

AGENDA ITEM

SEPT 112

**State Bar Rule Revision
Title 3 - Amendment of
Law Corporation Rules -
Request for Adoption**

DATE: August 30, 2010

TO: Members of the Board Committee on Operations,
Members of the Board of Governors

FROM: Dina DiLoreto, Director of Administration, Member Services

SUBJECT: State Bar Rule Revision - Title 3 - Law Corporations
Request to Adopt Amendments to Law Corporation Rules 3.150-
3.161 and Direct Transmittal to the Supreme Court for Approval

EXECUTIVE SUMMARY

At the March 2010 meeting, the Board of Governors adopted revised rules for law corporations that are subject to Supreme Court approval, as required by Business and Professions Code §6171. The revised law corporations rules, which were intended to replace the current Law Corporation Rules of The State Bar of California, did not include provisions for nonprofit public benefit corporations. In April 2010, the Supreme Court requested that the proposed revised law corporations rules 3.150-3.161 be amended to allow nonprofit public benefit corporations to register.

At the July 2010 meeting, the Board Committee on Member Involvement, Relations and Services authorized a 30-day public comment period for amendments that would add provisions for registration of nonprofit public benefit corporations to the revised rules. The 30-day public comment period began on July 27, 2010 and ended on August 26, 2010. No comments were received.

Staff recommends Board adoption of the proposed amendments as published for public comment, in the form attached, and transmittal of the amended law corporations rules 3.150-3.161 to the Supreme Court for approval. Upon the Court's approval of the amended rules and repeal of the Law Corporation Rules of The State Bar of California, law corporations rules 3.150-3.161 would be added to the State Bar Rules at Title 3, which deals with Programs and Services.

Any questions may be directed to Dina DiLoreto at dina.diloreto@calbar.ca.gov or (415) 538-2121.

ISSUE

Whether the Board Committee on Operations should recommend, and the Board of Governors should adopt, rules for law corporations amended to include nonprofit public benefit corporations, in the form attached, and direct staff to transmit the amended rules to the Supreme Court for approval.

BACKGROUND

Business and Professions Code § 6160 authorizes a law corporation that is registered with the State Bar to practice law in this state. Business and Professions Code § 6171 provides that, with the approval of the Supreme Court, the State Bar may formulate and enforce rules to carry out the purposes of law corporation statutes located in Business and Professions Code §§ 6160 - 6172.

In March 2010, the Board adopted new revised law corporation rules 3.150-3.161 and repealed the current Law Corporation Rules of the State Bar of California, subject to the Supreme Court's approval of the revised rules and repeal of current rules. Among the current rules, rule IV.A provides for certification of an applicant incorporated as a 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 revised rules adopted by the Board in March 2010 did not include provisions for nonprofit public benefit corporations, for which registration by the State Bar was at issue in *Frye v. Tenderloin Housing Clinic, Inc.*, (2006) 38 Cal.4th 23, 40 Cal.Rptr.3d 221. The *Frye* opinion directed the State Bar to advise the Court regarding appropriate regulation of nonprofit public benefit corporations. The State Bar submitted its recommendations to the Court in a December 2007 report ("*Frye* report") but in March 2010 it was not known whether the Court would act on the recommendations. In April 2010, after transmitting the revised rules to the Court, the State Bar was informed that the Court intended to take no action on the recommendations in the *Frye* report. Accordingly, it would be appropriate to amend the revised rules to include provisions allowing nonprofit public benefit corporations to register with the State Bar.

DISCUSSION

Initial exclusion of nonprofit public benefit corporations

In *Frye v. Tenderloin Housing Clinic, Inc.*, the California Supreme Court confirmed that precedent permits certain nonprofit entities, including nonprofit corporations that offer legal services to third parties in this state, to practice law in corporate form without registering with the State Bar or complying with Corporations Code § 13406(b), which states the circumstances under which a professional law corporation may be incorporated as a nonprofit public benefit corporation. Noting that the Court has inherent authority to consider imposing registration requirements on the practice of law by

nonprofit corporations under the Court's inherent authority over admissions and discipline of attorneys (*Frye*, 38 Cal.4th at p. 50, citing *In re Attorney Discipline System*, (1998) 19 Cal.4th 582, 506, 606-607), in the *Frye* opinion the Court directed the State Bar to advise it regarding appropriate regulation of such corporations.

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. . . . The question whether additional regulation is required is referred to the State Bar for further study and report to this court. *Frye*, 38 Cal.4th at p. 50.

The Board's December 2007 report to the Court found that there was insufficient evidence of actual abuse or endangerment to client interest to warrant new regulations over nonprofit corporations. The report recommended that the Court maintain the exemption for these organizations and that, at most, nonprofit legal services organizations be required to register with the State Bar so that the Bar could maintain a comprehensive registry of all individuals and entities entitled to practice law in California. In the absence of a formal response from the Court on the *Frye* report, the law corporations rules adopted by the Board in March 2010 did not explicitly address nonprofit public benefit corporations, which, if they wanted to, would have to register like any other law corporation. In April 2010, the State Bar was informed that the Court intended to take no further action on the Board's *Frye* Report. As a result, it would be appropriate to clarify how the revised law corporations rules apply to nonprofit public benefit law corporations that fall within the "safe harbors" discussed in *Frye*. The rule amendments that follow allow nonprofit public benefit corporations that meet statutory requirements to register with the State Bar as a law corporation.

Amendments to include nonprofit public benefit corporations

The amendments explained below, identified in the attached redlined version of the revised law corporations rules adopted by the Board of Governors in March 2010, would add provisions for nonprofit public benefit corporations to those rules.

1. Rule 3.151, on eligibility, has been modified as follows: "A corporation, including a nonprofit public benefit corporation, ~~may apply that applies~~ to register as a law corporation ~~if it meets~~ must meet statutory requirements."

The revision clearly indicates that nonprofit public benefit corporations that meet statutory requirements are eligible to register. The rule cites two statutes, Business & Professions Code § 6161, which deals with application requirements generally, and Corporations Code § 13406. By deleting "may apply" and "if", the sentence has been strengthened syntactically, giving the sentence one verb, "must meet," which emphasizes that statutory compliance is essential for registration.

2. Because nonprofit public benefit corporations do not have shareholders, rule 3.157, which deals with shares, has been amended to add a new (F): “This rule does not apply to nonprofit public benefit corporations.”

3. Rule 3.158, which deals with security, has been revised to indicate that there are different proof of security requirements for corporations generally, Rule 3.158(A)(1), and for nonprofit public benefit corporations, 3.158(A)(2). The revision also adds, as 3.158(A)(3), a historical exception applicable to a handful of law corporations incorporated before October 27, 1971. The March 2010 version of the rules addressed this historical exception in a footnote.

~~(A) ——— 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.¹ 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.²~~

(A) Each law corporation must provide the State Bar with proof of security for claims for errors and omissions of the corporation or any person who practices law on behalf of the corporation on its behalf as an employee or otherwise. The law corporation must provide proof of security with its Application to Register as a Law Corporation and provide new proof of security when that last provided is no longer current. Proof of security must be provided as indicated below.

(1) All law corporations except as otherwise provided in this rule must provide as 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. The guarantee must name each shareholder and be executed by each.³

(2) A nonprofit public benefit corporation⁴ must provide a certificate of annual insurance.

(3) Law corporations incorporated before October 27, 1971 that have elected to provide security by insurance must provide a certificate of insurance.

¹ ~~Business & Professions Code § 6171(b). A historical exception exists. 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.~~

² ~~Rule 3.156.~~

³ Business & Professions Code § 6171(b).

⁴ Corporations Code § 13406(b).

Distinguishing two different types of proof of security in Rule 3.158(A) has required revision of Rule 3.158(B), where the reference to “Law Corporation Guarantee” has been replaced by the more generic “proof of security.”

For purposes of determining the amount of ~~security~~ required for a ~~Law Corporation Guarantee~~ as proof of security, a person who practices law on behalf of a law corporation includes

Rule 3.158(C) has also been revised to replace “Law Corporation Guarantee.” The provision now refers to security generally. Since the amount of security required is applicable regardless of how it is offset, the reference to insurance payment offsets has been deleted as an unnecessary distinction.

The Schedule of Charges and Deadlines sets forth the minimum amount of security that ~~the Law Corporation Guarantee~~ a law corporation must provide annually for a single claim and for all claims, whether against the corporation or a person ~~covered by the guarantee practicing law on behalf of the corporation 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.~~

4. The above changes to Rule 3.158 have necessitated a change in Rule 3.152(A)(2), where a reference to “Law Corporation Guarantee,” which is not a requirement for nonprofit public benefit corporations, has been replaced with the generic “proof of security.”

To apply to register as a law corporation an applicant must . . . provide ~~a Law Corporation Guarantee as evidence~~ the proof of security for claims as required by Rule 3.158.

5. A citation to the *Frye* case has been added to rule 3.150, which concerns the scope of the rules. Rule 3.150(B) states “These rules do not reiterate or supersede the State Bar Act, statutory requirements for law corporations, or any other legal requirement.” An added footnote for “any other legal requirement” cites *Frye*: “See especially *Frye v. Tenderloin Housing Clinic, Inc.* (2006) 38 Cal.4th 23, 40 Cal.Rptr.3d 221 regarding nonprofit public benefit corporations.”

6. Revisions have been made to indicate that a subset of nonprofit public benefit corporations, qualified legal services projects and qualified support centers, are exempt by statute from requirements for annual renewal and special reports that otherwise apply to law corporations.

Rule 3.154(A), on duties, would acknowledge the annual renewal exemption and add as a general duty of a law corporation an obligation to report a change of address or e-mail address.

A law corporation must have a currently effective certificate of registration issued by the State Bar; submit an Annual Renewal with any required fee, unless exempt by these

rules; report to the State Bar within thirty days a change of address or e-mail address; and otherwise comply with these rules and applicable law.

A new footnote to 3.154(A) cross-references the annual renewal rule 3.156, where new provision 3.156(C) states that “This rule does not apply to a qualified legal services project or qualified support center incorporated as a nonprofit public benefit corporation.” Citations in rule 3.156(C) points to the statutory definition of “qualified legal services project” at Business & Professions Code § 6213(a); the definition of “qualified support center” at Business & Professions Code § 6213(b); and the circumstances under which these nonprofit public benefit corporations are deemed to have satisfied the annual renewal requirements, as specified in Corporations Code § 13406(c).

7. Rule 3.155, dealing with special reports, has been amended to indicate that it does not apply to qualified legal services projects and qualified support centers incorporated as nonprofit public benefit corporations. Rule 3.155(A) identifies the statutorily required special reports applicable to most corporations. A new provision (B) acknowledges the exemptions and the statutory bases for the exemption.

- (A) A law corporation must ~~report~~ submit within forty-five days as a Special Report any change in directors, officers, share ownership, articles of incorporation, or bylaws. ~~address, or e-mail address.~~⁵ ~~The report must comply with State Bar requirements. If the information required for the guarantee has changed, the renewal must also include a current Law Corporation Guarantee executed by all shareholders.~~
- (B) This rule does not apply to a qualified legal services project or qualified support center⁶ incorporated as a nonprofit public benefit corporation.⁷

Capitalization of “Special Report” in (A) signals that the report is a State Bar form and as such governed by State Bar Rule 1.24: “When a rule refers to a form, the State Bar reserves the right to reject a form that is altered in language or structure or that is not completed and submitted according to instructions.” The revision now refers to “proof of security” rather than to “the Law Corporation Guarantee” to align this rule with revised 3.158, where the proof of security required depends on whether a corporation is a nonprofit public benefit corporation or not. As noted above, the duty to update an address and e-mail address have been moved from the special reports rule to Rule 3.154(A) to indicate that all law corporations, without exception, must maintain a current address and e-mail address.

A law corporation must have a currently effective certificate of registration issued by the State Bar; submit an Annual Renewal with any required fee,⁸ unless exempt by these

⁵ Business & Professions Code § 6162.

⁶ Business & Professions Code § 6213(a) and 6213(b).

⁷ Corporations Code § 13406(c).

⁸ Rule 3.156.

rules;⁹ report to the State Bar within thirty days a change of address or e-mail address;
and otherwise comply with these rules and applicable law.

PUBLIC COMMENT

At the July meeting, the Board Committee on Member Involvement, Relations and Services approved a 30-day public comment period from July 27, 2010 through August 26, 2010.

No comments were received during the public comment period.

EFFECTIVE DATE OF PROPOSAL

Because statutory law requires these State Bar rules to be approved by the Supreme Court, the Court will determine the effective date of the proposed new revised law corporations rules.

FISCAL IMPACT

Adoption of the proposed rules would require no new resources.

BOARD BOOK IMPACT

None.

RULES/REGULATIONS IMPACT

Upon approval by the Court, the rules would be added to The Rules of the State Bar, Title 3: Programs and Services, as rules 3.150-3.161.

PROPOSED RESOLUTIONS

Should the Board Committee on Operations concur with the request to recommend that the Board of Governors adopt amendments to law corporations rules 3.150-3.161, adoption of the following resolution would be appropriate:

RESOLVED, following publication for comment, and no comments having been received, that the Board Committee on Operations recommends that the Board of Governors adopt the proposed law corporation rules 3.150-3.161 with amendments to include provisions for nonprofit public benefit corporations, in the form attached, as Division 2, Chapter 2 of Title 3 of the Rules of the State Bar of California and repeal the current Law Corporation Rules of The State Bar of California and direct staff to transmit the proposed new rules to the California

⁹ Rule 3.156(C).

Supreme Court with a request that the Court approve the new rules and repeal the current Law Corporation Rules of The State Bar of California.

Should the Board of Governors concur with the recommendation of the Board Committee on Operations to adopt amendments to law corporations rules 3.150-3.161, adoption of the following resolution would be appropriate:

RESOLVED, following publication for comment, and no comments having been received, and upon recommendation of the Board Committee on Operations, that the Board of Governors hereby adopts the proposed law corporation rules 3.150-3.161 with amendments to include provisions for nonprofit public benefit corporations, in the form attached, as Division 2, Chapter 2 of Title 3 of the Rules of the State Bar of California and repeals the current Law Corporation Rules of The State Bar of California and directs staff to transmit the proposed new rules to the California Supreme Court with a request that the Court approve the new rules and repeal the current Law Corporation Rules of The State Bar of California.

Attachments

A: Proposed Law Corporations Rules 3.150 - 3.161

B: Current Law Corporation Rules of The State Bar of California