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AND OTHER

HYBRID BUSINESS ENTITIES

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ACKNOWLEDGEMENTS

The Institute wishes to acknowledge its indebtedness to Mr. Richard H. Bowes, the Institute's Counsel who has had the carriage of this project. While the genesis of the project was a relatively focused question, the challenge in presenting the Issues Paper has been to ensure that the narrower question is appropriately placed in the context of all the broader issues which it touches. It will be clear to the reader that Mr. Bowes has met that challenge, and the Institute acknowledges the thoroughness and clarity with which the major issue has been described.

Mr. Bowes has been assisted by a small working group representing the various departments whose legislation might be impacted by the proposals. We are grateful to Mr. Clark Dalton from the Department of Justice, Ms. Brenda Johnson of the Department of Labour, Professions and Occupations, and Ms. Carol Patrick of Alberta Treasury. All have taken the time to read and comment on prior drafts, and their contribution has been most helpful. We also thank Mr. David G. Roberts of Cross Border Tax and Transactions of San Francisco, California, who provided the very helpful examples on page 168.

We look forward to comments on the Issues Paper from the broader audience, and to seeing the issues translated into legislative recommendations.

PREFACE AND INVITATION TO COMMENT

This paper is published to solicit input that will assist the Alberta Law Reform Institute in making recommendations to the Government of Alberta on two distinct but related matters. The first matter is whether members of certain professions who currently cannot practice in limited liability business entities should be allowed to do so and, if they are so permitted, what the limited liability entities should look like and what safeguards should be provided. Proposals have been made to the Government that professionals such as accountants, lawyers and doctors be permitted to practise in "limited liability partnerships." Each professional practising in a limited liability partnership would be personally liable for their own negligence (or other wrongful conduct) in providing professional services. The assets of the firm and any applicable liability insurance would also be available to meet professional malpractice claims. Individual partners, however, would not be personally liable for professional malpractice claims against the firm relating to a matter in which they had no personal involvement.

> **Invitation to Comment**
>
> The Institute invites comments on the matters discussed in this paper. We invite comments on the specific issues identified in the paper, but we also invite readers to make general observations and to suggest additional issues or lines of enquiry that we ought to consider when formulating our recommendations. Readers who intend to provide comments are requested to do so by **June 26, 1998**. Comments in writing should be addressed to:
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> Although readers are encouraged to comment in writing, readers who wish to provide oral comments or discuss any of issues before providing written comments may call Rick Bowes at 403-492-1797.

The second matter is whether Alberta should provide a "new" type of hybrid business entity that would combine certain characteristics of business entities that are presently available in Alberta, and would be available to any

type of business. The relationship between the two matters is that both raise questions regarding the circumstances in which it is appropriate for owners and managers of enterprises to be shielded from personal liability for obligations incurred by their firm, and the appropriate *quid pro quo* for this liability shield.

One difference between the two matters discussed in this paper is their apparent urgency. It has been argued that changes to laws that prevent certain professionals from practising in limited liability entities are urgently required to alleviate an ongoing liability crisis. On the other hand, while a new type of general-purpose hybrid business entity might be useful, no one is suggesting that it is a matter that requires the urgent attention of the government. For this reason, we may deal separately with these two matters after receiving and considering comments on this paper. Our intention is to issue a report with recommendations to the government regarding the professional liability matter in the fall of 1998. We will likely defer making any recommendations on the matter of general-purpose hybrid entities until a later date.

At this point, we do not anticipate that our report on the matter of limited liability for professionals will make a recommendation either that the government allow professionals to practice in limited liability firms or that it not do so. Ultimately, we think, the decision on that fundamental issue must reflect the sort of balancing of considerations and interests that is best left to elected representatives of the people of Alberta. We will, however, not hesitate to make recommendations as to the considerations that we think should inform legislators' decision on this issue. We will also make recommendations regarding the form that a limited liability vehicle should take and what safeguards might be provided to the public if legislators do decide that some sort of liability shield should be provided to the professionals in question.

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TABLE OF LEGISLATION

Statute Name	Additional Information
Alberta Corporate Tax Act	R.S.A. 1980 c. A-17
BCA [*Business Corporations Act*]	S.A. 1981 c. B-15
Canada Business Corporations Act	R.S.C. 1985 c. C-44
Certified General Accountants Act	S.A. 1987 c. C-3.6
Certified Management Accounts Act	S.A. 1987 c. C-3.8
Chartered Accountants Act	S.A. 1987 c. C-5.1
Chiropractic Profession Act	S.A. 1984 c. C-9.1
Companies Act	R.S.A. 1980 c. C-20
Companies Act (NS)	R.S.N.S. 1989 c. 81
Dental Profession Act	S.A. 1983 c. D-9.5
Highway Traffic Act	R.S.A. 1980 c. H-7
ITA [*Income Tax Act*] (Canada)	R.S.C. 1985 (5th Supp.) c.1
Joint Stock Companies Act, 1844 [*An Act for the Registration, Incorporation, and Regulation of Joint Stock Companies]* (UK)	7&8 Vict. c. 110
Legal Profession Act	S.A. 1990 c. L-9.1
Limited Liability Act, 1855 [*An Act for Limiting the Liability of Members of Certain Joint Stock Companies]* (UK)	18 & 19 Vict. c. 133
LLCA [*Limited Liability Companies Act*] (Delaware)	Del. Code Annot. Title 6, Chapter 18
Loan and Trust Corporations Act	S.A. 1991 c. L-26.5
Medical Profession Act	R.S.A. 1980 c. M-12
Optometry Professions Act	S.A. 1993 c. O-10
Partnership Act	R.S.A. 1980 c. P-2

Statute Name	Additional Information
Partnership Act (BC)	R.S.B.C. 1996 c. 348
Partnership Act, 1890 (UK)	55 & 54 Vict. c. 39
Pharmaceutical Profession Act	S.A. 1988 c. P-7.1
Private Securities Litigation Reform Act of 1995 (US)	Pub. L. No. 104-67, 109 Stat. 737 (1995)
Professional Standards Act 1994 (NSW)	Act 1994 No. 81
Securities Act	S.A. 1981 c. S-6.1
Solicitors Act 1974 (UK)	1974 c. 47
Solicitors Remuneration Act, 1881 (UK)	44 & 45 Vict. c. 44
The Attorneys' and Solicitors' Act, 1870 (UK)	33 & 34 Vict. c. 28
The Joint Stock Companies Act, 1856 (UK)	19 & 20 Vict. c. 47
Tort-Feasors Act	R.S.A. 1980 c. T-6
Trustee Act	R.S.A. 1980 c. T-10
ULLCA [*Uniform Limited Liability Company Act*]	(NCCUSL, 1996)
Unfair Contract Terms Act 1977 (UK)	1977 c. 50
UPA 1996 [*Uniform Partnership Act (1996)*]	(NCCUSL, 1996)

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Esanda	*Esanda Finance Corporation Ltd. v. Peat Marwick Hungerfords* (1997), 142 A.L.R. 750 (H.C. of Aust.)
Hague	*Hague v. Cancer Relief & Research Institute* [1939] 4 D.L.R. 191 (Man. K.B.)
Haughton	*Haughton Graphic Ltd. v. Zivot* (1986), 33 B.L.R. 125 (Ont. H.C.)
Hercules	*Hercules Managements Ltd. v. Ernst & Young* [1997] 2 S.C.R. 165
Nordile	*Nordile Holdings Ltd. v. Breckenridge* (1992), 66 B.C.L.R. (2d) 183 (B.C.C.A.)
Rafuse	*Central Trust v. Rafuse* [1986] 2 S.C.R. 147
Salomon	*Salomon v. Salomon & Company* [1897] A.C. 22

Reference in Text	Full Name and Citation
Trident	*Trident Holdings Ltd. v. Danand Investments Ltd.* (1988) 49 D.L.R. (4th) 1 (Ont. C.A.)

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Stratton & Hughes 1997	David J. Stratton & Debbie L. Hughes, "Case Comment: Canada (Attorny General) v. Roger M. Bourbonnais Professional Corporation" (1997) 35 Alta. L. Rev. 777
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Thompson 1995	Robert B. Thompson, "The Taming of Limited Liability Companies" (1995) 66 Colorado Law Review 921
TSE 1997	Toronto Stock Exchange Committee on Corporate Disclosure, *Responsible Corporate Disclosure: A Search for Balance, Final Report* (Toronto: Toronto Stock Exchange, March 1997)

TABLE OF ABBREVIATIONS

AICPA	American Institute of Certified Public Accountants
BCA	*Business Corporations Act*
CGAAO	Certified General Accountants Association of Ontario
CICA	Canadian Institute of Chartered Accountants
DTI	Department of Trade and Industry (UK)
FDIC	Federal Deposit Insurance Corporation (US)
GAPP	Generally Accepted Accounting Principles
ICAA	Institute of Chartered Accountants of Alberta
ICAEW	Institute of Chartered Accountants in England & Wales
IRS	Internal Revenue Service (US)
ITA	*Income Tax Act*
LLC	limited liability company
LLCA	*Limited Liability Company Act* (Delaware)
LLP	limited liability partnership
LLPC	limited liability professional corporation
LP	limited partnership
LSA	Law Society of Alberta
MAS	management advisory services
NAHBE	new Alberta hybrid business entity
NCCUSL	National Conference of Commissioners on Uniform State Laws (US)
PC	professional corporation
UL	unlimited liability [professionals]
ULLCA	*Uniform Limited Liability Company Act* (NCCUSL)
UPA 1996	Uniform Partnership Act (1996) (NCCUSL)

CHAPTER 1. PRELIMINARIES

A. Purpose of this Paper

In the summer of 1997 Alberta's Minister of Justice requested the Alberta Law Reform Institute to consider whether legislation should be enacted to allow businesses to be carried on through a hybrid entity known as the limited liability partnership ("LLP"). Over the last few years, the Institute of Chartered Accountants of Alberta ("ICAA") and the Law Society of Alberta ("LSA") have entreated the government to enact legislation that would allow their members, as well as the members of certain other professions, to practise in LLPs. Although, the accounting and legal profession have the keenest interest in LLPs, the Minister requested that we consider the possible role of LLPs as a general purpose business entity, not just as an entity that might be useful to certain professions.

This paper is published to solicit input that will assist us in making recommendations on the two distinct but related matters alluded to in the preceding paragraph. The first is whether Alberta professionals who currently cannot practise in limited liability business entities should be allowed to do so and, if so permitted, what form the limited liability entities should take and what safeguards, if any, are needed. The second matter is whether Alberta should create a new type of hybrid business entity and make this entity available to all enterprises. Such an entity might combine the following attributes: (1) limited liability for owners and managers; (2) flow-through taxation.[1] The relationship between the two matters is that both raise questions regarding the circumstances in which it is appropriate for participants in an enterprise to be shielded from personal liability for liabilities incurred by the enterprise, and the appropriate *quid pro quo* for this liability shield.

B. Reading Guide

The first three chapters of this paper lay the groundwork for the final three chapters, which discuss specific issues relating to professionals' liability and a possible new general-purpose hybrid business entity for Alberta.

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[1] Flow-through taxation means that the income of an enterprise is attributed to its members for tax purposes, so tax is paid directly by the individual owners on their share of the enterprise's income, rather than being taxed at the "entity" level.

Section C of this chapter provides an overview of the major issues that we consider in connection with the matter of professionals' liability, and the rationale for allowing, or not allowing, professionals to practise in limited liability entities. Section D discusses certain issues that, although not within the specific scope of this project, provide context for the issues that we do consider. Section E briefly describes some key legal concepts and doctrines that are referred to in succeeding chapters. It provides "nutshell" explanations of concepts like tort liability, vicarious liability, and joint and several liability. So they will fit in a nutshell, our descriptions gloss over many nuances of those concepts, but the descriptions are adequate for the purposes of this paper.

Chapter 2 briefly describes business entities, such as corporations and partnerships, that are currently available in Alberta, as well as certain business entities that are not currently available in Alberta, but are available or have been proposed in other jurisdictions. The descriptions concentrate on the characteristic of business entities that is of the most interest for the purposes of this paper: the liability of owners and managers for obligations of the firm.[2] We also provide a cursory overview of the tax treatment of the entities and their owners, because tax considerations are likely to play a very significant role in the type of entities through which businesses operate.

Chapter 3 starts with a brief historical sketch of the evolution of limited liability business entities. It then describes some moral and economic arguments that have been advanced for and against the concept of limited liability for participants in business enterprises. The discussion provides a foundation for the ensuing discussion of the liability position of certain professions. Chapters 4 and 5 deal with the matter of the current inability of certain professionals' to practice in limited liability business firms and the issue whether this should change, and if so how. Chapter 4 deals with "whether," Chapter 5 with "how."

If we were only concerned with the professional liability matter, this paper would conclude with Chapter 5. The final chapter considers whether it would be a good idea to provide a new hybrid business entity that could be

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[2] We do not use "firm" in any technical sense. We use it to denote a business organization, which might or might not be a legal entity.

used by any type of business enterprise. The discussion of this issue is not very detailed, because at this point we are mainly trying to determine whether there is sufficient interest in a new general purpose limited liability entity to make further work on the issue worthwhile.

C. Fundamental Issues Relating to Professionals' Liability

Chapters 4 and 5 contain a detailed discussion of many issues relating to whether professionals who currently are not able to practice in limited liability entities should be able to do so, and, if so, what those entities should look like. There is some danger that once you plunge into those chapters you will have the feeling of not being able to see the forest for the trees. Therefore, it would be useful at the outset to describe briefly what we see as the fundamental issues in connection with this matter.

1. Are Certain Professions Different than other Enterprises?

In Alberta today almost all enterprises, including many professional enterprises, can be conducted through ordinary business corporations. Subject to certain exceptions that need not detain us at the moment, owners (shareholders) and managers (directors and officers) of a corporation are not subject to personal liability for liabilities of the corporation. This immunity of owners and managers from the general run of the firm's liabilities is often referred to as a "liability shield." Ordinarily, the corporate liability shield will protect owners and managers against liability for ordinary debts of the corporation, as well as for liabilities incurred by the corporation for defective products or services. Thus, if a corporation goes bankrupt, the maximum amount that its shareholders stand to lose is the amount they have invested in the corporation. For shareholders and managers of closely held corporations, however, the liability shield will often be academic because they will have to provide personal guarantees to the bank.

The members of a handful of professions cannot currently practise in an entity that will provide them with a shield against liability for professional malpractice claims against their firm. The professions are accountants,[3]

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[3] This includes all three branches the profession: certified general accountants, certified management accountants and chartered accountants.

lawyers and certain health care professionals.[4] We refer to them collectively throughout this paper as the "UL" (for "unlimited liability") professions. The ICAA and LSA have argued that UL professionals should be allowed to practice in a type of business entity, the LLP, that would provide a partial shield against liability for professional malpractice claims against their firms. A notable feature of the LLP (at least the version that has been proposed for Alberta)[5] is that it would only shield the "innocent" members of an LLP from liability for professional malpractice claims. It would not provide a shield to a professional who was personally at fault or who was directly responsible for supervising someone who was personally at fault.

In considering the request that UL professionals be permitted to practice in LLPs, we think that one of the fundamental issues that need to be considered is whether there are good reasons of principle or policy for treating the UL professions differently than most other enterprises. If other enterprises can be conducted from behind a liability shield, why can UL professionals not do so as well? We should emphasize that the preceding question is not intended to be rhetorical. There might be good reasons for denying UL professionals the privilege of practising in limited liability entities, even though most other enterprises may be conducted in that manner.

2. Limited Liability and the Quality of Services

Many legal rules require persons ("actors") who cause harm to other persons to pay damages to the victim. Roughly speaking, their are two sorts of justification that might be offered for such rules of civil liability: (1) deterrence and (2) compensation. Theorists who examine the law from an economics perspective tend to emphasize the deterrent, or incentive, value of civil liability rules. The fundamental premise of this way of looking at civil liability rules is that rational actors will take into account the risk of incurring civil liability when considering various possible courses of conduct. From this perspective, the goal of civil liability rules should be to provide rational actors with an incentive to behave in a manner that maximizes social welfare. For example, civil liability rules should be designed to provide

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[4] The affected health care professionals are chiropractors, dentists, physicians, and optometrists.

[5] As will be discussed in Chapter 2, there are different varieties of LLP, which provide different levels of protection to their members.

actors who have entered into contracts with an incentive to honour those contracts. Similarly, liability rules should be designed to provide actors whose activities may cause harm to others with an incentive to take the socially optimal level of care to avoid causing such harm. The "socially optimal level of care," it should be noted, is *not* the maximum amount of care that the actor could conceivably take. The law of diminishing returns applies to "taking care." There comes a point where the reduction in the risk of accidents that would be produced by taking more care does not justify the cost of taking more care.[6]

Applying the foregoing to UL professionals, the object – or at least one object – of the civil liability rules applicable to UL professionals should be to give them an incentive to provide services of optimal quality: to take the socially optimal level of care in providing their services. If a proposal is made to allow UL professionals to practice in limited liability entities, the obvious question how such a change would affect the quality of their services. Would the proposal, if implemented, have any effect at all on the quality of services provided by UL professionals? If a move from unlimited liability to limited liability has any effect on the quality of services provided by professionals, it presumably would be to reduce that quality by reducing their incentive to take care.

From the perspective of the economist, it would not necessarily be a bad thing if a change in liability rules caused UL professionals to reduce their level of care. Whether it would be a bad thing or not would depend on whether the current matrix of liability rules causes UL professionals to take more than the optimal level of care. If the existing rules are causing UL professionals to take more than the socially optimal level of care, the savings that professionals would realize by reducing their level of care would exceed the incremental cost of accidents that would result from this reduction in care. These savings could be passed on to the consumers of professional services in the form of lower prices.

On the other hand, if UL professionals are currently taking no more than the optimal level of care, any decrease in their general level of care would be undesirable. For reasons explained in Chapter 4, we assume that

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[6] See Shavell 1987 at 5-32 for a lucid introduction to the basic concept of civil liability rules as a deterrence mechanism.

UL professionals are *not* currently exercising more than optimal care in providing professional services. Thus, we assume that *if* there is good reason to expect that limited liability would cause UL professionals to lower their level of care from what it is now, that would be a reason not to allow UL professionals to practise in limited liability entities.

3. Limited Liability and Compensation

The crucial question for economic analysis of civil liability rules is how they affect the behaviour of actors. Whether individuals who have suffered losses are actually compensated by the person responsible is incidental to this analysis. But in the real world, especially the real world of legislators answerable to constituents, whether liability rules will ensure that deserving victims of wrongful conduct are compensated for their loss cannot be regarded as of incidental importance. The effect that a proposed change in the matrix of liability rules will have on the prospect that victims of professional malpractice will be compensated for their losses is a highly relevant consideration from both a political and moral perspective. Thus, it is important to consider whether allowing UL professionals to practice in limited liability entities would be likely to substantially reduce the compensation that victims of professional malpractice will actually receive for their losses.

D. An Audit Liability Crisis?

In this section we briefly describe an issue that is outside the scope of this project, but not so far outside that it can be completely ignored in considering the issues that are within the scope of the project. The issue is whether accountants are afflicted by a liability crisis with respect to the provision of audit services.

Governing bodies of the accounting profession have led the charge for limits on professionals' liability, not only in Alberta, but throughout Canada and around the world. The major premise of their argument is that a confluence of social factors and legal doctrines has created a liability crisis with respect to the provision of audit services. Allowing accounting firms to practise as LLPs is put forward not as the solution to the crisis, but as part of a package of reforms that is necessary to alleviate the crisis. The main reform that is proposed is to replace the principle of joint and several liability with a

doctrine of proportionate liability.[7] The debate over the doctrine of joint and several liability is briefly alluded to in Section E, below.

1. Arguments of Certain Accounting Bodies

In this section we will summarize arguments that have been put forward on the liability crisis issue by three accounting bodies: the Canadian Institute of Chartered Accountants ("CICA"), the ICAA and the Certified General Accountants Association of Ontario ("CGAAO"). The arguments of the CICA and ICAA are more or less interchangeable; the CGAAO disagrees with many of the points raised by the other two accounting bodies.[8]

a. Importance of the audit function

The audit plays a very important function in the modern economy, so important that most large enterprises are required by law to produce audited financial statements:

> The law of the land now, in all parts of Canada, with limited exceptions, requires incorporated businesses to appoint auditors for the performance of an annual audit of the company's financial statements for delivery to the shareholders, securities commissions, and regulatory authorities, and to be made readily available to the public generally. Audited financial statements are also a standard demand by any bank or other agency extending credit to a company or any enterprise, by any regulator who may have surveillance duties with reference to the audited enterprise, and by major suppliers to the subject of the audit.
>
> The commercial community dealing with a business to which members of that community are supplying goods and services or extending credit generally require evidence of creditworthiness when the volume of the business done with the concern in question reaches even modest dimensions of debt or credit. The principal and usually the only source of such assurance comes from the annual or periodic audit reports or special audits by competent auditors.[9]

Given the importance and value of the audit institution, legislators obviously should be concerned if something threatens its continued viability. And it is

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[7] ICAA 1994 directs most of its fire at the doctrine of joint and several liability. CICA 1996 is a submission to the Standing Senate Committee on Banking, Trade and Commerce. The Committee has been examining the matter of joint and several liability of auditors in connection with a review "of a number of policy issues related to the modernization of the *Canada Business Corporations Act*:" Senate Committee 1996 at 1. We understand that the Committee's final report is to be released in the very near future.

[8] The CGAAO also takes issue with submissions by the Institute of Chartered Accountants of Ontario. We have not seen the latter's submissions, but we assume they are similar to the submissions of the CICA and ICAA. In Alberta Certified General Accountants may perform audits; in Ontario that privilege is reserved to chartered accountants.

[9] CICA 1996 at 13.

said that "devastating forces [are] abroad which threaten the continued existence of the auditor as we know that institution."[10]

b. The evidence for an audit liability crisis

The CICA and ICAA make two general points in support of their contention that there is an audit liability crisis. The first refers to the number of huge claims that have been made in recent years against auditors; the second refers to the high cost and scarcity of liability insurance coverage.

i. Huge claims and judgments

The submissions emphasize that in recent years a large number of claims for huge amounts – hundreds of millions or even billions of dollars – have been made against auditors of failed companies.[11] Not only are the claims numerous and for huge amounts, some settlements and judgments against large accounting firms have been for staggering amounts. Some judgments and settlements have greatly exceeded audit firms' liability insurance coverage, thereby threatening the firms and their partners with bankruptcy.[12] The actual burden of claims is much greater than the amount paid out to plaintiffs, because auditing firms incur substantial direct and indirect costs to defend themselves.

The ICAA and CICA's list of huge *claims* made against accounting firms is longer than their list of huge *settlements and judgments*, particularly settlements or judgments arising from claims made in Canada. Many of the larger claims and settlements that are referred to relate to litigation in the US. But the CICA warns:

> It must be remembered, in assessing the magnitude of the threatened or actual court proceedings for recovery of economic losses from auditors, that legal and financial conventions, practices, and principles arising in the United States are almost invariably transplanted into Canada through somewhat comparable political and legal institutions. In short, the American storms in very large-scale financial and corporate transactions invariably turn up in our "weather forecast."[13]

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[10] CICA 1996 at 1.

[11] CICA 1996 at 5; ICAA 1994 at 10-11.

[12] ICAA 1994 at 11.

[13] CICA 1996 at 12.

The CGAAO's laconic response is:

> In reality, however, there are sufficient differences between the Canadian and American legal systems which prevent the US storm clouds from drifting over our border.[14]

This assertion is elaborated by pointing out differences in rules regarding the awarding of costs against unsuccessful litigants and the lesser role of juries under the Canadian civil litigation system.

ii. Insurance: expensive and scarce

The CICA and ICAA submissions point out that premiums for audit liability insurance have increased dramatically in recent years, and that large accounting firms are unable to procure adequate liability insurance at any price.[15] Liability insurance of up to $10 million is available through an insurance plan sponsored by the accounting profession.[16] This may provide adequate insurance for small to medium sized firms but not for the larger firms, which are frequently subject to claims in the hundreds of millions of dollars. Referring specifically to the difficulties faced by "the Big Six international firms operating in Canada," the ICAA offers the following particulars:

> Their maximum coverage through true, third party insurers decreased by a factor of five in the last 10 years, dropping from more than $200 million to less than $40 million. The deductible amounts doubled in the first half of the 1980s and increased by more than 100 times since then and are now [1994] in the area of $50 million. This instability in the international liability insurance market has led all of Canada's largest accounting firms to self-insure themselves for the most part. Most of the Big Six firms today self-insure the first $50 million in claims, seeking insurance coverage for the next $25-35 million. No firm in Canada has access to commercial insurance for claims of more than $100 million – an unsatisfactory situation in cases like Castor Holdings and Standard Trust, where the initial claims were respectively $700 million and $1.5 billion.[17]

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[14] CGAAO 1997 at 12.

[15] CICA 1996 at 6; ICAA 1994 at 13.

[16] CICA 1996 at 6; ICAA 1994 at 13.

[17] ICAA 1994 at 13. [Paragraph breaks omitted.]

The CICA adds that "[t]he cost of insurance [for the national firms] is ten times the cost just seven years ago, and now [1996] approximates $35,000 a year per partner."[18]

For its part, the CGAAO accepts that the cost and scarcity of adequate insurance coverage, especially for the larger accounting firms are a real problem. However, referring to the conclusions of a 1995 report by the Ontario Ministry of Consumer Relations, the CGAAO makes the following point:

> . . . the Report acknowledges that the 60 to 67% self insurance level [of the Big Six firms] is not acceptable and the price and availability of insurance in the international market remains heavily conditioned by the history of claims and settlements in the United States. Changing the Ontario laws are therefore not likely to reduce insurance costs and availability.[19]

The last point would, of course, apply also to any change in the laws of Alberta. That is, if the insurance problem, specifically, the scarcity and high price of insurance, is really the result of factors that are external to Alberta and Canada, it is difficult to see how changes to Alberta law would increase the availability or lower the price of insurance.[20]

c. Causes of the liability crisis

A number of mutually reinforcing factors are said to account for the liability crisis facing auditors. The factors include the magnitude of claims against auditors, the structure of the accounting industry, and a collage of unfortunate legal doctrines. The confluence of all these factors has resulted in auditors being treated more like involuntary insurers of the ongoing success of audited companies than as experts who take reasonable steps to verify the accuracy and fairness of companies' financial statements.[21]

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[18] CICA 1996 at 6.

[19] CGAAO 1997 at 31.

[20] In Chapter 4 we discuss the possibility that allowing UL professionals to practise in limited liability entities would help to alleviate the insurance problems of large firms simply because it would effectively reduce their wealth at risk, thereby reducing their desired levels of insurance.

[21] CICA 1996 at 2, 12.

i. The magnitude of claims

To paraphrase the definition of "audit" in the *Chartered Accountants Act*, auditors examine the records of a company for the purpose of providing an opinion as to whether financial information is presented fairly.[22] Many audited companies' financial statements report assets and liabilities of hundreds of millions or billions of dollars, and their market capitalization may greatly exceed the value of their assets as shown in their financial statements. Unfortunately, large companies sometimes fail or suffer severe reverses. When the dust settles, shares that appeared to be worth hundreds of millions or billions of dollars may be virtually worthless. And creditors may also be out of pocket by hundreds of millions of dollars. Naturally, shareholders and creditors who have suffered these losses will look for compensation. Their gaze will frequently fall upon the auditor.

The basic thrust of claims against auditors of failed companies (or companies whose security prices have suffered major reverses) is that the auditor certified that financial statements fairly presented financial information about the company when they did not, in fact, do so. If this claim is proved to the satisfaction of a court, certain persons who relied on the inaccurate financial statements may have claims against the auditors. Not everyone who relied on inaccurate financial statements will necessarily have a legally enforceable claim against the auditor,[23] but the auditor's liability could very well run into the hundreds of millions or billions of dollars. Even if the magnitude of the claims for which auditors are potentially liable does not in itself constitute a liability crisis, it certainly indicates why auditors have more than a passing interest in means of limiting their liability exposure.

We note in passing that, to the extent that the sheer size of claims is regarded as the source of a liability crisis, one approach might be to place statutory ceilings on the amount of damages for which an auditor (or other professional) could be held liable. This approach has been taken in New South Wales, which several years ago enacted legislation that provides for caps on professionals' liability. The general thrust of the scheme, as described by the New South Wales Law Reform Commission, is as follows:

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[22] *Chartered Accountants Act*, s. 1(1)(a).

[23] See the discussion of *Hercules* below in section E.1(b)(2).

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

> (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.[24]

Whatever else one might say about them, statutes that place an arbitrary upper limit on damages would seem to be a pretty complete response to any liability crisis that arises out of exposure to huge claims. Obviously, however, such statutes are open to attack on the basis that an arbitrary limit on damages may arbitrarily deprive claimants of compensation to which they are entitled.[25]

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[24] NSWLRC 1987 at 23-24. The Commission noted that by the end of 1996 three schemes had been approved by the Professional Standards Council. Two of the schemes applied to engineers, the third to lawyers.

[25] NSWLRC 1997 summarizes the capping scheme in the course of a discussion of the debate over joint and several liability, without opining on the merits of the scheme. Common Law Team 1995 at 47-49 reviews the advantages and disadvantages of capping schemes and concludes:

> We can find no principled argument for a capping scheme – it simply benefits defendants at the expense of plaintiffs, when legally those defendants are liable

(continued...)

ii. The structure of the accounting industry

The public accounting market is dominated on a global basis by a handful of giant accounting firms: the so-called "Big Six."[26] This market dominance is particularly evident in the audit of major companies, the sort of companies whose failure is capable of generating very large claims against auditors. Investors in failed companies are apt to conclude that large size translates into deep pockets.[27] A Big Six auditing firm represents an almost irresistible target for claims by investors who have lost money as a result of the demise of one of the firm's audit clients. However, as the CGAAO points out:

> But it is also arguable that the *Big Six* accounting firms have been the authors of their own misfortune. Senator Michael Kirby, Chairman of the Senate Committee on Banking, Trade and Commerce alluded to this during the hearings:
>
> > Would this problem be nearly as serious had the accounting profession not, over the last 15 years, gone through all of the mergers, that reduced it to a very small handful of big players? . . . if we had 500 accounting firms and one went under it would not be a big issue. If one of the *Big Six* goes under it is a problem. In a sense, having made a whole bunch of business decisions which absolutely you had every right to do and were absolutely in your own interest, you are now saying by the way in the course of doing that you have created a problem which we ought to solve for you.
>
> Clearly, the mergers that occurred were completed in order to service the needs of multinational corporations who now expect cross-jurisdictional expertise from their accountants and auditors. The larger firms emphasize their service advantage and surely must have realized that the market advantage also is accompanied by certain risks, one of which is increased exposure to lawsuits respecting auditing services.[28]

The "big firm" issue is particularly significant in relation to the debate over joint and several liability.

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[25] (...continued)
for wrongs done to those plaintiffs.
For a critical assessment of the New South Wales Act, and the events that led up to its enactment, see Miller 1998, *passim*.

[26] In the 1970s it was common to find references to the "Big Eight:" e.g. Briloff 1976 at 13-14. Because of mergers within that group, in recent years we have become accustomed to references to the "Big Six:" eg. ICAA 1994 at 13. It seems that we will soon be referring to the "Big Five:" see e.g. Lang 1997; Rubin 1997; Lang 1998.

[27] See e.g. ICAA 1994 at 1, which refers to "deep pockets" without explicitly locating these pockets in the trousers of the major accounting firms. It goes without saying, however, that the pockets of one of the major firms will look much deeper than those of a sole practitioner or small local firm.

[28] CGAAO 1997 at 34.

iii. Tort liability

The accounting profession identifies potential tortious liability to third parties as a major contributor to the audit liability crisis. We will explore this point in a little more detail in Section E, below, when we compare the concepts of contract and tort liability. For the moment, it suffices to observe that in recent years and months the highest courts of Canada, the UK, and Australia have done much – many would say too much – to diminish the prospect that auditors will incur significant liability to non-clients in connection with routine audits.

iv. Joint and several liability

Accounting bodies view the doctrine of "joint and several liability" as the main culprit in the audit liability crisis. For example, immediately after referring to "devastating forces" that threaten the auditor's existence, the CICA continues: "The most serious of those forces is the yardstick of legal liability for the auditor's negligence, 'joint and several liability.'"[29] The concept of joint and several liability and the debate over whether it should be replaced by some other doctrine are discussed briefly in Section E. For the moment, it suffices to observe that the accounting bodies' complaint about the doctrine is that it makes it likely that auditors will be found liable for much more than their fair share of losses suffered by investors in or creditors of a failed company.

v. Unlimited personal liability

Unlike legal doctrines such as tort liability and joint and several liability, the fact that members of the accounting profession are subject to unlimited personal liability for their firm's liabilities does not increase the *firm's* liability risk. But it does exacerbate the effect of these other doctrines by increasing the risk faced by individual members of a firm:

> Aggravating this problem for accountants is the unlimited liability of the partnership structure. This could lead to an Edmonton partner of a national firm becoming personally bankrupt because of lawsuits brought against the firm for actions of partners operating in another province. Presently, damages that can't be met by the firm have to be met by individual partners – irrespective of any degree of responsibility.[30]

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[29] CICA 1996 at 1.

[30] ICAA 1994 at 2.

Unlimited personal liability magnifies the effect of all the other factors – huge claims, costly and inadequate insurance, plaintiff-friendly procedures, joint and several liability, potential tort liability and so on – that are said to create the liability crisis.

d. Possible consequences of a liability crisis

Members of accounting firms, especially the larger firms with greater exposure to large claims, face the ongoing and growing threat of firm and personal bankruptcy as a result of the combination of factors described above:

> Escalating litigiousness, joint and several liability, the pressure to settle out of court and the growing insurance gap have turned a largely theoretical risk of personal bankruptcy for accounting partners into a potential catastrophe.
>
> The failure of a major Canadian corporation or financial institution could result in the bankruptcy of a major accounting firm, all its partners, many former partners and retired partners.
>
> Examples have already happened in both Canada and the United States.
>
> - A small firm in Western Canada disbanded following a $4 million settlement against a $13 million claim.
> - Laventhol and Horwarth, the eighth largest accounting firm in the US was wiped out by lawsuits. Its former partners contributed $55 million from their personal assets as part of the settlements.
>
> It would be devastating if the Alberta partners of a major firm were faced with personal bankruptcy, because some Toronto partners played a minor role in auditing a major corporation that subsequently failed.[31]

Such descriptions of the plight of accounting firms and their individual partners are offered in support of the proposition that reforms are justified as a simple matter of fairness to the professionals who are beset by the liability crisis.

It is argued that the liability crisis for auditors will soon become a major problem for companies seeking to raise capital, for investors, for governments and for the economy as a whole. It is suggested that the natural consequence of the liability crisis is that the availability of high-quality audit services will be restricted because of a number of self-defensive measures taken by existing and potential members of the audit profession. The liability issue will make it difficult for the accounting profession, particularly the audit

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[31] ICAA 1994 at 16. The connection between the $4 million settlement and the disbandment of the "small firm in Western Canada" is not altogether obvious, given that it is stated (ICAA 1994 at 11) that the settlement (and $300,000 in defence costs) was paid by the firm's insurer.

specialization, "to attract the brightest students to the profession." Prospective auditors will not enter the profession in the first place, and existing auditors may flee from it, making it increasingly difficult for the profession to expand or even maintain its capacity to meet the demand for high-quality audits.[32]

It is said that accounting firms are already taking steps to reduce their liability exposure by "declin[ing] to accept clients in high-risk fields, such as initial public offerings, advanced technology companies and financial institutions."[33] If this trend continues, many budding Alberta enterprises in particularly vital sectors of the economy will find it difficult or impossible to get high-quality audits and, thus, being unable to raise capital here, will be forced to go elsewhere:

> If those start-up firms in the areas of medical research and advanced technology, and others in financial servicing (businesses identified as engines of Alberta's future economic growth) are unable to obtain the services of reputable auditors, the chances of those types of industries locating here (or continuing to operate here) will be greatly reduced.[34]

In addition to declining to audit risky companies, accounting firms are likely to decline to provide types of audits for which there is a growing demand, "such as assurances on forward-looking data and additional financial disclosure."[35]

Accounting firms' naturally will factor the direct and indirect costs of their liability burden (including insurance premiums, the cost of "defensive auditing," the cost of defending claims, and payouts in excess of insurance coverage) into audit fees. Thus, the cost of auditors' liability will ultimately be borne by the audited companies, investors in those companies, and consumers of their products. The cost of audits may become so high, especially for the riskier audit clients, that they may simply be unable to pay

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[32] ICAA 1994 at 16; CICA 1996 at 9. But CGAAO 1997 at 31 notes that "no empirical evidence is presented to support this claim."

[33] ICAA 1994 at 14.

[34] ICAA 1994 at 14.

[35] CICA 1996 at 8.

for an audit.[36] In short, the liability crisis is already having adverse effects on direct and indirect consumers of audit services, and those effects are likely to be magnified if the audit crisis is allowed to continue.

2. Alternative Accounts

Later in this paper we will come back to some of the points raised above in discussing arguments for and against allowing accountants, lawyers and other professionals to practise in LLPs or other types of limited liability entities. However, we will not approach the matter on the basis that we must try to determine whether auditors face a liability crisis. One of the main reasons why we do not propose to consider whether there is an audit liability crisis is suggested by the CICA's claim that "devastating forces [are] abroad which threaten the continued existence of the auditor as we know that institution."[37] We believe that any serious enquiry into the issue of whether there is an audit liability crisis would need to consider the arguments from within the accounting profession to the effect that it is perhaps "the auditor as we know that institution," as much as any legal doctrine, that is in need of reform. We will provide a very brief summary of a couple of the arguments to that effect.

a. Crisis? What Crisis?

Not all members of the accounting profession portray auditors as innocent victims of litigation gone mad. We have already noted the position of the CGAAO. Other examples abound. Professor Abraham Briloff, a longstanding member and critic of the American accounting profession, recently made the following observation regarding the alleged liability crisis:

> We are not confronted with a liability crisis. We are instead confronted with an identity crisis. We don't know for what, to whom and the when of our responsibility. We somehow or another straddle all kinds of fences. We are identified overly closely with management in the sense that we work with management to see how any transaction might be made to fit the Generally Accepted Accounting Principles (GAAP). And reciprocally, we sometimes work with management to see how GAAP can somehow be distorted to accommodate particular transactions – to take some notions of GAAP to hike the earnings of the enterprise.[38]

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[36] ICAA 1994 at 15.

[37] CICA 1996 at 1.

[38] Briloff 1998 at 2-3.

The next two sections briefly outline the nature of the two problems referred to by Professor Briloff: (1) auditor dependence, and (2) flexible accounting standards.

b. Auditor dependence

The premise underlying the auditor's role is that an independent party should verify that financial statements accurately and fairly portray managers' stewardship of investors' funds. Obviously, it is of vital importance to the successful discharge of their duties that auditors view their duty as being to provide an objective report to investors, not to please the managers. The problem is that it is generally management rather than investors who effectively control the selection of the auditor and who contract for other services provided by large accounting firms.[39] This combination of factors can create a substantial risk of a conflict between auditors' duty to investors and their financial self interest.[40]

A risk of a conflict of self-interest and duty does not necessarily translate into the subordination of the latter to the former. One view is that any temptation for auditors to subordinate duty to short-term self-interest is likely to be deterred by countervailing considerations, including long-term self-interest. An auditing firm that might be tempted to give in to management pressure to acquiesce in a dubious accounting practice would have to consider the effect that this would have on its credibility as an auditor if it became known that it was prepared to modify its audit reports to appease management.[41] Other deterrents to giving in to the temptation to put self-interest ahead of professional responsibility include the possibility of civil liability and disciplinary proceedings by professional bodies.[42]

Critics suggest that in many cases the factors that tend to promote auditor independence may be overwhelmed by factors that promote at least

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[39] Under s. 156(1) of the BCA the auditor is appointed by an ordinary resolution of the shareholders, but in a widely-held company management may have considerable influence on this decision, as well as other decisions that are formally within the domain of shareholders.

[40] Lee 1993 at 93-114 (Chapter 7) discusses the issue of auditor independence and summarizes arguments on all sides of the debate.

[41] Lee 1993 at 95-96 (describing, rather than making, the argument).

[42] Lee 1993 at 95-96

the appearance, and possibly the reality, of management-dependence. Not only may auditors be concerned about losing the audit engagement and the fees it generates, they may also be concerned about losing lucrative non-audit contracts with the same company. Reference is made to a troublesome linkage between audit services and management advisory services ("MAS"):

> The revenue potential of management advisory services, even narrowly defined, is breathtaking. In a few short years, MAS has begun to rival auditing as the primary income generator for most firms.[43]

The large accounting firms frequently provide audit and management advisory services to the same company, and it is suggested that firms will be reluctant to put substantial MAS revenue at risk by being overly fussy about management accounting practises when wearing their auditor's hat.[44] Thus, some commentators have suggested that accounting firms that provide audit services to a company should not be able to provide management advisory services at the same time.[45] Others argue that the risks of an accounting firm providing both auditing and management advisory services to the same company are manageable and that there can be benefits (such as cost-savings) in this practice.[46]

c. Accounting standards

When auditors report on a set of financial statements, they provide an opinion as to whether the statements fairly present the position of the audited company in accordance with a defined standard. The defined standard is commonly referred to as "generally accepted accounting

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[43] Fogarty 1991 at 208.

[44] Fogarty, Heian & Knutson 1991 at 208-09; Briloff 1990 at 25-26; Cousins, Mitchell & Sikka 1998 at 12-13.

[45] Lee 1993 at 108-09. The author summarizes arguments for and against this and other suggestions that have been advanced over the years for eliminating or mitigating perceived or actual problems of auditor dependence. Some of these suggestions would fundamentally change the conception of the auditor:

> The regulatory approach to resolving the problems of auditor independence is extended further with two specific suggestions which take the existing audit function out of the free-market, private-enterprise sector and, instead, place it within the boundaries of the state. The specific proposals are, first, for an audit court; and, second, the audit as a state appointment, including the existence of a state audit board: Lee 1993 at 109. [Citations omitted.]

We suspect that these proposals would meet with some resistance.

[46] Lee 1993 at 103-04 (describing, rather than advancing, the argument).

principles" ("GAAP"), but nowadays accounting standards are determined "by recognized standard-setting bodies, rather than by general acceptance. In Canada, accounting standards are very largely established and modified as required by the Accounting Standards Committee of the CICA."[47] In other words, although auditors, as such, do not establish the accounting standards against which they measure financial statements, the professional accounting bodies to which auditors belong play a major role in establishing those standards.

Some critics contend that auditors' inherently difficult task is made even more difficult than it needs to be by unnecessarily flexible accounting standards.[48] In particular, flexible accounting standards may make it difficult for auditors to resist management pressure to engage in creative accounting:

> . . . non-definitive [accounting] standards give managers extra leverage over auditors in disputes about accounting methods. Reducing choice might reduce the need to concede to client demands and thereby lessen legal liability.[49]

It has been suggested that bodies that set accounting standards have tended to oppose revisions that would reduce the indeterminacy of the standards for financial reporting, even though such revisions might reduce auditors' exposure to liability.[50]

3. The Foregoing and Limited Liability Entities

We do not propose in this project to try to determine whether auditors face a crisis, whether of liability or identity. Instead, we propose to investigate the considerations of principle and policy that underlie the privilege that is extended to most enterprises to carry on business in limited liability entities. We will consider whether, or to what extent, the considerations that presumably justify limited liability for enterprises generally also seem to apply to UL professionals. Any evaluation of the efficacy of existing or proposed laws needs to take into account the actual or anticipated effect of the existing or proposed laws. Thus, in evaluating the existing Alberta law

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[47] Expectations 1988 at 3.

[48] Briloff 1976, *passim*; Fogarty 1991 at 216-18.

[49] Fogarty 1991, 217.

[50] Fogarty 1991, 217.

that UL professionals must practice in unlimited liability firms, and a proposed change to that law, it is necessary to consider, amongst other things, what effect the change might have on the quality and price of professional services generally, or of any particular type of professional services, such as audits. Therefore, although we will not try to determine whether unlimited personal liability is contributing to a "liability crisis" for auditors, we will consider whether a change to a regime of limited personal liability might be expected to affect the quality and price of audits.

E. Key Concepts

This section briefly explains and discusses a few key legal concepts and distinctions that figure in the discussion of limited liability entities.

1. Contractual and Non-contractual (Tort) Liabilities

One of the more important distinctions to be made in discussing limited liability is between contractual and tort liability.[51] Contractual liability arises out of an obligation that a person has voluntarily agreed to accept in exchange for something of value[52] from the person[53] to whom the obligation is owed. Tort liability arises when a person fails to discharge a duty that is imposed upon them by law. It is possible for a person to incur contractual liability and tort liability for the same actions. That is, a person may have a contractual duty to do X as well as a duty imposed by law to do X. The person may incur both a contractual liability and a tort liability if they fail to do. The liability will (generally) be to pay damages to the person or persons to whom the contractual and tort duties were owed.

a. Some points about contractual liability

Contractual liability may be created directly by the contract or may arise indirectly when one of the parties fails to perform their obligations under the contract. For example, if a firm borrows money, the obligation to repay the

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[51] Lawyers do not classify all non-contractual liabilities as torts, but for our purposes no harm is done by treating non-contractual liability as synonymous with tort liability.

[52] As a matter of contract law there must be "consideration" (which might be nominal) to make a contract enforceable. In general, a unilateral promise by one person to another does not create a contract; the other person must supply some consideration for the promise to make it enforceable as a contract.

[53] There may be any number of parties to a contract, but it makes things simpler to assume that there are only two.

money is the primary obligation created by the contract; the firm performs the contract by repaying the money. On the other hand, if a firm contracts to provide certain services, its primary obligation is not to pay money to the other party but to provide services of the agreed quality. Failure to provide the services in accordance with the contract, which would include failure to provide services of the agreed quality, will create a liability to pay damages suffered by the other party because of non-performance of the primary contractual obligation.

Within certain limits, a person's contractual obligations and the extent of their liability for breach of those obligations can be specified explicitly by the contract. Therefore, a firm that enters into a contract to perform services is able to define its contractual duties and limit its liability for their breach. This ability is constrained by numerous factors, not the least of which is the willingness of the other party to agree to a particular definition of the firm's contractual duties or to limits on the firm's liability for their breach. Even if such "bargaining constraints" leave a firm somewhat unhappy about the terms of the contract, it will at least know the nature of its duties and extent of its possible liability for their breach. Thus, before entering into the contract, the firm can evaluate the risks and anticipated rewards and decide whether or not the latter justify the former.

Depending on the circumstances, certain "non-bargaining constraints" may also limit a firm's ability to define its contractual obligations or to define its liability for their breach. We will briefly discuss two types of non-bargaining constraints that could arise where a firm has contracted to provide services: (1) indeterminacy, and (2) preemptive rules.

The problem of indeterminacy is quite likely to arise when a firm is to provide services. Whether the services are to clear snow from a parking lot or to design a $1 billion industrial facility, it will rarely, if ever, be possible to specify with complete precision the "quality" of the services or the guaranteed characteristics of the finished product. Indeterminacy in the explicit description of a firm's contractual duties corresponds to uncertainty as to exactly what the firm must do to meet those duties. The more open-ended the specification of the firm's duties, the more difficult it will be for the firm to quantify the risk that it will be found to be in breach of those duties. The other side of the coin is that the customer may not know exactly what it is

supposed to get under the contract. Terms that define a service provider's maximum liability for breach of its contractual duties can be more precise than the terms that define what those duties are. Indeed a contract can define the service provider's maximum liability for breach of its duties (whatever they are) with something approaching absolute precision: for example, "the adviser's liability for breach of this contract shall not in any event exceed $10,000."

Preemptive rules of law constitute restrictions on freedom of contract, and may be imposed by legislators[54] or courts. The legislature or the courts may determine that for reasons of fairness or other considerations of public policy, certain contract terms will not be enforced. Some restrictions are absolute: a statute or judge-made rule may explicitly state that certain contractual provisions are void or unenforceable. Such absolute restrictions are relatively rare. More common are restrictions that manifest themselves not in absolute prohibitions on particular terms but in judicial hostility to certain types of terms or to terms that favour the party who is perceived to be in a dominant bargaining position. This may occur in the context of quantitative limitations on a firm's liability for breach of contract. Suppose that a contract limits a firm's liability for breach to $1,000 but a court believes that the damages actually suffered by the other party are closer to $1 million. In an effort to "do justice," the court may decide the firm has committed a "fundamental breach" of the contract and "interpret" the limitation on liability as not applying to cases of "fundamental breach."

The final point we will make about contractual liability is that, subject to certain exceptions that need not concern us here, contractual duties are owed by and to the parties to a particular contract, and no one else. Therefore, a person who enters into a contract cannot incur a liability under that contract to anyone who is not a party to that contract. The other side of the coin is that, generally speaking, a person cannot be bound by the terms of a contract to which they are not a party. This is important in terms of contractual limitations of liability. A contractual limitation on liability will not, as a rule, be effective against a person who is not a party to the contract and to whom the contracting party owes a non-contractual duty. This is important because, as noted above, the same action may create liability for

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[54] This might include professional governing bodies to whom the legislature has delegated the power to regulate the members of that profession.

breach of a contractual duty that is owed to one person and for breach of a non-contractual duty that is owed to some other person.

b. Some points about tort liability

i. General

A firm (or an individual) will incur liability in tort when it fails to discharge a duty imposed on it by law, as opposed to a duty that it has assumed under a contract. There are two main authors of such non-contractual duties: legislatures and courts. Legislation imposes duties on firms and individuals and subjects them to liabilities if they do not perform those duties. In most cases statutes create "penal" rather than "civil" liability; they require an offender to pay a fine to the government (or go to jail) rather than to pay damages to another firm or individual. Sometimes, however, statutes give ordinary citizens the right to recover damages from individuals or firms who breach a "statutory duty."

The courts are the source of most non-contractual duties that give rise to tortious liability. Over the years, courts have developed legal doctrines that in various circumstances impose duties on individuals and firms in favour of other individuals and firms who may be affected by their activities. Perhaps the most important of these court-created duties is a generalized *duty of care*; breach of a duty of care that causes injury to someone to whom the duty is owed creates liability for *negligence*. For many years it has been established that an actor owes a duty of care to anyone who is put at reasonably foreseeable risk of suffering physical injury (to their person or property) if the actor fails to take reasonable care to avoid causing such injury. In most cases where one person has suffered a physical injury as a result of another person's actions, there will be no question that the injurer owed the victim a duty of care; the question will be whether the injurer lived up to the applicable *standard of care*. If they did, they will not be liable for the victim's injury; if they did not, they will be liable to compensate the victim for their injury. The person who incurs such liability is referred to as a *tortfeasor*

In relatively recent years it has been established that, in certain circumstances, actors can owe a duty of care to persons who will be put at risk of suffering purely economic injury (e.g. a precipitous decline in the value of an investment) if the actor fails to take reasonable care not to cause such

injury. One of these circumstances involves what is called *negligent misrepresentation*.

ii. Negligent Misrepresentation

It is worth pausing to consider negligent misrepresentation because it has a particular bearing on the liability problems of at least two of the UL professional groups: accountants and lawyers. Accounting bodies have identified potential liability to third parties for negligent misrepresentation as a major contributor to the alleged audit liability crisis:

> 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 [sic] include personal or family assets of the partners or proprietor. 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 number of third parties who ultimately rely on the work of a CA, such as banks, investors and customers, is exponentially much greater than the number of clients. It is this area that leaves accountants relatively unprotected and in growing danger.[55]

It is easy to see how a doctrine of tort liability for negligent misstatements could have significant implications for auditors. Depending on how far the auditor's duty of care of care extends, the auditor might potentially be liable for negligent misrepresentation to anyone with a financial stake in the audited company. Thus, while the auditor's contractual liability to the audited company might be modest or even nil, it might be liable in tort to shareholders and creditors to the extent of hundreds of millions of dollars.

The auditor's liability to the company itself might be quite modest or even nil in a particular case because the company's fate was sealed long before the auditor made a culpable error. Accurate financial statements would merely have revealed to everyone that the company was a sinking ship; it would not have prevented it from going down. However, someone who bought shares of the sinking company the day after the financial statements were issued, and whose shares subsequently became worthless,[56] could reasonably argue that they would not have bought the shares if they had

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[55] ICAA 1994 at 10. [Paragraph breaks omitted.] The first sentence in the passage raises an interesting question of whether Alberta law firms are subject to a pre-emptive rule that prevents them from limiting their liability by contract. That point is discussed in Chapter 4.

[56] It would probably be more accurate to say that the shares were worthless when the investor bought them, it just wasn't apparent that they were worthless.

known the true state of affairs. Their claim, in a nutshell, is that the misleading information cause them to pay a lot of money for worthless shares. The huge potential difference in the magnitude of the company's losses and shareholders' individual losses means that the question whether individual investors have a separate cause of action will often be crucial in determining the extent of the auditor's potential liability.[57]

To the extent that auditors' liability concerns are based on the prospect of indeterminate liability to a huge class of non-clients who might rely on audited financial statements, the highest courts of Canada and other Commonwealth jurisdictions have recently gone out of their way to diminish that prospect. Of particular relevance in this regard is the Supreme Court of Canada's decision in *Hercules*, a case decided in May of 1987. The High Court of Australia had reached a very similar conclusion just a couple of months earlier in *Esanda.*[58] The UK House of Lords had reached essentially the same conclusion a few years earlier in *Caparo*.

To get to first base in a claim for negligent misrepresentation, a claimant must establish that the alleged tortfeasor owed them a duty of care.[59] Exactly what the victim must do to establish a duty of care is not entirely clear. The threshold condition for a duty of care to arise, as stated in *Hercules*, is "proximity" between the person who makes the representation and the person who claims to have relied on it to their detriment. Proximity is defined thus:

> (a) the defendant ought reasonably to foresee that the plaintiff will rely on his or her representation; and (b) reliance by the plaintiff would, in the particular circumstances of the case be reasonable.[60]

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[57] This is noted by Paskell-Mede & Selman 1997 at 40. Another reason why the distinction is crucial to shareholders is that, even if the insolvent company has a substantial claim against the auditors, the damages awarded are likely to benefit the company's creditors more than its shareholders.

[58] In *Hercules* the plaintiffs were shareholders of the failed company; in *Esanda* they were creditors.

[59] See *Hercules, passim*; Feldthusen 1994 at 30-77.

[60] *Hercules* at 188.

Establishing proximity only starts the plaintiff on their way to establishing the crucial duty of care; they must still overcome another hurdle, which is to convince the court that imposing a duty of care in the particular circumstances would not create a problem of "indeterminate liability."[61]

In affirming lower court decisions that dismissed claims against the auditor of a pair of failed companies, the Supreme Court in *Hercules* held that "[i]n the general run of auditors' cases, concerns over indeterminate liability will serve to negate a *prima facie* duty of care" to persons, such as existing or potential investors or creditors, who might be reasonably expected to rely on the auditor's report.[62] Someone who suffers losses as a result of relying on an auditor's report can sue the auditor for negligent misrepresentation only if two conditions are met: (1) the auditor knew that the person (or a class that included that person) was going to receive the report, and (2) the statements are used "for the specific purpose or transaction for which they were made."[63] The plaintiffs in *Hercules* satisfied the first condition but not the second. The gist of their claim was that they had relied on the auditor's report in making investment decisions (either to maintain existing investments or to put more money into the companies). The court held that the purpose of the audit of annual financial statements was –

> to permit the shareholders, as a body, to make decisions as to the manner in which they want the corporation to be managed, to assess the performance of the directors and officers, and to decide whether or not they wish to retain the existing management or to have them replaced. On this basis, it may be said that the respondent auditors' purpose in preparing the reports at issue in this case was, precisely, to assist the collectivity of shareholders of the audited companies in their task of overseeing management.[64]

The purpose was not to assist individual investors, or prospective investors, to make decisions about whether to invest in the company.[65] Therefore, even

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[61] *Hercules* at 200.

[62] *Hercules* at 197.

[63] *Hercules* at 198. The Court does not explicitly say that the test is conjunctive, but clearly treats it as conjunctive.

[64] *Hercules* at 205. This is the same approach that was taken by the House of Lords in *Caparo.*

[65] Paskell-Mede and Selman 1997 at 40 have a polite way of describing this explanation of
(continued...)

if the auditor knew that investors or potential investors were likely to rely on the audit report in making investment decisions, the auditor would not owe them any duty of care.

Whatever the merits or demerits of the Supreme Court's reasoning, *Hercules* certainly seems to limit accountants' exposure to tort liability for audits of annual financial statements. Given the Court's narrow interpretation of the purpose of such audits, it is difficult to see how, in the absence of special circumstances, a shareholder or creditor could successfully maintain a claim for damages against an auditor based on detrimental reliance on a negligent audit of annual financial statements.[66] Indeed, the Court's analysis seems to suggest that the only person to whom the auditors owe a duty when auditing the annual financial statements is the corporation, as a separate legal entity.[67] But since the auditor has contracted with the

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[65] (...continued)
the purpose of the audited financial statements: "Certainly, the court's view of the role of audit reports does not correspond to the view held by the capital markets."

[66] There would seem to be some possibility, however slight, that an auditor who has certified the financial statements for the purpose of the continuous disclosure requirements of securities legislation could incur liability to investors on the common law principles of negligent misrepresentation, notwithstanding the Supreme Court of Canada's decision in *Hercules*. The Supreme Court's specific reasoning only addresses situations where audited financial statements are required by *corporations* legislation. There is some plausibility in the Court's contention that corporations statutes would be concerned with financial statements primarily as an internal governance issue.

The Court's reasoning does not specifically address the situation where the audited financial statements are required by *securities* legislation, rather than corporations legislation. Given the explicit focus of securities legislation on investor protection, it might be argued that audits performed pursuant to the "continuous disclosure" requirements of such legislation fall outside the precise rationale of *Hercules*. That is, it might be argued that legislators who required disclosure of audited financial statements in *securities* legislation, rather than *corporations* legislation, must have intended that disclosure to be for the benefit of investors *qua* investors.

Of course, even if the investor plaintiffs could convince the court that they were using the audited financial statements for the very purpose contemplated by legislators, they would also have to convince the court that they constituted a "class" known to the auditors when they certified the financial statements. The court's denial of a duty of care in *Hercules* was really based on the fear (some would say an exaggerated fear) of imposing indeterminate liability on auditors for routine financial statements. Thus, other courts might conclude that even if investors are using audited financial statements for precisely the purpose for which securities legislation requires their disclosure, "investors" generally do not constitute a class of persons within the meaning of the *Hercules* test.

[67] The discussion of "the rule in *Foss v. Harbottle*" makes this clear: *Hercules* at 211-15.

corporation to perform the audit, the auditor will be in a position to define or limit its liability to the corporation by the terms of the audit engagement.[68]

The reasoning of *Hercules* will not protect auditors from tort liability in all contexts. In particularly it will not protect auditors where the audit relates to financial statements included in a prospectus that is required by securities legislation such as Alberta's *Securities Act*. To oversimplify things a bit, any entity (usually, but not necessarily, a corporation) that wants to distribute securities to the public must issue a prospectus containing audited financial statements. The issuer must file the written consent of the auditor to the inclusion of the auditor's report in the prospectus.[69] Having provided such a consent, the auditor incurs a potential liability under section 168 of the *Securities Act* to any person who purchases the securities during the distribution period. Liability would arise if the financial statements certified by the auditor contained a misrepresentation and the auditor ought to have detected that misrepresentation in the audit process.[70]

Where section 168 applies, auditors are in a worse position than they would be in a common law action for negligent misrepresentation. Not only does the section specifically provide for joint and several liability (as would be the case under the common law action),[71] but it relieves purchasers of the inconvenience of showing that they relied on the misrepresentation in making the purchase; they are deemed to have relied on it.[72] Moreover, if there is a misrepresentation in the financial statements and the securities have depreciated in value, the auditor (or any other defendant) would have

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[68] This appears to be a situation where the auditor could be subject to concurrent liability to the corporation in tort and contract: *Rafuse*. However, any contactual exclusion of or limitation on the auditor's liability could be made to apply to a claim based on breach of a non-contractual duty of care: see *Rafuse* at 206. This would be subject to any preemptive rule that might apply in a particular jurisdiction to prevent the auditor from limiting its liability.

[69] Alberta Securities Commission Rules, s. 85(1).

[70] *Securities Act*, s. 168(1), (5).

[71] *Securities Act* s. 168(9).

[72] *Securities Act* s. 168(1). It is open for the defendant to avoid liability by proving that the purchaser knew of the misrepresentation when purchasing the securities: s. 168(3).

the onus of showing that the depreciation was not a consequence of the misrepresentation.[73]

While section 168 of the *Securities Act* provides a powerful remedy where it applies, it applies in very limited circumstances. It applies only to misstatements in a prospectus and applies only in favour of persons who purchase the securities during the period of distribution. It would not apply, for example, to misrepresentations in audited year-end financial statements that are required to be filed with the Securities Commission and sent to security holders under the "continuous disclosure" requirements of the *Securities Act*.[74]

2. Direct and Vicarious Liability

We have said that tort liability arises when an actor breaches a non-contractual duty that the actor owes to some other person, and this breach of duty cause harm to that person. Tom is *directly* liable to Kathy if Tom breaches a duty of care that he owes to Kathy and thereby causes her harm. It does not matter, so far as Tom's liability is concerned, whether he was acting on his own time and for his own benefit or on someone else's time and for their benefit (e.g. as an employee). It does not matter what sort of relationship Tom may have had with some other person; the question is whether the law has imposed a duty of care on Tom in favour of Kathy and whether he has injured her by failing to live up to that duty of care.

In certain circumstances someone can incur tort liability not because of anything they have done themselves but because of something done by a person with whom they have a particular relationship. The situation where one person incurs liability in tort because of the actions of another person

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[73] *Securities Act* s. 168(8).

[74] *Securities Act* s. 121. This could change in the near future if the recommendations of the Toronto Stock Exchange Committee on Corporate Disclosure are enacted. The Committee recommends that provinces create a statutory civil remedy for misrepresentations by issuers in a wide range of circumstances: TSE 1997 at 48. The persons who might incur liability for misleading disclosures would include "experts" such as accountants and lawyers. Insofar as the subject of this paper is concerned, the key feature of the proposals is that the limits on liability proposed by the Committee would ensure that a professional firm's maximum liability would not exceed the *greater* of $1 million or its fee income from the issuer during the year preceding the misrepresentation: TSE 1997 at 70. Moreover, damages would be assessed on a proportionate basis, rather than a joint and several basis: TSE 1997 at 70-71. In short, the damages that might be awarded against an expert under this remedy would hardly be expected to be uninsurable.

with whom they have a certain relationship is referred to as *vicarious liability*.[75] It is not just any old relationship between two persons that can make one of them vicariously liable for a tort committed by the other. Rather, the courts and legislators have identified a number of relationships that create the potential for vicarious liability.[76] The relationship that is probably the most important source of vicarious liability is that of employer and employee. It has long been settled that employers are vicariously liable for torts committed by their employees in the course of their employment.[77] The vicarious liability of employers for employees' torts is a result of judicial decisions. An example of a legislative imposition of vicarious liability is the liability of owners of vehicles for damages caused by a driver who was operating the vehicle with the owner's consent.[78]

Another relationship that can create vicarious liability is partnership. In the nineteenth century the English courts decided that members of a partnership were vicariously liable for each other's torts, when committed in connection with the firm's business.[79] This doctrine is now embodied in sections 12 and 14 of the *Partnership Act*:

> 12 When, by a wrongful act or omission of a partner acting in the ordinary course of the business of the firm or with the authority of his co-partners, loss or injury is caused to a person not being a partner in the firm, or a penalty is incurred, the firm is liable therefor to the same extent as the partner so acting or omitting to act.

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[75] See generally Atiyah 1967, QLRC 1995.

[76] The rationale for imposing tort liability on someone who has not "done anything wrong" because of their relationship with someone who has done something wrong has been debated over the years. For successively more detailed discussions of the arguments that might be advanced for and against vicarious liability in various contexts see QLRC 1995 at 10-14; Atiyah 1967 at 12-28; Sykes 1984, *passim*.

[77] See Atiyah 1967 at 1. Principals are also liable for torts committed by agents acting within the scope of their actual, implied, usual or ostensible authority: see Fridman 1996 at 315.

[78] *Highway Traffic Act*, s. 181. Interestingly, the legislative drafter chose to piggyback on the common law doctrine of employer liability for employees' wrongs by deeming the driver to be the employee (and agent) of the owner.

[79] Atiyah 1967 at 116-17 points out that the common law foundation for this doctrine was somewhat thin at the time the doctrine was incorporated in the *Partnership Act, 1890* (UK). He also points out that the vicarious liability of partners is an instance of a principal being vicariously liable for torts committed by an agent.

> 14 Each partner is liable jointly with his co-partners and also severally for everything for which the firm while he is a partner in it becomes liable under section 12 or 13.[80]

Section 12 imposes vicarious liability on "the firm," and section 14 makes it clear that the firm's liability equates to joint and several liability of the members of the firm. Section 12 says nothing about torts committed by employees of a partnership, but it does not have to. An employee of a partnership is an employee of all the partners. Therefore, each partner is liable for torts committed by an employee, not because of section 12, but because of the common law doctrine of vicarious liability of employers for their employees' torts.

It is important to appreciate that an actor may be directly, rather than vicariously, liable for a victim's injury even though the actor did not commit the very deed that was the immediate cause of the injury. To take an obvious case, suppose I own a vicious dog, Spike. I let Spike roam at large and he bites you. I am liable in tort for your injury not because I am vicariously liable for Spike's behaviour, but because I owed you a duty of care, which I breached by letting Spike run at large. I did not bite you, but Spike's biting you was a reasonably foreseeable result of letting him run loose. Suppose that Spike is not a vicious dog but a vicious convict, and I am the prison officer assigned to guard him on a day trip to the shopping mall. If I fall asleep and he escapes and robs you I would not be vicariously liable for Spike's action. Rather, I am directly liable for the foreseeable consequences of my failure to take care to ensure that Spike did not escape. My employer, the government, would be vicariously liable for my negligence (not for Spike's actions). Conceivably, my superiors who authorized the excursion might also be directly liable if they should have realized that allowing Spike out on a day trip in the first place created an unreasonable danger to the public.

As a final point on vicarious liability, it is worth noting that, strictly speaking, the concept has no application in situations involving true contractual liability. Suppose that firm F has agreed to provide services of a certain quality for its customer C. The services performed on F's behalf by its employee E are not of the agreed quality because E did not follow

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[80] Section 13 deals with a specific type of wrongful act: misapplication of money received by the firm or one of its partners.

instructions. F is directly liable to C not because it is vicariously liable for a wrong committed by E, but simply because F agreed to provide services of a certain quality and failed to provide them. Incidentally, E is not contractually liable to C – the contract was between F and C – but may be liable in tort if the law imposed a non-contractual duty of care on E in favour of C.[81]

3. Where More than One Person Liable for Same Loss

When the doctrine of vicarious liability applies it is obvious that at least two persons are liable for the same loss: the person who is directly liable and the person who is vicariously liable. The person who is vicariously liable is liable for the loss even though they are not directly responsible for causing it. Another situation where two or more persons are liable for the same loss is where each of them independently plays a direct role in causing the loss. Here there is multiple liability without vicarious liability: none of the actors are liable simply because of their relationship with another actor; each is liable for the direct consequences of their own actions. For example, suppose that A and B are both driving carelessly and, as a result, collide with each other. A's car then smashes into and demolishes C's parked car. Both A and B are liable to C because the careless action of each of them was a cause of the demolition of C's car. Suppose that A was driving a car owned by D (with the latter's consent) while B was carrying out duties as an employee of E at the time of the accident. In this case A and B are directly liable, and D and E are vicariously liable, for the damage to C's car.

In the preceding paragraph we said that two or more persons might be directly or vicariously liable for the same loss, but we were deliberately vague about the extent of each actor's liability. If C's demolished car was worth $10,000, for what proportion of the loss is each of the actors liable? The answer of Anglo-Canadian tort law has traditionally been simple. Each independent tortfeasor is liable for the whole loss[82] because the actions of each actor were a contributing cause of the whole loss.[83] If either A or B had

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[81] To make matters more interesting, if the law imposed a duty of care on E, then F might be liable to C both for breach of contract and vicariously in tort.

[82] Obviously, though, the plaintiff's total recovery from all of the tortfeasors will be restricted to the amount of the loss suffered.

[83] It is important to note that each independent actor is liable for the whole loss only if their actions have contributed to the same loss. In theory, if the loss caused by each of two (or

(continued...)

exercised due care, the accident would not have occurred and C's car would not have suffered any damage. A tortfeasor who has been forced to pay the whole loss may be entitled to contribution from the other tortfeasors in accordance with their relative degree of responsibility, but this is not the victim's concern. The rule that each of several tortfeasors whose independent wrongful actions combined to cause a single loss is liable for the whole loss is commonly referred to as the doctrine of *joint and several liability*.[84]

a. Joint and Several Versus Proportionate Liability

In an earlier section we noted that many members of the auditing profession take a rather dim view of the doctrine of joint and several liability. The problem with the doctrine, so far as bodies such as the CICA and ICAA are concerned, is twofold. Firstly, it makes accounting firms, who are perceived to have deep pockets, irresistible targets for a claim when one of their audit clients fails. If the failed company is of any size, there is a good chance that its auditor will be one of the Big Six international accounting firms. Such firms might as well put up a big sign on top of their office tower saying, "Deep Pockets – Sue Us!" This is especially so because it will be obvious to one and all that the persons who are really to blame for the company's failure – the managers – will not have assets or liability insurance that comes anywhere close to covering investors' losses.

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[83] (...continued)
more) independent actors is separate and distinguishable, each actor is liable only for the loss that they caused. For example, if A negligently ran into the front of C's car and B came along moments later and negligently ran into the back of C's car, A would be responsible for the front-end damage and B for the back-end damage: see Common Law Team 1996 at 5-6; Fleming 1992 at 200-02. Fleming notes that in some cases where the loss caused by different tortfeasors is theoretically divisible, it will be treated as indivisible by the courts where it is difficult or impossible to figure out whose actions caused what part of the damage.

[84] For the purposes of this paper we needn't be particularly fussy about terminology. However, it may be noted that, technically, where liability is vicarious it is **joint** liability, **not** joint and several liability: see Common Law Team 1996 at 4. There was a time when this distinction was important (mainly because getting a judgment against any of the jointly liable actors would extinguish the cause of action against all of them), but the practical consequences have been eliminated by the *Tort-Feasors Act*, and by flexible rules of civil procedure. It may also be noted that not all learned commentators agree on the precise characterization of the liability of two (or more) independent actors whose independent wrongful actions combine to cause the same loss. One view is that their liability is joint and several: see Common Law Team 1996 at 4. Another view is that the independent actors are concurrently (severally) liable for the same loss, but are not jointly liable: see Fleming 1992 at 255-59. Again, the theoretical distinction is now of little or no practical importance; the important point is that each concurrent tortfeasor is liable for the whole loss.

The second and more fundamental problem, so the argument goes, is that when auditors are sued, they likely to end up paying for a much higher proportion of the claimants' total loss than is justified by their degree of responsibility for the loss:

> This technical term of law [joint and several liability] simply means that the auditor is exposed to the risk for the payment of 100% of all the claimant's losses where, on the facts of the case, only 1% of those losses may actually have been suffered by reason of the fault of the auditor. The other 99% in such an example would consist of the damages caused by all the other defendants in the action, who may be, and frequently are, insolvent, or in relation to the judgment damages, impecunious.[85]

This passage is notable more for its audacity than its accuracy as a description of either the theory of joint and several liability or its likely effect.[86] But it is fair to say that the doctrine of joint and several liability, combined with the insolvency of other defendants, could readily result in an audit firm paying for the whole of a loss for which managers are more culpable than the auditors.

Having fingered the doctrine of joint liability as the major factor in the audit liability crisis, accounting bodies have devoted considerable effort to getting this doctrine replaced with a regime in which liability would be apportioned between multiple defendants according to their relative responsibility. What they have proposed is a regime of proportionate liability:

> The alternative to joint and several liability is the principle of proportionate liability for the auditor and the other defendants in the action according to their individual degree of fault as determined by the court.[87]

In other words, if a court determines that investors have suffered total damages of $100 million damage and that management's and the auditors' degree of culpability is 75% and 25%, respectively, the investors would get a judgment for $75 million against the managers and $25 million against the

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[85] CICA 1996 at 1.

[86] As mentioned earlier, the doctrine of joint and several liability actually only applies where each defendant is causally responsible for the *whole* loss. What the CICA really seems to be talking about is the relative culpability of the various defendants. In theory, 1% culpability (whatever that means) might translate into 100% liability. In practice, we suspect that a court that really thought that an auditor was only 1% culpable would be more likely to find that the auditor bore no causal responsibility for the loss than to impose 100% liability.

[87] CICA 1996 at 1.

auditors. If the managers were insolvent, it would be the investors' problem, not the auditor's problem. As the CGAAO puts it:

> This is ultimately a public policy decision that, if implemented as CICA recommends, will shift the burden to the plaintiff with respect to insolvent defendants. This has broad implications which require a coordinated federal/provincial analysis prior to any substantive reform.[88]

This is a counsel of prudence with which we concur.[89]

It is not only in Canada (or only in connection with audits) that the efficacy and fairness of the doctrine of joint and several liability have been questioned and proposals made to replace it. In the United States joint and several liability has given way to proportionate liability in many states, and in 1995 Congress enacted a law that provided a complicated scheme of proportionate liability for private litigation under the *Securities Exchange Act.*[90] In the United Kingdom, the Common Law Team of the Law Commission conducted a feasibility study of the issue and concluded that no change from the existing regime of joint and several liability was warranted.[91] Undeterred, the Institute of Chartered Accountants of England and Wales published a response that attacked the Common Law Team's reasoning and conclusions.[92] The issue has also received considerable attention in Australia. The New South Wales Law Reform Commission

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[88] CGAAO 1997 at 52. At 51 the CGAAO states flatly that "we do not agree that accountants face a liability crisis situation and **do not support a move away from joint and several liability**." [Emphasis in original.] However, the implication of the passage quoted in the text is that their position is less an outright rejection of proportionate liability than a warning not to make a hasty decision to do away with joint and several liability.

[89] Campion 1996 also provides a useful analysis of the relationship between the liability problems of auditors and the doctrines of negligent misrepresentation and of joint and several liability, with particular reference to the arguments advanced in CICA 1996. We considered the issue of joint and several liability versus "apportioned liability" in ILRR 1979 at 30-33. In recommending that Alberta retain joint and several liability, we observed at 33 that "no significant demand has appeared in Alberta for its abandonment." At least that much has changed since 1979. In a 1988 report, the Ontario Law Reform Commission considered *in solidum* (i.e. joint and several) liability in the context of allegations that the doctrine was contributing to an "insurance crisis:" OLRC 1988 at 31-48. The Commission concluded that joint and several liability should be retained: OLRC at 48.

[90] *Private Securities Litigation Reform Act of 1995* (US). For an analysis of this statute see Langevoort 1996.

[91] Common Law Team 1996.

[92] ICAEW 1996.

recently canvassed the arguments on both sides of the issue and reaffirmed conclusions that it had reached in an earlier report that a shift from joint and several liability to proportionate liability is not justified.[93]

If we were considering the case against joint and several liability and for proportionate liability, especially as it relates to claims for financial losses arising out of negligent misrepresentation, we think it would be necessary to give very careful consideration to the implications of *Hercules*. In particular, it seems arguable that a regime of joint and several liability combined with the restrictive *Hercules* approach to the duty of care provides auditors with greater protection from huge liability exposure than a regime of proportionate liability combined with a less restrictive notion of the class of persons to whom auditors owe a duty of care. This can be illustrated by a simple example.

Suppose that a group of investors pays $100 million for shares in a company on the faith of misleading financial statements that were negligently audited. The true value of the company at the time of the transaction was $0. Suppose that the auditors were "25% responsible" for the misleading financial statements. In a regime of proportionate liability in which the auditors owed a duty of care to the investors, the auditors' liability to the investors would be $25 million. In a regime of joint and several liability in which the auditors owed *no* duty of care to the investors, they would be jointly and severally liable for all damages suffered by *the company*, but those damages might well be $0. Thus, it could be argued that the effect of *Hercules* is that in many cases auditors will be jointly and severally liable for a small fraction of the total losses to which their negligence has contributed, while being relieved of any liability for the largest portion of those losses. From the perspective of investors who might feel aggrieved by *Hercules*, a further rule that auditors are liable ouly for a portion of the small fraction of the losses that they have helped cause might be viewed as heaping insult upon injury.

b. Internal Joint and Several Liability of Partners

It is important to distinguish joint and several liability that arises in situations of vicarious liability from joint and several liability that arises

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[93] NSWLRC 1997 at 18-36. The Commission's discussion makes it clear that other bodies in Australia have taken a different view.

where the actions of independent actors combine to cause a single loss to a victim. The distinction could be said to be between *internal* and *external* joint and several liability.[94] In the former case, the relationship between two (or more) persons is considered, for reasons of policy, to justify imposition of liability on someone who bears no direct causal responsibility for the victim's loss. In the case of independent concurrent tortfeasors, each is held responsible for the whole loss not because of any relationship between them but because, as a matter of fact, each bears causal responsibility for the whole loss. The doctrine of external joint and several liability is based on the simple principle that an actor should be legally responsible for a loss caused by their own wrongful conduct, so it is essentially irrelevant whether or not some other actor's wrongful conduct helped to cause the loss. The rationale for internal, vicarious liability *emphasizes* the relationship between an actor and a person who is held vicariously for the actor's actions. In contrast, the rationale for external joint and several liability effectively *ignores* the relationship between the actions of two (or more) independent actors that combine to cause the same loss.

[94] This distinction is made in reference to the liability of members of a partnership by the Common Law Team 1996 at 2, note 4.

CHAPTER 2. BUSINESS ENTITIES

A. Chapter Overview

This chapter provides brief descriptions of different structures that are available, or might be made available, for business enterprises in Alberta. For convenience, we refer to these structures as "business entities." We will add the caveat that some of the business structures that we refer to as business entities are not regarded as separate entities for legal purposes. In other words, a business entity is not necessarily a legal entity.

Our description of the different business entities will focus on two of their attributes: (1) the extent to which owners and managers, or owner-managers, are liable for the liabilities of the firm; and (2) how the firm and its owners are taxed. "Focus" in the preceding sentence is a relative term. We are not going to discuss either the liability or the taxation attributes of different business entities in detail.

B. Preliminary Points

1. Limited or Unlimited Liability as a Default Rule

In discussing the liability position of participants in different business entities we are talking about the default rules that apply to such entities. We are talking about participants' liability according to the general legal rules that apply to a certain type of business entity. General purpose legal rules, such as those that determine whether the owners of a particular type of business entity are personally liable for its liabilities, can usually be replaced by customized rules that the parties to a particular transaction find more suitable. It is often pointed out that the liability shield provided to shareholders of corporations is of little practical benefit to shareholders of small corporations. Although they are not liable for the corporation's debts as shareholders, they will almost certainly be required to provide personal guarantees of the corporation's debts to banks and other major creditors. Conversely, a person who under the general law bears unlimited personal liability for the obligations of a firm might enter into a contract that excludes or limits their personal liability for such obligations.

2. Limits to Limited Liability

When discussing whether the owners or managers of different business entities enjoy limited liability, it is crucial to keep one point in mind. **No** business entity provides an individual with a shield against torts for which that individual is personally responsible. For example, the liability shield that the law provides to the shareholders and mangers of corporations means that liabilities of the corporation do not (in general) flow through to its shareholders or managers. However, this does not protect shareholders and managers from the consequences of breaches of duty that they may owe, as individuals, to other persons. An individual who takes actions or makes decisions on behalf of a corporation may be under a personal, non-contractual duty of care to persons who might be injured by those actions or decisions. If they are under such a duty, the fact that they are acting or deciding on behalf of the corporation will not shield them from liability if they fail to take care.

Our final preliminary point is to emphasize that when we talk about limited liability entities we are talking about limits on the personal liability of the owners or mangers of the entity. We are not talking about limits on the liability of the entity itself. Thus if a limited liability firm incurs a liability, the assets of the firm will be available to meet that claim.

C. Sole Proprietorships

A sole proprietorship is simply an individual who is carrying on a business. There is no reason in principle why a sole proprietor cannot carry on business on a large scale with many employees. In practice, however, sole proprietorships tend to be small enterprises with only a few (or perhaps no) employees.

The liability position of a sole proprietor is simple. The proprietor is the firm; the firm is the proprietor. If the firm incurs a liability, whether contractual or non-contractual, it is the proprietor's personal liability. The firm's employees are the proprietor's employees. Thus, the rule that employers are vicariously liable for their employees' torts amounts to a rule that the individual proprietor is liable for the torts of employees committed in the course of their employment.

The tax treatment of sole proprietors under the *Income Tax Act* ("ITA") is also quite simple (or as simple as anything relating to taxation can be).

The business is not regarded as a separate taxpayer. But the income (or loss) of an individual taxpayer for a year from a particular business carried on by the taxpayer is calculated separately from the taxpayer's income from other sources (such as employment or investments). Once the taxable income (or loss) of the business for the year is calculated, it is lumped in with the individual's income (if any) from other sources and the total is taxed at the appropriate rate or rates.[95]

D. Ordinary Partnerships

The fundamental factual distinction between a partnership and a sole proprietorship is a simple one of numbers. A partnership necessarily has at least two members. The term "partnership" is defined by the *Partnership Act* as "the relationship that subsists between persons carrying on a business in common with a view to profit."[96] Notice that the definition refers to a "relationship" between persons. A partnership is not a distinct legal entity; it is simply a business relationship between two or more persons that gives rise to certain legal consequences.

To elaborate the *Partnership Act*'s definition of "partnership" a bit, a partnership is formed when two or more persons agree to carry on a common enterprise with a view to profit. It is not necessary that they consciously agree "to form a partnership." They may have given no thought to whether they will be "partners." They may dearly wish to avoid having their relationship characterized as a partnership. Regardless of whether they want to be viewed as partners or not, they will be so viewed if they have agreed to carry on a joint enterprise with a view to profit. This definition is rather open-ended, and in many cases it has not been clear whether a particular business relationship constitutes a partnership until the matter has been settled by a decision of the court, and even then it may not be totally obvious how the court has reached its conclusion.

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[95] ITA s. 9.

[96] *Partnership Act* s. 1(d). The "persons" need not necessarily be individuals. The members of a partnership could be corporations or some could be individuals and some could be corporations.

1. Liability

The point that a partnership is not a separate legal entity, merely a relationship between its members is important when it comes to the personal liability of the partners. Since the firm is not a legal entity, "the firm" does not acquire rights or incur legal liabilities. Thus, to say that the firm has incurred a liability is a shorthand way of saying that the individual members of the firm have collectively incurred that liability. Each member of the partnership is an agent of all of the other partners, which means that each member of the partnership can enter into a contract on behalf of the firm.[97] Of course, to say that the firm is a party to a contract is really to say that each member of the firm is a party to the contract. This means that each partner is legally responsible, jointly with the other partners, for performance of the duties that the contract imposes on the partnership. Therefore, if the partnership fails to perform any of its contractual obligations, each partner is personally liable for the firm's failure to perform that obligation.[98] And as discussed in Chapter 1, each partner of the firm is vicariously liable for torts committed in carrying out the partnership business by any other partner or by any employee of the firm.[99]

The fact that all the members of a partnership are personally liable for the firm's obligations means that creditors of the firm do not need to be particularly concerned if assets of the firm – property owned jointly by the partners as partnership property – are transferred from the firm to individual partners.[100] If a partnership defaults on an obligation, the creditor can get a judgment that is enforceable both against the firm's assets and against the assets of individual partners. If $100,000 in what were formerly firm assets (jointly owned property) have been distributed equally to its ten individual partners, there are still $100,000 in assets available to satisfy the judgment. Because reduction of the firm's capital by converting firm property into the property of individual partners does not in itself reduce the pool of

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[97] *Partnership Act*, s. 6.

[98] *Partnership Act*, s. 11(1). The partners are jointly liable for contractual obligations, rather than jointly and severally liable. Nowadays, the distinction will generally be of little practical importance.

[99] Chapter 1.E.2.

[100] For a professional firm its major asset, in terms of realizable value, is likely to be amounts that are owed to it by its clients.

assets available to the firm's creditors, there is no pressing creditor protection reason to restrict transfers of assets from the firm to its individual members.[101]

2. Taxation

Partnerships are not regarded as legal entities for taxation purposes, so partnership income is taxed at the member level rather than at the entity level.[102] This is what we refer to as *flow-through* taxation. The partnership is not, however, totally ignored for tax purposes. The income or loss of the partnership for a taxation year is calculated "as if the partnership were a separate person resident in Canada."[103] But the partnership itself does not pay tax on that income. Instead, the partnership's income (or loss) for the year is attributed to individual partners, who then pay tax on their share of the income or deduct their share of the loss from their income from other sources.

E. Business Corporations

Modern business corporations are abstract legal entities that are created by statutes such as Alberta's *Business Corporations Act* ("BCA"). More precisely, a corporate entity is created by following incorporation procedures specified by the statute. When all the required procedures have been completed, a corporate entity springs to life. In Alberta a corporation can have one shareholder or thousands of shareholders. If the corporation has only a few shareholders, it is quite possible that all or most of the shareholders will be owner-managers. That is, they will be entitled to share in the profits of the enterprise as shareholders of the corporation and will also participate in its

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[101] This is not to say that a firm's creditors will be completely indifferent to the balance between firm assets and the assets of individual partners. Suppose that the firm is bankrupt and its two partners are each also individually bankrupt. In such a case, creditors of the firm and the creditors of the individual partners (i.e. for debts they each incurred outside of the partnership) will all have claims against the partnership property and the individual partners' property. But the creditors of the firm, as a group, will have first crack at the partnership property, while the creditors of each partner will have priority over the firm's creditors to that partner's non-partnership property. In such a case, the greater the proportion of the total wealth of the two partners that is held as partnership property, the greater the pool of assets to which the firm's creditors will have priority over the individual partners' creditors.

[102] ITA s. 96(1).

[103] ITA s. 96(1)(a).

management as directors, officers or both.[104] On the other hand, corporations with many shareholders are characterized by a separation of ownership and management. Most of the shareholders will merely be passive investors who take no role in the management of the enterprise.

1. Liability

Whether it has one shareholder or thousands of shareholders, a corporation is regarded as a distinct legal entity. It has legal rights, duties and liabilities that are distinct and separate from the rights, duties and liabilities of its shareholders or managers.[105] Concluding that a corporation is a separate legal entity with separate liabilities does not lead inexorably to the conclusion that shareholders or managers cannot share those liabilities. But modern corporate statutes go the other way and expressly state that shareholders are not in general responsible for the corporation's liabilities. In the words of section 43(1) of the BCA:

> The shareholders of a corporation are not, as shareholders, liable for any liability, act or default of the corporation except [for certain special cases that need not concern us at the moment.]

Special circumstances aside, it is more accurate to say that the shareholders of a corporation incorporated under the BCA have no liability for its obligations, rather than to say that they have "limited" liability.

There is no equivalent to section 43(1) that expressly grants corporate directors and officers immunity from liabilities of the corporation. However, it has long been established that the managers of a corporation (i.e. its directors and officers), as such, have no more responsibility for its general liabilities than do its shareholders. On the other hand, for various reasons of public policy legislators have seen fit to impose personal liability on directors and officers for various types of claims, including claims for unpaid wages, unpaid taxes, environmental damage and so on. Moreover, it is necessary to keep in mind the point we made earlier about the distinction between direct and

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[104] In business corporations statutes such as the BCA overall management of the corporation is officially vested in the directors (as a body), who appoint officers to execute the policies determined by the directors. Shareholders, as such, do not manage the corporation except to the extent that management powers (and duties) are transferred from the directors to the shareholders by a unanimous shareholder agreement: see BCA ss 97(1), 140.

[105] BCA s. 15(1).

vicarious liability. Managers of a corporation are not vicariously liable (generally, at least) for corporate liabilities, but in the course of carrying out their managerial functions they may incur direct liability for breach of a duty that they owe to a third person.

We noted above that creditors of a partnership do not have to be unduly concerned about transfers of assets from a firm to its members, because all the partners are personally liable for the firm's liabilities. It is otherwise with corporations and their shareholders. Since the shareholders are not liable for the corporation's liabilities, creditors of the corporation cannot enforce their claims against the personal assets of its shareholders. A *quid pro quo* for shareholder immunity from corporate liabilities is what might be referred to collectively as "financial responsibility" requirements. Such requirements are designed to increase the probability – they will never ensure – that a corporation's assets will be sufficient to meet its liabilities.

Possible financial responsibility requirements can be grouped into two broad categories. The first category consists of requirements designed to ensure that a corporation has a minimum level of resources from which to meet its liabilities. Minimum capitalization, insurance or bonding requirements are examples of this approach. However, modern business corporations statutes tend not to impose this type of financial responsibility requirement on run-of-the-mill corporations. Instead, they rely on requirements that are designed to prevent inappropriate transfers of assets from the corporation to its shareholders. Transfers of assets from a corporation to its shareholders are prohibited where the corporation is insolvent or unable to pay its debts as they come due or would be in that position after the transfer.[106]

2. Taxation

To greatly oversimplify things, corporate source income is taxed at two different levels: (1) in the hands of the corporation, and (2) in the hands of

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[106] See e.g. BCA ss 36(3), 33(2), 34(2) and 40. These restrictions only apply to transfers of assets to shareholders *qua* shareholders. If a shareholder has a valid claim as a creditor of the corporation, payment of that claim cannot be attacked on corporate law principles. It can be attacked, if at all, on general principles relating to fraudulent preferences. Technically, as the text suggests, there is a difference between a corporation (1) being insolvent and (2) being unable to pay its debts as they come due. But for the purposes of this paper we will sometimes use the term "insolvent" to cover either of these situations.

shareholders when it is paid out in dividends. Corporations, unlike partnerships, are treated as separate taxpayers whose taxable business income is determined in much the same way as an individual's taxable business income would be determined. The basic federal tax rate on corporate income is currently about 29%,[107] and the basic Alberta rate is 15.5%,[108] for a total of 44.5%. Not by coincidence, this is essentially the same as the top marginal tax rate for individual taxpayers. However, depending on the source of the income and the size of the company, deductions may be available that will lower the combined federal and provincial corporate tax rate to much less than 44.5%. The most important deduction is the "small business deduction" that is available on "active business income" of "Canadian controlled private corporations." Where available, the small business deduction lowers the total combined tax rate on the first $200,000 of an active business income for a year to about 19% (13% federal, 6% provincial).[109]

Ordinary dividends paid by a corporation resident in Canada are taxed in the hands of shareholders on a "gross-up and credit basis," which is designed to take account – but not necessarily full account – of the fact that the corporation has already paid tax on the income from which the dividend is paid.[110] When all is said and done, the gross-up and credit mechanism operates so that if all of a corporation's income was taxed at the small business rate, the total tax paid by the corporation and the shareholders will closely approximate the tax that would have been paid if the shareholders had carried on the business directly as partners. However, if all or a substantial proportion of the corporation's income was not eligible for the small business deduction, the gross-up and credit system will not achieve tax-neutrality. The combined tax paid by the corporation and the shareholders on a given chunk of corporate income will substantially exceed the tax that

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[107] See ITA ss 123(1), 123.2, 124(1).

[108] *Alberta Corporate Tax Act* s. 21(e).

[109] Another important credit that may be available is for 7% of a corporation's income from "manufacturing and processing:" ITA s. 125.1.

[110] ITA ss 82(1), 121.

would have been paid on the same chunk of income if it had been earned by a partnership.[111]

F. Hybrid Business Entities

For the purposes of this paper a hybrid business entity (or hybrid firm, for short), is a business structure that combines characteristics normally associated with corporations with characteristics normally associated with partnerships. The combination of characteristics that is of particular interest is limited owner liability (a "corporate" characteristic) and flow-though (owner-level) taxation. The first two hybrid entities that we describe – limited partnerships ("LP"s) and business trusts – are currently available in Alberta. The last two entities – limited liability companies ("LLC"s) and LLPs – are available in the United States and have been proposed in the United Kingdom[112] – but are not currently available in Alberta or any other Canadian province.[113] We should note that although it is convenient to think of limited liability as a "corporate" characteristic and unlimited limited liability as a characteristic of unincorporated business entities, there is no necessary connection between the form of an entity, incorporated or otherwise, and the issue of limited or unlimited owner liability.

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[111] If the corporation was not entitled to any deductions from the basic corporate rate and the individual shareholder paid tax at the top marginal rate, the total federal and Alberta tax rate paid by the corporation and the shareholder would be about 60%, as opposed to a total tax rate of about 45% if the shareholder had earned the same income as a member of a partnership. It should be kept in mind, however, that if all the shareholders are actually officers or employees of the corporation, the potential for double taxation could be minimized or eliminated through a salary structure for shareholder-employees that ensures that the bulk of the economic benefits of the enterprise accrues to them in the form of salaries rather than dividends.

[112] Actually it is only a type of LLP that has been proposed for the UK. However, as discussed in more detail below, the proposed UK LLP looks a lot like a US LLC.

[113] Nova Scotia's *Companies Act* allows companies to be incorporated with unlimited liability: *Companies Act* (NS) ss 9(c), 12, 135. Such companies may be useful for taxation purposes, because the unlimited liability characteristic helps them to be characterized as partnerships for US tax purposes: see section F.3(a) below. The provisions that give the members of an incorporated company the option of unlimited liability go back to mid-nineteenth century UK companies legislation. Interestingly enough, because of tax considerations the unlimited liability option may be more attractive now than it ever was in its place and time of origin. In the year following enactment of *The Joint Stock Companies Act, 1856* (UK) a total of 410 companies were formed under that Act. Of the 410 companies, 401 opted for limited liability, nine for unlimited liability: Joint-Stock 1857.

1. Limited Partnerships

Part 2 of the *Partnership Act* is entitled "Limited Partnerships." It allows two or more persons to form an LP. LPs have two classes of partners: general and limited. There must be at least one general partner and at least one limited partner.[114]

a. Liability

The characteristic that most clearly distinguishes an LP from an ordinary partnership is liability. A general partner of an LP is liable for the partnership's liabilities to the same extent as a member of an ordinary partnership is responsible for its liabilities.[115] Limited partners, however, enjoy essentially the same limited liability as corporate shareholders. So long as they are not also general partners[116] and do not assume any of the powers of general partners, the liability of a limited partner is limited to the amount they have contributed, or agreed to contribute to the partnership.[117] A limited partner who has paid in the money they have agreed to contribute to its capital will essentially have no liability, as a limited partner, for the LP's obligations. In any event, the amount they have agreed to contribute to the partnership defines their maximum exposure as a limited partner.

Traditional LP legislation insists on a rigid separation of ownership from management. The *Partnership Act* insists that limited partners be relatively passive investors who leave management of the LP's affairs up to the general partner. A limited partner who takes an active role in directing the affairs of the LP runs the risk of incurring the same unlimited liability as a general partner. This is a consequence of section 63 of the *Partnership Act*, which states that a "limited partner does not become liable as a general partner unless . . . he takes part in the control of the business." As important as this phrase is, it has not been the subject of much judicial scrutiny.

Haughton, an Ontario case decided in 1986, is the only reported decision that has directly considered section 63 of Alberta's *Partnership Act*. Here the

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[114] *Partnership Act* s. 50(2).

[115] *Partnership Act* s. 55.

[116] A person can be both a general partner and a limited partner: *Partnership Act* s. 52.

[117] *Partnership Act*, ss 56, 62, 63.

general partner was a corporation and two of the limited partners were employees or officers of the corporate general partner.[118] The two limited partners actually made all the managerial decisions in relation to the LP.[119] The court held that this brought them squarely within section 63, so they were liable as general partners.

The decision in *Haughton* may be contrasted with *Nordile*, a 1992 decision of the British Columbia Court of Appeal, which interpreted the corresponding section of BC's *Partnership Act*.[120] The facts of *Nordile* were similar to those of *Haughton*; two limited partners of an insolvent LP were directors and officers of the corporate general partner and, as such, had taken part in the management of the LP. The Court of Appeal held that they took part in the management of the LP not as limited partners but as officers and directors of the corporate general partner and, thus, were not personally liable as general partners.[121] In other words, the court in *Nordile* seems to have read into the provision a qualification that limited partners will be treated as general partners if they take part, *in their capacity as limited partners*, in the management of the LP'S business. This contrasts with the Ontario court's analysis, which focused on the factual question of whether persons who were limited partners took part, *in any capacity*, in the control of the business.[122] Given the conflict in the authorities, it would be a bold limited partner who would assume that they can act as an officer or director of a corporate general partner without incurring a substantial risk of being held to be a general partner under section 63 of the *Partnership Act*.

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[118] The exact title or role the two limited partners in the corporate general partner was not determined by the Court.

[119] *Haughton* at 129.

[120] Section 64 of the BC Act refers to "management", rather than "control," of the business, but little would seem to turn on that difference of wording.

[121] The Court of Appeal actually held for the defendant limited partners on a second independent ground. The other ground was that a provision of the mortgage upon which they were sued stated specifically that the plaintiff's recourse would be limited to the assets of the LP. This aspect of the court's reasoning is unremarkable. There is no preemptive rule of law that prevents a contract between a partnership and a third party from limiting the third party's recourse to the assets of the partnership, rather than the personal assets of the partners. That seems to be precisely what the contract in this case was intended to do.

[122] The BC Court of Appeal's rather terse analysis of the control (management) issue is criticized in Philipps 1993 and is inconsistent with the control analysis advocated by Flannigan 1992. For a contrary view, which would find the Court of Appeal's analysis more congenial, see Apps 1991.

When discussing corporations we mentioned that the *quid pro quo* for limited liability is restrictions on the transfer of assets from the corporation to its shareholders. These restrictions are intended to prevent corporate assets from being transferred to shareholders where this would be likely to prejudice creditors. A similar set of safeguards applies to LPs. Limited partners are only entitled to receive a share of the profits if, after such a payment, the LP would still have sufficient assets to meet its liabilities (other than liabilities to other partners).[123] Similar restrictions apply to return of a limited partner's contribution.[124] Moreover, although limited partners can make loans to the partnership, they cannot take a security interest in partnership property,[125] a restriction that does not apply to shareholders of corporations.

b. Taxation

Many of the characteristics mentioned above make LPs look more like corporations than ordinary partnerships. Nevertheless, LPs are treated as partnerships for income tax purposes. The same basic flow-through taxation principles apply to LPs that apply to ordinary partnerships. LPs are used as an investment vehicle where passive investors see advantages to flow-through taxation as compared to the entity-level taxation that would be associated with a corporate investment vehicle. An LP would be attractive (all else being equal) where the enterprise was too large to take advantage of the small business deduction[126] and all or most of its income for any given year was going to be paid out to investors, rather than retained in the company. In that case the tax paid by the limited partners would be substantially lower than the total tax that would be paid by a corporation and its shareholders on a given chunk of enterprise income.

An LP might also be attractive where the enterprise is expected to experience losses rather than profits in the first few years of operations. In such cases flow-through taxation will allow limited partners to apply their share of the partnership losses against their income from other sources: up to

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[123] *Partnership Act* s. 58(2).

[124] *Partnership Act* s. 61(1).

[125] *Partnership Act* s. 59(a).

[126] See Section E.2, above.

a point. A limited partner's ability to apply LP losses against income from other sources is limited by the ITA's "at-risk" rules.[127] As in all things connected with tax, the at-risk rules contain many twists and turns. Essentially though, they prevent a limited partner from realizing tax losses that exceed the amount that the partner has actually put at risk.[128]

2. Business Trusts

The trust is a very old concept that Canadian courts inherited from the courts of England. To oversimplify things somewhat, a trust arises when one person (the "trustee") holds legal title to property but is under an "equitable" duty to deal with the property for the benefit of some other person or class of persons: the "beneficiaries."[129] The trust is an extremely flexible concept. Trusts can be created by many types of instruments and for many purposes, including investment or commercial purposes. Many mutual funds, for example, are "unit trusts," in which a trustee holds marketable securities on trust for investors who purchase units of the trust. A less familiar (to Canadians) use of the trust concept for commercial purposes is the "business trust" (or "Massachusetts trust"as it is often called in the United States), which carries on an active business, rather than simply investing in securities.[130] From a trusts law perspective, business trusts are unremarkable: a trustee holds legal title to and employs assets for the benefit of a defined class of beneficiaries.[131] What distinguishes the business trust from more familiar trusts is its particular combination of characteristics. The trust agreement governing a business trust would give the trustees greater latitude to make aggressive investments and to carry on an active business than a typical testamentary trust for the benefit of a deceased person's family might.[132] And

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[127] ITA s. 96(2.1)-(2.7).

[128] For a detailed discussion of the at-risk rules see Stikeman CTS, Volume 7 at 96:152-96:163.

[129] The trustee may in fact be one of the members of a multi-person class of beneficiaries.

[130] The discussion here is based primarily on Flannigan 1983, *passim*, which contains a much more detailed discussion of issues relating to business trusts in Canada.

[131] Flannigan 1983 at 182-190 takes pains to point out that business trusts fit well within standard trust law concepts and that the distinction between business trusts and other trusts is functional rather than legal.

[132] But there is no legal reason why a family trust might not give the trustees extensive powers to make investments or carry on businesses that would not be permitted under the

(continued...)

while a family trust is likely to create various successive and contingent interests, the entire beneficial interest in the assets of a business trust will be vested in identifiable persons: the investors in the business trust.

A group of individuals (or a group of corporations or a group of individuals and corporations) who wanted to set up an enterprise as a business trust could do so by taking the following steps: (1) drafting a trust agreement that appoints a trustee and defines the respective powers, duties and rights of the trustee and beneficiaries; and (2) transferring property (probably money) to the trustee to be applied for the purposes of the business in accordance with the terms of the trust. The trustee would then use the funds with which it has been provided to carry on the business contemplated by the trust agreement. Under ordinary principles of trust law the beneficiaries would have no power either to remove the trustees or to direct them how to manage the trust,[133] but these principles might be modified by the terms of the trust agreement.

a. Liability

Like a partnership, a business trust is not regarded as a legal entity. The relationship between those involved in a trust is quite different from the relationship between the members of an ordinary partnership. Being the legal owner of the trust property, the trustee has all the powers of an absolute owner[134] to deal with the property. Third parties who want to purchase trust property (or sell property or services to the trust) deal with the trustee as a principal, not as an agent for the beneficiaries (nor as both an agent and a principal, as would be the case with a partner in an ordinary partnership). The "trust," as such, does not incur rights or liabilities. More importantly, the beneficiaries, as such, do not generally obtain rights against or incur liabilities to third parties because of transactions or actions undertaken by the trustee in exercising its powers and carrying out its duties

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[132] (...continued)
default rules of equity or the *Trustee Act*. The latter provides lists of permitted trustee investments but provides in s. 10 that "[t]he powers conferred by this Act relating to trustee investments are in addition to the powers conferred by the instrument, if any, creating the trust." In general, the *Trustee Act* is similar to the *Partnership Act* in that it supplies default rules and powers that give way to a contrary expressions of intention in the instrument creating the trust.

[133] But courts of equity have always had the power to do so if the trustees act improperly.

[134] This power must be exercised in accordance with the trustee's fiduciary duties.

as a trustee. Under ordinary trust principles, beneficiaries of a business trust may be liable to indemnify the trustee against liabilities incurred by the trustee in carrying out its duties, but this duty to indemnify the trustee can be excluded by agreement.[135]

If the trustee of a business trust is a corporation, the participants may effectively limit their liability to the assets of the corporate trustee (which may be minimal) and the assets held by the corporation on trust for the beneficiaries.[136] It should be noted, however, that the fact that legal title to the assets of a business are held by a trustee (corporate or otherwise) does not lead inexorably to the conclusion that the beneficiaries enjoy limited liability. Logically, where two or more persons have agreed to contribute funds to be used in a venture with a view to profit, they could be regarded as having formed a partnership, notwithstanding that legal title to the assets of the business and even the management of the business, has been vested in a trustee. Nevertheless, Anglo-Canadian courts have taken the view that, at least where the beneficiaries of a business trust are merely passive investors, their liability position will be that of beneficiaries of a trust, rather than that of members of a partnership.[137] On the other hand, where the trustee is merely a bare trustee who exercises no independent discretion but simply carries out the directions of the beneficial owners regarding the deployment of trust assets, the trustee will be regarded as acting also as the agent of the beneficiaries, and the beneficial owners will be liable as principals.[138]

The liability position of the beneficiaries of a business trust is less clear where they participate to some degree or in some capacity in the control or management of the business, but the trustee retains a significant measure of discretion in the management of the business. There is no statutory equivalent of section 63 of the *Partnership Act*[139] applicable to the

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[135] See Flannigan 1984 at 281-83; Cullity 1996 at 133-36.

[136] The corporate trustee could be an ordinary corporation incorporated under the BCA, rather than a trust corporation incorporated under the *Loan and Trust Corporations Act*, so long as it did not offer trust (or other fiduciary) services to the public: ss 1(1)(pp), 6(2).

[137] See Flannigan 1984 at 278.

[138] *Trident.*

[139] Section 63, it will be recalled, provides that limited partners who take part in control of

(continued...)

beneficiaries of a trust. Nevertheless, one view is that if the trust agreement gives the beneficiaries any direct rights of control over management of the trust property or allows them to exercise "ultimate control" over the trust's asset's, the beneficiaries are really members of a partnership and the trustee is their agent.[140] Ultimate control, on this view, would be in the hands of the beneficiaries if, for example, they could exercise effective control over the decisions of the trustees through a power to remove and replace them.

The contrary view is that the key issue as a matter of Anglo-Canadian law is not whether the beneficiaries are in a position to exercise some direct or indirect control over the assets or trustees, but whether the trustee exercises a measure of independent discretion with respect to the management of the trust's assets. On this view, even if the beneficiaries can and do exercise some measure of control over the trustee, if the latter nevertheless retains some independent management powers (i.e. is not a bare trustee), the trustee will not be regarded as an agent of the beneficiaries. Thus, the beneficiaries will not be personally liable, on this view, for obligations or liabilities incurred by the trustee in carrying out the trust's business.[141]

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[139] (...continued)
the LP's business will incur the liabilities of general partners.

[140] This view is expounded in Flannigan 1984, *passim*, esp. at 284-87, 297, 299-304; Flannigan 1986, *passim*. Flannigan argues that policy considerations require that essentially the same control test that applies to limited partners also apply to beneficiaries of a business trust: Flannigan 1984 at 284-85.

[141] This view is propounded in Cullity 1985, *passim*; Cullity 1988, *passim*; Cullity 1996 at 133-43. The thrust of Cullity's argument is that, regardless of what the position in the United States may be, English and Canadian authorities do not support Flannigan's thesis insofar as it presents the "control test" as part of the common law of Canada. Cullity's third article discusses the effect of *Trident*, which had mentioned the earlier exchange between Flannigan and Cullity without finding it necessary to choose between their different perspectives on the beneficiary control issue. As noted earlier, *Trident* involved the sort of "bare trustee" situation where there seems to be a consensus that the trustee is merely an agent for the beneficiaries. The facts and decision in *Trident* do not speak directly to the issue of the liability of beneficiaries who exercise some control, but not complete control, over the assets or the trustee.

b. Taxation

The ITA contains detailed rules regarding the taxation of trusts and their beneficiaries.[142] Not all trusts are treated the same way, but the following summary of the tax treatment of trusts would apply to a business trust:

> The rules applicable to the taxation of trusts and their beneficiaries are intended to ensure that no tax advantage (in particular, tax deferral) results where property is held in a trust rather than directly by the trust beneficiaries. This end is generally achieved by taxing trust income that has become payable in a taxation year to beneficiaries in their hands, and taxing trust income that has not become so payable in the hands of the trust itself. Generally, an *inter vivos* trust is taxed at the highest individual marginal rate . . . .[143]

Thus, to the extent that a business trust is not obliged to distribute its earnings for a given year to beneficiaries, the income would be taxed in the hands of the trustee at the highest individual marginal rate.[144] However, to the extent that trust income is payable to beneficiaries in the year it is earned, it is taxed in their hands at their respective marginal rates,[145] just as the income of an LP (or ordinary partnership) is taxed in the hands of the partners. Unlike the partners of an LP, however, the individual beneficiaries of a business trust cannot apply losses incurred by the trust in a given year against their personal income from other sources. Such losses would have to be carried forward by the trust to be applied against its income in later years. In that respect, the tax treatment of a business trust is closer to the tax treatment of a corporation than an LP.

3. Limited Liability Companies

a. Development in the United States

As discussed above in connection with corporations, when a Canadian shareholder receives a dividend from a corporation that has already paid tax on the income used to pay the dividend, the shareholder is credited with some portion of the tax paid by the corporation through the gross-up and credit mechanics. This does not necessarily eliminate all double taxation of corporate source income, especially where the corporation in question is large, but it does provide substantial relief from double taxation. In the

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[142] ITA ss 104-108.

[143] Stikeman CTS, Volume 7 at 104:158.

[144] See ITA ss 104(2) and 122(1), (1.1).

[145] See ITA ss 104(6), (13), (24), 105(1).

United States, however, shareholders who receive dividends do not receive a credit for tax paid by the corporation, so in the US there is a greater element of double taxation on dividends received from corporations.[146] This has long given American firms an incentive to adopt an organizational form that will not attract the double taxation of dividends paid out of corporate income.[147]

Over the years the American courts and the Internal Revenue Service developed rules for determining whether an entity that might not be labelled as a "corporation" for other purposes would nevertheless be regarded as corporations for tax purposes:

> The focus of corporate classification [for tax purposes] has been on characteristics that distinguish entities for non-tax purposes. Using this "resemblance" perspective, the IRS and the courts have served up four characteristics: (1) the continuity of life, (2) centralized management, (3) limited liability, and (4) free transferability of interests. The regulations provide that an unincorporated organization will not be treated as a corporation for tax purposes unless the organization has more corporate characteristics than non-corporate characteristics.[148]

Thus, assuming that investors in an enterprise wanted flow-through (non-corporate) taxation plus limited liability, they would have to adopt an organizational form that had no more than one of the other three corporate characteristics.

In the mid-1970s an oil company persuaded the state of Wyoming to pass the first LLC statute.[149] Its hope was that the LLC would not be regarded as a corporation for US tax purposes. The concept of the LLC did not really catch on, however, until the Internal Revenue Service ruled in 1988 that a Wyoming LLC would be treated as a partnership for tax purposes.[150] Almost all of the states had enacted LLC statutes within a few

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[146] Klein & Zolt 1995 at 1002-04. We need hardly point out that our discussion is a gross oversimplification of the US tax treatment.

[147] Of course, the tax disincentive to organizing as a corporation may be overborne by non-tax incentives to organize as a corporation. Moreover, Klein & Zolt 1995 point out that there are circumstances in which the overall tax burden may be lower if the corporate form is adopted, notwithstanding the double taxation of profits paid out as dividends.

[148] Klein & Zolt 1995 at 1009-10. [Citations omitted]

[149] Carney 1995 at 857.

[150] Carney 1995 at 858.

years after that ruling.[151] There is considerable variation in the LLC statutes of different states. In 1996, in an effort to bring greater uniformity to the states' LLC statutes, the National Conference of Commissioners on Uniform State Laws ("NCCUSL") adopted a Uniform Limited Liability Company Act ("ULLA").

The origin of LLCs, as entities designed to receive a particular characterization for United States federal tax purposes, explains many of the idiosyncrasies of LLC statutes. Recently, the need for US enterprises to adopt idiosyncratic characteristics simply to fit within the confines of the tax-definition of partnership has been obviated by new federal "check-the-box" regulations.[152] These regulations allow many entities to simply elect whether they will be taxed as corporations or partnerships. It seems, however, that this is not likely to dampen the demand for LLCs. In recent years LLCs have been heralded as the wave of the future by some American commentators, not simply for their tax characteristics, but because they provide the benefits of limited liability in a structure that is more flexible than a business corporation or traditional LP.

LLC statutes place a heavy emphasis on contract as the primary determinant of the structure of the firm and of the mutual rights and obligations of the LLC's members and managers. An LLC is created upon the registration of a document that contains basic information about the structure of the entity. Under the ULLCA this document is called the *articles of organization* and must set out the following information: (1) the name of the company; (2) the address of the initial designated office; (3) the name and street address of the initial agent for service of process; (4) the name and address of each organizer; (5) whether the company is to be a term company and, if so, the term specified; (6) whether the company is to be manager-managed, and, if so, the name and address of each initial manager; and (7) whether one or more of the members of the company are to be liable for its debts and obligations.[153]

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[151] Carney 1995 at 858, note 17.

[152] Heller & Carnevale 1997.

[153] ULLCA §203(a).

The articles of organization may also contain information that might otherwise go in the *operating agreement*, which is the primary constitutional document of an LLC. LLC statutes are much like partnership statutes in that, to the extent that they specify rules regarding the internal relations between LLC members, they are mainly default rules that will give way to a contrary agreement between the members of the company.

Although LLCs are not described as corporations in their enabling statutes (because doing so would defeat their original tax purpose), they are treated as separate legal entities.[154] Although the separate legal entity status does not entail limited liability for members and managers, the statutes specifically provide that neither members nor managers are liable, as such, for debts and liabilities of the LLC (unless they elect to be liable).[155] The statutes give members of LLCs great flexibility as to how they organize the company and provide for its management. An LLC may be member-managed (a characteristic of ordinary partnerships) or manager-managed (a characteristic of corporations and LPs), at the option of the members as expressed in the operating agreement. Member-management means that management is vested in the members as a group, and that, as in an ordinary partnership, each member of the company has the power to bind it. Manager-management means that the powers of management are vested in mangers chosen by the members, much as management of a corporation is vested in its directors.[156]

One subject upon which there is considerable diversity in the LLC laws of various states relates to the issue of what, if any, non-waivable duties should be owed by members or managers of LLCs to the company or to other members or managers. The issue, in the first instance, is the extent to which an LLC statute should impose duties on managers or members to the

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[154] See e.g. ULLCA §201. So far as American law is concerned, treating LLCs as separate legal entities does not distinguish them from partnerships. The Uniform Partnership Act (1996), another product of the NCCUSL, provides that a partnership is a distinct legal entity: UPA 1996 §201(a).

[155] See e.g. ULLCA §303(a). The operating agreement can provide that all or some members of the company are liable for some or all of its debts: ULLCA §303(c). This would be one way of avoiding a corporate characterization before the IRS adopted its check-the-box rules.

[156] Under ULLCA §301(b)(1) each manager of a manager-managed company is an agent of company. By way of contrast, individual directors of a corporation are not, as such, agents of the corporation.

company or to each other in addition to any duties that they expressly agree to accept under the operating agreement. But the more controversial issue is whether all duties that are imposed by statute should give way to a contrary agreement between the members, or whether some of the duties should be preemptive, in the sense that they cannot be excluded by contract. This is an issue that we consider in a little more detail in Chapter 6.

b. Extra-provincial registration of LLCs in Alberta

The LLC came to the attention of Alberta Registries[157] a few years ago. In a 1995 discussion paper on business corporations law Alberta Registries made the following observation:

> Recently, we have received three requests to register an LLC in Alberta. We cannot find any existing legislation that will accommodate the registration.
>
> It is our belief that any legitimate business entity should have the ability to register to do business in Alberta. To support this belief, we propose to amend the *Business Corporations Act* to permit the extra-provincial registration of business entities that do not fit into the scheme of existing legislation.[158]

Indeed, amendments were enacted in 1996 that added Part 21.1, *Other Extra-Provincial Legal Entities*, to the BCA.[159] The new provisions allow for regulations that would provide for registration of extra-provincial entities to which Part 21.1 applies. These entities are described as follows in BCA section 283.2:

> This Part applies to an organization that is formed in a jurisdiction other than Alberta and that
>
> (a) is recognized as a legal entity under the laws of that other jurisdiction,
>
> (b) does not qualify to be registered under this Act as an extra-provincial corporation, and
>
> (c) does not qualify to be registered under the *Partnership Act* as a partnership or a limited partnership.

Regulations have yet to be passed under Part 21.1.

If an LLC does not qualify to be registered as an extra-provincial corporation under Part 21 of the BCA, then it must be because it is not

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[157] Alberta Registries is a unit of the Alberta Department of Municipal Affairs.

[158] Alberta Registries 1995 at 18.

[159] S.A. 1996 c. 32, s. 1.

regarded as an extra-provincial corporation. Section 266(1) of the BCA *requires* all extra-provincial corporations to register within 30 days after starting to carry on business in Alberta. In other words, an extra-provincial corporation that carries on business in Alberta does not *qualify* to register; it *must* register. The BCA defines an "extra-provincial corporation" as "a body corporate" incorporated under the laws of some other jurisdiction.[160] The term "body corporate" is defined thus: "includes a company or other body corporate wherever or however incorporated."[161] In other words, the Act does not really define what a body corporate is. It is true that American LLC statutes go to great lengths to give these entities characteristics that will prevent them from being characterized as corporations for US tax purposes. And certainly, they are not called corporations. But the fact LLCs are contrived so as not to be regarded as corporations for US tax purposes does not mean that they might not be regarded as corporations under Canadian law.

Canadian courts have not adopted the same approach to distinguishing corporations from other entities that has been favoured in the US.[162] As a Manitoba court once put it:

> What is a corporation? According to our system of law, a corporation is a group or series of persons which by a legal fiction is regarded and treated as a person itself. It is a legal entity composed of persons.[163]

This, incidentally, reflects the approach that Revenue Canada takes to classification of entities for Canadian tax purposes; it regards LLCs as corporations.[164] Since LLCs are distinct legal entities, the fact that they are not described as corporations in the statutes that create them should not necessarily be determinative of whether they are regarded as bodies

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[160] BCA s. 1(i.1).

[161] BCA s. 1(e).

[162] For example, we expect that few Canadian courts or lawyers would consider provisions in a corporate charter that place restrictions on share transfers as a "non-corporate" characteristic. The difference between American and Canadian attitudes towards restrictions on share transfer reflects our *Companies Act* heritage: see Gower 1956 at 1377-78. Gower was comparing British and American corporation law. However, as he notes at 1370, in 1956 Canadian company law statutes were "virtually identical with the British."

[163] *Hague* at 193.

[164] This is discussed further in Chapter 6.

corporate for the purpose of extra-provincial registration in Alberta. One might apply the time-honoured legal doctrine: "If it walks like a duck and squawks like a duck, it probably is a duck." It is not obvious to us, either as a policy matter or as a matter of the legal definition of a corporation, why LLCs could not be registered as bodies corporate under Part 21 of the BCA.

ISSUE No. 1
What characteristics of LLCs, if any, prevent them from being registered as extra-provincial corporations under Part 21 of the BCA?

4. Limited Liability Partnerships: United States

The idea for the LLP has been credited to "a twenty-odd person law firm from Lubbock," Texas.[165] Their idea, which led to the enactment of the first LLP statute in Texas in 1991, was a reaction to the legal fallout from an economic calamity:

> The LLP is a direct outgrowth of the collapse of real estate and energy prices in the late 1980s, and the concomitant disaster that befell Texas's banks and savings and loan associations. Texas led the nation in bank and savings and loans failures during the 1980s.[166]

The US Federal Deposit Insurance Corporation ("FDIC"), having made huge payouts to depositors, did its best to recover some of its losses from those who were (or might arguably be) legally responsible for the losses. Of course, directors and officers of the failed financial institutions were pursued, but their personal assets were dwarfed by the size of the losses. Naturally, the FDIC looked in all directions for defendants who could provide more meaningful compensation for its losses, and its gaze fell on accountants and lawyers who had provided professional services to the failed institutions. Large accounting firms and law firms that had a relationship with the failed institutions were particularly inviting targets because, not only would they have liability insurance, but the personal wealth of their many partners would be available to help satisfy any judgment.

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[165] Hamilton 1995 at 1073. Our description of the genesis of the LLP in the next couple of paragraphs is based on Hamilton 1995 at 1068-74.

[166] Hamilton 1995 at 1069.

American partnership law is based on similar principles to Canadian partnership law. Thus, if the FDIC could show that one member of a professional firm was guilty of wrongful conduct in their professional relationship with a failed financial institution, all members of the firm would be personally liable. This gave the FDIC considerable leverage in its negotiations with firms and their insurers where there was substantial evidence that one or more members the firm had fallen short in discharging their professional duties or were parties to outright fraud. It was, of course, legally beside the point that the other members of the firm may have been entirely innocent of knowledge of their partner's wrongful conduct. The legally relevant point was that the partners were vicariously or contractually liable for each other's wrongs by virtue of the partnership relationship.

Given their exposure to claims arising out of the savings and loan debacle, the only complaint that some Texan law firms might have had about the original LLP legislation was that it was not retroactive. The legislation allowed members of certain professions who were carrying on business as ordinary partnerships to register as LLPs. Once a firm was registered as an LLP, each partner was shielded from personal liability claims against the firm arising from any future malpractice of other members of the firm. More precisely:

> (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.[167]

[167] Vernon's Texas Civil Statutes, Art. 6132b, §15.

The assets of the firm, and any applicable liability insurance, would be available to satisfy liabilities referred to in paragraph (2), as would the personal assets of any partners who committed or were directly involved in the actions (or inaction) that created the liability.

The "Texas model" for LLP legislation has two key characteristics. Firstly, its liability shield only covers what we will refer to generically as *professional malpractice* claims. Secondly, the liability shield does not protect a professional for what we will call *personal malpractice*, that is, where they were personally involved in the wrongful conduct or had direct supervisory responsibility over those who were personally involved in the wrongful conduct.

After Texas passed its LLP legislation, most other states quickly followed its lead.[168] Not only did they follow its lead in adopting LLP legislation, they also followed the original Texas model, with improvements to address technical issues that had been overlooked or ignored in the original statute.[169] However, a few states, including Minnesota, have adopted LLP legislation that departs substantially from the Texas model.[170] In these states the LLP provides a corporate-style liability shield against all firm liabilities, not just liabilities arising from professional malpractice.

The liability-shield provision of the Minnesota LLP statute looks very much like section 43 of Alberta's BCA:

> A partner of a limited liability partnership is not, merely on account of this status, personally liable for [any liabilities] of the limited liability partnership . . . .[171]

The Minnesota statute does not expressly confine the protection of the shield to partners who were not personally involved in the actions that created the liability. However, as pointed out in the Reporter's Notes, "The shield

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[168] An article published in 1996 stated that by the author's count 44 states (including Washington DC) had enacted LLP legislation by the time the article was written: McGaughey 1996 at 107, footnote 13.

[169] See Hamilton 1995 at 1076-78.

[170] Hamilton 1995 at 1087-90, who also refers to the New York LLP statute.

[171] Minn. Stat. Ann. §323.14, Subd. 2. (West 1995).

protects only against liability derived from partner status; it does not affect claims based on personal misconduct. For example, a partner who is culpably negligent cannot use the LLP shield to defend against his or her own personal liability." The Minnesota statute also contains restrictions on distributions to members of LLPs similar to those that apply to distributions to shareholders of corporations.

Although the majority of states have followed the Texas model, in 1996 the NCCUSL adopted LLP provisions along the lines of the Minnesota statute. The relevant provision in the Uniform Partnership Act (1996) ("UPA 1996") reads as follows:

> 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.[172]

Like the Minnesota reporter, the comment on the uniform section emphasizes that this provision would not shield partners from the consequences of their own personal misconduct.

5. Limited Liability Partnerships: UK Proposals

In early 1997 the UK Department of Trade and Industry ("DTI") circulated a consultation paper that begins with the statement that the UK government had announced its "intention to bring forward legislation at the earliest opportunity to make limited liability partnership available to regulated professions in the UK."[173] The rationale for the decision that professionals should be able to practise in limited liability partnerships is stated thus:

> 2. Mr Lang [President of the Board of Trade] said that he was aware of the concern of many in the professions that, under present partnership law in the UK, the personal assets of the active members of the partnership are at risk from the business decisions of other partners even though it may be impossible for partners to know all the other partners and their work in a modern partnership advising on large commercial transactions.
>
> 3. He noted that limited liability partnership (LLP) was now available in many parts of the USA and in an increasing number of other jurisdictions and said that the Government is determined to maintain a competitive and up-to-date legal framework for

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[172] UPA 1996 §306(c).

[173] DTI 1997 at 1.

> business in the UK. The Government therefore intends to enhance the competitiveness of professions in the UK by making LLPs available to them, subject to safeguards.[174]

The foregoing passage suggests that the UK government's decision to allow certain professionals to practice in LLPs was largely a response to pressures to maintain a "competitive and up-to-date legal framework," rather than a conclusion that, on principle, UK professionals ought to be able to operate as limited liability partnerships.

The background to the UK government's decision to allow professional firms to operate as LLPs is the ongoing campaign by accounting bodies to persuade governments to replace the doctrine of external joint and several liability with a doctrine of proportionate liability. While continuing to press the UK government on the proportionate liability front, a couple of the Big Six accounting firms have taken alternative steps to address their liability concerns. In 1996 they persuaded legislators of the Channel island of Jersey, a British Crown dependency, to enact an LLP law that was to come into force in November of 1997.[175] Several major UK accounting and law firms are expected to take advantage of the Jersey LLP.[176] Apparently, the prospect of UK accounting and law firms avoiding the consequences of partnership law by the simple expedient of reconstituting themselves as Jersey LLPs is one of the considerations that motivated the government's decision to create a UK version of the LLP.[177]

UK professional firms have for some years been able to gain limited liability through the traditional route of incorporation, but only one of the Big Six accounting firms has chosen this route, and then only in respect of its auditing operations.[178] It is suggested that most UK accounting firms find that the benefit of limited liability is outweighed by the burdens of

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174 DTI 1997 at 1.

175 Morris & Stevenson 1997 at 542.

176 Morris & Stevenson 1997 at 542.

177 Morris & Stevenson 1997 at 538-39, who point out at 546 that it is possible, but unlikely, that English courts would refuse to recognize the liability shield provided by the Jersey LLP.

178 Morris & Stevenson 1997 at 60.

incorporation: in particular, adverse tax consequences and unwelcome financial disclosure requirements.[179]

Turning from the impetus for the UK government's LLP initiative to its content, it is readily apparent that the LLP as proposed by the DTI would be a different creature than the American LLP. The American LLP is the result of adding a section or two to a preexisting partnership statute. In contrast, the DTI's detailed description of its proposed legislation takes up about 20 pages,[180] not counting a separate volume dealing with accounting requirements. The LLP proposed by the DTI would have as much in common with an American LLC as with an American LLP. Another way of putting it is that the LLP as proposed by the DTI would be "a large company in all but name."[181]

The LLP envisaged in the DTI paper would only be available to firms "subject to an effective scheme of regulation,"[182] that is, to the members of certain professions. In a sharp departure from traditional English (and Canadian) partnership principles, the LLP would be a separate legal entity, rather than an aggregate of its members.[183] The ordinary partnership rule that each partner is an agent of the firm would still apply; only now the agency would be on behalf of the firm as a distinct entity, not its individual members.[184] As in the Minnesota statute and UPA 1996, but in contrast to most American LLP statutes, members of an LLP would not be liable, as such, for any liabilities of the LLP. But they could iucur direct personal liability through contractual or tortious principles.[185] The most important difference between the DTI's proposed LLP and American LLPs is that the

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[179] Morris & Stevenson 1997 at 543.

[180] DTI 1997 at 20-40.

[181] Fearnley & Brandt 1997 at 28.

[182] DTI 1997 at 6.

[183] DTI 1997 at 4.

[184] DTI 1997 4.

[185] DTI 1997 at 4-5. One of the oddities of the DTI paper is that although it contains about 20 pages setting out the "details of proposed legislation," it never precisely specifies exactly what it means by limited liability. However, it seems to contemplate that the liability of members of an LLP will be limited in the same way as the liability of members of a limited company is limited.

quid pro quo for limited liability under the former would be elaborate disclosure and substantive requirements designed to protect outsiders who deal with the LLP. The primary safeguards proposed by the DTI are summarized briefly below.

a. Restriction to approved professions

The DTI proposes that the Secretary of State would be able to restrict access to LLPs "to members and firms subject to the discipline of a regulator which sets and enforces sufficient standards of professional conduct."[186] The stated rationale for such a restriction is that "professional regulation would help to safeguard the interests of those dealing with the firm."[187] The paper does not indicate why LLPs and their members should have to be regulated when this is not a requirement for ordinary companies. This is somewhat curious, since the rest of the safeguards proposed by the DTI seem to be strongly influenced by analogies to safeguards for outsiders that are built into company law.

b. Disclosure of information

In the DTI's view, the fact that members of an LLP will not be liable, as such, for the firm's liabilities makes it important for the LLP to publish certain information about itself for the benefit of outsiders who may deal with the firm:

> The LLP will be required to file, and keep up to date, information about its address, regulator and membership . . . In order to help third parties make a judgement about the financial record of the LLP it will be required to file audited accounts with the Registrar. These will be on the lines of those required of companies formed under the Companies Act, but modified to take account of the differences between LLPs and companies. The general aim will be to include those Companies Act accountancy provisions which are relevant to those dealing with the LLP but to omit those which are primarily for shareholders.

Undoubtedly the most important, and onerous, of the proposed disclosure requirements is that relating to audited accounts. The proposed financial disclosure requirements are addressed in a separate 76-page volume of the consultation paper.

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[186] DTI 1997 at 11.

[187] DTI 1997 at 11.

c. Financial responsibility requirements

We have noted that a *quid pro quo* for limited liability is that shareholders of corporations must put up with certain financial responsibility requirements. Under the BCA, as under most modern general purpose business corporation statutes, the financial responsibility requirements take the form of restrictions on transfers of assets from shareholders, rather than requirements designed to ensure that the corporation has a specific level of resources available to meet its liabilities. The DTI proposes two sorts of financial responsibility requirement for LLPs: (1) a "clawback" provision and (2) conditional personal guarantees by members.

The DTI's proposed clawback provision can be thought of as analogous to the restrictions business corporations statutes place on transfers of assets from the corporation to its shareholders. We noted that corporations statutes, including the BCA, prohibit transfers of assets from corporations to shareholders (*qua* shareholders) where this would prejudice creditors. The DTI paper does not propose express restrictions on transfers of assets from an LLP to its members. However, it proposes what amounts to essentially the same thing:

> To deal with cases in which the LLP is insolvent and members have run down the assets of the firm a 'clawback' provision will be available for use if there have been excessive drawings by its members.[188]

Under certain circumstances a court could require any member of an insolvent LLP to repay any amount withdrawn from the firm within the two years preceding the commencement of winding-up proceedings. This would be required if the withdrawal was made when the firm was already insolvent or would be made insolvent by the combination of that withdrawal and contemplated withdrawals by other members of the firm.[189] A "withdrawal" would include "a share of profits, salary, repayment of or payment of interest on a loan to the firm or any other withdrawal of property for [the member's] own benefit," but would not include amounts required to meet "the reasonable domestic needs" of the member and the member's family.[190]

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[188] DTI 1997 at 12.

[189] DTI 1997 at 35.

[190] DTI 1997 at 35-36.

Although they do not refer to it as a minimum capitalization requirement, the DTI's proposal regarding personal guarantees seems to be designed to serve the same purpose as a minimum capitalization requirement. Essentially, the DTI's proposal is that each member of an LLP would be required to contribute an amount to guarantee "that a certain sum will be available to creditors."[191] The proposal is that each member of the firm would be severally liable for their proportionate share of the difference between the amount that is required to be available for creditors and the amount that is actually available, apart from the guarantees. The DTI proposes that the guaranteed sum would be a specified amount per member multiplied by the number of members in the firm. The DTI does not say what the amount per member should be, but says that "some large firms" have proposed that each member be liable for up to £25,000 (instead of being subject to the clawback provision), while "others" have suggested "£100,000 in addition to the clawback."[192]

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[191] DTI 1997 at 14. It is not clear whether the proposal is referring to "free assets" that would be available to satisfy the claims of general creditors on a *pro rata* basis or would include assets that might be subject to a security interest in favour of one creditor.

[192] DTI 1997 (Vol 1.) at 14.

CHAPTER 3. WHY LIMIT OWNERS' LIABILITY?

This chapter is concerned with the general issue of limited liability business entities. It will provide a foundation for the discussion in Chapter 4 of the issue of limited liability entities for specific types of professional enterprises. Section A of this chapter provides a brief sketch of the historical development of limited liability, with an emphasis on the debates that took place in the UK in the nineteenth century. Section B considers theoretical arguments for and against the idea of limited liability for owners and managers of business enterprises.

A. The Development of General Limited Liability

At the beginning of the nineteenth century most enterprises in both the British Empire and the United States were carried on by individuals, partnerships or unincorporated joint-stock companies whose members had unlimited personal liability. In both Britain and America, to get the benefit of limited liability, the owners of a firm had to persuade the relevant branch of government – legislature or executive – to grant it this special privilege. However, by the middle of the nineteenth century limited liability was readily available to just about any type of enterprise in North America or Britain.[193] It was a change that did not come without lively and well-documented public debate, especially in Britain.

The debate took place against the background of increasing industrialization and a shift in the economic paradigm from one that emphasized the role of individual capitalism – the world of owner-managers – to one in which social capital – the pooling of many investors' capital in enterprises run by agent-managers – predominated.[194] Increasingly, enterprises were undertaking activities that demanded very large amounts of capital: much more than could be supplied from the internal resources of a small group of owner-managers, or even from the resources of a few "great capitalists."[195] The economic solution to the problem of raising large amounts

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[193] Blumberg 1986 at 581-85, 587-94.

[194] Bryer 1997, *passim*.

[195] Professor Bryer notes that one of the arguments against limited liability was that
(continued...)

of capital was the joint stock company, in which a large number of investors entrusted funds with managers with the expectation of realizing a return on their investment but with no expectation of participating in the management of the company. From a legal perspective, well into the nineteenth century most joint-stock companies were simply large partnerships with transferrable shares, and their members were in theory exposed to unlimited liability for the firm's obligations.

The *Joint Stock Companies Act, 1844* provided a relatively simple procedure for joint stock companies to incorporate but retained unlimited shareholder liability.[196] Supporters of limited liability had argued, and they continued to argue, that the spectre of unlimited liability deterred potential investors from investing in joint stock companies, thus artificially restricting the supply of capital and impeding economic growth.[197] Supporters of the *status quo* offered a variety of economic arguments in its defence, in addition to the moral argument that those who expected to reap the benefits of an investment should also bear its burdens. It was argued that limited liability would expose creditors to fraud, would give rise to excessive speculation, and would facilitate unfair competition.[198]

In response to the controversy, the British government established the Mercantile Laws Commission to enquire into the issue whether limited

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[195] (...continued)
Britain, unlike poor countries such as France and the United States, "surely had enough of capital and no want of enterprise:" Bryer 1997 at 41, quoting a statement of Thomas George Baring, one of the great capitalists, in the House of Commons debate regarding the appointment of a Royal Commission. Bryer at 48 points out that Baring's argument could be interpreted as a perception on the part of some of the great capitalists that limited liability would increase the supply of capital from the middle classes, and thus reduce their own return on capital.

[196] Ireland 1984 at 242 notes that the 1844 Act only applied to joint stock companies with transferable shares or with at least 25 members, and *required* such companies to incorporate.

[197] Apparently, amongst the proponents of limited liability there were different views about exactly who would be deterred from investing. One view was that potential middle class and working class investors would be deterred from investing because of the indeterminate risk associated with their investment, and companies would end up in the hands of a few wealthy investors. Another view was that the great capitalists would decline to make relatively small investments in companies in which there were many less wealthy investors, because of a well grounded fear that in the event of the firm's insolvency, the wealthy investors would bear the burdens of unlimited liability: see Halpern, Trebilcock & Turnbull 1980 at 118.

[198] Bryer 1997 at 47, summarizing the arguments of Lord Curriehill, one of the authors of the majority report of the Mercantile Laws Commission.

liability should be made generally available.[199] When it reported in 1854, a majority of its members recommended against making limited liability generally available.[200] Parliament, however, preferred the minority's view and in 1855 enacted the *Limited Liability Act, 1855*. It allowed members of incorporated joint-stock companies comprising at least 25 members to obtain limited liability by complying with certain formalities.[201] In the following year *The Joint Stock Companies Act, 1856* reduced the minimum number of members of limited liability joint stock companies to seven, and "dispensed with the minimum capital requirements, minium share denominations and distasteful [to members] publicity stipulations of the old law."[202]

That limited liability was extended at first to companies with at least 25 members, and then to companies with at least seven members, reflects the nature of the debate over limited liability, and the rationale for providing it.[203] The main rationale for providing limited liability was to promote investment by passive investors in joint-stock companies. This rationale did not on its face apply to small owner-managed firms, and it seems clear that Parliament did not intend to make the limited liability vehicle available to small partnerships and sole proprietorships.[204] But it was immediately apparent to many interested observers that nothing in the wording of the *Companies Act 1856* required all seven of the minimum number of required members to have a substantial stake in the company. Hence, the practice soon developed of incorporating companies in which as many as six of the seven required members were merely nominal shareholders.[205]

In 1896 the famous House of Lords decision in *Salomon* confirmed that the owner of a "one-man" company could enjoy the same advantages of

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[199] Bryer 1997, *passim*.

[200] Bryer 1997 at 40.

[201] Ireland 1984 at 242.

[202] Ireland 1984 at 242.

[203] This paragraph is based on Ireland 1984, *passim*.

[204] Ireland 1984 at 242 points out that in both 1855 and 1856 bills were before Parliament that would have extended limited liability to small partnerships. However, neither bill was enacted.

[205] Ireland 1984 at 244-49.

limited liability as the members of large joint-stock companies.[206] Since then it has been an accepted principle of Anglo-Canadian law that, exceptional circumstances aside, shareholders of any business corporation, no matter how big or how small, are shielded from the liabilities of the corporation.

B. Limited Versus Unlimited Liability

In what circumstances, if any, should individual owners of a business enterprise be liable for a tort or contractual liability incurred by the enterprise merely because of their status as owners, rather than because they have played a direct and culpable role in the events that created the liability or because they actually agreed to assume the contractual obligation? The first order of business is to briefly explain some of the terms and phrases in the foregoing question: (1) *participants*; (2) *because of the nature of their status* (3) *direct and culpable role*; (4) *voluntarily agreed to assume the contractual liability.*

We assume that a firm might have two sorts of participants: owners and managers. The owners are the persons who have invested money in the firm and are, by virtue of that investment, entitled to share in the firm's profits.[207] The managers are the persons who exercise effective control over the conduct of the firm's business, subject to occasional general directions from the owners and to the owners' right to dismiss the managers. We assume that managers' compensation (and continued employment) is related directly or indirectly to the firm's profits, so managers and owners have a mutual interest in the profitability of the enterprise. Some or all of the owners may also be managers, in which case they are owner-managers.[208] We are not

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[206] Halpern, Trebilcock & Turnbull 1980 at 119 point out that the House of Lords decision in *Salomon* has been harshly criticized as a glaring example of a court ignoring the clear policy of the legislature in favour of a literal construction of the statute. However, as Ireland 1984 points out at 249-55, there was a substantial body of opinion *outside* of the courts that small partnerships and sole proprietorships should be entitled to the benefits of limited liability. Indeed, a year before the Lords rendered their decision in *Salomon*, a Select Committee of the Board of Trade had considered the growth of the "private company" and issued a report that "implicitly endorsed the spread of the private company:" Ireland 1984 at 250-53.

[207] Whether they have or have not agreed to share in its losses, beyond the amount of capital they have expressly put at risk, is an open question.

[208] We will not trouble ourselves too much with the distinction between owners and owner-managers. There is no nicely defined line between an owner-managed firm and a firm in which ownership and management is separated.

interested in the legal characterization of the business entity through which the enterprise is carried on.

We are interested in the circumstances in which a participant should incur "*status liability*" for enterprise liabilities, by which we mean liability that is imposed on participants simply because of the nature of their participation in the enterprise. If liability is imposed on owners simply because they are owners, it must be because the fact that they expect to reap the profits of the enterprise is seen to be a reason, in itself, for making them liable for liabilities of the firm. If liability is imposed on mangers simply because they are managers, it must be because the fact that they have the authority to direct the conduct of the firm's business is in itself a reason to make them liable for liabilities of the firm.

Our discussion distinguishes tort liabilities from contractual liabilities. With respect to tort liabilities, we are not particularly interested in situations where a person who is a manager or owner is liable for a tort because they played a direct and culpable role in the events that caused the injury. In other words, we are concerned mainly with vicarious tort liability that is imposed on owners or managers because of that status, rather than direct personal liability based on their conduct. So far as contractual liabilities go, we are interested in cases where a participant is liable for a contract of the enterprise simply because of their status as an owner or manager (or both), rather than because they have actually agreed to be answerable for the contractual liability. The distinction between tort and contract claims will frequently be problematic; later in this section we consider the problem of "boundary" creditors.

Having cleared the decks (more or less) of these terminological matters, we proceed to more substantive issues. On what basis should one try to decide whether it is appropriate to impose status liability (i.e. "unlimited liability") on participants in an enterprise? We will consider two sorts of arguments that can be brought to bear on the issue: (1) moral and (2) economic. In neither case will we do anything resembling full justice to the arguments that might be and have been deployed on either side of the debate.

For our purposes, we can say that the difference between the moral and the economic approach to a given liability rule is that the former is rearward-

looking and compensation-oriented, while the latter is forward-looking and efficiency-oriented.[209] This can be illustrated by a simple example. A has acted in a way that has caused B to suffer a loss. Should A be required to pay damages to B? The moral analysis looks at what has occurred and asks whether it is "fair" or "right" or "just," to let B bear the loss or to require A to compensate B. The economic analysis is not really concerned with what has happened, or with whom, as between A and B "ought" to bear the loss. Rather, it asks what liability rule, if applied in this situation, might be expected to cause actors involved in the sort of activities in which A and B were involved to carry out those activities in a manner, and to an extent, that maximizes social welfare. In other words, from the economic perspective, the test of a liability rule is whether it can be expected to produce socially optimal behaviour in everyone involved in or affected by an activity.

1. The Issue at First Glance

To get a feel for some of the issues and arguments in the contest between limited and unlimited liability, it is useful to consider the following simple scenario:

> John, who has faith in Jane's business acumen, entrusts Jane with $100,000 to use in her new business of manufacturing widgets and selling them directly to consumers. They agree that Jane and John will each receive half of the profits of the venture and that if it is wound up, they will divide the assets evenly. Jane is to have total responsibility for running the business, is to enter into contracts in her own name, and is not to disclose John's involvement to anyone with whom she does business. To obtain additional working capital Jane borrows $100,000 in her own name from a financier, Frank. Ingrid buys a widget from Jane. Because of a hidden manufacturing defect, Ingrid's widget causes a fire that totally destroys the condominium complex in which Ingrid lives. There are no personal injuries but the property damage suffered by Ingrid and the other residents runs into the millions of dollars. Jane neglected to purchase liability insurance and is essentially impecunious. At this point someone discovers the arrangement between John and Jane. John has not received any return on his investment and has no prospect of recovering his investment.

Disregarding what the legal position might actually be and ignoring the legal characterization of the enterprise, to what extent should either or both of the

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[209] Readers will appreciate that our distinction between the moral and economic analysis has, shall we say, certain rough edges. Some moral theories are overtly forward-looking. And economic analyses of liability rules see them as potentially enhancing social welfare in two distinct ways. The first way is to influence the behaviour of actors so as to *reduce* risks, which is what we refer to in the text. The other way is by *transferring* risk. In this latter case liability rules can be designed to enhance social welfare by reallocating the risk of an activity from a more risk-averse to a less risk-averse person or by spreading a given risk amongst a number of risk-averse persons: see Shavell 1987 at 190-91.

participants be liable for the losses suffered by Frank, Ingrid, and the residents? We will consider the question of Jane's liability even though it is largely academic, given that she is impecunious.

a. The Voluntary Creditor

Dealing first with the question of Jane's personal liability to Frank, if there is a general principle that people who borrow money ought to be liable to pay it back, it would be hard to think of any reason that might take Jane outside of the general principle. She borrowed the money from Frank in her own name and did not give Frank any reason to think that she would not be liable for the full amount borrowed. It might have been otherwise if she had indicated to Frank that she did not intend to be personally liable for the amount borrowed, but then Frank might have taken a different view of whether he should make the loan. In short, we will assume that Jane is personally liable to Frank for the $100,000.

If there is a reason to impose liability on John for the money Jane borrowed from Frank, it is not self-evident. John did not agree to be liable for the debt. Jane did not indicate to Frank that John would be liable for the debt, nor did Frank believe that John would be liable for the debt. In short, in making the loan Frank believed that he was dealing with Jane and relied on her credit. He voluntarily assumed the risk of lending money to Jane, and the undisclosed fact that Jane had agreed to share profits with John did not materially affect that risk. In the absence of a promise by John to pay the debt or of any reliance by Frank on John's credit, it might well be fairer to let each of them bear his own loss than to require John to bear not only his own $100,000 loss but also Frank's. And fairness aside, there is no obvious policy that demands that the burden of Jane's insolvency be transferred from the creditor, Frank, to the investor, John.

b. Involuntary Creditors

The heading of this section refers to the residents of the condominium complex other than Ingrid. They are involuntary creditors in the sense that their claim does not arise out of an activity in which they were willing participants. Rather, undesirable consequences of an activity in which they had not chosen to participate were foisted upon them. We will first consider their potential claim against Jane and then their claim against John.

In describing the scenario we said that there was a manufacturing defect in the widget, but we did not say whether Jane was personally culpable for the defect. Suppose that she was. To save costs, she dispensed with the quality-control system that would have caught the defect in the widget that caused the fire. In these circumstances, there is a straightforward case for imposing direct personal liability on Jane for the damage suffered by residents on principles of negligence.[210]

Suppose that Jane exercised all the care that a manager of a widget factory could reasonably be expected to exercise, and then some. Despite her precautions, one of her usually reliable workers carelessly crossed a couple of wires and the normally vigilant quality-control officer momentarily dozed off as the widget went by on the assembly line. In this case, if Jane is personally liable for the losses of the condominium residents, it must be vicarious status liability. Vicarious liability might be imposed on Jane because she is an owner, but in that respect she is no different from John, so the comments that follow about John will apply equally to Jane. For the moment we are considering whether there is a basis for imposing vicarious liability on Jane in her capacity as the manager of the enterprise.

Given Jane's lack of culpability for the widget defect, it would be difficult to justify imposing vicarious liability on her on the basis that it will encourage other enterprise managers to take adequate care. The message sent to other managers would be "even if you take all reasonable care you will still be liable for accidents that happen through no fault of your own." It is not entirely clear what purpose would be served by that message. Suppose, however, that policy makers consider that enterprises that create risks to the public (as Jane's evidently has) should provide insurance that will cover losses suffered when the risk materializes. Such a policy would not be novel; it is the policy that lies behind mandatory insurance requirements for automobile owners. If there is such a policy, it may be thought that imposing personal liability on managers of enterprises that fail to purchase adequate levels of liability insurance is a rational way of enforcing this policy.[211] Thus, one might argue that Jane should be vicariously liable for the damage caused

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[210] We assume that dispensing with the quality-control system amounted to a failure to take due care.

[211] Hansmann & Kraakman 1991 at 1927-28 discuss this rational for imposing liability on corporate managers who fail to provide insurance coverage that meets a prescribed norm.

to the residents not because she is culpable for failing to ensure that adequate care was taken in the manufacturing process, but because she failed to ensure that the enterprise had adequate liability insurance. This might even be thought of as a form of direct liability for breach of a duty to ensure that the enterprise has adequate insurance.

The claims of the condominium residents (other than Ingrid) against John appear to stand on a different, and perhaps more solid, footing than Frank's claim against John. The residents did not choose to lend money to Jane. They did not choose to buy widgets from Jane. They did not choose to have any dealings with Jane. Yet, their homes have been burned down because of a defect in one of the widgets manufactured by Jane in pursuit of profits that were to be shared with John. Admittedly, John did not exert any direct control over the manufacturing process or, indeed, take any interest in that manufacturing process. He simply provided some money to Jane with the hope of reaping the profits (or half the profits) of the enterprise. It is arguable that as someone who expected to reap the benefits of the enterprise, John should in fairness share responsibility where the enterprise harms persons who did not choose to deal with the enterprise or use its products.

c. Boundary Creditors

We will categorize Jane as a *boundary creditor* because her claim seems to have contractual as well as tortious aspects. Suppose that Jane personally warranted to Ingrid that the widgets would be free of all manufacturing defects. In that case, Ingrid's case against Jane would seem to be as strong as Frank's claim. Jane personally warranted that there would be no defects and, if contracts mean anything, she should be liable. A similar point could be made if Jane did not expressly warrant to Ingrid that the goods would be free of defects but led her to believe that she would assume personal responsibility for their fitness. But suppose, on the other hand, that Jane's name did not appear on the sales contract (it was in the name of the Wacky Widget Company) and Ingrid did not know or care who the managers or owners of Wacky Widget were. In this latter case there does not seem to be a great deal to distinguish Jane's position from John's, unless there is a basis for imposing direct personal liability on Jane because of something that she did as the manager of the enterprise.

So far as John's liability is concerned, Ingrid's case seems to fall somewhere in between Frank's case and that of the other residents. Suppose that Ingrid did think she was buying the widget from Jane. One could say that just as Frank assumed he was dealing with Jane, weighed the risk and accepted her credit, Ingrid assumed she was buying a widget from Jane and was prepared to rely on Jane as the financial guarantor of the widget's fitness and reliability. Similarly, if she did not give any thought to whom she was buying the widget from, she must have been prepared to take her chances on whether she would be compensated if the widget proved defective. In either case, she did not ask for or get a warranty of the widget's fitness or of the enterprise's solvency from John when she bought the widget, so why should she get the benefit of such a warranty *ex post facto*?

The strength of the foregoing argument seems to depend on Ingrid's sophistication and knowledge about matters such as: (1) the risk of defects in Jane's widgets; (2) the possible consequences of those defects; and (3) Jane's financial responsibility for harm caused by defects in the widgets. It is reasonable to assume that a financier such as Frank will be able to make an informed assessment of the risk that a prospective borrower will default on the loan. It is more problematic to assume that a consumer such as Ingrid will be able to make an informed assessment of the risk of defects, their likely consequences, or of Jane's ability to pay for any damage caused by defects in her widgets. If it is not reasonable to assume that Ingrid can make such an assessment, the argument that she has voluntarily assumed a known risk (of defective widgets or Janes' insolvency) is somewhat harder to maintain than it is for Frank's loan.

Concluding that Ingrid did not voluntarily assume a known risk of suffering uncompensable damage does not lead inexorably to the conclusion that John should be liable to Ingrid because of his profit sharing arrangement with Jane. However, there might be policy reasons to adopt such a rule. Perhaps it would induce John to take socially desirable steps to protect himself against such liability. In particular, he may take a greater interest in the quality of Jane's manufacturing process. He may be more astute to ensure that Jane purchases adequate liability insurance, or he may buy his own liability insurance. In theory, Ingrid could purchase insurance that would indemnify her for damage caused by defective widgets. John, however, may be in a better position than Ingrid to get information about the

risks associated with widgets and to obtain insurance commensurate with those risks.

In the next few sections we take a slightly less impressionistic look at different approaches to the personal liability of participants for liabilities of the enterprise. The following discussion makes the distinctions suggested by our scenario involving John and Jane: (1) claims of voluntary creditors (ordinary contractual obligations); (2) claims of involuntary creditors ("pure" tort claims); and (3) claims of boundary creditors (claims that in one aspect look like ordinary contractual claims and in other aspects look like tort claims). We will pay more attention to the case for imposing liability on "pure" owners than the case for imposing vicarious liability on managers.

2. Voluntary Creditors

For our purposes a voluntary creditor of a firm is someone who is seeking to enforce an ordinary contractual financial obligation of the firm. The claimant is seeking to compel the firm to do precisely what it promised to do under the contract. This may be contrasted with a situation where a firm has failed to perform a contractual obligation to provide services of a certain quality and the other party is seeking monetary compensation for the loss it has suffered because of that failure. The latter falls into our category of boundary claims.

a. Morally Speaking

Is there a moral principle that clearly favours or abhors status liability for owners or managers of firms as regards the claims of voluntary creditors? It has been suggested that owners of a firm should have unlimited liability on the basis of the "symmetry principle: such as enjoy the benefit's shalt suffer the losses."[212] In the case of ordinary debts of the firm, however, it is hard to see how the symmetry principle necessarily favours unlimited owner liability. After all, creditors expect to derive benefits from their contracts with firms, so the principle that the persons who expect to enjoy the benefits should bear the burdens could as easily be deployed against creditors as against owners. As it was put many years ago:

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[212] Collin 1996 at 2. Collin's argument seems to be intended to apply to all types of enterprise liabilities, but it seems to be on a sounder footing when applied to the claims of involuntary creditors.

> [H]ow is the creditor a sufferer, and what just ground of complaint has he? He knows the nature of the speculation or he does not; if he does, he charges accordingly, and he becomes, in truth, a sharer in the risk. If he does not know its nature, and if he has not inquired, it is his own fault; if he has, and has been misinformed, he is defrauded.[213]

In other words, if someone who voluntarily extends credit to a firm knows that they will be able to look only to the assets of the firm for satisfaction of their claim, what moral principle is offended if they are held to their bargain? If we were to draw any moral conclusion about the liability of owners or mangers for a firm's debts, it might be by appealing to general notions of fairness. We might venture that, in general, whether it would be fair or unfair to hold participants liable for a debt of the enterprise depends on the expectations that the participants and the creditor (especially the latter) had at the time of the transaction, and the basis of those expectations. If the participants have expressly agreed that they will be answerable for the enterprise's debt, then it is fair to hold them to their promise. Conversely, if the creditor has expressly agreed that the participants will not be answerable for the debt, then it would not seem fair to make them liable for the debt.

What if the participants and the creditor have not expressly agreed on the matter of the formers' liability for the enterprise's debts? Here the fairness issue becomes somewhat more problematic. However, all things being equal, if it can be determined that all parties entered into the transaction under the same expectation as to whether the participants (or any subset of them) will or will not be liable for the enterprise's debts, it seems fair to give effect to those expectations. We take up this point in the next section.

b. Economically Speaking

If there is one thing that economic analysis loves it is contracts. Hypothetical contracts or implicit contracts will do in a pinch, but actual, express contracts are lovely. The welfare-maximizing liability rule is simply to hold contracting parties to their bargains. Thus, at one level, economic analysis says that it does not really matter whether or not the presumptive rule is that participants are liable for the enterprise's liabilities, so long as the parties to

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[213] G. Bramwell, writing for the minority of the Mercantile Law Commission: quoted by Bryer 1997 at 52. The import of the final point, regarding fraud, is that it was assumed that limited liability would not shield owners from liability for frauds in which they have participated.

a particular transaction are free to agree to some other rule if they so desire.[214] On another level, however, the choice of the default rule – participant liability for or participant immunity from the enterprise's contractual liabilities – does matter. It matters because one default rule may be more efficient than the other; it may involve lower "contracting-around" costs. We will return to this point in a moment after briefly describing the general nature of the economic arguments that have been made about participant liability.

The nineteenth century proponents of limited liability, who eventually swept their opponents from the field, argued that limited liability unduly restricted the supply and increased the cost of capital for joint stock companies. Today we speak of publicly traded or widely held firms, but the basic argument is the same. It just wears fancier clothes. In recent years economists have developed elaborate theoretical arguments to support the rather more intuitive arguments of the nineteenth century proponents of limited liability.[215] It is perhaps somewhat uncharitable to say that these elaborate economic arguments are –

> little more than a roundabout way of stating the obvious and traditional justification for the rule of limited liability . . . that limited liability reduces the potential costs of purchasing shares, and thus encourages investment.[216]

Uncharitable or not, this observation is useful in emphasizing that most economic arguments for limited liability focus on the problems that a rule of unlimited shareholder liability would allegedly create for the capital markets.[217]

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[214] Halpern, Trebilcock & Turnbull 1980 at 117 quote a passage from an 1854 number of the *Economist* (the year of the Mercantile Laws Commission) that asserts that the limited liability issue was not as important as was generally supposed because companies were already contracting for unlimited liability.

[215] Blumberg 1986 at 611-23 contains a concise summary of the arguments.

[216] Presser 1992 at 159-60, quoted in Klein & Zolt 1995 at 1031.

[217] The principal argument that unlimited liability would be a securities market killer, as described by Grossman 1995 at 68-70, is based on the proposition that, if unlimited liability were the rule, the value of a share to any given investor would depend not only on the firm's projected earnings but on the personal wealth of all the other shareholders: something that would be extremely costly, or impossible, to monitor unless there were only a few wealthy shareholders. Since the shareholders would be jointly and severally liable for an insolvent

(continued...)

The principal economic arguments for limited liability focus on the adverse impact of a rule of unlimited participant liability on the willingness of investors to provide equity capital to public companies. Obviously, these arguments do not apply directly to closely held firms that do not seek equity capital from organized capital markets. Indeed, some commentators who support a default rule of limited liability for widely held firms, take the opposite position on closely held firms. Professors Halpern, Trebilcock and Turnbull, for example, argue that

> . . . in the case of small, tightly held companies, a limited lability regime will, in many cases, create incentives for owners to exploit a moral hazard and transfer uncompensated business risks to creditors, thus inducing costly attempts by creditors to reduce these risks. An unlimited liability regime for this class of enterprise . . . would seem to be the most efficient regime. The availability of an organized securities market is not, of course, a countervailing factor with this class of company.[218]

The "moral hazard" problem to which they refer is that limited liability will give firms an incentive to take risks that were not anticipated by the creditors, who thus bear more risk than they bargained for.[219] Small closely held firms, it is argued, are particularly likely to take such unanticipated risks because "the owners [of such firms] have a direct interest in the

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217 (...continued)
firm's liabilities, the risk that a given investor assumed by purchasing a share would depend on their wealth relative to other investors' wealth. If you were wealthy you would be silly to buy, say, 5% of the shares in a widely held firm, because your risk would greatly exceed your potential rewards. If other investors were much less wealthy than you, you might end up being liable for 20% or 50% or an even greater proportion of the firm's liabilities on an insolvency.

Some theorists have argued that the foregoing problem would not arise or would be greatly mitigated if shareholder liability was *pro rata* rather than joint and several. An investor who owned 5% of the shares of an insolvent firm would be liable for no more than 5% of its liabilities, and investors could minimize their risk through diversification. Hansmann & Kraakman 1991 at 1892-1906 develop this argument in detail in support of their thesis that shareholders of all corporations should be liable for tort claims on a *pro rata* basis.

Blumberg 1986 at 581-82, 585, 597-99 points out historical examples of unlimited liability and organized markets coexisting, noting that there was for years an organized market for shares of English unlimited liability joint stock companies, and that unlimited *pro rata* shareholder liability was the rule in California until 1931. Grossman 1995, *passim*, points out that the American Express Company was a publicly traded unlimited liability company for most of the period between 1850 and 1965, and that this had no discernible effect on the market for its shares.

218 Halpern, Trebilcock & Turnbull 1980 at 148.

219 Halpern, Trebilcock & Turnbull 1980 at 140.

operations of the firm and will obtain the benefits of [taking on more risky activities]."[220] In other words, owner-managers are more likely than pure managers to assume excessive risk if they are not disciplined by the prospect of being liable for the firm's liabilities.

Other commentators have argued that, if the participants in large enterprises are shielded from the enterprise's liabilities, similar treatment should be accorded to participants in small enterprises even if the economic rationale for doing so is not quite so clear:

> [I]f one takes as given a decision to provide limited liability for publicly held firms, then, even if the arguments for that entitlement relate solely to large firms, there are strong reasons for extending the entitlement to smaller firms (even to the tiny ones). In other words, once one concludes that reasons of economic efficiency justify giving large firms limited liability, other considerations of efficiency and "democracy" (decentralization of power, etc.) argue persuasively for treating smaller firms in the same fashion.[221]

This justification for limited liability for closely held firms is self-evidently parasitic on the assumption that limited liability is available to participants in large enterprises.

Although the authors of the foregoing passage do not elaborate on how "other considerations of efficiency" would be served by providing a liability shield to participants in small enterprises, one argument might run like this. Given that participants in large enterprises enjoy limited liability, liability is justified for smaller companies in the interests of fair competition and efficient allocation of resources. Suppose that an individual has an opportunity to invest in Firm Big or Firm Small, who are competitors in a certain industry. Big is publicly traded, Small is not, and the law is that owners of publicly traded firms have limited liability but owners of private firms do not. Liability rules aside, there are various risk factors (such as the illiquidity of the investment) that will induce the prospective investor to demand a higher expected yield from Small than from Big. It seems likely that the asymmetric liability rules will cause the investor to demand an even

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[220] Halpern, Trebilcock & Turnbull 1980 at 141.

[221] Klein & Zolt 1995 at 1034.

higher risk premium from Small, thus putting Small at an even greater competitive disadvantage relative to Big in terms of its cost of capital.[222]

We now return to the matter of default rules. When we are talking about ordinary contract obligations, the economic analysis would say that the optimal rule for a transaction is the rule—participant liability or participant immunity—that the parties agree will govern the transaction. But you need to start with *some* rule: a default rule. What is really wanted is the most efficient default rule. To a large degree, the most efficient default rule can be thought of as the one that is expected to entail the lowest contracting-around costs. To compare contracting-around costs of different possible default rules, one would need to address at least a couple of questions. One question is how difficult (costly) it is expected to be for parties to contract around one candidate for the default rule relative to some other candidate for the default rule. If, say, it would be expected to be more costly to contract out of a "participants are liable" rule than a "participants are not liable" rule, that would suggest, all else being equal, that the latter rule is likely to be more efficient.

Suppose that there are two rules, Rule 1 and Rule 2, either of which might be chosen by legislators as the default rule for a particular type of transaction. In deciding which rule to adopt as the default rule, a factor that is probably more important than the cost of contracting around either rule in a particular case is the relative popularity of the two rules amongst transactors.[223] All else being equal, legislators should choose as the default rule the rule that is more popular with transactors. If it is suspected that the participants in nine out of ten transactions will choose Rule 1 over Rule 2, selecting Rule 1 means that transactors will be put to the trouble and expense of contracting around the default rule in only one case out of ten. Selecting Rule 2 would mean that they would either have to incur the

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[222] This concern about how asymmetric rules would affect the competitive balance between joint stock companies and small partnerships or sole traders influenced the debates over limited liability in nineteenth century Britain: see e.g. Bryer 1997 at 42; Ireland 1984 at 242-44.

[223] In the years before the enactment of the *Limited Liability Act, 1855*, it had become a common practice for joint stock companies to contract for limited liability, that is, to contract around the default rule of unlimited liability: Blumberg 1986 at 582. It may be that Parliament took the growing practice of contracting around unlimited liability as evidence that the market would prefer a default rule of limited liability over a rule of unlimited liability.

contracting around cost in nine cases out of ten or put up with what they regard as a suboptimal rule.[224]

Many commentators have pointed out that the doctrine of limited liability is of little substantive consequence to owners of closely held firms because major creditors routinely extract personal guarantees from the owners.[225] The default rule may be limited liability, but the actual rule in such transactions is unlimited liability. If in fact the majority of contracts entered into by closely held firms are guaranteed by the shareholders, this would suggest that a default rule of unlimited liability for closely held firms would produce a net saving on contracting-around costs. However, when it comes to calculating the contracting-around costs of a particular default rule, the number of transactions seems to be as important as the value of the transactions. For example, suppose that under the existing default rule all financial institutions require personal guarantees from all shareholders of all small enterprises before they will make a loan to the firm.[226] However, most small firms only have one bank but many trade creditors, and the latter rarely extract personal guarantees. Suppose also that it can be shown[227] that if the default rule were changed, most contracts with ordinary trade creditors would exclude personal liability of owners. On these assumptions, the existing default rule of no personal liability would still produce the lowest contracting-around costs, just because of the number of transactions in which transacting-around costs are saved.

Another consideration in deciding upon the most appropriate default rule is what we will call *transparency*. Although economic analysis is anxious to let people make their own bargains, in accordance with their own preferences, it does recognize that economic efficiency is enhanced when

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[224] It is possible that the contracting-around costs will be so large relative to the size of many transactions that the parties will generally put up with the default rule, even if it is not the rule they would choose if there were no contracting-around costs. If anything, this makes it even more important to try to find the default rule that most transactors would settle on if they actually did negotiate on this point.

[225] E.g. Booth 1997 at 62.

[226] In fact, even where small enterprises are concerned, a bank might only require a guarantee from the major shareholders. Moreover, the guarantees might be for specific amounts and might be several, rather than joint and several.

[227] In reality, it would be difficult to determine how various parties would react if the default rule were changed.

people actually know what they are bargaining for. Thus, one default rule will be better than another (all else being equal) if its adoption can be expected to make it more likely that both sides to a transaction will know what the terms of the transaction are.

Suppose that a particular type of transaction, such as a loan from a bank to a small business, is likely to have a relatively sophisticated party on one side and a relatively unsophisticated party on the other.[228] Obviously, all else being equal, the bank would prefer unlimited participant liability, the participants, limited liability. The chances are that the bank will get the rule it wants, whether it is the default rule or a customized rule. But it also seems that the bank, being the more sophisticated party, is more likely than the participants to know exactly what the default rule is. If limited liability is the default rule, and the bank wants unlimited liability, we can rest assured that the bank will ensure that a customized unlimited liability rule governs the transaction. It will demand guarantees from the participants. But if unlimited liability is the default rule, the bank can get the benefit of that rule without expressly bargaining for it. Given that the participants are less sophisticated, they are more likely to enter into the transaction on the basis of a mistaken assumption as to the governing rule. Making the rule that favours the unsophisticated party the default rule will not ensure that it will be the rule that actually governs the transaction, but it will make it more likely that both parties enter into the transaction with a full appreciation of the governing rule.[229]

3. Involuntary Creditors

a. Morally speaking

Where involuntary creditors are concerned, there seems to be a stronger moral case for imposing unlimited liability on the owners of a firm than there is in the case of an ordinary contractual obligation of the firm. The owners invested in the hopes of reaping the profits of the enterprise. Whether or not they exert much or any actual control over the conduct of the firm's business,

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[228] The point made in this paragraph is based on a point made in Booth 1997 at 62. Obviously, many proprietors of small businesses will not be babes in the woods. However, it seems pretty safe to assume that the financial institution will be *at least* as knowledgeable about the applicable laws as the participants in a small enterprise.

[229] From an efficiency point of view, the problem with the less sophisticated party making a mistake about the default rule is that they will overvalue the transaction, so the exchange will not be welfare-maximizing.

the fact is that by investing in an enterprise, they provide the enterprise with the means to go about its business, a business that creates risks for innocent third parties. The owners do not offer to share the benefits of taking those risks with outsiders. Therefore, when the risk materializes and an outsider is injured because of the enterprise's activities, it is only fair that they should be liable to compensate the victim for their injuries. That is, it seems fairer to transfer the burden to those who hoped to profit from the enterprise, rather than leaving it on victims who happened to get in the way.

b. Economically speaking

The moral intuition that those who hope to profit from a firm's success are the most appropriate bearers of the *full* burden of the loss it causes to involuntary creditors has been put in economic terms by a number of writers. Indeed, when the economics debate moves from contractual claims to tort claims, it appears that the proponents of limited liability have to scramble to fend off the arguments of those who argue for unlimited liability.

The most comprehensive case for unlimited shareholder liability for corporate torts has been developed by Professors Hansmann and Kraakman.[230] They start from the fairly standard assumption that, from an economic perspective, the function of tort liability is to prevent firms from externalizing the risks (costs) of their activities.[231] Externalization of the risks of an activity or transaction occurs when they are imposed on persons who are not voluntary participants in the activity or transaction. From the economist's perspective, externalization of risk is undesirable for at least a couple of reasons.[232] Firstly, if the participants in an activity do not bear its full costs, they are unlikely to exercise the socially optimal level of care.[233]

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[230] Hansmann & Kraakman 1991.

[231] Another view is that one of the functions of "enterprise liability" is to shift the cost of unpreventable (that is, not efficiently preventable) losses from victims to enterprises on the theory that the latter are lower cost insurers. One manifestation of the insurance theory is a preference for strict liability over negligence-based liability. Priest 1987 argues that the imposition of expansive liability on enterprises for the express purpose of making them involuntary insurers of unpreventable losses will be self-defeating.

[232] See Hansmann & Kraakman 1991 at 1882-83.

[233] A law of diminishing returns applies to efforts to reduce accidents. There will come a point where the social cost of additional efforts to prevent accidents exceeds the expected savings in accident costs generated by those efforts. From an economist's perspective, the

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Why spend the money to take an appropriate level of care to avoid accidents if someone else bears the risk, or a substantial proportion of the risk of accidents? Secondly, externalization of costs leads the participants in an activity to engage in more of that activity than is socially optimal. Because they do not have to pay for the full cost of the activity, they value it more highly, and thus engage in it to a greater extent, than they would if they had to bear its full cost.[234] Imposing tort liability on firms is a means of forcing those who benefit from the firm's risky activities to internalize the cost of those activities.

Limited liability allows those engaged in a commercial activity to avoid internalizing the full cost of their risky activities. The owners, who carry on an activity through the agency of a firm and its managers, will get the full benefit of the enterprise's success. But if the enterprise causes tort damage that exceeds its assets, the portion of the loss that exceeds the firm's assets will lie where it fell, which is to say, not where it should lie. Only through unlimited owner liability[235] for a firm's torts will the full social cost of its activities be borne by those who participate in the activity.[236]

Most commentators who look at unlimited liability from an economic point of view seem to agree that the opportunity it provides to externalize costs is a serious objection to unlimited liability in the context of claims by involuntary creditors (tort claims).[237] They differ mainly in their assessment

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[233] (...continued)
optimal level of care is reached when the marginal cost of taking additional care would exceed the marginal savings in expected accident costs : see Shavell 1987 at 5-21. The discussion in Shavell illustrates that the analysis becomes more complicated when the probability of an accident's occurrence depends on the level of care taken by both the potential tortfeasor and the potential victim. The problem is to design a liability rule that will provide both parties with an incentive to take the socially optimal level of care.

[234] See Shavell 1987 at 21-32.

[235] Unlimited liability does not necessarily mean joint and several lability. It could be unlimited *pro rata* liability amongst owners. That is, the collective liability of the owners would be unlimited, but each of them would be liable only for their proportionate share of the amount for which they are collectively liable: see note 217 above.

[236] The participants include those who buy the firm's products. If the firm is forced to absorb the full cost of its activities these costs will be reflected in the price paid by consumers of the firm's product.

[237] See e.g. Halpern, Trebilcock & Turnbull 1980 at 145 who, however, would stop short of
(continued...)

of the contexts in which it would be practical and effective to impose tort liability on shareholders. Suggestions include imposing tort liability on parent corporations,[238] on shareholders of closely held firms,[239] or, most comprehensively, on owners of all firms.[240] The proponents of the latter view argue that imposing tort liability on shareholders of widely held firms will provide managers with an incentive to take care because, amongst other reasons, the perceived riskiness of their activities would be reflected in share prices.[241]

4. Boundary Creditors

It will be recalled that boundary creditors, for our purposes, are persons with a claim against a firm whose claim looks somewhat like an ordinary contractual claim and somewhat like a tort claim. The boundary creditor has voluntarily chosen to deal with a firm or use its products. So the argument that imposing liability on owners is a means of forcing participants in an activity to internalize costs that they could otherwise externalize does not apply: the boundary creditor is a participant in the activity. So what is the rationale for imposing unlimited liability on the owners of firms where the person who has suffered a loss has chosen to deal with the firm or to use its product? The rationale is suggested in the following passage:

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[237] (...continued)
imposing tort liability on shareholders of widely held corporations in consideration of the problems they see this creating for the capital markets. For a view that "the potential for externalities may be less than has been supposed" see Ribstein 1992 at 438-49; and for a reply see Hillman 1995, *passim*.

[238] Blumberg 1986. In other words, limited liability would apply only to the ultimate owners of enterprises: individuals.

[239] Halpern, Trebilcock & Turnbull 1980, who, as noted earlier, also favour a default rule of unlimited liability for contract debts of closely held firms.

[240] Hansmann & Kraakman 1991, *passim*.

[241] Hansmann & Kraakman 1991 at 1907-09. As already noted, a central component of their thesis is that the liability of shareholders should be *pro rata*, rather than joint and several. A *pro rata* internal liability rule would be of benefit primarily to shareholders of large, widely held companies, where the risk is diversified amongst a large number of shareholders. Internal *pro rata* liability will obviously be of little assistance to firms with only a few shareholders. Hansmann & Kraakman at 1886-88 recognize that shareholders of small, closely held firms who are unable to procure adequate liability insurance are likely to be *risk averse*. Such owner-managers may be over-deterred (take less than the socially optimal level of risk) by a liability rule that imposes the full risk of a loss on them and, in any event, are not ideal risk bearers. Hansmann & Kraakman argue, however, that the appropriate solution to that problem likes in the reform of tort doctrines, rather than through the device of limited liability.

> The obvious difficulties [of distinguishing between voluntary and involuntary creditors] lie in areas, such as products liability and workplace injuries, where, although the victim had a contractual relationship with the firm prior to the injury the courts have been inclined to classify the injury as a tort.
>
> These difficulties do not, however, seem serious. The critical question is whether the victim was able, prior to the injury, to assess the risks she took in dealing with the firm and to decline to deal if those risks seemed excessive in comparison with the net advantages she otherwise derived from the transaction. In other words, the question is whether the victim can reasonably be understood to have contracted with the firm in substantial awareness of the risks of injury involved.[242]

Some readers may find that this passage provides a convincing rationale for imposing status liability on owners of firms in respect of certain product liability claims against their firms. Others may not be convinced. The subsection that follows expands on the basic point of the preceding passage insofar as it relates to customers who suffer a loss as a result of a defect in a product supplied by a firm.

a. Unsophisticated customers who cannot monitor product quality

The passage quoted above suggests that law makers should feel a special tenderness for contractors to whom information that is needed to evaluate the riskiness of a transaction is not readily available. We are particularly interested in the situation where a person buys a product (goods or services) from a firm and incurs a risk of suffering a loss for which the firm will be liable but will not have sufficient resources to pay full compensation. In principle, there is nothing particularly disturbing about such a transaction. A perfectly informed, rational buyer might decide to buy a product from a firm knowing that there is a probability (1) that the product will contain a defect, (2) that the defect will cause them to suffer a loss, and (3) that they will have to bear (or insure against) that loss themselves. For example, a sophisticated, perfectly informed buyer might agree to a contractual limitation of liability in return for a concession on the price.

The real problem arises where an unsophisticated customer is unable to observe the quality of a high-stakes product that they purchase from a limited liability firm.[243] What we mean by a "high-stakes product" is that it is

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[242] Hansmann & Kraakman 1991 at 1920-21; see also Halpern, Trebilcock & Turnbull 1980 at 146-47.

[243] In other words, any defect in the product will not be readily apparent to the customer. Thus, the customer is unlikely to realize that the product is defective, or of substandard

(continued...)

a product that has the potential to cause a very large loss, a loss that will substantially exceed the value of the firm's assets. Defects in the product will significantly increase the risk that a customer will suffer such a loss. Nevertheless, even if the product is of substandard quality, the probability that the loss will actually occur is still fairly low.[244] So the firm might be able to produce and sell the substandard product for a long time before a loss actually occurs. In such a situation, limited liability gives the participants in the firm an opportunity to maximize their profits at the expense of unsophisticated customers.

Given the unsophisticated customer's inability to detect inferior products until they actually cause a loss, it will be profitable for the firm to provide an inferior product. The firm saves costs by providing an inferior product, and the extra profits are paid out to the participants. To be sure, providing an inferior product increases the firm's risk of incurring a large *liability*. However, limited liability makes the prospect of incurring such liability much less daunting to the firm's participants, because their *payout* will be limited to the firm's assets. In effect, a substantial part of the risk that participants in a financially responsible firm would incur if the firm provided a substandard product can be subtly transferred to unsophisticated customers by the limited liability, thinly capitalized firm.[245]

In a situation where relatively unsophisticated customers purchase high-stakes products of unobservable quality, there would seem to be a good case for a default rule, perhaps even a preemptive rule, that owners of firms that provide such products are personally liable for losses caused by substandard products. Of course, there are other steps that might be taken to remove or lessen the opportunity or incentive for such firms to provide

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[243] (...continued)
quality, until the defect causes a loss. The defective widget from our hypothetical scenario is an example; Ingrid had no reasonable prospect of spotting this defect for herself. This is true of many types of defects in many types of goods *and* services.

[244] For example, if a product is of substandard quality, it may increase the risk that the customer may suffer a $1 million loss from 0.1% to 1%. The probability of the loss has increased tenfold, but is still only 1%. The firm might be able to provide substandard products for quite some time without a customer actually suffering a loss.

[245] We keep referring to the unsophisticated customer because it would be expected that a sophisticated customer would take steps to protect itself against opportunistic conduct by the firm's participants. It might require a bond, for example.

services of a lower quality than customers have paid for. The opportunity could be removed or reduced if customers knew the true state of the firm's financial responsibility and could monitor the quality of its services as they were provided. Thus, in certain cases disclosure requirements might be a substitute for a rule of unlimited owner liability. However, although it might be relatively easy to inform customers of the limits on a firm's financial responsibility, that would not resolve the problem unless the unsophisticated customer is also able to monitor the quality of services as they are provided.

Another approach might be to impose liability on managers or owners who deliberately cause a firm to provide a lower quality of service than it has agreed to provide. This would not be status (vicarious) liability; it would be *direct* liability for breach of a personal duty. In fact, existing doctrines of tort law could serve this purpose. A person who deliberately induces another person to breach a contract with a third person may be liable to the third person for the tort of inducing a breach of contract.[246] The potential for personal liability under such doctrines would make it more costly for managers or owners of a limited liability firm to deliberately cause the firm to provide substandard products in order to provide higher profits to the owners and mangers. It could be argued that this is an adequate substitute for a rule that would impose personal vicarious liability on owners for the firm's product defect liabilities.

On the other hand, whether or not the imposition of direct liability on those participants who are directly implicated in wrongful conduct would be an effective deterrent to opportunistic conduct might depend on the wealth of the managers. The following observation, although made in a slightly different context, suggests the potential shortcoming of a deterrent that operates through the threat of imposing liability only on those who are directly implicated in wrongful conduct:

> 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

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[246] Proving that the managers *deliberately* caused the firm to breach its contract by providing substandard services might be considerably more difficult than proving the breach of contract. Another approach might be to argue that the managers owed a duty to the firm's customers to take reasonable care to ensure that the firm provided the quality of services that it had agreed to provide.

> 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 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.[247]

In sum, while alternative approaches are possible, it could be argued that the surest and most efficient way to address the problem presented by the unsophisticated customer who purchases products of unobservable quality is through a rule that owners of firms that provide such products to such customers are personally liable for losses caused by substandard products.

b. Voluntary tort claimants

The heading of this subsection refers to a person who has voluntarily used a firm's product but has not contracted with the firm to get the product. They have suffered a loss because of a defect in the product and this loss gives them a legally valid claim against the firm. Since they do not have a contract with the firm their claim must, by definition be a tort claim. Voluntary tort claims come in many varieties and raise many interesting questions. For present purposes, however, we merely want to make an observation about the applicability to voluntary tort claims of the rationale for imposing personal liability on owners of enterprises for torts committed by the enterprise.

Our observation is that it is not obvious that the "internalization of costs" argument for imposing liability on enterprise owners applies to voluntary tort claims. A person with such a claim has voluntarily decided to use the firm's product. That person is a voluntary participant in the activity that has caused the loss, rather than an outsider upon whom costs of the activity have been foisted. Thus, the rationale for imposing personal liability on the owners of an enterprise for voluntary tort claims cannot be that this is necessary for the purpose of ensuring that the social costs of certain activities are borne by their participants. This sort of liability reallocates the loss amongst voluntary participants in the activity.

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[247] Sykes 1984 at 1241-42. Sykes' analysis, it goes without saying, is more sophisticated than ours. His article considers how vicarious liability might be expected to affect the behaviour of principals and agents under various conditions, such as where the loss-avoidance behaviour of the agent is (1) cheaply observable (by the principal), (2) unobservable or prohibitively expensive to observe, or (3) imperfectly observable. He also considers difference between wrongs committed by agents against involuntary and voluntary creditors.

5. Applicability of the Foregoing to UL Professionals

In this chapter we have been discussing the pros and cons of unlimited participant liability for liabilities of enterprises as if it were a live issue. But the fact is that, as a general matter, legislators in Alberta and elsewhere long ago decided that by going through certain rituals, participants in most types of enterprise can obtain a shield against status liability. We do not think that legislators in Alberta are minded to revisit the general point at this time.[248] However, the foregoing discussion is useful because we are about to discuss a class of enterprise – the UL professions – where unlimited personal liability of participants in an enterprise is still the governing rule. The question may be put this way. Do the UL professions have characteristics – such as the nature of their services or the structure of their industries – that gives arguments for imposing status liability more force when applied to those professions than they appear to have had with respect to other types of enterprise?

We defer detailed discussion of the foregoing question until the upcoming chapter. As a preliminary point, though, it may be observed that, to the extent that UL professionals are concerned about their current inability to practise in limited liability entities, their concern relates mainly to liability for professional services. And given the nature of their services, it does not seem likely that in rendering professional services UL professionals are likely to create the externalities of the sort discussed in Section 3 above. It seems more likely that professional liability claims will be asserted by boundary creditors of one or both of the types described in section 4.

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[248] Both courts and legislators are often happy to punch holes in the liability shield, especially as it applies to corporate officers and directors. It may be noted, however, that what might appear at first glance to be holes in the liability shield can often be better explained not as the imposition of status liability but as the imposition of direct personal liability for what is viewed as some form of personal culpability. In other words, rather than imposing vicarious liability, many of these provisions could be viewed as imposing an extended duty of care on participants.

CHAPTER 4. LIMITED LIABILITY AND UL PROFESSIONALS

A. Chapter Overview

This chapter considers whether it would be appropriate to change the law to permit some or all UL professionals to practice in limited liability entities. For the most part, we do not distinguish between different UL professions, but in Section B we consider whether there are distinctions between different UL professions that might argue for different treatment. Section C summarizes the arguments that two professional bodies, the ICAA and the LSA, have made in support of their proposals to allow Alberta UL professionals to practise in limited liability entities. Section D considers whether the UL professions, as a group, have special characteristics that might justify the existing policy against allowing them to practise in limited liability entities when most other enterprises enjoy that privilege. Section E considers the ability of UL professionals to limit their liability for malpractice claims by contract, and how this affects the issue of whether they should be allowed to practise in limited liability entities. Section F considers the effect that limited liability might have on (1) the quality of professional services, (2) claimants' prospects of actually realizing on large malpractice claims, and (3) competition in the market for professional services.

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.

ISSUE No. 2

Is it reasonable to start from the premise that UL Professionals should be treated like other enterprises on the limited liability issue unless there are particular reasons of policy or principle that justify different treatment?

B. Distinctions Between Different UL Professions

The UL professionals in Alberta are accountants, lawyers and some (but not all) medical professionals.[249] In most of this chapter we will lump them together for the purpose of discussing the limited liability issue. But it is possible that the UL professions differ in ways that would suggest different treatment on the limited liability issue.

There are many obvious differences between the various UL professions, the nature of the services they provide being the most obvious difference. But are there differences that are relevant to the issue whether they should be permitted to practise in limited liability entities? Is the burden of unlimited liability more onerous for certain UL professions than for others? Might it be more harmful to the public to allow the members of one UL profession to practice in unlimited liability entities than it might be to allow another to do so? We should say that our initial prejudice is that any differences that do exist are not so momentous as to justify different treatment of the UL professions on the limited liability issue.

1. Exposure to Huge Claims and Availability of Insurance

In Chapter 1 we summarized arguments that accounting bodies such as the ICAA and the CICA have advanced to establish that there is an audit liability crisis. It is unnecessary to concede that there is an audit liability crisis to concede that the audit function provides great scope for very large claims – running into the hundreds of millions or billions of dollars – against accounting firms. Law firms are less likely to be liable for huge claims than are auditors simply because most lawyers do not routinely perform services that, if improperly performed, can cause losses ranging into the hundreds of

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[249] To be more precise, the category of UL professionals consists of professions governed by the following acts: (1) *Certified General Accountants Act*; (2) *Certified Management Accounts Act;* (3) *Chartered Accountants Act*; (4) *Legal Profession Act*; (5) *Chiropractic Profession Act*; (6) *Dental Profession Act*; (7) *Medical Profession Act*; (8) *Optometry Profession Act*.

millions of dollars. On the other hand, we suspect that many lawyers can visualize circumstances in which, heaven forfend, a slip-up on a file could easily cause losses to a client (or third party to whom a duty of care is owed) running into the hundreds of millions of dollars.

We noted in Chapter 1 that one of the main arguments of accounting bodies is that their members, particularly the members of the large firms, cannot obtain adequate levels of liability insurance, and that even the insurance they can get is extremely expensive. The CICA noted that for partners of "national firms" insurance premiums are $35,000 per partner.[250] The LSA does not explicitly claim either that adequate levels of insurance are unavailable to law firms or that premiums have reached unreasonable levels.[251] Presumably, if Alberta lawyers were currently finding it difficult to purchase adequate insurance at reasonable premiums, this would have been mentioned in the LSA's submission in support of its proposal for LLP legislation.

While medical professionals, particularly certain specialists, could incur substantial liability for personal injury claims, a large claim against a medical professional might be for a few million dollars, as opposed to a few hundred million against an accounting firm or law firm. Moreover, medical professionals have the "luxury" that if they do incur a malpractice liability, responsibility is likely to be shared by one or more *solvent* co-defendants, such as a hospital or health care authority. Thus, although malpractice liability and the cost of liability insurance may well be a concern for medical professionals,[252] we presume that they are able to purchase at a reasonable

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[250] CICA 1996 does not mention how much insurance can be purchased for $35,000 per partner, just that the deductible exceeds $50 million. Nor does it indicate the ratio of partners to employed accountants in the affected firms. This is important because, as we understand it, insurance premiums for accounting firms are calculated on a "per partner" basis, rather than the "per lawyer" basis upon which premiums for law firms are calculated. Thus, if the ratio of partners to employed accountants in an accounting firm was, say, 1 to 2, a premium of $35,000 per partner would translate into a premium of about $12,000 per accountant.

[251] The LSA requires each member to carry a minimum of $1 million in liability insurance, which is provided through the legal profession's insurance program. The current premium for the minimum coverage is about $2150 per lawyer. Up to $5 million in coverage may be purchased through this program, for which the total premium is about $2800 per lawyer. Firms desiring insurance beyond $5 million must get it in the private insurance market.

[252] For a discussion of some of liability issues facing health professionals see Prichard 1990.

(continued...)

premium enough insurance to cover the largest liability claims that they are likely to incur. Thus, if exposure to huge, virtually uninsurable claims, were viewed as the main argument for allowing professionals to practise in limited liability entities it could be argued that accountants and, to a somewhat lesser extent, lawyers have a stronger argument than medical professionals.[253] On the other hand, one might turn the argument on its head. If accounting firms and law firms can cause huge damages, perhaps that is all the more reason *not* to provide them with a liability shield, because doing so would increase the chance that those who have suffered the damages will not be fully compensated.

ISSUE No. 3
Does unlimited personal liability impose a greater burden on accountants and (to a lesser extent) lawyers than on medical professionals because some accountants and lawyers are exposed to huge claims (in the hundreds of millions of dollars) to which medical professionals are not exposed?

ISSUE No. 4
Would an affirmative answer to the preceding issue provide a principled basis for distinguishing between different UL professionals in considering whether they should be permitted to practise in limited liability entities?

2. Industry Structure

Quite apart from the nature of the services they provide, the different ways in which the different professional industries are structured might influence the limited liability issue.[254] Limited liability entities of the type proposed for Alberta's UL professions would not protect professionals from the

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[252] (...continued)
Significantly, although that report discusses many concerns of health professionals, neither joint and several liability nor unlimited liability is mentioned.

[253] We might also observe that, in Alberta at least, accountants and lawyers are the only UL professionals who seem to have a heartfelt interest in LLPs.

[254] Of course, the nature of the services they offer may well affect such issues as whether large professional enterprises provide the potential economies of scale that presumably give rise to big firms.

consequences of their own personal malpractice. The limited liability proposals would provide *no protection* to sole practitioners in any profession. Later in this chapter it is suggested that members of large professional firms may be the primary beneficiaries of limited liability. The other way of putting it is that the burden of unlimited liability for professional malpractice weighs most heavily the members of very large professional firms.

The accounting industry (particularly the part of the industry that services the audit needs of big companies) is dominated on a global scale by the so-called Big Six accounting firms. No one ever talks about the "Great Eight" medical clinics or the "Titanic Twelve" dental firms. Simply stated, amongst the health professions there is no firm or group of firms that remotely resembles the Big Six accounting firms. There are some fairly large law firms but none of them are nearly as large as the Big Six accounting firms.

To the extent that unlimited liability creates a bigger problem for larger firms than for smaller firms, it could be argued that unlimited liability is a bigger problem for the accounting profession than for the other professions simply because it is more of a "big firm" industry. On the other hand, you would not have to be a member of a huge firm to garner some benefit from being able to convert the firm into a limited liability entity. Although members of the Big Six accounting firms might be the primary beneficiaries of limited liability, all of the UL professions would have firms that are big enough to derive some benefit from limited liability.[255] And, of course, even if it were economically rational to do so, extending a legal privilege to members of big firms that is denied to members of small firms would be hard to justify from the perspective of practical politics.

ISSUE No. 5
Arguments for allowing UL professionals to practise in limited liability entities often emphasize the hardships that unlimited liability creates for large professional firms. Would it be appropriate to allow UL professionals to practise in limited liability entities only where the firms exceed a certain size?

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[255] In theory, a firm with as few as two members could benefit from the type of limited liability entity that has been proposed for Alberta professionals.

C. Arguments of Professional Bodies for LLPs

The LSA and ICAA have proposed that UL professionals be permitted to form limited liability firms, specifically, LLPs of the Texas model. To be more precise, the proposal is that UL professionals should be permitted to practice in partnerships whose members would have the benefit of the following liability shield:

> Despite any other provision of this Act [the *Partnership Act*], a partner in a professional partnership shall not be individually liable directly or indirectly (including by way of contribution, indemnification or otherwise) for any debts, obligations or liabilities of the partnership or another partner, whether sounding in tort, contract or otherwise, arising from negligence, malpractice, incompetence, wrongful acts or misconduct in rendering professional services, unless that partner:
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> (a) was directly involved in the conduct, or
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> (b) had direct supervision of or control over the conduct, or
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> (c) had notice or knowledge of the conduct at the time it occurred and failed to take reasonable steps to prevent or cure it.[256]

As discussed in Chapter 2, this would not provide a shield against personal malpractice, nor would it shield any partner from liability for the firm's ordinary contractual obligations.

1. ICAA's Arguments

In Chapter 1 we referred in some detail to the ICAA and CICA's arguments regarding the audit liability crisis. We mentioned that the principal villain, so far as they were concerned, was the doctrine of external joint and several liability between concurrent, unrelated wrongdoers. This doctrine creates a high risk that audit firms – particularly the large firms – will incur huge liabilities, and also makes it impossible for them to obtain adequate professional liability insurance. That is bad enough, but the effect is exacerbated by the inability of accountants to practise in limited liability firms. Not only may accounting firms be wiped out through exorbitant liability, their individual partners face a very significant threat of personal bankruptcy because of claims that exceed the value of the firm's assets and liability insurance. Thus, it is argued that while the root of the audit liability crisis may be joint and several liability, and the ultimate solution a shift to

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[256] LSA 1995 at 22. This reflects refinements to the original Texas model that have been made by other states. The parenthetical material is intended to guard against the imposition of indirect liability on an innocent partner through, for example, a requirement to indemnify the negligent partner against their liability. The ICAA does not go into the details of the proposed LLP but seems to have in mind an LLP of the Texas model: see ICAA 1994 at 17.

proportionate liability, the crisis can at least be alleviated by allowing accountants to practice in limited liability firms.

2. LSA's Arguments

In reading the ICAA submission, it is not always easy to tell whether a particular point is meant to apply to the joint and several liability issue, the unlimited liability issue, or both. For the purposes of this paper, the LSA's submission has the advantage that it focuses on the issue of UL professionals' unlimited liability. We suspect that the ICAA would have made similar arguments to the LSA if the ICAA had been focusing on the limited liability issue rather than the joint and several liability issue.

The LSA argument begins by setting out what are supposed to be the traditional ethical justifications for imposing "vicarious liability on lawyers."[257] The first of these is said to be based on a distinction between ordinary businesses and professions. The former are driven purely by business considerations, while the latter also have a public service element. Therefore, it would be "unseemly for lawyers to attempt to shield themselves from accountability for wrongdoing."[258] The other supposed justification for "vicarious liability"[259] is that it will "raise the quality of legal representation by making lawyers more cautious in selecting partners for the practice of law."[260]

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[257] LSA 1995 at 6-7.

[258] LSA 1995 at 7.

[259] The LSA refers to the joint liability of all members of a partnership for liabilities arising from professional malpractice as "vicarious liability." Technically, in many cases the joint liability of each member of a partnership for negligent advice given by one of its members (or by an employee) is not vicarious liability at all, but direct liability for breach of contract. Each member of the firm is a party to a contract in which they collectively agreed that the firm would provide professional services of a certain quality. Having jointly agreed to provide services of this quality, each of them is directly liable for breach of contract if the firm does not provide services of the agreed quality. Liability for failure to do what you have agreed to do is not vicarious liability. Having said that, we will use the term "vicarious liability" in this discussion because it is used liberally in the LSA submission.

[260] LSA 1995 at 7.

On the point regarding the distinction between businesses and professions, the LSA argues that it is recognized nowadays that professional practice must be conducted in "a business-like and efficient manner."[261] Thus,

> . . . seeking to limit liability, particularly when the professional would remain liable for personal and supervisory conduct and firm obligations, is no longer "unseemly" . . . . [It would] enable professionals to deal with the commercial aspects of practice, an ability that is critical to the viability of professional firms and the continued supply of professional services.[262]

The LSA responds to the second supposed argument for vicarious liability – that it will raise the quality of legal services by making lawyers more selective in their choice of partners – with three points.[263] Firstly, "if exposure to vicarious liability is required to maintain quality standards, it would be unethical to buy malpractice insurance, transfer personal assets to a spouse or otherwise seek to minimize risk." Secondly, "lawyers have many incentives other than vicarious liability to ensure the quality of legal services, particularly in today's competitive market." Thirdly, "in large multijurisdictional firms, lawyers often have little say in who their partners are in any event."

Having argued that the benefits of imposing vicarious liability on lawyers are not as great as might be supposed, the LSA then argues that removing vicarious liability could have certain positive consequences. Three such consequences are suggested.[264] Firstly, "more competent and highly-qualified individuals would be encouraged to enter the profession and become partners and to establish their practice in Alberta." Secondly, "a firm's practice would become less 'defensive' in nature, possibly lowering the cost and improving the quality of legal services." Thirdly, "if recovery were limited to a firm's assets and those of the partners directly involved in the matter, plaintiffs might be motivated to resolve claims in a manner that would not threaten the viability of a firm, thereby fostering better relations between the bar and the public (including other clients)." We will come back to the first

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[261] LSA 1995 at 7.

[262] LSA 1995 at 7-8.

[263] LSA 1995 at 8.

[264] LSA 1995 at 8-9.

and second arguments but will leave the third argument to speak for itself as best as it can.

The LSA goes on to argue that the comprehensive regulations that govern the legal profession provide safeguards for the public that make it unnecessary to protect the public by making innocent partners liable for defects in legal services provided by their partners.[265] An assurance fund, to which all practising lawyers must contribute, covers misappropriations of clients' funds by lawyers, and all lawyers are required to maintain minimum levels of liability insurance through the profession's self-insurance program. The LSA summarizes its argument on this point thus:

> The comprehensiveness of the regulatory scheme governing lawyers indicates that resort to the personal assets of lawyers without culpability adds an unnecessary level of protection.[266]

We come back to this argument in Section F.

D. Special Characteristics of The UL Professions

One of the LSA's general points seems to be that lawyers and other professionals should be treated much like other businesses when considering whether they should be able to practise in limited liability firms. This point seems to be based on a similar premise to the one that we stated at the beginning of this chapter. 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 siugle out UL professionals for less favourable treatment than other types of enterprise. The issue, however, is whether there *are* good reasons for treating UL professionals differently (less favourably) than other enterprises. In this section we consider whether the UL professions share certain characteristics, or enjoy certain privileges, that might distinguish them from other enterprises in a way that provides a rationale for denying UL professionals the privilege of operating in limited liability entities.

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[265] LSA 1995 at 12-13.

[266] LSA 1995 at 13.

1. Specialized Knowledge and Skill

Perhaps UL professionals are denied the ability to practise in limited liability entities because their members have special knowledge and skills, for which they charge accordingly. If they do have special knowledge and skill, they should be encouraged to exercise them to the fullest. Allowing them to practise in limited liability firms does not appear to be a good means of providing such encouragement.[267] But even if that is so, it does not provide a reason for differentiating between the UL professions and many other professions and occupations whose members can form limited liability firms. The argument that limited liability reduces the incentive for an enterprise to provide a good product and, therefore, should not be permitted, would seem to apply with equal force to many other professions and occupations that can be practised in limited liability firms.

ISSUE No. 6
Is limited liability likely to create more of a disincentive for UL professionals to exercise an appropriate level of knowledge and skill than it creates for members of professions or occupations that are currently permitted to form limited liability firms?

2. Critical Responsibilities

Not only do UL professionals possess specialized knowledge and skill, failure to exercise that knowledge and skill can have catastrophic financial or personal consequences for clients, patients or other persons who rely upon UL professionals. Given the gravity of the consequences that can follow from a failure to exercise appropriate care, UL professionals should be provided with every incentive to exercise that level of care. Allowing them to practise in limited liability firms would reduce the financial incentive to take care.

Here again, though, it is easy to think of other professions or occupations whose practitioners must discharge responsibilities that are no less grave than those of the UL professions. Airline pilots and the engineers who design airplanes and air traffic control systems are but a couple of many

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[267] One reply to the argument in the text is that the LLP does not protect *individual* professionals from liability for their own personal malpractice, so an individual professional practising in an LLP will have just as much incentive to exercise care and skill as they would have in an ordinary partnership. The possible effect of LLPs on the overall quality of services provided by professional *firms* is discussed later in this chapter.

examples that come to mind. To the extent that the "incentive" argument applies to the UL professionals, it seems to apply to many other enterprises as well.

ISSUE No. 7
Are the potential consequences of malpractice by UL professionals so grave that it is appropriate to maintain the requirement that UL professionals practise in unlimited liability firms, given that other enterprises that provide critical services can be conducted through limited liability entities?

3. Statutory Monopoly

We come now to a characteristic that is more distinctive of the UL professions than the other characteristics we have mentioned, although it is not unique to the UL professions. The members of each of the UL professions have a statutory monopoly over the provision of a particular type of service.[268] More precisely, they have the exclusive right to carry on a particular type of enterprise that involves the provision of a particular type of service. To take legal services as an example, it is not just that legal services must be performed (or supervised) by persons who have satisfied the educational and other requirements for admission to the LSA. Not only do the actual legal services have to be provided by members of the LSA, only members of the LSA may own legal services firms. In this regard a contrast may be drawn between the UL professions and a profession such as pharmacy.

The *Pharmaceutical Profession Act* prohibits anyone other than a "pharmacist" from practising within the "exclusive scope areas of the practice of pharmacy."[269] However, any grocery store (or any accounting firm or law firm, for that matter) can have a pharmacy, so long as a pharmacist applies for the necessary license and "will personally manage, control and supervise the pharmacy insofar as the management, control and supervision relate to

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[268] Given Canada's public health care system, the medical profession's monopoly over the practice of medicine would seem to have less market significance than the monopolies enjoyed by the other UL professionals.

[269] *Pharmaceutical Profession Act* ss 1(1)(h.1), (r), 2(1).

the practice of pharmacy."[270] So in theory a law firm could hire a pharmacist and set up a pharmacy on its premises, but a firm of pharmacists could not hire a lawyer and set up a law office in an unused corner of the pharmacy. To take a somewhat more realistic example, UL professional firms' proprietary monopoly over "their" field might give them a significant competitive advantage over competitors when the UL professional firm offers services *outside* of its monopoly area. For instance, in addition to providing services in their monopoly field—the provision of audit services—the major accounting firms compete with non-accounting firms in providing management advisory services. As compared to its non-accounting firm competitor, the accounting firm has the distinct advantage of being able to offer a broader range of services: management consulting *plus* audit services. The competitor might well argue that unlimited liability is a small price to pay for the leverage provided to the accounting firm by the accounting profession's monopoly over audit services.

One might argue that the reason why UL professionals should be required to practise in unlimited liability firms is the same reason why they are granted a statutory monopoly in the provision of certain services: the protection of the public. There are, however, a couple of other professions that enjoy the same sort of monopoly as the UL professionals, but whose members may practise in limited liability firms. Both the *Architects Act* and the *Engineering, Geological and Geophysical Professions Act* contain "exclusive practice" provisions to much the same effect as the provisions in the UL professions' governing statutes. But the members of those professions can practice in ordinary, limited liability business corporations. So the UL professions are not unique in the extent of the statutory monopoly that their members enjoy.

ISSUE No. 8
Is the fact that members of each UL profession enjoy a monopoly over a particular type of commercial activity relevant to the question whether they should be able to practise in limited liability firms? If it is relevant, what are its implications?

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[270] *Pharmaceutical Profession Act* ss 1(1)(s), (y), 26(1)(b). Section 26(1) contains other requirements, such as the presence of a pharmacist on the premises at all times.

4. Access to Capital Markets

When discussing the economic rationale for limited liability in Chapter 3, we observed that the primary argument for limited liability focuses on the adverse effect that a rule of unlimited owner liability would have on organized capital markets.[271] This argument does not apply directly to closely held firms. However, it can be argued that if limited liability is justified for large, widely held firms, it would be unfair to deny this privilege to their closely held competitors.

When we turn to UL professionals, we find that they have a distinctive legal characteristic that might be relevant to the limited liability debate. In Alberta, all owners of a UL professional firm must be members of the relevant profession. For example, the provisions of the *Legal Profession Act* that provide for professional corporations ("**PC**"s) require all voting and non-voting shares of a PC to be owned by active members of the LSA. These provisions, and similar provisions in other professional statutes, preclude a PC from issuing shares to the public.[272] Therefore, that unlimited liability might adversely affect UL professionals' ability to raise equity capital in organized capital markets is a moot point. The same thing is true, however, of any closely held corporation, and the shareholders of most closely held corporations do enjoy limited liability. So UL professionals could argue that even though they do not and cannot raise equity capital in organized capital markets, the same principles (whatever they are) that justify limited liability for shareholders of ordinary closely held corporations apply to professional firms.

However, in Chapter 3 we suggested that there is a "fair competition" argument for affording limited liability to closely held companies. That is, if the shareholders of widely held enterprises are afforded limited liability, their closely held competitors might be at an unfair disadvantage (in terms of

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[271] We also noted that some theorists question how much effect unlimited liability would really have on the capital markets.

[272] It is interesting to speculate whether a professional firm could be set up as an LP with persons who are not members of the relevant profession as limited partners. As an exercise in statutory interpretation, this would raise the issue whether the limited partners could be said to be engaged "in the practice of" the relevant profession. They might reasonably contend that they are not practising the profession at all; they have just contributed capital in return for a share of the profits. A somewhat more esoteric approach might be to set up the professional enterprise as a business trust, with the non-professional investors (or family members) being beneficiaries of the trust.

their cost of capital) if they could not offer similar benefits to their shareholders. This argument does not help UL professional firms. Given that UL professionals, as a group, have a monopoly over their field of practice, they do not have to worry about competition from firms whose owners enjoy limited liability. All competitors in a particular UL profession are in the same unlimited liability boat. This is, perhaps, one sense in which the monopoly accorded to the UL professions is relevant to the limited liability issue.

> **ISSUE No. 9**
> **UL professional firms do not seek equity capital in organized capital markets, because their owners must be members of the relevant profession. And because of their statutory monopoly, UL professional firms do not have to worry about competition from firms whose owners enjoy limited liability. Is this a reason for not allowing UL professionals to practise in limited liability firms?**

E. Contracting Around Default Rules

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?

1. Malpractice Claims by Clients

If the existing legal rule that imposes unlimited liability for malpractice claims on members of UL professional firms is merely a default rule, professional firms could limit their members' potential malpractice liability to clients by contract. Indeed, they could limit the *firm's* own liability by contract, not just the liability of its individual members. So far as malpractice liability to clients goes, the fact that UL professionals must practice in unlimited liability firms would be neither a great detriment to them nor a great boon to their clients. It would only serve as the starting point for

negotiations about any restrictions on the firm's liability or its owners' personal liability.

Viewing the current rule of unlimited liability in that light, it could be supported on the basis that it is a better default rule for malpractice claims on the basis of the *transparency* argument discussed in Chapter 3. The gist of the argument there was that, all else being equal, where there is a choice between two default rules for a transaction or class of transactions—e.g. unlimited liability or limited liability—and one rule favours the less sophisticated party to the transaction, that is the better default rule. It is better because it will force the more sophisticated party to contract for the other rule if they want it. It seems like a fair presumption that UL professionals are likely to be at least as well informed as their clients about the default rule that governs their personal liability for malpractice claims against their firm. Thus, the goal of transparency regarding the personal liability of members of a professional firm would be served by retaining a default rule of unlimited liability.

ISSUE No. 10
So far as UL professionals' liability to *clients* for malpractice is concerned, is a *default rule* of unlimited liability preferable on the basis that the former would provide some protection to unsophisticated clients by requiring professionals to expressly contract for limited liability if they want to limit their liability for malpractice claims arising out of a particular contract?

In considering the foregoing issue, it is worth considering whether, or the extent to which, the prevailing legal rule of unlimited liability for UL professionals is actually a default rule, rather than a preemptive rule. A rule of unlimited liability is preemptive to the extent that a professional firm would not be able to agree with the client for some form of limited liability. Lawyers, for example, have a legislative impediment on their ability to limit their liability for malpractice by contract. Rule 620(1) of the Rules of Court reads:

> 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.

The precise scope of this somewhat curiously worded rule is unclear. Could it be got around by inserting a limitation of liability in an agreement that does not purport to deal with "solicitor and client fees"? Would it apply if the contract did not purport to relieve a lawyer from liability for personal malpractice, but only from personal liability for malpractice of a partner? In any event, if it were considered desirable to have a default rule of unlimited liability for lawyers for malpractice claims, but to allow them to limit their liability by contract, consideration would have to be given to clarifying or limiting the scope of Rule 620(1).[273]

Codes of professional conduct are another potential source of legislative[274] limitations on professionals' ability to limit their liability for malpractice claims by contract. So far as we are aware, none of the codes applicable to Alberta UL professionals expressly prohibit contractual limitations on a professional's potential liability for providing substandard services. However, a UL professional firm that attempted to severely limit its liability for malpractice might run afoul of one of the general ethical requirements of such codes.

Even if no statute, regulation or professional code of conduct placed express restrictions on professionals' ability to limit their liability to clients by contract, the courts would undoubtedly be extremely vigilant to ensure that any such contractual limitations were reasonable. The following statement, although made in the context of a UK statute[275] of which Alberta has no direct equivalent, reflects the attitude that Canadian courts would

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[273] The wording of Rule 620(1) is similar to the wording of section 60(5) of the *Solicitors Act, 1974* (UK), but the latter does not say anything about fees and applies only to "contentious business:" see Common Law Team 1996 at 43. Both provisions are derived from *The Attorneys' and Solicitors' Act, 1870* (UK), which was mainly concerned with remuneration of attorneys and solicitors but also contained, in section 7, a provision worded similarly to Rule 620(1). The *Solicitors Remuneration Act, 1881* (UK) contained provisions dealing with remuneration of solicitors in connection with non-contentious business. The 1881 Act excluded the application of the 1870 Act to non-contentious business and did not contain a provision similar to section 7 of the 1870 Act. Thus, since 1881 the UK rule against limiting liability has applied only to contentious business. Nevertheless, when the predecessor of Rule 620(1) was added to the 1914 Alberta Rules of Court (as Rule 37 under the heading "Rules as to Costs"), it was not restricted to contentious business.

[274] The professional codes of conduct are enforceable by the professional bodies against their members through disciplinary proceedings, and thus merit the adjective "legislative."

[275] *Unfair Contract Terms Act 1977.*

probably take to limitation clauses in contracts between professionals and their clients:

> It seems reasonably clear that a blanket attempt to exclude all liability arising under any particular head of the law will be at grave risk of being found unreasonable. On the other hand, the courts will look more favourably at clauses which seek to deal more selectively with the various types of liability which may arise, and which seek to achieve less dramatic ends.[276]

Unlike the UK courts, Alberta's courts are not given a general statutory authority to strike down limitation or exclusion clauses that are "unreasonable." But our courts do have a variety of doctrines that they could employ to avoid enforcing contractual limitations on liability that they perceive to be patently unreasonable: doctrines of unconscionability, breach of fiduciary duty, fundamental breach, and so on. The limitations that would pass judicial scrutiny would depend on a variety of circumstances, such as the court's perception of the substantive reasonableness of the limitation, the relative sophistication of the client and so on.

There is in theory, and quite possibly in practice, one further constraint on professionals' ability to limit their ability to clients by contract: the market. It may well be that some professional firms are reluctant to ask clients to agree to a limitation on the firm's liability for negligence, on the basis that even bringing up the subject of such a limitation might "look bad," be refused, or cause the client to look elsewhere for professional services. In short, asking clients to agree to limitations for liability might be thought to be bad for business. To the extent that such market considerations do prevent professional firms from attempting to limit their liability for malpractice by contract, we would not regard that as an argument for changing the existing default rule.

ISSUE No. 11
To what extent and in what manner do Alberta UL professionals currently seek to limit their liability by expressly contracting for such limitations with clients?

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[276] Common Law Team 1996 at 42.

ISSUE No. 12
To what extent do specific statutory provisions, regulations or professional codes of conduct prevent UL professionals from limiting their liability to clients through express contractual provisions?

ISSUE No. 13
Should UL professionals be allowed to limit the monetary extent of their liability for professional malpractice in contracts with clients? If so, what legislative constraints if any, should apply to such contractual restrictions of liability?

2. Malpractice Claims by Non-clients

Because of the nature of the services they provide, health professionals are unlikely to incur professional malpractice liability to non-patients. Accountants and lawyers are more likely to encounter situations where, in providing services to clients, they incur duties of care to non-clients. This is particularly so where an accountant or lawyer provides information that may be relied on by a non-client — or by many non-clients — in making decisions in financial matters. As discussed in Chapter 1, in certain circumstances the lawyer or accountant will owe a duty of care to such non-clients. The recent decision of the Supreme Court of Canada in *Hercules* takes a restrictive view of the circumstances in which a professional will owe the sort of duty of care to non-clients that could give rise to liability for negligent misrepresentation. Nevertheless, there remain circumstances where accountants and lawyers will owe a duty of care to non-clients. One problem for professional firms in such cases is that they cannot limit their potential liability to non-clients by contract for the simple reason that there is no contract in which to insert the limitation.

While a professional firm cannot contractually limit its liability to a non-client, it can sometimes take steps to reduce the possibility that it will be found to owe a duty of care to the non-client. By taking steps such as putting an appropriately worded warning on a document upon which a non-client might otherwise reasonably rely, a professional might make it unreasonable (in the mind of a court) for the non-client to rely on a representation

contained in the document.[277] The professional firm would, however, have good reason to be nervous about exactly how much protection such a warning will provide.

The foregoing suggests that whether or not professionals can practice in limited liability firms is likely to be of particular significance with respect to malpractice claims by non-clients. And if certain UL professionals are precluded by preemptive rules (e.g. rule 620(1) of the Rules of Court) from limiting their liability to clients by contract, allowing them to practise in limited liability firms would reduce the effect of such a rule. Whether such an effect would be desirable or not is, of course, a major issue. Moving from the current rule of unlimited liability to a rule of limited liability might be a benefit to professionals (lower total payouts) and a burden to non-client claimants (lower total recovery).

ISSUE No. 14
Is it fair to say that to the extent that UL professionals have legitimate concerns about unlimited liability for malpractice claims, the concerns relate primarily to claims by non-clients?

ISSUE No. 15
Given the restricted scope of the duty of care with respect to negligent misrepresentation after *Hercules*, do concerns about unlimited liability for negligent misrepresentations to non-clients actually provide a cogent basis for allowing certain UL professionals to practise in limited liability entities?

F. Possible Effects of Limited Liability

In this section we consider what the effects of allowing UL professionals to practise in limited liability firms might be. We focus mainly on the consequences for outsiders, rather than on the effects that a change to limited liability might have on the internal affairs of firms.[278]

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[277] See Common Law Team 1996 at 40-41; Feldthusen 1994 at 52-62. Obviously, if the professional's duty to the non-client is imposed directly by statute, the professional cannot disclaim liability.

[278] Hamilton 1995 makes some interesting observations, which he categorizes as "armchair (continued...)

1. The Quality of Professional Services

This section considers what effect, if any, allowing UL professionals to practise in limited liability entities – specifically LLPs of the type proposed by the LSA and ICAA – might have on the quality of the services they provide. By "quality of services" we mean the level of knowledge, care and skill that is deployed in providing those services. Increasing the quality of professional services by any increment will decrease the probability of "accidents" (socially undesirable outcomes). We would not regard "defensive practice" – techniques that are designed to "look good in court," rather than to lower the risk of accidents – as an example of exercising an increased level of knowledge, care and skill. Presumably, allowing professionals to practise in LLPs will not provide them with an incentive to provide *higher* quality services than they currently provide. But will it give them an incentive to provide *lower* quality services, and if it does, will that incentive nevertheless be overborne by other factors?

> **ISSUE No. 16**
> **If UL professionals were permitted to practice in limited liability firms – specifically, LLPs whose partners would remain liable for personal malpractice – would this be expected to reduce the quality of services provided by professional firms to any appreciable extent?**

The foregoing is the general issue considered in this section. As we go along we state more specific issues that are designed to tease out various aspects of the general issues.

a. Limited liability and onerous liability doctrines

It is not far fetched to argue that unduly onerous civil liability rules, particularly tort rules, can induce professionals (or anyone else) to take more than the socially optimal level of care in providing services. This argument is based on the premise that a matrix of liability rules — in particular the rules that determine to whom and for what type of damages a firm may be liable, and how damages are quantified — may be so onerous that it will be a firm's best interest to exercise a level of care that, in a nutshell, costs society (but

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[278] (...continued)
analysis", about the possible internal effects of a Texas-model LLP at 1078-81.

not the firm) more than the extra care is worth in terms of saved "accident" costs.[279] Allowing UL professionals to practise in limited liability firms could then be viewed as a rough and ready way of mitigating the effect of the unduly onerous liability rules. Taken by themselves, the liability rules would induce firms to take too much care. Limiting owners' liability for the firm's liabilities might remove the inducement to take too much care by insulating owners from the unduly onerous liability rules that apply to the firm.

Without denying that tort liability doctrines may sometimes be so onerous as to be counterproductive, we do not think that allowing UL professionals to practise in limited liability entities would be the appropriate

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[279] This might occur, for example, if the courts have adopted a method of calculating damages such that the amount of damages awarded against firms that cause accidents substantially exceeds the true *social cost* of the accidents they cause. For example, suppose that a buyer (B) pays $1,000 to a seller (S) for S's shares in Bubble Co. when B and S are under a misapprehension as to the value of the shares because of misleading financial statements that were carelessly audited by Audit Firm. S was as innocent as a lamb and B relied entirely, and reasonably, on the audited financial statements in deciding to pay $1,000 for the shares. As soon as the true facts come out, the value of the shares plummets to nil. B obviously has suffered a personal financial loss of $1,000. But there has been **no direct social loss** in this transaction, because B's loss is S's gain. It isn't as if Audit Firm's error caused the shares to lose $1000 in value; its error caused B to think they were worth $1000 when they were actually worth $0.

This is not to say that Audit Firm's carelessness is socially costless. Apart from any damage that may have been done directly to Bubble Co, Audit Firm's carelessness may be expected to cause *indirect* social costs. For instance, the fallout from the Bubble incident may increase transaction costs on the stock market because investors will have diminished faith in financial statements.

But there is no *a priori* reason to think that the indirect social costs of Audit Firm's carelessness correspond to the total personal losses of all investors in the same boat as B. Perhaps the indirect social costs of Audit Firm's carelessness are considerably less than the aggregate personal losses of all those in the same boat as B. In that case, if Audit Firm is held liable for all of the personal losses of all the investors who are in that boat, Audit Firm's liability might greatly exceed the actual social costs of its negligence. The *prospect* of incurring such liability would make it economically worthwhile for Audit Firm to take a level of care the cost of which would substantially exceed the expected savings in social costs that are achieved by taking such care. Of course, the extra cost of the extra care taken by Audit Firm will be reflected in the price of its audits (and the price of all audits by all auditors), which will eventually be borne by all market participants. The market will end up with better information, but the information will cost more than it is worth.

We will add the caveat that the example in this footnote is meant to illustrate how unduly onerous liability rules might provide an incentive for firms that are subject to those rules to take a *supra optimal* level of care. We should not be taken as arguing that a liability rule that imposed liability on Audit Firm for the full amount of B's personal loss would necessarily be inappropriate. One might argue, for example, that all things considered, investors' personal losses in such situations do serve as a reasonable proxy for the social costs of audit failures.

means of addressing this problem. Here we would adopt an observation that was made in the context of an argument that shareholders of corporations should be liable for corporate torts:

> . . . whether courts are capable of distinguishing among corporate defendants is irrelevant if one believes that courts are inclined to create excessively broad liability for corporate actors in general – for example, in the realm of products liability – and that limited liability therefore serves to restrain judicial overreaching. In this case, one might fear that unlimited liability would simply lead courts to search for deeper pockets for compensating victims, and thus encourage judges to be even more irresponsible than in the past in making unjustifiably large damage awards.
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> Yet this argument is not compelling. There may be good reasons for retreating somewhat from recent expansions of enterprise liability, although this remains a debateable issue. But, even so, limited liability is an extremely crude check on the courts; it restricts liability excessively in some cases and not enough in others, and it motivates shareholders and corporations to behave opportunistically. If the scope of enterprise liability needs to be narrowed, the appropriate reform is not to invite firms to opt out of the tort system by exploiting limited liability. Rather, one should craft liability rules and damage measures that impose costs upon corporations and their shareholders only to the extent that these actors appear to be the cheapest cost avoiders and/or insurers.[280]

Adapting this thought to our context, even if excessively onerous tort doctrines were inducing certain UL professionals to take more than the socially optimal level of care, the appropriate response would be to reform those doctrines, rather than to allow UL professionals to practise in limited liability entities.

ISSUE No. 17

We assume that allowing UL professionals to practise in limited liability entities would be an *inappropriate* response to a problem created by unduly onerous tort liability doctrines. That is, we assume that if substantive liability doctrines that apply to professional firms are unduly onerous, the appropriate response would be to reform the substantive liability doctrines, not to try to dull their effect by allowing professionals to practise in limited liability firms. Is that a reasonable assumption to make?

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[280] Hansmann & Kraakman 1991 at 1918. One might consider *Hercules* to be an example of an attempt by the courts to craft liability rules so as not to impose what are considered to be inordinate levels of liability on auditors.

b. Effect of self-regulation

The UL professions are self-regulating. Statutes require anyone who wants to practise a UL profession to belong to a governing body such as the ICAA, LSA or College of Physicians and Surgeons. The statutes give each governing body authority to set educational and other standards for admission to the profession, to prescribe rules of conduct for members, to prescribe financial responsibility (e.g. liability insurance) requirements, to discipline or expel members for misconduct, and so on. These powers of self-regulation are to be exercised for the benefit of the public, rather than the benefit of the members of the profession.[281]

It has been argued that because of self-regulation, there is no need to fear that allowing UL professionals to practise in LLPs will impair the quality of service that they provide. The relevant regulations are those that are intended to ensure that practitioners meet prescribed standards of education, competence and ethics.[282] As the ICAA puts it:

> The above processes [rigorous code of ethics, discipline processes, demanding admission requirements, etc.] of the Institute of Chartered Accountants of Alberta protect the public from incompetent or unethical auditors. The civil courts provide an avenue for financial restitution should an auditor fail to meet the standards or otherwise be negligent.[283]

It does seem reasonable to suppose that regulations regarding competency, ethics and so forth will have a positive effect on the quality of services provided by the professionals to whom they apply. But do these regulations make civil liability redundant as an incentive for professionals to exercise an optimal level of knowledge, care and skill?

The ICAA's point in the preceding passage seems to be that, at least as far as accountants and other regulated professions are concerned, the

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[281] Of course, although they may be intended to benefit the public, the educational and other requirements for admission to the governing body constitute barriers to entry to the relevant market. And as noted earlier in this chapter, UL professionals have a monopoly not only in providing the relevant professional services, but also over the ownership of firms that provide such services.

[282] Another type of public-protection regulation is a financial responsibility requirement, such as a requirement that professionals carry at least a specified level of liability insurance. Such requirements are dealt with below when we consider claimants' prospects of actually recovering the compensation to which they are entitled.

[283] ICAA 1994 at 7.

function of civil liability should be viewed as being purely compensatory – to compensate people for loss they have suffered – rather than to reduce the incidence of loss by providing an incentive to exercise the optimal level of knowledge, care and skill. Such an incentive is unnecessary, the reasoning seems to be, because the regulatory requirements provide all the incentive that is needed.

But even if it is conceded that self-regulation does help to increase the quality of professional services, it may be debated whether self-regulation alone will assure that professional services will be of optimal quality. For example, with respect to the debate over accountants' liability for defective audits, some observers within the accounting profession argue that the profession's regulatory system has proved to be less than totally effective in ensuring the optimal quality of audit services.[284] Undoubtedly, similar points could be made with respect to other UL professions. In any event, it could be and has been argued that the threat of civil liability will provide a useful incremental incentive for professionals to provide services of optimal quality.[285]

ISSUE No. 18
Do the competency, ethical and disciplinary regulations to which members of the various UL professions are subject make

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[284] See e.g. Fogarty, Heian & Knutsun 1991, *passim*. It should be noted that criticisms of the auditing industry do not necessarily walk hand in hand with endorsements of the current liability milieu. Fogarty, Heian & Knutsun at 214-15 refer to studies that suggest that audit firms' responses to liability concerns (apart from efforts to persuade legislators and courts to change the liability rules) will take the form of procedures calculated to reduce the likelihood of incurring liability that do not necessarily increase the information value of the audit.

[285] Prichard 1990 at 4 illustrates the difficulty of measuring the effect of the prospect of civil liability on the quality of services provided by regulated professionals. It is noted that some commentators think that the threat of civil liability has caused health care professionals to "[alter] their conduct in ways that are not in the best interest of patients or the health care system at large." Others "see the threat of malpractice action as an important stimulant to physicians to behave in accordance with the requirements of first-class medical practice and to act carefully at all times in the best interests of their patients." The chairman's conclusion is stated thus:

> My finding on this question is that on balance the good effects of the threat of litigation outweigh the bad. That is, on balance and in simplest terms, I find that the quality of health care provided by our physicians and health care institutions is higher than it would be in the absence of the threat of litigation. I do not doubt that there are some perverse effects of the threat of litigation . . . .

Undoubtedly, civil liability has similar pros and cons in the context of other regulated professions.

the deterrent function of civil liability redundant as a mechanism for ensuring that UL professional services are of optimal quality, or does the prospect of civil liability provide a useful incremental incentive?

The issue is not simply whether the prospect of civil liability does, in general, provide an incentive for UL professionals to take optimal care in providing services. Assuming that the prospect of civil liability does provide such an incentive, the further question is whether allowing UL professionals to practise in LLPs would diminish that incentive in any material way. If it were concluded that such a change would not diminish UL professionals' incentive to exercise the optimal level of knowledge, care and skill, then the change could not be objected to from a "quality of services" point of view. In this regard, it would be interesting to compare the quality of service provided by the UL professions with the quality of services provided by similar professionals, such as architects, engineers, geologists and geophysicists, who are self-regulated and permitted to practise in limited liability entities. Is there any reason to believe that the quality of services provided by those professionals is less than what it would be if they were required to carry on business in unlimited liability firms? If there is no reason to believe that limited liability has had an adverse impact on the quality of the services offered by, say, engineers or geologists, this might be taken as evidence that allowing UL professionals to practise in limited liability firms would not have an adverse impact on the quality of their services. And vice versa. This is an empirical question about which we suspect that it would be extremely difficult to acquire anything other than anecdotal evidence. Nevertheless, we will pose it as an issue.

ISSUE No. 19
Professionals such as architects, engineers and geologists may practise in limited liability entities. Is there any evidence that this privilege adversely affects the quality of services provided by firms in those professions?

c. Effect of personal liability for personal malpractice

It can be argued that even if the prospect of incurring civil liability provides UL professionals with an incentive to take optimal care, allowing them to practise in LLPs would not dilute this incentive. This is because the LLP that has been proposed for Alberta would *not* protect UL professionals from the consequences of their own personal malpractice. It will be recalled that personal malpractice, under the LSA proposal, would consist of the following:

(a) performing or being directly involved in the wrongful conduct;

(b) having had direct supervision of or control over the conduct;[286] or

(c) having had notice or knowledge of the conduct at the time it occurred and having failed to take reasonable steps to prevent or cure it.

An individual accountant, lawyer or health professional who is personally involved in conduct that constitutes professional negligence (or any other form of professional malpractice) will remain personally liable for all damages that they cause. Since they would remain personally liable for malpractice, each individual member of an LLP would have precisely the same incentive to exercise due care that they would have under the current unlimited liability regime. Thus, allowing professionals to practise in LLPs will not reduce their incentive to take due care.

There are several possible replies to the preceding argument. They are related in that they all question whether a regime of liability for personal malpractice is a satisfactory substitute for unlimited liability as a means of ensuring that firms provide services of optimal qnality. The first point that follows is a general objection to the argument that a regime of liability for personal malpractice would be a satisfactory substitute for the discipline of unlimited liability. The second and third points question particular aspects of the personal liability concept as proposed by the LSA.

i. The problem of insolvent members

Near the end of Chapter 3 we explored the problem that can arise where a rule of limited owner liability applies in favour of an enterprise that provides services in the following circumstances: (1) clients are relatively unsophisticated and trusting; (2) clients cannot readily monitor the quality of the services the enterprise provides; (3) the assets of the firm are not sufficient to satisfy losses that clients might reasonably be expected to suffer if the quality of the firm's services is less than what the client bargained for. We suggested that in such a scenario limited liability would provide a substantial incentive for the firm to provide a lesser quality of service than it has agreed to provide. A preemptive rule of unlimited owner liability might

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[286] We take it that the LSA proposal would impose *vicarious* liability on the partner who was in the supervisory position. That is, they would incur liability by virtue of having occupied the supervisory role, rather than by virtue of having failed to exercise due care in discharging their duties as a supervisor.

be supported on the basis that it would provide the optimal incentive for a firm to provide the quality of service it has contracted to provide.[287]

We recognized that there were plausible alternatives to imposing unlimited liability on all owners of a firm to address the problem of the "information deficit customer." One alternative would be to impose direct personal liability on individuals who were directly responsible for causing the firm to provide substandard services. We noted, however, that if the managers of the firm were likely to be insolvent in the face of the sort of liability claim that might arise from a breach of contract, the managers and owners would collectively have an incentive to provide services of substandard quality to the customer. This is because the managers' potential insolvency and the workings of bankruptcy laws reduces the risk that the owners and managers collectively incur if the firm provides services of substandard quality.[288]

The preceding point would seem to have potential application to the members of an LLP in a personal-malpractice regime. For any given transaction, the role of the manager in our example from Chapter 3 would be assumed by those members (and employees) of the firm who could incur personal liability for malpractice in respect of that transaction. The role of the owner would be assumed by members of the firm who would not incur

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[287] Chapter 3.B.4(a).

[288] The explanation for why this might be so is summarized in the passage from Sykes 1984 that is set out at page 94 above. The basic point is that where the magnitude of a possible liability that might follow from a possible course of action exceeds the decision-maker's total wealth, the expected cost to the decision-maker of following that course of action would depend on the decision-maker's wealth, rather than the magnitude of the possible liability. The decision-maker's potential insolvency allows them to externalize a portion of the risk of following that course of action. So assuming that a "principal" and "agent" want to maximize the expected profits from providing a service, and the principal is not personally liable for liabilities incurred by the agent for substandard performance of the services, the agent's potential insolvency gives principal and agent an opportunity to externalize risks and increase their expected profits. The increase in expected profits can be shared between principal and agent.

This analysis, it should be noted, depends on the ability of insolvent individuals to obtain discharges in bankruptcy and start rebuilding their wealth: see Sykes 1984 at 1241-42. We might note that, all things being equal, the prospect of insolvency in the face of a large claim might be expected to be more daunting to a senior partner than a junior partner. In the event of bankruptcy the senior partner will have less time after obtaining a discharge to earn back wealth that was lost through bankruptcy. This effect would mitigated if, for example, wealth held in registered retirement savings plans was an exempt asset in bankruptcy.

personal liability. For transactions where the maximum liability would not be expected to exceed the aggregate of (1) any applicable insurance, (2) the firm's assets and (3) the assets of "vulnerable" members, the personal liability regime would *not* seem to reduce the incentive for the firm to provide high-quality services. However, for transactions where the potential liability would exceed that aggregate, the personal liability regime might create an incentive for the firm to maximize expected profits by providing services of substandard quality.[289]

ISSUE No. 20
Would the proposed personal liability regime provide significantly less incentive than an unlimited liability regime for firms to provide high quality services in connections with transactions where potential liability would exceed the assets of those members who might be personally liable for any malpractice?

ii. What about the top managers?

The LSA's proposed definition of personal malpractice focuses on those who are directly involved in the particular sequence of events that created the liability: the doers, the direct supervisors and the "knowers." Notably absent from this list are the "managers," by which we mean the senior members of a firm who occupy positions equivalent to the senior officers or directors of a corporation. Managers may exercise overall control of the design of the firm's quality assurance procedures without actually performing or *directly* supervising or controlling any of the activities that are likely to create liabilities. Thus, although the professionals who actually perform or directly supervise or control the risky activities may have the same incentive to take care under an LLP as under an ordinary partnership, those further up the chain of command may not have as much personal incentive to ensure that all members of the firm are exercising optimal care. In short, the personal malpractice regime, as proposed by the LSA, might dull the personal incentive for managers of an LLP to ensure that appropriate supervision and control mechanisms are established and maintained.

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[289] This is not to say that the members of the firm would consciously decide to provide services of substandard quality in a particular transaction. It might be more accurate to say that what the firm considers to be the appropriate level of care for a given type of service might be affected in subtle ways that might not be observable to the client.

ISSUE No. 21
Would it be appropriate to retain personal liability for the members of an LLP who had ultimate responsibility for ensuring, but did not ensure, that the firm established and maintained adequate "quality assurance" mechanisms, where the lack of such mechanisms is a contributing factor in a malpractice incident?

iii. The supervisor's vicarious liability

The LSA's proposed definition of the circumstances that constitute personal malpractice would impose personal liability on a partner who "had direct supervision of or control over the conduct" that created the liability. This looks like a proposal that the direct supervisor of the person who actually "done wrong" would be vicariously liable for the wrong.[290] Presumably, it is thought that this 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 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.[291]

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

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[290] As noted earlier, an alternative interpretation of the LSA's proposal is that the supervisor would only be liable if the loss was caused because they were derelict in their supervisory role. But that is not what the proposal looks like.

[291] Although it deals with a different issue Miller 1992 is useful in emphasizing the importance of keeping in mind that the individual members of professional firms have interests that may diverge from those of the firm, viewed as a collective entity.

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.

ISSUE No. 22
Would the proposal to retain personal vicarious liability for members of an LLP who supervised the persons whose actions created a liability provide a disincentive for members of LLPs (especially senior members) to assume supervisory roles?

d. Additional arguments

This section briefly considers three specific arguments that the LSA advances in questioning whether "vicarious liability will improve the quality of legal services." We will not state any specific issues in connection with these arguments, but they do seem to warrant some discussion. The first argument is this:

> . . . if exposure to vicarious liability is required to maintain quality standards, it would be unethical to buy malpractice insurance, transfer personal assets to a spouse or otherwise seek to minimize risk.

Taking this as a point about the effect of malpractice insurance on the incentive to take care, it is certainly true that liability insurance creates a "moral hazard" problem.

It may be observed, however, that providers of insurance take a peculiar interest in the amount of risk they are assuming: the bigger their perceived risk, the larger the premium. In the context of professional malpractice insurance, information problems will prevent insurers from setting the premium for any given firm at an amount that perfectly reflects the risk associated with that firm. However, to the extent that it is practical to do so, insurers will adjust the premium to reflect the risk associated with a particular firm.[292] Because the premium for insurance reflects the risk

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[292] To take the legal profession's insurance program as an example, the basic premium for all lawyers in the province is the same. However, lawyers who claim against their insurance face premium surcharges. The *ex post facto* adjustment of premiums to reflect past claims is

(continued...)

incurred by the insurer, purchasers of insurance retain an incentive to take care even if they will not have to dig into their pockets to pay claims.

The LSA's second specific argument against the need for vicarious (unlimited) liability as a deterrent is:

> lawyers have many incentives other than vicarious liability to ensure the quality of legal services, particularly in today's competitive environment.[293]

The argument here seems to be that the market puts a premium on high quality legal services, so it pays law firms (and other professional firms) to maintain high quality services. The other way of putting it is that the market will penalize firms that get a reputation for not providing high quality services. Undoubtedly, there is something to be said for this. Common sense suggests that professional firms will not want to acquire a reputation for providing shoddy services and will strive to develop a reputation for excellence.[294] On the other hand, common sense also suggests that the discipline of the market will not necessarily provide quite as bracing an incentive to exercise the optimal level of care as will the discipline of the prospect of being personally liable for the firm's malpractice liabilities.[295]

The LSA's third argument is best stated by combining in a single passage points made at two different places in its paper:

> It was considered appropriate that small groups of partners having a close fiduciary relationship among themselves accept personal responsibility for the actions of one

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[292] (...continued)
obviously an imperfect means of estimating future risk. But the point is that an effort is made to find a way to take some account of the risk associated with a particular firm. Liability insurance might dull the incentive that is provided by the threat of civil liability, but it is not intended to eliminate that incentive.

[293] LSA 1995 at 8.

[294] This point is made in a more theoretical way by Carr & Mathewson 1988 at 779.

[295] In economic terms, the market is an imperfect disciplinarian largely because of information problems. It is difficult for most consumers of professional services to evaluate the quality of their prospective lawyer, accountant, doctor or whatever beforehand. And it is unlikely to be economical (profitable) for any knowledgeable person to provide such information. The information may be extremely valuable, but it is very difficult for the person who produces the information to capture that value. See e.g. Bishop 1980, where the difficulty that producers of valuable information face in capturing its value is the basis of an argument for a cautious approach to the imposition of liability for negligent misstatements.

> another in dealing with third parties on the firm's behalf. . . . When a firm has hundreds of partners that may be spread throughout several jurisdictions, the concept of personal responsibility for one another's actions becomes inappropriate. [. . . in large multinational firms, lawyers often have little say in who their partners are in any event.] Even in smaller firms, increasing departmentalization means that partners to a large degree are not involved in or aware of their colleague's activities.[296]

This seems partly to be an argument that it is simply not fair to impose vicarious liability on members of large firms because they cannot fairly be expected to take responsibility for the actions of people who they cannot possibly control and may not even have met.

The following could be viewed as a general response to the "We don't even know our partners" argument:

> In the March, 1994 *Journal of Accountancy*, Marvin Stone, an erstwhile AICPA chairman, argued in favor of such insulation [LLCs and LLPs] asserting: "It makes no sense for each owner's assets to be at risk in an action stemming from an engagement performed at some remote location with which he or she had no connection."
>
> Be it remembered that the behemoths in our midst have structured themselves as such; they are, then, presumed to have built in an effective system of checks and balances so as to prevent aberrations and to weed out those who may be responsible for such conduct. . . . it is this very enormity of scale which permits these giant enterprises to tout their strengths and power in the pursuit of new business. Thus, advertising and other forms of PR emphasize their very size and scope of peripheral services. Clearly, these firms want to, metaphorically, "run with the hare and hunt with the hounds."[297]

A reply to this point might be that imposing liability on the individual partners for acts performed at some remote location is not only unfair but pointless, because the innocent partner can exercise no real control over the selection or conduct of other partners or personnel. Imposing liability on all owners for liabilities of the firm will have certain consequences, but it is unlikely to lead to better quality legal or accounting work. The rejoinder, however, is that although the influence of any one partner on the affairs of a large firm may be small, unlimited liability will provide all of the partners, collectively, with the best incentive to ensure that the firm takes an optimal level of care.

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[296] LSA 1995 at 2, 8. The portion in square brackets is at 8.

[297] Briloff 1998 at 12-13.

2. Claimants' Prospect of Recovery

In this section we turn from the deterrent function of civil liability to its compensatory aspect. This involves a change in focus from a fairly abstract consideration – How might the LLP proposal affect the quality of professional services? – to a more concrete consideration – How might the LLP proposal affect the probability that someone who has a valid claim against a professional firm will actually receive the compensation to which they are entitled? It is necessary to consider the compensation issue because no combination of regulations and liability rules will prevent incidents of malpractice from occurring. These incidents will cause losses to members of the public for which they should, on principle, be compensated.

a. Innocent partners and deserving claimants

The arguments of the professional organizations who support the LLP concept make two general points about the compensation issue. The first point is one that we will not consider in great detail. The submissions of the LSA, ICAA and CICA all suggest that it is fundamentally unfair to impose unlimited personal liability on individual members of professional partnerships for the actions of partners over whom they have no control and might never even have met. The ICAA, for example, argues that –

> It would be devastating if the Alberta partners of a major accounting firm were faced with personal bankruptcy, because some Toronto partners played a minor role in auditing a major corporation that subsequently failed.[298]

The fact is, however, that the professional firm of which someone has chosen to become a partner has caused someone to suffer damages. It may well be that a particular partner was not involved in the conduct that led to the loss, and so cannot be said to be "to blame" for the loss in that sense. But is the injured person more to blame for the loss? It may well be that individual professionals in large firms cannot exercise direct control over all of their partners? But they did presumably have a choice whether or not to join a large firm. Presumably they chose to do so because there were perceived to be certain pecuniary advantages to doing so. It is not self-evident that it is unfair to impose personal liability on the innocent partner where the choice is to leave the outsider uncompensated, or inadequately compensated, for the harm they have suffered.

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[298] ICAA 1994 at 16.

There may in fact be good arguments why, in certain circumstances, it would be fair to leave victims of a professional firm's malpractice uncompensated, or less than fully compensated, than to impose personal liability on its partners. The following comment of the LSA provides a hint of such an argument:

> Furthermore, the benefit that such a remedy [personal liability of all partners] would confer on a claimant relative to the total amount of the claim is far outweighed by the detriment that would be suffered by the innocent lawyer or lawyers.[299]

The LSA does not explain why, in its view, the benefit to the claimant would be far outweighed by the detriment suffered by the innocent lawyer or lawyers. It is possible that it is a truncated version of an argument to the effect that imposing liability on a few innocent professionals for damages suffered by a large class of plaintiffs (e.g. investors in a failed financial institution) constitutes "risk concentration" rather than "risk spreading."[300] The large class of plaintiffs, so the argument would go, are better risk bearers than the small group of lawyers. To be convincing, however, the argument would require considerably more elaboration than is provided by the LSA's submission.

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Assume that, as a result of the negligence of a member or employee of a professional firm, outsiders have suffered losses that, in the aggregate, exceed the assets of the firm and the partners who were directly involved in the malpractice, plus any applicable liability insurance. Is it fairer that the burden of the excess losses should fall on the partners who were not directly involved or that the outsiders should go uncompensated for that portion of their losses? Or does the answer depend on the particular circumstances of a particular claim?

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[299] LSA 1995 at 13.

[300] This would assume that the lawyers could not obtain insurance to cover the potential claim. On that assumption, and leaving aside the matter of who is to blame for the loss, the risk concentration argument could have merit in some instances.

b. Firm assets and liability insurance

The issue considered above would be irrelevant if the LLP proposal would not materially affect injured persons' prospects of recovering compensation from LLPs. Therefore, it is worth considering exactly how allowing UL professionals to practise in LLPs might affect claimants' prospect of receiving compensation. In this discussion it should be kept in mind that under the LLP proposal persons with a malpractice claim against the firm would have access to the following sources to satisfy their claims: (1) the realizable assets of the partners who are guilty of personal malpractice; (2) the realizable assets of the firm; and (3) any applicable liability insurance.[301] There is not much to be said about the first source. But it is interesting to consider the second and third sources.

i. The firm's assets

The assets of the professional LLP would be available to creditors. Unfortunately for creditors, since servitude for debt has long been out of fashion, the firm's most significant economic asset, its "human capital," is not readily converted into cash. The physical assets that the firm requires for its practice can generally be leased either from an arm's length lessor or from a management company owned by the firm's owners.[302] Undoubtedly, from creditors' perspective, the most valuable asset of a professional firm is its accounts receivable. If an ordinary professional partnership were converted to an LLP, members of the firm would have more incentive than they currently have to keep the LLP "lean," as asset-free, as possible. Thus, one might expect there to be a tendency for LLPs to be astute to bill clients and distribute profits regularly, especially if there was a large malpractice claim looming on the horizon.

ii. Liability insurance

In their submissions supporting LLP legislation professional organizations point out that their members are subject to compulsory minimum insurance

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[301] Insurers do not willingly provide insurance against liability arising from deliberate unlawful conduct by the insured. Thus, if a liability arose because of fraudulent conduct by a member of an LLP, the victim of that fraud would not have access to liability insurance as a source of compensation.

[302] Where the firm is an ordinary partnership, transferring assets to a captive management company would not be an effective creditor-proofing strategy. Creditors of the firm could seize and sell the partners' shares in the management company, or cause the management company to be liquidated to realize the value of the partners' shares in the management company.

requirements, and that these requirements provide significant protection to the public.[303] Without denying that such requirements do protect the public, we may observe that many professionals carry liability insurance with limits far in excess of the mandatory minimums. This suggests – and the submissions of the professional organizations provide evidence – that some professional firms have a substantial prospect of incurring liability that greatly exceeds the limits of the mandatory insurance. While mandatory minimum insurance requirements provide some protection to the public, they fall far short of ensuring that there will be insurance coverage for the full amount of large malpractice claims.

The question we briefly consider now is this. Assuming that the mandatory insurance requirements establish a floor for insurance coverage, what effect would the personal liability regime proposed by the LSA have on the malpractice insurance *preferences* of professional firms? We approach this as a question of the demand for malpractice insurance, without considering questions of supply. We suggest that adopting a personal liability regime will give firms – especially larger firms – an incentive to choose a malpractice insurance strategy that would substantially reduce the amount of insurance available to meet very large claims.[304]

Where professionals practice in ordinary partnerships with unlimited liability, the firm and its members will necessarily have the same level of liability insurance coverage. Since all members of the firm are jointly liable for any malpractice by anyone in the firm, they all bear the same risk of incurring malpractice liability for a given amount. And if they do incur a malpractice liability, the assets of all of the partners, whether held inside or outside the firm, are at risk. Therefore, it is appropriate for insurance purposes to treat the firm and all its members as a single entity whose total wealth is the aggregate wealth of all its members. In theory, the optimal level of insurance coverage for the firm would approximate the total wealth of all its members.[305] For example, a hypothetical firm with 100 members whose

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[303] ICAA 1994 at 6; LSA 1995 at 13.

[304] It might take some time for these strategies to be possible, because the supply side of the insurance market might take some time to adjust to the possibilities that LLPs afford.

[305] There is likely to be a considerable divergence between theory and practice. For one thing, the theory assumes that there is perfect knowledge of the risk or, at least, that the (continued...)

total wealth is $100 million has $100 million at risk, so the firm's optimal insurance coverage is $100 million.[306]

This relationship between wealth-at-risk and insurance coverage is illustrated by the following table, which indicates the percentage of Alberta law firms that in a recent year purchased "excess" insurance (above the $1 million minimum).

It is readily apparent from this table that larger firms are more likely to purchase excess insurance. One explanation might be that larger firms are more likely to take on higher value files with more potential for large claims. However, it seems reasonable to suppose that a large part of the reason why large firms tend to buy more insurance is that their members have more total wealth at risk than members of smaller firms.

Excess Insurance Purchased
By Firm Size

Lawyers in Firm	Number of Firms	Purchased Excess	
		Number	Percent
1-5	553	59	11%
6-10	72	31	43%
11-20	32	23	72%
21-30	9	9	100%
31-50	11	11	100%
50+	9	9	100%

Source: Alberta Lawyers Public Protection Association

[305] (...continued)
insured and the insurer have the same appreciation of the risk. Different levels of risk aversion between different insureds is another fly in the theoretical ointment. But the basic point holds true in practice as well as in theory: **the more wealth that a person has to lose, the more liability insurance it makes sense for them to buy**.

[306] For a detailed explanation of this (and other) points relating to liability insurance, see Shavell 1987, Chapter 8 (esp. at 192-94). The basic point can be illustrated by assuming that in a given year there is known to be a 1% probability that the firm will incur a liability for $1 billion [and a 0% chance of incurring a liability for any amount between $100 million and $1 billion—unrealistic but convenient.] The firm's insurance coverage is $100 million, reflecting the combined wealth of its members. Obviously, if the firm incurs a $1 billion liability the firm and all its members will become bankrupt. Their combined loss will be $100 million (plus maybe a few million, or a few tens of million to take into account the costs of being made bankrupt).Therefore, when the firm is deciding how much insurance to buy, the expected cost of a $1 billion liability is 1% of $100 million (plus a bit) or roughly $1 million. In other words, insurance coverage of $1 billion would be worth a little over a $1 million to the *firm's members*. But if they bought that much insurance the insurance company's expected cost would be at least 1% of $1 billion, or $10 million, because the insurance company (presumably) *does* have the wherewithal to pay a $1 billion judgment. In other words it would cost the firm at least $10 million to buy insurance that is worth closer to $1 million to the members of the firm, given their wealth.

Suppose that the hypothetical 100-member firm mentioned above converts from an ordinary partnership to an LLP, so that a malpractice claim may only be enforced against the firm's assets and the assets of the professionals who were personally involved in the malpractice. In this regime it would be rational for different members of the firm to have different levels of personal liability insurance, depending on their own personal wealth. In particular, it would be rational for the firm and its members to structure their insurance coverage along the following lines:

- Purchase "firm insurance" to a level that reflects the value of the firm itself.[307] If the firm is valued at about $10 million by its members, the optional level of firm insurance is about $10 million.

- Purchase excess "personal insurance" for each member of the firm.[308] The limit of coverage on each member's personal insurance will approximate the personal wealth of that member held outside the firm. If the wealthiest member of the firm ("W") has outside wealth of $10 million and the least wealthy member ("L") has outside wealth of $100,000, W will purchase $10 million and L will purchase $100,000 of personal insurance.[309]

If a change in the liability regime caused firms to alter their preferred insurance coverage in anything like the manner suggested above, a change to a limited liability regime could have a significant effect on the recovery of very large claims against large professional firms. Only if virtually every

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[307] The "going concern" value of the firm to its members may well be considerably higher than the realizable value of its assets if liquidated to meet a liability claim. In deciding on the appropriate amount of malpractice insurance, the firm's members might place a substantial value on intangibles such as human capital, even though the realizable value of those assets in an insolvency situation might be close to nil.

[308] For this purpose, "member" would include employee-professionals who could be exposed to personal malpractice claims.

[309] See note 306, above. The premium for the $10 million in personal insurance for the wealthy partner should be considerably less than the premium for the $10 million in firm insurance. The probability of the former being called on is considerably lower than the probability of the latter. This is partly because the personal insurance is presumed to be "excess" coverage that is called only if the firm insurance is not sufficient to cover the claim. More importantly, the probability that the firm insurance will be called on reflects the aggregate risk that *any* member of the firm will cause a malpractice liability, whereas the probability that the personal insurance will be called on reflects only the probability that *that particular* member, or someone under their supervision, will cause a malpractice liability.

member was somehow fixed with personal responsibility would the total firm insurance and personal insurance approach the level of firm insurance coverage under the unlimited liability regime.[310]

For example, suppose that "C" has a valid $100 million malpractice claim against the 100-member LLP. The claim arises because of bad advice given to C by L, who was under the direct supervision of W.[311] Under the unlimited liability regime, the full amount of C's claim would be covered by the firm's insurance of $100 million. Under the personal liability regime, C would in theory have access to (1) the firm insurance – $10 million, (2) the

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[310] It is assumed here that the coverage limits of personal insurance is *cumulative*. If three members have personal responsibility and each has $1 million excess coverage, their total coverage is $3 million. Such cumulative insurance would make no sense where all members of the firm are jointly and severally liable for any firm malpractice liabilities, but it does make sense in a personal liability regime.

Given that the optimal level of insurance is the amount at risk, the aggregate of the firm and personal insurance purchased under the personal liability regime should be about the same (in theory, exactly the same) as the amount purchased under the unlimited liability regime. The important difference is that only a fraction of the aggregate amount of insurance will be available in respect of any single claim. The insurer has assumed less risk, so the aggregate premiums paid by the firm should be lower.

There is some correlation of the risk associated with the individual members' personal insurance. Where the limits on personal insurance are cumulative, there is presumably a non-zero probability that the insurer will have to pay out the aggregate of *every* firm member's personal insurance. If every member of the firm were to be found personally liable for the same $100 million claim, and the firm insurance plus the aggregate of each member's personal insurance was $100 million, the insurer(s) would be on the hook for $100 million, just as it would be in the unlimited liability situation where there is a single firm policy for $100 million. However, the risk that all 100 members of the firm will be found personally liable for a given $100 million claim must be quite remote. It must certainly be remote relative to the possibility that the firm itself will incur such a liability. Since the probability of a $100 million insurance payout is much lower on the basis of cumulative coverage than on the basis of unitary coverage, the insurer's expected cost, and hence the premium, should be substantially lower.

If insurers were bashful about writing these types of policies, it would seem that members of limited liability firms could achieve a similar result by simply purchasing a single policy that reflects their estimate of the greatest amount of wealth that is likely to be exposed to any single claim against the firm. They might say, "Well, the firm's worth $10 million and, surely, no more than 10 of us could be found liable for the same claim, and the outside wealth of any ten of us does not exceed $25 million." On that reasoning, they might end up purchasing $35 million in insurance.

[311] W is the wealthiest, and presumably one of the more senior, members of the firm. This serves to illustrate a point we made earlier about the disincentive that imposing vicarious liability on supervising partners might create for wealthy partners to assume such roles. W probably would not be caught dead supervising a junior member of the firm on a file that could involve a liability of $100 million.

firms' assets – $10 million[312] (2) W's and L's personal insurance – $10.1 million, and (3) W's and L's personal assets – $10.1 million. The total available to satisfy C's claim is $40.2 million, leaving C about $60 million short of full satisfaction.

The foregoing suggests that after a change from an unlimited liability regime to a personal liability regime, larger firms would prefer to structure their insurance coverage in a way that would be likely to substantially reduce the insurance coverage available to meet large claims. The effect on small firms' preferred levels of insurance would be less dramatic. To take the extreme case – a one person firm – its preferred level of insurance would be exactly the same under either regime because this person will be personally responsible for any liabilities of the firm.[313] Firms with a few members might derive some benefit from restructuring their insurance coverage along the "basic firm insurance - excess personal insurance" lines suggested above,[314] but it seems that, as a general matter, the bigger the firm, the more incentive it will have to restructure its insurance in the manner suggested above.

ISSUE No. 24
Would a change from an unlimited liability regime for professional firms to a regime of personal liability for malpractice cause professional firms, particularly larger professional firms, to restructure their insurance coverage in a

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[312] Since the firm's valuation of $10 million for liability insurance purposes might substantially exceed the realizable value of its assets on liquidation, C may get considerably less than $10 million out of the firm's assets.

[313] Since partnerships require at least two members, a one-person LLP would be a legal impossibility. In Chapter 5, however, we consider the concept of a limited liability professional corporation or LLPC. A professional practising as a sole proprietor could form an LLPC, but it would not provide any protection to its shareholder.

[314] Where a firm has as only a few members, insurers may assume that there is a high probability that all or most of its members will be found to have been personally involved in any occurrence that gives rise to a large malpractice claim. Intuitively, it seems much more likely that every member of a five member firm will be found to have been personally involved in a malpractice occurrence than it is that every member of a 100 member firm will be found to have been personally involved in a single occurrence. Thus, a small firm would derive less relative benefit than a large firm by insuring on the firm insurance - excess personal insurance basis. In any event, the mandatory minimum insurance requirements are likely to be more relevant to the level of coverage purchased by small firms; the minimum coverage might well exceed the total wealth of all members of the firm.

manner that would, in effect, substantially reduce the insurance available to meet very large claims?

3. Competition

This section briefly considers the effect that a move from unlimited liability to personal liability might be expected to have on competition in the market for professional services.

a. Firms big and small

Near the end of the preceding section we suggested that moving to a personal liability regime would be likely to have a greater impact on larger firms' than smaller firms' preferred levels of insurance coverage. If the predicted effect is accurate, larger firms would gain a relatively larger advantage from LLPs. To the extent that the larger firms and smaller firms are competitors, it could give the former a competitive advantage over the latter by lowering their relative insurance costs.

A number of commentators have noted that various approaches to limiting professional liability are likely to have different effects on professional firms of different sizes. In Australia, for example, researchers who examined the responses of accounting firms to a discussion paper on different options for limiting auditors' liability concluded that the data suggested that larger audit firms tend to be more in favour of capping liability than smaller firms.[315] In the United States various authors have used abstract theoretical models to try to predict what the result of limiting professionals' liabilities might be. Dye, for example, develops a model that predicts that allowing audit firms to incorporate would benefit larger (wealthier) firms at the expense of smaller (less wealthy) firms.[316]

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[315] Johnson, Stokes & Watts 1995.

[316] Dye 1995 at 105. Dye offers "anecdotal evidence" for some of these conclusions. Carr & Mathewson 1988 use their model to develop similar predictions, for which they offer empirical support in the form of data on US law firms. The validity of the conclusions they draw from their data is debated in Gilson 1991 and Carr & Mathewson 1991.

ISSUE No. 25
Would allowing UL professionals to practise in LLPs enhance the competitive position of larger professional firms relative to smaller professional firms?

b. Price of services

The theorists mentioned in the preceding section who predict that allowing professionals to practice in limited liability firms will favour large firms over small firms also predict that this will enhance competition. Unlimited liability is beneficial to small firms because it creates barriers to entry (or springboards to exit) for large firms:

> 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. Aggregate shareholder wealth will increase with the adoption of limited liability.[317]

One reason why mandatory unlimited liability is said to decrease competition is that it forces partners to engage in inefficient monitoring of their partners' levels of wealth, which "drives the law firm to be inefficiently small under unlimited liability."[318]

The point we made earlier about preferred levels of insurance also suggests that abandoning the rule of limited liability in favour of one of personal liability could have the effect of lowering prices. Larger firms, in particular, would prefer lower levels of insurance than they currently carry and, thus, might pay less for insurance. These savings might result in lower prices for professional services.[319]

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[317] Dye 1995 at 105. Carr & Mathewson 1988 make a similar point at 768.

[318] Carr & Mathewson 1988 at 779-80. The authors have no problem with unlimited liability if the parties agree to it in a particular transaction. Their complaint is that the "most efficient policy would be to allow freedom of choice on liability:" at 766. One might observe that if unlimited liability serves only as a default rule, it does not prevent freedom of choice on liability, at least for contractual claims.

[319] Obviously, this would not apply to members of the medical profession who provide services within a public health care system in which fees for their services are not established by the market.

ISSUE No. 26
What effect would allowing UL professionals to practise in LLPs be likely to have on the price of professional services?

c. Multidisciplinary firms

It has been suggested that allowing professionals to form unlimited liability firms will facilitate the formation of multidisciplinary firms. To the extent that multidisciplinary firms would tend to be larger than unidisciplinary firms, the arguments that suggest that limited liability favours larger firms would seem to apply to multidisciplinary firms. It is not readily apparent, however, that the liability issues affecting the members of a multidisciplinary firm would be different in kind than those that face a firm whose members all belong to the same profession.

ISSUE No. 27
Would LLPs facilitate the formation of multidisciplinary professional firms, and, if so, how?

CHAPTER 5. DESIGNING A LIMITED LIABILITY PROFESSIONAL ENTITY

This chapter assumes, for the purposes of argument, that UL professionals should be permitted to practise in limited liability entities. Starting from this assumption, it considers how such entities should be structured. Section A asks why the liability shield should not apply to ordinary contract debts of professional firms, just as shareholders of corporations are protected from the corporation's ordinary business debts. Section B considers what safeguards should be provided for members of the public who deal with limited liability professional firms. Section C asks why it is necessary to create a new type of entity – the LLP – that would be available only to certain professions when there is already a limited liability vehicle – the corporation – that would meet UL professionals' liability concerns. We consider whether, in proposing that they be allowed to practise in LLPs, UL professionals might be proposing both to eat their cake and to have it.

A. The Liability Shield and Voluntary Creditors

Under the current legal regime, the default rule seems to be that members of UL professional firms have unlimited personal liability for ordinary contract debts of their firm. Clearly, the members of a professional partnership have unlimited liability for ordinary firm debts because each member of the partnership is a party to the contracts that create such debts. Where a professional corporation ("PC") is involved, the prevailing view is that the ordinary debts of the PC – such as debts arising under office and equipment leases – flow through to the shareholder(s). However, the relevant statutory provision is not a paradigm of clarity, and it has been argued that it is only intended to deprive UL professionals of a liability shield from malpractice claims.[320] For the purposes of this discussion we assume that the prevailing view (unlimited shareholder liability for a PC's ordinary contract debts) is correct. The more interesting question is whether, if UL professionals can practise in limited liability entities of any description, they should or should not be able to practise in limited liability entities that shield them from ordinary contract debts.

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[320] Stratton & Hughes 1997 at 780-83.

Under the LLP proposal put forward by the LSA, there would be no change in the default rule that UL professionals have unlimited liability for the ordinary debts of the professional firm. The LSA's argument for retaining unlimited liability for ordinary debts is set out in a couple of passages. The first passage refers to the legal profession's Code of Professional Conduct:

> The recommended limitation of vicarious liability . . . would not affect a lawyer's responsibility for other commitments incurred by the firm in the normal course of business and would therefore not contravene [the relevant provisions of the Code of Conduct].[321]

The next step in the argument is in a statement that the appropriate vehicle for limiting UL professionals' liability is the LLP rather than the LLC:

> It is appropriate that professionals remain responsible for their own negligence or misconduct as well as firm obligations incurred in the course of business. LLCs typically confer a more complete liability shield than LLPs by also protecting partners from the firm's contractual and general tort liability.[322]

The LSA's concern for the ordinary creditors of a professional enterprise is, however, subject to an important qualification. The particular rule to which the LSA is referring is Rule 3 of Chapter 8 of the Code of Conduct:

> A lawyer having personal responsibility for a financial commitment incurred in the business aspects of practice must ensure that such commitment is fulfilled unless there is reasonable justification for the lawyer's failure to do so.

The official commentary on this rule contains the following elaboration on what is meant by "personal responsibility" for a financial commitment:

> Rule #3 is not intended to apply to debts for which the lawyer has no personal responsibility that have been incurred by a management company or similar corporate entity other than a professional corporation.

In other words, the LSA's statement that professionals should be personally liable for their firms' commitments seems to be subject to the qualification that it does not apply where commitments are prudently incurred through a limited liability entity, such as a management company. Many UL professionals exercise such prudence.

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[321] LSA 1995 at 10.

[322] LSA 1995 at 17.

So far as we are aware, no one argues that unlimited liability for a UL professional firm's ordinary debts is or should be a preemptive rule. Members of a UL professional partnership can arrange for limited liability in contracts with landlords, equipment suppliers and so on. Thus, the question of limited liability for ordinary firm debts of a professional firm is not of transcendental importance. Whether the legal rule is limited liability or unlimited liability, it is a default rule that the parties can contract around if they wish. There does not seem to be any particular reason to treat UL professionals differently than other enterprises with respect to their firms' ordinary contract debts. On the principle of treating like cases alike, perhaps professional firms should be able to adopt a structure that gives them the benefit of a default rule of limited liability for ordinary contract debts, in which case, "[a] third party supplier of goods and services [would be] at liberty to ask for a guarantee or indemnity from the shareholders."[323]

The argument for maintaining the existing default rule of unlimited liability for ordinary contract debts might proceed like this. The members of professional firms are likely either to be relatively sophisticated and knowledgeable about the law or to have the financial resources to hire advisers who are. Some of their ordinary business contracts will be with firms who are equally sophisticated. However, they are also likely to have contracts with suppliers who are less sophisticated or who have fewer financial resources. On this view, the *transparency* criterion[324] for selecting a default rule might favour a default rule of unlimited liability for ordinary contract debts.[325] Of course, if this view were taken seriously, UL professionals would not be allowed to shield themselves from ordinary contractual obligations through the simple expedient of incorporating a limited liability management corporation.

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[323] Stratton & Hughes 1997 at 783.

[324] See Chapter 3 at page 87.

[325] A similar point is made at greater length by Hamilton 1995 at 1092-95. It should be noted, though, that Hamilton's objection is to allowing professional firms (law firms in particular) to obtain the benefit of a default rule of limited liability for ordinary obligations while maintaining the *form* of an ordinary general partnership, with which a default rule of unlimited liability has been associated for centuries. His analysis would not necessarily extend to situations where a professional firm carries on business through an entity that traditionally has been associated with limited liability: i.e a corporation.

ISSUE No. 28
Should UL professionals continue to be required to practise in unlimited liability firms, insofar as ordinary contract debts of the firm are concerned?

ISSUE No. 29
Insofar as ordinary contract debts are concerned, what is the point of requiring UL professionals to practise in unlimited liability firms if they can avoid personal liability through the simple expedient of using a limited liability management corporation?

B. Safeguards

In Chapter 2 we noted that although they have identical labels, the American LLP – especially the dominant Texas model[326] – and the DTI's proposed LLP are very different creatures. The American LLP legislation shields members of LLPs from certain liabilities to which they would be subject as an ordinary partnership but otherwise treats LLPs as ordinary partnerships. The only *quid pro quo* for the liability shield is that, in certain states, LLPs must have a minimum level of insurance.

The liability shield provided by the UK's proposed LLP would come at a higher price. The DTI's proposals contemplate a much more elaborate package of safeguards than is provided by any US LLP statute. It is worth considering whether safeguards similar to those proposed by the DTI should be provided if Alberta's UL professionals were allowed to practice in limited liability entities. We will briefly consider (1) disclosure requirements, (2) "clawback" provisions and (3) minimum "wherewithal" requirements.

1. Disclosure requirements

The DTI has proposed that LLPs be required to disclose certain information about the firm and its members including, most significantly, financial information in the form of audited accounts. Disclosure of information such as the address of the firm, the identity of its members and the identity of its

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[326] In this discussion references to American LLPs can be taken as references to the Texas model.

regulators would be neither terribly problematic for the firms involved nor terribly useful to outsiders. Disclosure of audited accounts, however, would be another matter.

Arguably, audited accounts would be much more useful to outsiders who might deal with a firm than general non-financial information about the firm and its members. It seems like a safe bet, however, that professional firms would be loath to disclose financial information to the public, arguing that it is confidential information that they should be entitled to keep to themselves. The following passage, although somewhat lengthy, provides a good summary of the argument for requiring public disclosure of financial information by professional firms operating as limited liability entities:

> Perhaps *the* most glaring defect of the [Jersey LLP] legislation in relation to disclosure, however, is the absence of a requirement for the LLP to file audited annual accounts. The principle enshrined in most company law codes is that disclosure of material financial (and other) information via this mechanism is a perfectly proper 'price' to be paid for the benefit of limited liability. Firms registering as Jersey LLPs obtain the significant advantage of protection for innocent partners' personal assets; disclosure of key financial information represents a fair *quid pro quo* for the grant of this privilege. Jersey officials, on the other hand, seek to justify this unbalanced aspect of the legislation by claiming that disclosure of financial information via audited annual accounts is characteristically an information aid for actual and potential investors in the company, and that clients contemplating a transaction with the LLP could protect themselves by negotiating access to the LLP's (private) financial statements. On this view, since the partners in a Jersey LLP are also 'the owners' and there are no external investors in the practice, the case for public disclosure of financial information is not established and the extent of any disclosure should be a matter for negotiation between the LLP and its clients. This is an outmoded and legalistic analysis. Given the size and stature of partnerships (especially those in the accountancy and legal services sectors which resemble national and multinational corporations) likely to seek registration as Jersey LLPs, there exists a powerful analogy with modern thinking on corporate governance which recognises a wide range of 'stakeholders' (other than owners) such as employees, creditors and contracting partners ["parties"?] having a very real interest in disclosure of material information relevant to the future prospects of the company.[327]

A less sanguine view of the effect of financial disclosure requirements is evident in the following observations:

> [The DTI's proposed LLP] will be equipped with all the bells, whistles, filing requirements, auditing and reporting baggage (including relevant accounting standards) that have proved to be time-wasting, non-productive burdens on all companies. This baggage can only get heavier with the globalisation of accounting standards – so how relevant can it be to what is still an owner-managed business? Stewardship accounting does not apply, as there are no non- participating shareholders. And where does decision usefulness come in? The lack of publicly available financial information about the big firms has not

[327] Morris & Stevenson 1997 at 548.

> prevented anyone trading with them, appointing them as auditors or making claims. Accounts prepared to comply with accounting standards would be unhelpful and meaningless, as the firms' main assets, reputation, knowhow and client portfolios, such as self-generated goodwill, would not appear on any balance sheet that the Accounting Standards Board would approve. What is also threatening about the DTI proposals is the implication that audited accounts should be publicly filed solely for the benefit of creditors.[328]

From the foregoing passages it is readily apparent that there are different views in the UK about the value and appropriateness of requiring professional LLPs to disclose financial information to the public. When the issue is considered in the context of Alberta professional LLPs, it is important to note that our legislators have taken a different approach to disclosure of *corporate* financial information than UK legislators. The DTI's proposals to impose financial disclosure requirements on professional LLPs are made in the context of a company law that imposes such requirements on companies generally. Canadian legislators, on the other hand, have tended to view public disclosure of financial information as a matter of securities regulation rather than corporations law. For better or for worse, corporations, as such, are not required to make financial information available to the general public, just to their shareholders. Thus, if Alberta professional firms were required to publish financial information as a condition of obtaining limited liability, this would go well beyond the disclosure requirements that are imposed on ordinary (non-distributing) corporations as a *quid pro quo* for limited liability.[329]

ISSUE No. 30
Should professional firms whose members enjoy limited liability be required to publish financial information about themselves as a *quid pro quo* for limited liability, bearing in mind that Alberta corporations are generally not required to publish financial information about themselves unless required to do so by securities law?

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[328] Fearnely & Brandt 1997.

[329] We recognize that a case might be made for imposing more extensive financial disclosure requirements on ordinary business corporations, but a consideration of that issue is beyond the scope of the present project.

2. Clawback

In Chapter 2 we described the DTI's proposed "clawback" requirement as akin to the provisions in the BCA that restrict transfers of assets from a corporation to its shareholders where the corporation is insolvent or would be insolvent after the transfer. Under the DTI proposal, members of an insolvent LLP would be liable to repay "excessive withdrawals" that were effected (1) while the LLP was unable to pay its debts[330] and (2) within two years before the commencement of the winding up proceedings. Unliquidated claims that were later found to be valid would constitute debts for the purpose of determining whether the LLP was insolvent at a particular time. This aspect of the clawback proposal seems to be consistent with the corresponding provisions of the BCA. The BCA provisions refer to transactions that occur when the corporation is (or would after the transaction be) unable to pay its "liabilities." The term "liabilities" is not defined by the Act, nor has it been the subject of judicial consideration in this context, but it probably would include unliquidated claims for damages that have a reasonable chance of being upheld by a court.

The DTI proposal goes further than the BCA in that it would apply to withdrawals regardless of how they are characterized. For example, it would apply to the repayment of a loan made by a member to the LLP, whereas the repayment by a BCA corporation of a loan from one of its shareholders could be attacked, if at all, only under general laws relating to fraudulent preferences. Nevertheless, the DTI's clawback proposal reflects essentially the same principle as the BCA's restrictions on transfer of corporate assets to shareholders. The principle is that where owners of a firm enjoy limited liability, their claims as owners against the assets of the firm should be subordinated to the claims of outside creditors.

Should professional LLPs in Alberta be subject to some sort of clawback requirement similar to that proposed by the DTI? Such a requirement can be supported on the basis that it is analogous to the asset-protection provisions of the BCA and similar restrictions that apply to LPs under the *Partnership Act*. Against such a proposal it might be argued that it would provide unnecessary protection because of the nature of the limited liability entity that has been proposed for Alberta. Members of an LLP would only be

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[330] Or would be unable to pay its debts after the withdrawal or withdrawals.

protected against professional liability claims for which they bear no personal responsibility, whereas the partners of the sort of LLP contemplated by the DTI would shelter behind a broader liability shield. But even if the liability shield proposed for Alberta LLPs is narrower than what is proposed for UK LLPs, the Alberta LLP would still provide significant protection to its members. Outsiders with malpractice claims against an LLP will not be able to look to the assets of innocent partners. It is one thing to argue that innocent partners should not be personally liable for malpractice claims. It is quite another thing to argue that the innocent partners should be able to withdraw assets from the firm when there is a claim against the firm and the claimant's prospect of being fully compensated will be prejudiced by the transfer.

ISSUE No. 31
Would it be appropriate for members of an LLP to be subject to a "clawback" requirement along the general lines of that proposed by the UK DTI: a liability under certain circumstances to repay amounts received from the firm in order to meet the claims of malpractice claimants?

If it were concluded that members of an insolvent LLP should be subject to some type of clawback requirement, its mechanics might be considerably different from those proposed by the DTI. For instance, rather than asking whether the LLP was insolvent at the time assets were transferred from the LLP to one or more of its partners, one could ask a different question. The premise of this question would be that what claimants are entitled to expect is that the aggregate realizable value of the LLP's assets will not be reduced between the time the claim is made and the time it is determined to be valid because of transfers of assets from the partnership to the partners who are not liable for the claim.

Proceeding from this premise, the question would not be whether the firm was insolvent at the time a particular transfer occurred, but whether the realizable value of the firm's assets has been reduced between the time the claim was made and the time it was determined to be valid. If this question was answered in the affirmative, a partner might be subject to a clawback limited to the lesser of the following amounts: (1) their share of the amount by which the net realizable value of the firm's assets available to meet the

claimant's claim has been reduced during the relevant period; and (2) the amount that the partner had received from the firm during that period. It will be noted that under this approach, if the realizable value of the firm's assets stayed the same or increased during the relevant period, a partner would not be subject to a clawback no matter how much they had received from the firm in the meantime.

ISSUE No. 32
Assuming that some sort of clawback provision is appropriate, what sort of transfer of assets from an LLP to a partner should trigger the clawback, and how should the extent of the partner's liability be determined?

3. Minimum wherewithal to satisfy claims

One possible *quid pro quo* for limited liability is to require that a professional firm have the wherewithal to satisfy claims up to a certain amount. There are a variety of techniques by which such a requirement could be implemented. Professional LLPs could be required to maintain a certain amount of "free capital": unencumbered assets with a specified realizable value (or a bond) that would be available to creditors on a liquidation of the firm. The DTI's "conditional personal guarantee" approach seems to be a variation of this technique.

As we understand the DTI's proposal, rather than requiring the firm to maintain a certain amount of free capital, partners would be required to guarantee (on a *pro rata* basis) that the realizable value of the firm's free assets will be £X. This is not quite the same thing as requiring the firm to maintain that level of assets, because it is quite possible that one or more of the partners will not be good for their portion of the guarantee when the time comes. Another technique would be to require LLPs to maintain a minimum level of liability insurance.

Given that we are concerned primarily with malpractice claims, the most straightforward means of implementing a "minimum wherewithal" requirement would be to require LLPs to have a specified minimum level of liability insurance. Indeed, compulsory liability insurance requirements are often imposed on professionals even where they have unlimited personal liability for malpractice claims. The LSA's perspective is as follows:

> The Law Society is of the view that it is not necessary for the Alberta legislation to impose [a minimum insurance] requirement. The self-governing professions have been extremely responsible to date in ensuring that sufficient resources are available to meet legitimate malpractice claims. The legal profession, for example, maintains an assurance fund[331] and an indemnity program under the *Legal Profession Act* and requires each member to maintain minimum levels of professional liability insurance. It is reasonable to assume that the same degree of responsibility would continue under a limited-liability regime, rendering additional statutory protections superfluous.[332]

The LSA's point is not that minimum insurance requirements would be inappropriate, but that they should be left up to the governing bodies of the relevant professions.

The obvious attraction of a minimum insurance requirement is that, to the extent it causes certain firms to purchase more insurance than they would otherwise carry, it increases the likelihood that persons with malpractice claims will get full compensation. On the other hand, it is in the very nature of "minimum" insurance requirements that they will be set at fairly modest levels. If the level of mandatory insurance were set at a level that greatly exceeded the level that most firms would choose in a free market, the insurance requirement would create a significant barrier to entry and increase the cost of the relevant services. The level of mandatory insurance will probably be set at a level that approximates or is less than the amount of insurance that most firms would buy if given a choice. Thus, mandatory insurance requirements, like any type of minimum wherewithal requirement, can best be viewed as a means of protecting clients with relatively modest claims. While valuable, such requirements will not necessarily ensure that professional LLPs have the wherewithal to pay really large malpractice claims.[333]

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[331] The *assurance fund* is not liability insurance. It is a fund to compensate members of the public where, for example, their lawyer misappropriates trust funds.

[332] LSA 1995 at 25.

[333] See e.g. Hamilton 1995 at 1076; Morris & Stevenson 1997 at 546-47 (referring to Jersey's requirement of a £5 million bond). Hamilton makes the following additional point about the Texas LLP statute's $100,000 minimum financial responsibility requirement:

> This requirement seems anomalous because minimum capital requirements have been virtually eliminated for other forms of limited liability entities. A Texas corporation can be created with minimum capital of $1,000; in most states today there is no minimum capital requirement for corporations. . . . It seems odd, to say the least, that an entity providing a complete shield against personal liability can be created with only nominal capital (or with zero capital) while an LLP which provides only a partial shield must maintain a significant capital

(continued...)

ISSUE No. 33
Should LLPs be subject to some sort of "minimum wherewithal" requirement or, more specifically, a requirement to maintain at least a specified minimum amount of liability insurance? Should this be left up to the governing bodies of the relevant professions?

ISSUE No. 34
If LLPs were required to maintain a specified minimum amount of liability insurance how should that amount be established? Should it, for example, be related to the number of professionals who are members of or employed by the LLP?

C. Partnerships or Corporations

In this section we assume that the appropriate liability shield for UL professionals, at least with respect to malpractice claims, is that proposed by the LSA, which is based on the Texas LLP model. Under this model, the assets of the firm are available to satisfy malpractice claims and so are the assets of members who bear personal responsibility for the malpractice. But the personal assets of other members of the firm are not available, except to the extent of any clawback provision that may exist.

Having made the foregoing assumption, we consider whether the specific vehicle proposed by the LSA and ICAA is necessarily the most appropriate vehicle for attaining the proposed objective. Here it is crucial to note that the LSA and ICAA are proposing that the LLP would be available *only* to the UL professions. LLPs would be ordinary general partnerships except in two particulars: (1) their members would have limited liability; and (2) only UL professionals could use them. In Chapter 6 we consider whether there is a case for introducing a new type of hybrid firm to Alberta that would be available to all types of enterprise. For the moment, however, we consider

[333] (...continued)
base. This requirement, however, reflects the force of the political sentiment in Texas that limiting traditional general partnership liability was a radical change taking away something of importance to tort claimants.

whether it is necessary to create a brand new type of entity for which "only professionals need apply."[334]

The ICAA paper seems to assume, rather than argue, that LLPs would be available only to professionals. The LSA argues that LLPs be made available

> *only* to professionals as an expeditious solution to the serious, perhaps urgent, liability exposure of professionals and due to the unavailability to professionals of other means of limiting liability.[335]

There are two contentions here: (1) LLPs are an expeditious solution to a problem; (2) UL professionals do not have other means of limiting liability. UL professionals may practise in PCs, but they do not provide protection from liability.[336] The question we consider here is this. Assuming that the objective is to allow UL professionals limited liability, why not just change the law applicable to PCs so that they do provide the desired level of protection? That is, why not amend the relevant professional statutes so that today's professional corporation would be tomorrow's limited liability professional corporations ("LLPC")?

Neither the LSA's nor the ICAA's submission devotes much attention to the question posed above. However, the following are three rationales that might be offered for choosing the LLP, rather than the LLPC, as the vehicle for providing limited liability to professionals.

(1) The LLP solution is legislatively and administratively less complicated than a solution involving LLPCs.

(2) The LLPC solution would provide professionals with *too much* protection from liability.

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[334] See McGaughey 1996.

[335] LSA 1995 at 20-21. [Emphasis in original.]

[336] LSA 1995 at 18 acknowledges that "there do not appear to be any legal impediments to practising through a limited partnership," but notes several practical difficulties in doing so. The main one is that the limited liability benefit is only available to partners who do not take part in the control of the LP.

(3) UL professionals prefer partnership (with limited liability) to incorporation because of tax and internal governance issues.

We consider each of these issues in turn. Our current view is that it is difficult to see why the LLP is preferable to the LLPC if the policy objective is to put UL professionals on a similar liability footing to the owners of other enterprises.

1. Are LLPs a "Neater" Solution than LLPCs?

As noted above, the LSA and ICAA seem to take it for granted that allowing UL professionals to practice in LLPs is the most efficient solution to the problem of limiting professionals' liability. This seems partly to be based on the contention that LLPs could be brought in merely by making a couple of teeny weeny changes to the *Partnership Act*.[337] No new legislation would be required, and the demands on legislative resources would be minimal. But would modifying the PC to convert it into an LLPC really be any more difficult?

In most respects, PC are ordinary business corporations incorporated under the BCA. The differences between a PC and an ordinary business corporation arise not out of the BCA but out of the relevant professional statutes. In order to get a permit to practice, a corporation must satisfy the relevant governing body – we will use the LSA and lawyers as an example – regarding certain matters. The key requirement is that all shareholders and directors of the corporation be active members of the LSA.[338] A corporation that receives the necessary practice permit is designated as a PC, and is denuded of most of its liability-limiting characteristics by section 129 of the *Legal Professions Act*:

> (1) Notwithstanding anything to the contrary in the *Business Corporations Act*, every person who is a voting shareholder of a corporation during the time that it is the holder of a permit . . . is liable to the same extent and in the same manner as if the voting shareholders of the corporation were during that time

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[337] It might be contended that the proposed teeny weeny change to the law of partnership might be akin to a teeny weeny hole in a balloon: the bang may be disproportionate to the size of the hole.

[338] *Legal Profession Act* s. 127(3). Until 1994 the spouse and other relatives of an active member could be non-voting shareholders of a PC, but the government apparently thought that this provided unwelcome (to the government) opportunities for income-splitting.

> 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.[339]

But for this section, a PC would have the same liability-limiting characteristics as any other corporation. Thus the objective of allowing professionals to operate within limited-liability entities could be achieved by simply repealing – or perhaps modifying – one section in each of a handful of professional statutes. This would not be a complex chore for the legislative drafter nor would its implementation and ongoing administration by the government be onerous.

ISSUE No. 35
In what respect, if any, would it be simpler or more efficient to implement limited professional liability through the LLP vehicle than through the LLPC vehicle?

2. Would LLPCs Provide too much Protection?

The LSA briefly considers whether another hybrid entity, the LLC, would be an appropriate limited liability vehicle for UL professionals. It concludes that LLCs would not be an appropriate vehicle because, amongst other reasons, LLCs would provide UL professionals with too much protection from liability:

> It is appropriate that professionals remain responsible for their own negligence or misconduct as well as firm obligations incurred in the course of business. LLCs typically confer a more complete liability shield than LLPs by also protecting partners from the firm's contractual and general tort liability.

The same argument might be made about LLPCs. If the legislature simply repealed section 129 of the *Legal Profession Act* and similar provisions in other professional statues, UL professionals would be given too much protection. They would be protected from ordinary contractual obligations and general tort liability.

As discussed earlier, it is not altogether clear what the justification is for treating professional firms differently than other firms with respect to

339 The uncertain meaning of this provision is discussed in Stratton & Hughes 1997.

ordinary contract debts and ordinary torts. We have noted that the LSA's concern for the well being of trade creditors of law firms does not seem to extend to trade creditors of law firms' management corporations. Nevertheless, we will assume here that the preferred policy is to leave UL professionals with personal liability for contract debts (at least as the default rule) and ordinary tort liabilities of their firms.

Given the preferred policy, it would not be difficult to provide the same level of liability protection that would be provided through an LLP by modifying the wording of section 129 of the *Legal Profession Act* (and similar provisions in other professional statutes) so that it would read something like this:

X Shareholder liability

(1) In this section "malpractice liability" means a liability arising from negligence, incompetence, wrongful acts, or misconduct in the provision of professional services, whether the liability is characterized as direct, vicarious, contractual, tortious or otherwise.

(2) Notwithstanding anything in the *Business Corporations Act*, where a professional corporation incurs a malpractice liability, any shareholder of the corporation who was directly involved in the conduct that gave rise to the liability or who
- (a) was directly responsible for supervising or controlling that conduct, or
- (b) had notice or knowledge of or control over that conduct at the time it occurred and failed to take reasonable steps to prevent or cure it

is personally liable for that malpractice liability jointly and severally with the corporation and any other person who is liable for that malpractice liability.

(3) Where a professional corporation incurs any liability other than a malpractice liability, every shareholder of the corporation is liable jointly and severally with the professional corporation and each other for that liability.

(4) Nothing in this section invalidates or renders unenforceable an agreement respecting the liability of a shareholder of a

professional corporation where that agreement would otherwise be valid and enforceable.[340]

One structural difference between the foregoing provision - call it *section X* – and the LSA's proposed provision is in their respective starting points. The LSA proposal would provide a partial liability shield to owners of a type of firm – an ordinary partnership – that does not now provide any liability shield. Section X would reach the same result by poking holes in the liability shield currently provided by an ordinary business corporation. When all is said and done, it seems that both shields would let through the same liability missiles.

ISSUE No. 36
Would the proposed "section X" provide shareholders of an LLPC with essentially the same liability shield as would be provided by the proposed LLP?

Would malpractice claimants be better off having a claim against an LLPC or an LLP? There should be no difference insofar as their claims against particular shareholders or partners are concerned. Whether the firm is an LLPC or an LLP, the same professionals – those who are implicated in personal malpractice – would be personally liable. However, insofar as recovery from the firm's assets is concerned, it could make a difference whether the firm is structured as an LLP or an LLPC.

If the firm was an LLPC, its shareholders might structure their contributions to the firm's capital primarily as secured debt rather than equity. Thus, virtually all of the LLPC's assets might be subject to security interests held by its shareholders. On ordinary principles, this secured debt would have priority over the claims of subsequent creditors of the LLPC, including malpractice claimants. This could not occur if the firm was organized as an LLP because the LLP would not be a separate legal entity.[341] Since the LLP would simply be an aggregate of the partners, they could not

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[340] The effect of subsection (4) would be to make it clear that section X is intended to create a default rule rather than a preemptive rule. Some other legislative or common law rule might restrict the ability of professionals to limit their liability by contract.

[341] At least, the LLP would not be a separate legal entity under the proposals that have been made.

make a loan to themselves, much less grant themselves security for it on the common law principle that you cannot make a legally enforceable contract with yourself. On the other hand, as discussed earlier, the members of an LLP would have an incentive to keep it as asset-free as possible, particularly where a malpractice claim might be looming.

It would be fairly easy to ensure that shareholders of an LLPC could not give themselves a leg up on malpractice creditors of the LLPC through the mechanism of secured debt. The LLPC provisions of the relevant professional statutes might simply provide that any security interest granted by an LLPC to one or more of its shareholders is void. This would be similar to the approach taken by section 59(a) of the *Partnership Act* with respect to loans by limited partners to an LP. Or the provision might go further and stipulate that any unsecured loan by a shareholder to an LLPC is subordinate to any malpractice claims against the LLPC.[342]

ISSUE No. 37
If UL professionals were permitted to practise in LLPCs, would it be appropriate to provide that any security interest granted by the LLPC to one or more of its shareholders is void? Would it be appropriate to provide that any loan by a shareholder to the LLPC is subordinate to malpractice claims against the LLPC?

3. Professionals' Preference for LLPs

Even if the LLP approach does not have any inherent advantage over the LLPC approach in terms of legislative simplicity or protection of the public, it is possible that UL professionals – or some of them – would simply rather practice in LLPs than in LLPCs. Liability rules aside, they might perceive that the partnership form has certain advantages over the corporate form. Possible reasons for such a preference might include the following: (1) internal governance issues (e.g. unity of ownership and management functions); (2) income tax or other fiscal issues; (3) the interface with other areas of the law (e.g. securities regulation). However, if the object of the exercise is to put UL professionals on approximately the same liability

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[342] It would not be necessary to protect ordinary contract creditors of the LLPC, since the default rule would be that shareholders would be personally liable for contractual obligations of the LLPC.

footing as other enterprises, the possible preference of some or all UL professionals for LLPs over LLPCs does not seem like a compelling reason for choosing the LLP route, *if LLPs would only be available to certain professions.* We will briefly consider some issues that might cause some professionals to prefer LLPs to LLPCs, and ask whether those issues are unique to professionals.

a. Internal Governance Issues

As mentioned in Chapter 2, and as will be discussed again in Chapter 6, members of a partnership have somewhat more flexibility than the shareholders of a business corporation in how they structure their internal relationships. This flexibility might be considered by the members of some professional firms to make the partnership form preferable to the corporate form, all else (especially liability exposure) being equal. They might prefer to have both the flexible internal structure of partnership and limited liability, rather than being forced to choose between the two. That, however, is a preference that is not necessarily unique to members of the UL professions. If UL professionals were required to choose between the advantages of ordinary partnerships and the advantages of limited liability, they would be in much the same position as the owners of other enterprises.[343] It is difficult to see why UL professionals should get exclusive access to an entity that combines advantages of ordinary partnerships with advantages of corporations or limited partnerships.

We might also note that the LLPC is consistent with professional firms' maintaining their existing partnership structures if they wished to do so. Suppose that the members of an existing UL professional partnership wanted to take advantage of the liability-limiting features of the LLPC. Either of two approaches could be taken. The first would be to transfer the partnership business to an LLPC, with members exchanging their partnership interests for shares in the LLPC. The firm would then have the structure of an ordinary corporation, with directors, officers, employees and shareholders.

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[343] It may be objected that the analogy breaks down because the liability shield provided by an LLPC or LLP would not be as bullet-proof as the liability shield provided to the shareholders of ordinary corporations. However, it may be replied that even an ordinary corporation would not protect shareholders or managers against personal malpractice, so there is not a great deal of difference between either an LLPC or an LLP and an ordinary corporation on that issue. As for the default rule of unlimited liability for ordinary contract debts, it would not be difficult for the LLPC or LLP to contract around that rule, or to avoid it altogether by the use of an ordinary corporation as a management company.

Another approach would be for the firm to remain as an ordinary partnership, but for each professional to transfer their partnership interest to their personal LLPC.

It is worth considering how the liability shield would operate where the partnership structure is preserved, with LLPCs instead of individuals as the partners. Since the LLPCs are partners of an ordinary partnership, traditional partnership principles would apply as between the LLPC partners and as between creditors of the firm and the firm's LLPC members. That is, each LLPC would be liable for all liabilities of the firm, including malpractice liabilities, on ordinary partnership principles. To the extent that liabilities thus incurred by the LLPCs came within section X(2) or X(3), the shareholder of the LLPC would be jointly and severally liable for the liability with everyone else who was liable for it. But if the shareholder was not personally involved in the conduct that created a malpractice liability, the shareholder would not be personally liable for their LLPC's liability.[344]

> **ISSUE No. 38**
> **Compared to owners of other types of enterprises, would UL professionals suffer particularly heavy burdens relating to the governance and other internal business of their firms if they had to use the LLPC vehicle instead of the LLP vehicle?**

b. Income Tax Issues

The general point made above applies to income tax issues. For certain tax purposes, certain professionals might prefer to be regarded as members of a partnership (LLP) rather than as shareholders of a corporation (LLPC). It is also possible that certain professionals would have the opposite preference. In any event, so far as ongoing tax consequences are concerned, it may be suggested that any tax planning preferences for the LLP form are as likely to be shared by barbers, engineers, drycleaners (etc.) as by UL professionals.

One difference between UL professionals and barbers, engineers, drycleaners and so on is that the latter are unlikely to be currently carrying

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[344] Of course, the prudent LLPC shareholder would not leave a lot of assets hanging around in their LLPC, since those assets would be available to all creditors of the partnership.

on business as large partnerships. They do not have to worry about the one-time tax consequences of moving from the partnership form to the corporate form in order to take advantage of limited liability. If the members of existing professional partnerships would incur significant tax liabilities as a result of moving from the partnership form to the corporate form, the benefits of the LLPC form might in practice be unattainable.

The foregoing is a serious issue. However, it would appear that the one-time tax consequences of transferring the professional enterprise from a partnership to an LLPC could be minimized by utilizing the "rollover" mechanism provided by subsections 85(2) and 85(3) of the ITA. And as discussed in the preceding section, an alternative to turning an existing partnership into an LLPC would be to turn the individual partners into LLPCs, for which tax rollovers would also be available. In short, we suspect that the one-time tax consequences to professionals who wanted to take advantage of the LLPC form would not be particularly onerous. And we are confident that if we are wrong in our suspicions, the proponents of the LLP form will not hesitate to point out the error of our ways.

> **ISSUE No. 39**
> **As compared to other enterprises, would UL professionals suffer particularly onerous tax burdens if they had to use the LLPC vehicle to get the benefit of limited liability instead of the LLP vehicle?**

4. Interface with other Laws and Legislation

In comparing the LLPC with the LLP, it is necessary to take account of how either vehicle might be affected by other laws or legislation. Would the particular characteristics of UL professionals, or UL professional firms, make one of the vehicles less suitable than the other because of how they would react with other legislation? Again, we are particularly interested in the question of whether requiring UL professionals to use the corporate form if they want the benefits of limited liability would work a particular hardship on UL professionals, as compared to owners of other types of enterprise.

a. Securities regulations

In its submission to the Alberta government the LSA considered whether LLPs should be treated as ordinary partnerships or limited partnerships. It

was pointed out that "[i]n the case of lawyers, for example, there do not appear to be any legal impediments to practising through a limited partnership, but there are a number of practical impediments" to doing so.[345] For present purposes, the relevant impediment is that "[i]f characterized as a limited partnership, the LLP may be subject to regulation under the *Securities Act.*" This raises the question of whether LLPCs might also be subject to regulation under the *Securities Act.*

Clearly, shares in an LLPC fall within the Act's definition of a security, and some transactions involving such shares could be regarded as distributions. However, the Act's prospectus requirements do not apply to transactions involving "private companies," which are defined as corporations with fewer than 50 shareholders that do not issue shares to the public. Since the professional statutes require all shareholders to be members of the relevant profession, it seems likely that any LLPC with fewer than 50 shareholders would fall within the private company exemption.

A number of Alberta UL professional firms – especially accounting and law firms – have more than 50 members. If they were LLPCs, they would have more than 50 shareholders and would not come within the private company exemption in the *Securities Act*. There are, however, other exemptions that would probably apply to prevent transactions in LLPC shares being subject to the prospectus requirements of the *Securities Act*. Of course, if they chose to take advantage of the LLPC vehicle by becoming partnerships with LLPC members, the firm would remain a partnership and each LLPC would have but one shareholder. In any event, if the *Securities Act* would create a problem for large professional LLPCs, the relevant professional statutes could simply provide that the *Securities Act* does not apply to transactions involving shares of LLPCs. Since LLPCs would be prohibited by statute from having shareholders who are not members of the relevant professions, it seems highly unlikely that any transactions involving LLPC shares would engage the investor-protection goals of the *Securities Act.*

ISSUE No. 40
In what circumstances, if any, would transactions involving shares of LLPCs be caught by the requirements of the

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[345] LSA 1995 at 18-19.

Securities Act? Is there any reason why it would be inappropriate to provide in the relevant professional statutes that the _Securities Act_ does not apply to transactions involving shares of LLPCs?

b. General corporate disclosure requirements

As ordinary partnerships, Alberta professional firms of all sizes currently are immune from the public disclosure requirements that apply to the tiniest of corporations. Indeed, they are not even subject to the disclosure requirements that the *Partnership Act* imposes on partnerships formed for the purpose of carrying on many other businesses. Therefore, professional firms might prefer to remain partnerships simply to avoid having to comply with the disclosure requirements that apply to corporations. We have already noted that the public disclosure requirements that the BCA imposes on Alberta corporations are far from onerous. No public disclosure of financial information is required because public disclosure of financial information is regarded as an issue of securities market regulation rather than corporate law. In any event, it does not seem that the BCA's disclosure requirements would be more onerous for UL professionals than they are for other enterprises who wish to obtain the benefits of limited liability.

ISSUE No. 41
Would the _BCA_'s public disclosure requirements impose more onerous burdens on UL professionals than they impose on owners of other types of enterprises?

c. Multijurisdictional professional firms

The larger accounting firms have for many years carried on business without much concern for territorial boundaries, whether intranational or international. This practice is becoming more prevalent for law firms and, so far as we know, there is no inherent reason why other UL professionals might not wish to establish multijurisdictional firms. So far as we are aware, there is no reason to think that the LLP would be a better vehicle for interjurisdictional professional travel than the LLPC would be.

In fact, it may well be that the LLPC, being essentially an ordinary corporation with a slightly leaky liability shield, would avoid or at least

reduce some of the uncertainties that are associated with the LLP. In its submission to the Alberta Government the LSA noted that recognition of LLPs' liability-limiting characteristics in other jurisdictions would be an issue:

> The effect in other jurisdictions of an amendment to Alberta's *Partnership Act* is uncertain. One issue is whether other courts would recognize the limitation on liability if suit were brought in a jurisdiction other than Alberta. Another issue is whether, if a plaintiff obtained judgment in that other jurisdiction on the basis of unlimited liability, Alberta courts would enforce it in this province under reciprocal enforcement legislation.
>
> It is difficult to predict what path a particular court, or courts in general, might follow, particularly in the absence of an existing body of law. It is submitted, however, that the resultant uncertainty is not sufficient reason to delay implementation of unlimited liability in Alberta.

It would seem that the limited liability afforded by Alberta law to an LLPC might be less problematic than that of an LLP. To the extent that an Alberta LLP's uncertain status would be based on its departure from traditional partnership principles, this would not be an issue with an LLPC. The notion that the shareholders of a corporation – even a corporation that provides professional services – might enjoy limited liability will not strike courts in other jurisdictions as a novel concept.

Although we suspect that, so far as its *form* is concerned, the LLPC would be a more robust limited liability vehicle for multijurisdictional travel than the LLP, we doubt that the reception of this vehicle in other jurisdictions will have much to do with its form. Rather, its reception will have more to do with how the government of a particular jurisdiction regards the concept of UL professionals practising in limited liability entities. If they see nothing wrong with the concept, then an Alberta limited liability professional entity might encounter no difficulty at all. On the other hand, if they regard limited liability professional entities as an abomination, the Alberta entity would likely receive a rather rude reception regardless of its form.

ISSUE No. 42
What would be the relative advantages and disadvantages of the LLP and LLPC in a multijurisdictional setting?

CHAPTER 6. A NEW HYBRID BUSINESS ENTITY

A. Chapter Overview

This chapter is not concerned with the liability problems of UL professionals or any other specific type of enterprise. The relationship between this chapter and the preceding chapters is that they all consider whether Alberta law should be modified to create a new hybrid business entity. But whereas the preceding chapters considered that issue in the context of professionals who cannot currently practise in limited liability entities, this chapter considers whether there is a case for creating a new hybrid business entity that would be available to any type of enterprise. It also considers, in a very preliminary way, what the entity might look like. It should be noted at the outset that when we speak of a possible "new" hybrid business entity, we are not suggesting that such an entity would necessarily be dramatically different from business entities that are currently available under Alberta law. A new hybrid business entity might inherit almost all of the characteristics of one of its parent entities.

In section B, we consider in a very preliminary way whether there is a need, or at least a case, for a new Alberta hybrid business entity ("NAHBE") that would be available to all business enterprises in Alberta. We consider two sorts of rationales that might be offered for creating a NAHBE. The first has to do with taxation issues, both domestic and trans-border. The second relates mainly to a debate over the appropriate balance between the freedom of members of business entities to order their internal affairs as they see fit and the perceived need to ensure minimum standards of fairness and good faith in dealings between the participants in business enterprises.

Section C considers what a NAHBE might look like, if it were to be created. Again, the discussion is of a very preliminary nature. At this point in time, we do not know whether the demand for a NAHBE is strong enough to warrant detailed consideration of what its characteristics might be. If the responses to this paper indicate that further consideration is warranted, we will do so in the next phase of this project.

At the end of Section C we raise the question of whether the NAHBE might be, in essence, a spruced-up LP in which limited partners could

participate in control of the partnership without having to put down the limited partner's liability shield. They would, however, be subject to the same liabilities as directors of a corporation.

B. The Case for a New Alberta Hybrid Firm

1. A Taxing Question

As discussed in Chapter 2, LLCs originated in the United States essentially as tax planning vehicles: entities that would have many of the attributes of corporations but would be classified as partnerships for the purposes of the US Internal Revenue Code. The original purpose of state LLC legislation reveals itself in some of the idiosyncrasies of the LLC structure. These idiosyncrasies reflect the idiosyncrasies of the Internal Revenue Service's approach to entity-classification that prevailed at the time the LLC legislation was adopted.

That a substantial number of Canadian enterprises are organized as LPs testifies that in Canada, too, it is sometimes advantageous to employ a vehicle that combines limited liability and flow-through taxation. However, as a business vehicle the traditional LP has certain disadvantages, the principal one being that investors who want limited liability and flow-through taxation cannot take part in the control of the business. If they take part in the control of the business, they are treated as general partners for liability purposes. Therefore, Alberta entrepreneurs and investors might appreciate a NAHBE that combined the following characteristics: (1) limited liability; (2) flow-through taxation; and (3) flexible internal governance, including the ability of owners to take part in the control of the business without losing the benefit of limited liability. Another possibility is that a NAHBE could have characteristics that would make it attractive where international tax issues, particularly Canada-US tax issues, are a concern.

a. Domestic taxation issues

Suppose that some Alberta residents (the "owners") want to launch a business enterprise with the three characteristics mentioned in the preceding paragraph. Most of the owners will not actively participate in the business, but they want to have some say in how the enterprise is conducted. They are interested in flow-through taxation for two reasons. Firstly, it is expected that the enterprise will incur substantial losses during the first few years of operation. Rather than waiting until the enterprise becomes profitable to

apply its accumulated tax losses against profits, the owners want to apply their respective share of the losses as they occur against their taxable income from other sources. Secondly, the enterprise is on a large enough scale that once it does become profitable the small business deduction would not be available if the enterprise were carried on through a corporation. Moreover a substantial proportion of the anticipated profits will be paid out to owners as they are earned. Flow-through taxation will result in a somewhat lower overall tax bite than if the enterprise's income were taxed first at the corporate level and then when paid out to shareholders as dividends.[346]

The owners can achieve two of their three objectives by structuring the enterprise as an LP whose general partner is a corporation that is not overly endowed with assets. Subject to the *ITA*'s "at risk" rules, the limited partners would be able to apply their respective shares of the initial years' losses against their income from other sources. The problem with the LP, however, is that any of the limited partners who served as directors or officers of the general partner would risk being treated as general partners themselves. Under the current provisions of the *Partnership Act* and under the current state of legal authorities, the limited partners of an LP are assured of limited liability only if they take no part in the control of the partnership business, whether as directors or officers of the corporate general partner or otherwise.[347] In some enterprises that may not be a problem, but in the hypothesized situation the owners want to have some say in the operation of the enterprise.[348]

Although it still might not be an ideal business vehicle, the LP would satisfy the owners' three main objectives if the limited partners could serve as officers and directors of the corporate general partner without running the

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[346] See the brief discussion of this subject in Chapter 2.E.2.

[347] See Chapter 2.F.1(a).

[348] The enterprise might also be set up as a business trust with a corporate trustee. As noted in Chapter 2.F.2(a), however, the extent to which the beneficiaries of a business trust may participate in the management of the trust (e.g. as officers and directors of the corporate trustee) without being regarded as members of a partnership is open to debate. Another drawback which would be important to the owners in this case is that the business trust would only achieve half of the owners' tax planning objectives. There would be no double taxation, but the early years' losses could not be applied by the individual owners' against income from other sources. The losses would have to be carried forward and applied against future earnings of the trust.

risk – a very substantial risk – of being regarded as general partners. Thus, we suspect that there would be considerable interest in a NAHBE that was basically an ordinary LP in which limited partners who wanted to retain the benefit of limited liability were not barred from participating in the control of the enterprise.

b. Cross-border taxation issues

If we look beyond a purely domestic context, we find situations where international tax considerations and the differences between Canadian and American tax laws are relevant. One example is where a US citizen wishes to establish a business in Canada:[349]

> A US citizen individual (who may also be a Canadian citizen) wishes to establish a business in Canada. Because she must file both Canadian and US income tax returns, she seeks tax advice on the entity. Her choices are an ABCA corporation (which would leave her subject to onerous US rules applicable to foreign corporations), a Canadian partnership (with unlimited liability), or a Nova Scotia unlimited liability company (which has an obsolete structure and unlimited liability but avoids the US tax rules because it is treated as a partnership for US tax purposes). Most would choose the ABCA corporation for Canadian tax reasons and bear US double tax and substantial US tax compliance costs.

Another example involves a situation where one investor is from Canada and the other from the United States:

> A US business and a Canadian business wish to establish a joint venture. The US business wants partnership tax treatment for US purposes. The Canadian business does not want unlimited liability for the business. Use of a Nova Scotia unlimited liability company satisfies the US business only. Use of a limited partnership satisfies only the US business because of the risk of unlimited liability for the Canadian business because of its role in managing the entity. They ultimately decide to use a US LLC.

Obviously, these examples ignore many complexities of the relevant tax law, but they illustrate the desirability of entities that combine limited liability and partnership status for the purposes of United States tax law. It may also be observed that the firm may wish to be treated as a partnership for American tax purposes and a corporation of Canadian tax purposes.[350]

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[349] The two examples were provided to us by Mr. David G. Roberts.

[350] See Lanthier 1993, *passim*, esp. at 3:20-3:24.

ISSUE No. 43
How much demand is there for a hybrid business entity that would combine the attributes of (1) flow-through taxation for Canadian tax purposes, (2) limited liability, and (3) the opportunity to participate in management without losing the benefit of limited liability.

ISSUE No. 44
How much demand is there for a hybrid entity that would combine (1) flow-through taxation for US tax purposes, (2) entity-level (corporate) taxation for Canadian tax purposes, (3) limited liability, and (4) the opportunity for owners to participate in management without losing the benefit of limited liability.

c. Tax policy and hybrid entities

It has undoubtedly occurred to many readers that neither the Alberta government nor the federal government will necessarily have the same enthusiasm for an improved tax planning vehicle as its prospective passengers might have. Indeed, it is not unreasonable to suppose that government enthusiasm would be inversely proportional to that of prospective passengers. Even if it is supposed that many investors and entrepreneurs might wish for a vehicle that provides flow-through taxation, limited liability, and management participation, there is the question whether there are persuasive reasons of principle or policy for the government to provide a NAHBE with these attributes.

One argument for doing so might be that, from the perspective of tax policy, it is difficult to see the connection between the issues of the availability of flow-through taxation and the ability of owners with limited liability to participate in management of the enterprise. Flow-through taxation applies to members of ordinary partnerships, who participate in management but have unlimited liability. Flow-through taxation applies to limited partners in LPs, who have limited liability but no ability (or uncertain ability) to participate in the control of the enterprise. Thus, with presently available business entities owners can have flow-through taxation with limited liability or flow-through taxation with management participation but not both. It is difficult to see why, in principle, the

combination of limited liability and management participation should affect the appropriateness of flow-through taxation.

Indeed, it does not seem that the reasons why LPs are treated as partnerships for tax purposes has anything to do with the fact that existing provincial law prevents limited partners from participating in control. Rather, the reasons are purely formal: LPs are not taxed as corporations because they are not "corporations" as Revenue Canada defines that term. The ITA itself does not define the term "corporation" in any helpful way, but Interpretation Bulletin IT-343R[351] gives Revenue Canada's views on what constitutes a corporation:

> 2. A corporation is an entity created by law having a legal personality and existence separate and distinct from the personality and existence of those who caused its creation or those who own it. A corporation possesses its own capacity to acquire rights and to assume liabilities . . . As long as an entity has such separate identity and existence, the Department will consider such entity to be a corporation even though under some circumstances or for some purposes the law may ignore some facet of its separate existence or identity.

There is no hint here that Revenue Canada regards any characteristic of a business entity other than its "legal entity" status as significant to the characterization issue.[352] Indeed, if anything, it might be thought that direct participation by owners in management would be more characteristic of partnerships than corporations.[353]

On the other hand, it would not be surprising if government revenue authorities, at both the provincial and federal level, are less concerned with

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[351] September 26, 1977.

[352] Apparently, considerable scope for trans-border tax planning is provided by the fact that Revenue Canada and the IRS do not necessarily classify entities in the same way. Investors may prefer an entity that is regarded for US tax purposes as a partnership and for Canadian tax purposes as a corporation: Lanthier 1993 at 3:20-3:27.

[353] As mentioned in Chapter 2, the US has recently adopted a "check-the-box" classification scheme that allows many business entities to elect whether they will be taxed as corporations or partnerships. Prior to that, a business entity would be treated as a corporation for federal tax purposes only if it had more than two of the four "corporate characteristics:" (1) continuity of life; (2) limited liability; (3) separation of management and ownership; and (4) free transferability of ownership interests. It will be noted that participation by owners in management counted as a *partnership* characteristic, rather than a *corporate* characteristic. In other words, direct owner participation in management was regarded as an argument *in favour* of flow-through taxation.

the niceties of the conceptual characterization of business entities than with the bottom line. It may be that revenue authorities find the control constraint on limited partners convenient simply because it makes the LP less desirable to many enterprises than it would be when viewed purely from the perspective of its treatment for taxation purposes. Revenue authorities' fear might be that if the control constraint were removed, many enterprises that already would be organized as LPs but for that constraint would become LPs, with negative implications for tax revenues.

> **ISSUE No. 45**
> **What would be the fiscal implications for the federal and provincial governments of the creation of a hybrid business entity that combines limited liability, flow-through taxation and owner participation in management?**

2. No courts please, we're LLCs

In its 1995 discussion paper on the law of business corporations, Alberta Municipal Affairs Registries summarized some of the key characteristics of the LLC.[354] It noted that the LLC's chief attraction in the US was its tax characteristics but went on to observe:

> The obvious advantage to creating an LLC is that the members can tailor the operating agreement to suit their individual needs. This offers the members tremendous flexibility over their internal governance. This allows the members to choose their own procedures for matters like calling of meetings, voting, and quorums.[355]

After noting that the exact concept of the LLC might not be ideal for Alberta, the paper suggested that

> . . . the concept of creating a new type of business entity may be beneficial in the Alberta marketplace.
>
> In Alberta, the majority of corporations formed are closely held small businesses. The flexibility and reduced regulation this type of business organization offers, makes it particularly attractive to small businesses. This structure may also be attractive to joint ventures in oil and gas, mining, and real estate development.

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[354] Alberta Registries 1995 at 24-25.

[355] Alberta Registries 1995 at 25.

Does Alberta need to look for additional way of creating and managing business entities?[356]

It is somewhat ironic that we are now looking at the LLC as a possible model for a new type of hybrid firm. In conception at least, the roots of the modern American LLC lie in the unincorporated joint stock company that flourished in Britain in the eighteenth and early nineteenth centuries.[357] The irony is that our *Companies Act*, which has more or less been in mothballs since Alberta adopted the American-style BCA in the early 1980s,[358] is a direct descendant of the British unincorporated joint stock company. Perhaps all we need to do to take advantage of the advantages of the LLC is to dust off and spruce up the *Companies Act*, and give business enterprises the choice of incorporating under the *Companies Act* or the BCA![359]

The heading of this section reflects a feature of LLCs that is not specifically mentioned in the Alberta Registries paper, but which is seen by some American commentators as the primary non-tax benefit of the LLC structure. As compared to American state business corporations statutes (or the BCA), their LLC statutes provide LLC members with more opportunity to order their own affairs by agreement without having to worry about their decisions being second-guessed, *ex post facto* by the courts:

> . . . [a] small but growing number of states [have chosen] to use the occasion of drafting their new LLC statutes to declare their displeasure with evolving case law affecting small business entities. These states, which include the single most important state in corporate jurisprudence, Delaware, attempted to deliver to state courts a message: "Stop the officious (although admittedly well-intentioned) meddling with the internal affairs of small businesses." Most of the changes aim at increasing the flexibility and autonomy of

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[356] Alberta Registries 1995 at 25. [Emphasis in original.]

[357] Carney 1995 at 860-72.

[358] The *Companies Act* has not been repealed, and not-for-profit companies can still be formed under it. However, profit-oriented corporations must be incorporated under the BCA. Moreover, profit-oriented companies that were in existence when the BCA came into force were required to "continue" under that Act.

[359] As readers may suspect, we are not entirely serious about bringing the *Companies Act* out of mothballs insofar as it relates to for-profit businesses. However, the analogy between creating an LLC-like entity and dusting off the *Companies Act* is instructive. Allowing business entities (or some business entities) the option of adopting an LLC-like structure would come at the cost of having essentially two parallel business corporation structures for the province.

> firm participants in ordering, free from court restructuring, their firms' internal affairs through the firms' constitutional documents.[360]

Many US commentators and legislators are less sanguine about the benefits of an unrestricted "freedom of contract" approach to firm governance.

The matter of the duties that are owed by the managers of an enterprise to its owners, and the related matter of duties that may be owed by the owners to each other, illustrates what is at stake. American business corporations statutes, like the BCA and other Canadian business corporations statutes, tend to impose certain non-waivable duties on the managers (directors and officers) of a corporation. Section 117 of the BCA, for example, contains the following stipulation of directors' duties:

> (1) Every director and officer of a corporation in exercising his powers and discharging his duties shall
> (a) act honestly and in good faith with a view to the best interests of the corporation, and
> (b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.
> (2) Every director and officer of a corporation shall comply with this Act, the regulations, articles, by-laws and any unanimous shareholder agreement.
> (3) Subject to section 140(7), no provision in a contract, the articles, the by-laws or a resolution relieves a director or officer from the duty to act in accordance with this Act or the regulations or relieves him from liability for a breach of that duty.

The key aspect of this provision, for our purposes, is that the duties are essentially non-waivable.[361] They are preemptive rules rather than default rules.

While section 117 does not apply to shareholders as such, BCA section 234 provides a broad "oppression remedy" that can be invoked by just about anyone who feels that they have been "oppressed" by the actions of the corporation, which would include actions of majority shareholders:

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[360] Oesterle 1995 at 883.

[361] Section 140(7) specifies that to the extent that a unanimous shareholder agreement restricts the powers of the directors, the duties and liabilities that would otherwise fall on the directors fall upon the shareholders. Thus, rather than providing for the waiver of directors' duties, it provides for their transfer to the shareholders.

> (1) A complainant[362] may apply to the Court for an order under this section.
> (2) If, on an application under subsection (1), the Court is satisfied that in respect of a corporation or any of its affiliates
> (a) any act or omission of the corporation or any of its affiliates effects a result,
> (b) the business or affairs of the corporation or any of its affiliates are or have been carried on or conducted in a manner, or
> (c) the powers of the directors of the corporation or any of its affiliates are or have been exercised in a manner
>
> that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of any security holder, creditor, director or officer, the Court may make an order to rectify the matters complained of.

The section goes on to provide a very long list of things that the court can do "to rectify the matters complained of."

In Canada in recent years there has been considerable discussion and debate of the rationale for imposing broad non-waivable duties on directors of corporations[363] or of giving courts broad powers to intervene, after the event, to rectify corporate actions that they consider to be oppressive or unfair.[364] A similar debate has taken place in the US. In the US, however, the explosion of LLC and LLP statutes (especially the former) has added another dimension to the debate. In most American states, enterprises – especially closely held enterprises – may be structured either as LLCs or as ordinary business corporations. There is thus a debate as to how far LLC statutes should depart from corporations statutes in defining (or not defining) the rights and duties of members and mangers as between themselves.

What is at stake in the debate can be illustrated by comparing the approach of the ULLCA and the Delaware LLCA. The former specifies that members of a member-managed company and managers of a manager-managed company are subject to (1) a duty of loyalty and (2) a duty of care, and further specifies that a member or manager must discharge duties and exercise rights under the Act or operating agreement "consistently with the

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[362] The term "complainant" is defined in s. 231 to include security holders, directors, officers and "any other person who, in the discretion of the Court, is a proper person to make an application under this Part."

[363] See e.g. ALRI 1989; Howard 1991; Cheffins 1991; Chapman 1993; MacIntosh 1993.

[364] Cheffins 1990; Chapman 1996.

obligation of good faith and fair dealing."[365] The content of these duties is described in some detail. For example, the duty of care "is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law." But for our purposes, the interesting issue is the extent to which the duties, as specified, may be waived or modified by the members.

As mentioned in Chapter 2, under the ULLCA the operating agreement is the basic constitutional document for an LLC. The flexibility that is afforded to the members to order their internal affairs is illustrated by the following description of the function of the operating agreement:

> The operating agreement is the essential contract that governs the affairs of a limited liability company . . . . [T]he only matters an operating agreement may not control are specified in subsection (b). Accordingly, an operating agreement may modify or eliminate any rule specified in any section of this Act except matters specified in subsection (b). To the extent not otherwise mentioned in subsection (b), every section of this Act is simply a default rule.[366]

What the operating agreement may not do is:

> (1) unreasonably restrict a right to information or access to records under Section 408;
> (2) eliminate the duty of loyalty . . . but the agreement may:
>   (i) identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable; and
>   (ii) specify the number or percentage of members or disinterested managers that may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty;
> (3) unreasonably reduce the duty of care . . .
> (4) eliminate the obligation of good faith and fair dealing . . . but the operating agreement may determine the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable.[367]

Delaware's LLCA takes a different approach. To begin with the Delaware LLCA states that "[i]t is the policy of this chapter to give the maximum effect to the principles of freedom of contract and to the

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[365] ULLCA §409. Section 409(h) specifies that a member of a manager-managed company "who is not also a manager owes no duties to the company or to the other members solely by reason of being a member."

[366] ULLCA §103 Comment.

[367] ULLCA §103(b).

enforceability of limited liability company agreements."[368] The Act does not expressly impose any internal duties on managers or members. That is left up to the members to determine by agreement. Anticipating that duties may be imposed on members or managers under judicial doctrines, the Act provides:

> To the extent that, at law or in equity, a member or manager has duties (including fiduciary duties) and liabilities relating thereto to a limited liability company or to another member or manger:
>
> . . .
>
> (2) The member's or manager's duties and liabilities may be expanded or restricted by provisions in a limited liability company agreement.[369]

If interpreted broadly (as the Delaware legislature has indicated it ought to be) this provision would seem to allow members of an LLC to prospectively relieve managers of any duty to take care, act in good faith, or exhibit any loyalty to the firm or its members.

Some commentators argue that virtually everything should depend on the agreement of the members, and that there should be no preemptive rules regarding the internal affairs of LLCs.[370] Other commentators take a less sanguine view of a virtually unrestricted "freedom of contract" approach to firm governance.[371] Still others argue that the new statutory provisions are not likely to make much difference when all is said and done:

> My analysis of the development of this new form of business, placed within the context of business associations generally, suggests LLC law will look a lot like existing corporate or partnership law.[372]

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[368] LLCA (Delaware) §18-1101(b).

[369] LLCA (Delaware) § 18-1101(c).

[370] See e.g. Oesterle 1995; Ribstein & Kobayashi 1995. The latter article criticize the ULLCA on the basis (amongst others) that it has too many preemptive rules and too many hard-to-contract around default rules. It also takes a hearty kick at the whole concept of uniform legislation, on the basis that it interferes with the free market in state business organizations statutes.

[371] See e.g Booth 1997, who argues in favour of the approach taken by the ULLCA.

[372] Thompson 1995 at 922-23. A similar conclusion is reached by DeMott 1995, who observes at 1062: "My prediction is that doctrines to control opportunistic conduct in LLCs will evolve toward results that resemble present doctrine developed prior to the LLC phenomenon. In particular, to the extent the flexibility afforded by some LLC statutory regimes attracts

(continued...)

In any event, by their terms at least, American LLC statutes do provide members with somewhat more flexibility and freedom from court "interference" than is provided by American (or Canadian) business corporations statutes.

Let us assume, for the purposes of argument, that American courts have meddled in the internal affairs of American corporations to an extent that has caused a legislative reaction in the form of "leave us alone" provisions in LLC statutes. It does not necessarily follow that Canadian courts have been as meddlesome as their American counterparts. To be sure, our business corporations statutes do provide courts with wide powers to intervene in the affairs of corporations big and small, where they perceive that there has been unfairness or oppressive conduct. And they have, in fact, used those powers. We are not, however, aware of any widespread sentiment that Alberta courts, or Canadian courts in general, have exercised these powers to such an extent as to interfere unduly with the ability of corporate shareholders and managers to arrange and conduct their internal affairs as they see fit. We would be interested in receiving comments on whether there is a significant demand in Alberta for a business entity that would be modelled on the American LLC, to the extent that it would contain fewer preemptive internal governance rules than the BCA.

ISSUE No. 46
How much demand is there for a hybrid limited liability entity that would provide more flexibility in internal governance, and greater freedom from court intervention, than is provided by the BCA?

C. Designing a New Alberta Hybrid Business Entity

In this section we assume that there is sufficient demand for a NAHBE to consider what, in general terms, it might look like. We suspect that, to the extent that there is a demand for a NAHBE, it will be based more on the considerations discussed in section B.1 (taxation) than the considerations

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[372] (...continued)
opportunistic use, legal doctrine is likely to be responsive under one doctrinal guise or another."

discussed in B.2 (internal governance), although there is some overlap between these considerations.

1. Limited Liability

a. Owners

We suspect that if there is a substantial demand for a NAHBE, it will be for an entity that provides its owners with the same sort of liability shield that is currently enjoyed by shareholders and managers of BCA corporations. If limited liability were not an issue, the ordinary partnership already provides an extremely flexible business entity.

In Chapter 2 we examined arguments that have swirled around the issue of limited liability in general, and limited liability in particular contexts. We noted that some forceful arguments have been made for restricting or even eliminating limited liability in certain contexts. For example, lucid arguments have been made for denying limited liability to corporate shareholders for tort claims, or particular types of tort claims, against the corporation. We suspect, however, that the Alberta legislature does not at this time wish to revisit the basic concept of limited liability. That is, we assume that the legislature is content with the general notion of limited owner liability as embodied in the BCA. Presumably, the same considerations that are thought to justify limited liability for shareholders of BCA corporations or limited partners of LPs would also apply to owners of a NAHBE.

> **ISSUE No. 47**
> **Should owners of a new Alberta hybrid business entity be provided with a liability shield that is essentially the same as that provided to shareholders of a BCA corporation?**

b. Liability of managers

Although managers of a BCA corporation – directors and officers – are not, as such, liable for the general *liabilities* of the corporation, they are subject to a host of specific liabilities. In certain circumstances they may owe a duty of care, as individuals, to persons who may be injured by their actions or decisions as directors. Moreover, for diverse reasons of public policy, various statutory provisions impose liability on directors of corporations in specific circumstances and for specific types of corporate obligations. Some of the

provisions that impose liability are found in the BCA itself, but many are found in other provincial or federal statutes. We cannot think of any reason why the policy reasons that support the imposition of liability in certain circumstances on corporate directors would not also apply to managers of a NAHBE.

> **ISSUE No. 48**
> **Is it appropriate to assume that managers of the new hybrid entity would be subject to the same liabilities to outsiders as directors and officers of BCA corporations, but would not otherwise be liable, as managers, for liabilities of the enterprise?**

2. Types of Enterprise that Could Use the Entity

We assume that the NAHBE would be a general purpose business entity that would be available to any type of enterprise, just as a BCA corporation can carry on essentially any type of enterprise.[373]

3. Legal Entity or Aggregate

As we noted in Chapter 2, the traditional legal view of partnerships in common law countries has been that they are not separate legal entities, merely a relationship between persons who are carrying on a business together. This characterization has always been acknowledged to have many inconvenient aspects, both for the members of the partnership and those who deal with it. Many of these inconveniences have been mitigated over the years.[374] Nevertheless, the partnership's lack of personality is not one of the highlights of traditional partnership law. In the United States partnerships are now treated as separate legal entities.[375] In the UK the DTI has proposed

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[373] Certain types of financial business can only be carried on by corporations incorporated under special-purpose statutes, such as the *Loan and Trust Corporations Act*. We assume that those restrictions would apply to a NAHBE as well.

[374] An example is provided by rule 80(1) of the Alberta Rules of Court, which allows partnerships to sue or be sued in the name of the firm. At common law, each partner had to be separately named.

[375] At least, that is how they are treated under the new uniform Act: see UPA 1996, §201(a).

that LLPs be treated as a separate legal entity.[376] We also understand that the Law Commission, which has recently commenced a general review of partnership law, is considering whether the ordinary partnership should be regarded as a separate legal entity.

While it is not difficult to think of many advantages that would accrue from treating a NAHBE as a separate legal entity, it might also have one rather serious drawback if the object of the NAHBE were to achieve flow-through taxation.[377] If legislation creating the NAHBE gave it separate legal entity status, this might very well cause it to be treated as a corporation for the purposes of the ITA. As noted earlier, Revenue Canada has taken a formalistic view of what constitutes a corporation: if it's a separate legal entity, it's a corporation; if it's not, it's not.[378] If provincial legislation cloaked a NAHBE with a separate legal personality, this might well cause it to be treated as a corporation for the purposes of the ITA.

ISSUE No. 49
Are there any reasons, other than the possible tax implications of such a characterization, why it might not be appropriate to characterize the new hybrid entity as a separate legal entity?

ISSUE No. 50
What characteristics would the entity have to have (or lack) to ensure that it would be regarded as a partnership for Canadian tax purposes?

4. Internal Governance Issues

The matter of internal governance is one that would require very close attention if we were actually going to design a NAHBE. As mentioned in section B.2, there is considerable room for debate regarding the extent to which it is appropriate to impose preemptive duties or confer preemptive rights on participants in a business entity. In particular, what duties to

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[376] DTI 1997 at 4.

[377] In addition to the taxation issue mentioned in the text, artificial legal entities might have other drawbacks, but none of them would be as serious as the tax issue.

[378] Interpretation Bulletin IT-343R, §2, which is set out above at page 170.

owners should be imposed on managers, and to what extent, in what circumstances, and by what procedures, if any, should those duties be waivable? A similar issue arises with respect to the rights and duties of members as between themselves.

For the time being, we will frame the issue in very broad terms. So far as the internal affairs of a NAHBE are concerned, should the statute look more like the *Partnership Act* (or an American LLC statute) or more like the BCA? The former provides a framework of general default rules that apply in the absence of a contrary agreement by the members.[379] The latter's rules of internal governance are more numerous, more detailed and in many cases more preemptive.

ISSUE No. 51
So far as rules governing the internal affairs of the hybrid entity are concerned, should a statute that creates the hybrid entity take an approach more like that of the *Partnership Act* (general, default rules) or more like that of the BCA (detailed rules, of which some are preemptive)?

5. Relations With and Protection of Outsiders

The traditional *quid pro quo* for limited liability has been certain restrictions on transfers of assets from the firm to its owners, combined with a requirement to disclose certain information in a public register, or otherwise make it available to outsiders. We assume that a NAHBE would be subject to both asset-transfer restrictions and disclosure requirements. The general nature of these restrictions and requirements is discussed below.

a. Financial Responsibility Requirements

A possible *quid pro quo* for the privilege of limited liability is a requirement that the limited liability entity satisfy a financial responsibility test. This might take the form of a minimum capitalization requirement, a bonding requirement or a liability insurance requirement. Alberta, however, does not impose such requirements on business corporations or LPs. Any rationale

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[379] *Partnership Act*, s. 21(1) provides: "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."

that could be provided for imposing minimum capitalization requirements on a NAHBE would apply equally to corporations or LPs, so it would seem somewhat incongruous to impose such requirements on a NAHBE.

> **ISSUE No. 52**
> **Should consideration be given to imposing financial responsibility requirements (e.g. minimum capitalization or liability insurance requirements) on the hybrid entity, even though such requirements are not imposed on corporations or LPs?**

b. Restrictions on distributions of profits or returns of capital

Although minimum capitalization or insurance requirements are rare, it is almost axiomatic that statutes that confer limited liability will also impose restrictions on transfers of assets from the firm to its owners. If there were no such restrictions, the owners of a firm would effectively have limited liability *and* a priority to the firms assets over the firm's creditors.

The BCA's restrictions on firm-to-owner transfers are fairly typical. The following restriction applies to reductions of stated capital:

> A corporation shall not reduce its stated capital . . . if there are reasonable grounds for believing that
>
> (a) the corporation is, or would after the reduction be, unable to pay its liabilities as they become due, or
>
> (b) the realizable value of the corporation's assets would thereby be less than the aggregate of its liabilities.[380]

Similar restrictions apply to LPs.[381] At the moment we assume that similar restrictions on transfers of assets should apply to a NAHBE.

> **ISSUE No. 53**
> **Is there any reason not to subject a new hybrid entity to restrictions on firm-to-owner transfers of assets that would be**

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[380] BCA s. 36(3). Similar restrictions apply to acquisitions of its own shares [s. 32(2)], redemption of shares [s. 34(2)], and payment of dividends [s. 40].

[381] *Partnership Act*, ss 58(1), 61(1), 62(5).

similar to restrictions that apply to business corporations and LPs?

c. Disclosure of information about the firm to outsiders

There are several sorts of question that may be asked about disclosure to outsiders. What information must be disclosed? When must it be disclosed? How must it be disclosed? To whom must disclosure be made? The design of a NAHBE would require careful consideration of all these questions. For present purposes we will consider only two fairly general questions. Firstly, what type of information should be filed in a public register upon the formation of a NAHBE? Secondly, what type of information, if any, should be required to be filed, or at least made available for inspection to outsiders, on a periodic or continuous basis, or on the happening of certain events?

i. Disclosure at time of formation

All legislation that provides for the creation of limited liability firms provides for the filing of information about the firm in a public records office. The information that must be filed, however, varies considerably from jurisdiction to jurisdiction, and from entity-type to entity-type within a given jurisdiction. The variation in disclosure requirements can be illustrated by comparing the BCA and the LP provisions of the *Partnership Act.*

The information a BCA corporation must provide at the time of incorporation provides a skeletal portrait of the corporation. The information to be provided upon incorporation includes (1) the corporate name, (2) the share structure, (3) any restrictions on share transfer, (4) the number, or minimum and maximum number, of directors, and (5) any restrictions on the corporation's business, (6) a notice of registered office, and (7) a notice of directors.[382] Although the corporation must maintain a "stated capital account" for each class or series of shares it issues,[383] there is no requirement to file this information or make it available to members of the public or to creditors.

The initial disclosure required for an LP is considerably more extensive than for a corporation. The *Partnership Act* lists thirteen separate items to be

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[382] BCA ss 6(1), 7, 19(2), 101(1).

[383] BCA s. 26(1).

included in the certificate of limited partnership,[384] which may be grouped roughly as follows: (1) general information about the firm; (2) information about the general partners and limited partners and the latter's contributions to the firm's capital; and (3) rights to assign limited partnership interests. The most significant element of the LP disclosure requirement is that it requires fairly detailed information about the initial capitalization of the partnership, whereas a BCA corporation is not required to disclose any information about the firm's capitalization. The LP must also identify and specify the contribution of *each* limited partner: an onerous requirement for an LP that might be an investment vehicle with many limited partners.

So far as outsiders are concerned, it seems difficult to justify radically different disclosure requirements for entities that, although different in form, share the same fundamental characteristic of limited liability. If public policy considerations regarding the protection of outsiders require disclosure of information regarding the capitalization of LPs, one would think that the same considerations would apply to corporations or a NAHBE. Conversely, if public policy does not require disclosure of information about the capitalization of corporations, it is difficult to see why it should be required of LPs or NAHBEs either.[385]

The matter of public disclosure of financial information about limited liability firms has been debated as long as limited liability has been debated. The basic argument for disclosure of, at least, the capitalization of the firm is that such disclosure is a reasonable *quid pro quo* for limited liability. If prospective creditors can only look to the assets of the firm, not to the assets of its owners, for satisfaction of their claims, it is reasonable that some minimum amount of information about the firm's capitalization and assets be made publicly available. A contrary argument is that prospective creditors of a limited liability firm who are worried about the firm's financial situation have other means of getting that information. Most obviously, they can ask

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[384] *Partnership Act*, s. 51(2).

[385] We add the reminder that we are really talking about "private" corporations, LPs and NAHBEs. Firms that issue securities to the public are subject to the financial disclosure requirements of the *Securities Act* regardless of their form, and we are taking that as a given. We suspect that relatively few LPs are "private" in this sense because the LP is a less than ideal vehicle for owner-managed firms.

the firm for the information they require or obtain the information from third parties (credit reporting agencies) that specialize in providing such information. It could be suggested that information obtained by one of these latter methods is likely to be more detailed and up to date than information that might have been filed in a public register.

> **ISSUE No. 54**
> **Should the initial disclosure (registration) requirements for a new hybrid entity be closer to those which currently apply to Alberta LPs or those that apply to Alberta corporations. In particular, what information, if any should be required about the capitalization of the entity and about its members?**

ii. Post-formation disclosure

Once a limited liability firm comes into existence it may be subject to two sorts of disclosure requirements: (1) event-driven disclosure and (2) periodic disclosure. An example of the former is the requirement for an LP to file an amendment to its certificate whenever there is change in its membership.[386] An example of a periodic disclosure requirement is the BCA's requirement that corporations file annual returns.[387] In addition to the requirements to register certain information in a public register, BCA corporations are required to permit outsiders to inspect certain corporate records. Creditors of a corporation are permitted to inspect certain documents – constitutional documents, and documents that identify directors and shareholders – but this does not include any financial information.[388] Anyone may examine the documents that identify directors and shareholders.[389]

From the point of view of protection of outsiders, the same sorts of argument could be made about disclosure of periodic financial information as were made about disclosure of a firm's initial capitalization. It could be argued that disclosure of, say, audited annual financial statements is a rational *quid pro quo* for limited liability, on the basis that it will allow

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[386] *Partnership Act*, s. 69(1).

[387] BCA, s. 256.

[388] BCA, s. 21(3).

[389] BCA, s. 21(4).

outsiders to assess the firms financial strength before dealing with it. The alternative view is that prospective creditors can get this information directly from the firm, or from third party providers, if they are interested in it.[390] The BCA and *Partnership Act* are consistent with each other on this point; no periodic disclosure of financial information is required.[391] We cannot discern any reason for treating a NAHBE any differently than corporations or LPs in this regard.

> **ISSUE No. 55**
> **Given that Alberta corporations and LPs are not subject to periodic disclosure of financial information (except where this is required by the *Securities Act*) are there any grounds for imposing such a requirement on a new hybrid entity?**

d. Owners as creditors

Shareholders of Alberta corporations have an advantage over limited partners of LPs in terms of their ability to make secured loans to the firm. A shareholder of a corporation can make a loan to a corporation and obtain security that will be as valid and enforceable as security given to an outsider. Assuming that the loan was not just a sham transaction, if the corporation becomes insolvent, the shareholder's security interest will take priority over the claims of ordinary creditors, including tort claimants. Limited partners, on the other hand, can make loans to the limited partnership, but they cannot take security for the loan from the partnership.[392]

The *Partnership Act*'s approach could be supported by an appeal to fairness. That is, it is unfair for a person to try to have the benefits of equity ownership in a firm (a claim on future profits) at the same time as they protect themselves from losses by taking security. On the other hand, one could argue that there is nothing unfair about the BCA's more permissive approach, so long as creditors who deal with the corporation know, or have the means of knowing, of the security. The shareholder's security will only

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[390] It may be noted in passing that disclosure of financial information is not going to be of any assistance to involuntary creditors.

[391] As noted earlier, disclosure of financial information is regarded as a securities law issue, rather than an entity law issue. As such it is dealt with under the *Securities Act*.

[392] *Partnership Act*, s. 59(a).

have priority over other creditors' claims if it is duly registered in the personal property registry or land titles office. Of course, this argument would not apply to tort claimants.

ISSUE No. 56
Should members of a new hybrid entity of be permitted to make secured loans to the entity?

6. The Hybrid Entity as a Refurbished Limited Partnership

We conclude this paper with an invitation to readers to consider and provide comments on the possibility that a NAHBE would really be a refurbished LP. This entity would maintain the distinction between limited partners and general partners, although they might be referred to as "members" and "managers" The fundamental distinction between the NAHBE and the traditional LP would be that members of the NAHBE could be managers without losing the privilege of limited liability. The managers of the NAHBE would have essentially the same duties, and would exercise essentially the same powers, as the directors and officers of a corporation. Moreover, they would be in essentially the same liability position. Obviously, since the managers would play much the same role as directors and officers, they would have to be individuals, which would be a contrast to the traditional LP where (for liability reasons) the general partner is often a corporation.

ISSUE No. 57
Would a hybrid entity that was structured essentially as an LP with the following characteristics be a useful business organization? The characteristics are that managers (i.e. general partners) would have the same liability shield as the ordinary members (i.e. limited partners), except that the managers would be subject to the same liabilities as the directors of a corporation. The managers would have to be individuals.

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