

# AGENDA ITEM

NOVEMBER 125  
Frye v. THC Report  
to Supreme Court

DATE: October 22, 2007

TO: Members, Board Committee on Regulation, Admissions and Discipline (RAD)  
Members, Board of Governors

FROM: Robert A. Hawley, Deputy Executive Director

SUBJECT: Report of the State Bar of California to the Supreme Court of California Regarding Nonprofit Entity Legal Practice in Response to the Supreme Court's Referral to the State Bar in *Frye v. Tenderloin Housing Clinic, Inc.* (2006) 38 Cal.4<sup>th</sup> 23

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## EXECUTIVE SUMMARY

*The Board Committee on Regulation, Admissions and Discipline (RAD) and the Board of Governors is requested to approve the Report of the State Bar of California to the Supreme Court of California Regarding Nonprofit Entity Legal Practice in Response to the Supreme Court's Referral to the State Bar in Frye v. Tenderloin Housing Clinic, Inc. (2006) 38 Cal.4<sup>th</sup> 23, for submission to the Supreme Court by December 31, 2007, or to give other direction. The report was released in August for an abbreviated period of public comment. That comment is incorporated into the record before RAD and the Board and will be made a part of the record before the Supreme Court. The comment from the affected constituencies predictably resists the recommendations of the report. Comments from other sources viewed the report favorably. The negative comment disagreed with the analysis, conclusions and recommendations of the report. The report and its recommendations have not changed materially. The recommendation here is that the report be finalized in its current form for submission to the Supreme Court for its final action, or that the Board give other direction. If you have further questions on this subject, please contact Robert Hawley at 415-538-2277, [Robert.Hawley@calbar.ca.gov](mailto:Robert.Hawley@calbar.ca.gov).*

## INTRODUCTION

The Board Committee on Regulation, Admissions and Discipline (RAD) has overseen the development of the State Bar's response to the Supreme Court's request that the State Bar study nonprofit law practice in California and address issues that the Supreme Court identified in *Frye v. Tenderloin Housing Clinic, Inc.* A staff working

group developed a report based upon public surveys, hearings, and significant other research and outreach. The State Bar has reported to the Supreme Court that it anticipates filing the report by December 31, 2007.

The report, as an administrative communication between the Supreme Court and the State Bar, fulfilling its role as the administrative arm of the Supreme Court in public protection matters, is not required to undergo the public comment process. However, in light of the public policy nature of the report, staff recommended in August that it be circulated for an abbreviated 45-day period of public comment. That comment period ended October 15, 2007. The comment received is presented and summarized in Appendix 2-7 to the report is and briefly discussed below.

The comments from those most affected by the report, i.e., the nonprofit community, disagree with the analysis, findings, conclusions and recommendations of the report. Comments from others generally support the report with some suggested modifications. The staff working group has not identified any error in the report warranting correction in light of the public comment. There are suggested modifications identified in the public comment that are consistent with the overall report. These are identified below for Board consideration.

It is now up to RAD and the Board to determine whether the report is: 1) adopted in its current form and forwarded to the Supreme Court for its consideration; 2) rejected and replaced by an alternative perspective formulated by the Board; 3) referred back to the working group to modify the report with guidance from the Board on specific points.

### **RECOMMENDATION/RESOLUTION**

It is recommended that RAD approve the report for submission to the Board of Governors. If this is the will of RAD, the following resolution is suggested:

“RESOLVED, that the Board Committee on Regulation, Admissions and Discipline recommends that the Board of Governors approve the Report of the State Bar of California to the Supreme Court of California Regarding Nonprofit Entity Legal Practice in Response to the Supreme Court’s Referral to the State Bar in *Frye v. Tenderloin Housing Clinic, Inc* (2006) 38 Cal. 4<sup>th</sup> 23, in the form attached for filing with the Supreme Court.”

It is recommended that the Board of Governors approve the report for submission to the Supreme Court. If this is the will of the Board, the following resolution is suggested:

“RESOLVED, that upon the recommendation of the Board Committee on Regulation, Admissions and Discipline, the Board of Governors approves the Report of the State Bar of California to the Supreme Court of California Regarding Nonprofit Entity Legal

Practice in Response to the Supreme Court's Referral to the State Bar in *Frye v. Tenderloin Housing Clinic, Inc* (2006) 38 Cal. 4<sup>th</sup> 23, in the form attached for filing with the Supreme Court."

## **DISCUSSION**

### **Background**

In *Frye v. Tenderloin Housing Clinic, Inc.* (2006) 38 Cal.4<sup>th</sup> 23, the Supreme Court of California requested the State Bar of California, as its administrative arm in public protection matters, to conduct a study of law practice by nonprofit corporations and organizations in California and report back to the Court as to whether enhanced registration or regulatory standards governing nonprofits practicing law were warranted to protect the public interest. A detailed history of the *Frye* case, the referral to the State Bar and related matters is provided in the report, attached.

By Board action, the RAD Committee was given oversight responsibility for the development of the report. Following significant work, a staff-working group has developed the report. The State Bar has advised the Supreme Court that it anticipates filing the report with the Supreme Court by December 31, 2007.

Under the State Bar's public comment rules, this report was not required to be circulated for comment. It is a report of the State Bar to the Supreme Court in which the State Bar is acting as the administrative arm of the Supreme Court. The State Bar is providing guidance to the Supreme Court on issues unique to the expertise of the State Bar. However, RAD believed that both the Board and the Supreme Court would be well served by comment on the report from interested parties so RAD circulated the report for an abbreviated period of public comment.

The comments are varied. No new issues are raised. No material changes to the report are recommended by staff. However, staff identifies below suggested changes raised in the public comment that are consistent with the overall report that the Board may wish to consider. The report and its supporting record gives the Supreme Court the opportunity to fully consider the issues and take action as it deems appropriate.

### **The Essence of the Report**

The report is extensive and not easily summarized, consuming 400 pages between the report itself and its appendices. It concludes that there are certain "disconnects" between law practice in the nonprofit environment and public protection. Some of these "disconnects" are inherent in nonprofit law practice. The "disconnects" are: 1) limited entity liability in the corporate setting, 2) lack of errors and omissions insurance in the corporate setting despite limited liability, 3) splitting legal fees with nonlawyers in nonprofit governance, 4) independence of attorney professional judgment where nonlawyers are in nonprofit governance, 5) mixed legal/nonlegal services in nonprofits.

These are “disconnects” because, under existing professional standards, they are not tolerated in any other law practice setting. The recommendations standardize these “disconnects” for nonprofits in exchange for heightened accountability. This accountability comes through the registration of the “head of legal practice” within the nonprofit entity.

Under the report’s recommendations, nonprofit law practices do not need to incorporate. But if they do, they receive favored treatment on liability issues. The report’s recommendations condition receipt of this favored treatment upon the registration of the entity’s “head of legal practice” and upon maintaining security for claims. Under the recommendations, all nonprofit legal practices, in whatever form, are required to register through their “head of legal practice,” if they wish to safely operate with mixed attorney/nonattorney governance, mix legal and nonlegal services, generate fee revenues from law practice for the nonprofit’s other missions, or wish to incorporate as a nonprofit entity.

The goal is enhanced accountability within existing regulatory standards rather than enhanced regulation. The focus is upon the law practice within the nonprofit rather than the nonprofit itself, and, more precisely, upon the responsible “head of legal practice” within the entity.

A synopsis of the report is best captured by the following review of the report’s key conclusions:

Conclusion No. 17: A registration/certification program for nonprofit entities that harmonizes the conflicting authorities that now exist, that addresses those public protection “gaps” identified here (errors and omissions insurance in the corporate setting, entity liability, fee-splitting, independence of professional judgment, mixed legal/nonlegal services) and does so through the certification of the designated “head of legal practice” rather than through the entity itself, is not intrusive nor burdensome to the entity, maximizes public protection and does not materially limit the constitutional freedoms these entities enjoy.

Conclusion No. 16: There are identifiable risks to the public interest that are unaddressed by existing regulation and which can be addressed by an unburdensome certification/registration program directed at the “head of the legal practice” within any entity that provides legal services where there is the potential for nonattorney governance, fee-splitting and mixed legal and nonlegal services.

Conclusion Nos. 4-6: The everyday practice of law in the nonprofit setting is substantially similar to the practice of law in general. The complaints and claims faced by nonprofit entities practicing law are not materially different than those encountered in any law practice setting. There is no compelling evidence that nonprofits imperil client interests to any greater extent than encountered in the general practice of law. Nor is there compelling evidence that nonprofits imperil client interests to such a negligible

extent that an exemption from requirements governing for-profit practice is warranted, particularly where nonattorney governance is tolerated.

Conclusion No. 8: Nonprofits that choose to incorporate and practice law do not generally incorporate as professional corporations. As a result, they are not required to maintain errors and omissions insurance, although most do so voluntarily. This is a significant departure from for-profit law corporations and limited liability partnerships. It is a condition of their existence that they maintain errors and omissions insurance due to the protections from liability that they obtain through incorporation. Incorporation in the nonprofit setting is sought for the same benefits as in the for-profit setting, including limitations on liability. The exemption from maintaining errors and omissions insurance is a “gap” in public protection that currently exists for nonprofits that incorporate and practice law.

Conclusion No. 9: For-profit professional corporations and limited liability partnerships are required, as a condition of formation, to assure that:

“A law corporation shall not do or fail to do any act the doing of which or the failure to do which would constitute a cause for discipline of a member of the State Bar, under any statute, rule, or regulation now or hereafter in effect. In the conduct of its business, it shall observe and be bound by such statutes, rules and regulations to the same extent as if specifically designated therein as a member of the State Bar.”

The exception under *Frye* for nonprofit corporations practicing law exempts these nonprofits from this assurance and creates the possibility that the nonprofit corporate entity could be used to limit or avoid the professional responsibilities of lawyers through the nonprofit corporation. This is a “gap” in public protection that currently exists within the nonprofit corporation law practice sector

Conclusion No. 10: The issue is not whether financial and ideological pressures exist in the nonprofit environment. They do exist and they push toward the margins defined by professional standards. The issue is whether these pressures are adequately managed within the nonprofit law practice setting and whether the management of these forces can be effectively enhanced with additional tools. The recommendations here seek to enhance management of these forces.

Conclusion No. 12: California’s standards should be amended to explicitly allow attorneys to represent client interests in a nonprofit corporation or other organization governed by nonattorney board members and where nonlegal services are also provided, subject to the registration/certification “safe harbor” recommended here.

Conclusion No. 13: California's standards should be amended to explicitly allow nonprofit organizations to seek attorney fees, limited by Internal Revenue Service restrictions, subject to the registration/certification "safe harbor" recommended here.

### **The Essence of the Public Comment with Responses**

Fifteen comments were received on the report. These comments are presented and summarized at Appendix 2-7 of the report. Several of the comments were from groups, particularly the legal aid and public interest community most affected by the report. Comments were also received from the State Bar's Standing Committee on Professional Responsibility and Conduct. Comments from the legal aid and nonprofit community disagreed with the report in nearly all respects. Comments from others generally agreed with the report, in some instances making suggestions for modifications. Key critical comments are presented below with responses on the issues raised.

Comment: The recommendations exceed the Court's mandate and risk negative unforeseen consequences.

Response: The Supreme Court's directive to the State Bar is:

"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." [Report pp. 5-6].

Comment: The recommendations involving legislation are subject to an unpredictable legislative process potentially resulting in unanticipated consequences.

Response: The report offers a complete response to the issues involving both Judicial Branch and Legislative initiatives. However, as this is the response of the State Bar, a Judicial Branch agency, to the Supreme Court, it is appropriate, if the Board sees fit, to eliminate the suggested legislative initiatives from the report's recommendations to the Supreme Court.

Comment: The report does not document any demonstrated danger of injury.

Response: Public protection “gaps” are identified in the areas of 1) entity liability in the corporate setting, 2) errors and omissions insurance where liability is limited in the corporate setting, 3) fee-splitting, 4) independence of professional judgment, 5) mixed legal/nonlegal services.  
[Report pp. 16-31.]

Comment: The proposed recommendations are unwieldy, potentially expensive, may have unforeseen consequences, and interfere with the associational and expressive rights of nonprofit entities.

Response: The recommendations are narrowly drawn, use existing regulatory structures and are minimally intrusive into the operations of nonprofits. This is a law practice accountability initiative, not a nonprofit regulatory initiative, and focuses upon the responsible attorneys within the nonprofit law practice, not the entity itself. [Report, pp. 31-38].

Comment: The existing regulatory framework is sufficient and fully protects the public.

Response: Existing regulation of nonprofit entities focuses primarily upon the entity itself, not upon the practice of law within the entity. The study and report focuses upon the law practice within the entity and seeks the accountability of lawyers within the existing regulatory framework through a compliance certification process by the “head of legal practice.” This is sought in exchange for standardizing the “disconnects” with public protection that are inherent in nonprofit legal practice. [Report, pp. 36-38.]

Comment: The “head of legal practice” registration process is untested and could interfere with the management structure of some nonprofits.

Response: Any legal practice by a nonprofit has to have a responsible lawyer in charge. The report recommends that this responsible lawyer be identified as accountable for professional standards through a “head of legal practice” registration/certification process. This is modeled after accountability requirements that corporate finance officers must meet in certifying financial documents and practices within business entities. [Report, pp. 36-38.]

Comment: The malpractice insurance requirement is excessive and unnecessary.

Response: This is one of the primary “gaps” in public protection identified in the report. Individual lawyers are not required to have insurance. But lawyers who incorporate are. Otherwise, incorporation is an undue limitation on the attorney’s liability as a professional for services rendered. This has not historically been extended to law practices in the nonprofit corporate form. The clients of

nonprofits, who are often the disenfranchised, deserve undiminished protection as members of the public receiving legal services. The report identifies the malpractice requirements for professional law corporations as the recommended standard. The goal is to provide security for claims where liability is limited by incorporation. If the recommended professional law corporation standard is too rigorous in coverage amount, a more realistic coverage standard is welcome.

Comment: The recommendation that fees may only be dedicated to the reasonable operating expenses of the legal practice or programmatic public service activities of the legal practice is a content-based restriction that threatens First Amendment rights.

Response: As the report notes, this recommendation derives from the concerns articulated by Supreme Court Justice Chin: "Unauthorized practice of law and fee-splitting concerns arise when those, other than lawyers and clients, stand to benefit from legal fee revenues. As Justice Chin notes, to avoid this, ' . . . courts have required either use of a cost-plus approach [to fee calculations] or a showing that all of the fee award will be put back into the legal operations, rather than general corporate coffers. [Citations omitted].' [*Id.* at 1106-07; See also, *Gafcon, Inc. v. Ponsor & Associates, supra* 98 Cal.App.4th at p. 1419]." This is an issue appropriately raised in the report to be addressed by the Justices of the Supreme Court. [Report pp. 27-31].

Comment: Law clinics do not fit the nonprofit corporation model.

Response: Nonprofit law practices do not have to incorporate. But if they do, under the report, they benefit from limited liability and should provide security for claims. The "disconnects" with public protection identified in the report cut across all areas of nonprofit law practice. Any law practice must have a responsible attorney overseeing the practice of law. The recommendations seek accountability for public protection through the identification of that "head of practice" as responsible for assuring adherence with professional standards where "disconnects" with public protection are tolerated. [Report, pp. 36-38.]

Comment: The recommendations would likely have a disproportionate impact upon smaller and newer nonprofit legal organizations and upon law school clinics.

Response: This is speculative. But public protection and accountability inevitably have costs. The report finds that public protection and accountability warrant the cost. The Board may find otherwise.

Comment: In the report, the State Bar's Office of the Chief Trial Counsel (OCTC) reports that few discipline complaints are received against nonprofits, but then is quoted in the Daily Journal saying hundreds of complaints are received against "fake" legal aid offices.

Response: The Daily Journal Article, comment number 7 in Appendix 2-7 to the report, quotes OCTC as stating that “fake” legal aid centers are a “big problem” throughout the state and that over 200 open files are pending in the discipline system on this subject. These entities are “fakes” and generally do not operate as nonprofits. They were not captured in the data search that focused on nonprofits. There appears to be a public protection issue presented by “fake” legal aid operations. As true legal aid operations are nonprofits, the registration/certification process recommended in the report would enhance the ability of the State Bar to address the problem of “fake” legal aid entities claiming to be legitimate.

### **CONCLUSION**

Assuming that the RAD Committee and Board of Governors approve the report for submission to the Supreme Court, adoption of the above resolutions is recommended.

**PERSONNEL/FISCAL IMPACT:** None (at this time)

**ADMINISTRATIVE MANUAL IMPACT:** None

**RULE/STRATEGIC PLANNING CONSIDERATIONS:** None (at this time)