effects of this increase will be further discussed in section D, below.

C. *Loss of Talent*

An additional impact on the professional environment is an overall reduction in the number of qualified individuals seeking to enter and remain in the professions. The accounting profession has already experienced this phenomenon, as new recruits are reluctant to get into the business[119] and qualified professionals are seeking to get out.[120] Although the overall legal profession may not yet have experienced this effect, this is probably because a smaller percentage of lawyers are involved in the corporate marketplace, where most of this litigation has occurred. A true assessment of the impact could be obtained through asking recent law school graduates with an interest in finance whether they still intend to practice corporate banking or securities law.

The effects of a smaller talent base upon which to draw could be far-reaching. Less talent means less qualified professionals, which

116. Aronow, *supra* note 29, at 20.

117. This can occur for several reasons. In theory, a small firm could be more easily "pushed around" by a client such as Ford or General Motors, as that client would likely provide over fifty percent of the firm's total revenue. In that case, the professionals would be less likely to question a decision of management or the board of directors and more likely to push ethical and legal limits for the sake of the client.

Additionally, a small accounting firm would be far less likely to uncover a fraudulent scheme at a large corporation than a Big Six firm with far greater manpower and financial resources.

Finally, smaller firms will also, in theory, be made up of less talented professionals than large firms. Thus, the professionals would not possess the skill to detect certain fraudulent schemes that the most qualified attorney or accountant would uncover.

118. McCarrol, *supra* note 4, at 50 (internal quotations omitted).

119. David C. Walters, *Liability Risk Worries Accounting Recruits*, CHRISTIAN SCI. MONITOR, Dec. 28, 1992, at Economy 9.

120. *See id.*

could mean a further opportunity for fraudulent practices, and further erosion of the already tarnished public image of both accountants and lawyers.[121] However, the loss of professional talent, as serious as it is, pales in comparison to the possible effect that excessive professional litigation will have on the economic underpinnings of this country.

D. Economic Impact

The most significant impact of the litigation crisis will occur within the financial marketplace.[122] The skyrocketing insurance costs, the cost of client screening, and the cost of wasteful overchecking of work all serve to increase the cost of running a business or making a public offering. The economy could feel the effects of these increases in a significant way.

These effects are demonstrated in detail by a recent study on the potential effects of the professional litigation crisis.[123] The study, performed by AUS Consultants, a Philadelphia research firm, showed that litigation against professionals will cost the country over 224,000 jobs per year between 1992 and 1996; will increase the federal budget deficit by $3.7 billion per year; will reduce real manufacturing output by $6.9 billion per year; and will increase the cost of capital by 1.3% over that period.[124]

The study was based upon certain assumptions, including the premise that insurance costs would continue to rise and that professional services would become more costly because of client screening and reviewing of work.[125] The study further assumed that professionals would pass most of the costs on to their clients.[126] However, the validity of these assumptions was strengthened by the Supreme Court in *Central Bank*: "[T]he increased costs incurred by professionals because of the litigation and settlement costs under 10b-5 may be passed on to their client companies, and in turn incurred by the company's investors . . . ."[127]

The logical starting point for this economic crisis is within the professional arena itself. Indeed, litigation has already brought some surprisingly large firms to their knees.

121. *See* Arthur Andersen, *supra* note 11, at 20; McCarrol, *supra* note 4, at 48.

122. *See* Bill Atkinson, *A Determined Defender of Lawyers, Accountants*, AM. BANKER, Aug. 20, 1992, at 2.

123. For a description of the study, see *id.*

124. *Id.*

125. *Id.*

126. *Id.*

127. *Central Bank*, 114 S. Ct. at 1454.

E. *Loss of Professional Firms*

Not only will the overall economy feel the heat of the crisis, but the professions themselves will see prominent members fail or substantially restructure their practices as a result of the burden of litigation. Already, Laventhol & Horwath, once the seventh largest accounting firm in the United States, has gone bankrupt. The primary cause of this phenomenon was the 112 lawsuits pending against the firm, forty of which sought a total of $351 million in damages.[128] In addition, Pannell Kerr Forster, another high-visibility accounting firm, has closed or sold ninety percent of its offices. A prominent factor in this decision was liability.[129]

The Laventhol failure had far-reaching consequences throughout the capital markets.[130] Audits in process were interrupted, replacement auditors had to be found, and the SEC had to adopt special rules to accommodate the public companies that had been previously audited by Laventhol.[131] All of the companies audited by the firm were put under a cloud of uncertainty through no fault of their own.[132]

Several steps must be taken to curb the substantial effects stemming from the litigation crisis. If no action is taken, the accounting and legal professions, the capital markets, and the economy as a whole will suffer. Most of the available remedial measures are beyond the scope of this Comment, and no single measure would solve the litigation problems in this country. However, this Comment addresses one option that will provide a foundation for a stronger professional industry: The LLC.

IV. A REMEDY: THE LLC

This Part identifies a possible remedy to the above-described problems apparent in today's professional arena. Section A introduces the LLC and discusses its relevant attributes; section B discusses the Washington Act and its professional provisions; section C shows the various ways that the professional has been treated with respect to LLC legislation; and section D shows how the LLC fits within the current ethical codes and duties peculiar to professionals.

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128. Douglas McLeod, *Claims Help Sink Laventhol; Virtually All E&O Coverage Depleted*, BUS. INS., Nov. 26, 1990, at 2.

129. *See* Arthur Andersen, *supra* note 11, at 21.

130. *Id.*

131. *Id.*

132. *Id.*

A. *An Introduction to the LLC*

1. History

First introduced in Wyoming in 1977, it was not until 1990 that the LLC's popularity spread among the states.[133] This was largely a result of the Internal Revenue Service's decision in 1988 to treat the Wyoming LLC as a partnership for federal tax purposes.[134] This opened the floodgates to LLC legislation, as forty-five states enacted LLC statutes between 1990 and the present, including Washington.[135] Every state has now at least considered some form of LLC legislation.[136]

2. Attributes

This section addresses two key attributes of the LLC that are relevant to this Comment: limited liability of LLC owners and tax treatment of LLCs.[137]

a. Limited Liability

Given its name, it is fairly clear that the LLC limits the liability of its owners. The key question is, to what extent does the LLC protect professionals from liability? The focus of the discussion here is on professional liability, as opposed to liability for business debts. Professionals in an LLC will only be able to limit their liability for the negligence of other members of the firm.[138] This logically follows from the maxim that one is always liable for her own torts. In addition, when a member of an LLC supervises or participates in a negligent engagement, she will be personally liable under a vicarious liability or respondeat superior theory.[139] Furthermore, the LLC

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133. *See* Keatinge, *supra* note 23, at 384.

134. Rev. Rul. 88-76, 1988-2 C.B. 360, 361.

135. *See supra* note 18.

136. *See supra* note 19.

137. This Comment is not intended to provide a comprehensive review of LLCs. Rather, the focus here is on those aspects of LLCs that are of particular significance to professionals. For a complete overview of the LLC, see Keatinge, *supra* note 23.

138. *See* Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L.Q. 417, 434 (1991); *AICPA Members to Vote on Proposal to Let CPA Firms Form Corporations*, Daily Tax Reports (BNA) No. 205, at G-1 (Oct. 23, 1990) (AICPA Vice President Bernard Lee assured House Energy and Commerce Committee Chairman John Dingell that individuals responsible for audits will not escape personal responsibility through the use of LLCs).

139. *See* Stephen E. Kalish, *Lawyer Liability and Incorporation of the Law Firm: A Compromise Model Providing Lawyer-Owners with Limited Liability and Imposing Broad Vicarious Liability on Some Lawyer Employees*, 29 ARIZ. L. REV. 563, 580 (1987).

itself remains vicariously liable for the negligent acts of any of its members.[140]

b. *Tax Treatment of LLCs*

The Internal Revenue Service has published several rulings classifying an LLC as a partnership for tax purposes.[141] The basis of these rulings was that the entities had fewer than four of the six characteristics necessary for corporate tax treatment.[142]

These rulings were extremely significant because partnerships are not taxed as an entity, but are subject to "flow through" treatment, where the income of each partner "flows" to her individual tax return.[143] Thus, members of a partnership avoid the "double taxation" problems that affect most corporations.[144] As such, the tax benefits of LLCs are their most popular attribute, and are the primary benefit of an LLC over another corporate form.

B. *The Washington LLC Act*

The Washington LLC Act permits professionals to practice as LLCs.[145] The relevant section, WASH. REV. CODE § 25.15.045 (1994), subjects a "Professional LLC" (PLLC) to all of the provisions of WASH. REV. CODE § 18.100 (1994), the Washington professional service corporation statute.[146]

The statute also requires that at least one member of the LLC be licensed in Washington,[147] and that each member personally practicing in Washington be licensed in Washington.[148] Furthermore, the name of any firm that becomes an LLC must include the term "Professional Limited Liability Company," or "P.L.L.C."[149]

Finally, and most importantly, Washington's LLC Act requires that each PLLC maintain an insurance policy upon itself and its

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140. *Id.*

141. *See, e.g.*, Rev. Rul. 93-93, 1993-2 C.B. 321 (Arizona); Rev. Rul. 93-91, 1993-2 C.B. 316 (Utah); Rev. Rul. 93-38, 1993-1 C.B. 233 (Delaware); Rev. Rul 88-76, 1988-2 C.B. 360 (Wyoming).

142. *Id.*; *see also* Treas. Reg. § 301.7701-2(a)(1) (1994) (giving six characteristics of corporate tax status).

143. *See* I.R.C. §§ 701, 702(a), 704(b) (1988).

144. Corporate income is taxed at the entity and shareholder level. *See* I.R.C. §§ 11, 301 (1988).

145. WASH. REV. CODE §§ 25.15.045, 18.190.010 (1994).

146. WASH. REV. CODE § 25.15.045 (1994).

147. *Id.* § 25.15.045(1)(a).

148. *Id.* § 25.15.045(1)(b).

149. *Id.* § 25.15.045(4).

members practicing in Washington in a minimum amount of $1,000,000.[150] The Act further provides that the Insurance Commissioner may require a greater amount for a specific profession.[151]

Washington is the first state to adopt a provision in its LLC statute mandating professional liability insurance,[152] but other states have implemented such a requirement in their Limited Liability Partnership statutes or professional licensing acts.[153]

Although Washington has clearly answered the issue raised by this Comment, the recent enactment of LLC statutes in Oregon and California that prohibit professionals from forming LLCs has kept the issue in the forefront. Indeed, professional firms (and their clients) in Washington are likely to do a large portion of their out-of-state business within these two states.

When a suit is brought against them in California or Oregon, Washington firms will likely be held to the liability standards which exist there.[154] Thus, even if a Washington firm becomes an LLC under the Washington statute, the members of the firm will be exposed to personal liability in California, Oregon, and any other state which prohibits professional LLC practice.

Clearly, the Washington statute provides complete liability protection only to small firms who neither practice nor serve any clients doing business in Oregon or California. Furthermore, the inconsistent treatment of professionals by LLC statutes in other states creates even more uncertainty for Washington professionals.

C. *Other LLC Legislation and Professionals*

The majority of the LLC statutes from other states exclude any mention of professionals. Presumably, this means that professionals are allowed to take advantage of the statute.[155] However, this Comment argues that each state legislature should specifically mention professionals within its LLC statute to assure professionals that their use of the LLC form is permitted by state law. This assurance is

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150. *Id.* § 25.15.045(2).

151. *Id.*

152. WASHINGTON STATE BAR ASSOCIATION, LIMITED LIABILITY COMPANIES IN WASHINGTON 10-9 (1994) (on file with *Seattle University Law Review*).

153. *See, e.g.*, COLO. REV. STAT. § 12-2-117(3)(c) (Supp. 1994) ($150,000 per CPA minimum for all claims, not to exceed $1,000,000 minimum); TEX. REV. CIV. STAT. ANN. art. 6132b, § 3.08(d)(A) ($100,000).

154. 1 LARRY R. RIBSTEIN & ROBERT R. KEATINGE, LIMITED LIABILITY COMPANIES § 13.04 (1994); Steven C. Crane, *An Ethical Lawyer's Guide to LLC Firms*, N.Y. L.J., Nov. 7, 1994, at Outside Counsel 1.

155. *See Shop Talk: Tax Trap for Professionals Forming LLCs*, 79 J. TAX'N 63, 63 (1993).

crucial; without it, many large firms with interstate practices may be hesitant to take advantage of LLC legislation.

Currently, Rhode Island, Oregon, and California expressly prohibit professionals from becoming LLCs.[156] However, originally, Arizona, Virginia and Maryland also excluded professionals, with the latter two actually enacting "no professionals" clauses that were later repealed.[157] Arizona amended its legislation before it became law, due in large part to the lobby of the Arizona Society of Certified Public Accountants.[158]

The reasons given by the respective legislatures for denying professionals were largely practical: The legislators involved were under the belief that a bill limiting the liability of professionals would be seen as "special interest" legislation and would not pass.[159] The statement of a Virginia legislator summed up the perspective of the lawmakers:

> Generally, in Virginia we did not want the legislators to perceive the LLC [A]ct as special interest legislation. We had not received any actual objections—there were just the informal discussions among our drafting committee to the effect that if lawyers and accountants are perceived to be the beneficiaries of this legislation it may be more difficult to get it enacted.[160]

An Arizona newspaper editorial also took this viewpoint, noting that, "to avoid charges that the proposed legislation is simply a tool fashioned by special interest groups—people such as lawyers, doctors, or accountants—these professions have been omitted from Arizona's LLC bill."[161]

Conversely, several states have specifically provided that professionals may take advantage of their LLC statutes.[162] These statutes

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156. 1994 Cal. Adv. Legis. Serv. 1200 § 93 (Deering); OR. REV. STAT. § 63.074(2) (1994); R.I. GEN. LAWS § 7-16-3 (Supp. 1992).

157. *See It's Time LLCs Make Sense; Let's Do It*, PHOENIX GAZETTE, May 21, 1991, at Front 2 (editorial) [hereinafter *It's Time*] (discussing the proposed Arizona act's "no professionals" clause); VA. CODE ANN. § 13.1-1008 (Michie Supp. 1991) (prior to 1992 repeal) (denying professionals); MD. CODE. ANN., CORPS. & ASS'NS § 4A-201 (prior to 1993 repeal) (denying professionals).

158. *See* Max Jarman, *Legislature OKs Limited Liability Firms*, ARIZ. BUS. GAZETTE, May 29, 1992, at Front 2.

159. *See* Sharon E. Connaughton, *The Dawn of the Limited Liability Company in Virginia: An Analysis of the Statute*, 14 GEO. MASON U. L. REV. 177, 197 (1991).

160. *Id.*

161. *See It's Time*, *supra* note 157.

162. See *supra* note 22.

typically provide a non-exclusive listing of professionals, which always mentions lawyers and accountants.[163]

D. *The LLC vs. the Professional Corporation (PC)*

Professionals may incorporate and limit their liability to some extent in every state.[164] Thus, professionals are already able to use an entity that limits their liability. However, there are several problems with the professional service corporation that make it an ineffective vehicle for professionals to limit their liability. These problems include tax disadvantages, lack of a limitation on professional liability in some states, and restrictions on interstate practice.

First, there are tax disadvantages to being a PC. Because PCs are corporate entities, they are subject to double taxation of income. This is no small hurdle to a firm seeking to maximize its profits.[165] Indeed, a PC may pay even *higher* taxes than a similarly situated corporation.[166] As noted above, LLC members are subject to the partnership tax laws, which provide for flow-through treatment of all partner income, and thus only single taxation.

Second, several states do not limit the personal liability of shareholders in a PC.[167] In these states, the PC is completely ineffective to protect professionals from having their personal assets

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163. *See, e.g.*, VA. CODE ANN. § 13.1-543 (Michie 1993) (listing professionals).

164. *See* Karen M. Maycheck, *Shareholder Liability in Professional Legal Corporations: A Survey of the States*, 47 U. PITT. L. REV. 817 (1986); Thomas W. Rimerman, *The Need for Expanding Organizational Options for CPAs*, J. ACCT., Oct. 1991, at 45.

165. For example, if a corporation earns $100 in income, $34 of that profit would be paid in taxes at the corporate level (assuming a corporate rate of thirty-four percent). When the remaining $66 is distributed to the owners of the corporation through a dividend, that income is taxed again at the personal rate of the owners (assume a thirty-one percent rate), resulting in a net profit of $45 to the owners (the personal rate is applied to the $66 to obtain the $21 personal tax).

However, when a partnership (or LLC) earns $100, this entire amount flows through to the owners' personal tax returns (assuming the same thirty-one percent personal rate), resulting in $69 of net profit (a $24 increase over the owners' net profit under corporate form).

166. *See* I.R.C. § 11(b)(2) (West 1994) (denying graduated tax rates to professional service corporations).

167. *See* ARIZ. REV. STAT. ANN. § 10-905 (1990); OR. REV. STAT. § 58.185 (1993); WIS. STAT. ANN. § 180.1915 (West Supp. 1994); WYO. STAT. § 17-3-102 (1994).

Other states that have PC statutes limiting professional liability, but whose courts have refused to acknowledge the limitation, include Hawaii, *see* HAW. REV. STAT. § 415A-11 (1993) (limiting innocent shareholder liability); *but see In re* Bar Ass'n of Haw., 516 P.2d 1267 (Haw. 1973) (denying a limitation on shareholder liability for acts of other shareholders); North Carolina, *see* N.C. GEN. STAT. § 55B-9 (1993); *but see* Nelson v. Patrick, 326 S.E.2d 45 (N.C. Ct. App. 1985); and Georgia, *see* GA. CODE ANN. § 14-7-7 (1994); *but see* First Bank and Trust Co. v. Zagoria, 302 S.E.2d 674 (Ga. 1983) (denying a limit on professional liability of attorneys).

seized through a malpractice suit. LLC legislation in these states would solve this problem.

Third, several PC statutes limit the amount of interstate practice that a PC may conduct.[168] This hinders medium and larger size firms from limiting their liability, as many firms of this size have offices and clients in other states. Currently, no LLC legislation places any restrictions on interstate commerce or practice.[169]

E. *The LLC and Ethical Codes of Professionals*

1. Accountants

The American Institute of Certified Public Accountants (AICPA) specifies which entities may engage in the practice of public accounting.[170] In October 1990, the AICPA council sent a ballot to members asking them whether accountants should be allowed to practice as LLCs,[171] and the measure was overwhelmingly approved.[172] The vote amended rule 505 of the AICPA Code of Professional Conduct to allow accountants to use any entity permitted by state law.[173]

2. Attorneys

Similarly, both the American Bar Association's (ABA) Code of Professional Responsibility[174] and the Model Rules of Professional Conduct[175] provide that an attorney may limit her liability for the malpractice of her associates, but only to the extent permitted by state

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168. *See* Rimerman, *supra* note 164, at 45, 48; Gilbert Simonetti & Andrea R. Andrews, *A Profession at Risk/A System in Jeopardy*, J. ACCT., Apr. 1994, at 45, 47.

169. *See* Keatinge, *supra* note 23, at 375, 447.

170. Prior to its amendment in 1992, Rule 505 of the AICPA Code of Professional Conduct provided in part: "A member may practice public accounting only in the form of a proprietorship, a partnership, or a professional corporation whose characteristics correspond to resolutions of the Council." AICPA CODE OF PROFESSIONAL CONDUCT RULE 505.

171. *See AICPA*, *supra* note 138, at G2; Rimerman, *supra* note 164, at 45.

172. The resolution was approved by approximately ninety-two percent of the voting members. Keatinge, *supra* note 23, at 459 n.642 (citing AICPA Press Release, Jan. 16, 1992).

173. *See* Rimerman, *supra* note 164, at 45.

174. MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 6-102, EC 6-6 (1981) provides that "[a] lawyer who is a stockholder in or is associated with a professional legal corporation may, however, limit his liability for malpractice of his associates in the corporation, but only to the extent permitted by law."

175. Rule 1.8(h) of the MODEL RULES OF PROFESSIONAL CONDUCT (1990) provides:

> A lawyer shall not make an agreement prospectively limiting the lawyer's liability to a client for malpractice unless permitted by law and the client is independently represented in making the agreement, or settle a claim for such liability with an unrepresented client or former client without first advising that person in writing that independent representation is appropriate in connection therewith.

law. It seems clear that, if a state adopts LLC legislation and allows attorneys to form LLCs, the ABA would not prevent such a practice. However, only one state entity governing the practice of law has expressly permitted attorneys to form LLCs.[176]

Because it fits within the ethical rules of both professions, the LLC is an available remedy for both accountants and lawyers to protect themselves and to slow the effects of the crisis upon the professional world.

V. How the LLC Will Help Solve the Crisis

The LLC will curb the effects of excessive litigation against professionals in four ways: (A) by eliminating the effects of "intimidation" of firms with unlimited liability, (B) by reducing insurance costs, (C) by providing professionals with the confidence necessary to successfully serve their clients and the public, and (D) by providing a safety net for professionals who, because of the severity of the crisis, cannot afford liability insurance, but nevertheless are able to provide quality services to the public.

A. *Intimidation*

According to at least one source, the threat of personal financial ruin allows plaintiffs to intimidate accountants into settling disputes out of court.[177] Rather than risk both the demise of the firm and personal bankruptcy, accountants often will choose to settle a case, even when they believe they should succeed at trial.[178] This phenomenon would clearly be eliminated through a limitation on liability.

B. *Insurance*

The LLC will also help to keep professionals' insurance costs from skyrocketing even further. By eliminating the intimidation factor, settlement amounts are sure to be reduced, and professionals will likely take more cases to trial successfully, knowing that they cannot be held personally liable. In addition, professionals would no longer need to purchase insurance to protect their personal assets.[179]

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176. *See* COLO. R. CIV. P. 265 (allowing attorneys to practice as LLCs).

177. *Business This Week; Accountancy - Subject to 'Intimidation,'* IRISH TIMES, Oct. 8, 1993, at supp.

178. *See* CONGRESSIONAL TESTIMONY, *supra* note 28, at *10.

179. *Cf.* Joseph A. Grundfest, *The Limited Future of Limited Liability: A Capital Markets Perspective*, 102 YALE L.J. 387, 389 & n.8 (1992) (discussing the need for "portfolio insurance" in the absence of a limited liability regime).

Furthermore, the size of future lawsuits filed against professionals could be reduced by the implementation of the LLC. Plaintiffs or agencies may be less likely to sue for as large an amount if they can reach only the personal assets of the negligent parties. This also would decrease the risk factor involved in insuring professionals for malpractice, which would presumably translate into lower premiums.

However, the conclusion that LLC legislation will have any effect on insurance premiums is admittedly a disputed proposition. Some experts have noted that the legislation is solely tax related and will have virtually no effect on the market for professional insurance.[180] The answer to this question is yet to be determined, but it is noteworthy that some insurance brokers have applauded the move toward limited liability of professionals as something that will have a positive impact on the professional insurance market.[181]

Notwithstanding the dispute over the insurance factor, the LLC's greatest impact will not be felt in this area. Rather, the confidence that the LLC's protection will bring to professionals is what makes the LLC such an attractive entity.

C. *Confidence*

Several of the effects listed in Part II, sections A through D, revolve around the professional's confidence. Whether it is manifested through attracting new clients, reducing wasteful review time, or serving riskier industries, the confidence of the professional that her personal assets are sheltered from judgment cannot be overstated.[182] This confidence will be substantially increased by assuring the professional that she cannot be sued personally unless she is negligent.[183]

This confidence will lead to the professional's retention of high-risk clients,[184] and will therefore help to prevent the fraud that occurs when unqualified professionals serve large high-risk companies. Furthermore, this confidence will help to prevent the professional from

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180. *See* Janet Elliot, *Partnership Liability Bill May Face Governor's Veto*, TEX. LAW., June 10, 1991, at 4 (noting that "[t]he bill was driven by tax considerations rather than insurance concerns and insurance agents say it is unlikely to reduce malpractice premiums.").

181. *See, e.g.*, Jonathan Groner, *This Tort Reform is Pro-Lawyer*, LEGAL TIMES, Nov. 16, 1992, at 1 (noting that the chairman of a mutual insurance company applauded the limited liability bill in Washington, D.C.).

182. *Cf.* Rimerman, *supra* note 164, at 49 ("CPAs can [serve public needs] most productively and cost effectively only after eliminating the threat of losing their life savings if another of their shareholders or partners makes a mistake or acts negligently.").

183. *See id.* at 49.

184. *See id.*

over-protecting herself from the threat of litigation. This process is wasteful, and results in magnifying the economic effect of the litigation explosion.[185]

D. *Insurance for the Uninsured*

Another way that the LLC will help ease the pains of the litigation crisis is by providing those professionals who cannot obtain insurance the ability to continue their businesses without it. Through use of the LLC, they will receive some protection of their personal assets, rather than being on the verge of personal bankruptcy. Although the preferred situation would be for every firm to have insurance, this is simply not the reality of today's professional arena. Allowing uninsured professionals to maintain their personal assets through LLC protection will protect the health of the professions.

Although its effect on the overall litigation crisis will be rather small,[186] the confidence that a limit on liability will bring to professionals cannot be replaced. In short, allowing professionals to become LLCs will enable them to serve their clients more efficiently and cost effectively, while further enabling them to put their minds at ease. Indeed, one commentator has noted that the LLC could be the best solution to the professional liability crisis, because a liability cap is much more palatable to both congressional leaders and state politicians than tort reform.[187] Furthermore, according to one source, virtually all professional firms now operating in partnership form would convert to LLCs if given the choice.[188] This interest exists for a reason: The LLC can end the litigation explosion.

VI. WHY THE LLC IS A PROPER ENTITY FOR PROFESSIONALS

This Part addresses the fundamental reasons why the LLC is a proper remedy for professionals in their defense against the onslaught of litigation in our country today. Section A introduces the public duties of professionals and shows how the LLC is consistent with those duties. Section B addresses policy arguments regarding whether a limitation on liability would be beneficial to society in general.

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185. *See* Atkinson, *supra* note 122.

186. The LLC will not prevent the majority of suits from being filed.

187. Andrew Wheat, *CPAs See Incorporation Reforms as Alternative to Tort Law Changes*, THOMSON'S INT'L BANK ACCT., July 26, 1993, at 1.

188. Vineeta Anand, *Executive Update; Business Law*, INVESTOR'S BUS. DAILY, Dec. 29, 1992, at 3.

A. *The Duties of Professionals*

1. Accountants' Public Duty

The accountant has been referred to as a "public watchdog."[189] Several cases have followed this dictum by then Chief Justice Warren Burger,[190] and it seems to have the force of law. One court has gone so far as to refer to an accounting firm as a "quasi-public official."[191] In *Rosenblum, Inc. v. Adler*,[192] the Supreme Court of New Jersey defined the public duty of the accountant in these terms: "The auditor's function has expanded from that of a watchdog for management to an independent evaluator of the adequacy and fairness of financial statements issued by management to stockholders, creditors and others."[193] The court went on to note that "[t]he certified public accountant acknowledges a moral responsibility . . . to be as mindful of the interests of strangers who may rely on his opinion as of the interests of the client who pays his fee."[194] This moral duty has arisen in modern times in large part because of the increasing public ownership of enterprises and the requirements of stock exchanges.[195]

The extent of this duty has become the subject of much debate in recent years. Accountants have referred to what they call the "expectations gap" between what the public *believes* and what *truly is* the function of an audit.[196] Indeed, as one professional stated, "the

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189. United States v. Arthur Young & Co., 465 U.S. 805, 818, *cert. denied*, 466 U.S. 936 (1984).

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.

Id. at 817-18.

190. *See, e.g.*, First Nat'l Bank v. Monco Agency, Inc., 911 F.2d 1053, 1059 (5th Cir. 1990); United States v. Rockwell Int'l, 897 F.2d 1255, 1265 n.6 (3rd Cir. 1990); Adam v. Silicon Valley Banc Shares, No. C93-20399, 1995 U.S. Dist. LEXIS 1306, at 14 (N.D. Cal.).

191. Mishkin v. Peat, Marwick, Mitchell & Co., 658 F. Supp 271, 275 (S.D.N.Y. 1987).

192. 461 A.2d 138 (N.J. 1983).

193. *Id.* at 149.

194. *Id.* at 150 (quoting J. CARCY, PROFESSIONAL ETHICS OF PUBLIC ACCOUNTING (1946) at 13-14).

195. *See id.* at 149 n.8.

196. *See* Travis Morgan Dodd, *Accounting Malpractice and Contributory Negligence: Justifying Disparate Treatment Based Upon the Auditor's Unique Role*, 80 GEO. L.J. 909, 916 (1992) (citing VINCENT M. O'REILLY ET AL., MONTGOMERY'S AUDITING 19 (11th ed. 1990)); McCarrol, *supra* note 4, at 49.

public has a misconception that it's the CPA's job to detect fraud."[197] The AICPA standards seem to support the assertion that CPAs lack a duty to uncover fraud.[198] However, the conservative view held by many professionals is in complete contrast with the "public watchdog" viewpoint taken by many courts.

This viewpoint is accountant-specific, and other professions have not yet been placed upon such a public pedestal. However, the lawyer's duty to the public has been greatly increased in recent years.

2. Duty of Attorneys

Traditionally, attorneys have not been held to a "public watchdog" standard. However, a few courts have denied any limitation on the professional liability of attorneys, invoking the judiciary's inherent power to regulate the practice of law.[199] In *First Bank & Trust Company v. Zagoria*, the Supreme Court of Georgia expressed concern that, if limited liability were allowed, the practice of law would cease to be a professional service and become a "commercial enterprise."[200] The court went on to note that the primary distinction between the two is "that a profession is a calling which demands adherence to the *public interest* as the foremost obligation of the practitioner."[201] In support of this assertion, the court noted that the relationships between lawyer and client and between lawyer and the other members of her firm are special, stating that "when a client engages the services of a

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197. *Auditors Take Steps to Reduce Their Liability Exposure*, MINNEAPOLIS-ST. PAUL CITY BUS., Sept. 11, 1992, at 13, 14 (quoting Annette Ruzicka, Director of Communications for the Minnesota Society of CPAs).

198. One group of pronouncements by the AICPA is Statements on Auditing Standards (SAS), describing the accountant's duties with regard to the audit function. SAS 53 requires that the auditor "assess the risk that errors and irregularities may cause the financial statements to contain a material misstatement" and to "design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements." *See* AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, AICPA PROFESSIONAL STANDARDS § 316 (1990). The term "errors" refers to unintentional misstatements or omissions. *Id.* § 316.02. The term "irregularities" refers to intentional misstatements or omissions. *Id.*

However, the standard also indicates that the auditor is not an insurer. Her report "does not constitute a guarantee." *Id.* § 316.08. The AICPA defends this position by noting that even a properly designed and executed audit may not uncover irregularities such as collusion among officers to falsify the records, as accountants are not trained to detect such problems. Dodd, *supra* note 196, at 916 n.40.

199. *See* First Bank and Trust Co. v. Zagoria, 302 S.E.2d 674 (Ga. 1983) (denying a limit on professional liability of attorneys); *In re* Bar Ass'n of Haw., 516 P.2d 1267 (Haw. 1973) (denying a limitation on shareholder liability for acts of other shareholders). This power does not necessarily extend to other professions, however. *See* Fure v. Sherman Hospital, 371 N.E.2d 143 (Ill. 1977) (noting that the court's power does not extend to the medical profession).

200. *Zagoria*, 302 S.E.2d at 675.

201. *Id.* (emphasis added).

lawyer the client has the right to expect the fidelity of the other members of the firm."[202] Cases such as *Zagoria* have thrust the lawyer into a position similar to that of an accountant: a protector of the public.

Furthermore, with the recent explosion in lawsuits arising out of the savings and loan debacle, lawyers are increasingly being thrust into a position of public protector. According to one source, the government could be trying to redefine the attorney-client relationship by seeking to emphasize lawyers' duty to the public.[203] This would be accomplished by adjusting the duty of attorneys when they represent clients before a federal agency, such as banking regulators, "at the expense of their obligations to act as advocates."[204] This approach would most likely invade an area traditionally protected by the attorney-client privilege. Notwithstanding this possibility, attorneys will never quite reach the accountant's position as "public watchdog," due to the lawyer's position as an advocate for the client, as opposed to an independent provider of information.

Although professionals are held to higher standards than other businesses and individuals, they should nevertheless be allowed to limit their liability through use of the LLC entity. This practice is consistent with both the professional ethics and public duties of accountants and lawyers.

3. The LLC's Consistency with Professionalism and Public Duty

As one commentator noted: "[A]ll arguments based on professionalism and public reputation are suspect. It is difficult to determine what set of rules will best enhance the legal profession's reputation. Insistence that lawyers are somehow special and different . . . [is] probably see[n] as hypocritical cant."[205]

This analysis should apply with equal force to accountants. Although accountants provide services that affect the public at large, they should not be treated specially. The analysis applied in *Zagoria*[206] and related cases[207] is conclusory at best. The *Zagoria* court simply stated that the relationships among clients, attorneys, and other partners are special and thus professionals should not be able to limit

202. *Id.*

203. *See American Professions, On the Defensive*, ECONOMIST, Mar. 14, 1992, at 90.

204. *Id.*

205. Kalish, *supra* note 139, at 581.

206. First Bank and Trust Co. v. Zagoria, 302 S.E.2d 674 (Ga. 1983).

207. *In re* Bar Ass'n of Haw., 516 P.2d 1267 (Haw. 1973); Nelson v. Patrick, 326 S.E.2d 45 (N.C. Ct. App. 1985).

their liability. What the court failed to do, however, is balance the interests of the client in obtaining the "fidelity of other members of the firm"[208] with the professionals' interest in being treated like any other business. Had the court done such an analysis, it would have discovered that the client's interest in being able to sue every lawyer in a firm is far outweighed by the innocent lawyer's interest in protecting her life savings against judgment for the acts of another. The effect of limited liability on the psyche of the client cannot compare with the constant fear of partner malpractice that invades the mind of the professional on a daily basis. This is especially true in today's world of megafirms spanning the country and even the globe.

Additionally, requiring unlimited liability only because of the higher responsibility that professionals owe society is manifestly unfair. For example, General Motors conducts a business that affects a great deal of the public (and, indeed, affects primarily physical rather than economic safety), and yet neither the shareholders of that company nor its officers are liable for any of the company's torts. No one would argue that such a large corporation lacks *any* public duty. The far reaching public duty of accountants and lawyers should also not be translated into mandatory unlimited liability. As one commentator noted:

> Lawyers are in business. . . . In spite of assertions made by a few courts, law practice in the 1980s is big business. Law firms own buildings, libraries and equipment. They employ large staffs. They often have many branches in several jurisdictions. Law firms need capital, and, as other businesspersons, lawyer-owners should be entitled to shield their personal assets . . . . When lawyers rent space, hire secretaries and purchase equipment, they act like any other businessperson. There is nothing peculiarly professional about these endeavors. This is the ordinary stuff of business.[209]

Accountants are similarly in business. There is no valid reason to ignore this fact and to require professionals to practice in a form mandating unlimited liability. Likewise, there is no policy argument strong enough in favor of unlimited liability to deny professional firms the opportunity to practice as LLCs.

208. *Zagoria*, 302 S.E.2d at 675.
209. Kalish, *supra* note 139, at 575-76 (citations omitted).

B. Other Policy Arguments Regarding Limited Liability for Professionals

1. Public Protection

The most popular argument against limiting the liability of professionals is that unlimited liability provides professionals with a certain discipline and incentive to be careful, thereby further protecting the public.[210] As one politician has said, "[o]ften the best way to ensure quality control is to impose the threat of liability."[211] However, there are several problems with such an assertion.

First, an LLC would only protect professionals from liability for the acts of other members.[212] If a member has been negligent, has supervised negligent work, or has participated in the negligent acts of others, she will be held personally liable.[213] Thus, the LLC only offers its protection to nonnegligent parties, who would not be influenced by a limited liability scheme, as they have not acted negligently.

Second, in a professional context, the goodwill of the firm is at stake whenever a firm is named in a lawsuit.[214] Often, the firm name will have been used for more than a century, having been passed from one generation to the next.[215] This alone provides a significant deterrent to any professional who may feel less reason to be careful due to a limit on her liability.

Third, the extra liability may not provide clients with any true benefit. Although there is more incentive for partners to monitor one another when liability is unlimited, this can be wasteful and even counterproductive.[216] Often this monitoring will involve the second guessing of complex professional decisions and judgment.[217] And, as one commentator has noted, sophisticated corporate clients may effectively monitor their own cases.[218]

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210. *See* Jack L. Carr & G. Frank Mathewson, *Limited Liability as a Barrier to Entry*, 96 J. POL. ECON. 766, 779 (1988).

211. Groner, *supra* note 181, at 1.

212. *See AICPA Members to Vote on Proposal to Let CPA Firms Form Corporations*, *supra* note 138, at G-1.

213. *See id.*

214. *See* Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L.Q. 417, 435 (1992); Carr & Mathewson, *supra* note 210, at 779.

215. *See* Carr & Mathewson, *supra* note 210, at 779.

216. *See* Ribstein, *supra* note 214, at 435.

217. *Id.*

218. *Id.*

Finally, the accounting profession in particular has extensive quality control mechanisms in place.[219] These controls will remain, regardless of the liability status of accountants.

2. Denial of Full Recovery

Another popular argument of those in favor of full liability is that allowing professionals to form LLCs denies a plaintiff the right to be fully compensated for her loss.[220] This argument is flawed as well.

One key problem with this argument is that it ignores the fact that a significant amount of assets is available to victims of malpractice even with a limit on liability. The LLC itself remains vicariously liable for the actions of all of its members.[221] This provides a plaintiff with access to all of the marketable assets of the firm. In addition, any participants in or supervisors of the negligent activity will have their entire share in the firm at stake.[222]

Furthermore, the members will still have a substantial incentive to purchase insurance, as professional firms often have a large net worth that they will obviously seek to protect.[223]

3. Fairness

Yet another argument against professional LLCs is that it is unfair to allow professionals to "have it both ways" by profiting from their professional status but not remaining personally liable for their partners' torts.[224] According to one lobbyist, the professionals, by seeking limited liability, are saying "to heck with the people who rely on our work and opinions."[225] This argument is similarly flawed.

First, the denial of limited liability for attorneys and accountants puts them at a competitive disadvantage against other sectors of the business world by inhibiting their ability to raise capital and protect their assets.[226] Furthermore, by denying a liability cap, professionals

219. Rimerman, *supra* note 164, at 45.

220. *See* Kalish, *supra* note 139, at 579 ("[I]t is true that if lawyer owners are not financially responsible, these injured persons may have fewer sources for compensation than if there were no limited liability.") *Cf.* Ribstein, *supra* note 214, at 434-35 (illustrating why clients would not insist on unlimited liability).

221. Ribstein, *supra* note 214, at 435; *see also* Kalish, *supra* note 139, at 579-80.

222. *See* Ribstein, *supra* note 214, at 435.

223. *Id.*

224. Berton & Lublin, *supra* note 46, at 5.

225. *Id.*

226. *Cf.* Kalish, *supra* note 139, at 575.

are required to answer for the sins of their peers and accept the business risk of their clients.[227]

Additionally, it is illogical to argue that because an individual is successful, that person should be allowed to be sued for things she has not done. The fact that the "wealth of the supplier will compensate" does not explain why all corporate executives are not personally liable for the negligence of their employees. They usually own a share of the company, have substantial assets, and have profited greatly from their occupations, and yet they may limit their liability. Why are professionals singled out merely because they provide a service rather than a product? This question cuts to the essence of the issue of unlimited professional liability.

The personal nature of offering services should not prevent professionals from limiting their liability for negligent acts. Long ago, when accountants and lawyers practiced in one or two person shops, this principle had definite application. There is an obvious public interest in making professionals choose wisely with whom they practice. However, in today's world of nationwide professional practices and diverse service lines, the same reasoning cannot apply. As one professional has said, "[a] partner in Boston shouldn't have all of his assets at risk because another partner in Dallas made a mistake. It's simply unfair."[228]

In order to achieve the most fair situation, a balance must be struck. This balance is between the protection of the public from bad professionals and protection of innocent and uninvolved professionals from the loss of their homes and life savings.[229] The LLC achieves this balance. It allows for the negligent lawyers and accountants to be sued by their victims, but protects innocent professionals from unwarranted liability.

4. Efficiency

Allowing professionals to limit their liability is also more efficient than the alternative. Illustrating this point are two scholars from the University of Toronto, Jack L. Carr and G. Frank Mathewson, who have written an article regarding the efficiency of mandating unlimited liability upon different business forms.[230] The second half of the

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227. *See* Daniel F. Kolb & Michael P. Carrol, *Novel Lawsuits are a Threat to Lawyers, Accountants*, AM. BANKER, Feb. 15, 1991, at 4.

228. Berton & Lublin, *supra* note 46, at 9.

229. *See* Groner, *supra* note 181, at 3.

230. Carr & Mathewson, *supra* note 210, at 779.

article was dedicated specifically to law firms, and the authors assert that this analysis applies to professionals in general.[231]

According to Carr and Mathewson, selectively applied limited liability rules create barriers to entry into the professions and cause those firms excluded from limited liability to be inefficiently small.[232] This is because, by requiring unlimited liability, the cost of ownership rights is raised.[233] This discourages investment in the firm, which in turn causes the firm to remain small in size.[234]

Furthermore, the argument goes, any partner in a law firm is exposed to the inability of the other partners to meet their financial obligations because of limitations on their personal wealth. A sudden downturn in the wealth of an individual partner leads that partner to "free-ride on his partners' ability to deal with any solvency problem that would result."[235]

This, in turn, leads to an allocation of resources to monitoring costs to avoid the "free rider" problem. These monitoring costs are then passed on to the consumers of the law firm, who pay prices that are beyond the expected value of the services they receive.[236]

Finally, the authors show that law firms have higher average receipts and more income per lawyer in states that allow limited liability. This situation presumably results because larger firms, which exist primarily in states allowing limited liability, may handle more complex cases that require better legal talent.[237] This conclusion further illustrates the greater efficiency associated with professional limited liability.

Although the objective of providing professionals with greater profits may not be a valid basis for allowing lawyers and accountants to limit their liability, protecting consumers from inefficiency and the resulting higher costs of professional services certainly is.

Additionally, as noted above, the public protection and fairness arguments asserted by those opposing limited liability do not outweigh the fairness and efficiency reasons to allow professionals the protections they deserve. As one commentator correctly noted: "[T]here does not

231. *See id.* at 778 (noting application to all professional services, including "accounting, law, and medicine").

232. *Id.* at 779.

233. *Id.*

234. *Id.*

235. *Id.*

236. *Id.*

237. *Id.* at 780.

seem to be a valid public policy argument for precluding the use of the LLC form by professional service firms."[238]

C. *The Washington Professional LLC Act: A Model Compromise*

As noted above, the Washington statute requires all professional LLCs to maintain at least $1,000,000 in professional liability insurance.[239] Thus, while the Washington Act protects a professional from liability for negligent acts of other members of the firm, it also protects consumers from the problem of "thinly capitalized" firms with insufficient assets to satisfy judgments or settlements.

Washington's insurance requirement provides an ideal compromise between the competing interests of professionals on one side and their clients and other users of the professionals' services on the other. This compromise may indeed represent the necessary balance between these interests that states prohibiting professional LLCs are seeking in order to fulfill their consumer protection objectives.

VII. CONCLUSION

The litigation crisis in this country is having an outrageous impact on professionals, and the lack of an adequate professional entity only makes the problem worse. The limited liability company is a necessary vehicle for returning to a level of sanity regarding the legal status of professionals in our society. Several states have recognized this fact and acted to change the status quo. However, many states have either ignored or denied the interests of professionals in protecting their personal assets from seizure because of someone else's negligence. This has to change.

The LLC is the proper entity to bring about this change; it complies with every ethical obligation and duty of both lawyers and accountants. To deny these individuals the legal protection they deserve is unfair, inefficient, and irresponsible. As one professional has noted, "[t]he only barrier we have today to obtaining a form of practice that would be more realistic and reasonable is what is not permitted by state laws and regulations."[240] Washington has removed this barrier, while retaining its interest in protecting consumers. Every other state should follow Washington's lead.

238. Connaughton, *supra* note 159, at 197.

239. *See supra* note 150 and accompanying text.

240. Louise D. Haberman, *NASBA Annual Meeting Focuses on Uniformity and Liability*, J. ACCT., Mar. 1993, at 20.