



The State Bar of California

OPEN SESSION AGENDA ITEM 54-142 MAY 2022 FINANCE COMMITTEE III.D

DATE: May 19, 2022

TO: Members, Finance Committee
Members, Board of Trustees

FROM: Aracely Montoya-Chico, Chief Financial Officer

SUBJECT: Approval of Reserve Policy Revision and Budget Spend-Down Plans

EXECUTIVE SUMMARY

This agenda item proposes updates to the State Bar's reserve policy specifically as related to the Client Security Fund (CSF). It also includes recommended actions with regards to those funds that have excess reserves per the reserve policy.

State Bar staff have identified three funds that have had excess balances (greater than 30 percent reserve) for six consecutive months or more, in accordance with the reserve policy: (1) the Lawyers Assistance Program (LAP) fund; (2) the Legal Specialization fund; and (3) the Legislative Activities fund.

BACKGROUND

REVISIONS TO RESERVE POLICY

The State Bar's reserve policy requires a minimum target reserve of two months of operating expenses (17 percent) for each fund and requires a spend-down plan when reserves remain greater than 30 percent for longer than six consecutive months. Grant-related funds (Grants fund, Legal Services Trust fund, Equal Access fund, Justice Gap fund, and Bank Settlement fund) are exempted from the minimum target reserve.

Spend-Down Plan, Funds with Excess Reserves

The State Bar's Reserve Policy requires a minimum target reserve of two months of operating expenses (17 percent) for each fund and requires a spend-down plan when reserves remain greater than 30 percent for longer than six consecutive months. Whenever reserve levels in the General Fund, or any restricted fund, other than excluded excess reserve funds, surpass 30 percent for a consecutive six-month period, spend-down funding shall occur in accordance with the following principles:

1. Fund balance spend-down should be utilized to offset member dues and other assessments and use charges, where possible.
2. Fund balance spend-down should be used to advance strategic efficiency investments that will result in short- or long-term reductions in operating costs.
3. Fund balance spend-down should be used to bolster the CSF, where possible.
4. Fund balance spend-down should be used to increase legal services funding, where possible.

The table below shows the projected 2022 reserve balance for the three funds with excess reserves as defined by the policy.

Table 1. Minimum-Maximum Potential Spend-Down by Fund

Fund	2022 Projected Reserve Balance	2022 Reserve Level %	Min Target Spend 17%	Max Target Spend 30%
Lawyers Assistance Program	1,080,611	41.5%	525,000	250,000
Legal Specialization	6,553,405	312.4%	5,275,000	4,600,000
Legislative Activities	397,538	62.6%	245,000	160,000

LAWYERS ASSISTANCE PROGRAM (LAP) FUND

LAP is projected to have a reserve level of 41.5 percent. In order to comply with the State Bar's reserve policy, a spend-down of at least \$250,000 is required.

LEGAL SPECIALIZATION FUND

Legal Specialization is projected to have a reserve level of 312.4 percent. In order to comply with the State Bar's reserve policy, a spend-down of at least \$4.6 million is required.

LEGISLATIVE ACTIVITIES FUND

Legislative Activities is projected to have a reserve level of 62.6 percent. In order to comply with the State Bar's reserve policy, a spend-down of at least \$160,000 is required.

DISCUSSION

RESERVE POLICY REVISIONS

The current reserve policy excludes all grant-related funds from the minimum target reserve range (maximum of 30 percent and minimum of 17 percent), as these funds pass through

revenues (after funding operating costs to manage those funds) to third-party organizations. Similar to grant-related funds, CSF revenues (after funding the administrative operating costs of the fund) must be almost entirely disbursed, in this case to reimburse licensees' clients for pecuniary losses resulting from dishonest conduct on the part of their attorneys (referred to as the "application payouts" portion of the fund).

The current reserve policy excludes from the minimum reserve target only the application payouts portion of the fund but not the administrative portion. There is no policy that stipulates the reserve allocation between the application payouts and the administrative portion of the fund. As a result, all reserves can (and should be) budgeted to application payouts. To align with grant-related funds that are excluded in their entirety from the reserve policy, a revision to the reserve policy is proposed as follows:

Exclusion in its entirety of the Client Security Fund within the operating expenses for the purpose of the minimum target reserve policy.

The proposed revisions to the reserve policy are shown in Attachment A (redline version).

SPEND-DOWN, FUNDS WITH EXCESS RESERVES

Potential spend-down initiatives considered for the LAP fund are outlined below. Staff are not recommending any spend-down in relation to the Legal Specialization or Legislative Activities funds, also as described below.

LAP SPEND-DOWN PLAN

Business and Professions code section 6140.9 requires that any "excess funds not needed to support the program [LAP], including reserve funds, may be transferred to fund the Client Security Fund (CSF) established pursuant to Section 6140.5, provided there are sufficient funds available to fully support the program." At the close of each calendar year, an assessment is made as to whether LAP has excess funds and whether all or a portion of that excess reserve should be transferred to the CSF. Although LAP does have an excess fund balance at this time, CSF staff has indicated that there is no need to redirect excess funds from LAP—the CSF program would not be able to spend the additional funds in the current year. As such, an alternate spend-down plan has been developed by LAP staff:

1. Create new targeted LAP programming using group facilitators to lead discussion groups on wellness and other topics. Cost associated – \$2,000.
2. Promote new grant program instead of loan program for participants who need financial assistance. Cost associated – \$60,000.
3. Create new targeted LAP programming using group facilitators to lead discussion groups on wellness and other topics. Cost associated – \$30,000.
4. Make new LAP video for State Bar's website. Cost associated – \$30,000.
5. Hire consultant to help create new Minimum Continuing Legal Education and other support resources and e-learning modules regarding the intersectionality of substance use and behavioral health issues, bias, and other relevant topics. (Cost to create a one-hour e-learning module is approximately \$50,000.) Cost associated – \$85,000.

6. Software to track progress and statistics and to report on the program's success and its defined metrics. Cost associated – \$43,000.

Total: \$250,000

LEGAL SPECIALIZATION SPEND-DOWN PLAN

The Legal Specialization fund has excess reserves of at least \$4.6 million. While ideas for excess reserve spend-down have been generated by the California Board of Legal Specialization, as outlined in Attachment C, staff does not recommend any spend-down at this time. As the Finance Committee will discuss during its May 19, 2022, meeting in relation to agenda item III.D, the Admissions fund is facing a significant structural deficit. The Legal Specialization fund has been used to support the Admissions fund in the past—most recently, via a \$1 million loan to support the procurement of the AIMS system. Staff recommends that no significant spend-down of the Legal Specialization fund be authorized or required until such time as the Board has made a determination as to how the deficit in the Admissions fund will be addressed on short-term and long-term bases.

LEGISLATIVE ACTIVITIES SPEND DOWN PLAN

The Legislative Activities fund currently covers lobbyist contracts and staff time associated with lobbying work. The fund is funded through voluntary fee donations by attorneys, which are currently set to \$5. The State Bar's 2023 fee bill aims to convert the Legislative Activities fee from an opt-out to opt-in status; a significant reduction in the level of funding received as a result of this conversion is anticipated. As such, staff does not recommend any spend-down of reserves at this time, enabling the State Bar to use the remaining balance of this fund to support legislative activities work for as long as possible, with the understanding that incoming revenue levels will be vastly lower than in the past.

FISCAL/PERSONNEL IMPACT

\$250,000 to effectuate recommended LAP spend-down plan.

AMENDMENTS TO RULES

None

AMENDMENTS TO BOARD OF TRUSTEES POLICY MANUAL

None

STRATEGIC PLAN GOALS & OBJECTIVES

Goal: None

RECOMMENDATIONS

Should the Finance Committee concur in the proposed action, passage of the following resolution is recommended:

RESOLVED, that the Finance Committee recommends that the Board of Trustees approve the proposed amendments to the Reserve Policy as proposed by the Chief Financial Officer; and it is

FURTHER RESOLVED, that the Finance Committee recommends that the Board of Trustees approves the proposed recommendations relating to excess reserves in the Lawyers Assistance Program fund, Legal Specialization fund, and Legislative Activities fund.

Should the Board of Trustees concur in the proposed action, passage of the following resolution is recommended:

RESOLVED, that the Board of Trustees, upon recommendation of the Finance Committee approves the proposed amendments to the Reserve Policy as proposed by the Chief Financial Officer; and it is

FURTHER RESOLVED, that the Board of Trustees, upon recommendation of the Finance Committee approves the plan for addressing excess reserves in the Lawyers Assistance Program fund, Legal Specialization fund, and Legislative Activities fund.

ATTACHMENTS LIST

- A.** 2022 Reserve Policy (redline version)
- B.** 2022 Reserve Policy (clean version)
- C.** California Board of Legal Specialization Recommended Spend-Down Initiatives

The State Bar of California Reserve Policy

~~Revised December 2020~~

Revised May 2022

A. DEFINITION AND CLASSIFICATION OF RESERVES

1. **Working Capital.** In accordance with best practices, State Bar reserves are defined as working capital (current assets less current liabilities). Since the State Bar uses Enterprise Fund accounting for its financial operations in accordance with Generally Accepted Accounting Principles (GAAP), working capital is the financial measure that most closely matches the concept of “fund balance” in the Governmental Funds and what is typically meant by the concept of “reserves” in a budgetary policy context. This is also the financial measure recommended by the Government Finance Officers’ Association of the United States and Canada (GFOA) as a “best practice” in setting reserve policies for Enterprise Funds (web site link): www.gfoa.org/materials/working-capital-targets-for-enterprise-funds
2. **Classification of Reserves.** The Governmental Accounting Standards Board (GASB) is responsible for establishing GAAP for state and local governments in the United States. For Governmental Funds, GASB Statement No. 54 adopted in 2009 requires that Fund Balance be classified into five components: non-spendable, restricted, committed, assigned and unassigned. While these classifications are only used for Governmental Funds and are not applicable to Enterprise Funds (in fact, there is no discussion under GAAP of the concept of “fund balance” or reserves for Enterprise Funds), they nonetheless provide a useful framework for assessing the State Bar’s reserves:
 - a. **Non-Spendable.** Amounts that are not in spendable form, such as prepaid items or inventories. (The State Bar does not currently have any reserves that would be classified as non-spendable.)
 - b. **Restricted.** Revenues where the use is subject to *externally* enforceable restrictions imposed by outside third parties.
 - c. **Committed.** These are outstanding obligations for contractual or policy commitment for programs or projects approved in prior fiscal years that are carried forward into the new year. They are typically composed of two types:
 - Encumbrances: unfilled purchase orders and outstanding contractual obligations at year-end. Since these commitments were made during the fiscal year, adequate resources should be available at year-end to cover them and carryover balances into the new fiscal year.
 - Policy Commitments: Balances formally set aside by the Board in order to fund future projects based on adopted plans.
 - d. **Assigned.** Minimum reserve targets established based on assessing risks in accordance with the structured assessment methodology developed by the GFOA (see Section C), after addressing non-spendable, restricted and committed reserves.

- e. **Unassigned.** Residual classification of spendable amounts available for other purposes. Under GASB Statement No. 54, unassigned fund balance should not be shown as a negative number. However, as noted above, GASB Statement No. 54 is only being used as a policy framework in assessing the State Bar's reserves. Accordingly, in the interest of policy clarity, where the State Bar's ending reserves are not sufficient to meet its non-spendable, restricted, committed and assigned amounts, the unassigned balance will be shown as a negative number in clearly disclosing how short reserves are in meeting policy goals.

B. ESTABLISHMENT AND CLASSIFICATION OF FUNDS

While usually created with the goal of improving accountability, the proliferation of funds often makes an agency's financial position and fiscal operations more confusing and less transparent. As such, in accordance with GAAP, the State Bar will limit the proliferation of funds and only establish separate funds where there are compelling policy reasons to do so. This approach will not only simplify accounting and financial reporting, but by focusing on meaningful resource restrictions and earmarking, it will improve accountability, transparency and understandability.

State Bar funds are organized into funds as follows:

1. **Restricted Funds.** Using GAAP as the framework, "restricted" funds will be established for revenues that are externally restricted via legislation, bond covenants or similar external restrictions, or activities for which there are compelling policy reasons to account for the use of resources separately. In short, to be classified as a "restricted" fund, the restriction must be externally imposed as set forth under GAAP. This means that all significant special purpose assessments approved by the State Legislature, including voluntary ones, will be accounted for in a separate restricted fund. In the case of limited-term assessments that will expire at some point, the fund will be closed-out when the last assessment is received or all proceeds are used for designated purposes, whichever occurs last. Closed-out fund balances will typically be transferred to the General Fund; however, the Board will determine the disposition of any residual balances on a case-by-case basis. The following are Restricted Funds:
 - a. Client Security Fund
 - b. Elimination of Bias Fund
 - c. Equal Access Fund
 - d. Justice Gap Fund
 - e. Lawyer's Assistance Program Fund
 - f. Legislative Activities Fund
 - g. Legal Services Trust Fund
 - h. Legal Specialization Fund
 - i. Bank Settlement Fund
 - j. SF Tenant Improvement Fund
 - k. Information Technology Fund
 - l. Admissions Fund
 - m. Grants Fund

2. **General Fund.** All other revenues, expenditures and other uses will be accounted for in the General Fund.

C. MINIMUM RESERVE TARGET

The State Bar will maintain reserves in its General Fund, and each Restricted Fund, other than Excluded Minimum Target Reserve Funds, that equate to 2 months of operating expenses for the respective funds; this translates to a target minimum reserve level of 17 percent.

Since the State Bar accrues assets and liabilities only at year-end, reserves are determined annually at that time. Mid-year estimates of reserves, if needed, are determined by adding projected revenues and subtracting projected expenses from prior year reserves.

Excluded Minimum Target Reserve Funds: All grant-related Funds (specifically the Grants, Legal Services Trust, Equal Access, Justice Gap, and Bank Settlement Funds) are excluded from the requirement to have a minimum reserve target.

For purposes of the Minimum Reserve Target, operating expenses of the Client Security Fund ~~shall exclude application payouts.~~ shall be excluded in its entirety and not be subject to have a minimum reserve target.

D. APPROPRIATE RESERVE USES

Circumstances where taking reserves below target minimum levels would be appropriate include responding to the risks that reserves are intended to mitigate, such as:

1. One-time uses in meeting cash flow needs; closing a projected short term revenue-expenditure gap; responding to unexpected expenditure requirements or revenue shortfalls; and making investments in human resources, technology, liability reductions, revenue base improvements, productivity improvements and other strategies that will strengthen State Bar revenues or reduce future costs.
2. Where a multi-year forecast shows an ongoing structural gap, in providing a strategic bridge to the future.

Any expenditure that would cause the balance of the General Fund or any Restricted Fund, other than Excluded Minimum Target Reserve Funds, to fall to a level totaling 10 percent or less of recurring annual operating expenses, must be approved by the Board of Trustees.

E. FUND BALANCE SPEND DOWN WHEN RESERVES ABOVE POLICY LEVELS

Whenever reserve levels in the General Fund, or any Restricted Fund, other than Excluded Excess Reserve Funds, surpass 30 percent for a consecutive six-month period, spend-down funding shall occur in accordance with the following principles:

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3. Fund balance spend-down should be used to bolster the Client Security Fund, where possible.
4. Fund balance spend-down should be used to increase legal services funding, where possible.

All spend-down in excess of \$250,000 must be approved by the Board of Trustees.

F. RESTORING RESERVES TO POLICY LEVELS

Whenever reserve levels in the General Fund, or any Restricted Fund, other than Excluded Minimum Target Reserve Funds, fall below the target minimum reserve level of 17 percent, the State Bar will strive to restore reserves to this level within five years. Annual surpluses of revenues over expenses of the State Bar will be allocated at least half to reserve restoration, with the balance available to fund outstanding liabilities, asset replacements, service levels restoration, new operating programs or capital improvement projects.

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The Legal Specialization spend-down plan, based the California Board of Legal Specialization's (CBLS) recommend initiatives is as follows:

1. 2022 Legal Specialization Program Annual Fee Holiday – \$1,800,000 (a one-time fee waiver in 2023)

The Legal Specialization Program Annual Fee is a \$360 fee assessed each year on a specialist's annual fee statement. Elimination of the annual fee for certified specialists for one year would be consistent with the policy, provide benefits to all certified specialists in a neutral manner, and will accomplish a significant and timely spend-down of the reserves needed to conform to State Bar policy.

2. Advertising/Outreach – \$120,000 (\$30,000 per year for the years 2023 through 2026)

Funding is proposed to research and develop social media campaigns to the public and to attorneys. Social media is the most common means of communication today, and statistics show that, after personal referrals, consumers are most likely to search for an attorney online, and most attorneys manage their lives online.

There are several investments that may take place to expand Legal Specialization's online presence and establish a strong foundation for digital communication, including social media campaigns or promotions. Other marketing opportunities include print/digital publications, and pending the return to in-person events, conference travel and in-person outreach.

Adoption of this plan would not bring the Fund into compliance with the reserve policy. As a result, the CBLS planned to seek a waiver of the reserve policy with respect to the remaining fund balance.