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REPORT OF THE SUPREME COURT COMMITTEE ON PROFESSIONAL CORPORATIONS

April 1994

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INTRODUCTION

The Court has requested the Committee to undertake the tasks of analyzing and reporting on the requirements and limitations, if any, for foreign legal corporations seeking to practice in New Jersey, and on the mandatory insurance provisions of Rule 1:21-1A. In addition, the Court invited the Committee to make any other recommendations concerning the practice of legal corporations that the Committee deemed appropriate. The Report of the Committee follows. A summary of the Committee's findings and recommendations appears in the Conclusion of the Report.

I. FOREIGN LEGAL CORPORATIONS

The Committee has concluded that a law firm incorporated in a state other than New Jersey is not permitted to practice in New Jersey as a professional corporation. The Professional Services Corporation Act (PSCA), N.J.S.A. 14A:17-1 through 18, provides for the practice of professionals in corporate form only for professionals that incorporate in New Jersey. No provision is made to permit professionals incorporated in another state to practice in corporate form here. By contrast, the New Jersey Business Corporations Act, which the PSCA supplements, expressly permits a foreign corporation to "transact business" in New Jersey if it procures a certificate of authority to do so from the Secretary of State. N.J.S.A. 14A:13-3.

Because of the absence of an express authorization in the PSCA permitting a foreign professional corporation to transact business here, the Secretary of State's representative on the Committee advises that the Secretary does not issue certificates of authority to foreign professional service corporations. The Secretary's interpretation is therefore consistent with the conclusion of the Committee that a foreign professional legal corporation cannot practice in this State as a professional corporation.

There is further support in the PSCA for this view. One provision of the PSCA provides that:

> . . . A professional corporation organized under this act may consolidate or merge only with another professional corporation organized under this act and empowered to render the same professional service. A merger or consolidation with any foreign corporation is prohibited. . . . N.J.S.A. 14A:17-15.

If a New Jersey professional corporation is not even permitted to consolidate with a foreign corporation, it only follows that a foreign corporation cannot simply open an office and start operations here.

Notwithstanding this limitation, the Committee is aware that many foreign professional legal corporations are practicing in New Jersey as partnerships. The foreign corporations simply form a New Jersey partnership that is a part of, or affiliated with, the foreign corporate entity. The authority for such relationships is apparently derived from the implicit approval by this Court of New Jersey attorneys establishing formal business relationships with firms in other states. In re Professional Ethics Advisory Comm. Op. 475 (Jacoby & Meyers), 89 N.J. 74 (1982). In addition, the Committee on Attorney Advertising has addressed the situation of a foreign professional corporation practicing in this State as a partnership. (Opinion No. 1, issued September 10, 1987). The Committee there expressed no objection to the proposal as long as the firm clearly identified its affiliation and the fact that it was practicing as a partnership in this State.

Since a policy decision has apparently already been made that foreign legal corporations may establish offices in New Jersey in the form of a partnership, the Committee limited its consideration to whether there is any reason to prohibit foreign professional corporations from practicing here in corporate form. The Committee is of the view that provided assurances exist that all attorneys practice law in accordance with the applicable Rules of Court,

there is no sound basis for prohibiting foreign legal corporations from establishing affiliated branch offices in this State that practice in corporate form. The Committee believes that the primary consideration should be ensuring that every attorney practicing in New Jersey practices in accordance with the Rules of Court, no matter what the form of practice or the affiliation with a foreign firm.

The Committee therefore recommends that the Court recommend to the Legislature that the PSCA be amended to permit foreign professional corporations to transact business in New Jersey. The amendment should follow the Business Corporations Act in requiring the foreign professional corporation to register with and secure a certificate of authority from the Secretary of State. Obviously, the amendment should also require that all professionals practicing in the New Jersey office of the foreign corporation be licensed and eligible to practice in New Jersey. The Committee further recommends that the amendment also eliminate the PSCA's prohibition against a New Jersey professional corporation merging or consolidating with a foreign professional corporation. It makes no sense to continue with such a prohibition once foreign professional corporations are permitted to practice here. Elimination of this prohibition will provide flexibility to New Jersey corporate law firms in establishing whatever relationship they deem appropriate with a foreign corporate firm.

On the adoption of these recommended legislative changes, the Rules of Court should also be amended to implement such changes.

The Committee's proposed Rule amendments appear in Appendix A to this Report.

Most of the amendments to the Rules of Court recommended by the Committee concern Rule 1:21-1A, the Rule that covers professional corporations. The proposed amendments to subparagraph (a) are mostly stylistic, to indicate that attorneys will be able to practice in corporate form without necessarily incorporating in New Jersey. The proposed amendments to subparagraph (b) require the corporation incorporated in a state other than New Jersey to file a certificate of insurance within thirty days of its registration with the Secretary of State.

Consistent with the Rule's requirement that clients be given notice that a law firm is practicing in corporate form, the Committee also recommends amendments to subparagraph (c) to require that clients receive notice when a legal corporation is not incorporated in New Jersey, as well as its state of incorporation. Similarly, the Committee recommends that subparagraph (f) be amended to give clients notice when a partner in a partnership is a corporation that is not incorporated in New Jersey. The latter proposal does not require identification of the state of incorporation, because such a requirement would be impractical for an entity with multiple corporate partners located in different states.

Subparagraph (e) of the Rule, dealing with permitted directors and officers of the professional corporation, should also be amended to permit attorneys licensed to practice in states other

than New Jersey to be directors and officers of a legal corporation practicing in this State. The Committee recommends, however, that the Rule require at least one member of the board of directors to be a member of the New Jersey bar, regardless of the state of incorporation. This will help ensure that attorneys practicing in the New Jersey office are familiar with and comply with all New Jersey Rules of Court.

As noted above, foreign law firms, both corporations and partnerships, are already practicing in this State as partnerships. The Committee has been made aware of situations in which the New Jersey partnerships have failed to comply with the recordkeeping and bookkeeping requirements of the Rules of Court. This should not be permitted to continue. The Committee believes that New Jersey attorneys affiliated with foreign law firms must be made to understand the need to comply with all of the Rules of Court. To this end, it recommends that the Court also amend Rule 1:21-6 to provide expressly that all attorneys and law firms practicing in New Jersey, regardless whether they are incorporated in other states or are otherwise affiliated with foreign law firms, must fully comply with the recordkeeping requirements of the Rule.

The Committee proposes that this amendment can take the place of existing subparagraph (e) of the Rule. The current subparagraph prohibits attorneys who are members, associates, or employees of foreign firms from sharing fees in violation of RPC 1.5(e) and further requires them to maintain separate records of fees and expenses. The proposed amendment would make clear that every

attorney practicing in New Jersey must comply with all of the requirements of Rule 1:21-6. Concerning the fee-splitting provision, the Committee does not believe it is necessary, since the Committee starts from the premise that every attorney practicing in New Jersey must comply with all of the Rules of Court, including, of course, the Rules of Professional Conduct. The proposed amendments to this Rule are also included in Appendix A to this Report.

In addition, to underscore the need for every attorney who practices in this State to understand and fully comply with the New Jersey Rules of Court, the Committee also recommends a new section in the annual registration form for attorneys affiliated with a foreign law firm. The section should be a certification expressly stating that the attorney and the New Jersey office in which the attorney practices are in full compliance with all of the Rules of Court.

II. MANDATORY MALPRACTICE INSURANCE REQUIREMENT

A. Application to Professional Legal Corporations Only

A professional legal corporation is required to carry malpractice insurance under Rule 1:21-1A(a)(3). No such requirement applies to attorneys practicing in some other business form. The Committee understands that the justification for imposing the mandatory insurance requirement only on attorneys practicing in corporate form is that such attorneys enjoy the benefit of limited personal liability for the malpractice of other attorneys in the firm. The Committee questions whether this is a persuasive reason for such discriminatory treatment.

A lawyer practicing in a partnership is personally liable for the malpractice of all the other attorneys in the firm, including that of the other partners. N.J.S.A. 42:1-13 and -15. The PSCA provides that an attorney-shareholder is liable for his or her own malpractice and that of those attorneys ". . . under his direct supervision and control . . . ." N.J.S.A. 14A:17-8.

It is not clear from the PSCA what other attorneys might be deemed to be under an attorney-shareholder's "direct supervision and control." Nor has the meaning of this phrase been addressed in any reported opinion. The Appellate Division has, however, considered in dictum the general issue of a professional shareholder's liability for the malpractice of another shareholder under the PSCA. Commercial Union Insurance Co. v. Chubb Group Insurance Co., 194 N.J. Super. 69 (App. Div. 1984), rev'd 101 N.J. 24 (1985).

Commercial Union involved a dispute between insurance carriers about coverage in a malpractice action against a medical doctor-shareholder and his professional corporation. The issue was which policy provided coverage after the coverage of the doctor's primary malpractice policy was exhausted -- the corporation's policy, which expressly excluded coverage for a shareholder's liability for his or her own professional malpractice, or the doctor's excess policy. The majority held that the corporation's policy was liable based, in part, on its belief that under the PSCA, a professional shareholder could not be personally liable for the malpractice of another shareholder. The majority concluded that if the corporate policy did not provide coverage to an individual doctor for his or her own malpractice, it provided little or no coverage at all.

Judge Brody filed a dissenting opinion that was ultimately adopted by this Court. He concluded that even if the professional shareholder could not be held directly liable under the PSCA for the malpractice of another shareholder, he or she could be liable for damages caused by that malpractice under the separate theory of "administrative negligence." Commercial Union, supra., 194 N.J. Super. at 81, note 1. He cited, as examples of such negligence, the torts of negligent hiring and retention. Judge Brody therefore disagreed with the majority's conclusion that the corporate policy did not provide any insurance at all unless it were deemed to cover an individual doctor-shareholder for his or her malpractice.

Such an interpretation dilutes the effect of any intended limitation in the PSCA on the personal liability of attorney-

shareholders. In addition to attorney-shareholders being subject to this indirect liability, it is not difficult to envision fact-finders applying a broad definition of the phrase "direct supervision and control" to find attorney-shareholders who are somewhat removed from the malpractice personally liable where such a finding is necessary to compensate a wronged client. The Committee has therefore concluded that any actual limitation on the personal liability of attorneys practicing in corporate form is not so great as to warrant the imposition of the malpractice insurance requirement on them only.

The Committee does not recommend the repeal of the mandatory malpractice insurance requirement to remedy this discrimination, since such a repeal could result in the loss of some amount of the public's protection against attorney malpractice. The Committee recommends, instead, that the Court appoint a committee to consider ways to help assure the payment of valid legal malpractice claims, including extending the mandatory insurance requirement to all attorneys, regardless of the form of practice. The Committee notes that it considered embarking on a full-fledged analysis of this issue for the Court. However, given that the Court did not assemble this Committee with such a charge in mind, the Committee's actual composition, and the special staffing needs for an endeavor of such magnitude, the Committee determined that it would not be appropriate for it to assume this responsibility. The Committee strongly believes, however, that the time has come to address the issue.

B. Review of the Existing Requirements of Rule 1:21-1A

The Committee considered the detailed requirements of Rule 1:21-1A with the assistance of a general partner at Herbert L. Jamison Co., insurance brokers. The Committee concluded that several of these requirements should be amended, as recommended below. The proposed amendments are found in Appendix B. In addition, the Committee identifies other issues for the Court without recommending amendments to the Rules of Court.

Please note that a member of the Committee has filed a Minority Report in respect of the recommendations on required minimum and aggregate insurance coverage. (Appendix C).

1. Amount of required insurance coverage

As an initial matter, the Committee notes that in establishing minimum insurance requirements, one faces the problems of ensuring that the required policies are available in the marketplace and that firms can afford to purchase them. Further, because the market is constantly changing, the rules must be flexible enough to accommodate such changes. The Committee believes that the problem of availability is best resolved by simplifying the requirements, and maintaining them at the minimum levels necessary to protect the public. In considering amendments to the existing requirements of the Rule, the Committee was guided by these principles.

The existing Rule requires legal corporations to purchase coverage of at least $100,000 per claim and $300,000 aggregate per year for each attorney in the firm, up to a maximum of $500,000 per claim and $5,000,000 aggregate. The insurance representative that

the Committee consulted advised that the major insurance carriers do not now offer policies with coverage amounts that change in such increments. In fact, a corporate firm of two attorneys apparently has to purchase $800,000 in aggregate coverage (instead of the permitted $600,000) to comply with the existing requirements, because that is the amount of aggregate coverage offered in policies with per claim coverage of $200,000. Also, a corporate firm of three or four attorneys has to purchase per claim coverage of $500,000 (the next available amount over $200,000), and aggregate coverage of $1,500,000, which is the amount of aggregate coverage offered with $500,000 of per claim coverage.

The insurance representative expressed his opinion that the minimum coverage requirements of the existing Rule were inadequate, given the recent claims history of attorneys. Notwithstanding the market realities identified above, however, he suggested that the per claim coverage should be increased to $250,000 per attorney, and the aggregate increased to $500,000 per attorney. Given the policies available in the market today, such minimum requirements would mean that a sole-practitioner practicing in corporate form would have to purchase a policy offering per claim coverage of $500,000, and aggregate coverage of $1.5 million. According to the insurance representative, such a policy is likely to cost 1.6 times as much as a policy offering the existing, minimum required coverage of $100,000 per claim, $300,000 aggregate. The Committee is of the view that such an increase would work an extreme hardship on the sole-practitioner practicing in corporate form, and cannot

recommend that the Rule be amended as suggested by the insurance representative.

The Committee recommends, instead, that the existing, $500,000 cap on required per claim coverage be increased to $5,000,000. Such an amendment would require the larger corporate firms, which are more likely to be able to afford increased premiums, to purchase increased per claim coverage in the face of increasing malpractice claims and awards. However, the Committee is reluctant to recommend any increase in the amount of required coverage for the sole-practitioner or small firm, out of a concern for the financial impact such an increase would have on those firms. The insurance representative advised that, even if the minimum per claim coverage that an attorney were required to purchase were increased to $200,000 (the next amount over the presently required $100,000 typically offered by insurance carriers), this would result in a premium increase of approximately thirty percent.

The Committee considers the insurance requirements of the Rule to be minimum requirements, intended to ensure that some amount of compensation is available to a client who suffers malpractice at the hands of an attorney practicing in corporate form. The Committee believes that the minimum insurance requirements of the Rule should not serve as a financial barrier to sole-practitioners and newly-admitted attorneys.

There is also the issue of fairness to consider, since attorneys or firms that are not incorporated are not subject to mandatory insurance requirements. As the Committee noted above, it

questions whether the continuation of such unequal treatment is warranted. The Committee therefore believes that, under such circumstances, it would be unfair to burden further the sole-practitioner or small firm practicing in corporate form with increased insurance premiums.

The Committee also notes that, as a result of regulations adopted by the New Jersey Department of Insurance that became effective in 1992, a greater amount of a legal malpractice policy's stated coverage must go to pay claims. Prior to the adoption of these regulations, most policies included a provision requiring that the costs of defending the insured firm against a malpractice action come out of and reduce the amount of coverage. Such provisions are known as "defense within limits" provisions. In an extreme example, if a policy with such a provision offered coverage of $100,000, and the costs of defense reached that amount, there would be no coverage left to pay the claim.

The regulations adopted by the Department of Insurance prohibit defense within limits provisions to be included in legal malpractice policies when the amount of coverage is less than $1,000,000. N.J.A.C. 11:13-17.3. For coverage above $1,000,000, defense within limits provisions are still permitted, subject to express limitations. These limitations are discussed in greater detail below, under "Other Issues."

The insurance representative advised that approximately ninety-five percent of the attorneys practicing in the State are in practices of three or fewer attorneys. Thus, for the vast majority

of attorneys, the regulatory prohibition against defense within limits provisions effectively means that more money will be available to pay claims with the same amount of coverage. This reduces the need to require increased coverage, as suggested by the insurance representative.

The insurance representative also expressed the opinion that the regulatory prohibition against defense within limits provisions will come at a cost to attorneys. He speculated that the prohibition will result in increased payouts by insurers (which will now pay both successful claims and costs of defense), which eventually will be passed on to attorneys in the form of higher premiums. Thus, the Committee is reluctant to impose requirements that will further increase the premiums of sole-practitioners and small firms.

The Committee also recommends that the Rule be amended to eliminate the separate requirement for a specific amount of aggregate coverage. As noted above, the malpractice policies offered by carriers in the marketplace do not offer per claim and aggregate coverage, or combinations of such coverage, that reflect the requirements of the Rule. The Committee is of the view that the difficulties involved in establishing minimum requirements that are consistent with market realities could be minimized by imposing requirements only on per claim coverage.

According to the insurance expert, per claim coverage is, after all, the more important coverage. In addition, the elimination of the aggregate coverage requirement is not likely to

pose a significant risk of non-coverage to the public. As explained by the insurance representative, the lower-end policies offered by insurance carriers typically require the attorney to purchase aggregate coverage that exceeds per claim coverage. It is not until the policies start to offer per claim coverage in amounts approaching the newly-recommended cap of $5,000,000 that the difference between per claim and aggregate coverage is eliminated.

Finally, the Committee again notes the regulatory prohibition against defense within limits provisions discussed above. The effects of this prohibition will serve to offset any reduction in aggregate coverage that might be occasioned by the elimination of the requirement of a separate and higher aggregate coverage. The Committee therefore recommends that the separate requirement for a specific amount of aggregate coverage be eliminated from the existing Rule.

2. Amount of permitted deductible

The existing Rule prohibits an attorney practicing in corporate form from purchasing an insurance policy with an annual deductible in excess of $2,000 multiplied by the number of attorneys in the firm, or $5,000, whichever is less.

The Committee was informed that it is impossible for some attorneys to procure insurance with only a $2,000 per attorney deductible. It was also advised that the Court has permitted large corporate firms and their insurance carriers to enter into indemnity agreements to avoid violating the prohibitions of the Rule. Under such agreements, the insurance policy includes the

requisite $5,000 deductible, but the firm indemnifies the carrier for the amount of any settlement or judgment up to a much higher amount -- the <u>effective</u> deductible, so to speak.

The Committee recommends that the Rule be amended to permit expressly the use of indemnity agreements to meet the maximum deductible prohibitions of the Rule. As the Court recognized when it approved the use of such agreements, the insurer remains liable for the payment of any judgment above the stated deductible amount, and must then pursue the law firm for indemnification. The insurance representative indicated that insurers recognize their risk under these indemnity agreements, and investigate the financial condition of firms before entering into an indemnity agreement.

The insurance representative suggested that a more realistic minimum deductible in today's market would be $5,000 per attorney. The Committee believes that even this is too low and recommends that the minimum deductible be increased to $10,000 per attorney. The Committee notes that insurance carriers are responsible for paying the entire amount of a judgment to a successful plaintiff, and then collecting the deductible from the attorney. The insurance representative advised that, because of this, carriers scrutinize an attorney's financial position to determine what level of deductible would be permissible. Given the existence of such controls in the marketplace, the Committee does not deem there to be an urgent need to maintain low deductible requirements. The Committee further recommends that, for the same reasons, the cap on

the permitted deductible amount be increased to $500,000. The Committee believes that this deductible amount is quite reasonable for a firm of greater than 50 attorneys carrying the minimum $5,000,000 per claim coverage proposed by the Committee.

3. Other Issues

The Committee wishes to bring to the attention of the Court several other issues relating to mandatory insurance coverage. The Committee does not, however, recommend that the Rule be amended at this time to address these issues.

The insurance representative advised that there were several areas of practice that are excluded from coverage under the typical malpractice policy. The most common exclusions apply to banking and securities work. The representative stated that with some effort, a firm can probably secure coverage in these areas, but the premium will be quite high.

Some members of the Committee also indicated that they were familiar with policies that excluded coverage for specific clients of the law firm. The insurance representative confirmed that such exclusions exist.

The Committee also was informed that the Court has received an application from a corporate firm seeking permission to practice in an area of law (securities) that is subject to an exclusion under its malpractice insurance policy. This firm apparently claims that it simply cannot secure the requisite coverage.

The existing Rule requires a legal corporation to provide coverage for all of its clients. It states that the policy of

insurance ". . . shall insure the corporation against liability imposed upon it by law for damages resulting from <u>any</u> claim made against the corporation by its clients arising out of the performance of professional services . . ." <u>Rule</u> 1:21-1A(a)(3). Thus, a corporate firm that practices in an area of law or provides professional services to a client that is subject to an exclusion under its malpractice policy is violating the Rule.

The Committee recommends that the Rule's prohibition against practicing in an excluded area remain in place. It does not believe that an amendment to provide for exceptions to this requirement is either feasible or desirable. The Committee did not have before it sufficient evidence demonstrating that it was necessary to amend the Rule to permit a corporate firm to practice in certain specific areas, such as regulatory or securities law, without insurance coverage. After all, the insurance representative indicated that coverage in excluded areas could be located -- for a price. In addition, the Court has apparently received only one formal application requesting approval to practice in an excluded area.

Nor does the Committee deem it appropriate to establish special procedures for applying for relief from the requirements of the Rule on exclusions. As a practical matter, any such relief would have to be reviewed and approved by some entity, and there would appear to be no body in a better position to make such a determination than the Court. In addition, the establishment of special procedures for seeking relief from the Rule to practice in

an area subject to an exclusion is likely to encourage requests for such relief, if nothing else. The Committee therefore believes that the existing practice -- requiring a corporate firm that wishes to practice in an area of law that is subject to an exclusion under its malpractice policy to file a formal application to the Court for relaxation of the Rules of Court -- should continue.

As mentioned above, defense within limits provisions, which require that costs of defense come out of and reduce the amount of the stated coverage in the policy, are still permitted when the offered coverage is at least $1,000,000, subject to certain limitations. This means that, for policies containing such provisions, the amount of coverage that is available to pay claims is likely to be less than the stated amount of coverage.

When the coverage is $1,000,000 or more, the regulations permit defense costs to reduce the coverage by the costs of defense that exceed 50% of the coverage limit. The regulations further provide that, regardless of the amount of defense costs incurred, such costs cannot reduce coverage by an amount greater than 50% of the stated limit. As an example, for a policy providing $1,000,000 in coverage and including such a provision, defense costs can reduce coverage by the amount that those costs exceed $500,000. However, even if defense costs exceed $1,000,000, a minimum of $500,000 in coverage must remain available to pay claims (costs in excess of $1,000,000 no longer reduce coverage).

The Committee does not recommend that the Rule be amended to require that the minimum required coverage amounts be exclusive of any costs of defense. Based on the information provided by the insurance representative, very few attorneys are required to purchase a malpractice policy offering coverage of $1 million or more. Thus, the number of policies that can include defense within limits provisions is quite small. In addition, any such requirement could result in a huge increase in premiums for the firms that were required to purchase such polices. For example, if a large firm of 50 attorneys has an existing policy requiring that defense costs be charged against coverage to the maximum extent permitted under the regulation (50 percent of the stated coverage), the firm would be required to purchase a policy that offered coverage of $10,000,000, instead of the $5,000,000 that would be required by the Committee's proposed amendments to the Rule.

The Committee believes that the effects of the Department of Insurance's regulatory prohibition against defense within limits provisions provides a valuable opportunity to analyze the relationship between insurance premiums and such provisions. The Committee therefore recommends that the effects on premiums of the Department of Insurance's regulatory prohibition be assessed fully prior to the Rule being amended to address the use of these provisions.

The Committee also considered the issue of dissolution of the legal corporation and its effects on the availability of insurance coverage for former clients of the firm. The Committee notes that

the existing Rule does not establish any continuing obligation on the part of the attorneys who were shareholders or employees of the corporation to carry malpractice insurance after dissolution. This means that claims made against the corporate firm and its attorneys after dissolution might not be covered by insurance. It is, of course, possible that some of the attorneys will voluntarily purchase their own insurance to cover them for any malpractice while with the corporate firm. However, such insurance is not subject to the same minimum coverage requirements that might have been applicable to the prior legal corporation.

Although there is an obvious gap in the Rule concerning continued coverage for the legal corporation after dissolution, the Committee does not recommend that the Rule be amended to close this gap, for the following reasons. First, the Committee is unable to determine whether such a gap poses a serious problem. As noted above, many attorneys who continue to practice after dissolution will voluntarily purchase malpractice insurance to protect themselves. Indeed, those that form new professional corporations will be required to do so.

In addition, it may be difficult for a dissolving legal corporation to afford continued coverage for claims made after dissolution against all attorneys who were with the firm. The insurance representative advised that such coverage, which is known as an "extended reporting endorsement," is quite expensive. Finally, to the extent that dissolving legal corporations pose insurance problems for members of the public, such problems would

be ameliorated by a requirement that all attorneys, regardless of form of practice, carry malpractice insurance. Were all attorneys required to purchase insurance, only the attorney retiring from practice in New Jersey would pose a potential problem of coverage. The Committee therefore recommends that this issue also be addressed by any committee the Court forms to consider ways to ensure that valid legal malpractice claims are paid, including extending the mandatory malpractice insurance requirement to all attorneys.

CONCLUSION

The Committee has reviewed the requirements for foreign legal corporations practicing in New Jersey, and the mandatory insurance provisions of Rule 1:21-1A, as requested by the Court. The following is a summary of the Committee's findings and recommendations.

The Committee concludes that the Professional Services Corporation Act prohibits foreign legal corporations from practicing in New Jersey in corporate form. The Committee notes, however, that foreign legal corporations are permitted to practice in New Jersey as partnerships in affiliation with the foreign corporation. The Committee concludes that this makes little sense, and recommends that the Professional Services Corporation Act be amended to expressly permit foreign legal corporations to practice in New Jersey in corporate form. The Committee proposes specific amendments to the Rules of Court to effectuate such a statutory amendment. These amendments appear in Appendix A of this Report. In addition, the Committee proposes that the Rules of Court be further amended to ensure that all attorneys practicing in New Jersey comply with all requirements of the Rules of Court, regardless whether they are affiliated with a foreign law firm. These amendments also appear in Appendix A.

A representative from the Department of State, Division of Commercial Recording, participated as a member of the Committee at the invitation of the Court. The Committee specifically sought feedback from the Division regarding the technical feasibility of

filing by foreign professional corporations pursuant to the Committee's recommendation, found under Point I. The Division's representative indicated that there appeared to be no technical barriers to such filings. The representative noted, however, that any specific statutory changes allowing foreign professional corporation filings should address general licensing and regulatory requirements, and allow for full executive branch review and comments in the context of New Jersey's corporate statutes.

Concerning the insurance requirements of Rule 1:21-1A, the Committee concludes that the differences in personal liability between an attorney practicing in corporate form and an attorney practicing in some other form are not significant enough to warrant imposing the mandatory insurance requirement only on attorneys practicing in corporate form. This inequity could be remedied if the mandatory insurance requirement were extended to apply to all attorneys, regardless of the form of practice. The Committee determined not to address this far-reaching and sensitive issue, however, primarily because the Court did not create it with such a charge in mind. The Committee strongly recommends that the Court appoint a committee for the express purpose of addressing this issue. The Committee further suggests that such a committee be advised of the additional question of whether dissolving firms or retiring attorneys should be required to purchase an extended period of coverage.

The Committee consulted with a representative of the insurance industry in considering whether the specific requirements of Rule

1:21-1A should be amended to reflect changes in insurance practices and economic realities since the Rule was last reviewed. The Committee concluded that several of these requirements should be amended. The Committee recommends that the minimum amounts of required coverage should remain unchanged, but that the cap on such coverage should be increased to $5,000,000 to satisfy the increased damages awarded for malpractice claims. It also recommends the elimination of the separate requirement for aggregate coverage, since the policies offered in the marketplace do not offer combinations of per claim and aggregate coverage that are consistent with the requirements of the Rule. The Committee further recommends increasing the amounts of the minimum deductibles that are permitted, based on the deductibles that are realistically available in today's market. In addition, it recommends that the Rule expressly permit the use of indemnity agreements to meet the minimum permitted deductible requirements. All of these proposed amendments to the requirements of the Rule appear in Appendix B of the Report.

As a final note, the Committee points out that a law was recently enacted in New Jersey that authorizes a new business form -- the limited liability company (LLC). The Committee understands that this new business form has received much attention from professionals because of the beneficial tax treatment afforded it by the federal government, and the flexibility in establishing what is known as the LLC's "operational agreement" (which may include limiting the personal liability of "members" of the LLC). The

Committee anticipates that the Court will be requested to approve the use of the LLC by attorneys in New Jersey. The major question that the Court will face in this regard is the extent to which the operational agreements of legal LLC's would be permitted to limit the personal liability of attorney-members for legal malpractice. Although the Committee has not reviewed the law authorizing LLC's in detail, it anticipates that the remainder of the requirements imposed on legal LLC's would closely mirror those imposed on attorneys practicing in corporate form under Rule 1:21-1A. Detailed recommendations, however, should await the review of a committee established for the purpose of reviewing whether legal LLC's should be permitted and, if so, under what conditions.

Respectfully submitted,

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Dated: April 8, 1994

APPENDIX A

Proposed amendments to Rules of Court to permit foreign legal corporations and other foreign firms to practice in New Jersey. (Additions to existing Rules are underlined, deletions in brackets.)

Rule 1:21-1A. **Professional Corporations for the Practice of Law**

(a) Attorneys may [form professional corporations under the "Professional Service Corporation Act" (N.J.S.A. 14A:17-1 et seq.), to] engage in the practice of law as professional corporations in the same manner as an individual or a partnership may engage in the practice of law, provided that;

(1) All provisions of the "Professional Service Corporation Act" (N.J.S.A. 14A:17-1 et seq.), shall be complied with.

(2) No change.

(3) No change.

(b) Within 30 days after filing its certificate of incorporation or, in the case of a corporation incorporated in a state other than New Jersey, the filing of its registration with the Secretary of State, each professional corporation formed to engage in the practice of law shall file with the Clerk of the Supreme Court a certificate of insurance, issued by the insurer, setting forth the name and address of the insurance company writing the insurance policies required by paragraph (a)(3) of this rule and the policy number and policy limits. The professional corporation shall also file such other information as the Supreme Court may from time to time prescribe.

Amendments to and renewals of the certificate of insurance shall be filed with the Clerk of the Supreme Court within 30 days after the date on which such amendments or renewals become effective.

(c) The corporate name of the professional corporation shall comply with the provisions of RPC 7.5 and shall contain only the full or last names of one or more of its shareholders or members of a predecessor firm, whether the shareholder or member be living, deceased or retired. Wherever the corporate name of the professional corporation is used it shall be followed by the phrase "A professional corporation," or by any other phrase or abbreviation authorized by N.J.S.A. 14A:17-14 to indicate that it is a professional corporation. When a professional corporation is incorporated in a jurisdiction other than New Jersey, the phrase shall also identify the state of incorporation (e.g., "A professional corporation incorporated in the State of New York"). The corporate name shall be used on all pleadings, correspondence or other documents. Correspondence, pleadings and other documents executed in connection with the practice of law shall be executed on behalf of the corporation by one of its attorney employees. Corporate documents executed other than in connection with the practice of law may be executed on behalf of the corporation by an authorized employee who is not licensed to practice law.

(d) No change.

(e) The Board of Directors of a professional corporation for the practice of law shall consist of one or more persons, all of

whom shall be licensed [members of the bar in New Jerseey] to practice law, and at least one of whom shall be licensed to practice in New Jersey. Such directors need not be shareholders. [Other than the President, officers] Officers of the professional law corporation need not be licensed members of the New Jersey bar unless the corporation is incorporated in New Jersey, in which case the president shall be so licensed.

(f) A professional corporation may engage in the practice of law in partnership with another professional corporation or corporations, or with an attorney or partnership of attorneys. The partnership name shall, in addition to meeting the requirements of [R.] Rule 1:21-1A(c), be followed by the designation "a partnership of professional corporations" or "a partnership including professional corporations." When any member of a partnership is a professional corporation that is incorporated in a state other than New Jersey, the required designation shall also state this fact. [In such event,] When the professional corporation is engaged in the practice of law in partnership with another corporation, partnership, or attorney, all disciplinary rules and rules of practice applicable to partnerships of attorneys will apply.

Rule 1:21-6 Recordkeeping; [Sharing of Fees;] Examination of Records

(a) - (d) No change.

(e) [Members, Associates and Employees of Out of State Firms. No attorney who practices in this State who is a member of a firm, or an associate or employee of a firm or attorney, practicing outside this State;

(1) shall share with such firm or attorney any fee for legal services rendered in this State if payment to such firm or attorney is prohibited by R.P.C. 1.5(e) of the Rules of Professional Conduct; or

(2) shall fail to maintain and preserve for 7 years separate records of the fees received and expenses incurred in the attorney's practice of law in the State.]

Attorneys Practicing with Out of State Attorneys, Partnerships, or Professional Corporations. All of the requirements of this rule shall be applicable to every attorney or office of a legal corporation or legal partnership practicing in this State regardless whether it is affilitated with or otherwise related in any way to an attorney or legal corporation or legal partnership in some other state.

(f) - (i) No change.

APPENDIX B

Proposed amendments to specific insurance requirements imposed on professional corporations. (Additions to existing Rule are underlined, deletions are in brackets.)

Rule 1:21-1A. **Professional Corporations for the Practice of Law**

(a) Attorneys may form professional corporations under the "Professional Service Corporation Act" (N.J.S.A. 14A:17-1 et seq.), to engage in the practice of law in the same manner as an individual or a partnership, provided that;

(1) All provisions of the "Professional Service Corporation Act" shall be complied with.

(2) The professional corporation shall comply with and be subject to all rules governing the practice of law by attorneys and it shall do nothing which, if done by an individual attorney would violate the standards of professional conduct applicable to the attorneys licensed to practice law in this State. Any violation of this rule by the professional corporation shall be grounds for the Supreme Court to terminate or suspend the professional corporation's right to practice law or otherwise to discipline it.

(3) The professional corporation shall obtain and maintain in good standing one or more policies of lawyers' professional liability insurance which shall insure the corporation against liability imposed upon it by law for damages resulting from any claim made against the corporation by its clients arising out of the performance of professional services by attorneys employed by

the corporation in their capacities as attorneys. The insurance shall be in an amount for each claim of at least $100,000 multiplied by the number of attorneys employed by the corporation [with an aggregate maximum limit of liability per policy year for all claims in the amount of at least $300,000 multiplied by the number of attorneys employed by the corporation], provided that the maximum coverage shall not be required to exceed [$500,000] $5,000,000 for each claim [and $5,000,000 for all claims during the policy year], and further provided that the deductible portion of such insurance shall not exceed [$2,000] $10,000 multiplied by the number of attorneys employed by the corporation or [$5,000] $500,000 whichever is less. The corporation may enter into an indemnity agreement with its insurer under which the corporation agrees to indemnify the insurer for losses in excess of the amount of the permitted deductible, provided that the insurer remains liable to pay all judgments against the corporation up to the policy limits regardless whether the corporation indemnifies the insurer as required under the indemnity agreement.

(b)-(f) No change.

APPENDIX C

MINORITY REPORT

This member of the Committee disagrees with the Committee's recommendation regarding the amount of required malpractice insurance coverage. He believes that the Rule should be amended to increase the minimum amount of coverage per claim, as the current $100,000 minimum has not been changed in over a dozen years, despite inflation and, more importantly, despite increases in the value of potential losses suffered by clients in the event of attorney malpractice.

The Majority's recommendation not to increase the $100,000 minimum per claim per attorney appears to be based on at least three considerations, none of which I find sufficiently compelling to justify not increasing that minimum. First, the Majority notes that increasing the minimum to $200,000 would likely result in a premium increase of approximately 30%. However, that increase would only occur for those attorneys who are currently carrying only the minimum. The Committee did not obtain statistics (and they may not be readily available) regarding how many professional corporations carry only the minimum coverage. Moreover, when balanced against what I perceive as higher potential losses to clients in the event of malpractice, as well as my concern as to how the public would perceive a decision that no increase in minimum coverage is required, I do not view a 30% premium increase as inappropriate. While I appreciate the financial realities facing sole-

practitioners and newly-admitted attorneys, the pubic might well perceive that the potential for malpractice is even greater in such practice situations.

The Majority also cites the issue of fairness, noting that firms that do not chose to practice as professional corporations have no mandatory malpractice insurance requirements. Putting aside for subsequent review by another Committee the wisdom of continuing this differential treatment, the fact that a sole-practitioner or newly-admitted attorney need not chose to practice in the corporate form in some ways undercuts the Majority's concern regarding increased premiums.

The Majority also notes that the effect of the New Jersey Department of Insurance's recently adopted prohibition against defense within limits will mean that more money will be available to pay claims with the same amount of coverage. While that observation is accurate, the impact of that change will be significant only in those cases in which relatively significant defense costs have been incurred. In those situations in which malpractice was clearly committed, presumably the effect of this prohibition will be minimal in terms of making a larger portion of the coverage amount available to pay the claim.

Because this member finds the Majority's reasons for not increasing the minimum coverage unpersuasive, he recommends that the Rule be amended to require minimum per claim coverage to start at $200,000 per attorney, up to a maximum of $5,000,000 per claim.

This member also disagrees with the Majority's recommendation that the Rule be amended to eliminate the separate requirement for a specific amount of aggregate coverage. My concern is that if no aggregate is required, then it is certainly conceivable that the market may adjust its current offerings so that attorneys will be able to obtain the minimum per claim coverage with no aggregate. That development would result in even less protection for the second or third malpractice victim than currently exists.

Recognizing the concerns of the Majority regarding costs to sole practitioners, newly-admitted attorneys and smaller firms, I would recommend that the current minimum aggregate amount of $300,000 per attorney remain in place, up to a maximum of $5,000,000. This maximum recognizes the fact that as policies reach the level of $5,000,000 per claim, the difference between per claim and aggregate coverage is eliminated.