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ACKNOWLEDGEMENTS

This report represents the culmination of our project on Limited Liability Partnerships ("LLP"). The Final Report was preceded by a Issues Paper No. 4, published in March of 1998, and a Summary Report which was issued in December 1998 to the government and other interested organizations.

Mr. Richard Bowes, the Institute counsel with carriage of this project, has faced two inter-related challenges. The first is that the narrower question of amending the Partnership Act to allow for limited liability partnerships raised many much broader questions, such as: the history of and justification for the prohibition on professional practice in incorporated entities; the explanations for the apprehension of the liability crisis; the allocation of risk of loss in the different kinds of cases which might arise; the role of self-governing professions in creating and maintaining the necessary safeguards to ensure quality of service and client protection. These are all broad issues which are relevant to the creation of the appropriate policy directions for the existence of LLP's.

Second, the time frame for consideration of these issues has been somewhat short. Several professions argued for the creation of LLP's almost four years ago, and the proposed legislation is a response to that initiative. Our request came from the Minister in 1997. However, there has been a great deal of development in this area since that time, and it would be unfortunate not to take advantage of that information, particularly from the U.S. where the concept was created and first implemented in Texas in 1991.

The short time frame explains why we adopted the unusual procedure of providing a Summary Report, containing our policy recommendations, prior to the issue of the Final Report, but in time for the recommendations to be considered in advance of the introduction of legislation in the spring of 1999.

We have had extensive input from both the Institute of Chartered of Accountants of Alberta and the Law Society of Alberta. We have also profited from the input and comments of representatives of three provincial government departments: Labour, Justice and Treasury.

As in all of our projects, we have been greatly assisted by many individuals who have taken the time to provide input, whether as representatives of a government or organization or in their personal capacity. This input includes formal responses to our issues paper and oral and written responses to our specific queries regarding existing or developing law and practice in Alberta and many other jurisdictions. It also includes sending us written material such as draft legislation and unpublished papers. The individuals to whom we are indebted for such input include Carter G. Bishop, Sarah Brickett, Vivien Brighton, Brian Cheffins, Tufyal Choudhury, David J. Cooper, Bob Creamer, Clark Dalton, Allan G. Donn, J. Bruce Dunlop, Robert Flannigan, Keith Fletcher, Robert Foord, Peter Freeman, Tony Friend, Gordon W. Fuller, Thomas Geu, Nicole Graham, Lawrence D.W. Graves, Duncan Green, George W. Gregory, Melanie Gushue, Peg James, Simon Jelf, Brenda Johnson, Wayne Kaufmann, Elizabeth Lanyon, Stuart Levine, Sanford J. Liebschutz, Keith Matthews, John M. McCabe, Bruce McGovern, Mindy Paskell-Mede, Carol Patrick, David G. Roberts, Prem Sikka and Eric Spink. We also acknowledge the valuable assistance provided by research students Frank Friesacher, Naomi Nind and Anne Schutte.

We also acknowledge Mr. Bowes' dedication to completing the project quickly, and providing a treatment which is as comprehensive as possible. We hope that the report will also assist with the medium to longer term deliberations on these issues.

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ABBREVIATIONS

NCCUSL	National Conference of Commissioners on Uniform State Laws
LLC	Limited Liability Company
LLP	Limited Liability Partnership
LLPC	Limited Liability Corporation
PC	Professional Corporation
UPA	Uniform Partnership Act (US)
UPA 1994	Uniform Partnership Act (1994) (US)
UPA 1996	Uniform Partnership Act (1996) (US)

PART I — SUMMARY OF REPORT

OVERVIEW

In Alberta most types of enterprise can be carried on by corporations whose shareholders enjoy limited liability for the corporation's obligations. The exception is that a few professions – accounting, law and certain health care disciplines (medicine, dentistry, chiropractic and optometry) – cannot be carried on by ordinary corporations. They can be carried on by "professional corporations," but the shareholders of professional corporations do not enjoy limited liability for the corporation's liabilities.

The restrictions on limited liability professional practice used to apply to a wider range of professions. Over the years, however, restrictions on limited liability practice of professions such as engineering, architecture and pharmacy have been removed. Looking beyond Alberta's borders, it is readily apparent that there is a clear trend towards the removal of traditional restrictions on limited liability professional practice. In most states of the United States, for example, it is now possible for a limited liability firm to carry on any profession.

The fundamental issue considered in this report is whether the accounting, legal and health care professionals who are currently required to practise in unlimited liability firms should be given the option of practising in limited liability firms. We conclude that they should be given this option. One argument for allowing these professionals to practise in limited liability firms is simply that, on this issue, there are no compelling reasons for distinguishing between professional enterprises and the general run of enterprise that can be carried on through a limited liability firm. However, our recommendation is also based on somewhat more specific reasons, which are mentioned momentarily.

The traditional vehicle for limited liability enterprise is the business corporation, while the traditional vehicle for unlimited liability professional practice has been the ordinary partnership. Over the last ten years almost every American state has adopted a hybrid limited liability vehicle known as the limited liability partnership ("LLP"). The LLP is essentially an ordinary partnership whose members enjoy limited liability with respect to some or all of the firm's obligations. In particular, innocent members of an LLP are not subject to personal "vicarious liability" for malpractice liabilities of the firm merely because they are a member of the firm. Only those members of the LLP who are in some way personally implicated in the wrongful acts or omissions that created the liability are subject to unlimited personal liability.

Canadian professionals – especially accountants and lawyers – have been lobbying provincial governments to be permitted to practise in limited liability firms. But more specifically, they have been urging provincial governments to import the LLP concept from the United States and to permit professionals to practise in LLPs. They have argued that the LLP is a more suitable vehicle for limited liability practise than the corporation. There is not an overwhelmingly persuasive case for adopting the LLP concept, as opposed to allowing professionals to practise in limited liability professional corporations. On the other hand, we do not think allowing professionals to practise in LLPs is any more problematic than allowing them to practise in limited liability corporations. Therefore, we recommend that Alberta enact LLP legislation. We also recommend that the LLP be made available to any type of enterprise, not just to the members of certain professions.

SUMMARY OF CHAPTERS

This section provides a brief summary of the points discussed and the major recommendations in each of the report's three chapters.

Chapter 1 – Introduction

This chapter does not contain any recommendations. It provides a somewhat more detailed overview of the issues than is provided in this summary and outlines the history of this project. It also provides a general description of certain legal concepts that play a central role in the more detailed discussion in Chapters 2 and 3.

Chapter 2 – Limited Liability and Professionals

This chapter is the core of the report. It begins by discussing the historical position regarding limited liability professional practice in Alberta and kindred jurisdictions. It then moves on to consider the fundamental issue whether it is appropriate to allow professionals – and here we are referring to the accounting, legal and health care professions – to practise in limited liability firms. A distinction is drawn between liability for ordinary obligations (e.g. loans and office leases) and malpractice liabilities of the firm. It is suggested that the issue of limited liability for ordinary obligations is not all that important, but that the decision on this issue should follow the decision on the issue of limited liability for malpractice liabilities.

When we consider limited liability for malpractice liabilities, we focus on two main issues. First, would limited liability professional firms be likely to provide lower quality service than unlimited liability firms? Our conclusion is that any adverse effect of limited liability on the overall quality of service provided by professional firms is likely to be negligible. We reach this conclusion on the basis that the incremental incentive to supply professional services of optimal quality provided by unlimited liability is relatively minor when compared to other incentives, such as reputational concerns.

The second main issue relating to malpractice liabilities is the allocation of risk of loss as between the members of a professional firm and the potential victims of malpractice by one (or more) of the firm's members or employees. Here, we suggest that limited liability raises concerns regarding the potential for inappropriate shifting of malpractice risk to unsophisticated clients (or in some cases, non-clients) of professional firms. These concerns, however, can for the most part be allayed by robust mandatory insurance requirements. One situation where mandatory insurance requirements cannot prevent the shifting of risk from members professional firms to clients (or non-clients) is where potential claims are so large as to be uninsurable. We conclude, however, that in such cases limited liability does not necessarily produce an inappropriate allocation of risk between the affected persons.

The main recommendations contained in Chapter 1 are to the following effect.

- The professionals who cannot currently practise in limited liability firms in Alberta should be permitted to do so, and these firms should provide limited liability against ordinary obligations as well as malpractice liabilities (Recommendation 1);

- The affected professionals should be permitted to practise in limited liability firms only if they have met minimum insurance requirements and have met any other conditions prescribed by the relevant governing body (Recommendations 2 and 3);

- A professional who is personally implicated in wrongful acts or omissions that create a malpractice liability for a limited liability firm should be personally liable for the liability along with the firm (Recommendation 6).

Chapter 3

Chapter 3 is concerned with the implementation of our proposal to enact LLP legislation. Most of its recommendations are concerned with "nuts and bolts" issues that we will not attempt to summarize here. However, a few of the more substantial recommendations are worth noting here.

- LLPs should be available to any enterprise, not just to the members of certain professions (Recommendation 7).

- Although members of an LLP should generally enjoy limited liability with respect to all liabilities of the LLP, they should be liable for certain "special liabilities" for which directors of a corporation would be liable, in particular, for wage claims (Recommendation 11).

- LLPs should be subject to restrictions on distribution of firm assets to members of the firm that are similar to the restrictions that apply to corporations and limited partnerships (Recommendation 13).

SUMMARY REPORT

In early December, 1998 we provided the Alberta government with a summary report that set out the recommendations that we intended to make in this report and provided a brief explanation of our rationale for those recommendations. Apart from minor changes in the wording and arrangement of certain recommendations, the recommendations in this report are identical to those in our summary report.

PART II — REPORT

CHAPTER 1. INTRODUCTION

A. What This Report is About

In Alberta accountants,[1] lawyers and certain health care professionals[2] must practise their professions in unlimited liability firms.[3] What distinguishes an unlimited liability firm from a limited liability firm is the liability of its owners for the firm's obligations. The owners of an unlimited liability firm have unlimited personal liability for the firm's obligations, while the owners of a limited liability firm are not generally liable for the firm's obligations. Creditors of a limited liability firm can generally look only to the assets of the firm for satisfaction of their claims against the firm. The requirement that the members of certain professions[4] practise in unlimited liability firms contrasts with the regime applicable to most businesses, which can be, and usually are, carried on through limited liability firms.

For many years the professionals required to practise in unlimited liability firms showed little, if any, sign of being disturbed by the legislative constraints on their choice of business organization. The following observation, although made in New Zealand, is probably equally applicable to the history of the prohibition on incorporated practice of certain professions in other countries, including Canada:

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[1] This includes chartered accountants, certified general accountants and certified management accountants.

[2] This includes chiropractors, dentists, medical doctors and optometrists.

[3] In this report we use the term "firm" in a non-technical way to refer to any type of business organization. This contrasts with the way that lawyers sometimes use this term, which is to refer specifically to partnerships.

[4] In this report we often use the term *profession,* without any qualifying adjective, to refer specifically to the occupations whose practitioners are required by existing Alberta law to practise in unlimited liability firms. On other occasions we use the term in a broader sense so as to include, for example, engineers, pharmacists and other occupations to which the term is often applied. The sense in which we are using the term should be clear from the context.

> Professional firms could be permitted to incorporate with limited liability. . . It needs to be kept in mind that the bans on such incorporation were not imposed from the outside but have their origin in the genteel distaste for limiting liability that marked the early years of joint stock companies.[5]

In recent years, however, genteel distaste for limiting liability has given way, especially within the accounting and legal professions, to consternation over the implications of unlimited liability in an environment in which professional firms are exposed to malpractice claims that may greatly exceed the amount of liability insurance that is available.

It is argued that it is unfair and contrary to the public interest that professionals are required to practise in firms in which the personal assets of every owner are answerable for all claims against the firm. It is particularly unfair and counterproductive, it is argued, that the personal assets of a member of a professional firm should be answerable for malpractice claims that arose out of an engagement in which that particular individual had no personal involvement. Professionals, the argument continues, should be able to practise in firms whose members would be shielded from personal liability for liabilities arising from negligent or otherwise wrongful acts or omissions of other members, employees or representatives of the firm. Only those members of the firm who are personally implicated in the wrongful acts or omissions should be subject to personal liability for the firm's malpractice liability.

The fundamental issue addressed by this report is whether professionals ought to be permitted to practise in limited liability firms. As noted above, professionals' concern with the existing regime relates mainly to personal liability of innocent members of a firm for malpractice liabilities of the firm. Thus, it is not surprising that in Alberta, as elsewhere, professional bodies have focused their attention on those types of liability. They have given little overt attention to whether professionals should be able to practise in firms in which owners are shielded from personal liability for the firm's ordinary business obligations: loans, leases and so on. This report, however, considers whether professionals should be able to practise in firms that shield their members from all types of obligations and liabilities of the firm: ordinary

[5] Law Commission (NZ) 1998 at 8.

debts as well as malpractice liabilities. We conclude that they should be permitted to do so.

If one concludes that professionals should be permitted to practise in limited liability firms, the next question is what form the firm should take. Ten years ago this latter question would probably not have arisen. It would simply have been assumed that if professionals were to practise in a limited liability firm, it would be a business corporation.[6] The difference between ten years ago and now is the development of the *limited liability partnership* ("LLP") in the United States. After its birth in Texas in 1991, the LLP propagated throughout the rest of the United States at legislative light speed. Professionals in Alberta and other provinces have argued that legislation should be enacted that would allow them to practise in LLPs, rather than being required to incorporate in order to get the benefit of limited liability. These arguments have already borne fruit in one province. Ontario enacted LLP legislation in 1998.[7]

We are not convinced of the cogency of all the reasons that have been offered for allowing professionals to practise in LLPs, rather than simply allowing them to practise in ordinary limited liability business corporations. On the other hand, we have concluded that if professionals are allowed to practise in limited liability firms at all, there are no cogent reasons of public policy for requiring them to do so through corporations rather than LLPs. Conversely, we have concluded that if professionals can practise in LLPs, there is no reason to restrict them to practising in this form of limited liability firm. Therefore, we suggest that professionals be allowed to practise either in LLPs or limited liability business corporations ("LLPC"s).

Having concluded that professionals should be permitted to practise in LLPs, we consider whether LLPs should be made available to other types of enterprise as well. The great majority of American states do not restrict the

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[6] In theory, professionals could practise in a traditional limited partnership, which provides limited liability to the "limited partners," while the "general partners" remain personally liable for all of the firm's obligations. The problem is that, as the price for limited liability, the limited partners are not permitted to take part in the control of the business: *Partnership Act*, s. 63. Thus, any members of a professional limited partnership who took part in the control of the firm's business would be liable for all of the firm's obligations as general partners.

[7] S.O. 1998, c.2, amending the *Partnership Act* (Ont.).

availability of LLPs to particular professions. But Ontario's recently enacted LLP legislation makes LLPs available only to a narrow range of professions.[8] Our own conclusion is that if LLPs are made available at all, they should be available to all enterprises, not just to a few professions.

The final group of issues considered in this report relates to the design of LLPs. What should they look like? Our basic premise is that LLPs should provide their members with essentially the same liability shield that ordinary business corporations provide to their shareholders. This means that partners in an LLP will not generally be personally liable for LLP obligations merely because they are partners. In general, creditors of an LLP will be able to look only to the LLP's assets for satisfaction of their claims against the LLP. Proceeding from this premise, we consider various major and minor issues relating to the design of LLP legislation. The major issues include whether there should be any restrictions on distributions of LLP property to members, and the form that any such restrictions should take. Other issues include the mechanics of creating an LLP and the recognition of LLPs created under the laws of other jurisdictions.

B. History of this Project

As mentioned above, and as will be discussed in more detail in Chapter 2, the LLP was born in Texas in 1991. Within a few years most US states had LLP legislation. Canadian professionals, particularly accountants and lawyers, found the LLP concept attractive and soon began lobbying Canadian provincial legislators to enact LLP legislation. In late 1994 the Institute of Chartered Accountants of Alberta circulated a draft discussion paper that detailed chartered accountants' concerns regarding their exposure to huge liability claims in respect of audit work.[9] Although the draft discussion paper focused primarily on the issue of joint and several liability between concurrent tortfeasors,[10] it also argued that chartered accountants, and perhaps other professionals, should be permitted to practise in LLPs. Not long afterwards, the Law Society of Alberta submitted a paper to the Alberta

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[8] *Partnership Act* (Ont.), s. 44.2.

[9] ICAA 1994. The final version of this document, ICAA 1995, appears to be identical to the draft version, except for the addition of "letters of support" at the end of the 1995 document.

[10] This report does not address the issue of joint and several liability versus proportionate liability for damages caused by concurrent, unrelated tortfeasors.

government that argued that Alberta professionals should be permitted to practise in LLPs.[11]

In July 1997, responding to continuing entreaties for LLP legislation from professional bodies, Alberta's Minister of Justice requested the Alberta Law Reform Institute to look at "the area of limited liability partnerships generally, not just specifically associated with auditors." After responding affirmatively to the Minister's request, our first step was to prepare and publish an issues paper.[12]

1. The Issues Paper

Our issues paper, published in March 1998, dealt with two groups of issues. The first group was related specifically to the use of limited liability firms by what we referred to as "UL professionals:" the professionals who currently are required to practise in unlimited liability firms in Alberta.

The issues paper placed the issue of professional practice in limited liability firms within the context of historical and current discussions of the general concept of limited liability for owners of enterprises. Given that most enterprises can operate as limited liability firms, the issues paper asked whether it is rational to deny this option to a few professions. It also considered and invited comments on some specific issues, such as whether allowing professionals to practise in limited liability firms might have an adverse effect on the quality of professional services. Finally, assuming for the purposes of argument that professionals should be able to practise in limited liability firms of some description, the issues paper considered what the description should be.

To explain the second group of issues considered in our issues paper, it is necessary to refer briefly to another type of business organization that emerged in the United States a few years ago: the *limited liability company* ("LLC"). Although Wyoming enacted the first LLC statute in 1977,[13] the LLC did not really catch on with enterprises or legislatures until, in 1988, the

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[11] LSA 1995.

[12] ALRI 1998.

[13] Carney 1977 at 581.

Internal Revenue Service issued a ruling that the Wyoming LLC would be treated as partnership for taxation purposes.[14]

For Canadian lawyers, the briefest way to describe the LLC is to say that it is essentially a business corporation with very flexible statutory rules regarding its internal affairs. To the extent that LLC statutes set out rules regarding the internal affairs of LLCs, they tend to be default rules for which the members can substitute other rules by agreement. In that respect, such statutes owe much to traditional principles of partnership law.

Although LLCs were conceived as tax planning devices, over the last few years some US commentators have emphasized the non-tax advantages of LLCs – less formality, greater flexibility and greater freedom from meddlesome courts – as a major explanation for their popularity, especially amongst the owners of small businesses.[15] Other commentators are unconvinced that LLCs really provide much more flexibility or greater freedom from court interference than could be achieved through the ordinary business corporation.[16] And to the extent that LLC statutes succeed in restricting courts' ability to rectify what the latter perceive as unfairness in the treatment of minority interests, some commentators have questioned whether that would necessarily be something to celebrate.[17]

Our issues paper described the explosion of LLC legislation (and LLCs) in the US and raised the issue whether Alberta should create a new type of general-purpose hybrid entity that would, like an LLC, combine the flexible internal rules and flow-through taxation of the ordinary partnership with limited liability. The issues paper did not deal with the structure of such an entity in any detail. Instead, it described the basic concept and solicited input with a view to determining "whether there is sufficient interest in a new

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[14] Carney 1995 at 858. The US literature on LLCs is vast. However, Professor Carney's 1995 article will be of particular interest to Canadian lawyers in that he finds the roots of the LLC in the English unincorporated joint-stock company, which is also the direct ancestor of the "memorandum of association" company of the *Companies Act*, R.S.A. 1980, c. C-20.

[15] See e.g. Oesterle 1995; Ribstein 1992, especially at 420-22.

[16] See e.g. Thompson 1995; DeMott "Preludes" 1995.

[17] See e.g. Thompson 1995 at 934-39; DeMott "Preludes" 1995, *passim*.

general purpose limited liability entity to make further work on the issue worthwhile."[18]

2. Response to Issues Paper

We received only a handful of written responses to our issues paper. With respect to the second group of issues, if we were to assess the demand in Alberta for an LLC-like business organization based solely on the responses to the issues paper, we would have to conclude that the demand is nil. None of the written responses to our issues paper directly addressed the question whether it would be a good idea for Alberta to create a general-purpose limited liability entity along the lines of the LLC. Notwithstanding the absence of response regarding the LLC issue, we suspect the demand for an LLC-like entity for Alberta actually exceeds zero. But in the absence of evidence that it substantially exceeds zero, we do not propose to pursue the matter further at this time except to the extent indicated in the following paragraph.

As already mentioned, we recommend the enactment of legislation that would permit certain professionals to practise in LLPs. This raises the question, If certain professionals are permitted to practise in LLPs, is there any cogent reason why other enterprises should not be able to operate as LLPs as well? As will be discussed at greater length in Chapter 3, we find it difficult to discern any reason of public policy for making LLPs available only to certain professionals. And if legislation were enacted that allowed any type of enterprise to operate as an LLP, the legislature would thereby have achieved much the same result that would be accomplished through LLC legislation in terms of combining the flexible internal rules of partnership with limited liability and flow-through taxation.

The few written comments that we received in response to the issues paper focused on the issue of limited liability for professionals. Of those comments, a couple expressed skepticism regarding the case for allowing professionals to practise in LLPs, but it would be fair to say that those commentators did not express the reasons for their skepticism in detail. The only detailed responses that we received to the issues paper were from

[18] ALRI 1998 at 3.

proponents of permitting professionals to practise in limited liability firms, in particular, LLPs.

C. Some Important Legal Concepts

This section provides a brief introduction to some legal concepts and distinctions that are central to the subject matter of this report. In addition to being brief, the discussion is as non-technical as possible.

1. Characteristics of Certain Business Organizations

This subsection discusses and compares three characteristics of two types of business organization that are available in Alberta: the ordinary partnership, and the business corporation. Although these are not the only types of business organization available in Alberta, they are the two that are of the most interest for the purposes of this report.[19] We confine our attention to the following characteristics of partnerships and corporations: (1) legal status; (2) liability of owners; (3) restrictions on use. We note that the characteristics we discuss are contingent, rather than inherent, features of the two types of firm. For example, although modern lawyers generally assume that limited shareholder liability is a fundamental characteristic of corporations, the limited liability of shareholders simply reflects a legislative decision to extend limited liability to shareholders. Historical examples of unlimited liability corporations are not hard to discover.[20]

a. Ordinary Partnership

Partnership, to quote the *Partnership Act*, is "the relationship that subsists between persons carrying on a business in common with a view to profit."[21] The reference to a *relationship* emphasizes a fundamentally important aspect of the traditional common law approach to partnership.[22] In law, a

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[19] For a somewhat more extended description of business organizations that are available (or might be made available) in Alberta, see *ibid.*, Chapter 2.

[20] In 1844 the UK Parliament enacted legislation requiring joint stock companies with more than 25 members or transferable shares to incorporate: *An Act for the Registration, Incorporation and Regulation of Joint Stock Companies* 7-8 Vict. c. 110, ss 2, 4. Incorporation did not limit the shareholders' liability for the company's obligations: *ibid.*, s. 25.

[21] *Partnership Act*, s. 1(d).

[22] It has long been recognized that there is no logical necessity in the legal characterization of partnerships as relationships rather than as legal entities. Civil law systems (including

(continued...)

partnership is not an *entity* distinct from its members; it is simply a legal characterization of their relationship. It has long been recognized that the law's failure to treat the partnership as a separate entity distinct from its members is at odds with how the commercial world views the partnership:

> Merchants and lawyers have different notions respecting the nature of a firm. Commercial men and accountants are apt to look upon a firm in the light in which lawyers look upon a corporation; *i.e.*, as a body distinct from the members composing it, and having rights and obligations distinct from those of its members. . . But this is not the legal notion of a firm. The firm is not recognized by lawyers as in any way distinct from the members composing it.[23]

One implication of the relationship view of partnerships is that a partnership as such, as distinguished from the several members of the partnership, cannot have legal rights and duties.

Because the law does not recognize the partnership as a separate legal entity, the rights and duties of a partnership are the rights and duties of its partners:

> . . . but speaking generally, the firm as such has no legal recognition. The law, ignoring the firm, looks to the partners composing it; any change amongst them destroys the identity of the firm; what is called the property of the firm is their property, and what are called the debts and liabilities of the firm are their debts and their liabilities.[24]

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[22] (...continued)
Scottish law) have long treated partnerships as separate legal entities. When the US National Conference of Commissioners on Uniform State Laws ("NCCUSL") was working on a Uniform Partnership Act in the early years of this century, there was a lively debate whether to stick with the relationship theory or to move to the entity theory. The relationship theory carried the day in the 1914 Uniform Partnership Act: see Rosin 1989 at 401-04. In 1994 the NCCUSL adopted the Uniform Partnership Act (1994) (often referred to as the Revised Uniform Partnership Act or "RUPA" but abbreviated herein as "UPA 1994"). UPA 1994 adopted the entity theory. More precisely, in the words of the Commissioners' Prefatory Note on UPA 1996 (a revision to the 1994 Act to provide for LLPs):

> The Revised Act [referring here to UPA 1994] enhances the entity treatment of partnerships to achieve simplicity for state law purposes, particularly in matters concerning title to partnership property. RUPA does not, however, relentlessly apply the entity approach. The aggregate approach is retained for some purposes, such as partners' joint and several liability.

[23] Lindley 1878 at 206-07. We suspect that, nowadays, many lawyers are also apt to think of partnerships as entities in their unguarded moments, even if they appreciate that, strictly speaking, they are not legal entities.

[24] *Ibid.* at 207.

Thus, the owners of a partnership – the partners – have unlimited liability for all partnership obligations simply because they are the partners' obligations in the first place.

If two or more persons are carrying on a business in common with a view to profit, they fall within the legal definition of a partnership.[25] It is hard to think of any type of enterprise that could not be carried on by two or more persons in common with a view to profit. Thus, any restriction on the type of enterprise that may be conducted through a partnership would be the result of some specific statutory restriction. One of the few examples of such a restriction is found in section 27 of the *Insurance Act*,[26] which requires that insurers be corporations or unincorporated Lloyd's associations.

Although there are no general restrictions on the type of enterprise that may be carried on by partnerships, there was for many years a restriction on the size of partnerships. Until 1981 section 7 of the *Companies Act* prohibited any unincorporated company, association or partnership of more than 20 people from carrying on any business for profit unless it fell within exceptions set out in the section.[27] The restriction on large partnerships was repealed by the *Business Corporations Act*.[28] Thus, in Alberta there is no formal limit on the number of persons who can carry on any type of enterprise as an ordinary partnership.

Outside of the professions traditionally (of necessity) carried on through the partnership form, we know of no numerically large, ordinary partnerships operating in Alberta. One obvious reason for this is the doctrine of unlimited liability of partners for partnership obligations. To the extent that many members of a large partnership would probably be passive investors, rather than active participants in the partnership business, they

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[25] This definition would apply to corporations, but corporations are specifically excluded from the definition by section 3 of the *Partnership Act*.

[26] R.S.A. 1980, c. I-5.

[27] The main exception was for medical, legal or accounting partnerships. The prohibition on large unincorporated business associations still exists in the UK and some other jurisdictions with a UK company law heritage.

[28] S. 284(5)(c).

would probably much prefer to invest in limited liability firms such as a business corporation or limited partnership.

b. Business Corporation

The law views a corporation as a legal person with rights and duties distinct from those of its owners. In the words of the *Business Corporations Act*, "a corporation has the capacity and . . . powers and privileges of a natural person."[29] To be a shareholder of a corporation is to be the owner of a defined bundle of rights in and claims against the corporation.[30] Ownership of these bundles can be transferred from person to person without any effect on the identity of the corporation itself.

That a corporation has a separate legal personality does not entail that the corporation's shareholders will enjoy limited liability for the corporation's obligations. To be sure, the corporation's separate legal personality entails, as a matter of definition, that the corporation can have legal rights and duties that are distinct from the legal rights and duties of its shareholders. However, it does not follow from this as a matter of logical necessity that shareholders will be free from direct or indirect personal liability for the corporation's obligations. Whether shareholders will be liable for the corporation's obligations is a policy choice, albeit a policy choice that for the last 150 years or so has generally been made in favour of limited liability. Corporations statutes have varied over time and between jurisdictions in exactly how they limit shareholder liability. Under Alberta's *Business Corporations Act*, as a general proposition it is more accurate to say that shareholders, as such, have no liability for the corporation's obligations, rather than to say that their liability is merely limited.[31]

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[29] S. 15(1).

[30] It is also possible that ownership of shares could create duties *to* the corporation or creditors of the corporation.

[31] Section 43 provides that "the shareholders of a corporation are not, as shareholders, liable for any liability, act or default of the corporation except under section 36(4), 140(7) or 219(4)." Section 36(4) creates a liability to return money or property that the shareholder received on an improper reduction of capital. Section 140(7) transfers liabilities from directors to shareholders where a unanimous shareholder agreement transfers to shareholders powers and duties that would normally be exercised by the directors. Section 219(4) makes shareholders of a dissolved corporation liable to persons with claims against the corporation, to the extent of the amount they received in the corporation's liquidation. Although not referred to by section 43, section 113(6)(a) allows the court to require a shareholder to return

(continued...)

In principle, any type of enterprise can be carried on through a corporation. Certain enterprises, notably in the financial services sector, must be conducted by corporations incorporated under special purpose statutes (such as the *Insurance Act*), rather than the general-purpose *Business Corporations Act*. Corporations incorporated under these special-purpose statutes are not, however, fundamentally different from corporations incorporated under the general-purpose statute. For many years, the only important restrictions on incorporated enterprise have been in the area of concern to this report. As discussed in more detail in Chapter 2, the practice of certain professions by corporations has historically been prohibited or restricted.

2. Different Types of Enterprise Obligations

This section considers in a very general way how enterprises incur obligations. The term "obligation"[32] is used here to denote any legally enforceable duty to pay money, regardless of how the duty arises. In this section we do not concern ourselves with the legal structure of the enterprise or the question of exactly who, or what assets, are answerable for the enterprise's obligations. We are concerned simply with how the obligations arise. We refer to persons who are entitled to enforce the obligations as "creditors."

The following discussion divides obligations into three general types: (1) ordinary contract debts; (2) product (or malpractice) liabilities; and (3) general tort liabilities. The categories are not necessarily exhaustive; an enterprise could incur an obligation that does not fall neatly into one of the three categories. The three categories are broad enough, however, that between them they would comprehend almost all of the monetarily significant obligations that a typical enterprise is likely to incur.

a. Promises to Pay Money: Ordinary Debts

The most straightforward and common way for an enterprise to incur an obligation is by promising, either expressly or implicitly, to pay money in

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[31] (...continued)
money or property that was improperly distributed to the shareholder by the corporation.

[32] We use the term "obligation" as a synonym for "liability," rather than in the narrower sense of a liability that arises under a contract. We use "obligation" instead of "liability" mainly so that we can avoid frequent use of constructs such as "liable for a liability."

exchange for something of value provided to the enterprise by a creditor. The value received by the enterprise in consideration for its promise would generally comprise either a loan of money or the provision of goods or services on deferred payment terms. We refer to an obligation that arises out of a promise by the enterprise to pay money as an *ordinary debt*.

b. Product or Malpractice Liability

Enterprises attempt to make money by selling products to customers. An enterprise's product might be goods, services or some combination of goods and services.[33] The enterprise incurs a product liability obligation when it comes under a legal duty to pay money to a person (a "victim") because a product of the enterprise has caused the victim to suffer some sort of injury. The injury might be to the victim's person, or it might consist of damage to or destruction or loss of the victim's property. The injury might also be purely financial: for example, a reduction in the value of securities owned by the victim or a decrease in the revenues of the victim's business.

Obviously, a firm will incur a product liability obligation for a victim's injury only if the injury is in some way attributable to the firm's product. There must be a causal connection (at least in the mind of a judge or jury) between the victim's or someone else's use of the product and the victim's injury. Generally, though, the causal connection must be stronger than this. The injury must be attributable to a *defect* in the product: its failure to meet some defined standard of quality.[34] The standard of quality might be defined by an agreement between the enterprise and the victim or it might be imposed and defined by the state through legislation or judicial decisions. The standard might be quite precise, as might be expected in a detailed performance specification for a machine purchased by one enterprise from another. Or the standard of quality might be vague and indeterminate, as in a judicially imposed requirement to take "reasonable care" to ensure that a machine will not cause injury to persons using it.

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[33] We intend the phrase "goods and services" to have a broad enough meaning to comprehend anything that an enterprise might hope to sell or exchange for value.

[34] Liability might be imposed on the provider of a product for injuries caused by the product without any pretense that the product is defective. For example, if as a matter of policy gun manufacturers were held liable for all injuries caused by the unlawful use of their products, the basis of liability would have nothing to do with defects in the manufacturers' products. The rationale for such an approach might be to provide an assured source of compensation for persons injured by the unlawful use of guns.

In this report the type of product we are principally concerned with is professional services. We suspect that many professionals do not regard themselves as being mere "producers" of a "product." Rather, they *practice* a profession in which they provide *professional services*. In deference to this usage, we will speak of professional services and will refer to *malpractice liabilities*, rather than product liabilities, when discussing professional firms. A malpractice liability, then, is simply an obligation incurred by professional firm as a result of a defect in a professional service that it has provided. Depending on the circumstances, the defect might be characterized as negligence, misconduct, breach of trust or fiduciary duty or, more generally, as a wrongful act or omission.

c. General Tort Liability

An enterprise can incur obligations for wrongful acts or omissions that have nothing to do with defects in its products or, in the case of a professional firm, nothing to do with professional malpractice. The distinctive feature of *general tort liabilities*, as compared to product liability claims, is the absence of any special relationship between the nature or circumstances of the victim's injury and the nature of the firm's product or services. For example, a lawyer employed by a law firm might negligently run over a pedestrian while driving from the firm's office to a client's office to get a document executed. The lawyer who runs over the pedestrian is liable for the tort of negligence, and so is the law firm that employs the lawyer, because the lawyer was acting in the course of employment. Obviously, though, the victim's injury and the circumstances in which it occurred have no particular relationship to the type of services provided by the firm.

3. Vicarious Liability

Why is the lawyer mentioned in the preceding paragraph liable for the pedestrian's injury? In terms of legal doctrine, the answer is simple. The law firm is liable through the application of the doctrine of *vicarious liability*. Under this doctrine, one party to certain types of relationship may be held liable for torts committed by the other party even if the first party cannot realistically be assigned any personal blame for the victim's injury. Over the centuries courts, and, in more recent years, legislatures have determined that certain relationships should create the potential for vicarious liability. Employers are liable for torts committed by their employees while acting in the course of their employment.[35] A partnership is liable for wrongful acts or omissions committed by a member of the firm while acting in the ordinary course of business of the firm.[36] And the owner of a motor vehicle is liable for injuries caused by the negligent operation of the vehicle by someone operating the vehicle with the owner's consent.[37]

We pause here to note the connection between vicarious liability and unlimited liability in the context of product liability obligations or general tort liabilities of a firm. Suppose that one firm is a corporation and another firm is a partnership. An employee of each firm commits a tort while acting in the course of their employment. In each case the magnitude of the victim's loss exceeds the combined assets of the responsible employee and the firm, which has no liability insurance for this sort of injury. Both firms are vicariously liable for their respective employee's tort. In the case of the corporation, imposition of liability on the firm exhausts the operation of the doctrine of vicarious liability. The concept of limited shareholder liability means that the corporation's shareholders are not vicariously liable for the victim's damages if they exceed the corporation's assets. In the partnership's case, however, vicarious liability has more stamina. It does not stop when it reaches the firm and the firm's assets. Instead, the unlimited liability of the partners means that vicarious liability flows right through the firm to its individual members.[38] Readers should keep this relationship between "flow-

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[35] This version of vicarious liability is rooted in the common law: see Atiyah 1967 at 3. For our purposes it is unnecessary to consider how courts determine whether or not the tortious acts of an employee were carried out while acting in the course of their employment or, indeed, whether a particular relationship is one of employment rather than some other relationship that does not create the potential for vicarious liability.

[36] *Partnership Act*, ss 12, 14. Atiyah 1967 at 116-17 notes that the vicarious liability of partners for each other's "pure" torts (as opposed to misappropriation of property entrusted to the partnership) was not firmly established in the common law before the *Partnership Act 1890* (UK) settled the matter.

[37] *Highway Traffic Act*, R.S.A. 1980, c. H-7, s. 181. The Act's technique for imposing vicarious liability on the owner is to deem the driver to be the owner's "agent or servant . . . driving the motor vehicle in the course of his employment." In the absence of such a legislative provisions, judges were often driven, as it were, to perform judicial gymnastics in order to impose vicarious liability on the owner on the basis that the driver was acting as the owner's agent: QLRC 1995 at 50-55.

[38] Or as DeMott "Keepers" 1995 at 119 puts it:

> In the partnership context, two forms of vicarious liability are significant: the vicarious liability of the partnership itself and the derivative (or secondary) vicarious liability of individual partners.

(continued...)

through" vicarious liability and unlimited liability in mind in the ensuing discussion of possible rationales for vicarious liability.

Vicarious liability, as a legal concept, must be distinguished from situations where liability is imposed on someone whose wrongful actions or omissions, although not the immediate cause of an injury, created the opportunity for the actions of another actor to cause the injury. In the latter case, the analysis is that the first person was under, and failed to discharge, a personal duty to anticipate and take steps to reduce the risk that another actor's actions would cause the injury. For example,

> if a parent fails in his or her duty to supervise an infant child who wanders into a busy street and a driver, swerving to avoid the child, has a collision, the parent is liable for the damage, not because of vicarious liability for the infant child, but because the parent owes a personal duty of care to road users to prevent the child escaping into the street.[39]

In a case of vicarious liability, on the other hand, what the principal did or did not do, or might have done or not done, to help cause or prevent the injury, is basically irrelevant to the issue of liability. Liability flows simply from the relationship between the principal and the actor whose wrongful action caused the injury.

While the theoretical distinction between personal liability for one's own wrongful conduct (including omissions) and vicarious liability for another action's wrongful conduct is clear enough, the line may easily become blurred in operation:

> In legal theory, vicarious liability is readily distinguishable from personal liability. There is generally an obvious difference between holding a person liable for his own torts and holding him liable for the torts of a servant, agent or independent contractor . . . Nevertheless, on further analysis, the distinction between personal and vicarious liability becomes a good deal more blurred than it appears at first sight.[40]

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[38] (...continued)
This idea of two levels of vicarious liability can be seen in the *Partnership Act* itself. Section 12 imposes vicarious liability on the firm for the wrongful actions of a partner; section 14 then makes the individual partners jointly and severally liable for the firm's liability.

[39] This example is given by the Queensland Law Reform Commission: QLRC 1995 at 8.

[40] Atiyah 1967 at 3.

One source of this blurring is the flexibility of the concepts of duty of care and standard of care as employed by modern courts. In many situations, a court that did not have the doctrine of vicarious liability at its disposal could still impose liability on an employer by finding that the employer owed, but failed to discharge, a personal duty to the victim to take reasonable care in selecting, training, equipping, controlling, supervising or monitoring the employee.

Nevertheless, where liability would be personal rather than vicarious, it will at least be necessary for the court to enquire into and make findings about what the employer actually did or did not do in order to reduce the risk of injury: to determine whether the employer personally exerted reasonable risk-reduction effort. Where liability would truly be vicarious, such an enquiry is unnecessary; it is only the wrongfulness of the employee's actions that is in issue.

Why would the courts or the legislature impose liability on one person (the "principal") for wrongs committed by another person (the "related actor")[41] because of their relationship where the principal cannot realistically be assigned any blame for the actor's wrongful actions? In particular, why impose liability on a principal for the actions of a related actor merely because of the economic relationship – employer and employee, principal and agent, partner and partner – between them? Various rationales for doing so have been propounded and debated over the years.[42] The rationales can be divided into two rough categories: (1) injury prevention rationales; (2) loss shifting rationales.

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[41] We use the terms "principal" and "related actor" for lack of better general terms to denote the parties to relationships that can give rise to vicarious liability: employer and employee; principal and agent, partner and partner (a special instance of the principal-agent relationship), car owner and car driver, and so on. Some writers use the terms "principal" and "agent" as general terms. We use the term "related actor" (and sometimes just "actor") instead of "agent" as our general term to avoid the implication that relationships that give rise to vicarious liability are necessarily "agency" relationships in the strict legal sense.

[42] See Atiyah 1967 at 15-22, discussing different justifications for vicarious liability that had been propounded at one time or another.

a. Vicarious Liability and Injury Prevention

An injury prevention rationale claims that the threat of vicarious liability may induce the principal to take optimal measures[43] to reduce the risk that the actor's wrongful actions will cause injuries to others. The obvious difficulty with an injury prevention rationale for vicarious liability is that liability is imposed on the principal regardless of how much care they took to reduce the risk of an accident occurring. In legal proceedings arising out of an injury caused by the related actor, the principal cannot avoid liability by establishing that the principal, as opposed to the related actor, made reasonable efforts to reduce the risk of injury. If the object of imposing liability for injuries is to encourage someone to take steps to reduce the risk of injuries, one might expect that the steps they actually took or failed to take to reduce the risk of injury would be relevant in determining their liability for an injury that has occurred. Given that a principal will be liable for failing to discharge a *personal duty* to take reasonable steps to reduce the risk that a related actor's wrongful actions will cause injury, how will the prospect of vicarious liability increase the principal's incentives to make optimal risk-reduction efforts?

One sort of response to the preceding point would focus on the evidentiary difficulties faced by victims. It starts from the premise that persons who have been injured by the actions of a related actor of a principal would often face great difficulty and expense in acquiring and presenting the evidence necessary to establish that their injury was partly attributable to the principal's failure to make reasonable risk-reduction effort. It could be much more difficult and expensive to acquire and present this sort of evidence than to establish that the injury was caused by the related actor's wrongful action.[44]

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[43] We refer to *optimal* measures to reduce risk, or *optimal* risk-reduction effort, in a number of places in this report. Optimal risk-reduction effort can be thought of as *cost-effective* effort. For a more elaborate discussion of optimal effort to reduce risk ("socially optimal level of care") see Shavell 1987, Ch. 1, esp. at 6-7.

[44] See Atiyah 1967 at 20-21, where the evidentiary point is discussed as a compensation issue, rather than as an incentives issue. See also DeMott "Keepers" 1995 at 120, referring to "suppressed fault on the part of the principal – that is, when an agent acts wrongly, the principal often has failed to fulfill its own duty even if the principal's failure is not always provable."

If victims would often be unable to *prove* fault on the part of principals, even when the principals are *in fact* at fault, how might this adversely affect principals' risk-reduction effort? The argument is that principals could anticipate that, even if they make sub-optimal risk-reduction effort, they will often escape liability for victim's losses simply because of victims' evidentiary difficulties. The prospect of avoiding liability because of victim's evidentiary difficulties could dilute the principal's incentive to make optimal-risk reduction effort. By dispensing with the requirement for victims to prove that their injury flows from a principal's failure to make optimal risk-reduction effort in the selection, supervision or training of a related actor, vicarious liability helps to prevent the dilution of principals' incentive to make optimal risk-reduction effort.

It might also be argued that vicarious liability can reduce the overall cost of injuries caused by a particular sort of risky activity by helping to ensure that the participants in the activity will take full account of its costs in deciding "how much" of the activity to engage in. To illustrate the point, we might begin by supposing that in a regime of personal liability (i.e. no vicarious liability), firms in a particular industry would escape liability for 75% (by value) of the injuries caused by wrongful actions of employees in the course of their employment.[45] Since firms will escape liability for 75% of the value of tortious injuries caused by their economic activity, the cost of those injuries will not form part of the industry's cost structure.[46]

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[45] The assumption is that in 25% of the cases the employer would be found to be in breach of a personal duty to the victim, such as a personal duty of supervision.

[46] In theory, the tort costs might be fully reflected in the firms' cost structure because of their employees' potential liability. Employees who are aware of their potential liability might insist on being indemnified by the firm against their potential liability, or they might purchase insurance against liability and take the cost of insurance into account in pay negotiations with the firm: see Mayers & Smith 1982 at 283-84. However, where the potential liabilities are very large in relation to the assets of any given employee, the employee's impecuniosity in the face of such a claim is likely to provide the firm and its employee with an opportunity for a mutually beneficial bargain that ignores or greatly discounts the employee's potential liability. The point is put thus in Sykes 1984 at 1241-42:

> Many agents are potentially insolvent in the face of a substantial judgment against them. Indeed, if an agent's activities create the risk of a judgment that exceeds the agent's net worth and the agent can obtain a discharge in bankruptcy, then the principal and the agent can use the agent's potential insolvency to their advantage under a rule of personal liability [i.e. no vicarious liability]. The agent's insolvency increases the expected profits of the principal-agent enterprise by the value of the judgment less the agent's ability to pay, multiplied by the probability of the judgment. A rule of personal liability thus

(continued...)

From an economist's perspective, the fact that firms do not bear all the costs of their employees' torts is not necessarily problematic. In particular, it is unproblematic if all or substantially all of the potential victims are fully informed customers of the firm. A fully informed customer appreciates both the risk of injury associated with the firm's product and the implications of the personal liability regime for their prospects of being compensated for any injury they suffer because of a defect in the product. Fully informed customers will take these risks into account in considering how much they are willing to pay for the firm's product. In other words, although a firm's costs will be diminished by the absence of vicarious liability, so will the value of its product to customers, and, hence, the price they are willing to pay for the product. Fully informed customers will get the same net value from the firms' products in the absence of vicarious liability as they would have received if firms had been vicariously liable.

That firms are relieved from the cost of their employees' torts will be more problematic if customers are not well informed about the risks associated with the product or about the implications of the absence of vicarious liability for their prospect of being compensated for injuries that do occur. Such customers will be prepared to pay more for the product than they would if they knew all the risks. Another way of looking at it is that consumption of the risky product at a given price will be greater than it would be if customers fully appreciated the risks they incur in purchasing the product. Customers are getting less bang for their buck than they think they are getting. If firms were vicariously liable, they would have to build their liability costs into the price of their product, so the level of consumption of the product would more accurately reflect the risks involved in using the product.

The personal liability regime will also be problematic where the risk of loss falls not on a firm's customers but on persons who have no voluntary association with the firm or its products. Here the lack of vicarious liability may facilitate the *externalization* of risk: the imposition of some portion of the risk of loss associated with an activity on persons who are not voluntary participants in the activity. Again, the potential for externalization of risk

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[46] (...continued)

> allows the principal and the agent jointly to increase their expected profits by eschewing any risk-sharing agreement or any insurance policy that averts agent insolvency and concurrently provides greater compensation to injured parties.

See also Shavell 1987 at 170.

arises where the wealth of the related actors (e.g. employees) who would be liable under a personal liability regime is likely to be much less than the loss their actions might cause to outsiders. In the absence of vicarious liability, the firm will not have to factor potential liability for such losses into its price structure. Therefore, the price customers pay for the firm's product will be lower than it would be if the firm was vicariously liable for its employees' wrongful actions. The customers as well as the firm benefit from this externalization, because the risk of loss is borne by persons other than customers. Since the price paid by customers does not reflect the true cost of the product, consumption of firm's product will be excessive relative to its true cost.

b. Vicarious Liability and Loss Shifting

Although it might be advanced in conjunction with an injury prevention rationale, a loss shifting rationale is not concerned with how the threat of liability might affect a principal's (or anyone else's) risk reduction effort. A loss shifting rationale is compensatory, emphasizing vicarious liability's function as a means of ensuring, or at least increasing the likelihood, that a person injured by the related actor's wrongful action will be compensated. Obviously, this sort of rationale involves a premise that the goal of ensuring that the victim is compensated makes it appropriate to impose liability on the principal even if the principal bears no personal blame for the injury. This premise might be defended from a number of different bases.

A possible moral justification for requiring the innocent principal to compensate the injured victim focuses on the benefits that the principal hopes to derive from the related actor's activities.[47] The principal expects to enjoy the benefits of the activities carried out on its behalf by the actor. It is only fair, therefore, that as between the principal and persons who might be injured by the wrongful actions of the actor in carrying out those activities, the principal should bear the burden of the risk of injuries arising from those actions.[48] Otherwise, the principal gets the potential benefit of the related

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[47] This sort of justification obviously has no general application to the statutory vicarious liability imposed on the owner of a motor vehicle; it is aimed at situations where there is an economic relationship between principal and related actor.

[48] Atiyah at 17-18, where it is pointed out that, as a legal proposition, the fact that a principal may expect to benefit from the activities of a related actor is neither a sufficient nor a necessary condition for the imposition of vicarious liability. "Nevertheless, the feeling that

(continued...)

actor's activities while offloading some of their downside risk onto outsiders. So on this analysis, imposing vicarious liability on the principal is less a case of shifting risk from victim to principal than of preventing the principal from shifting a portion of the risk of its economic activities onto outsiders.[49]

Other justifications for requiring the innocent principal to compensate the victim of the related actor's wrongful conduct focus not on the fairness of imposing liability on the principal but on the relative ability of the principal and the victim to bear the risk of loss or to insure against the risk of loss.[50] In other words, as compared to the victim, the principal is either a *better risk bearer* or is a more *efficient insurer*. In either case, this sort of justification assumes that if the related actor were the only person liable, victims would often go uncompensated, or would be less fully compensated, because the actor would be unlikely to have either sufficient wealth or sufficient liability insurance to cover the victim's loss.

As a general proposition, it is reasonable to assume that where the principal is a fairly large enterprise and the victim is an individual (or a small number of individuals), the principal will be a better risk bearer than the victim. The odds are that the financial impact on the firm of having to pay for the loss will be much less than the impact of having to bear the loss would be on the victim. For example, if the firm is a large publicly traded

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[48] (...continued)
one who derives a benefit from an act should also bear the risk of loss from the same act is probably a deep-rooted one which has played its part in the formulation of the modern law:" *ibid.* at 18. See also Collin 1996, *passim.*

[49] The argument is presented here as a moral argument to the effect that it is unfair for the principal not to bear the full risk of the harmful effects that may result from the economic activities carried on by the principal through related actors. There is a parallel economic version of this argument, which emphasizes that the lack of vicarious liability facilitates the externalization of risk. The gist of the argument it is that if the persons who stand to benefit from an activity do not bear all of its risks, they will overvalue the activity when deciding whether to engage in it all, or in deciding on the extent of their participation in the activity: see e.g. Shavell 1987 at 171-72.

[50] In legal terms, an actor who would be liable for a particular injury might be said to bear the risk of loss from that injury. Conversely, a victim who would have no legal right to redress from the person who causes an injury might be said to bear the risk of loss. In economic terms, however, if the person who bears the *legal* risk of loss has purchased insurance against that loss, the insurer, rather than that person is the ultimate risk bearer. When we speak in this report of a person bearing the risk of loss, we are generally referring to someone who bears the legal risk of loss *and* has no formal arrangement with an insurer whereby the latter assumes responsibility for the loss.

corporation, the impact of say, a $1 million personal injury award on any given shareholder's wealth is likely to be negligible, while the consequences for the victim of not being compensated for their injury would be severe.

It is worth noting that the impact of a corporation's $1 million liability on a given shareholder is likely to be minimized by two related but distinct considerations.[51] In the first place, a $1 million liability is likely to be but a small fraction of the corporation's assets and revenues, so the impact on the corporation, or the market value of its stock, is likely to be minimal relative to the impact of the injury on the victim. But just as importantly, so far as risk bearing-capacity is concerned, the proportion of a given investor's wealth represented by a particular corporation's stock is likely to be only a small proportion of the investor's total wealth. So even if the liability is large in relation to the corporation's assets and income, its impact on any given, well-diversified investor should still be relatively small.[52]

Of course, the fact that a principal may be in a better position to absorb a loss than someone injured by a related actor's wrongful conduct cannot provide a complete rationale for imposing vicarious liability on the principal. The problem is that if you only look at relative ability to bear risk as between principal and victim, this provides no clue as to where to draw the line in imposing vicarious liability. If relative capacity to bear risk is the only issue, why not impose vicarious liability on the employer for torts committed by people who happen to be its employees, whether they commit the tort in the course of their employment or not? Indeed, if the problem were simply to find a good risk bearer, why would one care whether there is any relationship between the actor and the enterprise at all? If a person is injured by an impecunious actor, the court could just draw names of well endowed firms out of a hat and assign liability to the firm whose name is drawn. Or, more

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[51] We are assuming here that the corporation – and its shareholders – are actually bearing the risk rather than paying an insurer to bear it.

[52] Investors' ability to "diversify away risk" by maintaining a diversified portfolio of investments – putting their eggs in several baskets – often comes up in discussions of limited liability and other contexts relating to the behaviour of widely held corporations and their shareholders. For example, the ability of investors to diversify away risk raises the question of why widely held corporations would ever buy insurance. It has been suggested that one of the reasons for corporations to purchase insurance is to protect the corporation's risk averse managers and employees, rather than to protect the investment of risk neutral shareholders: Mayers & Smith 1982 at 283-84.

rationally, one could simply dispense with assigning liability and devise a no-fault compensation scheme for victims of particular types of injury.

One way of putting a brake on the slide of the "enterprise as better risk bearer" argument down the slippery logical slope to the valley of no-fault compensation is to point out that not only is the enterprise likely to be a better risk bearer than the victim, it is also an *appropriate* risk bearer. If the firm is liable for torts committed by its employees in the course of their employment or for injuries caused by defects in its products, then the cost of those torts will be shared in some fashion by stakeholders in the enterprise or its product, including, owners, employees and customers.[53] This furthers the social goal of internalizing the costs of an activity to those who participate in it (whether as stakeholders of the firm that makes a product or as users of the product), something that a no-fault compensation system would not necessarily accomplish.

The legal doctrine of vicarious liability is insensitive to the actual wealth of the principal relative to that of the victim. It is not difficult to think of examples where bearing the financial burden of a victim's loss would be at least as onerous for the enterprise whose employee causes the injury as it would be for the victim. Even in such cases though, there could be an argument for imposing the *legal* risk of loss on the enterprise not because it is necessarily a better risk bearer than the victim (or potential victim) but because it is a more efficient insurer. The theory here is that even if the magnitude of a potential loss relative to the size of a firm is such that the firm is not a particularly good risk bearer in relation to a loss of that magnitude, the firm is likely to be in a better position to evaluate and insure against the risk than are potential victims:

> According to enterprise liability theory, expanded legal liability does more than achieve optimal control of accident and activity rates. Expanded tort liability improves social welfare, in addition, because it provides a form of compensation insurance to consumers. A provider, especially a corporate provider is in a substantially better position than a consumer to obtain insurance for product- or service-related losses, because a provider can either self-insure or can enter one insurance contract covering all consumers – in comparison to the thousands of

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[53] See e.g. Atiyah 1967 at 23, noting that the extent to which the cost is borne by owners (shareholders) and employees, on the one hand, or customers on the other, depends on market conditions which determine how far the liability costs can be passed along to customers in the price of the product.

> insurance contracts the set of consumers would need – and can easily pass the proportionate insurance premium along in the product or service price. Most importantly, to tie insurance to the sale of the product or service will provide insurance coverage to consumers who might not otherwise obtain first-party coverage, in particular the poor or low-income among the consuming population.[54]

On this view, imposing vicarious liability on the firm is one means of encouraging the party who is better placed to purchase insurance to actually do so.

4. Limited Liability and Unlimited Liability Firms

To this point we have referred to limited and unlimited liability firms without really explaining what is and is not entailed by the two concepts. We do so in this section.

a. Unlimited Liability Firms

The owners of an unlimited liability firm, as owners, bear unlimited liability for all of the firm's obligations. This means that personal assets of the owners, as well as the assets of the firm itself, are subject to enforced liquidation to meet the latter's obligations. Unlimited liability entails that, in theory at least, there is no upper limit on the amount of an owner's personal liability for the firm's obligations; as the amount of the firm's obligations increase, so does the amount for which the owner is personally liable. In an ordinary partnership, unlimited liability is implemented through a doctrine of joint, or joint and several, liability.[55] However, unlimited liability might be implemented, and sometimes has been implemented, through a regime in which each owner is liable only for that proportion of the firm's debts that corresponds to their proportionate ownership interest in the firm.[56]

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[54] Priest 1987 at 1535. We hasten to add that the object of Priest's paper is to demolish the insurance rationale for enterprise liability, rather than to propound it. It may also be observed that Priest is not talking about vicarious liability *per se*. But vicarious liability could be regarded as one manifestation of enterprise liability theory.

[55] Strictly speaking, the liability of partners for contractual obligations is joint, while their liability for torts is joint and several: *Partnership Act*, ss 11(1), 14. Nowadays, the distinction between joint and joint and several liability is unlikely to be of practical importance in very many contexts.

[56] Blumberg 1986 at 597-99 notes that until 1929 a provision of California's constitution imposed *pro rata* liability on shareholders of California corporations, as well as on the shareholders of non-California corporations with respect to debts arising in California. Grossman 1995 employs the American Express Company to test certain hypotheses about the

(continued...)

b. Limited Liability

Some or all of the owners of a limited liability firm enjoy a ceiling on their maximum liability, as owners, for the firm's obligations.[57] As already discussed, in the absence of special circumstances, the ceiling on the liability of the shareholders of a corporation incorporated under the *Business Corporations Act* is nil.

The limited liability of the owners of a limited liability firm applies only to what might be called "status liability," liability to which they would be subject because of their status as owners if the firm were an unlimited liability firm. Another way of putting it is that limited liability cuts off liability which would otherwise flow through the firm to its owners if the firm were an unlimited liability firm. The limited liability of owners has absolutely no effect on their liability for obligations that they incur directly, rather than through their status as owners of the firm.

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[56] (...continued)
effect of unlimited liability on the market for a company's shares. The American Express Company serves this purpose because its shareholders were subject to unlimited *pro rata* liability from its formation in 1850 until 1965: Grossman 1995 at 72-75.

[57] As already discussed, in a business corporation all owners (shareholders) enjoy limited liability, but it is only the limited partners of a limited partnership who enjoy limited liability.

CHAPTER 2. LIMITED LIABILITY AND PROFESSIONALS

A. The Historical and Current Position in Alberta

Although most enterprises have been able to operate as limited liability firms for decades, certain professional enterprises in Alberta and other jurisdictions have been required to operate as unlimited liability firms. The professions subject to this requirement have varied from jurisdiction to jurisdiction and from time to time. Even when we confine our attention to one province, Alberta, it is difficult to discern any coherent principle or policy by which it has been determined whether a particular profession may be practised in limited liability firms. Indeed, it is not readily apparent that legislators have consciously applied any criteria in determining whether or not a particular of profession or occupation should be capable of being practised through limited liability firms.

One thing that is clear is that influential views on the appropriateness of various professional services being provided through limited liability firms have changed over the years. Going back to 1922,[58] corporations were implicitly prohibited from operating pharmacies in Alberta. This was the effect of a provision that stipulated that only registered persons, who by implication had to be individuals, could "keep open shop for retailing, dispensing or compounding" specified drugs.[59] But in 1923 the relevant legislation was amended to permit corporations or partnerships to operate retail pharmacies, so long as the operation of retailing, dispensing and compounding drugs was controlled and managed by a registered pharmacist.[60] This basic approach survives in the current legislation governing the pharmaceutical profession.[61]

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[58] We pick 1922 to begin our historical survey simply because revised statutes were published that year.

[59] *The Alberta Pharmaceutical Association Act*, R.S.A. 1922, c. 203, s. 25.

[60] S.A. 1923, c. 5, s. 2.

[61] *Pharmaceutical Profession Act*, S.A. 1988, c. P-7.1, s. 25.

In 1942[62] legislation specifically provided that the professions of architecture;[63] dentistry;[64] and engineering[65] could not be carried on through corporations. For certain other professions, legislation did not specifically prohibit incorporation, but licensing requirements created an implied prohibition on incorporated practice. Anyone who was not licensed to practise the profession was prohibited from practising, or holding themselves out as being entitled to practise, the relevant profession. Although the legislation did not specifically state that corporations could not be licensed, the qualifications for obtaining a license applied only to individuals. Thus, a corporation that purported to offer the relevant services would infringe the prohibition on unlicensed practice, even if all its shareholders and directors were individually authorized to practise the profession.[66] Professions coming within the ambit of the implied prohibition on incorporated practice included chiropractic;[67] law;[68] medicine;[69] and optometry.[70]

As noted in the preceding paragraph, the 1942 statutes governing engineering and architecture expressly prohibited corporations from carrying on the businesses of architecture or professional engineering. The prohibition on the incorporated practice of engineering survived until 1955, when *The Engineering Profession Act* provided for the practice of engineering by corporations under the following conditions:

> . . . a firm, partnership, corporation or association of persons may practise professional engineering in its own name if the practising is done under the direct supervision of a member of the firm, partnership or association or a director of the

[62] Again the only magic in the year 1942 is that revised statutes were published in that year.

[63] *The Alberta Architects Act*, R.S.A. 1942, c. 285, ss 2(2), 10(1).

[64] *The Dental Association Act*, R.S.A. 1942, c. 291, ss 25, 28.

[65] *The Engineering Profession Act*, R.S.A. 1942, c. 292, ss 6, 9.

[66] Since partnerships are not legal persons, partnerships would not run into this problem. If a partnership of qualified practitioners provides certain professional services, it is the qualified practitioners, not a separate legal entity, who are providing the services.

[67] *The Chiropractic Act*, R.S.A. 1942, c. 290, ss 5, 19, 21.

[68] *The Legal Profession Act*, R.S.A. 1942, c. 206, ss 73, 74, 76, 79.

[69] *The Medical Profession Act*, R.S.A. 1942, c. 295, ss 69, 72(1).

[70] *The Optometry Act*, R.S.A. 1942, c. 296, s. 13.

> corporation, or under the direct supervision of a full-time permanent employee of the firm, partnership, association or corporation who, in either case, is a member or visitor.[71]

This is essentially the position today, although it is worth noting that the practice must be carried on under "the direct personal supervision and responsibility" of a member or licensee.[72] There are no restrictions on the ownership of shares in, or on the persons who may serve as directors or officers of, an engineering corporation.

Alberta's architects could not incorporate their practice until 1969, when amendments to the *Architects Act* provided for incorporated practice.[73] The amended act provided that a permit to practise architecture could be issued to a corporation if all of its issued shares were owned by architects and all of its directors and officers were architects.[74] The requirements regarding shareholders, directors and officers have subsequently been relaxed. The current requirement is that ownership of the majority of the voting shares must be vested in architects and that a majority of the directors and officers must be architects.[75]

In 1975 four professional statutes were amended to allow practitioners to form "professional corporations" (or "PC"s).[76] The four affected professions were chartered accountants, dentists, lawyers and medical doctors. Subsequently, the members of four other professional groupings were allowed to form PCs: certified general accountants;[77] certified management

[71] S.A. 1955, c.74, s. 19(2).

[72] Alta. Reg. 244/81, s. 44, as am. by Alta. Reg. 61/96.

[73] S.A. 1969, c. 10, amending R.S.A. 1955, c. 16, s. 3.

[74] R.S.A. 1955, c. 3, s. 3(1) as am. by S.A. 1969, c. 10.

[75] Alta. Reg. 242/82, s. 3(3), as am. by Alta. Reg. 382/84. We ignore here the special provision that is made for joint architect - engineer firms.

[76] *The Attorney General Statutes Amendment Act, 1975 (No. 2)*, S.A. 1975, c. 44.

[77] *Certified General Accountants Act*, S.A. 1984, c. C-3.5, ss 12-20.

accountants;[78] chiropractors;[79] and optometrists.[80] The impetus for the professional corporation concept was taxation, rather than any concern about unlimited liability.[81] Consequently, the amended professional statutes deprived the PC's shareholders of the liability shield that normally comes with incorporation. For example, section 129 of the *Legal Profession Act* reads as follows:[82]

> (1) Notwithstanding anything to the contrary in the *Business Corporations Act*, every person who is a voting shareholder of a [PC] is liable to the same extent and in the same manner as if the voting shareholders of the corporation were during that time carrying on the business of the corporation as a partnership or, if there is only one voting shareholder, as an individual practising as a barrister and solicitor.
>
> (2) The liability of any person in carrying on the practice of a barrister and solicitor is not affected by the fact that the practice of a barrister and solicitor is carried on by that person as an employee and on behalf of a professional corporation.

Although the precise effect of this provision has been debated, it clearly leaves all voting shareholders of a PC personally liable for malpractice claims against the PC.

There is an issue as to the extent to which PCs might provide some sort of liability shield to shareholders against obligations of the corporation other than malpractice liabilities. The authors of one recent article, after discussing certain conflicting court decisions and the debates in the legislature preceding the enactment of the PC legislation, reach the following conclusion:

> In light of the debates as recorded in Hansard it would appear that what the Legislature intended by the phrase that a person is liable "to the same extent and in the same manner . . . as an individual practi[s]ing as a barrister and solicitor" is the liability which the professional has to a client or patient and not to third party liability.
>
> It therefore seems clear that the intention of the Legislature in 1975 was to put individuals who practice as lawyers, chartered accountants, medical doctors

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[78] *Certified Management Accountants Act*, S.A. 1987, c. C-3.8, Part 4.

[79] *Chiropractic Profession Act*, S.A. 1984 c. C-9.1, ss 19-27.

[80] *Optometry Profession Act*, S.A. 1983, c. O-10, ss 17-20.

[81] Stratton & Hughes 1997 at 781-82.

[82] The current version of the provision, which is set out above, is essentially unchanged from the original 1975 version.

> and dentists in the same position as those other professions, such as engineers, that can carry on their professional practice through a corporation without the individual shareholders being exposed to personal liability.[83]

In other words, so the argument goes, provisions such as section 129(1) of the *Legal Profession Act* evince a legislative intention to provide shareholders of a PC with limited liability for ordinary debts of the corporation while leaving them exposed to liability for malpractice liabilities.

We feel bound to observe that if the legislature's intention was to shield shareholders of a PC from personal liability for the latter's ordinary debts, it chose an odd way to express that intention. Saying that the voting shareholders of a PC are liable "to the same extent and in the same manner" as if they were "carrying on the business of the corporation as a partnership" would be a curious way to express an intention to provide shareholders with a liability shield against certain obligations of the PC. In this regard, it may be noted that if the legislature had intended to make PC shareholders personally liable only for the corporation's malpractice liabilities, it would not have been exceptionally difficult to say so. As will be discussed below, by 1975 many American PC statutes contained provisions that clearly provided shareholders with limited liability for the corporation's obligations other than malpractice liabilities.

The experience of Alberta's accounting profession regarding incorporated practice is somewhat more complicated than that of the legal profession and the various health care disciplines mentioned above. The latter professions have long been subject to licensing requirements. Formal licensing of the accounting profession in Alberta goes back only to 1987. Before 1987 legislation relating to the accountancy profession only provided what is referred to as "protection of title."[84] For example, until 1987 the *Chartered Accountants Act* prohibited anyone who was not a member of the Institute of Chartered Accountants of Alberta from adopting the designation "Chartered Accountant", "F.C.A.", "A.C.A" or "C.A." or any description implying that they were a chartered accountant.[85] The Act went on to

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[83] Stratton & Hughes 1997.

[84] See Jenkins 1986, *passim*, esp. at 8-10.

[85] *Chartered Accountants Act*, R.S.A. 1980, c. C-5.

provide, however, that "[n]othing in this Act affects or interferes with the right of a person not a member of the Institute to practise as an accountant in Alberta."[86] Since 1987, accountancy statutes have defined "exclusive accounting practise" (audits or reviews) and have provided that no person other than a chartered accountant, certified general accountant, or certified management accountant (or a professional corporation) may engage in or purport to be able to engage in exclusive accounting practice.[87]

Prior to 1987, since there were no formal restrictions on the persons who could practise accountancy in Alberta, an ordinary limited liability business corporation could in theory practise accountancy. But the protection of title provisions prevented any corporation other than a duly authorized PC from holding itself out as a "Chartered Accountant." Thus a firm of chartered accountants who wanted to make it clear that they were indeed a CA firm – as they undoubtedly would wish to do – would either have to operate as a partnership or as a PC with unlimited shareholder liability. As a practical matter, then, even before 1987 CA firms were effectively required to deliver CA services in unlimited liability firms: ordinary partnerships. On the other hand, even after 1987, CA firms may incorporate parts of their business that offer services, such as management consulting or bankruptcy trusteeship, that fall outside the scope of exclusive accounting practice.

To summarize, over the last few decades legislative requirements that prevented the professions of pharmacy, architecture and engineering from being carried on in Alberta by limited liability firms have been abandoned. Such requirements have been retained, however, for the legal profession and several health care disciplines and have been formally added for that part of accounting firms' business that falls within the definition of "exclusive accounting practice." This latter group of professions can be practised through professional corporations, but PCs provide shareholders with, at most, a very narrow and porous liability shield, and provide no protection against malpractice claims.

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[86] *Ibid.*, s. 51.

[87] See e.g. *Chartered Accountants Act*, S.A. 1987, c. C-5.1, ss 1(1)(d), 2.

B. The Historical and Current Position Elsewhere

In considering whether all Alberta professionals should be permitted to practise in limited liability firms it is useful to briefly consider how other jurisdictions have dealt with this issue in recent years. The trend in other countries with legal traditions similar to ours is clearly towards allowing professionals of all descriptions to practise in limited liability firms.

We begin our brief survey in the United States. It is useful to look at the United States first because business organizations such as the PC and LLP were developed in the US. After looking at the United States, we briefly consider the position in other Canadian jurisdictions. We pay a little more attention to Ontario than to other Canadian jurisdictions, for the obvious reason that Ontario is the first Canadian jurisdiction to import the LLP from the US. Another reason is that Ontario overtly considered and rejected professional limited liability practice about twenty years ago. Thus, Ontario presents an interesting example of changing perceptions regarding the concept of limited liability professional practice. We conclude our survey with a brief look at developments in the UK and Australia.

1. The United States

It seems that limited liability professional firms came to the United States almost by accident. In the 1950s US professionals[88] could not practise in limited liability firms and it was more or less taken on faith by professionals themselves that this was as it should be. An article written in 1958 advocating the creation of a special type of corporation for professionals – the professional corporation – listed "the chief reasons" why professionals were not permitted to practise in corporations. The eighth and last item in the list was:

> Unscrupulous practitioners might find shelter from liability in corporations in cases of malpractice claims, particularly in the medical profession.[89]

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[88] Again, we use the term "professional" without trying to identify exactly what professions we are talking about, except that it would probably be accurate to say, "accountants, lawyers and certain other professions, depending on the state."

[89] Jones 1958 at 355. It is not self evident, nor does the author explain, why the danger presented by unscrupulous practitioners would be particularly acute in the case of the medical profession.

The perceived problem with professionals' inability to incorporate had nothing to do with unlimited liability. The problem was that "this doctrine operates to deprive the practitioner of many opportunities for tax shelter, business continuity, and business planning which are otherwise available under existing tax laws only when business is done in the corporate form."[90] The author went on to propose that professionals be permitted to take advantage of the tax planning aspects of incorporation through a modified form of the standard corporation.

The author's proposed modifications to the standard corporate form were intended to address the standard objections to corporate professional practice, including the objection that it would provide shelter against malpractice claims:

> The professional corporation shall afford no limitation on the liability of its officers, directors or shareholders for any errors, omissions, malpractice or other torts committed by its agents, employees, officers, directors, or shareholders in the scope of their employment by or professional activities on behalf of the corporation.[91]

It would appear that the author saw the justification for such a limitation as being self evident. In any event, apart from the aforementioned reference to "unscrupulous practitioners," he saw no need to justify the contention that professional corporations should not shield shareholders from personal liability for the corporation's malpractice liabilities.

By 1962 fifteen states had enacted professional corporation statutes.[92] Contrary to the recommendation of the 1958 article, many of the statutes provided their shareholders with the same sort of liability shield that would be enjoyed by the shareholders of an ordinary corporation. In 1961 the Ethics Committee of the American Bar Association issued a ruling to the effect that lawyers could practise in limited liability corporations subject to two conditions: (1) the lawyer or lawyers actually rendering the service must be personally responsible to the client; (2) the limited liability of the other

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[90] *Ibid.* at 353.

[91] *Ibid.* at 361.

[92] HLR Note 1962 at 776.

members of the firm must be made apparent to clients.[93] Interestingly enough, the leaders of the accounting profession were hostile to the idea of limited liability. In 1961 the Council of the American Institute of Certified Public Accountants passed a resolution opposing state legislation allowing accountants to practise in corporations.[94]

By the middle of the 1970s all states had enacted PC statutes.[95] In the "vast majority" of states, shareholders of a professional corporation enjoyed limited liability with respect to the firm's ordinary debts.[96] On the other hand, the great majority of states made it clear that professionals practising in a PC remained liable for their own professional malpractice.[97] There was more variation in the approach to the personal liability of shareholders who were not personally implicated in a wrongful act or omission that created a malpractice liability for the corporation. A small minority of states – five to be precise – imposed joint and several liability for any malpractice liability on all of shareholders of the PC.[98] Twelve states provided a liability shield to all shareholders who did not participate in the conduct that created the liability.[99] Seventeen states extended personal liability to a shareholder for wrongful actions of a person acting under that shareholder's direct supervision and control while rendering professional services on behalf of the firm.[100] Statutes in the remaining fourteen states said nothing about shareholder liability as such, but contained –

> a saving clause to the effect that nothing in the act will affect the law applicable to the professional relationship and liabilities between a person rendering professional service and a person receiving the service. Because this clause,

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[93] *Ibid.* at 788.

[94] *Ibid.* at 790, note 79.

[95] Prins 1977 at 364.

[96] Cook 1988 at 730.

[97] Maycheck 1986 at 819-20 identifies only three states whose statutes did not clearly impose personal liability on the individual professional implicated in the wrongful conduct, and argues that in these states the courts would be likely to impose such liability in any event.

[98] *Ibid.* at 820-22.

[99] *Ibid.* at 822-25.

[100] *Ibid.* 1986 at 826. Later in this report we will consider "supervisor's liability" provisions in more detail.

> standing alone, does not specifically address the extent of the professional's liability it attempts to preserve, this deficiency provides fertile ground for a spectrum of policy arguments supporting positions ranging from liability only for one's own misdeeds to complete unlimited liability.[101]

Although the impetus for PC legislation in the US came from tax considerations, by the middle of the 1980s changes to federal tax legislation had effectively eliminated the tax planning incentives for incorporation of a professional practice.[102] And it seems that the non-tax advantages of incorporation, including (in most states) limited shareholder liability, did not provide an overwhelming reason for firms to adopt the corporate form. Thus, in the late 1980s many professional firms retained the ordinary partnership form even though, in most states, they could have achieved limited liability through incorporation. Most professionals, it seems, were not unduly troubled by the prospect of unlimited personal liability that came with the traditional partnership vehicle.[103]

The late 1980s saw a collapse of real estate and energy prices that led to the US savings and loans, or "thrifts," crisis, and to the birth of the LLP.[104] Many of the failed thrifts were based in Texas. When they collapsed the Federal Deposit Insurance Corporation ("FDIC") and the Federal Savings and Loan Insurance Corporation ("FSLIC") pursued a number of large Texan law partnerships and accounting partnerships on the basis that one or more of their members or employees had been guilty of professional malpractice in acting on behalf of failed thrifts. The amounts claimed were huge, and under ordinary partnership law doctrine, all partners would be personally liable for any liability that fell upon the firm because of the malpractice of one of its members.[105]

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[101] *Ibid.* at 834-35, where it is pointed out that all but five states have this saving clause, but that all but fourteen states have a more specific provision dealing with limited liability.

[102] Cook 1988 at 721-22.

[103] Murphy 1995 at 206, note 24.

[104] Hamilton 1995 at 1069. Our account of the origins of the limited liability partnership is based on Hamilton 1995 at 1068-1074.

[105] The only material difference, if it can be called material, between US and Alberta partnership law on this point seems to be that in the US creditors must attempt to execute their judgments against partnership assets before looking to the personal assets of the partners: Ribstein 1997 at 34-35.

It appear that one of the major effects of the FDIC's and FSLIC's efforts to recover some of the public funds that had been paid to depositors of the failed thrifts was to focus many Texan lawyers' and accountants' minds on the practical implications of practising in unlimited liability partnerships. Professor Hamilton writes of a large law firm (which he calls the "Dallas Law Firm"), one of whose former partners had been "deeply involved" with three thrifts whose failure led to over $1 billion in losses. By the time of the events described below, this former partner had been "criminally prosecuted, convicted, sentenced to two five year prison terms, and disbarred."[106] Since his personal assets did not quite cover the losses,

> . . . the FSLIC and FDIC turned their attention to the malpractice insurer for the Dallas Law Firm and to all persons who were partners during the period the firm represented the S&Ls. Caught within the FSLIC/FDIC net were retired partners, partners who had since left the Dallas Law Firm to join other firms, partners who had been promoted from associate to partner, persons who had become "of counsel" to the Dallas Law Firm, and the forty-some partners who had nothing at all to do with representation of the various thrift institutions. The total claims asserted by the FSLIC greatly exceeded the liability insurance available to the firm and the assets of the firm itself. To emphasize this point, in one particularly chilling meeting, FSLIC personnel used an overhead projector to show a slide listing the name of each Dallas Law Firm defendant with estimates of total net worth and the amount likely to be available from each of them to satisfy the governments's claims.[107]

Professor Hamilton describes how, amidst all the commotion, "a twenty-odd person law firm from Lubbock" came up with the idea of the LLP.[108] The idea was taken up and refined by the business law section of the Texas Bar Association, and in 1991 Texas amended its partnership legislation to allow for the creation of LLPs.[109] American Professionals embraced the LLP much more readily than they had its more venerable cousin, the professional corporation. Professor Hamilton writes that in Texas "more than 1200 law

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[106] Hamilton 1995 at 1070.

[107] *Ibid.* at 1070-71. Professor Hamilton notes that the lawsuit "was ultimately settled for approximately the amount of malpractice insurance carried by the firm." This in itself is an interesting observation in the context of the debate over auditors' liability. Huge claims do not necessarily, and indeed rarely, translate into huge judgments or settlements.

[108] *Ibid.* at 1073.

[109] *Ibid.* at 1065, 1073-74.

firms, including virtually all of the state's largest firms, elected to become LLPs within one year after its enactment."[110]

So what is an LLP? One thing it is not is a traditional limited partnership. It is best described as an ordinary partnership whose members are equipped with a liability shield. The original Texas legislation created what American lawyers have come to refer to as a "partial shield" LLP:

> (2) A partner in a registered limited liability partnership is not individually liable for debts and obligations of the partnership arising from errors, omissions, negligence, incompetence, or malfeasance committed in the course of the partnership business by another partner or a representative of the partnership not working under the supervision or direction of the first partner at the time the errors, omissions, negligence, incompetence, or malfeasance occurred, unless the first partner:
>
> (a) was directly involved in the specific activity in which the errors, omissions, negligence, incompetence, or malfeasance were committed by the other partner or representative; or
>
> (b) had notice or knowledge of the errors, omissions, negligence, incompetence, or malfeasance by the other partner or representative at the time of occurrence.
>
> (3) Paragraph (2) does not affect the joint and several liability of a partner for debts and obligations of the partnership arising from any cause other than those specified in Paragraph (2).
>
> (4) Paragraph (2) does not affect the liability of partnership assets for partnership debts and obligations.[111]

The distinctive feature of the partial shield LLP statute is that it does not protect partners from personal liability for obligations other than malpractice liabilities. Thus, partners in a partial shield LLP remain liable for the firm's ordinary contract debts.

Within a few years of its conception in Texas, LLP legislation had been enacted in almost every state.[112] As the LLP migrated it also mutated. At

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[110] *Ibid.* at 1065. Professor Hamilton also notes that on August 1, 1994 three of the Big Six (as they then were) accounting firms announced that they had decided to become LLPs under Delaware law: *ibid.*, at 1065-66.

[111] Tex. Rev. Civ. Stat. Ann., art. 6132b-15 (West Supp. 1998). But see now (effective January 1, 1998) art. 6132b-3.08(b), which appears to adopt the full shield approach of UPA 1996.

[112] Hamilton 1995 at 1065 notes that by the beginning of 1995, twenty -four states had enacted legislation recognizing LLPs. By late 1997 every state except Wyoming and Vermont had enacted LLP legislation: Bishop 1997 at 101.

first, the mutations were merely refinements of Texas' original partial shield approach. But in 1984 Minnesota and New York made a more notable departure from the original LLP mold, making their LLPs much more like ordinary business corporations (and most US professional corporations).[113] This departure was to shield partners of LLPs from personal liability for any obligations of the LLP, rather than for malpractice liabilities only. The "full shield" approach is rapidly overtaking the partial shield approach in U.S. LLP legislation. In 1996 the NCCUSL adopted a full shield LLP statute. The relevant provision in the UPA 1996 reads:

> An obligation of a partnership incurred while the partnership is a limited liability partnership, whether arising in contract, tort, or otherwise, is solely the obligation of the partnership. A partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for such an obligation solely by reason of being or so acting as a partner.[114]

By late 1997 the full shield approach had been adopted in approximately twenty states, most of which had originally followed the partial shield approach.[115]

The current position in the US is that in most states professionals may practise in a PC, an LLP or an LLC.[116] So far as personal liability for professional malpractice claims is concerned, each state applies essentially the same rule to all three types of entity. If, for example, a state favours a rule of "supervisor's liability," that rule will apply to PCs, LLPs and LLCs. Determining the exact liability position of any given profession in any given state may be a fairly complicated undertaking. The introduction to an unpublished paper summarizing the liability position of law firms makes the following observation:

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113 Hamilton 1995 at 1087-90.

114 UPA 1996 §306(c). As previously noted, since UPA 1994 the uniform act has been based on the entity theory of partnership, rather than the traditional common law relationship (or aggregate) theory: see e.g. Colo. Rev. Stat. §7-64-201 (1998): "A partnership is an entity distinct from its partners."

115 Bishop 1997 at 125-138. The figure of twenty is derived by counting the full shield states shown in the author's table of liability shield features of different LLP statutes.

116 Of course, they may also practise in an ordinary partnership or as sole practitioners.

> The protection to be provided against vicarious liability depends upon the response to the following questions:
>
> A. Does the statute providing for the limited liability entity permit the use of the entity for the conduct of a professional practice?
>
> B. Does the statute governing the conduct of the particular profession permit the use of the limited liability entity?
>
> C. Does the state body regulating the particular profession, including the state supreme court in the case of law practice, permit the conduct of that profession by the limited liability entity?
>
> D. If the particular profession may be conducted in the form of the limited liability entity, does that entity protect against vicarious liability?
>
> E. Do the rules of ethics of the particular profession permit the conduct of a profession by the limited liability entity?[117]

For most states and for most professions, the answers to all of these questions is affirmative.

However, in a few states a negative answer to one of the foregoing questions may preclude a particular profession from practising with limited liability. The legal profession in Illinois is a case in point. Lawyers in Illinois may practise in PCs, LLCs or "professional associations," whether formed in Illinois or some other state.[118] However, Supreme Court Rule 721(d) provides, in effect, that lawyers may practise in limited liability firms only if they agree to forego limited liability for the firm's malpractice liabilities:

> The articles of incorporation or association or organization shall provide, and the shareholders of the corporation or members of the association or limited liability company shall be deemed to agree by virtue of becoming shareholders or members, that all shareholders or members shall be jointly and severally liable for the acts, errors and omissions of the shareholders or members and other employees of the corporation or association or limited liability company arising out of the performance of professional services by the corporation or association or limited liability company while they are shareholders or members.

A handful of courts in other states take the same dim view of limited liability practice by lawyers, but in most states lawyers are able to practise in limited

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[117] Donn 1998 at 1.

[118] Illinois Supreme Court Rules, Rule 721(a). A professional association is essentially an early version of the PC: see HLR Note 1962 at 776-77, 780. Since the rule does not authorize LLPs, LLPs are not currently an option for the practice of law in Illinois: see Donn 1998 at 10.

liability firms that protect them from vicarious liability for the firm's malpractice liabilities.

The following propositions seem to be a reasonable summary of the current position with respect to limited liability practice in the United States:

- In most states, a profession may be carried on through an unlimited liability firm (sole proprietorship or ordinary partnership) or through any one of three types of limited liability firm: PC, LLP or LLC.
- In all but a few states, professionals practising in a PC or LLP will have limited liability for the firm's ordinary business debts. In most states the partners of LLPs remain personally liable for such debts, but the trend is towards full shield LLPs (which provide limited liability for ordinary debts).
- In the great majority of states, the legislation specifically provides that professionals who are members of a limited liability firm are personally liable for their own wrongful acts or omissions in the provision of professional services.
- Many states impose personal liability on a member of a limited liability firm for the wrongful acts of another member or employee of the firm who is under that member's direct supervision and control in the provision of professional services.

2. Other Canadian Jurisdictions

We do not attempt to describe how each Canadian province restricts or does not restrict the use of limited liability firms by different professionals. We imagine that the history of such restrictions in other provinces is as convoluted as it has been in Alberta. Instead, we will briefly describe different approaches that have been taken over the years in Canadian jurisdictions. We pay particular attention to Ontario, since it is the first Canadian jurisdiction to enact LLP legislation.

a. No incorporation

Several provinces still follow the approach that Alberta took before the introduction of professional corporations in the 1970s. Certain professions cannot be carried on through corporations. As was discussed earlier in relation to the historical position in Alberta, the restriction on incorporation may be implicit or explicit. Saskatchewan takes the implicit approach. Certain professions are subject to licensing requirements, and the qualifications for obtaining a license are such that only real individuals, not artificial persons, could satisfy the criteria.[119] In Manitoba the general-purpose business corporations statute prohibits members of "a profession governed by an Act" from incorporating their practice unless their governing statute specifically permits it.[120]

b. Incorporation with Unlimited Liability for Malpractice

Nova Scotia allows lawyers to incorporate but has taken a similar approach to some American states regarding the liability of shareholders of a "law corporation:"

> Every person who is a voting shareholder of a law corporation . . . is liable to every person for whom professional services of a barrister are undertaken or provided by the law corporation in respect of such professional services to the same extent and in the same manner as if such voting shareholders were carrying on the practice or profession of a barrister in partnership or, if there is only one such voting shareholder, as an individual carrying on the practice or profession of a barrister.[121]

Unlike section 129(1) of Alberta's *Legal Professional Act*, this provision clearly seems to be intended to impose liability on shareholders only for the corporation's malpractice liabilities.[122] Thus, it would seem that shareholders of a Nova Scotia law corporation would not be personally liable for ordinary debts of the corporation.

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[119] See e.g. *Legal Profession Act, 1990*, S.S. 1990-91, c. L-10.1, ss 24(1), 30.

[120] *The Corporations Act*, CCSM, c. C225, s.15(3); In MLRC 1994 at 78 the Manitoba Law Reform Commission noted that the phrase "governed by an Act" is not particularly helpful, since the Commission had "identified 156 occupational groups who are directly regulated by legislation." The Commission took the view that the prohibition was probably meant to apply to self-governing occupations. The Commission noted that of the self-governing occupations, only pharmacists, architects and denturists were specifically permitted to incorporate by their governing statutes: *ibid*.

[121] *Barristers and Solicitors Act* R.S.N.S. 1989, c. 30, s. 5A(10), as am. by S.N.S. 1995-96, c. 18, s. 2.

[122] Moreover, the Nova Scotia provision seems to apply only to malpractice liabilities to clients of the corporation – "a person for whom professional services . . . are undertaken or provided" – as opposed to a non-client who might have a cause of action for, say, negligent misrepresentation against the corporation.

c. Incorporation with Full Limited Liability?

British Columbia allows the members of a number of professions to incorporate subject to criteria set out in the relevant professional statute. The *Legal Profession Act* contains the following provision relating to the liability of lawyers practising in a law corporation:

> The liability for professional negligence of a lawyer carrying on the practice of law is not affected by the fact that the lawyer is carrying on that practice as an employee, shareholder, officer, director or contractor of a law corporation or on its behalf.[123]

This provision is similar to section 129(2) of Alberta's *Legal Profession Act*, but there is no equivalent of section 129(1) of the Alberta Act, which expressly imposes liability on voting shareholders of a professional corporation for the corporation's liabilities. The British Columbia provision makes it clear that an individual professional who is negligent is personally liable for their own negligence, even if they are acting as an employee, or otherwise acting on behalf of, a professional corporation. It is less clear whether the British Columbia provision is intended to impose vicarious personal liability for professional negligence on all the shareholders of a professional corporation. One thing that does seem clear is that the provision does not impose liability for a law corporation's ordinary debts on its shareholders.

d. Limited Liability Partnerships in Ontario

As is discussed in more detail later in this chapter, there was some discussion of the issue of limited liability professional practice in Ontario in the 1960s and late 1970s.[124] However it appears that unlimited liability was not a serious concern to the affected professionals until the mid 1980s. The prospect of vicarious personal liability for malpractice liabilities of one's firm need not be particularly disconcerting to the professionals involved if insurance for the amount of any liability they are likely to incur is available (at a reasonable price). Where adequate liability insurance is available, the theoretical prospect of unlimited liability for malpractice translates into little more than an ongoing business expense (insurance premiums) that will be

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[123] *Legal Profession Act*, S.B.C. 1998, c. 9, s. 84(1). This provision is similar to a provision in the former *Legal Profession Act*: R.S.B.C. 1996, c. 255, s. 94(1).

[124] See section C.1, below.

reflected in the price of professional services. In the 1970s and into the 1980s this condition seems to have been satisfied, so unlimited liability for malpractice was not a major practical issue.

Things changed rather abruptly and dramatically in the mid-1980s, when Canada and other countries experience an “insurance crisis” marked by dramatic reductions in coverage and equally dramatic rises in the premiums for coverage that was available.[125] The crisis affected all types of liability insurance, and there was much debate about the causes and solutions to the crisis. The crisis was acute enough in 1986 for the Ontario government to appoint a task force on insurance. The impact of the insurance crisis on large accounting firms is illustrated by the following passage from a paper delivered to the task force:

> The large international [accounting] firms have never been included in the CICA program because the reinsurers have seen their risk as quite different from that of the small- and medium-sized firms. The large firms have written their individual policies through Minets [an international insurance broker specializing in professional indemnity insurance]. Their significant concern is limits.
>
> Until two years ago virtually unrestricted limits were available. Some had \$250,000,000 limits. This last year the limits have been reduced to \$50,000,000, for which the insureds are paying four times the premium. At least one of the major firms has been reduced to \$1,000,000 limits, a level simply insufficient for a professional practice with several hundred accountants doing business on an international scale.[126]

Professionals were not the only enterprises to feel the impact of the liability insurance crisis, but it is easy to appreciate why persons required to earn their livelihood in unlimited liability firms might feel the impact more keenly than shareholders of limited liability firms. If a limited liability firm cannot get adequate liability insurance, its owners may lose their investment in the firm if the latter incurs a catastrophic product liability. If the same thing happens to an unlimited liability firm its owners could all be made bankrupt.[127]

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[125] See e.g. Priest 1987; Trebilcock 1987; Daniels & Hutton 1993.

[126] Lilly 1986 at 294. See also ICAA 1995 at 13, stating that no accounting firm has access to commercial insurance in excess of \$100 million, with deductibles of \$50 million.

[127] Of course, in an ordinary corporation the lack of adequate liability insurance coverage could have greater implications for directors, officers and other persons who might be subject
(continued...)

By the end of the 1980s Canadian professionals who were required to practice in unlimited liability firms, especially accountants, were very much concerned about unlimited liability. However, the flame of professional passion for limited liability practice was undoubtedly dampened by the assumption that the vehicle for getting there would have to be the corporation. If the US and UK[128] experience is anything to go by, many Canadian professional firms would not have incorporated to get the benefit of limited liability even if they were permitted to do so. But then along came the limited liability partnership.[129] As legislators in state after state rushed to enact LLP statutes, the phenomenon could not help but come to the attention of Canadian professionals. That the idea of practice in LLPs greatly commended itself to Canadian professionals, particularly accountants and lawyers, is evidenced by the assiduous efforts that have been made over the last few years to get LLP legislation enacted across the land.

As noted in Chapter 1, in June 1998 Ontario became the first Canadian jurisdiction to accede to the entreaties of professionals to import the LLP from the United States. The importation was effected by amendments to Ontario's *Partnership Act*. The legislation allows LLPs to be formed only for the purpose of carrying on a profession governed by an Act, and then only if the relevant professional statute specifically provides for LLPs and the profession's governing body requires the firm to carry a minimum amount of liability insurance.[130] The statute that amended the *Partnership Act* to provide for LLPs also amended the *Chartered Accountants Act, 1956*[131] to provide for the formation of LLPs by professionals governed by the latter

[127] (...continued)
to personal liability. And it would also have greater implications for shareholders in closely held corporations, since a substantial portion of the shareholders' personal wealth could be impounded in the corporation.

[128] See section 3, below.

[129] See text at note 108, above.

[130] *Partnership Act* (Ont.), s. 44.2.

[131] S.O. 1956, c. 7.

act.[132] A statute passed later in 1998 amends the *Law Society Act* to provide for the formation of LLPs by Ontario lawyers.[133]

The Ontario statute creates what we have referred to as a partial shield LLP, in that it only applies to malpractice liabilities, not to ordinary contract debts. But the liability shield is even narrower than the shield provided by US partial shield LLPs. Rather than shielding partners from vicarious liability for malpractice liabilities generally, the Ontario statute only shields partners from vicarious liability for "negligent acts or omissions."[134] It would seem, then, that individual partners of an Ontario LLP would remain vicariously liable for wrongful actions of a partner or employee that go beyond negligence and stray into the territory of, say, fraudulent misrepresentation or criminal misconduct. The practical implications of this restriction on the breadth of the shield are illustrated by the "Dallas Law Firm" case, which apparently was fairly typical of the cases that provided the impetus for the LLP movement in Texas.[135] It will be recalled that the partner whose actions created the problems for the Dallas Law Firm ended up in jail, suggesting that his misdeeds went well beyond negligence. Thus, if the Dallas Law Firm were the Toronto Law Firm LLP, the innocent partners of the LLP might still incur vicarious liability for the liability arising from the unlawful actions of the rogue partner.

As in the US, a partner in an Ontario LLP is only protected from vicarious liability for the negligence of some other member, or an employee, of the firm. The liability shield does not protect partners from the consequences of their own negligence. Moreover, the Ontario statute follows the approach of many US statues in imposing liability on a partner who has supervisory responsibility for the individual whose negligence actually created the liability:

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[132] S.O. 1998, c. 2, s. 10.

[133] *Law Society Amendment Act, 1998*, S.O. 1998, c. 21, s. 28, amending R.S.O. 1990, c. L.8.

[134] *Partnership Act* (Ont.), s. 10(2).

[135] See text at note 106, above.

> Subsection (2) [the liability shield] does not affect the liability of a partner in a limited liability partnership for the partner's own negligence or the negligence of a person under the partner's direct supervision or control.[136]

It will be noted that the supervisor's liability arises not for negligent supervision, but for being the supervisor of someone who is negligent. In other words, the supervisor is vicariously liable for someone else's negligence.

3. The United Kingdom

The experience of professionals in the United Kingdom with respect to limited liability practice seems to have been similar to that of professionals the United States. A 1989 text on professional negligence describes the trend in the following terms:

> In the face of mounting liability claims against professionals and increasing difficulties in obtaining full indemnity insurance, the attitude that practice with limited liability is unethical is changing. Over the last decade professional bodies have been removing or relaxing restrictions on incorporated practice.[137]

The text went on to describe the position of particular professions.[138] Architects, doctors, engineers and surveyors could practise in limited liability companies. Accountants were unable to provide audit services through limited liability firms because of provisions of the *Companies Act 1985* regarding the qualifications of company auditors. Solicitors had been provided with statutory authority to incorporate in accordance with rules of the Law Society, but the Law Society had not at the time of writing decided whether to allow solicitors to practise in limited liability companies. Dentists were unable to incorporate unless they had done so before July 1952.

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[136] *Partnership Act* (Ont.), s. 10(3).

[137] Dugdale & Stanton 1989 at 470.

[138] *Ibid.* at 470-71. Of course, the term "limited liability company" has an entirely different connotation in the UK (and for many Canadian lawyers as well) than it has for American lawyers. While to an American lawyer a limited liability company is a novel and (nominally) unincorporated business entity, the term "limited liability company" has been used in the UK and Canada for 150 years or so to denote an ordinary incorporated business entity.

By the end of 1988, however, the Law Society had made rules that allowed solicitors to practise in limited liability companies,[139] and by 1991 company audits could be performed by limited liability companies.[140] It would appear, however, that accounting firms' concerns about unlimited liability did not necessarily dominate perceived disadvantages of incorporated accounting practice. We have observed that although US professionals had been able to incorporate with limited liability in most states for many years, most preferred to remain in ordinary partnerships.[141] Similar forces have been at work in the UK:

> Accountancy firms can, of course, secure the benefits of limited liability without registering as Jersey LLPs by incorporating their entire practice or audit arm, the latter having recently been done by the Big Six firm, KPMG. This option is cheap, relatively straightforward and avoids charges of political brinkmanship being levelled at accountancy firms. There are, however, disadvantages flowing form partial or total incorporation as a technique of negligence liability protection, in particular, financial disclosure requirements, the duty to observe accounting standards and, perhaps, most importantly of all, the generally less favourable tax regime for companies compared with partnerships. Clearly, those accountancy firms committed to registration as Jersey LLPs have engaged in a 'cost-benefit' analysis and decided that the disadvantages of incorporation outweigh the benefits of limited liability.[142]

It has been suggested that UK accountancy firms were less interested in converting themselves into Jersey LLPs than in using the threat of doing so as a lever to persuade the UK government to enact its own LLP legislation or other liability reforms.[143] In any event, in early 1997 the UK Department of Trade and Industry circulated a consultation paper that began with the statement that the government intended "to bring forward legislation at the earliest opportunity to make limited liability partnership available to regulated professions in the UK."[144] The consultation paper was followed in

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139 Solicitors Incorporated Practice Rules 1988, s. 9(1)(a).

140 Arora 1991 at 273.

141 See text at note 103, above.

142 Morris & Stevenson 1997 at 542-43.

143 *Ibid.* at 542.

144 DTI 1997 at 1.

September 1998 by another consultation document containing detailed proposals for LLP legislation.[145]

We will refer to certain aspects of the British LLP proposals later in this report. For the moment, it suffices to observe that the LLP proposed for the United Kingdom would be a very different creature than the American LLP. In a typical American state, "LLP legislation" consists of a handful of provisions dealing specifically with LLPs that are integrated into the state's ordinary partnership statute. The British LLP, as envisioned by the draft bill, would involve a great deal more than a bit of tinkering with the *Partnership Act, 1890*. Indeed, clause 1(4) of the draft bill provides that "except as otherwise provided by this Act or regulations under it or by any other enactment, the law relating to partnerships does not apply to a limited liability partnership." In most respects, the LLP would be "a large company in all but name."[146]

4. Australia

The traditional prohibition on the practice of certain professions by corporations seems also to be falling by the wayside in Australia.[147] So far as we have been able to determine, however, the LLP concept has yet to make much of an impression in Australia.

Insofar as the LLP movement has been spurred by professionals' concerns about huge liability claims, New South Wales has taken a somewhat different approach to addressing those concerns. In 1994 it enacted the *Professional Standards Act 1994*. The general thrust of the Act has recently been described by the New South Wales Law Reform Commission in the following terms:

> The *Professional Standards Act 1994* (NSW), which took effect on 1 May 1995, sets out its objects in s. 3:

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[145] DTI 1998.

[146] Fearnley & Brandt 1997 at 28.

[147] Fletcher 1996 at 5 observes that "[t]raditionally, solicitors and accountants [have been prohibited from practising in corporations] but these prohibitions are being challenged and have already been overcome in some jurisdictions," citing legislation in Victoria and New South Wales.

> (a) to enable the creation of schemes to limit the civil liability of professionals and others;
> (b) to facilitate the improvement of occupational standards of professionals and others;
> (c) to protect the consumers of the services provided by professionals and others;
> (d) to constitute the Professional Standards Council to supervise the preparation and application of schemes and to assist in the improvement of occupational standards and protection of consumers.
>
> The Act excludes situations which involve death or personal injury, breach of trust, or fraud and dishonesty. A scheme under the Act may apply to any class or classes of an occupational association, or to all members of the association.
>
> 2.18 The liability to damages of a member of such an occupational association may be limited to either a "monetary ceiling" or a "limitation amount". In the case of a monetary ceiling, where specified as part of a scheme, the limitation has effect for a person who can satisfy the court that he or she has occupational liability insurance cover up to the amount specified in the monetary ceiling, or can satisfy the court that he or she holds business assets alone or business assets and insurance coverage amounting to a sum not less than the monetary ceiling. A limitation amount, however, is different from a simple monetary ceiling in that it is defined as:
>
>> a reasonable charge for the services provided by the person or which the person failed to provide and to which the cause of action relates, multiplied by the multiple specified in the scheme in relation to the person at the time at which the cause of action arose.
>
> In the case of a limitation amount, where specified as part of a scheme, the limitation operates for a person who can satisfy the court that occupational liability insurance cover up to the amount specified has been effected, or that he or she hold business assets or a combination of business assets and insurance sufficient to cover a sum not less than the limitation amount.[148]

The Commission noted that by the end of 1996 the Professional Standards Council had approved two schemes for branches of the engineering profession and a scheme to be administered by the Law Society of New South Wales.[149]

C. Should Professionals be Able to Use Limited Liability Firms?

As mentioned at the beginning of this report, we have concluded that, subject to certain safeguards, it would be appropriate to give Alberta professionals –

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[148] NSWLRC 1997 at 23-34.

[149] *Ibid*. at 24. For a critical assessment of the concept of legislative caps on professionals' liability for malpractice, see Common Law Team 1996 at 46-49.

accountants, lawyers and medical professionals – who cannot currently practise in limited liability firms the option of doing so. These limited liability firms would provide the type of liability shield enjoyed by shareholders of an ordinary business corporation. It would be made clear, however, that the professionals who are personally implicated in the acts or omissions that create a malpractice liability for the firm would be personally liable.

In our issues paper we made the following observation about the general approach that we thought appropriate in considering the issue of limited liability professional practice:

> In this chapter we proceed from the premise that the public policy of Alberta favours the general concept of allowing owners of enterprises great and small the privilege of operating through limited liability entities. In the preceding chapter we suggested a number of reasons why it might be argued that public policy should not be quite so concerned to protect shareholders of corporations from liabilities, especially tort liabilities, of the corporation. But we assume here that public policy with respect to status liability for participants in most enterprises is reflected in the law applicable to ordinary business corporations. Therefore, we proceed from the premise that if limited liability for owners of enterprises is a "good thing" generally, it should be a good thing for UL professionals too, unless there are particular reasons of policy or principle to single out the UL professionals for less favourable treatment than other types of enterprise.[150]

We still consider this approach to be appropriate.

Of course, the interesting issue is how you go about determining whether there are "particular reasons of policy or principle" to continue the prohibition on limited liability professional practice when all other enterprises can be carried on through limited liability firms. For example, in its 1995 submission to the Alberta government, the Institute of Chartered Accountants makes the following argument:

> It is unfair that accountants – and other professionals – are not able to organize their firms like the business people they serve. It is also particularly unfair that accountants may lose their entire family possessions because their firm served clients whose businesses subsequently failed.[151]

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[150] ALRI 1998 at 97.

[151] ICAA 1995 at 15. See also LSA 1995 at 5: "Professionals have disproportionate exposure since, unlike other businesspeople, they are unable to use incorporation as a shield against
(continued...)

It is reasonable for accountants, lawyers and health care professionals to point out that the owners of the great majority of enterprises, including many professional enterprises, can use limited liability firms and to ask why a few professions are prevented from doing so. We do not think, however, that it can simply be assumed that it is unfair to treat accountants, lawyers and certain health care professionals differently than other enterprises with respect to limited liability practice.

The legal framework under which a particular type of enterprise is conducted may reflect special considerations of public policy that do not necessarily apply to other enterprises. In some cases legislative restrictions on who can undertake a particular type of enterprise – restrictions that an economist might characterize as "barriers to entry" – are rationalized on the basis that such restrictions are necessary to protect the public. Take the provision of audit services, for example. In the context of the debate over auditor liability in Australia one writer made the following observation:

> While state imposed monopolies are a common feature in professional fields, few are as lucrative as that enjoyed by the Australian accounting profession in respect of company audits. This profession . . . enjoys not just a monopoly over the provision of company audit services but also an assured demand for such services.[152]

The assured demand is courtesy of legislative requirements (which, of course, are not unique to Australia) for certain enterprises (especially those that want access to organized capital markets) to obtain audits from accountants who have met specified licensing requirements.

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[151] (...continued)
personal liability." In reference to the second sentence of the passage from ICAA 1995, it might be pointed out there is no legal doctrine that accounting firms are liable to anyone for anything merely because they "served clients whose businesses subsequently failed." There would have to be a causal connection between the client firm's failure and some wrongful action (e.g. a negligent audit) by the accounting firm. It may also be observed that many individuals connected with a *limited liability* firm could face personal bankruptcy if the firm were to fail. Shareholders of closely held firms may have signed personal guarantees; directors and officers of widely held firms may incur huge "directors and officers" liabilities; employees who have lost their jobs might not be able to find new ones; and so on. It is, however, fair to say that being a member of an unlimited liability firm adds an extra dimension of risk beyond that to which owners of limited liability firms are generally exposed, especially where adequate liability insurance is not available.

[152] West 1995 at 24.

We suspect that accountancy bodies and accountancy firms do not think it unfair that accountants are singled out for the sort of special treatment mentioned in the preceding paragraph. Indeed, there are undoubtedly public policy reasons behind this special legislative treatment of auditors, just as there are public policy reasons for restrictions on the practice of professions such as law and the health care disciplines. But it is not beyond the realm of possibility that similar reasons of public policy might justify special, less favourable, treatment of these same professionals on the limited liability issue, as well.

In the end, however, we do not think that our initial presumption in favour of treating accountants, lawyers and health care professionals like other enterprises (including other professions) on the limited liability issue is rebutted by any countervailing considerations of principle or policy that apply with particular force to these professionals. We believe, however, that the nature of the services provided by accounting, legal, and health care professionals is such that it is appropriate to impose certain conditions on limited liability professional practice.[153]

1. Previous Consideration of the Issue in Canada

The Canadian literature discussing the issue of limited liability professional practice is not extensive. The relative dearth of literature is probably attributable in large measure to the fact that, until recently, professionals who were required to practise in unlimited liability firms were not greatly disturbed by this requirement.

Although professional discomfort with unlimited liability practice did not become acute until the insurance crisis of the mid 1980s, there had been some consideration of the issue in Canada before then. In the mid 1960s Ontario appointed a legislative committee (the Lawrence Committee) to look into the subject of company law. The committee's 1967 interim report dealt briefly with the matter of professional corporations and expressed the view that "the objections to incorporating the professional practice are unfounded."[154] It proposed, however, that "the professional person, albeit

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[153] We note here that a case for the sort of safeguards we propose, such as minimum insurance requirements, could easily be made with respect to many other types of enterprise.

[154] Lawrence 1967 at 19.

practising his profession through the instrumentality of a corporation, should remain personally liable for his tortious Acts [sic] jointly and severally with the company."[155] On the other hand, the committee "concluded that there is no reason why the professional service corporation and its shareholders may not enjoy limited liability for debts or other obligations except liabilities arising for tortious acts as mentioned above."[156] The statements just quoted are all that the Lawrence Committee had to say on the subject of limited liability professional practice.

The issue of limited liability professional practice came up again in Ontario in the late 1970s, this time in the context of a comprehensive study of the accountancy, architectural, engineering and legal professions by the Professional Organizations Committee. The Committee commissioned a number of research papers, including one by Professor J. R.S. Prichard.[157] One of the issues Prichard considered was whether professional corporations should provide limited liability with respect to malpractice liabilities. His discussion of this issue was prefaced with the observation that "the engineers enjoy limited liability, the architects would have received it under the draft *Architects Act*, the lawyers do not seek it and the accountants do not appear to have taken a position regarding it."[158] After examining arguments for and against limited liability, both in the context of enterprises generally and professional firms in particular, Prichard ventured the following recommendation:

> In conclusion, on the question of limited liability, I recommend that it not be extended to closely-held professional firms and that it be used only in the case of firms with such dispersed shareholdings that the uncertainties generated by share transfers would be unacceptable. The statutory provision distinguishing the closely-held and widely-held firms should be based simply on the number of shareholders in the corporation. . . However, under no circumstances should limited liability be permitted in the absence of compulsory insurance at levels sufficiently high to reflect the potential liabilities of the firm.[159]

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[155] *Ibid.*

[156] *Ibid.* at 20.

[157] Prichard 1978.

[158] *Ibid.* at 73.

[159] Prichard 1978 at 78-79. In the part of the passage that has been omitted Professor Prichard conceded that an exception might be made for closely held engineering and

(continued...)

Shortly after receiving the Prichard paper, the Professional Organizations Committee published a staff study that advocated a somewhat more permissive approach than proposed in the Prichard paper:

> We would therefore propose that professional firms be permitted to incorporate either with unlimited shareholder liability or with limited liability but with mandatory insurance coverage. . . In the event of a professional firm electing to incorporate with limited liability but subject to mandatory insurance coverage, the insurance requirement to which such a firm is subject should be related to the size of the firm as measured either by the number of professionals participating in the firm or some other proxy for the likely liability exposure of the firm.[160]

The proposal was more permissive than the Prichard proposal in that it would not have restricted limited liability to firms of a certain size.

The report of the Professional Organizations Committee published its report in 1980 recommended that professionals be permitted to incorporate but that "shareholders of a professional corporation should remain liable with respect to claims arising out of the provision of professional services."[161] The report ignored the recommendations of both the Prichard paper and the staff study. We say "ignored" rather than "rejected" because the report does not even mention the recommendations of its consultant or staff. The report's rationale for rejecting limited liability is comprised of the following statements:

> If limited liability incorporation were permitted, the client's right of redress through civil liability for professional negligence might also be compromised. . .[162]
>
> [T]o protect the client's right to redress in cases of professional malpractice, legislation could provide that shareholders in professional corporations have unlimited liability with respect to claims arising out of the provision of professional services, though they could enjoy limited liability with respect to the non-professional aspects of their business...[163]

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[159] (...continued) architectural firms.

[160] Trebilcock, Tuohy & Wolfson 1979 at 359.

[161] Professional Organizations Committee 1980, recommendation 8.4 at 168.

[162] *Ibid.* at 164.

[163] *Ibid.* at 165.

> We must also ensure that incorporation of professional firms does not prejudice the interests of clients and third parties by insulating practitioners from actions arising out of negligence in the provision of professional services. This can best be done by restricting the limitation of corporate liability to non-professional aspects of the firm's business.[164]

The committee's casual dismissal of the idea of limited liability for professional malpractice lends support to the conclusion that affected professionals were not arguing passionately for limited liability at that time.

Limited liability practice by professionals was also considered by the Manitoba Law Reform Commission in its 1994 report on regulation of professions and occupations.[165] We have already mentioned that the Commission concluded that a somewhat vague statutory prohibition on corporations' practising a profession governed by an Act, unless expressly authorized by the governing Act to do so, was probably meant to apply to self-governing occupations.[166] Having reached this conclusion, the report posed the following questions:

> Does a prohibition against incorporation by practitioners who are self-governing serve a purpose and does it benefit the public? Is there a good reason why practitioners of all other services (including those who are licensed and certified but not self-governing) are permitted to incorporate but those who are self-governing are not? Furthermore, are there good reasons why architects, pharmacists and denturists are currently allowed to provide their services through a corporation while other practitioners (such as lawyers, dentists and accountants) are not?[167]

The Commission's view was that the primary focus should be on the effect on the public of allowing incorporated practice by professionals who are currently denied this privilege.[168] To this end, the report first considered the

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[164] *Ibid.* at 167-68.

[165] MLRC 1994.

[166] See note 120, above.

[167] MLRC 1994 at 78. We note that the report takes it for granted that if professionals were permitted to incorporate, shareholders would have the advantage of an ordinary corporate liability shield. No overt consideration is given to the possibility of allowing incorporation with unlimited liability for all or some of the corporation's obligations.

[168] *Ibid.* at 81.

possible public benefits of allowing incorporation and then considered the possible disadvantages.

In the Commission's view, the one significant potential benefit to the public from allowing professionals to practise in corporations would only be realized if "it is accompanied by a relaxation of the rule which prevents non-members of a self-governing body from investing in or controlling the management of businesses which offer a regulated service to the public."[169] Relaxation of the prohibition on outside ownership would allow professional firms to raise outside capital, which could facilitate competition in the market for professional services.[170] The report considered various objections that might be made to allowing outside investment in professional firms. Its conclusion was that the objections to allowing non-professionals to invest in and participate in the management of professional firms were not particularly cogent and that, to the extent such participation might present certain theoretical dangers, they could be ameliorated by appropriate safeguards.[171]

The report dealt briefly with the specific subject of whether limited shareholder liability (which was assumed to be an incident of incorporation) might adversely affect consumers of professional services.[172] The report considered that there were two possible disadvantages to the public from the limited liability aspect of incorporated practice. The first possible disadvantage was that it might "reduce the likelihood of financial compensation for consumers or third parties who have been harmed by negligent practice on the part of practitioners."[173] The Commission's analysis of this concern is as follows:

> While recognizing this as a legitimate concern, the limited effect of incorporation on liability should be kept in mind. First, practitioners would normally remain personally liable for their own wrongdoing. Second, it is already possible for practitioner to escape the effects of personal liability by transferring personal

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[169] *Ibid.*

[170] *Ibid.* at 81-82.

[171] *Ibid.* at 83-84.

[172] *Ibid.* at 85.

[173] *Ibid.*

> assets to a spouse or children and business assets to a service corporation. In addition, many practitioners carry liability insurance. In order for unlimited liability to be a significant benefit for victims at the present time, the practitioner must be relatively wealthy, carry no insurance and have failed to transfer his or her major assets.
>
> It should also be noted that there are other ways of ensuring that victims are compensated, regardless of the wealth of the practitioner or the amount of the claim. For example, corporations which provide a relatively dangerous service could be required to carry a specified level of liability insurance or, alternatively, maintain sufficient unencumbered corporate assets to allow victims to recover for their losses.[174]

The second possible disadvantage of limited liability identified by the Commission was that it might diminish practitioners' incentives to take care in the provision of services. Here too, however, the report concludes that the actual effect of allowing professionals to practise in limited liability firms would be minimal:

> Again, this concern may be more apparent than real. First, it is likely that other factors will affect a practitioner's behaviour at least as significantly as exposure to personal liability. The personality of the practitioner and peer pressure will probably be at least as important in his or her behaviour as the threat of liability. Moreover, to the extent that practitioners are currently able to limit the effects of liability (through, for example, obtaining liability insurance or transferring their assets), the effect of incorporation on their conduct would be negligible.[175]

Both of these issues – the effect of limited liability on compensation of victims and its effect on incentives – are examined in more detail below.

2. Obligations other than Malpractice Liabilities

In Chapter 1 we distinguished between an enterprise's ordinary debts, malpractice (product) liabilities, and general tort liabilities. We observe that general tort liability is unlikely to be a major issue with professional firms. To the extent that professional firms incur liabilities in tort, they will generally be liabilities for malpractice. Therefore, the following discussion focuses on the distinction between professional firms' ordinary debts and malpractice liabilities.

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[174] *Ibid.*

[175] *Ibid.*

In our view, if there is a sound rationale for denying the privilege of practising in limited liability firms to accountants, lawyers and certain health care professionals, this rationale must relate to the type of product they provide. That is, the rationale must have something to do with the effect that limited liability practice might have on issues relating to malpractice: either the incidence of malpractice or the compensation of victims of malpractice. We cannot think of any sound reason to distinguish the relevant professions from other enterprises on the question of liability for ordinary debts or general tort liabilities.

Whenever the concept of limited liability professional practice has been debated in other jurisdictions, the difficult issue has always been considered to be limited liability for malpractice liabilities of the firm. The issue whether professionals should be able to practise in firms that confer limited liability for contract debts has hardly been considered worthy of discussion. We have already mentioned that the Lawrence Committee, after recommending that professionals practising in professional corporations should remain liable for their own malpractice, casually concluded that there was no reason why such corporations should not provide limited liability for ordinary contract debts.[176]

In his 1978 paper for the Professional Organizations Committee, Professor Prichard indicated why the issue of limited liability for ordinary debts is not regarded as a matter of monumental importance:

> In financing transactions, one may assume that as a general rule the terms of the agreement will reflect the assessment and allocation of the risks involved. Furthermore, to the extent that risk assignment dictated by the rule of limited liability is unsatisfactory to the parties, they can contract away from it. . . Therefore, in financing arrangements where the transactions costs of reaching a mutually satisfactory assignment of the risks are relatively low, the rule of limited liability is acceptable in that it can be rendered irrelevant if the parties so desire.[177]

In other words, the statutory (or common law) liability rule governing the liability of the owners of a firm for its contractual obligations is merely a default rule. Whether the default rule is limited or unlimited owner liability, if the parties to a particular transaction do not find that the rule meets their needs, they can specify a customized liability rule in their contract.

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[176] See text at note 156, above.

[177] Prichard 1978 at 74.

After emphasizing that different considerations arise in the context of malpractice liability, as opposed to ordinary contract debts, Professor Prichard considered the possibility of adopting different default rules for ordinary debts and malpractice liabilities:

> Some have suggested that while professional corporations should have unlimited liability for matters arising from the delivery of professional services, this personal liability need not extend to normal commercial obligations. Given the analysis above, the issue becomes relatively unimportant since the obligations will arise in the context of voluntary transactions in which the terms of trade can reflect the allocation of risks. My preference is to reject the distinction in order to avoid confusion and misunderstanding arising from misinformation effects. However, it is difficult to make a compelling argument one way or the other.[178]

As discussed earlier, the actual report of the Professional Organizations Committee did not really discuss the issues relating to limited liability: it simply rejected limited liability of any sort for professionals.[179]

One reason for allowing professionals to practise in business organizations that protect owners from ordinary contractual liabilities is that professionals can effectively achieve the same result by incorporating a management corporation. Suppose that a professional firm is organized as an ordinary partnership. With the exception of contracts to provide professional services and employment contracts with employed professionals, almost any significant contractual obligation that the partnership might incur in the ordinary course of business – office leases, equipment leases, support staff employment contracts, and so on – can be and often is incurred by a limited liability management corporation whose shareholders are the professional firm's partners.[180]

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[178] *Ibid.* at 78. Prichard's preference for not making a distinction between malpractice liabilities and ordinary debts, in order to avoid confusion, was echoed in Trebilcock, Tuohy & Wolfson 1979 at 359: "Moreover the segregating of debts and liabilities into two classes for the purpose of applying different liability rules to each class may well pose difficult problems of definition."

[179] See text associated with notes 161 through 164, above.

[180] In many cases the other party will require personal guarantees from the partners. Such evidence of "customized" liability rules supports the economist's contention that when all is said and done, the default rule – limited or unlimited personal liability – for contractual obligations is not of fundamental importance. It is a matter of selecting the most appropriate default rule.

If the legislature were really serious about making sure that members of professional firms bear unlimited personal liability for the firm's contractual obligations, professionals would be prohibited from employing management corporations. Short of such a prohibition, it is difficult to discern any principle or policy objective that might be served by prohibiting professionals from practising in firms that protect them from ordinary contract debts. All the prohibition accomplishes, if it can be described as an accomplishment, is to require professionals to interpose a management corporation between themselves and their suppliers and lenders if they want to get limited liability for ordinary debts. If no principle or policy is served by the prohibition, we see no point in maintaining it.

Like Prichard in 1978 and the Professional Organization Committee's staff study in 1979, our view is that the decision whether professionals should be permitted to practise in firms that provide a shield against contract debts should follow the decision whether they should be able to practise in firms that provide a shield against vicarious personal liability for malpractice obligations. Trying to draw a distinction between the two types of liability is more trouble than it is worth. Therefore, we defer making any recommendation about the issue of limited liability for ordinary contract debts until we have discussed the issue of limited liability for malpractice obligations.

3. Malpractice Liabilities

a. Overview

In this section we consider the case for and against allowing professionals to practise in limited liability firms with the following characteristics:

1. the resources available to satisfy malpractice liabilities of the firm are:
    - the firm's assets;[181]
    - the exigible assets of the members or employees of the firm who are personally implicated in the acts or omissions that created the liability;[182]

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[181] What is meant by the "firm's assets" is discussed in section D of Chapter 3. For the moment it suffices to observe that we are talking about the realizable value of the firm's assets, subject to claims that may rank ahead of or be entitled to share with the malpractice claimant. The same point holds true with respect to the individual professionals who are personally liable.

[182] For the moment, we leave to readers' imagination what is meant by "personally
(continued...)

- any applicable liability insurance of the firm or the members who are personally liable;

2. unless otherwise agreed,[183] the personal assets of members of the firm who are not personally implicated in the acts or omissions that created the liability are *not* available to satisfy the firm's malpractice liability.

A few pages ago we referred to the fact that in Alberta all enterprises except a few professions can be carried on through limited liability firms, and we said that it seemed reasonable that the relevant professionals should be treated in the same manner as other enterprises unless there are cogent reasons not to do so. Unfortunately (insofar as the length of this report is concerned), that sort of analysis does not get us very far. Perhaps there *are* cogent reasons for treating professional firms differently. For instance, some commentators have suggested that public policy reasons for allowing enterprises to organize themselves as limited liability firms simply do not apply to professional firms:

> More importantly, limited liability is a legislative creation designed to stimulate the passive investment necessary for rapid industrialization and commercial growth. Professional corporations [i.e. limited liability professional firms] fail to produce these benefits, however, because passive investment in professional corporations is both impractical and severely restricted as a matter of law . . .[184]

In Alberta, whether or not members of the public might wish to make equity investments in law or accounting firms if they could, they cannot, as a matter of law, do so. Thus, to the extent that the general justification for limited liability rests on a "capital raising" argument, it has little if any application to professional firms.

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[182] (...continued)
implicated," except that it would include, at the very least, any member of the firm who was personally negligent or worse.

[183] We presume that it would always be possible for members of such a firm to agree to assume a greater measure of liability than is provided by the default legislative rule.

[184] Prins 1977 at 387. On the point that passive investment in a professional firm is impractical, the author makes the following point at 387, note 133:

> The capital requirements of most professional corporations are so low and the proportion of income from professional services so high that an equity investment in a professional corporation would earn almost nothing.

For a theoretical discussion of the peculiar nature of "residual" (ownership) claims against cash flows from professional partnerships, see Fama & Jensen 1983 at 334-37.

We do not intend to dwell upon the inapplicability of the "capital raising" argument to professional firms.[185] We have mentioned it simply to indicate why we are not content to say simply, "Everyone else can organize themselves as limited liability firms, so professionals should be able to do likewise." It is, we think, necessary to consider what the effect of allowing professionals to practise in limited liability firms might be on potential victims of professional malpractice, and to consider whether those effects are acceptable from the perspective of public policy. Therefore, this section contains a fairly lengthy discussion of the possible effects of allowing professionals to practise in limited liability firms, insofar as malpractice liabilities are concerned.

Subsection (b) of this section starts from the premise that many professionals are concerned about the possibility of exposure to malpractice liability for amounts that will exceed the maximum available liability insurance coverage or the maximum liability insurance coverage that it is practical for them to obtain.[186] Starting from this premise, it discusses a possible approach to dealing with those concerns that would not entail (but would not rule out) allowing professionals to practise in limited liability firms. This approach is simply to let the parties to a contract for professional services to decide for themselves on the extent of the firm's liability, or the firm members' personal liability, for losses caused by defects in the firm's services.

Subsection (c) discusses whether allowing professionals to practise in limited liability firms is likely to materially and detrimentally affect their incentive to provide services of optimal quality. Our conclusion is that it is conceivable that in certain limited circumstances the fact that all members of a firm are not personally liable for its malpractice obligations could have

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[185] It is discussed in a little more detail in our issues paper: see ALRI 1998 at 109-10.

[186] If insurance companies will not provide insurance coverage for more than $X, then coverage above $X is simply unavailable. But insurance above $X, although available in theory, may be prohibitively expensive. An interesting example of what for most firms would be a prohibitively expensive premium is cited by Priest 1987 at 1577: an asbestos removal firm paid a premium of $460,00 for $500,000 coverage. The firm paid the premium only because customers demanded proof of insurance: *ibid.*, note 222. Priest points out that "the premium payment is a form of savings in which the insurer is promising eight percent interest for what both parties must believe is a certain loss:" Obviously, the firm could afford to pay $460,000 for $500,000 coverage. It might not have been able to afford to pay $4.6 million for $5 million in coverage or $46 million for $50 million in coverage.

such an effect. However, in the vast majority of professional engagements we would not expect limited liability to have any material effect on the quality of services provided by the firm.

Subsection (d) discusses limited liability as it affects the allocation of risk between the members of professional firms and their clients or other persons (referred to herein as "non-clients")[187] who might be adversely affected by the provision of substandard professional services. The discussion takes as its point of departure the conclusion reached in subsection (c) that limited liability will not materially affect the quality of professional services. It also assumes, however, that in virtually every professional engagement there is a non-zero probability that the client (or a non-client) will suffer a loss for which the firm would be legally liable. Obviously, limited liability does not reduce the risk of loss; all that it might do is alter the allocation of the risk from what it would be under unlimited liability. If limited liability has any affect at all on the allocation of risk in a particular engagement, it presumably shifts risk from members of the firm who would otherwise be personally liable to clients or non-clients. We consider the extent to which limited liability might facilitate such risk-shifting and whether risk-shifting, if it occurs, is necessarily a bad thing.

To the extent that limited liability in its raw form might lead to *inappropriate* risk shifting, we consider how this might be countered through the imposition of conditions on limited liability practice: particularly, mandatory insurance requirements. But we also suggest that the allocation of risk achieved through limited liability is not necessarily inappropriate. In particular, in the case of potential damages that are so large as to be uninsurable, limited liability professional firms arguably allocate risk in a manner that approximates the allocation that would often result if the firm and potential malpractice claimants could allocate risk through explicit bargaining before the professional service is rendered. Allowing professionals to practise in limited liability firms would arguably achieve a fair allocation of risk to the extent that it approximates the allocation that a professional firm and potential victims of malpractice would be expected to agree to if there was an opportunity for explicit bargaining.

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[187] We use the plural "non-clients" as a reminder that the circumstances in which a firm is likely to incur a liability to a person other than a client will often involve liability to many persons.

Subsection (e) refers briefly to arguments that allowing professionals to practise in limited liability firms will have a healthy on competition in the market for professionals services. Essentially these arguments are to the effect that limited liability facilitates more efficient markets for professional services, so that clients will get more bang for their professional services buck.

b. Customized (Contractual) Liability Rules

As mentioned above, this subsection proceeds from the assumption that many professional firms face potential malpractice liabilities for uncomfortably large amounts. Let us say that a firm faces an uncomfortably large liability if it faces a "significant" risk[188] of incurring a malpractice liability for an amount that substantially exceeds the maximum insurance coverage that is available or that it is practical for it to obtain.

We have mentioned that in the context of ordinary contract debts the default rule – limited or unlimited owner liability – is not all that important because the parties can supply their own customized rule if the default rule is not to their liking. In theory, the same thing could be said of potential malpractice liabilities to clients of a professional firm. As we put it in the issues paper:

> Does it really make much difference whether UL professionals are allowed to practise in limited liability firms or not? When all is said and done, is not the applicable liability rule – unlimited liability or limited liability – just a default rule that the parties can alter if they wish? More generally, if the heaviest part of the burden of unlimited liability falls on large firms, cannot those firms, which presumably will have considerable bargaining power, simply require appropriate limitations of liability in their contracts with clients?[189]

In their respective responses to the issues paper, both the Institute of Chartered Accountants and the Law Society took issue with the proposition that customized limitations of liability might be a satisfactory substitute for limited liability professional firms.

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188 What is a "significant" risk? It depends on what is at stake. Few people would regard an activity that entails a 90% chance of increasing their wealth by 5% and a 10% chance of losing 5% of their total wealth as particularly risky. Many people would probably change their view if it was a 90% chance of increasing their wealth by say 15% and a 10% chance of losing all their wealth.

189 ALRI 1998 at 110.

We are not convinced of the cogency of some the arguments that have been put to us as reasons why professional firms could not protect themselves from excessive liability exposure through contract. For example, it was suggested that because most enterprises are conducted through limited liability firms, they will have no experience with the notion that the parties to a contract might agree to limit the liability of a party for non-performance or defective performance of its contractual obligations. Therefore, the managers of such limited liability firms would have no sympathy for and would not be prepared to entertain a proposal by an unlimited liability professional firm to limit the latter's potential liability to some mutually agreeable amount.

We find the foregoing argument unconvincing. Limited liability firms that are parties to ordinary business transactions often give considerable thought to the possibility that one of the parties will fail to perform, or defectively perform, its contractual obligations. Having thought about the possibility, the parties might still leave the matter of damages to the default rules provided by judicial doctrine. On the other hand, the parties might well – and often do – decide to substitute a customized rule for the default rules. For example, they might agree that the service provider will not be liable for consequential damages, or that there will be a specified monetary ceiling on its potential liability. In short, the contention that limited liability firms that engage the services of professional firms will have no experience with or sympathy for contractual limitations of liability rests on a questionable foundation.

We also have some difficulty with the contention that contractual limitations of liability will be of no avail in tort actions by third parties with whom the professionals did not have a contract. In this regard, it has been argued that accountants, in particular, face the potential of huge liabilities to non-clients in respect of audits. In its 1995 submission to the Alberta government the Institute of Chartered Accountants put the point thus:

> It is understood that some large legal firms have engagement contracts with clients that limit liability to the total assets of the law firm, including insurance coverage, but does not include personal or family assets of the partners . . . Such a solution, however, would not effectively deal with the problem facing accountants. The majority of lawsuits filed against CA firms have been generated by third parties, rather than by clients.

The argument, at its simplest, is that a contractual limitation of liability will be of no avail against a person who is not a party to the relevant contract. Of course, contracts generally only bind the parties to the contract. But the question remains whether there are effective do-it-yourself measures that professionals could take to eliminate or effectively manage their exposure to claims by third parties.

Although negligent misrepresentation is not the only possible basis upon which a professional might incur tort liability to non-clients, it is probably the most likely source of very large damage claims by non-clients against professionals. Liability for negligent misrepresentation can arise if a non-client to whom a professional owes a duty of care reasonably relies to their detriment on a careless misrepresentation by the professional. But for liability to arise the professional must owe a duty of care to the non-client. As discussed in the issues paper, the recent decision of the Supreme Court of Canada in *Hercules Management Ltd.* v. *Ernst & Young*[190] makes it clear that auditors will not usually owe a duty of care to persons who might rely on audited financial statements in making decisions whether to purchase debt or equity securities of a public company on the secondary market.[191]

To be sure, notwithstanding cases such as *Hercules*, accountants or other professionals may still incur a duty of care to non-clients with respect to statements or representations. For example, if an accounting firm audits financial statements of a client pursuant to a specific request by a prospective lender for audited financial statements to support the client's application for a loan, the professional may come under a duty of care to the financial institution. However, ever since the tort of negligent representation was recognized by the House of Lords in *Hedley Byrne*,[192] and indeed in the seminal case itself, the courts have made it clear that the information provider can prevent a duty of care from arising by a clear disclaimer of responsibility. Thus, the hypothetical accounting firm could avoid

[190] [1997] 2 S.C.R. 165, 146 D.L.R. (4th) 577.

[191] ALRI 1998 at 25-30.

[192] *Hedley Byrne & Co.* v. *Heller & Partners Ltd.*, [1964] A.C. 465; [1963] 2 All. E.R. 575.

responsibility to the financial institution by an appropriate disclaimer of responsibility for the accuracy of the information.[193]

Notwithstanding that some of the objections to the efficacy of do-it-yourself limitations on professional liability are overstated, it must be conceded that such limitations are not a complete answer to concerns regarding uninsurable liability. One obvious constraint on the efficacy of the do-it-yourself approach in a particular engagement is the willingness of the other party to agree to a proposed limitation. We would not, however, regard the other party's reluctance to agree to a contractual limitation on the professional firm's liability as an argument for achieving that result by legislation.

Another constraint is that rules applicable to particular professions or particular types of engagement may exclude the possibility of customized limitations of liability. An example of a profession-specific restriction is rule 620(1) of the Alberta Rules of Court:

> Any provision in any agreement respecting solicitor and client fees which purports to relieve any barrister and solicitor for liability for negligence or any other liability to which he might be subject as a barrister and solicitor is void.

As discussed in our issues paper, although the precise effect of this rule is unclear, it arguably precludes law firms from limiting their liability by contract.[194] Similarly, a do-it-yourself limitation on liability would not appear to be an option where the liability in question would be imposed by statute. For example, section 168 of the *Securities Act* imposes potential liability on "experts" for misrepresentations in a prospectus. We take it as a given that there is no scope for an expert to limit its prospective liability under such a provision by contractual means.

Another context in which do-it-yourself limitations might not be a viable substitute for being able to practise in a limited liability firm is where a firm

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[193] The technique of excluding responsibility has the disadvantage of being a blunt instrument. In a contractual setting a professional can limit its liability to some mutually agreeable amount. It would seem difficult, as a theoretical matter, for a professional firm to both accept non-contractual responsibility for its statements and to impose a non-contractual cap on its liability for negligently failing to discharge that responsibility.

[194] ALRI 1998 at 111-12.

located in Alberta performs services in, or for persons resident in, a jurisdiction that would not recognize a contractual limitation on liability. Such a jurisdiction might give effect to the liability shield provided to its members by a limited liability firm, even though it would not recognize a contractual limitation on liability.

We will make one final observation regarding the relationship between customized (contractual) liability rules and limited liability professional firms. Even if professional firms could theoretically limit their liability for malpractice in any imaginable situation, that would not necessarily answer arguments that they should be able to practise in limited liability firms. It could be argued that the proper legislative approach is to make both types of firm – limited liability and unlimited liability– available to professionals and then let them decide which type to use. If the default owner-liability rule is inappropriate in the context of a particular engagement, then the parties can agree to substitute a different rule.

c. Limited Liability and Quality of Service

The issues paper considered whether professionals practising in limited liability firms might have less effective incentives to provide services of optimal quality than professionals practising in unlimited liability firms. Those who commented on this issue were of the view that professionals practising in limited liability firms would have just as much incentive to take care in providing professional services as professionals practising in unlimited liability firms. To put the argument in a slightly different way, even if vicarious personal liability might in theory provide an incentive for professional firms to take adequate care, it is redundant to other incentives to take such care. These other incentives include: reputational concerns; the mechanisms of professional regulation, especially professional discipline; and the "going concern" value of the firm to its members that could be lost if the firm incurs a catastrophic liability. Moreover, even in a limited liability firm the professionals who are personally implicated in wrongful acts or omissions would be personally liable for damages. Thus, the members of a limited liability firm who are actually working on an engagement would have as much incentive to take care as they would in an unlimited liability firm.

It seems obvious that limited liability practice will *not* adversely affect a firm's incentives to take optimal care in respect of a particular engagement where its members have as much to lose as they would if practising with unlimited liability. This condition would be met in any engagement where the firm's maximum potential malpractice liability is less than the amount of its liability insurance coverage. In such a case, a malpractice claim could result in any or all of the following sorts of costs: (1) liability for the insurance deductible; (2) damage to the value of the firm's reputation (goodwill); (3) disruption to the firm caused by the litigation process (e.g. time spent by members of the firm on their own litigation file); (4) the potential for professional discipline; (5) increased liability insurance premiums in future periods; and (6) damage to the firm members' professional pride. For a claim within the insurance limits, the foregoing costs will be the same whether the firm's members have limited or unlimited liability for the malpractice liability. Thus, for engagements where the maximum potential liability is within the limits of the firm's insurance coverage, the incentive to exert optimal risk-reduction effort will not be affected by whether the firm's members are subject to unlimited liability or not.

We pause here to clarify a point about the effect of liability insurance on incentives. The argument in the preceding paragraph is not meant to suggest that having liability insurance gives a firm an incentive to provide services of optimal quality. If anything, it has long been recognized that liability insurance may impair the incentive to take care that would otherwise be provided by the prospect of incurring a malpractice liability.[195] Suppose, for example that a firm has $5 million in assets and has an engagement where failure to take adequate care could result in a malpractice liability of $5 million. If the firm has at least $5 million in liability coverage, its incentive to take care is provided by the factors mentioned in the preceding paragraph. If the firm has no liability insurance coverage, it has the incentives mentioned in the preceding paragraph *plus* the prospect of losing $5 million if the liability materializes.[196] That prospect is likely to provide a fairly bracing

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[195] See e.g. Shavell 1987 at 242. However, the insurer has an incentive to monitor risk management effort of the insured, so as to reduce the likelihood that the insurer is bearing more risk than it has been paid to bear. Therefore, if it is relatively easy for insurers to monitor the risk management effort of insureds, a mandatory insurance requirement combined with active monitoring of insureds by insurers could increase the overall level of care: *ibid.*

[196] The uninsured firm would also have to take the prospective costs of defending an action into account.

incentive to take care, given that the firm actually has the assets to satisfy its liability.

The dulling effect of liability insurance on the incentive to take due care can be counteracted to some degree through techniques such as making liability insurance subject to substantial deductibles and through "experience rated" premiums (claims in one period lead to higher premiums in subsequent periods).[197] However, as the deductible amount is increased for deterrence purposes, you will begin to run into a conflict between the deterrence and compensatory objectives of civil liability.[198] It may also be observed that a practical difference between a limited liability and an unlimited liability firm may begin to emerge as the amount of the insurance deductible is increased. If the purpose of, say, a $100,000 deductible is to provide a bracing incentive for firms to provide high quality services, the incentive may be dulled in the case of a thinly capitalized firm whose members enjoy limited liability.

We believe the great majority of professional engagements will fall within the parameters described above. That is, the firm's maximum potential liability will be less than its insurance coverage, so it will make no difference, so far as incentives are concerned, whether it is a limited or unlimited liability firm. But we should consider what might happen where there is a non-negligible risk that if a firm provides services of suboptimal quality, it will incur a malpractice liability for an amount substantially in excess of the liability insurance coverage that is available or that it has chosen to carry. We will use the adjective "high-stakes" to refer to an

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[197] These and other techniques are discussed in Belobaba 1978 at 73-75, where the following observation is made:

> The incentive for continuing competence created by the imposition of civil liability is virtually eliminated if the professional's insurance package has a nominal or non-existent deductible. It is absolutely imperative from a deterrence perspective that the professional insurance plan carry a substantial, uninsurable deductible requirement.

[198] The issue of substantial deductibles for mandatory insurance highlights the tension between the deterrence and compensatory goals of civil liability. Substantial deductibles are great from a deterrence perspective but have obvious drawbacks so far as the compensatory goals of civil liability are concerned. For example, we are advised that the Alberta Lawyers Public Protection Association (ALPPA) is involved in an experimental program wherein it is waiving the standard $5,000 deductible on lawyers' liability insurance policies. The reason is that ALPPA was finding that the inability of some lawyers to come up with the $5000 deductible was hampering efforts to settle some malpractice claims.

engagement where the potential malpractice liability exceeds the firm's insurance by a substantial margin.

Suppose that (1) in a particular engagement the firm's maximum liability is $25 million; (2) the firm's liability insurance coverage is $5 million; (3) the exigible personal wealth of the firm's members who are not involved in the engagement is $20 million; (4) the exigible personal wealth of the professionals who would be personally implicated in any malpractice is $1 million; (5) the total going concern value of the firm *to its members* is $5 million.[199] The particular members of the firm who would be personally implicated in any malpractice would have just as much incentive to take care in a limited liability firm as they would in an unlimited liability firm.

But this is not the end of the story. It is reasonable to consider the firm members' collective incentive to implement costly procedures and safeguards designed to reduce the risk of incurring a malpractice liability. If the firm is an unlimited liability firm and incurs a $25 million malpractice liability with only $5 million in insurance, the members will collectively have to come up with $20 million. If the firm is a limited liability firm, the uninvolved partners will stand to lose only their portion of the going-concern value of the firm: $5 million. Thus, it is possible that loss-avoidance procedures and safeguards that they would view as cost-effective if their personal assets were at risk might not be so viewed where those assets are not at risk.

Moreover, given that *only* the members of the firm who are personally implicated in malpractice will incur personal liability, members will have an incentive *not* to do anything that might implicate them in a malpractice liability:

> However, an LLP law firm partner cannot be held liable for any acts of her co-partners unless that partner participated in or supervised the malpractice. A lawyer's insulation from liability for acts of other lawyers in a limited liability law partnership could arguably reduce the motivation of lawyers to actively monitor fellow attorneys. In addition, since lawyers are held liable for acts which they are in some sense "connected with," the insulation from vicarious lability that LLP

[199] The firm's going concern value to its members might substantially exceed the amount that could be realized and paid to creditors if the firm was liquidated. But when considering the incentive effect of civil liability, the going concern value of the firm to its members is more important than the amount that creditors would receive if the firm were liquidated.

> statutes create will encourage lawyers to take steps to separate themselves from potential connection to malpractice.[200]

After amplifying this point and referring to the possibility of informal fragmentation and formal departmentalization, the writer continues:

> The decreased monitoring which limited liability encourages among a law firm's partners will result in an increase in malpractice. As fewer lawyers within a firm consult with and "check up" on one another, the quality of legal service that each lawyer provides becomes more and more dependent on the *individual* aptitude of each lawyer. The increased solitude among a law firm's partners heightens the likelihood of a legal oversight formerly avoidable through co-monitoring and peer consultation. This common sense notion – that no individual is infallible – finds support in the disproportionate number of malpractice judgments against solo practitioners versus multi lawyer firms.[201]

In our view, the foregoing argument has considerable force. Nevertheless, we think there would be a number of factors working the other way. First, as already discussed, in the great majority of engagements the firm's maximum liability exposure is likely to be less than its liability insurance. In such engagements it will not make any difference to firm members' incentive (or disincentive) to monitor each other whether the firm is a limited or unlimited liability firm. In either case, incentives to monitor and supervise will come largely from reputational (goodwill) concerns, professional pride and so on. Second, if a firm has implemented quality control systems and procedures that are effective for engagements that do *not* involve the potential for catastrophic liability claims, it is likely that those systems and procedures will also be effective for engagements that *do* have that potential.

It also seems unlikely that the firm will abandon monitoring and supervision procedures that have proven effective for moderate-stakes engagements (i.e. where the maximum potential liability is within insurance limits) for high-stakes engagements merely because those procedures put more members at risk of incurring personal liability.[202] On the other hand,

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[200] Murphy 1995 at 215-16. See also Fortney 1997 at 732-37. We come back to this point when discussing "supervisor's liability" below.

[201] Murphy 1995 at 216.

[202] If the procedures could be counted on to work perfectly, the members would not have to

(continued...)

limited liability may provide a disincentive for the firm (or members of the firm) to engage in *extra* supervision or monitoring for high-stakes engagements that might be cost-effective if the firm's members were subject to unlimited liability. That is, in certain high-stakes engagements, extra risk-reduction efforts that would be cost-justified if all the firm members' assets were at risk might not be cost-justified (from the members' perspective) in the context of a limited liability firm.

On balance, while we cannot bring ourselves to dismiss the possibility that allowing professionals to practise in limited liability firms could sometimes have a material, adverse effect on their incentives to provide services of optimal quality, we are confident that such cases would be few and far between. In all engagements involving moderate stakes and most involving high stakes, we suspect that there would be no material difference in the level of care that would be exhibited by a professional firm depending on whether its members were or were not exposed to unlimited liability for its malpractice obligations.[203]

d. Limited Liability and Allocation of Risk of Loss

In this subsection we consider how limited liability might affect the allocation of the risk of loss as between clients or non-clients of a firm and members of the firm who are not personally implicated in the events that caused the loss.[204] Of course, by "loss" we are talking about a loss for which

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[202] (...continued)
worry about malpractice liabilities at all. They could *ensure* that they will not incur malpractice liabilities. But in practice, even the most well thought-out and implemented procedures will not eliminate the risk of liability-creating errors.

[203] For even more emphatic conclusions that limited liability is unlikely to materially affect the deterrent value of civil liability in the context of professional firms, see Prins 1977 at 373-82; Belobaba 1978 at 77, MLRC 1994 at 85 (see text at note 175).

[204] Logically, when talking about the allocation of risk rather than about deterrence objectives, the case for distinguishing between the negligent partners and the innocent partners is less than compelling. If the risk allocation principles suggest that the client is in a better position to bear risk than the members of a firm who *are not* involved in an engagement, it is also likely be a better risk-bearer than the members who *are* involved in the engagement. However, since all proposals for limited liability professional firms assume that the personally implicated members will bear unlimited liability we assume likewise.

As an aside, we observe that the personal liability of the personally implicated partners is likely to be academic in malpractice litigation against large partnerships with substantial insurance coverage. In the great majority of cases the result of the litigation will be determined by settlement agreement rather than by a judgment after a trial. Suppose that
(continued...)

the firm is legally liable because of wrongful acts or omissions by one or more of its members or employees. We are also assuming that although the firm is liable for the loss, the members of the firm collectively have made optimal efforts to prevent the loss from occurring. Thus, the members of the firm who are not personally implicated in the events that caused the loss cannot realistically be said to be blameworthy for the loss. Therefore, if personal liability is to be imposed on the uninvolved members of the firm, it is true vicarious liability, and the reason for imposing such liability must be that the members of the firm are better risk bearers or more efficient insurers than the person who has suffered the loss.

Our overall conclusion on the risk allocation issue is similar to our conclusion on the incentives issue. Allowing professionals to practise in limited liability firms has the potential in certain circumstances to facilitate the shifting of risk that would otherwise be borne by professionals to clients or non-clients. Such risk shifting would be particularly troublesome where it would shift risk from professionals onto unsophisticated, risk averse clients. Fortunately, the scope for this sort of risk shifting can be minimized by suitable safeguards: in particular, mandatory insurance requirements. Mandatory insurance requirements will not prevent limited liability professional firms from shifting risk in all cases. We conclude, however, that risk shifting facilitated by limited liability is not necessarily to be deplored. In particular, in a significant number of cases, the allocation of risk achieved by limited liability may approximate the allocation of risk that informed parties would agree to in any event. We reach the conclusions outlined above by the following route.

In division (i) of this subsection we suggest that even where professional firms incur liabilities to non-clients, the latter are not likely to be the classic "innocent bystander" of tort theory. Instead, the non-client is likely to have

[204] (...continued)
a 100-member LLP has $25 million in liability insurance and the plaintiff has a claim worth anywhere from $0 (i.e. if the firm was found not to be liable) to, say, $100 million. The two or three members of the firm who are alleged to be personally liable have, say, $1 million in exigible assets between them. If the plaintiff's lawyers could negotiate a settlement in which they received $25 million (i.e. the insurance limit), they probably would not be overly concerned about foregoing the possibility of extracting an extra $1 million out of the firm members who might be found to bear personal liability if the matter were to go to trial. The plaintiff's lawyer might take a different view of the settlement value of personal assets if *all* members would be answerable for a judgment.

been a voluntary user or beneficiary of the firm's services. Thus, the non-client's potential for suffering harm as a result of defects in the firm's services does not present a problem of negative externalities so much as a problem of achieving an optimal allocation of risk between willing participants in an economic activity.

In division (ii) we discuss the general idea of allocation of risk as between a risk averse and risk neutral party, the archetype of the latter being a commercial insurer. It is pointed out that individuals who face a loss with respect to which they are risk averse will be inclined to pay a risk neutral party to assume that risk. If one of two persons, both of whom are risk averse, must initially bear a risk of loss, it will be to their mutual advantage to decide which of them, as between themselves, is to bear the risk and then for that party to purchase insurance against the risk. In this context, it is suggested that in an engagement for professional services where both the professionals and the client are risk averse, it will often be more efficient for the professional firm to bear the risk of loss and to insure against it. This is particularly the case where the risk averse client is unsophisticated.

Division (iii) considers the effect of mandatory insurance. It argues that suitably robust mandatory insurance requirements can greatly reduce the potential that limited liability might otherwise have to allow professional firms to shift risk onto unsuspecting, unsophisticated risk averse clients. If limited liability professional firms are subject to higher mandatory insurance requirements than are unlimited liability firms, it could well be *less* risky for an unsophisticated client to deal with a limited liability firm than an unlimited liability firm.

Division (iv) suggests that limited liability could affect a firm's (or its members') incentive to purchase insurance above the mandatory minimum level. Limited liability allows the members of the firm to expose only a portion, and perhaps a relatively small portion, of their total wealth to malpractice claims. In other words, it will allow them to have less wealth at risk. Where the firm's potential liabilities could substantially exceed the wealth at risk, the firm's incentive to insure will be diluted because the cost of a given amount of insurance will remain the same while its value to the firm's members will decline. It is pointed out, however, that if the mandatory minimum insurance requirements are reasonably robust, it will generally be sophisticated clients who incur the risk of losses for amounts in excess of the mandatory insurance requirements. Such clients should be able to anticipate the possibility that limited liability firms will not be fully insured, and govern themselves accordingly.

Division (v) considers the case where adequate market insurance is simply not available. It suggests that where such cases arise, the members of the professional firm are not necessarily the most appropriate bearers of the uninsurable risk. The argument is developed by considering how the affected parties might agree to allocate the risk of loss at the outset of an engagement if they had an opportunity to bargain explicitly about the matter beforehand. It suggests that limited liability approximates the result that the parties might often be expected to reach through explicit bargaining.

There is one fundamental point that should be kept in mind throughout the ensuing discussion. Unlimited liability of members of a professional firm, even a large professional firm, does not ensure that victims of professional malpractice (or other creditors of the firm) will be paid. This is illustrated by certain large law firm bankruptcies in the United States.[205] These bankruptcies appear to have resulted from ordinary "business failure" causes rather than from huge malpractice liabilities. What is of interest, though, is that even in the case of large firms whose partners were personally liable for the firms' debts, returns to creditors were but a small fraction of the amount they were owed. In one case, the total amount that could be recovered by "liquidating the 100 partners of a large partnership"was but $5 million.[206] This goes to a point we will discuss in a little more detail later; the level of a firm's liability insurance coverage will often be a more important determinant of malpractice victims' actual recovery than will the personal liability of the firm's members.

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[205] Ribstein 1997 at 45-47.

[206] *Ibid*, at 47. One presumes it was the partners' *assets* that were to be liquidated, rather than the partners themselves. Why would the partners have only $50,000 apiece to apply to their debts? "Assuming partners are accurately disclosing their net worth [in the bankruptcy proceedings], the surprisingly low settlements might be explained by a variety of factors, including widespread profligacy by law partners, large state exemptions, or debt-avoidance planning by the partners, such as placing assets in spouses' names or in foreign bank accounts:" *ibid*.

i. Risk allocation and non-clients

Much of the academic debate about limited liability over the last thirty years or so has focussed on the distinction between "voluntary" and "involuntary" creditors, the latter often being referred to as "tort" creditors.[207] The problem with limited liability in the context of involuntary creditors is that it creates an opportunity for the owners of an enterprise to externalize risk. A risk (or cost) of an activity is externalized if the risk (or cost) is borne by someone who is not a voluntary participant in the activity. The noise from your rowdy neighbour's 3 A.M. party provides a perfectly serviceable example of a negative externality.[208]

The average person might say that the problem with externalities is that it is unfair to throw the costs of your activities onto others. An economist would prefer to talk in terms of efficiency. From the economist's perspective, the difficulty with limited liability in the context of involuntary creditors is as follows:

> The efficiency consequences of limiting liability thus differ with respect to contracted debtholders and potential tort victims. . . When liability is limited with respect to third-party tort victims, the potential loss beyond the equity investment is simply not part of any actor's calculation and thus disappears as an element in the enterprise's investment evaluations. In this sense, costs of the enterprise are not internalized to any actor; an investment may be undertaken even though from society's point of view it is not worthwhile. In addition, the full risk of the enterprise will not be reflected in the required rate of return. The tort victim, or society at large, may be quite averse to the prospect of the catastrophic loss. The purely rational investor, however, will continue to regard the enterprise as being only moderately risky since the worst possible outcome is the loss of the investment.[209]

Even the most vocal proponents of limited liability are somewhat embarrassed by the problem of involuntary creditors. A recent overview of the debate over the efficiency of limited liability puts the point thus:

> As to involuntary creditors, [limited liability] proponents have to concede that the economics give rise to a strong negative inference. They respond by pointing to

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[207] See e.g. Halpern, Trebilcock & Turnbull 1980 at 145-47; Easterbrook & Fischel 1985 at 107-09; Leebron 1991, *passim*; Hansmann & Kraakman 1991, *passim*; Ribstein 1992 at 438-450; Hillman 1992, *passim*.

[208] Unless you happen to share your neighbour's taste in music and preferred listening times, in which case the noise might be viewed as a positive externality.

[209] Leebron 1991 at 1584-85.

> the offsetting benefits respecting relations with voluntary creditors, pointing to the possibility of veil-piercing, making old-fashioned appeals for the need to encourage capital formation, and asserting that the equity investments and risk aversion of small-firm investors will lead to considerable internalization of tort risk.[210]

The references in the preceding passages to "tort victims" and "involuntary creditors" bring to mind the potential victims of professional malpractice whom we have referred to as non-clients. By definition, non-clients do not have a contract with the professional firm, so their claim, if they have one, must be in tort. However, the point we want to make here is that typical non-client victims of professional malpractice do not necessarily present the same sort of problem as is presented by, say, individuals who are killed or injured by emissions from a chemical factory operated by a thinly capitalized limited liability company.

There does not seem to be a great deal of scope for health care professionals to incur huge malpractice liabilities to persons other than their patients.[211] Thus, insofar as liability to non-clients is concerned, we are mainly talking about accountants and lawyers. The services provided by these professionals might be described generally as advice, representation and information. Given the nature of these services, the most likely circumstance in which non-clients will have a plausible claim for damages against a professional firm is where they have relied to their detriment on information provided by the firm: the tort of negligent (or perhaps fraudulent) misrepresentation. Whatever one may think about the proper scope of the action for negligent misrepresentation, it is difficult to think of potential victims of negligent misrepresentation as classic victims of externalized risk.[212]

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210 Bratton & McCahery 1997 at 639-40.

211 Of course, when it comes to liability for negligence, anything is possible. For example, it is not inconceivable that a physician who negligently failed to diagnose a patient's highly contagious disease might incur liability not only to the patient but also to persons who were infected by the patient because the disease was not correctly diagnosed.

212 Indeed, the circumstances surrounding negligent misrepresentation seem as likely to give rise to a problem of positive externalities – a "free rider" problem – as to the negative externalities problem with which tort theorists are usually concerned: see Bishop 1980, *passim*, esp. at 364-68.

Suppose, for example, that a bank relies on carelessly audited financial statements in making a loan to the auditor's client and suffers a loss as a result of this reliance.[213] The bank chooses whether to rely, or how much to rely, on the audited financial statements. The information in the financial statements is not forced down the bank's throat. Presumably, the bank chooses to rely on the information in the audited financial statements because it decides it is more cost-effective to do so than to conduct its own investigation of the borrower's financial affairs.

The same general point could be made regarding an individual who invests (or retains an investment) in a widely held company on the faith of carelessly audited financial statements and suffers a loss as a result. The average investor in a publicly traded company has little or no influence on the company's choice of auditor, the terms of the audit engagement, and so on. And unlike the bank, the investor probably does not have a practical opportunity to conduct independent enquiries into the company's finances. Nevertheless, the investor is able to choose whether or not to invest in the company and how much reliance to place on audited financial statements in making their investment decisions.

The foregoing is *not* intended as an argument that the auditor should not owe a duty of care to the bank or investor. It is intended point out that the problem is one of allocating risks between the participants in an economic activity, rather than a problem of internalizing risks of an activity that would otherwise be externalized. Moreover, if one assumes that auditors generally are providing audits of optimal quality,[214] then it must also be assumed that auditors' potential liability to investors for defective audits will be reflected in the fees they charge to audit clients. That is, auditors' expected liability costs are as much a part of the cost of providing audits as are the wages they pay to their staff, and those costs will show up one way or another in audit fees. Of course, the fees charged to audit clients will ultimately be borne by

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[213] Actually, this is what Shavell 1987 at 9-21 refers to as a "bilateral accident." Both the care taken by the potential injurer (the accounting firm) and the care taken by the potential victim (the bank) affect the probability of the latter suffering a loss. But this aspect of the scenario does not concern us here.

[214] This is an assumption that we *are* making here because we are talking about the allocation of risk, rather than the incentives problem.

the investors who are supposed to benefit from the imposition of liability on auditors.[215]

ii. Risk allocation where it can be assigned to a risk neutral party

The concept of attitude to risk – risk aversion, risk neutrality, or risk seeking[216] – is important in the analysis of many types of economic activity, including the market for insurance and investment behaviour. It should be emphasized that to say that an individual is risk neutral with respect to a potential loss is *not* to say that the individual is *indifferent* to suffering the loss. Rather, it is to say that the individual is a strict odds-player with respect to that loss. A risk neutral individual offered a bet with a 51% probability of winning $1000 and a 49% probability of losing the same amount will take the bet, because the odds are favourable, if only slightly so. A risk averse individual, on the other hand, would reject the bet because they assign more weight to the probability of loss than to the probability of gain. This is not to say that a risk averse individual will never knowingly risk a

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[215] The other side of the coin is that if auditors owe no duty of care to investors in audited companies, investors may eventually begin to wonder exactly what the value of audits is, anyhow. It has been pointed out by observers within the accountancy profession that too much judicial solicitude for auditors' liability concerns may be bad for auditors' business. A possible drawback of cases such as *Hercules*—and its UK and Australian counterparts, *Caparo Industries PLC* v. *Dickman*, [1990] 2 A.C. 605 and *Esanda Finance Corporation Ltd.* v. *Peat Marwick Hungerfords* (1997), 142 A.L.R. 750 (H.C. of Aust.)—so far as the audit industry is concerned, is that they raise questions about the value of statutory audits. As it is put in Power 1998 at 77:

> While the [accounting] firms complain publicly about their predicament, they also prefer to settle out of court, even when the existing case law seems to favour the auditor. This points to a deeper puzzle about the auditor liability debate: while auditors are adopting strategies to minimize their exposure to liability claims, they are equally conscious that they do not wish to go too far in lowering public expectations about what the audit process can deliver. For example, the famous judgement in the *Caparo* case in the U.K. has been regarded as a Trojan horse for the auditing profession. On the surface it seems to offer protection from third party liability claims. On closer inspection the judgement challenges the conventional wisdom enshrined in every basic accounting text book: that financial statements provide useful information for third party investors and that auditors add to the credibility of this function. In short, highly protective legal judgments may erode the value of the audit function.

Of course, since auditors have a legislatively assured demand for their services, the fact that the value of the audit function is eroded by highly protective judgments will not necessarily have immediate revenue implications for accounting firms.

[216] We ignore risk seeking behaviour in this discussion.

loss in order to realize a potential gain, but they will demand more favourable odds than would satisfy a risk neutral actor.[217]

The interplay of risk neutrality and risk aversion can be illustrated by a simple example. Suppose that A is subject to a 1% probability of suffering a $100,000 loss. The *expected loss* (the probability of the loss times its magnitude) is $1,000. If risk neutral, A will pay up to, but no more than, $1000 to eliminate the risk of incurring this loss. If risk averse, A would pay more than $1000 to eliminate the risk of incurring the $100,000 loss: exactly how much more would depend on just how risk averse A is.

Suppose now that A is risk averse and B is risk neutral. While A would be willing to pay more than $1000 to eliminate the risk, B would be prepared to accept the risk in return for a present payment of slightly more than $1000. If A were to pay B $1050 to accept the risk, both parties might consider themselves to have made a good bargain. B has an expected profit of $50 (i.e. the $1050 payment minus the expected loss of $1000), while B has purchased peace of mind for $1050.

It is reasonable to assume that most individuals will be effectively risk neutral with respect to a potential loss that represents a small fraction of their total wealth but highly risk averse with respect to a potential loss that would wipe out all or a substantial proportion of their wealth. For example, most people would be risk averse with respect to the possible destruction of their house in a fire because the house represents a substantial portion of their wealth. An insurance company, on the other hand, is effectively risk neutral with respect to such a loss because the value of a single house is but a tiny proportion of the insurance company's assets. The fact that you are risk averse and the insurance company is risk neutral with respect to the possible destruction of your house in a fire means that there is room for a deal whereby it assumes the risk of loss in return for payment of a premium. As in the example of A and B, the premium will be related to the *expected loss*, the value of the house multiplied by the probability (as estimated by the insurer) of its destruction.[218]

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[217] For a more sophisticated explanation of risk neutrality and risk aversion, see Shavell 1987 at 186-91.

[218] The probability of loss times its magnitude determines the *actuarially fair premium* for a (continued...)

Suppose that instead of talking about you and your house we are talking about a professional firm and a client. The firm has been engaged by the client. There is a non-zero probability that, notwithstanding the efforts of the firm to take adequate care, an error will occur that will cause the client to lose a substantial sum of money. The sum is substantial both in relation to the assets of the client and in relation to the total assets of the firm's members. Thus, both the firm's members and the client will be risk averse with respect to the potential loss. The obvious answer is for the party – firm or client – who bears the legal risk of loss to purchase insurance. The net result will be that the risk of the large loss is borne by the insurer, rather than by either of the parties. The question is, which party should bear the legal risk of loss and purchase the insurance.[219]

Given a perfect insurance market and sophisticated parties, it would not really matter which party – professional firm or client – buys the insurance and pays the premium. If the firm buys the insurance, the premiums will be built into the fee charged for its services.[220] On the other hand, if the client has to purchase the insurance, it would expect to pay less for the professional service than it would if the insurance premium was built into the fee. However, if one of the parties can procure insurance more cheaply than the other, it makes sense for the former to purchase insurance. And if the nature of the loss is such that one party can purchase insurance but the other cannot, then it makes even more sense to assign the legal risk of loss, and the task of purchasing insurance, to the former. There is reason to think that for reasons of both cost and availability, it will often be more efficient for a professional firm to purchase liability ("third-party") insurance against a potential loss than for a client to purchase casualty ("first-party") insurance that would cover the loss.

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[218] (...continued)
given risk: *ibid.* at 192, note 90.

[219] We are assuming here that if the client insures against the loss, the client will not be able to recover damages from the firm. The parties could achieve this result by a contractual limitation on the firm's liability.

[220] One case where the firm might not be able to build the premium into its fees is where liability insurers risk-rate professional firms based on, say, prior claims experience. If a particular firm is in a high risk category, it will pay higher insurance premiums. If the market for professional services is competitive, the firm will not be able to simply pass these higher premiums on to clients in the form of higher fees. Prospective clients could take their business to firms with lower risk ratings who pay lower premiums.

A sophisticated client contracting for professional services can either insist that the professional firm carry a certain level of liability insurance or make its own insurance arrangements. But it might never even occur to many unsophisticated clients that there is a risk they will suffer a loss through professional malpractice. Even if they appreciate that there is such a risk, they might not appreciate that there is a further risk that the firm will not have sufficient assets or liability insurance to compensate them should the loss materialize. Thus, if a professional firm does not purchase adequate liability insurance, unsophisticated clients might not realize they are exposed to a risk against which it would be prudent to insure. This raises the issue whether allowing professionals to practise in limited liability firms might impair their incentive to purchase appropriate levels of liability insurance.

iii. Limited liability and mandatory insurance

It is a fairly simple matter to ensure that unsophisticated clients with moderately large claims against a professional firm would not be prejudiced by the fact that it is a limited liability firm. The solution lies in robust mandatory insurance requirements. In fact, if the level of mandatory insurance for professionals practising in limited liability firms is higher than for professionals practising in unlimited liability firms, it will often be less risky for an unsophisticated client to deal with a limited liability firm than an unlimited liability firm.

Alberta lawyers, for example, are currently required to carry at least $1 million in liability insurance.[221] Suppose that it was made a condition of lawyers' practising in a limited liability firm that the firm must maintain at least $5 million in liability coverage. A client with a $2 million malpractice claim against a relatively small firm might well stand a better chance of being fully compensated if the firm is a limited liability firm with $5 million coverage than if it is an unlimited liability firm with $1 million in coverage. It also seems probable that the great majority of malpractice claims against law firms by unsophisticated clients will be for less than $5 million. Therefore, if limited liability law firms were required to carry that much insurance, unsophisticated clients would generally incur no more risk in

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[221] Although each lawyer in a firm must carry $1 million in liability insurance, the coverage is not cumulative. If each member of a 10-lawyer firm has $1 million coverage, the firm's total coverage for any given malpractice liability is $1 million, not $10 million.

dealing with such a firm than they would in dealing with a traditional partnership.

iv. Limited liability where potential damage exceeds realistic mandatory insurance levels

Although mandatory minimum insurance requirements can play a very useful role in protecting unsophisticated clients of limited liability professional firms, they are not a panacea. In particular, there are practical limits on how high the mandatory minimums can be set. For example, while we can readily imagine the mandatory minimum for limited liability law firms being set at $5 million, we find it more difficult to imagine them being set at, say $25 million.[222] In other words, professional firms could occasionally face malpractice liabilities for amounts in excess of mandatory insurance coverage. Thus, it is necessary to consider how limited liability might affect professional firms' incentive to insure for amounts in excess of the mandatory minimum. The short answer, we suggest, is that in some circumstances limited liability firms would have a tendency to purchase less liability insurance than they would if they were unlimited liability firms.

The wealth a firm's members collectively have at risk will influence the amount of liability insurance they will prefer to buy, *given its price*.[223] If the largest malpractice liability the firm can incur is less than or equal to the wealth its members collectively have at risk, they will probably prefer coverage for the full amount of their potential liability ("full coverage").[224] Suppose now that nothing changes except that the firm members' wealth at

[222] We are not saying that $25 million, or even some larger figure, would necessarily be an inappropriate mandatory insurance requirement for large limited liability firms. We are saying that we find it hard to imagine that the requirement would in fact be set that high. A number of US states impose mandatory minimum insurance requirements on limited liability professional firms that are based on a multiple of the number of professionals in the firm. If strictly applied, such an approach could lead to very robust mandatory insurance requirements for large firms. However, states that base the insurance requirement on a multiple of professionals in a firm tend to cap the requirement at a fairly modest level. California, for example, imposes a mandatory insurance requirement on LLPs of $100,000 per professional with a floor of $500,000 and a ceiling of $5 million for accountants and $7.5 million for lawyers: Cal. Corp. Code §16956 (West Supp. 1998).

[223] Keeton & Kwerel 1984; Shavell 1986, *passim*; Shavell 1987 at 240-41.

[224] We are assuming that insurance is available and the price is a reasonable approximation of the actuarially fair premium: see note 218, above.

risk decreases.[225] As their wealth at risk decreases, the value of any given level of insurance coverage decreases as well, because they have less to lose. On the other hand, an insurer's expected cost of providing any given level of insurance remains constant, because the insured's level of wealth at risk does not affect the insurer's obligation to pay.

Assuming that the firm's members are risk averse, if their wealth at risk does not fall too much below their maximum potential liability, they will still find it worthwhile to purchase full coverage. If their wealth at risk keeps dropping, however, there will come a point where they no longer consider it worthwhile to purchase full coverage, even though they are risk averse. If their wealth at risk drops still further, there may finally come a point where their preferred level of insurance coverage (given the cost of insurance) is zero. The implication of this is that, if left to their own devices, the members of a limited liability firm may prefer to purchase considerably less insurance coverage than they would purchase if they had unlimited personal liability for the firm's malpractice obligations.

Of course, many factors will affect the dynamics of a professional firm's decision whether to purchase liability insurance at all, or how much to purchase if it decides to purchase any. An obvious constraint is how much insurance insurers are willing to provide. Other factors would include the relative riskiness of different firm members' practices; the probability of incurring liabilities of various magnitudes; the relative wealth of different members of the firm; how much wealth is actually left in a limited liability firm; and so on. The basic point, however, is that in certain circumstances limited liability could have a substantial negative effect on a firm's, or more precisely, its members' incentive to purchase liability insurance for amounts in excess of the mandatory minimum.[226]

Again, however, there are countervailing considerations. It should be noted that the higher the mandatory minimum, the more likely it is that a

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[225] Wealth at risk could decrease because the firm members' collective wealth is decreasing: they are getting poorer. The more interesting possibility, though, is that their collective wealth is stable, but some of that wealth is shielded from liability by the interposition of a limited liability firm.

[226] See e.g. Murphy 1995 at 217-18; Fortney 1997 at 754-56, where the incentive for limited liability firms to underinsure is discussed in the context of an argument that limited liability firms will tend to be thinly capitalized.

client who might suffer a loss for an amount greater than that minimum will be sophisticated. The sophisticated, risk averse client will understand the role of insurance and will appreciate that the professional firm might or might not have adequate liability insurance to cover the client's potential loss. The client might require the firm to provide proof of insurance. Alternatively, the client might be able to buy first party insurance against the relevant risk. In either case, the sophisticated client will understand that the price it pays for the professional service should reflect the allocation of risk as between the parties, which includes the firm's ability to satisfy any liability it may incur to the client.

v. Risk allocation where (adequate) insurance unavailable

We have already mentioned several times that unlimited liability only becomes a matter of urgent interest to members of professional firms when they face a realistic prospect of incurring malpractice liabilities that greatly exceed available insurance coverage. It is easy to appreciate why professionals who cannot obtain adequate liability insurance might wish to limit their personal exposure to personal liability by practising in a limited liability firm. That the affected professionals might prefer to limit their liability in this fashion, however, does not establish that it is appropriate to allow them to do so. To the extent that limited liability shields the personal assets of innocent members of a professional firm against huge, uninsurable claims, it increases the risk that claimants will suffer uncompensated losses. Given that the choice is between imposing the loss on the innocent members of the firm or the innocent victims of a firm member's malpractice, perhaps it is fairer or otherwise more appropriate to impose it on the former.

Where economic activities carried out by an agent on behalf of a principal[227] impose a risk of harm on outsiders, imposing vicarious liability on the principal might be justified as a means of internalizing costs (or risk) that would otherwise be externalized. This sort of rationale might be advanced in support of the proposition that innocent members of a professional firm are better bearers of uninsurable risk than malpractice victims would be:

> Firm partners stand to benefit from activities of other firm members and agents. This justifies the imposition of vicarious liability on principals because principals benefit through their agents' acts and should bear, jointly and severally with

[227] We are using the terms "agent" and "principal" in a broad sense here.

> agents, the liability created by agents' misdeeds. On the other hand, a limited liability rule allows firm principals to avoid costs associated with acts or omissions of other firm actors by allowing the firm principals to externalize the costs of doing business. . . In this sense, tort liability can be viewed as a "cost of the enterprise that limited liability transforms into an externality borne by persons not associated with it. . ."[228] In the case of limited liability law firms, liability falls on the shoulders of tort victims when firm and tortfeasor assets [and insurance] do not satisfy tort claims. Therefore, limited liability allows firms to shift to others some of the costs of economic activity, resulting in economic inefficiency and offending one's sense of fairness.[229]

On the other hand, if a professional firm is providing services that carry a risk of huge, uninsurable malpractice liabilities, it is arguable that neither efficiency nor fairness necessarily demands that the innocent members of the firm bear the uninsurable risk. The argument goes back to the point that we made in subdivision (i) that although persons who suffer losses through professional malpractice are often characterized as "tort" claimants, their predicament may not present a classic case of externalization of risk. This is because the "tort" victims of professional malpractice are probably paying, either directly or indirectly, for the relevant professional service. Thus, the issue is whether they are getting the optimal bang for their professional service buck, rather than a problem of internalizing risk that would otherwise be externalized. The argument, in a nutshell, is that where a professional firm faces an appreciable risk of incurring huge, uninsurable liabilities, it is quite likely that the firm's members will be more risk averse than the potential malpractice claimants. In this context, unlimited liability of the firm's members for the potentially huge liability amounts, in effect, to a risk averse party insuring a risk neutral party against loss. This would be an odd form of insurance, to say the least.[230]

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[228] Here the author cites Blumberg 1986 at 616.

[229] Fortney 1997 at 752-53. Professor Fortney's argument, it should be noted, is not directed specifically to uninsurable risk. For a similar argument directed specifically at the situation where firms cannot obtain adequate insurance, see Murphy 1995 at 232.

[230] The argument that is made below emphasizes two points: (1) that in the case of uninsurable liabilities the members of the professional firm may well be risk averse while the potential victims are risk neutral; and (2) that the potential malpractice victims would have to pay, either directly or indirectly, for the benefit of the implicit guarantee provided by unlimited liability. For an argument that relies on the first point but not the second, see Leebron 1991 at 1630. Leebron argues that the case for imposing unlimited liability for corporate torts on the shareholders of closely held corporations is not as compelling as it is often made out to be:

In the case of publicly held corporations [that commit a tort that causes a large loss],

(continued...)

To illustrate the argument, we employ a hypothetical in which a professional firm is engaged to provide services to a large commercial client with sophisticated managers. There is presumed to be appreciable risk that the client company could suffer a loss for which the firm would be liable and which would substantially exceed the liability insurance that is available to the firm. The hypothetical is based on an engagement involving a large client company because such an engagement seems much more likely to give rise to the potential for uninsurable liability than an engagement involving a consumer client or a small commercial client.

Our hypothetical supposes that a 100-member professional firm simply cannot get more than $25 million in liability insurance. The total wealth of the firm's members is $25 million, of which $5 million consists of the value of the firm and $20 million consists of firm members' personal assets.[231] The firm is engaged to provide professional services to a publicly traded, widely held company. Given the amount at stake for the client company in the matter to which the professional services relate, it is conceivable that a negligent act or omission by a member or employee of the firm could result in the company suffering a $100 million loss.[232] The impact of a $100 million loss on the client company might fall into one of two categories depending on just how large the company is: (1) a disappointing charge against quarterly earnings (a Type 1 risk); or (2) a catastrophe that would throw the company into bankruptcy and make its shares worthless (a Type 2 risk).

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[230] (...continued)

> the large number of shareholders allows the loss, and hence the risk, to be spread among many individuals. Thus shareholders are probably better risk bearers than tort victims when the individual injuries are very serious, and probably at least as good risk bearers when the injuries are not.
>
> This will not be the case with closely held or one-person corporations. Particularly where the potentially bankrupting tort consists of numerous small injuries . . . [u]nlimited tort liability will concentrate these injuries on a small number of shareholders. Because their individual loss will be extraordinarily large, perhaps approach their wealth, the risk will be large and a high discount rate will be applied to expected returns. This allocation of risk will be socially inefficient, since the risk aversion of the victims to the damage caused is smaller.

[231] For convenience, we make the unrealistic assumption that the total wealth of the firm's members could be handed over to creditors if the members' assets were to be liquidated for that purpose.

[232] It is possible that the client company or investors could purchase some sort of first party insurance, but we assume here that they cannot. Thus, the client company and the investors will be self-insuring for any portion of the loss that they cannot recover from the professional firm.

At the outset of the engagement, both the firm and the managers of the client company know that there is a non-negligible risk that a wrongful act or omission by one of the firm's members or employees could cause the company to suffer the $100 million loss. Since the potential loss substantially exceeds the maximum market insurance that is available, the risk of the uninsurable portion must be allocated in some fashion between the members of the professional firm and the client company. Where the size of the company creates a Type 1 risk (a disappointing charge against earnings) it is convenient to treat the risk allocation issue as if the company were a very wealthy individual.

For a Type 2 risk, however, where the loss would bankrupt the company, treating the company as a single wealthy individual is unhelpful. Instead, it is more instructive to abandon the fiction that the company is one wealthy individual, and to consider it as being comprised of the many individuals who would lose their investment in the company if it were to go bankrupt. Thus, for a Type 2 risk, we look at the issue as being the allocation of risk between the members of the professional firm and the many thousands of individuals who have invested in the client company, either directly as shareholders or indirectly through mutual funds, pension funds and so on.

For both the Type 1 risk and Type 2 risk it is useful to consider what sort of allocation of risk the parties might agree to *if* they could bargain explicitly about the matter beforehand.[233] Would they be likely to agree to an allocation of risk that approximates the allocation achieved by limited liability? Or, on the contrary, would they be more likely to agree to the allocation of risk achieved by unlimited personal liability of all the firm's members?

We should be specific about the allocation of risk achieved by limited and unlimited liability, respectively, under the hypothetical facts. The

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[233] In fact, in the Type 1 case it may well be practical for the parties to bargain directly over the allocation of risk, since the relevant parties are the members of the professional firm and the client company, *per se*. In the Type 2 situation, where we are concerned with the allocation of risk as between the professional firm and the many individual investors in the client company, the latter will not be in a position to bargain explicitly over the allocation of risk. However, we can still consider what sort of allocation of risk the investors might agree to if they could bargain explicitly about the matter, or what sort of bargain they might instruct the company's managers to make on their behalf.

common ground is that there is a risk that a negligent error by a member or employee of the firm will cause the client company to suffer a $100 million loss. If such a loss were to materialize, it would be allocated as follows under the two liability regimes:

- under *limited* liability $25 million would be covered by the firm's insurance, $5 million would come from the liquidation of the firm, and $70 million would be borne by the client company or investors in the client company;[234]

- under *unlimited* liability, $25 million would be covered by insurance, $5 million would come from the firm, $20 million would come from the members' personal assets, and $50 million would be borne by the company or the investors.

It is worth emphasizing that even where the firm's members have theoretically unlimited liability, the company and its investors must bear the risk of losing at least $50 million because the total wealth of the firm's members plus the available insurance only adds up to $50 million.

The professional firm's members are likely to be highly risk averse to the prospect of losing all their wealth. Therefore, if they were asked to voluntarily assume such a risk, they would demand substantial compensation for doing so. Suppose, for example, that the firm's members believe there is a 1% probability that one of its members or an employee will make a calamitous error that will cause the client to suffer a $100 million loss for which the firm would be liable. The client company's expected loss is $1 million (1% of $100 million), but the firm members' expected liability cost is less because of their (relatively) limited wealth. If the firm members' personal assets, $20 million in total, were answerable for a $100 million liability, their total expected loss (leaving aside their interest in the firm, which will be vulnerable under either liability regime) would be $200,000 (1% of $20 million). *If* they were risk neutral with respect to such a loss, they would be prepared to accept the risk of loss for a payment (probably in the

[234] We ignore the amount that would come from the personal assets of the members of the firm (or its employees) who are personally implicated in the wrongful acts or omissions. The assets of that handful of individuals are likely to be insignificant relative to the size of the loss and the other sources of compensation.

form of an increment to their professional fee) of just over $200,000. However, since they are in fact highly risk averse, they will require considerably more than $200,000 to voluntarily accept the risk.[235]

In the case of a Type 1 risk, the client company is so large that it is effectively risk neutral with respect to a $100 million loss. Being risk neutral, the company is effectively in the same position as an insurer with respect to the potential loss. If the company and the professional firm bargained explicitly over the allocation of risk, they could be expected to agree that the firm's members would *not* be liable for an amount in excess of the firm's liability insurance and the firm's assets.[236] This is a consequence of the company's being risk neutral with respect to the potential loss, while the firm's members are risk averse. The value of the professional firm members' personal liability to the risk neutral company is no more than $200,000: the probability of loss multiplied by the value of the members' personal assets. But the firm's members are risk averse and will demand much more than $200,000 to accept personal liability. Therefore, there is no scope for a mutually satisfactory bargain whereby the company pays the firm's members to assume the risk of losses above the amount of the available insurance. Therefore, the argument goes, limited liability is fair in this context because it approximates an allocation of risk that the professional firm and the company could be expected to arrive at if they bargained explicitly over the allocation of risk.

The Type 2 risk is more interesting. If the client company were treated as an individual, it would undoubtedly be risk averse with respect to a $100 million loss that would bankrupt it. However, as mentioned earlier, for a Type 2 risk the fiction that the company is an individual is unhelpful. It is more appropriate to look at the matter from the perspective of the many individual investors with a stake in the company.[237]

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[235] As discussed earlier, the premium they would require would depend on just how risk averse they are.

[236] We interject a reminder that we are assuming here that the client is satisfied that limited liability will not materially impair the firm's incentives to provide the quality of service that the client is paying for.

[237] In truth, there will be other stakeholders in the company, notably managers, who will be more risk averse than its shareholders: see e.g. Mayers & Smith 1982 at 283-84; Easterbrook & Fischel 1985 at 107-08; Hansmann & Kraakman 1991 at 1908-09. Unlike passive investors (continued...)

As previously noted, these individual investors will have no opportunity to reach an explicit bargain with the professional firm regarding the allocation of risk. Nevertheless, in considering whether the risk allocation implicit in limited liability is fair, it is still useful to consider whether it approximates an allocation of risk that the investors would be likely to agree to if they could in fact bargain over it. A slightly different way of looking at it is to ask the following question. If the investors were fully informed about all relevant factors, would they want the company's managers to pay the professional firm's members the premium the latter would demand to assume unlimited personal liability for the potential loss?[238]

When economic or financial theorists consider how publicly traded, widely held companies make investment (or expenditure) decisions, they generally assume that individual investors in such companies will be risk neutral, because they can effectively "diversify away" risk by holding a diversified portfolio of investments. As was discussed earlier, any given individual is likely to be highly risk averse with respect to a prospective loss that represents all or most of their wealth, while the same individual is likely to be effectively risk neutral with respect to a loss that represents a small fraction of their total wealth. Given that an investor of ordinary prudence will hold a diversified portfolio of investments,[239] the value of their investment in a particular company should represent only a small proportion of the total value their investment portfolio.

The typical diversified investor in the company facing the potentially catastrophic $100 million loss should be effectively risk neutral with respect

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[237] (...continued)
with diversified holdings, managers are likely to have considerable "human capital" tied up in the company, which they could lose if the company were to become bankrupt. It is possible that risk averse managers would prefer an arrangement in which the members of the professional firm bear the uninsurable risk, even though risk neutral investors would prefer the company to bear the risk. The company's managers might be tempted to use the company's money to pay the implicit premium the professional firm's members would demand to assume unlimited liability. If they do so, however, the managers would not necessarily be acting in the best interest of diversified shareholders.

[238] Or, to put it in even more general terms, would a well-diversified investor want the managers of each of the companies in which the investor has invested to enter into this sort of bargain in this sort of circumstance?

[239] Nowadays, of course, individual investors often achieve such diversification by purchasing equity mutual funds, rather than by buying shares of individual companies.

to their investment in the company. What sort of arrangement would this investor want the company's managers to make with the professional firm regarding the allocation of risk of loss? In particular, would an informed investor want the managers to use the company's funds to pay the premium that the professional firm's (risk averse) members would demand to agree to unlimited liability? In all likelihood, the investor would not want the managers to do so, because it would not maximize the investor's expected return from their investment in the company. The investor wants the managers to make risk neutral investment and expenditure decisions. As already discussed, a risk neutral actor would not pay more than $200,000 for the "guarantee" provided by the firm members' unlimited liability.[240] Paying the premium the professional firm's risk averse members will demand to accept unlimited liability would not maximize investors' expected returns from their investment.

Thus, even where the client company's potential loss would be catastrophic for the company, limited liability of the professional firm's members arguably achieves a reasonable approximation of the allocation of risk that rational, fully informed investors would prefer the company's managers to agree to if the risk was allocated through explicit bargaining. Therefore, in the hypothesized situation, limited liability arguably achieves a reasonable and fair allocation of risk as between the professional firm's members and investors in the company.[241]

We would not argue that it is never appropriate for the members of a professional firm to bear the risk of uninsurable loss. However, given that professional firms are most likely to be exposed to uninsurable liability when providing services to large companies, it seems reasonable to conclude that

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[240] The $200,000 figure, it will be recalled, is the total value of the firm members' personal assets ($20 million) multiplied by the 1% probability that the company will incur the loss for which those assets would be answerable.

[241] Our hypothetical assumes that the professional firm simply *cannot* get malpractice insurance for the full amount of the firm's potential liability. However, a similar argument to the one developed in the text could be made even if professional firms could get malpractice insurance for the full amount of a large potential liability, but the insurance was very expensive. Because of imperfections in the insurance market – imperfections that might be caused or exacerbated by onerous liability doctrines (see Priest 1987) – the premium for a given level of professional liability insurance might greatly exceed the actuarially fair premium. In such a situation, risk neutral clients could probably maximize the bang for their professional service buck by dealing with limited liability professional firms that do not purchase as much liability insurance as might theoretically be available to them.

limited liability will often achieve a satisfactory allocation of uninsurable risk. Moreover, if the allocation of risk implicit in limited liability is not acceptable to the client company's managers (who are likely to be more risk averse than its diversified shareholders), the latter can either require a contractual guarantee from the firm's members or take their business to another professional firm.

e. Limitation of Liability and Competition

We noted earlier that it has been suggested that one explanation for why certain professionals have historically been required to practise in unlimited liability firms is that professionals themselves considered it "ungenteel" to practise with limited liability.[242] Another suggested explanation for professionals' historical "acquiescence" in the "imposition" of unlimited liability focuses on the self-interest of the affected professionals. It is suggested that professionals have historically welcomed unlimited liability because it creates a barrier to entry that allows professional firms to earn "rents" (uncompetitively high returns):

> Currently, in many jurisdictions, most firms have the freedom to choose liability rules [i.e. limited or unlimited liability]. This freedom, however, is not universal; some firms have no choice. For example, in service professions such as accounting, law and medicine, owners of firms typically are forced to accept unlimited liability . . . Why should any jurisdiction mandate a liability rule? What are the effects of these rules? . . . One potential explanation lies in an externalities argument: a public-interest approach. . . In our view, these public-interest arguments are incorrect and are refuted by the available data. In particular, we advance a private-interest explanation for mandated unlimited liability rules: Such rules reduce the ability of firms to enter the capital market, increase costs, and reduce competition; as such, unlimited liability facilitates local monopolies, protecting the rents of these firms.[243]

The "available data" the authors of the foregoing passage have in mind comes from the Scottish banking industry of the eighteenth and nineteenth centuries and, more relevantly for our purposes, the American legal industry of more recent years. With respect to law firms, the authors argue that enforced unlimited liability, "by raising the cost of ownership rights

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[242] See text at note 5 above.

[243] Carr & Mathewson 1988 at 767.

discourages investment in the firm, causing legal firms to be inefficiently small."[244]

A similar argument has been advanced in the context of audit services. It is argued that forcing auditors to provide their services through unlimited liability firms creates barriers to entry to (or an incentive to exit from) the audit market. The effect of these barriers is to lower the net value of audits to the shareholders of the audited companies:

> (2) The way unlimited liability manifests itself as a barrier to entry is to prevent . . . large (wealthy) firms from entering the audit market. Phrased differently, wealthy audit firms who are currently in the market under unlimited liability may exit unless limited liability becomes an option. Removing the unlimited liability barrier increases competition in the market (relative to what it [would] be if unlimited liability were retained) and leads to lower equilibrium audit fees. (3) Aggregate shareholder wealth will increase with the adoption of limited liability.[245]

The author of this passage finds some anecdotal support for his conclusions in the reaction of some US auditors to a proposal to allow auditors to practice in ordinary corporations:

> . . . auditors have not been unanimous in their support for incorporation: the board of directors of the AICPA delayed the referendum on changing its code of ethics to allow for incorporation because of concern that it would not be approved. This is consistent with some auditors believing that their profits may decline once incorporation becomes an option.[246]

For our part we would not put a great deal of emphasis on the argument that allowing professionals to practice in limited liability firms might make the relevant markets more competitive and thus allow consumers to get more bang for their professional services buck. In one respect, the positive effect of

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[244] *Ibid.* at 779. The validity of the inferences the authors draw from their data regarding US law firms is questioned by Gilson 1991 and defended in Carr & Mathewson 1991. Gilson, it should be noted, does not explicitly contest Carr and Mathewson's hypothesis about the effect that enforced unlimited liability might have on competition. Rather, he contests their conclusion that data about law firms provides any empirical support for their hypothesis: "Rather than a change in liability status causing better economic performance, as Carr and Mathewson posit, it is more likely the case that, for law firms, better economic performance caused the change in liability status:" Gilson 1991 at 421.

[245] Dye 1995 at 105.

[246] *Ibid.* at 78. Of course, it is also consistent with other, more principled, explanations for some auditors' opposition to incorporated audit practice.

limited liability professional practice on the competitiveness of the market for professional services is likely to be similar to its potential negative effect on the quality of professional services: in a word, small. We have concluded that the negative effect of limited liability on the overall quality of professional services is likely to be minimal. Similarly, we suspect that any positive effect on the net value of professional services to consumers because of increased competition would also be quite small. But it is worth keeping in mind the possibility that limited liability may make the relevant markets more competitive.

4. Recommendation

We summarize our views on the issue whether professionals should be permitted to practise in limited liability firms in the following propositions:

- While it is possible that limited liability for malpractice liabilities will have some negative effect on professional firms' incentives to take care, we believe this effect would be minimal. For the great majority of engagements, we do not believe that limited liability would make any difference to the firm members' incentives to take care in the provision of the relevant professional services.

- Insofar as allocation of risk is concerned, the potential for inappropriate shifting of risk to unsophisticated clients can largely be eliminated through robust mandatory insurance requirements. The most problematic risk allocation issue arises in engagements where the potential loss is so large that full commercial insurance coverage is not available. In such engagements, the allocation of risk implicit in limited personally liability may often approximate the allocation that rational, informed parties would agree to in any event if they had an opportunity to allocate risk through explicit bargaining.

- As discussed in section 2, above, we cannot think of any good reason to distinguish between professionals and other enterprises with respect to limited liability for ordinary debts. Moreover, it seems pointless to prevent professionals from practising in firms that provide limited liability with respect to ordinary debts when they can easily achieve the same result through the device of management corporations. Therefore, if, as we recommend, professionals are permitted to practise in firms that provide limited liability with respect to *malpractice liabilities*, we see no reason why such firms should not also provide limited liability for contract debts.

RECOMMENDATION No. 1

(a) Alberta professionals who are currently unable to practise in limited liability business organizations should be permitted to do so, subject to the restrictions and conditions set out in following recommendations.

(b) Subject to the exceptions set out in following recommendations, limited liability should apply to all obligations of the organization, not just to "malpractice liabilities."

D. Conditions of Professional Practice in Limiteds

1. Minimum Insurance or Similar Requirements

From what we have already said in section C, it will be obvious that we believe that professionals who wish to practice in limited liability firms should be required to provide a minimum level of liability insurance. This, of course, is a foregone conclusion for professionals who are already subject to mandatory insurance requirements even when they practice with unlimited liability.

There is a question of who should be responsible for establishing the mandatory insurance requirements for professionals who wish to practice in limited liability firms. One perspective is that the government or some independent agency should set the levels of mandatory insurance. This is a common feature of US legislation that allows professionals to practise in limited liability firms; the minimum insurance requirement is generally specified in the relevant LLP statute.[247] This approach might be justified on the basis that since the legislature confers the privilege of limited liability practice, it is appropriate for the legislature, or at least for some independent government agency, to determine the conditions under which the privilege may be exercised.

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[247] See Wolfram 1997 at 392, note 111, referring to state statutes that specify minimum insurance requirements for LLPs.

Where a profession is self-governing, however, establishing the levels of mandatory insurance for limited liability firms could be viewed as being much like the other regulatory functions that the legislature delegates to the relevant self-governing body. Presumably, one of the main reasons for delegating responsibility for the regulation of a profession or occupation to its members is a perception that they will have a comparative advantage over government departments or an independent agency in determining and enforcing appropriate standards. In the present context, the governing bodies of the relevant professions might be expected to have an advantage in obtaining and evaluating information that is relevant in determining the appropriate levels and types of mandatory liability insurance. This would include information about the magnitude and frequency of claims, their relationship, if any to firm size and area of practice, the availability and cost of liability insurance, and so on.

Another consideration is that determination of minimum insurance requirements for members of the relevant professions is currently left to the relevant self-governing bodies. If this function is delegated to the self-governing bodies for professionals practising in unlimited liability firms, it seems logical to do so in the case of limited liability firms. Thus, we conclude that it would be appropriate for the legislature to delegate the task of setting the level of mandatory minimum insurance requirements for limited liability professional firms to the relevant self-governing bodies.

We note that our conclusion that it would be appropriate to delegate to the relevant self-governing bodies the function of setting the levels of mandatory insurance for limited liability firms is based on pragmatic considerations. Since the legislature has gone to the trouble of creating the self-regulatory edifice, it seems reasonable and cost-effective for the legislature to delegate the task of establishing mandatory insurance levels to the self-regulating body. We should not be taken to be suggesting, however, that it would necessarily be inappropriate for the legislature to reserve to itself or to some independent agency the task of setting or approving the mandatory insurance levels.

Having suggested that the governing bodies of the relevant professions should be delegated the task of setting the level of mandatory insurance coverage for limited liability firms, we now highlight a couple of considerations we think such bodies should take into account in discharging that duty. The first consideration is that there is much to be said for establishing a *higher* limit for professionals who wish to practise in limited liability firms than for professionals who are content to practise with unlimited liability. We think it is an appropriate *quid pro quo* for the ability to shield personal assets from malpractice claims that professionals who desire that benefit be required to have higher insurance coverage than those who do not.[248] Subjecting limited liability professional firms to higher minimum insurance requirements than unlimited liability firms should help allay possible concerns that allowing professionals to practise in limited liability firms will effect an uncompensated transfer of risk from professional firms to their clients.

Obviously, the purpose of minimum insurance requirements is to protect potential victims of malpractice, rather than to protect the professionals themselves. Liability insurance takes on particular importance as a compensatory mechanism when innocent members of the firm are not personally liable for malpractice obligations. Professional liability insurance typically excludes coverage for deliberate or criminal acts, such as fraud. There are obvious reasons for such exclusions, insofar as they would benefit the person who engages in fraudulent behaviour. However, the policy reasons behind such exclusions can be served without denying coverage to the *firm* of which the fraudster is a member or employee. Moreover, the compensatory, public protection goals of mandatory liability insurance coverage clearly would not be served if the firm was automatically denied coverage for claims arising out of fraudulent conduct on the part of one of its members or employees. What needs to be ensured, we think, is that the mandatory insurance coverage is drawn so as to cover the *firm* for malpractice liabilities, even if coverage is denied to the individual member or employee of the firm whose fraudulent or otherwise deliberately wrongful conduct created the liability.

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[248] This is effectively the position in the US, where professionals practising in unlimited liability firms generally are not required to carry any liability insurance. For example, it appears that only one state, Oregon, imposes a mandatory minimum insurance requirement on lawyers: Wolfram 1997 at 394, note 114. On the other hand, professionals practising in limited liability firms are routinely required to satisfy minimum insurance requirements: *ibid.* at 393, note 111.

In this context, it is interesting to consider the exclusions in the existing mandatory liability insurance policy for Alberta lawyers, as provided through the Alberta Lawyers Public Protection Association ("ALPPA"). If applied in the context of a limited liability law firm, the general thrust of the exclusions in the ALLPA policy seems to strike a reasonable balance between the policy of not indemnifying a lawyer against the consequences of their own fraudulent or otherwise deliberately wrongful conduct and the compensatory objectives of mandatory insurance requirements. Coverage is excluded for the following types of acts and omissions by the "individual insured:"

> 3.5 the theft or misappropriation of trust funds . . .;
>
> 3.6 a dishonest, fraudulent or criminal act or omission that does not fall within Exclusion 3.5;
>
> 3.7 a malicious act or omission . . .

The policy, however, preserves coverage for innocent members of the firm, or what it refers to as "additional insureds," except for claims arising from theft or misappropriation of trust funds.[249]

Although the general approach of the ALPPA policy seems appropriate for limited liability firms, we suspect that some adjustments might be necessary to make the coverage consistent with the liability position of the members of a limited liability firm. The ALPPA policy provides protection to the individual lawyers within a firm, rather than to the firm itself. This approach works well where the partners of a firm are all vicariously liable for damages arising from the acts or omission of another member or employee of the firm. But suppose that a member of an LLP engages in fraudulent conduct that causes a client or third party to suffer a large loss for which "the firm" is liable. The fraudster is not covered by the insurance policy. The innocent partners would be covered to the extent they are liable. The trouble is that under the standard language of LLP legislation, the innocent partners would not be "individually liable" for the client's loss. But if the innocent

[249] ALPPA policy, §4.5(a). The additional insureds cannot take advantage of the protection provided by §4.5(a) if they have "concealed or acquiesced or participated in the conduct that has disqualified the Individual Insured:" §4.5(d). Although the innocent members of the firm are not covered where the individual insured has stolen trust funds, the Law Society maintains a separate "assurance fund" that is designed to ensure that clients whose trust funds are misappropriated by a lawyer will be compensated.

partners are not individually liable for the loss, and the insurance policy purports to indemnify individual, innocent partners against liability, it might be argued that they have not incurred a liability for which they require an indemnity. One possible approach might be to adjust the terms of the policy to make it clear that the limited liability firm, as such, is an additional insured.[250]

RECOMMENDATION No. 2
A limited liability firm should be able to practise one of the professions under consideration in this report only if the profession's governing body has established mandatory minimum levels of professional liability insurance coverage to be maintained by such firms.

The governing body of a profession might consider it to be in the public interest to impose requirements on limited liability firms in addition to minimum insurance requirements. These might be ongoing requirements, such as financial responsibility requirements in addition to the provision of a minimum level of insurance. The governing body might also decide to impose one-time requirements for firms that convert from an ordinary partnership to a limited liability firm. The firm might be required, for example, to take specific steps to alert existing clients or creditors to the change in status. It almost goes without saying that the rationale for such requirements would apply to limited liability professional firms that wish to provide professional services in Alberta, regardless of where the firm is formed.

RECOMMENDATION No. 3
The governing body of a profession should have authority to prescribe additional conditions under which a limited liability firm may practise the profession in Alberta, regardless of whether the firm is formed under the laws of Alberta or some other jurisdiction.

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[250] If the firm is an additional insured, there could still be a problem in that the knowledge of the fraudster might be attributed to the firm, especially if the fraudster is a partner, rather than an employee, of the firm. Another approach might be to say that, in the case of LLPs, innocent partners are covered in the same circumstances and to the same extent as they would be covered if they were members of an ordinary partnership.

2. Limited Liability Partnerships or Limited Liability Professional Corporations

We have already discussed that fact that professionals in Alberta, as in other jurisdictions, do not simply want to be permitted to practise in limited liability firms. They wish to be permitted to practise in a specific type of limited liability firm: the LLP. A variety of arguments have been advanced as to why they should be permitted to do so, and as to why a limited liability professional corporation ("LLPC") would not be a satisfactory substitute for an LLP.

Frankly, we are not persuaded that it is necessary for professionals to use LLPs rather than LLPCs. We are, however, convinced of two things. The first is that many professionals would rather practice in LLPs than in LLPCs.[251] The second is that insofar as the public interest is concerned, it does not much matter whether professionals practise in LLPs or LLPCs. That is, to the extent that there are risks involved in dealing with a limited liability firm, the risks need not be any greater if the firm is an LLP than if it is an LLPC. Therefore, given many professionals' heartfelt preference for LLPs over LLPCs, and given that the former do not pose any greater risk to the public than the latter, we recommend that professionals be permitted to practice in LLPs. Of course, this would require amendments to the *Partnership Act* to provide for this new type of business organization, a subject that is discussed in more detail in Chapter 4.

We emphasize that in recommending that professionals be permitted to practice in LLPs, we have taken *no* account of the taxation implications of allowing professionals to practice in LLPs. We are confident that the Government is in a much better position to evaluate such implications than we are.

RECOMMENDATION No. 4
The *Partnership Act* should be amended to provide for the formation of limited liability partnerships under that Act.

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[251] As discussed earlier, professionals in most American states have long been able to practise in LLPCs. Many large professional firms chose not to do so, but jumped at the opportunity to form LLPs.

In the discussion leading up to Recommendation 4 we emphasized that LLPs would be no more problematic than LLPCs from the perspective of protecting the public. But the converse is also true. It would be no riskier for members of the public to deal with an LLPC than to deal with an LLP, assuming, of course, that the two types of business organization provide the same sort of liability shield and are subject to the same safeguards. As discussed earlier, in most American states professionals can practise in LLPs or LLPCs (or LLCs); no matter which type of business organization they choose, the firm's members get the same sort of liability shield against malpractice claims. Since we can see no public policy purpose that would be served by denying shareholders of a professional corporation the same liability shield that is provided to members of an LLP, we recommend that the relevant professional statutes be amended so that professional corporations provide essentially the same liability shield that will be provided by LLPs.

RECOMMENDATION No. 5
Professionals should have the option of practising in a limited liability partnership or a limited liability professional corporation, and each type of firm should provide the same liability shield and be subject to the same safeguards for the protection of persons who deal with the firm.

3. Personal and Supervisory Responsibility for Malpractice

Legislation in other jurisdictions that allows professionals to practice in limited liability firms almost always provides specifically that the liability shield does not protect an individual professional from personal liability for their own negligence or other wrongful acts or omissions. This merely states a result that would usually follow as a matter of general law. As discussed in Chapter 1, the liability shield provided by a limited liability firm protects its owners (partners or shareholders) against *vicarious liability*. That is, the liability shield only deflects liability missiles that would otherwise flow through the firm to the owner by virtue of their status as an owner. It provides no protection against liability missiles that do not pass through the firm, but go straight to the owner because of the owners' own wrongful acts or omissions.

Under the general law, an individual professional who is performing professional services for a client on behalf of a limited liability professional firm will usually owe that client an independent duty of care, quite apart from any contractual duty that the firm owes to the client.Breach of the professional's independent duty of care, in addition to creating a contractual liability for the firm, will create a tortious liability for the individual professional. Nevertheless, situations may arise where it is not beyond debate whether or not a particular professional who is performing services for a client on behalf of a professional firm would owe a common law duty of care to the client. Therefore, it cannot do any harm, and may do some good to state specifically that the professional whose wrongful acts or omissions create a malpractice liability for a limited liability firm is personally liable for the damages along with the firm.

The liability of supervisors is a more interesting question. As mentioned earlier in this chapter, LLP statutes (and American PC statutes) frequently impose what amounts to vicarious liability on supervising partners. The Ontario statute, for example, provides as follows:

> [The liability shield] does not affect the liability of a partner in a limited liability partnership for the partner's own negligence or the negligence of a person *under the partner's direct supervision or control.*[252]

Given that professionals are going to be permitted to practise in limited liability firms, we do not agree that it is appropriate or useful to impose vicarious liability on partners merely because they happen to be supervising the person who is actually guilty of a negligent or otherwise wrongful act or omission. In fact, we think it may be counterproductive to do so.

We continue to have the concern about imposing vicarious liability on supervising partners that we expressed in the issues paper:

> Presumably, it is thought that [vicarious liability] will increase the supervisor's vigilance, and thus help to prevent losses from occurring. But this proposal might have an unintended and deleterious consequence for the overall level of care taken by a firm. It would seem to promote a "watertight compartments" approach to the provision of professional services. Given that direct supervisors are personally responsible for the sins of their subordinates, who would want to be a

[252] *Partnership Act* (Ont.), s. 10(3) [emphasis added]. The great majority of US statutes say "supervision *and* control."

> supervisor? To a certain extent, there could be a divergence of interest between the firm, as a collective, and its individual members. The firm, as a collective, would have an incentive to adequately monitor and supervise. But individual members of the firm would have a disincentive to assume those roles.
>
> Individual members of the LLP would have an incentive to avoid supervisory responsibilities and to know as little as possible about what other members of the firm are doing, so as to minimize the potential for guilt (and personal liability) by association. This might be particularly true of the more senior partners, who would generally have more to lose if found personally liable than would the less senior partners. This might result in supervisory roles being cast upon less experienced partners who are less capable of fulfilling the supervisory role. For this reason, it is arguable that the LLP proposal would have less impact on the overall incentive for the firm and its members to provide services of optimal quality if it *did not* impose liability on partners merely because they occupied supervisory positions.[253]

We believe that it will be more efficacious to impose liability on members of limited liability firms who are negligent in discharging supervisory responsibilities or who are negligent in failing to supervise the persons who are actually doing the work. This is the approach taken in some US states. Maryland's LLP statute, for example, provides that a partner remains personally liable for

> debts and obligations of the partnership that arise from any negligent or wrongful act or omission of the partner or of another partner, employee, or agent of the partnership if the partner is *negligent in appointing, directly supervising, or cooperating with* the other partner, employee, or agent.[254]

We would expressly include negligence in *failing to supervise* the person who actually "did the deed" as a ground for imposing liability. We believe that the approach that we propose will provide more effective incentives for a firm to

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[253] ALRI 1998 at 125. A more detailed analysis of the problem may be found in Fortney 1997 at 732-37, where the following observation is made at 736-37:

> If liability can be imposed on a supervisor, manager, or control person without establishing negligence, then liability appears to be a kind of strict liability imposed for serving in [that] role . . . [Therefore] risk-averse attorneys will probably elect to do less supervising rather than more and to know less rather than more when it comes to working with peers and subordinates. Similarly, wealthy senior attorneys might avoid acting as monitors, mentors, and supervisors simply because those roles could subject them to personal liability for others' acts and omissions. The reluctance of experienced attorneys to train and supervise associates and junior partners can adversely affect the quality of legal services and may hamper the subordinates' professional growth and undermine their loyalty to the firm.

See also Murphy at 215-17.

[254] Md. Code Ann., Corps. & Ass'ns §9-307(c)(1) (Supp. 1998).

provide adequate supervision than an approach that imposes vicarious liability on supervisors.

RECOMMENDATION No. 6
Irrespective of the form of limited liability organization through which a professional firm practises, a partner or shareholder ("member") of the firm should be personally liable for liabilities incurred by the firm because of that member's negligent or otherwise wrongful acts or omissions in the provision of professional service, including negligence in appointing, directly supervising, or failing to supervise another member, employee or representative of the firm in the provision of professional services.

CHAPTER 3. SPECIFIC LLP DESIGN ISSUES

A. Assumptions About the General Nature of LLPs

This section describes certain assumptions that we make about the general nature of LLPs or about the fundamental principles that should govern LLP design. These assumptions provide the foundation for the recommendations contained in subsequent sections of this chapter.

Our basic assumption is that the LLP is a modified ordinary partnership. The principal modification – and in truth it is a fundamental departure from ordinary partnership principles – is the substitution of limited partner liability for the ordinary partnership doctrine of unlimited liability. Obviously, the substitution of limited for unlimited liability requires certain complementary modifications or additions to the rules applicable to ordinary partnerships. Nevertheless, we have assumed that the principles applicable to ordinary partnerships will be modified only to the extent necessary to create the liability shield and to recognize the effect of the liability shield on persons who deal with LLPs.

One example of the application of ordinary partnership principles to LLPs relates to the doctrine that partners are each other's agents. A distinguishing characteristic of ordinary partnerships, as compared with corporations or limited partnerships, is that every member of the partnership is an agent of the firm. Each partner has the power to bind the firm to contracts that fall within the scope of the partner's actual or apparent authority.[255] Similarly, the firm is responsible, that is, vicariously liable, for wrongs committed by a partner acting in the ordinary course of the firm's business, in much the same way that a corporation would be liable for acts of its employees.[256] We assume that this agency principle will apply to LLPs. Of

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[255] *Partnership Act*, ss 7-10. These sections largely reflect common law principles of agency, except that a partner acting on behalf of the firm is acting both as principal and agent.

[256] *Ibid.*, ss 12, 13. The Act says nothing about the firm or its individual partners being vicariously liable for wrongs committed by employees of the firm. Such liability would follow from the common law principle that employers are vicariously liable for their employee's torts.

course, the agency principle will cash out differently in the context of an LLP than in the context of an ordinary partnership, since the partners of an LLP have limited liability for the firm's obligations.

As discussed in Chapter 1, the common law world has traditionally viewed a partnership not as a distinct legal person or "entity" but as a relationship between two or more persons carrying on business in common.[257] The factual relationship of partnership entails certain legal consequences, both as between the partnership's members and as between the members and "outsiders." But these legal consequences fall short of creating that fiction of all legal fictions: the artificial legal person.

One of the implications of the relationship view of partnership is that "partnership property" is the partners' property, since the firm is not a separate legal entity. The partners are co-owners of the partnership property. This contrasts with the position of shareholders of a corporation, who are not viewed as having a direct ownership interest in the corporation's property. Another implication of the relationship view of partnerships is that they are "fragile" business organizations that, technically at least, dissolve and reform upon any change of their membership. These implications are considered in section D below.

B. Who Can Use LLPs?

In Alberta, as well as other jurisdictions, the LLP concept has been promoted by professionals – chiefly accountants and lawyers – for professionals. The original submissions of the Institute of Chartered Accountants and Law Society argued, or rather, assumed that LLPs would be available only to professionals.[258] Ontario's LLP legislation specifies that an LLP "may carry on business in Ontario only for the purpose of practising a profession governed by an Act."[259] LLPs would be similarly restricted under the current

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[257] See Chapter 2, section C.1.a.

[258] It is apparent from discussions we have had with both of these bodies during the course of our project that neither is opposed to the idea of making LLPs available to other enterprises. Rather, they assumed that the partial-shield LLPs contemplated in their respective 1995 submissions to the Alberta government would not appeal to owners of enterprises that can already be conducted through ordinary corporations.

[259] *Partnership Act* (Ont.), s. 44.2.

UK LLP proposals.[260] In contrast, the vast majority of US states allow LLPs to be used by enterprises generally, rather than only by practitioners of certain professions.[261]

We can think of no compelling reason of public policy to restrict the availability of LLPs to certain professional enterprises. Indeed, tax policy aside, we cannot think of any good reason of public policy to restrict the availability of LLPs to members of certain professions. As pointed out in Chapter 2, firms organized as LLPs need not be any "riskier" to deal with than firms organized as corporations, provided that appropriate safeguards are included in LLP legislation.

What of tax policy? As mentioned in Chapter 2, we have not considered taxation issues in recommending that certain professionals be permitted to practise in LLPs; we believe the government is in a better position to assess the tax implications than we are. But suppose, for the purposes of argument, that there are circumstances where the members of a professional firm could lower their total ongoing tax burden by organizing as an LLP rather than an LLPC. Presumably, if ordinary firms could organize as LLPs rather than as corporations, there would be circumstances where they too could lower their total tax burden by adopting the LLP form. That would have revenue implications for government. However, assuming that there may sometimes be a potential tax benefit in adopting the LLP form over the corporate form, it is hard to see what the rationale would be for providing this benefit to professionals and withholding it from other types of enterprise.

Allowing members of certain professions to practise in LLPs while denying that privilege to other enterprises could also have implications for fairness in the marketplace, as recognized by the UK's Department of Trade and Industry:

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[260] DTI 1998, Pt I at 13-14. Although the draft bill is framed so as to restrict LLPs to regulated professions, the DTI's commentary recognized that there is an issue whether such a restriction is necessary or appropriate and solicited "views on the intention to restrict access to regulated businesses:" *ibid* at 13.

[261] California is one of the few states that makes LLPs available only to members of certain professions, in California's case, accountants and lawyers: Cal. Corp. Code §16101(4), (6) (West Supp. 1998). But in California, as in other states, non-professional enterprises can operate as LLCs.

> 4.4 It has been suggested that LLPs should be available to any form of business for reasons of fairness, and in particular so as not to limit access to a commercial benefit to a few businesses which compete (for example for tax advice and consultancy work) with businesses which would be excluded from LLP status because they are not [one of the favoured professions.]

This to us raises a significant point. If one were to take seriously the proposition that the only services that can be provided by LLPs are those which are within the statutory monopoly area of certain professions, then many of the services provided by major accounting firms could not be provided through LLPs. The only services that could be provided by an accounting LLP would be those falling within the definition of "exclusive accounting practice."[262] On the other hand, suppose that accounting firms organized as LLPs are permitted to provide services, such as investment advice or management advisory services, that fall outside the scope of exclusive accounting practice. What would the rationale be for allowing accounting firms to provide investment advice and management advisory services through LLPs while denying that privilege to their non-accounting firm competitors?

Even if allowed to use LLPs, many non-professional enterprises would probably still prefer the more familiar corporate form. Certain aspects of ordinary partnership law, such as the principle that every partner is an agent of the firm, might not appeal to many non-professional enterprises. On the other hand, we suspect that if given the opportunity, owners of some non-professional enterprises would prefer the LLP over the corporation. We briefly consider below why some non-professional enterprises might prefer to be organized as an LLP rather than as a corporation. Again, we do not consider possible tax reasons for such a preference.

The majority of corporations incorporated under a statute such as the *Business Corporations Act* conduct business on a decidedly modest scale, if at all.[263] Nevertheless, like corporate statutes everywhere, the *Business Corporations Act* is designed to deal comprehensively with the sort of internal issues likely to be encountered by large corporations with many shareholders.

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[262] *Chartered Accountants Act*, S.A. 1987, c. C-5.1, s. 1(1)(d).

[263] We say, "if at all", because many corporations are formed not for the purpose of actively carrying on business themselves, but as a conduit for the investment of funds by their shareholders.

The drafters of the *Business Corporations Act* appreciated that a regime designed to address the issues faced by corporations with hundreds or thousands of shareholders will not necessarily be suitable for corporations with a handful of shareholders. If imposed on closely held corporations, mandatory procedures designed to protect the interests of shareholders in widely held corporations might do little more than create inconvenient and expensive formalities.

With the foregoing considerations in mind, some of the *Business Corporations Act*'s procedural requirements apply only to a "distributing corporation"[264] or are relaxed for non-distributing corporations.[265] In addition, shareholders of a closely held corporation may opt out of some of the Act's procedural requirements by entering into a unanimous shareholder agreement.[266] Even in the context of a closely held corporation, however, certain statutory requirements relating to the corporation's internal affairs cannot be ousted by agreement. In the substantive area, directors or officers cannot be relieved of any duty imposed on them by the Act, nor can they relieved of liability for breach of such a duty by contract.[267] The duties that cannot be excluded by contract include the duty of good faith and the duty to exercise due care, diligence and skill.

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[264] A distributing corporation is defined as a corporation that has more than 15 shareholders and any of whose issued shares were part of a distribution to the public: *Business Corporations Act*, s. 1(i). "Distribution to the public" is defined, sort of, in section 2.

[265] For example, section 97(2) requires a distributing corporation to have at least three directors, two of whom must not be officers or employees, but only requires a non-distributing corporation to have one director.

[266] In theory, any corporation can have a unanimous shareholder agreement, but they obviously are more practical for corporations with a small numbers of shareholders. Many of the *Business Corporations Act*'s default procedural rules can be excluded by the articles or a by-law, as well as by unanimous shareholder agreement. But a few of the default rules can be excluded only by unanimous shareholder agreement. This applies to the default rule that the directors' will manage the corporation's affairs (ss 97(1), 140(1)(c), (7)); the default rule that a director can be removed by an ordinary resolution (ss 6(4), 104(1)); the default procedure for directors to disclose potential conflicts of interest (s. 115(9)); the default procedure for the compulsory purchase of non-tendering shareholders' shares following a successful takeover bid (s. 188(3)).

[267] *Business Corporations Act*, s. 117(3). This provision is "subject to section 140(7)," but the latter does not so much relieve the directors of a duty as transfer it to the shareholders who are parties to a unanimous shareholder agreement.

In addition to certain substantive requirements that are mandatory for non-distributing corporations, certain procedural requirements cannot be avoided even by the smallest corporation. For example, although a unanimous shareholder agreement may deprive directors of all of their duties and powers (reserving the duties and powers to the shareholders), a corporation must still have at least one director.[268] Similarly, the shareholders of a non-distributing corporation can dispense with the appointment of an auditor[269] but cannot dispense with the requirement to prepare financial statements, which must be prepared in accordance with generally accepted accounting principles.[270]And every corporation must either hold an annual shareholders meeting or get every shareholder to sign a resolution dealing with all the matters that would otherwise have been dealt with at the annual meeting.[271] Thus, although shareholders of a closely held corporation can avoid many of the administratively onerous procedures that are mandatory for larger corporations, there is a core set of procedural requirements – or "red tape," depending on one's perspective – that cannot be avoided even by the smallest of corporations.

The ordinary partnership is an extremely flexible business organization, insofar as its internal affairs are concerned, and the same thing would be true of the proposed LLP. The *Partnership Act* stipulates default rules that govern the internal affairs of partnerships. If the members of a prospective partnership are content with the Act's rules, they can adopt them simply by agreeing to enter into a partnership. But the *Partnership Act*'s rules regarding the internal affairs of partnerships are merely presumptive rules that apply in the absence of contrary agreement:

> The mutual rights and duties of partners whether ascertained by agreement or defined by this Act may be varied by the consent of the partners.[272]

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[268] *Ibid.*, s. 97(2).

[269] *Ibid.*, s. 157. The resolution dispensing with an auditor requires unanimous consent and is valid for only one year.

[270] *Ibid.*, ss 149(1), 152(1): *Business Corporations Regulation* Alta. Reg. 27/82, s. 9 as am. 187/83.

[271] *Business Corporations Act*, ss 127(1), 136.

[272] *Partnership Act*, s. 21(1).

In other words, the members of a partnership are free to govern their internal affairs with customized rules of their own design. The customized rules could apply to any aspect of their relationship: decision-making;[273] the sharing of profits and losses; duration of the partnership; continuance of the partnership upon the death, retirement or addition of a partner;[274] expulsion of a partner; and so on. Thus, the members of a small enterprise might decide that the LLP form provides greater internal flexibility and requires fewer procedural niceties than would a corporation, incorporated under the *Business Corporations Act*, even when the latter's special dispensations for non-distributing corporations are taken into account.

RECOMMENDATION No. 7
LLPs should be available to enterprises generally, rather than being available only to practitioners of certain professions.

Assuming that LLPs are available to all enterprises, we believe that rules intended to apply to specific professions should be placed in the relevant professional statutes, rather than the *Partnership Act*. This is the current approach with respect to professional corporations: the special rules for professional corporations are placed in the relevant professional statutes rather than the *Business Corporations Act*.[275]

RECOMMENDATION No. 8
Any special rules that are intended to apply specifically to professional LLPs, as opposed to LLPs generally, should be placed in the relevant professional statutes, as is currently done for professional corporations.

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[273] For example, authority to make everyday decisions on partnership matters could be delegated to a managing partner or management committee, and machinery could be provided for selection of the managing partner or the members of the management committee.

[274] A provision in the partnership agreement that the partnership will continue notwithstanding changes in its membership could not prevent dissolution of the partnership as a matter of law. But through appropriate provisions regarding the taking of accounts, assignment of assets, and continuation of the partnership business, the agreement may allow the reconstituted partnership to be treated as if it were the same partnership for most practical purposes.

[275] The only special rules relating to professional corporations in the *Business Corporations Act* relate to corporate names and amalgamation with out-of-province corporations.

C. Conversion to an LLP: Preexisting Obligations

If an ordinary partnership converts to an LLP, it is likely that its members will have obligations under existing contracts. It almost goes without saying that where an ordinary partnership transforms itself into an LLP, the liability shield should only apply to liabilities that arise after the LLP is formed. Moreover, it should not apply to liabilities that arise after the LLP was formed if the liability arises out of a contract that was entered into before the partnership became an LLP. For example, in the context of professional malpractice claims, if the firm entered into an engagement before acquiring LLP status, the partners should be liable on ordinary partnership principles, whether the acts constituting malpractice occurred before or after conversion to an LLP.

> **RECOMMENDATION No. 9**
> **Where an existing partnership becomes an LLP, this should not affect the liability of members of the partnership for liabilities that arose before, or that arise out of a contract entered into before, the partnership became an LLP.**

D. LLPs and the Relationship Theory of Partnership

So far as we are aware, no one has ever argued that the LLP's liability shield should protect the assets of "the firm" itself. On the contrary, it is assumed as a matter of course that the assets of the firm will be available to meet judgments against the firm. The Institute of Chartered Accountants, for example, made the following observation in its 1995 submission to the Alberta government:

> Individual partners found negligent in their duties would still place all of their business and personal assets at risk, as is the case today. *All partnership assets and insurance remain at risk.* However, LLP legislation would ensure the personal assets of the negligent auditor's partners, who did not provide any services to the failed client, would not be placed at risk.[276]

Thus, we take it as uncontroversial that the assets of "the firm" should be available to creditors even where some or all of the partners are shielded from personal liability. The problem is how to implement this principle in the

[276] ICAA 1995 at 17. [Emphasis added.]

context of the relationship theory of partnership. What are “the firm’s” assets? Indeed, assuming that “the firm” is liable for some obligation, how do you identify “the firm” that is so liable?

The problem can be illustrated by considering subsections 10(2) of Ontario’s amended *Partnership Act*:

> (2) Subject to subsection (3), a partner in a limited liability partnership is not liable, by means of indemnification, contribution, assessment or otherwise, for debts, obligations and liabilities of the partnership or any partner arising from negligent acts or omissions that another partner or an employee, agent or representative of the partnership commits in the course of the partnership business while the partnership is a limited liability partnership.

We assume that the Ontario legislature did not intend to protect “the firm’s” assets from malpractice liabilities. That is, we assume that the Ontario legislature intended that the partnership property would be available to satisfy the firm’s malpractice liabilities. But it is not self-evident that the provisions actually achieve this result.

The problem is that under the relationship theory of partnership, “partnership property” is not the property of some legal entity, the firm. It is the individual partners’ property:

> The expressions partnership property, partnership stock, joint stock, and joint estate, are used indiscriminately to denote everything to which the firm, or in other words *all* the partners composing it, can be considered to be entitled as such. . . It is often a difficult matter to determine what is to be regarded as partnership property, and what is to be regarded as the exclusive property of each partner. The question, however, is of importance not only to the partners themselves, but also to their creditors; for . . . if a firm becomes bankrupt, the property of the firm and the separate property of each partner have to be distinguished from each other, it being a rule to apply the property of the firm in the first place in payment of the creditors of the firm, and to apply the separate properties of the partners in the first place to the payment of their respective separate creditors.[277]

The fundamental point is that references to partnership property in cases and the *Partnership Act* are simply shorthand references to property that the members of the partnership own as co-owners.

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[277] Lindley 1878 at 642. As to the point regarding bankruptcy, see *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, s. 142(1) .

If the partnership property is really the partners' property, for creditors of the partnership to get at that property, the partners themselves must be liable *to some extent*. If they are not liable at all, how can the creditor get at their interest in the partnership property? Therefore, we think that LLP legislation should be drafted to make it clear that, rather than having *no liability* for the LLP's obligations, its members are responsible for those obligations only to the extent of their interest in the partnership property.

Acme Professional Partnership

Acme is a professional partnership. In 1999 it consists of 50 partners, including Bob. In 1999 Bob commits a blunder while working on a major file for Sue. The blunder goes unnoticed. In 2000 ten new members join the firm. In 2002 Bob's blunder manifests itself and Sue suffers a large loss. The loss easily exceeds the amount of any applicable liability insurance plus Bob's personal assets. Sue, who had long since ceased to be a client of the firm, sues. There is no doubt that she has a good claim.

The point discussed above arises from the fact that since partnerships are not legal entities, they do not own property: the partners own the property. The problem we are about to discuss is also a consequence of the relationship theory. The easiest way to present the problem is in the form of a hypothetical that assumes that a partnership has incurred a malpractice liability in an amount that exceeds the combined total of the personally responsible partners' assets plus any applicable liability insurance.[278] The "Acme" firm could be either an ordinary partnership or an LLP. We first consider the problem on the assumption that Acme is an ordinary partnership; then we consider it on the basis that it is an LLP. It will be seen that rather than creating wholly new problems, limited liability tends to amplify problems inherent in the relationship theory. The problems are far from insoluble, but they do call for some thought. In the ensuing discussion, the Acme firm as constituted immediately after a particular event is identified by the year of the event: e.g., the "2000 firm" refers to the firm as constituted immediately after ten new partners joined the firm.

Suppose that the assets of the 2000 firm (consisting largely of accounts receivable and the value of unbilled work in progress) would be sufficient to satisfy, or at least make a substantial dent in, Sue's claim. The question is

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[278] The same general considerations would apply to an ordinary contract debt. We use the malpractice example, however, to indicate that the problem could as easily arise in the context of a partial shield LLP as a full shield LLP.

whether Sue has any claim against the assets of the 2000 firm. Is the 2000 firm the same firm as the 1999 firm? If not, does the 2000 firm inherit the liability of the 1999 firm for Bob's blunder?

Where Acme is an ordinary partnership, rather than an LLP, identifying the assets of "the firm" is somewhat less important, since there is no doubt that all the members of the 1999 firm are personally liable for its debts. But even here the issue is not without potential importance. In a bankruptcy situation separate creditors of each partner would have priority over partnership creditors to that partner's separate property, while partnership creditors would have priority over separate creditors of a particular partner to that partner's interest in the partnership property.[279]

In all likelihood the 50 individuals who were members of the 1999 firm and are members of the 2000 firm regard themselves as having been in the same partnership throughout the relevant period. And in a commercial sense, indeed they have been. Strictly speaking, though, in law there is not one continuing "Acme" partnership. There are two different partnerships during the relevant period, both called Acme. The change in membership in 2000 terminated one partnership, consisting of 50 partners, and created a new partnership, consisting of 60 partners. What we have here is a "technical dissolution."[280] From the commercial perspective there is one ongoing partnership; in law there are two successive partnerships.

Insofar as Sue has a cause of action against a "firm," it is against the 1999 firm, rather than the 2000 firm. Under the relationship theory, when there is a technical dissolution the new partnership does not automatically inherit the obligations of the old partnership. This non-transfer of obligations goes beyond the familiar point, embodied in section 19(1) of the *Partnership Act*, that an incoming partner "is not liable to the creditors of the firm for anything done before he became a partner." The point here is that, in the absence of an express or implied novation,[281] the new firm, as such, is not

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279 See *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, s. 142.

280 We borrow this term from Lindley & Banks 1995 at 10-33.

281 A "novation" occurs when one person is substituted for another person as the party liable for a debt, under an agreement between the original debtor, the new debtor *and* the creditor. The agreement of all three parties is required. To illustrate what happens in the absence of (continued...)

liable for any obligations of the old firm.[282] Given that Sue had ceased to be a client of the firm before the old Acme became the new Acme, it is difficult to see how there is any possibility of a novation.

Given that we are dealing with an ordinary partnership, the fact that Sue does not have a claim against the 2000 firm, as such, or the ten new partners, is probably not a matter of great moment. She has a cause of action against all 50 members of the 1999 firm. If she sued them and got a judgment, she could enforce it against their personal assets. She could also get at their interest in the 2000 firm through the charging order remedy provided by section 26 of the *Partnership Act*. What she could not easily do is get a judgment against the ten new members or get at their interest in the 2000 firm's assets (that is, their interest in the co-owned property).

Now suppose that Acme is an LLP. What assets are available to satisfy the portion of Sue's claim that exceeds the available insurance and the assets of Bob the blunderer? As noted at the beginning of this section, everyone seems to be agreed that "the firm's" assets should be available. But the intricacies of the relationship theory are of more practical importance than they are where the firm is an ordinary partnership.[283] Sue has a claim

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281 (...continued)
such three-party agreement, suppose that B, who owes money to A, enters into an agreement with C whereby the latter agrees to "assume" (be responsible for paying) B's debt to A. This agreement between B and C is neither binding on nor enforceable by A. Notwithstanding the agreement between B and C, A can still enforce the debt against B. On the other hand, since A is not a party to the contract between B and C, A cannot directly enforce C's agreement with B to be responsible for paying the debt. If B were to become bankrupt, A could not sue C to collect the judgment. It is possible, however, that B's trustee in bankruptcy could sue C to enforce the agreement.

282 Where ordinary partnerships are concerned, this point is likely to be of practical importance only if the firm becomes bankrupt and there is a "priorities fight" between creditors of the old firm and creditors of the new firm. Absent an express or implied novation, creditors of the old firm would not be creditors of the new firm: they are "separate creditors" of the partners of the old firm. As such, their claims against the partnership property of the new firm are subordinated to the claims of the creditors of the new firm. The potential bright side for the creditors of the old firm is that, as separate creditors of the individual partners of the old firm, they have priority over the creditors of the new firm with respect to those partners' individual estates.

283 At least, they are of practical importance if one assumes that the firm's assets are worth anything to creditors. This is by no means a foregone conclusion. As Wolfram 1997 observes at 365-66:

> The assets of the partnership were, of course, the first thing exposed to liability and seizure, but, however prized and useful, a law library, desks, and personal

(continued...)

against the 1999 firm. The problem is that the 1999 firm has no assets; they have long since been transferred to the 2000 firm. And if ordinary principles of partnership law apply, the 2000 firm is not liable for the 1999 firm's malpractice liability. Sue's claim against the assets of "the firm" is worthless.

We think it is obvious that Sue *ought* to have a claim against the assets of the continuing firm. The question is how this result is to be accomplished. The Ontario legislation does not address the problem. It is possible that the drafter considered the problem and decided that the legislation did not need to address it, because the courts will be able to sort it all out if the need should arise. We suspect, however, that the drafter might have borrowed LLP provisions from US statutes without considering other aspects of US partnership law that provide a context for the LLP provisions, a context that is not necessarily provided by existing Canadian legislation.

In the early part of this century the NCCUSL decided to draft a uniform partnership act.[284] American partnership law at the time, like Anglo-Canadian partnership law, was based on the relationship (or "aggregate") theory. A debate ensued as to whether the uniform act should adopt the relationship theory or the entity theory. Eventually the proponents of the relationship theory carried the day, and the Uniform Partnership Act (1914) ("UPA") embodied that theory.[285]

The drafters of the UPA, however, were not altogether happy with the implications of the common law relationship theory, including its effect on creditors of an existing partnership when there is a technical dissolution. Therefore, the UPA partially reversed the common law rule (and the rule embodied in acts patterned on the *Partnership Act 1890* (UK)) that incoming partners are not liable for pre-existing obligations of the firm. Section 17 of the UPA provided:

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[283] (...continued)

> computers are not very interesting objects out of which to satisfy a large judgment.

As noted earlier, the assets of a professional firm that are most likely to be "interesting objects out of which to satisfy a large judgment" are intangibles: accounts receivable and the like.

[284] This paragraph is based on Rosin 1989 at 401-04.

[285] UPA §6(1).

> A person admitted as a partner into an existing partnership is liable for all the obligations of the partnership before his admission as though he had been a partner when such obligations were incurred, except that this liability shall be satisfied only out of partnership property.

In explaining the rationale for and effect of this section, the Commissioners noted that although it changed the formal statement of the law, "as a matter of fact the section as worded conforms to the actual decisions of the courts, which however, are arrived at by making every effort to impress an assumption of liability on the part of the new partnership."[286]

UPA section 17 only purports to make the incoming partner liable for pre-existing debts; it does not purport to make the new firm, as such, liable. Normally, this rather technical distinction would not be an issue, but it could be an issue in a priority fight between creditors of the old and new firms.[287] To address the problem, UPA section 41 contained a number of provisions designed to make it clear that in various permutations of the incoming or outgoing partner scenario, creditors of the old firm became creditors of the new firm, as such. Thus, section 41(1) provides:

> When any new partner is admitted to an existing partnership, or when any partner retires and assigns (or the representative of the deceased partner assigns) his right in partnership property to two or more of the partners, or to one or more of the partners and one or more third persons, if the business is continued without liquidation of the partnership affairs, creditors of the first or dissolved partnership are also creditors of the partnership so continuing the business.

This indicates why American LLP legislation can assume that changes in the membership of an LLP do not give rise to a problem of identifying "the firm" to whose assets creditors can look for satisfaction of their claims. We believe that Alberta LLP legislation should make it clear that a creditor of an LLP can look to the assets of the LLP for satisfaction of its claim, notwithstanding any changes in the membership of the LLP since the claim was created.

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[286] Commissioners' Note on UPA §17.

[287] See 7 Uniform Laws Annotated at 229-30 (the Commissioners' Note to §41) for a discussion of the problem.

RECOMMENDATION No. 10
Limited liability for members of an LLP should be implemented through statutory provisions to the following effect:

(a) Where the law relating to ordinary partnerships would impose a liability on the members of a partnership by reason only of their membership in the partnership, the liability imposed on partners of an LLP should be limited to their interest in the partnership property.

(b) Subject to any agreement to the contrary and to specific exceptions mentioned in other recommendations, a member of an Alberta LLP should not be liable to the LLP or any other member by way of contribution, indemnity, or otherwise, with respect to any obligation of the LLP or the other member.

(c) Members of an LLP should not be proper parties to an action based on an obligation or liability of an LLP.

(d) Notwithstanding that the members of an LLP are not parties to an action against the LLP, a judgment against the LLP should be enforceable against their interest in the partnership property.

(e) A judgment against an LLP should be enforceable against the partnership property of its current members, regardless of any change in the membership of the LLP between the time the liability arose and the time the judgment is obtained or enforced.

Paragraph (a) is intended to deal with the point that since partners in an LLP own the partnership property they cannot simply be absolved of liability for partnership obligations. Rather, their liability is limited to their interest in the partnership property.

Paragraph (b), reflects wording found in many existing LLP statutes. It is designed to prevent partners of an LLP from incurring indirect liability for obligations for which they would not be directly liable. The rules regarding partners' mutual indemnification and contribution obligations are concerned with the internal relations of the partnership. Therefore, we assume that the rule proposed in paragraph (b), like other statutory rules governing the internal relations of a partnership, would merely be a default rule that the partners in an LLP could replace with some other rule.

Paragraph (b) is not meant to protect the partners' interest in the partnership property; it is intended to protect partners from having to contribute additional funds where the partnership's assets are not sufficient to discharge its liabilities. Nor is this paragraph intended to reverse the ordinary partnership principle that a partner who incurs personal liabilities "in the ordinary and proper conduct of the business of the firm" is entitled to be indemnified *by the firm*.[288] A partner who incurs liabilities on behalf of an LLP firm would still be entitled to be indemnified by the firm; however, they could look only to the assets of the firm for such indemnity. Other partners would not be required to put more money into the partnership if there was a shortfall. The point is put nicely in the Prefatory Note to UPA (1996):

> The Act does not alter a partner's liability for personal misconduct and does not alter the normal partnership rules regarding a partner's right to indemnification from the partnership (Section 401(c)). Therefore, the primary effect of the new liability shield is to sever a partner's personal liability to make contributions to the partnership when partnership assets are insufficient to cover its indemnification obligation to a partner who incurs a partnership obligation in the ordinary course of the partnership's business.[289]

It should be noted, however, that a firm's obligation to indemnify a partner for liabilities incurred by the latter in the course of carrying on the firm's business has limits. Indeed, the direction of the indemnity obligation may be reversed in the case of negligent or otherwise wrongful acts. Rather than being entitled to an indemnity from the firm, a partner whose wrongful

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[288] *Partnership Act*, s. 27(b).

[289] UPA 1996 Prefatory Note at 4.

actions create a liability for the firm may be required to indemnify the firm and the other partners in respect of their liability.[290]

Paragraph (c), which recommends that partners are not proper parties to an action against the firm, is similar to section 10(4) of Ontario's amended *Partnership Act*:

> A partner in a limited liability partnership is not a proper party to a proceeding by or against the limited liability partnership for the purpose of recovering damages or enforcing obligations [to which the liability shield applies.]

The problem we have with the Ontario provision is that, standing alone, it raises the following question. If the partners own the partnership property, and the partners are not proper parties to an action to enforce a partnership obligation, how can the creditor enforce their judgment against the partnership property? At the risk of being considered unduly pedantic, we think it prudent to state, as we have in paragraph (d) of the recommendation, that although the partners are not parties to an action, a judgment against the LLP is enforceable against their interest in the partnership property.

We note that our recommendation, like the Ontario amendments, glosses over a technical point about actions by and against partnerships. Given the relationship theory of partnership, there is no partnership entity that can be a party to legal proceedings. Although actions against partnerships may be brought in the name of the firm,[291] naming the firm is simply a shorthand way of making all the partners parties to the action. So if the partners themselves are not parties to the action, and the partnership itself is not an entity, who *is* a party when an action is brought against an LLP? Strictly speaking, it might be more accurate to recommend that partners of an LLP are proper parties only to the extent necessary to bind their interest in the partnership property. But we think that *would* be unduly pedantic.

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[290] See Lindley & Banks 1995 at 571-72:

> . . . it is not entire clear *what* degree of misconduct or negligence is required to invoke this principle. The current editor takes the view that . . . something more than "mere" negligence must normally be shown, *i.e.* gross negligence or recklessness in the course of carrying on the partnership business.

[291] Alberta Rules of Court, r. 80(1).

Paragraph (e) is intended to address the potential problem created by changes in the membership of a firm, given the relationship theory of partnership. Our proposal is that a judgment against an LLP would be enforceable against the partnership property of all its current members, regardless of whether they were members when the liability arose. We note that legislative implementation of this proposal will require more precise language than we have used in the recommendation. One possible technique, following the approach of the 1914 version of the American UPA, would be to state that persons who are creditors of the firm as it existed before a change in membership are creditors of the firm as it exists after the change in membership.

E. Safeguards

This section discusses safeguards for creditors (and prospective creditors) of LLPs. The general thrust of our recommendations is easy to describe. Since the members of an LLP enjoy the benefits of limited liability, creditors of LLPs should be provided with the same sort of safeguards as are provided to creditors of other types of limited liability firm: business corporations and limited partnerships. Of course, the safeguards provided for LLP creditors cannot be exactly the same as those provided to both corporation and limited partnership creditors. The protections offered to corporation and limited partnership creditors are based on the same general principles, but they differ in points of detail. Our recommendations tend to follow the approach of the *Business Corporations Act* rather than the limited partnership provisions of the *Partnership Act* on points of detail, especially in the area of disclosure requirements.

1. Special Liabilities

A number of statutes place special responsibilities on corporate directors[292] regarding certain corporate liabilities. Probably the most significant responsibility relates to an insolvent corporation's liability for unpaid wages. Under both section 112 of the *Employment Standards Code*[293] and section 114 of the *Business Corporations Act*, corporate directors may be personally liable to employees for up to six months' unpaid wages. These provisions indicate

[292] Sometimes the provisions impose the liabilities on directors and officers. The two provisions referred to in the text refer only to directors.

[293] S.A. 1996, c. 10.3.

that the legislature believes that individuals who are responsible for management of a limited liability firm should be given a powerful incentive to ensure that the organization's employees are paid for services they have rendered to the organization.[294]

We believe that the same considerations apply to LLPs, and that the partners of LLPs should be personally liable for LLP obligations for which directors would be liable if the LLP were a corporation. We say that the "partners" should be liable, because the internal organization of LLPs is that of ordinary partnerships, in which management is vested in the partners as a whole. The position of the partners of an LLP would be analogous to that of the shareholders of a corporation who have entered into a unanimous shareholder agreement that transfers management responsibilities from the directors to the shareholders.[295]

One of the purposes of statutory provisions that impose personal liabilities on corporate directors is to impose liability on individuals who make decisions. Directors of a corporation are necessarily individuals. However, some or all of the members of an LLP could be corporations. Therefore, given the objective of imposing liability on real persons for certain enterprise liabilities, it seems reasonable that where a corporation is a partner of an LLP, the corporation's directors should be liable for any special liabilities that would be imposed on the corporation as a partner in the LLP.

RECOMMENDATION No. 11

(a) Partners of an LLP should be personally liable for liabilities and obligations of the LLP for which they would be liable under Alberta law if the LLP was a corporation of which they were the directors.

(b) Where a corporation is a partner in an LLP, the directors of the corporation should be personally liable for any liability of the corporation arising under paragraph (a).

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[294] For an analysis that supports the general thrust of such provisions on economic grounds, see Halpern, Trebilcock & Turnbull 1980 at 149-50.

[295] See *Business Corporations Act*, s. 140(7).

2. Disclosure Requirements

As discussed in our issues paper,[296] there are grounds for arguing that limited liability firms should be required to publish[297] financial information, such as audited financial statements, for the benefit of creditors or prospective creditors. In the UK, that is precisely what the Department of Trade and Industry has proposed for LLPs.[298] A rationale for such a requirement is that publication of financial information by a limited liability firm makes it easier for prospective creditors to get information about the state of the firm's financial affairs, information that will be useful in making an informed decision whether to extend credit. The substantive argument against such a requirement is that the value of such information to creditors will be outweighed by the cost of producing it.[299]

In our view, the short answer to any suggestion that LLPs be required to publish financial information for the benefit of prospective creditors is that, whatever the merits of such a proposal, they would apply with equal force to corporations. In Alberta, unlike the UK, corporations are not generally required to publish financial information for the benefit of prospective creditors. Financial disclosure requirements are dealt with as a matter of investor protection and securities law, rather than as a creditor protection issue. We see no justification for imposing financial disclosure requirements on LLPs that are not imposed on corporations. Of course, if at some point the government were to reconsider the whole matter of financial disclosure by corporations, it would also be appropriate to reconsider the matter in the context of LLPs (and limited partnerships).

One thing that corporations *are* required to do by way of disclosure is to make some effort to make it clear to those with whom they deal that they are a corporation, rather than some other type of business organization:

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[296] ALRI 1998 at 144-46.

[297] Publication would consist of filing the information in a public registry of some sort.

[298] DTI 1997 at 8-9; DTI 1998, Pt I at 9-10.

[299] The contrasting positions are starkly presented in passages set out in ALRI 1998 at 145-46. Another point that could be made against mandatory financial disclosure for the benefit of creditors is that, if creditors want such information, they can generally get it from commercial credit reporting agencies.

> A corporation shall set out its name in legible characters in or on all contracts, invoices, negotiable instruments, and orders for goods and services, issued or made by or on behalf of the corporation.[300]

Since the corporation's name is required to contain a word or abbreviation (such as "Limited" or "Ltd.") that indicates its corporate status, the requirement to set out its name implies a requirement to disclose that it is a corporation. We believe that a similar requirement should apply to LLPs.[301]

If a corporation does not comply with the disclosure requirement in section 10(8) of the *Business Corporations Act*, the penalty is what might best be described as a slap on the firm's fictitious wrist.[302] We think it is reasonable that if an LLP does not take steps to bring its limited liability status to the attention of third persons with whom it enters into contracts, the LLP and its members should run the risk of being treated as an ordinary partnership for the purpose of such contracts. The mere fact that a contract between an LLP and another party fails to mention the firm's status as an LLP should not create an irrebuttable presumption that the firm is an ordinary partnership for the purposes of that contract. Rather, failure to disclose the firm's LLP status in a contract should lead to the firm being regarded as an ordinary partnership for the purposes of the contract, unless it is established that the other party knew that it was a limited liability firm.

RECOMMENDATION No. 12

(a) An LLP must set out its name on all contracts, invoices, negotiable instruments and orders for goods and services.

(b) Where an LLP enters into a contract without complying with paragraph (a), its partners should be liable for any

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[300] *Business Corporations Act*, s. 10(8).

[301] Of course, it is far from certain that the average person who sees "Inc," "Corp," "Ltd" or whatever in a corporation's name will immediately infer that this is a body whose owners enjoy limited liability. It is even less certain that they will make that inference upon encountering the initials, "LLP." Fortney 1997 at 752, note 158, questions whether the designation "LLP" (or whatever) at the end of a firm's name, or even the knowledge that it is a "limited liability partnership," will give the average client any useful information about the risks of dealing with such a firm compared to the risks of dealing with an unlimited liability firm.

[302] There is no specific penalty. Section 244 creates a general offence of contravening a provision of the Act, for which the penalty is a $1000 fine.

liability of the LLP arising out the contract to the same extent as if the firm was an ordinary partnership, unless the other party knew when they entered into the contract that they were dealing with a limited liability firm.

3. Restrictions on Distribution of LLP Property to Members

Creditors of an ordinary partnership can look to the personal assets of all partners for satisfaction of their claims. Since each member of a partnership is personally liable for the whole of the partnership's obligations, a partnership creditor need not be too concerned about transfers of assets from the partnership to individual partners. In theory, at least, an asset is available to satisfy the creditor's claim whether the asset is in the hands of the partnership or one of its partners.[303]

The distinction between the assets of the firm and the assets of its owners is more important in the context of a limited liability firm. Since creditors of a limited liability firm can in general look only to the firm's assets for satisfaction of their claims, transfers of assets from the firm to its owners reduce the pool available to meet the claims of creditors. Thus, enabling legislation for limited liability firms customarily imposes restrictions on the transfer of assets from the firm to its owners.

The precise details of the restrictions on firm-to-owner transfers have varied from jurisdiction to jurisdiction, from time to time and from one type of limited liability firm to the next. In essence, though, the restrictions are designed to prevent transfers of the firm's assets to its owners in circumstances that are considered especially likely to prejudice creditors. Whatever their precise character, such restriction have been regarded as a fundamental *quid pro quo* for the privilege of limited liability:

> A statute which limits the liability of investors to the amounts of their investments must also assure creditors that the assets will be applied first to satisfaction of debts and thereafter to return of their contributions to investors. The same considerations that result in statutory prohibitions on declaration and payment of dividends to stockholders of corporations, or purchase or redemption of their

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303 Creditors will not be totally indifferent to whether a given asset is partnership property or property of a particular partner. For reasons discussed earlier, a transfer of assets from the partnership to individual partners could make partnership creditors worse off in a priority fight with creditors of the individual partners.

> stock, when corporations are insolvent or thereby rendered insolvent, or in the event of any other impairment of capital, require similar restrictions on limited partnerships with respect to payments and distributions to the limited partners.[304]

In our view, essentially the same consideration apply to transfers of assets from LLPs to their members.

The restrictions on transfers from LLPs to their members that we propose are borrowed from both the limited partnership provisions of the *Partnership Act* and the *Business Corporations Act*. In our view, such provisions would be called for even if LLPs were only available to professionals and only provided a shield against professional malpractice claims. Situations could still arise where inappropriate transfers of LLP assets to LLP members would reduce the pool of assets available to persons with a malpractice claim against the LLP.

RECOMMENDATION No. 13
An LLP should not be permitted to distribute any partnership property (including money) to a partner or an assignee of a partner's share of the partnership, whether as a share of profits, a return of capital contributions, a repayment of advances or otherwise, if there are reasonable grounds for believing that, after the distribution,

(a) the LLP would be unable to pay its liabilities as they come due or

(b) the realizable value of the partnership property would be less than the LLP's liabilities.

The circumstances in which a distribution would not be permitted reflect the dual liquidity-solvency test that is found in various provisions of the *Business Corporations Act*: e.g., section 32(2) (acquisition of own shares); 36(3) (reduction of stated capital); 40 (payment of dividends).

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[304] Rowley 1960 at 576.

There is one respect in which the relationship theory of partnership could work to the advantage of creditors of an LLP, as compared to the creditors of a corporation. Because corporations are regarded as separate legal entities from their shareholders, there is nothing to prevent shareholders of a corporation from entering into contracts with the corporation. In particular, the shareholders of a corporation can lend money to the corporation and take security for their loan, just like any other creditor.[305] Under partnership law, however, a partner cannot contract with the partnership, as such, because this would be entering into a contract with themself.[306] The upshot is that although partners can make "advances," as distinguished from contributions of capital, to the partnership, such advances do not make the partner a creditor in the normal sense. Thus, our recommendation is that, except as provided in the next recommendation, *any* transfer of property from an LLP to its members will have to pass the liquidity-solvency test.

Suppose that over an extended period of time an LLP arguably does not meet the dual liquidity-solvency test, because it faces a large malpractice claim. All partners of the LLP are active participants in the LLP's business. If the partners receive draws during the period in question, can those drawings be attacked if the malpractice claim eventually translates into a large judgment that casts the LLP into bankruptcy? If the LLP were a corporation, its partners might be described as employee-shareholders. Clearly, amounts they received as salary would not offend corporate law restrictions on payments to shareholders. But what should happen in the case of an LLP?

The commentary on the UK Department of Trade and Industry's draft LLP bill frames the problem in these terms:

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[305] The House of Lords decision in *Salomon v. Salomon & Company*, [1897] A.C. 22 is famous for firmly establishing the validity of the "one man company." However, what really annoyed the creditors of Salomon & Company was not that it was a one man company, or even that Mr. Salomon enjoyed limited liability, but the fact that he had structured the bulk of his investment as a secured loan, which took priority over the claims of general creditors.

[306] The point in the text is emphasized by section 59 of the *Partnership Act*, which specifically allows limited partners of a limited partnership to make loans to the partnership. However, limited partners are not permitted to take security for their loan to the partnership, and their claims as creditors are subordinated to claims of other creditors.

> 3.2 . . . *the objective has been to make the regime for LLPs neither more lax, nor more severe, than that for companies.* The companies legislation rules [regarding transfers of assets to members] cannot be reproduced exactly for LLPs because the internal structure of the LLP is distinctly different from that of the company. . .
>
> 3.3 Other technical differences between company and LLP organisation also cause difficulty: for example, members' drawing may be seen to have some of the character of remuneration for work done on behalf of the LLP and some of the character of the return to shareholders for their investment in the business. It would be difficult to distinguish between the two in a watertight way that prevented abuse without rules of great complexity.[307]

After referring to the necessity of balancing the need to discourage members from withdrawing capital when the LLP is insolvent against the desire not to "deter viable LLPs from attempting to trade through temporary financial difficulties," the commentary summarizes the proposed restriction thus:

> 3.5 Accordingly, the draft legislation provides that a liquidator may apply to the court to recover withdrawals of property of the firm made by a member within the two years prior to winding-up at any time *when that member knew that the firm was insolvent or would be made insolvent* by the withdrawal. *The burden of proof will rest with the liquidator*, and the court will not be able to declare in his favour if it is satisfied that there remained a *reasonable prospect that the firm would avoid going into insolvent liquidation.*[308]

The Department of Trade and Industry acknowledged the distinction between withdrawals in the nature of remuneration for current services rendered and withdrawals more in the nature of dividends, but thought that the distinction would be too difficult to make. However, we think that not only is there a justification for making the distinction, but that it is practical to make it. As for the justification, we think that where an LLP pays a partner reasonable remuneration for current services, the LLP is not simply handing over partnership property to the partner. Rather, it is giving present value for present value. It is paying for current services rendered to the partnership, services that presumably generate revenue and that would have to be provided by someone else if they were not provided by a partner.

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[307] DTI 1998, Pt I at 11. [Emphasis in original.]

[308] DTI 1998, Pt I at 12. [Emphasis in original.] The proposed legislative provision, which is set out *ibid.*, Pt IV at 66, is a new s. 214A of the *Insolvency Act 1986*. It would apply to all withdrawals, whether in the form of salary or otherwise.

As for the practicalities, we are attracted to the approach taken by the Colorado partnership statute. It prohibits an LLP partner from receiving a distribution if the firm's liabilities would exceed the fair value of its assets after the distribution. The prohibition does not apply, however, "to a distribution made as reasonable compensation for current services provided by the general partner to the limited liability partnership or limited liability limited partnership, to the extent that the amount of such payment would be reasonable if paid as compensation for similar services to a non-partner employee."[309] We recommend that the Alberta statute contain a provision to the same general effect as the Colorado provision.

RECOMMENDATION No. 14
The restriction on distributions to partners should not apply to distributions constituting reasonable compensation for current services rendered by a partner to the LLP, to the extent that the amount of compensation paid would be reasonable if paid to a non-partner employee for similar services.

We now turn to the consequences of a distribution that offends Recommendation 13. In our view, a remedy should be available both against the recipient of the distribution and those who authorized it. Even if the recipient was "innocent" in the sense of not knowing that the distribution offended the restriction on distributions, the recipient has received property of the LLP that they were not entitled to receive, and to which creditors have superior claims. Thus, they should be required to return the property to the LLP. The case for imposing liability on those who actually authorized the distribution seems equally clear. The following recommendation borrows from both the limited partnership provisions of the *Partnership Act* and from section 113 of the *Business Corporations Act*.

RECOMMENDATION No. 15
Where an LLP makes a distribution contrary to Recommendation 1,

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[309] Colo. Rev. Stat. §7-64-1004 (1998).

(a) the person receiving the distribution should be liable to the firm for the amount, not exceeding the value of the property received with interest, necessary to discharge liabilities of the firm that existed at the time of the distribution;

(b) any partners of the LLP who authorized the distribution should be jointly and severally liable for any amount due to the firm under paragraph (a), to the extent that it is not recovered from the person who received the distribution;

(c) the firm, any member of the firm, or any person who was a creditor of the firm at the time of the distribution should be able to initiate proceedings to enforce the firm's rights under paragraph (a) or (b);

(d) proceedings to enforce a liability under this recommendation should be required to be commenced within 2 years of the date of the distribution.

Paragraph (a) of this recommendation is based on section 62(5) of the *Partnership Act*. The latter deals with situations in which a limited partner who has *rightfully* received a return of capital may nevertheless be required to restore it to the limited partnership. We think it provides a reasonable approach to defining the extent of a recipient's liability in respect of an improper distribution.

Paragraph (b) is based on the premise that the members of a partnership who authorize an improper distribution should be responsible to restore to the partnership the value of the improperly distributed property, to the extent that it cannot be recovered from the person who received it. This paragraph is based on section 113(3) of the *Business Corporations Act*, which imposes liability on directors who vote for or consent to a resolution that authorizes an improper payment. In the context of an LLP there is no direct equivalent of the directors of the corporation, since management of a partnership is vested in all the partners. Therefore, paragraph (b) contemplates that liability would fall on the partners who authorize a particular distribution. In some contexts this might be all the partners; in other contexts it might be a subset of the partners.

Paragraphs (c) and (d) are based on sections 113(5) and (9) of the *Business Corporations Act*. It may be noted that paragraph (c) does not contemplate that creditors would have a direct cause of action against the recipient of a distribution or the partners who authorized it. Rather, they would be able to initiate proceedings to enforce the partnership's right to have improperly distributed property restored to the partnership. The property would then be available to meet the partnership's liabilities.

F. Limited Liability Partnership Mechanics

In this section we consider issues relating to the mechanics of acquiring and maintaining LLP status, whether as an "Alberta" LLP or as an "extra-provincial" LLP that does business in Alberta.

1. Alberta LLPs

a. Becoming an Alberta LLP

How do you create a limited liability partnership? How does an ordinary partnership become a limited liability partnership? The foregoing are not necessarily just different ways of posing the same question. The first question suggests that something is to be brought into existence where before there was nothing. The second question assumes that something that already exists, a partnership, is to acquire some new characteristic or status, limited liability. We think that, strictly speaking, the second question more accurately captures what is going on under the relationship theory of partnership. That is, a partnership is presumed to exist, and the issue is how it goes about acquiring the status of an LLP.

If becoming an LLP is viewed as the acquisition of a particular status by a partnership that already exists, the technicalities of partnership law immediately give rise to an annoying difficulty. The difficulty only arises in the context of newly formed partnerships, as opposed to partnerships that have been carrying on business as ordinary partnerships and want to acquire LLP status. The problem is disclosed by the definition of "partnership" in section 1(d) of the *Partnership Act*, which reads:

> "partnership" means the relationship that subsists between persons carrying on a business in common with a view to profit.

The problem arises because the definition refers to persons "carrying on" a business in common; it does not refer to persons who have "agreed" to do so at some point in the future. As a leading textbook puts it:

> It is perhaps self evident, but nonetheless deserving of specific mention, that the definition of partnership requires the "carrying on" of a business. It naturally follows that a partnership cannot exist before the business is commenced.[310]

Strictly speaking, an ordinary partnership comes into existence not when two or more persons agree to carry on business in common, but when they actually commence carrying on business.

For obvious reasons, if two or more persons are planning to start up a new business and carry it on as an LLP, they would prefer to acquire LLP status *before* they start carrying on business. But how can their partnership acquire LLP status before beginning to carry on business if the partnership itself does not exist until it begins carrying on business? This is a highly technical point. From a policy perspective, we can think of no reason why persons who intend to carry on a new business as an LLP should not be able to form a partnership and acquire LLP status before they actually commence carrying on business. To that end, we suggest that the definition of "partnership" be modified so as to make it clear that, in the case of an LLP at least, the term "partnership" includes two or more persons who *have agreed* to carry on business in common as an LLP, whether or not they have actually started to carry on business. Such a definition will remove any possible technical objection to the registration as an LLP of a firm that has not yet commenced business.

Whether considering an ongoing partnership or one that has been formed to undertake a new venture, we believe that the only prior condition for registration as an Alberta LLP should be that the partnership agreement provides for such an application. This condition should present no difficulty for partnerships formed after the LLP legislation comes into effect. In such

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[310] Lindley & Banks 1995 at 10; see also at 13.

cases, if the prospective partners intend that their partnership will become an LLP, this intention can be expressed in the partnership agreement.

Partnerships that exist before LLP legislation is enacted may be somewhat more problematic. Unless the partners were particularly prescient, their original partnership agreement presumably will not have provided for the partnership to become an LLP. However, it is always possible to amend a partnership agreement. In the absence of express agreement to the contrary, amendment of a partnership agreement would require unanimous consent. On the other hand, a partnership agreement might expressly provide for its own amendment by something short of unanimous consent. In the latter case, the partners' decision to become an LLP could be made by whatever majority is stipulated by the partnership agreement.[311]

RECOMMENDATION No. 16

(a) The definition of "partnership" in the Partnership Act should be modified to make it clear that it includes two or more persons who have agreed to carry on business in common as an LLP, whether or not they have actually commenced carrying on business.

(b) A partnership should be able to apply for registration as an Alberta LLP if the partnership agreement provides for it to do so.

In the discussion preceding Recommendation 12, we noted that the requirement that LLPs disclose their name in contracts and other documents is intended to bring the partnership's LLP status to the attention of persons

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[311] The Ontario act requires unanimous consent of all partners in an existing partnership: *Partnership Act* (Ont.), s. 44.1(2). Our proposed approach is closer to that of UPA 1996, §1001(b), which provides:

> The terms and conditions on which a partnership becomes a limited liability partnership must be approved by the vote necessary to amend the partnership agreement except, in the case of a partnership agreement that expressly considers obligations to contribute to the partnership, the vote necessary to amend those provisions.

The exception regarding votes necessary to amend contribution obligations contemplates that a partnership agreement may provide for different majorities to amend different parts of the agreement. "The specific 'contribution' vote is preferred because [becoming an LLP] directly affects partner contribution obligations:" *Comment* on UPA 1996 §1001.

with whom it deals. Obviously, it will only do so if the name indicates the partnership's LLP status. Therefore, we recommend that the LLP name should contain a word or abbreviation indicating its LLP status. This is a common (or universal) requirement in LLP legislation, the obvious abbreviation being "LLP" or "L.L.P."

This is all that we propose to say about LLP names in this report. However, we recognize that a case could be made for treating LLP names like corporate names and requiring LLP names to satisfy the same sort of requirements as corporate names. Indeed, one could argue that the same general requirements should apply to all business names: proprietorship names, partnership names, corporate names, whatever. This is an issue whose consideration we defer to our forthcoming report on business names legislation.

RECOMMENDATION No. 17
The LLP name must contain prescribed words or a prescribed abbreviation indicating its status as a limited liability partnership.

In our view, the process of acquiring LLP status should be similar to the process of incorporating a business corporation under the *Business Corporations Act*. The gist of the process for incorporation is that the incorporator must file documents containing prescribed information with the Registrar. If the documents meet the formal requirements of the statute and regulations, the Registrar issues a certificate of incorporation as a matter of course. Similarly, to acquire LLP status, we propose that a partnership be required to file documents containing prescribed information with the Registrar. If the documents meet the formal requirements, an official document certifying the partnership's LLP status would be issued as a matter of course. It will be noted that there is a conceptual difference between the two processes. The official act at the end of the incorporation process creates something (albeit a fictitious something) out of nothing. The official act at the end of the LLP registration process confers a particular status on a partnership that already exists.

What information should a partnership be required to file in order to acquire LLP status? We must confess that this is a question upon which we have not been able to come up with any profound insights. What we have done is look at the information requirements of the *Business Corporations Act* and asked ourselves how those requirements could be adapted to the purposes of LLPs. It should be noted that another possible approach would be to model the LLP information requirements on the limited partnership provisions of the *Partnership Act*, rather than the information requirements of the *Business Corporations Act*. We have followed the latter mainly because it represents a more modern and less cumbersome approach to business organization information requirements.

To incorporate a corporation under the *Business Corporations Act* an incorporator must file the following documents: (1) articles of incorporation;[312] (2) notice of directors;[313] (3) notice of registered office;[314] and (4) prescribed documents relating to corporate names.[315] Between these documents, the following information will be disclosed:

1. the corporation's (proposed) name;
2. the address of
    - the registered office;
    - the records office (if not the registered office);
    - the post office box for service by mail, if any;
3. information regarding the share structure and any restrictions on transfer of shares;
4. the number of directors, or the minimum and maximum number of directors, and the names and addresses of the directors;
5. any restrictions on the business the corporation can carry on.

Which of the foregoing disclosure requirements can and ought to be applied to LLPs? Obviously, the first item, the firm's name, should be disclosed in an application for registration of an LLP. We think also that

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[312] *Business Corporations Act*, s. 7(1)(a).

[313] *Ibid.* s. 101(1).

[314] *Ibid.* s. 19(2). As discussed below, if there is a separate records office, its address must also be provided, and the corporation has the option of designating a post office box for service of documents by mail. For convenience, we use the term "notice of registered office" to include a document that contains any of this information.

[315] *Ibid.* s. 12(3). These are name searches and so on designed to satisfy the corporate name requirements. As mentioned earlier, our recommendations do not deal with restrictions on LLP names.

LLPs should be subject to the same requirement to maintain and disclose a registered office and records office as a corporation.[316] The main purposes of requiring a corporation to maintain a registered office and records office (which may or may not be at the same location) seem to be (1) to facilitate the service of documents on the corporation, and (2) to ensure that shareholders or other persons who are entitled to look at certain corporate documents know where they can go to look at those documents. In the context of LLPs we are less concerned with partners' access to partnership documents than with access to information about the LLP by outsiders. The information to which outsiders might have access – information about the partners – is discussed in subsection (b) below.

We do not believe that LLPs should be required to disclose information about their share structure to the public, assuming that the concept of a share structure has any application to an LLP. Nor do we think it is necessary to require LLPs to give notice of restrictions on transfer of partnership shares. Unlike a corporation, where the presumption is that shares are freely transferable unless transfer is expressly restricted, the presumption under ordinary partnership law is that "no person may be introduced into the firm as a partner without the consent of all existing partners."[317]

The fourth item to be disclosed in the documents submitted with an application for incorporation is information about the number and identity of the directors. This item has no direct application to LLPs, since the management of a partnership is vested in all the partners, rather than in persons known as directors. We discuss the issue of disclosure of the identity of partners in subsection (b), below.

The final item to be disclosed in an application for incorporation is any restrictions on the corporation's business. Similarly, section 51(2)(b) of the

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[316] And the LLP should have the same option to maintain and disclose a post office box for service of documents by mail as a corporation.

[317] *Partnership Act*, s. 27. A distinction should be made between purporting to transfer one's rights to participate in the affairs of the partnership, as a partner, and assigning one's right to receive a share of profits and to receive one's share of the partnership assets upon dissolution. The latter can be assigned, but the assignee does not thereby become entitled to the partner's rights to participate in the affairs of the partnership: *Partnership Act*, s. 34. For a discussion of the distinction see Lindley & Banks 1995 at 556-65.

Partnership Act requires a certificate of limited partnership to state "the character of the business." On the other hand, the *Partnership Act* does not require an ordinary partnership or proprietorship that is required to file a declaration under section 81 or 85 to provide any information about the nature of the firm's business. Although we do not have strong views on the subject, we are not convinced that requiring a partnership applying for registration as an LLP to disclose the general nature of its business in its application would serve an exceedingly useful purpose. Therefore, we make no recommendation as to whether the application for registration of a firm as an LLP should be required to disclose the nature of the firm's actual or proposed business.

RECOMMENDATION No. 18
A partnership applying for registration as an Alberta LLP should be required to provide the following information:

(a) its name;

(b) a statement that the partnership applies for registration as an Alberta LLP;

(c) the address of its registered office and the address of its separate records office, if any, and a post office box for service of documents by mail, if any.

RECOMMENDATION No. 19
(a) An Alberta LLP should be required to have a registered office in Alberta, which would also serve as its records office unless a separate records office is designated.

(b) An Alberta LLP should be able to designate a separate records office, which must be in Alberta, and to designate a post office box for service of documents by mail.

b. Information Regarding Partners

The *Business Corporations Act* does not require the application for incorporation to disclose any information about shareholders; it just requires information about the share structure. One good reason for the lack of a requirement to disclose information about shareholders in the application for incorporation is the that a corporation cannot issue shares before it is created. However, the *Business Corporations Act* requires corporations to file annual returns, which must disclose all the shareholders or the five shareholders with the highest proportion of issued voting shares if there are more than five shareholders in total.[318]

In Recommendation 18 we did not propose to require an LLP (or a partnership applying for LLP status) to identify or file any information about the partners. Nor would we propose to require an LLP to provide such information in annual returns. In this we follow the US uniform act.[319] We would not say that we are opposed to a requirement that LLPs be required to register the names of all or some of their partners. We are just not convinced that doing so would serve an exceptionally useful purpose. More precisely, we suspect that it would be less cumbersome to dispense with registration of names and addresses of partners, but to require LLPs to provide this information to anyone who requests it. This issue is discussed briefly in the next few paragraphs.

The *Business Corporations Act* requires publication (through the filing requirement) of the names and addresses of all directors and disclosure (in annual returns) of all voting shareholders or the five shareholders with the largest number of voting shares, if there are more than five shareholders. Of course, in an LLP the role of shareholder and director is merged in each partner. So the issue is what information, if any, must be published regarding the identity and addresses of the individual partners of an LLP. One approach would be to require publication of the names and addresses of all partners of an LLP. This is the *Partnership Act's* approach to limited partnerships,[320] as well as its approach to ordinary partnerships that are required to file a declaration under section 81.[321] As already mentioned, this could be quite cumbersome where a firm has many partners, especially if the

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[318] *Business Corporations Regulation*, Form 22.

[319] UPA 1996, §1001(c).

[320] *Partnership Act*, s. 51(2)(c).

[321] *Ibid.*, ss 81, 83.

firm is required to amend its registration whenever there is a change in the composition of the partnership.

Ontario adopts a compromise approach. In Ontario the *Partnership Act* does not directly require an LLP to file anything – LLP status arises by virtue of the agreement to form an LLP.[322] However, before an LLP can carry on business it must comply with the requirements of the *Business Names Act*.[323] This act requires all partnerships (including professional partnerships) to register their business name before carrying on business in Ontario.[324] Regulations require a partnership to register the names and addresses of all of its partners unless the firm has more than ten partners.[325] In the latter case the partnership is only required to register the name and address of a "designated partner," who in turn must maintain a record of current and former partners at the firm's principal place of business in Ontario.[326] The information in the record must be made available free of charge to anyone who requests it.[327]

The approach of the Ontario *Business Names Act* must seem attractive to the members of a partnership with dozens or even hundreds of members. One question that we have about the Ontario approach, however, is what the point is of requiring registration of information about one "designated partner," as opposed to simply requiring the partnership to disclose the relevant information about partners upon request and without charge. Presumably, anyone who wants information about the members of the partnership will not really be very interested in the name of the designated partner *per se*. It strikes us that where publication of the names of partners is concerned, an all or nothing approach makes sense. This is what we have proposed. The LLP would not have to register the names or addresses of any partners, but would be required to maintain this information and disclose it upon request.

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[322] *Partnership Act* (Ont.), s. 44.1(1).

[323] R.S.O. 1990, c. B.17.

[324] *Ibid.*, s. 2(3).

[325] O. Reg. 121/91, ss 2, 3.

[326] *Ibid.*, s. 3(3). We ignore some of the nuances of the provision.

[327] *Ibid.*, s. 3(6), (7).

RECOMMENDATION No. 20
An Alberta LLP should be required to maintain a record of current and former members at its records office, and any person should be entitled to inspect the list without charge and to obtain a copy of the list from the firm upon payment of the reasonable costs of providing the copy.

Although we do not make a formal recommendation on this point, it seems reasonable for regulations to provide for the deletion of former members from an LLP's record of members after a certain period of time.[328] Similarly, we note that it would seem reasonable to allow third persons to get a copy of the record of partners by delivering a written request to the LLP, rather than having to actually attend at the records office to view and make a copy of the record.

c. Accounting Records

We have stated that we do not think it is appropriate to require LLPs to publish financial information for the benefit of creditors, given that business corporations are not required to do so. However, we think that LLPs should be under a statutory obligation to maintain adequate accounting records. We have proposed that creditors of an LLP should be able to attack certain distributions of LLP property to LLP partners: roughly speaking, transfers made when the LLP is insolvent. If a creditor does have occasion to attack a distribution, it obviously will be necessary to enquire into the state of the LLP's finances at the time the distribution is made. For this reason, we believe it is appropriate to require an LLP to maintain adequate accounting records. We do not propose that creditors should be entitled to inspect the accounting records in the ordinary course of events. Rather, the accounting records would be producible in court proceedings involving the LLP to the extent provided by relevant rules of procedure.

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[328] *Business Corporations Regulation*, Alta. Reg. 27/8, s. 12, as am. by Alta. Reg. 408/87, s. 6 allows a corporation to delete information regarding a former security holder seven years after they cease to be a securities holder.

RECOMMENDATION No. 21
An LLP should be required to prepare and maintain adequate accounting records, to be kept either at the registered office or the records office.

d. Service of Documents

As mentioned earlier, one of the purposes of requiring a corporation to maintain a registered office is to facilitate the service or delivery of documents on the corporation. A number of provisions in the *Business Corporations Act* provide for the delivery of specific documents or notices by sending or delivering them to the registered office. Section 247 provides generally for the service of documents on corporations. The methods provided are delivery to the registered office or sending the document by registered mail to the registered office or post office box designated for that purpose. In addition to any other method that is available for serving documents on a partnership,[329] we believe that the methods of service set out in section 247 of the *Business Corporations Act* should also apply to LLPs.

RECOMMENDATION No. 22
In addition to any other method by which documents may be served on a partnership, it should be possible to serve a document on an LLP by the methods of service contemplated by section 247 of the *Business Corporations Act*.

e. Periodic Returns

Legislation that requires business organizations to register information about themselves generally imposes requirements designed to keep the information up to date. There would not be much point in requiring businesses to register information about themselves unless some effort is made to keep the information reasonably current. There are two sorts of updating requirements: (1) event-driven and (2) periodic. The *Partnership Act*'s approach to updating information about limited partnerships and

[329] See Alberta Rules of Court, r. 15(3).

"Part 3" registrations[330] is purely event driven. When a change takes place in the partnership that affects the registered information, the registration must be amended to take account of the change. There is, however, no requirement to file periodic updates of any information relating to a limited partnership or a Part 3 registration.

The *Business Corporations Act* contains a mixture of event-driven and periodic updating requirements. Changes of registered office, changes of name and changes in directors are examples of events that generate a requirement to file an updating document with the Registrar.[331] But the Act also has a periodic updating requirement: the annual return. The annual return contains information about matters that the government considers important enough to be updated on a periodic basis.

Should updating requirements for LLPs be based on the current *Partnership Act* model or should they be based on a model more like that of the *Business Corporations Act*? The only information we have proposed to require LLPs to register is their name and registered office (and a separate records office and post office box for service, if any). This is the sort of information for which event-driven updating seems perfectly satisfactory. Even if information about the individual partners is required to be registered, such information could be kept up to date by a requirement to file an amendment whenever there is a change in membership of the partnership.

Nevertheless, we believe it is appropriate to impose a periodic return requirement on LLPs similar to the annual return requirement for corporations. What purpose, it might be asked, would be served by requiring LLPs to file a periodic return? In our view, a requirement for LLPs to file a periodic return would serve at least one purpose. It would provide a means of culling deceased or dormant LLPs from the register. In the absence of a periodic return requirement, LLPs may clutter up the register long after the

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330 By Part 3 registrations, we mean registration of partnerships and sole proprietorships under sections 81 and 85 of the *Partnership Act*.

331 A further distinction could be drawn between changes that occur "on the ground" and which must be recorded, and changes that can only be effected by filing the appropriate document. A change in a corporate name is an example of the latter. The corporate name *is* the name shown on the register until it is changed by following the prescribed steps, which include the filing of certain documents.

partnership itself has ceased to carry on business (as is currently the case with Part 3 registrations).

Given that the proposed periodic filing requirement would serve a fairly modest purpose, we are not convinced that it necessarily needs to be an annual requirement; a longer period might be appropriate. Nor do we think that failure to file the periodic return should, in itself, have drastic consequences. It should simply allow the Registrar to notify the LLP that it must file the required information within a certain period if it wishes to maintain its LLP status. Only if the LLP fails to respond to that notification should its registration be subject to revocation. And even if the registration is revoked, we do not think that it would be amiss to allow its LLP status to be restored retroactively if it takes corrective steps within a certain period after the revocation. The recommendation that follows is modeled on section 1003 of UPA 1996.

RECOMMENDATION No. 23

(a) An Alberta LLP should be required to file periodic returns in order to maintain its status as an LLP.

(b) An LLP should not lose its LLP status automatically if it fails to file a periodic return. Loss of status should occur only if the LLP does not take appropriate steps within a specified period after receiving a notice of the Registrar's intention to revoke its LLP status.

(c) If a partnership's LLP status is revoked under paragraph (b), that status should be capable of being restored retroactively if the partnership makes the appropriate application within two years after its LLP status is revoked.

f. Continuation of LLP Status Notwithstanding Technical Dissolution

We have noted that, technically, under the relationship theory of partnership any change in the membership of a partnership constitutes the dissolution of the existing partnership and the formation of a new partnership. With ordinary partnerships, ignoring the technical point about dissolution will rarely have practical legal consequences. But it needs to be kept in mind when considering the question of LLP status.

Suppose that A, B and C have registered their partnership as an Alberta LLP under the name Alpha LLP. C retires from "the firm" and D joins "the firm.". The A-B-D firm carries on the business of the A-B-C firm under the same name: Alpha LLP. Technically, "Alpha LLP" is not the name of a single, continuing partnership that at one time consists of A-B-C and at another time of A-B-D. It is a name used consecutively by two different partnerships: the A-B-C partnership and the A-B-D partnership.[332] We think it is uncontroversial that a technical dissolution ought to be ignored for the purpose of maintaining LLP status. However, while the policy seems obvious, we think it would be prudent for LLP legislation to specifically address the point.

RECOMMENDATION No. 24
LLP legislation should make it clear that where a change in membership causes a technical dissolution of a partnership that has LLP status, the partnership that continues after the dissolution should succeed to the former partnership's LLP status.

2. Extra-provincial LLPs

Extra-provincial LLPs are partnerships that acquire their LLP status under the laws of a jurisdiction other than Alberta and that wish to carry on business in Alberta. The discussion preceding the recommendations in this section is quite terse. For the most part, our proposals regarding extra-provincial LLPs follow the current of LLP legislation in other jurisdictions. In

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[332] *The Companies Act 1989* (UK) provides an interesting example of a legislative drafter's efforts to mesh the relationship theory of partnership with the commercial convenience of treating a partnership as an entity. Before the 1989 Act came into force, appointments of company auditors had to be of a specific individual, rather than of a firm; one of the objects the 1989 Act was to allow for the appointment of firms: Arora 1991 at 273. Section 25(2) allows for the appointment of a firm as an auditor. Section 26 then deals with the problem that a partnership that is so appointed is likely to have but a transitory existence if it is "constituted under the law of England and Wales or Northern Ireland, or under the law of any other country or territory in which a partnership is not a legal person:" s. 26(1). Section 26(2) provides that the appointment is deemed to be "an appointment of the partnership as such and not of the partners." Section 26(3)(a) provides that where the partnership ceases, the appointment is considered to extend to a partnership that "succeeds to the practice" of the first partnership. Section 26(4) defines what is meant by one partnership succeeding to the practice of another: "a partnership shall be regarded as succeeding to the practice of another partnership only if the members of the successor partnership are substantially the same as those of the former partnership." There is no elaboration of what is meant by the members of the two partnerships being "substantially the same."

broad outline, the approach of existing LLP legislation in the US and Ontario to "foreign" LLPs is consistent from one jurisdiction to the next, although there is some variation in the details.

Probably the most significant issue regarding LLPs that are formed under the laws of one jurisdiction (the "home jurisdiction") but that carry on business in another jurisdiction (the "host jurisdiction") is whose laws should govern the liability of partners for obligations of the LLP incurred in the host jurisdiction. This is of particular importance where different jurisdictions equip their LLPs with different liability shields. This issue is discussed in subsection (b) below.

a. Requirement to Register

We propose that an extra-provincial LLP should be required to register before carrying on business in Alberta. This is essentially the same requirement that applies to extra-provincial corporations under the *Business Corporations Act*. However, our proposed approach to dealing with extra-provincial LLPs that carry on business in Alberta before registering is more robust than the "slap on the wrist" approach of the *Business Corporations Act*. We propose that if an extra-provincial LLP incurs an obligation while carrying on business in Alberta before it has registered, it should be regarded as an ordinary partnership with respect to that obligation. In other words, the partners of the LLP should be personally liable for the relevant obligation to the same extent that they would be liable if the partnership was an ordinary partnership.

> **RECOMMENDATION No. 25**
> **An LLP formed under the laws of another jurisdiction should be required to register as an extra-provincial LLP before conducting business in Alberta.**

> **RECOMMENDATION No. 26**
> **If an extra-provincial LLP incurs any liability or obligation in a transaction governed by Alberta law while conducting business in Alberta contrary to Recommendation 1 the LLP should regarded as an ordinary partnership with respect to that liability or obligation.**

We propose that an extra-provincial LLP should be required to provide essentially the same information in its application for registration as would be required of a firm applying for registration as an Alberta LLP. Naturally, the information will be modified to account for the fact that the firm is an extra-provincial LLP, rather than an Alberta LLP. In particular, the extra-provincial LLP should be required to indicate its home (or "governing") jurisdiction and to provide satisfactory evidence of its status as an LLP under that jurisdiction's laws. Another modification is that, rather than having to maintain a registered office in Alberta, an extra-provincial LLP would be required to designate an agent for service in Alberta.

RECOMMENDATION No. 27
To register as an extra-provincial LLP, an LLP formed or acquiring that status under the laws of another jurisdiction should be required to provide the following information:

(a) its name;

(b) a statement that it applies for registration as an extra-provincial LLP;

(c) its governing jurisdiction;

(d) satisfactory evidence of its status as an LLP under the laws of the governing jurisdiction;

(e) the address of its registered or principal office; and

(f) an agent for service in Alberta.

We believe that an extra-provincial LLP should be subject to the same requirements regarding the filing of periodic returns as apply to Alberta LLPs. Again, we conceive the main purpose of the periodic return requirement as being to ensure that LLPs shown on the register are still active.

RECOMMENDATION No. 28
An extra-provincial LLP should be subject to the same requirements regarding periodic returns as Alberta LLPs.

b. Liability of Partners of Extra-Provincial LLP

We noted at the beginning of this section on extra-provincial LLPs that the most significant issue relating to extra-provincial LLPs is whose law should govern the liability of the LLP's partners. We are interested here in situations where an extra-provincial LLP incurs liabilities in Alberta. The question is whether Alberta law or the home jurisdiction's law should govern the liability of the members of the LLP for the latter's obligations. Of course, it does not matter whose laws apply if the "partner liability" rules for LLPs are virtually identical in the two jurisdictions. But as discussed earlier, there is considerable variation in the protection afforded by LLP liability shields from one jurisdiction to the next.

The approach that is taken by the vast majority, if not all, US states and by Ontario is generally to defer to the partner liability rules of the *home* jurisdiction.[333] However, some states make exceptions to their general deferral to the home jurisdiction's partner liability rules. For example, Alaska is a partial shield state and imposes vicarious liability for malpractice on supervising partners as well as on the partner who actually commits the wrongful act or omission.[334] The section that defers to the law of the home jurisdiction makes an exception for "acts and omissions in this state of the type described in AS 32.05.100(c)." The latter is the section that denies the protection of the liability shield to partners who are personally implicated in a wrongful act or omission.

We propose that Alberta should generally follow the current of LLP legislation in other jurisdictions. That is, where an extra-provincial LLP incurs an obligation in Alberta, the laws of its home jurisdiction should determine the personal liability of its partners for that obligation. This

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[333] See e.g. Alaska Stat. §32.05.630(b) (1998); Cal. Corp. Code §16958(a)(1) (West Supp. 1998); Fla. Stat. Ann. §620.7885(4) (West Supp. 1998); Mich. Comp. Laws Ann. §449.47(5) (West Supp. 1998); *Partnership Act* (Ont.), ss 10(5), 44.4(4).

[334] Alaska Stat. §32.05.100(c) (1998).

deference, however, should be subject to certain exceptions, which are discussed below.

In Recommendation 1 we proposed that a partner who is personally implicated in the wrongful acts or omissions that cause an LLP to incur a professional malpractice liability should be personally liable for the liability. We believe that this rule should apply to malpractice liabilities arising out of the provision of professional services in Alberta whether the partner who is implicated in the wrongful acts or omissions is a member of an Alberta LLP or an extra-provincial LLP carrying on business in Alberta. Since liability would be imposed on this partner because of their own negligent or otherwise wrongful conduct in the provision of professional services, their liability is not really a matter of "business organization" law at all.

In Recommendation 1 we proposed that the members of an LLP should be personally liable for any obligations for which they would be liable under Alberta law if they were the directors of a corporation. What we had in mind were special obligations of a corporation – of which wage claims are the primary example – for which its directors are made liable. We noted that since LLPs will not have directors, the LLP equivalent of imposing liability on the directors is imposing it on the partners. We believe that the policy reasons for imposing liability for these special obligations on the partners would apply regardless of whether the LLP acquired that status under the laws of Alberta or the laws of some other jurisdiction.[335]

RECOMMENDATION No. 29
Subject to Recommendation 30, after an extra-provincial LLP has registered in Alberta the liability of its members for

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[335] As noted earlier, directors may incur liability for wage claims under section 114 of the *Business Corporations Act* or section 112 of the *Employment Standards Code*, S.A. 1996, c. 10.3. Section 114(1) of the *Business Corporations Act* refers to directors of a "corporation," a term defined in section 1(1)(f.1) so as to apply only to corporations incorporated or continued under that Act. Section 112(2) of the *Employment Standards Code* also refers to the directors of a "corporation," but the *Code*'s definition of this term simply says that it does not include a society incorporated under the *Societies Act* or a company incorporated under Part 9 of the *Companies Act*. Although we are aware of no case law on the point, it would seem that section 112 of the *Employment Standards Code* could apply to directors of any corporation that incurs wage claims in Alberta, whether the corporation was incorporated under Alberta law or not.

liabilities and obligations of the LLP should be governed by the law of its home jurisdiction.

RECOMMENDATION No. 30
Recommendation 1 (personal liability of professional for their own malpractice) should apply to members of an extra-provincial LLP with respect to professional services provided in Alberta and Recommendation 1 (partners liable where corporate directors would be liable) should also apply to obligations incurred by the LLP in Alberta.

We note that Recommendation 3 also could have implications for the liability of partners in extra-provincial LLPs that wish to provide professional services in Alberta. Recommendation 3 is to the effect that the governing body of a profession may prescribe conditions for the limited liability practice of the profession in Alberta. To the extent that such conditions might subject the members of an extra-provincial limited liability firm to more extensive liability than they would be subject to under the laws of the firm's home jurisdiction the conditions would prevail.

PART III — LIST OF RECOMMENDATIONS

RECOMMENDATION No. 1

(a) Alberta professionals who are currently unable to practise in limited liability business organizations should be permitted to do so, subject to the restrictions and conditions set out in following recommendations.

(b) Subject to the exceptions set out in following recommendations, limited liability should apply to all obligations of the organization, not just to "malpractice liabilities." 102

RECOMMENDATION No. 2

A limited liability firm should be able to practise one of the professions under consideration in this report only if the profession's governing body has established mandatory minimum levels of professional liability insurance coverage to be maintained by such firms. 106

RECOMMENDATION No. 3

The governing body of a profession should have authority to prescribe additional conditions under which a limited liability firm may practise the profession in Alberta, regardless of whether the firm is formed under the laws of Alberta or some other jurisdiction. 106

RECOMMENDATION No. 4

The *Partnership Act* should be amended to provide for the formation of limited liability partnerships under that Act. 107

RECOMMENDATION No. 5

Professionals should have the option of practising in a limited liability partnership or a limited liability professional corporation, and each type of firm should provide the same liability shield and be subject to the same safeguards for the protection of persons who deal with the firm. 108

RECOMMENDATION No. 6

Irrespective of the form of limited liability organization through which a professional firm practises, a partner or shareholder ("member") of the firm should be personally liable for liabilities incurred by the firm because of that member's negligent or otherwise wrongful acts or omissions in the provision of professional service, including negligence in appointing, directly supervising, or failing to supervise another member, employee or representative of the firm in the provision of professional services. 111

RECOMMENDATION No. 7

LLPs should be available to enterprises generally, rather than being available only to practitioners of certain professions. 119

RECOMMENDATION No. 8
Any special rules that are intended to apply specifically to professional LLPs, as opposed to LLPs generally, should be placed in the relevant professional statutes, as is currently done for professional corporations. 119

RECOMMENDATION No. 9
Where an existing partnership becomes an LLP, this should not affect the liability of members of the partnership for liabilities that arose before, or that arise out of a contract entered into before, the partnership became an LLP. 120

RECOMMENDATION No. 10
Limited liability for members of an LLP should be implemented through statutory provisions to the following effect:
(a) Where the law relating to ordinary partnerships would impose a liability on the members of a partnership by reason only of their membership in the partnership, the liability imposed on partners of an LLP should be limited to their interest in the partnership property.
(b) Subject to any agreement to the contrary and to specific exceptions mentioned in other recommendations, a member of an Alberta LLP should not be liable to the LLP or any other member by way of contribution, indemnity, or otherwise, with respect to any obligation of the LLP or the other member.
(c) Members of an LLP should not be proper parties to an action based on an obligation or liability of an LLP.
(d) Notwithstanding that the members of an LLP are not parties to an action against the LLP, a judgment against the LLP should be enforceable against their interest in the partnership property.
(e) A judgment against an LLP should be enforceable against the partnership property of its current members, regardless of any change in the membership of the LLP between the time the liability arose and the time the judgment is obtained or enforced. 127

RECOMMENDATION No. 11
(a) Partners of an LLP should be personally liable for liabilities and obligations of the LLP for which they would be liable under Alberta law if the LLP was a corporation of which they were the directors.
(b) Where a corporation is a partner in an LLP, the directors of the corporation should be personally liable for any liability of the corporation arising under paragraph (a). 131

RECOMMENDATION No. 12
(a) An LLP must set out its name on all contracts, invoices, negotiable instruments and orders for goods and services.
(b) Where an LLP enters into a contract without complying with paragraph (a), its partners should be liable for any liability of the LLP arising out the contract to the same extent as if the firm was an ordinary

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