You Wanna Do What? Attorneys Organizing as Limited Liability Partnerships and Companies: An Economic Analysis

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A law school graduate should expect to be sued at least three times in his career.¹

In 1989, I thought I understood what my professional responsibilities were. Now I don’t have a clear understanding of what law is applicable.²

I. INTRODUCTION

It could happen to any law firm in America. Someone makes a drafting mistake, overlooks a filing date, or merely misinterprets a statute or case. The result can be enormous liability that taps not only into a firm’s assets and malpractice insurance policy, but also into the pockets of individual partners; on the line could be a partner’s house, car, investments, even the Matisse hanging on his wall. Just ask the partners at the white shoe Wall Street firm of Kaye, Scholer, Fierman, Hays & Handler (Kaye Scholer).

Their saga began in June 1986, when Peter M. Fishbein, the partner in charge of the Lincoln Savings & Loan Association (Lincoln) account and former chairman of the firm, was called in to help the thrift through a difficult examination by the Federal Home Loan Bank Board, the predecessor agency of the Office of Thrift Supervision

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(OTS). After Lincoln failed, regulators claimed "that Kaye Scholer had concealed damning information about Lincoln from the government." Regulators further claimed "that the firm had a responsibility to the public, not just its client." In addition to requiring Kaye Scholer to pay a monetary fine, regulators insisted that Mr. Fishbein agree to lifetime banishment from practice involving thrifts.

When Kaye Scholer decided to fight, the OTS answered by filing administrative charges, seeking $275 million from the firm and an order permanently barring Mr. Fishbein and three others from practice involving federally insured banks and thrifts. The OTS then froze the partnership's assets. Kaye Scholer was thus forced to capitulate to a $41 million settlement "and the humiliating ostracism of Mr. Fishbein from bank and thrift practice." The first $25 million was covered by the firm's malpractice insurance, but the partners were left to pay the remaining $16 million out of their own pockets. Other firms have also been forced to pay huge settlements over work done for thrifts, including Jones, Day, Reavis & Pogue (Jones Day), the nation's second-largest law firm; Wall Street's Paul, Weiss, Rifkind, Wharton & Garrison; and O'Melveny and Myers.

The increase in liability that attorneys face today is by no means limited to the savings and loan (S&L) crisis, however. Changes in attorney malpractice law and the commercialization of the practice of law are leading to significant settlements and fines.

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4. Id.

5. Id.

6. Id.

7. Id.

8. Id.

9. Id.


13. Anthony E. Davis, The Long-Term Implications of the Kaye Scholer Case for Law Firm Management—Risk Management Comes of Age, 35 S. TEX. L. REV. 677, 677 (1994). Other professionals have also been found liable in similar situations. Besides Kaye Scholer and Jones Day, the underwriting firm of Offerman & Co. in Minneapolis, the accounting firm of Arthur Andersen & Co., and the accounting firm of Ernst & Young have all had liability imposed on them and paid fines arising solely from work done for Lincoln. See Amy Stevens, Ernst & Young and Jones Day Law Firm To Pay $87 Million in Lincoln S&L Case, WALL ST. J., Mar. 31, 1992, at A3.
law have also contributed to the phenomenon of increased liability. As a result of this increase, attorneys now take a long, hard look at the way their firms are organized, often opting for business forms that offer limited liability. As one commentator recently remarked, "Throughout the nation . . . [the use of limited liability forms for professionals] is a tide that is definitely rolling in."14 Although many states have for years recognized the personal services corporation, or PC, two new forms are beginning to loom large on the legal landscape: the limited liability company (LLC) and the limited liability partnership (LLP).15 Both forms seem to offer firms the characteristics they desire most—limited liability and pass-through taxation.16

Although many states have embraced the concept of limited liability for attorneys, approval is not universal. Rhode Island and California statutorily ban attorneys from practicing in such forms.17 Further, even those states that have embraced the concept recognize concerns that, under a limited liability scheme, the quality of attorney work may suffer, and sufficient funds may not be available for potential plaintiffs.18

This Comment argues that attorneys should be allowed to limit their liability by using the LLP and LLC forms to provide relief from the upsurge of liability because traditional arguments against attorneys' use of such forms ignore the changes that have taken place in the practice of law and the dynamic of economic forces, both of which operate as a counterweight to liability limitation.19

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Pass-through taxation allows income to flow through to the partners of an entity without being taxed at the partnership level. The benefit, of course, is that partners do not twice pay taxes on partnership income, once at a partnership level, and again at their personal level. See I.R.C. § 701 (1994); Thomas E. Rutledge & Lady E. Booth, The Limited Liability Company Act: Understanding Kentucky's New Organizational Option, 83 KY. L.J. 1, 7 n.7 (1995).


18. See infra notes 91-95 and 120-122 and accompanying text.

19. The scope of this Comment is limited to consideration of the LLP and LLC forms as a solution to the problems identified. An evaluation of any or all alternative solutions proposed by other commentators is not contemplated or intended. This Comment is also limited to the discussion of issues relating to attorneys. Although accountant liability has also received a great deal of publicity, the problems faced by accountants are not considered. Additionally, although
Section II sets out the traditional arguments against allowing attorneys to limit their liability. It then provides a brief history of limited liability forms and describes the important characteristics of PCs, LLCs, and LLPs. Section III examines the forces driving firms towards limited liability. It looks at the increase in legal malpractice suits, the impact of the S&L crisis, and changes in the law of attorney malpractice, all of which have created an untenable situation. Further, this section examines changes that have occurred in the practice of law, including changes in how attorneys organize and view their practices, and the effects those changes have had on malpractice insurance. Finally, Section IV examines the current legal marketplace from a law and economics perspective, detailing the factors that drive actors to act as they do. It further applies that perspective to the behavior and motivations of attorneys in today's marketplace. This Comment ends by examining the massive externalizations taking place because of the current malpractice crisis.

II. AN OVERVIEW OF THE LIMITED LIABILITY LANDSCAPE

Traditionally, attorneys have not been permitted to limit their potential liability to clients. However, limitations on liability such as those afforded by PCs have recently come into play, and LLPs and LLCs have also emerged as new possibilities. Part A of this section sets out the traditional arguments against allowing attorneys to limit their liability. Part B provides a brief history of how and why attorneys have organized, and parts C, D, and E examine the PC, LLC, and LLP forms respectively.

A. The Three Traditional Arguments Against Allowing Limited Liability

Traditionally, three arguments have been advanced against allowing attorneys to limit their liability to clients.20 First, courts and commentators assert that limited liability will thwart a client's legitimate expectation that the entire firm will be engaged on her

behalf. The Supreme Court of Georgia echoed this concern when it wrote:

A lawyer's relationship to his client is a very special one. So also is the relationship between a lawyer and the other members of his or her firm. . . . When a client engages the services of a lawyer the client has the right to expect the fidelity of other members of the firm. It is inappropriate for the lawyer to be able to play hide-and-seek in the shadows and folds of the corporate veil and thus escape the responsibilities of professionalism.

Second, courts and commentators assert that the practice of law is a professional service, not a commercial business, and that limited liability might erode "traditionally rigorous notions of legal responsibility." Courts require professionals to "exercise the learning and skill ordinarily possessed by members of their profession in the community." Consistent with this requirement for professionals, courts have required attorneys to exercise "that degree of care, skill, diligence and knowledge commonly possessed and exercised by a reasonable, careful and prudent lawyer in the practice of law." Toward that end, attorneys have been prohibited from engaging in certain types of conduct, such as contracting out of the duty of care.

Finally, courts and commentators assert that limited liability may leave injured clients with inadequate remedies. This assertion assumes that unless all of a firm's attorneys can be held personally liable, a deserving plaintiff may be unable to collect on his or her judgment.

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22. See, e.g., id. ("The diligence of this court has been directed toward the assurance that the law practice will be a professional service and not simply a commercial enterprise."); Holm, supra note 20, at 1217.
B. A Brief History of Limited Liability Forms

Prior to the 1960s, law firms organized exclusively as partnerships. Incorporation of professional organizations was so unusual that some states required approval by the state legislature, and others denied it altogether. The noncorporate status of the professional was considered necessary to preserve for clients "the benefits of a highly confidential relationship based upon personal confidence, ability, and integrity." Unlike other businesspersons, attorneys were (and in some states are still) viewed primarily as public service providers. Some states feared that professionals, if allowed to incorporate, would emphasize the business aspect of their professions rather than the service aspect, and clients would suffer as a result.

The 1960s, however, saw the advent of "traditional" PC statutes. Interestingly, the adoptions of the first PC statutes were driven by professionals who wanted corporate tax status, not limited liability. Because professionals were historically organized as partnerships, they were taxed as such; thus, they were unable to obtain any of the employee fringe benefits available only to corporations. A few partnerships found relief in 1960 when the Internal Revenue Service (IRS) adopted the Kintner Regulations, under which professional associations could be taxed as corporations if they exhibited at least

32. In re Florida Bar, 133 So. 2d 554, 556 (Fla. 1961).
33. For example, the Supreme Court of Georgia commented, the diligence of this court has been directed toward the assurance that the law practice will be a professional service and not simply a commercial enterprise. The primary distinction is that a profession is a calling which demands adherence to the public interest as the foremost obligation of the practitioner. Zagoria, 302 S.E.2d at 675; see also In re Florida Bar, 133 So. 2d at 556 ("This necessary personal relationship imposes upon the lawyer a standard of duty and responsibility which does not apply in the ordinary commercial relationship. . . . The corporate entity as a method of doing business will not be permitted to protect the unfaithful or unethical.").
34. See, e.g., Zagoria, 302 S.E.2d at 675; In re Florida Bar, 133 So. 2d at 556.
35. See Holm, supra note 20, at 1216-17.
three of the following four criteria: (1) centralized management, (2) continuity of life, (3) transferability of interest, and (4) limited liability for all investors. Unfortunately, it was nearly impossible for most professionals to meet this standard, and they responded by pressuring state legislatures to pass laws enabling them to organize as corporations. By 1970, virtually all states had adopted enabling mechanisms for lawyers to practice as professional service corporations, primarily so that professionals could obtain "equal footing with other taxpayers." Yet, in spite of this availability, most law firms were still organized as general partnerships.

The LLC was the next organizational form to emerge, and it was completely different from forms previously available. The first LLC statute was enacted in Wyoming in 1977, and the second was enacted in Florida in 1982. The Wyoming LLC statute was used for mining leases, and its principal utility was found in its "unique blend of limited liability and tax status as a pass-through entity." The Florida statute was designed to lure capital into the state. Beyond these specifics, there is very little information on exactly where the idea for LLCs came from or for what use they would be most appropriate.

Despite the enactment of these early LLC statutes, the popularity of LLCs did not explode until 1990 when the IRS ruled that Wyoming

38. See United States v. Kintner, 216 F.2d 418, 422 (9th Cir. 1954).
40. See Holm, supra note 20, at 1218 n.31.
41. In re Florida Bar, 133 So. 2d at 556; see also In re Bar Ass'n of Haw., 516 P.2d at 1268 ("We are mindful that petitioner's principal motive . . . is to enable the attorneys of this State to qualify for the federal tax advantages which would accompany such incorporation."); In re Rhode Island Bar Ass'n, 263 A.2d 692, 695 (R.I. 1970) ("The professional service corporation law in this state was enacted for the purpose of enabling members of the covered professions, not previously allowed to incorporate, to form corporations, thus putting such members on an equal footing with other taxpayers").
42. See Sheldon I. Banoff, New Ruling Adds Further Encouragement for Large Firms to Form LLCs, 81 J. Tax'n 12, 12 (1994).
43. WYO. STAT. §§ 17-15-101 to -125 (1994); see 1 RIBSTEIN & KEATINGE, supra note 29, § 1.06, at 1-7.
45. See Geu, supra note 16, at 48 n.28 (quoting Thomas N. Lung, The Limited Liability Company 3 (Feb. 15, 1989) (unpublished paper on file with the Wyoming Secretary of State)).
47. See Geu, supra note 16, at 50.
LLCs would be treated as partnerships for federal tax purposes.\textsuperscript{48} Since then, a majority of states have adopted LLC statutes,\textsuperscript{49} some of which expressly allow attorneys to organize under them, and some of which are silent on the subject.\textsuperscript{50}

The third organizational form to emerge was the LLP. Similar to LLCs, LLPs provide "greater protection for [their] members."\textsuperscript{51} These protections, while similar, are not identical.\textsuperscript{52} However, LLPs are far easier to create from existing partnerships than are LLCs because, in many states, partnerships can convert to LLPs merely by amending their partnership agreements.\textsuperscript{53}

The first LLP statute was enacted in Texas in 1991,\textsuperscript{54} followed


\textsuperscript{50} Some states that omitted any mention of professionals in their LLC statutes have since recognized the use of LLCs by professionals in other statutes. For example, the Colorado Supreme Court has modified Rule 265 of the Colorado Rules of Civil Procedure to allow attorneys to practice as LLCs. COLO. R. CIV. P. 265 (1990 & Supp. 1995). This change, without statutory recognition, could cause problems in the future. See Smith, supra note 19, at 577.


\textsuperscript{52} See id.

\textsuperscript{53} See id.; see also infra notes 104-114 and accompanying text.

\textsuperscript{54} TEX. REV. CIV. STAT. ANN. art. 6132b (West 1993). As of January 1, 1994, most Texas LLPs are governed by the provisions of Texas House Bill No. 273, which was enacted in
by Louisiana in 1992,55 and Delaware in 1993.56 Since then, many other states have enacted similar legislation.57

C. The Professional Services Corporation—The Outmoded Standard

Currently, attorneys may incorporate as PCs in all fifty states.58 Because PCs provide limited liability for shareholders,59 LLPs and LLCs are ostensibly unnecessary. However, tax disadvantages, the disregard of liability limitations in some states, and restrictions on interstate practice make PCs inefficient and ineffective vehicles for professionals to limit their liability.

First, without LLCs and LLPs, attorneys are forced to choose between the pass-through taxation provided by the partnership form and the limitation on liability provided with the PC form. As corporate entities, PCs are subject to double taxation of income.60 Consequently, at current tax rates, PC members often end up with less than fifty cents for every dollar of pre-tax profits distributed to them as bonuses.61

1993 as the Texas Revised Partnership Act (to be codified as 1993 Tex. Sess. Law Serv. 917, § 9 (Vernon)).


59. See Holm, supra note 20, at 1216-17.


61. See Smith, supra note 19, at 579 n.165 (explaining that under current tax law, the profits of PCs are taxed at a corporate rate, and then the partners must pay personal tax after distribution).
Second, a number of states do not adhere to the limitations on liability that PCs ostensibly provide to their shareholders. For example, the Oregon professional corporation statute provides that shareholders of professional corporations may be held jointly and severally liable with all other shareholders of the corporation for "negligent or wrongful acts or misconduct committed by any shareholder, or by a person under the direct supervision and control of any shareholder in the rendering of professional services on behalf of the corporation to a person receiving the service." The only limitation on liability provided by the statute is for "other contractual obligations of the corporation."

Further, other PC statutes have been rendered useless by judiciaries who either refuse to give weight to liability limitations contained in PC statutes or otherwise disregard the statutes' liability restrictions. For example, the Georgia PC statute, which appears to limit liability, was eviscerated by the Supreme Court of Georgia in 1983. The court held that attorneys who hold themselves out as members of a law firm are jointly and severally liable for all malpractice claims made against the firm. The court commented, "We make no distinction between partnerships and professional corporations in this respect. We cannot allow a corporate veil to hang from the cornices of professional corporations which engage in the law practice." The Supreme Court of Hawaii acted similarly after the Hawaii Legislature passed a PC statute limiting liability. The court allowed organization as PCs for tax purposes, but forbade liability limitations.

62. OR. REV. STAT. § 58.185(2)(c) (Supp. 1994). However, each partner's liability is capped at $300,000 per year. OR. REV. STAT. § 58.185(5) (Supp. 1994). These statutes also apply to professionals organized as LLCs and LLPs. See 1995 OR. LAWS 63.074(2); 1995 OR. LAWS 68.270(6). See also ARIZ. REV. STAT. ANN. § 10-905 (1977); WIS. STAT. ANN. § 180.99(8) (West Supp. 1985).
63. OR. REV. STAT. § 58.185(7) (Supp. 1994).
64. GA. CODE ANN. § 14-7-7 (1980).
66. Zagoria, 302 S.E.2d at 676.
67. Id.
68. HAW. REV. STAT. § 415A-11(b) (1988).
70. Id. at 1268 (holding that "adoption would not provide adequate protection to a client's claims against a law corporation"); see also Vinall v. Hoffman, 651 P.2d 850, 851 (Ariz. 1982) (discussing ARIZ. REV. STAT. ANN. § 10-909 (1977)); Anderson v. McBurney, 467 N.W.2d 158, 163 & n.7 (1991) (discussing WIS. STAT. ANN. § 180.99(8) (West Supp. 1985)).
Third, some PC statutes contain limits on interstate practice. This nullifies much of a firm's liability protection, as many firms have business interests in multiple states. Currently, no LLC or LLP legislation restricts a firm's interstate volume.

D. The Limited Liability Company—The New Kid on the Block

1. Typical Provisions for Formation

To form an LLC, a certificate of formation must be filed with the appropriate state agency. This certificate must set forth: the name of the LLC; the address of the registered office and agent for service of process; the address of the LLC's principal place of business; the specific date of dissolution if one exists; a statement that the management of the LLC is vested in a manager or managers if that decision is made; the names and addresses of all members; the period of duration, which may be perpetual; the purpose for which the LLC is organized; and anything else the members choose to include.

72. See Smith, supra note 19, at 580.
74. Texas and Washington have representative LLC statutes. Accordingly, the analysis in this Comment is based on the provisions in those states. To the extent that statutes in other states differ, the analysis in this section may or may not apply.
75. The Secretary of State is usually the proper agency. E.g., TEX. REV. CIV. STAT. ANN. art. 1528n-11.01(A)(1) (West Supp. 1995); WASH. REV. CODE § 25.15.070(1) (1994).
83. TEX. REV. CIV. STAT. ANN. art. 1528n-3.02(3), 11.01A(1)(b). Washington does not require this.
Additionally, the name of the organization must include "Limited Liability Company," "Limited Liability Co.," or "L.L.C."\(^{85}\) LLCs also must maintain a registered office\(^{86}\) and a registered agent for service of process.\(^{87}\) Washington requires LLCs to deliver their annual reports to the Secretary of State in order to keep all information current.\(^{88}\) Although Texas does not have that requirement, the Texas Secretary of State does have the right to propound interrogatories to any LLC, and these interrogatories must be answered under oath.\(^{89}\) Finally, foreign LLCs may register and do business in both states.\(^{90}\)

The principal difference between the Texas and Washington statutes is that professionals organizing as Texas LLCs are not required to maintain liability insurance, while Washington requires professional LLCs to carry at least one million dollars of malpractice insurance or its equivalent to ensure protection from personal liability.\(^{91}\) Another significant difference is that in Texas, each LLC may render only one specific type of professional service, while Washington has no such express limitation.\(^{92}\)

Personal liability for LLC members is unchanged from that under traditional forms. Attorneys who commit negligent or fraudulent acts subjecting them to liability under current PC or partnership statutes

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88. WASH. REV. CODE § 25.15.105 (1994). Texas requires only that any changes be filed with the Secretary of State. See TEX. REV. CIV. STAT. ANN. art. 1528n-2.06(A) (West Supp. 1995).
89. TEX. REV. CIV. STAT. ANN. art. 1528n-8.01(A) (West Supp. 1995).
91. WASH. REV. CODE § 25.15.045(2) (1994). The statute provides:
If the company's members are required to be licensed to practice such profession, and the company fails to maintain for itself and for its members practicing in this state a policy of professional liability insurance, bond, or other evidence of financial responsibility of a kind designated by rule by the state insurance commissioner and in the amount of at least one million dollars or such greater amount as the state insurance commissioner may establish by rule for a licensed profession or for any specialty within a profession, taking into account the nature and size of the business, then the company's members shall be personally liable to the extent that, had such insurance, bond, or other evidence of responsibility been maintained, it would have covered the liability in question. Id.
92. TEX. REV. CIV. STAT. ANN. art. 1528n-11.01A(2) (West Supp. 1995).
remain personally liable under typical LLC statutes. For example, the Texas Legislature provided that "[t]his Act does not remove or diminish any rights at law that a person receiving professional service has against a person rendering the service for an error, an omission, negligence, incompetence, or malfeasance." Additionally, the LLC itself is jointly and severally liable for any acts performed by a member during the course of employment.

2. The LLC—Leaving Many Questions Unanswered

LLC legislation is often problematic because of its brevity and because no specific analogue for LLC choice of law problems has been adopted. For example, questions remain regarding the appropriateness of traditional concepts of partner liability, particularly in connection with the potential liability of partners for the tortious conduct of other partners.

Additionally, questions exist as to whether or not case law regarding piercing of the corporate veil is appropriate in situations involving LLCs. Thus far, only Colorado has given a definitive "yes," although commentators anticipate that other jurisdictions may follow. For example, statutory changes brought on by the Georgia Revised Limited Partnership Act may signal the application of veil-piercing case law to LLCs. Washington has apparently followed suit, providing that members of an LLC are "[p]ersonally liable for

97. See id. at 670-71.
98. See id. at 670.
99. The Colorado LLC Act provides:
In any case in which a party seeks to hold the members of a limited liability company personally responsible for the alleged improper actions of the limited liability company, the court shall apply the case law which interprets the conditions and circumstances under which the corporate veil of a corporation may be pierced under Colorado law.

100. See Keatinge, supra note 73, at 445 (explaining that because Georgia has eliminated the control rule, corporate veil piercing precedents may apply).
any act, debt, obligation, or liability of the limited liability company to the extent that shareholders of a Washington business corporation would be liable in analogous circumstances."\footnote{101} The statute goes on to say that courts may consider case law developed with regard to piercing the corporate veil of business corporations.\footnote{102} To date, no uniform law has emerged on the subject of veil piercing, although the ABA has a committee looking into drafting a uniform act.\footnote{103}

\section{E. The Limited Liability Partnership—Modification of an Existing Standard}

1. Typical Provisions for Formation\footnote{104}

To form an LLP, an existing partnership must file an application\footnote{105} with the appropriate state agency,\footnote{106} stating information such as the following: the name of the partnership;\footnote{107} the address of its principal office, and for partnerships not in the state, the address of a registered office and the name and address of a registered agent for service of process in the state;\footnote{108} and a brief statement of the business in which the partnership engages.\footnote{109} In addition, the typical statute requires payment of an annual fee based upon the number of partners;\footnote{110} the addition of the words "Registered Limited Liability Partnership" or the abbreviation "L.L.P." to the firm name;\footnote{111} and

\footnote{101}{WASH. REV. CODE § 25.15.060 (1994).}
\footnote{102}{Id.}
\footnote{104}{Delaware and Texas LLP statutes are typical. To the extent that statutes differ from those in Delaware and Texas, this Comment may or may not apply.}
\footnote{105}{DEL. CODE ANN. tit. 6, § 1544(a) (1993); TEX. REV. CIV. STAT. ANN. art. 6132b-3.08(b)(4) (West Supp. 1995).}
\footnote{106}{The Secretary of State is usually the appropriate agency. DEL. CODE ANN. tit. 6, § 1544(a) (1993); TEX. REV. CIV. STAT. ANN. art. 6132b-3.08(b)(1) (West Supp. 1995).}
\footnote{107}{DEL. CODE ANN. tit. 6, § 1544(a)(1) (1993); TEX. REV. CIV. STAT. ANN. art. 6132b-3.08(b)(1)(A) (West Supp. 1995).}
\footnote{108}{DEL. CODE ANN. tit. 6, § 1544(a)(2)-(3) (1993) (Delaware LLPs have a continuing duty to maintain a registered office and agent.); TEX. REV. CIV. STAT. ANN. art. 6132b-3.08(b)(1)(C) (West Supp. 1995) (Texas does not require LLPs to maintain a registered agent for the service of process.).}
\footnote{109}{DEL. CODE ANN. tit. 6, § 1544(a)(4) (1993); TEX. REV. CIV. STAT. ANN. art. 6132b-3.08(b)(1)(E) (West Supp. 1995).}
\footnote{110}{DEL. CODE ANN. tit. 6, § 1544(c) (1993) ($100 per partner, which is capped by the maximum annual corporation franchise tax as specified in § 503(c) of title 8); TEX. REV. CIV. STAT. ANN. art. 6132b-3.08(b)(3) (West Supp. 1995) ($200 per partner).}
\footnote{111}{DEL. CODE ANN. tit. 6, § 1545 (1993); TEX. REV. CIV. STAT. ANN. art. 6132b-3.08(c) (West Supp. 1995).}
the execution of the application by a majority of the partners or by one or more partners authorized to execute such an application.\textsuperscript{112}

Further, LLPs typically must carry malpractice insurance, or post a bond or similar deposit "of a kind that is designed to cover the kinds of negligence, wrongful acts, and misconduct for which liability is limited . . . and which insures the partnership and its partners."\textsuperscript{113} If an LLP is in compliance with the insurance requirements, those requirements shall not be admissible or made known to the jury in determining liability for the extent of a debt, an obligation, or damages.\textsuperscript{114}

2. Future Implications

Many of the provisions in LLPs resemble those of the Uniform Partnership Act, as many states have merely revised their limited partnership acts to allow for LLPs.\textsuperscript{115} Consequently, courts are likely to rely on traditional partnership law in addressing LLP choice of law problems. Further, the "internal affairs doctrine," which gives controlling weight to the laws of the state in which organizations such as corporations and limited partnerships are organized, may apply to LLPs.\textsuperscript{116} The Texas Legislature, for example, specifically included such a provision in its LLP legislation.\textsuperscript{117}

Although negative implications accompanying LLPs are minimal, two seem possible. First, none of the current LLP legislation defines the terms used in its lists of excused conduct. However, because many

\textsuperscript{112} DEL. CODE ANN. tit. 6, § 1544(b) (1993); TEX. REV. CIV. STAT. ANN. art. 6132b-3.08(b)(2) (West Supp. 1995).

\textsuperscript{113} DEL. CODE ANN. tit. 6, § 1546(a) (1993). Delaware requires a minimum of $1,000,000 of insurance or "$1,000,000 of funds specifically designated and segregated for the satisfaction of judgments against the partnership or its partners based on the kinds of negligence, wrongful acts, and misconduct for which liability is limited . . . ." DEL. CODE ANN. tit. 6, § 1546(d) (1993). Texas has an almost identical statute, except that the minimum amount is $100,000. TEX. REV. CIV. STAT. ANN. art. 6132b-3.08(d)(A) (West Supp. 1995).

\textsuperscript{114} See DEL. CODE ANN. tit. 6, § 1546(c) (1993); TEX. REV. CIV. STAT. ANN. art. 6132b-3.08(d)(2) (West Supp. 1995).

\textsuperscript{115} Alson R. Martin, \textit{Limited Liability Companies (LLCs): The New Game In Town}, in ALI-ABA COURSE OF STUDY: ESTATE PLANNING FOR THE FAMILY BUSINESS OWNER 89, 143 (1994); see also R. Dennis Anderson et al., \textit{Registered LLPs}, TEX. B.J., July 1992, at 728 (explaining that Texas's LLP act was "authorized by amendments to the Texas Uniform Partnership Act").


of the lists appear to have originated in the provisions of PC statutes, the definitions in the PC statutes will likely be used. 118 Second, certain partners in the same firm may be more likely than others to be held liable for malpractice judgments. Consequently, partners in high-risk departments, such as mergers and acquisitions, may become the target of ire from partners in less risk-prone departments. 119

Individual negligence, fraud, and malpractice are not excused under LLP statutes. Attorneys who commit negligent or fraudulent acts subjecting them to liability under current PC or partnership statutes remain personally liable under typical LLP statutes. 120 For example, if two partners are jointly working on a project, and one makes a mistake that the other knows about (or reasonably should know about) but fails to take reasonable steps to fix, both partners are liable. 121 Additionally, joint and several liability for partnership debts arising out of obligations such as contracts and mortgages remains intact. 122

III. FORCES DRIVING NEW BUSINESS FORMS—THE MALPRACTICE CRISIS

Professionals are probably the most prevalent users of limited liability business forms. As one commentator has noted, the principal benefit derived from limited liability forms is "peace of mind." 123 As a practical matter, partners' personal assets are at risk in a malpractice suit only when all of the firm assets and malpractice insurance have been depleted, something that has rarely happened. 124 Yet, attorneys are worried. 125 These worries are principally fueled by an increase in malpractice suits, actions taken by government regulators in the wake of the S&L crisis, revisions in the rules governing attorney malpractice, erosion of the partnership tradition, and increases in the cost of malpractice insurance coupled with decreases in coverage.

118. Cf. Anderson, supra note 115, at 729-30 (dealing with the term "Representative").
120. See, e.g., DEL. CODE ANN. tit. 6 § 1515(b) (Supp. 1994); TEX. REV. CIV. STAT. ANN. art. 6132b-3.08(a) (West Supp. 1995).
122. See, e.g., id. art. 6132b-3.08(a)(2).
124. See Adams, supra note 119, at 2.
125. See Stevens, supra note 2, at B12.
A. Increase in Malpractice Suits

In recent years, the frequency of malpractice claims against lawyers has soared, and large verdicts against attorneys are no longer an uncommon occurrence. Further, law firm liability exposure—and that of its partners—has climbed sharply with the increase in the size of business transactions that major corporate law firms now routinely handle. Even more distressing is the extreme imbalance that exists between the fee collected by the firm and the amount of money involved in a transaction, which is typically the amount for which the firm can be sued. Moreover, liability insurance, particularly for smaller firms, may cover only a fraction of the funds at stake in big transactions.

An additional cause for concern is that law firms are finding themselves liable in situations they never before anticipated. For example, in Washington State Physicians Insurance Exchange & Ass'n v. Fisons Corp., liability was imposed on a firm for acts that the firm's partners never imagined could subject them to liability. In Fisons, the Washington Supreme Court determined that sanctions should be imposed against one of Seattle's largest firms, Bogle & Gates, for discovery abuses. The court made this determination despite the fact that many large litigation firms in Washington filed declarations stating that Bogle & Gates had followed the same discovery practices that Washington litigation firms have followed for years, and prominent legal ethics experts filed declarations stating

126. See Sheldon G. Larkin, Legal Negligence: Strategies to Avoid Law-Practice Pitfalls, TRIAL, Feb. 1987, at 30, 31 (showing evidence that legal malpractice claims rose from one for every fifty lawyers in 1980 to one for every seventeen lawyers in 1985); Donna K.H. Walters, New Liability Twist Has Lawyers, Accountants Scurrying, L.A. TIMES, Mar. 29, 1992, at D1 (explaining that law firms are so worried about potential liability that many now review the riskiness of each potential new client before deciding whether or not to accept it as a client).
127. See King, supra note 1, at 28 (explaining that the numbers involved are "mind-boggling").
128. Geyelin, supra note 123, at B3.
129. See King, supra note 1, at 28.
130. See Geyelin, supra note 123, at B3.
131. See infra notes 133-36 and accompanying text.
133. Id. at 344-45, 858 P.2d at 1078.
134. See, e.g., Smith Affidavit at 3, Fisons (No. 57696-3) (Chairman of Litigation Department at Davis Wright Tremaine, Seattle, Washington); McNaull Affidavit at 4, Fisons (No. 57696-3) (partner in charge of Litigation Department at Culp, Guterson & Grader, Seattle, Washington); Greenan Affidavit at 8, 10, Fisons (No. 57696-3) (senior partner specializing in complex litigation at Schwabe Williamson Ferguson & Burdell, Seattle, Washington, member of Washington State Bar Association Permanent Committee on Character and Fitness); Gerrand
that they saw no ethical violations. Fisons underscored the fundamental dichotomy that attorneys regularly face: how to balance the role of zealous advocate with the role of officer of the court.

The uncertainty in the standards to which they will be held is a compelling impetus for attorneys seeking limited liability forms. Nowhere has this uncertainty been more drastically illustrated than in the S&L crisis.

B. The Savings and Loan Crisis

In recent years, the federal government has brought more than 150 claims against law firms involved in thrift bailouts, with more than half of those arising from the S&L crisis. Although none of the cases have been submitted to a jury, many resulted in settlements. Some of the larger settlements include:

- Wall Street’s Kaye Scholer’s settlement with the OTS for $41 million. The settlement came after the OTS filed administrative charges seeking $275 million from Kaye Scholer and froze the partnership’s assets.

- A $51 million settlement between Jones Day, the nation’s second-largest law firm with more than 1,000 lawyers, and the Resolution Trust Company (RTC) over Jones Day’s role in the breakup of Lincoln Savings & Loan.

- Wall Street’s Paul, Weiss, Rifkin, Wharton & Garrison’s settlement with the RTC for $45 million over its representation of CenTrust Savings Bank.

Affidavit at 4-5, Fisons (No. 57696-3) (Chairman of Aviation and Products Liability Department at Perkins Coie, Seattle, Washington); Moceri Affidavit at 4-5, Fisons (No. 57696-3) (senior litigation partner at Reed McClure, Seattle, Washington); Tausend Affidavit at 8-10, 13, Fisons (No. 57696-3) (partner at Preston Gates & Ellis, Seattle, Washington, former Dean of the University of Puget Sound School of Law).

135. See, e.g., Boerner Declaration at 3, 10-11, Fisons (No. 57696-3) (Associate Professor of Law at Seattle University School of Law teaching Professional Responsibility, former chair of Rules and Professional Conduct Committee of the Washington State Bar Association); Hazard Affidavit at 9, Fisons (No. 57696-3) (Sterling Professor of Law at Yale Law School, Director of American Law Institute).

136. See Stevens, supra note 2, at B12.


139. See Reuben, supra note 10, at 55-56.

140. Lambert, supra note 11, at B12.

141. See Stevens, supra note 2, at B12.
As of mid-1992, over ninety cases were still pending against law firms for the S&L debacle alone.\textsuperscript{142} Attorneys and their insurers have paid out roughly $400 million in response.\textsuperscript{143} To date, few firms have, like Kaye Scholer, exceeded their malpractice coverage.\textsuperscript{144} In the near future, however, firms are likely to be faced with claims that drastically exceed their policy limits. According to Robert O'Malley, loss prevention counsel for the Attorneys' Liability Assurance Society, which insures 370 firms, "[I]n the next five years, it is quite possible some [firm] will face a $150 million or $200 million judgment."\textsuperscript{145}

At a time when attorneys are being charged with violating their ethical duties at an unprecedented rate, no court has spoken with finality to whether the standards applied by government agencies are correct.\textsuperscript{146} The Kaye Scholer case discussed in the introduction is a case in point. Kaye Scholer attorneys thought they were properly and ethically serving their client.\textsuperscript{147} In fact, the firm paid approximately $10,000 for an evaluation from Geoffrey C. Hazard Jr., a Yale Law School ethics professor who has played a pivotal role in the development of lawyers' rules of conduct. According to Professor Hazard, had Mr. Fishbein and Kaye Scholer volunteered the information that the OTS said it should have, the lawyers would have violated their ethical duties to their client.\textsuperscript{148} A disciplinary committee of the New York Bar Association has since looked into the case and found no evidence that any Kaye Scholer partner violated ethical rules.\textsuperscript{149} However, because the firm's assets were frozen, paying employees, partners, and suppliers became impossible.\textsuperscript{150} Settlement was its only option.

\textsuperscript{142} Edward A. Adams, \textit{Thrift Litigation Fallout Suits Increasing; Firm Grip Sought}, N.Y. L.J., June 18, 1992, at 5.
\textsuperscript{143} See id.; see also Harris Weinstein, \textit{Attorney Liability in the Savings and Loan Crisis}, 1993 U. ILL. L. REV. 53, 53. Mr. Weinstein notes that in the four years ending in October 1992, there were over "1000 criminal cases and nearly 2000 civil cases arising from the savings and loan crisis. These include more than ninety civil cases brought against lawyers." Id.
\textsuperscript{144} Adams, supra note 119, at 1.
\textsuperscript{145} Id.
\textsuperscript{146} See Stevens, supra note 2, at B12.
\textsuperscript{148} See Stevens & Thomas, supra note 3, at A1.
\textsuperscript{150} See Stevens & Thomas, supra note 3, at A5.
C. Changes in the Law of Liability

Changes in legal malpractice law have also contributed to the increase in liability for attorneys, thus encouraging them to seek new business forms. Specifically, revisions have occurred in areas such as statutes of limitations, privity, and the duty of care.

First, statutes of limitations have changed dramatically from the 1960s, when they were “extremely favorable to legal malpractice defendants.” In the 1960s, statutes generally started running when “the essential facts constituting the claim” occurred, unless “an attorney . . . affirmatively conceal[ed] his negligence.” Thus, in many cases, injured parties were barred from bringing claims before they even discovered the alleged injury. Worse, the injury may not have been foreseeable or it may not have even occurred before the statute extinguished the remedy. Now, however, most states require than an actual injury occur before the applicable statute is triggered.

Second, the duty of care—“generally the next element of a legal malpractice claim”—has also undergone significant changes in the last thirty years. The traditional rule has been that only those with privity—actual clients—can maintain malpractice actions. The origins of this doctrine can be traced to two English cases from the mid-1800s. The court in one case summed up the policies underlying the rule when denying standing to a party by commenting,

152. See id.
153. Statutes of limitations are “the most common and effective affirmative defense to allegations of legal malpractice.” Id. at 1559.
154. Id.
156. Lawyers' Responsibilities, supra note 151, at 1559 n.49 (citing, for example, Wilder v. Secor, 33 N.W. 448, 449 (Iowa 1887)).
159. Lawyers' Responsibilities, supra note 151, at 1560.
160. See id.
161. See 1 RONALD E. MALLEN & JEFFREY M. SMITH, LEGAL MALPRACTICE § 7.4, at 364 (1993) [hereinafter LEGAL MALPRACTICE].
162. Id. (citing Winterbottom v. Wright, 152 Eng. Rep. 402 (1842) and Robertson v. Fleming, 4 Macq. 167 (H.L. 1861)).
The only safe rule is to confine the right to recover to those who enter into the contract: if we go one step beyond that, there is no reason why we should not go fifty. The only real argument in favor of the action is, that this is a case of hardship; but that might have been obviated, if the plaintiff had made himself a party to the contract.\(^\text{163}\)

In recent years, however, courts have generally begun to relax the privity requirement, but only where there is a "basis for a duty between the plaintiff and the attorney."\(^\text{164}\) The two principal theories under which privity has been expanded are "the California determination by a multicriteria balancing test,"\(^\text{165}\) and a "more traditional approach . . . based upon the concept of a third-party beneficiary contract."\(^\text{166}\)

Third, more and more attorneys are finding themselves subject to a standard of care higher than that of an ordinary attorney.\(^\text{167}\) As specialization increasingly dominates the realities of modern legal practice,\(^\text{168}\) higher expectations are being placed on attorneys.\(^\text{169}\) The current trend is toward holding attorneys to a standard equivalent to that of "other specialists of ordinary skill and capacity specializing in the same field."\(^\text{170}\) This trend "significantly increase the likelihood that [specialists] will be found in breach of their professional duty."\(^\text{171}\)

The bottom line is that things that were once certain are certain no longer. One of the key factors generating uncertainty has been erosion of the partnership tradition.

**D. Erosion of the Partnership Tradition**

The practice of law has undergone enormous change in the last fifteen years. Previously, nearly all law firms were "small shops" organized as partnerships, in which "like-minded men"\(^\text{172}\) worked mind-numbing hours as associates in order to ascend to the "holy

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\(^\text{164}\) LEGAL MALPRACTICE, supra note 161, § 7.11, at 381.
\(^\text{165}\) Id. § 7.11, at 382.
\(^\text{166}\) Id.
\(^\text{167}\) See id. § 15.7, at 335 (citing FDIC v. O'Melveny and Myers, 969 F.2d 744 (9th Cir. 1992), rev'd, 114 S. Ct. 2048 (1994)).
\(^\text{168}\) See id. § 15.4, at 864.
\(^\text{169}\) See Lawyers' Responsibilities, supra note 151, at 1563.
\(^\text{170}\) Wright v. Williams, 121 Cal. Rptr. 194, 199 (Ct. App. 1975).
\(^\text{171}\) Lawyers' Responsibilities, supra note 151, at 1563.
\(^\text{172}\) Lublin, supra note 30, at 5.
grail" of a lucrative partnership. The practice of law was an "essentially collegial occupation, whose essence was defined by the word 'profession' and which was practiced by individuals either alone or in firms that prized their members' individuality." The issue of liability did not even cross the minds of partners because they knew their fellow partners well. This partnership tradition traces its roots to the late 1700s, when incorporation still required a state legislature's approval.

In recent years, however, many firms have become "huge, anonymous, far-flung enterprises, where making partner doesn't even guarantee job security." Additionally, attorneys are moving from firm to firm at an unprecedented rate, often taking clients with them. Such moves are commonly made to gain a partnership position when one is not available at one's old firm, or to increase a salary. Put simply, business considerations have come to dominate the practice of law.

Further, as firms balloon in size to accommodate multinational clients and diffuse the costs of expensive equipment, partners are now liable for the work of hundreds of partners they may never have met. As one partner put it, "In 1970, when a predecessor firm had 23 partners, if one got a divorce, we all cared." With the current 375 partners, "we don't always know and nobody cares unless it affects the partner's performance in the firm." Indeed, it is unlikely that attorneys practicing twenty-five years ago would have envisioned the business realities that dominate law practice in the 1990s. Yet commentators now make statements like, "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." The very fact that this statement was made underscores just how many changes have occurred.

173. Id.
174. Davis, supra note 13, at 679.
175. See Lublin, supra note 30, at 5.
176. Id.
177. Id.
179. Davis, supra note 13, at 679.
181. Lublin, supra note 30, at 5.
182. Id. (quoting John Hunnicut, lobbyist for the American Institute of Certified Public Accountants).
E. Malpractice Insurance

Malpractice insurance is one area that reflects many of the above mentioned changes in the practice of law. Malpractice premiums have increased at astronomical rates while overall coverage has decreased. This problem is amplified by malpractice policy provisions that hold firms liable for work their partners performed at their former firms.

1. Escalating Costs of Insurance

Legal malpractice insurance costs are increasing at a double-digit rate annually. These increases are attributable to several causes, such as the increase in malpractice suits, the S&L crisis, and changes in legal malpractice law. Many attorneys look to the professional insurance crisis of the mid-1980s, during which many lawyers' malpractice insurance premiums doubled or even tripled, as the beginning of this phenomenon. This problem of escalating premiums is worsened each time a large settlement is forced on a firm. One commentator recently remarked that "Kaye Scholer's staggering settlement—and a $24 million settlement this spring by Jones, Day, Reavis & Pogue—may push up legal-malpractice premiums paid by partners by as much as 50 percent in the next two years.

Whatever the cause, the crisis is clearly ongoing: Malpractice premiums have skyrocketed in recent years, with Southern California malpractice rates running from $5,000 to $12,000 per attorney annually. Additionally, premiums in all areas of the country continue to increase twenty percent every year.

2. Structure of Malpractice Insurance

Malpractice insurance is typically written on a claims-made basis rather than as "occurrence" coverage. This means that the policy

183. See King, supra note 1, at 28 (explaining that rates are rising at an average of twenty percent annually).
184. See supra section III.A.
185. See supra section III.B.
186. See supra section III.C.
188. Lublin, supra note 30, at 5.
189. Walters, supra note 126, at D1.
190. See King, supra note 1, at 28.
covers only those claims that are made while the policy is in effect; it does not necessarily cover all claims arising from one event. Thus, if partner "A" is negligent, and partner "B" leaves the firm before a claim is made, partner B’s new firm could be liable for part of the settlement. In fact, a plaintiff would find partner B to be a particularly attractive defendant because of the addition of another insurance company. As unfair as this practice sounds, it happens. The government, in the wake of the thrift bailout, has aggressively gone after the insurance proceeds of those firms having partners who were previously partners in firms sued over thrift failures. Further, the potential for these kinds of lawsuits will only increase in light of the fact that major law firms are going out of business and those still in business are reducing the number of partners they do have.

3. Results of the Insurance Crisis

The results of this ongoing "insurance crisis" are reflected in the behavior of law firms and liability carriers, and by the economic health of the country. Insurance companies are sometimes excluding particular practice areas from coverage altogether, and they are becoming more aggressive when investigating potential insureds. For example, Myers-Baker & Co., Inc., an insurance company specializing in lawyers’ liability policies, now includes on its application questions about the firm’s office procedures for monitoring liability-incurring situations. “If in [response to] the question related to docket control or deadline control systems an attorney says that he has no systems, he would be turned down and the risk would be denied.”

Law firms themselves are reacting defensively to the insurance crisis. For example, at Los Angeles-based Kindell & Anderson, each new file goes through eight steps in the liability review process. Additionally, some firms have dropped existing high-risk clients or refused to accept business from others. Further, in a disturbing trend, many firms, especially small to medium size firms, are now “going bare,” or operating without any insurance. These firms are doing so both because of spiraling costs and because many insurers

192. Booth, supra note 191, at 5.
193. See Lublin, supra note 30, at 5.
194. King, supra note 1, at 28.
195. Id. (quoting Holly Myers, Executive Vice President at Myers-Baker & Co., Inc.).
196. Id.
197. See Walters, supra note 126, at D1.
simply no longer cover professionals due to the enormous amount of uncertainty and risk involved.199

The costs of the crisis are not confined to insurers and law firms, however. Professional liability lawsuits cost the country $17.8 billion per year.200 According to a study commissioned by the American Tort Reform Association, litigation against professionals will
- cost the nation 224,000 jobs per year between 1992 and 1996;
- increase the federal budget deficit by an average of $3.7 billion per year;
- cut state and local government surpluses $1.2 billion per year; and
- reduce real output in manufacturing by $6.9 billion per year.201

Thus, the changes that the malpractice crisis has thrust upon the legal profession are enormous. The increase in the number of malpractice suits, coupled with the savings and loan crisis and evolving notions of lawyer responsibilities, have created an untenable situation. However, many of the economic factors that have driven the legal market to where it is today also dictate that the concerns identified by critics of the new forms are misplaced.

IV. THE REGULATING IMPACT OF THE MARKET

Although attorneys have sought relief from increased malpractice liability by organizing as LLPs and LLCs, troubling questions remain. Will attorneys lose their incentive to regulate each other? Will clients who suffer real and serious wrongs be left without a remedy? Will the practice of law degenerate into an environment where liability for one’s own actions becomes a meaningless concern?

199. See Thomas McCarrol, Who’s Countirng, TIME, Apr. 13, 1992, at 48 (although McCarrol’s article emphasizes the accounting profession, professionals generally are considered).
201. Id. Atkinson’s article also provides a description of the study.
Economic theory, which asserts that people make those choices that maximize their personal wealth, "is a valuable tool for understanding, interpreting, and creating law." The theory is grounded in "neoclassical price theory, or microeconomics." The theory indicates that the answers to questions such as those raised above are "No," as such alternatives result in an inefficient allocation of resources, which is counter to the way in which professionals such as attorneys generally behave.

Economic theory dictates that the quality of legal work will not be diminished by allowing attorneys to utilize LLPs and LLCs to limit their liability for several reasons. First, attorneys will work to produce error-free, high quality legal services for their clients because they want to retain employment positions and clients. Second, attorneys are deterred from negligent behavior because they have invested substantial resources in their careers and reputations, and will thus act to protect their accumulations of wealth, not risk them. Third, attorneys will continue to monitor each other to ensure continued malpractice coverage, which is a requirement under most LLP and LLC statutes.

Further, imposing unlimited liability on attorneys does not always guarantee attorney self-monitoring. It does, however, guarantee that

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202. One of the more prominent adherents to this approach is Judge Richard Posner. Judge Posner, who was appointed to the federal bench December 4, 1981, is a prolific writer, having authored numerous books, appellate decisions, and over 100 articles. Gordon Crovitz, Winds of Change on the Bench, WALL. ST. J., Mar. 15, 1985, at 24. He also wields great influence—his opinions having been cited in approximately 1,000 cases. Id.

Although economic analysis has traditionally been associated with conservative political views, scholars as a whole have not limited its application in that manner. Economic analysis has, for example, been applied in radical legal analysis. See, e.g., Bruce A. Ackerman, The Marketplace of Ideas, 90 YALE L.J. 1131, 1138-39 (1981). Throughout this Comment, the terms "economic" and "economics" will refer to neoclassical microeconomics. Alternative schools of thought, such as Marxist economics, are inapplicable to the analysis used in this Comment.

203. See George M. Cohen, Comment, Posnerian Jurisprudence and Economic Analysis of Law: The View From the Bench, 133 U. Pa. L. REV. 1117, 1118 (1985). Although Mr. Cohen wrote his article while a student at the University of Pennsylvania Law School, he was also a Ph.D. candidate in economics. Id. at 1117 (author's biography). See also Whitney Cunningham, Note, Testing Posner's Strong Theory of Wealth Maximization, 81 GEO. L.J. 141, 161 (1992).

204. See Cohen, supra note 203, at 1117.

205. Id. Another commentator has explained that "[t]he behavioral claim of economics establishes the consensus view that 'law is rational, and hence analyzable by economic concepts.'" Gary Minda, The Jurisprudential Movements of the 1980s, 50 OHIO ST. L.J. 599, 611 (1988) (quoting R. COOTER & T. ULEN, ECONOMICS OF LAW 12 (1988)).

206. See infra notes 207-222 and accompanying text. It is important to remember that individual negligence, fraud, or malpractice of any kind are not excused under the new organizational forms. Attorneys who commit acts subjecting them to liability under current PC or partnership statutes are still personally liable under LLP and LLC statutes. See, e.g., TEX. REV. CIV. STAT. ANN. art. 6132b-3.08(a) (West 1993); WASH. REV. CODE § 25.15.125 (1994). See supra notes 93-95 and 120-122 and accompanying text.
monitoring costs will be externalized. Moreover, because consumers receive the same protection from firms organized as LLPs and LLCs as they do from solo practitioners, arguments that LLP and LLC forms treat clients unfairly are untenable.

A. The Laws of Demand and Supply

The foundation of economic theory can be found in two hypotheses.\(^{207}\) The first hypothesis holds that "resources are scarce in relation to people's desires to consume them."\(^{208}\) Consequently, "people must make choices between various resources or activities."\(^{209}\) The second hypothesis holds that "people behave rationally when making decisions."\(^{210}\) These two hypotheses drive the view held by law and economics theorists "that rational, self-interested calculations of individual cost and benefit is the key to understanding and evaluating legal relations and various rule systems."\(^{211}\)

The result is the "law of demand".\(^{212}\) The consumption of goods is inversely proportional to their price.\(^{213}\) The corollary to the law of demand is the "law of supply."\(^{214}\) Simply stated, "when the price of a good increases, producers will supply more of it."\(^{215}\) The laws of supply and demand form the central tenet of economic theory regarding social behavior: "[U]nder competitive conditions, free trade among individuals will result in a socially optimal allocation of resources."\(^{216}\) Thus, law and economics indicates that "rules of law [are] like prices and legal actors [are] like perfectly rational individuals."\(^{217}\)

Economic theory dictates that the average attorney will strive to produce error-free, high quality legal services for her clients regardless of the liability structure under which she practices. By doing so, the attorney makes a choice that will maximize her personal benefit—she

\(^{207}\) This analysis is taken from a similar economic discussion in Cohen, supra note 203.

\(^{208}\) Cohen, supra note 203, at 1119.

\(^{209}\) Id. Economists refer to these choices as "tradeoffs." Id. (quoting P. SAMUELSON, ECONOMICS 18-23 (10th ed. 1976)).

\(^{210}\) Id.

\(^{211}\) Minda, supra note 205, at 610-11.

\(^{212}\) Cohen, supra note 203, at 1119.

\(^{213}\) Thus, the more expensive a good is, the less it will be consumed and vice versa. See id. at 1119-20.

\(^{214}\) Id. at 1119.

\(^{215}\) Id.

\(^{216}\) Id. at 1120.

\(^{217}\) Minda, supra note 205, at 611 (quoting Lewis A. Kornhauser, The Great Image of Authority, 36 STAN. L. REV. 349, 353 (1984)).
chooses to do that which is likely to cause her firm to continue her employment, which in turn provides her with monetary resources. In today's highly competitive market, doing the opposite can be dangerous, as many firms are cutting back the number of partners they have.\textsuperscript{218} Associates are likewise driven in this regard, as failure to produce high quality legal work is likely to cost one a partnership position and, hence, the greater rewards that accompany it. The bottom line is that personal choices are shaped by the market. Attorneys, like everyone else, are most concerned with what will affect them directly, and in that regard LLCs and LLPs change nothing.

The economics of the market also indicate that clients will force attorneys to maintain their current level of ethics and quality of practice. Because the statutes generally all require that indicia of the limited liability form, such as "LLP" or "LLC," be included in the firm name,\textsuperscript{219} clients will be on notice of the restrictions, as all business cards, letterhead, and other promotional materials will have the identifying characteristic. Thus, clients can shop around for firms that do or do not opt for limited liability, just as they currently do for firms that do or do not carry malpractice insurance, which is not required by statute in most states. Because clients have scarce resources in relation to their desires to consume them, they do not want to needlessly expend them on legal services. The rational choice for a client is to discontinue an employment situation with attorneys who provide substandard service.

The law of supply provides that producers of a service will act to "maximize"\textsuperscript{220} their profits by providing services that will generate the greatest long-term income. Good work generates the most income for attorneys, not fraudulent or negligent work that misses filing deadlines, overlooks elements needed to prove causes of action, or has other omissions that decrease expected returns to the client or needlessly raise costs.

Moreover, no one is suggesting that all firms must, or even should, reorganize under limited liability statutes. If law firms practicing as LLPs or LLCs prove to be as bad as critics contend, they will, theoretically, go out of business, as those that do not choose limited liability forms will get the majority of clients. It appears, however, that those firms currently operating as LLCs and LLPs are

\textsuperscript{218} See Lublin, supra note 30, at 5.
\textsuperscript{219} See supra notes 85 and 111.
\textsuperscript{220} Cohen, supra note 203, at 1119.
not experiencing a drop in their market share, as firms continue to convert at an unprecedented rate.\textsuperscript{221}

Firms invest considerable resources in developing their reputations. This stake provides an incentive toward minimizing malpractice,\textsuperscript{222} as loss of professional reputation will result in decreased future profits and the loss of funds invested in good will. Consequently, if the overall quality of work were decreasing, and firms felt that their reputations were threatened, they would revert back to traditional forms, as the rational economic actor would not expend scarce resources only to counteract them with wasteful activity. After all, lower quality work, whatever the cause, will lead clients to go elsewhere, a situation that firms find intolerable.

\textbf{B. The Deterrent Theory of Criminal Behavior}

The deterrent theory of criminal behavior and punishment is a useful analogue to apply to these theories of limited liability. For two reasons, the theory applies to attorneys remarkably well.\textsuperscript{223} First, attorneys often commit economic crimes.\textsuperscript{224} In fact, the vast majority of attorney misconduct is centered around economic gain.\textsuperscript{225} Second, attorneys are likely to have a high level of understanding of the ramifications of their actions, both for themselves and for their clients. Attorneys, as a group, are typically more educated and sophisticated than the average criminal and are, thus, more careful and accurate when balancing the potential costs and benefits before acting.

Deterrent theory allows various levels of sophistication to be considered when analyzing behavior. One author has illustrated the deterrent theory of criminal behavior in terms of two forms of rationalization, the strong form and the weak form.\textsuperscript{226} The strong form of rationalization assumes that the person considering criminal

\begin{thebibliography}{99}
\item[221.] See Reuben, supra note 10, at 55; N. Scott Murphy, Note, \textit{It's Nothing Personal: The Public Costs of Limited Liability Law Partnerships}, 71 IND. L.J. 201, 207 (1995); Lawrence, supra note 51, at 212.
\item[223.] That deterrence can, at this time, be applied specifically to attorneys is not critical to the underlying thesis; however, the clear weight of current evidence does hold that deterrence works against the general criminal population, and specifically against white collar crimes. See infra notes 236-243 and accompanying text.
\item[225.] See id. at 923-24.
\item[226.] These terms are used only for convenience. They are borrowed from a similar economic discussion in Bené, supra note 224, at 921.
\end{thebibliography}
activity is a rational actor who will make what he believes to be his optimal choice concerning various resources or activities. He realizes that he does not have unlimited resources, and in deciding how to utilize them, he rationally balances (perhaps unconsciously) the returns (psychological and monetary) against the costs (potential failure and foregone opportunities) available from a variety of activities, both legal and illegal.\textsuperscript{227} Under this strong form, the potential criminal sums up and weighs the costs against the benefits, after discounting each by the likelihood of occurrence. This calculation is, of course, complex, and as such is probably not done on a highly technical level.\textsuperscript{228}

The weak form of rationalization is somewhat less technical in nature. Under this form, the act of weighing costs and benefits is done on a subconscious level.\textsuperscript{229} Thus, potential criminals respond in some predictable manner to incentives, or in more simple terms, they are deterrable.\textsuperscript{230} The weak form of rationalization simply provides for a downward-sloping supply curve.\textsuperscript{231} Because the criminal has limited resources, a decrease in the utility of an action will cause him to engage in a particular activity less, in relation to his other choices. "Thus the assumption is that people respond to directions of change in the relevant variables, not that they have complete knowledge of the magnitude of these variables."\textsuperscript{232}

One does not need a doctorate in economics to be influenced in this manner. If the potential benefit of an action is outweighed by the chances and consequences of being caught, a potential criminal will be deterred. Because the actual calculating of risk and reward can be quite complex, most actors make these choices instinctively, or under the weak form. That is, they behave in a predictable, rational manner.

Enforcement agencies (such as courts) deter the potential criminal by raising the cost of failure (the punishment faced, for example),

\textsuperscript{227} See Michael K. Block & Robert C. Lind, An Economic Analysis of Crimes Punishable by Imprisonment, 4 J. LEGAL STUD. 479, 484 (1975); Gary S. Becker, Crime and Punishment: An Economic Approach, 76 J. POL. ECON. 169 (1968), reprinted in ESSAYS IN THE ECONOMICS OF CRIME AND PUNISHMENT 1, 9 (Gary S. Becker & William M. Landes eds., 1974). Although the title of this work indicates that the analysis applies to criminal actions only, the author observed that the article is "sufficiently general to cover all violations . . . tax evasion, the so-called white collar crimes, and traffic and other violations." Id. at 3.

\textsuperscript{228} See Bené, supra note 224, at 921.

\textsuperscript{229} See id. at 922.


\textsuperscript{231} See Bené, supra note 224, at 922.

\textsuperscript{232} Paul H. Rubin, The Economics of Crime, 28 ATLANTIC ECON. REV. 38, reprinted in ECONOMICS OF CRIME 13, 16 (Ralph Andreano & John J. Siegfried eds., 1980).
multiplied by the percentage chance he will fail. The cost scheme exists on a basic level. A criminal is less likely to expend resources on a course of action if there is a ninety-five percent probability of detection versus a five percent probability of detection. Similarly, a week in jail is much less likely to deter the criminal than a twenty-year prison sentence. Increasing either variable should then work to deter the criminal, but with decreasing marginal returns.\(^{233}\)

Although some scholars remain skeptical about deterrence theory, most scholars accept it as true.\(^{234}\) As the National Academy of Sciences noted,

Our reluctance to draw stronger conclusions [from current empirical studies on the deterrent effects of punishment] does not imply support for the position that deterrence does not exist, since the evidence certainly favors a proposition supporting deterrence more than it favors one asserting that deterrence is absent.\(^{235}\)

Due to the nature of their profession, attorneys are probably more deterrable than the general criminal population. Because of the large career investments, the status of the profession, and the “vital importance of a lawyer’s reputation to his career,”\(^{236}\) they have more to lose than the average criminal.\(^{237}\) Consequently, attorneys, as a group, are more likely to make the rational and more cautious decision of protecting large aggregations of wealth rather than risking them.\(^{238}\) In a study examining the loss of income associated with embezzlement and fraud crimes (among others), John Lott concluded that (1) the largest penalty suffered by the white-collar criminal is the loss of

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234. See Bené, supra note 224, at 923-24 n.83.


236. Bené, supra note 224, at 925.


238. Although this seems a logical progression, my research has not discovered studies specifically focusing on attorneys. However, commentators have pointed out that white-collar criminals are deterrable. See, e.g., William J. Chambliss, Types of Deviance and the Effectiveness of Legal Sanctions, 1967 Wis. L. Rev. 703, 709-10 (although the author fails to compare white-collar criminals to other criminal groups); Becker, supra note 227, at 9.

One commentator has observed that “evidence is especially lacking concerning the impact of sanction threats upon various types of people.” Charles R. Tittle, The Economics of Crime and Punishment 85, 100 (S. Rottenberg ed., 1973).
earnings rather than the fine or prison term imposed, and (2) the loss of income is steeply progressive, so that the higher the level of preconviction income, the greater the postconviction decline.

Lott's observations are of particular importance in predicting attorney behavior. Given that the practice of law has become more commercialized over time, the financial aspects and rewards have become more and more important to individual attorneys. Because of this, financial deterrents, which have the greatest impact on white-collar criminals in general, seem to have the greatest impact on the average attorney.

Many financial deterrents exist for attorneys. For example, individuals are still personally liable for negligence or malfeasance. Further, as firm assets and malpractice policies are still available to satisfy judgments, individual attorneys continue to risk significant income reductions because their income is directly tied to the firm's financial health. Moreover, successful malpractice actions are likely to increase malpractice premiums, which will also affect future income. Finally, because individual attorneys with greater preconviction income will have a greater postconviction decline, more experienced senior attorneys, who generally have more knowledge and ability to implement change, will be the most motivated to monitor other attorneys within their own firms. Consequently, arguments which assume that a decrease in liability will result in either decreased monitoring of one's partners or a decrease in the overall quality of legal work are misplaced.

Furthermore, much of an attorney's job is balancing the costs and benefits of possible courses of action. Presumably then, attorneys are both more comfortable and better than the average criminal at making such determinations. Indeed, because attorneys are aware of factors such as the level of their own personal assets, the level of malpractice insurance their firm carries, and the level of the firm's assets, they are in a unique position to measure the monetary and reputational costs of being sanctioned for misconduct.

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239. Lott, supra note 237, at 21.
240. Id. at 21-22.
241. See supra notes 172-182 and accompanying text.
242. See Lublin, supra note 30, at 5.
243. See Bené, supra note 224, at 924-25.
C. Insurance Needs Drive the Market

Malpractice insurance is becoming more expensive and more difficult to obtain. As one commentator noted, "[F]irms are going to have to pay increasing attention to liability underwriting, and firms without tight controls inside will find it difficult to get."244 Because many LLC and LLP statutes require that attorneys carry malpractice insurance or its equivalent,245 attorneys will not let the quality of their work slide. Bad work will quickly equal no protection.

Additionally, to the extent that salaries and bonuses of all attorneys in a firm are affected by the cost the firm pays for liability insurance, the incentive to monitor one's partners is still high. As rational economic actors, attorneys will act in a manner that will prevent wasteful allocation of the firm's economic resources. Further, as firms must carry insurance or its equivalent under many of the new statutes, the incentive is even higher.

D. The Solo Practitioner v. The Large Firm

The contrasting abilities of solo practitioners and large firms to pay claims provides another interesting perspective on the issue of limited liability forms for attorneys. When a potential consumer hires a solo practitioner, the solo practitioner's liability may extend to the assets of his practice, his malpractice policy, and his personal assets.246 Yet that is precisely the same kind of protection that consumers get from large firms who are practicing as LLPs or LLCs.

In contrast, a partner in a large firm that is organized as a traditional partnership has partners who may, in certain circumstances, also be personally liable.247 Additionally, the firm assets that other partners have helped build up are also available to help settle claims against any one attorney.248 Thus, attorneys who have partners can potentially be punished merely for having partners, something from which solo practitioners are immune.

244. Reuben, supra note 10, at 55-56.
245. See supra notes 91 and 113.
246. As explained earlier, no organizational form absolves individuals from their own malpractice. See supra notes 93-95 and 120-122 and accompanying text.
247. See Lawrence, supra note 51, at 211.
248. See id.
E. Will Attorneys Continue to Monitor Each Other?

Many of the ethical restrictions that forbid professionals from limiting their liability were drafted at least fifty years ago, before the advent of firms with hundreds of lawyers in many cities and states.249 The traditional argument, of course, is that attorneys who monitor each other reduce problems by regulating each other.250 Joint and several liability for partners was thought to motivate others in the firm to pay attention to what their partners were doing and "supervise" each other. By limiting liability, the incentive to regulate is thought to be gone.251 In firms that are scattered across states or even the entire country, however, most partners usually do not work closely enough to monitor each other even if they know each other.

Many of the policies the regulations were designed to achieve are, thus, no longer reached by preventing limited liability. How is someone in the tax department of the Seattle or Houston office going to have any idea what someone in the land use department in Washington, D.C. or New York is doing? Furthermore, it is difficult to see how holding a Washington, D.C., land use attorney liable for a tax mistake made in Seattle is going to increase the Seattle lawyer's incentive to supervise her partner. Although it may be argued that partners can pursue internal measures to regulate one another, even to the extreme of resigning if higher levels of professional responsibility are not adopted, that argument does not take into account the types of liability that frequently have been imposed.252 In the Kaye Scholer case, for example, the firm went as far as getting an ethics opinion from a national expert.253 In cases such as that one, additional monitoring would be of no value.

Further, as the law of diminishing returns254 indicates, additional monitoring may not be particularly useful. To the extent that monitoring involves second-guessing complex professional decisions, it may become counterproductive by imposing higher transactional costs upon clients.255 Indeed, because the practice of law has become

251. See supra notes 172-182.
252. See supra notes 3-13 and 131-135.
253. See supra note 148 and accompanying text.
254. See supra note 233 and accompanying text.
255. See Ribstein, supra note 222, at 435; see also infra notes 257-260 and accompanying text.
highly commercialized, and because malpractice insurance and all of the assets of a firm are still on the line, attorneys continue to have an incentive to regulate each other to prevent inadvertent mistakes. Additionally, with escalating legal malpractice costs, attorneys today have an increased incentive to ensure that more firm assets do not have to be spent for future malpractice coverage. Finally, as firms routinely dedicate funds to building firm reputation, the economic motivation to monitor one's partners remains high.

F. The Forcing of Massive Externalization

Basic economic theory indicates that when a market-driven enterprise such as a law firm incurs a major expense, the probable result is that the business will externalize the cost, passing it along to clients. Further, it is likely that when a major expense is avoidable by the adoption of a practice, that practice will be adopted, especially if the cost can be passed along to the consumer or client.

As one might expect, exactly that has started happening in some areas of law practice. Some attorneys who represent financial institutions now privately talk about spending hours "creating obsessively detailed memoranda about what they have told their clients, in case they are questioned later." They also bill for endless "due diligence" investigations into their clients' financial health, just to be on the safe side. All of this does little or nothing to actually help the client. Creating memoranda on what an attorney told her client does nothing in terms of helping the client solve the situation that drove the client to the attorney in the first place. Additionally, the extra fees generated by time spent creating such memoranda only make attorneys that much more expensive and inaccessible to the public.

Additionally, mandatory unlimited liability for attorneys, in some ways, artificially raises the cost of legal services to the public. Exposing attorneys to personal risk for debts arising out of contracts made by partners imposes significant risk-bearing and monitoring costs on partners. To the extent that these costs to the client can be lowered—and the evidence indicates that decreased liability lowers them—it would be desirable, for this reason as well, to allow LLPs and LLCs. Finally, costs from professional liability litigation, as noted

256. See supra notes 167-172 and accompanying text.
257. Stevens, supra note 2, at B12.
258. Id.
above,\textsuperscript{260} have imposed significant burdens on society as a whole, something that could also be reduced by a decrease in liability.

\section*{V. CONCLUSION}

The malpractice crisis in this country is having a significant impact on attorneys, and the organizational forms traditionally available to them have amplified the problems. Further, traditional forms ignore the dramatic changes that have overtaken the legal profession in recent years. The LLP and LLC forms are the vehicles that can help ease these problems and enable attorneys to successfully practice into the next century. Although commentators argue otherwise, many states have realized that changes need to be made, and their legislatures have acted to that end.

When examined from the law and economics perspective, it becomes evident that the traditional arguments against limited liability are outdated. The new limited liability forms will not cause work quality to deteriorate or leave clients with legitimate claims without a significant remedy. To deny attorneys the ability to organize as LLPs and LLCs is to ignore the realities of the marketplace and perpetuate current problems and inequities. As one commentator stated, "Professional Liability . . . Malpractice suits . . . Megaverdicts. The numbers are mind-boggling."\textsuperscript{261} Denying protection to attorneys must stop.

\textsuperscript{260} See \textit{supra} notes 194-201 and accompanying text.

\textsuperscript{261} King, \textit{supra} note 1, at 28.