When is an LLP Not an LLP?

Supreme Court to Decide Whether an LLP Loses its Status if it Fails to Maintain Liability Insurance

by Peter J. Gallagher

On Feb. 1, the New Jersey Supreme Court heard oral argument in *Mortgage Grader, Inc. v. Ward & Olivo*,[1] a case that could have been ripped straight from a law school exam. The question on appeal is whether a partner in a law firm organized as a limited liability partnership loses the liability protections normally afforded in those partnerships if the business fails to maintain professional liability insurance.

The answer sits at the intersection of the Court Rules, the Rules of Professional Conduct, and the Uniform Partnership Act. The Supreme Court wrestled with each during oral argument. The Uniform Partnership Act does not require limited liability partnerships to maintain professional liability insurance. That requirement, only applicable to attorneys, comes from the Court Rules. But, the Court Rules do not empower courts to terminate a partnership's limited liability status for any reason, including for not maintaining malpractice insurance. Instead, the Uniform Partnership Act sets forth the only circumstances in which this status can be revoked and, because maintaining insurance is not a requirement under the Uniform Partnership Act, failing to maintain insurance is not one of those circumstances.

This was the dilemma faced by the trial court and the Appellate Division, and now being faced by the Supreme Court. Attorneys engaged in the practice of law as a limited partnership must maintain malpractice insurance. But what happens when they don't? Or more accurately, what happens when they don't continue to maintain malpractice insurance after they have stopped practicing as a limited liability partnership?

Background

The defendants in *Mortgage Grader* were a law firm, Ward & Olivo, LLP (W&O), and the two named partners in that firm, John Ward and John Olivo. As the name suggests, Ward and Olivo formed W&O as a limited liability partnership under the Uniform Partnership Act.[2] While practicing as W&O, Ward and Olivo obtained and maintained a claims-made professional liability insurance policy.

In 2009, the plaintiff retained W&O to sue various individuals and entities for patent infringement. Olivo and the plaintiff entered into a contingency fee arrangement in connection with these lawsuits, all of which were settled by the plaintiff granting the individuals and entities it sued licenses in exchange for a one-time settlement payment. Ward had no involvement in these lawsuits, the settlements, or Olivo's representation of the plaintiff.

In June 2011, Ward and Olivo stopped practicing law as W&O. Ward left W&O and began practicing with another partner in a different limited liability partnership. W&O thereafter began to wind up its practice by collecting outstanding legal fees. Two months later, W&O's professional liability insurance policy expired. Ward and Olivo did not renew the policy or purchase a tail policy to cover any malpractice claims that might have accrued, but had not yet been asserted, during the claims-made policy period.

The Underlying Lawsuit and the Trial Court's Decision

In 2012, approximately one year after Ward and Olivo stopped practicing law as W&O, the plaintiff sued W&O, Ward, and Olivo, alleging that Olivo's legal advice had harmed its patent rights. The plaintiff did not allege that Ward did anything wrong, but instead alleged that both Ward and W&O were vicariously liable for Olivo's acts and omissions.

Ward answered the complaint, but the plaintiff subsequently failed to serve him with an affidavit of merit. Ward moved to dismiss, arguing that: 1) the plaintiff never served him with an affidavit of merit, and 2) even if this were not the case, the Uniform Partnership Act shielded him from vicarious liability for Olivo's alleged negligence. The plaintiff countered

that it had substantially complied with the affidavit of merit requirement by serving Olivo and W&O with affidavits of merit, and that Ward was not shielded from liability because W&O lost its status as a limited liability partnership when it dissolved without obtaining a tail insurance policy.

The second of these arguments was based on the plaintiff's interpretation of the Uniform Partnership Act, which governs all partnerships, and the Court Rules, which govern lawyers practicing as a partnership. Under the Uniform Partnership Act, a general partnership can become a limited liability partnership by amending its partnership agreement and filing a statement of qualification with the Department of Treasury.[3] However, under Rule 1:21-1C, attorneys engaged in the practice of law as a limited liability partnership are required to not only satisfy these general requirements, but also "obtain and maintain in good standing…lawyers' professional liability insurance which shall insure the limited liability partnership against liability imposed upon it by law for damages resulting from any claim made against the limited liability partnership by its clients…."

The plaintiff argued that W&O failed to satisfy this requirement and, therefore, should be treated as a general partnership, in which all partners are vicariously liable for their fellow partners' acts and omissions.

The trial court agreed with Ward on the first issue, holding that the plaintiff was required to serve a separate affidavit of merit on Ward, but disagreed with Ward on the second issue. It held that obtaining malpractice insurance was a condition precedent to practicing as a limited liability partnership, and because W&O allowed its policy to expire after it dissolved, it was "relegated…to the status of a general partnership." Once W&O was converted to a general partnership by the trial court, Ward became vicariously liable for Olivo's alleged negligence. Ward appealed.

The Appellate Division's Decision

The Appellate Division reversed, holding that neither the Uniform Partnership Act nor the Court Rules permit a court to strip a partnership of its limited liability status for failing to maintain malpractice insurance.[4]

The Appellate Division began by analyzing the plain language of the Uniform Partnership Act. In doing so, it was guided by the well-established maxims: 1) that its goal was to determine the Legislature's intent, 2) that the best indicator of that intent was the statutory language, and 3) that the statutory language had to be given its ordinary meaning and significance.[5]

The Appellate Division then observed that the plain language of the Uniform Partnership Act "express[ed] the Legislative intent that the partners of an LLP are shielded from liability for a fellow partner's acts."[6] It further observed that, under the Uniform Partnership Act, the status of a limited liability partnership remains intact until the partnership cancels its status or the Department of the Treasury revokes it. Therefore, the Appellate Division concluded that the Legislature did not intend for a limited liability partnership to revert to a general partnership whenever the limited liability partnership failed to maintain professional liability insurance as required by the Court Rules.

The Appellate Division took the same approach to its review of the Court Rules. It agreed that, under Rule 1:21-1C(a)(3), attorneys practicing as a limited liability partnership must maintain malpractice insurance. But it held that the Court Rules enumerate specific sanctions for limited liability partnerships that fail to do so, and stripping partners of the liability protections generally afforded to partners in a limited liability partnership was not one of them. Instead, the Court Rules provide the following: "[a]ny violation of [Rule 1:21-1C] by the [limited liability partnership] shall be grounds for the Supreme Court to *terminate* or *suspend* the [limited liability partnership's] right to practice law *or* otherwise *discipline* it."[7] The Appellate Division, therefore, concluded that the Court Rules allowed the Supreme Court to terminate or suspend a limited liability partnership's right to practice if it failed to maintain liability insurance, but, "[a]s currently written," did not allow the Supreme Court, or any court, to convert a limited liability partnership to a general partnership for its failure to do so.[8]

Ultimately, the Appellate Division held that, because the plain language of the Uniform Partnership Act and the Court Rules did not permit a court to convert a limited liability partnership to a general partnership when a law firm fails to maintain a tail insurance policy, it could not "assume the Legislature or [the] Supreme Court intended such a result."[9] The Appellate Division concluded that "[o]nly the Legislature [could] amend the [Uniform Partnership Act], or our highest court [could] revise Rule 1:21-1C, to make such an outcome explicitly clear."[10]

The Supreme Court

The plaintiff filed a petition for certification with the Supreme Court, which was granted. Although it is always dangerous to infer a decision from the questions asked during oral argument, it appeared a majority of the Supreme Court was inclined to affirm the Appellate Division's decision. Several justices noted, like the Appellate Division, that neither the Uniform Partnership Act nor the Court Rules appeared to allow for the remedy imposed by the trial court. While it is undisputed that attorneys practicing as a limited liability partnership must maintain liability insurance,

several justices appeared unwilling to adopt the trial court's remedy, and the remedy urged by the plaintiff, for an attorney's failure to do so absent statutory authority.

Under Rule 1:21-1C(a)(2), the sanctions available to the Supreme Court for a limited liability partnership's failure to obtain and maintain liability insurance are: 1) "to terminate or suspend the limited liability partnership's right to practice law," or 2) "otherwise to discipline it." A majority of the Supreme Court appeared to accept that these sanctions were the only sanctions available to remedy the failure of a partnership to obtain liability insurance. Moreover, a majority of the Supreme Court appeared to read "otherwise [ ] discipline it" as allowing for "discipline" akin to the discipline that could follow a violation of the Rules of Professional Conduct (*i.e.*, censure, reprimand, admonition, etc.), not a remedy like the one imposed by the trial court.

Nonetheless, the Supreme Court did not ignore the competing policy interests presented by this case—balancing the rights of attorneys to practice as business entities (professional corporations, limited liability corporations, limited liability partnerships) with the right of clients to be protected against uninsured risks. But, unlike the trial court, the Supreme Court appeared less inclined to address those issues through this case, and instead appeared content to leave them, if at all, to the Legislature to resolve. The trial court had concluded that the "entire dilemma could have been avoided by the purchase of tail coverage," and that a tail policy was "the unfortunate cost of doing business in New Jersey." The Supreme Court did not appear to share in this belief, as several justices noted the various policy decisions that were subsumed in the trial court's conclusion. For example, it was impossible for any court to fully understand the costs of obtaining tail coverage; whether the issue was widespread enough to impose these costs on all lawyers; the length of time the tail coverage would need to be in place; and the equity of different lawyers having to obtain tail coverage of different durations based on their practices. A majority of the Supreme Court appeared unwilling to resolve these difficult policy questions in the context of the case before them.

Ultimately, it appears that the Supreme Court is likely to affirm the Appellate Division. This does not necessarily mean the issue will go away. Although the Supreme Court did not suggest that change was warranted, the Legislature and the Supreme Court could, respectively, amend the Uniform Partnership Act and the Court Rules to create a new remedy like the one imposed by the trial court. However, if this happens, changes could only be made after the deliberative processes that accompany the amendment of a statute or the revision of a Court Rule, and only after providing interested stakeholders with the opportunity to weigh in on the costs and benefits of any proposed changes. ⚖

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ENDNOTES

1. 438 N.J. Super. 202 (App. Div. 2014).
2. N.J.S.A. 42:1A-1 to -56.
3. N.J.S.A. 42:1A-47.
4. The Appellate Division reversed the trial court's decision on Ward's vicarious liability for Olivo's actions, but affirmed the trial court's decision on the ramifications of the plaintiff's failure to serve Ward with an affidavit of merit. On the latter issue, the Appellate Division agreed with the trial court that it was inappropriate to employ the equitable principle of substantial compliance to excuse the plaintiff's failure to serve Ward with an affidavit of merit. It agreed with the trial court that there were "no deliberate, thoughtful steps taken to comply with the statute, the purpose of the statute was essentially ignored, there was no reasonable notice of the claim as to Ward personally and no remotely reasonable explanation of why there was not strict compliance." However, this issue was not certified for appeal to the Supreme Court; therefore, it is not discussed at length in this article.
5. Mortgage Grader, 438 N.J. Super. at 209.
6. *Id.*
7. *Id.* at 211 (*citing* R. 1:21-1C(a)(2)) (emphasis in original).
8. *Id.* at 213.
9. *Id.*
10. *Id.*