

IN THE SUPREME COURT OF THE STATE OF CALIFORNIA

IN RE ATTORNEY DISCIPLINE SYSTEM;)
CALIFORNIA RULES OF COURT, RULE 9.9)
_____)

S237081

REPORT OF SPECIAL MASTER
OCTOBER 1, 2017 THROUGH DECEMBER 31, 2017



SUPREME COURT
FILED

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Jorge Navarrete Clerk

PREPARED BY

Elwood Lui, Administrative Presiding Justice
Court of Appeal of the State of California
Second Appellate District, Division Two
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SPECIAL MASTER FOR OVERSIGHT
OF THE ATTORNEY DISCIPLINE FUND
OF THE STATE BAR OF CALIFORNIA

**REPORT OF SPECIAL MASTER
OCTOBER 1, 2017 THROUGH DECEMBER 31, 2017**

In compliance with rule 9.9 of the California Rules of Court, I submit this fourth and final quarterly report to the Court as Special Master charged with supervision and oversight of the collection, disbursement, and allocation of the interim special regulatory assessment ordered by the Court on November 17, 2016 to support specified components of the State Bar's attorney discipline system ("P-2 programs").¹

SUMMARY

In this fourth quarter report, I review the status of the Special Master's Attorney Discipline Fund (Special Master's Fund) as of December 31, 2017, and the fourth quarter and year-end financial results within the P-2 programs funded in part by the Court's special regulatory assessment. Additionally, as this is likely my final report to the Court in my capacity as Special Master, I have also included brief observations and recommendations concerning the serious financial challenges that I believe the State Bar's attorney discipline system is likely to face in the coming year and beyond.

¹ The Court's November 17, 2016, order and rule 9.9 of the Rules of Court specified 10 components of the State Bar's attorney discipline system that would be funded through the special regulatory assessment: (1) the Office of Chief Trial Counsel (OCTC), including efforts to implement workforce plan recommendations from the National Center for State Courts (NCSC); (2) the State Bar Court (SBC); (3) the Office of Probation (Probation); (4) the Mandatory Fee Arbitration program (MFA); (5) the Office of Professional Competence (OPC); (6) the Office of General Counsel (OGC); (7) the Office of Member Records and Compliance (MRC); (8) Member Billing (MB); (9) the discipline related activities of the California Young Lawyers Association (CYLA); and (10) the activities of the Office of Communications (OC) in support of the discipline system. I will refer to these as the "P-2 programs," which corresponds to Appendix P-2 to the State Bar's Supplement Submission Concerning Methodology of Options for a Special Assessment to Fund the State Bar (Supplemental Submission) that contained a set of preliminary 2017 budgets for these programs. OGC and MB are funded through indirect cost allocations. The other eight P-2 programs are funded directly through disbursements from the Special Master's Fund and other General Fund revenues.

A. Special Master's Fund balance and cash flow management through the fourth quarter and for the year

On September 30, 2017, the balance of the Special Master's Fund stood at \$16,065,929.

From October 1 through December 31, 2017, an additional \$157,400 was deposited into the Special Master's Fund from the following revenue sources: \$90,000 from the Court-ordered special regulatory assessment (\$297 per active member); \$17,600 from the discipline assessment (\$25 per active and inactive member pursuant to Business and Professions Code section 6140.6); \$39,800 from inactive member fees (\$65 per inactive member pursuant to section 6141); and \$10,000 from member late fees and penalties.

From October 1 through December 31, 2017, I made five disbursements from the Special Master's Fund to the State Bar to support the P-2 programs, totaling \$12,750,000: (1) on October 17, 2017, I disbursed \$2,750,000 to fund the programs through the second half of October; (2) on October 27, 2017, I disbursed \$2,000,000 to support operations for the first half of November; (3) on November 14, 2017, I disbursed \$2,000,000 to fund P-2 programs for the second half of November; (4) on November 27, 2017, I disbursed \$4,000,000 to fund the P-2 programs through the first half of December²; and (5) on December 13, 2017, I disbursed \$2,000,000 to fund the programs through the end of the year.

In total, \$66,701,400 was deposited into the Special Master's Fund from the first deposit on December 22, 2016 through the final deposit on December 27, 2017. The following summarizes total deposits by revenue source: \$56,071,000 from the Court-ordered special regulatory assessment (\$297 per active member); \$5,991,600 from the discipline assessment (\$25 per active and inactive member pursuant to Business and Professions Code section 6140.6); \$3,238,800 from inactive member fees (\$65 per inactive member pursuant to section 6141); and \$1,480,000 from member late fees and penalties. Over the same period, I disbursed \$63,228,071 to the State Bar to fund the P-2 programs. As of December 31, 2017, the Special Master's Fund ending balance with accrued interest factored in was \$3,496,057.³

² As a reminder, this larger amount disbursed for the first half of December was necessary to cover the close of three payroll periods within that month.

³ Interest continued to accrue through the first two months of 2018. The balance in the Special Master's Fund now stands at approximately \$3,556,919.

B. Summary of P-2 program expenses over the fourth quarter of 2017

Spending in the eight directly funded P-2 programs⁴ from October through December 2017 was approximately \$17,102,673, which is \$33,010 (0.2%) *below* the fourth quarter budget. Five of the eight P-2 programs directly supported by the Special Master's Fund were *over* budget for the fourth quarter: (1) Probation (14.8% over budget); (2) SBC (4.1% over budget); (3) OPC (16.4% over budget)⁵; (4) MRC (1.9% over budget); and (5) CYLA (65% over budget). Two departments were *under* budget in the fourth quarter: OCTC and OC. As the Court will recall, OCTC trended far under budget throughout 2017 due to slower than expected hiring in the department, but for reasons discussed *post*, its spending picked up considerably in the fourth quarter. OCTC was originally expected to spend \$11,513,282 in the fourth quarter and its actual expenses totaled \$11,297,781.

Turning to cumulative year results, the State Bar spent \$62,973,730 on the P-2 programs through December 31, 2017, which is \$4,935,934 (7.3%) *less* than budgeted expectations. Five of the eight directly funded P-2 programs were *under* budget for the year: (1) OCTC (10.2% below budget); (2) MFA (22.6% below budget); (3) OPC (5.6% below budget); (4) MRC (4.7% below budget); and (5) OC (6.6% below budget). SBC and CYLA each ended the year only slightly over budget. SBC was 1.3 percent, or \$161,000, over budget, and CYLA was 8 percent, or \$1,999 over budget.

For the fourth quarter, Probation continued its unbroken trend of exceeding its budget. As discussed in the prior quarterly reports, this variance was initially attributable to salary and benefit expenses of subject matter experts (SMEs) within Probation who were expected to spend a larger percentage of their time this year assisting with the design and implementation of the new case management system (CMS). Instead, the CMS team only began pulling these SMEs into the project in September and ended their involvement earlier than expected in November. Thus, a larger percentage of the personnel costs attributable to these SMEs had to be charged back to the Probation

⁴ Footnote 1, *ante*, lists all ten P-2 programs, which includes eight directly funded by the Special Master's Fund. The two P-2 programs funded through indirect cost allocations — OGC and MB — were budgeted to spend \$1,388,873 during the fourth quarter of 2017, but in fact spent \$997,945, which is \$390,928 *below* budget. These two programs are \$992,529 below budget for the year. The budgeted costs for the eight directly funded P-2 programs include indirect cost allocations that support these two indirectly funded programs.

⁵ This was largely due to a one-time charge of \$174,566 for professional services incurred in December 2017 to develop the new 10-hour New Attorney MCLE training module.

department, causing the overall department expenses to rise. Probation ended the year with a cost variance of \$189,522, or 16.8 percent, over budget.

As the Court is aware, lower than expected spending in OCTC drove overall P-2 program expenses far below expected levels throughout the year. However, this budget gap closed considerably in the fourth quarter, resulting in OCTC ending the year with a below-budget variance of 10.2 percent. For reference, OCTC was trending between 12.6 to 13 percent under budget YTD from the end of the second quarter through to the end of the third quarter of 2017. The increased spending was attributable to higher personnel costs as the State Bar began to make significant headway in its recruiting and hiring efforts. At the end of September 2017, OCTC has 33 open unfilled positions in the department. By mid-November, the number reduced to 29 and by the end of the year, there were only 15 vacant positions in OCTC.

C. Release of remaining balance in the Special Master's Fund

On January 10, 2018, I informed the Court that I had received a letter from Kevin W. Harper, the State Bar of California's Interim Chief Financial Officer, requesting the release of the remaining balance in the Special Master's Fund to support several key initiatives within the attorney discipline system in 2018 for which the State Bar currently lacks adequate funding. These key initiatives include: (1) additional internal staffing needed to support implementation of the active attorney fingerprinting rule at an estimated cost of \$650,085; (2) an estimated \$2 million in unfunded costs related to the implementation of a new case management system to support OCTC, SBC, and Probation; and (3) an estimated \$1.5 million in investments needed for OCTC's continued expansion. As my report indicated, I agree it is reasonable and appropriate to release the balance of the Special Master's Fund to the State Bar in exchange for its assurances that the funds will be used exclusively to support these initiatives within the attorney discipline system. In a letter dated January 17, 2018, Jorge Navarrete, the Clerk and Executive Officer of the Supreme Court, informed me that the Court had no objection to my proposed release of surplus funds subject to any adjustments I deem necessary or appropriate. Thus, following issuance of this final fourth quarter report, I will transfer the remaining balance in the Special Master's Fund to the State Bar and make arrangements to close the public funds commercial checking and investment accounts with Wells Fargo Bank.

D. Recommendations to address future financial challenges facing the attorney discipline system

In the course of discharging my duties as Special Master throughout the past year, I identified several financial challenges that the State Bar's attorney discipline system will likely face in the coming year. Given my independent position, I feel it incumbent to raise these issues, and where appropriate to make recommendations, so they may be

weighed and factored into any relevant and ongoing policy discussions and decision-making.

The attorney discipline system is completely dependent on unrestricted General Fund revenues for its survival. Nearly all of those revenues are generated from mandatory licensing fees which are normally set by the Legislature, except on those rare occasions when this Court must intervene to support the attorney discipline system such as it did last year and previously in 1998. Mandatory licensing fees have not significantly increased for nearly 20 years.⁶ At the same time, the attorney discipline system has seen other revenue sources dwindle or disappear altogether. For instance, with the recent departure of the Sections, the General Fund is expected to lose \$4 million in annual funding attributable to revenue from its affinity and insurance programs as well as from indirect cost allocations that the discipline system will now be forced to absorb. This is not a one-time loss of revenue — it is permanent and ongoing.

At the same time, the State Bar has seen the costs of maintaining the attorney discipline system rise considerably, a trend that is only expected to continue. Contractually-obligated annual salary increases for represented staff alone, the cost of which comprises nearly 70 percent of the State Bar's non-grant budget, have increased at an annual rate of 2.2 percent since 2010, which far outstrips the growth in the Consumer Price Index average over that same period.

Additionally, the State Bar continues to struggle with antiquated information technology systems, and this has a direct and detrimental effect on its ability to fulfill its public protection mission. For instance, the annual maintenance and software subscription for its enterprise resource planning (ERP) system expired in 2014 and the State Bar struggled to fund an upgrade. The many shortcomings with the current ERP system's reporting capabilities were evident to me throughout the year. The ERP system is critical infrastructure that, if properly maintained and upgraded, would function to fully integrate financial, procurement, and human resource functions. Without steady and dependable funding sources for such IT costs and initiatives, the State Bar will continue to be hampered in its ability to generate timely, accurate, and comprehensive data reports that can deliver key insights and meaningful analysis for management decision making and legislative reporting purposes.

In 2017, the State Bar spent down its General Fund reserves in order to supplement funding for public protection programs not covered under the Court-ordered

⁶ To review, the mandatory membership fee for active State Bar members remained at \$380 from 2000 to 2016. It rose slightly to \$383 per active member this year due to a change in the optional deduction for elimination of bias programs from \$5 to \$2 per member. For reference, prior to the Court-ordered interim assessment in 1998, mandatory State Bar fees were \$478 per active member from 1992 to 1996 and \$458 per active member for 1997.

assessment such as the Client Security Fund and the Commission on Judicial Nominees Evaluation. Unfortunately, spending down General Fund reserves is always at best a temporary solution, and may no longer be a viable option beyond this year. According to the latest version of the State Bar's 2018 budget, the General Fund is projected to spend a total of \$84.6 million this year with the vast majority of this amount going to support the attorney discipline system. With total 2018 General Fund revenues expected to be approximately \$74.1 million, it is projected that the General Fund will run a deficit of approximately \$9 million this year, a funding gap that can only be closed by further tapping General Fund reserves. The General Fund is projected to close 2018 with a reserve balance of \$14.1 million and an available balance of \$9.5 million. Notably, this reserve balance will be far below the 17 percent reserve target recommended by the State Auditor and mandated by the Board.

With the foregoing in mind, I recommend the Legislature, the Court, and the State Bar work closely together in the coming months to consider and agree on a reasonable increase in mandatory fees for State Bar members. As I observed in my final Special Master's report in March 2000, the California attorney discipline system is unique in that we are the only jurisdiction that maintains an independent state bar court system funded exclusively through license fees. This stands in stark contrast to other state bar systems and even other professional licensing agencies within California, such as the Medical Board of California (MBC), which largely relies on the Attorney General's (AG) office to prosecute and the Office of Administrative Hearings (OAH) and the statewide trial court system to adjudicate and review its disciplinary proceedings.⁷ While California physicians and surgeons currently pay \$820 to renew their two-year medical license, for the past 20 years California lawyers have paid no more than \$383 to renew their active membership with the State Bar. A fee increase is long overdue, and I believe the continued postponement of an increase will fundamentally and detrimentally affect the State Bar's ability to discharge its critical public protection functions.

There is a second, and equally significant, issue that warrants attention and consideration. In 2000, I made the following observations:

"The State Bar's current budgetary process fosters severe and detrimental financial instability for the State Bar. Currently, representatives of the State Bar must spend a large portion of each year in Sacramento lobbying

⁷ Following an investigation, the MBC refers disciplinary matters to the Attorney General's office for prosecution with few exceptions. If the matter does not settle, the parties have a hearing before an administrative law judge (ALJ) from the OAH. The ALJ issues a proposed decision for review by the MBC, which can choose whether to adopt it or to take other statutorily authorized action on the proposed decision. Any California licensed physician seeking review of a final MBC disciplinary decision must file an administrative mandamus action in superior court.

for the State Bar's fee bill for the following year. Not only does this create an unhealthy obsession with the annual budget, more significantly, it precludes the State Bar from making long term strategic plans. The scenario is demoralizing and causes inefficiencies and short and long term problems. A recent and clear example of this is the impasse over the 1998 fee bill, which resulted in the layoffs of hundreds of State Bar employees. Indeed, that crisis has resulted in difficulties recruiting staff to re-fill positions during the restaffing and restructuring of operations." (J. Lui, Report of Special Master, Sept. 25, 1999 through March 28, 2000, p. 19.)

Because those observations remain true today, I recommend — once again — that all stakeholders take up the issue of a multi-year funding bill, which I understand was briefly considered in the Legislature last year but ultimately abandoned.

I recognize that remaining on an annual funding cycle arguably allows for a greater level of external control over the State Bar. As noted above, however, the disadvantages are far too great. Indeed, as the 2015 California State Auditor's report more recently concluded, a yearly funding cycle significantly impedes the State Bar from engaging in the type of long-term financial and strategic planning needed to address its public protection mission and saps the agency of precious staff time and resources that may be better dedicated to those efforts. (Cal. State Auditor, State Bar of California, Report 2015-030 (June 2015) pp. 4-5.)

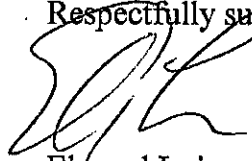
While this Court's immediate intervention last year prevented the type of large-scale layoffs and virtual shutdown that the State Bar discipline system experienced in 1998, the Court should recognize several important parallels when comparing the State Bar's recovery from the prior funding crisis in 2000 with the present one. One need look no further than OCTC's ongoing difficulties throughout 2017 in recruiting and hiring open positions within the department. The continual uncertainty inherent in a year-to-year funding cycle severely hampers the State Bar's ability to engage in meaningful financial planning and is extremely corrosive to staff morale. I continue to believe, as I did 18 years ago, that only through adoption of a multi-year fee bill cycle can California take the necessary first steps toward ensuring we will have an effective, efficient, modern, and responsive attorney discipline system for years to come.

CONCLUSION

With the submission of this final report and the transfer of the remaining balance in the Special Master's Fund to the State Bar, I will have fully discharged my duties under the Court's November 17, 2016 order and rule 9.9 of the California Rules of Court. Thus, I believe the appropriate time has come for me to conclude my services as Special Master for the State Bar's Attorney Discipline System. I wish to express my appreciation to the State Bar executive team, staff, and Board of Trustees for their helpful assistance and support over the course of my appointment.

Dated: March 12, 2018

Respectfully submitted,



Elwood Lui