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LEGAL SERVICES CORPORATION: A REVIEW OF LEASING CHOICES AND LANDLORD RELATIONS

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCIAL AND ADMINISTRATIVE LAW

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

JUNE 28, 2005

Serial No. 109–145

Printed for the use of the Committee on the Judiciary

Available via the World Wide Web: http://judiciary.house.gov

U.S. GOVERNMENT PRINTING OFFICE

22–186 PDF WASHINGTON : 2006

For sale by the Superintendent of Documents, U.S. Government Printing Office
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LEGAL SERVICES CORPORATION: A REVIEW OF LEASING CHOICES AND LANDLORD RELATIONS

TUESDAY, JUNE 28, 2005

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCIAL
AND ADMINISTRATIVE LAW,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Subcommittee met, pursuant to notice, at 12:41 p.m., in Room 2141, Rayburn House Office Building, the Honorable Chris Cannon (Chair of the Subcommittee) presiding.

Mr. CANNON. Good morning, ladies and gentlemen. This hearing of the Subcommittee on Commercial and Administrative Law will now come to order.

I will keep my opening remarks brief, as I believe that the testimony and the opportunity to ask questions of our witnesses will prove to be more valuable, and I want to leave as much time as possible for the Members of the Subcommittee to utilize this opportunity.

We consider today the "Legal Services Corporation: Leasing Choices and Landlord Relations." This hearing comes as a result of the findings in the report of the Office of the Inspector General for LSC, a report which raised several issues of serious concern and which was unanimously rejected by the LSC board of directors.

It is important to stress the reason why we are here. Congress wanted an independent review of the Executive Branch and independent agencies to determine if there is waste, fraud, or abuse occurring in Government generally.

Is this microphone working?

In order to aid Congress and the agencies for whom they work in this endeavor, the Inspector General was created. The success that the IGs have had across the spectrum is unquestioned. Upon receiving this report, I'm glad to see the IG at LSC is trying hard to continue in this tradition.

The posture which the board and LSC management has adopted in this matter is troublesome. Some of the LSC management questioned the utility of this hearing, despite the conclusions of the IG's report. In view of their reluctance, I'm glad that Mr. Strickland, the board chairman, is here today to answer questions raised by that report.

At issue today is how federally appropriated dollars are being utilized; whether there is efficient use of those dollars; and whether

they are being used appropriately. These issues become all the more important when we're discussing the budget of an organization that is in existence to assure the provision of civil representation to those who could otherwise not afford it, and whose every inefficiency equates to the loss of representation to a potential client in need. These are serious questions which I can assure you this Committee and I will always have time for.

I would like to thank each of our witnesses for taking the time to inform the Subcommittee of the facts involving this arrangement between LSC and Friends of LSC.

At this time, I'd like to recognize my good friend and distinguished Ranking Member, Mr. Watt. I understand there are some issues he would like to address at this time. With the permission of Mr. Watt and the Subcommittee, I would also like to comment on the issues which he presents. I believe them to be of great concern to our body and our ability to conduct hearings which are conductive and can accomplish that which Congress needs to do as this Government's legislative arm. Thank you, Mr. Watt.

Mr. WATT. Thank you, Mr. Chairman. And I want to start by thanking the Chairman for convening this oversight hearing of the Legal Services Corporation which, in my estimation, is an extremely vital part of our legal system.

Last year, the Legal Services Corporation celebrated its 30th anniversary. It was created by Congress in 1974 to ensure that Americans have access to our justice system regardless of their economic means. The Legal Services Corporation has for three decades lived up to the high purpose for which it was created, providing legal assistance in civil matters to tens of millions of low-income Americans who would have otherwise gone without counsel.

Today, we are here to exercise our oversight responsibilities with respect to the Legal Services Corporation. The briefing materials issued by the Chairman in preparation for this hearing identify the purpose of the hearing to be, "to examine the fiscal soundness of a lease entered into by Legal Services Corporation, the potentially false representations made by Friends of the Legal Services Corporation, the relationship key agents played in the interactions occurring between the Legal Services Corporation and Friends of the Legal Services Corporation, and the overall relationship between the Legal Services Corporation and Friends of the Legal Services Corporation." That's the purpose for which this hearing is here.

Now, today we have three witnesses before us, and we have an empty chair in front of which I've taken the liberty of putting the name of the fourth witness who we've been trying to get to be here. The empty chair was to be occupied by John McKay, who is currently the U.S. Attorney for the Western District of Washington State. For the second consecutive year, the U.S. Department of Justice has thumbed its nose at a legitimate request from Congress, and refused to allow Mr. McKay to testify about the matters about which he has personal, historical, and professional knowledge.

Before I continue, Mr. Chairman, I do want to acknowledge the support and assistance you have provided in attempting to secure Mr. McKay's presence. I believe you agree that the Department of Justice is undermining the ability of this Subcommittee to faithfully execute its oversight function.

The position of the Justice Department lacks credibility. Last year we were told, "DOJ officials testify on DOJ matters, not on matters relating to other entities." Similarly, this year we were told that, "Department of Justice witnesses testify about Department of Justice issues."

Notwithstanding this curious position, on Mr. McKay's DOJ website, his bio proudly proclaims, "Between 1997 and 2001, Mr. McKay served as the president of the Legal Services Corporation in Washington, D.C. Mr. McKay's tenure at the Legal Services Corporation was characterized by a bipartisan approach to working with Congress, driven by a deeply-held commitment to the principle of equal justice." Apparently, that approach has not been adopted by Mr. McKay's superiors, who have again treated this Subcommittee with disdain.

Mr. Chairman, I have specifically requested from the Department an official copy or reference to the policy that prohibits DOJ employees from responding to invitations from Congress to testify about issues relevant to their prior Government service—all to no avail. Can it be that the DOJ requires all of its employees to check their past lives at the door, even when the past life was with other entities of, or connected to, the Federal Government?

I have not asked for Mr. McKay's cooperation because I think he would make an entertaining witness. The focus of this hearing is on the leasing arrangement between the Legal Services Corporation and the Friends of the Legal Services Corporation, Inc. Mr. McKay is integral to that leasing arrangement, which is both complicated in detail and lacks some key documentation.

Mr. McKay's role in the formation of Friends is undisputed. Let me quote from some of the submitted testimony. Mr. Smegal, Chair of Friends, states this concept of Friends—and I'm quoting, "The concept of a Friends-owned building, leased to LSC for its administrative headquarters at a flat, fixed rate, was the motivation for the efforts of those including John McKay and Congressman John Erlenborn during their terms as president of LSC."

Mr. Strickland, the Chair of the LSC Board, states, "This transaction was conceived by John McKay, who President Bush appointed as, and is now U.S. Attorney for the Western District of Washington." Even the Inspector General acknowledges Mr. McKay's role by reference to the dates of his presidency of LSC.

As one of, if not the principal architect of the lease arrangement that we now review, Mr. McKay's presence is vital to a complete understanding of LSC's intent in entering into this arrangement with the Friends of LSC.

While it is true that Congressman Erlenborn made many of the subsequent decisions necessary to implement the concept, he is, unfortunately, ill, and therefore unavailable to testify.

The present president, Ms. Barnett, has only been over—been at Legal Services for a little over a year.

Mr. McKay is the only prior LSC official with knowledge of the contemporaneous events and circumstances surrounding the lease arrangement that we are now asked to scrutinize so closely. Mr. McKay, at least last term, was willing to testify. This year, after 20 days of negotiating with the Department of Justice commencing on June 8, we were advised only yesterday, and I quote from a

DOJ e-mail, "Even if we agree that U.S. Attorney McKay should participate in this hearing—which we don't—he could not do it anyway, because we were told last week that he was away on vacation."

It strikes me that that response is arrogant and insulting. Either the DOJ is totally inept, or completely contemptuous of this Congress.

This matter was left unresolved last term, Mr. Chairman. But given Mr. Erlenborn's condition, it will certainly arise again if this Subcommittee is serious about getting to the facts about this lease arrangement.

I will listen to the witnesses who are here today; but without Mr. McKay present before us, actively engaged in the dynamics of a hearing about his brainchild, the Friends of the LSC, and about a period he proudly and clearly—without the Department of Justice's objection—boasts on his website about, I certainly can't consider this record complete.

Mr. Chairman, I hope that you will actively join with me to pursue this to an appropriate conclusion. I believe that the time is now for us to consider issuing a subpoena to either Mr. McKay or the appropriate Department of Justice official or officials who continue to disregard and disrespect this Committee's jurisdiction. And I yield back the balance of my time, if I have any.

Mr. CANNON. Thank you. Let me just add to your comments that being on vacation is not an appropriate reason to not be here, especially when one wonders whether the vacation was planned in advanced, or a matter of convenience.

The request that we made of Mr. McKay was as you said, a legitimate request. And it is not possible for us to faithfully fulfill—again, quoting you, Mr. Watt—our oversight obligations, if we don't have the ability to bring witnesses before us.

You mentioned that the Department of Justice is contemptuous. There may be people there who are contemptuous, who need to learn a lesson. And may I just suggest for the gentleman that I am willing to consider leaving this hearing open at the end of the hearing—recessing, rather than adjourning, so that we retain our options as they relate to Mr. McKay and the Department of Justice.

Mr. WATT. If the gentleman would yield on that point?

Mr. CANNON. Certainly.

Mr. WATT. I've been told though, that the Chairman of our full Committee will not allow that to happen, so I suspect——

Mr. CANNON. But actually, I'll run it by the Chairman of the full Committee just—I think we actually have authority here in our Committee to do what we want to do; but he was gracious enough to suggest that if we wanted to keep it open, he would be fine with that.

Mr. WATT. Hallelujah.

Mr. CANNON. The heavens open. I'm only going to introduce our board Members and submit their background for the record for purposes of conserving time here. I want to just say that we're very grateful to have the people who are here, who are outstanding individuals with terrific histories.

We'll begin with Mr. Thomas Smegal, who is the Chairman of the Board of Friends of Legal Services Corporation; and then go to

Mr. Frank Strickland, who is the Chairman of the Board of Directors of the Legal Services Corporation; and then finally, we'll go to Mr. Kirt West, who is the Inspector General for Legal Services Corporation.

And if you gentlemen will excuse me for not giving your whole bios here, I would appreciate that. And let us begin, Mr. Smegal——

Mr. DELAHUNT. Mr. Chairman, I would like to make a statement.

Mr. CANNON. Oh, the gentleman from Massachusetts. Or would anyone else like to make an opening statement at this point?

[No response.]

Mr. DELAHUNT. I'd just like to make an observation.

Mr. CANNON. The gentleman is recognized for 5 minutes.

Mr. DELAHUNT. I'm conflicted about this hearing. First, let me say that I think it's important that we conduct aggressive oversight. And I want to compliment the Chair of the Subcommittee, the Chair of the full Committee, for their work with Members on this side, in terms of doing that oversight in a way that is in camera, if you will.

And I see Mr. Daley here. Let me also acknowledge his role in terms of conducting oversight into the FBI.

And I think we need to be much more aggressive in public. Yet at the same time, here we are with the LSC again. A year or two ago, we were talking about a lease where there was a disagreement over—I don't know—$1,000 a month. I'm looking at the facts as put—as memorialized in a memorandum.

And again, I'll just presume that these facts, in arguendo, are accurate. Over the life of the lease, they will overpay 1.2 to 1.9 million. This is according to the Inspector General. And I should add that there appears to be a disagreement between the board of directors and the IG, and I'm sure that's what we'll hear about today.

It's submitted that there could be saved 680,000, plus a 440,000 early termination fee, by staying at original location. And yet, here we are in Congress, Mr. Chairman, where it was just this past week that there was a congressional hearing on the development fund for Iraq—the first occasion for an oversight hearing—where there are allegations of fraud, waste, and abuse of some 9 billion. I guess I'm talking about proportionality here. I think it's time that we take on some issues that have more significance than the one we are today.

Having said that, I think we need a sense of proportion. And I would like to discuss with you and Mr. Watt and other Members, as well as the Chair of the full Committee, some areas. And I think we should communicate in letter, requesting oversight hearings into areas that I think have vastly more significance, with all due respect to Legal Services, because Legal Services is an easy target. And again, I think we should have a conversation, and then a letter.

But—my final observation—to think that the Department of Justice—and I've met Mr. McKay, and I found him to be an individual of integrity, and I think he attempted to do well by Legal Services. I'm sure that this disagreement most likely will be a matter of opinion, but will establish that people were motivated by an effort to do better by Legal Services Corporation.

But at the same time, to think that the Department of Justice won't provide Mr. McKay for testimony, that is contemptuous. And I would remind the Chair that I served with—on an ad hoc basis with the Government Reform Committee, and we ran into the same resistance there. And Chairman Burton had to threaten the White House with a contempt citation before there was cooperation. And again, I would suggest that it wasn't a full measure of cooperation; not what should be expected to a congressional Committee.

And I would add that Chairman Burton had bipartisan, full support of every single Member of that Committee to issue a subpoena. So I would just mention that to you, and suggest that that's something to consider.

One further final thought. When we talk about the sunset provision in the hearings that the Crime Subcommittee has had—and I know the Chairman of the Crime Subcommittee is here, Mr. Coble; and I see my friend from Texas, Mr. Gohmert—if this isn't an example of what myself and others have been saying about the need for a sunset provision to ensure that there is cooperation and collaboration by the Department of Justice, I can't think of a better case.

With that, I'll yield back.

Mr. CANNON. If the gentleman would yield just for a moment, let me just say that no one has been more careful of the prerogatives of Congress than I have, regardless of the Administration, Republican or Democrat. And so I agree with the gentleman.

And putting in perspective this hearing—and I think Mr. McKay is relevant to that fact—if he were here, that would help us solve the problem at one time and move on to what I agree with the gentleman are much more important problems. That said, I believe that our role here is, when we have a problem as has presented itself before us today, that we need to look at it. And it will be interesting to hear our witnesses present their information and be questioned.

There is no question but what there's a problem. The problem is not in the nature of the 1.2 million or the 1.9 million dollars for rent. The question is in the nature of the relationship between the two organizations, a relationship that was created in the context of a rule by OMB that would have disallowed Legal Services Corporation from owning its own home because of its scoring rules.

And so I think this is an appropriate time to look carefully and intimately into this problem, and then move on. But I agree with the gentleman, we have many things that we ought to look to. And we in particular ought to be enormously concerned about the prerogatives of this body, as opposed to those of what every Administration is going to presume, as opposed to what is appropriate. So I pledge to the gentleman that we'll work together both on our oversight process and as to this witness who is not with us today, in particular.

Are there other Members who would like to make an opening statement? Mr. Gohmert? The gentleman is recognized for 5 minutes.

Mr. GOHMERT. I thank you, Mr. Chairman. And I would like to applaud you for calling the hearing. And even though some might feel like 1.2 to 1.9 million dollars overpayment over a 10-year pe-

riod is not all that significant, as the old adage goes, you know, "A million here, and a million there, and before long you're talking about—"

Mr. DELAHUNT. "A billion."

Mr. GOHMERT. Well, we're dealing with a million here, so before long you're talking real money.

But it is important. And where we have an institution that's supposed to be providing legal advice and helping others with legal rights, my goodness, they certainly ought to be able to help themselves appropriately, ethically. And I think it's certainly worthy of review and oversight, and I applaud the Chairman, regardless of what Administration is in the White House. And I think it speaks volumes for the Chairman that we'd have a hearing of this nature with Republicans in the White House. It just shows, if there's some problem, we're not going to mask it. Let's get it out there where we can look at it.

Now, I would like to also hear from Mr. McKay. I couldn't agree with my friend from Massachusetts more on that, and with Mr. Watt, as well. I think from what I was hearing there's a multiple problem, a multi-faceted problem in that he's on vacation, as well. But I get the impression that we're going to get a chance to hear from Mr. McKay, if enough of us want to hear from him, and that's what it sounds like.

So I'm very interested in getting to the bottom of this, especially where we have officers of the bar who are supposed to be providing help to other people and yet, if you do what my old professor in law school said and apply the smell test, there's an odor here that is not good, and we need to get to the bottom of it. So I appreciate the chance.

Mr. WATT. Would the gentleman yield just briefly?

Mr. GOHMERT. Surely.

Mr. WATT. Just he hasn't been around quite as long as we have. But I've been working on getting Mr. McKay here for 2 years, and I haven't seen him yet. So my patience is running a little thin.

Mr. GOHMERT. Well, there is——

Mr. CANNON. If the gentleman would yield, I've been here for the last 2 years, and my patience is—"thin" is a gentle way to say it.

Mr. GOHMERT. Well, I'm newer here, and I have that hope that springs eternal in the human breast, I guess. And I believe we're going to get him here at an appropriate time, so I would encourage the Chairman. And I expect to see that happen, or there will be consequences.

But I appreciate the effort, and I applaud the Chairman's effort, and thank you for allowing me to be a part of it.

Mr. CANNON. The gentleman yields back. Without further opening statements, let's turn to the panelists. Mr. Smegal, would you please take 5 minutes and explain. I assure you, we'll have time after.

There's a light in front of you illuminating all panelists. It stays green for 4 minutes; turns yellow for a minute; and then turns red. You don't have to stop in the middle of a sentence, but if you could begin to wrap up at that point, we'd appreciate it. Thank you.

TESTIMONY OF THOMAS SMEGAL, CHAIRMAN OF THE BOARD, FRIENDS OF THE LEGAL SERVICES CORPORATION

Mr. SMEGAL. Thank you, Chairman Cannon, Ranking Member Watt, and the outpouring of others at this Committee. I appreciate the opportunity to address you. My name is Thomas Smegal, and I am Chairman of this Board of the Friends of the Legal Services Corporation, which is a District of Columbia non-profit Corporation recognized by the Internal Revenue Service as a public charity under section 501(c)(3) of the Internal Revenue Code.

Congressman Watt, in my past life—you mentioned John McKay's past life—in my past life, I was first honored to be nominated by President Reagan in 1984 to serve on the Legal Services Corporation Board. In 1993, I was again honored by President Clinton to serve on this board, and I served over the course—each of those nominations, by the way, were confirmed unanimously by the United States Senate—and I served for approximately 18 years.

Now, I've made an attempt to balance a Federal budget while I've been on the board—while I was on the board. There's an attendance fee that members of the board get. Chairman Strickland tells me it's now $318. I didn't take that $318 a day for the 20 years I was on that board. I worked on my own nickel. I represent friends pro bono. The only compensation I have ever gotten—and I haven't gotten it yet—is that I understand from Mr. Daley that I may be reimbursed for my plane fare and hotel room last night, in coming to attend this hearing.

Friends was established in 2001, during my then most recent term on the Board of the Legal Services Corporation. Until a month ago, when we replaced a pro bono staff person from the Corporation, there was no one who was paid to be part of Friends of the Legal Services Corporation. Friends has always been staffed by non-paid volunteers. Its sole mission has been to act in the best interests of the Legal Services Corporation. Upon dissolution of Friends, any asset that has accumulated, including the building that is the subject of this hearing, will revert—must revert—to the Legal Services Corporation.

The way this process started was when John McKay was president—Congressman Watt pointed out that he was president of this—the staff president of the Legal Services Corporation, as Helaine Barnett is now, from 1997 to, I recall, about June of 2001, when he was then being nominated by President Bush to be the U.S. Attorney for the Western District of Washington. But prior to his departure, in 1999 he and others went to the Office of Management and Budget with the idea that had been created by some of us who were sitting on the board, had been subjected to two leases, payment of two leases, when we became board members in 1992—one at 750 Northeast First Street, and the other on Virginia Avenue. Our prior board had determined to move, expecting property in D.C. in 1991 to be rentable on a sublease, and we paid—we paid double rent for 2 years.

Anyway, the concept here was: Is there some way we can cap the rent of the Legal Services Corporation in the District of Columbia? We have to be in the District of Columbia. We have to have space here. And the concept was: If we owned our own building, if the

Corporation owned its own building, then maybe we'd have some control over what the rent would be.

In addition, it occurred to us—and at that time, I spent a lot of time before various Committees of the House and the Senate, defending the Corporation and defending its budget. And we got a lot of—there was a lot of concern upon the Hill here for the Legal Services Corporation. The other concept was: If we had a permanent home, we weren't just wandering around town renting, that maybe that would be helpful with you Members of Congress to demonstrate that we were a vital component of the United States delivery system of legal services.

So John McKay and others went to OMB and said, "Here's what we want to do. We want to buy a building." And OMB said, "Well, you can do that, but if you do that, we're going to score it. We're going to take whatever that building costs off the top of your appropriation in whatever year you do it." And John McKay and others said, "Geez, that doesn't sound like something that we want to do, then. Is there any alternative?" And OMB said, "Yes, there is an alternative. You can set up a 501(c)(3) corporation which will own the building, and you can rent from that corporation."

And there happens to be—and I think Mr. Strickland will share with you several examples of that, that existed before. The Navy has a setup like that; Friends of the Zoo here has a similar situation; and there are a couple of others that Mr. Strickland will get to.

In any event, that was the first conversation. There was no Friends of the Legal Services Corporation at that point. The next meeting—and I was part of that meeting, and went to the White House. And we talked to Counsel to the President, Charles Ruff, and we explained to him what we had hoped to do, if we could accomplish this. And the Clinton White House, through Charles Ruff, said, "This is a great idea."

The process kept going. And incidentally, I'm not here to defend the Justice Department. I'm not here to defend John McKay. But let me at least give you a little insight into what was going on. If you want someone who was there all the time and can answer all the questions, I'm here.

The original Gates offer of $4 million to buy a building occurred in the year 2001—19—no, 2001, when John McKay was, in fact, staff president. The problem with that original grant was that it would expire on December 31, 2001. The problem was at that point we had an opportunity. We hoped to buy a vacant lot up here, which fell through, and December 31 came and went.

Now, John McKay had left the Corporation in June of 2001. He hadn't been there for 6 months. So when the contact is again made with Bill Gates, Sr., I make the contact. I call Bill Gates, Sr. I say, "We couldn't make the deal by the end of December 31, 2001. Can you extend the term in which we could have this grant?" And Bill Gates, Sr., said, "Well, I'll check with my son. I'll call you back." A few months later, I got a call from Bill Gates, Sr., saying, "I'm going to make your day, Tom. My son says we'll give you the money. You can have additional time in which to find a building for the Legal Services Corporation."

Now, we're now in 2002, and we've got a building in sight. And the significance of the building—which, by the way, has to be a Class "B" building, because you can't be a Class "A" building unless you have 100,000 square feet of space. The building has 65,000 square feet. As the Inspector General's appraiser points out, it's 46 percent empty. It's the old adage of, "Is the glass half-full or half-empty?" To us, that's the good news; because we're looking for space to put the Legal Services Corporation in, in June of 2003, when they can get out of the lease at 750 Northeast First Street.

We come to Congress; we come to this Committee; we come to the Judiciary Committee on April 23, 2002. There's no lease. There is no deal. We've got a hold on the building. We're trying to get it. We come up here. And John Erlenborn, Vic Fortuno, Lynn Bulan, Mauricio Vivero, and the person who's trying to put this deal together for us, a financial person, Don Carpenter—the five of them come up here. They meet with Patty DeMarco and J. Keith Ausbrook, who I understand then to have been the chief counsels for oversight investigation for this Committee. That was April 23, 2002, at 2 p.m.

Now, this Committee signed off on the deal, and it was structured at that point. We understood what we were going to do. And then, we went to the only bank that would give us any money. We've got $4 million of Gates' money, maybe, and we have nothing else.

Mr. CANNON. Mr. Smegal, I apologize for cutting you off, but we have—I can assure you that under questioning time you'll have the opportunity to finish——

Mr. SMEGAL. Well——

Mr. WATT. Can I just yield him my 5 minutes, so we can get a clear picture of how this occurred?

Mr. CANNON. Yes. Absolutely.

Mr. SMEGAL. Thank you.

Mr. CANNON. The gentleman is recognized for an additional 5 minutes.

Mr. SMEGAL. Well, BankAmerica is very skeptical about this whole deal, and they say, "Well, geez, we're going to have to give you $15.5 million. We want a million and a half of the Gates money set in a separate account as a reserve, in case you lose your tenant. We want a tenant in that building that will yield $1.7 million a year, so that we know you can service the debt, the 15-point-million-dollar debt that you're going to incur. And as long as you can guarantee us that, then we're willing to give you the opportunity to have this money and go and try and make your deal with the bank."

They had an appraiser. The appraiser is in here. You've got the appraiser's report that the BankAmerica—someone they trust; someone they went to; someone they go to a lot. And they said, "What's this building worth?" This individual said, "This building is worth $60.2 million, once they put some tenant improvements in there." And the concept was up to $2 million in tenant improvements in this 54 percent of this vacant building that the Corporation is going to occupy in June of 2003.

The bank says, "We'll make the deal. You get $38 a square foot, flat, because that's what we need—" They didn't say that. "That's

what we need to carry the debt. That's what you're going to need to carry the debt in addition to the million and a half we've asked you to set aside."

So we go to the Corporation. John McKay is a year away from what's going on here now. He left in June of 2001. This is now June of 2002. The bank gets their appraisal. The banks says, "Okay, we've got a deal." And I, as part of the Legal Services Corporation—I'm serving on the board—and the rest of us who are involved in this—there's nobody else here. It's just us. There's no conflict of interest. There's nobody. It's the Legal Services Corporation, trying to save the Government some money; trying to create a permanent home.

So we create a lease. And the lease is for $38 a square foot, flat, forever. No pass-throughs; no increases; nothing. So what else did we do? There's parking spaces in the building. They're going for $175 to $200 a month in 2002. We say, "A hundred bucks a month, forever." What else? No pass-throughs, no tax increases; $38.

We have a meeting of the board on February 6, 2002. You have the minutes. Bill McAlpin, one of my fellow board members—appointed to the Legal Services Corporation twice—says to me, "Tom, you know, when we came in the office in 1993, we were saddled with two leases, only one of which we could occupy. And you know, that was troublesome." And that was in response to the question he had asked me, "How long is the lease going to be, Tom?" And I said, "Bill, how long do you want the lease to be?"

The tax-free Government bonds that I persuaded the District of Columbia to provide to us, in lieu of the $15.5 million in loan from the Bank of America, is a 25-year bond issue. Twenty-five years sounds like an appropriate term.

The only reason for having the rent level at $38 a square foot, the million-seven, is to service the debt. We have other tenants in the building from which we obtain sufficient funding to accomplish the rest of the management of the building.

And incidentally, there was some question raised somewhere along the way as to, "Gee, the other tenants are paying much less. And how come the Corporation is having to pay this incredible amount?" The other tenant on the fourth floor, Penzance, renewed their lease. We inherited a lot of leases in 2002, in the part of the 46 percent of the building that was occupied.

Penzance recently executed a lease at $31 a square foot. They pay $175 a month for eight parking places; and they have pass-throughs and bumps every year; and their lease is going to end in 2009. The Corporation's current lease is going to end in 2013.

Frank Strickland and his board asked for an additional lease extension—we're now past the owning two buildings, or renting two buildings—a number of months ago. And we started to prepare that. And the Inspector General decided that there was something wrong with a lease extension, so we have put that aside. But certainly, at some point we're going to pick that up.

And incidentally, the other thing that seems to get overlooked in this process, the rest of our tenants are now paying for the space on what is called a BOMA measurement standard. The Corporation is paying on the D.C. standard process. And when you measure with the D.C. standard process, you now get 45,000 feet. If you

measure with BOMA, you'd get 48,000-something. The rest of our tenants are paying more rent, based upon the way you measure the building. BOMA is the way you measure buildings in this city presently. The Corporation has the old standard; much less space they're paying for.

Your Honor, I appreciate—or Congressman, I appreciate this opportunity. And I expect to hear some questions.

Mr. CANNON. I thought you were talking to Mr. Watt there for a moment. [Laughter.]

Who is certainly honorable.

Mr. SMEGAL. I'm sorry, I do have one other point that I want to make right now. Somebody referred—I think it may have been you, Congressman Gohmert—to this 1.3 to 1.8 million of overpayment over a 10-year period. And it was Adlai Stevenson said, "A million here and a million there and sometimes—sooner or later, you have a lot of money."

The cover letter that the appraiser for Mr. West provided to him in his January 25 report contains the following statement, "While the lease was—" And he's evaluating this in 2001–2002. "While this lease was under negotiation as of our retrospective value date, it had not been signed. And at your request, our evaluation does not include the terms of this lease. Our valuation is based on the terms of the seven existing leases that Friends inherited, encumbering 46 percent of the building, with 54 percent vacant; with the balance of the space being vacant on a current basis." Thank you.

[The prepared statement of Mr. Smegal follows:]

PREPARED STATEMENT OF THOMAS SMEGAL

Chairman Cannon, Ranking Member Watt and Members of the Subcommittee:

Thank you for inviting me to speak at this hearing. My name is Thomas Smegal and I am the Chairman of the Board of Friends of the Legal Services Corporation ("Friends"), a District of Columbia non-profit corporation recognized by the Internal Revenue Service as a public charity under Section 501(c)(3) of the Internal Revenue Code.

In 1984 I was nominated to the Board of the Legal Services Corporation ("Board") by President Reagan. In 1993 I was again nominated to the Board by President Clinton. Both nominations received unanimous confirmation by the United States Senate and resulted in my serving on the Board for parts of 18 years until 2003.

Friends was established in 2001 during my most recent term on the Board and at the direction of the Board. Until a month ago when Friends hired a part-time executive director, Friends has always been staffed by non-paid volunteers, including myself. Its sole mission has been to act in the best interests of the Legal Services Corporation ("LSC"). Upon dissolution of Friends, any assets it has accumulated, including the Building that is the subject of this hearing, must revert to the LSC.

At the outset, let me suggest that, as the Inspector General ("IG") himself has acknowledged, the discussions we are having today are premature. The IG has stated that his evaluation of the 3333 K Street Lease is not complete. In effect, what we are discussing is an interim report by the IG that says "LSC is paying more for this car than the price of other cars available at the car dealer." What this statement omits is any discussion about whether the car being bought is a used Saturn with 100,000 miles on it or a brand new Buick.

In its simplest terms, the IG is saying "LSC is paying $38 per square foot in rent, and that seems too high to me." What that comment ignores—by the IG's own admission—is the rest of the terms of both the Lease itself and the relationship between Friends and LSC. Thus, I would rather that the Subcommittee had the benefit of the full analysis—which the IG has suggested he is undertaking—as that full analysis will show this transaction to have been extremely favorable to both LSC and the Federal Government. However, as we are here today, let me point out the main features of the Lease that the IG has yet to consider and which, I am confident, will obligate him to render a favorable final report when it is written.

First, the Lease at a fixed $38 per square foot is a *long-term* lease. All other leases in the building are for 5 years or less, as opposed to the 10-year lease Friends has with LSC. It is customary in the District of Columbia ("DC") for long-term leases to have different terms than *short-term* leases. This long-term fixed rate Lease, with the resulting security of tenancy, was one of the primary goals the Board was seeking in looking for new space to occupy when the existing LSC lease on Capitol Hill expired in 2003.

Second, this long-term Lease does not include any rent increases. A typical long-term lease would include both "bumps" every 5 years and CPI increases in each year. As the IG's appraisers acknowledge, even if there were a slightly higher initial rental rate *fixed for 10 years,* versus a slightly lower initial rental rate that rose over the term of a lease, the actual result would be a *net savings* to LSC. Further, the IG has yet to consider the added value throughout the Lease term of providing 52 below-market parking privileges to LSC.

Third, the Lease is a "full service" lease, which transfers the risk of rising real estate taxes, utilities and other operating expenses to the landlord. With oil prices spiraling, you can easily see that the structure of this Lease is highly favorable to LSC.

Finally, and perhaps more importantly, the IG has not evaluated the unique relationship between Friends and LSC. As I noted in the beginning of this statement, Friends was created by LSC and its sole mission is to support LSC. Once the mortgage on the Building is paid, Friends has several options. Friends can either dissolve and turn the Building over to LSC, rent the Building to third parties and turn over the profits to LSC, or relet the Building to LSC at terms even more favorable to LSC than those provided by the present ten-year Lease.

The concept of a Friends' owned building, leased to LSC for its administrative headquarters at a flat, fixed rate—to cap the LSC annual rent appropriation requested from Congress—was the motivation for the efforts of those including John McKay and Congressman John Erlenborn during their terms as President of LSC.

As the attached chart shows, in 1992, the per square foot price of LSC's space was $28 per square foot (DC standard). By 2001, the year Friends was incorporated, that price had risen to $36 per square foot. One of the IG's appraisers projected that LSC's cost was going to rise to nearly $49 per square foot by 2012, and the Board actually saw it going higher than that. By contrast, LSC's current cost per square foot, fixed at $38 gross through 2013, is actually less than $37 net and declining annually when the increasing value of the parking subsidy is thrown in. Thus, as the attached chart clearly illustrates, bringing an end to soaring occupancy costs had already been one of the significant results of the Lease.

As the Board informed the IG in its "Response" of April 20, 2005, the creation of Friends and acquisition of 3333 K Street were vetted with and approved by his predecessor, OMB and both the Senate and House Appropriations Committees. The structure of Friends as a 501(c)(3) corporation was designed by the Board, based on advice of counsel, to satisfy OMB and CBO budgeting rules, and provide LSC with a mechanism to fix, and then to reduce, and finally to eliminate the occupancy cost component of its budget. Through the acquisition of 3333 K Street by Friends, LSC will be able to devote more of its precious resources—the taxpayers' dollars—to its vital mission of delivering legal services to indigents.

We are proud of the creativity that went into developing Friends as an opportunity to save taxpayers' dollars, made possible by the generous contribution of the Melinda and Bill Gates Foundation in supporting the LSC mission through the vehicle of Friends.

Thank you for your time. I'll be happy to respond to any questions.

Mr. CANNON. Thank you, Mr. Smegal.

Mr. Strickland, you're recognized for 5 minutes.

Pardon me. Let me point out, staff has just pointed out that we did not swear witnesses in as we typically do. That's fine. Let me just say that if you swear in, then you're subject to perjury. If you just talk to Congress and say something that would otherwise be perjury, it is telling—it's not being truthful with Congress; which has exactly the same penalties.

So I just want to inform you that, in my view, a swearing in is redundant. And given the lawyers we're dealing with, I think you understand the implications of that. And I apologize for that diversion.

Mr. Strickland, we're looking forward to hearing from you for 5 minutes.

TESTIMONY OF FRANK B. STRICKLAND, CHAIRMAN OF THE BOARD OF DIRECTORS, LEGAL SERVICES CORPORATION

Mr. STRICKLAND. Thank you. Chairman Cannon and Mr. Watt, and other Members of the Committee, thank you for inviting me to be here today. I'm Frank Strickland, and this is my third year as Chairman of the Board of Directors of the Legal Services Corporation.

I will add, also, that when our board members were nominated and confirmed in 2003, it was by unanimous vote of the Senate.

You already have my prepared remarks, which I understand will be entered into the record, so let me just make a few brief comments.

The transaction we're talking about today is at 3333 K Street. It was conceived by our predecessor board, not the current board. We have simply inherited what was delivered to us. So the question would be: Was it a good deal?

We think it was. And we've said so in our replies to the Inspector General's report. The evidence to us is clear that what the prior board did was a far better alternative than the continued reliance on the Washington, D.C., commercial real estate market. And the market today, as we understand it, is that non-profit organizations are leaving the District, because they can't afford to pay the rent. LSC doesn't have that option. We're required by law to be located in D.C.

Now, another question might be whether everything that was done in connection with the lease transaction was done perfectly. I can't say that it was. But we do believe that our predecessors had a good idea, and that they implemented it successfully.

Was the transaction transparent? We think it was. You've just heard Mr. Smegal explain all the bases he touched, and others in LSC touched, when the transaction was being contemplated.

As far as we can tell, Congressman Erlenborn, who was then the president of LSC, and the LSC staff, briefed all appropriate parties, including this Committee and the Office of Inspector General.

We've been told that because the Inspector General's report did not contain any recommendations, that our board actually did not have to respond. But when we got the report and reviewed it, we concluded that we had to reply to it. We disagreed with the methodology in the report, the conclusions reached in the report, and the characterization of the transaction.

From the perspective of our board, dealing with a report that's critical of our organization, even though we didn't do the lease transaction, that's very distracting to our board and to our management from doing what we should be doing; and that's trying to run an efficient and effective nationwide program to provide legal assistance to the poor.

That's our mission, and we shouldn't forget it. We know that in the past there have been disagreements between LSC and the Congress on exactly how our mission should be undertaken. Since I've been the Chairman, our instructions to the staff have been clear.

We're going to run an efficient, high-quality legal services program exactly in the manner that Congress intends that we run it.

Our predecessors, we believe, were correct in trying to get LSC out of the D.C. office market. They were looking for a way to cap occupancy costs. They were creative, and they put together a deal that was far better than the status quo at the time.

And as Mr. Smegal said, in doing so, they persuaded the Gates Foundation to donate $4 million, specifically for the purpose of this building. They cleared it with both the Clinton and Bush administrations and briefed the House and the Senate Appropriations Committees, as well as this Committee.

Mr. Chairman, that concludes my short opening statement.

[The prepared statement of Mr. Strickland follows:]

PREPARED STATEMENT OF FRANK B. STRICKLAND

Mr. Chairman, Mr. Watt, and Members of the Subcommittee, thank you for the opportunity today to testify with regard to the current leasing arrangement the Legal Services Corporation has for its headquarters at 3333 K Street, Northwest.

When I and seven of my fellow members of the LSC Board of Directors had the honor of being nominated by President Bush and unanimously confirmed by the Senate in 2003, our plan was to oversee the delivery of high quality and efficient legal services to the poor throughout America, and to faithfully enforce the intent of Congress as expressed by the various laws governing both LSC and our local legal services programs. I believe we are doing that.

One of our first tasks was to fill the two positions at LSC that report directly to the Board. The President, former Congressman John Erlenborn, a distinguished member of this body for twenty years, clearly indicated his desire to retire and we had an acting Inspector General. The Board brought on Helaine Barnett as President in January 2004 and Kirt West as Inspector General last September.

In February, the Inspector General delivered a draft report prepared by his Office regarding the lease of 3333 K Street. Because that report made no recommendations and did not question the conduct of either the current Board or President, the Board had no legal or substantive obligation to respond, a fact the Inspector General pointed out to us.

However, because the report stated that LSC was overpaying rent by as much as $1.9 million over 10 years compared to fair market value, and paying more than if it had remained in its previous offices, we decided to examine the report carefully. Moreover, because of vague allusions to conflict of interest and breaches of fiduciary duty, our President in consultation with me decided to appoint a new senior staff person, who had not been present during the transaction, to help the Board review the matter.

The Board concluded its review in the third week of March. We voted unanimously that, based on the information provided to us by the OIG, we could not conclude that the lease transaction was "inappropriate or fiscally unsound." In short, we rejected the draft OIG report. The final OIG report, basically unmodified from the draft, and the Board response were transmitted to Congress on April 22.

Let me quickly highlight the key findings of the Board. First, we had serious problems with the methodology employed by the two appraisers hired by the OIG as well as the manner in which the OIG analyzed those appraisals. The appraisers, on the apparent instructions of the OIG, used a static, retrospective analysis based solely on the state of the commercial real estate market in July 2002. It seems obvious, in reviewing the judgment of the prior Board and Congressman Erlenborn, the evaluation should be based on expectations of the commercial market from June 2003 through May 2013 (the life of the lease) and should take into account events that have transpired since mid-2002. In this regard, one of the OIG's appraisers noted that the retrospective analysis they employed is normally used for estate valuations, tax assessments, and condemnations. That kind of analysis is irrelevant to evaluating the merits of LSC's current lease.

Second, in comparing LSC's costs to those at its prior offices, the OIG ignored the fact that the prior Board and management had concluded that LSC needed additional space, and in fact acquired 5,000 additional square feet and 27 additional parking spaces as a result of the move. The OIG did not take into account what it would have cost LSC to get 5,000 additional square feet in its previous office building on First Street, even if such space was available. The OIG also ignored the

fact that LSC's lease was expiring in 2007 and that LSC had would have had to renegotiate with its then-existing landlord or find new space in what is clearly now a very hot D.C. commercial real estate market. In fact, as of this moment, LSC is paying less, when taking into account the additional space and parking spots, than it would have been paying had it not moved, a point one of the OIG's appraisers acknowledged.

Third, with respect to the allegation that LSC is overpaying compared to fair market value, the Board concluded that the analysis employed by the OIG failed to take into account several key factors. I will not repeat all of them here; they are in our response. The key one is that LSC received tenant improvements of up to $2 million—well over what a typical market transaction would have provided for. Just like a car buyer gets a different price depending on whether he puts up cash or insists the dealer provide him with a no interest loan, when a tenant receives above market concessions from the landlord, they have to be paid for and that will reflect itself in the lease cost. The difference between tenant concessions assumed by one of the OIG's appraisers in estimating fair market rent and what LSC actually received is $1.6 million—$1.3 million in tenant improvements and at least $300,000 in parking concessions—over 80 percent of the alleged $1.9 million over-payment that the OIG calculated using that appraiser's assumptions. Even accepting some questionable assumptions on the part of the OIG and its appraisers, we are left with an alleged overpayment over ten years of $300,000 when the tenant concessions are accurately counted. That amounts to 1.7 percent of the total lease payments to be made under the contract.

A week after the OIG report was submitted to Congress, I was provided a copy of the contemporary appraisal commissioned by the Bank of America in 2002 before it agreed to finance the transaction. That appraisal concluded, taking into account the value of the above market build-out, that the proposed LSC rent was within the range of fair market value. The Board was not made aware of the appraisal during its consideration of the OIG draft report, although the OIG had the appraisal, and the Board subsequently voted unanimously that we should have had it and that it confirmed our conclusion. Accordingly, we believe the OIG failed to make his case and we consider this matter closed.

Finally, I would like to make a few observations. First, I will not try to assert that everything done by LSC from 2001 to 2003 was perfect. However, the OIG's suggestion that LSC overpaid by $1.9 million over ten years or somehow failed to adequately serve as a reasonable, fiscally prudent steward of public funds is incorrect. I would note that the then-Inspector General was at the time represented at virtually every meeting at which the lease transaction was discussed and was fully aware of all the details of the transaction, even requesting and receiving a private briefing. It is my understanding that no objections were raised with the previous Board or management by the previous Inspector General or the OIG.

Second, it is indisputable that this transaction will ultimately save LSC money. The only question is how much and beginning when. The OIG pegged the beginning of savings to be in the last couple of years of LSC's ten year lease with total savings only to be realized if there is an extension. Based on the evidence provided to the Board, it appears more likely that LSC is beginning to see savings now and will show significant savings during the current lease term. There is no question that, during a second ten year term and beyond, savings will be substantial compared to the alternative of continuing to rent commercial office space.

Third, there has been no evaluation by the OIG of the substantial benefits to LSC from the transaction. These include efficiencies from LSC's possession of space built to its needs and specifications; stabilizing LSC's cost of space and removing its dependence on the D.C. commercial office market; and the long-term advantage of having a nonprofit landlord which was specifically created for, and whose charter provides as its purpose, to benefit LSC and support its mission of delivering legal services to the poor. No other landlord fits this description.

This transaction was conceived by John McKay, who President Bush appointed as and is now U.S. Attorney for the Western District of Washington. The K Street building was found, the details negotiated, and the contracts executed under the direction of former Congressman Erlenborn, with every key decision approved by my predecessors on the Board. I cannot say everything was done perfectly; I was not here at the time. I am confident, however, that the prior LSC Board acted honorably and properly every step of the way and that, if any mistakes were made, they were miniscule compared to the overall long-term gains that are and will be realized by LSC. The current Board has reviewed the reports of the Inspector General suggesting that our predecessors, previous management and the former Inspector General all erred in approving this transaction and we unanimously rejected that finding.

Mr. SMEGAL. Would you mind referring to the graph, please?

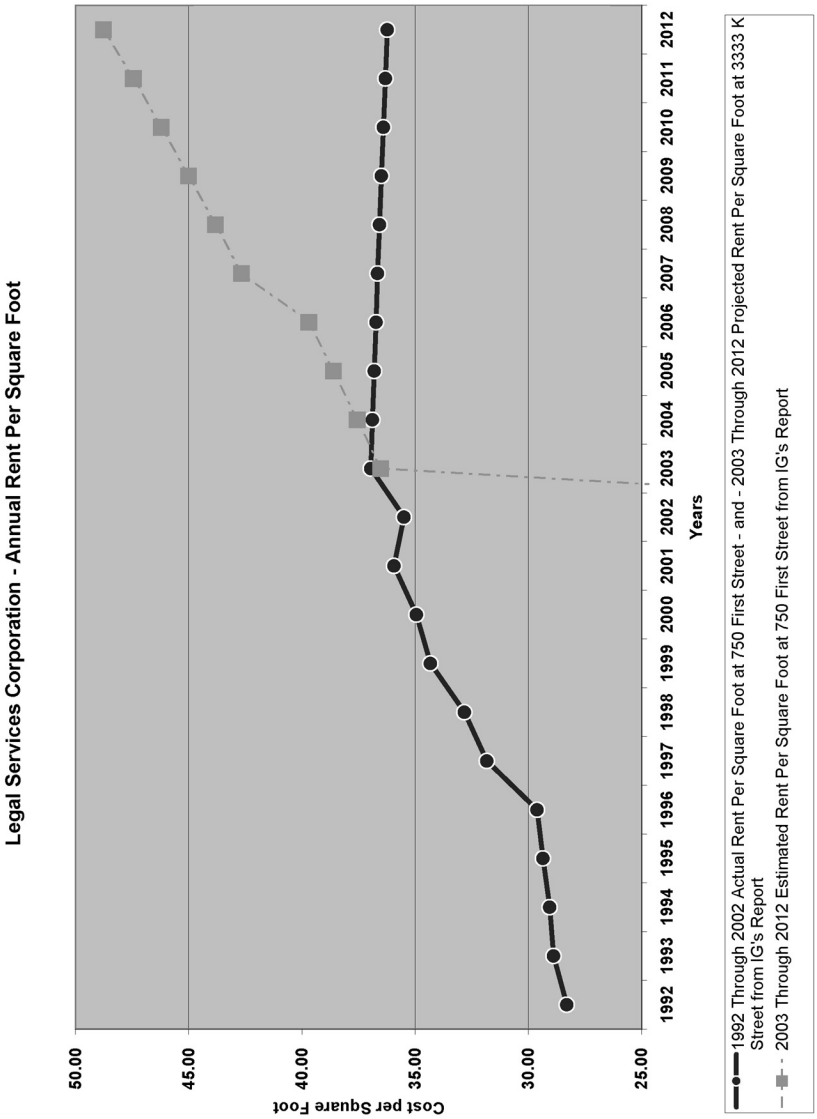
Mr. STRICKLAND. I would want to refer—you mean to the graph?

Mr. SMEGAL. Yes, I'm sorry, Your Honor——

Mr. STRICKLAND. I'm sorry. Mr. Smegal reminded me, I want to refer to the graph that's over here on the chart. And I hope that we've provided—we're now providing copies of the graphs so that you can read it up close.

Mr. CANNON. Without objection, the graph will be made part of the hearing record.

[The information referred to follows:]



Mr. STRICKLAND. I'd be glad to discuss that, or Mr. Smegal can discuss that graph at the appropriate time, whether that's now or later, Mr. Chairman. But except for the presentation of the graph, that would conclude my brief opening. And I'll be glad to answer questions at the appropriate time.

Mr. CANNON. Thank you, Mr. Strickland.

Mr. West, you're recognized for 5 minutes.

TESTIMONY OF R. KIRT WEST, INSPECTOR GENERAL, LEGAL SERVICES CORPORATION

Mr. WEST. Good afternoon, Mr. Chairman, Mr. Watt, and Members of the Subcommittee. My name is Kirt West. I've been the Inspector General of the Legal Services Corporation since September 1, 2004.

For nearly 20 years, I've served in various legal and executive capacities in the inspector general community. I appreciate this, my first opportunity to discuss the work of the LSC OIG with the Subcommittee. A more exhaustive review will be included in my written statement.

Before discussing the leasing arrangement, I would like to begin briefly by discussing my role as IG. Like all IGs, my mission is to prevent and detect waste, fraud, and abuse, and to promote efficiency and effectiveness. IG quality standards require me to adhere to the highest ethical principles, and to conduct my work with integrity.

Ultimately, my job is to write independent and objective information to the LSC board, the Congress, and the public, as to whether federally-appropriated tax dollars are being spent wisely and prudently in carrying out the LSC mission.

This past October, in response to inquiries from the Subcommittee, I decided to look into LSC's 2003 move from Capitol Hill to Georgetown. Staff from OIG and LSC management had also told me in confidence that they believed that LSC was overpaying for its Georgetown location. At that time, I was also aware that LSC was negotiating a lease extension, so I wanted to provide prompt, independent, and objective information about rent to assist the board in its negotiations.

Because we are not commercial real estate experts, I hired two experienced commercial real estate appraisal firms to determine whether LSC was paying fair-market rent when it signed a lease in July of 2002, as well as in November in 2004, in case there had been significant changes in the Georgetown market.

The appraisers followed their professional standards and used their independent judgment. No one from my office directed the appraisers' work or suggested any particular outcome. Both appraisers independently concluded that LSC is paying higher than market rent for its Georgetown space. This was the case in July 2002, and is still the case.

Based on these reports, the OIG calculated LSC would overpay the landlord between 1.23 million and 1.89 million over the life of the 10-year lease. This overpayment occurs in the first 7 years of the lease. For example, over the next 12 months, LSC will overpay at least $300,000.

In addition to these appraisals, Mr. Chairman, the OIG has overwhelming objective evidence that LSC is overpaying rent. For instance, all other tenants in the building are paying below market rent. Even the landlord's own rental agent states that LSC's first-floor space would only rent for 24 to 26 dollars per square foot; far below what LSC is paying.

The OIG also calculated that LSC could have saved at least $1.1 million by remaining at its Class "A" location on Capitol Hill, next to Union Station, instead of moving to its Class "B" building in Georgetown.

Finally, LSC may be due a rent credit of more than $100,000. LSC was charged for 2,000 square feet of space that it did not occupy for 18 months.

I'd like to mention a few of the many other observations that have come from this review. Although this building is commonly referred to as LSC's permanent home—or, as Mr. Smegal suggested, forever—LSC has a 10-year lease, and the OIG is not aware of any legally binding agreement allowing LSC to stay permanently or to take ownership from Friends.

LSC management has not provided the OIG with any documents that support the need for LSC to have a 45,000-square-foot headquarters out of a 65,000-square-foot building—which I think is more like two-thirds than 54 percent.

LSC did not have records tracking how much of its $2 million tenant improvement allowance was spent.

Although LSC officials created the Friends of Legal Services Corporation, LSC no longer controls Friends.

Friends recently made an unrestricted contribution to the National Legal Aid and Defenders Association, that LSC itself could not make directly.

Thank you, Mr. Chairman, for this opportunity to testify before the Subcommittee. I am proud of the work being done by the staff of the LSC OIG. We look forward to continuing to conduct independent and objective reviews, so that the LSC Board of Directors, the Congress, and ultimately the American taxpayers can be assured that federally-appropriated tax dollars are being spent wisely and prudently to provide legal services to those in need.

[The prepared statement of Mr. West follows:]

PREPARED STATEMENT OF R. KIRT WEST

Statement of

R. Kirt West, Inspector General

Legal Services Corporation

Before the

U.S. House of Representatives

Committee on the Judiciary

Subcommittee on Commercial and Administrative Law

June 28, 2005

Chairman Cannon, Ranking Member Watt, and Members of the Subcommittee. My name is Kirt West. I have been the Inspector General of the Legal Services Corporation (LSC) since September 1, 2004. Before becoming Inspector General, I served for nearly twenty years in various legal and executive capacities at the Postal Service, the Central Intelligence Agency, and the Department of Labor. I am a career Federal employee, not a political appointee, and came to LSC to keep Congress and the LSC Board of Directors informed as required by the Inspector General Act. I appreciate this opportunity, my first, to discuss the work of the LSC Office of Inspector General (OIG).

Introduction

Like all other Federal Inspectors General, the LSC OIG operates under the Inspector General Act of 1978. In 1988, Congress amended the IG Act and required LSC and about 30 other, mostly smaller, federally funded entities to

establish independent Inspector General offices. LSC is headed by an 11- member Board of Directors appointed by the President and confirmed by the Senate. The OIG is headed by the inspector general who is hired by, reports to and is under the general supervision of the LSC Board of Directors. In addition to the duty of the inspector general to report to Congress, a similarly important role is to provide independent and objective information to the Board of Directors and to Congress, which may not always receive such information from other sources.

The OIG conducts audits, investigations and other reviews to assist management in identifying ways to promote economy, efficiency and effectiveness in the activities and operations of LSC and its grantees; and to prevent and detect fraud and abuse. In addition, beginning with LSC's FY 1996 appropriation, Congress directed that the primary tool for monitoring grantee compliance with legal requirements would be the annual audits of all grantees. These audits are conducted by independent public accountants under guidance developed by the OIG and the OIG monitors their compliance with the guidelines. Congress has also specifically authorized the OIG to conduct program reviews of grantee compliance.

Like all Inspectors General, my mission is to prevent and detect waste, fraud and abuse, and to promote efficiency and effectiveness in the operations of LSC and its grantees. Inspector General Quality Standards require me to adhere to the

highest ethical principles by conducting my work with integrity. My job is to provide independent and objective information to the LSC Board of Directors, the Congress, and the public as to whether federally appropriated tax dollars are being spent wisely and prudently in carrying out the LSC mission. It is my role to report to management and it is their decision, subject to Congressional oversight, to act or not act on the information I report.

Changes at the LSC's Office of Inspector General

Over the past several years, the LSC Board and Congress may not have had the benefit of an independent and objective OIG. Prior to my appointment, there was an acting IG for nearly four years working under two different Boards of Directors. The former acting IG served as a caretaker and did not develop a comprehensive work plan.

Shortly after I started, I conducted an analysis of the activities of the OIG to determine whether the office was performing its mission adequately. Members of my staff, as well as some LSC managers, told me they thought the OIG was underperforming. In making courtesy visits to the Oversight and Appropriations Committees of the Congress, I heard similar concerns that the OIG was underperforming.

There were also Congressional concerns about the perceived lack of IG independence. The IG had failed to spend over one million dollars of previously

appropriated funds. In FY 2005 Congress made one million dollars of these funds available to LSC management to establish a Loan Repayment Assistance Payment Program.

I observed that for several years, the OIG had not conducted reviews of LSC's internal operations. The OIG did not have any investigators on staff but used a contract investigator on the rare occasions when the former acting IG determined that a criminal investigation was warranted. The OIG had used contractors instead of OIG audit staff to oversee the review of the Independent Public Accountants, which LSC grantees are required to employ to conduct audits of the grantee financial statements as well as grantee internal controls and compliance with LSC prohibitions and restrictions. The OIG did not appear to be targeting high risk programs, was not very responsive to Hotline complaints received from concerned members of the public, and did not appear to pursue a consultative relationship with the Congress. I concluded the OIG was clearly underperforming.

Thus, in addition to continuing to carry out our responsibility to oversee the monitoring of LSC grantee compliance with the restrictions placed on them to refrain from certain activities, we have started to review the internal operations of LSC as authorized by the Inspector General Act. While we are including internal reviews of LSC operations, we are also strengthening our grantee compliance oversight procedures. Our investigative activity has increased markedly with the

hiring of two investigators; our legal staff continues to support all of our efforts and to provide comments on significant LSC regulatory and policy initiatives. The OIG is also making progress by defining and setting new directions and allocating OIG resources to high-risk areas and by starting to identify major management challenges facing LSC.

Within the OIG, we are improving ourselves and our work environment by conducting training and undergoing a peer review. Staff received training in writing and editing reports. The OIG also is working toward becoming a high-performing organization, and we have begun that effort with the assistance of a consultant on staff at the Office of Personnel Management's Federal Executive Institute. In addition, in accordance with inspector general community standards, another OIG is completing an audit peer review of work done before I arrived. The results of this independent review should inform me of ways the new OIG can improve its performance.

The OIG is committed to delivering high-quality professional audit, investigative, and other services to help the Board and management improve LSC programs and operations. To that end, we will provide timely, accurate and fact-based audits, inspections, evaluations, and investigations to help LSC carry out its mission. That was our intention when we issued a report to the LSC Board concerning a 10-year, $17.1 million lease of 45,000 square feet of office space signed by LSC in 2002.

The decision to review LSC's lease and 2003 relocation from Capitol Hill to Georgetown came from a number of sources including inquires from the Subcommittee. There were concerns about how LSC could afford to relocate to Georgetown. Around the same time, staff from the OIG and LSC management had told me in confidence that they believed LSC was paying above market rent for its Georgetown space, that LSC's total rent was more than what LSC was paying for its Capitol Hill space and that some employees were unhappy with the longer and more difficult commute because the office was no longer near Union Station and Metro Rail.

At the time I was hearing these concerns late last year, I became aware that LSC was in the process of negotiating a lease extension with its landlord and felt the Board could benefit from independent and objective information as to whether LSC was paying fair market rent. That is why I decided the OIG should conduct a review of the lease.

As background, in 1998 LSC began pursuing the idea of purchasing its own building to provide LSC with higher visibility and a sense of permanence. LSC believed a permanent home would also cap its future occupancy costs. When LSC decided to look for a new home, it was hoping to find comparable space for a comparable price to their 40,000 square feet of office space.

Purchasing a building outright, however, concerned LSC advisors because it could have triggered Office of Management and Budget (OMB) "scoring" rules. The scoring rules could have required that the entire purchase price be counted against LSC's appropriation in the first year rather than being charged annually over the term of years of the mortgage. The purchase price would have exceeded the entire LSC annual budget for management and administration, including salaries, thereby making the purchase impossible. LSC was advised that establishing a not-for-profit supporting organization could avoid OMB scoring as long as the lease itself was not a capital lease. Consequently, Friends of Legal Services Corporation was established by three LSC officers in 2001.

OIG Lease Review

The OIG began the lease review by first discussing the project with the General Services Administration OIG because of its oversight responsibilities of GSA's commercial leasing operations for the Federal government. It recommended that the OIG consult an appraiser to determine whether LSC was paying fair market rent. As a result, we hired two experienced commercial real estate appraisal firms in January 2005 to determine whether LSC was paying fair market rent.

One of the real estate appraisal firms hired by the OIG was recommended and used by the U.S. Postal Service (Joseph J. Blake and Associates, Inc.) in its leasing of commercial office space, and the other firm's principal had experience working at GSA and OMB (MillenniuM). The appraisers met with OIG and were

given the same task order, which included calculating how much rent LSC should be paying for the space it now occupies based on the Georgetown real estate market. No one from my office directed their work or suggested any outcome. The appraisers did not discuss details of their work or their results with each other.

OIG conducted this work in accordance with professional standards established by the President's Council on Integrity and Efficiency. The OIG and the appraisers conducted their work with impartiality and independence, and the OIG's conclusions were indexed to supporting documentation which in turn was checked for accuracy by an independent auditor.

Unlike a lender's appraisals whose main purpose is to support the purchase price so that a loan can be approved, commissions earned, etc., the OIG appraisers had the straightforward task of determining what would have been the fair market rent if LSC had entered into a lease at 3333 K Street in July 2002 in a business-like, arms-length transaction. I was prepared to seek a third appraisal in the event the two appraisals reached materially different conclusions, but both appraisals reached similar conclusions.

Both appraisers concluded that LSC is paying higher than market rent even though the landlord is Friends, which was established by LSC to help control its rent costs. The appraisers concluded LSC was paying above market rent in July 2002 when LSC entered into the lease with Friends and was paying above market rent in November 2004 when the OIG began the review. These

appraisals also revealed that currently all non-LSC tenants are paying below market rent, including those that entered into a lease after LSC signed its lease.

Based on the two independent appraisal reports, the OIG calculated LSC would overpay at least $1.23 million and perhaps as much as $1.89 million in rent over a 10-year period as a result of paying above market rent. Based on information provided by the appraisers, the OIG also calculated that LSC could have saved at least $1.1 million over a 10-year period by remaining at its Class A location on Capitol Hill near Metro Rail instead of moving to its Class B location in Georgetown. The OIG also calculated that LSC could be due a rent credit of over more than $100,000 because it was paying Friends for 45,000 square feet when it only occupied 42,852 square feet between June 2003 and late 2004.

In gathering information concerning this project, the OIG ran into several unexpected challenges obtaining documents and interviewing people. LSC management was unable to locate some information that would have assisted us in our review. LSC did not have records tracking how much of LSC's $2 million tenant improvement allowance was spent. This lack of records made it impossible for the OIG to determine whether LSC received full value of the allowance and whether Friends owes LSC about $200,000 for costs incurred by LSC. We reported this to LSC management. Also, the only copies of some LSC records were not in LSC's files but were instead mixed up with the landlord's records which were kept by an LSC staff attorney serving as the custodian of

records for Friends. While LSC was cooperative, Friends was not nearly as cooperative, and we found ourselves having to deal with an LSC staff attorney as well as Friends' President and outside counsel in order to obtain Friends records.

Throughout our review it has been difficult to ascertain who was on whose side. For example, private outside counsel who was retained by LSC to provide legal advice to LSC on creating Friends is now representing Friends. And in reviewing LSC Board meeting transcripts, it was difficult at times to determine whether those LSC employees and LSC Board members concurrently serving on the Friends Board of Directors were representing LSC or Friends.

Another challenge faced by my office was the lack of criteria used by most other OIGs to evaluate LSC actions. Unlike most other agencies that have OIGs, LSC is not subject to most Federal laws and regulations that provide criteria for evaluating management action. Some agencies, such as the CIA and Postal Service, where I previously worked, also are not subject to many of the rules applicable to other Federal agencies. However, even the CIA and the Postal Service are subject to laws such as the Ethics in Government Act, which prohibit conflicts of interest, and civil service laws that protect employees who report fraud, waste, abuse, and mismanagement. LSC is not subject to those requirements, and in some cases has not developed a counterpart policy, such as a corporate code of conduct.

I am extremely concerned there may have been conduct by LSC officials that, but for this lack of applicable laws and regulations, could constitute administrative and even possibly criminal violations of the conflicts of interest laws applicable to all Executive Branch employees. In addition, I am concerned that LSC is not subject to the Whistleblower Protection Act. All LSC employees, including the Inspector General, are at-will employees, not subject to the due process protections afforded Federal employees and most state and local government employees. This at-will environment and lack of due process protections present a challenge to the OIG to effectively carry out its mission because it can deter employees from reporting their concerns and observations without fear of retaliation. As a first step to encourage my own employees to report any of their concerns, I have asked the Office of Special Counsel to ensure that OIG employees have whistleblower protection. I also intend to propose to the LSC Board that it develop an LSC corporate code of conduct which, if adopted, would enhance employee integrity and provide criteria against which to measure employee actions.

Although our review has focused on the two independent appraisals and the question whether LSC is paying fair market rent, we also made the following observations.

- LSC is overpaying more in the earlier years of the lease than in the later years. The OIG calculates LSC already overpaid between $752,000 and

$872,000 for the first two year of the lease, June 1, 2003 – May 31, 2005, and will overpay between $301,000 and $363,000 in the next twelve months.

- The above market rate of $38 per square foot appears to have resulted from the amount of rent Friends needed from LSC to satisfy the lender. As a condition of providing financing to Friends, the Bank of America required Friends to have an income rent stream of $1.71 million per year, which resulted in LSC having to rent 45,000 square feet of office space at $38.00 per square foot for a term of 10 years.

- The two independent appraisals were not the only evidence that LSC is overpaying rent. In an April 1, 2004 email, Friends was told by its real estate management firm that " the rental rate for the first floor LSC space would likely fall somewhere in the $24-$26 range with 2.5 to 3.0 percent escalations. There will likely be 4-6 months down time to find a user."

- As the 10-year lease reaches its term, it becomes more favorable to LSC. Friends, however, has proposed a lease extension that would require LSC to pay pass through costs, which it does not currently pay, beginning in June 2013. These additional costs would make the lease less favorable to LSC.

- A Memorandum of Understanding between LSC and Friends regarding the lease extension uses a different method of measuring space and includes pass through costs. This new measurement standard would increase LSC's annual rental by more than $200,000 per year, not counting pass through costs.

- Some LSC employees and Board members were more sensitive to actual or apparent conflicts of interest than others. For example, LSC President and Board member John Erlenborn, who was also serving as Friends' President and Board member, recognized the importance of LSC and Friends being able to enter into arms length negotiations. Mr. Erlenborn resigned from Friends but two other LSC officers and one LSC Board member continued to serve on the Friends Board through as late as the spring of 2004.

- LSC lost control of Friends and therefore lost control of the building. At the time it was established, LSC had a controlling membership on Friends' Board of Directors. Over time, the Friends' Board expanded and the three LSC officers either resigned or were replaced. Today, although the LSC Board appoints one Friends Board member, there are no LSC employees or current LSC Board members on the Friends Board. In the recent past, Friends began taking calculated measures to gain distance and

independence from LSC. Currently, the actual relationship between Friends and LSC is unclear.

- Friends made a $50,000 unrestricted contribution to an organization although LSC could not make such an unrestricted contribution.

- LSC does not own the building. Although the building is commonly referred to as LSC's permanent home, we were not able to identify any permanent or ownership interest of LSC in the building. LSC has a 10-year lease and the OIG is not aware of any legally binding agreement allowing LSC to stay permanently at market (or below market) rent or to take ownership of the building from Friends.

- There is only one document, a lender's appraisal, that could even possibly be construed to justify a $38.00 per square foot rent rate and it contains a flawed market rent analysis. The analysis compared the LSC headquarters, a Class B building, to among others, two Class A buildings, the Watergate Office Building and Washington Harbor. In Georgetown, Class A building rent commands about $8.00 per square foot more than Class B Buildings. In addition, the appraisal contained no analysis of the relative merits of the comparables nor did it provide any justification for the adjustments in comparables in determining fair market rent.

OIG Review of LSC Space Needs

The OIG will soon be issuing its review of whether LSC had a valid business case to lease 45,000 square feet for approximately 110 employees, or over 400 square feet per employee, when GSA guidelines recommend 230 square feet per employee unless justified by specific mission requirements and validated though benchmarking. As soon as our report is final, we will issue it to the Board of Directors and Congress.

Conclusion

Mr. Chairman, thank you for this opportunity to testify before the Subcommittee. I am proud of the work being done by the staff of the LSC Office of Inspector General. We look forward continuing to conduct independent and objective reviews so the LSC Board of Directors, the Congress, and ultimately the American taxpayers can be assured that their money is being spent wisely and prudently to provide legal services to those in need.

Mr. CANNON. You obviously practiced your time. That was within the 5 minutes. Thank you. Elegantly done.

The Chair recognizes himself for 5 minutes. That's something I don't normally do. I usually go last on the questioning, but the situation really begs for my discussion early, I think.

I was surprised, Mr. Strickland, on seeing this chart on the board when I walked in, because we talked about this chart last night in my office. And I thought I made some compelling points on that chart. Do you recall those points?

Mr. STRICKLAND. As I recall our discussion, the chart demonstrates the cost of continuing at 750 First Street, versus the flat rate at 3333 K Street. Mr. Smegal wanted to make use of the chart, to make some of his points, and that's the reason why we brought it today.

Mr. SMEGAL. Congressman, yes, it's part of my presentation. But I ran out of even Congressman Watt's time, so I went on.

Mr. CANNON. Thank you. We'll come back to it. But let me just tell you why I think the chart is a problem here. The pink dots represent a possible future scenario that you can't know until you get to the signature on a new lease. And while that—even if it were true and not a fantasy, not a future projection, it totally misses the underlying point; which is looking backwards to the time when Friends of Legal Services was created.

Friends of Legal Services was created to do something that Legal Services itself could not do directly; that is, get around the OMB A-11 regulation that dealt with capitalized loans. And so we have this. What is really deeply concerning me here about this discussion is that there is—and the presentation so far—is that you all are acting as lawyers and advocates; instead of acting as board members and considering the policy implications of what's going on.

And as a result of that, the advocacy that you're presenting just begs for challenge. And in fact, if you will look at the issues, there are many points that can be challenged. And what's not happening here is you're not saying, "We've got a problem. We've got a building. We have got a conflict of interest. We have two groups."

And I've read Mr. West's report very carefully. And Mr. Strickland, I think you were a little bit upset yesterday in my office about the statement in Mr. West's report that referred to if there were the Federal Government standards and ethics applicable to this agency there may be even a crime. That was outrageous, given the stature of the board members—which I agree is a pretty remarkable set of people.

The point is not that a crime was committed. The point is that there is an inherent context of conflict which you're not dealing with, and which leaves your opening statements subject to, I think, some serious questioning that puts your integrity on the line; instead of the problem with the decision.

And the decision—I don't want to go back and say, "Oh, you guys did it wrong, looking backwards." But you as a board—representing two boards, President of Legal Services, and LSC—ought to be looking back and saying, "Hey, wait a minute. What did we do?"

So for instance, you have said, Mr. Smegal, in your opening statement that the issue was vetted—not a legal term, but it is in

fact a term of art. And that's important, because you said it's vetted with OMB and both the Senate and the House Appropriations Committees. And then you said here a moment ago that it was run by—the agreement was run by counsel to this Committee. Now, when you say "vetted," what do you mean, Mr. Smegal?

Mr. SMEGAL. Well, I'm sorry, Congressman, if I used a term that is too legal. But what I mean by that is that this Committee, April 23, 2002, 2 p.m. in the afternoon, its staff asked to be briefed on what it was the Corporation was intending to do. John Erlenborn, 20 years one of the members of your body——

Mr. CANNON. Did you present to the staff the details of the lease?

Mr. SMEGAL. That was the purpose of the meeting, "Here's what we're going to do." Don Carpenter had it all laid out. That was there for that purpose. They were there for that purpose. The Committee members—Patty DeMarco and J. Keith Ausbrook—were there for the purpose of asking those questions.

Mr. CANNON. And did they agree with your proposed——

Mr. SMEGAL. They agreed that the Corporation, through the vehicle of Friends, could proceed with the purpose of a building, if we could find one. We had one in sight. As I've told you, we had this——

Mr. CANNON. Let me read Mr. Ausbrook's recollection of that meeting.

Mr. SMEGAL. Okay.

Mr. CANNON. Thank heaven for modern technology—or curse it; whatever you will. "On the latter point, we did meet with them on their building. We expressed some concerns about the expense and the appearance of luxury digs in Georgetown. No further action was taken. The previous Chairman of the Subcommittee was aware of the purchase at the time. Are you now looking at this, almost 3 years later?"

Well, the answer is, yes, we're looking at it. And I suspect that if Mr. Ausbrook was sitting here as a witness, he would disagree with you that there was an agreement.

Mr. SMEGAL. Oh, I don't know. I wasn't there——

Mr. CANNON. Certainly, not as to details.

Mr. SMEGAL. There are staff people who were here then. They were there for the meeting. I was not present. I didn't come to every meeting. I couldn't afford that, Your Honor. I live in San Francisco.

Mr. CANNON. My——

Mr. SMEGAL. But I do understand. My understanding of what happened at that meeting is this Committee was told April 2002, before any of this happened. We didn't make any deals. We didn't have the Gates money. Bill Gates says to me, "When you have a building, call me up, and we'll see how we get you the money."

There was no building in April. We were there to the Committee to tell them what we had in mind; as we'd gone to OMB; as we'd gone to the Office of the Counsel to the President.

Mr. CANNON. My time has expired. I think we'll probably do a second round on this issue.

Mr. SMEGAL. I hope so, Your Honor.

Mr. CANNON. And, well, normally, I would. If there were only three of us, we could probably share time. But we have so many

Members that I think that we'll go, and I probably in an hour—Bill, would you like to take some time? The gentleman from Massachusetts is recognized for 5 minutes.

Mr. DELAHUNT. You know what I'm concerned about, Mr. Chairman, is that I see these two gentlemen here. It's clear that they were well intentioned; felt that they had a good deal. I concur. I happen to think that you did the right thing.

Now, I don't know the details. But the last thing that we want to find ourselves in the position of doing is discouraging the likes of Mr. Strickland and Mr. Smegal from serving on the board of directors of the Legal Services Corporation, which is a non-profit charity. I mean, they're not getting a lot, other than just a sense of public service and reward, from their effort.

Mr. CANNON. Would the gentleman yield?

Mr. DELAHUNT. Yes.

Mr. CANNON. I agree with the gentleman. And that's why this is such a matter of concern. The issue here is not to attack people of great integrity. The issue is to have the perspective of the current board on a problem that I think is a significant problem, and resolve the problem.

Mr. SMEGAL. Congressman——

Mr. CANNON. Not flail people here. That's not my objective at all.

Mr. SMEGAL. Congressman, the only reason there is an alleged problem is because the OIG has suggested there was one. I've seen no legal brief on a conflict of interest. I don't have a conflict of interest.

Friends was created by the Legal Services Corporation. They were one entity. What OMB told us, we had to have a separate entity in order to avoid, as the Navy has done, as the Smithsonian Institute has done, as—what's the other one; there's a third one—has done, we had to set up a separate 501(c)(3). We did what we were told.

Mr. CANNON. Mr. Smegal, look, I understand what you're saying and——

Mr. STRICKLAND. It's the National Academy of Science.

Mr. SMEGAL. National Academy of Science, Congressman.

Mr. CANNON. I understand. The problem is that you now have an entity that has, as you pointed out, a lease figure that was set by the lender; not by two parties at an arm's length. And the owner of the building does not—is not—the same as the institution for which it was set up. That's an inherent conflict. And I just would—I'm on the gentleman's time, and I apologize for going on. I don't mean to lecture.

Mr. DELAHUNT. That's all right.

Mr. CANNON. But what I see is defensiveness about an issue, instead of resolution. And that is remarkable. This is not Mr. West who's bad; it's Mr. West who's doing his job and who should be not argued against, but considered and have the underlying problem resolved so we can get the little sliver out and go on with life.

Mr. SMEGAL. Well, Your Honor——

Mr. CANNON. I yield back to the gentleman.

Mr. SMEGAL. Congressman, I disagree with you on your characterization of Mr. West. But nevertheless, if you go to a bank and try to buy property, they're going to ask you for a financial state-

ment. Friends did not have a financial statement. So the lender said to us, the prospective lender said, "We want a certain amount of income to service this debt you're asking us to take on, $15.5 million."

Mr. CANNON. If the gentleman would yield again?

Mr. DELAHUNT. Sure.

Mr. CANNON. Our arguments are not joining here. I understand your argument. Just take my word for it. I understand your argument. And I'm suggesting that the animosity that you've just expressed toward Mr. West is highly misplaced. And everybody is better served if the animosity disappears and you deal with the underlying problem.

You were talking about billions of dollars maybe that we ought to be overseeing at other places. Let me just reiterate, this is a problem in a context that is not infinite. But the problem which I am deeply concerned about is the reaction of both boards to Mr. West and his presentation of an issue which, on its face—and I've read his report very carefully—is valid. And your incensed reaction to it doesn't make it less valid.

And if you step back and look at it, nobody is being called criminal. The issue of a conflict between two entities is there and clear. But it's, again, not infinite. It has narrow scope. It has a clear definition. And what I'm not hearing is—I'm hearing more animosity toward Mr. West than I am about solving an underlying problem—which, by the way, can't be solved with a simple dissolution of Friends of Legal Services and with the building being turned over to LSC, because I think you'd still probably have the underlying problem with OMB.

So instead of arguing back and forth, it would be a matter of great appreciation from my perspective if you said, "Look, we have a problem. How do we solve it? We can't just dissolve. Let's talk to OMB and see what the path is." And if you did that, we'd say, "Thanks."

Mr. SMEGAL. Congressman, I disagree. There is no problem. In fact, the statement of the Inspector General is internally inconsistent; contrary to what you've just said. He says on the one hand, the problem is that the Legal Services Corporation no longer controls Friends; and then on the other hand, he says the problem is that the Corporation is independent. You can't have it both ways. He's working both sides of the street in his statement. He's worked both sides of the street in everything he's filed.

Mr. CANNON. That's consistent. He says that Legal Services doesn't control Friends.

Mr. SMEGAL. That's right.

Mr. CANNON. And he says that Friends is independent.

Mr. SMEGAL. That's right.

Mr. CANNON. Those are highly consistent.

Mr. SMEGAL. But he criticizes both of those.

Mr. CANNON. Well, because when you have two independent organizations that overlap, then there is obviously criticism from both points of view. But it's actually really the same point of view.

Mr. SMEGAL. No, no, he's saying—Congressman, he's saying that——

Mr. DELAHUNT. Mr. Chairman, I ask unanimous consent that I receive an additional 2 minutes. [Laughter.]

That I'll yield to the Chairman.

Mr. CANNON. Without objection.

Mr. GOHMERT. Mr. Chairman, I have no objection to 5 minutes. You really didn't get started.

Mr. DELAHUNT. I withdraw my unanimous consent, and concur with the gentleman from Texas and ask unanimous consent for an additional 5 minutes that I'll yield to the Chairman.

Mr. CANNON. Thank you. And without objection, so ordered.

Now, let me just say, Mr. Smegal, this is not a debate. And I actually don't want to pursue it any more, and I'd like to leave this part aside. Although let me just admonish the two of you that I have read this very carefully, and Mr. West's report does not go beyond the bounds of what an appropriate IG should be doing. And in the environment of advising the board—and the board that he advises is just LSC, and it gets to the friends of LSC, I think appropriately—I don't think in that report there is anything that is amiss.

And the problem here is that the retrenching around that issue has created a problem where one probably doesn't need to be. There is a problem. The problem is, what do you do with OMB and this building long-term? I think we need to—you need to deal with that.

But I don't want this just to be a back-and-forth debate where you assert something, and I'm just telling you something entirely different. I hope you'll recognize the difference.

Mr. SMEGAL. Yes, Congressman. In fact, I'm particularly pleased that you've given me this opportunity to be a participant in this debate, because the OIG wouldn't do that. In his letter of February 23, 2005, in response to my request for his report, he says the following: I won't give it to you, "However, we will consider your letter a request for a copy of the final report under the Freedom of Information Act. And once the final report is issued, we will release it to Friends, as appropriate, in accordance with FOIA."

I haven't been part of this debate. I didn't have a chance to file anything with this Committee, Your Honor, other than my statement.

Mr. CANNON. But you are not the agency that Mr. West represents. He couldn't give that to you directly. You're a lawyer. I don't understand why you've just made that statement. He couldn't do that.

Mr. SMEGAL. That's incorrect, Congressman.

Mr. CANNON. Well——

Mr. SMEGAL. He could give it to me.

Mr. CANNON. Why?

Mr. SMEGAL. There is no basis for him taking this position with respect to this——

Mr. CANNON. Well, because his client—he is the IG for LSC. The appropriate request would be from you to Mr. Strickland.

Mr. SMEGAL. No, that's not correct. The appropriate request is from him. He labeled Friends as a contractor, a Government contractor. And under the provisions of the OIG Act, I get that report. I get the report from him. He never gave it to me. I'm here today

for the first time in a position to respond to his various statements that he's filed with this body.

Mr. CANNON. And gave to LSC. And I assume that you got it from LSC at some early point, which would be perfectly appropriate.

Mr. SMEGAL. I did, yes.

Mr. CANNON. Let me just ask——

Mr. SMEGAL. Not at an early point; at a later point.

Mr. CANNON. Mr. West, Mr. Smegal has just said that he had a legal right, because you characterized him as a contractor, to get your report. Does he have that right, in your view? And did you appropriately withhold it?

Mr. WEST. I'm unaware of ever calling him a contractor. In the financial statement that was prepared for the Legal Services Corporation, Friends of Legal Services is listed as a component.

When I have dealt with contractors in previous instances, if we did an audit of the contractor, they of course get the draft audit report. But this was a report to the board that was for them to negotiate the lease extension with Friends. I had—and that's all that was, was information to the board.

Mr. CANNON. Mr. Smegal, do you agree with that analysis?

Mr. SMEGAL. I wasn't listening. I'm looking at a letter I wrote to the Inspector General. Incidentally, I'd like, if it's possible, to keep the record open. I have an exchange of correspondence that I had with the Inspector General starting on December——

Mr. CANNON. I can assure you that——

Mr. SMEGAL. —December 9; none of which is in his report. But starting on December 9.

Mr. CANNON. Well, without objection, that will be made part of the record.

Mr. SMEGAL. Thank you, Your Honor.

[The information referred to is available in the Appendix.]

Mr. SMEGAL. In that, one of these communications from him, he did—he or one of his assistants referred to Friends as a Government contractor.

Mr. CANNON. I think he dealt with that issue in his response.

Mr. SMEGAL. Well, I'm not sure. I don't have a legal brief on it, so I don't know.

Mr. DELAHUNT. Mr. Chairman, reclaiming my time?

Mr. CANNON. Oh, yes, it is your time. The gentleman—I yield.

Mr. DELAHUNT. You know, I can see that this dispute has become, you know, a question of, I think, both—particularly Mr. Smegal feels that the role, as he understands it and has lived it, of the LSC and its clear, to me, good intentions have been impugned by the report. Now, I understand there are rules and guidelines, etcetera. But I would hope that, you know, an exchange that was appropriate and civil and courteous would always exist between any office of inspector general and those individuals that are participating or are being—whose actions and transactions are being reviewed.

I mean, this is—well, let me ask you a question, Mr. West. Is there anything that you have discovered where any individual has accrued any particular financial benefit from this transaction?

Mr. WEST. With respect to anybody on the LSC board?

Mr. DELAHUNT. Right.

Mr. WEST. Anybody on the Friends of LSC? No.

Mr. DELAHUNT. Okay. I mean, which confirms, I think, what you and I have both been saying, Mr. Chairman; is that these are people of integrity.

I think, as I'm hearing the exchanges going on, you alluded to the OMB and the rule that requires this pass-through public charity corporation being created; not just in the case of the LSC but, I understand, the Smithsonian, the Navy, and others. You know, I would like to understand the rationale for that particular rule. It appears to me to be somewhat archaic.

You know, maybe there is good reason. But I daresay we wouldn't be having this hearing today if the LSC as a board could have acquired the property directly; rather than the need to create another vehicle. It just doesn't seem to make any sense to me; particularly when, for protection of the taxpayer, we have an Office of Inspector General as part of the LSC board.

So maybe Mr. Chairman, you should request the representative of the Office of Management and Budget to come and sit down. We don't need a public hearing. If the public wants to sit and listen to the conversation, I don't have any problems with that. But to explain to us the rationale for the rule. And then, among ourselves we ought to consider whether the rule has—no longer serves its original purpose—we don't know what that original purpose is—and do whatever has to be done to put the rule into the dustbin of oblivion, if you will.

So that we don't find ourselves enmeshed in this kind of—you know, I'm sure they're great appraisers but, you know, that Bank of America appraiser, I bet he went to school for appraisers, and has his benefits, and has a master's degree in appraising buildings in Georgetown. I mean, that's the micro level that we're getting ourselves into, a dispute among professionals.

I mean, it's like in my former life, it was always fascinating to me that when a criminal defendant pled insanity in a criminal trial—I yield to my——

Mr. GOHMERT. I take exception to saying "insanity" and pointing to me.

Mr. DELAHUNT. No, I did it like this, Charlie. [Laughter.]

It was up in the air. I didn't mean——

Mr. CANNON. That was the Almighty.

Mr. DELAHUNT. Okay? And somehow, psychiatrists—you could disagree as to whether there was legal responsibility on the behalf of the defendant. And we are, as a Subcommittee, monitoring, you know, which appraiser is right. I yield back.

Mr. CANNON. The gentleman yields back. Let me point out, there are actually three appraisals. Two agreed, and the other appraisal was by the lender, which is in a different context. But I agree with most of what you said, Mr. Delahunt.

Now the Chair recognizes the gentleman from Texas, Mr. Gohmert, for 5 minutes.

Mr. GOHMERT. Okay, thank you, Mr. Chairman. And I do want to say, I am grateful that people of high esteem are willing to serve in these thankless jobs. I'm grateful that we have someone who would be able to solicit or obtain a $4 million contribution to an

entity like this, because that's not something easy to do. So I'm grateful for that.

I think probably all of us up here agree that there are aspects of OMB scoring that we don't like. We don't think that they use good business judgment. And I will readily acknowledge right up front that all three of you are a lot more financially smart than I am, because you've never run for judge and you've certainly not—smart enough to avoid running for Congress. So I'll give you right up front, you're smarter than me.

But just to go back on some of the testimony, Mr. Smegal, that you've given us. You gave us a good overview of the whole scenario, how this came about. Have you been with LSC board from the beginning? How long were you with it?

Mr. SMEGAL. Congressman, you may have missed my opening remarks. I was nominated——

Mr. GOHMERT. Oh, I was here for all of your remarks.

Mr. SMEGAL. Well, I've been on the Legal Services Corporation Board at the nomination of two Presidents and the unanimous confirmation of the United States Senate for 18 years.

Mr. GOHMERT. I guess what I was trying to get to was——

Mr. SMEGAL. I was there—excuse me.

Mr. GOHMERT. What I was getting to was, you were testifying about conversations, some of which you said, "And I was there at that one." And I take that to mean that you may have been testifying about conversations where you weren't there. And so I'm just trying to——

Mr. SMEGAL. Yes.

Mr. GOHMERT. So obviously, you're giving us an overview which includes some hearsay of what you've heard from other people; which if we want to get to the bottom of it, it's always best to hear it straight from the people that were there personally.

But I am concerned, as the Chairman has indicated, as smart as you obviously are just—and I mean, I know I look stupid, but I did not miss some of the snubs like when you were talking about vetting and you comment, "Well, sorry I used a term that was too legal," like, "You wouldn't understand."

But you say you don't see a conflict. And I mean, it's very, very basic. If I'm a judge, and I'm dealing with a landlord and a tenant, and they may be friends, and one's got an attorney, I'm going to appoint an ad litem attorney to represent the other side; because there is a clear conflict between a landlord and a tenant.

There is a clear conflict between someone who is a borrower on a note, and someone who is not a party to that note. There is a conflict between someone who's trying to get enough rent to service a note, as opposed to somebody that's trying to get the cheapest rent they possibly can, and therefore get the biggest bang for their buck. There is a conflict. And I'm shocked that, as brilliant as you are, that you cannot come in here and say that you actually see that.

So let me ask you this. Is there a legitimate basis for agreeing to $38 a foot for the LSC?

Mr. SMEGAL. Is there a legitimate basis?

Mr. GOHMERT. That's right.

Mr. SMEGAL. Absolutely, Congressman. And in fact, the chart that I—that was supposed to be attached to my remarks, which is over there displayed, and you have, demonstrates that the reality of what the Corporation now has by way of its space is represented at 2003 by the line that continues.

Now, $38 a square foot continues on that line and goes down because of the advantages of the $100-a-month parking spaces. So it's actually going down, as we go out to the right. Whereas the Corporation would have continued in—and the numbers there out through 2007 are real numbers. Congressman Cannon suggested maybe they weren't. They are the lease that the Corporation had through 2007. So you're up there at 42 or 43 dollars a square foot.

The rest of that would be the anticipated—there was no additional renewal at 750 First Street, Northeast, Congressman. So those red numbers are what is anticipated might have happened after that time.

Mr. GOHMERT. And we take it as just that: something that might have happened. But we're looking at a $38-a-foot lease for this whole—you indicated in your testimony in your opening statement—which I did hear—that by law any property of the Friends would revert or go to the LSC. The OIG says he knows of no contract or anything that would cause that to revert to the LSC. Do you know what law that is that would cause it to automatically revert to the LSC, if Friends is dissolved?

Mr. SMEGAL. Yes, the bylaws by which the LSC was created. It's a document that had to be filed with the District of Columbia when the 501(c) incorporation was obtained. It clearly spells out exactly what happens to Friends, should it be abolished. All—whatever assets Friends has is automatically transferred to the Legal Services Corporation.

Mr. GOHMERT. Okay, so bylaws——

Mr. SMEGAL. Incidentally——

Mr. GOHMERT. —and I will conclude. My time is running out. But you mentioned bylaws. Bylaws, as you know, can be unilaterally changed by the Corporation that set up those bylaws; isn't that correct?

Mr. SMEGAL. I apologize. I misspoke. "Vetted" was a bad term, and I apologize for that, too. But it's the articles of incorporation; not the bylaws.

Mr. GOHMERT. All right. The articles of incorporation.

Mr. SMEGAL. Of Friends.

Mr. GOHMERT. Of Friends.

Mr. SMEGAL. Yes, sir.

Mr. GOHMERT. And are you familiar with how—or the manner in which articles of incorporation could be changed?

Mr. SMEGAL. I'm sure there's a provision in there that would permit changing under some circumstances, yes, sir.

Mr. GOHMERT. And that LSC would not necessarily be a part.

Mr. SMEGAL. Well, I don't know. I can't speculate.

Mr. GOHMERT. Well——

Mr. SMEGAL. Incidentally, I am advised that the red numbers that you and I were referring to a minute ago actually are the OIG's numbers, right off his materials that he's provided to you in one or more of his presentations.

Incidentally, Congressman Delahunt, you said—or maybe it wasn't you, and I apologize if I'm——

Mr. GOHMERT. All right, obviously, my time is up, and so it's up to the Chairman at this point to determine who's going to talk after this.

Mr. CANNON. Are you yielding back, Mr. Gohmert?

Mr. GOHMERT. My time has expired.

Mr. CANNON. I thank the gentleman.

Let me just thank the members of the panel. I appreciate your being here through a relatively tense period. And it's been actually a pleasant exchange, let me just say, from my point of view. It's like a bunch of lawyers going back and forth at each other. Mr. Smegal, you wanted to say something?

Mr. SMEGAL. I do. I have one other comment, and I apologize. Mr. West, in response to a question, I think it was of Congressman Delahunt, indicated that he had accused no one of doing anything, and he mentioned specifically the Friends and the Board of the Legal Services Corporation. But I would direct your attention to—his pages are unnumbered, but if you go to what I've numbered page 14, he's got a bullet. And the bullet is the following: "Friends made a $50,000 unrestricted contribution to an organization to which LSC is restricted from making the same kind of contribution."

Now, three things. He doesn't identify the organization there, but he did in his opening statement. It's the National Legal Aid and Defender Association.

Mr. CANNON. I think he identifies it earlier in his report.

Mr. SMEGAL. I don't think it's in here, Your Honor. But in any event, there's two things wrong with what he says, two significant errors. One, it was not an unrestricted contribution. He has my letter of February 9, 2005, which will be in the packet that I'm providing, which includes the nine-page grant to the NLADA—very restricted in its use of the $50,000.

The other point that I would make is that NLADA is not an organization described as he states. Legal Services Corporation—and they can speak for themselves—have given grants to the NLADA for years for various things. There's nothing wrong with the National Legal Aid and Defender Association and, in particular, this $50,000 grant.

The innuendo here by this Inspector General is that Bill Gates would give us $4 million so somehow we could give $50,000 to some organization that's going to violate congressional restrictions on LSC activities? That's nonsense.

Mr. WATT. Mr. Chairman?

Mr. CANNON. Certainly, Mr. Watt.

Mr. WATT. Could I ask unanimous consent just to ask one question? And I know I gave my time away.

Mr. CANNON. Before you do that, may I just say, Mr. West, I think you understood the two statements, or the two accusations made by Mr. Smegal. Are you comfortable responding to those in writing? Not now, because we're——

Mr. WEST. Yes, I'll respond to them in writing.

Mr. CANNON. Thank you. The Chair recognizes Mr. Watt for 5 minutes.

Mr. WATT. And I'm not sure exactly what implications this has, but Mr. West, do you have any idea what the value of this building is now?

Mr. WEST. I have no idea. I have not seen an appraisal of the building. My report was restricted to what would have been the fair-market rent if the Legal Services Corporation entered into an at-arm's-length transaction in July 2002. That's what we wanted our appraisers to tell us: If they were going out in the marketplace, what would have been a fair-market rent?

Mr. WATT. But the appraisers did the appraisal on an income approach?

Mr. WEST. They did an income, and they also did a sales approach. Income—I don't have it in front of me. I could get the specific information for you. But the appraisals, I believe, are going to be in the record.

Mr. WATT. Okay. Mr. Strickland or Mr. Smegal, either of you have any idea of what the value of this building is now?

Mr. SMEGAL. Yes, and I haven't got this in writing, Congressman, but the tenant on the fourth floor along with us, who's working its way up and about to pass through $38 a square foot, I am advised by our realtor, is prepared to offer us $20 million for the building.

Mr. WATT. So the bottom line is this building was acquired for—what?—$15 million, $16 million?

Mr. SMEGAL. No, Congressman, actually what happened was this building was sold for $16 million, and the deal fell through; which is the reason we got an opportunity to buy it. We bid 14.2. There were two other bidders at 14.2. The prior owner understood who we were and what we were going to do with the building, and said, "You get it."

So we bought it for 14.2. We put $2 million, roughly, of tenant improvements in—a million-eight, eight-fifty—into it. And the bank then appraised it; understanding that to happen at 17.1. And my understanding from the realtor that's leased space for us in the building is that the other tenant on four is prepared to offer us $20 million.

Mr. WATT. And of that $16.2 million that you all have in it, Bill Gates gave you 4 million of it?

Mr. SMEGAL. Yes, Congressman, that's correct.

Mr. WATT. So the net amount that Legal Services has in this building is approximately $12.2 million, and you have an asset that's worth $20 million in today's market.

Mr. SMEGAL. Yes, Your Honor. Actually, we've been paying off the bonds over the last couple of years, so—and our financial statements show that our liabilities are even less than that.

Mr. DELAHUNT. Would the gentleman yield?

Mr. WATT. Yes, I'm happy to yield.

Mr. DELAHUNT. Mr. Chairman, there's a certain irony here because—and I'm not being critical of the work done by the Inspector General—but because of the lack of flexibility that's inherent in Government bureaucracy, big Government, we find ourselves not allowing a certain entrepreneurial initiative which I think is inherent in the free market.

When you see something that's a good deal, if you can get 4 million out of Bill Gates and negotiate favorable terms and look down the future 20 years when the bonds are paid off, we have a quasi-public corporation not paying, you know, any rent; probably generating some revenue from this asset which would reduce the cost to the taxpayers, or maybe provide services for more individuals who need them. Because my recollection is Legal Services is incapable, because of lack of resources, to provide individuals—in terms of the number—the pie that ought to be receiving services, only 20 percent are in fact receiving the services that are necessary for them, thereabouts. I'm sure my figures are not exact. But again, with all due respect to Mr. West, you're building equity up.

Mr. WATT. Let me reclaim my time, though. Because I want to be clear that just because the value of the building may exceed the investment, the end doesn't always justify the means. And I think what the Chair's concern is that a means was used that might have been an end around.

But the bottom line is that the Friends of Legal Services and, if they ever dissolve, Legal Services, would be the beneficiary of a much, much more valuable asset. So we need to figure out a way to resolve this in a way that it will cut off our nose despite our face or whatever the——

Mr. DELAHUNT. Well, Mr. Watt, I just—I'm sure that, you know, the panel, and maybe those that are here, are somewhat confused. This is the Democratic side of the panel—— [Laughter.]

—those, you know, who ascribe to the "big Government" theory——

Mr. CANNON. If the gentleman would yield——

Mr. DELAHUNT. And they're the Republicans over there, the "free marketeers."

Mr. CANNON. If the gentleman would yield——

Mr. WATT. No, I'm not going to yield. I'm not going to yield to either one of you—— [Laughter.]

Mr. CANNON. The gentleman's time has expired. He yields back.

Mr. WATT. I'm not going to yield to either one of you. I'm just going to try to walk right down the middle here—— [Laughter.]

—and remind you all that this is the result of an entrepreneurial ownership spirit. But it's a good thing, and we shouldn't be discouraging it for non-profits and valuable organizations like Legal Services any more than we discourage it—now, that doesn't mean that the end justifies the means.

So we've got to figure out a way to step back from this. Now that we've got it all out on the table now, let's just figure out a way to resolve this in a way that doesn't disadvantage the clients of Legal Services.

Mr. STRICKLAND. If I may address that, Mr. Watt's point, Mr. Chairman, certainl, it is the case with the current board having inherited this transaction, that it is our intent, if there's a problem that needs to be resolved, we will work diligently to resolve it. And I think the reason that we disagreed with the Inspector General is that as I said in my opening, we had questions about his methodology and his conclusions. And we don't necessarily think his office is infallible, so we disagreed with it. But having said that, I'll em-

phasize again that if there is a problem, we will do our best to resolve it.

Mr. CANNON. Thank you. The gentleman yields back.

A couple of points. First of all, let me ask—well, let me get to that, I guess, in order. First of all, as to the relevant rule at OMB, this is a rule that's been around for a very long time under both Administrations. In the fiction of Government, it's very difficult to deal with. And so the point I don't think is to change OMB, but to adapt to the circumstances.

And I suspect that both Friends and Legal Services Corporation—and what I take it that you've just suggested, Mr. Strickland, is that you're going to be working on this rule with Friends and with OMB to see how the underlying problem can be resolved.

Because currently, all the equity that you referred to, Mr. Delahunt, is in Friends. In other words, it doesn't accrue yet to LSC. And so I suspect that we will see some discussion there.

I ask unanimous consent that the record be kept open and that questions may be directed to the witnesses. Without objection, so ordered.

One of those first questions, Mr. Smegal, is going to be in relationship to the grant that Friends has given, which you referred to as restricted. And staff tells me they've been through it; they don't see any restrictions. We'd like to understand what you view those restrictions as being. We'll get that to you by way of a written request.

I'd also like to ask unanimous consent that we recess this hearing at this point, subject to the call of the Chair. Without objection, so ordered, and we'll finish.

[Whereupon, at 2:15 p.m., the Subcommittee was recessed, subject to the call of the Chair.]

[The following is excerpted from the transcript of the legislative hearing on H.R. 6101, the "Legal Services Corporation Improvement Act," held on Tuesday, September 26, 2006 by the Subcommittee on Commercial and Administrative Law, Committee on the Judiciary:]

> Mr. CANNON. If we could just take one more moment, Mr. Watt, I'd like to make the following motion: The unfinished business before the Subcommittee is the adjournment of the Subcommittee's June 28, 2005 hearing, which was recessed subject to the call of the Chair. Without objection, the aforementioned hearing is so adjourned. Without objection, so ordered. We left it open.

APPENDIX

MATERIAL SUBMITTED FOR THE HEARING RECORD

LETTER FROM THOMAS F. SMEGAL, JR., CHAIRMAN, FRIENDS OF LEGAL SERVICES CORPORATION, DATED DECEMBER 9, 2004, TO LAURIE TARANTOWICZ, OFFICE OF THE INSPECTOR GENERAL, LEGAL SERVICES CORPORATION

COPY

Friends of the
Legal Services Corporation

E-mail: tsmegal@kmob.com

December 9, 2004

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Washington, DC

Ms. Laurie Tarantowicz
Office of the Inspector General
Legal Services Corporation
3333 K Street, N.W.
Washington, D.C. 20007

Dear Laurie:

Thank you for your time on December 1, 2004 and for the offer you made at our meeting concerning the willingness of the staff of the Inspector General's Office to assist in our response to your request for documents. Your Office has indicated that it is investigating the financial reasonableness of the arrangements that exist between Friends and Legal Services Corporation ("LSC"), insofar as they pertain to 3333 K Street and apparently even more broadly. As we discussed last week, these arrangements were previously reviewed by the two most recent LSC Inspectors General, and also had been vetted and approved by OMB, CBO, and LSC Congressional funding Committee(s). While complex, we believe the arrangements developed in 2002 are appropriate and consistent with law and policy.

However, in spite of the foregoing, the Board of Friends of Legal Services Corporation ("Friends") has agreed to make its on-site records available to the Inspector General's Office for review and copying. We understand that this review will be done by the staff of the Inspector General and that all copying will be done at the sole expense of the Inspector General. Because Friends has an all volunteer staff and attempts to expend all its resources to the discharge of its exempt mission, it would be very burdensome for Friends to comply in any other manner or to make staff available to assist you. We have instructed our volunteers (including Lynn Bulan) to make our files available to you in a "reading room" to be established.

To further assist your inquiry, we will outline what we believe are several key facts to inform your review of the Friends – LSC relationship. First, as we discussed, Friends was created to achieve several objectives: (i) to act as a landlord to LSC and in that capacity to (a) allow LSC to get favorable lease terms, including discounted parking and (b) long-term budgetary certainty as to its occupancy cost item, projected not to exceed the rent then being paid by LSC at 750 First Street, N.E. (about $1.7 million) in 2002; (ii) to act as a fund-raising vehicle by which individuals not otherwise focused on day-to-day LSC business could raise monies to be used to

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advance LSC's mission, and (iii) to "support" LSC within the meaning of both IRS and D.C. property tax laws.

With respect to objective (i), Friends (and LSC) determined that the best way of achieving this goal was to combine the use of tax-exempt bonds (which are available to 501(c)(3) organizations) that bear interest at approximately two percent below conventional rates, with a lease to LSC from an entity whose independence is recognized for OMB/CBO scoring purposes. Being a 501(c)(3) also dovetailed with objective (ii), insofar as gifts can be made to a 501(c)(3) which generate deductions for the donor, where such deductions are not available for gifts to a more passive 501(c)(2) property holding company that Friends might otherwise have resembled and which would not have been eligible to obtain tax exempt bonds.

Objective (ii) was manifestly successful insofar as Friends obtained a seed money grant from the Gates Foundation, and as of 2004 has achieved a fully autonomous Board composition. Finally, the created Friends' structure was necessary and desirable as an autonomous vehicle for achieving LSC's fiscal and programmatic objectives. Thus, Friends' organizational structure and operations satisfy objective (iii).

The reasonableness of the terms of the Friends-LSC lease, of course, cannot be evaluated with hindsight, although we believe in today's market, the terms are even more favorable to LSC. The lease was made on a "full-service" basis (*i.e.*, without pass-throughs for expenses such as utilities, maintenance, or real estate taxes); without escalations (or "bumps"); using the more favorable (to LSC) D.C. standard space measurement rather than less favorable BOMA; was for a long term; and gave LSC contiguous space and enormous control, but still represented a rental rate sufficient to service the below-market debt that Friends was able to access through the use of tax exempt bonds. Any similar deal financed with conventional debt would have required there to be a higher occupancy cost for LSC. There were studies by CBRE done for LSC at the time the lease was negotiated that fully support the conclusion that its terms were then reasonable and beneficial to LSC.

LSC's flat rent, when combined with other income that Friends receives from the building and from other sources (*i.e.*, fundraising) may hopefully, from time to time, exceed Friends' costs of ownership of the 3333 K Street building (including debt service, taxes, maintenance and utilities). As noted above, in order to access the low cost tax-exempt bonds, Friends had to be a 501(c)(3). For that reason, any such excess funds can only be used for 501(c)(3) purposes—here, restricted to purposes that "support" (or are consistent with) those of LSC. Friends is obligated to use any surplus to support its tenant's mission. A profit-driven landlord, such as at 750 First Street, N.E., would not have such an obligation.

In order to become eligible for property tax relief in D.C., we are advised that it is necessary to engage in "substantial" 501(c)(3) activities in the District of Columbia that also support the LSC mission. Thus, Friends' Board continues to evaluate funding opportunities that are not only in compliance with 501(c)(3) but will

satisfy the D.C. administrators in our efforts to be relieved of property tax assessments.

It may also be appropriate to discuss the "end game" contemplated by this arrangement. Because Friends is a supporting corporation vis-à-vis LSC, Friends is compelled by its charter to act in the best interests of LSC.* Once the property debt is paid, Friends can do only one of three things: (i) go out of business and distribute its assets (the building) to LSC (in which event LSC would have occupancy costs comprised of only utilities, maintenance, taxes and the like), (ii) continue to charge a flat rent to LSC but use any net income so derived in furtherance of its and LSC's shared mission. As a third alternative, Friends could continue to lease the building to LSC, but at a rental rate even more favorable to LSC. Whichever way is chosen at a future date, in our view the objectives outlined above and LSC's mission will be significantly advanced.

We stand ready to further discuss this complex relationship and the set of transactions by which it was created, after you have completed your evaluation of our in-house documents. We would like to be given an opportunity to review any preliminary or tentative/draft conclusions or reports you produce for this matter to assure completeness and accuracy.

Thank you again for your consideration.

Very truly yours,

FRIENDS OF LEGAL SERVICES CORPORATION

Thomas F. Smegal, Jr.
Chairman

Attachment

cc: Friends Board of Directors,
Lynn Bulan
Richard A. Newman

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120904

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* The original ten-year term of the lease was set by LSC in light of a prior difficult lease experience inherited by the Board nominated by President Clinton; see Transcript of LSC Board Meeting dated April 5, 2002, at p. 103.

PROGRAM RELATED INVESTMENT AGREEMENT

THIS PROGRAM RELATED INVESTMENT AGREEMENT, dated as of January 19, 2005 (the "Agreement"), between the **FRIENDS OF THE LEGAL SERVICES CORPORATION**, a non-profit corporation organized and existing under the laws of the District of Columbia, with offices at 3333 K Street, NW, Washington, DC 20036 (the "Grantor") and **NATIONAL LEGAL AID AND DEFENDER ASSOCIATION**, a District of Columbia non-profit corporation, with offices at 1140 Connecticut Ave. NW, Suite 900, Washington, DC 20036 (the "Recipient").

WITNESSETH:

WHEREAS, the Grantor has, as of the date hereof, made a grant in the amount of Fifty Thousand Dollars ($50,000.00) (the "Grant") to the Recipient, to be used by the Recipient in furtherance of its exempt purposes under Section 501(c)(3) of the Internal Revenue Code of 1986, as amended from time to time (the "Code"), to fund a program more particularly described on Exhibit A to faster improve delivery of legal services to persons of low and moderate income in the District of Columbia.

NOW THEREFORE, in consideration of the premises, and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties hereto hereby agree as follows:

ARTICLE I
THE GRANT

The Recipient, in consideration of the receipt of the Grant proceeds, hereby promises to use the proceeds of the Grant for the purposes set forth on Exhibit A attached hereto and in accordance with the requirements of this Agreement.

ARTICLE II
REPRESENTATIONS AND WARRANTIES

The Recipient represents and warrants that:

2.1 **Organization and Powers.** The Recipient is a non-profit corporation duly organized, validly existing and in good standing under the laws of the District of Columbia. The Recipient has the corporate power and authority to own its assets and properties, to carry on its activities as now conducted by it and to execute, deliver and perform this Agreement.

2.2 **Tax-exempt Status.** The Recipient is an organization described in Section 501(c)(3) of the Code and is not a private foundation as described in Section 509(a) of the Code and is exempt from federal income tax under Section 501(a) of the Code. The Internal Revenue Service has determined that the Recipient is an organization described in Section 501(c)(3) of the Code and is not a private foundation as described in

Section 509(a)(i) of the Code and is exempt from federal income tax under Section 501(a), and such determination continues in full force and effect. The Recipient has not engaged in any transaction or activity that could cause such tax exemption to be revoked, and no such transaction or activity is presently contemplated or under consideration. The Recipient has complied with all statutory or regulatory requirements necessary to retain its tax exemption, including without limitation, the filing of all returns and reports. The execution, delivery and performance by the Recipient of this Agreement and the use by the Recipient of the proceeds of the Grant for the purposes contemplated above, will directly further the exempt purposes of the Recipient described in Section 170(c)(2)(b) of the Code and will not affect the status of the Recipient as an organization described in Section 501(c)(3) of the Code that is not classified as a private foundation as described in Section 509(a)(i) of the Code.

2.3 **Authorization: Binding Agreement.** The execution, delivery and performance by the Recipient of this Agreement have been duly authorized by all requisite corporate action. Upon execution and delivery thereof by the Recipient, this Agreement will constitute the legal, valid and binding obligation of the Recipient enforceable in accordance with its terms, except to the extent that enforceability may be limited by applicable bankruptcy, insolvency or other similar laws of general application or equitable principles relating to or affecting the enforcement of creditors' rights from time to time in effect.

2.4 **Litigation.** There is no action, suit or proceeding pending or threatened before any court or governmental or administrative body or agency which may reasonably be expected to result in a material adverse change in the activities, operations, assets or properties or in the condition, financial or otherwise, of the Recipient, or impair the ability of the Recipient to perform its obligations under this Agreement. The Recipient is not in default with respect to any judgment, writ, injunction, decree, rule or regulation of any court or any governmental or administrative body or agency.

2.5 **No Conflicts.** The execution, delivery and performance by the Recipient of this Agreement and the borrowing hereunder will not violate any provision of law, any order, rule or regulation of any court or governmental or regulatory body, the Articles of Incorporation or By-Laws of the Recipient or any indenture or deed of trust, agreement or instrument to which the Recipient is a party or by which the Recipient or its assets or properties are bound, or conflict with, result in a breach of or constitute (with due notice or lapse of time or both) a default under any such indenture or deed of trust, agreement or instrument, or result in the creation or imposition of any lien, charge or encumbrance of any nature whatsoever upon any of the assets or properties of the Recipient, except as otherwise permitted, required or contemplated by this Agreement.

2.6 **Governmental Consents.** No consent, approval or authorization of, or declaration or filing with, any governmental or administrative body or agency on the part of the Recipient is required for the valid execution, delivery and performance by the Recipient of this Agreement.

2.7 **No Default or Event of Default.** The Recipient is in compliance with all of the terms and provisions set forth in this Agreement on its part to be observed or performed, and no Event of Default specified in Article V, or any event which upon the giving of notice or the lapse of time, or both would constitute any such Event of Default, has occurred and is continuing.

2.8 **Financial Condition.** There has been no material adverse change in the Recipient's financial condition since the date of the Recipient's most recent audited annual financial statements, for fiscal year 2004, which have heretofore been provided by the Recipient to the Grantor.

ARTICLE III
DOCUMENTATION

3.1 **Closing Deliveries.** On or before the date hereof, the Recipient has delivered to the Grantor the following:

(a) a certificate, issued by the Department of Consumer and Regulatory Affairs of Washington, DC within 45 days of the date of this Agreement, that the Recipient is a non-profit corporation in good standing and is qualified to do business in the District of Columbia;

(b) a copy of the Internal Revenue Service's letter determining Recipient's tax exempt status and a copy of Recipient's most recently prepared and filed Form 990 or Form 990 EZ;

ARTICLE IV
COVENANTS OF THE RECIPIENT

The Recipient covenants and agrees that so long as this Agreement shall remain in effect and the proceeds of the Grant shall not have been fully expended, unless the Grantor shall otherwise consent in writing, the Recipient will:

4.1 **Use of Proceeds.** Use the proceeds of the Grant solely and exclusively for the purposes set forth above. Without limiting the generality of the foregoing, Recipient will make special efforts in its procurement and hiring (if any) in furtherance of this Grant to providing job opportunities to District of Columbia residents and subcontracting opportunities to local small disadvantaged business enterprises ("LSDBEs") registered with the District of Columbia Office of Human Rights.

4.2 **Tax Status.** Maintain its status as an organization described in Section 501(c)(3) of the Code including its exemption from federal income tax under Section 501(a) of the Code, and, in furtherance thereof, comply with all provisions of the Code and the regulations thereunder applicable to such organizations.

4.3 **Corporate Existence and Properties.** Do or cause to be done all things necessary to preserve, renew and keep in full force and affect its corporate existence, and comply in all material respects with all applicable laws and regulations applicable to it.

4.4 **Payment of Indebtedness and Taxes.** Pay all of its indebtedness and obligations in accordance with the terms thereof, file or cause to be filed all federal, state and local tax or information returns which are required to be filed by it and pay and discharge or cause to be paid and discharged promptly any taxes, assessments and governmental charges or levies imposed upon it or upon its income or profits, or upon any of its property or upon any part thereof, before the same shall become in default; provided, however, that the Recipient shall not be required to pay and discharge or to cause to be paid and discharged any such indebtedness, obligation, tax, assessment, charge, levy or claim so long as the validity thereof shall be contested in good faith by appropriate proceedings.

4.5 **Compliance with Laws.** Comply with all laws, orders, rules or regulations of any court, governmental or regulatory body applicable to the Recipient or its properties.

4.6 **Keeping of Books, Reports, Visitation, Inspection etc.**

(a) Keep proper books of record and account, containing complete and accurate entries of all financial and business transactions relating to the discharge of the Grant Agreement and the expenditure of Grant proceeds in conformity with generally accepted accounting principles and all requirements of any laws, rules or regulations applicable to the Recipient.

(b) Permit any representative of the Grantor to observe the program funded by Recipient with Grant proceeds, to examine the books and records of the Recipient, and to discuss the discharge of the Grant Agreement and the expenditure of Grant proceeds with the officers and independent public accountants thereof, all at such reasonable times during normal business hours upon reasonable notice and as often as the Grantor may reasonably request.

4.7 **Disclosure.** In all relevant written materials, the Recipient will acknowledge the role of Grantor. The Recipient will extend to the Grantor the right to review in advance, and will not issue until the Grantor has approved the form, any relevant press release, public announcement or written material of or relating to the Grantor or this Grant, such approval not to be unreasonably withheld.

ARTICLE V
EVENTS OF DEFAULT

5.1 Events of Default. The following events shall constitute Events of Default under this Agreement:

(a) Failure in the due observance or performance of the Recipient's obligations under this Agreement, and such failure shall not have been cured within fifteen (15) days after receipt of written notice with respect to such default by Grantor; or

(b) Any representation or warranty made in writing by or on behalf of the Recipient which shall have been incorrect in any material respect on the date as of which made; or

(c) The Recipient shall (A) cease operations; (B) apply for or consent to the appointment of a custodian, receiver, trustee or liquidator for it or for all or a substantial part of its assets or properties; (C) generally not pay its debts as they become due or admit in writing its inability to pay its debts as they become due; (D) make an assignment for the benefit of creditors; or (E) file a petition commencing a voluntary case under any chapter of the Bankruptcy Code, 11 U.S.C. Section 101 et seq. or a petition seeking for itself any reorganization or arrangement with creditors or to take advantage of any bankruptcy, insolvency, readjustment of debt, dissolution or liquidation law or statute, or an answer admitting the material allegations of a petition filed against it in any proceeding under any such law, or corporate action shall be taken by the Recipient for the purpose of effecting any of the foregoing; or

(d) An order for relief, judgment or decree against the Recipient shall be entered by any court of competent jurisdiction approving a petition seeking reorganization, arrangement, readjustment, dissolution or liquidation of all or a substantial part of the Recipient's assets or properties, or appointing a custodian, receiver, trustee or liquidator for the Recipient, and such order, judgment or decree shall continue unsatisfied and in effect for a period of sixty (60) consecutive days without a stay of execution; or

(e) A judgment or judgments for the payment of money aggregating in excess of $25,000 shall be entered against the Recipient, and the same shall remain unsatisfied and in effect, without stay of execution, for a period of sixty (60) consecutive days.

5.2 **Remedies on Occurrence of an Event of Default.** If any Event of Default shall occur, Grantor may exercise all or any of the following remedies:

(a) Grantor may refuse to disburse any proceeds of the Grant that have not been disbursed as of the date of such Event of Default; and

(b) Grantor may protect and enforce its rights by appropriate judicial proceedings, including, in appropriate cases, an award of specific performance or other equitable remedy in aid of the exercise of power granted in or pursuant to the Agreement.

ARTICLE VI
MISCELLANEOUS

6.1 **Entire Agreement**. This Agreement and the Exhibit annexed hereto constitute the entire agreement between the parties with respect to the subject matter hereof and supersede all prior agreements or understandings, written or oral, in respect thereof, and shall not be amended or modified in any fashion except by instrument in writing signed by the party charged with such amendment or modification. The Exhibit annexed hereto is incorporated in and made a part of this Agreement.

6.2 **Notices**. Any notice or communication given pursuant hereto by either of the parties hereto to the other party hereto shall be in writing and delivered by hand or mailed by first class mail, or by courier, postage prepaid (mailed notices shall be deemed given when duly mailed), to the parties at their addresses set forth above or to such other address or addresses as hereafter shall be furnished as provided in this Section 6.2 by either of the parties hereto to the other party hereto.

6.3 **Waiver; Remedies**. No delay on the part of either party hereto in exercising any right, power or privilege hereunder shall operate as a waiver thereof, nor shall any waiver on the part of either party hereto of any right, power or privilege hereunder operate as a waiver of any other right, power or privilege hereunder, nor shall any single or partial exercise of any right, power or privilege hereunder preclude any other or further exercise thereof or the exercise of any other right, power or privilege substantially.

6.4 **Assignment**. Neither the Grantor nor the Recipient may assign all or any portion of its rights under this Agreement without the prior written consent of the other party hereto.

6.5 **Captions**. All Article and Section titles or captions contained in this Agreement are for convenience only and shall not be deemed a part of this Agreement.

6.6 **Variation of Pronouns**. All pronouns and all variations thereof shall be deemed to refer to the masculine, feminine-or neuter, singular or plural, as the identity of the person or persons may require.

6.7 **Counterparts**. This Agreement may be executed in counterparts, each of which shall constitute an original and all of which, when taken together, shall constitute one agreement, and either party hereto may execute this Agreement by signing one or more counterparts thereof.

6.8 **Governing Law**. This Agreement shall be governed by and construed in accordance with the laws of the District of Columbia.

IN WITNESS WHEREOF, the parties have duly executed this Agreement as of the day and year first above written.

RECIPIENT:

NATIONAL LEGAL AID AND DEFENDER ASSOCIATION, a District of Columbia non-profit corporation

By: _____ Date: 1.19.2005
Name CLIOT LYONS
Title: PRESIDENT AND CEO

GRANTOR:

FRIENDS OF THE LEGAL SERVICES CORPORATION, a District of Columbia non-profit corporation

By: _____ Date: 2/1/05
Name THOMAS E SMEGOIC, JR
Title: CHAIRMAN

EXHIBIT A

FRIENDS OF THE LEGAL SERVICES CORPORATION FINANCIAL SUPPORT

NLADA will utilize the financial support provided by Friends of the Legal Services Corporation to provide scholarships and other support to providers of civil legal services to indigent persons to enable them to participate in training events delivered by NLADA. This support will be made available primarily to residents of the District of Columbia and lawyers and paralegals serving disadvantaged clients living in the District of Columbia. A small portion of the funds will be used for administration and to facilitate participation at NLADA training events from civil legal services lawyers and paralegals from outside the District of Columbia.

This financial support will significantly improve the quality of the civil legal services available to indigent residents of the District of Columbia by exposing their lawyers and paralegals to the latest developments affecting their practice from the top experts in the nation in poverty law issues. They also will be able to learn and strategize with their colleagues from across the country, thus creating colliegial relationships that will greatly enhance their capacities as advocates. The support will also enable lawyers and paralegals from the District of Columbia to gain access to and participate in the various communications and technical assistance vehicles provided by NLADA to improve their advocacy skills.

LETTER FROM LAURIE TARANTOWICZ, ASSISTANT IG AND LEGAL COUNSEL, LEGAL SERVICES CORPORATION, OFFICE OF INSPECTOR GENERAL, DATED DECEMBER 13, 2004, TO THOMAS F. SMEGAL, JR., CHAIRMAN, FRIENDS OF THE LEGAL SERVICES CORPORATION

LSC

Legal Services Corporation
Office of Inspector General

December 13, 2004

Thomas F. Smegal, Jr., Chairman
Friends of the Legal Services Corporation
c/o Knobbe, Martins, Olsen & Bear
One Sansome Street – Suite 3500
San Francisco, CA 94104

Dear Mr. Smegal:

Thank you for your letter dated December 9, 2004 and for agreeing on behalf of Friends of the Legal Services Corporation to make Friends' records maintained on-site at 3333 K Street, NW, Washington, D.C. available to the Office of Inspector General for review and copying. We will begin our review tomorrow and as indicated in your letter, will coordinate our efforts with Lynn Bulan.

In addition to the documents maintained here on-site, our work requires certain information contained in the audit workpapers prepared by M.D. Oppenheim and Company in support of its audit of Friends. However, Oppenheim will not release that information to us without the consent of Friends. As it happens, OIG staff will be at the Oppenheim offices tomorrow and, if possible, we would appreciate your providing the required consent in time for us to obtain the needed information while we are at the firm's offices tomorrow.

Finally, I wish to address the comments in your letter mentioning previous reviews of the financial or other arrangements between Friends and LSC conducted by the two most recent Inspectors General, Edouard Quatrevaux and Leonard Koczur. The OIG is unaware of any such reviews. Mr. Quatrevaux likely could not have conducted an inquiry as his tenure ended in December 2000, some months prior to the establishment of Friends. In addition, Mr. Koczur and OIG staff made some general inquiries regarding the lease arrangement, however, this office did not conduct a comprehensive review of the matter.

Thank you again for your cooperation in providing access to the documents.

Sincerely,

Laurie Tarantowicz
Assistant IG and Legal Counsel

cc: Lynn Bulan

3333 K Street, NW, 3rd Floor
Washington, DC 20007-3522
Ph: 202.295.1500 Fax: 202.337.6616
www.oig.lsc.gov

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LETTER FROM THOMAS SMEGAL, CHAIRMAN, FRIENDS OF LEGAL SERVICES CORPORATION, DATED FEBRUARY 3, 2005, TO KIRT WEST, OFFICE OF THE INSPECTOR GENERAL, LEGAL SERVICES CORPORATION

Friends of the
Legal Services Corporation

E-mail: tsmegal@kmob.com

February 3, 2005

Board of Directors

Thomas F. Smegal, Jr.
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Chairman

John W. Martin, Jr.
Boca Grande, FL
Vice-Chairman

Alexander Forger
New York, NY

Hulett H. Askew
Atlanta, GA

Deborah Hankinson
Dallas, TX

Peter Edelman
Washington, DC

Kirt West
Office of the Inspector General
Legal Services Corporation
3333 K Street, N.W., 3rd Floor
Washington, D.C. 20007

Re: LSC/Friends Lease

Dear Kirt:

I am advised that the agenda of the Legal Services Corporation (LSC) Board meeting scheduled for Saturday, February 5, includes an executive session report by your office of its preliminary findings concerning the LSC/Friends Lease. In that there is no one from Friends who will be present, I thought it appropriate to summarize my understanding of events that have transpired since October 14, when you and I first briefly met to discuss the 2001 creation of Friends, the acquisition and financing of 3333 K Street by Friends, and the leasing thereof to LSC.

While attending the 30th anniversary celebration of LSC in December, Friends Bond Counsel Richard Newman and I met with Laurie Tarantowicz, Assistant OIG Legal Counsel, and Karena Dees. I also met with Laurie and Mike Shiohama, OIG Chief Investigator. I responded frankly and candidly to all inquiries regarding how it came to be that Friends was formed, and that LSC is occupying 3333 K Street as a tenant of Friends including, inter alia, the various discussions with your predecessors in the IG office about these transactions as they were being conceived. Furthermore, I called Mike later that same week and provided additional information. I summarized those conversations in a communication to Laurie dated December 9, 2004 (copy enclosed).

During the intervening three-month period, we have provided to your staff all documents that Friends has maintained in its files at least since its creation in 2001. In addition, I understand that your office has obtained all documents that LSC has in its files relating to the Lease, as well as more broadly, the procedure by which Friends

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Phone 202.295.1520 Fax 202.337.6519

was created and how and why the purchase and financing of the property at 3333 K Street was accomplished in the manner in which it was.

I also responded to additional requests of Laurie and Mike for documents and other information. In particular, as recently as January 21, I had a conversation with Mike regarding any grants that Friends may have made. As I advised him then, the only grant that had been approved was a grant to NLADA. This grant is in furtherance of Friends' mission, and also is to support Friends' goal of providing substantial charitable involvement with lawyers in the District of Columbia who provide legal services to the poor. I am advised that such "substantial" involvement is necessary to achieve real property tax exemption in the District of Columbia. Since I talked to Mike on January 21, I have executed that grant and include a copy with this letter.

In summary, and as Richard Newman and I advised Laurie and Karena during our initial conversation on December 1, 2004, we would appreciate an opportunity to review (and if necessary comment upon or respond to) any draft report that your Office intends to prepare with respect to the subject of this letter. We are proud of the creativity on the part of LSC that lead to the creation of Friends, and of the cost savings for LSC that Friends does and will provide as the primary element of its mission. We believe that the partnership between LSC and its supporting corporation Friends has ample precedent and is in the long term best interest of LSC, and we hope your investigation validates in hind-sight those efforts. As always, if you, or any of the many members of your staff involved with evaluation of the LSC/Friends lease, need any further information from Friends, please give me a call and I will make every effort to accommodate your requests.

Kindest regards,

FRIENDS OF LEGAL SERVICES
CORPORATION

Thomas F. Smegal, Jr.
Chairman

Enclosures

cc: Friends Board of Directors
Frank Strickland
Helaine Barnett
Vic Fortuno
Richard A. Newman

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LETTER FROM KIRT WEST, INSPECTOR GENERAL, LEGAL SERVICES CORPORATION, OFFICE OF INSPECTOR GENERAL, DATED FEBRUARY 23, 2005, TO THOMAS F. SMEGAL, JR., CHAIRMAN, FRIENDS OF THE LEGAL SERVICES CORPORATION

LSC

Legal Services Corporation
Office of Inspector General

Inspector General
Kirt West

February 23, 2005

Mr. Thomas F. Smegal, Jr., Chairman
Friends of the Legal Services Corporation
c/o Knobbe, Martins, Olsen & Bear
One Sansome Street – Suite 3500
San Francisco, CA 94104

Re: Financial Implications of the LSC/Friends Lease

Dear Mr. Smegal:

This responds to your letter dated February 3, 2005, concerning the OIG's report of its findings on the financial implications to LSC of its lease agreement with Friends of Legal Services Corporation (Friends) for the property at 3333 K Street, NW, Washington, DC.

In your letter, you request that I provide the OIG's draft report on the lease to Friends for its review and comment. I consider the OIG's work in this area to be internal to LSC until issuance of a final report and, therefore, cannot accommodate your request. However, we will consider your letter a request for a copy of the final report under the Freedom of Information Act (FOIA) and once the final report is issued, we will release it to Friends as appropriate in accordance with FOIA.

I also wish to thank you for the cooperation that Friends has extended to the OIG in connection with our review and your offer of continued assistance.

Sincerely,

Kirt West

Kirt West
Inspector General

3333 K Street, NW 3rd Floor
Washington, DC 20007-3522
Phone 202 295 1500 Fax 202 337 6616
www.oig.lsc.gov

LETTER FROM THOMAS F. SMEGAL, JR., CHAIR, FRIENDS OF LEGAL SERVICES CORPORATION, DATED MARCH 2, 2005, TO KIRT WEST, INSPECTOR GENERAL, OFFICE OF THE INSPECTOR GENERAL, LEGAL SERVICES CORPORATION

Friends of the
Legal Services Corporation

E-mail: tsmegal@kmob.com

March 2, 2005

Board of Directors

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Chairman

John W. Martin, Jr.
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Vice-Chairman

Alexander Forger
New York, NY

Hulett H. Askew
Atlanta, GA

Deborah Hankinson
Dallas, TX

Peter Edelman
Washington, DC

Kirt West, Inspector General
Office of the Inspector General
Legal Services Corporation
3333 K Street, N.W.
Washington, D.C. 20007

Re: Financial Implications of the LSC/Friends Lease

Dear Kirt:

I have now received your letter of February 23, responding to my February 3 letter. I understand from your letter, as well as a subsequent telephone message from Laurie Tarantowicz of your Office, that you contend the OIG's draft report (distributed last Friday, February 25, 2005) to be internal to LSC. From that premise, you propose Friends request a copy of a "final report" under the Freedom of Information Act (FOIA).

Unfortunately, the genie has been out of the bottle since your November 1, 2004 memorandum to Helaine Barnett, President of LSC, advising of the OIG review of the 3333 K Street lease "to determine whether lease payments are reasonable." In that memorandum, identifying David Young and Christopher Aballe -- a tip of the iceberg of staff members that have become involved in this review -- you advised Ms. Barnett, *inter alia*, that "As part of the review, we will need to have access to .... information from LSC contractors, including the landlord, Friends of Legal Services Corporation."

Consistent with the memorandum was the facsimile I received from Ms. Tarantowicz on November 23, setting forth an incredibly extensive document request specifically directed to Friends of the Legal Services Corporation. For your convenience, a further copy of that document request is enclosed.

During the December 1 meeting that Richard Newman, Friends counsel, and I had with Ms. Tarantowicz and Karena Dees, they made it clear that it was the position of the OIG that Friends was a "government contractor" obligated to fully cooperate with the OIG . With that understanding of Friends' obligation to your Office, we agreed to produce all Friends documents maintained at 3333 K Street. In

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Washington, DC 20007-3522
Phone 202.295.1620 Fax 202.337.6519

exchange for such cooperation, we made it clear that Friends expected an opportunity to review "any preliminary or tentative/draft conclusions or reports that you produce for this matter to assure completeness and accuracy," see my December 9 letter to Ms. Tarantowicz, to which she responded on December 13 (copy enclosed), also requesting further documents from our auditors.

Thus, I personally have spent a lot of time assisting the many members of your staff that have become involved in this review (I count about eight), to make available to your Office every document maintained in Friends' files. We did so, in spite of Richard Newman having advised Ms. Tarantowicz that a number of those documents were attorney-client privileged.

Thus, for you to now suggest that your draft report will not be available for review and comment by Friends -- identified in November as a government contractor -- is inconsistent with the specific circumstances under which we agreed to incur the expense and time necessary to provide the aforementioned documentation to your Office. I would not be surprised if a refusal to permit Friends to review and comment on the draft report is inconsistent with procedures required of your Office under the Inspector General's Act.

Kirt, in an effort to assist in assuring that your report is complete and correct, please provide a copy of that draft report and any attachments by overnight mail so that Mr. Newman and I will have an opportunity to respond within whatever time frame you may have established.

Very truly yours,

FRIENDS OF LEGAL SERVICES
CORPORATION

Thomas F. Smegal, Jr.
Chair

Enclosures

cc: Friends Board of Directors,
Frank Strickland
Helaine Barnett
Victor Fortuno
Richard Newman

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DOCUMENT REQUEST FoLSC

1. A copy of all 3333 K Street leases, to include lease amendments and proposed lease amendments
2. A copy of any documents to/from LSC regarding its financial obligations/commitments/promises to be committed/etc...to Friends of Legal Services Corporation (FoLSC).
3. Any other agreements, official or otherwise, between LSC and FoLSC (prior to incorporation or after).
4. Any documentation of FoLSC' corporate structure (including Board composition and staffing) and compensation for any officer or employee of FoLSC.
5. FoLSC application for IRC 501(c)(3) and/or 509(a)(3) status.
6. FoLSC IRS Form 990 and/or 990T since 2001.
7. Correspondence with anyone regarding FoLSC filings with IRS.
8. Tapes, transcripts and/or minutes of FoLSC board meetings since inception.
9. Audited financial statements of FoLSC since incorporation, including management letters.
10. FoLSC's contracts with MD Oppenheim, P.C. and/or other IPA's
11. FoLSC contracts with EOS Financial
12. FoLSC contracts with C.B. Richard Ellis.
13. Retainer agreements between FoLSC and any lawyer or law firm in connection with office space for LSC, including leasing arrangements, development of FoLSC or like entity, financing, etc.
14. FoLSC Board meeting transcripts or minutes, including committees of the Board from FoLSC inception to the present.
15. Analyses of the reasonableness of the cost of the leasing arrangement, Market Rate Analysis, e.g., Studley Reports, CB Richard Ellis, etc.

16. Correspondence (including letters, memoranda, e-mail) concerning office space for LSC, including leasing arrangements between any person, firm, or other entity acting on behalf of FoLSC and:
    - LSC
    - CBRE
    - Bank of America
    - EOS
    - The Gates Foundation
    - Any other real estate expert or advisor, financial expert, advisor or institution, or any other party in connection with office space for LSC, including leasing arrangements, development of FoLSC of LSC or like entity, financing, etc.

17. Any slides or other documents prepared for presentation to the LSC Board and/or management on office space for LSC

18. FoLSC organic documents – articles of incorporation and by-laws, including any and all modifications and amendments.

LETTER FROM LAURIE TARANTOWICZ, ASSISTANT IG AND LEGAL COUNSEL, LEGAL SERVICES CORPORATION, OFFICE OF INSPECTOR GENERAL, DATED MARCH 7, 2005, TO THOMAS F. SMEGAL, JR., CHAIRMAN, FRIENDS OF THE LEGAL SERVICES CORPORATION

Legal Services Corporation
Office of Inspector General

March 7, 2005

Thomas F. Smegal, Jr., Chairman
Friends of the Legal Services Corporation
c/o Knobbe, Martins, Olsen & Bear
One Sansome Street – Suite 3500
San Francisco, CA 94104

Re: Financial Implications of the LSC/Friends Lease

Dear Mr. Smegal:

This is in response to your March 2, 2005, letter to Kirt West, LSC's Inspector General. Because it implicates legal matters, the Inspector General asked that I respond to your letter.

Your letter reiterates Friends' request for a copy of the OIG's draft report of its findings on the financial implications for LSC resulting from its lease agreement with Friends for office space at 3333 K Street, NW, Washington, DC. The Inspector General responded to your February 3rd request for the draft report by letter dated February 23, 2005. That letter states that the OIG work is internal to LSC until issuance of a final report, at which time we will release the report to Friends as appropriate under the Freedom of Information Act.

In your letter, you attach some significance to the view that Friends is a "government contractor." Government or LSC contractor status does not bear on the OIG's authority to access records relevant to activities undertaken pursuant to the IG Act. As I stated to you and Mr. Newman in our December 1st meeting, with limited exception, the OIG is authorized to gain access to *all* records reasonably relevant to its review of the leasing arrangement from *any* organization in possession of such records. This authority is not limited to records in the possession of Government or LSC contractors. The IG Act provides this access and, in the case of a refusal to voluntarily comply with OIG document requests, authorizes the OIG to subpoena records that the Inspector General deems necessary to the performance of an IG function, *see* 5 USC App. 3, § 6(a)(4). Such subpoenas are routinely enforced by Federal District Courts. Government or LSC contractor status also is irrelevant to the OIG's position that its draft report is an internal LSC document and that release to Friends of the final report should and will be made pursuant to the law governing the release of LSC documents to third parties. Further, contrary to your suggestion, the OIG's position on this is not inconsistent, in any way, with our duties under the IG Act.

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Washington, DC 20007-3522
Ph: 202.295.1500 Fax: 202.337.6616
www.oig.lsc.gov

Your letter intimates that at our December 1st meeting, Friends agreed to cooperate with the OIG's document request in exchange for an opportunity to review the OIG's draft report. Although we met the morning of December 1st to discuss the OIG's request for documents, the meeting did not result in agreement that Friends would provide the documents requested. You and Mr. Newman expressed concerns about the potential time and expense responding to the OIG's document request would cost Friends. Later that day, the OIG Investigator and I interviewed you in connection with the OIG's lease review. Before starting the interview, I responded to your concerns by offering that the OIG would undertake to review and copy the Friends' records rather than requiring Friends to respond with the specific records identified in our document request. You did not accept that offer until December 9, 2004, via letter. That letter did not "[make] clear that Friends expected an opportunity to review [the OIG's draft report]" in exchange for its production of all Friends documents. Rather, it simply requests an opportunity for review.

Finally, your letter states that you have spent a lot of time assisting many members of OIG staff to make the Friends' records available to the OIG and that this was done despite Mr. Newman's having advised me that a number of those records were attorney-client privileged. Other than our December 1st meeting and a few follow-up phone calls with three members of OIG staff, including myself, there have been no interactions between you and OIG staff members. Once Friends agreed to accept our offer to make its documents freely available to the OIG, our staff undertook to review and make copies of the documents. Thereafter, the OIG asked Friends to expend minimal time facilitating our document review. Further, Mr. Newman took the position in our December 1st meeting that retainer agreements between Friends and its lawyers are privileged, a position with which I disagreed; in my recollection, Mr. Newman identified no other documents as privileged.

As the IG's February 23rd letter states, the OIG's work in this area is internal to LSC until issuance of a final report. Once the final report is issued, we will release it to Friends as appropriate in accordance with FOIA.

Sincerely,

Laurie Tarantowicz
Assistant IG and Legal Counsel

cc: Frank Strickland
Helaine Barnett
Victor Fortuno
Richard A. Newman, Esq.

RESPONSE TO POST-HEARING QUESTIONS FROM THOMAS SMEGAL, CHAIRMAN OF THE BOARD, FRIENDS OF THE LEGAL SERVICES CORPORATION

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August 1, 2005

The Honorable Chris Cannon
Chairman
Subcommittee on Commercial and Administrative Law
2138 Rayburn House Office Building
Washington, DC 20515

Re: June 28, 2005 Oversight Hearing

Dear Congressman Cannon:

Enclosed are my responses to the questions identified in your letter of July 14, 2005 as having been submitted by the Subcommittee Members after the June 28, 2005 oversight hearing:

Question 1: Do you maintain that the leasing situation which your corporation has established with LSC is in the best interest of LSC? Do you believe that the rate they are paying is reasonable and fair? If so, how do explain the following transcription of comments you made during the course of a Board of Directors meeting for Friends: **"Mr. Smegal pointed out that Friends and LSC both have to be wary of Congress as it would be difficult to explain how LSC is paying the highest rental rates in the building for the less choice space in the building"?**

Response to Question 1:

We do indeed maintain that the lease is in the best interest of LSC. As explained both in my prepared statement and oral testimony, the 10-year lease is eminently reasonable and fair, particularly when the following factors are among those taken into account:

— for the entire life of the lease there is no annual escalating adjustment whatsoever and no pass-through, as is the case in most conventional commercial leases where the rent is "triple net" with "bumps";

— the lease provides LSC with 52 parking spaces at the deep discount to $100/month for the entire life of the lease instead of the current market rates of over $200/month (which will most certainly continue to go up particularly in an area like Georgetown). Thus, the monetary difference in parking fees represents an annual $1.35/year reduction in the effective per square foot lease price;

— the build-out was designed specifically to meet LSC staff's needs and represents a reduction of $4.40 /square foot for each year of the entire life of the 10-year lease. Without even factoring in the time-value of money over a 10-year lease term, the tenant improvement allocation alone represents a reduction in the 10-year flat rate to $33.60.

— security of tenancy is highly valuable and the 10-year lease provides that.

In summary, had the IG's appraisers been given the opportunity to merely credit the value of the tenant improvements and reduced parking charges, they would have understood that the net per square foot rate was actually about $32.25, and remains at that amount (flat) for the entire 10 year lease term.

For the IG (and his appraisers) to have focused only on the $38/square foot required to generate $1.7 million/year for the debt coverage service required by Bank of America, is like suggesting that the manufacturer's suggested retail price (MRSP) is what you paid for an automobile when the automobile was actually purchased at a deeply discounted price because of all the added optional equipment.

Friends' obligation to the mission of LSC (and obligation to the Gates Foundation) has always been to provide a permanent facility for occupancy by LSC in DC until the bonds and loans on the building are paid off. At that time (presently anticipated to be 2028) Friends will be able to transfer clear and free title of the building to LSC. Not only is this "Friends' intention" as reflected in its Articles of Incorporation, but represents the sole purpose of the Gates Grant, i.e., "to support a National Home for Legal Services Corporation." This is clearly stated as a controlling condition of the Gates Grant. The Gates Grant also requires Friends to provide annual reports of the status of the acquisition until the Building is transferred to LSC. Oversight counsel Daley had a copy of the Gates Grant produced at his request under cover of their letter of April 15, 2005.

The quote attributed to me in the question -- while not identified by reference to any document – appears to have been cropped from a summary of a

lengthy discussion among Friends Board members on September 16, 2003. It is not a "transcription of comments" I made (Friends can't afford transcripts).

Even while out of context, the discussion reflects a concern of the Board with the risk of confusion that might arise if persons inexperienced in commercial real estate -- such as the current IG and his staff -- attempted to compare the apples and oranges represented by (i) full service vs. triple net, (ii) partial floor vs. full floor, (iii) big vs. small, (iv) pre-existing v. new, and (v) short term vs. long term leases.

In addition the minutes of that September Board meeting reflect a discussion at that time about whether Friends should maximize non-LSC rent by preserving upper floor space for third-party leasing or lease other top floor space to LSC.

A more complete, and therefore appropriate summary of that discussion, is the following:

> Mr. Smegal inquired about the lease renewals. Mr. Fortuno stated that the first lease to roll over is the Oldcastle lease. Mr. Forger asked how much space Oldcastle has and Mr. Martin asked what Oldcastle is paying in rent. Ms. Bulan passed out the most recent stacking plan provided by CB Richard Ellis with that information. Mr. Fortuno stated that the Board needed to decide how to proceed with Oldcastle regarding its renewal. Mr. Smegal inquired about Oldcastle's subtenant and why Oldcastle was willing to absorb the loss from the subtenant paying much less in rent. Mr. Richardson explained that LSC did that with its rental space at its prior location. Mr. Forger asked about the escalation clauses and the lease term for Oldcastle. Ms. Bulan reported that under Oldcastle's present lease, it is entitled to a five-year term but that this would be the last renewal Oldcastle is entitled to under its lease. Both Mr. Martin and Mr. Fortuno inquired about comparables. Ms. Bulan provided a list of comparables compiled by CB Richard Ellis.
>
> Mr. Martin then posed the question of whether there is any basis to charge less to Oldcastle than to LSC. Mr. Smegal pointed out that Friends and LSC both have to be wary of Congress as it would be difficult to explain how LSC is paying the highest rental rates in the building for the less choice space in the building. Mr. Smegal also pointed out that Oldcastle also has parking. Ms. Bulan stated that she believes Oldcastle to currently have 16 spots. Mr. Fortuno stated that Friends is currently charging the

other tenants (not LSC) $175/month for each parking spot. Mr. Martin pointed out that the absolute minimum that Friends can charge Oldcastle is 95% of the LSC rate of $38/square foot. Oldcastle's lease provides that the landlord may increase Oldcastle's rent up to 95% of market rate. Mr. Forger pointed out that the most expansion space for LSC appears to be on the fourth floor and would this be a likely place for LSC expansion. Mr. Fortuno replied that LSC has a presence on all five floors of the building. Mr. Smegal stated that the fourth floor would be natural expansion space for LSC and did Oldcastle have another extension in its lease. Ms. Bulan reported that this is the final extension under Oldcastle's lease. Mr. Fortuno asked whether Friends needs the best space in the building for LSC expansion and explained that this space would be very marketable.

Mr. Richardson reported that as of July 2003, Oldcastle's pass-throughs are $2.04/square foot. As to Oldcastle's request for right of first refusal on the space, Mr. Martin and Mr. Forger said to go ahead and give it to Oldcastle. Mr. Smegal asked if there was a renewal clause in the LSC lease. Mr. Richardson explained that the LSC Board of Directors would like to negotiate one. Mr. Fortuno explained that at the time LSC entered into the lease, the lease term was dictated both by the financial situation and the lender. Mr. Forger asked how Friends could rationalize a rental rate of less than $36.00/square foot. Mr. Richardson explained that the rental rate for LSC was originally set at $35.00/square foot but Bank of America wanted it raised to $38.00/square foot so that Friends would be able to service the debt. Mr. Martin asked where the $35.00 rate came from and Mr. Smegal replied that the rate was tied to what LSC was paying at 750 First Street.

Mr. Fortuno stated that Friends looked at comparables when setting current rental rates and that based on financials and its history with e building, he believes that Oldcastle will want to stay. Oldcastle is a good tenant and Friends probably would like to keep it. He will negotiate with Oldcastle, bearing in mind that LSC is paying $38.00/square foot, and will work with adjusting either the pass throughs or the parking. Ms. Bulan stated that Oldcastle currently has 15 spots in the building. Mr. Martin said that he would not throw in the spots. Mr. Richardson said that Friends is talking about $36.00 or $38.00 with no pass throughs and to bear in mind that Friends property taxes have already increased. Mr. Smegal stated that the pass throughs may be more

significant to Oldcastle. Mr. Forger asked what Friends would do if Oldcastle vacates the space.

Question 2: In your opening statement, you made the claim, relying on the current LSC Board's response to the IG report, that "the creation of Friends and acquisition of 3333 K Street were vetted with and approved by his predecessor, OMB and both the Senate and House Appropriation Committees." Do you still maintain that? House Appropriations has indicated that it had no formal communications with LSC concerning these issues, and LSC has admitted that no reprogramming notice was ever sent to anyone. OMB has stated that **"...some discussions about a leasing arrangement took place between OMB career officials and LSC staff around 1999. At the time it appears LSC had a general idea of what they wanted to do, and OMB provided general guidance about how circular A-11's lease scoring rules work. Beyond this, we do not believe OMB was consulted on the transaction itself, nor did OMB review any proposed or final lease arrangement for compliance with A-11. LSC tells us that they do not have any written guidance from OMB, and we are not aware of any either."**

Response to Question 2:

Yes, I maintain that the quotation of a portion of a statement attributed in the question to the current LSC Board is accurate and reflective of LSC's preliminary activities regarding contacts with OMB and the relevant Congressional committees to outline the purpose for the creation of Friends and the planned acquisition of a building as a permanent home for LSC. While this question would seem more appropriate for a response from LSC, it is my understanding that then-LSC Board member (and acting LSC President) John Erlenborn met with the mentioned governmental entities to apprise them of LSC's plan. I am advised that no one raised an objection. Further, during my testimony I even provided details by time, date and the names of the participants -- in addition to Congressman Erlenborn -- who met with the House Judiciary Committee staff members on April 23 2002 at 2 p.m.

As the Chairman noted during the hearing, and as the stenographic minutes reflect (page 43), the Committee also didn't keep any records of that meeting. However, during the Hearing, the Chairman appeared to be reading from a recent communication reflecting upon Mr. Ausbrook's recollection of that meeting, stating in part: "No further action was taken. The previous Chairman of the Subcommittee was aware of the purchase at that time." Mr. Erlenborn's "vetting" of the situation demonstrated LSC's abundant caution, even though no regulatory or statutory approval was required.

Question 3: The April 2004 Friends Board meeting minutes indicate that the LSC occupies only 42,852 square feet but under the BOMA standard of measure

it is the equivalent of 48,800. Three months later you signed an MOU with President Barnett in which LSC would extend its lease for 10 more years and would pay for the space under the BOMA standard, and also include pass-through costs. How was it in the best interests of LSC to sign an MOU that would increase its rent by more than $200,000 when the purpose of Friends is to reduce occupancy costs for LSC? How does this correlate to your verbal opening statement, when you indicated that the $38 per square foot was flat and forever, with "no pass-throughs, no increases, nothing."?

Response to Question 3:

The quote "no pass-throughs, no increases, nothing" is taken out of context. My verbal opening statement was directed specifically to the existing 10-year lease, which was identified as the subject of the IG's April 2005 report to the Committee. The entire relevant portion of my verbal opening statement (at pages 25-26 of the Stenographic Minutes) is as follows:

> So we go to the corporation. John McKay is a year away from what's going on here now. He left in June of 2001. This is now June of 2002. The bank gets their appraisal. The bank says, "Okay, we've got a deal." And I, as part of the Legal Services Corporation -- I'm serving on the board -- and the rest of us who are involved in this -- there's nobody else here. It's just us. There's no conflict of interest. There's nobody. It's the Legal Services Corporation, trying to save the Government some money; trying to create a permanent home.
>
> So we create a lease. And the lease is for $38 a square foot, flat, forever. No pass-throughs; no increases; nothing. So what else did we do? There's parking spaces in the building. They're going for $175 to $200 a month in 2002. We say, "A hundred bucks a month, forever." What else? No pass-throughs, no tax increases; $38. (Emphasis added).
>
> We have a meeting of the board on February 6th, 2002. You have the minutes. Bill McAlpin, one of my fellow board members--appointed to the Legal Services Corporation twice--says to me, "Tom, you know, when we came in the office in 1993, we were saddled with two leases, only one of which we could occupy. And you know, that was troublesome." And that was in response to the question he had asked me, "How long is the lease going to be, Tom?" And I said "Bill, how long do you want the lease to be?"

Question 4: Section 1005(c) of the LSC Act states "[n]o member of the Board may participate in any decision, action, or recommendation with respect to any matter which directly benefits such member or pertains specifically to any firm or organization with which such member is then associated or has been associated within a period of two years." Why is it that you seemingly violated the LSC Act's Conflict of Interest Statute by recommending and participating in LSC Board decisions pertaining to Friends when you were a Friends' Board member? Please explain how your actions did not constitute a breach of your fiduciary duty to LSC?

Response to Question 4:

This question misreads Section 1005(c) of the LSC Act and its application to the LSC Board Members who created Friends in 2001. LSC created Friends as its alter ego. Since its creation in 2001, Friends has only existed to further LSC's mission.

As I advised the Committee during my verbal opening statement (Stenographic Minutes at page 18-19), I served on the LSC Board at the nomination of President Reagan from November 1984 until January 1991 and again at the nomination of President Clinton from September 1993 to April 2003. Those are the only periods during which Section 1005(c) of the LSC Act would apply to me. Section 1005(c) of the LSC act did not apply to me after April 2003 when my second term of service on the LSC Board came to an end.

During the second of those periods of my service as a member of the LSC Board, and at the oral recommendation of personnel in the Office of Management and Budget, LSC incorporated Friends with the hope of obtaining a foundation grant to purchase a building to become the long-term headquarters for the LSC staff in DC. There was no money available from any source, other then LSC, to create Friends in 2001. The Gates Grant was non-existent until much later.

Friends purchased the 3333 K Street building ("Building") after it was determined that there would be a Gates Grant. While the purchase price was $14.2 million, it was necessary for the Bank of America to make a $15.5 million bridge loan, inter alia (1) to enable $2 million in renovations to be completed, (2) to service the debt for 11 months until LSC would begin rent payments in June 2003; and (3) to provide the Bank of America with security for the debt service. Portions of the Building to be occupied by LSC were then renovated for occupancy by staff as of June 1, 2003.

Each member of the Board of Friends at the time of my appointment to it in 2001 and all but one, as of April 2003 (when I completed my service as

defined in Section 1005(c)) was either an LSC Board member or officer. The single exception was Jack Martin, former General Counsel of Ford Motor Company, who was appointed to the Friends Board by the LSC Board pursuant to Friends bylaws.

No conflict of interest resulted from the formation of Friends by the LSC Board, either for myself or for any other overlapping Board members of the two organizations. Any ongoing "fiduciary duty to LSC" of myself and others was accomplished by the creation of Friends to utilize a foundation grant to purchase a building, should one ever be obtained.

I reiterate that my service as member of the LSC Board for over 18 years, and of the Friends Board since 2001, has been entirely *pro bono*. Neither I nor any member of either Board or our respective firms has ever benefited personally or professionally from the "entrepreneurial initiative"[1] of providing a permanent home for LSC, resulting from the generous grant from the Gates Foundation. I unequivocally state that there is no violation of any conflict rule or statute. Such allegations, now repeated several times by Mr. West are without substance and are libelous, as discussed in greater detail in my response to question 16.

Based on advice received from auditors of LSC and Friends – unrelated to conflict concerns -- a transition was made in 2004, by which those officers of LSC still on the Board of Friends were replaced by others who were not then board members or officers of LSC. The only exception in April 2003 -- and the only exception now -- is Jack Martin, former general counsel of Ford Motor Company, who continues to serve as the appointee of the Chair of the Board of the LSC.

Question 5: Friends has submitted a tax appeal to the District of Columbia that contains several troubling statements. In the appeal, Friends states that all five levels of 3333 K Street, NW. 'are located below the Whitehurst Freeway." In addition, Friends states that the space leased by LSC is "owner occupied" from which Friends derives no rental income for the 44,676 square feet that LSC occupies. Furthermore, the appeal states that the assessor's conclusion of $32 per square foot is too high, and that the building has never achieved such a rate, even though LSC pays $38 per square foot. Lastly, you state that potential gross rent for the building is $1,561,381 despite the fact that LSC's rental income alone is approximately $1,710.000, not including the rent of other building tenants. Do you have any explanation for the submission of these apparently material misrepresentations to a government agency?

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[1] A complementary term suggested by Congressman Delahunt to properly describe the LSC Board having created Friends (Stenographic Minutes at page 66).

Response to Question 5:

Friends is a private, non-profit corporation. We comply with all relevant laws and are represented by lawyers, auditors, accountants and realtors I understand are required to be licensed in the District of Columbia. The "below the Whitehurst Freeway" statement was made by an agent of the real estate broker CB Richard Ellis. The shadow of the Whitehurst Freeway clearly obstructs the building's view of the river as represented by the Wilkes Artis firm and detracts from the value of the building. Furthermore, since LSC and Friends are alter egos, Friends is a "disregarded entity" for tax purposes. It also is appropriate (and lawful) to describe the portion of the facility leased to LSC as owner-occupied.

Beyond that I am not prepared to discuss Friends' tax matters in a public forum. Moreover, I believe it was manifestly improper for Mr. West and his OIG staff to have provided to this Committee's Staff, tax information which is not publicly available. It is also inappropriate for the Committee to make confidential tax information public.

Question 6: Friends was established to provide funds to support all aspects of the missions of LSC and to acquire, hold, and manage assets for the benefit of LSC where doing so may result in lower costs and greater efficiencies for LSC. How have the profits derived from rent collected been distributed? Has there been any payment to a grantee or to Legal Services Corporation directly? Have any requests from either LSC or grantees been denied? How is this consistent with your opening statement that Friends "sole mission" has been to act in the best interests of LSC?

Response to Question 6:

The entire portion of my relevant testimony at page 19 of the Stenographic Minutes is as follows:

> Friends has always been staffed by non-paid volunteers. Its sole mission has been to act in the best interest of the Legal Services Corporation. Upon dissolution of Friends, any assets that have accumulated, including the building that is the subject of this hearing, will revert -- must revert -- to the Legal Services Corporation.

The Gates Grant, the sole purpose of which is to support a National Home for LSC, enabled the Building to be purchased in July 2002. The basic purpose of Friends is to stabilize the occupancy costs of the LSC in an ever rising Washington DC marketplace by purchasing a building made possible by

the generosity of the Gates Foundation. There can be no doubt that that has already happened. The LSC rent -- when properly evaluated -- is considerably less than it would have been had LSC continued to occupy the commercially-owned facility at 750 First Street and is certainly far less than current market rents. This was dramatically demonstrated to the Committee on June 28, with the graph illustrating rental rates computed by the IG appraiser, were LSC to have remained at 750 First Street after June 1, 2003.

To discharge its duty to LSC, Friends must (1) comply with the Gates Grant obligations until the Building is transferred to LSC, (2) comply with the Bank of America funding obligations, including maintaining an acceptable debt coverage service ratio until bonds and loans are paid off, (3) continue to satisfy the provisions of Section 501(c)(3) of the Internal Revenue Code; and (4) attempt to satisfy the District of Columbia that Friends has "substantial" involvement in reducing conditions of poverty in the District of Columbia by assisting DC lawyers in their delivery of legal services to the indigent. To the extent that there may be an excess of revenue over expenses from the Building -- not required to service the debt and maintain the Building -- Friends Board will try to direct such funds to such charitable and mission-related activities in the District of Columbia. The Board of Friends will prudently act to do so. An example of such prudent and responsible conduct in supporting the mission of the LSC is the NLADA Grant in 2004 for the specific purpose stated in that Grant.

Since June 1, 2003, there has been significant reduction of loan and bond principal. Furthermore, the Building has significantly appreciated in value as I advised the Committee during the Hearing (Stenographic Minutes at pages 65-66). The long-term prospects for greater appreciation of the Building are obvious from the many attractive developments along K Street since June 1, 2003.

There is no profit generated by a non-profit 501(c)(3) corporation. LSC will be the beneficiary of this asset – by being given title to a valuable debt free building – once the debt obligations are discharged. As stated in our by-laws, Friends' mission is to further LSC's mission. Similarly, the Gates Grant restricts the use of the Gates money -- and any funds the Building may generate -- first to the Building and then to the LSC mission.

Question 7: Does the fact that almost all lenders approached to finance this building declined that opportunity suggest that this may not have been a very good deal? And isn't it true that the only lender that would agree to lend for the purchase of the property in question did so only on the condition that LSC stipulate to the 10 year lease at $38 per square foot? Furthermore, it certainly appears that every decision relating to the formation of the agreement between

Friends and LSC was done to secure that rate, for the interests of Friends, and against the interest of LSC. Please explain.

Response to Question 7:

Beginning in about April 2002, Friends actively negotiated with a number of prospective lenders in an effort to secure financing for the 3333 K Street property. In securing financing, LSC faced a difficult task. Friends was a start-up nonprofit organization with no operating history and no assets other than the promised Gates Grant. Moreover, the proposed principal revenue source for debt service was rent from LSC, which is subject to non-appropriation risk. Due to the nature of Friends asset base (there was none), and this uncertain revenue source, profit-motivated financial institutions offered term sheets that fell considerably short of the requisite amount of funds necessary to purchase the Property, save one organization.

Bank of America is a highly respected financial institution with a special division assigned to public service activities and with unique capability to underwrite non-appropriation risk. Other banks that we approached were not so well experienced. Bank of America was the sole financial institution that recognized the promise and potential in the Building being purchased by Friends. Obviously, they are fiscally conservative as banks must be. While lawyers may engage in *pro bono* activities, even public service oriented banks (such as Bank of America) cannot give away their money.

Bank of America agreed to assist LSC (and Friends) after obtaining a thorough appraisal from a highly respected appraiser.[2] The Bank worked tirelessly to craft a financial strategy that would allow Friends to execute the transaction. Bank of America offered leverage at 90% loan-to-value. Other financial institutions were only willing to offer leverage at between 60-75% loan-to-value ratio. Remarkably, the Bank of America also provided an additional short-term unsecured loan of $1,500,000 that bridged the collateral and permitted Friends to renovate the LSC space without any rent being paid by LSC from July 1, 2002 to June 1, 2003. In exchange for this flexibility and added risk, Bank of America mandated a First Deed of Trust on the Building, an assignment of a 10-year LSC lease stipulating a rate of $38 per square foot when rent payments commenced in June 2003, and a number of standard financial covenants.

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2 The IG has not denied that he concealed the Bank of America Appraisal from the two appraisers that he hired to evaluate the Building, until long after they submitted their appraisals.

From Friends perspective, the $38 per square foot mandate was the subject of two critical tests. First, Friends needed to determine if the $38 figure was a reasonable market rate for the space to be occupied. This analysis was important not only from a practical perspective, but also from a legal perspective since Friends would not be able to borrow on a tax-exempt basis should there be a risk that the lease would fail various tax tests, including one that requires that the lease rate not be above market conditions. This would ultimately result in a significant increase in Friends cost of borrowing should tax-exempt status be unavailable. Second, Friends needed to determine if the $38 lease rate would generate enough revenue to meet the other financial covenants imposed by Bank of America. Of particular concern was the debt service coverage ratio of 1.20 to 1.00, that required Friends to generate $1.20 in net income annually (revenues compared to expenses) for every $1.00 of annual debt service obligation.

To determine the reasonableness of the $38 lease rate mandated by Bank of America, LSC (and Friends) relied on Studley Reports (a respected industry-recognized market research source produced by Julian J. Studley Company) and an analysis performed by CB Richard Ellis, Friends initial real estate broker and property manager. According to the 2002 first quarter Studley Report (the latest data that was available in May 2002), the Average Rental Rate Offered for Class A office space in Georgetown was $40.80. For context, Studley states that Class A office space in the District of Columbia is defined as buildings of 100,000 square feet or more that are typically no older than 10 years, or completely renovated, which must contain modern building systems. While the Property does not meet the "technical standard" of Class A office space, it was determined that a 15-year old, 65,000 square foot facility that was undergoing extensive renovations would come close to the Class A standard. As a result, $38 per square foot was deemed by LSC advisors to be on par with the average rate for comparable office space. Thus having LSC pay a 10-year flat rate for comparable space was perfectly reasonable and well within generally accepted nonprofit management practices.

Again, since Friends is the alter ego of LSC for these purposes and is required by its own Charter to direct all of its assets to LSC, its actions are in furtherance of LSC's interests. While the $38 per square foot did figure in the financing of the Building, as already addressed in Question 1, the entire lease is fair and reasonable to LSC when all of the other financial considerations and advantages are properly evaluated.

Question 8: Could you explain why tenants other than LSC are paying substantially lower rents in the same building? Those rents seem to vary greatly, with tenant Penzance paying 30.4% less rent as the closest, all the way up to Victor Properties, which is paying an astonishing 67.9% less rent.

Response to Question 8:

When Friends purchased the building, various leases were already in place and Friends had no legal authority to terminate those leases. As the IG appraisers were instructed by the IG to assume (noted in their reports), only 46% of the Building was even occupied in July 2002. Those existing leases had been entered into during an economic slump in the DC real estate. Thus the rental rates reflected the economic picture in the period 2000-2002. Since Friends took ownership of the building in July 2002, the hold-over tenants who have renewed their leases have done so with their rental rates adjusted upward.

In addition to what appears to have been poor leasing decisions by the Building's prior owner, there are other factors that explain why these leases presently have lower rental rates: they are all for much smaller (niche) space, partial floors and required no significant tenant improvements. Moreover, there is a discount for hold-over tenants as the landlord avoids the cost of tenant improvements, reduces leasing agent fees, and avoids potential vacancy losses. But, with the improved rental market, all renewed leases are being negotiated at conventional triple net as well as having rental rates adjusted upward significantly.

Question 9: The OIG's report and the Board's response indicate that the establishment of Friends was designed to avoid OMB scoring rules. In response to the Committee's document request, LSC could produce no documents regarding communications with OMB or the White House regarding the building. Further inquiry of staff to OMB revealed that there were only some preliminary, general discussions, but nothing specific to the purchase/lease of 3333 K Street. How then did LSC and Friends confirm that its lease was not a capital lease, which would subject it to scoring?

Response to Question 9:

LSC officers analyzed the OMB scoring regulations by reading them and published interpretations of them. OMB was orally briefed about the structure of Friends. My understanding from others then actively involved was that OMB did not consider it a capital lease at the time the acquisition was being contemplated. LSC could not have proceeded if there was any chance OMB would have ruled otherwise. As late as February of this year, LSC was told by OMB that they continued to be of the view that the lease is not a capital lease.

Question 10: In response to the Committee's document request, LSC could provide no documents relating to LSC's decision to create Friends. It is clear from the IG's reports and the Board's responses that LSC employees established Friends. Was the establishment of Friends expressly sanctioned by the Board of

Directors of LSC? Were there any parameters established by the Board to guide LSC employees in ensuring that Friends acted in the interests of LSC?

Response to Question 10:

This question would appear more appropriately to be addressed to LSC. That aside, yes, the LSC Board expressly approved the creation of Friends. In fact, LSC expressly appointed a member of Friends' board, Jack Martin, once by the Eakeley Board and once by the Strickland Board. The LSC Board was continually briefed on Friends' activities and the search for a building (both at breakfast briefings and public board meetings).

Question 11: In your opening statement you declared that Friends is recognized as a public charity under Section 501 (c)(3) of the Internal Revenue Code. Could you please explain and document what charitable functions Friends has actually partaken in, and how the 501(c)(3) status is being maintained?

Response to Question 11

Friends is a 501(c)(3) organization that derives its tax status as a public charity from the supporting role that it plays to LSC in accordance with the Internal Revenue Code and the Income Tax Regulations. Responses to other questions will describe the NLADA grant. Beyond that, I decline to discuss our tax matters in a public forum.

Question 12: Did you use any resources of the Legal Services Corporation, including resource material and staff, in your preparation for the Subcommittee's hearing? If so, please describe and account.

Response to Question 12

Prior to the Hearing before the Subcommittee on June 28, I met with LSC Board Chair Frank Strickland and several LSC staff for the purpose of reviewing my oral testimony. LSC resources were utilized to create the graph attached to my written statement. That graph included the rental payments while LSC occupied 750 First Street, and projections of what the rental payments would have been had LSC remained at 750 First Street beyond June 1, 2003. Those projections were reproduced from the report of one of the appraisers hired by the IG.

Question 13: During your verbal opening statement, you indicated that "this Committee signed off on the deal, and it was structured at that point." Could you please provide some documentation or other evidence to support this statement?

Response to Question 13:

I repeat what I said at the hearing. I didn't mean "signed off" literally. It is often used, as I did, figuratively. All relevant Congressional Committees were briefed about LSC's intention to acquire the Building and the steps LSC anticipated taking in order not to have the purchase price scored against a current appropriation. No one voiced objection. As the Chairman testified at the Hearing on June 28, J. Keith Ausbrook confirmed the substance of the meeting that Congressman Erlenborn and others had with the House Judiciary Committee staff in April 2002. Friends does not have access to the Committee's files to provide any further details. Furthermore, there was no obligation of LSC to obtain formal approval of any Congressional Committee. The visits were intended as a courtesy.

Question 14: Please explain which current leases were agreed to prior to the purchase of 3333 K Street by Friends and had been inherited at lower rental rates.

Response to Question 14:

The other tenants building are private tenants. Friends does not think they should be subject to this public inquiry. Thus I decline to provide information pertaining to our leases with them, except to say that the last "inherited" lease is running out in 2006. It is anticipated that all existing leases, when and if renewed, will continue to be at higher triple-net rates.

Question 15: You mention in your verbal opening statement that the reason other tenants pay significantly less today than LSC is that Friends inherited a lot of leases. Additionally, you indicated that all other tenants are paying rent based upon the BOMA standard of measurement. Could you please list all tenants who are under the BOMA standard, and what date that system of measurement was implemented? Please include this in a chart explaining a list of all tenants, the current amount of space each is renting (with the standard of measurement being applied), the lease commitment, when the lease was entered in to, renewal options, and expiration date, annual increase clauses, and total pass-through costs for each.

Response to Question No. 15:

I confirm that gradually as leases have come up for renewal, Friends is converting them to BOMA measurement. Again, these are private tenants holding private contracts with Friends. Therefore, I decline to provide specific information about them in this public forum.

Question 16: You indicated that you thought Mr. West, Inspector General of the Legal Services Corporation, was not doing his job. Please provide evidence or documentation to support this claim.

Response to Question 16:

I believe that Mr. West has drained hundred of thousands of dollars of LSC funds in a needless investigation of a nonexistent problem. The real problem is Mr. West and his staff. It is outrageous that I have been required to defend the current and previous Boards of LSC and of Friends against his allegations of criminal conflicts of interest contained in THE FINANCIAL IMPLICATIONS OF THE 3333 K STREET LEASE ("IG Report") that he submitted to the Committee in April 2005, and repeated in his written statement to the Committee.

In addition to his irresponsible allegations of overpayment by LSC of $1.23-1.89 million in rent during the current ten-year lease period (2003-2013) - - based upon two deliberately incomplete and deeply flawed appraisal reports that he commissioned - - his IG report also expressed his unsubstantiated concerns regarding (a) "any conflicts of interest pertaining to LSC's relationship with Friends," as well as (b) questioning whether there had been "any breaches of fiduciary duty" in creating Friends to utilize the Gates Grant.

While such statements in the IG report bordered on libel, even more actionable is the expansion of such allegations in his June 28, 2005 dated written Statement ("Hearing Statement") submitted to the Subcommittee. His Hearing Statement (page 11) contains the following assertion regarding the conduct by (unidentified) LSC officials:

> "I am extremely concerned there may have been conduct by LSC officials that, while not a violation of LSC rules or regulations, could constitute administrative and even possibly criminal violations[3] of the conflicts of interest laws applicable to all Executive Branch employees." (Emphasis added)

Even though individuals were not named, his Hearing Statement was understood by at least the Chairman of the Subcommittee to identify a "problem" - - that "problem" being his baseless allegations against former LSC President

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[3] Apparently the Chairman had overlooked this portion of Mr. West's Hearing Statement in observing during the Hearing (Stenographic Minutes at page 48) that "and if you step back and look at it, nobody is being called criminal."

John McKay,[4] former LSC Board Member and President John Erlenborn,[5] and myself, as well as Victor Fortuno,[6] David Richardson[7] and Lynn Bulan[8] of "criminal violations" of conflict of interest laws.

While none of us did anything improper, and as Congressman Delahunt observed during the hearing "I happen to think that you did the right thing." (Stenographic Minutes at page 45), Mr. West implies that because certain statutes applicable to federal employees don't apply to LSC, there is no recourse were there to have been improper conduct at LSC. That is obviously incorrect. The full panoply of federal and DC laws governing Corporation behavior apply to LSC, its directors, officers, and other employees.

Still further, at page 14 of his Hearing Statement, Mr. West also alleged violations by Friends of regulations governing LSC in stating that:

> "Friends made a $50,000 unrestricted contribution to an organization to which LSC is restricted from making the same kind of contribution."

Thus, he asserted that Friends -- whose Board of Directors consists of former LSC President Alexander Forger, former LSC Board member Hulett Askew, former Ford Motor Company General Counsel John Martin, former Texas Supreme Court Justice Deborah Hankinson, Georgetown Law Professor Peter Edelman and myself - - violated Congressional restrictions governing the delivery of legal services by LSC, in providing a grant[9] to NLADA[10] for the

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4 John McKay had stepped down as President of LSC in June 2001.

5 John Erlenborn had served for 20 years in the House of Representatives before serving on several occasions as a Board member of LSC and then also as its interim president from June 2001-May 2004.

6 LSC Vice-President for Legal Affairs, General Counsel and Corporate Secretary.

7 LSC Treasurer and Comptroller.

8 LSC Senior Assistant General Counsel.

9 That grant – not a contribution – was defined in an 8-page document that I provided to Mr. West under cover of my letter of February 3, 2005.

10 While not identified in his Hearing Statement, Mr. West confirmed in his oral testimony that the "organization" was NLADA.

purpose of financially assisting legal services lawyers in the District of Columbia in attending CLE programs.

The OIG repeatedly refused to permit Friends to review his report,[11] thus denying Friends an opportunity to provide an appropriate response from those with the background and understanding of the subject matter to refute his ridiculous allegations. While Mr. West testified at the Hearing that "I'm unaware of ever calling him a contractor … when I have dealt with contractors in previous instances, if we did an audit of the contractor, they of course get the draft audit report." (Stenographic minutes at page 52). Yet in his November 1, 2004 memorandum to LSC President Helaine Barnett, he specifically identified Friends as a "contractor" in stating that "as part of our review, we will need to have access to … information from LSC contractors, including the landlord, Friends of Legal Services Corporation" (emphasis added).

In addition to refusing to share the IG Report with Friends, he had limited the information from which his appraisers were to render their reports. In particular, the Bank of America Corporation had obtained from Cheney and Associates (the "Cheney report"), dated May 29, 2002, which was the basis for Bank of America agreeing to provide a bridge loan of $15.5 million to enable Friends to purchase the Building[12].

The Cheney report evaluated the Building both as to its appraisal value and the anticipated rental rates even before any loan was negotiated.[13] That the IG

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11 I submitted to the Subcommittee following the June 28, 2005 hearing, letters dated 2/3/05, 2/23/05, 3/2/05 and 3/7/05 between myself and the OIG, twice requesting and twice being refused an opportunity to review his report. Instead the OIG suggested that at a future date Friends could process a request under the Freedom of Information Act (FOIA).

12 On January 15, 2005 I authorized Bank of America to provide a copy of the Cheney report to the OIG -- in response to his demand for it -- and also provide a copy to me. My records reflect that they did so on about that date.

13 In his subsequent June 13, 2005 letter to the Board, while denying that he personally knew about the Bank of America appraisal, he asserted that one of his appraisers (unidentified) had reviewed the Bank of America document and "stated that the Bank of America obtained limited applicable data and very limited analysis particularly with respect to the fair market rent analysis." Mr. West's June 13, 2005 letter is silent as to when his appraisers – whose reports were dated January 25 and February 11, 2005 – were actually given a copy of the Cheney report.

had not shared the Cheney report with his appraisers prior to the dates of their reports is clear from his letters to the Board dated May 5, 2005 when he attempted to justify not having previously advised the Subcommittee and Board of the Cheney report. [14]

Moreover, the OIG placed other limitations on his appraisers that produced a distorted valuation of the transaction. As I pointed out during my testimony to the Subcommittee (Stenographic minutes at page 28), the January 25, 2005 cover letter by which the Blake report was transmitted - - acknowledging that the 10-year lease agreement included a gross rental rate of $38/sq.ft. without escalation throughout the term of the lease - - also revealed that:

> "... at your request, our valuation does not include the terms of this lease. Our valuation is based on the terms of the seven existing leases (as of July 1, 2002) encumbering 46% of the building, with the balance of the space being vacant on a current basis."

Further at page 59 of the Blake report, it was stated that:

> "The purpose of this appraisal is to determine the market value of the subject property in accordance with accepted value estimating procedure" (emphasis added).

Limited to an appraisal date of July 1, 2002 - - with 54 percent of the building vacant - - the Blake report concluded that the Building had a value of $11.4 million. Had the IG appraisers not been restricted from evaluating the available information upon which their appraisals should have been based, they would have been able to include in their reports that the Building had sold for $16 million in 2001, received three bids of approximately $14,000,000 when put back on the market in 2002, was evaluated by the Bank of America appraiser already to have a market value $14,400,000 as of May 21, 2002 and a estimated market value of $17,200,000 as of January 2003 (in anticipation of the LSC tenant improvements completed in May 2003) .

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[14] In his Hearing Statement, the IG characterizes the Bank of America appraisal as unreliable because its "main purpose is to support the purchase price so that a loan can be approved, commissions earned, etc." (Emphasis added) Apparently the IG has some yet-to-be alleged accusations to direct against Bank of America.

Yet the IG appraisers had been required by the IG to limit their appraisals to a date eleven months earlier then June 1, 2003 - when LSC commenced paying rent for the Building. The July 1, 2002 date merely reflected the execution date of the lease agreement that enabled Friends (and LSC) to obtain the necessary loan from the Bank of America to purchase the Building.[15]

While the expenditure for his appraisers is known ($22,000), what is not known is the dollar value of the time spent by about eight members (roughly half) of his staff during the last eight months,[16] as well as all of the other out-of-pocket expenses incurred by his office (such as copying all of the thousands of document in Friends' files), in pursuing this unjustified -- and, as I and the LSC Board see it, terribly flawed-- investigation.

In my view, in reasserting such allegations in his Hearing Statement, the current IG and his staff are not conducting his Office in a responsible manner appropriate under either the Legal Services Corporation Act or the Inspector General's Act. Mr. West is not doing the job for which he was hired and, in my opinion he should be terminated.

Question 17: You indicated in your testimony that the grant made to NLADA was "very restricted". Could you please indicate what language in the grant made by Friends to NLADA supports this notion that none of the grant money could be used for restricted activities? In addition, you have indicated that there is nothing which would cause concern in giving a grant to NLADA in any instance. Considering NLADA employs a lobbyist, represents and is involved in subject matter such as illegal alien cases. and has most recently filed a brief against the position of the United States and LSC in the *Dobbins* litigation, how do you support that statement?

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15 The IG appraisers are also silent as to the debt service required of Friends - - from July 1, 2002 until June 1, 2003 -- while LSC was paying no rent. As one might expect, the interest on $15.5 million for eleven months was not de minimus and should have been among the "facts" the IG's appraisers were permitted to consider.

16 His memorandum to LSC President Helaine Barnett was dated November 1, 2004, and advised of "initiating a review of LSC's lease for 3333 K Street, N.W. The objective of this review will be to determine whether lease payments are reasonable. .... As part of the review, we will need to have access to LSC files and knowledgeable staff as well as information from LSC contractors, including the landlord, Friends of the Legal Services Corporation."

Response to Question 17:

The grant to NLADA is specifically limited to the purpose of "providing scholarships and other support to providers of civil legal services to indigent persons to enable them to participate in training events delivered by NLADA." Such activities are not restricted activities under the LSC Act. Further, none of the Friends grant to NLADA was used to support any restricted activities.

A primary reason for the grant, beyond furthering the professional growth of lawyers serving an area with a large and entrenched poverty population, was to demonstrate to the District of Columbia that a percentage of the revenue from the Building was being used for charitable purpose under the non-profit real property tax laws of the District of Columbia. This requirement was accomplished by the grant condition that most of the funds of the grant were to be used to support training of lawyers for the poor, practicing in the District of Columbia.

NLADA has used the grant for the purposes specified. NLADA began training for District of Columbia lawyers in June of 2004, by underwriting the attendance of a number of them at their Civil Impact Leadership training in Utah, as well as their Litigation and Advocacy Directors' training the followed immediately upon the Leadership event.

NLADA also helped a number of DC lawyers attend NLADA's nationally recognized Substantive Law Conference in Los Angeles in July of 2004. That conference has served for over 20 years as the leading national training event for new and moderately experienced lawyers to learn specialized areas of poverty law.

In December 2004, NLADA used some of the Grant to underwrite the attendance of lawyers and faculty from the District of Columbia to NLADA's Annual Conference, the premier learning and networking event for legal aid lawyers and public defenders in the United States.

Finally, NLADA recently expended the remainder of the Grant to support DC lawyers in attending NLADA's Trial Advocacy College at Temple Law School in Philadelphia. This event utilized the extensive trial advocacy facilities at Temple along with an outstanding faculty from the American College of Trial Lawyers and leading legal aid attorneys in the field for an outstanding week of honing lawyers' trial skills.

The Friends' grant to NLADA was a payment for services consistent with the purposes of the LSC Act. The relevant language of the LSC Act itself specifically authorizes LSC to make grants and contracts with outside entities:

"SEC. 1006(a). To the extent consistent with the provisions of this title, the Corporation shall exercise the powers conferred upon a nonprofit corporation by the District of Columbia Nonprofit Corporation Act (except for section 1005(o) of title 29 of the District of Columbia Code). In addition, the Corporation is authorized-- ...

"(B) to make such other grants and contracts as are necessary to carry out the purposes ... and provisions of this title," *Section 1006(a)(1)(B), 42 U.S.C. Section 2996.*

LSC has made a number of grants related to training advocates and grantee boards of directors specific to this power, including:

(1) six grants of $10,000 to provide special accommodation to its grantees at the ABA/NLADA Equal Justice Conference;

(2) a grant to the Sargent Shriver National Center on Poverty Law to support publication of a training manual and on-line training on legal research for LSC-funded lawyers; and

(3) a contract with a private consultant to develop a board of directors' training module on diversity and other issues.

Even the OIG has made payments for activities such as its Geographic Information Systems (GIS) study and other initiatives aimed at improving the efficiency and effectiveness of grantee performance.

Question 18: Article 26 of the Lease entered into between Friends and LSC gives LSC the option to terminate the lease, without penalty, if LSC does not receive an appropriation sufficient to satisfy the ability of LSC to pay its monthly rent. As such, isn't it true that LSC is only obligated to this lease insomuch as Congress demonstrates support for the current leasing terms?

Response to Question 18:

No.

Question 19: Please describe all efforts which have been made on or prior to July 14, 2005, the date this letter was sent, which address resolving the issues raised in the OIG's report and discussed at the Subcommittee hearing.

Response to Question 19:

The "issues" raised by the OIG are without substance, and were fully dealt with by Friends, through my written statement, oral presentation and subsequent document production to the Subcommittee, as well as by all documents filed on behalf of a unanimous LSC Board.

As to the structural concerns raised by Chairman Cannon, Friends will work with LSC to try to address them. Other than some very preliminary discussions, however, not much has happened as of July 14, 2005 in part because LSC's management has been preoccupied with other immediate pressing concerns.

Friends takes seriously its obligation to assist the Subcommittee in its understanding of the "good deed" represented by the hard, selfless work of Friends' volunteer board, the Gates Grant and the resulting permanent home for LSC, at already demonstrated savings in LSC occupancy costs. Friends has fully cooperated with the Subcommittee through my continuing to spend many hours of additional *pro bono* time, preparing thorough responses to these unnecessarily accusatory questions.

Respectfully submitted,

Thomas V. Smegal, Jr.

cc: Congressman Melvin L. Watt
LSC Board Chair Frank Strickland

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RESPONSE TO POST-HEARING QUESTIONS FROM FRANK B. STRICKLAND, CHAIRMAN OF THE BOARD OF DIRECTORS, LEGAL SERVICES CORPORATION

Legal Services Corporation
America's Partner For Equal Justice

August 10, 2005

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Helaine M. Barnett

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Galveston, TX

Florentino A. Suñe
El Paso, TX

Ernestine P. Watlington
Harrisburg, PA

The Honorable Chris Cannon
Chairman, Subcommittee on Commercial
and Administrative Law
Committee on the Judiciary
House of Representatives
B-353 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Cannon:

Enclosed please find my answers to your supplemental questions from the Legal Services Corporation's Oversight Hearing on June 28, 2005.

As I said then, I understand your concerns about the relationship between LSC and Friends of LSC and I intend to reach a solution that satisfies those concerns. Please contact me if you have any further questions.

Sincerely,

Frank B. Strickland
Chairman

5333 K Street, NW 3rd Floor
Washington, DC 20007-3522
Phone 202.295.1500 Fax 202.337.6797
www.lsc.gov

QUESTIONS FOR FRANK STRICKLAND

1. **You noted in your opening statement that LSC was in need of additional space, and thus justify the gaining of an added 5,000 square feet with the move to the current location. Has there been any space needs analysis to determine if this is accurate? How is it that LSC needs approximately 410 square feet per employee when GSA standards are only 230 square feet per employee? In fact, isn't LSC now forced to sublet some of their space which is not being used, at an expected greatly reduced rate, thus requiring LSC to supplement other's usage of space which is in excess of that which they need?**

Response:

It is my understanding that LSC commissioned two independent analyses of space requirements prior to 2001. In addition, after the 3333 K Street building was selected, the Corporation worked closely with an independent architectural and space planning firm to conduct a detailed evaluation of the Corporation's space needs. LSC created an internal LSC committee to review these issues. The committee included a representative of each office of LSC, including the Office of the Inspector General (OIG). Working in tandem, the independent firm and the internal committee did most of the space planning and decision-making. Final decision-making authority resided with the internal committee and ultimately with the then LSC President, former Congressman Erlenborn.

My further understanding is that the plans went through numerous revisions, that the committee thoroughly discussed and considered all issues, and that the OIG did not raise any objections or concerns at the time to any decisions made by LSC.

Regarding the space needs of LSC, since the OIG is currently conducting an analysis of the space occupied by LSC, perhaps this issue should be deferred until that report is complete and LSC has had a chance to review any recommendations made by the OIG.

Last month, LSC consolidated some of its offices in order to sublease 2,139 square feet on the first floor of the building. The location and arrangement of that space is not considered prime space within the building, so the initial lease will be for less than the overall rate per square foot paid by LSC.

2. **You hinted in your opening statement that the OIG kept the Bank of America appraisal from the Board during its consideration of this issue. However, it has come to the Committee's attention that LSC already had a copy of this appraisal at its disposal. Could you please clarify this? In addition, since the Bank of America appraisal was commissioned for justifying the purchase price and rental terms that became conditions of the mortgage agreement, from which the Bank**

of America would profit, don't you agree that the findings in that appraisal are somewhat suspect?

Response:

The OIG expressed a sense of urgency for LSC file documents and demanded from LSC staff that documents be produced without spending the time to catalog and copy them, and LSC staff complied. Thus, in fact, the current LSC Board and management did not have access to the Bank of America-commissioned appraisal at the time the Board was preparing its response to the OIG's report. In the future LSC will catalogue and copy all documents before being turning them over to the OIG.

No one on the current LSC Board knew about the Bank of America appraisal, nor did the LSC staff assisting the Board on drafting a response to the OIG report. However, the OIG knew about the appraisal yet failed to mention its existence.

Having reviewed the assumptions underlying the OIG-commissioned and the Bank of America-commissioned appraisals, the Board found the one commissioned by the Bank of America to be more credible. I have enclosed a table created by LSC staff which shows the differences in the assumptions. The LSC Board also provided this table to the Committee in May as part of its response to the OIG's second report on the lease.

3. **You indicate that the Inspector General's (IG's) report included "vague allusions" regarding conflicts of interest in this business model, and you seem dismissive of that portion of his report. Didn't former LSC President, John Erlenborn note such conflicts as being the cause for his resignation from Friends? Don't LSC Staff Attorney, Lynn Bulan, negotiating on behalf of Friends against LSC regarding building maintenance issues, and LSC's General Counsel, Vic Fortuno, signing the lease on behalf of Friends of LSC (FoLSC) support the IG's premise that there may be actual and inferred conflicts of interest? Why has the Board been dismissive of these serious and substantiated allegations?**

Response:

The LSC Board approved the creation of Friends of LSC, and Friends' initial Board members were LSC President John McKay, and LSC's General Counsel and Comptroller. When Mr. McKay left LSC to become the U.S. Attorney for the Western District of Washington, the new LSC President, Congressman John Erlenborn, and LSC Board member Tom Smegal were added to the Friends Board. At all times, through finding the 3333 K Street site, negotiating the terms of the agreements with the seller and Bank of America, and working out the specifics of the move into the building, the Friends Board consisted entirely of LSC Board members and officers with one exception. That exception was Jack Martin, the retired General Counsel of Ford Motor Company. My predecessor named him to the Board in late 2001 under provisions which allow the LSC Board Chairman to name a Board

member. (I reappointed Mr. Martin when I became Chairman, and he remains on the Friends Board.)

The activities of Friends through this period were fully disclosed and regularly routinely discussed at LSC Board meetings and every LSC Board member knew who was serving on the Friends Board.

It is clear that through at least April 2003, Friends was an organization controlled by LSC. In short, there could have been no conflict of interest.

I would also note, as the IG did in his testimony before the Committee, that no member of the Friends Board has profited in any way from his or her service. Their service was and is pro bono for the ultimate benefit of LSC.

With respect to Congressman Erlenborn's resignation from the Friends Board in late 2001, his resignation letter has been taken out of context. It is clear from the totality of the record that Congressman Erlenborn's concern was that he would be signing a lease with "himself." That was what concerned him. When he left the Friends Board, he left that Board firmly in control of LSC Board members and officers, although he clearly had the authority to ask, and in the case of the LSC officers, to direct that they resign from the Board. Therefore, Mr. Erlenborn was not concerned about conflicts of interest by other LSC Board members and officers.

It is not our intent to be dismissive of the IG's concerns. At this point, however, we do not agree that the allegations concerning possible conflicts of interest have been substantiated. Moreover, we continue to believe that it is improper to make public allegations questioning a person's integrity without a thorough investigation, evidence and an appropriate legal analysis.

4. **You mention the benefit of the $2 million build-out allowance that Friends gave to LSC. In fact, LSC management has been unable to determine how this amount has been utilized. How can you quantify this as a benefit without an accurate accounting?**

Response:

LSC management is nearing completion of its review of the build-out spending, as requested by the OIG. The current evidence available to LSC is that somewhere between $1.9 and $2 million was spent. Therefore, accounting for the build-out as a benefit to LSC is appropriate.

5. **You mention that it is only a question of when and how much when it comes to determining the savings realized by LSC. In fact, there have been attempts already to retard this effort. How is Friends working towards this goal when memorandum's of understanding (MOU's) entered into have already increased**

real expenditures from LSC by including pass-through costs as well as utilizing different standards of measurement which would increase the total amount of space LSC is paying for without any "real" expansion?

Response:

A Memorandum of Understanding (MOU) is only an agreement to agree. The July 2004 MOU was a reflection of the intent of LSC and Friends to negotiate and enter into a new lease beyond the May 2013 expiration of the current lease. The current lease remains in effect and nothing has occurred which is binding on either party. Any new lease agreement, whether or not it reflects terms of an MOU, would be subject to Board approval. Lease negotiations have yet to occur and no new agreement will be entered into to extend the lease past 2013 without a thorough review by the LSC Board. I can assure the Committee that any extension of the lease agreed to by the Board will be beneficial to LSC and will involve substantial savings to LSC compared to the alternative of being in the District of Columbia commercial market for suitable office space.

6. **Was there ever a reprogramming notice sent to the Administration or Appropriations Committee regarding the move to 3333 K Street or the arrangement agreed to between Friends and LSC? If not, why was this never done?**

Response:

Congressman Erlenborn had no intention of proceeding with any transaction if OMB raised any objections. The proposed purchase and lease was thoroughly discussed with OMB and OMB declined to score the lease against the LSC budget. OMB reviewed the agreement again early this year, and concluded they scored it properly in 2002 and 2003.

With respect to the reprogramming procedure of the two Appropriations Committees, Congressman Erlenborn personally met with both Subcommittee chairmen and Appropriations Committee staff were fully briefed, and no objections were raised. As the Committee knows, LSC has no record of a written reprogramming having been sent. Nonetheless, the basic reprogramming requirement, that the Appropriations Committees be notified and given an opportunity to object, was met.

7. **Friends was established by LSC employees for the benefit of LSC, but now no LSC employees are involved in Friends and LSC would appear in fact to have no control of Friends. Is LSC concerned that it now has no control over the disposition of the property it established Friends to purchase?**

Response:

I appreciate the concerns raised by Chairman Cannon at the hearing about the nature of the structure and LSC's legal guarantee that it will ultimately gain possession of the building. There have been some preliminary discussions with Friends about how to perfect LSC's interest in the building without triggering any OMB scoring. This matter will require discussions with OMB and further conversations with the Committee. I intend to reach a solution that satisfies Chairman Cannon's concerns.

However, in the short term, there is no cause for concern. First, a majority of the current Friends Board consists of two former LSC Board members, one former LSC President, and one person I appointed, all individuals of the highest integrity. The other two Board members are a former justice of the Texas Supreme Court (an appointee of then-Governor Bush) and a distinguished Georgetown University law professor. The current Friends Board will not act against the interests of LSC. Second, the terms of the grant from the Gates Foundation require that the grant be used to secure a permanent home for LSC and Friends is required to report annually to the Foundation. Third, the only way LSC's interest could be threatened, assuming Friends would even try to avoid its legal obligation to the Gates Foundation, is to amend its Articles of Incorporation to change its stated business purpose, and to our knowledge that has never even been contemplated by the Friends Board.

Therefore, while I intend to address the concerns of the Chairman to ensure that LSC's interests are fully protected 20 years from now, we have time to resolve this carefully without acting precipitously and running the risk of making a mistake.

8. **The Board's response to the OIG's report states that Friends is required to act in the interests of LSC. Friends has provided a grant to the National Legal Aid and Defenders Association that could be used for activities involving restricted activities and could support organizations that LSC could not fund. Do you believe this is in the interest of LSC? Hasn't LSC made a request for funding from Friends which has been denied? Recently, LSC management has indicated that LSC in fact makes grants itself directly to NLADA. Isn't this against the restrictions which Congress has mandated against the usage of LSC appropriations? Please explain.**

Response:

The appropriation rider requires, in relevant part, that any entity receiving funds from LSC for the delivery of legal services agree to abide by the riders for both their LSC and non-LSC funds. The statutory language and legislative history are clear that the rider only applies to those entities that receive financial assistance for the delivery of legal services. Other LSC grants and contracts are not governed by the rider, nor could LSC function if they were. I am attaching a legal opinion prepared by LSC's Office of Legal Affairs which explains the scope of the appropriations rider.

My understanding of the grant from Friends to NLADA is that the use of funds was controlled by a contract and that it was for a specific purpose and limited to activities that would not be prohibited by the rider if the rider applied.

I would of course be concerned if Friends were to use funds for purposes prohibited by the appropriations riders. However, that situation does not exist at present and, having discussed this matter with Tom Smegal, Chairman of the Friends Board, I am confident it will not arise in the future.

9. **One of the records provided by the OIG in response to the subcommittee's request is a transcript of the January 30, 2004 meeting of LSC's Finance Committee. At this meeting, LSC's General Counsel presents a proposal to the Committee to acquire additional space at the location. At this time, the LSC General Counsel was a member of the Friends Board. Who was the General Counsel representing at the LSC meeting?**

Response:

The LSC General Counsel was representing the interests of LSC and providing information to the Finance Committee of the LSC Board as requested.

10. **In its response to the OIG's lease report, the Board stated that LSC conducted a thorough space needs assessment. In addition, in the minutes of the Friends Board meeting of 2/3/04, the LSC President indicates that LSC did a needs assessment of whether LSC required additional office space. In response to the Judiciary Committee's document request, LSC only provided a 1998 assessment which indicated the need for 37,000 square feet. Have there been increases in staff since 1998 to require the current 45,000 square feet being leased? Why have no current space needs assessments been provided to the Committee?**

Response:

The Board's statement in its response to the OIG's lease report with respect to space needs assessment was: "Prior LSC management and the previous Board concluded, after a study involving outside consultants, that LSC required more space than the 40,000 square feet it was occupying at First Street." The statement by LSC President Helaine Barnett in February 2004 refers to a review of whether or not LSC needed additional office space. LSC concluded there was no need for more space, but there was no written needs assessment.

President Barnett has been reviewing the LSC organization and staff to make our operations more effective and efficient since she took office eighteen months ago. Space requirements are being constantly re-assessed in light of staff changes that have been made or might be made in the future. As noted above, LSC recently entered into an agreement to sublet 2,139 square feet on the first floor of the building.

11. **One of the records provided by the OIG in response to the subcommittee's request is an MOU between LSC and Friends dated May 2004. In this MOU, LSC agrees that even if it were to occupy less that the 45,000 square feet it is to be provided under its lease agreement, in no event will LSC pay less that $1,710,000 per annum in rent. Why would LSC require itself to pay even more rent than it is obligated to pay under its lease?**

Response:

The May 2004 MOU was supplanted by a July 2004 MOU, so the May MOU is now moot. Please refer to question #5 for a discussion of the July 2004 MOU.

12. **Article 26 of the Lease entered into between Friends and LSC gives LSC the option to terminate the lease, without penalty, if LSC does not receive an appropriation sufficient to satisfy the ability of LSC to pay its monthly rent. As such, isn't it true that LSC is only obligated to this lease insomuch as Congress demonstrates support for the current leasing terms?**

Response:

No.

Moreover, if the implication underlying this question is that Congress should consider legislation overturning the current arrangement, LSC would strongly oppose any such proposal. If LSC were to be forced to negotiate a new lease at another location in the current commercial real estate market, it would be at terms far less favorable to LSC than our current lease and would likely include periodic rent increases and payment of both operating costs and annual real property taxes. Moving costs would also be substantial.

13. **On July 16, 2004 LSC sent a written response to questions posed by this Subcommittee. Specifically, the Subcommittee asked LSC to "explain the function of the organization 'Friends of LSC', who comprises it, what activities it engages in, and what your organization's role is in conjunction with it?" Please explain why the response fails to mention that LSC employees created Friends in order to circumvent OMB scoring, that LSC has staffed Friends , and two LSC officers sat as Members of the Board of Friends until April of 2004.**

Response:

I attempted to be fully responsive to the question one year ago. My answer included a discussion of the LSC staff person who worked for Friends on her own time and all

other information directly asked. Committee staff was already aware that Friends was created by the LSC Board and why. It is important to note that the former LSC Board directed LSC employees to create Friends; LSC staff did not take this action on their own motion, although the former President did support it. No LSC Board members or officers were on the Friends Board one year ago, and I assumed the Committee was aware of the prior Friends Board composition due to the briefing given to its staff by former Congressman Erlenborn in 2002.

14. **Is there an accurate accounting to assure Congress that federal funds have not been misspent on Friends rather than LSC daily functions and activities? Please provide documentation to show that LSC did not inappropriately subsidize Friends by providing space, supplies, and employees to act as Friends employees and officers and to carry out business functions on behalf of Friends.**

Response:

Friends of LSC and LSC are now separated. Friends employs a part-time staff person to do its work, has its own office and supplies, and receives no support from LSC. From its creation in 2001 through 2004, Friends' administrative requirements were carried out by a volunteer from LSC working on her own time. Inasmuch as LSC created Friends and controlled it through most of that period, some *de minimus* expenditures may have occurred (postage, use of filing cabinets, etc.). Federal funds have not been misspent on Friends rather than LSC daily functions and activities.

15. **The Articles of Incorporation of FoLSC currently provide that should FoLSC dissolve, LSC will gain any remaining assets. Can the Articles be changed by FoLSC without any discussion, notification, or input from LSC? Can you provide any written support that LSC has a current and permanent vested interest in the property at 3333 K Street?**

Response:

See my answer to question #7.

16. **The Subcommittee is pleased that the Inspector General is fulfilling his role but finds the posture of LSC management and the LSC Board troublesome. The underlying problem is the leasing arrangement and not the Inspector General, whose presentation, on its face, is valid. The IG's report does not go beyond the bounds of what an inspector general does to advise a Board of Directors. The LSC Board has been acting as lawyers and advocates instead of acting like Board members and considering policy implications of the lease arrangement and their response to the IG's report. The IG has pointed out a problem and an inherent conflict of interest, yet the Board is not dealing with it. The Board has been acting defensively instead of resolving the problem, which they can do by considering the IG's report instead of arguing against it. Their animosity**

towards the IG is misplaced, and needs to be replaced by resolving the underlying problem. As Mr. Delahunt stated in the hearing, "I would hope that an exchange that was appropriate and civil and courteous would always exist between any office of inspector general and those individuals that are participating or are being...reviewed." How will the Board utilize the IG's report as well as follow-up reports to resolve the underlying problems with the lease? Instead of treating the IG as an adversary, what steps will the Board take to ensure that it addresses the recommendations in future IG reports that are designed to improve programs and operations of LSC? What will the Board do to support and encourage the IG in carrying out his statutorily-mandated responsibility to conduct independent reviews and report his findings to the Board and to Congress?

Response:

The LSC Board will carefully consider any recommendations made by the OIG on any subject and will respond appropriately. If the OIG uncovers a problem that needs addressing, the Board will ensure that the appropriate steps are taken to resolve it. At the same time, the Board takes its fiduciary duties seriously. It has the obligation to independently review OIG reports and recommendations and, when it believes that the OIG is incorrect, to note that fact.

The OIG reports on the lease did not make a recommendation on what the current Board should do. However, the LSC Board is reviewing its space requirements, potential additional sublcases, possible renegotiation of current lease terms and other alternatives.

I had a personal meeting with the Inspector General during a visit to Washington on July 25. At the LSC Board meeting on July 30, the Board, pursuant to OMB guidelines, designated me in my capacity as Chairman to deal with the Inspector General on behalf of the Board. Since the Board meeting, Mr. West and I have continued our discussions about establishing a more effective working relationship with the OIG.

17. During the hearing, Mr. Watt stated that he had concerns, declaring "[t]hat doesn't mean that the end justifies the means." In response, you stated that "If I may address that point, Mr. Chairman, certainly, it is the case, with the current board having inherited this transaction, that it is our intent, if there's a problem that needs to be resolved, we will work diligently to resolve it." However, in the "LSC Updates" dated July 13, 2005 and published by LSC's Office of Governmental Relations & Public Affiats, under the title "House Judiciary Subcommittee Holds Oversight Hearing on LSC Rent", the tone presented is that LSC, LSC's Board, and Friends are still not working towards a solution, by summarily dismissing the concerns of the Subcommittee, and stating "Chairman Strickland stated that the report failed to prove its case and he considered the

matter closed". Are these your current feelings? Could you explain why you would demonstrate an openness at the hearing to look further into the issues which were raised by Members of this Subcommittee, and then a mere two weeks later allow a LSC publication to quote you as dismissing any further inquiry.

Response:

I did not see the LSC publication in question until after it was issued. I apologize for any mistaken impression that the statement in LSC Updates may have created. I do not consider the matter closed. As stated in answers to preceding questions, the LSC Board is fully engaged in working toward a resolution to any problems associated with the structure of the lease.

RESPONSE TO POST-HEARING QUESTIONS FROM R. KIRT WEST, INSPECTOR GENERAL, LEGAL SERVICES CORPORATION

August 4, 2005

The Honorable Chris Cannon
Chairman, Subcommittee on Commercial
and Administrative Law
House of Representatives
Committee on the Judiciary
B-353 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Cannon:

Enclosed please find my response on behalf of the Office of Inspector General, Legal Services Corporation (LSC), to your supplemental questions from LSC's Oversight Hearing on June 28, 2005. In addition, enclosed is the one correction to the transcript from the hearing.

Please do not hesitate to contact me at (202) 295-1600, if you have any questions.

Sincerely,

Kirt West
Inspector General

cc: The Honorable Melvin L. Watt

Response of Kirt West
Inspector General
Legal Services Corporation
To
Questions from the Subcommittee on Commercial and Administrative Law
House of Representatives
Committee on the Judiciary

August 4, 2005

Questions for Kirt West, Inspector General of the Legal Services Corporation

1. ***There appeared to be an apparent adversarial nature in the tone of the Board's responses to your reports. What is the current working relationship between the IG and the LSC Board and management? Do you believe that the Board understands the function and role of the OIG at LSC? What protections does LSC Staff have against retaliation with regard to cooperation with the OIG? Are additional protections required? In a written response dated January 6, 2004 LSC has indicated that existing protections are sufficient. Do you agree with this statement?***

Response:

Having been involved in inspector general work for nearly twenty years, I have seen how difficult it is for many heads of agency to accept the independence and autonomy that the IG Act gives to Inspectors General. This may be particularly the case for a part-time Board whose members do not have much federal government experience, are not familiar with the IG concept, and may not be aware of the high standards under which an OIG is required to conduct its work.

Unfortunately, the LSC Board appeared to have adopted an adversarial approach to working with me as was noted by Chairman Cannon at the recent hearing. This is evidenced by the Board's responses to the OIG lease report. Several Board members have questioned my contacts with Congress and have called into question why I undertook the lease project even though it was prompted by concerns raised by the staff of two committees of the Congress. Some Board members have indicated to me that they believe the issuance of the lease report has hurt LSC. This indicates that there is not yet a full understanding that Congress expects IGs to uncover problems and that, if the agency addresses the issues, Congress will not need to get involved.

I would like to note that I believe there were some positive steps taken by the LSC Board at its recent July 30th meeting to reestablish an effective relationship with the IG. The LSC Board Chairman and I hope to meet soon with Clay Johnson, Deputy Director for Management at the Office of Management and Budget and President's Council on Integrity and Efficiency Chair, to discuss how to build a more effective relationship between the LSC Board and the IG.

As I stated in my written testimony, LSC employees, including the Inspector General, are at-will employees who do not have the due

process rights afforded federal employees. Even though LSC has a whistleblower protection policy in its Personnel Manual, the at-will environment and lack of due process protections may deter LSC employees from reporting their concerns and observations to the Inspector General or to the Congress. While I have asked the Office of Special Counsel to ensure that LSC OIG employees have whistleblower protections, I believe that it would be beneficial for all LSC employees to have such protections as well as other due process protections.

In its January 6, 2004, response to Chairman Sensenbrenner and Chairman Cannon, LSC states the LSC IG is appointed in the same manner as all Inspectors General for Designated Federal Entities (DFEs) and it would therefore be inappropriate to change the appointment and removal of LSC's IG without making similar changes to all DFEs. There is, however, a significant difference in the at-will status of the LSC IG and the career service status of most other DFE IGs. A career status DFE IG who is removed from his position remains an employee of the agency, receiving the same level of income and benefits, unless the agency were to pursue and ultimately prevail in an adverse action proceeding. The LSC IG does not have contract. The LSC IG does not have any due process rights or other employment protections. Thus, if the IG were to be removed by this Board or a successor Board, such removal would be tantamount to being fired. While I intend to continue to follow the IG tradition of independence and objectivity, there is, nonetheless, the potential for an adverse effect on the independence of the LSC IG.

2. ***Could you summarize your thoughts concerning the Bank of America proposal and whether or not it is an accurate description of the market as it existed at the time Friends purchased 3333 K Street?***

Response:

The appraisal commissioned by the Bank of America did not accurately reflect a description of the rental market for the Georgetown submarket at the time Friends purchased 3333 K Street, NW, and is not a credible basis on which a prospective tenant should rely in determining a fair and reasonable rental rate for the property.

Consideration of the party that commissioned an appraisal is important to any assessment of the appraisal's usefulness by another party and/or for another purpose. For example, lenders are not permitted to use appraisals commissioned by the borrower in support of a loan transaction and may only use appraisals commissioned by loan brokers or other lenders if certain strict criteria are met.

The Bank of America appraisal was commissioned by the lender, and the appraisal itself makes clear its intended user. The stated intended use of the Bank of America appraisal is to aid in proper underwriting and loan classification for lending purposes. The intended user of the appraisal is Bank of America. The purpose of the appraisal is to provide the market value of the property for sale by estimating the prospective net operating income of the property, assuming the existence of the LSC commitment to lease 45,000 square feet at $38 per square foot. Because the Bank of America appraisal takes into account the LSC lease, which it characterizes as a "non-arms length" rental agreement, it cannot objectively provide a basis for determining the fair market rent.

On the other hand, the stated intended use of the two OIG commissioned appraisals is to assist LSC management in internal decision making. The intended user of the OIG commissioned appraisals is LSC. The purpose of the OIG commissioned appraisals is not merely to provide the market value of the property, but additionally to determine whether LSC is paying fair market rent for its space at 3333 K Street at the date of the transaction and assuming an arms-length transaction. Thus, the OIG commissioned appraisals are considerably more suited to aid LSC in determining what it should be paying for space at 3333 K Street than the cursory rental market analysis in the Bank of America appraisal.

Additionally, in determining market rent for 3333 K Street, a Class B property, the Bank of America appraisal uses as comparables two Class A properties, including one not even located in Georgetown. As a result of relying on Class A rents in Georgetown that are on average $8.00 per square foot higher, the Bank of America appraisal overstates the market rent for 3333 K Street.

3. ***Mr. Strickland has indicated in his opening statement that you have ignored facts relating to the need for additional space, the savings in parking spots, and that the appraisers you commissioned themselves indicated this to be the case. Do you have any response to this?***

Response:

We have not ignored any relevant facts in conducting our work. Both appraisers concluded that the total cash outlay for the leases over a 10-year period would be higher at 3333 K Street than it would have been had LSC remained at 750 First Street. When compared to 750 First Street, the lease at 3333 K Street only becomes more favorable if the space leased at 750 First Street was increased from

40,000 square feet to 45,000 square feet and parking was increased from 25 spaces to 52 spaces. In addition, as the Blake appraisal points out, a straight cost analysis does not consider all factors such as moving from a class A building to a class B building, lack of accessibility to public transportation, and the cost of moving.

The OIG has addressed the issue of the additional space acquired by LSC in the move to 3333 K Street by conducting an audit of LSC's space needs. As part of this audit and in light of the Board's reference to a space study in the Board's comments to our lease report, we asked LSC management to provide the OIG with copies of the assessment LSC conducted in support of its need for the additional 5000 square feet of space at 3333 K Street as well as any assessments of LSC's overall space needs. In response to the request, LSC management provided a copy of a review completed by a firm under contract with LSC's landlord, Friends. This contractor conducted the review in connection with designing the 45,000 square feet of space LSC already had committed to lease at 3333 K Street. The contractor's staff informed the OIG that LSC management in 2002 declined the contractor's recommendation to do a benchmarking study or apply specific space utilization standards. Management has not provided any documents supporting the need for 45,000 square feet. In fact, we have obtained two other documents that relate to LSC space. Even though these documents fall far short of a space needs study, one concludes that LSC may need 37,000 square feet or less. The other is a design study for the 40,000 square feet of space occupied at LSC's 750 First Street location based on a staff size of 122.

As for the parking spaces, both appraisals took parking into account. This included the additional 25 (now 27) spaces that LSC obtained as part of the lease at 3333 K Street. Consideration of the parking spaces is plainly disclosed in the appraisal reports.

In the same paragraph of his testimony, Mr. Strickland states the OIG ignored the fact that LSC's lease at 750 First Street was expiring in 2007 and that LSC would have had to renegotiate with its then-existing landlord or find new space. I have reviewed the 750 First Street lease and found that it contained an option to renew in 2007 for five additional years at 95 percent of market rent.

4. ***Mr. Strickland indicates that the previous Inspector General, Len Koczur, was fully aware of all the dealings in this transaction and raised no objection. Based on conversations with your staff and other research, have you been able to determine if this was in fact the case, or were similar concerns raised by your predecessor and his staff as well? Was the former IG in a position to fully voice his staff's concerns?***

Response:

I am not aware of the extent of the former Acting IG's knowledge or whether he raised objections. Having reviewed the transcripts, I am aware that my predecessor attended the April 5, 2002 meeting of the LSC Board's Finance Committee and the next day's Board meeting at which the property at 3333 K Street was presented and the LSC President was authorized to enter into a lease with Friends. LSC signed the lease with Friends for 45,000 square feet of space at 3333 K Street at a rental rate of $38.00 per square foot on July 2, 2002. Some members of my staff who were here at the time state that they subsequently raised concerns with my predecessor. According to my staff, the former Acting IG expressed concerns about the rental rate of OIG space with LSC/Friends.

This led to a meeting with representatives of Friends' financial advisor, Dawn Carpenter and Brad Kearne of EOS Financial Group, in early April 2003. Presumably, this is the "private briefing" to which Mr. Strickland alluded. During the meeting, the former Acting IG and staff raised concerns about how the $38.00 square foot rental rate came about and other basic questions regarding LSC's transactions with Friends. On April 11, 2003, Friends provided to the OIG a memorandum prepared by EOS, discussing the "Valuation of the Lease Rate for LSC at the 3333 K Street Building." My staff informs me the memorandum was the result of concerns raised by the OIG at the meeting. The meeting and memorandum occurred in April 2003, well after LSC's Board resolved to allow the President to enter into a lease agreement with Friends (April 2002) and the lease was signed (July 2002). OIG staff continued to raise concerns about LSC's rental rate at 3333 K Street and suggested, among other things, that the OIG hire an independent appraiser to evaluate the fair market rent for the space.

Additionally, the former Acting IG's notes prepared for a meeting with LSC Board Members Frank Strickland and Lillian BeVier and dated May 20, 2003 show that he was concerned about the fact that LSC would be paying more in rent at 3333 K Street than at 750 First Street; that LSC would be paying higher rents than any other tenants at 3333 K Street; and that he was skeptical of the savings and intangible

benefits LSC was supposed to realize as a result of the move to 3333 K Street. I understand that the Acting IG did not raise the issues at the meeting due to time constraints, and to my staff's knowledge he did not raise them at any subsequent time.

Irrespective of whether or not the former Acting IG had been fully informed of the dealings in this transaction in a timely fashion, the fact that the OIG did not perform any work related to that issue does not mean the OIG was without concerns. The former Acting IG's silence should not be construed as approval of the transactions. In any event, whether or not the former Acting IG voiced concerns about the arrangement is irrelevant to the fact that LSC was and is overpaying for space at 3333 K Street.

I do not have any specific information as to whether the former acting IG was in a position to fully voice his staff's concerns.

5. ***You indicate in your opening statement that LSC initially had the idea for Friends to avoid scoring of their lease. Was this done successfully?***

Response:

LSC was advised by outside counsel that it could avoid scoring of the purchase of 3333 K street and its lease if it set up a separate 501(c)(3) organization to purchase the building and ensured that its lease did not meet the criteria of a capital lease under OMB Circular A-11. To date, the lease at 3333 K Street has not been scored against LSC's appropriation, but we are not aware whether there was any official determination by OMB whether it should have been scored under the requirements of A-11. Scoring also is discussed in response to question 7.

6. ***In your opinion, are there any examples of what you would consider inappropriate relationships, resources, or access afforded to Tom Smegal and the Friends corporation, or inappropriate use of LSC funds to support Friends activities other than the rental payments being paid?***

Response:

Some directors, officers and employees of LSC, past and present, were members of Friends' Board of Directors and provided legal and/or accounting services to Friends. Such intermingling of officers, directors and personnel between two organizations entering into a purportedly arms-length transaction is inherently fraught with potential conflicts of interest, which could act to the detriment of one or the other organization, or both. Please see my response to Question 10 for a more complete discussion of this aspect of the LSC/Friends relationship.

The documents and other information compiled by the OIG indicate that LSC resources were used to support Friends from its inception until the spring of 2005. Friends was dependent on LSC facilities and staff for a variety of services such as record storage, computer equipment, email, meeting rooms, and mail facilities. For a while, LSC provided accounting services. Friends was also able to piggyback on LSC's insurance policies for flood, rent loss, workers' compensation and Director & Officer liability.

We have not analyzed this usage to determine the extent of any reimbursement or whether the usage was an inappropriate use of LSC funds and resources, particularly in light of Friends having been established as supporting organization to a 501(c)(3) non-profit organization.

7. ***Could you explain the difference, in regards to OMB Scoring, between an operating lease and a capital lease? How would you characterize the current leasing agreement between LSC and Friends, and what implications are there, if any, as a result of that?***

Response:

For capital leases, budget authority is scored against the legislation in the year in which the budget authority is first made available. The amount scored is the estimated net present value of the Government's total estimated legal obligations over the life of the lease, except for certain imputed interest costs and identifiable annual operating expenses that would be paid by the Government as owner (such as utilities, maintenance, and insurance). Property taxes are not to be considered an operating cost.

For operating leases, budget authority is scored against the legislation in the year in which the budget authority is first made available in the amount necessary to cover the Government's legal obligations. The amount scored includes the estimated total payments expected to arise under the full term of a lease contract or, if the contract includes a cancellation clause, an amount sufficient to cover the lease payments for the first fiscal year during which the contract is in effect, plus an amount sufficient to cover the costs associated with cancellation of the contract.

According to OMB Circular A-11, in order for a lease to be considered an operating lease, it must meet six specific criteria. If the lease fails to meet any of the six criteria, the lease is considered to be a capital lease or a lease-purchase, as appropriate.

LSC appears to meet five of the six criteria to be considered an operating lease. Specifically,

1. Ownership of the asset remains with the lessor during the term of the lease and is not transferred to LSC at or shortly after the end of the lease period.

2. The lease does not contain a bargain-price purchase option.

3. The lease term does not exceed 75 percent of the estimated economic lifetime of the asset.

4. The asset is a general purpose asset and not built to unique specifications.

5. There is a private-sector market for the asset.

However, we have not conducted an analysis of the sixth criterion—the present value of the minimum lease payments over the life of the lease does not exceed 90 per cent of the fair market value of the asset at the inception of the lease. Should LSC not meet this criterion, the lease would be considered a capital lease and should have been scored accordingly. Also, any lease extension presumably would also require an analysis under the scoring rules.

8. ***You indicate that the above market rate which LSC is paying appears to be the result of the amount Friends needed from LSC to satisfy the lender. Could you explain this?***

Response:

The above market rental rate that LSC is paying is a result of Friends' financing arrangement with the lender and Mr. Smegal, the Chairman of Friends, acknowledged this in his testimony before the Subcommittee.

As a condition of financing, the lender required that Friends enter into a lease with LSC for 45,000 square feet at $38 per square foot. The May 30, 2002, Commitment Letter from the lender to Friends conditions loan closing as follows: "The bank shall have received the executed Legal Services Lease, under which Legal Services shall have agreed to lease a minimum of 45,000 square feet with a gross rent of $38.00 per square foot for a term of at least 10 years and with rental payments beginning in May 2003." Friends' Board minutes also note as early as May 14, 2002, that "the Friends Board is unable to act on the lease terms at this point in time because the bank will determine what LSC's rental rate should be."

9. ***You state that LSC has no control over Friends. Could you explain that? Doesn't the stated purpose of Friends suffice to guarantee that LSC will gain long-term benefits from their relationship with Friends? Is there any ownership interest which LSC currently has?***

Response:

The initial Board of Directors of Friends consisted of three LSC officers: the LSC President, General Counsel and Treasurer. LSC had been advised that it could avoid OMB scoring by establishing a 501(c)(3) supporting organization to purchase a building and lease it to LSC pursuant to a lease that avoids OMB scoring. LSC was further advised to comprise the Friends Board of LSC officers, whose positions on the Friends Board would in fact, if not on paper, be self-perpetuating. Thus, for example, no matter what individual held the position, the LSC General Counsel would always be a member of the Friends Board. There are no current LSC officers or employees on the current Board of Friends, however. LSC is authorized to appoint one of the six members of Friends Board, but has not retained a controlling interest on the Board.

The stated purpose of Friends does not guarantee that LSC will gain long term benefits from its relationship with Friends. One of the stated purposes of Friends is to acquire, hold and manage assets for use by LSC where doing so may result in lower costs or greater efficiencies for LSC. As stated in the OIG report, LSC has not achieved lower costs and instead has been paying above market rent. Although Friends' current Articles of Incorporation provide that if Friends ceases to exist, after Friends' liabilities are extinguished, Friends' remaining assets will be turned over to LSC, as Representative Gohmert pointed out at the recent Subcommittee hearing, Friends can change its Articles of Incorporation. Further, Friends is not required to dissolve itself and turn its assets over to LSC even after the debt on the building has been paid.

We could find no LSC ownership interest in 3333 K Street; rather, LSC has a 10-year lease.

10. ***How would you characterize the relationship between FoLSC and LSC, and do you have concerns about LSC officials upholding their fiduciary duties?***

Response:

Legally, the relationship between Friends and LSC is one of landlord and tenant. Friends was originally established by officers of LSC and shortly thereafter was qualified as a supporting organization for LSC under the Internal Revenue Code. As announced in the OIG's lease report, I am reviewing but have not yet completed work on whether there are or were

any apparent or actual conflicts of interest involving LSC officers, employees or Board members involved in Friends. A request for OIG work in this area has also been conveyed by the Subcommittee.

The existence of potential or perhaps actual conflicts was first identified by then LSC Board member and President John Erlenborn in October 2001, and he took steps to remove himself from the conflicts, including resigning from the Friends Board.

Although LSC is not subject to regulation by the U.S. Office of Government Ethics (OGE), an OGE letter to a federal agency ethics official on July 10, 1995, provides useful guidance to understand the concerns raised in my testimony. The OGE letter addresses whether there are any restrictions on an agency entering into arrangements with an independent, nonprofit organization, "Friends of [the agency]," to provide various services to the agency consideration.

Regarding the assignment of agency employees to support Friends, OGE cautioned that the agency and affected employees would need to be aware of and take care to avoid conduct prohibited by the criminal conflict of interest statutes and the Standards of Ethical Conduct. OGE pointed out that "[a]s a general matter, avoidance of such difficulties will be easier if one keeps in mind that, even though the objectives of the [agency] and Friends may sometimes overlap, they remain separate entities with distinct interests." These are the same concerns raised at the hearing by Chairman Cannon and Representative Gohmert.

The basic conflict of interest prohibition prevents a Federal employee from participating personally and substantially as a Government employee in particular matters affecting the financial interests of another organization that is served by the employee. OGE stated that the rationale for the conflict provision is that the fiduciary duty owed to any organization served by the Federal employee may conflict with the duty the employee owes to the Government. OGE agreed that while it seemed highly unlikely that a conflict would arise from occasional clerical or organizational support to Friends, the situation was more problematic if a Federal employee served on a Friends' advisory committee or board. OGE advised that the difficulties under the criminal conflict of interest statute, which does not apply to LSC, could be avoided if agency employees assumed the position of "coordinators," "liaisons to Friends," or "liaisons to the Friends advisory committee or board" and did not assume "employee," "director" or "officer" position within Friends.

In addition, D.C. law appears to indicate that a director violates his fiduciary duty by using his corporate office to promote, advance or effectuate a transaction between the corporation and another organization

in which he is involved, and that transaction is not fair to the corporation. Such fiduciary duty may not be waived. Breach of the fiduciary duty does not require intent to personally benefit; rather even a director acting in good faith may unintentionally violate the duty of loyalty.

During the hearing, Mr. Smegal referred to an instance in which the OIG characterized Friends of the Legal Services Corporation (Friends) as a "contractor" and a "government contractor." I responded on page 52 of the hearing record that I was unaware of any instance in which the OIG had referred to Friends as a contractor. I provide the following clarification.

Upon review of the correspondence between the OIG and Friends and/or Mr. Smegal, the OIG finds no instance of characterizing Friends as a "government contractor." An internal memorandum dated November 1, 2004, providing notice to LSC's President that the OIG was undertaking the lease review (the entrance memo) does state, "[a]s part of the review, we will need to have access to LSC files and knowledgeable staff as well as information from LSC contractors, including the landlord, [Friends]." When conducting an audit, the OIG's common practice is to submit a draft report to the audited entity in order to allow for comment on the contents of the audit report. The entrance memo, however, is an internal memorandum between LSC and the OIG and announces a review of LSC's leasing arrangement, not an audit of Friends. I am unaware of any requirement in the IG Act that the OIG provide a draft report concerning LSC's financial arrangement with an outside entity to that entity for review and comment. Moreover, the purpose of the report was to provide information to the LSC Board to assist it in negotiating a favorable lease extension with its landlord, Friends.

11. ***Was the affect of the MOUs to extend the lease signed by LSC going to improve or make worse the overpayment issue? In your opinion, is FoLSC acting in LSC's best interest currently? Did it ever and, if so, at what point did that change?***

Response:

The OIG lease report estimated that LSC will overpay between $1.23 million and $1.89 million in rent over a 10-year period as a result of paying above market rent, depending upon the degree to which LSC actually received an above market tenant improvement allowance. LSC and Friends entered into two MOUs since execution of the original lease. Under both, LSC's occupancy costs would increase.

The original lease (dated July 2, 2002) provides that LSC is to receive 45,000 square feet of rental space, subject to re-measurement after

renovation "in accordance with the Washington Board of Realtors Standard Method of Measurement [WBRSM], and the Rentable Area of the Premises [would be] adjusted upward or downward accordingly." The annual base rent is $1,710,000 per year, ($142,500 per month), the total of $38.00 multiplied by the rentable area. Further, "the Rental Area" is used as "the basis for the computation of the Annual Base Rental, and Annual Base Rental shall be recomputed, if necessary, based on changes in the calculation of the rentable area."

As stated, LSC and Friends entered into two MOUs, both signed by Friends Chairman Thomas Smegal and LSC President Helaine Barnett, to extend the LSC lease for an additional ten years starting in June of 2013. The first MOU, signed in May 20, 2004, committed LSC to continue to pay $1,710,000 in annual rent despite LSC having learned on April 1, 2004, that its Rental Area was approximately 42,852, or 2,148 square feet less than the 45,000 square feet contemplated in the lease. At this point, LSC's effective rent per square foot was $39.91. Further, the MOU documented that LSC would swap existing first floor space of 1,971 square feet for available fourth floor space of 2,294 square feet, gaining an additional 323 square feet of rentable space, for a total of 43,176 square feet. Yet, the MOU committed LSC to pay the same $1,710,000 in annual rent "for the existing space, as per a May 30, 2002 commitment letter from the Lender to Friends," a letter to which LSC was not a party. This would have set LSC's effective rent per square foot at $39.61, continuing through the original lease term. Friends was to contribute up to $82,500 of building improvement costs for the modified space and LSC was to have the first right of rental for any additional space that became available at $38 per square foot with Friends paying improvements to such space up to $35 per square foot.

With these terms agreed upon, Friends would grant LSC the option to extend its lease for 10 years at the $1,710,000 rate, with additional adjustments for pass-through costs and other Friends' operating expenses, thereby increasing the effective rent even above $39.61 per square foot

My staff informs me that the then acting Inspector General became aware of these circumstances and advised the LSC President of his concerns. A new MOU was drawn up, although this second MOU does not explicitly revoke or rescind the first MOU.

The second MOU, signed in late July of 2004, acknowledges that LSC was occupying 2,147 square feet less than it was paying for and provides that LSC would take over the available space on the fourth floor while retaining the first floor space, giving it approximately 45,000 square feet. However, the ten-year renewal option would be effective at the $38 a

square foot at the Building Owners and Managers Association (BOMA) measuring standard, not the original lease WBRSM measurement standard, and subject to adjustments for pass through and Friends operating costs not contained in the original lease. The BOMA measurement standard is more favorable to the building owner in that it results in a larger square footage calculation than WBRSM.

In my written testimony, I indicated that the BOMA standard would increase LSC's annual rental costs by more $200,000. After the hearing, LSC management provided additional information to the OIG that indicates that information in the April 6, 2004, Friends' Board minutes that LSC's 42,853 square feet under WBRSM equates to 48,800 under BOMA was not correct. According to management's new information, the OIG now estimates that employing the BOMA measurement standard would increase LSC's annual rental costs approximately $67,000, not including pass through costs. However, the OIG has some questions about how the contractor arrived at the numbers provided to the OIG by management and will soon be meeting with the Friends' contractor that measured the space. The OIG will supplement this answer in the event that the contractor provides additional responsive information.

12. ***How is it possible that LSC was paying for one and a half years for 2,000 square feet of space they did not have, and why hasn't LSC asked for a reimbursement for that miscalculation?***

Response:

I believe that this is a question that should be addressed to the LSC Board as the OIG is not in the position to answer it.

13. ***How would you characterize LSC office space? Is it in excess of what is necessary for LSC to accomplish its mission?***

Response:

We are currently conducting an audit of LSC space needs. We have issued a discussion draft to management on the subject. Until we have given management appropriate time to respond to the conclusions reached, it would pre-mature to comment on whether or not LSC has space in excess of mission requirements. We will provide a copy of the final report to the Subcommittee.

14. ***Does the tenant improvement allowance offset the over-market rate paid for the building?***

Response:

The tenant improvement allowance does not offset the over-market rent rate LSC is paying for its leasehold. As stated in the OIG's lease report, even assuming that LSC received the full benefit of the tenant improvement allowance, the over payment for the ten-year period is estimated to be at least $1.23 million. However, management has no assurance that full value was received for the tenant improvement allowance.

In our recent audit on the tenant improvement allowance, we were unable to determine how much of the allowance LSC actually received. LSC did not have a detailed accounting of the expenditures charged against the funds and did not have a representative acting solely for the benefit of LSC to monitor the expenditures related to the tenant improvement allowance. We recommended that LSC management obtain a full and detailed accounting of all cost associated with the allowance, conduct a detailed analysis of the costs to determine their reasonableness, and recoup from Friends all payments made by LSC that should have been paid with the tenant improvement allowance. LSC management has indicated that it will obtain the recommended accounting and conduct the recommended analysis and that the determination as to any recoupment will depend on management's ability to document and analyze the expenditures.

15. ***In your opinion, has LSC subsidized FoLSC by permitting employees to act essentially as FoLSC employees and officers? Is there an accurate accounting issue to assure Congress that Federal funds have not been misspent?***

Response:

We have not performed any work to determine whether LSC subsidized Friends by permitting employees to act essentially as Friends employees and officers. However, the audited financial statements of Friends show that in two years LSC officers and employees contributed $155,708 for legal and accounting services: $85,305 in FY 2002 and $70,403 in FY 2003. The audited financial statements do not indicate whether the contributions were made by LSC or by the individual employees in their personal capacities. The contributed amounts were based on the employees' LSC salaries and benefits.

For FY 2002, Friends' outside auditors noted that Friends did not maintain contemporaneous records of these contributions of donated legal and

accounting services during the year and had to reconstruct the information to ensure the books of account properly reflected these amounts.

In a July 2004 letter, LSC informed the Subcommittee that only one LSC staff member does any volunteer work for Friends and that while her supervisor had informally tracked any time spent during the workweek on Friends, LSC would institute a formal tracking procedure.

LETTER FROM THOMAS SMEGAL, CHAIRMAN OF THE BOARD, FRIENDS OF THE LEGAL SERVICES CORPORATION, DATED OCTOBER 13, 2005, TO THE HONORABLE MELVIN L. WATT, SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW, COMMITTEE ON THE JUDICIARY

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October 13, 2005

The Honorable Melvin L. Watt
Subcommittee on Commercial
and Administrative Law
Committee on the Judiciary
B-353 Rayburn House Office Building
Washington, DC 20515

Re: June 28, 2005 Oversight Hearing

Dear Congressman Watt:

I am writing at the invitation of Oversight Counsel Jim Daley to correct statements filed by Inspector General (IG) Kirt West of the Legal Services Corporation (LSC) with your Subcommittee last month in response to my answers to the Subcommittee filed on August 13, 2005.

Under the heading of "Question 15," Mr. West stated his view that, with the exception of a sublessee of LSC, "None of the new leases employ the BOMA standards." Please find enclosed a letter from CB Richard Ellis (CBRE) - - the leasing agent for Friends of Legal Services Corporation's (FLSC) since 2003 - - who have negotiated the leases in question. The CBRE letter confirms the information provided in my August 13, 2005 answer to Question 15 that "...gradually as leases come up for renewal, Friends is converting them to BOMA measurement." In other words, once again Mr. West is mistaken.

I also want to take this opportunity to reassure the Subcommittee that FLSC is strongly committed to the position that I stated at the hearing on June 28 regarding our iron-clad plan to transfer the building to LSC free of costs once FLSC pays off the various bonds and loans on the building. This purpose – providing LSC with a permanent headquarters in the District of Columbia – is FLSC's *raison d'etre*. More importantly, the purpose of the special capital support grant awarded to FLSC from the Bill & Melinda Gates Foundation ("Foundation") is limited to "support a National Home for LSC."[1] In particular, FLSC is required to file annual narrative and financial reports with the Foundation until "all the Foundation funds have been

[1] Letter of May 8, 2002 to FLSC from the Bill & Melinda Gates Foundation.

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expended and the project is complete."[2] FLSC would be in violation of the terms of the Foundation grant were the building title to be transferred in any other manner. Furthermore, Friends would undoubtedly face legal consequences were we, as cavalierly suggested by the IG, to retreat from honoring the commitment to use the building as a permanent headquarters for LSC.

Thank you for your support of and interest in equal justice for low-income Americans.

Respectfully submitted,

Thomas F. Smegal, Jr.
Chair

cc: Frank Strickland, LSC Board Chair
Kirt West, LSC's IG

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[2] *id.*