

2009 CHANGES TO RULE 265 AND C.R.C.P. 5.4

BACKGROUND

Rule 265, Chapter 22 of the Colorado Rules of Civil Procedure (C.R.C.P.) authorizes lawyers to render legal services through a professional company. The Rule was first promulgated in the late 1960's to enable lawyers to take advantage of opportunities for income tax savings resulting from changes then being made in the Federal Income Tax laws. The Internal Revenue Code had been changed to allow incorporated businesses to take advantage of deductible expenses and deferred compensation retirement benefits. The advantages of these opportunities were being legislatively conferred upon other professional organizations and the Supreme Court was importuned to allow lawyers to take advantage of the same opportunities. In response the Supreme Court created Rule 265 (Chapter 22 C.R.C.P) and lawyers were then permitted to practice law in business organizations generally called professional companies.

The Colorado Constitution vests the Supreme Court with plenary authority to regulate the practice of law. Lawyer regulation is within the jurisdiction of the Supreme Court rather than the Colorado legislature by virtue Section 21, Article VI of the Colorado Constitution which delegates to the Supreme Court the rule making authority to govern practice and procedures in the courts. The Supreme Court, therefore, has plenary authority and exclusive jurisdiction for such regulation. (*Denver Bar Association v. Public Utilities Commission*, 391 P.2d 467). Initially there was a concern that an unrestricted authorization for lawyers to incorporate might unintentionally create a shield for lawyers against liability for professional mistakes by virtue of the corporate shield

(C.R.S. §7-80-101). To resolve this, the Court created a "give up and get back" opportunity that has remained in the Rule since it was first ordained. The "give and get" process encourages lawyers who avail themselves of the advantages of the Rule to cover their professional civil liability with attorney malpractice insurance. The Court wanted to preserve the vicarious liability for professional errors and omissions that prevailed when group law practice was as a general partnership. The Supreme Court, however, did not have the authority to modify the Colorado Corporation Code so as to impose vicarious civil liability on corporate shareholders for professional mistakes. It could not create an exception to the statutory protection that applied to all corporations, professional and otherwise.

Since it could not change the Corporate Code, the Court put a condition on the opportunity for lawyers to incorporate. The condition was that all of the owners of the organization would have to overtly agree to be jointly and severally liable for the professional acts, errors, or omissions of any other member, notwithstanding the protection of the corporate shield. The Rule required that the organizational document of the entity express an agreement among the owners whereby they all agreed to be vicariously liable for the civil damages caused by the substandard professional practice by any of them or their staff and employees. But there was more. The agreement could also express a way for the owners to avoid this assumed vicarious liability by having professional liability insurance. So long as this insurance was in force, the members of the organization who had not participated in the act giving rise to liability would not be vicariously liable. This was the "get back." This arrangement reflected the traditional general partnership liability that lawyers and law firms had lived with historically insofar as professional acts were concerned. By conditioning the opportunity for avoiding vicarious professional liability, the Court encouraged the acquisition of professional liability insurance.

THE 2009 CHANGES

Effective February 26, 2009, the Supreme Court made three fundamental changes to the Rule and some corresponding changes to Rule 5.4 of the Colorado Rules of Professional Conduct (C.R.C.P.). The changes to the rule accomplished three objectives. The first authorizes the professional company to provide any professional service authorized by the Colorado Rules of Professional Conduct. The second change eliminated the requirement for an overt agreement and replaced it with a presumption that arises automatically from rendering of any legal services through the professional company. A third change was the elimination of the restrictions on the name of the professional company.

THE PURPOSE OF THE PROFESSIONAL COMPANY

The modifications reassigned much of the focus and function of Rule 265 to the Rules of Professional Conduct. The purpose for which a professional organization can operate is now addressed in the Conduct Rules instead of the Rules of Civil Procedure. One of the principal reasons for the revision was the limiting purpose expressed in the Rule before 2009. Before 2009, the purpose for which the professional service company could be established was limited to conducting the practice of law (Old Rule 265 (A) (2)). When the Supreme Court repealed and re-enacted the Rules of Professional Conduct effective January 1, 2008, it added two new rules, C.R.P.C. 2.4 and C.R.P.C.5.7. Comment [1] to new C.R.P.C. 2.4 noted that lawyers often serve as third party neutrals in the alternate dispute resolution process that had become a substantial part of the civil justice system. C.R.P.C. 5.7 addresses the lawyer's responsibilities in furnishing "Law Related

Services."

These changes presented a question as to whether a practitioner's function as a third party neutral or in rendering law related services was technically the practice of law because there is no attorney/client relationship in the arrangement. In order to clarify any misconceptions about this issue, the Court re-issued Rule 265 and issued some changes to Rule 5.4 dealing with the professional independence of lawyers. The effect of these changes was to have the Rules of Professional Conduct define the details of the practice of law and to limit the operation of Rule 265 to the formation of the organization and the inherent insurance issue. Thus, the function of Rule 265 is now to authorize the establishment of a professional company in accordance with the provision of the Rules of Professional Conduct (New Rule 265 (a)). This means that any activity that is appropriate under the Rules of Professional Conduct can be undertaken through a professional company organizer by Rule 265. These activities include third party neutrals for dispute resolution, expert witness engagements, and the purveyors of law related services.

To better implement this change, the Court also modified 5.4 to accompany the new C.R.P.C. 2.4 and C.R.P.C. 5.7. Rule 2.4 addresses the lawyer serving as a third party neutral and establishes guidelines for the lawyer's function as such. By implication, it authorizes the function as a third party neutral as part of the practice of law. Rule 5.7 addresses law related services. Like Rule 2.4, Rule 5.7 implies that the lawyer may provide services that may not be strictly the practice of law and applies even when the lawyer does not provide any legal service to the person for whom the law related service is performed. In doing so, the court enlarged the type of services the professional company could offer to more than just the strict practice of law. Rule 265 now allows the

professional company to be established and operated in for whatever purpose is allowed by the Rules of Professional Conduct. By implication, this tells lawyers and law related professional companies that they may provide mediation and arbitration services, expert witness consultation, and even perhaps such things as litigation support services as a function of a Rule 265 professional company.

ELIMINATION OF THE VICARIOUS LIABILITY AGREEMENT

The rule did change with regard to the process by which the owners' vicarious liability for professional acts is addressed. The former rule required a specific provision expressed in the governing document of the professional company of the owners' joint and several liability for acts, errors, and omissions of any other owner or actor for whom the company would be liable. If they did not so agree, each of them would continue to be vicariously liable for the professional acts of their organizational colleagues to the same extent as if the organization were a general partnership. This agreement was limited to professional acts, not other liabilities of the company. The owners could avoid this assumed vicarious liability by adding to the governing document another provision. They could provide that if the professional company would have professional liability insurance at the time of the act, error, or omission occurs, any owner who did not participate in the offending conduct would not be personally liable.

The express, overt agreement has been eliminated. Now if any of the attorneys in the professional company render legal service, all of the owners are deemed to agree to be vicariously liable for the actions of the offending attorney, unless the professional company has secured

professional liability insurance that covers the act of the offending attorney. It is no longer necessary to have an expressed, specific provision in the governing document or agreement of the professional company for all of the members to be liable, unless the company obtains professional liability insurance. Now, the very act of providing legal service through the professional company is deemed to be an agreement to such vicarious liability, unless the company has obtained and is covered by professional liability insurance at the time the offending act, error or omission occurs.

THE NAME CHANGE

Before the amendment, Rule 265 required that the name of the professional company contain certain descriptive or identifying characteristics, such as P.C., LLC, Prof. Co., and so forth. These terms were allowed by C.R.P.C. 7.5 before the 2008 changes to the Rule. The new Rule 265, after the amendment, directs that the name of the company comply with the provisions of the Rules of Professional Conduct. In this regard, one must refer to C.R.P.C. 7.5 as changed in 2008. The change to C.R.P.C. 7.5 eliminated the prohibition against certain kinds of firm names. By this amendment, a law firm may employ a trade name and is not required to have any designating or identifying characteristics. It is no longer necessary to have words, such as professional company, limited liability partnership, P .C., LLC, or the like. This, again, is a relegation of the characteristics of the professional service company to the directives of the Rules of Professional Conduct rather than as part of Rule 265.

THE INSURANCE REQUIREMENTS

Rule 265 continues to state the requirements for the professional liability insurance. The rule requires that in order for the owners to avoid vicarious liability for the professional acts of the company, the company must have professional liability insurance at the time the act, error or omission occurs. In this respect, it must be noted that the available protection pertains only to vicarious liability. It does not address or provide any protection against personal liability for one's own conduct or negligent act.

The insurance must insure the professional company against liability arising out of the rendering of legal services. The professional service must be furnished by an attorney through the professional company and it must also include the liability arising out of the acts of nonattorney employees. The limit of liability must be at least \$100,000 multiplied by the number of attorneys in the company or \$500,000, whichever is greater. Aggregate top limits is the lesser of \$300,000 multiplied by the number of attorneys or \$2,000,000.

The policy can provide for a deductible contribution by the company and may provide for the payment of defense costs out of the limits of the policy. The vicarious liability each owner is deemed to have assumed is the lesser of the actual liability in excess of the insurance, or the amount of the deductible, and the amount by which defense costs may have reduced the available limits for indemnification. The act giving rise to the liability is deemed to be covered if the insurance covers the activity regardless of whether previous claims have exhausted the aggregate top limit. Finally, note that the time when the coverage must be in effect is the time when the act that gives rise to the liability takes place. Virtually all professional liability policies are written on policies that are described as "claims made and reported coverage". This means that the coverage provided applies

only to claims that are first made by an aggrieved claimant against the insured and reported to the insuring company during the stated dates of the policy period. The claim must be made against the professional company or the lawyer who performed the service and it must also be reported to the company during the period when the policy is in effect. To fulfill the requirement of this rule, the professional company must have the coverage in effect at the time when the act, error, or omission giving rise to the claim takes place (C.R.C.P. 265 (a) (2)). If an error happens in one year and the company is insured during that year, the protection applies even though the insurance is not renewed and a notice of claim given after the nonrenewal would be ineffective resulting in no coverage.

Rule 265 continues to be an important resource and reference for the establishment of a professional company where two or more lawyers are involved. It is not as critical for the corporate organization of the sole practitioner who remains responsible for his or her own actions. The Rules of Professional Conduct have gained significance in this process and must certainly be consulted.