

# The Catholic Lawyer

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Volume 8  
Number 2 *Volume 8, Spring 1962, Number 2*

Article 10

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July 2016

## Recent Decision: Lawyers' Right to Incorporate

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## Recent Decision: Lawyers' Right to Incorporate

For many years, because of the fear that the attorney-client relationship would be undermined, attorneys have been denied the right to incorporate. Recently, however, the Florida Supreme Court, acting on a request of the Florida Bar Association, amended its Integration Rules and Code of Ethics to allow members of the Florida Bar to incorporate. Considering the restricted nature of the corporation and the possible tax advantages to be had by the members of the bar, the Court held that attorneys may practice law in the corporate form.<sup>1</sup>

At common law corporations could not be formed for the purpose of practicing law.<sup>2</sup> In 1910, the New York Court of Appeals<sup>3</sup> flatly denied the right of attorneys to practice law in the corporate form, stating that to permit a corporation to stand between the attorney and client

would tend to subvert the high standard of care owed by the attorney to his client. The court further stated that the attorney would be subject to the directions of the employer-corporation, rather than those of the client, and that the corporate stock might be owned totally or in part by laymen, who would then in effect, be practicing law or controlling its practice. The lack of judicial control over the corporation, since it could not be disbarred or suspended, and the fact that unscrupulous practitioners might find shelter from malpractice liability in the corporation were other factors which persuaded the court to forbid such incorporation.

The same reasoning was invariably applied as the principle of law established by the New York court was accepted throughout the country.<sup>4</sup> The court decisions were fortified by statutes, which were of two general types—the first forbidding incorporation for the purpose of practicing

<sup>1</sup> In the Matter of The Florida Bar, — Fla. —, 133 So. 2d 554 (1961).

<sup>2</sup> See Jones, *The Professional Corporation*, 27 *FORDHAM L. REV.* 353 (1958); Lewis, *Corporate Capacity to Practice Law — A Study in Legal Hocus Pocus*, 2 *MD. L. REV.* 342 (1938); Maier & Wild, *Taxation of Professional Firms as Corporations*, 44 *MARQ. L. REV.* 127 (1960).

<sup>3</sup> In the Matter of the Co-operative Law Co., 198 N.Y. 479, 92 N.E. 15 (1910).

<sup>4</sup> *Boykin v. Hopkins*, 174 Ga. 511, 162 S.E. 796 (1932); *New Jersey Photo Engraving Co. v. Carl Schonert & Sons, Inc.*, 95 N.J. Eq. 12, 122 Atl. 307 (Ch. 1923); *Land Title Abstract & Trust Co. v. Dworken*, 129 Ohio St. 23, 193 N.E. 650 (1934); *State ex rel. Lundin v. Merchants Protective Corp.*, 105 Wash. 12, 177 Pac. 694 (1919); *cf.* In the Matter of Eastern Idaho Loan & Trust Co., 49 Idaho 280, 288 Pac. 157 (1930).

law,<sup>5</sup> and the second making the unauthorized practice of law by a corporation a misdemeanor.<sup>6</sup> The professions of medicine, accounting, and architecture, to name a few, were under the same prohibitions, but not to the same degree as the legal profession.<sup>7</sup>

The consequence of this proscription against the incorporation of attorneys and other professional groups was to put them at a decisive tax disadvantage. Since a partner or sole proprietor cannot be an employee of his own business,<sup>8</sup> he cannot take advantage of qualified pension plans,<sup>9</sup> deferred compensation plans,<sup>10</sup> stock options at slightly below market price,<sup>11</sup> accident, health and wage contribution plans,<sup>12</sup> or special employees' death benefits.<sup>13</sup> But where a business is incorporated, any shareholder who is active in the business is considered an employee as well as

a proprietor and may enjoy the above-mentioned benefits.<sup>14</sup>

Thus, pressure began to build among professional people and was directed toward gaining for themselves the same tax advantages available to other businessmen who could incorporate. One result of this pressure for tax equality was the introduction in Congress in 1951 of the Jenkins-Keogh Bill,<sup>15</sup> a proposal to permit self-employed individuals and unincorporated groups to contribute to and participate in pension plans, to a limited extent, on terms comparable to those incorporated in Section 401 of the Internal Revenue Code of 1954. This and subsequent attempts to enact similar legislation have met with little success.<sup>16</sup> It is interesting that similar bills were passed in both England<sup>17</sup> and Canada.<sup>18</sup>

Losing faith in the eventual passage of the Jenkins-Keogh Bill, professional groups began to exert pressure in other directions and to look for new methods of achieving the desired tax advantages. Since, as a general rule, only the states may determine who may incorporate, and

<sup>5</sup> IDAHO CODE ANN. § 30-102 (1947); MONT. REV. CODES ANN. § 15-104 (1947); N.Y. STOCK CORP. LAW § 7; OHIO REV. CODE ANN. § 1701.03 (Baldwin 1953).

<sup>6</sup> ALA. CODE tit. 46, § 42 (1958); ARK. STAT. ANN. § 25-205 (1947); ILL. ANN. STAT. ch. 32, § 411 (Smith-Hurd 1954); ME. REV. STAT. ANN. ch. 105, § 8 (1954); MD. ANN. CODE art. 27, § 14 (1957); N.Y. PEN. LAW § 280.

<sup>7</sup> See Jones, *The Professional Corporation*, 27 FORDHAM L. REV. 353 (1958).

<sup>8</sup> Rev. Rul. 61-157, 1961 Int. Rev. Bull. No. 35, at 9.

<sup>9</sup> INT. REV. CODE OF 1954, § 401(a).

<sup>10</sup> INT. REV. CODE OF 1954, §§ 401-04.

<sup>11</sup> INT. REV. CODE OF 1954, § 421.

<sup>12</sup> INT. REV. CODE OF 1954, § 105.

<sup>13</sup> INT. REV. CODE OF 1954, § 101(b). See generally Maier & Wild, *Taxation of Professional Firms as Corporations*, 44 MARQ. L. REV. 127 (1960); Note, *Qualified Pension Plans for Unincorporated Professional Associations*, 12 STAN. L. REV. 746 (1960).

<sup>14</sup> See Rev. Rul. 61-157, 1961 Int. Rev. Bull. No. 35, at 10.

<sup>15</sup> H.R. 4371, H.R. 4373, 82d Cong., 1st Sess. (1951). See Note, *Favorable Tax Treatment for Individual Pension Plans: The Jenkins-Keogh Bill*, 66 HARV. L. REV. 1105 (1953).

<sup>16</sup> See Keogh, *Social Security Legislation & the Jenkins-Keogh Bill*, 28 N.Y.B. BULL. 273 (1956); Note, *Qualified Pension Plans for Unincorporated Professional Associations*, *supra* note 13, at 747. The most recent version of this legislation is embodied in H.R. 10, 87th Cong., 1st Sess. (1961).

<sup>17</sup> Hosking, *United Kingdom's Experience with Pensions for Self-Employed*, 97 TRUSTS & ESTATES 313 (1958).

<sup>18</sup> See Fairbanks, *Taxation—Pension Plans for Self-Employed Persons*, 35 CAN. B. REV. 564 (1957).

under what terms they may incorporate,<sup>19</sup> the bulk of the pressure was then focused upon them in order to force approval of professional corporations. However, the state legislatures could not be dissuaded from their traditional opposition, and a compromise seems to have developed which gave to professional groups some corporate attributes. The compromise took the form of "associations [which] have been taxed in the same manner as corporations in every revenue act since 1913. . . . But nowhere has Congress undertaken to define 'associations'."<sup>20</sup>

*United States v. Kintner* was the first tax case involving an association of professionals in which a court upheld the claimed corporate status for tax purposes.<sup>21</sup> The Commissioner, motivated by this decision, set up definite standards which an association had to meet in order to qualify for corporate tax treatment.<sup>22</sup> The *Kintner* case and the Commissioner's subsequent action acted as a stimulus for states to enact legislation allowing the formation of

either professional corporations<sup>23</sup> or professional associations<sup>24</sup> which would qualify for favorable tax treatment. Whether the statutes call for associations or corporations, the limitations and requirements set down by the states are basically the same. However, despite the number of statutes allowing professionals to incorporate or associate, attorneys were still not permitted to practice in the corporate form, prior to the present case. This was so because even though the legislatures have the power to determine who may incorporate,<sup>25</sup> only the judiciary can determine who may practice law.<sup>26</sup>

Florida was the first state in which the judiciary took the necessary action to permit attorneys to incorporate under its Professional Service Corporation Act. *In the Matter of The Florida Bar* brought

<sup>19</sup> See BALLANTINE, CORPORATIONS § 8a (rev. ed. 1946).

<sup>20</sup> See Note, *supra* note 13, at 754.

<sup>21</sup> 216 F.2d 418 (9th Cir. 1954). In this case an association of medical men was allowed corporate status for tax purposes.

<sup>22</sup> Treas. Reg. § 301.7701-2(a)(3) (1960) provides that an "unincorporated organization shall not be classified as an association unless such organization has more corporate characteristics than noncorporate characteristics." The following are held to be characteristics of a pure corporation:

- (1) Associates
- (2) An objective of carrying on a business and dividing the profits
- (3) Continuity of life
- (4) Centralization of management
- (5) Liability of corporate debts limited to corporate property
- (6) Free transferability of interests.

<sup>23</sup> Ark. Laws 1961, art. 179, § 2; Ark. Laws 1961, art. 471, § 2; COLO. R. CIV. P. 231, ch. 19; Fla. Laws 1961, ch. 61-64 § 5; Minn. Laws 1961, ch. 1, § 3; Okla. Laws 1961, art. 399, § 4; S.D. Laws 1961, ch. 29, § 2; Wis. Laws 1961, ch. 350, § 180.99.

<sup>24</sup> Ala. Laws 1961, art. 865, § 2; Conn. Laws 1961, P.A. 158, § 44; Ga. Laws 1961, art. 285, § 3; Ill. Laws 1961, art. 804, § 1; Ohio Laws 1961, art. 550, § 1785.02; Pa. Laws 1961, art. 525, § 3; Tenn. Laws 1961, ch. 181, § 1; Tex. Laws 1961, ch. 158, § 6(3).

<sup>25</sup> *In the Matter of The Florida Bar*, — Fla. —, 133 So. 2d 554, 555 (1961). See also BALLANTINE, CORPORATIONS § 8a (rev. ed. 1946).

<sup>26</sup> See *Howe v. State Bar of California*, 212 Cal. 222, 298 Pac. 25 (1931); *In the Matter of The Florida Bar*, — Fla. —, 133 So. 2d 554, 555 (1961); *Land Title Abstract & Trust Co. v. Dworken*, 129 Ohio St. 23, 193 N.E. 650 (1934); *In the Matter of Bruen*, 102 Wash. 472, 172 Pac. 1152 (1918). In Colorado there was no statute preventing professionals from incorporating, and thus the courts were able to allow incorporation merely by changing the rules governing admission to the Colorado Bar. COLO. R. CIV. P. 231, ch. 19.

about this result by the Court's modification of its Bar Integration Rules, thereby permitting attorneys to incorporate under the statute. But in so doing, two important qualifications were required, *i.e.*, that all shareholders, officers and directors be licensed to practice law, and that all lawyers connected with the corporation comply with the Bar Integration Rules and general ethical standards.<sup>27</sup> Canon 33 of the Florida Code of Ethics was amended to permit a law corporation to use a fictitious name,<sup>28</sup> and Canons 35 and 47 were amended to provide that a law corporation shall not be deemed a lay agency or intermediary.<sup>29</sup>

The Court declared that the historic reason for the prohibition against the practice of law by a corporate entity is the preservation of the attorney-client relationship. It stated:

[I]f a means can be devised, which preserves to the client and the public generally, all of the traditional obligations and responsibilities of the lawyer and at the same time enables the legal profession to obtain a benefit not otherwise available to it, we can find no objection to the proposal.<sup>30</sup>

After a careful examination of the Professional Service Corporation Act,<sup>31</sup> and the proposed implementing rules, the Court concluded that the "highly personal obligation of the lawyer to his client is in no way

adversely affected"<sup>32</sup> and that the corporate entity could not act as a shield for the unfaithful or the unethical. Further, the corporate entity would automatically fall within the ambit of the Court's jurisdiction in regard to discipline.

Although the Florida Professional Service Corporation Act and the decision under discussion deal with most of the prior objections to the incorporation of attorneys, there are certain aspects of the problem which seemed to have been overlooked by both the legislature and the Court. The act provides that no shares may be issued to individuals not licensed to practice the profession and that no member may sell his shares to an unlicensed person.<sup>33</sup> No provision was made, however, to prevent such stock from descending, or passing by will or attachment of creditors to unauthorized persons.

The American Bar Association's Opinion 303, speaking generally of professional corporations, indicates that should any such stock fall into the hands of an unauthorized person in this manner, there would be a violation of Canon 35 which prohibits a layman from sharing in the profits of the corporation.<sup>34</sup> There would also be violations of Canon 31, since the layman would have a vote in the operation of the corporation,<sup>35</sup> and of Canon 47, since a lawyer would thereby assist a lay agency in the practice of law.<sup>36</sup> These problems may be solved by a provision that, unless otherwise provided for in the articles of incorporation, the estate or

<sup>27</sup> In the Matter of The Florida Bar, *supra* note 25.

<sup>28</sup> Canon 33, Rule B, "Ethics Governing Attorneys." See also In the Matter of The Florida Bar, *supra* note 25.

<sup>29</sup> Canons 35, 47, Rule B, "Ethics Governing Attorneys." See also In the Matter of The Florida Bar, *supra* note 25.

<sup>30</sup> In the Matter of The Florida Bar, *supra* note 25, at —, 133 So. 2d at 556.

<sup>31</sup> Fla. Laws 1961, ch. 61-64, § 5.

<sup>32</sup> In the Matter of The Florida Bar, *supra* note 25, at —, 133 So. 2d at 556.

<sup>33</sup> Fla. Laws 1961, ch. 61-64, § 9.

<sup>34</sup> 48 A.B.A.J. 159, 161-62 (1962).

<sup>35</sup> *Id.* at 160.

<sup>36</sup> *Id.* at 161.

creditor may hold the stock for six months, for purposes of finding a qualified buyer, during which time, no distribution of the profits will be paid or accrued on such stock, and no power to vote will be had by its holder, nor may the holder solicit or obtain the confidence of any client.<sup>37</sup>

In Opinion 303, the American Bar Association answered the question whether lawyers can carry on the practice of law as a professional association or professional corporation, indicating that:

. . . It is the substance of the arrangement and not the form which will be controlling in determining whether the ethical restraints imposed on the legal profession have been violated.<sup>38</sup> [Necessary safeguards must assure that the lawyer or lawyers rendering the legal services will] be personally responsible to the client.<sup>39</sup>

The Florida statute when read in conjunction with the case under discussion, would seem to satisfy the Canons of Ethics, because the attorney is still held to the same degree of care toward the client and remains personally liable to the client for malpractice. In addition, the client has recourse to the assets of the corporation which are also under the control of the courts. Every shareholder must be an attorney and cannot use the corporation as a shield against disbarment, since he is

still individually held to the observance of the Canons of Ethics.<sup>40</sup> At the same time the standards established by the Commissioner seem to have been met, so that the law corporation may receive favorable tax treatment.<sup>41</sup> Thus, Florida has been able to bestow upon its bar members the benefits of corporate taxation, without substantially affecting the basic attorney-client relationship, in a form which will not violate the Canons of Ethics.

It would appear that the action taken by Florida and other states regarding professional corporations and associations will prompt Congress to take another look at the Jenkins-Keogh Bill, if only to allow it to regulate the amount of tax benefit to be gained by this type of organization. Just as the rash of adoptions of community property statutes prompted the federal government to allow the joint return, so also might the passage of a number of state laws permitting professional incorporation, which may be prompted by the ABA's Opinion 303, induce federal action. Until such time, however, the Florida decision is worthy of note by those attorneys who would benefit by incorporation and who are willing to voice an opinion in support of professional corporation statutes.

<sup>37</sup> *Id.* at 160.

<sup>38</sup> *Id.* at 162.

<sup>39</sup> *Id.* at 160.

<sup>40</sup> In the Matter of The Florida Bar, — Fla. —, 133 So. 2d 554 (1961).

<sup>41</sup> Treas. Reg. § 301.7701 (1960). See note 22 *supra*.