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BY THE U.S. GENERAL ACCOUNTING OFFICE

Report To The Honorable Orrin G. Hatch And The Honorable Jeremiah Denton United States Senate

The Establishment Of Alternative Corporations By Selected Legal Services Corporation Grant Recipients

GAO reviewed corporations established by three Legal Services Corporation (LSC) grant recipients allegedly to avoid grant restrictions. In reviewing these "alternative" corporations, GAO found that:

--The LSC Act and regulations do not prohibit LSC grant recipients from establishing alternative corporations provided that funds transferred to the alternative corporations are used in accordance with the LSC Act and regulations.

--In Texas and Connecticut the establishment of the alternative corporations GAO reviewed has enabled the grant recipients to circumvent restrictions in the LSC Act and regulations.

--The LSC grant recipient and alternative corporation in Maine have operated independently since 1981 and complied with the LSC Act and regulations.

GAO recommends that LSC apply restrictions in the LSC Act and regulations to the grant recipients and alternative corporations in Texas and Connecticut as though they were single entities because, since early 1982, they have maintained such close relationships and such an identity of interests that, in GAO's view, they are not separate entities for purposes of compliance with the LSC Act.

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UNITED STATES GENERAL ACCOUNTING OFFICE

WASHINGTON, D.C. 20548

HUMAN RESOURCES DIVISION

B-202116

The Honorable Orrin G. Hatch
United States Senate

The Honorable Jeremiah Denton
United States Senate

This report is in response to your request that we review certain "alternative corporations" that were established by three Legal Services Corporation (LSC) grant recipients in the early 1980's. The grant recipients and alternative corporations were Texas Rural Legal Aid, Inc., and the Texas Rural Legal Foundation, Inc.; the South Central Connecticut Legal Services Corporation and New Haven Legal Assistance Association, Inc.; and Pine Tree Legal Assistance, Inc., and Downeast Law Offices in Maine.

Specifically, you asked us to determine whether these LSC grant recipients set up alternative corporations to avoid restrictions placed on LSC grant recipients. To make this determination, we assessed

--how and why the three LSC grant recipients established alternative corporations;

--whether the establishment of alternative corporations complied with the LSC Act and regulations; and

--whether the LSC grant recipients and alternative corporations have maintained such close relationships through, for example, shared staff and facilities that the corporations can be considered single entities for purposes of compliance with the LSC Act.

Appendix I provides a detailed discussion of the results of our work.

In performing our work, we reviewed the LSC Act and regulations to determine the legality of establishing alternative corporations. We interviewed LSC headquarters officials, the two former LSC regional directors in whose regions the corporations were established, and officials at each of the original grant recipients and corporations. We also reviewed documents at each recipient and corporation regarding the establishment of the corporations and the relationships between the corporations and grant recipients. (Our objectives, scope, and methodology are detailed in app. II.)

In summary we found that:

1. The LSC Act and regulations do not prohibit LSC grant recipients from establishing alternative corporations provided that funds transferred to the corporations are used in accordance with the act and LSC regulations.

2. In 1981, senior LSC officials encouraged LSC grant recipients to develop strategies, including establishing alternative corporations, to counter anticipated funding reductions and additional restrictions on the use of LSC funds. As discussed below, the three programs you asked us to review cited different reasons for establishing corporations.

   --The alternative corporation in Texas was established to (1) comply with LSC's fund balance policy (which limited the amount of fund balances that could be carried over and later used by the grantees) in a manner which would insure that the funds would remain in Texas and would not be subject to recapture by LSC or result in future reductions in LSC funds provided Texas Rural Legal Aid, Inc., and (2) comply with LSC's requirement that recipients involve private attorneys in the delivery of legal assistance.

   --In Connecticut the former grant recipient created a corporation which became the new grant recipient. The former recipient relinquished its role as the LSC grant recipient because it did not want to be subject to a potential restriction on recipient activities or a restriction in the LSC Act on how recipients could use private funds.

--In Maine the LSC grant recipient helped establish a separate corporation to reduce future expenses in anticipation of LSC funding cuts. Sixteen employees left the recipient to join the new corporation, a private law firm.

3. The LSC grant recipients and subrecipients (i.e., the alternative corporations) in Texas and Connecticut have, since early 1982, maintained such close relationships that a true separation of the corporations does not exist. When recipients and subrecipients have such an identity of interests, we believe that LSC, under its authority in the LSC Act to insure that recipients and subrecipients comply with the act, is justified in considering the two corporations as one.

   --In Texas the establishment of the alternative corporation enabled the grant recipient to retain unspent grant funds in excess of levels permitted under LSC's fund balance policy. Had LSC considered the Texas programs' combined fund balances as one in 1982, 1983, and 1984, the programs would have been required to take steps to reduce the fund balances.

   --In Connecticut the former grant recipient used private funds to engage in activities in which it could not have engaged if it had remained the LSC grant recipient or if LSC had subjected it to the same restrictions as it subjected grant recipients. For example, the former grant recipient used private funds to organize nursing home residency councils.

   --In Maine the grant recipient and alternative corporation have operated independently since 1981 and complied with the LSC Act and regulations.

Although we are not implying that any of the corporations we reviewed worked an injustice or promoted a fraud, LSC has authority under section 1007(d) of the act to exercise oversight over programs supported in whole or in part by LSC funds to insure that these programs are in compliance with applicable laws and regulations. Under this oversight authority, LSC should, in our view, examine the factors that indicate the identity of interests between these organizations and prospectively consider the grantees and alternative corporations in Texas and Connecticut as single entities.

RECOMMENDATIONS TO THE PRESIDENT OF LSC

We recommend that the President of LSC apply LSC's fund balance regulation starting with the fiscal year ending September 30, 1985, to Texas Rural Legal Aid's and its alternative corporation's combined fund balance. We also recommend that the President require the South Central Connecticut Legal Services Corporation and New Haven Legal Assistance Association to include in their next agreement for the provision of legal services, which will replace their current agreement which expires on October 30, 1985, a stipulation prohibiting the New Haven Legal Assistance Association from using private funds for restricted purposes.

AGENCY COMMENTS AND OUR EVALUATION

The grant recipients and subrecipients in Texas, Connecticut, and Maine; the former executive director of the Connecticut program; and LSC were given an opportunity to comment on a draft of this report.

The grant recipients and subrecipients in Texas and Connecticut disagreed with our conclusion that the recipients and subrecipients maintained such close relationships that LSC should consider them single entities for purposes of compliance with the LSC Act. They stated that the facts on which we based our conclusions were incomplete or inaccurate.

We generally disagree with these comments. The grant recipients and subrecipients have offered little evidence to suggest that the organizations are separate.

The grant recipient and alternative corporation in Maine were satisfied with our report as it related to their programs.

LSC said it accepted our findings and conclusions and intends to follow our recommendations.

Our detailed evaluation of these comments is included in appendix I. Copies of the comments are in appendixes III through VIII.

As arranged with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time we will send copies to interested parties and make copies available to others upon request.

Edward A Densmore

for Richard L. Fogel
Director

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ABBREVIATIONS

GAO	General Accounting Office
LAA	New Haven Legal Assistance Association, Inc.
LSC	Legal Services Corporation
SCC	South Central Connecticut Legal Services Corporation
TRLA	Texas Rural Legal Aid, Inc.

THE ESTABLISHMENT OF ALTERNATIVE CORPORATIONS BY SELECTED LEGAL SERVICES CORPORATION GRANT RECIPIENTS

BACKGROUND

Senators Orrin G. Hatch and Jeremiah Denton asked us to determine whether three Legal Services Corporation (LSC) grant recipients established mirror corporations (hereinafter referred to as alternative corporations) to avoid restrictions placed on grant recipients. According to the director of LSC's office of field services at the time the alternative corporations discussed in this report were created, alternative corporations are second legal aid organizations established by LSC grant recipients in communities that grant recipients already serve. He stated that their purpose was to (1) provide services in areas of the law in which the use of LSC funds was progressively being restricted and (2) generate alternative funding to make up for cuts in public funding by using other funding sources and delivery mechanisms, such as sliding fee scales and attorney fee awards, to meet the legal needs of poor people.

The three grant recipients and alternative corporations we reviewed were Texas Rural Legal Aid, Inc., and the Texas Rural Legal Foundation, Inc.; the South Central Connecticut Legal Services Corporation and New Haven Legal Assistance Association, Inc.; and Pine Tree Legal Assistance, Inc., and Downeast Law Offices in Maine.

The Legal Services Corporation Act of 1974 (Public Law 93-355) established LSC as a private, nonprofit corporation to provide financial support for legal assistance programs for the poor in noncriminal proceedings. This support is provided through grants to over 300 independent organizations. LSC's office of field services is responsible for managing grants and contracts for all field programs, supervising nine regional offices that monitor and evaluate field programs, and providing technical assistance to improve local program operations.

Each field program is an independent, nonprofit organization governed by a local board of directors, which is responsible for establishing service priorities that reflect the needs of local clients.

For fiscal years 1981 and 1982, during which time the alternative corporations we reviewed were established, LSC's funding was $321 million and $241 million, respectively. LSC's fiscal year 1985 appropriation is $305 million.

LSC ENCOURAGED LOCAL PROGRAMS TO PREPARE FOR BUDGET CUTS AND ADDITIONAL RESTRICTIONS

In 1981, senior LSC officials believed the Corporation faced an uncertain future because (1) the new administration had proposed that LSC not be funded in fiscal year 1982 and (2) the House of Representatives had passed an LSC reauthorization bill containing new restrictions on the activities for which LSC funds could be used. As a result, LSC encouraged grant recipients to develop strategies, including establishing alternative corporations, to counter anticipated funding reductions and additional restrictions on the use of LSC funds.

LSC faced an uncertain future in 1981

During much of 1981, LSC's future was uncertain. On March 10, 1981, the new administration recommended that LSC not be funded for fiscal year 1982. Also during 1981, the Congress had recommended reducing LSC's funding.

For fiscal year 1982, the Senate Labor and Human Resources Committee recommended authorizing $100 million for LSC--a $221 million reduction from the fiscal year 1981 appropriation. In June 1981 the House of Representatives passed H.R. 3480, LSC's reauthorization legislation, which authorized $241 million for fiscal years 1982 and 1983. H.R. 3480 was not enacted, but the Congress, through a series of continuing resolutions, appropriated $241 million to LSC for fiscal year 1982.

H.R. 3480 contained new restrictions on how grant recipients could use LSC funds, including the proposed "sole purpose" restriction, which would have required LSC grant recipients to be chartered for the sole purpose of providing legal assistance to eligible clients. Under the proposed sole purpose restriction, which never became law, LSC grant recipients could not have used non-LSC funds to engage in activities for which the LSC Act prohibits the use of LSC funds, such as providing criminal representation or representing individuals whose incomes and assets exceeded LSC guidelines. As discussed later, two of the programs we visited cited the proposed sole purpose restriction as one of several reasons for establishing alternative corporations.

Local programs prepared for anticipated funding cuts

By spring of 1981, senior LSC staff were encouraging LSC regional offices and grant recipients to develop strategies, including establishing alternative corporations, to respond to anticipated funding cuts. This effort, known as "retrenchment," included developing strategies on layoffs, office closings, obligations to continue serving clients, and alternative legal service delivery systems.

By June 1981, retrenchment planning had become a high priority of LSC. A June 3-4 meeting of LSC regional directors and headquarters officials focused on retrenchment issues. The then-deputy director of LSC's office of field services, in a June 1981 memo to LSC's regional directors, said that he saw the role of LSC, and specifically the regional directors, as

> ". . . one of supporting, assisting, and in some cases prodding programs to examine the issues and make some very difficult choices. A proactive role for the Regional Offices is our obvious strong preference (as opposed to a reactive role)."

He urged local programs to prepare contingency plans for fiscal year 1982 based on reductions of 25, 50, and 100 percent in their LSC grant levels.

By late summer and early fall of 1981, regional and local program officials around the country were discussing establishing alternative legal service delivery systems, including alternative corporations, which were variously referred to as "mirror," "sister," and "clone" corporations.

In an August 10, 1983, letter to the Chairman, Senate Committee on Labor and Human Resources, regarding the Committee's July 1983 oversight hearings on LSC, the former director of LSC's office of field services expressed his support for the establishment of alternative corporations. He wrote,

> "My policy statements with regard to these activities make clear that the Corporation recognized the legitimacy of these initiatives. We also recognized their potential risks and insisted that they be implemented in absolute conformity with the Act, regulations, grant assurances and conditions, the Corporation's Audit Guide and Property Management Manual, Generally Accepted Accounting Principles (GAAP) and the Code of Professional Responsibility."

In this letter he said that he and others at LSC monitored the establishment of alternative corporations as closely as time and resources permitted.

To research the establishment of these corporations, LSC provided a total of $7,750 in technical assistance funds to the grantees we reviewed in Texas and Maine. At each of the programs we reviewed, LSC regional directors approved the transfer of funds from the LSC grant recipient to the subrecipient.

GRANTEES' REASONS FOR ESTABLISHING ALTERNATIVE CORPORATIONS

The three programs we reviewed established their alternative corporations for different reasons. The grant recipients in Texas and Connecticut established alternative corporations in response to actual or anticipated restrictions on the use of LSC funds. The Maine grant recipient established an alternative corporation as a way to reduce expenses in anticipation of LSC budget cuts.

TRLA and the Foundation

In December 1981, Texas Rural Legal Aid, Inc. (TRLA), the LSC grant recipient serving a 47-county area of south and west Texas, created the Texas Rural Legal Foundation, Inc., and in 1982 TRLA transferred $736,048 to the Foundation. TRLA had accumulated these funds as its LSC support increased during the late 1970's and early 1980's, largely as a result of receiving funds to expand the availability of legal services to previously unserved areas. In January 1982, LSC approved TRLA's transfer of funds to the Foundation as a method of meeting LSC's requirement that grantees involve private attorneys in delivering legal services.

According to TRLA's executive director,[1] the Foundation was established for two primary reasons. First, TRLA was concerned that a newly appointed LSC board of directors would attempt to recover LSC grant recipients' carryover funds under the provisions of LSC's fund balance policy issued in December 1980. The carryover funds, or fund balance, consisted of unspent LSC grant funds, interest income earned on such funds,

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[1]While TRLA's executive director also serves as president of the Foundation, he is referred to throughout this report as TRLA's executive director.

and attorney fee awards. According to TRLA's executive director, by transferring funds to the Foundation, TRLA intended to comply with LSC's fund balance policy in a manner which would insure that the fund balance remained in Texas and would not be subject to recapture by LSC or result in future reductions in LSC funds provided TRLA. In the event that the Congress eliminated or severely reduced LSC's funding, TRLA hoped to be able to use the funds transferred to the Foundation to complete TRLA's ongoing cases.

The second major reason for establishing the Foundation was to comply with LSC's requirement that grant recipients use funds to involve private attorneys in the delivery of legal assistance to eligible clients. On October 2, 1981, the LSC board of directors approved a statement of principles requiring local programs to allocate at least 10 percent of their annualized basic field grants (i.e., the LSC annual awards to legal services programs for the direct provision of legal services and on which the next year's funding is based) to allow private attorneys to provide legal assistance to eligible clients.[2] According to TRLA's executive director, while many LSC-funded programs hired staff to coordinate work with private attorneys, TRLA chose to meet the private attorney involvement requirement through the Foundation by advancing fees to and reimbursing litigation costs of private attorneys.

According to TRLA's executive director, another consideration in the Foundation's establishment was that TRLA feared that the "sole purpose" restriction in H.R. 3480, if passed by the Congress, would limit the range of activities in which TRLA could engage. For example, in fiscal year 1981 TRLA received about $13,000 from a private source to provide legal assistance to the handicapped and about $30,000 in an Area Agency on Aging grant. Neither funding source limited participation to LSC-eligible clients. The sole purpose restriction, had it become law, would have prohibited TRLA from participating in this type of activity. Creating a separate organization, such as the Foundation, would allow the separate organization to use non-LSC funds for purposes prohibited by the LSC Act.

TRLA's executive director stated that none of the events about which TRLA was concerned and which led to the Foundation's

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[2]As of January 1, 1984, local programs were required to allocate at least 12-1/2 percent of their annualized basic field grants to private attorney involvement activities.

establishment occurred. LSC did not attempt to recover carryover funds, and the sole purpose restriction did not become law. He also stated that TRLA could have complied with LSC's private attorney involvement requirement without establishing the Foundation by advancing fees to, and reimbursing litigation costs of, private attorneys.

SCC and LAA

In December 1981, the New Haven Legal Assistance Association, Inc. (LAA), the then LSC grant recipient, established the South Central Connecticut Legal Services Corporation (SCC). With LSC's approval, SCC replaced LAA as the LSC grant recipient serving the New Haven area through a successor-in-interest agreement effective January 1, 1982. According to the agreement, LAA transferred to SCC "all rights, obligations, and responsibilities" it held as an LSC grant recipient. SCC succeeded to LAA's interest in receiving future LSC grants, including the $543,892 grant LSC had approved for LAA for calendar year 1982.

According to SCC's executive director,[3] SCC was established for two reasons. First, the proposed sole purpose restriction would have limited the activities in which LAA, as the LSC grant recipient, could have engaged. In a November 2, 1983, letter to GAO, SCC's executive director stated that the sole purpose restriction in H.R. 3480 would have conflicted with both the LAA certificate of incorporation and the specific requirements of several of LAA's funding sources. He indicated that LAA's mandate, which dated back to 1964, was broader than LSC's. For example, LAA was incorporated to provide legal representation and advice in criminal cases and to conduct research into a variety of legal areas, including criminal law. Also, LAA's certificate of incorporation did not limit LAA to providing assistance only on the basis of financial eligibility. In contrast, LSC grant recipients are not allowed to use LSC funds to participate in criminal cases or to represent clients whose incomes exceed specified levels.

As a result of these concerns about the potential impact of the sole purpose restriction, LAA gave up its role as an LSC grantee. According to the November 2, 1983, letter, the LAA board

[3]While SCC's executive director also serves as LAA's executive director, he is referred to throughout this report as SCC's executive director.

". . . realized that the corporation [LAA] could not provide the full range of services envisioned by its charter and continue to accept LSC funding. In that LSC funding represented less than 50% of NHLAA's total income, the NHLAA board decided to relinquish its role as a LSC recipient."

By the time SCC was incorporated, the Congress had funded LSC for the first 6 months of fiscal year 1982, and the sole purpose restriction had not become law. However, according to SCC's executive director, LAA proceeded with its plans to establish SCC because the threat of future restrictive amendments remained.

According to SCC's executive director, the second reason for establishing SCC was that LAA anticipated conducting an aggressive fund raising campaign from private sources to offset anticipated LSC and non-LSC funding cuts. Any restrictions that the private funding sources would have imposed on either the types of clients that could be served or the substantive cases that could be handled were not likely to be identical to LSC requirements. As a result, some of the private funds LAA expected to raise might have been used to support LSC-restricted clients or cases. Section 1010(c) of the LSC Act, while allowing LSC grant recipients to spend public funds in accordance with the purposes for which they are provided, prohibits the expenditure of private funds for purposes prohibited by the act.[4]

In fact, from 1981 to 1984 LAA's income from private sources increased from 6 to 18 percent of LAA's total support and revenue. This was due to both a decrease in grants and contracts from public sources and an increase in private funding.

Pine Tree and Downeast

In 1981, Pine Tree Legal Assistance, Inc., the LSC grant recipient in Maine, helped establish Downeast Law Offices,

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[4]Section 1010(c) of the LSC Act is less restrictive than the sole purpose restriction that was proposed in H.R. 3480. The sole purpose restriction would have limited the recipients' activities regardless of the source of funds to those permitted by the act, while section 1010(c) permits recipients to engage in other activities not covered by the act provided they are funded by public sources.

P.A.,[5] a private law firm, to reduce Pine Tree's projected 1982 expenses in anticipation of LSC funding reductions. Sixteen Pine Tree employees resigned to join Downeast and received $127,487 to complete their ongoing cases. As a result of the employees leaving, Pine Tree was able to reduce its 1982 salary expenses and potential unemployment insurance liability and ensure that ongoing cases were handled by the same individuals.

The departure of the 16 employees--9 attorneys, 3 paralegals, and 4 secretaries--reduced Pine Tree's salary expenses by about $19,348 per month. Following the departure of the 16 employees, Pine Tree's average monthly wage payments were about 22 percent less than they had been during the first 6 months of 1981.

Through early 1981, Pine Tree was a self-insured employer for unemployment insurance--that is, it was solely responsible for paying unemployment benefits to laid-off staff. A worst-case projection developed by Pine Tree determined that its maximum unemployment insurance liability was $243,360. This estimate assumed that all 72 employees were laid off and received the maximum benefits to which they were entitled for as long as they were entitled to receive them. In April 1981, however, Pine Tree's request to participate in the state's unemployment insurance program was approved, retroactive to January 1, 1981. As a result, Pine Tree's potential unemployment insurance liability decreased quarterly beginning in July 1981 and became less of a concern. Pine Tree became fully insured as of January 1, 1983.

Another advantage to Pine Tree was that Downeast agreed to handle 477 of Pine Tree's ongoing cases, thus ensuring that clients would continue to be represented by the same people. Downeast received $127,487 to take these cases. According to Pine Tree's former executive director, that figure represented the funds Pine Tree estimated it would have spent during the last 5 months of 1981 to pay the salaries and overhead expenses, such as rent, of the employees transferring to Downeast.

A final advantage was that Pine Tree avoided having to close offices around the state by leasing its surplus office space and equipment to Downeast.

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[5]Downeast was originally incorporated under the name Geores Downeast Law Offices, P.A., but on October 8, 1981, changed its name to Downeast Law Offices, P.A.

The agreement with Pine Tree was also advantageous for Downeast. The transfer of Pine Tree cases with each attorney and paralegal, along with the $127,487 paid to Downeast for the continued representation of clients, provided Downeast employees with the cases and capital to begin their private practice.

LSC SHOULD APPLY STATUTORY REQUIREMENTS TO ALTERNATIVE CORPORATIONS THAT LACK SEPARATE IDENTITIES FROM LSC GRANTEES

The LSC Act does not prohibit LSC-funded programs from establishing and transferring funds to alternative corporations provided that the transferred funds are used in accordance with the LSC Act and regulations. LSC has authority under section 1007(d) of the act to insure that alternative corporations supported in whole or in part by LSC funds comply with applicable laws and regulations.

There are some restrictions that apply only to LSC grantees but do not bind legitimate private corporations. However, where the grantee and subgrantee have so close an identity of interests, we believe that LSC, under its authority in the act to insure that recipients and subrecipients comply with the act, is justified in considering the two corporations as one.

The grant recipients and subrecipients we reviewed in Texas and Connecticut have, since early 1982, maintained such close relationships and such an identity of interests that, in our view, the grantees and alternative corporations they established are not in fact separate organizational entities for purposes of compliance with the LSC Act. As discussed later, LSC should consider the organizations in Texas and Connecticut as single entities for purposes of the act. As a result, TRLA and the Foundation would jointly have to comply with LSC fund balance restrictions, and LAA would have to comply with the LSC Act's restriction on the use of private funds.

There is an analogous doctrine in corporation law called the "alter ego doctrine." Under this theory, a court may disregard the legal fiction of corporate organization where a complainant demonstrates that there is such unity of interest that the separation of one corporation from another has ceased to exist, and where it is clear that one corporation has become a mere business conduit for another and has been used to work an injustice or promote a fraud.

While the alter ego doctrine is not directly applicable to the relationship between the grant recipients and alternative corporations, we used the criteria in the doctrine to demonstrate that through shared offices, staff, and facilities; control over workload; and in one instance, interlocking boards of directors, the corporations have, in our opinion, a single identity for purposes of the LSC Act. The criteria demonstrating an identity of interest are included in alter ego doctrine case law. See, for example, American Trading & Producing Corporation v. Fischbach & Moore, Inc., 311 F. Supp. 412 (1970) and FMC Finance Corporation v. Murphree, 632 F. 2d 413 (1980).

Although we are not implying that any of the corporations we reviewed worked an injustice or promoted a fraud, LSC has authority under section 1007(d) of the act to monitor, evaluate, and exercise oversight over programs supported in whole or in part by LSC funds to insure that these programs are in compliance with applicable laws and regulations. Under this oversight authority, LSC should, in our view, examine the above factors that indicate the identity of interests between these organizations and prospectively consider the grantees and alternative corporations in Texas and Connecticut as single entities. While court precedents regarding the alter ego doctrine are not directly applicable as a matter of law to LSC's oversight authority, LSC can use the principles established in these cases to guide them in determining whether such organizations are separate.

TRLA AND THE FOUNDATION SHOULD BE CONSIDERED A SINGLE ENTITY FOR PURPOSES OF THE LSC ACT

Although TRLA's establishment of the Foundation did not violate the LSC Act or regulations, the two corporations have maintained such a close relationship since 1982 that, in our view, the corporations should be considered as a single entity for purposes of the LSC Act.

The Foundation and TRLA have common staffs, management, and facilities. In addition, after LSC issued an instruction that, effective January 1, 1984, had the effect of prohibiting TRLA from using the Foundation to satisfy LSC's private attorney involvement requirement, the Foundation transferred cases to TRLA so TRLA could use the cases to satisfy the requirement.

Because the two corporations should be considered as having a single identity for purposes of the act, LSC should consider the Foundation's fund balance as part of TRLA's fund balance. Had LSC done this in 1982, 1983, and 1984, the combined fund balance would have exceeded 10 percent of the programs' annualized LSC support. According to LSC's fund balance policy, in 1982 TRLA would have been required to obtain LSC's approval for a plan to spend the funds exceeding 10 percent of the programs' annualized support. For 1983 and 1984 LSC would have had to either reduce TRLA's annualized grant award for the next period by pro rata deductions from TRLA's monthly allocations or grant TRLA a waiver of the 10-percent ceiling. The fund balance exceeded 10 percent of the programs' annualized support by $585,183 in 1982, $194,467 in 1983, and $186,459 in 1984.

The Foundation's organizational structure

While TRLA and the Foundation maintain separate boards of directors and financial records and have their own federal tax exemptions under section 501(c)(3) of the Internal Revenue Code, the Foundation's day-to-day operations are conducted by one part-time paid staff member and three other unpaid or volunteer staff, all of whom are full-time TRLA employees.

TRLA's executive director serves as the Foundation's president and is responsible for supervising the Foundation's affairs and presiding at the Foundation's board meetings. The Foundation's president also sits on the executive committee that decides which cases the Foundation will fund. TRLA's director of administration is the Foundation's treasurer responsible for investing the Foundation's funds and coordinating the Foundation's annual board meetings. The TRLA executive director's secretary receives $1,200 per year from the Foundation for part-time secretarial services. TRLA's senior accountant maintains the Foundation's bookkeeping records. The senior accountant estimated she spends 2 to 4 hours per month on Foundation business and is not paid by the Foundation for her work. The Foundation does not have its own office space or telephone, and the TRLA employees who conduct the Foundation's business use TRLA facilities to perform their Foundation work. The Foundation's records are kept in two file cabinets in TRLA's headquarters, and its mail is sent to a post office box. The Foundation has its own brochures and letterhead.

TRLA's attempt to satisfy LSC's private attorney involvement requirement

According to TRLA's executive director, one of TRLA's reasons for establishing the Foundation was to satisfy LSC's requirement that grant recipients use funds to involve private attorneys in the delivery of legal assistance to eligible clients. This requirement directed local programs to spend at least 10 percent of their annualized basic field grants on this activity.

According to its work program, the Foundation is supposed to provide a revolving, long-term source of funds for litigation and client representation for LSC-eligible clients. The Foundation awards funds to attorneys to handle cases that fall within TRLA's priority areas and "significant" cases that are likely to result in court awards of attorney's fees and costs upon their successful conclusion. According to TRLA's executive director, significant cases are those that are likely to be time consuming and expensive to litigate and are expected to affect large numbers of poor people. Attorneys may apply for advances of fees or for reimbursements for the costs of legal representation, such as filing fees, depositions, travel, and expert witness fees. If a case results in an award of attorney's fees or costs, the Foundation expects the attorney to reimburse it for any fees or costs previously advanced to the attorney. The executive director said that private attorneys are unlikely to handle these sorts of cases without advances of attorney's fees or reimbursements of litigation costs. In 1982 and 1983, TRLA used the Foundation to satisfy LSC's private attorney involvement requirement.

Effective January 1, 1984, LSC's private attorney involvement instruction, published in the Federal Register, prohibited the use of a revolving litigation fund, such as the Foundation's, to satisfy the private attorney involvement requirement. According to the instruction,

> "Such a mechanism is clearly counter to the restrictions in the Act which are meant to deter Legal Services Corporation funds and recipients' involvement in fee-generating cases."

As a result of the prohibition, the Foundation transferred 34 cases to TRLA to allow TRLA to credit the amount it spends on these cases toward its private attorney involvement requirement. The 36 cases that remained with the Foundation,

such as cases involving aliens, could properly be funded with funds previously transferred to the Foundation but may have been restricted under later years' LSC appropriations. The funds TRLA transferred to the Foundation were from fiscal year 1981 and earlier grant awards and, thus, were not subject to later years' restrictions.

The Foundation's fund balance should be considered part of TRLA's

In our opinion, the Foundation is subject to the LSC Act and regulations that govern LSC grant recipients because it is so closely related to TRLA that it lacks a separate identity. As long as the Foundation maintains this close relationship with TRLA, LSC should consider the Foundation's fund balance as part of TRLA's and should apply LSC's fund balance regulation to the programs' combined fund balance.

In December 1980, LSC formalized its policy concerning fund balances accumulated by its grant recipients. The purpose of this policy was to permit grant recipients to maintain "reasonable fund balances" to continue program operations, while insuring that grant recipients spend LSC funds in a timely and effective manner for the delivery of high quality legal assistance to eligible clients. This policy followed an August 1980 GAO report,[6] which indicated that LSC grant recipients had accumulated millions of dollars in unused grant funds. We recommended that LSC monitor the use of funds by its grant recipients to minimize year-end carryover funds and reduce a grantee's subsequent funding to adjust for excessive carryover funds.

LSC's fund balance policy in effect from December 1980 through December 1982 required grant recipients with fund balances in excess of 10 percent of their annualized LSC grant awards to submit a plan for LSC approval for the expenditure of the fund balance. The plan was to indicate how the grant recipient would use its fund balance and include a timetable showing over what period of time the fund balance would be used. According to the policy, noncompliance with the plan could result in an adjustment of funding for the recipient. LSC did not publish this policy in the Federal Register but, rather, communicated it to regional directors in directives.

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[6]"Review of Legal Services Corporation's Activities Concerning Program Evaluation and Expansion" (HRD-80-103, Aug. 28, 1980).

In early 1983, LSC modified its fund balance policy. According to an instruction published in the Federal Register on January 5, 1983, and effective February 4, 1983, in the absence of a waiver from LSC, any fund balance in excess of 10 percent of a grant recipient's LSC support for the grant period in question was to be set off against the recipient's annualized grant award for the next period by pro rata deductions from the remaining monthly allocations to the recipient. The instruction permitted LSC to extend the ceiling to 25 percent if the recipient, among other things, developed a plan for spending the fund balance in either the current or subsequent grant periods.

Effective June 20, 1984, LSC published a regulation stipulating that, absent a waiver from LSC, any fund balance amount exceeding the 10-percent ceiling was to be repaid to LSC in a lump sum or by pro rata deductions from the recipient's grant checks. As in the 1983 instruction, LSC could grant a waiver to extend the ceiling to 25 percent.

In 1982, 1983, and 1984 TRLA's and the Foundation's combined fund balances exceeded 10 percent of TRLA's annualized LSC support. The following table shows the combined TRLA/Foundation fund balances in 1982, 1983, and 1984.

Year	Foundation fund balance	TRLA fund balance	Combined fund balance	Foundation's LSC support	TRLA's LSC support	Combined LSC support	Combined fund balance as a percent of LSC combined support
1982	$742,448	$223,976	$966,424	$ 91,215	$3,721,196	$3,812,411	25
1983	534,472	8,561	543,033	56,565	3,429,091	3,485,656	16
1984	576,016	(7,807)	568,209	106,419	3,711,080	3,817,499	15

Note: The Foundation's fund balance and LSC support totals are for years ended December 31, 1982, 1983, and 1984. The Foundation's LSC support represents the interest income and awards of attorney's fees derived from TRLA's grant to the Foundation. The TRLA figures are as of September 30, 1982, 1983, and 1984. As a result, the combined fund balance and combined LSC support totals are only approximations since adjustments would have to be made to calculate the combined figures for the same year-end dates.

In 1982, if LSC had considered TRLA's and the Foundation's fund balance as a single fund balance, LSC would have required TRLA to develop a plan to spend $585,183, the amount by which the combined fund balance exceeded the 10-percent ceiling. In 1983 and 1984 the combined fund balance exceeded the 10-percent ceiling by $194,467 and $186,459, respectively. Under LSC's fund balance policy effective in 1983 and 1984, LSC would have

been required to either set off these funds against TRLA's annualized grant award for the next period or grant TRLA a waiver of the 10-percent ceiling.

In June 1983 LSC's office of general counsel ruled that the Foundation's fund balance should not be included in TRLA's fund balance because LSC had approved the transfer of funds to the Foundation as part of TRLA's spend-down plan. The ruling was based on a statement attributed to LSC's Denver regional director. In June 1985, however, the Denver regional director told us he never saw a TRLA spend-down plan and did not consider the Foundation's establishment and TRLA's transfer of funds to the Foundation as a method of complying with LSC's fund balance policy. Further, his January 1982 letter to TRLA approving the establishment of and transfer of funds to the Foundation does not mention either LSC's fund balance policy or a TRLA plan for spending its fund balance. Thus, the LSC office of general counsel ruling appears to be based on inaccurate information. Further, the ruling did not address whether the Foundation and TRLA had separate identities. In our view, LSC should consider TRLA and the Foundation as one entity for purposes of the act, and as a result, it should include the Foundation's fund balance in TRLA's.

Effective December 30, 1983, LSC issued a regulation governing the relationships between LSC grant recipients and subrecipients which, had it been in effect at the time of TRLA's agreement with the Foundation, would have enabled LSC to consider their fund balances as one. The regulation stipulates that subgrants may not be for a period longer than 1 year and that all funds remaining at the end of the grant period shall be considered part of the grant recipient's fund balance. However, TRLA's January 1982 agreement with the Foundation predates this regulation and, thus, is not covered by it. Had the regulation been in effect at the time of the agreement between TRLA and the Foundation, the Foundation's entire fund balance would have been considered part of TRLA's fund balance after a maximum time of 1 year. Since this agreement has no time limit, it appears unlikely that these organizations will negotiate further agreements. The regulation should prevent future subgrantees from retaining fund balances for extended periods.

Recommendation to the President of LSC

We recommend that beginning with the fiscal year ending September 30, 1985, the date on which TRLA's current accounting period will end, the President consider TRLA's and the Foundation's combined fund balance as a single fund balance and apply the procedures prescribed in LSC's fund balance regulation.

TRLA's and the Foundation's comments and our evaluation

In a May 29, 1985, letter, the counsel for TRLA and the Foundation provided comments on a draft of this report.[7] (See app. III.) TRLA and the Foundation disagreed with our findings and conclusions. Specifically, they said that our discussion of the reasons the Foundation was established and the relationship between the two organizations was inaccurate and did not consider all relevant facts, and that we did not properly apply the alter ego doctrine or demonstrate that the relationship had resulted in some fraud, wrongdoing, or injustice. As discussed below, we generally disagree with TRLA's and the Foundation's assessment, although we have revised the report to include additional information to clarify our views.

Reasons for establishing the Foundation

TRLA and the Foundation disagreed with our statement that one of the principal reasons for establishing the Foundation was "to make it more difficult for LSC to recover the carryover funds." They said this statement, attributed to TRLA's executive director, was unfair and untrue. According to TRLA, LSC approved the transfer of funds to the Foundation as a legitimate expenditure of carryover funds under the then-existing LSC fund balance policy. As a result, TRLA said that its transfer of funds to the Foundation complied with LSC's policies for expending carryover funds and for satisfying the private attorney involvement requirement and was not intended primarily to make it more difficult for LSC to recover the funds.

TRLA's comments, in our view, reconfirm that a primary reason for establishing the Foundation was to insure that TRLA's fund balance remain in Texas and not be subject to recapture by LSC or result in future reductions in LSC funds provided to TRLA. Further, there is no evidence to substantiate TRLA's contention that its contract with and transfer of funds to the Foundation represented an LSC-approved spend-down plan to expend carryover funds in compliance with the then-existing LSC fund balance policy. Although TRLA says that its fund balance was expended by transferring funds to the Foundation, the transfer does not meet LSC's definition of an expenditure because the expense should be recorded only when the services are

[7]Hereafter we refer to these as TRLA's comments.

delivered, not when a future contract for such services is made. In fact, as of the end of 1984, the Foundation had not yet spent about 41 percent of the funds it initially received from TRLA. As a result, about $300,000 in LSC funds provided to TRLA to deliver legal services in 1981 and previous years had not been spent on eligible clients over 3 years later.

Although TRLA's executive director told us, after commenting on a draft of this report, that the Foundation was not established primarily to make it more difficult for LSC to recover TRLA's fund balance, he acknowledged that TRLA attempted to comply with LSC's then-existing fund balance policy in a manner which would insure that the funds remained in Texas. TRLA's comments also indicate its concern that, had it not expended its carryover funds, it risked a reduction in later years' LSC funding. In our view, TRLA's intent was to insure that its carryover funds be used in such a way that they would not be recovered by LSC.

TRLA indicates that its contract with and transfer of funds to the Foundation were approved by LSC as a legitimate method of reducing its carryover funds in compliance with LSC policies. However, our review of LSC Denver regional office files, Foundation files, TRLA correspondence files, TRLA's board of director minutes at which the Foundation's establishment was discussed, and the LSC Denver regional director's January 1982 letter to TRLA's executive director approving the transfer of funds to the Foundation did not reveal any evidence that LSC or TRLA viewed the transfer of funds to the Foundation as a means of complying with LSC's fund balance policy. Further, an April 1982 memorandum from LSC's Denver regional director to the then-deputy director of LSC's office of field services said the Foundation was established to comply with LSC's private attorney involvement requirement and did not mention LSC's fund balance policy. In July 1985, the regional director told us he did not view the Foundation's establishment as part of a spend-down plan by which TRLA could comply with LSC's fund balance policy.

TRLA indicates that by transferring funds to the Foundation it expended its fund balance pursuant to the LSC fund balance policy in existence when the transfer was made in January 1982. TRLA's executive director told us that he assumed LSC approved this method of expending TRLA's fund balance since LSC no longer inquired about TRLA's fund balance after the funds were transferred off TRLA's books to the Foundation.

TRLA's view is inconsistent with LSC's then-existing fund balance policy, LSC's definition of an expenditure, and the

manner in which TRLA later applied the Foundation's funds for purposes of complying with LSC's private attorney involvement requirement. Although TRLA contends that its fund balance has been expended, about $300,000 of the fund balance had not yet been spent on providing legal services to eligible clients as of the end of calendar year 1984.

The LSC fund balance policy in effect at the time TRLA established the Foundation required grant recipients with fund balances above a specified level to submit plans for spending the fund balance, including a timetable for the expenditures. As discussed, we found no evidence that TRLA's transfer of funds to the Foundation was considered by LSC as a spend-down plan, and TRLA's contract with the Foundation did not establish a timetable for spending the transferred funds.

According to LSC's audit department, generally accepted accounting principles applicable to LSC grant recipients require that expenses be recorded only when services are delivered, not when a contract for future services is made. Had TRLA applied this principle, it would have been justified in recording as expenditures only those funds the Foundation used to provide legal services.

Although TRLA claims the $736,048 transferred to the Foundation was expended at the time of the transfer, it did not credit the entire amount toward its private attorney involvement requirement at the time of the transfer. Instead, TRLA credited Foundation expenses toward TRLA's private attorney involvement requirement only as they were incurred. As a result, in 1982, TRLA applied Foundation expenses of $84,638 toward its private attorney involvement requirement, rather than the entire $736,048 transferred to the Foundation.

While TRLA contends that its fund balance was expended when it transferred $736,048 to the Foundation in December 1981, about 41 percent of the funds initially transferred had not been spent on providing legal services to eligible clients 3 years later. As of December 31, 1984, the Foundation had spent $433,748 (about 59 percent) of the $736,048 it received from TRLA in 1982, leaving $302,300 (about 41 percent) unspent on delivering legal services. Since its establishment, the Foundation has also earned $197,325 in interest income on the unspent portion of the funds it received from TRLA. Thus, 3 years after its establishment, the Foundation had almost $500,000 in unspent LSC funds and interest earned on these funds that had not been spent on providing legal services to eligible clients.

Although TRLA stated that it established the Foundation to comply with LSC's private attorney involvement requirement and fund balance policy, its executive director acknowledged that TRLA could have complied with the private attorney involvement requirement without establishing an alternative corporation. However, without setting up such a corporation, TRLA would have had to develop another method of spending its fund balance or risk having LSC attempt to recapture TRLA's fund balance or reduce TRLA's future grant awards. Thus, the primary effect of establishing the Foundation has been that the Foundation's fund balance has not been included in TRLA's and, as a result, has not been subject to LSC's fund balance policy.

TRLA's and the Foundation's close relationship

TRLA disagreed with our conclusion that it was so closely related to the Foundation that the two organizations could be considered a single entity for purposes of compliance with the LSC Act and identified certain facts it believed contradicted our conclusion.

While the Foundation and TRLA maintain separate boards of directors and financial records and have their own federal tax exemptions under section 501(c)(3) of the Internal Revenue Code, many factors lead us to conclude that TRLA and the Foundation are so closely related that they should be considered a single entity for purposes of compliance with the LSC Act. The Foundation was incorporated by TRLA's executive director, director of administration, and then-president of the board of directors. While the two corporations have separate boards of directors, the Foundation board does not decide which cases the Foundation funds. Instead, these decisions are made by a three-person administrative committee, of which TRLA's executive director, who is also the Foundation's president, is a member. Further, the agreement between TRLA and the Foundation prohibits the Foundation from changing its articles of incorporation, bylaws, or tax exempt status to alter or affect its use of transferred funds without prior written approval from TRLA.

TRLA's statement that it does not share common management with the Foundation but is managed by a separate board of directors needs to be considered in context with other information on how the two corporations operate. While each board of directors is responsible for its corporation's management and control, the Foundation's board, which meets only

once a year, delegated responsibility for its day-to-day operations to the Foundation's president, who is also TRLA's executive director. As discussed on page 11, the three other individuals involved in conducting the Foundation's day-to-day activities are also TRLA staff.

TRLA's statement that the corporations do not have common staff since the Foundation has no actual staff is incorrect. Although the Foundation has no full-time paid staff, its operations are conducted by one part-time paid staff member and three other unpaid or volunteer staff, all of whom are TRLA employees. TRLA's executive director volunteers his time to act as the Foundation's president. The TRLA executive director's secretary received $1,200 per year from the Foundation for part-time secretarial services, and TRLA's senior accountant maintained the Foundation's bookkeeping records. Also, TRLA's director of administration, who served as the Foundation's treasurer, was responsible for investing Foundation funds and coordinating the Foundation's annual board meetings.

TRLA states that the two corporations do not have common facilities because the Foundation has no real space needs. Although its space needs may be limited, the Foundation's day-to-day business is conducted in TRLA's facilities because that is where the TRLA employees who make up the Foundation staff are located. The Foundation's records are also maintained in TRLA's headquarters.

In response to our discussion of TRLA's and the Foundation's common staffs, management, and facilities, TRLA said that it would be a waste of funds for the Foundation to have its own full-time paid staff and facilities.

We do not suggest that the Foundation take such action. Rather, our evaluation of the relationship between the corporations was intended to identify the extent of the relationship. As discussed on pages 9 and 10, in our view, the corporations have such a close relationship that they could be considered a single entity for purposes of compliance with the LSC Act. The corporations' close relationship is also illustrated by reviewing the cases the Foundation has funded. At the time of our work at TRLA in July and August 1984, the Foundation had funded 70 cases. TRLA had previously funded 36 of these cases and later transferred them to the Foundation. As discussed on page 12, in 1984 the Foundation transferred 34 cases to TRLA so TRLA could credit the amount it spends on these cases toward its private attorney involvement requirement.

TRLA's contention that the Foundation's purpose and operations are totally different and distinct from TRLA's is inconsistent with its description of the reasons the Foundation was established. According to TRLA's executive director, the Foundation was established to satisfy TRLA objectives--that is, LSC's fund balance and private attorney involvement requirements.

TRLA also stated that the Foundation was supposed to maintain a close relationship with TRLA and has done exactly that. We agree. The manner in which TRLA and the Foundation have exchanged cases and the discussion above illustrates the corporations' close relationship.

Application of the alter ego doctrine

TRLA stated that we incorrectly applied the legal doctrine of alter ego to the relationship between TRLA and the Foundation. According to TRLA, the cases we cited in the report do not support application of the alter ego doctrine. TRLA said that two essential elements must exist in order to apply the alter ego doctrine--control of one corporation over the other and fraud, wrongdoing, or injustice. TRLA said we did not demonstrate either of these elements.

On page 10, we state that the alter ego doctrine is not directly applicable to the Foundation's relationship with TRLA. However, using its authority under section 1007(d) of the LSC Act to monitor programs and ensure compliance with the act, LSC can use the factors set forth in the doctrine to determine if the corporations are separate for purposes of compliance with the act. Using these factors, we believe that LSC should prospectively consider the corporations as a single entity for purposes of compliance with the act and regulations.

SCC AND LAA SHOULD BE CONSIDERED A SINGLE ENTITY FOR PURPOSES OF THE LSC ACT

Since SCC's establishment, SCC and LAA have maintained such a close relationship that, in our view, the corporations have a single identity for purposes of compliance with the LSC Act. Although SCC and LAA maintain separate financial recordkeeping systems, which the former LSC Boston regional director said was the LSC audit department's minimum acceptable technical level of independence between SCC and LAA, in our view, agreements between the corporations have been negotiated on a less than arm's length basis. Since early 1982, SCC has paid most of its LSC grant to LAA to handle cases and for miscellaneous expenses. Further, the corporations have interlocking boards of directors and share the same executive director and other staff.

According to an October 13, 1982, LSC monitoring report on SCC, the LSC Boston regional director at that time was concerned about the lack of separation between the two corporations. The report stated that

> "When demarcation lines [between SCC and LAA] are blurred, it is not accidentally so. Both SCC and LAA are attempting to coordinate their activities as closely as possible, as efficiently as possible, and as economically as possible. The question that is raised, however, is whether the coordination is so fine that the organizations cannot claim the advantage of being separate legal entities."

Negotiations between SCC and LAA are not arm's length

Since February 1982, LAA and SCC have entered into a series of agreements stipulating that SCC refer eligible clients to LAA and pay LAA to provide legal services to these clients. SCC currently pays LAA $180 per case, which, according to SCC's executive director, is a negotiated rate between the two corporations. In our view, however, the negotiations do not constitute an arm's length transaction because the agreement was prepared by the joint executive director and approved by interlocking boards of directors.

Effective February 1, 1982, SCC and LAA entered into an agreement which provided that SCC would refer LSC-eligible clients to LAA to provide legal services. According to the agreement, which lasted from February 1 through April 30, 1982,

SCC was to pay LAA $250 to complete each of LAA's 350 pending LSC-eligible cases, or a total of $87,500. The agreement also provided that SCC would pay LAA $400 for each new LSC-eligible case referred. According to SCC's executive director, the $400 rate was based on a report prepared by the four Connecticut legal services programs on legal services funded by title XX of the Social Security Act. The agreement has since been amended four times; the rate per case for the period November 1, 1984, through October 30, 1985, is $180. LSC has approved the agreements.

No documentation exists showing how LAA and SCC computed the average cost of handling cases referred by SCC. However, SCC's executive director said that the title XX study discussed above and a 1983 South Central Connecticut Agency on Aging study showing a $180 average cost per case for services provided to the elderly serve as guides SCC and LAA can use to negotiate a per case rate.

He said that the corporations generally arrived at the per case rate in the following manner. First, SCC projects its income and expenses for the coming year based on its anticipated annual basic field grant from LSC. SCC's estimated expenses are subtracted from the basic field grant, and whatever remains is allocated to LAA for contract services. According to the executive director, based on experience, the two programs know about how many cases LAA can handle on referral from SCC. Once SCC and LAA know the amount available for contract services and the number of cases LAA can handle, they can determine the per case rate.

According to the executive director, however, the rate on which LAA and SCC agree allows LAA to accept more cases from SCC than for which SCC is actually billed. He said this ensures that SCC does not pay for cases for which LSC funds may not be used. For example, during 1983 LAA accepted 2,271 cases from SCC but billed SCC for only 1,558. If LSC finds that SCC has referred an ineligible client to LAA, SCC is able to claim that it did not pay LAA to handle that case.

LAA bills SCC monthly for cases transferred from SCC. According to SCC's executive director and controller, while the number of cases for which LAA bills SCC versus the number of cases actually referred to LAA is somewhat arbitrary, SCC's objective is to evenly pace its payments to LAA throughout the year. According to SCC's controller, sound accounting practices suggest that income and expenses be accounted for evenly

throughout the accounting period. SCC is also limited in the number of cases it can pay LAA to handle by the amount of money SCC has on hand.

The executive director prepares the SCC/LAA agreement and presents it to the SCC and LAA boards of directors for their approval. The executive director stated that the boards have requested changes in the agreements, although not in the per case rate.

In our view, due to the interlocking boards of directors and shared executive director, the agreement between SCC and LAA constitutes a less than arm's length transaction. However, we found no evidence that the agreement between SCC and LAA unfairly favored the interests of one corporation over the other or that transferred funds were used for ineligible clients or restricted activities.

SCC's executive director believes that the procedure for approving the SCC/LAA agreement constitutes an arms's length transaction since both boards must approve the agreement. However, at three of the five SCC board meetings at which the agreements were approved, board members who sit on both the SCC and LAA boards accounted for all of the directors present. At the two remaining meetings, common board members accounted for seven of the eight members present.

SCC has paid most of its LSC grant to LAA

From its establishment in January 1982 through July 1984, SCC has paid LAA $872,890, or 70 percent of its LSC basic field grant money. Ninety-three percent of the payments, or $809,700, have been for the direct delivery of legal services to clients SCC determined were eligible for LSC-funded services. The other 7 percent of the transferred funds, or $63,190, represent SCC's monthly payments to LAA for space rental and other miscellaneous expenses. A breakdown of SCC's payments to LAA through July 1984 follows.

Payments from SCC to LAA
(Jan. 1, 1982-July 31, 1984)

	SCC's basic field grant	SCC's payment to LAA for cases	SCC's other monthly payments to LAA	SCC's total payments to LAA
		(As a percentage of SCC's basic field grant)		
1982	$ 474,219	$335,800 (71)	$28,860 (6)	$364,660 (77)
1983	472,331	288,680 (61)	20,890 (4)	309,570 (66)[a]
1984[b]	306,393	185,220 (60)	13,440 (4)	198,660 (65)[a]
Total	$1,252,943	$809,700 (65)	$63,190 (5)	$872,890 (70)

[a]Totals may not add due to rounding.

[b]1984 figures are for the period from January 1 through July 31.

The two corporations have interlocking boards of directors

Since SCC's establishment in December 1981, at least two-thirds of the members of SCC's board of directors have simultaneously sat on LAA's board of directors. SCC board meetings have been attended predominantly by individuals who also sit on LAA's board, and 13 of SCC's 17 board meetings have been held jointly with LAA board meetings. (We were unable to determine if one SCC board meeting was held jointly with LAA.)

SCC's initial board consisted of 10 persons, all of whom belonged to the LAA board. As of October 1, 1984, 10 of SCC's 15 board members also sat on the LAA board. At each of the SCC board's 17 meetings through October 1984, at least 75 percent of the directors in attendance were joint SCC/LAA board members. At nine SCC board meetings, 100 percent of the members present were also LAA board members.

In his October 1982 monitoring report, the then-director of LSC's Boston regional office expressed concern about the interlocking boards of directors.

> "Even though neither board appoints members to the other-rather, outside entities do all appointing, thereby removing the possibility of control of one by the other-excessive overlap weakens the arms-length relationship that is needed."

The monitoring report urged that SCC modify its bylaws by setting a ceiling on the number of common board members permitted. However, SCC's bylaws have not been revised. SCC's bylaws, which set forth the procedures for appointing board members, require board members to be appointed by third parties, such as bar associations.

SCC and LAA share staff and facilities

As of February 26, 1985, 11 of SCC's 17 employees worked part-time for SCC and part-time for LAA. According to SCC's controller, seven employees--the executive director, the controller, a bookkeeper, a statistical clerk, an administrative assistant, and two receptionists--received 40 percent of their salary from SCC and 60 percent from LAA. SCC and LAA arrived at the 40-60 salary split because historically about 60 percent of LAA's income came from non-LSC sources.

SCC had two part-time managing attorneys who supervised the screeners, or intake clerks. One managing attorney received 25 percent of her salary from SCC and 75 percent from LAA, and the other received half his salary from SCC and half from LAA. LAA's litigation director received 12.5 percent of his salary from SCC, and an LAA staff attorney received 25 percent of his salary from SCC.

In addition to having interlocking boards of directors and shared staff, SCC and LAA had other sharing arrangements. The corporations shared office space and telephones. At the time of our fieldwork, LAA provided space to SCC at $3.75 per square foot, the same rate that LAA paid the owner of the building. SCC did not pay LAA for the use of its telephones, since they were provided free of charge by the City of New Haven.

At the time of our fieldwork, SCC and LAA shared an office building in New Haven. Since we completed our fieldwork, the corporations have moved to new offices where LAA and SCC continue to share space.

The two corporations have jointly entered into a collective bargaining agreement with the Legal Workers Union of New Haven. A joint SCC/LAA pension plan was terminated, effective January 1, 1984, when SCC and LAA employees were absorbed into the social security system.

LAA has engaged in LSC-restricted activities

Because SCC's corporate identity cannot be separated from LAA's, we believe LSC should consider LAA as subject to the same restrictions as other LSC grant recipients. As discussed on page 7, section 1010(c) of the LSC Act allows grant recipients to spend public funds for the purposes for which they are provided but prohibits the expenditure of private funds for purposes prohibited by the act. Accordingly, we believe LSC should prohibit LAA from using private funds for purposes prohibited under the act.

According to SCC's executive director and controller, since establishing SCC as the new LSC grant recipient in 1982, LAA has used at least $6,563 in private funds for activities in which it could not have engaged had it remained the LSC grant recipient. For example, LAA has used grants from a private organization to organize nursing home residency councils. The LSC Act's restriction on forming organizations prohibits LSC grant recipients from engaging in these activities. In addition, the provider of these funds did not require that only LSC-eligible clients be served with these funds.

LAA has engaged in other activities which, according to SCC's executive director, LSC grant recipients may be restricted from performing. LAA has used $10,000 in private funds to establish an adolescent pregnancy project. The services supported by these funds were not based on financial eligibility as are LSC-funded legal services.

In our view, SCC and LAA are so closely related that, for purposes of compliance with the LSC Act, the two corporations' corporate identities cannot be separated. As a result, LSC should consider these organizations as one and subject LAA to the same restrictions as SCC, including section 1010(c) of the LSC Act.

Recommendation to the President of LSC

We recommend that the President require SCC and LAA to include in their next agreement a provision prohibiting LAA from using private funds for activities restricted by the LSC Act. The current agreement between SCC and LAA for the provision of services expires October 30, 1985.

SCC's and LAA's comments
and our evaluation

In letters dated April 25 and May 30, 1985, the current SCC and LAA executive director[8] and LAA's former executive director (Congressman Bruce A. Morrison), who was responsible for SCC's establishment, respectively, provided comments on a draft of this report. (See apps. IV and V.) They stated that our conclusion that LSC can apply the principles of the alter ego doctrine to relationships between LSC grant recipients and subrecipients under its oversight authority in section 1007(d) of the LSC Act created a new legal standard not authorized by the act for determining if two corporations can be considered a single entity. They also said that our conclusion that LAA used private funds for restricted activities was either not supported by the facts set forth in the report or was based on incorrect facts. As discussed below, we generally disagree with these comments, although we have revised the report to recognize information the current executive director provided us after receiving our draft report.

Creating a new legal standard

SCC and the former executive director said we created a new legal standard for distinguishing between subgrantees that are legitimate private corporations and those with so close an identity with a grantee that they should be subject to the same restrictions as grantees. They stated that the LSC Act does not contain authority for this distinction.

We have not established a new legal standard regarding relationships between recipients and subrecipients; rather, we state that LSC may use its authority under section 1007(d) of the LSC Act to apply the principles of the already existing alter ego doctrine, such as interlocking directorates and shared personnel and facilities, as guidance in determining whether the organizations are truly separate. Section 1007(d) of the LSC Act gives LSC authority to monitor programs and ensure compliance with the act. Upon determining that the organizations are not separate and that creating the alternative corporation has allowed the grant recipient to circumvent provisions of the act, LSC can initiate corrective action under its subgrant regulation. This may include disapproving the subgrant agreement until certain organizational changes are made.

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[8]Hereafter, we refer to the current SCC and LAA executive director's comments as SCC's comments.

The former executive director said, and we agree, that LSC has the authority to track LSC funds to ensure they are not used for purposes prohibited by the statute. However, SCC and the former executive director said that section 1007(d) of the LSC Act makes no reference to subgrantees. The former executive director stated that the legislative intent of section 1007(d) was to provide for independent evaluation of recipients as distinct from monitoring and evaluation by LSC.

We disagree. In our view, LSC's oversight authority under section 1007(d) includes grant agreements with subrecipients by empowering LSC to "monitor and evaluate . . . programs supported <u>in whole or in part</u> under (the act) to insure that the provisions of (the act) and . . . regulations . . . are carried out." (Emphasis added.) The legislative history makes no mention of "recipients," but, instead, refers to "programs." According to the House-Senate Conference report (H. Rep. No. 93-1039, May 13, 1974, p. 28), the original House bill and Senate amendment both empowered LSC to monitor and evaluate <u>programs</u> to insure that the act's requirements were carried out. In addition, the Senate amendment required LSC to provide for independent evaluations of <u>programs</u> to ensure compliance with the law.

In addition, SCC said LSC cannot make grant conditions without authority. As support, SCC cited <u>National Senior Citizens Law Center</u> v. <u>Legal Services Corporation</u>, 581 F. Supp. 1362 (D.D.C. 1984). In the case cited by SCC, the court granted an injunction against LSC enforcing regulations that had not been promulgated with an opportunity for public notice and comment. As previously stated, we are not recommending that LSC promulgate new regulations but, rather, that it should consider the grantee and subgrantee as a single entity for purposes of the act, utilizing the principles of the alter ego doctrine as guidance.

<u>SCC's and LAA's close relationship</u>

SCC said we did not adequately develop how the alter ego doctrine is applied to determine whether two corporations can be considered as a single entity and that we did not apply relevant factors to the LSC recipient and subrecipient in Connecticut.

We disagree. On page 10, we stated that we did not apply the alter ego doctrine; however, the criteria in the doctrine may be used to demonstrate an identity of interests. Pages 22 to 26 describe the close relationship between SCC and LAA and the factors that lead us to conclude that the two corporations are so closely related that they may be considered a single entity for purposes of compliance with the LSC Act.

<u>LAA's use of private funds for restricted activities</u>

LAA's former executive director said that our statement that LAA used private funds to engage in prohibited activities was not supported by the facts set forth in the draft report. SCC said that the grants of private funds to LAA either were used to provide proper services to eligible clients or were made in conjunction with grants of public funds. According to both the former executive director and SCC, private grants made in conjunction with public funds should be treated as public funds.

Since receiving our draft report, the executive director has reviewed the activities supported by two grants of private funds and told us these grants were used to support LSC-eligible clients and activities. We have not verified these statements.

In one instance, at the time we made our review of SCC and LAA, the executive director told us that private funds LAA received to handle employment and housing discrimination cases may have been used to serve clients who were financially ineligible for LSC services. SCC's executive director told us that he has since determined that these funds were used to serve only LSC-eligible clients.

In the other instance, the executive director originally told us LAA used private funds for tenant organizing activities that were restricted by the LSC Act. After reviewing these activities, he determined that LAA used the funds to provide legal assistance activities to eligible clients in accordance with the act.

The current and former executive directors stated that private funds that are used to match public funds should be treated as public funds. Treating the funds as public funds, as opposed to private funds, would remove restrictions imposed by the LSC Act on how the funds could be used. As an example, SCC cited LAA's grant from a private organization to organize nursing home residency councils. SCC's executive director said the activities supported by these funds were permissible because the funds were used in conjunction with funds from a public agency. However, the current and former executive directors were unable to cite any authority, including the LSC Act, that permits legal services programs to treat private funds, even if used in conjunction with public funds, as public funds. We are also unaware of any such authority.

Regulations needed before recommendation can be implemented

LAA's former executive director stated that our recommendation that LSC require SCC and LAA to include in their next agreement a provision restricting LAA from using private funds for prohibited activities is inappropriate because LSC has not promulgated regulations on how grant recipients and subrecipients should establish separate identities. He said that since SCC and LAA have acted in good faith and with LSC's approval, no sanction should be imposed upon them.

We believe the recommendation concerning SCC and LAA sets forth a practical and appropriate method for LSC to ensure compliance with the LSC Act's restriction on the use of private funds. LSC's subgrant regulation, effective December 30, 1983, was intended to ensure that funds transferred from grant recipients to subgrantees were spent in accordance with the LSC Act. The regulation provides that LSC shall approve, disapprove, or suggest modifications to subgrants. Subgrants which are disapproved or to which modifications are suggested may be resubmitted for approval. At the time LSC suggests a modification to the SCC/LAA subgrant agreement, the corporations will have the opportunity to either accept the modification or alter their relationship to satisfy LSC that they no longer share an identity of interests. In 1984, LSC exercised this authority by suggesting modifications to the SCC/LAA subgrant agreement, which SCC and LAA later accepted.

The recommendation does not impose a sanction on SCC and LAA in that it does not suggest that LSC attempt to recover any funds spent improperly in the past. Instead, we have recommended that LSC require any future SCC/LAA agreements to contain a restriction on how private funds can be used.

Establishing alternative corporations is legal

The former executive director said our report should contain a specific finding that creating alternative corporations did not violate the LSC Act or regulations. He said SCC was not created to circumvent the law but, rather, to segregate LSC funds to ensure they were spent in compliance with the LSC Act and to maintain LAA's ability to comply with the requirements of other funding sources and its own charter. He added that LSC has approved the agreements between SCC and LAA.

In the draft report provided to SCC, we stated that the LSC Act does not prohibit LSC-funded programs from establishing and transferring funds to alternative corporations provided that transferred funds are used in accordance with the LSC Act and regulations. However, as discussed on pages 9 and 10, when a recipient and subrecipient maintain an identity of interests, such as that in Connecticut, we believe the subrecipient is subject to the same restrictions in the LSC Act as is the grant recipient.

Although the former executive director said that SCC was not created to circumvent restrictions, a memorandum he wrote to the LSC Boston regional office on December 23, 1981, suggested that the reason for establishing SCC was that LAA did not want to be subject to the proposed sole purpose restriction, which would have limited the activities in which LAA could engage. To continue providing the full range of services it had always provided, including those that the proposed sole purpose restriction might limit, the LAA board chose to relinquish its role as the LSC grant recipient and establish SCC as the new recipient.

While the former executive director stated that SCC was "created . . . to maintain LAA's ability to comply with the demands of other funding sources . . . and its own charter," LAA was never prevented from engaging in activities in which it had historically engaged, such as providing representation in criminal matters, because the sole purpose restriction never became law.

In his comments, the former executive director said that "SCC was created to segregate LSC funds in order to ensure that they were provided in a manner fully consistent and in compliance with the LSC Act . . ." However, the act and LSC audit guide required separate reporting of grants and contracts even before SCC was established. As a result, LAA did not need to establish a separate corporation to segregate its LSC funds.

In our view, the primary effect of SCC's establishment has been to allow LAA to engage in activities that, according to SCC's executive director, may have been prohibited had it remained the grant recipient.

Per case rate

According to SCC, we incorrectly stated that no documentation exists showing how LAA and SCC compute the average cost of handling cases referred by SCC. SCC said the $400 per case figure used in the initial SCC/LAA agreement was based on

what the state of Connecticut paid Connecticut legal services programs to provide legal services in 1981. SCC also said a 1983 LAA time study performed for the South Central Connecticut Agency on Aging showed that the $180 per case was an appropriate rate.

Although we have revised the report to indicate that the initial per case cost between SCC and LAA was based on a report on legal services supported by title XX of the Social Security Act prepared by the four Connecticut legal services programs, SCC has not provided us with any documentation showing how SCC and LAA computed the average cost of cases referred.

After SCC submitted its comments on this report, SCC's executive director told us that to place the SCC/LAA per case rate in context we should note that the title XX and South Central Connecticut Agency on Aging studies provided per case rates SCC and LAA could use as a guide to determine the per case rate in their agreement. We did not compare the services provided with these grants to those funded by LSC to determine if the services were comparable.

According to SCC, the $180 per case rate is favorable to SCC, is sufficiently low to constitute economical service, and is evidence that LSC funds were expended in a manner as to maximize services for minimal cost. However, SCC did not provide us with any evidence to substantiate this point.

After-the-fact accounting

SCC disagreed with our statement that it follows an after-the-fact accounting arrangement to ensure that LSC funds are not used to serve ineligible clients. The executive director said that when an applicant applies for assistance at SCC, SCC screeners and an SCC managing attorney determine whether the applicant is eligible for SCC. If so, and if the case is within SCC priorities, the matter is referred to LAA. SCC pays for the referral at the per case rate. He said that ineligible applicants may be referred to LAA but are not paid for with LSC funds and are not claimed for LSC statistical purposes.

As indicated on page 24, we found no evidence that SCC used LSC funds to pay for services provided to ineligible clients referred to LAA. However, the executive director's description of SCC's application and intake procedures should be considered in context with two other facts. First, the number of clients SCC determines to be eligible and refers to LAA is greater than

the number it pays LAA to represent. Second, LAA does not identify the specific cases for which it bills SCC. For example, as discussed on page 23, during 1983 SCC referred 2,271 cases to LAA that SCC had determined were SCC eligible but was only billed for 1,558 cases. SCC could not identify which of the 2,271 cases it paid for and which it did not pay for. We continue to believe that SCC's referral and billing procedures provided insufficient documentation to identify which clients received LSC-funded services.

Time studies

SCC stated that our final report should reflect the fact that SCC provided us with time studies for the LAA litigation director and a staff attorney that were the basis for determining how their salaries would be divided between SCC and LAA. According to SCC, by attributing the information to SCC's controller instead of presenting it as substantiated fact, the report carries a tone of partiality and places credibility in question.

At the time we sent our draft report to SCC and LAA, we were not provided the time studies to which SCC refers. SCC later provided us with a memorandum from LAA's litigation director in which the litigation director estimated he spent 5 hours per week on SCC activities. SCC also provided us with a time study it said was used to determine the appropriate salary split for the staff attorney. Although the staff attorney received 25 percent of his salary from SCC and 75 percent from LAA, the time study indicates that nearly one-third of the staff attorney's time was spent on SCC activities.

In our view, the important point is that the corporations share staff who receive their salaries from both SCC and LAA, not how the salary splits were determined.

Interlocking boards of directors

With regard to our statement that SCC and LAA have interlocking boards of directors, SCC stated that SCC's and LAA's bylaws, which determine the manner in which members of the SCC and LAA boards of directors are appointed, do not provide SCC or LAA control over appointments to their boards of directors.

While we agree that the bylaws, which set forth procedures for appointing board members, do not give SCC and LAA control over which members are appointed to their respective boards, the

executive director has written letters to certain groups recommending that the groups reappoint specific individuals to the SCC board. These individuals also sat on the LAA board. In addition, as we point out on pages 25 and 26, the SCC board has not adopted the 1982 recommendation of LSC's then Boston regional director that SCC revise its bylaws to limit the number of common board members. This recommendation was based on the regional director's concern that excessive overlap of the boards of directors weakens the arm's length relationship between the two corporations.

PINE TREE AND DOWNEAST FUNCTION INDEPENDENTLY

Pine Tree and Downeast are distinct corporations and maintain separate accounting systems, staff, officers, and board members. Other than the original agreement between the two corporations, by which Pine Tree agreed to pay Downeast a fixed fee to complete ongoing cases, Pine Tree has not paid Downeast to handle additional cases. Downeast rented office space and equipment from Pine Tree for about 3 years, but all rental agreements were terminated by the end of 1984.

According to Downeast's president, there is little difference between Downeast's relationship with Pine Tree and its relationship with other law firms. However, Pine Tree may be more likely to consult with Downeast than with some other firms, because of Downeast's areas of expertise and its proximity to Pine Tree in some locations. According to Pine Tree's executive director, Pine Tree is no more likely to refer clients for legal representation to Downeast than to other law firms.

Downeast represents low-income clients

Downeast is incorporated as a Maine professional corporation. Since its inception in July 1981, Downeast has handled low-income clients. According to Downeast's articles of incorporation, "The Corporation shall endeavor to the extent fiscally possible to represent indigent persons in matters of particular and peculiar importance to low income persons in the State of Maine."

According to Downeast's president, the only operational difference between Downeast and other private law firms is that Downeast employees do not have an equity interest in the corporation that they can retain. Downeast can issue up to 20 shares of nontransferrable stock to its employees, but the

employees relinquish the shares when they leave Downeast. Each employee is limited to holding one share.

Downeast's president estimated that 50 to 75 percent of Downeast's work is spent on behalf of clients who would meet LSC's income eligibility guidelines or come close to meeting them. Poor clients are either accepted on a pro bono basis or are charged reduced rates. According to its president, Downeast charges about the same as other law firms for lengthy litigation; however, Downeast is relatively less expensive for cases involving divorces, criminal activities, bankruptcies, and wills. Downeast also handles cases involving court-appointed custody, child support, workers' compensation, government benefits, personal injury, evictions, and commitment hearings for the mentally ill.

Downeast's commitment to provide pro bono services

Downeast has fulfilled its obligation to provide pro bono (free) services, as required in its agreement with Pine Tree. The agreement stipulated that for each of its attorneys and paralegals, Downeast would dedicate a minimum average of 10 pro bono hours per month from January 1, 1982, through December 31, 1983, to LSC-eligible clients. The agreement also provided that, in the event that Downeast received an award or settlement of attorney's fees on a transferred case, Downeast would either reimburse Pine Tree in cash for time spent while the Downeast attorney was a Pine Tree employee or increase its commitment of pro bono services to Pine Tree.

According to records Downeast submitted to Pine Tree, Downeast incurred a total pro bono commitment of 2,389 hours. As of June 30, 1984, Downeast had provided 2,394 hours of pro bono service, thus fulfilling its pro bono commitment to Pine Tree.

Downeast employees earned $16,889 in attorneys' fees on transferred cases for time spent on the cases while employed by Pine Tree. Of the $16,889 in attorneys' fees, Downeast has elected to keep $15,708. In lieu of reimbursing these funds, Downeast increased its pro bono commitment to Pine Tree.

Downeast has paid Pine Tree for miscellaneous services and expenses

Between July 1, 1981, and September 30, 1984, Downeast paid Pine Tree $74,147 for miscellaneous services and expenses.

About 72 percent of this money was for office space, equipment rental and repair, and library use. The following table summarizes the payments from Downeast to Pine Tree.

Payments from
Downeast to Pine Tree
(July 1, 1981 - Sept. 30, 1984)

	July 1- Dec. 31, 1981	1982	1983	Jan. 1- Sept. 30, 1984	Total
Office space	$ 4,873[a]	$10,152	$ 9,252	$ 6,641	$30,918
Equipment rental and repair and library use	0	9,636	7,873	5,302	22,811
Administrative services	5,000	0	0	0	5,000
Half-time secretarial services	4,979	0	0	0	4,979
Photocopying	370	840	627	395	2,231
Postage	1,109	2,386	2,163	1,168	6,825
Property tax	0	533	850	0	1,384
Total	$16,331	$23,547	$20,764	$13,505	$74,147

[a]This amount includes payment for rental of office space and use of equipment.

Pine Tree initially rented office space and equipment to Downeast in four locations throughout the state, although the two corporations maintained separate entrances and phone numbers. One Downeast office terminated its lease with Pine Tree in 1983, another did so in September 1984, and the other two did so by November 1984. Pine Tree removed the option to renew these leases from its 1984 lease agreement with Downeast because, according to Pine Tree's program administrator, these sharing arrangements were difficult to monitor and billing and collection was an administrative burden.

The initial contract between Pine Tree and Downeast stipulated that Pine Tree would provide administrative and half-time secretarial services to Downeast for 5 months. Upon expiration, the contract was not renewed. Downeast's reimbursement to Pine Tree for photocopying and postage also ended by the end of 1984.

Pine Tree's and Downeast's comments

In a letter dated June 18, 1985, Pine Tree's executive director said he did not have any substantive comments on our draft report. (See app. VI.)

In a May 2, 1985, letter, Downeast's president said he was satisfied with the report as it related to Downeast. (See app. VII.)

LSC'S COMMENTS

In a June 5, 1985, letter, LSC said it accepted our findings and conclusions and indicated that it would implement our recommendations. (See app. VIII.)

OBJECTIVES, SCOPE, AND METHODOLOGY

To assess whether selected LSC grant recipients established alternative corporations to avoid restrictions placed on grant recipients, we directed our review toward determining

--how and why selected LSC grant recipients established alternative corporations,

--whether the establishment of alternative corporations complied with the LSC Act and regulations, and

--whether the LSC grant recipients and alternative corporations have maintained such close relationships through, for example, shared staff and facilities, that the corporations can be considered single entities for purposes of compliance with the LSC Act.

We did not determine how many alternative corporations had been established nationwide or whether the corporations we reviewed were typical of others created by LSC grant recipients in 1981 and 1982.

The programs and alternative corporations we reviewed as requested by Senators Hatch and Denton were Texas Rural Legal Aid, Inc., and the Texas Rural Legal Foundation, Inc.; the South Central Connecticut Legal Services Corporation and New Haven Legal Assistance Association, Inc.; and Pine Tree Legal Assistance, Inc., and Downeast Law Offices in Maine. Our audit work was conducted at these programs between July and October 1984.

We reviewed the LSC Act and regulations to determine if the establishment of alternative corporations complied with the law. We interviewed the former director of LSC's office of field services about current regulations governing transfers of funds from LSC grant recipients to subrecipients and audit division senior officials about LSC's fund balance policy. We also interviewed LSC's former Boston and Denver regional directors about their roles in the establishment of alternative corporations.

We interviewed officials at each of the programs to determine how and why the alternative corporations were established and whether the grant recipients and alternative corporations maintain continuing relationships.

At each of the three programs, we reviewed (1) documents concerning the establishment of the alternative corporations, including correspondence between LSC regional offices and grant recipients; (2) all contracts between the grant recipients and alternative corporations and information relating to how the programs have implemented the contracts; (3) financial records on transfers of funds between the programs; (4) other documents, such as policy statements, board minutes, and staff rosters, pertaining to the current relationships between the grant recipients and alternative corporations; and (5) information relating to cases handled by the alternative corporations. In Texas we examined all of the Foundation's case files, in Connecticut we reviewed case logs to determine how cases transferred from SCC to LAA were closed, and in Maine we reviewed records indicating how much time Downeast employees spent on cases transferred from Pine Tree.

Our review was conducted in accordance with generally accepted government audit standards.

BOASBERG, KLORES, FELDESMAN & TUCKER
ATTORNEYS AT LAW
2101 L STREET, N.W.
WASHINGTON, D.C. 20037
(202) 466-8960

TERSH BOASBERG
NOEL H. KLORES
JAMES L. FELDESMAN*
MARNA S. TUCKER
ANN STEINBERG*
JACQUELINE C. LEIFER
EUGENE R. FIDELL
RITA M. BANK
CARREN S. OLER*
MARY S. PENCE*
YVONNE M. HUNOLD
*ALSO ADMITTED IN MARYLAND

OF COUNSEL
JOHN J. COHRSSEN

MARYLAND OFFICE
200 A MONROE STREET
SUITE 325
ROCKVILLE, MARYLAND 20850
(301) 279-6770

May 29, 1985

Mr. Richard L. Fogel
Director
Human Resources Division
United States General Accounting Office
Washington, DC 20548

Re: Comments of TRLA and TRLF on Draft GAO Report on The Establishment of Alterative Corporations by Selected Legal Services Corporation Grant Recipients

Dear Mr. Fogel:

Thank you for providing us with your draft report identified above. I represent TRLA and TRLF (the Foundation) in this matter. Our comments follow.

1. Carryover Funds

Throughout the TRLA portion of the report, one of the principal reasons cited for creation of the Foundation (the alternative corporation) was "to make it more difficult for LSC to recover the carryover funds." (Draft Letter from Fogel to Senators Hatch and Denton at p. 2 -- hereafter cited as DL.) (Draft Report at p. 4 -- hereafter cited as DR.) This intention is attributed by GAO to TRLA's executive director, David Hall. There is a distinct smart-alecky tone which GAO imparts to Mr. Hall's choice of words without ever putting them into actual quotations. This connotation is unfair and untrue.

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The GAO draft does not discuss the then existing (1980-81) LSC policy with regard to carryover funds. This policy specifically required each local legal services program (LSP) to expend its carryover funds according to a plan which it had to have approved by the LSC regional office.[1/] Moreover, if TRLA (or any other LSP) did not expend its carryover funds in fiscal year 1981, there was a clear inference that the local program's 1982 funding would be cut back accordingly. See ¶8, p. 3 of Exhibit A. It is in this context then -- under a direct order from LSC headquarters -- that TRLA (and other local LSPs) adopted its plan for the expenditure of 1981 carryover funds.

Under these circumstances, we strongly object to GAO depicting the primary reason for the Foundation's establishment as trying to make it "more difficult" for LSC to recover carryover funds. There was no such tenebrous or evil purpose. TRLA's contract with the Foundation was fully open, fully discussed, fully legitimate, and fully approved by LSC as a desirable way for TRLA to expend its carryover funds so as not to have its next year's funding cut back.[2/]

Whatever may be the case with the other LSPs covered in GAO's report, here we are dealing solely with carryover funds -- not with any other type of LSC funds. And, these carryover funds clearly were required to be and were, in fact, expended pursuant to the then existing LSC policies. As such, they most definitely are not recoverable by LSC now, any more than would be any other legitimate, approved past expenditure of a LSP.

2. Separate Corporations

Throughout the report, GAO states that a "true separation" of TRLA and the Foundation "does not exist" (DL p. 3); they are "not in fact separate organizational entities" (DR p. 9); they have "common staffs, management, and facilities" (DR p. 10); they are a "single entity" (DR p. 10); they have an "identity of interests" (DR pp. 9, 10).

[1/] See Exhibit A attached hereto, Memorandum from Bucky Askew to LSC Regional Directors dated December 18, 1980. This memo should be included in GAO's report.

[2/] See letter from LSC Regional Director to TRLA attached hereto as Exhibit B. This letter also should be included in GAO's report.

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The GAO Report, however, does not point out certain facts which directly contradict this gratuitous assumption:

- TRLA and the Foundation are separate, distinct corporations, managed by completely separate Boards, and each has its own 501(c)(3) federal tax exemption which repeatedly has been upheld in IRS audits.

- No member of TRLA's Board of Directors is a member of the Foundation's Board of Directors. Nor is any member of the Foundation's Board, a member of TRLA's Board. There is not a single overlapping person!

- There is absolutely no control exercized by one organization over the other.

- There is no common staff since the Foundation has no actual staff.

- There is no common management since each corporation is managed by its own board of directors, no director of which sits on the other's board.

- There are no common facilities since the Foundation has no real space needs.

- For the Foundation to have its own full-time paid staff or facilities would be a total waste of precious funds.

- The Foundation conducts its own Board of Directors' meetings; does not hold its Board meetings at the same time or with TRLA; keeps completely separate minutes, books of account, files, financial records, and is separately audited. Further, it has its own brochures, stationery, and post office box.

- The Foundation's purpose and operations are totally different and distinct from TRLA. The Foundation exists solely to contract with private attorneys to render assistance to low-income clients. It has no staff or operating program of its own. It deals exclusively with members of the private bar. At the time LSC encouraged its formation, there was virtually no local LSP involvement with private attorneys or pro bono publico contributions from private attorneys to LSPs in South Texas.

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- The Foundation always was supposed to establish a "close working relationship" with TRLA, and it has done exactly that. (See Foundation Proposed Work Program, p. 3, attached hereto as Exhibit C.)

For GAO now to conclude on the basis of the above facts that TRLA and the Foundation are a "single entity" flies in the face of reality.

3. Circumvent Restrictions

Repeatedly, GAO states that the only purpose for the establishment of the Foundation "seemed to be to circumvent restrictions." (DL p. 2; DR p. 9). This is an ad hominem argument totally in opposition to the true facts.

When TRLA contracted with the Foundation, there were no restrictions on using carryover funds (or any other funds) to establish a revolving litigation fund for advancing costs/fees to private attorneys. Far from trying to avoid restrictions, TRLA placed a specific restriction in the Foundation's contract to ensure that any funds received from TRLA could be used only for purposes then permitted under the LSC Act and its regulations, policies, and instructions. (See, the contract between TRLA and the Foundation, ¶6(b)).[3/] At all times, the Foundation has scrupulously conducted itself according to such regulations, the LSC Act, and the intent of the Congress.

Further, there would be no need to create a separate corporation if TRLA's purpose was to "circumvent [proposed] restrictions." As GAO recognizes in its own draft, the 1982 "restrictions" -- even if they had passed the Congress -- would not have been retroactively applicable to TRLA's 1981 carryover funds.[4/] Thus, regardless of whether TRLA's carryover funds remained with its own program or were contracted out, the proposed restrictions would not have been applicable to them.

Rather, as we have noted, one of the key reasons for the contract with the Foundation was LSC's directive to "use or lose" the carryover funds. TRLA's contract with the Foundation was openly encouraged, approved, and even commended in this regard by the LSC.

3/This contract also should be included in GAO's report.

4/DR p. 15.

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(See attached approval from LSC's Regional Director, Exhibit B hereto.) Indeed, in 1983, the LSC's own office of general counsel ruled that there was full LSC approval of the Foundation's establishment (DR p. 15). For GAO now to state that the "only purpose for the establishment" of the Foundation "seems to be to circumvent a restriction that would otherwise bind the grantee [TRLA]" (DR p. 9), is a flagrant abuse of the actual facts.

4. The Alter Ego Doctrine

GAO applies the equitable legal doctine of alter ego to the facts discussed above. It maintains that a court may disregard the separation of one corporation from another "when it is clear that one corporation has become a mere business conduit for another and, of paramount importance, has been used to work an injustice or promote a fraud." For this authority, GAO cites the two cases of American Trading and Production Corporation v. Fischbach and Moore, Inc., 311 F. Supp. 412 (1970) (hereafter American) and FMC Finance Corporation v. Murphree, 632 F.2d 413 (1980) (hereafter FMC).

Upon examination, these two cases support TRLA -- not GAO. Let us, too, look at them more closely.

Both cases deal with a parent corporation and its subsidiary -- not our type of case. American points out initially that the rule of disregarding separate corporate entities should be invoked only "after mature consideration and caution" (p. 413), noting:

> This rule is rarely applied, and only under special circumstances, for it runs contrary to the established principle of corporate limited liability. (p. 413)

American goes on to set forth the test for applying the rule by quoting from Steven v. Roscoe Turner Aeronautical Corporation, 324 F.2d 157 (7th Cir. 1963) at 160:

> In order to establish that a subsidiary is the mere instrumentality of its parent, three elements must be proved: control by the parent to such a degree that the subsidiary has become its mere instrumentality; fraud or wrong by the its mere instrumentality; fraud or wrong by the parent through its subsidiary, e.g., torts, violation of a statute or stripping the subsi-

> iary of its assets; and unjust loss or injury to the claimant, such as involvency of the subsidiary. (311 F. Supp. at 414)

Similarly, the test is expressed in the FMC case as:

> The common verbalization of the corporate disregard test is that there must be such unity of interest and ownership that the separate personalities of the corporation and the shareholder no longer exist, and adherence to the fiction of separate corporate existence would under the circumstances sanction a fraud or promote injustice. To find the parent liable for the acts of the subsidiary, it must be shown that there is control by the parent to such a degree that the subsidiary has become a mere "alter ego" or "instrumentality." (632 F.2d at 422) (citations omitted)

Both American and FMC require in the first instance that there must be the essential element of control before the test can be applied. But as we have discussed in ¶2 above, neither TRLA nor the Foundation possessed or exercized any control over the other. There is not a single overlapping board member between the two. The analogy of parent and controlled subsidiary present in both American and FMC is totally lacking in our situation.

Secondly, and even more importantly, both cited cases (and GAO itself) require that there be some fraud or wrongdoing or injustice present. No such claim can be made against TRLA or the Foundation.

As we have taken great pains to point out, the expenditure of carryover funds to establish a revolving litigation fund was fully appropriate under LSC's then existing carryover policy. It was, moreover, fully encouraged and given prior approval in writing by LSC and, apparently, even backed up by a ruling of LSC's own general counsel in 1983. For GAO to insinuate that TRLA or the Foundation has participated in a fraud or wrongdoing of any kind under these circumstances is not only inappropriate; but it is highly insulting to the dedicated, able leadership of these two charitable corporations.

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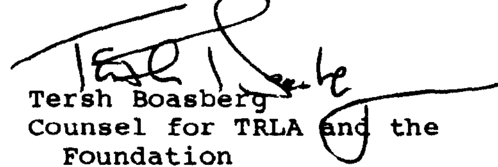
Thank you once again for letting us review your draft report. We hope you will correct the report as indicated in this letter. We would be pleased to discuss our comments further at your convenience.

Sincerely yours,



Tersh Boasberg
Counsel for TRLA and the Foundation

TB/vrr
Enclosure
cc: David G. Hall

GAO notes:

1. Page references in this appendix have been changed to correspond to page numbers in the final report.

2. Although the enclosures to these comments have not been included, these documents are discussed in the report.

NEW HAVEN LEGAL ASSISTANCE ASSOCIATION, INC.

95 ORANGE STREET
NEW HAVEN, CONNECTICUT 06510-3108
TELEPHONE (203) 777-4811

April 25, 1985

Richard L. Fogel
Director
Human Resources Division
United States General Accounting
Office
Washington, D.C. 20548

Dear Mr. Fogel:

Thank you for supplying the draft of the GAO report on the establishment of alternative corporations by Legal Services Corporation grant recipients. My comments on behalf of New Haven Legal Assistance Association, Inc. (LAA) and South Central Connecticut Legal Services Corporation (SCC) follow.

On page four, the report concludes that "the former grant recipient [LAA] used private funds to engage in activities for which, as the LSC grant recipient, it could not have used private funds." As an example, the draft notes that LAA used private funds to organize nursing home residency councils, an activity prohibited under the LSC Act.

This conclusion is based on incorrect facts. At the same time LAA expended this particular grant (from the Campaign for Human Development), it was a grantee of the South Central Connecticut Agency on Aging. The SCCAA grant, public funds pursuant to Title III-B of the Older Americans Act, funded the same activity as funded by CHD. Because of the public funding, the activity was permissible, in accordance with §1010(c) of the Act.

On page 9, the draft states §1007(d) of the Act as authority for LSC to require that subgrantees comply with the Act and regulations as to non-LSC funds. §1007(d) requires the Corporation to monitor and evaluate recipients to ensure compliance with the Act. This section does not concern contracts between grantees and subgrantees. 45 CFR §1627, the LSC regulation concerning subgrants, does not

Richard L. Fogel
April 25, 1985
Page Two

even cite §1007(d) as authority. Nothing in §1627 provides authority for the legal position enunciated in the draft. The Corporation can not simply make grant conditions without authority. (See National Senior Citizens Law Center v. Legal Services Corporation, C.A. No. 83-3867 (D.D.C. 1984).

On page 9, the draft states that the recipients and subrecipients in Texas and Connecticut are not "separate organizational entities for purposes of compliance with the LSC Act." The recipient and subrecipient in Connecticut have a complete segregation of funds and are legally separate entities. The question is not determined by interlocking directorates; corporate entities can be legally separate even with identical boards. Instead of applying established law to determine legal separation, the draft pulls a new standard out of the air, i.e. whether an organization is a separate entity "for purposes of compliance with the LSC Act." There is no statutory or regulatory authority for this new legal principal.

The "alter ego doctrine" is the only standard to determine whether two corporations can be considered as a single entity. The doctrine is not developed in the draft and there is no attempt to apply relevant factors to the LSC recipient and subrecipient in Texas or Connecticut. Instead, the draft avoids analysis and opts for summary conclusion. That conclusion, i.e. that §1007(d) precludes the need for determining legal separateness, is not supported by law.

On page 23, the draft claims that SCC's executive director stated that no documentation exists showing how LAA and SCC compute the average cost of handling cases referred by SCC. This is a misstatement of fact. We provided GAO personnel with documentation showing that, in 1981, the State of Connecticut paid legal services programs at the rate of $400 per case through Title XX of the Social Security Act (now the Social Services Block Grant). We stated that this figure, based on extensive arm's length negotiations with the State, was used as a basis for the first contract between SCC and LAA. GAO personnel informed us that they accepted that rationale and had no further questions as to the first contract. We also provided data concerning a 1983 time study performed by LAA for the South Central Connecticut Area on Aging and a unit cost analysis for that grant showing that $180 per case was an appropriate

Richard L. Fogel
April 25, 1985
Page Three

amount to charge. It is factual error to state that SCC divides the amount available for contract cases by the number of cases LAA can handle. SCC makes the sole determination of which cases to refer and does so based on a cost/benefit analysis. We provided to GAO substantial information concerning that cost/benefit analysis, including intake logs, time studies and grant documents.

[See GAO note 2, p. 52.]

Footnote 6 also constitutes a misstatement of fact. At no time did we state that either SCC or LAA, in conjunction or individually, followed an after-the-fact accounting arrangement concerning ineligible clients or restricted activities. We supplied GAO with LAA and SCC application forms and explained our intake procedure. Simply stated, when an applicant applies at SCC, SCC screeners and an SCC managing attorney determine whether the applicant is eligible for SCC. If so, and the case is within SCC priorities, the matter is referred to LAA. SCC then pays for the referral at the per-case rate. If the applicant is not eligible for SCC, SCC refers the matter to the Lawyer Referral Service, another agency or LAA. Applicants ineligible for SCC may be referred to LAA for representation with non-LSC funds, but these cases are never claimed for LSC statistical purposes and there is no payment from SCC to LAA. These referrals are identical to those made to private law firms for *pro bono* cases.

In addition, the draft should note that this procedure was specifically approved by LSC for compliance with the "alien rider." As late as 1983, LSC personnel approved the application form and the referral mechanism set forth above.

On page 22, the draft states that the agreement between SCC and LAA does not constitute an arm's length transaction. The draft notes that GAO found no evidence that the agreement unfairly favored the interests of one corporation over the other. The draft should note that payment of $180 per case is favorable to SCC, is sufficiently low to constitute economical service, and is evidence that LSC funds were expended in a manner as to maximize services for minimal cost.

On page 26, the report notes that "[A]ccording to the Executive Director," members of the board of directors are appointed by third parties. You have the bylaws of both corporations. It is not the Executive Director, but the

Richard L. Fogel
April 25, 1985
Page Four

bylaws which determine the manner in which members of the boards of directors are appointed. The final report should reflect the bylaws and the precise mechanism by which board members are appointed. In fact, neither LAA nor SCC have any control over appointment of its board of directors.

Likewise, on page 26, the report notes that "according to SCC's controller" salary ratios are determined by time studies. Since we supplied GAO with the time studies in question, the final report should reflect those findings. By framing statements in the context of an attribution instead of a substantiated fact, the report carries an unfortunate tone of partiality and places credibility in question.

On page 27, the draft again concludes summarily that SCC's and LAA's corporate identity are not separate. To the contrary, an analytical appraisal in accordance with the "alter ego doctrine" would show that the two corporations are separate entities. That analysis is not made in the draft.

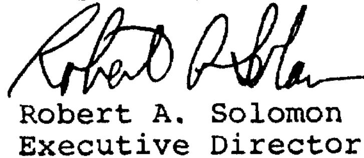
On the same page, the statement that the Executive Director and Controller stated that LAA used at least $15,535 in private funds for activities in which it could not have engaged as an LSC recipient is incorrect. The private funds used for nursing homes was in conjunction with a grant of public funds from the South Central Connecticut Agency on Aging. The grant of private funds to establish an adolescent pregnancy project was in conjunction with the New Haven public school system, which supplied substantial public funds. While LAA received private funds to provide legal services in housing and employment discrimination cases, there is no showing in the report that the funds were used for ineligible clients. In fact, those funds were used for clients eligible under the Act. Similarly, "organizing" is a term of art under the Act; the CHD grant for work in public housing was not to form a group, as prohibited by the Act, but to provide legal assistance activities to eligible clients in accordance with the Act. Again, the draft has drawn summary conclusions with no basis in fact.

As a whole, the draft emphasizes the negative. SCC was established to segregate LSC funds and ensure compliance with LSC regulations. In a conclusory fashion, the draft converts that careful delineation of funds into an attempt

Richard L. Fogel
April 25, 1985
Page Five

to avoid the LSC Act and regulations. There is no basis for this determination. At all times, LAA sought to effectuate the will of Congress. The draft presumes LAA's activity to be improper, placing the burden on LAA to prove appropriate behavior. This standard is incorrect and displays prejudice against LAA and SCC.

Very truly yours,



Robert A. Solomon
Executive Director

RAS/cbd/3/1

GAO notes: 1. Page references in this appendix have been changed to correspond to page numbers in the final report.

2. This footnote was deleted from the report.

Congress of the United States
House of Representatives

437 Cannon House Office Building
Washington, DC 20515
Telephone: (202) 225-3661

Bruce A. Morrison
Member of Congress
Third District, Connecticut

May 30, 1985

Richard L. Fogel
Director
Human Resources Division
U. S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

Thank you very much for requesting my comments on the draft GAO report on the establishment of alternative corporations by three Legal Services Corporation (LSC) grantees, including the creation of the South Central Connecticut Legal Services Corporation (SCC) by the New Haven Legal Assistance Association, Inc. (LAA). My comments follow.

1) <u>GAO has exceeded its authority in creating new legal standards not authorized by statute.</u>

The draft report (pp. 9 - 10) creates new legal standards for distinguishing between subgrantees which are "legitimate private corporations" and those which have so close an identity of interest with a grantee that they should be subject to the same restrictions as grantees.

There is no authority in the LSC Act for this distinction. The provision cited by the draft report, section 1007(d), merely requires the LSC to monitor and evaluate recipients to ensure compliance with the Act. It makes no reference to subgrantees. Its legislative history establishes that the legislative intent behind the provision was to provide for independent evaluation of recipients as distinct from monitoring and evaluation by the LSC.

Nor is there authority anywhere else in the LSC Act for the standards which the draft report sets forth. Congress has chosen to require the LSC to place a variety of restrictions on recipients, but has not required the LSC to go further and place restrictions on certain categories of subgrantees.

Clearly the LSC has authority to track its funds and to ensure that they are spent in compliance with the LSC Act. Pursuant to that authority, it has promulgated regulations concerning subgrants. However, the standards set forth in the draft report are not contained in the regulations.

Richard L. Fogel
June 3, 1985
page 2

Thus neither the LSC Act nor LSC regulations provide authority for GAO's standards, and GAO has no independent authority to create new legal standards. It is up to Congress to do so. Indeed, we are considering providing further guidance to the LSC on this matter.

The report must therefore conclude that there are presently no standards in the LSC Act or regulations which would authorize a conclusion that certain subgrantees should be considered to be the same entities as the recipients.

2) The recommendation concerning LAA and SCC is an inappropriate remedy.

Even assuming that GAO has the authority to create new standards for determining which subgrantees should be treated as recipients, the draft report's recommendation (p. 27) that the LSC require SCC and LAA to include in their next agreement a provision restricting LAA from using private funds for activities prohibited by the LSC Act is inappropriate.

Since LAA and SCC have acted in good faith and with the approval of the LSC, there should be no question of imposing a sanction upon them. Nor should GAO should create a new rule of general applicability and single out one or two recipients to which it will be applied.

Any such rule should be promulgated in regulations, and LAA and SCC should be given an opportunity to comply before any special requirements are imposed upon them. If they can establish the degree of independence required by the regulations, then SCC should not be required to place restrictions on LAA's use of private funds.

Therefore, if GAO persists in applying its new legal standards, the report should recommend that the LSC promulgate regulations setting forth the standards and instruct the affected recipients that they must either (a) meet the requirements of the regulation for establishing a separate identity or (b) require the subgrantee to comply with restrictions affecting grantees.

3) The conclusion that LAA used private funds to engage in activities prohibited for recipients is not supported by the facts set forth in the draft report.

The report concludes that LAA used private funds for activities prohibited for the LSC grant recipients (p. 27). The specific examples cited were 1) organizing nursing home residency councils, 2) organizing tenant groups, 3) an adolescent pregnancy project, and 4) housing discrimination cases.

Richard L. Fogel
June 3, 1985
page 3

The report states that these activities are prohibited for LSC grantees because the first two are alleged to have involved prohibited organizing and eligibility for the second two was not based on the financial standards required by the LSC Act.

These conclusions are unwarranted on the basis of the facts set forth in the draft report. First, section 1010(c) only restricts private funds "received for the provision of legal assistance." "Legal assistance" is a term defined by the LSC Act. GAO has made no determination that the private funds at issue here were received for the provision of legal assistance.

Moreover, the analysis ignores the exception for using public funds in accordance with the purposes for which they are provided. This exception was clearly designed to assure that recipients could seek and use public funds without being restricted by the provisions of the LSC Act. Some public funds require the grantee to obtain private funds as a match. Clearly, private funds which are used to match public funds should be treated as public funds. To treat such matching funds as private funds would be to frustrate legislative intent by making it impossible for the public funds to be used for the purposes for which they were awarded.

The draft report's analysis of the nursing home grant received by LAA ignores the public funds exception. The nursing home grant was awarded to LAA under Title III of the Older Americans Act. Under the OAA Act, LSC grantees are preferred recipients, and are required to obtain private matching funds. To treat these matching funds as private funds under the LSC Act not only frustrates the purpose of the public funds exception in section 1010(c) but also frustrates the legislative intent of the OAA Act by making it impossible for an LSC recipient, the preferred provider, to obtain the OAA public funds and use them for the purpose for which they were intended.

In addition, the report fails to determine whether the activities of LAA which GAO has characterized as organizing were in fact prohibited "organizing activities" or were instead the provision of legal assistance to eligible clients. Congress has been very explicit on what types of activity are prohibited and what are permitted. In 1977, when the organizing section was amended, the Committee Reports in both the House and Senate explicitly indicated that legal services recipients were acting <u>legally</u> if they were "(1) assisting groups of poor people to organize by providing advice on matters of incorporation, bylaws, tax problems and other matters essential to the planning of an organization; (2) providing counsel to poor people regarding appropriate behavior for group members; and (3) encouraging poor people aggrieved by particular problems to consider organizing to foster

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page 4

joint solutions to common problems..." See H.R. Rep. No. 95-310, 95th Cong., 1st Sess. 14, and S. Rep. No. 172, 95th Cong., 1st Sess. 18. What was prohibited was "actually initiating the formation of, or organizing directly, an association, group, or organization." Id.

The report thus contains insufficient facts to conclude that private funds were actually used for purposes prohibited by the LSC Act. The facts as set forth in that draft would only support a conclusion that LAA has engaged in activities which may have been prohibited for SCC.

In any event, because the report deals only with prospective remedies, it is not necessary that GAO make a final determination as to whether in the past LAA has actually engaged in activities in which SCC could not engage.

4) The report should contain a specific finding that there has been no violation of the LSC Act or regulations in the creation and operation of the three alternative corporations.

As you know, there has been a great deal of political controversy surrounding this issue, and accusations of illegal activity have been made. GAO should anticipate that the report may be used for partisan political purposes. Since GAO found no violation of the LSC Act or regulations in the creation of the "alternative corporations," it is important that the report should include a specific finding to that effect.

I am particularly distressed by the language contained in the standards applied to LAA and SCC stating that "the only purpose for the establishment or operation of the subrecipient seems to be to circumvent restrictions that would otherwise bind the grantee" (p. 3). [See GAO note 2, p. 57.]

SCC was created to segregate LSC funds in order to ensure that they were provided in a manner fully consistent and in compliance with the LSC Act and to maintain LAA's ability to comply with the demands of other funding sources (including other public funding sources) and its own charter. For example, LAA was incorporated to provide representation in criminal as well as civil matters, and has long received public funds for that purpose. The result of the "sole purpose" provision in H.R. 3480 would have been that the program would either have to forego its LSC grant or the public funds awarded for criminal representation.

Richard L. Fogel
June 3, 1985
page 5

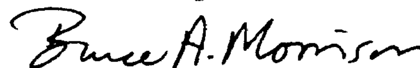
LAA and SCC undertook their new funding arrangements with full aproval of the LSC. SCC has received subsequent approval of its subgrants with LAA.

Thus whether or not LAA and SCC have maintained such a close relationship that they have an "identity of interest," the suggestion that there has been any attempt to circumvent the law is unjustified. On the contrary, extraordinary effort has been made to comply with the law.

I urge you to correct this misleading implication of wrongdoing.

I would welcome the opportunity to discuss these matters with you in more depth.

Sincerely,



BRUCE A. MORRISON
Member of Congress

GAO notes: 1. Page references in this appendix have been changed to correspond to page numbers in the final report.

2. This statement has been revised; see pages 9 and 10.

PINE TREE LEGAL ASSISTANCE, INC.
Four Milk Street
P.O. Box 547, D.T.S.
Portland, Maine 04112
(207) 774-4753

John David Kennedy
Executive Director

June 18, 1985

Richard L. Fogel, Director
Human Resources Division
United States General Accounting Office
200 Constitution Avenue
Washington, D.C. 20210

Dear Mr. Fogel:

I write to confirm this organization's conversation with John Hanson, of GAO over the past few weeks with respect to the draft report prepared concerning Pine Tree Legal Assistance, Inc. and two other Legal Services Corporation grantees.

Let me first apologize for the delay in formally responding to your draft due to a series of recent illnesses which have kept me out of the office. However, both myself and Elinor Miller, Pine Tree's Program Administrator have spoken with Mr. Hanson and relayed the information confirmed by this letter.

As we have noted, there is one typographical error on page 8 of the draft referring to the first six months of 1981, which should be the first six months of 1982.

With the exception of this typographical error, we wish to offer no comment, nor to proffer any objections to the draft report as written.

On behalf of Pine Tree Legal Assistance, Inc., and especially on behalf of those of us in the Program's Administrative Office who worked with GAO's team while they were in Maine, I would like to note our appreciation

Area Offices:

Augusta Office
39 Green Street
P.O. Box 2429
Augusta, Maine 04430
622-4731

Bangor Office
Coe Building
61 Main Street
Bangor, Maine 04401
942-8241

Farmworker Unit
Coe Building
61 Main street
Bangor, Maine 04401
942-0673

Lewiston Office
277 Lisbon Street
Lewiston, Maine 04240
784-1558

Machias Office
P.O. Box 120
26 Main Street
Machias, Maine 04654

Portland Office
Four Milk Street
Portland, Maine 04101
774-8211

Presque Isle Office
P.O. Box 1207
1 Second Street
Presque Isle, Maine 04769
764-4349

Richard L. Fogel, Director
June 18, 1985
Page two

for your staff's professionalism and courtesy and our further appreciation for their understanding of, and sensitivity to, the difficult circumstances and very difficult choices which Pine Tree faced in late 1981.

Thank you for your attention and cooperation.

Sincerely:

John David Kennedy

JDK/sr

cc: Elinor Miller
Gerald F. Petruccelli, Esq.
Robert E. Mittel, Esq.

GAO note: The page reference in this appendix has been changed to correspond to the page number in the final report.

Downeast Law Offices, P.A.

Attorneys at Law

37 Green Street, P.O. Box 897
Augusta, Maine 04330
207-623-8460

Kim M. Vandermeulen
Richard M. Goldman
M. Michaela Murphy
Robert J. Allen

Elizabeth G. Sienko
Paralegal

Portland Office
Deborah Shaw Rice
James R. Bushell
4 Milk Street
PO Box 7485, DTS
Portland, Maine 04112
(207) 773-1107

Bangor Office
Richard A. Estabrook
Raymond L. Gill
Perry O'Brian
61 Main Street
Bangor, Maine 04401
(207) 942-4697

May 2, 1985

George D. Peck
Group Director
United States General Accounting Office
Washington, D.C. 20548

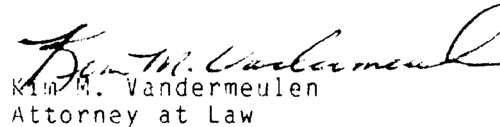
Re: Draft Report concerning Legal Services Corporation

Dear Mr. Peck:

Recently I received a copy of the draft report prepared by your office at the request of Senators Hatch and Denton. As I am sure you are aware, our business was involved in that report. This letter is merely to advise you that we do not have any specific comments concerning the report and are satisfied with the report as it relates to our organization.

Thank you for your consideration.

Sincerely,



Kim M. Vandermeulen
Attorney at Law

KMV/ejb

LEGAL SERVICES CORPORATION
733 Fifteenth Street, N.W., Washington, D.C. 20005

Writer's Direct Telephone
(202) 272-4040

June 5, 1985

Mr. Richard L. Fogel
Director
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

The Legal Services Corporation (LSC) accepts the General Accounting Office's findings of fact, and substantive and legal conclusions concerning the establishment of "mirror" corporations by LSC grant recipients at the urging of agents of LSC (GAO/HRD-85-51).

As noted in the draft report on page 15, an LSC regulation (45 CFR 1627), adopted December 30, 1983, would require any alternative or "mirror" corporation's fund balance to be counted as part of the parent corporation's fund balance. As noted, this regulation also limits such agreements to a one year duration.

Since LSC has the power to disapprove a subgrant or successor-in-interest agreement, LSC has the authority to prevent the establishment of future alternative or "mirror" corporations by LSC recipients or subrecipients. Here, LSC wishes to note that Senator Orrin Hatch's revelations on "mirror" corporations, which led to this GAO investigation, were a factor for adoption of the regulation.

LSC concurs with the specific recommendations made in this draft report and wishes to vigorously pursue them.

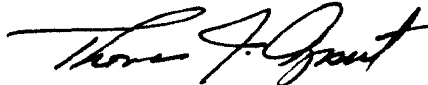
We agree with the general recommendation that, where the facts warrant, the alter ego doctrine should be applied and the two organizations considered a single entity as to their legal and fiduciary relationship with the Legal Services Corporation.

Mr. Richard L. Fogel
June 5, 1985
Page Two

LSC urges the General Accounting Office to adopt the draft report in its entirety. As such, the Legal Services Corporation's ability to enforce applicable statutes with respect to the specific entities cited, and to similar mirror entities created under similar circumstances and for similar reasons.

Finally, LSC wishes to commend the GAO for the thoroughness reflected in the report, both in finding of facts and in legal interpretations.

Very truly yours,



Thomas J. Opsut
Interim President

GAO note: The page reference in this appendix has been changed to correspond to the page number in the final report.

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