LAWYERS AS PCs, LLCs & LLPs

By Robert K. Winger

Today, more and more lawyers are considering practicing in limited liability partnerships (LLP), limited liability companies (LLC) or professional corporations (PC). In many instances, the vicarious liability aspect of the entity is the driving force behind the formation of the entity. This article reviews how the vicarious liability of the owners of these entities works and its interplay with professional liability coverage. ***It does not address the tax and other issues that may be relevant in determining what form of entity to use.***

Since ORS 58.185 dealing with the professional liabilities of licensed shareholders in PCs applies equally to the licensed owners in LLCs and LLPs as well *(see ORS 58.037, 63.074 and 67.025)*, the rules discussed in this article apply equally to PCs, LLCs and LLPs when discussed using the terms “Entity” and “Owner.” In addition, when reading the main statute regarding professional liability (ORS 58.185), it may be helpful to substitute these words for “corporation” and “shareholder.” If a rule applies only to one form of Entity, the type of Entity and type of Owner will be specifically referred to in this article.

DIRECT LIABILITY

Owners of professional entities have direct and unlimited personal liability for their own professional negligence. ORS 58.185. The statute does not address the liability of the Entity, but, under the doctrine of *respondeat superior,* the Entity and its assets, including its accounts receivable, are liable for the professional negligence of its Owners or employees acting within the course and scope of their employment. Under general indemnity principles, the Entity has an indemnity claim against a directly negligent Owner or employee.

SUPERVISORY STATUS LIABILITY

In addition, an Owner is also vicariously liable for any professional negligence committed by another person (licensed or not) who is under the Owner’s direct supervision and control. Generally, a supervisor is liable for negligent supervision, but under ORS 58.185, a supervising Owner’s liability may not be limited to negligent supervision. It has been argued that the statute imposes liability on the supervising Owner merely on account of his or her status as the supervisor of the tortfeasor.

Since the statute does not contain any definition of “direct supervision and control,” some managing partners, associate mentors, and others with general management roles within a firm have been concerned that they *might* be held personally liable *without limit* for the acts of others with whom they have had no direct contact as to the matter involved.

Conversely, firms train young associates and for a period of time encourage them to build a client base. As the associate develops, the need for supervision and control lessens so that often, before an associate becomes an Owner, he or she may practice without any direct supervision or control.

LIMITED LIABILITY

In addition, non-negligent, non-supervising Owners have joint and several vicarious liability for professional negligence of others in their Entity. This is limited to those Owners who (1) are licensed to practice in this state, (2) are in the profession for which the Entity was formed, and (3) practice more than incidentally in this state.

As of 2018, this vicarious non-supervisory liability is limited to $550,000, (the “individual limit”) with an aggregate $3.55 million limit (the “aggregate cap”) on vicarious liability of all non-supervising Owners. These limits are adjusted every six years with the last adjustment being as of 2018.

HOW THE LIABILITY CAPS WORK

What is often misunderstood is the interplay between the individual limit and the aggregate cap. For example, assume that an Owner causes $3 million dollars of damages due to professional negligence. If there are four Owners, three of whom are non-negligent, non-supervising Owners, the liability of the three non-negligent, non-supervising Owners is limited to $550,000 each, for a total of $1,650,000. The aggregate cap would not come into play. The client would be unable to collect more than $1,650,000 from the three vicariously liable Owners.

The client would, however, retain his or her right to collect the full amount from the negligent Owner and the Entity.

In the example above, the aggregate cap is not triggered, since the total amount of liability of the three vicariously liable Owners was $1,650,000 and, therefore, less than the $3.55 million cap. In order for the aggregate cap to apply, the Entity would have to have at least seven non-negligent, non-supervising Owners.

If we change the facts above and instead assume that there are eight Owners and a $10 million error is made, the aggregate cap does apply. The negligent Owner and the Entity would be directly liable for the full $10 million. The seven non-supervising, non-negligent Owners would each have $550,000 of vicarious liability exposure. Thus, the total exposure of the seven non-supervising, non-negligent Owners would be $3,850,000—*EXCEPT THE CAP OF $3.55 MILLION IS TRIGGERED.* The cap reduces the non-supervising, non-negligent Owners' liability exposure from $3,850,000 to $3,550,000.

If the Entity has more than eight Owners, the client with the malpractice claim against the Entity can sue and recover up to the aggregate cap from *any seven* of the non-supervising, non-negligent Owners. The client is not required to pursue all of the non-supervising, non-negligent Owners in order to collect his or her damages. For example, where the Entity has 11 Owners, one of whom made a mistake and 10 of whom are not supervisors and not negligent, the client with a $10 million claim is not obligated to collect a pro rata share of the aggregate cap limit from all 10 vicariously liable Owners. The client does not have to collect only a pro-rata share from each of the 10 non-supervising and non-negligent Owners in order to get the aggregate cap. The client can collect the full individual limit of $550,000 from any of the vicariously liable Owners until he has collected a total of $3.55 million.

RIGHTS OF INDEMNITY & CONTRIBUTION

The foregoing raises a concern about the application of the principles of indemnity and contribution. "*Indemnity*" is the <u>common law principle</u> that allows one, who may be liable for an injured party's damages (without playing any active role in causing them) to recover fully for any loss incurred against those more actively involved. For example, an employer who properly maintains a vehicle may be indemnified by the employee for negligent driving within the course and scope of his employment. "*Contribution*" is a <u>statutory right</u> under ORS 18.430-460 which results in the sharing of liability between joint or joint and several tortfeasors.

The potential unlimited exposure of non-negligent, non-supervising Owners is one reason some people have been hesitant to race into becoming one of the "limited" liability Entities. In a general partnership, a partner is not directly liable unless the partner is negligent. There is no status liability for non-negligent "supervisors" comparable to what may exist in the context of these three "limited" liability Entities. The non-negligent, supervising partner would have *indemnity* rights against the offending partner and the partnership, and he or she would have *contribution* rights against the other partners for any amount in excess of his or her pro rata share of the joint and several liability. In a general partnership, this contribution right would not be limited by the $550,000 individual limit or the $3.55 million aggregate cap.

For example, assume (1) 10 lawyers formed a general partnership in which all partners are equal, (2) one partner caused $10 million in damages due to professional negligence, (3) one was a non-negligent supervisor, (4) eight partners were not involved at all (other than being partners with the negligent attorney), and (5) the negligent partner and the partnership were insolvent. If the client collected from the supervising partner, the supervising partner would have a claim of contribution against the eight remaining partners for $1,000,000 each or $8 million, leaving the supervising partner potentially exposed to $2,000,000, i.e., more than his or her pro rata share. (The supervising partner would also have an indemnity claim against the insolvent partner and the insolvent partnership.)

The statutes relating to all three Entities provide that an Owner shall not be jointly and severally liable solely by reason of being an Owner except as provided by ORS 58.185. Since the statutes are silent as to any contribution rights of a non-negligent, supervising Owner against his or her fellow non-negligent but non-supervising co-Owners, it can be argued that a non-negligent supervising Owner is liable to the full extent of the damages incurred without any right of contribution from the vicariously liable Owners in excess of the mandatory limits. Any obligation of contribution would arise solely by reason of one's status as an Owner and therefore be limited to the $550,000/$3.55 million limit. As such, a $10 million liability with one negligent Owner; one non-negligent, supervising Owner; and eight non-negligent, non-supervising Owners would result in the non-negligent, supervising Owner having a claim for *contribution* against the eight non-negligent, non-supervising Owners, but the claim against each would be limited to $550,000/$3.55 million cap. Absent *indemnity* from the negligent and insolvent Owner and Entity and even assuming the eight non-negligent, non-supervising Owners make good on their limited vicarious *contribution* liability, the non-negligent supervising Owner would be responsible for $6.45 million, i.e., $4.45 million more than his or her exposure under the general partnership described above.

Thus, becoming an Owner in an Entity could potentially expose a non-negligent, supervising Owner to liabilities with respect to which he or she might not have the same recourse by way of contribution as he or she would have in a general partnership. To avoid this risk, special contribution provisions ought to be incorporated in the operating documents of these Entities to protect the non-negligent supervisors to the same degree they would be protected in a regular general partnership.

PROFESSIONAL LIABILITY FUND COVERAGE

Substantial confusion arose in the late 1990s when the newer forms of professional limited liability entities were being born because, at that time the individual vicarious liability limit was $300,000, which appeared to be amount of the primary Professional Liability Fund malpractice coverage limit. However, the two concepts or limits were not tied together.

Unlike the vicarious liability limits in the statute, this amount is not subject to a cost of living adjustment every six years.

Only one limit of coverage is available under the PLF insurance when two or more claims arise out of related activities even if multiple lawyers in a firm are involved.

In addition multiple and successive errors by the same or different attorneys which cause harm or which cumulatively enhance damages or losses, are deemed to be related acts and only one set of limits will apply to the set of acts.

For example, if two attorneys work on a client's file and make a $3 million mistake, the total coverage limit available to the client from the PLF primary fund is $300,000. If one lawyer in the firm makes a $3 million mistake and the PLF pays the $300,000 policy limits on the claim, no additional coverage limits are available to pay on behalf of any other lawyer/Owner. Therefore, no additional coverage from the primary fund is available to that client for the remaining $2,700,000 regardless of the number of lawyers who had some involvement with the matter or were Owners in the Entity. These same principles typically apply to excess coverage limits.

The interplay between the insurance coverage and the statutory caps on liability, in some instances, works to relieve the non-negligent, non-supervising Owners of liability. Assume, for example, that the Entity has four Owners, (one negligent Owner and three non-negligent, non-supervising Owners) and has $1 million of liability coverage. If the negligent Owner made a $2 million mistake, the liability coverage available and the statutory caps would work together to relieve the non-negligent, non-supervising Owners of liability. The three non-negligent, non-supervising Owners would each have a vicarious liability cap of $550,000. With three of the Owners, the injured party could collect up to $1,650,000 from the vicariously liable Owners. However, if the injured party was paid $1 million of malpractice coverage on behalf of the negligent Owner, this payment would almost cover the portion of the damages ($1,650,000) for which the non-negligent, non-supervising, vicariously liable Owners would otherwise owe. These vicariously liable Owners would be liable for $550,000 each, for a total of $1,650,000, but $1 million of this amount was already paid by the malpractice carrier. Of the remaining $1,000,000 of the damages ($2 million damages minus $1 million paid in insurance), only $650,000 would have to come from the three vicariously liable Owners and the balance would have to be collected from the negligent Owner, or the Entity. The vicariously liable Owners would not be personally liable beyond the $650,000.

In addition, some claims, such as punitive damages, sanctions, and theft, are often not covered by the Professional Liability Fund Coverage Plan of the negligent or errant Owner. However, there may be coverage in those instances for the vicariously liable Owners.

MULTIPLE ONE PERSON PCs OR LLCs COMBINE TO PRACTICE TOGETHER

Since the vicarious liability provisions are expressed in terms of sharing the liability with the other Owners in the Entity in which the negligence occurred, can personal vicarious liability be escaped by each professional forming separate one-person PCs or LLCs, which join to form a partnership, LLP or LLC? *NOTE: By definition, you cannot have a one person LLP since it takes two or more to form a partnership under state law.* In a partnership, LLP, or LLC made up of one person PCs or LLCs, there would not be any person who is <u>another</u> Owner of the Entity in which the negligent person is a co-Owner and, hence, personal vicarious liability might be escaped by the Owners of the other PCs or LLCs. Each PC and LLC and the "umbrella" entity may be liable under general partnership law, ORS 58.185, or *respondeat superior*, but the personal assets of the Owners of the other Entities might escape liability. Since most of the federal tax reasons for forming separate Entities which practice in partnership together have disappeared, if this structure works to avoid <u>any</u> vicarious liability, such avoidance may remain a significant benefit of the often more complicated and administratively costly structure.

DRAFTING CONSIDERATIONS

If one is going to practice in one of these limited liability Entities, how should the governing documents be drafted to address the allocation of professional liabilities? Clearly the "winding up" or "dissolution" section should be examined closely to ensure that there is no obligation on the part of the non-negligent, non-supervising Owners to contribute or restore capital accounts due to losses attributable to claims for which they are intending to enjoy limited liability, or at least the obligation should be limited to the extent permitted by ORS 58.185(5). Should the agreement provide recourse against the negligent Owner? Should the vicariously liable Owners share their liabilities on a per capita, profit interest, or other basis? At what point in time are those interests to be determined? Is it when the negligence occurred, the damage is incurred or the liability is satisfied? Admission agreements and withdrawal releases or settlements should be drafted carefully with these issues in mind. Addressing these difficult issues will help encourage Owners to become supervising Owners, thereby offering the firm training and second opinions which are invaluable.

MULTI-STATE PRACTICES

It is important to note that the extent of personal liability (especially vicarious liability) of professionals practicing in various limited liability entities varies from state to state and from profession to profession. The foregoing is in reference to Oregon only.

WHAT SHOULD I BE?

Adding all of the above described malpractice liability complexity to the tax differences between a general partnership, PC, LLC, and LLP makes it difficult for a group of general practitioners to determine which route to follow. There isn't one clear answer for all situations. Different situations may tip the scale in different directions. If you are not experienced in the issues involved, you may want to seek competent advice before proceeding.

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Reviewed and updated through 2019 by the author, Robert K. Winger.

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IMPORTANT NOTICES