

AGENDA ITEM

AUGUST 127

Status Report Re:
Frye v. THC

DATE: August 1, 2006

TO: Members Board Committee on Regulation, Admissions & Discipline
Members, Board Committee on Stakeholder Relations

FROM: Robert A. Hawley, Deputy Executive Director

SUBJECT: Status Report: Study, Report & Recommendations Regarding Practice of Law in Nonprofit Corporations [On Referral from the Supreme Court, (see *Frye v. Tenderloin Housing Clinic, Inc.* (2006) 38 Cal 4th 23.)]

EXECUTIVE SUMMARY

On March 9, 2006, the California Supreme Court issued its decision in Frye v. Tenderloin Housing Clinic, Inc., (2006) 38 Cal.4th 23, 40, holding that nonprofit public benefit corporations (including legal aid societies, public interest advocacy organizations and mutual benefit entities) providing legal services to the public are not subject to existing regulations governing the practice of law by professional law corporations. In doing so, the Supreme Court directed the State Bar, as its administrative arm in the regulation of the profession, to conduct a study and report back to the Court as to whether regulation of nonprofit legal service providers is warranted. The State Bar has developed an action plan to respond to the directive of the Supreme Court. This process is being overseen by the Board Committee on Regulation, Admissions & Discipline (RAD). The action plan was "previewed" at the last Board meeting. It is presented here for RAD's approval and implementation and the Board's information. Once the process is completed, RAD will report to the Board on its recommended response to the Supreme Court. For further information or questions on this item please contact Robert Hawley at Robert.Hawley@calbar.ca.gov, 415-538-2277.

Introduction

On March 9, 2006, the California Supreme Court issued its decision in *Frye v. Tenderloin Housing Clinic, Inc.*, (2006) 38 Cal.4th 23, 40 Cal.Rptr.3d 221, holding that nonprofit public benefit corporations (including legal aid societies, public interest advocacy organizations and mutual benefit entities) providing legal services to the public are not subject to statutory regulations governing the practice of law by professional law corporations. In doing so, the Supreme Court directed the State Bar, as its administrative arm in the regulation of the profession, to conduct a study and report back to the Court as to whether regulation of nonprofit legal service providers is warranted. The Supreme Court's directive to the State Bar was as follows:

“In view of the State Bar’s experience in regulating the practice of law, its knowledge of the practical problems presented by various forms of law practice, and its ability to seek information and recommendations from the legal community and other interested persons, we believe the matter should be referred to the State Bar for further study, followed by a report and specific recommendations to this court. After appropriate study and specific recommendations from the State Bar, we shall consider the implementation of carefully drawn regulations directed at the practice of law by nonprofit corporations, if such regulations meet a demonstrated danger of injury to clients without impairing First Amendment expressive and associational rights.”

Frye v. Tenderloin Housing Clinic, Inc. (2006) 38 Cal 4th 23, 241.

State Bar staff has developed an action plan to respond to the directive of the Supreme Court that includes surveying the consuming public and providers of legal services of the nature at issue, conducting public hearings, and gathering relevant data from State Bar records and other enforcement agencies. This process is being overseen by the Board Committee on Regulation, Admissions & Discipline (RAD). The action plan was “previewed” at the last Board meeting. It is presented here for RAD’s approval and implementation and the Board’s information. Once the process is completed, RAD will submit to the Board its recommended response to the Supreme Court.

Recommendation/Resolution

This item is before the RAD Committee, on referral from the Board Operations Committee, for approval and implementation. This study is being treated as a form of public comment authorized by the Committee rather than full Board. Once RAD develops its final report and recommendations upon completion of the study, the Board will be requested to review and approve it. Assuming that the action plan set forth meets with the approval of the committee the following resolution is proposed:

RESOLVED, that the Board Committee on Regulation, Admissions & Discipline directs staff to proceed with the action plan discussed this date in response to the California Supreme Court’s referral to the State Bar in *Frye v. Tenderloin Housing Clinic, Inc.*, (2006) 38 Cal.4th 23, 40 Cal.Rptr.3d 221; and it is

FURTHER RESOLVED, that staff periodically report back to the Board Committee on Regulation, Admissions & Discipline as to the progress being made on the action plan; and it is

FURTHER RESOLVED, that staff provide a proposed report and recommendations to the Committee at the completion of the action plan for approval prior to submission to the Board of Governors.

Personnel/Fiscal Impact

There are personnel workload and budget costs associated with this item. They will be absorbed by within existing budget limitations.

Administrative manual impact

None.

Background

As early as 1922, public policy articulated by California courts prohibited lawyers from practicing law through corporate forms. The policy was based on the nature of the attorney-client relationship, predicated as it was, upon the individualized duty of loyalty, confidentiality, and fidelity between a lawyer and client, and the potential dilution of those duties when law is practiced through a corporate entity that is itself a legal “person” unlicensed to practice law. This perspective is presented in *People v. Merchants Protective Corporations* (1922) 189 Cal. 531; *People v. California Protective Corporation* (1926) 76 Cal.App. 354; and *Gafcon v. Ponsor & Associates* (2002) 98 Cal.App.4th 1388,

As experience with corporate forms grew, the possibility of lawyers forming professional corporations and still retaining the necessary commitment to professional ethics became a reality. In 1968, the Knox-Moscone Professional Corporations Act (Corporations Code Sections 13400-13410) and Business & Professions Code 6127.5 and 6160 were enacted with the support of the State Bar allowing lawyers to incorporate and practice law as professional corporations. To address the professional responsibility issues governing the attorney-client relationship, law corporations were required to register with the State Bar in order to receive the benefits of that form of practice.

The goal of this regulation was to assure that the legal entity created by incorporation was authorized to practice law, as well as the individual lawyers within the entity. The individual lawyer representing client interests is always subject to the regulation of the State Bar. When practicing in an association or partnership, the individual lawyer’s professional responsibilities flow through the entity to the client. But incorporation creates a separate legal corporate entity that must itself be entitled to practice law.

The Professional Corporations Act focused upon private law firms practicing in the corporate form and did not address nonprofit entities practicing law for the public interest. These nonprofit organizations consisted of legal aid societies, public interest advocacy organizations (like the ACLU, NAACP, Pacific Legal Foundation) and mutual benefit associations (like trade unions) that provided legal services to the California public through a variety of business forms for decades, and continued to do so without change after the enactment of the Professional Corporations Act.

In 1972, the California Attorney General was called upon to opine as to whether these nonprofit entities could continue to engage in law practice without complying with State Bar registration requirements. The Attorney General recognized three exceptions that allowed nonprofit entities to engage in the practice of law without the formalities of entity regulation where the mission of the entity was the public interest, rather than profit advancement. The three excepted entities were: 1) public interest entities established and operated for the purpose of preserving and defending the legal rights and interests of the indigent or oppressed; 2) associations that represented their members in matters of common interest; and 3) legal aid societies that provided free legal services to those unable to afford counsel. [See, 55 Ops.Cal.Atty.Gen. 39 (1972) and 75 Ops.Atty.Gen. 92 (1992).]

In 1993-94, the Oakland Community Law Center (OCLC), an unincorporated legal service entity that charged fees on a sliding scale, sought an opinion from the Attorney General allowing it to incorporate as a nonprofit public benefit corporation and still remain within the legal aid society exception to State Bar registration. The Attorney General found that by charging fees, OCLC failed to fit within the legal aid society standard, and did not fit the other exceptions recognized by the Attorney General. [See, 75 Ops.Cal.Atty.Gen. 92 (1992).]

OCLC then sought legislation to allow it to incorporate as a nonprofit entity, charge fees, and practice law, subject to registration. Section 13406(b) was then added to the Corporations Code, permitting organizations to incorporate as nonprofit public benefit corporations and practice law, subject to various restrictions.

These issues were at the center of *Frye v. Tenderloin Housing Clinic, Inc.* The underlying litigation in *Frye* began as a landlord-tenant dispute. Frye and several other tenants of a residential hotel retained Tenderloin Housing Clinic, Inc. (“THC”). THC was a nonprofit public benefit corporation that provides, among other things, legal services to low and moderate income tenants in San Francisco, California. It did not register as such with the State Bar.

Frye claimed that THC was not entitled to attorneys fees because it had not complied with Corporations Code section 13406(b) that required registration with the State Bar to practice law as a nonprofit law corporation. The trial court found that there was no requirement that THC register with the State Bar in order to render legal services. The Court of Appeal reversed, holding that all nonprofit public benefit corporations must register with the State Bar in order to practice law in California in the corporate form.

The Supreme Court ultimately determined that incorporation as a nonprofit public benefit law corporation under section 13406(b) is permissive rather than mandatory. The Supreme Court noted that section 13406(b) is not the exclusive body of law under which nonprofit organizations are authorized to operate and provide legal services in California and that, in enacting section 13406(b), the Legislature intended to expand the provision of legal services in California, not place restrictions on existing nonprofit

providers. The Court reasoned that to hold otherwise could raise First Amendment issues, since such organizations have a First Amendment right of association and expression to organize for political and advocacy purposes, and nonprofit law practices tended to involve themselves in activities which engage these protections.

The Supreme Court's Referral to the State Bar

Despite its holding in *Frye*, the Supreme Court recognized that it could impose registration and other requirements on nonprofit law corporations under its plenary authority to regulate the practice of law in California. The Court indicated that it would only consider such regulations if they addressed a demonstrated danger of injury to clients and appropriately balanced the applicable First Amendment expressive and associational rights. The Court then referred the matter to the State Bar of California for a study and report to the Court on the advisability of any such regulations.

Specially, the Court directed the Bar to determine whether there is evidence of actual client endangerment resulting from law practice in a nonprofit setting and whether any discovered harm to clients warrants regulation of the nonprofit entity itself, as opposed to the regulation of the individual attorneys, who remain always subject to State Bar and Supreme Court oversight. To this end, the Court instructed the Bar to:

1. Determine whether nonprofits actually imperil client interests and to consider how such a danger, if it exists, may be mitigated by regulations consistent with First Amendment principles.
2. Determine whether, absent the usual profit motive, a nonprofit organization's ideological motivation may, nevertheless, pose a risk to client interests, and if so, whether it is appropriate to impose reasonable regulation directed at the nonprofit and the employed lawyers governing the day-to-day practice of law within the nonprofit. If appropriate, such regulations must be carefully drawn to accommodate the expressive and associational interests of the nonprofit.
3. Determine if existing Rules of Professional Conduct applicable to individual attorneys already afford adequate safeguards to clients in the nonprofit setting.
4. Evaluate the benefits and detriments of a regulatory structure for nonprofit entities, balanced against their First Amendment expressive and associational protections.

The State Bar's Action Plan

Since the Supreme Court's referral of this matter to the State Bar, State Bar Staff developed an action plan for responding to the Supreme Court. This action plan was previewed at the June Board meeting. It is presented here for RAD's approval and implementation. Once the process is completed, RAD will submit to the Board its recommended response to the Supreme Court. This is being treated as being similar to

the public comment process that is subject to Committee rather than Board oversight at this stage.

The Action Plan consists of the following elements:

1. Distribute questionnaires that survey consumers of legal services provided by nonprofit entities to gather data relevant to public protection. These would target self-help centers, community based organizations, social service agencies, and other likely contact points for this constituency.
2. Distribute questionnaires that survey nonprofit legal services providers to gather data on the operation of these entities in providing legal services and on their perspective as to the potential benefits and detriments of any potential regulation.
3. Conduct public hearings on the above subjects. As the RAD Committee, by statute, conducts annual public hearings on the State Bar discipline system in San Francisco and Los Angeles in December, this subject will be added to the agenda of those public hearings to avoid duplication of resources.
4. Communicate all of this available through the State Bar's website and through public announcements.
5. Consult with the State Bar's Commission on the Revision of the Rules of Professional Conduct on its review of existing California Rule of Professional Conduct 1-600 [Legal Service Programs] that confirms the professional responsibilities of lawyers who provide legal services through nonprofit entities.
6. Survey the State Bar's Office of the Chief Trial Counsel for available data on public protection issues within OCTC files that pertain to legal services provided by nonprofit entities.
7. Survey the State Bar's Legal Trust Fund Office for available data on the operations of qualified legal service projects funded by the trust fund under Business & Professions Code Section 6210 et seq.
8. Survey other enforcement entities like the state Department of Corporations, the state Franchise Tax Board, the United States Internal Revenue Service, the state Attorney General's Office, District Attorneys Offices and others for data on public protection issues known to them to arise from the provision of legal services by nonprofit entities.
9. Survey state legislative offices and court officials for available data on public protection issues known to them to arise from the provision of legal services by nonprofit entities.

10. Undertake other similar activities appropriate to fulfill the assignment given to the State Bar by the Supreme Court in the *Frye* case.