

# AGENDA ITEM

**MARCH 153**

**State Bar Rule Revision  
Title 3 - Law Corporations  
Return from Comment**

**DATE:** February 19, 2010; **March 29, 2010\***

**TO:** Members of the Board Committee on Member Involvement,  
Relations and Services  
Members of the Board of Governors

**FROM:** Starr Babcock, Senior Executive for Member Services  
Dina DiLoreto, Director of Administration, Member Services

**SUBJECT: State Bar Rule Revision - Title 3 - Law Corporations  
Return from Public Comment**

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## **EXECUTIVE SUMMARY**

As part of a State Bar rules revision project begun in 2006, proposals to clarify the organization and language of State Bar rules for law corporations were presented to the Board Committee on Member Involvement, Relations and Services in November 2009 with a request that the committee authorize a period of public comment on the proposals. The Committee authorized a sixty-day public comment period that began November 16, 2009 and ended January 15, 2010. The State Bar received six comments, copies of which are attached. After consideration of the comments, staff requests that the Board Committee recommends that the Board of Governors adopt the proposed rules at its March 2010 meeting. The new rules would then be transmitted by staff to the Supreme Court with a request that they be approved, repealing the current rules. The newly adopted rules would be part of Title 3 of the Rules of the State Bar, which deals with Programs and Services.

## **ISSUE**

Whether the Board Committee on Member Involvement, Relations and Services should recommend that the Board of Governors adopt at its March 2010 meeting the proposed State Bar rules for law corporations, which, if adopted, and approved by the Supreme Court, would replace the current Law Corporations Rules of The State Bar of California.

\* 03/29/10 corrected

## **BACKGROUND**

In 2006 the State Bar undertook a rules revision project to integrate the organization's more than two dozen sets of rules into a comprehensive structure of seven titles and to make the rules simpler, clearer, and more uniform. Of the seven titles, the board has adopted four.

- Title 1: Global Provisions
- Title 2: Member Rights and Responsibilities
- Title 4: Admissions and Educational Standards
- Title 7: Miscellaneous (Judicial Nominees Evaluation)

The board has adopted two titles in part.

- Title 3: Programs and Services
- Title 6: Governance

In the first half of 2010, staff anticipates forwarding proposals to complete Title 6 and substantially complete Title 3. Revision of Title 5, Discipline, is expected to begin in 2010.

## **DISCUSSION**

The Law Corporations Rules of The State Bar of California were originally adopted by the Board of Governors in 1968 and have since been amended on occasion, most recently in 1994. The rules for law corporations proposed here were drafted by State Bar rules revision staff working closely with staff for law corporations.

There is one substantive change within the proposed rules:

- Proposed rule 3.157 (F) no longer excludes disbarred members from those members eligible to repurchase law corporation shares after reinstatement as a member.

Although the revised rules for law corporations are not intended to substantially modify current requirements, they exclude nonprofit public benefit corporations for reasons explained below, require law corporations to provide and maintain a current e-mail address, and propose the following three changes that conform to administrative practice:

- Proposed rule 3.153 provides applicants a simpler approach to fixing problems with applications than does current rule III.
- Rule 3.154(D) includes attorneys who have resigned with charges pending among those who may not practice law for a law corporation.

- Rule 3.155 (B) involuntarily terminates certification of a law corporation that has not remedied a suspension after more than a year.

With these exceptions, changes to the proposed rules are intended to be organizational and stylistic rather than substantive.

Copies of the current and the proposed rules are attached. In the proposed rules, footnotes in Roman type are citations or cross-references to other rules and are intended to be part of any board-adopted version. Also attached is summary of the comments received, backed with the full text copies of those comments.

### **Provisional exclusion of nonprofit public benefit corporations**

Current rules permit but do not require nonprofit public benefit corporations to register with the State Bar. Rule IV.A provides for certification of an applicant incorporated as nonprofit public benefit corporation under the Non-profit Public Benefit Corporation Law under specified conditions; current IV.B.4 deals with security for such corporations; and VI.D deals with their reporting obligations. The proposed rules make no reference to nonprofit public benefit corporations.

In *Frye v. Tenderloin Housing Clinic, Inc.*, (2006) 38 Cal.4th 23, 40 Cal.Rptr.3d 221, the California Supreme Court noted that established case law permits legal aid, mutual benefit, and advocacy groups to practice law in corporate form without registering with the State Bar or complying with Corporations Code § 13406(b), which specifies the circumstances under which a professional law corporation may be incorporated as a nonprofit public benefit corporation under the Nonprofit Public Benefit Corporation Law. Registration with the State Bar has been discretionary and ultimately a business decision for these groups.

A nonprofit public benefit corporation continues to have an option to apply to the State Bar for certification as a law corporation as a common law exception pursuant to *Frye*. Pending action on recommendations submitted by the State Bar in an August 2007 report to the court, this option has not been delineated in the proposed rules. It will, however, be explained on the State Bar Web site page that deals with law corporations.

### **Clarification of requirements**

The rules revision project has streamlined rules by eliminating procedural steps that relate to internal operations; using forms to specify steps required for compliance; and using a schedule to specify fees and due dates. The proposed rules for law corporations offer three examples of this approach. Current rule III uses about 200 words to explain the application process. Proposed rule 3.152(A) is approximately three-fourths shorter by focusing on the applicant's obligations; deleting language dealing with internal processing of the application; and using

the Schedule of Charges and Deadlines to specify the calendar date for filing an application and the amount of the application fee. Similarly, rather than specify a due date of March 31 for the annual report as does current rule VI.A, proposed rule 3.156(A) states that “A law corporation must annually renew its authorization to practice law by submitting an Annual Renewal with the fee set forth in the Schedule of Charges and Deadlines.” The schedule provides the board an annual opportunity to specify the fee and compliance deadline. Perhaps the most conspicuous example of streamlining is proposed rule 3.158(A), which references the schedule for the minimum amounts of security required for errors and omissions. This use of the schedule reduces proposed 3.158(A) to about half the length of IV.B, the current rule on the topic. The schedule provides an opportunity to revisit these amounts, which have in fact not been updated in more than forty years.

### **Effective date of certification**

Both the current and proposed rules make certification of a law corporation effective on the date the State Bar receives a complete application, and they give the State Bar discretion to grant a later effective date. Current rule III.B.2 also gives the State Bar discretion to make certification effective earlier than the date on which it receives a complete application “if the interests of justice require and good cause appears therefor.” The proposed rule eliminates the alternative for an earlier date. In practice, the State Bar has not issued certifications for such earlier dates and could not legally certify for a date earlier than the one on which the Secretary of State certified the articles of incorporation.

### **Incomplete or abandoned applications**

Current rule III.B provides that “A request for further information or a request that the application be amended may be deemed by the applicant to be a refusal to approve the application.” The remainder of the rule explains how the applicant may request that a board committee review a refusal. Proposed rule 3.153 would streamline this process considerably. An applicant would have sixty days to cure an incomplete or defective application upon notice by the State Bar, and failure to cure would cancel the application. Proposed 3.153, which covers the topic in about fifty words as opposed to nearly 500 in current rule III, conforms to administrative practice and eliminates a review function the board has never exercised.

### **Involuntary termination following suspension**

The most common compliance problem for law corporations is failure to submit an annual report. Although current rule VI.A allows the State Bar to suspend or revoke the certification of a law corporation that fails to do so, the rule does not spell out consequences of such a failure. Proposed rule 3.156(B) addresses the problem by providing that “A law corporation that fails to submit a complete

Annual Renewal and fee is suspended and is not entitled to practice law. It may be reinstated upon submission within one year of the renewal, fee, and any penalty. If the suspension lasts more than one year, the registration of the law corporation is involuntarily terminated.”

## **Evidence of security**

Business & Professions Code § 6171 requires “That a law corporation, as a condition of obtaining a certificate pursuant to the Professional Corporation Act and this article, shall provide and maintain security by insurance or otherwise for claims against it by its clients for errors and omissions arising out of the rendering of professional services.”

Current rule IV.B spells out two alternatives for meeting the statutory requirement, depending on whether the State Bar certified a law corporation before or after October 27, 1971. The rule provides three options for a law corporation certified before October 27, 1971: 1) insurance in specific minimum amounts; 2) a written agreement whereby the shareholders agree to cover the deductible portion of the required minimum amount of insurance; and 3) a written guarantee whereby the shareholders agree to cover the minimums that would otherwise be required for insurance. The rule limits law corporations certified after October 27, 1971 to the third means available to earlier certified law corporations, namely “a written guarantee whereby the shareholders agree to cover the minimums that would otherwise be required for insurance.”

Proposed rule 3.158(A) requires the written guarantee of every law corporation and allows the shareholders to back up the guarantee in whatever manner they choose, “by insurance or otherwise.” The approximately sixty active law corporations certified prior to October 27, 1971 would still be permitted to provide a certificate of insurance rather than a written agreement, as noted in a footnote to the rule: “Law corporations incorporated before October 27, 1971 that have elected to provide security by insurance must provide as a guarantee a certificate of insurance issued by the insurer.”<sup>1</sup> Use of the footnote allows the rule to focus on the vast majority of law corporations rather than a few dozen exceptions.

## **Duties**

Proposed rule 3.154 reiterates in one place duties that current rules impose on law corporations but with two additions, one in subpart (C) and another in (D). Rule 3.154 (C) states that “A law corporation must observe all rules and law that apply to a member of the State Bar and must not do or fail to do anything that would constitute a cause for discipline of a member.” Although current rules do not state this duty, it is mandated by Business & Professions Code § 6167. Reiterating the obligation here highlights the broad disciplinary implications of noncompliance with rules or law. Rule 3.154(D) conforms to Business & Professions Code

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<sup>1</sup> On 03/29/10, Attachment A was corrected to insert the quoted sentence in footnote 21 to rule 3.158(A).

\* 03/29/10 corrected

sections 6132 and 6133 regarding removal from firm names the names of shareholders who have resigned or been disbarred and the supervision of disciplined attorneys.

### **E-mail address required**

If the board adopts the proposed rules, the application for certification will be revised to require an e-mail address. To ensure that a law corporation maintains a current e-mail address, proposed rule 3.155 includes the e-mail address as information required for a special report.

### **Public Information**

The proposed rules incorporate the current law corporation public records policy and will be consistent with the current and proposed LLP rules.

### **Public comment**

The six comments received during the public comment period are summarized below. Full text of the comments is provided within Attachment C.

Member Jeffrey S. Dawson (member number 147847) objected to the fact that proposed rule 3.157 (F) would give disbarred members a “second chance at the practice” through the repurchase of shares. In fact, only once reinstated would formerly disbarred members be eligible to repurchase shares. Members eligible for reinstatement otherwise regain the same duties and privileges of other members.

Member J. Jeffries Goodwin (99310) supports proposed 3.157, because he believes that a member reinstated after being required to sell or transfer law corporation shares “should regain all benefits, including repurchase of corporate share [sic].”

Member Douglas Chaffee (43920) commented that limited liability partnerships should be permitted to practice law. They are, in fact, under current as well as proposed State Bar rules. Chafee also stated limited liability corporations should be permitted to practice law, but Corporations Code § 17375 prohibits this: “Nothing in this title shall be construed to permit a domestic or foreign limited liability company to render professional services, as defined in subdivision (a) of Section 13401 and in Section 13401.3, in this state.”

Member Ron H. Oberndorfer (82554) objected that proposed rule 3.158(A) eliminates the limitations set forth in current rule IV.B and provides no limitation of liability for guarantors. Member Thomas Martin (108539) also raises this issue. Rule 3.158(A) provides as follows:

Each shareholder must execute a Law Corporation Guarantee providing that the shareholders jointly and severally agree to pay all claims established against the

law corporation for errors and omissions arising out of the rendering of professional services by the law corporation or anyone who practices law on its behalf as an employee or otherwise. The guarantee must name each shareholder and be executed by each. The guarantee serves as proof of security, which may be provided by insurance or otherwise. [Citation to Business & Professions Code § 6171(b).] An executed copy of the Law Corporation Guarantee must be provided to the State Bar with the Application to Register as a Law Corporation. The law corporation must submit a new guarantee executed by all shareholders whenever the guarantee last provided to the State Bar is no longer current.

Section (C) of proposed 3.158 indicates addresses the issue raised by members Oberndorfer and Martin:

The Schedule of Charges and Deadlines sets forth the minimum amount of security that the Law Corporation Guarantee must provide annually for a single claim and for all claims, whether against a person covered by the guarantee or the corporation. Security paid for a claim for errors and omissions may be offset by an insurance payment made on behalf of the corporation or any of its shareholders.

The proposed rules do not recommend any change to the minimum security required by the current rules, but as indicated above, including these amounts in the Schedule of Charges provides the board an opportunity to revisit the minimums, which have not been updated in more than forty years. Before changing the amounts, presumably the board would require staff to develop and defend proposed new amounts and solicit public comment on any proposals it found acceptable.

Mr. Oberndorfer also suggests modifying proposed rule 3.152(B) to include “A.P.C” as a designation of corporate status along with Professional Corporation, Prof. Corp., Corporation, Corp, Incorporated, and Inc. There are actually many acceptable corporate designations, and those listed in the rule are meant to be examples. Perhaps a more comprehensive list could be provided to members as part of the Law Corporation FAQs listed on the State Bar’s web site.

Member Thomas E. Martin (108539) objects to the annual renewal requirement of 3.156 in the absence of any change in shareholders, articles, or the like. The annual renewal requirements of proposed 3.156 are statutory. Business & Professions Code §§ 6161.1 provides that “Each law corporation shall renew its certificate of registration annually at a time to be fixed by the State Bar and shall pay a fee therefor which shall be fixed by the State Bar in accordance with subdivision (a) of section 6163.” Business & Professions Code §6163 details the requirements for the annual renewal. Mr. Martin also objects that the proposed rules allow the State Bar to set policy limits for errors and omissions coverage. The objection is addressed by Business & Professions Code §6171(b), which authorizes the State Bar to require that a law corporation have “security

by insurance or otherwise for claims against it by its clients for errors and omissions arising out of the rendering of professional services.”

Member Dixon Dern (25007), a former member of the Board of Governors, commented that he supports the proposed rules.

### **Effective date of proposal**

If the board adopts new rules for law corporations at its March 2010 meeting, the rules will be transmitted by staff to the Supreme Court with a request that the new rules be approved and the current rules repealed by the Court.

### **FISCAL IMPACT**

Adoption of the proposed rules would require no new resources.

### **BOARD BOOK IMPACT**

None.

### **RULES/REGULATIONS IMPACT**

The Rules of the State Bar, Title 3: Programs and Services

### **RECOMMENDATION**

Having considered the public comments received, staff requests that the Committee on Member Involvement, Relations and Services recommend that the Board of Governors adopt the proposed law corporations rules as Division 2, Chapter 2 of Title 3 of the Rules of the State Bar, Programs and Services.

### **Proposed Board Committee resolution**

Should the Board Committee on Member Involvement, Relations and Services agree with the staff recommendation, adoption of the following resolution would be appropriate:

**RESOLVED**, following publication for comment and consideration of comments received, that the Board Committee on Member Involvement, Relations and Services recommends that the Board of Governors of the State Bar of California adopt, in the form attached, the proposed rules for law corporations as Division 2, Chapter 2 of Title 3 of the Rules of the State

Bar and repeal the Law Corporation Rules of the State Bar of California, and direct that the proposed new rules be transmitted by staff to the Supreme Court with a request that the new rules be approved and the current rules repealed by the Court.

### **Proposed Board of Governors resolution**

Should the Board of Governors concur with the recommendation of the Board Committee on Member Involvement, Relations and Services, adoption of the following resolution would be appropriate:

**RESOLVED**, following publication for comment and consideration of comments received, and upon recommendation of the Board Committee on Member Involvement, Relations and Services, that the Board of Governors of the State Bar of California hereby adopt, in the form attached, the proposed rules for law corporations as Division 2, Chapter 2 of Title 3 of the Rules of the State Bar and repeal the Law Corporation Rules of the State Bar of California, and direct that the proposed new rules be transmitted by staff to the Supreme Court with a request that the new rules be approved and the current rules repealed by the Court.

### Attachments

- A: Proposed Law Corporations Rules\*
- B: Current Law Corporation Rules of the State Bar of California
- C: Comments received on the proposed law corporation rules