

MEMORANDUM

To: R. William Ide, III, Chair
ABA Task Force on Attorney-Client Privilege

From: Professor Otto J. Hetzel

I finally received a long-delayed response to my request (which I earlier shared with the Task Force) to the U.S. Department of Housing and Urban Development (HUD), for confirmation that federal funds received by state and local government entities to administer federal programs (such as Community Development Block Grant (CDBG) or for Public Housing) are eligible to pay for costs of their employee's legal defense when acting on behalf of the entity. **HUD's letter confirms what we believed was clear authority in Office of Management and Budget (OMB) Circular A-87 that a state or local government entity administering federal programs is authorized to use such federal funds for legal expenses incurred in the administration of such programs, including their employees' legal defense.**

HUD's letter provides useful support for the positions taken by the American Bar Association (ABA) to counter recent efforts by several agencies of the federal government that would prevent expenditures by employers for their employees' costs of legal defense. The ABA position objects to interference by prosecutors in employer decisions to provide financial support to their employees where allegations of misconduct have arisen regarding their actions on behalf of their employer. The ABA policies would also protect against prosecutor efforts to force disclosure of attorney-client communications, frequently involving employee communications with legal counsel, which if an employer waiver was coerced would ultimately deter needed communications with entity counsel.

Unfortunately, while HUD acquiesced in our reading of the OMB Circular's language, it limited its concurrence expressly to the circumstances of the particular matter, authorizing after-the-fact reimbursement of such legal expenses following a finding of no wrong-doing related to the charges brought. HUD's letter also adds a qualifier that legal fees may be reimbursed where the employee acted "with due diligence" in the administration of the program, although finding that to be met in the specific circumstances. It would seem that such determinations should be made by the entity, not by federal prosecutors.

In the specific matter placed before HUD, it notes that the employee was cleared of all charges and that no CDBG funds were used to finance the defense during the course of the proceedings. That seems to suggest that an employee still has to front the fees and can be reimbursed only if cleared. As my original request for HUD confirmation sets forth, OMB A-87 does not contain such a qualification, although other OMB Circulars I cited in contrast do provide such a qualifier, but these are unrelated to state and local government entities. HUD's Enforcement Center attorneys in a debarment proceeding, however, have maintained that such expenditures for its employees' legal defense by an entity are not allowed, because they would be used only for the employee's "personal expenses," even when the employee was acting on behalf of the employer.

The authority to use federal funds to cover employee legal costs arising from administration of these federal programs involving activities on behalf of the entity that occur in the course of employment is so important because many such entities that administer federal

programs have no other significant sources of funds to do so. Interestingly, HUD's instant letter is consistent with the federal government's general approach to legal challenges regarding actions of its own employees since the federal government routinely provides legal representation or funds to do so when such proceedings arise.

I wanted to share this important development with you and the Task Force. Clearly HUD's position only goes part of the way towards providing needed protections to employee rights. Further, the Department still appears to take the position that entities using federal funds should waive their attorney-client privilege if requested by federal investigators or prosecutors. As we earlier discussed, I will prepare another draft of a letter for you to the HUD Secretary regarding his inappropriate policies and the need to revise them. Please let me know if you have any questions.



U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-0500

OFFICE OF GENERAL COUNSEL

September 7, 2007

Otto J. Hetzel, Esq.
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Dear Mr. Hetzel:

This is in response to your letter of August 18, 2006, to former Associate General Counsel Robert S. Kenison requesting our advice on the eligibility of certain legal expenses under the Community Development Block Grant (CDBG) program. On March 20, 2007, you sent a similar request to General Deputy Assistant Secretary Nelson R. Bregón and Deputy Assistant Secretary William H. Kargle of the Office of Community Planning and Development (CPD). (See enclosures.) CPD referred your request of March 20 to this office for direct reply. This letter responds to both requests.

Specifically, you inquired whether a recipient may use CDBG funds to reimburse an employee for attorney's fees "where the fees were incurred to defend against criminal allegations involving the administration of Federal programs." According to your letter, the recipient's Community Development Director faced criminal charges for improperly using CDBG funds for economic development loans. After a trial, the Director was acquitted of the charges and "the [c]ourt expressly found that 'every single one' of the seven economic development loans questioned were properly granted and documented."

Section 105(a)(13) of the Housing and Community Development Act of 1974 authorizes CDBG funds to be used for "the payment of reasonable administrative costs and carrying charges related to the planning and execution of community development and housing activities." See also 24 CFR § 570.206. The CDBG regulation at 24 CFR § 570.200(a)(5) further subjects administrative costs to OMB Circular A-87, "Cost Principles for State, Local, and Indian Tribal Governments" (May 10, 2004). Under the Circular, Attachment B, section 10.b, *Defense and prosecution of criminal and civil proceedings, and claims* provides "[l]egal expenses required in the administration of [f]ederal programs are allowable."

As a general matter, CPD has taken the position that a recipient may use CDBG funds to pay reasonable legal expenses incurred in defense of lawsuits resulting from its administration of the CDBG program as long as the grantee has acted with due diligence in the administration of the program. In this case, we note that the proceedings resulted from actions undertaken in the ordinary course of the Director's employment and the court acquitted him of all charges after a trial on the

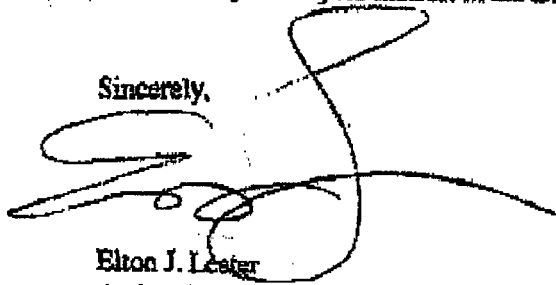
merits. Further, no CDBG funds financed the employee's defense during the proceedings. Under these circumstances, we believe the legal expenses would be required in the administration of the CDBG program for purposes of section 10.b.

Please note that OMB Circular A-87 includes other provisions that would affect a final determination on reimbursement. In addition to section 10.b, third-party legal services are subject to Attachment B, section 32, *Professional service costs*. Section 32 lists several factors the recipient must consider when using federal funds for third-party legal services, such as the past pattern of such costs and the adequacy of the contractual agreement for the service. While no single factor or any special combination of factors is necessarily determinative, these factors are relevant in assessing whether the legal expenses are allowable for CDBG reimbursement.

Finally, as administrative costs, all legal expenses must also conform to the general policies and principles described in Attachment A of OMB Circular A-87 (e.g., reasonableness and consistency with policies, regulations, and procedures that apply uniformly to both federal awards and other activities of the recipient). As a final note, if CDBG funds comprised only a percentage of the economic development loans that were the subject of the criminal action, then CDBG funds can only be used to reimburse the same or less percentage of the legal expenses incurred in defending against the action.

We hope this information is useful to you. Thank you for your interest in the Department's programs.

Sincerely,



Elton J. Lester
Acting Associate General Counsel
Office of Assisted Housing
and Community Development

Enclosures

cc:
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March 20, 2007

By Email

Nelson R. Bregón, General Deputy Assistant Secretary, and
William H. Eargle, Jr., Deputy Assistant Secretary for Operations and Comptroller
Office of Community Planning and Development
U.S. Department of Housing and Urban Development
451 7th Street S.W.
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Re: Request for Confirmation of Authority for City of Middletown, N.Y. to Pay from
CDBG Funds the Costs of the Legal Defense of Its Community Development
Director in a Prosecution Initiated by Local District Attorney for Actions Arising
Within the Employee's Scope of Work Under the City's CDBG Program.

Gentlemen:

As you may know, I represent the City of Middletown, N.Y., and on its behalf I am requesting confirmation of the City's authority for expenditure of its Community Development Block Grant (CDBG) funds to pay the City's Community Development Director's, Mr. Neil Novesky, legal expenses he incurred in successfully defending his actions undertaken on behalf of the City under its CDBG program. It is our understanding that use of program funds by such a local government CDBG recipient for employee legal costs, as long as they do not involve affirmative claims against the United States, is authorized under Office of Management and Budget (OMB) Circular A-87, Attachment B, Item 10.

Item 10 states: "**Defense and prosecution of criminal and civil proceedings, and claims.**" Subsection (b), states: "Legal expenses required in the administration of Federal programs are allowable. Legal expenses for prosecution of claims against the Federal Government are unallowable." Attachment B, Section 32(a) of the Circular permits use of such funds for "costs of professional and consultant services rendered by

persons who are members of a particular profession or possess a special skill ... when reasonable in relation to the services rendered ...".¹

The N.Y. state judge who heard the matter determined that Mr. Novesky was "not guilty" of all charges filed against him. That portion of the transcript is attached. In fact, the judge expressly found that "every single one" of the seven economic development loans questioned in the proceeding (that were the basis for the prosecution of Mr. Novesky) were properly granted and documented. The applicable portion of the transcript is also attached.

These charges were made against Mr. Novesky while he clearly was performing work on behalf of the City under its CDBG program in making economic development loans. The City, therefore, has the authority, and should be able to exercise its discretion under the OMB provision above cited, to make payments on behalf of its employees' legal defense when they are engaged in administration of its CDBG program.² This letter requests confirmation of the City's authority and the eligibility of its use of its CDBG funds in these circumstances.

¹ Payment of legal expenses of employees of state and local government entities, where not acting as military "defense contractors," are made allowable under A-87, Attachment B, Item 10(b). This conclusion is supported in light of the limiting language in Item 10(a) applicable to military defense contractors covered by 10 U.S.C. 2324(k) (so-called "Defense Contracts"). Even for such defense contractors, payment with federal funds for such legal expenses is allowed where a defendant military contractor prevails and meets other conditions. Otherwise, Item 10(b) provides discretionary authority for a state and local government entity to pay its employees' legal expenses in a criminal or civil action arising from administration of its Federal program from its program funds. The defense contracts limitation does not apply to other federal grants, contracts, or cooperative agreements with state and local governments and tribal entities, such as grants under the CDBG program.

² The eligibility for payment of employee legal costs by state and local government entities is made quite clear in light of the language in OMB Circular A-122, "Cost Principles for Non-Profit Organizations." That Circular governs costs for non-profit organizations. For these non-governmental entities, A-122 disallows legal costs "incurred in connection with any criminal, civil, or administrative proceedings commenced by the Federal government or a state, local, or foreign government where the proceeding relates to a violation or failure by the non-profit organization (including its agents and employees) to comply with a statute or regulation," *but only* when that proceeding results in a final decision (as relevant here): "(a) [i]n a criminal proceeding, a conviction." Where an acquittal occurs, under A-122 the legal costs of the entity, its agents and employees may be paid from federal funds.

Since under OMB Circular A-122 costs associated with legal expenses for defense of agents and employees are expressly allowable unless a conviction occurs, the only reasonable interpretation of the language in these juxtaposed OMB Circulars is that OMB chose to limit defense costs in debarment actions brought against a defense contractor, when it is required to by statute, and in the other instance, when the contractor is a non-profit private corporation and not another sovereign entity. OMB clearly chose to permit state and local government entities to charge legal defense costs to their federal award in enforcement actions. It is obvious that state and local government entities are given full discretionary authority under OMB A-87 to make expenditures on behalf of their employees' legal expenses unless the two exceptions for defense contracts or suits against the government are applicable, which is not the case here.

The allowability of payment from federal funds of legal costs of state and local government employees when acting on behalf of their employer is consistent with the Federal government's own policies in this regard. Payment of such legal fees is routinely provided by the Federal government with respect to its own employees to ensure that they are adequately represented in equivalent circumstances. The Federal government routinely pays the legal fees of its officials who are sued, or even indicted personally, if their actions were taken in good faith and as part of their official duties. Under 28 CFR 50.15, federal officials and employees may be represented by Department of Justice attorneys or by private counsel funded by the Department in civil, criminal, and congressional proceedings in which Federal employees are sued, subpoenaed, or charged in their individual capacities.

For example, in 1997, the Department of Justice indemnified an FBI agent, and paid all of his defense expenses, after he was indicted by a state grand jury in connection with the events surrounding the Ruby Ridge incident.³ A state governmental entity administering a federally-authorized program should also have the discretionary right to provide its employees with the same assistance that the Department of Justice deemed appropriate to provide to Agent Horiucki -- the right to a fair trial with adequate legal representation when the criminal action arose out of the employee's scope of work.

Fundamental legal principles support recognizing corporate and governmental authority to pay the legal expenses of their employees through whom they act, including for state and local government legal entities to use their federal funds when administering federal programs. As the President of the American Bar Association, Karen Mathis, recently testified before the Senate Judiciary Committee,⁴ employers should be able to provide financial assistance to their employees who are accused of criminal actions and denying that right would be "inconsistent with the fundamental legal principle that all prospective defendants—including an organization's current and former employees, officers, directors and agents—are presumed to be innocent."

³ In August 1997, an Idaho state prosecutor announced the criminal indictment of FBI Agent Lon Horiucki for the death of Vicki Weaver in the now-infamous Ruby Ridge standoff between the FBI and the family and friends of Randy Weaver (a suspected white separatist who was under indictment for a weapons charge). Starting in 1995, both in connection with the agent's appearance before Congress and also in a wrongful death and civil rights case against him, the Department of Justice paid Agent Horiucki's attorney fees relating to this incident. Shortly after the Idaho state criminal indictment was released, the Department announced that "it will continue to pay for his [Horiucki's] legal representation." DOJ Press Release No. 97-342 (August 21, 1997). Agent Horiucki apparently was acting in the course of his official duties, as part of a hostage rescue team. The Federal government obviously did not want to force him into bankruptcy to defend himself as a result of the Idaho state prosecution of his actions as part of that team. He, like all defendants, was believed to be entitled to a fair trial and competent legal representation.

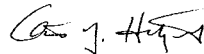
⁴ On September 12, 2006, ABA President Mathis testified before the Senate Judiciary Committee on the topic of "The Thompson Memorandum's Effect on the Right to Counsel in Corporate Investigations" involving issues raised if the government were to attempt to prevent a corporation from providing assistance for its employees' legal expenses in defending themselves.

She also referenced in her testimony “well-established corporate governance practices . . . of indemnifying their employees and agents or otherwise assisting them with their legal defense for employment-related conduct until it has been determined that the employee or agent somehow acted improperly.” Unless employees are acting solely for his or her own personal benefit (e.g., receiving kickbacks or self-dealing), or have acted far beyond the scope of any good faith judgment, they should be entitled to assistance with their legal expenses for their defense against accusations. Here, of course, the N.Y. court determined that Mr. Novesky acted properly and the City’s request involves use of CDBG grant funds for administration of the program to pay legal expenses already incurred in his successful defense.

If the costs involved in defending against such allegations had to be borne by the individual employee, few persons could defend themselves against what the court in this proceeding determined were baseless allegations. ABA President Mathis has observed that “[t]he costs associated with defending a government investigation involving complex corporate and financial transactions can often run into the hundreds of thousands of dollars,” and unless the employer can provide assistance, she noted, “the employee typically may be unable to afford effective legal representation.” The result would be to force acquiescence to a prosecutor’s allegations, without testing their validity, because they cannot realistically be disputed without assistance of counsel.

We very much appreciate your attention to and review of this matter and trust that the City will be provided confirmation that it has the authority in its discretion to so act to pay Mr. Novesky’s costs of his successful legal defense out of funds available for administration of the CDBG program.

Sincerely,



Otto J. Hetzel
Attorney for the
City of Middletown, N.Y.

Enclosure: Excerpts from Orange County, N.Y.
Court, April 7 transcript, pp. 1-2, 8-9, 11-12