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California’s Limited Liability Company Act Gets a Facelift

Andrew J. Glendon

I. INTRODUCTION

In 1994, the Beverly-Killea Limited Liability Company Act established a new form of business enterprise in California. This new business enterprise, known as a limited liability company (LLC), is a hybrid form of business that is neither a corporation nor a partnership, but is an attractive alternative that will “give business owners the best of both worlds: they will be afforded the limited liability enjoyed by corporate shareholders, as well as the pass-through tax advantages of a partnership.”

Wyoming enacted the first LLC statute in 1977 at the request of Hamilton Oil, and this Wyoming LLC was classified as a partnership. A few years later, in 1982, Florida adopted an LLC act that included certain provisions that were not in the Wyoming statute. However, it was not until 1988 when the Internal Revenue Service (IRS) issued Revenue Ruling 88-76, which classified the Wyoming LLC as a

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3. Jeffery A. Russell, New Form of Business Available, FRESNO BEE, Nov. 7, 1994, at C2. But see Robert L. Sommers, A Better Deal for Small Firms in California, S.F. EXAM., Mar. 7, 1995, at B1 (noting that a drawback to LLCs is the lack of legal precedent involving LLC issues that allows for predictability when forming any business entity); id. (stating that when choosing between an S corporation and an LLC, in cases where one can be satisfied with the benefits of an S corporation, one should incorporate as an S corporation because “it is an established business and tax entity”).
4. See WYO. STAT. ANN. §§ 17-15-101 to 17-15-136 (Michie 1989 & Supp. 1996) (promulgating the first LLC act which included some of the defining corporate characteristics such as limited liability, partnership tax treatment, free transferability of interests, and centralized management). However, the LLC was not fully developed at this time because the act was lacking critical rules regarding fiduciary duties among members and the agency powers of members and managers. See Larry E. Ribstein, The Emergence of the Limited Liability Company, 51 BUS. LAW. 1, 4 (1995) (stating that the original Wyoming LLC act was more of a tinkering with existing limited partnership and corporate statutes than a true LLC act and lacked detailed rules regarding fiduciary duties and agency powers of members).
7. Jelsma, supra note 5, at 322; see id. (noting that the added provisions created a more flexible business entity than was available under the Wyoming statute).
partnership for tax treatment, that the promulgation of LLC acts began to increase. The enactment in recent years of the many LLC statutes has come in response to business owners' demands for the establishment of a business entity with limited liability for its owners without subjecting itself to a corporate level tax.

II. OVERVIEW OF BUSINESS ASSOCIATIONS AND THEIR RELATION TO LIMITED LIABILITY COMPANIES

A. Corporations

A corporation is a statutorily created legal entity which incurs liability separately from its owners. A corporation's day-to-day business affairs are conducted by its officers, who are supervised by the corporation's board of directors, who are elected by the corporation's owners, known as shareholders. An LLC, however, is managed directly by its members, or the management decisions can be vested in a manager selected by its members.

A business entity will be given corporate status by the Internal Revenue Service if it possesses the following six characteristics: (1) Associates, which are a group of

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9. *See id.* at 361 (holding that since the Wyoming LLC "lacks a preponderance of the four remaining corporate characteristics . . . [the LLC] is classified as a partnership for tax purposes"); *infra* notes 15-17 and accompanying text (listing corporate characteristics that will cause an unincorporated association to be classified as a partnership or corporation for tax purposes depending on how many characteristics the association possesses); *see also* SENATE COMMITTEE ON REVENUE AND TAXATION, COMMITTEE ANALYSIS OF SB 469, at 1-2 (Jan. 5, 1994) (stating that serious interest in LLCs began with the 1988 IRS determination that an LLC would be treated as a partnership for tax purposes).

10. Louis B. Schatz et al., *What Every Insurance Professional Needs to Know About Limited Liability Companies*, 50 J. AM. SOC'Y C.L.U. & CHt. F.C. 80, 80 (1996); *see* John E. Karayan, *Easy-To-Form Legal Entity Still Poses Host of Questions*, BUS. PRESS, Jan. 1, 1996, at 35 (providing that legislation recognizing LLC formation is pending in the three states that do not yet have LLC statutes, however, since this article was published, there remain only two states without an LLC act); *see also* Ribstein, supra note 4, at 1 (noting that the two states which have not yet passed LLC statutes are Hawaii and Vermont).

11. Jelsma, supra note 5, at 323.

12. Schatz et al., supra note 10, at 81.

13. *Id.; see*, e.g., CAL. CORP. CODE § 55100 (West 1990) (establishing rules for corporate meetings, including how often and who must attend, as well as provisions for failure to hold said meetings); *see also* Schatz et al., supra note 10, at 81 (noting that failing to follow corporate formalities with respect to managing and operating the corporation, such as periodic meetings and documentation of those meeting, can lead to personal liability for shareholders). These restrictions do not apply to LLCs, thus corporate formalities can be eliminated by forming an LLC.

14. *See* CAL. CORP. CODE § 17150 (West Supp. 1997) (providing that the business and affairs of the LLC shall be managed by the members, unless the articles of organization include the statement referred to in California Corporation Cods § 17151(b)); *id.* § 17151(a) (amended by Chapter 57) (stating that the articles of organization may provide that the business and affairs of the LLC may be managed by nonmembers); *see also* id. § 17151(b) (amended by Chapter 57) (requiring that if the LLC is to be managed by nonmembers, the articles of organization shall contain a statement to that effect).
people coming together to form a business enterprise; (2) the objective to carry on as a business and divide gains; (3) continuity of life; (4) free transferability of interests; (5) centralized management; and (6) limited liability. Unincorporated associations, such as LLCs, will be taxable as a corporation if they possess more corporate than noncorporate characteristics. The first two characteristics listed above are not considered in classifying an LLC, and an LLC, by definition, will always possess limited liability. Thus, in order to ensure partnership tax status, the LLC must possess no more than one of the three remaining corporate characteristics: free transferability of interests, centralized management, or continuity of life.

Corporations doing business in California or deriving income from California sources are required to pay a 9.3% tax on their net profit. If a corporation has little or no net profit, a “minimum tax” of $800 is imposed. In addition, the corporation’s shareholders must also pay tax on any dividends they receive. Thus, corporations are subject to a double level of tax.

A properly structured LLC will avoid this double level of taxation, imposing federal tax only upon the income earned by the members instead. This member-level tax is like that imposed upon a corporation’s shareholders on the dividends they

15. 26 C.F.R. § 301.7701-2(a)(1) (1996); see id. (noting that an organization will be treated as a corporation if the corporate characteristics more nearly resemble a corporation than a partnership or trust).

16. Id. § 301.7701-2(a)(3) (1996); see id. (stating that the characteristics common to both types of organizations, such as the corporate characteristics of associates and an objective to carry on business and divide gains, will not be considered in determining whether an organization possesses corporate characteristics).

17. Id.; Jelsma, supra note 5, at 329.

18. Jelsma, supra note 5, at 329.

19. Id.; see 26 C.F.R. § 301.7701-2(c)(1) (1996) (noting that an LLC will possess the characteristic of centralized management “if any person (or group of persons which does not include all of the members) has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed”); id. § 301.7701-2(e)(1) (1996) (finding that an LLC will possess the characteristic of free transferability “if each of its members or those members owning substantially all of the interests of the organization have the power, without the consent of other members, to substitute for themselves in the same organization, a person who is not a member of the organization”); see also id. § 301.7701-2(b)(1) (1996) (stating that an LLC will possess the characteristic of continuity of life “if the death, insanity, bankruptcy, retirement, resignation or expulsion of any member will not cause a dissolution of the organization”); id. § 301.7701-2(b)(2) (1996) (defining “dissolution of an organization” as “an alteration of the identity of an organization by reason of a change in the relationship between its members as determined under local law”).

20. CAL. REV. & TAX. CODE § 23501(a)-(c) (West 1992); see id. (imposing upon every corporation for each taxable year a minimum tax rate upon its net income derived from sources within this state to be determined by § 23151 of the California Revenue and Taxation Code); id. § 23151(d) (West 1992) (finding the tax rate upon a corporation’s net profits for calendar or fiscal years ending in 1987 and thereafter to be 9.3%); see also SENATE COMMITTEE ON REVENUE AND TAXATION, COMMITTEE ANALYSIS OF SB 469, at 1 (Jan. 5, 1994) (noting the imposition of a 9.3% tax upon the net profit of a California corporation).

21. See CAL. REV. & TAX. CODE § 23153(d)(1) (West 1992) (providing that the minimum franchise tax to be paid annually to the State shall be $800).

22. Jelsma, supra note 5, at 323; see id. (noting that a corporate-entity-level tax is imposed on corporations in addition to the shareholder’s personal income tax on any distributions to the shareholders).

Avoiding this double level of taxation is one of the "primary reasons for the growth of LLCs in the United States."  

B. Subchapter S Corporations

Subchapter S corporations are "certain small business corporations with no more than thirty-five shareholders ... which are generally treated as partnerships for tax purposes." If the S corporation meets certain federal tax law requirements, it is entitled to a pass-through tax treatment like the LLC, while also giving its owners the protection of limited liability. Thus, subchapter S corporations and LLCs are very similar business entity choices, with respect to the tax advantages and limited liability, for a small business owner.

However, an LLC is free from many of the organizational and operational restrictions imposed upon subchapter S corporations, which make LLCs a superior form of business entity. For example, while an LLC can be formed with any number of ownership interests required to suit the needs of the organization, a subchapter S corporation can issue only one class of stock. Also, only individuals who are United States citizens or resident aliens can be shareholders in a subchapter S corporation, whereas any individual, partnership, corporation, or other legal entity may be a member of an LLC. Additionally, while a subchapter S corporation, by definition...

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24. See supra note 20 and accompanying text.
25. Schatz et al., supra note 10, at 81; see id. (noting that LLCs are not subject to an entity-level tax, rather the member's income is subject to federal tax).
26. SENATE COMMITTEE ON REVENUE AND TAXATION, COMMITTEE ANALYSIS OF SB 459, at 1 (Jan. 5, 1994).
27. See CAL. REV. & TAX. CODE § 23801(b)(1) (West Supp. 1997) (declaring that in order to be considered an S corporation, a corporation must have a valid election under Internal Revenue Code § 1362(a)); id. § 23810(a)(4) (West Supp. 1996) (stating California's requirements for determination of status of S corporations after January 1, 1990); see also 26 U.S.C.A. § 1363(a) (West Supp. 1996) (noting that the effect of an election under Internal Revenue Code § 1362(a) is that the S corporation will not be subject to the taxes imposed by this chapter). See generally 26 U.S.C.A. § 1363 (West Supp. 1996) (computing an S corporation's taxable income).
28. See CAL. REV. & TAX. CODE § 23400(b) (West 1992) (providing that a corporation electing to be treated as an S corporation shall not be subject to the tax imposed upon the corporation's net income). But see id. § 23802(c) (West 1992) (stating that an S corporation will be subject to the minimum tax imposed under Internal Revenue Code § 23153); see also id. § 23153(d)(1) (West 1992) (imposing an $800 minimum tax).
30. Compare 26 U.S.C.A. § 1361(b)(2)(B) (West Supp. 1996) (listing S corporation requirements) with CAL. CORP. CODE § 17001(x) (amended by Chapter 57) (defining an LLC "member" as: (1) A person who has acquired a membership interest in accordance with the articles of organization, operating agreement, or pursuant to California Corporation Code § 17303, or (2) Any person who has not resigned, withdrawn, or been expelled from the LLC) and id. § 17001(se) (amended by Chapter 57) (defining "person" to mean any individual, partnership, limited partnership, trust, estate, association, corporation, LLC, or other domestic or foreign entity). But see Sommers, supra note 3, at B1 (stating that professionals, such as lawyers and accountants, are prohibited from establishing an LLC).
can have only thirty-five members or less, an LLC can have an unlimited number of membership interests and members.\textsuperscript{31}

C. Partnerships and Proprietorships

Partnerships and proprietorships are forms of business entities, other than corporations, that are not subject to taxation as an entity;\textsuperscript{32} however, the income, when distributed to the business owners, is subject to a personal tax similar to a corporation shareholder's dividends.\textsuperscript{33} The major disadvantage of these business entities, however, is that any member may be held personally liable for the debts incurred by the partnership or proprietorship.\textsuperscript{34} Thus, even though partnerships and proprietorships avoid the double layer of taxation, LLCs are superior because they offer members limited liability also.

III. OVERVIEW OF CALIFORNIA'S LIMITED LIABILITY COMPANY ACT

A. Formation, Membership and Fiduciary Obligations

In order to form a limited liability company, the organization must file its articles of organization\textsuperscript{35} with the Secretary of State and have the LLC members enter into an operating agreement.\textsuperscript{36} As in a partnership, a unanimous vote of the existing members of an LLC is required for a new membership interest\textsuperscript{37} to be established in

\textsuperscript{31} Compare 26 U.S.C.A. § 1361(b)(1)(A) (West Supp. 1996) with CAL. CORP. CODE § 17050(b) (West Supp. 1997) (stating that an LLC is to have two or more members).

\textsuperscript{32} For tax purposes a partnership is considered a separate taxable entity for some purposes, and as an aggregate of its partners for others. JOHN C. FOSSUM ET AL., TAX ASPECTS OF CALIFORNIA PARTNERSHIPS; FORMING, DISSOLVING, TERMINATING 3, 4 (1983).

\textsuperscript{33} The partnership is a conduit, or a "flow-through entity" for purposes of capital gains or losses that are passed on to the partners and personally taxed as income or loss. Id.; see 26 U.S.C.A. § 702 (West Supp. 1996).

\textsuperscript{34} See SENATE COMMITTEE ON REVENUE AND TAXATION, COMMITTEE ANALYSIS OF SB 469, at 1 (Jan. 5, 1994); see also 26 U.S.C.A. § 702 (West Supp. 1996).

\textsuperscript{35} See CAL. CORP. CODE § 15015(a)(1), (2) (West Supp. 1997) (providing that all partners are jointly and severally liable for the wrongs of a partner, for a partner's misapplication of money or property, and for all other debts and obligations of the partnership).

\textsuperscript{36} See id. § 17001(b) (amended by Chapter 57) (defining "articles of organization" to mean the articles filed under California Corporations Code § 17050, including any and all amendments or restatements, or in the case of a foreign LLC, any documents that serve a like function under the laws of the jurisdiction in which it was formed).

\textsuperscript{37} Id. § 17050(a) (West Supp. 1997); see infra notes 63-64 and accompanying text (stating that with the promulgation of Chapter 57, to form an LLC, the articles of organization must also be filed with the county recorder); see also CAL. CORP. CODE § 17001(ab) (amended by Chapter 57) (defining "operating agreement" to mean any agreement between all of the members as to the affairs of the LLC, or any agreement between all the members to organize a LLC pursuant to the provisions of this title).

\textsuperscript{38} See CAL. CORP. CODE § 17001(z) (amended by Chapter 57) (defining "membership interest" as a member's rights in the LLC, including the member's economic interest, as well as, the right to vote, to participate in management, and any right to information concerning the business and affairs of the LLC).
the LLC; however, this unanimity requirement may be otherwise provided for in the articles of organization or the operating agreement. In contrast, a corporation’s board of directors or shareholders may bring new shareholders into the company at any time.

California’s LLC act provides that a manager owes the same fiduciary duties to the LLC and its members as a partner owes to a partnership and the members of that partnership. These partnership fiduciary duties are governed by the Uniform Partnership Act (UPA) which dictates that the fiduciary duty of a partner to a partnership is to account for any profits derived without consent of the other partners that is in any way connected to the partnership and hold such profits in trust for the other partners. Although this fiduciary rule may seem unable to address all of the potential issues that may arise, much partnership case law exists that speaks to many, if not most, of the possible issues that may arise.

Using the rules of partnership law as a model for governing the fiduciary duties of an LLC manager seems appropriate because LLCs are similar to partnerships. Like partnership, LLCs are likely to be closely held, have substantial member participation in management, and have limited markets for their membership interests. However, the LLC act fails to mention the fiduciary duties governing relations between members. If the LLC is to be managed directly by members, then the UPA’s fiduciary rule presumably applies. However, LLCs differ from partnerships in that LLC members may retain significant authority in an LLC run by

38. Id. § 17100(a)(1) (amended by Chapter 57).
39. Id.
40. See id. § 409 (West 1990) (providing that the board of directors has the power to issue shares of a corporation); see also Franklin A. Gevurtz, California’s New Limited Liability Company Act: A Look at the Good, the Bad, and the Ambiguous, 27 PAC. L.J. 261, 275-76 (stating that, barring a valid share transfer restriction, shareholders can bring in new owners by selling their stock).
42. See id. §§ 15001-15058 (West 1995 & Supp. 1997) (implementing the UPA to govern California’s partnership law).
43. Id. § 15021(1) (West 1992).
44. See Gevurtz, supra note 40, at 268; see id. (stating that after the definition of fiduciary duties provided by the UPA, many questions concerning fiduciary duties still remain, such as: What is the duty of care a partner owes to fellow partners or the firm? Is a partner liable for acts of negligence? Does a partnership have a duty to disclose information to a prospective partner? Are there any limits on dissolving an at-will partnership?).
45. Id.; see id. (stating that it may be too much to expect that California’s LLC statute would resolve all the issues possibly related to fiduciary duties, when definitive answers do not exist in other business forms with more history).
46. Id. at 268-69.
48. See CAL. CORP. CODE § 17153 (West Supp. 1997) (stating that the fiduciary duties a manager owes to the LLC and its members are the same as those owed by a partner to the partnership and to the partners of that partnership).
managers. Thus, arguably no fiduciary duties exist that govern the relations between LLC members.

B. Operating Rules

California's LLC act allows the members to make any agreement they wish concerning management, contributions, and profit and loss sharing. The Act also contains provisions governing fundamental transactions that are nonwaivable, including a provision requiring no less than a majority vote in order to amend the articles of organization.

California's LLC act also contains default rules to govern the LLC in the event that issues were overlooked in the drafting of the articles of organization. The default rules call for direct management by members, as well as establishing voting in proportion to profit interest rather than per capita. The Act provides that no member may be paid a salary without the agreement of all the members. This provision prevents an active majority from paying themselves salaries, while "squeezing-out" the inactive minority by declaring few or no dividends. The Act further provides for contributions of any nature and allocates profit sharing in proportion to these contributions. However, it is rare for any business venture to fail to make an explicit agreement about profit sharing; thus this default rule may rarely be utilized.

49. Gevurtz, supra note 40, at 269; see id. (providing that LLC members in a manager-run LLC may vote on mergers, the sale of assets, expulsions and dissolutions, or numerous other actions that may be subject to abuse).
50. Id. at 270. But see id. at 270 (providing that California Corporation Code § 17613(b) and (c) may be helpful in refuting this argument because it places the burden of proving that the transaction is just and reasonable upon persons who control both sides of an LLC merger or other "reorganization," thus establishing a fiduciary duty).
51. CAL. CORP. CODE § 17005 (amended by Chapter 57).
52. Id. §§ 17005(b)(3), 17103(b) (amended by Chapter 57) (including the rights of a member to challenge expulsion clauses as unreasonable); id. § 17005(b)(2) (amended by Chapter 57) (conferring the rights of members to vote on a merger or dissolution); id. § 17005(b)(5) (amended by Chapter 57) (establishing the right of a member obliged to provide services to withdraw).
53. Id. § 17150 (West Supp. 1997); see Gevurtz, supra note 40, at 264-65 (stating that members may choose to govern by managers if provided for in the articles of organization to cut off the apparent authority of the members to bind the firm).
54. CAL. CORP. CODE § 17103(a)(1) (amended by Chapter 57).
55. Id. § 17004(b) (West Supp. 1997).
56. See Gevurtz, supra note 40, at 266-67 (describing how the active participants may attempt to squeeze the inactive minority out of the business's operations by obtaining all of the economic benefit of the business). This is a situation that occurs in closely held businesses operating as corporations. Id.
57. See CAL. CORP. CODE § 17200(a) (West Supp. 1997) (providing for profit sharing from members in proportion to capital contributions); id. § 17202 (West Supp. 1997) (allocating profits and losses among members); see also id. § 17201(a)(3) (amended by Chapter 57) (authorizing a wide variety of contractually established sanctions when a member fails to make an agreed upon contribution).
58. Gevurtz, supra note 40, at 266; see id. (stating that overlooking the prospects of losses may be a likely occurrence, thus a default rule enforcing proportional divisions makes sense because it preserves limited liability); id. (noting that the problem with equal loss sharing is that members who made less contributions may be forced to reimburse those who made more contributions, thus creating "a contradiction between the loss sharing arrangement
IV. Changes Made to the Beverly-Killea LLC Act by Chapter 57

The 1994 Beverly-Killea Limited Liability Company Act was a comprehensive and exhaustive bill introducing a new area of law to California. However, California’s LLC act contained a number of ambiguities and inconsistencies. Chapter 57, signed into law on June 5, 1996, became effective immediately. Chapter 57 provided amendments which corrected the problems contained in prior LLC law, thus “facilitating the purposes of the Act,” without constituting changes in policy.

Existing law requires the members of an LLC to file the articles of organization with the Secretary of State. Chapter 57 requires that the articles be filed with the county recorder in addition to being filed with the Secretary of State. Chapter 57 also modifies the provisions of California’s LLC act that govern the effect of the withdrawal of a member.

To dissolve an LLC under prior law, the company was required to file a certificate of cancellation of the articles of organization with the Secretary of State identifying the member or party responsible for any existing tax debt. Chapter 57 would require the Secretary of State to notify the dissolving LLC to the effect that it will only be dissolved if the Franchise Tax Board informs the Secretary of State that certain taxes and fees have been paid or secured.

Since increased LLC formation has spread quickly throughout the country, California’s LLC act has provisions governing the actions of foreign limited liability companies doing business in the state. Existing law provides that the internal

59. ASSEMBLY FLOOR, COMMITTEE ANALYSIS OF SB 141, at 3 (May 2, 1996); see 1994 Cal. Legis. Serv. ch. 1200, at 6009-6104 (enacting CAL. CORP. CODE §§ 17000-17705) (establishing limited liability companies in California).

60. See infra notes 62-83 and accompanying text (detailing the shortcomings of the 1994 Beverly-Killea Limited Liability Company Act and noting that solutions are provided via Chapter 57).


62. ASSEMBLY FLOOR, COMMITTEE ANALYSIS OF SB 141, at 3 (May 2, 1996).

63. CAL. CORP. CODE § 17050(a) (West Supp. 1997).

64. Id. § 17052(f) (amended by Chapter 57).

65. Compare id. § 17252 (amended by Chapter 57) (providing that the operating agreement or articles of organization shall govern the withdrawal of a member of an LLC, and that notwithstanding the articles of organization or operating agreement, a member may withdraw from an LLC upon giving notice to the other members; however, the withdrawn member may incur substantial penalties) with 1994 Cal. Legis. Serv. ch. 1200, sec. 27, at 6046 (enacting CAL. CORP. CODE § 17252) (providing that a member may withdraw from an LLC upon giving six months written notice to each member without prejudice to the rights of the LLC or the other members under any contract to which the withdrawn member is a party).

66. 1994 Cal. Legis. Serv. ch. 1200, sec. 27, at 6053 (enacting CAL. CORP. CODE § 17356(a), (b)).

67. CAL. CORP. CODE § 17356(b)(3) (amended by Chapter 57).

68. See supra note 10 and accompanying text.

69. See CAL. CORP. CODE § 17001(q) (amended by Chapter 57) (defining “foreign limited liability company” to mean either (1) an entity formed under the LLC laws of any other state, or (2) an entity organized under the laws of any foreign country that is an unincorporated association organized so that each of its members
affairs and the relations among members and managers are to be governed by the laws of the state where the company was organized. Chapter 57 adds to this provision providing that if the LLC is organized in a foreign country, then the laws of the foreign country shall govern the internal affairs and member and manager duties.

Chapter 57 specifically affects the default voting requirements of certain provisions of California's LLC act by reducing the required vote of the members from unanimous to a “majority in interest of the members.” For example, if an existing member wished to assign a membership or economic interest in the LLC to another individual, under prior law, the unanimous approval of the other members of the LLC was required. Chapter 57 reduces this voting requirement to a majority in interest of the members.

This unanimity requirement was established to help the LLC receive partnership tax treatment. A unanimous vote requirement ensured that the LLC would avoid the corporate characteristic of free transferability. The reason for the change provided by Chapter 57 is likely due to Revenue Procedure 95-10, which was issued by the IRS at the end of 1994. Revenue Procedure 95-10 “clarified and liberalized the requirements for an LLC to receive a ruling that it successfully avoided corporate characteristics.” Thus, an LLC could retain partnership tax treatment and successfully avoid the corporate characteristic of free transferability by reducing the unanimous vote requirement for an assignee to enter as a member to a majority in interest.

have limited liability with respect to the liabilities of the company).

70. Id. § 17450 (amended by Chapter 57).
71. Id. § 17450(a) (amended by Chapter 57).
72. Id.
73. See id. § 17001(v) (amended by Chapter 57) (defining “majority in interest of the members” as more than 50% of the interests of members in current profits of the LLC, unless otherwise defined in the operating agreement); see also infra notes 74-83 and accompanying text (detailing the prior law Corporation Code sections in which the voting requirement is reduced from unanimous to a majority in interest of the members by Chapter 57).
75. Id. (amended by Chapter 57).
76. See infra note 77 and accompanying text; see also supra note 19 and accompanying text (noting corporate characteristics used in determining the tax treatment of an unincorporated association).
77. See Rev. Rul. 88-76, 1988-2 C.B. 360 (holding that a Wyoming company lacks the corporate characteristic of free transferability of interests because the assignee or transferee of a member's interest could not acquire all the attributes of the member's interest in that company except upon unanimous approval of the remaining members).
79. Id.; see id. (stating that the IRS will rule that the LLC lacks free transferability if each member does not have the power to confer upon a nonmember the attributes of the member's interests without the consent of not less than a majority in interest of the nontransferring members); see also Gevurtz, supra note 40, at 277 (declaring that Revenue Procedure 95-10 stated that requiring unanimous consent for an assignee was not necessary with respect to avoiding the corporate characteristic of free transferability, instead a vote of a majority would be sufficient).
Prior law provided that a person could acquire a membership interest directly from an LLC either in accordance with the company’s operating agreement or upon a unanimous vote of the members of the company, if the operating agreement does not so provide.\(^{80}\) Instead Chapter 57 provides that a membership interest may be acquired upon a vote of a majority in interest of the members.\(^{81}\)

A final vote requirement change was made with respect to the decision to continue the business of the LLC after dissolution of the company. Prior law provided that a unanimous vote was required for the members to decide to continue to do business upon the death, withdrawal, resignation, expulsion, bankruptcy, or dissolution of a member.\(^{82}\) Chapter 57 reduces this vote requirement to a majority in interest of the LLC members.\(^{83}\)

**V. CONCLUSION**

California’s Legislature, through the promulgation of Chapter 57, modifies the 1994 Beverly-Killea LLC Act, thereby making the establishment of LLCs in California easier by clarifying and correcting problems associated with the LLC Act that have developed in the past two years.\(^{84}\) Limited liability companies have become a widely used form of business enterprise in the United States and worldwide.\(^{85}\) Because LLCs combine the attractive features of both partnerships and corporations, while retaining few disadvantages,\(^{86}\) LLC growth in California should be vast and consistent.

**APPENDIX**

**Code Sections Affected**

- Code of Civil Procedure § 699.720 (amended);
- Corporations Code §§ 1113, 15642, 17001, 17005, 17051, 17052, 17054, 17061, 17100, 17101, 17103, 17151, 17154, 17158, 17201, 17250, 17251, 17252, 17254, 17301, 17303, 17350, 17352, 17356, 17450 (amended);
- Labor Code § 3351 (amended);
- Revenue and Taxation Code §§ 18633.5, 23092 (amended).

SB 141 (Beverly); 1996 STAT. Ch. 57
(Effective June 8, 1996)

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80. 1994 Cal. Legis. Serv. ch. 1200, sec. 27, at 6038 (enacting CAL. CORP. CODE § 17100(a)(1)).
81. CAL. CORP. CODE § 17100(a)(1) (amended by Chapter 57).
82. 1994 Cal. Legis. Serv. ch. 1200, sec. 27, at 6050 (enacting CAL. CORP. CODE § 17350(d)).
83. CAL. CORP. CODE § 17350(d) (amended by Chapter 57).
84. See supra notes 62-83 and accompanying text.
85. See supra note 10 and accompanying text.
86. See Jelsma, supra note 5, at 325-30 (describing the potential disadvantages of limited liability companies); see also Sommers, supra note 3, at B1 (noting that a specific drawback to choosing an LLC is the lack of legal precedent governing potential LLC problems).
Changes to Medical Board Diversion Programs in an Effort to Protect the Public Will Be Unlikely to Have Any Real Impact

David M. Boyers

I. INTRODUCTION

In 1991, President George Bush described the medical profession as a “special calling [in which] reverence for human life and individual dignity is both the hallmark of a good physician and the key to truly beneficial advances in medicine.” Saddled with the tremendous responsibility of sustaining life on a daily basis, physicians have been heralded as human equivalents to God. As such, many in society believe doctors can do no wrong. However, a little known contradiction existing in the medical world may taint that pristine image. While most doctors are able to cope with the stresses of societal deification, remaining competent and honest, others succumb to the pressures, turning to drugs and alcohol. Unfortunately, in the end, some of the very physicians responsible for preserving life may end up needlessly taking it away. Risks to patients posed by drug- or alcohol-impaired physicians include imprecise performances of various procedures, improper diagnoses resulting from distortion in judgment, or unnecessary treatments designed to increase physician cash flow rather than patient health. Yet, because many hospitals and medical malpractice attorneys zealously protect the privacy of even bad-apple doctors, most patients seeking care have no idea whether or not their doctor may be abusing drugs or alcohol.

One anesthesiologist’s personal account of addiction reveals just how vulnerable patients can be. His addiction was to the drug fentanyl, which he first began taking because he “saw how great it made patients feel.” Over a period of several months

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2. See id. (quoting former president of the American Medical Association, Dr. Elmer Hess, as once writing, “There is no greater reward in our profession than the knowledge that God has entrusted us with the physical care of His people.”).
4. Anne Bobinski, Autonomy and Privacy: Protecting Patients from Their Physicians, 55 U. Pitt. L. Rev. 291, 299 (1994); see Bernstein, supra note 3, at B1 (reporting that Robert Coombs, a professor at the UCLA School of Medicine specializing in researching substance abuse among medical professionals, described as scary “how many [physicians he has] interviewed who’ve said they did surgery and had blackouts” because of their drug use).
6. See DORLAND’S ILLUSTRATED MEDICAL DICTIONARY 618 (Elizabeth J. Taylor, 27th ed. 1988) (defining “fentanyl citrate” as “[a] narcotic analgesic... used mainly preoperatively, postoperatively, and during surgery, administered intravenously or intramuscularly”); see also Bill Lohmann, Drugged-Out Doctors Find Help Among Their Peers, L.A. Times, Oct. 5, 1986, at 2 (describing fentanyl as a powerful analgesic capable of providing a quick high that can be more addictive than street narcotics).
his addiction grew so intense that he felt the urge to shoot up every two hours. On one occasion, during a twenty-hour neurosurgical operation, he mistakenly injected a blood product into the wrong end of a catheter, causing a blood clot that went to his patient’s lung. Apparently, he became distracted by the edginess brought on by minor withdrawal. The patient nearly died.

Other personal accounts suggest that physician drug abuse may be more widespread than most would think. For example, one physician reported becoming addicted to cocaine during his residency, snorting up with fellow residents in the hospital’s physician’s lounge late at night when they were all on call. That addiction led to heroin use which, at its peak, blossomed into a $300-a-day habit. Another physician, also addicted to cocaine, reported shooting up nearly forty times per day in his arms, legs, hands, and groin. He relied on long sleeve shirts, long pants, and even bandages to cover his track marks. Even though the hospital administration suspected he had a problem, they let him stay because he was bringing in patients and money.

II. PREVALENCE OF PHYSICIAN SUBSTANCE ABUSE

Studies estimating the prevalence of substance abuse among physicians have varied in their results. Some surveys have concluded that physicians are no more likely to abuse drugs or alcohol than are members of the general population. Other studies, however, estimate physician substance abuse at higher than that of the general population. In the 1950s, one commonly accepted study originating from

8. Id.; see id. (observing that, for the anaesthesiologist, fentanyl was “ridiculously easy” to obtain because all one had to do was “open a cabinet and take as much as [desired]”).
9. See DORLAND’S ILLUSTRATED MEDICAL DICTIONARY, supra note 6, at 284 (defining a “catheter” as a tube-shaped surgical instrument designed for withdrawing or introducing fluids from or into a cavity of the body).
10. Pekkanen, supra note 7, at 94; see id. (describing how the blood clot leading to the patient’s lung caused him to go into cardiac arrest).
11. Id.
12. See id. (recounting how doctors had to shock the patient with defibrillator pads six times before his normal heart rhythm was restored).
13. See infra notes 14-18 and accompanying text.
14. See Pekkanen, supra note 7, at 96.
15. Id.; see id. (describing that although the physician was earning $100,000 per year, his drug habit led to such financial instability that he had to borrow money to fix a flat tire).
16. Id.; see id. (noting the delusion the doctor had in believing that drugs would work forever and could always be controlled).
17. Id.
18. Id.; see id. (reporting that eventually a group of recovering doctors found the physician on the roof of his house, shooting dope and wearing only his underwear, and sent him to a long-term treatment center).
19. See infra notes 20-26 and accompanying text (illustrating the varied results).
20. See Leslie Berkman & Dave Lesher, Drugs, Doctors: Worrisome Mix After O.C. Crash, L.A. TIMES, July 18, 1993, at A1 (stating a commonly accepted rule of thumb that physicians are representative of the entire population in terms of the percentage suffering drug or alcohol problems).
21. See infra notes 22-26 and accompanying text.
Germany estimated that physicians were thirty to one hundred times more likely than the general population to become addicted to narcotics. That estimate, however, has questionable application to North America.

A more recent survey estimates that physicians are more likely than their age and gender peers in the general population to use certain substances, including alcohol and prescription drugs such as benzodiazepines and opiates. Even more recently, a 1994 report compiled by the Medical Board of California estimated that eighteen percent of doctors practicing in California will form chemical dependencies at some point in their lives—a rate two percent higher than that of the general public. Regardless of the actual percentage of physician drug abuse, the issue is of great concern because innocent lives are at stake when a physician is performing medical services. Thus, any substance abuse at all should be unacceptable and intolerable.

III. REASONS DOCTORS TURN TO DRUGS

A variety of explanations have been offered to elucidate why physicians embrace drugs or alcohol, the examination of which may ultimately lead to a solution. First, the persistent demand to maintain control, perform error free, and stay emotionally unattached has been implicated as one of the causes of physician drug and alcohol abuse. Dr. G. Douglas Talbott, founder of the Impaired Health Professionals Program at Ridgeview Institute—a nonprofit facility that pioneered the treatment of drug-abusing doctors—asserts drug addiction among physicians stems from what he calls a combination of the “M. Deity Syndrome” and the “Titanic Syndrome.” That is, the coupling of doctors being told how special they are in terms of making life-and-death decisions, along with being taught that they are unsinkable, leads to a...
belief that they can use drugs in order to cope with daily pressures and evade addiction. Ultimately, their ill-founded confidence creates an opening into which an addiction may creep. Having access to a myriad of drugs also contributes to the ease with which a doctor may fall into an abusive habit. Those doctors who are routinely exposed to mood-altering drugs at work, initially only on the administering side, tend to have the highest rate of drug abuse among all doctors because of the ease of access. Finally, deficiencies in physician training have been credited with provoking physician substance abuse. Medical students learn to associate certain pharmaceuticals as remedies for certain ailments, but rarely learn the nature of addiction that can stem from the misuse of those pharmaceuticals.

IV. DIVERSION PROGRAMS

To deal with physicians who are identified as having drug or alcohol problems, existing California law authorizes various medical boards to establish diversion programs in which doctors needing help can undergo intense in-patient therapy and drug rehabilitation. For example, the Board of Dental Examiners of California, the Osteopathic Medical Board of California, and the Medical Board of California are authorized under current law to establish diversion treatment programs for the rehabilitation of their licentiates who are abusing drugs or alcohol, as well as establish criteria for the acceptance, denial, or termination of those licentiates.

30. Id.
31. See Hughes et al., supra note 22, at 2333 (warning that ready access to drugs "places physicians at an increased risk for inappropriate personal use, dependence, and impaired patient care").
33. Id.
34. Id.
35. See infra notes 36-43 (listing three California medical boards and the authority that allows them each to establish a diversion program).
36. See CAL. BUS. & PROF. CODE § 1601 (West Supp. 1997) (organizing the Board of Dental Examiners of California into standing committees, and assigning to them the task of dealing with examinations, enforcement, and auxiliary matters, as well as other subjects as the Board deems appropriate).
37. See id. § 2450 (West Supp. 1997) (establishing the Osteopathic Medical Board of California and authorizing it to enforce Chapter 5 of the Business and Professions Code relating to persons holding or applying for physician's and surgeon's certificates issued by the Board under the Osteopathic Act); see also 1923 Cal. Stat. ch. 292, sec. 1, at 618-21 (enacting the Osteopathic Act).
38. See CAL. BUS. & PROF. CODE §§ 2001-2003 (West Supp. 1997) (organizing the Medical Board of California into two divisions: a Division of Medical Quality and a Division of Licensing); id. § 2004 (West 1990) (listing the responsibilities of the Division of Medical Quality); id. § 2005 (West 1990) (listing the responsibilities of the Division of Licensing).
39. See CAL. CODE REGS. tit. 16, § 1020.1 (1997) (listing the criteria for admission to a diversion program established by the Board of Dental Examiners of California as follows: (a) a dentist or dental auxiliary licensed in California; (b) residence in California; (c) abuse of narcotics, dangerous drugs or alcohol which may effect the licentiate's ability to practice in a safe and competent manner; (d) licentiate has voluntarily requested admission to the program; (e) licentiate agrees to any medical or psychiatric examinations ordered; (f) licentiate cooperates by disclosing medical information, disclosure authorizations, and release of liability; (g) licentiate agrees in writing to comply with all elements of the treatment program and to bear all costs of the program; (h) licentiate has not been
either in, or attempting to enter into, their respective diversion programs. Current law further requires each board to establish a Diversion Evaluation Committee and to assign them duties including the evaluation of their licentiates requesting participation in a diversion program, the designation of treatment facilities for participant referral, and the consideration of the competency of a participant's ability to resume his or her practice.

The problems with diversion programs in the past has been their protection of otherwise bad physicians who, once in the program, could avoid further disciplinary action by the board and their limitation on accessibility to otherwise good physicians in need of help, who had not yet caused public harm. These restrictions on the diversion program's ability to effectively protect the public from substance-abusing physicians stem from prior California case law, specifically Kees v. Board of Medical

40. See id. § 1020.2 (1997) (listing the criteria for denial of admission to the diversion program established by the Board of Dental Examiners of California as follows: (a) Failure to meet the requirements set forth in § 1020.1 of the California Code of Regulations; (b) the applicant has been subject to disciplinary action by any state dental licensing authority; (c) complaints or information have been received by the Board which indicate that the applicant may have violated a provision of the Dental Practice Act, other than § 1681 of the California Business and Professions Code; or (d) the committee determines that the physician will not substantially benefit from participation in the program or if admission to the program were allowed, too great a risk to the public health, safety or welfare would be created); id. § 1357.4 (1997) (listing similar criteria for denial of admission to a diversion program established by the Medical Board of California); id. § 1660.2 (1997) (listing similar criteria for denial of admission to a diversion program established by the Osteopathic Medical Board of California).

41. See id. § 1020.3 (1997) (listing criteria leading to the termination of a participant from a diversion program established by the Board of Dental Examiners of California as follows: (a) Successful completion of the program; or (b) the committee votes to terminate participation because the licentiate has failed to comply with the treatment program, or the licentiate has failed to comply with any of the requirements set forth in section 1020.1 of the California Code of Regulations, or any cause for denial of an applicant set forth in section 1020.2 of the California Code of Regulations, or the committee determines that the licentiate has not substantially benefited from participation in the program, or that the licentiate's continued participation in the program creates too great a risk to the public health, safety, or welfare); id. § 1660.4 (1997) (listing similar criteria leading to the termination of a participant from a diversion program established by the Osteopathic Medical Board of California); id. § 1357.5 (1997) (listing similar criteria leading to the termination of a participant from a diversion program established by the Medical Board of California).

42. See CAL. BUS. & PROP. CODE §§ 1695-1695.5 (amended by Chapter 257) (authorizing the Board of Dental Examiners of California to establish diversion programs); id. §§ 2340-2350 (West 1990 & Supp. 1997) (authorizing the Medical Board of California to establish diversion programs); id. §§ 2360-2365 (amended by Chapter 149) (authorizing the Osteopathic Medical Board of California to establish diversion programs).

43. See id. § 1695.6 (West 1990) (listing the duties and responsibilities of the Diversion Evaluation Committee established by the Board of Dental Examiners of California); id. § 2366 (West 1990) (listing the same for the Diversion Evaluation Committee established by the Osteopathic Medical Board of California); id. § 2352 (West 1990) (listing the same for the Diversion Evaluation Committee established by the Medical Board of California).

44. See infra notes 45-47 and accompanying text (discussing the origins of the problems facing diversion programs in the past).
Quality Assurance.45 Kees implied that the Medical Board of California was precluded from investigating or disciplining a physician who was formally participating in its diversion program.46 That ruling subsequently resulted in a policy of limiting participation in the diversion programs to those physicians who were actually referred by the Medical Board of California to the program following a disciplinary investigation, stipulation or decision.47 Thus, after Kees, both the Board and its licentiates became limited in their ability to utilize the diversion program effectively. The Board was precluded from investigating a formal participant, while its licentiates who needed help, but were not under Board investigation, were precluded from self-referral.

In 1995, California enacted Chapter 252 in an effort to afford the public greater protection from substance-abusing physicians by permitting increased and earlier participation in the diversion program established by the Medical Board of California.48 Chapter 252 allows investigation and disciplinary actions against physicians and surgeons licensed by the Medical Board while they are participating in diversion programs, as well as voluntary admission to diversion programs by physicians not yet under Board investigation.49 Thus, the enactment of Chapter 252 effectively cured the problems created by the Kees decision.50 However, because Kees could be applied to boards other than the Medical Board of California, its ruling still raised concern.51

This year, new laws—Chapters 257 and 149—prevent the Kees decision from having an effect on the diversion programs established by the Board of Dental Examiners and the Osteopathic Medical Board of California, respectively.52

45. 7 Cal. App. 4th 1801, 10 Cal. Rptr. 2d 112 (1992).
46. ASSEMBLY COMMITTEE ON HEALTH, COMMITTEE ANALYSIS OF SB 1479, at 2 (June 11, 1996); SENATE FLOOR, COMMITTEE ANALYSIS OF AB 3265, at 2 (June 24, 1996); see Kees, 7 Cal. App. 4th at 1812, 10 Cal. Rptr. 2d at 118 (ruling that without proof of formal participation in the diversion program, the Division of Medical Quality was free to investigate a program participant and institute disciplinary action).
47. ASSEMBLY COMMITTEE ON HEALTH, COMMITTEE ANALYSIS OF SB 779, at 2 (June 27, 1995); see Kees, 7 Cal. App. 4th at 1812, 10 Cal. Rptr. 2d at 118 (explaining that because Kees was an informal, voluntary participant in the Board diversion program, he was subject to investigatory and disciplinary action).
51. See SENATE FLOOR, COMMITTEE ANALYSIS OF SB 1479, at 3 (May 2, 1996) (noting the Dental Board's concern that the Kees case is also applicable to their diversion program); SENATE FLOOR, COMMITTEE ANALYSIS OF AB 3265, at 3 (June 24, 1996) (stating that the bill is sponsored by the Osteopathic Medical Board to provide the Board with the authority to investigate and discipline formal diversion program participants—an authority that had been called into question by the Kees case).
52. See infra notes 54-57 and accompanying text.
V. CHAPTERS 257 AND 149

Chapters 257 and 149 enhance both the physicians’ and the Boards’ ability to better utilize diversion programs established by the Board of Dental Examiners of California and the Osteopathic Medical Board of California in several ways. First, the new laws, like Chapter 252, remedy the problems created by Kees. Specifically, Chapters 257 and 149 nullify the ruling in Kees by providing that neither acceptance nor participation in a diversion program precludes one of the Boards from investigating, continuing to investigate, or disciplining a participant for unprofessional conduct committed before, during, or after participation in the program. Chapters 257 and 149 also resolve the policy issue developed in Kees by permitting physicians who are not subject to a Board investigation to self-refer to the diversion program on a confidential basis. In cases where a participant not subject to Board investigation either withdraws or is terminated from a diversion program at a time when the Diversion Evaluation Committee determines that the participant presents a threat to public health and safety, the confidential status is revoked, and records amassed during the program become available to the Board for use in disciplinary and criminal proceedings.

Second, for those physicians under current Board investigation, Chapters 257 and 149 give an incentive for them to seek help in a diversion program. They provide that if the investigation is based primarily on the self-administration of any controlled substance, dangerous drugs, or alcohol, or the illegal possession, prescription, or nonviolent procurement of any controlled substance or dangerous drug for self-administration that does not involve actual, direct harm to the public, the Board shall close the investigation without further action upon successful acceptance into, and completion of the Board’s diversion program. The legislature’s intention in enacting Chapters 257 and 149 is to increase participation in diversion programs both

53. See CAL. BUS. & PROF. CODE §§ 1680-1681 (West 1990 & Supp. 1997) (listing the activities constituting unprofessional conduct as including the unlawful possession or use of any controlled substance, as defined in division 10 (commencing with § 11000) of the Health and Safety Code, or any dangerous drug as defined in article 8 (commencing with § 4211) of Chapter 9, or the use of alcoholic beverages or other intoxicating substances in a dangerous manner which impairs his ability to safely conduct his dental practice).

54. Id. § 1695.5(e) (amended by Chapter 257); id. § 2365(e) (amended by Chapter 149). But cf. Kees v. Board of Medical Quality Assurance, 7 Cal. App. 4th 1801, 1812, 10 Cal. Rptr. 2d 112, 118 (1992) (holding that absent proof of formal participation in a diversion program, the Board could investigate and discipline a participant).

55. See CAL. BUS. & PROF. CODE § 1695.5(b) (amended by Chapter 257); id. § 2365(b) (amended by Chapter 149). But cf. Kees, 7 Cal. App. 4th at 1812, 10 Cal. Rptr. 2d at 118 (holding that because Kees was an informal, voluntary participant in the diversion program, he was subject to investigatory and disciplinary action).

56. CAL. BUS. & PROF. CODE § 1695.5(f) (amended by Chapter 257); id. § 2365(f) (amended by Chapter 149).

57. Id. § 1695.5(d) (amended by Chapter 257); id. § 2365(d) (amended by Chapter 149).
prior to and during any investigatory action by one of the Boards, furthering the protection of the public from drug-addicted doctors.\textsuperscript{58}

VI. PHYSICIANS UNLIKELY TO SELF-REFER TO DIVERSION PROGRAMS

While Chapters 257 and 149 may encourage some physicians to consider seeking rehabilitative assistance in a Board diversion program, the incentives provided by the new laws to self-refer, for most physicians, are unlikely to outweigh the incentives to maintain the secrecy of their drug addiction and avoid any outside intervention which may jeopardize a physician's continued ability to practice.\textsuperscript{59} This is made even more true by the fact that doctors on drugs are rarely caught.\textsuperscript{50}

Several factors contribute to the ease with which substance-abusing doctors may conceal their addictions and evade diversion programs altogether. First, many physicians are able to sustain their anonymity as addicts simply by denying that a problem even exists—denial both to themselves as well as to their colleagues.\textsuperscript{61} Often, knowledge as to the effects of certain drugs facilitates a physician's denial of his or her addiction.\textsuperscript{62} A clever physician can maintain a calm facade, counteracting the effects of one drug simply by taking another.\textsuperscript{63} Unfortunately, those fooled by this facade may include not only a physician's colleagues, but the addicted physician as well.

Second, the "conspiracy of silence" that exists throughout the medical world, in which an unspoken rule seems to shun, or even prohibit, physicians from exposing one another, fosters a physician's ability to elude detection.\textsuperscript{64} Because most medical boards consist mainly of fellow physicians, that fraternal atmosphere translates into

\textsuperscript{58} See Richard D. Aach, Alcohol and Other Substance Abuse and Impairment Among Physicians in Residency Training, ANNALS INTERNAL MED., 245, 247 (1992) (stating that, even though physicians may recognize their substance abuse problem, too often they believe they can treat it alone, and they may end up avoiding outside interventions which might jeopardize their continued ability to practice).

\textsuperscript{59} Most Doctors Abusing Drugs Aren't Caught, SAN DIEGO UNION-TRIB., Apr. 11, 1986, at A29.

\textsuperscript{60} See Lohmann, supra note 6, at 2 (recognizing that denial is common to any addict and that, for health professionals, it usually takes either the loss of a license, criminal charges, or a failed marriage before treatment is sought).

\textsuperscript{61} Bernstein, supra note 3, at B1.

\textsuperscript{62} Pekkanen, supra note 7, at 96; see id. (describing how one physician took drugs such as Inderal and Valium to counteract the damaging effects of his cocaine addiction); see also Berkman & Lesher, supra note 20, at A1 (recounting the story of one doctor in Los Angeles who took speed to get started in the morning, tranquilizers to calm down during the day, and barbiturates to get to sleep at night).

\textsuperscript{63} Aach, supra note 59, at 247; see Berkman & Lesher, supra note 20, at A1 (observing that physicians' failure to expose drug-abusing colleagues is due to the fear physicians have of being stonewalled by the hospital community); see also Hugh W. Glenn, Why Bad Doctors Seldom Have to Take Their Medicine, L.A. TIMES, July 14, 1996, at B7 (professing that until California has an inspector general for medicine, or until the Medical Board operates as more than just an "old-boy network," the public's health remains at risk); Teresa Simons, Physicians Heal Thyself, CAL. J., Apr. 1990, at 215, 215 (citing Robert Fellmeth, Director of the Center of Public Interest Law at the University of San Diego, as saying the "doctor's club," although difficult to access, gives its members "a free license to do as [they] will").

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a reluctance to impose stiff penalties for physician misconduct. The most severe action, actually revoking or suspending a physician's license, is a disciplinary action only rarely taken by a Medical Board.

Third, and finally, physician aid committees often fail to carry out their duties as identifiers and intervenors of problem doctors, protecting a drug impaired physician's identity. Since 1988, California regulations have required acute care and psychiatric facilities to provide assistance and regulations for the impaired physician. However, because of confusion as to what exactly needs to be done, anxiety associated with confronting problem physicians, and fears of punishing fellow doctors, the effective implementation of these laws has not yet occurred.

The net effect of these factors has been the relative ease with which physicians maintain hidden addictions and avoid outside interventions, especially those connected with their governing Board—including diversion programs—which potentially could jeopardize their continued ability to practice.

This strong desire and ability to avoid Board diversion programs is illustrated by several statistical accounts of program participation. First, since the inception of the Medical Board of California's diversion program in 1980, until just last year, only 742 doctors had actually participated and received some kind of treatment. However, at any one time, 1560 physicians licensed by that Board needed help for their addictions. Similarly, between 1989 and 1996, of the 1800 osteopathic physicians and surgeons licensed by the Osteopathic Medical Board of California, only twenty-five had participated in the Board's diversion program, while a mere four had completed it successfully.

This critical inadequacy with diversion programs in their ability to attract drug-and alcohol-abusing physicians renders Chapters 257 and 149 essentially ineffective in providing greater protection for the public, as the incentives to volunteer for such programs offered by the new laws are insufficient.

65. See Glenn, supra note 64, at B7.
66. Id.
68. See CAL. CODE REGS. tit. 22, § 70703(b)-(d) (1997) (requiring medical staff bylaws, rules, and regulations in general acute care hospitals to include provisions for the assistance of medical staff members impaired by chemical dependency to obtain necessary rehabilitation services); id. § 71503(c)-(e) (1997) (requiring the same for acute psychiatric hospitals).
70. See infra notes 71-73 and accompanying text (illustrating how this ease is manifested in statistical accounts of physician participation in Board diversion programs).
72. Id.
73. SENATE COMMITTEE ON BUSINESS AND PROFESSIONS, COMMITTEE ANALYSIS OF SB 3265, at 3 (June 10, 1996).
VII. POTENTIAL SOLUTIONS

The surest way to adequately safeguard the public from substance-abusing doctors is to implement preventative measures ensuring that doctors maintain sobriety. Increased peer support, stress management, and education regarding the nature of addiction in medical school is necessary to prevent substance abuse from taking hold early in a physician’s career.\textsuperscript{74} Similarly, harsher and more consistent penalties are needed to deter doctors tempted by drugs later in their careers from surrendering to those temptations.\textsuperscript{75}

The current problem with medical schools is that students are not taught the nature of drug addiction, but rather only which drugs to prescribe and when to prescribe them.\textsuperscript{76} With time devoted to substance abuse education being usually less than one percent of the total curriculum time,\textsuperscript{77} most students fail to realize the consequences which may eventually stem from experimenting with certain drugs.\textsuperscript{78} Seminars on mental health, focusing on drug- and alcohol-related problems, would provide struggling students with vital feedback on methods of resolving questions of competence and self blame resulting from treatment failure, subjects rarely dealt with in medical training.\textsuperscript{79} These educational programs may also help reduce the stigma associated with impaired physicians, as well as curb the collusion that exists among fellow physicians in their denial of colleague substance abuse.\textsuperscript{80}

In addition to educating physicians as to the dangers of addiction, there must be harsher penalties for those who are actually caught using drugs. Currently, doctors in California are simply not punished as often or as severely as are doctors in other parts of the country.\textsuperscript{81} Nationally, from 1986 through 1994, 13,012 medical doctors were disciplined, representing nearly two percent of all physicians.\textsuperscript{82} California, however, ranked thirty-fourth among all states in doctor discipline.\textsuperscript{83} In 1994, disciplinary actions were taken against only .03\% of all California physicians.\textsuperscript{84} The

\textsuperscript{74} Nathan Sherry et al., Drug and Alcohol Abuse by Doctors, MED. J. AUSTL., Apr. 4, 1994, at 402, 406-07.
\textsuperscript{75} See infra notes 81-92 and accompanying text.
\textsuperscript{76} Bernstein, supra note 3, at B1.
\textsuperscript{77} Aach, supra note 59, at 247.
\textsuperscript{78} Bernstein, supra note 3, at B1; see id. (quoting Robert Coombs, a professor at the UCLA School of Medicine, as saying that medical students “don’t know one thing about chemical dependency [and that] they have outrageous slang terms for people who have a (chemical) problem”).
\textsuperscript{79} Sherry et al., supra note 74, at 406.
\textsuperscript{80} Id.
\textsuperscript{81} See infra notes 82-85 and accompanying text.
\textsuperscript{82} Douglas P. Shuit, State Ranks 34th in Disciplining Doctors; Medicine, L.A. TIMES, Mar. 29, 1996, at A3.
\textsuperscript{83} Id.; see id. (observing that California’s rate of 3.28 serious actions filed per 1000 physicians is relatively low compared to the national average of 4.3 actions per 1000 physicians).
\textsuperscript{84} Id.; see id. (reporting that because doctors in California are not better than those practicing in other states, the percentage of doctors disciplined in California should be higher than 0.3\% and more along the lines of the national average).
most severe action, the revocation or suspension of a physician’s license, is rarely taken.\footnote{Glenn, \textit{supra} note 64, at B7.}

In an article appearing in the \textit{Los Angeles Times}, Hugh W. Glenn suggested that there be a policy of zero tolerance for physician’s caught abusing drugs—a policy he termed “one strike and you’re out.”\footnote{\textit{Id.}} This contrasts with policies suggested by physicians themselves, which seem to push a gentle, nonconfrontational intervention strategy in which physicians suffering drug abuse problems are quietly removed and referred to a diversion program for rehabilitation.\footnote{See Mandell, \textit{supra} note 67, at 7 (describing how the first encounter with a physician suspected of abusing drugs should be done by a friend or colleague who knows that physician and who can “advise [the physician] that there are some concerns regarding his or her health and . . . recommend that assistance be sought”). If the physician fails to cooperate, an intervention meeting should be scheduled so that it “catches the alcoholic (drug abuser) by surprise and when he or she is sober (drug free).” \textit{Id.}} William Mandell, in an article appearing in the \textit{Physician Executive}, promotes this latter, softer type of intervention, suggesting that, because “slips,” or relapses, are the rule rather than the exception,\footnote{\textit{See id.} (explaining that more than 40% of physicians who have completed a Board diversion program will have relapses during the first year after release).} upon release from a rehabilitation program, physicians should be given “three strikes” (or slips) until they are “out.” Mandell says that this “finality” will motivate the physician in the recovery process, with the threat of loss of practice increasing the chances for success.\footnote{\textit{Id.}}

The problem with this and other theories that are lenient on substance-abusing doctors is that they accept, and in a sense condone, the fact that doctors may be using drugs while treating patients—a scary and dangerous result for the rest of us.

Glenn pointed out that if a police officer, who is responsible for protecting the lives of the public, is caught abusing drugs while on duty, the officer would not be on patrol the following day.\footnote{\textit{Id.}; see \textit{id.} (noting that without the threat of loss of practice, physicians undergoing treatment may continue to make excuses, escape reality, and live in denial—which in the end worsens the addiction).} But a doctor, also responsible for protecting the lives of the public, who is convicted of this charge while on duty in an emergency room, would receive only the “standard probationary slap.”\footnote{Glenn, \textit{supra} note 64, at B7.}

\section*{VIII. Conclusion}

The problem of substance abuse among practicing physicians has never been thoroughly addressed by medical schools, the doctors themselves, their colleagues, or the legislature. In order to solve the problem and truly offer protection to the public, first, the medical schools need to further education on the nature of addiction. This, in turn will decrease the rate of substance abuse among physicians, because
fewer will risk addiction knowing its consequences. In cases where this first line of
defense fails and doctors opt for drugs despite the risks, hospital intervention com-
mittees and medical boards need to quickly identify and punish substance abusing
physicians before they cause public harm, setting an example of zero tolerance for
others. The public’s well being has no room for anything less.

APPENDIX

Code Sections Affected
Business and Professions Code §§ 2365, 2369 (amended).
AB 3265 (Gallegos); 1996 STAT. Ch. 149
Business and Professions Code §§ 1695.5, 1697, 1698 (amended).
SB 1479 (Lewis); 1996 STAT. Ch. 257
Tenant Screening: Advance Fees and Security Deposits Distinguished

Mike A. Cable

I. INTRODUCTION

Currently many landlords require screening of prospective tenants because of the high prevalence of rent default.1 Applicant screening is a process by which the landlord charges the prospective tenant a fee to obtain information about the applicant to decide whether he or she will be a good tenant.2 Although tenant screening occurs frequently in California, until recent legislation, landlords were not regulated in how they should charge tenant screening fees.3 Consequently, prospective tenants confused screening fees with other fees and deposits, and some landlords misused screening fees for personal gain.4

The Department of Real Estate (DRE) reacted to this confusion and misuse by stating that it would use advance fee regulations to control tenant screening.5 Advance fee regulations would have placed a severe burden upon landlords and the rental industry.6 This prompted the California Legislature, at the insistence of

1. See Richard L. Colvin, Suit Hinges on Tenant-Screening Service’s Accuracy, L.A. TIMES, July 5, 1989, at 8 (stating that tenant screening firms found an eager market because California’s rent default rate is about 15%, and the annual losses from unpaid rent exceed $1 billion); see also Gaye P. Randall, Tenant Screening Firm Helps Little Landlord Weed Out the Bad Apples, CHI. TRIB., July 17, 1992, at 20 (discussing tenant screening as a means of helping small-time landlords protect themselves from tenant default).
2. Cotto v. Jenney, 721 F. Supp. 5, 6-7 (D. Mass. 1989); see id. (explaining that tenant screening services provide landlords with information about a prospective tenant’s credit history and rental history); Carolyn H. Crowley, Rental Screening Thrives, Raises Doubts, WASH. POST, Apr. 19, 1986, at F1 (reporting that tenant screening outfits are trying to provide information to determine whether a prospective tenant will pay the rent and leave the apartment in good condition); Susan Dentzer, Big Brother Keeps an Eye on Tenants, NEWSWEEK, Nov. 16, 1981, at 87 (noting that tenant screening services are helping landlords to select prospective tenants); see also Gary Williams, Can Government Limit Tenant Blacklisting?, 24 SW. U. L. REV. 1077, 1083-84 (1995) (stating that tenant screening becomes tenant blacklisting because many landlords refuse to rent to prospective tenants that are listed by the tenant screening service as a risk).
3. SENATE RULES COMMITTEE, COMMITTEE ANALYSIS OF AB 2263, at 1 (Aug. 8, 1996); see id. (acknowledging that the law did not cover application processing fees before the enactment of Chapter 525); see also ASSEMBLY FLOOR, COMMITTEE ANALYSIS OF AB 2263, at 3 (Aug. 26, 1996) (noting that it is common practice for landlords to charge a screening fee to individuals who apply to rent a unit); Crowley, supra note 2, at F1 (stating that tenant screening services began on the West Coast).
4. ASSEMBLY FLOOR, COMMITTEE ANALYSIS OF AB 2263, at 3 (Aug. 26, 1996); see id. (stating that screening fees have been confused with security deposits or advance fees); SENATE COMMITTEE ON JUDICIARY, COMMITTEE ANALYSIS OF AB 2263, at 3 (July 9, 1996) (noting that some courts have held credit report fees to be security fees); see also id. (explaining a situation where a firm collected large fees from prospective tenants even though the firm did not have a good faith intent to rent to all of the applicants).
5. SENATE COMMITTEE ON JUDICIARY, COMMITTEE ANALYSIS OF AB 2384, at 3 (July 9, 1996); SENATE RULES COMMITTEE, COMMITTEE ANALYSIS OF AB 2263, at 1 (Aug. 8, 1996).
6. See infra notes 20-21 and accompanying text (discussing the strict regulations of advance fees and how these regulations would place a burden upon landlords and the rental industry).
residential property owners, property managers, and tenant groups, to enact legislation that clarifies the law. Consequently, Chapter 469 and Chapter 525 prevent the misuse of tenant screening fees by amending the definition of "advance fee" and establishing applicant screening regulations.

II. LEGAL BACKGROUND

A. Advance Fee and Security Deposit Defined

Before the enactment of Chapter 469 and Chapter 525, California law defined and regulated advance fees and security deposits, but did not define or regulate screening fees. Security deposits provide landlords with protection from tenants that either abuse the premises or default on payments owed to the landlord. Specifically, a security deposit is any payment made by a tenant to a landlord to compensate for tenant default, damages to the premises, or cleaning costs, or to remedy any future defaults by the tenant. California law describes an advance fee, on the other hand, as a fee collected for promoting the sale or lease of property by listing, advertising, or offering the property. California law regulates the procedure of collecting and using these fees, but until recently, screening fees were not defined or regulated in California.
B. Ambiguity of Screening Fees Before the Enactment of Chapter 469 and Chapter 525

Before the enactment of Chapter 469 and Chapter 525, applicant screening fees for residential property were misused by landlords who took advantage of an applicant’s confusion about the purpose for the payment.\(^\text{14}\) Because applicants misunderstood the purpose for the payment, many prospective tenants confused the screening fee with the security deposit.\(^\text{15}\) Additionally, since there was no regulation of tenant screening, situations arose where landlords misused screening fees for personal gain. For instance, some landlords required an excessive fee for screening applicants, and others required screening fees from applicants when the landlord had knowledge that there were no vacant units available.\(^\text{16}\) Consequently, these applicants paid excessive costs to find a place to rent. This situation motivated the DRE to search for a solution.\(^\text{17}\)

Before the enactment of Chapter 469 and Chapter 525, the DRE announced that it would apply advance fee regulations to remedy the problems caused by tenant screening.\(^\text{18}\) Unfortunately, this solution would have placed a severe burden upon landlords because advance fee regulations require the creation of trust accounts under the supervision of the Real Estate Commissioner.\(^\text{19}\) Moreover, these added requirements and stricter limitations would have forced the cost of screening applicants to double in price.\(^\text{20}\) Chapter 469 and Chapter 525 were enacted to avoid these burdensome effects, by establishing guidelines that govern the collection of screening fees.\(^\text{21}\)

\(^{14}\) See infra notes 15-17 and accompanying text.

\(^{15}\) See infra note 15 and accompanying text.

\(^{16}\) See infra note 16 and accompanying text.

\(^{17}\) See infra note 17 and accompanying text.

\(^{18}\) See infra note 18 and accompanying text.

\(^{19}\) See infra note 19 and accompanying text.

\(^{20}\) See infra note 20 and accompanying text.

\(^{21}\) See infra note 21 and accompanying text.
This prevented the DRE from applying the stricter advance fee regulations to the collection of screening fees.\textsuperscript{22}

III. \textbf{CHAPTER 469 AND CHAPTER 525—PROVIDING A BETTER SOLUTION}

Chapter 469 and Chapter 525 attempt to resolve the problems of screening fees by amending the definition of advance fee and establishing screening fee procedures.\textsuperscript{23} Although each Chapter has a distinct effect in current law, both appear to be a reaction to the announcement that advance fee regulations would be used to control tenant screening. Moreover, Chapter 469 and Chapter 525 were joined by the Legislature so that neither would be operative unless they were enacted together.\textsuperscript{24}

\textbf{A. Chapter 469}

Chapter 469 amends the definition of “advance fee” by declaring that security deposits and screening fees are not included in the definition of “advance fee.”\textsuperscript{25} Under Chapter 469, the regulations controlling advance fees do not apply to security deposits and screening fees.\textsuperscript{26} However, Chapter 469 does not exempt security deposits and screening fees from all regulation.\textsuperscript{27} Instead, it specifies that security deposits and screening fees will be regulated under provisions set forth in §§ 1950.5 and 1950.6 of the California Civil Code.\textsuperscript{28}

Proponents of Chapter 469 believe that this legislation will assist in clarifying the law pertaining to advance fees.\textsuperscript{29} Specifically, Chapter 469 will ensure that advance fee regulations will not be used to restrict tenant screening.\textsuperscript{30} Chapter 469, in effect,
allows landlords to screen applicants without the burden of satisfying advance fee regulations.

B. **Chapter 525**

Chapter 525 declares that landlords may charge an applicant a screening fee, but also provides protection for prospective tenants by regulating tenant screening activity. Under Chapter 525, a landlord may request a fee to screen an applicant, but landlords are restricted from doing so if there are no units available for rent. Moreover, landlords may charge a fee that reflects only the actual out of pocket expense to screen the applicant, and this cost may not exceed thirty dollars. Landlords may use this fee to obtain information about the applicant, but landlords shall provide the applicant with a receipt and must give the applicant a copy of the consumer credit report upon request of the prospective tenant. Chapter 525 further declares that a screening fee should not be considered an advance fee or security deposit, and that none of its provisions intends to preempt regulations that govern the collection of fees or deposits under federal or state housing assistance programs.

Chapter 525 prevents the DRE from attempting to use advance fee regulations to regulate screening fees by enacting new guidelines that govern tenant screening by landlords. In doing so, Chapter 525 allows landlords to continue to protect themselves from tenant defaults by screening applicants, but at the same time, protects applicants from misuse by unscrupulous landlords. Thus, Chapter 525 balances the

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31. CAL. CIV. CODE § 1950.6(a) (enacted by Chapter 525); see id. (declaring that landlords may charge an application screening fee to applicants wanting to rent residential property); see also id. § 1950.6 (enacted by Chapter 525) (providing regulations that restrict and guide landlords in requesting screening fees from applicants).

32. Id. § 1950.6(c) (enacted by Chapter 525); see id. (stating that a landlord may not charge an applicant a screening fee if the landlord knows, or should have known, there were no rental units available, unless the applicant agrees to the charge in writing).

33. Id. § 1950.6(b) (enacted by Chapter 525).

34. See id. § 1950.6(a) (enacted by Chapter 525) (stating that the landlord may use screening fees to obtain information about the applicant); id. § 1950.6(d) (enacted by Chapter 525) (requiring that the landlord provide the applicant with a receipt for the screening fee paid by the applicant); id. § 1950.6(f) (enacted by Chapter 525) (declaring that the landlord shall produce a copy of the consumer credit report if the applicant pays the screening fee and requests a copy from the landlord).

35. See id. § 1950.6(j) (enacted by Chapter 525) (explaining that application screening fees are not to be considered an advance fee or a security deposit); id. § 1950.6(k) (enacted by Chapter 525) (stating that § 1950.6 of the California Civil Code does not preempt regulations governing deposits or fees under federal or state housing assistance programs).

36. SENATE COMMITTEE ON JUDICIARY, COMMITTEE ANALYSIS OF AB 2263, at 1 (July 9, 1996); see id. (declaring that the purpose of Chapter 525 is to establish clear guidelines to govern screening fees); see also ASSEMBLY FLOOR, COMMITTEE ANALYSIS OF AB 2384, at 2 (Aug. 12, 1996) (explaining that the DRE has held off applying advance fee regulation to tenant screening fees so that the law can be clarified).

37. See supra notes 31-36 and accompanying text (stating that Chapter 525 allows landlords to continue to use tenant screening, and setting forth the restrictions that Chapter 525 places upon landlords choosing to utilize tenant screening fees).
needs of landlords and prospective tenants by setting forth procedures that protect both parties.

IV. CONCLUSION

Screening of prospective tenants is one way in which landlords attempt to avoid the problems of tenant default.\(^{38}\) Although tenant screening is a popular way for landlords to protect themselves, California did not regulate the procedures concerning the collection of screening fees until the enactment of Chapter 469 and Chapter 525.\(^{39}\) Consequently, some landlords created problems by abusing the system for personal gain, and the DRE reacted to the problems by declaring that it would use advance fee restrictions to regulate the tenant screening process.\(^{40}\) Because advance fee regulations would have created a severe burden upon landlords, the legislature responded by clarifying the law and providing provisions concerning tenant screening.\(^{41}\) Chapter 469 and Chapter 525 protect landlords and applicants by establishing provisions that landlords must follow when collecting screening fees.\(^{42}\)

APPENDIX

Code Sections Affected

Business and Professions Code § 10026 (amended).
AB 2384 (Kuykendall); 1996 STAT. Ch. 469
Civil Code § 1950.6 (new).
AB 2263 (Murray); 1996 STAT. Ch. 525

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38. See supra note 1 and accompanying text (discussing the prevalence of tenant default and the reason why landlords use tenant screening).
39. See supra note 3 and accompanying text (explaining that California did not regulate tenant screening before the enactment of Chapter 469 and Chapter 525).
40. See supra Part II.B.
41. See id.
42. See supra Part III (discussing Chapter 469 and Chapter 525).

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