Review your business entity to minimize your malpractice exposure

By Karen Stromeyer and Timothy Halloran

Two lawyers, one specializing in family law, the other focusing on entertainment law, agree to share space together. They identify themselves as "Clinton & Trump" on their letterhead, on business cards, and on pleadings. They rent office space, for which they each pay half. They keep separate client-trust accounts, and business accounts, however, there is a general office account for overhead costs such as rent, utilities, etc. Each lawyer "eats what they kill," so do not share profits from any case. Each files his or her own separate, individual tax returns. They rarely, if ever, assist one another on cases. There is no written or formal agreement between them.

One of Trump's clients sues him for malpractice, and also sues Clinton and "Clinton & Trump." Can Clinton get out of the case? The answer – which was shocking to our client when we handled this actual case – is not so easy. Regardless of intention, Clinton's and Trump's informal relationship may have created a general partnership. If so, under partnership law Clinton is jointly and severally liable for *all* liabilities of the partnership, including her partner's malpractice.

As many attorneys practice in small groups, formal or informal, understanding the options and "default rules" for various business entities is crucial to understanding what liability you may be accepting. The primary considerations in choosing your firm's business entity are limiting your personal liability and tax consequences, the latter of which will only be touched on briefly here.

No business entity shields an attorney from personal liability for their own malpractice, or from that of the attorneys they personally supervise; however, some entities, if properly administered, can shield the lawyer from the negligence of other lawyers in the firm, and the business liability of the entity. The primary business entities available to California attorneys such as Clinton & Trump are:

General partnership

A general partnership is an association of two or more persons who carry on business with the aim of making profit. (Corp. Code, § 16202(a).) Intention is completely irrelevant, and these partnerships are often formed accidentally. Generally, if you start a law practice with any partners and do not incorporate, then your law practice is by default considered a general partnership. Although a partnership agreement is highly recommended, it is not required.

A general partnership is an entity distinct from the partners. (Gov. Code, § 16201.) It can sue and be sued in the name of the partnership. (Corp. Code, § 16307). The primary features of a general partnership are: each partner can bind the partnership in its ordinary course of business (Corp. Code, § 16301; and each partner is personally liable for the obligations of the partnership (Corp. Code, § 16306).

In the absence of a written partnership agreement, the partnership statutes will govern relationships among the partners, and between the partners and the partnership. General partnerships are governed by the Uniform Partnership Act of 1994 at Corporations Code sections 16100-16962.

Under these default partnership rules, each partner has an equal right to make decisions affecting the business, an equal share in revenue, profits and losses, and an equal right to manage and operate the business. Any partner can unilaterally bind the partnership and all of its owners to a deal with or without the other partner's knowledge or consent. Absent a written agreement to the contrary, each partner is authorized to sign contracts, checks, leases, and carry on all the business of the partnership. This means that each partner assumes personal liability for the consequences of, and the actions of, the other partner(s) even when the acts were committed without the knowledge or consent of the other partners.

Most importantly, partners are jointly and severally liable for all legal and financial obligations of the partnership and for all wrongful acts of any partner acting in the ordinary course of partnership business. This cannot be modified though a partnership agreement, as it would not be binding on third parties.

Partners may dissolve their partnership and wind up the partnership's business at any time by mutual agreement. (Corp Code, § 16801.) However, as long as the partnership exists, the partners are fiduciaries of one another and have a high duty of fair dealing, and owe to the partnership and the other partners the duty of loyalty and duty of care.

Tax: A general partnership is not a taxable entity. Instead, partners are taxed on a "pass-through" basis on their individual tax returns (the partners pay individual income tax on their respective share of the partnership's profits). Therefore, if profits are low, partners will pay little in taxes (and no taxes if they make no profit), but if profits are high, then you might pay more taxes as a partnership than as a corporation.

Pros: This entity is easy to create and maintain, and no corporate formalities or fees are required.

Cons: Unlimited liability for all liabilities of the law practice business, including for one another's malpractice.

Limited liability partnership

A limited liability partnership is like a general partnership except that it gives all partners protection from vicarious liability for the malpractice or other tortious conduct of their partners and

employees, as well as the debts, obligations, or liabilities of the partnership. (Corp. Code, § 16306(c).) Thus an LLP partner's personal assets will generally *not* be at risk in the event of a financial disaster resulting from business losses, or errors and omissions or other tortious conduct of an employee or a co-LLP partner.

The LLP law eliminates personal exposure for vicarious tort liability as well as liability for partnership debts and obligations such as bank loans and lease obligations. The LLP law does not, however, change the fact that an LLP partner will still be personally liable for his or her own errors and omissions; whether arising from his or her own acts or failures to act, or negligent supervision of associates and staff. (See *PCO, Inc. v. Christensen, Miller, Fink, Jacobs, Glaser, Weil & Shapiro, LLP* (2007) 150 Cal.App.4th 384, 391.)

Corporate Formalities/Formation: LLPs are required to file a registration with the California Secretary of State. (Corp. Code, § 16953(a).) The partnership must be formed under a partnership agreement governed by Corporations Code sections 16951-16962. A limited liability partnership must be registered with the California State Bar to be entitled to this protection, and maintain at least a million dollars in malpractice insurance. (Corp. Code, §§ 16306(f); 16956(a)(2).) Annual certification must be filed with the California Secretary of State, as well annual renewal with the California State Bar.

Taxes: While an LLP must file an informational tax return, its income is passed through to its partners and taxed at the individual partner level, without any income tax assessment at the LLP entity level.

Pros: Pass-through taxation, and no vicarious liability.

Cons: Some corporate formalities required and annual reporting required.

A professional law corporation

A California Professional Corporation is organized to provide services in professions that require a state license in order to practice. (Corp. Code, § 13401.) Professional corporations are available to associations of attorneys and solo attorneys, however, all owners of the corporation must be licensed attorneys.

Professional Corporations require the greatest administrative burden, but can provide the greatest tax advantages. Like LLPs, incorporation protects the shareholders of a corporation from personal liability for liabilities that arise in the normal course of business (premises liability, employee liability, etc.), and the malpractice of other attorneys in the firm.

To form a professional corporation, Articles of Incorporation must be filed with the California Secretary of State and register with the California State Bar. However, in order to keep limited liability protection, corporate formalities must be observed, such as enacting bylaws; annual reports; conducting regular meetings for the individuals managing the corporation and annual meetings for the shareholders; preparing minutes of those meetings; maintaining a separate bank account for the corporation and maintaining detailed financial records that are separate from the owners, such as balance sheets and records of transactions.

A professional corporation may be a C-Corporation or an S-Corporation, and can be structured to allow for corporation profits to be distributed to the lawyer as a dividend, which is taxed at a lower rate than salary. Tax benefits may also include greater deductions for health insurance and medical expenses, and have lower payments for Social Security and Medicare taxes.

Pros: Limited liability. Shareholders of a corporation do not have personal liability for liabilities that arise in the normal course of business or vicarious liability for liabilities that arise from the malpractice of other attorneys in the firm. Possible tax benefits.

Cons: Administrative burden.

Ostensible partnership

What Clinton and Trump may have created is an ostensible partnership. Under California law the informal arrangement in which *the public* sees a purported partnership, can create partnership liability based on an estoppel theory, even where no partnership ever really existed. "Ostensible agency or acts within the scope of the partnership business are presumed where the business done by the supposed agent, so far as open to the observation of third parties, is consistent with the existence of an agency, and where, as to the transaction in question, the third party was justified in believing that an agency existed." (*Blackmon v. Hale* (1970) 1 Cal.3d 548, 557; *Redman v. Walters* (1979) 88 Cal.App.3d 448, 453; see also Civ. Code, § 2300: "An agency is ostensible when the principal intentionally, or by want of ordinary care, causes a third person to believe another to be his agent who is not really employed by him; Corp. Code § 15016 states: When a person, by words spoken or written or by conduct, represents himself, or consents to another representing him to anyone, as a partner in an existing partnership or with one or more persons not actual partners, he is liable to any such person to whom such representation has been made ...). Thus in such a case as "Clinton & Trump," the use of letterhead, business cards, shared office space and shared pleadings, all can support the imposition of liability for the negligent attorney on all other attorneys with whom the attorney shares these indicia of partnership.

Formalities in the arrangements with other attorneys can be a pain, but are absolutely essential to make sure everyone is aware what risks exist. When choosing to work with another attorney, you are essentially in for a penny in for a pound. If you do not intend to share partnership and malpractice liability, do not. But, if you show the public that you are a partnership, you will likely be judged as one.


Stromeyer

Karen Stromeyer is a senior associate attorney at Murphy, Pearson, Bradley & Feeney *with a practice emphasizing general civil litigation including defending lawyers against claims of professional liability. Prior to joining Murphy, Pearson, Bradley & Feeney, she spent several years as an associate at a prominent plaintiffs' firm in San Francisco where she represented catastrophically injured individuals.*

Timothy Halloran is a senior partner at Murphy, Pearson, Bradley & Feeney. *An experienced trial lawyer and civil litigator, he has tried over 20 legal malpractice cases to jury verdict and is a member of the American Board of Trial Advocates, is a Certified Legal Malpractice Specialist, and currently sits on the State Bar Legal Malpractice Law Advisory Committee.*


Halloran