

Law Firm LLPs Carry No Guarantees

BY ROY SIMON

If your law firm is organized as a limited liability partnership - an LLP - you are probably feeling much more confident than you did a few years ago that you can avoid enormous personal liability arising out of the wrongful acts or omissions of your partners and associates. You are correct to feel that way. When your law firm practices in the form of an LLP in New York State, you are not vicariously liable for the misdeeds of your partners solely because they are your partners. Your personal assets are on the line only for your own negligent or wrongful acts, or for the negligent or wrongful acts committed by those you directly supervise and control while rendering professional services.

But LLPs carry no guarantees. If the LLP is not formed and maintained to the letter of the law, or if the LLP does something to negate its limited liability, the protections that an LLP promises can evaporate - and by the time you learn the facts, it may be too late to avoid the monstrous personal liability that you feared. That's like finding out that your foolproof alarm system wasn't connected when a burglar broke into your house. And even when an LLP works perfectly, the LLP form has disadvantages as well as advantages. This article discusses the pitfalls that can destroy the protections an LLP is designed to bestow, and discusses some of the limitations and disadvantages of the LLP form.

Introduction: New York LLP Law

In an ordinary general partnership, if one partner commits legal malpractice or fraud, then all of the partners are vicariously liable, and thus bear joint and several liability for the partner's wrongdoing, solely by reason of their status as general partners. In a law partnership that handles large commercial matters, that potential liability can be mammoth. If your law firm has grown so large that you cannot possibly supervise all of your partners and associates (not to mention the secretaries, paralegals, and other nonlawyers whose mistakes can also cause liability), then you may not be willing to risk your personal assets by continuing to practice in the form of a general partnership. Instead, you would like to have the limited personal liability accorded to shareholders in a corporation.

Law firms in New York can achieve limited liability by practicing as professional corporations (P.C.s), which give lawyers the same protection from liability that ordinary corporations give shareholders - but unless your firm is small enough to qualify as an S corporation (no more than 75 partner-shareholders), the tax consequences of practicing in the form of a professional corporation will be devastating. (In a P.C. that is not an S corporation, both the firm and the shareholders are taxed on the firm's income.)

An LLP may have an unlimited number of partners, and it combines the tax advantages of a general partnership with the liability protections of a corporation. But the LLP is a relatively new invention. The first state to allow lawyers to practice as LLPs was Texas, in 1991. New York's LLP law did not take effect until October of 1994, less than a decade ago.

The New York Legislature expressly designed the LLP form to mirror the liability characteristics of corporations. Thus, under New York Partnership Law § 26(b), partners of a limited liability partnership are not liable for the debts or liabilities, whether arising in tort or contract, of the partnership solely by reason of their membership in the partnership. Under Partnership Law § 26(c), however, "each partner, employee or agent of a partnership which is a registered limited liability partnership shall be personally and fully liable and accountable for any negligent or wrongful act or misconduct committed by him or her or by any person under his or her direct supervision and control while rendering professional services on behalf of such registered limited liability partnership"

What Can Go Wrong with an LLP?

At the end of the movie 2001: A Space Odyssey, made in 1967, the computer in charge of the space ship (the famous Hal) said over and over, like a vinyl record stuck on a scratch, "Nothing can go wrong. Nothing can go wrong. Nothing can go wrong." Today we all realize, much better than we did in 1967, that computers can fail - and lawyers should realize that LLPs can fail, too. What can go wrong?

Defective registration or maintenance

An LLP is relatively easy to form, but it must be registered and maintained according to the letter of the law. The registration and maintenance requirements, which are lengthy and detailed, are specified in § 121-1500 of Chapter 39, Article 8-B of the New York Consolidated Laws. Compliance is routine clerical work, but you should take the time to read the statute so that you can intelligently monitor how your firm is fulfilling the statutory mandate. Don't let your hard-earned assets be exposed to unlimited vicarious liability just because a clerical employee with no legal education and relatively little to lose does not understand or carry out the requirements for registering and maintaining the LLP.

Defective releases

One of the beauties of a general partnership is that a release of the partnership functions as a release of the vicarious liability of all individual partners. That is true because New York General Obligations Law §15-107 provides that a release of a partner from a partnership liability "shall release his co- partners from the same liability to the creditor giving the release." When a general partnership commits a tort, "the wrong is imputable to all of the partners jointly and severally, and an action may be brought against all or any of them in their individual capacities or against the partnership as an entity." *Pedersen v. Manitowoc Company, Inc.*, 25 N.Y.2d 412 (1969).

In *Kinetics, Inc. v. El Paso Products Company*, 99 N.M. 22, 27, 653 P.2d 522, 527 (1982), citing *Pedersen*, New Mexico's highest court held that when a partner's liability for a tort committed by the partnership was solely vicarious, the release of the partnership "destroyed" vicarious liability and released a partner even though the release did not expressly name that partner. Accord, *Saliba v. Exxon Corporation*, 865 F. Supp. 306 (W.D. Va., 1994) (releasing a partnership from a tort absolves the partners from derivative liability).

Does the same principle hold true in an LLP? Not for partners who supervise or control a wayward partner. In *Schuman v. Gallet, Dreyer & Berkey, L.L.P.*, 180 Misc.2d 485, 689 N.Y.S.2d 628 (N.Y. County Supreme Ct. 1999), *aff'd*, 280 A.D.2d 310; 719 N.Y.S.2d 864 (1st Dep't 2001), a partner named David Berkey found this out the hard way. Berkey was a partner in Gallet, Dreyer & Berkey. So was Martin

Licht. In 1995, for mysterious reasons, a man named Schuman gave Licht about \$1 million to deposit into the law firm's escrow account, with oral instructions to disburse the funds as Schuman directed for Schuman's exclusive use and benefit. (Schuman was not a client of the firm, but he claimed in an affidavit that he needed a place to put his money because he was a new resident of Florida and Florida banking regulations prohibited him from opening a bank account there. [Does that sound credible to you? Did a bank really say, "We're sorry but we can't take your \$1 million cash deposit because you just moved here"? But that's a side issue.])

Less than a year after depositing his money, Licht informed Schuman that the escrow fund was exhausted, and Schuman demanded an accounting. The accounting showed that nearly two thirds of the escrow money had been disbursed without Schuman's direction or consent. Schuman retained counsel and demanded that the law firm pay him back. When Licht confessed that he had misappropriated the funds for his personal use and promised that he would personally pay back what he had taken, Schuman gave the law firm a complete written release. In exchange for the release, the LLP gave Schuman a mere \$10.

When Licht did not pay back the stolen money, Schuman sued the law firm, as well as Berkey and Licht personally. He sought damages based on claims of fraud, breach of trust, conversion, legal malpractice and negligence. Schuman expressly alleged that Berkey had personally exercised some level of supervisory control over the fund.

Based on Schuman's unconditional and unambiguous release of the law firm itself, both the LLP and Berkey moved to dismiss the suit. The court granted the motion as to the LLP, and concluded that the release thus extinguished Berkey's vicarious liability for Licht's wrongdoing. Nevertheless, the court denied Berkey's personal motion to dismiss. Under New York Partnership Law § 26(b), the court noted, partners in an LLP are not generally vicariously liable for negligent or wrongful acts committed by their partners, but they remain liable for their own negligence, and they remain liable for wrongs committed by any person under their "direct supervision and control" while rendering professional services on behalf of the LLP. Berkey was being sued both for his own negligence and breach of fiduciary duty as well as for negligent supervision and control over the escrow funds. Thus, the release of the law firm itself could not release Berkey as an individual partner unless Berkey himself was named in the release, which he was not. (The court said this would be true whether the entity was a general partnership or an LLP.) Giving a little bit of advice for the future, the court said that "the safe course of a partnership that wishes to be certain that all of its partners are released of liability when procuring a release is to have all the partners specifically named therein."

The First Department affirmed, noting that Schuman's release of the law firm as an entity also released Berkey from vicarious liability to plaintiff, even though Berkey was not specifically named in the release. But a release of the LLP could not release Berkey from allegations against him individually for negligence, breach of fiduciary duty, and legal malpractice in supervising the LLP's escrow account. Despite practicing in an LLP, therefore, Berkey was essentially hung out to dry for the sins of his partner.

The lesson of the *Schuman* case is clear. If you are a partner in an LLP and an unhappy client or creditor sues the LLP, make sure you see any release that the LLP negotiates as part of a settlement. Specifically, make sure you are named individually in that release. If you are not personally named, then you may open yourself up to a later suit by the same plaintiff alleging that you had "supervision and control" over

the partner who committed the wrongdoing, or that you were personally negligent in failing to supervise your errant partner. The protections you thought you enjoyed because your firm is organized as an LLP will be lost.

Defective marketing

Partners in an LLP can also lose the benefits of limited liability if the firm's web site and marketing brochures give clients the impression that every partner guarantees the work of the firm. Because web sites and marketing brochures are typically written by non-lawyers, they may make claims that are at odds with the LLP statute. One law firm's marketing brochure, for example, made the high-minded claims that "every partner stands behind the work of every other partner" and that "the entire partnership is committed to each client's success." When one of the LLP's partners negligently mishandled a client's case, the client sued every partner in the firm individually. The court refused to dismiss the claims against the individual partners because the marketing brochure gave the client a basis for holding every partner personally liable for the negligent partner's substandard legal work.

If you have not visited your firm's web site or read your firm's marketing brochure lately, you may want to spend some time looking them over. If you find claims that might undermine the limited vicarious liability enjoyed by partners in an LLP, get rid of those claims before they come back to haunt you by jeopardizing your personal assets.

Some Disadvantages of LLP form

LLPs obviously have some very attractive advantages. They represent the better of two worlds - the limited liability of a corporation married to the tax advantages of a partnership. But there are disadvantages as well. What are some of the disadvantages of practicing in LLP form? Here are two.

Overexposed partners

If your firm is in the process of converting (or has recently converted) from a general partnership to an LLP, some partners may feel that their personal assets have become exposed to a greater degree than the assets of other partners. For example, securities law or M&A partners who routinely handle multi-million dollar matters may be concerned that they face the potential for much greater personal liability than partners who practice in less risky areas. The high-risk partners may therefore believe that they have given up more than they have gained by trading relief from vicarious liability for the wrongs of their partners (as in a general partnership) for the comfort of limited group liability (as in an LLP). Unless your firm reassures these partners that they are financially safe, they may leave the firm to practice elsewhere.

Your firm can reassure these partners through internal indemnification agreements. All partners in the firm can agree to indemnify all of the other partners against personal liability. "Isn't this just back to a general partnership?" you might ask. No, it isn't. In a general partnership, vicarious liability to third parties for the wrongful conduct of other partners is imposed by law and is unlimited. Internal indemnification agreements, in contrast, are creatures of contract and can be capped. (For example, partners can agree to indemnify each other only up to a specified dollar amount, or only in proportion to their share of the partnership's profits.) Moreover, under an internal indemnification agreement, your

liability is to your partners, not to hostile strangers who have sued your firm. If your firm does not have an internal indemnification agreement, it should consider adopting one.

Diminished incentives to supervise others

In the olden days, when most law firms practiced as general partnerships, every partner had a reasonably strong incentive to monitor and supervise other lawyers in the firm to make sure that they did not commit fraud or malpractice or breaches of their fiduciary duties. New York's LLP law, however, seemingly turns the incentives in the opposite direction.

Because partners in an LLP are no longer automatically liable for the misdeeds of the other partners, they may be tempted to shy away from supervision or control. Indeed, because limited liability partners remain "fully liable and accountable" for negligent or wrongful acts committed by anyone under their "direct supervision and control," some partners may be tempted to avoid supervising their partners at all. Your firm may need to remedy the imbalance by significantly increasing the compensation of lawyers in the firm who take on management roles or who supervise more than the average number of other lawyers at the firm. The increased compensation will reflect the increased personal risk that LLP law imposes on managers and supervisors. In addition, internal indemnification agreements can realign these incentives by giving every partner a financial incentive to monitor the work of every other partner.

Even in LLPs lacking internal indemnification agreements or attractive compensation packages for managing partners, however, the New York Code of Professional Responsibility gives partners incentives to supervise each other. To begin with, the 1996 amendments to the Code subjected law firms as entities to professional discipline. See DR 1-102 (providing that a lawyer "or law firm" is prohibited from engaging in professional misconduct). More specifically, DR 1-104(A) requires a law firm as an entity to make "reasonable efforts to ensure that all lawyers in the firm conform to the disciplinary rules," and DR 1-104(C) requires a law firm to "adequately supervise, as appropriate, the work of partners, associates and non-lawyers who work at the firm." Moreover, under DR 1-104(D), a partner in a law firm is responsible for a violation of the disciplinary rules by another lawyer if the partner "knows" of the misconduct - or "in the exercise of reasonable management or supervisory authority should have known of the conduct" - in time to take "reasonable remedial action." The "should have known" language is broad enough to draw many partners into its web even if they have no role in managing the firm.

Unfortunately, the disciplinary authorities have so far shown no enthusiasm for imposing professional discipline on law firms as entities, or for imposing vicarious disciplinary liability on one partner for the professional misconduct of another partner. Indeed, only the First Department has even adopted rules to implement the 1996 Code amendments that subject law firms as entities to professional discipline. See 22 NYCRR 603.1(b) and 603.2(b) (providing that any law firm that has a partner subject to the New York Code of Professional Responsibility can be disciplined for professional misconduct). Accordingly, the LLP statute may discourage partners from assuming management or supervisory responsibilities. In economic terms, an LLP may permit partners to reap the benefits of partnership profits without bearing their fair share of the costs of keeping the partnership on track.

Conclusion: Trust, but verify

When Ronald Reagan was negotiating an arms reduction treaty with the former Soviet Union, he said the United States should heed a favorite Russian proverb: "Trust, but verify." If you practice law in an LLP, you should do the same. It's wonderful to enjoy the limited liability that is the hallmark of an LLP, and if you are not interested in management then you can relax and concentrate on practicing law while you trust your partners to manage the shop. But to attract capable and conscientious managing partners, your firm may have to increase the compensation of those who manage and supervise the firm's work. And every so often, you should take the time to verify that your partners are doing things right. Check your firm's periodic registration as an LLP. Check the releases that your firm obtains from clients and creditors who have made claims against the firm. Check your firm's web site and marketing claims. Otherwise, you may one day find, to your eternal regret, that your hard earned personal assets have been taken from an LLP vault that you thought was shut and locked up tight.

Roy Simon is a Professor of Law at Hofstra University School of Law, where he teaches Legal Ethics and Economics and serves as Director of Hofstra's Institute for the Study of Legal Ethics. He is the author of SIMON'S NEW YORK CODE OF PROFESSIONAL RESPONSIBILITY ANNOTATED, available from Thompson West.