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High Drama and Hindsight: The LLP Shield, Post-Anderson

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First, Enron. Then Arthur Andersen. We all look for lessons in these spectacular flame-outs.

Andersen partners and former partners are in a similar position as they ask questions and agonize over how the firm's collapse will affect them individually. Current partners know that they will probably never see a cent from their capital contributions to the firm. Retired partners anxiously wonder whether their \$500 million in retirement accounts will be protected or used to pay creditors and claimants.

With Andersen already facing more than \$1 billion in claims and insurance coverage estimated to be only \$300 million, the most looming concern for former and current partners of Andersen is whether they may be held personally liable for Andersen debts and claims.

According to the *Wall Street Journal* (on April 2, 2002), many Andersen partners who had "nothing to do with the firm's work for Enron" are seeking legal advice because they fear personal liability for the Enron-related claims.

In considering partners' personal liability exposure, some believe that the good news may be that Andersen reorganized as a limited liability partnership. At the same time, the bad news is that Andersen is registered as an Illinois limited liability partnership and that nationwide, the LLP structure is largely untested. Even if a partnership satisfies the statutory requirements for LLP status, plaintiffs could attack the LLP shield or try to plead around the shield. For claims against lawyers, courts may exercise their inherent power to regulate the legal profession, refusing to allow lawyers to limit their vicarious liability. Courts must also answer questions related to interstate practice and conflict of law issues.

Despite the uncertainty surrounding professionals practicing in limited liability firms, the claims against Andersen

and the law firms that represented Enron have renewed interest in professionals practicing as LLPs. Firms that have not previously converted to LLPs are now considering doing so.

Before rushing to jump on the LLP bandwagon, this article urges firm managers to consider the various negative consequences of professionals practicing as an LLP. Using information gleaned from the Andersen-Enron experience, we'll discuss the possible traps of practicing as an LLP and identify some developments and challenges to watch for in the cases against the accounting and law partners who represented Enron.

This discussion should help firm partners realize that conversion to an LLP is no panacea, but a relatively new organizational structure that may create new problems and predicaments for practicing professionals and persons who rely on their work and solvency.

The situation the Andersen partners and former partners (collectively called Andersen partners) currently face is the very type of catastrophe that the LLP structure was intended to address — the risk of personal liability when the firm's assets and insurance are wholly inadequate to satisfy claims.

To address this risk, Texas lawyers in 1991 proposed the nation's first LLP legislation, enabling firms to continue to function as general partnerships while limiting partners' vicarious liability for malpractice. Following the adoption of LLP legislation in Texas, accountants and lawyers aggressively pushed other state legislatures to adopt LLP statutes. Now every state has modified its partnership laws, permitting general partnerships to register as LLPs.

The actual protection for LLP partners varies from state to state. For charts and commentary on state variations, see Alan R. Bromberg & Larry E. Ribstein, *Limited Liability Partnerships and the Revised Uniform Partnership Act* (2001 edition), Chapter 3. Most statutes now limit vicarious liability for all partnership debts and obligations ("full shield"

protection). In some states, including Illinois, the liability shield only limits a partner's vicarious liability for claims based on negligence or misconduct of some partnership agent ("partial shield" protection).

Under full and partial shield statutes, partners remain liable for their own negligence, wrongful acts and misconduct. Most LLP statutes also provide some degree of personal liability for supervisory partners. As explained below, the differences in the statutory liability shield can affect both the dynamics of firm practice and the handling of claims.

Conceptually, the general partnership principle of "all for one, one for all," encouraged firm partners to actively participate in firm affairs and management. General partners with unlimited liability should be willing, indeed eager to devote time and resources to monitoring and risk management activities that promise to reduce their personal liability exposure. Conversion to an LLP undercuts this incentive in two ways. First, it eliminates unlimited liability as an economic incentive to devote time and resources to monitoring the conduct of firm players. Second, the LLP statutes that impose supervisory liability actually create a disincentive, undermining partners' willingness to participate in firm management and supervisory activities.

As an LLP partner with no vicarious liability exposure, why should such a partner get involved in firm management and supervision if those activities will expose the person's assets? Is the desire to protect the firm's reputation and assets enough to risk personal liability exposure?

When I was a firm partner specializing in legal malpractice work, I took an active role in firm management and supervision. As a matter of professional responsibility, risk avoidance and good business, I supported the investment in monitoring and supervision activities to protect clients, as well as the firm's assets, reputation and partners. Now,

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senior lawyers may be more inclined to shirk supervisory responsibilities when LLP status eliminates vicarious liability, concentrating liability on individual tortfeasors and supervisors.

To address the liability exposure of supervisors, firms should carry adequate malpractice coverage. Another approach to providing supervisors some level of comfort would be for firm partners to agree to indemnify managers and supervisors for losses they suffer for serving as managers and supervisors. Without indemnification or insurance protection, risk-averse partners may avoid supervision and management activities.

The reluctance of risk-averse partners to get involved in supervision and

An Enron-related class action suggests how far sophisticated plaintiffs' counsel might seek to extend supervisory liability. In addition to naming Andersen partners who were an "integral part of the Enron audit and consulting engagement," the complaint names country and regional managing partners of Andersen and Andersen-related entities. *In re Enron Securities Litigation*, Complaint, U.S. District Court for the Southern District of Texas, Cv. H-01-3624 (April 8, 2002).

While the complaint identifies four Andersen partners as "control persons" for purposes of the federal securities acts, their managerial involvement may expose them to liability if they had "direct supervision and control" as

misconduct-type claims, partners in an Illinois LLP can still be personally liable for contract obligations such as those relating to the firm's lease and line of credit. As a result, Andersen partners may remain personally liable for contractual obligations after they leave the firm.

Two former partners of Keck, Mahin & Cate, an Illinois general partnership, believed that they could escape liability for Keck debts by switching law firms. Following the bankruptcy of the law firm, former Keck partners had the option to pay between \$5,000 and \$10,000 to settle claims against them under the firm's bankruptcy plan. After Barbara P. Billauer and Thomas E. Ho'okano declined to participate in the settlement, they were sued for claims exceeding \$5 million. Billauer and Ho'okano denied liability, asserting that the claims were not in existence when they withdrew from the partnership.

A bankruptcy judge for the Northern District of Illinois rejected the former partners' arguments, finding the partners jointly and severally liable for more than \$3.7 million, including \$1.6 million in malpractice claims. As stated by the judge in a March 6, 2002, opinion, a partner cannot escape liability simply by leaving the partnership after the malpractice is committed but before the client wins or settles a malpractice claim. *Keck, Mahin & Cate v. Billauer*, 274 B.R. 740 (Bankr. N.D. IL, 2002). The clear message from the bankruptcy judge was that a partner's change of address does not matter because a partner remains liable for matters pending at the time of dissolution. The Keck decision should concern Andersen partners who believed that they could escape the Enron nightmare by switching firms.

The exodus of Andersen partners and practice groups is another negative consequence of the LLP structure. Andersen's U.S. payroll has dwindled from 28,000 to 1,000 and its worldwide staff of approximately 85,000 has been similarly decimated. Lee Hackstader, "Andersen Hit with Maximum Penalty; Judge Fines Firm \$500,000, Puts It on Probation," *The Washington Post*, Oct.

A PARTNER REMAINS LIABLE FOR MATTERS PENDING AT THE TIME OF DISSOLUTION.

management is exacerbated by the failure of the LLP statutes to define clearly the degree and nature of control that will subject a supervisor or manager to personal liability. Although most statutes hold supervisors liable for persons under their direct supervision and control, the statutes provide little guidance on precisely when a partner should be considered a supervisor.

Is a supervisor strictly liable for acts and omissions of subordinates or must a plaintiff establish negligence in supervision? Would membership on an opinion committee or service as a section leader be enough to expose a partner to personal liability if that partner had no direct involvement in the alleged malpractice?

Professor Alan R. Bromberg's Comments following the 1991 Texas LLP amendments explain that questions of supervisory control liability "involve fact questions as well as interpretation of the statutory language." Tex. Rev. Civil Stat. Ann. Art. 6132b § 15 cmts. (1991 expired). Malpractice plaintiffs' lawyers will attempt to raise fact questions on the responsibility of all firm partners connected with the representation.

required by the Illinois LLP statute. If Andersen supervisors are held personally liable, LLP partners around the country will be even more reluctant to serve as managers and supervisors.

Andersen's status as an Illinois LLP also illustrates the problems created when professional firms eliminate the "all for one, one for all" relationship in which all partners share unlimited liability for all partnership debts. The LLP's elimination of unlimited liability for all debts can create serious conflicts relating to sharing of liability and payment of debts.

When the firm does not carry sufficient insurance to pay malpractice claims, those partners with personal exposure will lobby for firm assets to be devoted to pay the malpractice claim. Contrarily, other partners will push for firm assets to be used to pay general firm debts such as bank loans and other debts for which partners have personal liability.

This conflict becomes particularly acute when the partnership is registered under an LLP "partial shield" statute such as the one in Illinois. Because the Illinois statute only limits liability for

17, 2002. Rather than jumping ship, Andersen partners might have been more committed to rebuild the firm had they believed that they were personally on the hook for Enron claims. Why remain with a crippled firm and have your future accounts tapped when you have no personal liability?

Consider the response of accountants and lawyers sued by saving and loan regulators. Law firm partners at Kaye, Scholer, Fierman, Hayes and Handler, as well as other firms, stuck with their partnerships. To settle the government's claims, Kaye Scholer partners agreed personally to pay \$16 million. If Kaye Scholer partners had limited liability, they might have been more inclined to find another firm home rather than paying the claims out of future revenue.

Lawyers, more than accountants, enjoy a great deal of mobility in theory because courts typically do not enforce restrictive agreements that violate lawyer ethics rules. LLP law partners with portable business have little incentive to stick with a firm facing large claims. On the other hand, general partners will be more committed to firms when they share personal liability.

Committed partners who share unlimited liability should be interested in carrying adequate levels of insurance and devoting commensurate resources to risk management. Conversion to an LLP firm can affect the firm's purchase of insurance if partners no longer worry about vicarious liability exposure and carry lower limits of liability. Andersen's \$300 million in malpractice liability coverage appears woefully inadequate given Andersen's exposure and \$4 billion in revenues in 2001.

At insurance renewal time, the LLP structure can also create conflicts between partners. Those LLP partners who believe that they have a limited liability shield may prefer to carry policies with lower limits of liability than they would carry if their firms operated as traditional partnerships in which partners shared personal liability. On the other hand, LLP partners with more personal exposure because of the nature of their practices and firm responsibili-

ties will prefer that the firm carry higher limits. With the costs of malpractice insurance significantly increasing, partners who lobby for lower limits may prevail.

The limited liability structure can also affect the adjustment of claims made under professional liability policies. Unlike the traditional partnership in which all partners are aligned in sharing unlimited liability, partners in an LLP sit in different positions. Those partners involved in the representation share personal liability, while other partners will try to stand behind the LLP liability shield. Possible conflicts between sued partners can also result in cross-claims, requiring separate counsel.

Assuming that the policy requires that defense costs be deducted from the limits of liability, these additional defense costs will further drain the amount available to pay judgment and settlements.

The LLP structure can create conflicts and other problems within firms that affect both firm stability and relationships. From the perspective of clients and the public, the most serious consequence of the LLP structure may be asset insufficiency. Asset insufficiency occurs when the assets of the firm and the tortfeasors fall short of the amount necessary to satisfy creditors' claims.

This is a real risk with thinly capitalized firms in which partners minimize their investments in the firm and rely on debt financing. Following a large judgment, firm partners who are not personally liable could seek to dissolve the defendant firm and relocate.

To the extent that firm property is collateral for secured creditors' claims, it will be unavailable to tort victims both in and outside of bankruptcy. Once the firm is in bankruptcy, the court will give secured creditors priority over tort victims. This leaves the tort victim holding a judgment against the bankrupt law firm and the individual tortfeasors.

This brings us to the billion-dollar question — would the Andersen collapse have happened if Andersen were a traditional partnership? While Andersen's obstruction of justice conviction sounded Andersen's death knell as a full-service auditing powerhouse, we

are left wondering about the deleterious effects of Andersen functioning as an LLP. Would Andersen partners have elected to carry higher levels of insurance if they were exposed to vicarious liability? Would Andersen partners with vicarious liability have been more inclined to scrutinize risky Enron transactions rather than take the \$52 million in annual revenue from Enron?

As suggested by two scholars, limited liability creates a moral hazard by allowing participants to reap the benefits of risky activities and not bear all of the costs. Frank H. Easterbrook & Daniel R. Fishel, "Limited Liability and the Corporation," 52 *Chicago Law Review* 89, 103-04 (1985).

These questions should spur firms to evaluate carefully the advisability of operating as LLPs. Legislators should revisit statutory minimum insurance requirements. Rather than using a "one size fits all approach" requiring that LLP firms carry a specified amount of insurance, a modest modification would be to require that insurance be based on the number of firm partners or revenue.

Ten years after adoption of the first LLP statutory provisions, we should seriously consider if the adoption of LLP legislation was a misguided reaction to the malpractice claims brought by government regulators. Now with the failure of Arthur Andersen, we are left re-evaluating whether the public, and even firm partners, would have been better served had firms invested in monitoring, insurance and risk management, rather than relying on the untested LLP shield.

In October, 2002, Joe Berardino, former chief executive officer of Andersen, participated in a panel discussion at Georgetown University. In discussing the failure of companies like Enron and WorldCom, he concluded by saying, "I think that the future is full of promise for those who heed the lessons and mistakes of the past." *Georgetown University Wire*, Oct. 22, 2002.

Identifying lessons from the collapse of Andersen gives professionals an opportunity to address problems created by practicing in LLPs. 

