



7050-01

LEGAL SERVICES CORPORATION

45 CFR Part 1629

Bonding Requirements for Recipients

AGENCY: Legal Services Corporation.

ACTION: Final rule.

SUMMARY: This final rule revises the Legal Services Corporation's (LSC or the Corporation) regulation about bonding requirements for LSC recipients. It requires recipients to bond all their employees and to ensure that third parties who handle recipients' funds have bond coverage, allows recipients to use other forms of insurance similar to fidelity bonds, raises the minimum level of coverage, and allows recipients to use LSC funds to pay for bonding costs. This final rule updates regulations to reflect current insurance practices and simplifies the language in the rule to reduce confusion.

DATES: This final rule is effective [INSERT DATE 30 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. LSC recipients and subrecipients must comply with the rule no later than December 31, 2017.

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SUPPLEMENTARY INFORMATION:

I. Regulatory Background

LSC created part 1629 in 1984 after several situations in which recipients lost LSC funds through the dishonest behavior of persons associated with the recipient. 49 FR

28717, July 16, 1984. While the recipient recovered the funds in some cases, in others, the recipient had to absorb the loss. Id.

Before enacting part 1629, LSC recommended that recipients have fidelity coverage as a basic internal control. See LSC Audit and Accounting Guide for Recipients and Auditors, revised June 1977, p. 3-3. LSC intended part 1629 to “make mandatory [this] important protection for the limited funds available to serve eligible clients.” 49 FR 23396, June 6, 1984. LSC originally proposed requiring programs to obtain fidelity bond coverage at a minimum level equal to 25% of the recipient’s annualized LSC funding. Id. Based on comments received in response to the proposed rule, LSC decreased the required coverage level to 10%. 49 FR 28717, July 16, 1984. LSC also set a \$50,000 minimum coverage level “in response to the recognition that a loss to a small program is proportionally greater in effect than a similar one to a large program.” Id.

LSC added rulemaking on part 1629 to its annual rulemaking agenda in April 2016. Regulatory action is justified for three reasons.

First, the regulation is outdated. LSC has not revised part 1629 since it was adopted in 1984, and LSC should update it to reflect current insurance practices.

Second, the regulation was derived from a source that does not provide the optimal model for a federally funded grant-making entity today. The original rule was based on fidelity bonding provisions found in the Employee Retirement Income Security Act of 1974 (ERISA). See Section 412 of Pub. L. 93-406, and related regulations at 29 CFR 2550.412-1 and 29 CFR part 2580. ERISA concerns minimum standards for retirement plans in private industry. LSC no longer believes that this is an appropriate

model for LSC to follow, and that instead LSC should look to current regulations governing similar grant-making entities and to reflect current insurance practices.

Third, the current regulation is in some respects unclear or ambiguous. LSC has received requests for guidance on how to interpret certain provisions in part 1629, particularly those sections about the form and extent of coverage required by the rule. LSC does not believe that the language in part 1629 provides sufficiently clear guidance to LSC recipients or to LSC staff. LSC proposed an approach that is tailored to LSC's needs and that simplifies the language in the rule.

On October 17, 2016, the Operations and Regulations Committee (Committee) of LSC's Board of Directors (Board) voted to recommend that the Board authorize rulemaking on part 1629. On October 19, 2016, the Board authorized LSC to begin rulemaking. On April 23, 2017, the Committee voted to recommend that the Board approve publication of a Notice of Proposed Rulemaking (NPRM) in the Federal Register for notice and public comment. On April 24, 2017, the Board accepted the Committee's recommendation and voted to approve publication of the NPRM in the Federal Register. 82 FR 20555, May 3, 2017. On July 21, 2017, the Committee recommended publication of this final rule to the Board. On July 22, 2017, the Board voted to publish this final rule.

Material about this rulemaking is available in the open rulemaking section of LSC's Web site at <http://www.lsc.gov/about/regulations-rules/open-rulemaking>. After the effective date of this rule, those materials will appear in the closed rulemaking section of LSC's Web site at <http://www.lsc.gov/about/regulations-rules/closed-rulemaking>.

II. Section-by-Section Discussion of Comments

LSC received one comment during the public comment period from Legal Action of Wisconsin, Inc. (Legal Action), an LSC recipient. Legal Action generally supported LSC's proposed changes but expressed concern about the inclusion of "volunteers" as among the persons required to be bonded. Legal Action also asked that LSC allow recipients to charge bonding costs as "direct" costs to their LSC grant. These comments and LSC's response will be discussed in more detail below.

Section 1629.1 Purpose.

Part 1629 currently does not have a purpose section. LSC proposed to add a purpose section stating who must be covered under the bond and what losses the bond must protect against.

LSC received one comment on this section which will be addressed in the response to the comment on § 1629.3 of the proposed rule. LSC does not propose to make any changes to this section in the final rule.

Section 1629.2 Definitions.

LSC proposed to define annualized funding level to include the amount of the Basic Field Grant and special purpose grant funds a recipient receives annually from LSC. LSC believes it is necessary to include "special purpose grants" of LSC funds, such as Technology Initiative Grants, Pro Bono Innovation Fund grants, and emergency relief grants in the definition of annualized funding level to ensure that the maximum amount of LSC funds are protected.

LSC received no comments on this section of the proposed rule. LSC will adopt the language as proposed in the final rule.

Section 1629.3 Who must be bonded?

LSC currently requires recipients to bond “[e]very director, officer, employee and agent of a program who handles funds or property of the program” 45 CFR 1629.2(a) (emphasis added). LSC considers the term “handles” to include access to funds or other recipient property or “decision-making powers with respect to funds or property which can give rise to [] risk of loss.” Id. Through a review of recipient insurance policies, LSC has found that most grantees have fidelity coverage for all their employees. This common practice exceeds the current minimum requirements of part 1629. When employees who were not required to be bonded under part 1629 have misappropriated LSC funds, grantees that exceeded the minimum part 1629 coverage have typically been protected from loss. LSC believes this common practice is desirable and proposes to require that recipients carry coverage for all employees, regardless of whether the employees “handle” program funds.

LSC does not believe that requiring coverage for all employees will impose more costs on the recipients. LSC examined 136 recipient policies from 2015-2017, including recipients that are no longer receiving an LSC grant, and only one recipient had a schedule policy covering a select number of individuals. LSC compared that schedule policy to blanket policies purchased by grantees of similar size and determined that the schedule policy was more expensive than the blanket policies of the other recipients. This analysis supports the conclusion that LSC is not imposing costs that the recipients do not already bear, and that the proposed update to the regulation is consistent with recipients’ existing practices.

LSC currently requires grantees to bond “agents” who handle funds or property of the program. 45 CFR 1629.2(a). But LSC has found that most recipients’ policies do not

cover the dishonest or fraudulent actions of agents and independent contractors. In fact, many policies explicitly exclude agents and independent contractors from the definition of “covered employee.” This exclusion is problematic, as LSC recipients are now turning to third parties to handle payroll functions. See Legal Services Corporation Board of Directors, Operations and Regulations Committee, Transcript of Rulemaking Workshop, Wednesday, May 18, 2016, pp. 82-84 (comments of Diana White). This means that LSC funds are handled by persons outside of the recipient’s control and insurance coverage. In areas where there are few insurers to choose from, it may be impossible for recipients to get insurance that covers “agents” or “independent contractors.”

To address these issues and adequately protect LSC funds from misappropriation by recipients and third parties, LSC proposed three changes to the existing rule. First, LSC proposed to require that recipients’ bonds cover volunteers, in addition to directors, officers, employees, and agents of the recipient. Second, LSC proposed to require recipients to ensure that third parties who provide payroll, billing, and collection services to the recipient have fidelity bond coverage or similar insurance. The recipient may accomplish this either by extending its own insurance to the third party or by ensuring that the third party has its own fidelity bond coverage sufficient to protect LSC funds in the third party’s hands. Finally, LSC proposed to include language allowing recipients to either cover subrecipients through their own fidelity policies or ensure that the subrecipients have policies adequate to protect subgranted funds.

Comments: Legal Action provided three comments about this section. First, Legal Action expressed support for LSC’s proposal to extend the coverage requirement under § 1629.3(b) to third parties that only provide payroll, billing, or collection services. Legal

Action believed that it would not need to buy more insurance coverage to comply with this requirement.

Legal Action also expressed concern, however, about the proposal to require recipients to bond “volunteers.” Legal Action stated that this will make obtaining coverage more difficult because its current policy covers directors, officers, and employees, but not volunteers. Per Legal Action’s insurance agent and its carrier’s underwriting staff, Legal Action will need to purchase a stand-alone crime policy with an added endorsement to broaden its coverage to include “volunteers.” Legal Action’s agent believes this could increase annual premiums by 26%.

Because of the increased premiums, Legal Action asked LSC to drop “volunteers” from the proposed rule in §§ 1629.1 & 1629.3(a). Legal Action also suggested that if LSC decided to keep “volunteers” in the proposed rule, then LSC should define “volunteers.” Legal Action suggested that LSC limit the requirement to volunteers who have access to LSC funds and exclude volunteer attorneys who accept cases referred from Legal Action.

Finally, Legal Action asked that LSC drop the requirement under § 1629.3(c)(1) that subrecipients supply coverage for volunteers. Legal Action expressed concern that subrecipients also would likely incur additional costs to meet this requirement. Legal Action stated this requirement may discourage potential subrecipients from partnering with LSC recipients in cases where the subgrant is small and the cost of compliance is high.

Response: LSC will retain the language from the proposed rule. For most recipients, the proposed rule will not impose additional costs. This is because most

recipients' policies already include "volunteers" in the definition of a covered "employee." In those policies, "volunteers" are limited to those who are subject to the recipient's direction and control and who perform services for the recipient.

LSC reviewed the policies of six recipients similar in size to Legal Action who have policies that include "volunteers" as employees covered by the policy. Policies ranged in amount from \$250,000 to \$1 million in coverage, with deductibles ranging from \$2,500 to \$10,000, and annual premiums ranging from \$1,124 to \$3,628. From this analysis, it appears that insurers offer policies Legal Action could consider purchasing that would provide coverage for the actions of volunteers without additional expense.

As to the requirement that subrecipients also provide coverage for volunteers, LSC will retain the proposed language. Anytime a recipient delegates tasks to another entity, often with less capacity and/or fewer controls than the recipient itself has, that recipient runs the risk that LSC funds may be misappropriated. Because most subgrantee agreements may entail a greater risk, LSC thinks it would be imprudent to relax the requirements proposed in the NPRM.

Section 1629.4 What forms of bonds can recipients use?

Current § 1629.5 allows recipients to choose different forms of bonds, such as individual, blanket, or schedule. 45 CFR 1629.5. Section 1629.5 currently does not address whether recipients may choose types of insurance other than a fidelity bond that achieve the same purpose as a fidelity bond. Most LSC recipients now protect against employee dishonesty through riders to their standard commercial crime policies. Few grantees obtain separate fidelity bonds.

In 1999, LSC issued an external opinion permitting recipients to use employee dishonesty insurance to satisfy the bonding requirements of part 1629 if the recipient could show that the policy gives the same level of protection as a fidelity bond. See External Opinion 1999-10-26, Part 1629 Purchase of Employee Dishonesty Insurance in Lieu of a Fidelity Bond (October 26, 1999). To reflect this long-standing LSC policy, LSC proposed revising part 1629 to expressly allow recipients to substitute employee dishonesty policies or other methods of coverage for fidelity bonds. This revision would give recipients greater flexibility to choose the most readily available and cost-effective methods of insuring LSC funds. The revision also would make clear that the substance and amount of coverage is more important than the form.

LSC received no comments on this section of the proposed rule. LSC will adopt the language as proposed in the final rule.

Section 1629.5 What losses must the bond cover?

Current § 1629.4 requires recipients to have bonds that protect them against “all those risks of loss that might arise through dishonest or fraudulent acts in the handling of funds[.]” The strict language—“all those risks of loss”—implies that recipients must be completely covered in the event of a loss, and that policies with deductibles would not be acceptable under current part 1629. This is because if a recipient has LSC funds stolen, and the policy requires the recipient to absorb a portion of that loss by paying a deductible, then the recipient’s policy did not cover against “all those risks of loss.” Such strict language makes sense under ERISA statutes and regulations, as they are designed to protect retirees’ pension funds. But such language may prevent recipients from obtaining

policies that will protect LSC funds adequately if policies without deductibles are prohibitively expensive.

In the NPRM, LSC proposed to simplify the language about the types of losses that the bond must cover and revise the rule to allow recipients to purchase policies that require payment of deductibles. LSC proposed revising the definition to state simply that the “bond must provide recovery for loss caused by such acts as: fraud, dishonesty, larceny, theft, embezzlement, forgery, misappropriation, wrongful abstraction, wrongful conversion, willful misapplication, or any other fraudulent or dishonest act committed by an employee, officer, director, agent, or volunteer.”

LSC received no comments on this section of the proposed rule. LSC will adopt the language as proposed in the final rule.

Section 1629.6 What is the required minimum level of coverage?

Under the existing rule, recipients must maintain bond coverage equal to at least 10% of the recipient’s annualized LSC funding or of the initial grant if the program is a new grantee. 45 CFR 1629.1(a). The minimum level of coverage may never be less than \$50,000. *Id.* In the NPRM, LSC proposed to increase the minimum coverage level, which has remained unchanged since 1984. Based on a sampling of current recipients’ policies, most recipients already exceed the \$50,000 minimum level of coverage. In fact, most policies provided coverage in excess of \$100,000. For those recipients that currently have a \$100,000 policy limit, the average annual premium was \$561. Because the common practice among recipients already is to insure recipient funds above the minimum amount required by current § 1629.1(a), LSC believes it is reasonable for LSC to raise the

minimum coverage level to \$100,000. LSC does not propose to change the minimum percentage for coverage.

LSC received no comments on this section of the proposed rule. LSC will adopt the language as proposed in the final rule.

Section 1629.7 May LSC funds be used to cover bonding costs?

Part 1629 currently is silent as to which costs associated with fidelity bond coverage —deductibles, premiums, rates, and single loss retention— are allowable using LSC funds. To improve clarity on this point, LSC proposed to allow recipients to use LSC funds to pay for the costs of bonding under this part if they are (1) consistent with 45 CFR part 1630, (2) in accordance with sound business practice, and (3) reasonable. This proposed rule is based on the Uniform Guidance, which allows for such costs. See 2 CFR 200.427.

LSC considered limiting the amount of deductibles that LSC would consider reasonable in the proposed rule. During the process of drafting this proposed rule, LSC examined a sample of recipients' current fidelity bonds and found that most of those recipients' policies have deductibles ranging from \$1,000 to \$5,000. LSC could not determine, based on research of external sources, whether there are current best practices in the nonprofit insurance world that would help LSC establish a reasonable limit on deductibles. LSC determined that it would need more data to set deductible limits and has therefore chosen to allow recipients the flexibility to consider the losses they are willing to absorb when deciding the appropriate deductibles, if the deductibles are consistent with part 1630, in accordance with sound business practice, and reasonable.

Comments: Legal Action suggested that LSC allow recipients to charge bonding costs to the LSC grant as either direct or indirect costs. Legal Action reasoned that some recipients may not utilize “indirect” cost allocation or may not have an approved “indirect” cost rate.

Response: LSC will retain the language from the NPRM in the final rule. LSC does not think it should make an exception to the standard principle set out in the Uniform Guidance that the costs of bonding required by non-Federal entities in the general conduct of their operations are allowable as an indirect cost.

List of Subjects in 45 CFR part 1629.

Fidelity bond, Grant programs-law, Insurance.

For the reasons set forth in the preamble, the Legal Services Corporation revises 45 CFR part 1629 to read as follows:

PART 1629—BONDING REQUIREMENTS FOR RECIPIENTS

Sec.

1629.1 Purpose.

1629.2 Definitions.

1629.3 Who must be bonded?

1629.4 What forms of bonds can recipients use?

1629.5 What losses must the bond cover?

1629.6 What is the required minimum level of coverage?

1629.7 Can LSC funds be used to cover bonding costs?

Authority: 42 U.S.C. 2996e(1)(A) and 2996f(3).

§ 1629.1 Purpose.

This part is intended to protect LSC funds by requiring that recipients be bonded or have similar insurance coverage to indemnify recipients against losses resulting from fraudulent or dishonest acts committed by one or more employees, officers, directors, agents, volunteers, and third-party contractors who handle LSC funds.

§ 1629.2 Definitions.

Annualized funding level means the amount of:

- (1) Basic Field Grant funds (including Agricultural Worker and Native American) and
- (2) Special grants of LSC funds, including Technology Initiative Grants, Pro Bono Innovation Fund grants, and emergency relief grants, awarded by LSC to the recipient for the fiscal year included in the recipient's annual audited financial statements.

§ 1629.3 Who must be bonded?

- (a) A recipient must supply fidelity bond coverage for all employees, officers, directors, agents, and volunteers.
- (b) If a recipient uses a third party for payroll, billing, or collection services, the recipient must either supply coverage covering the third party or ensure that the third party has a fidelity bond or similar insurance coverage.
- (c) For recipients with subgrants:
 - (1) The recipient must extend its fidelity bond coverage to supply identical coverage to the subrecipient and the subrecipient's directors, officers, employees, agents, and volunteers to the extent required to comply with this Part; or
 - (2) The subrecipient must supply proof of its own fidelity bond coverage that meets the requirements of this Part for the subrecipient's directors, officers, employees, agents, and volunteers.

§ 1629.4 What forms of bonds can recipients use?

- (a) A recipient may use any form of bond, such as individual, name schedule, position schedule, blanket, or any combination of such forms of bonds, as long as the type or combination of bonds secured adequately protects LSC funds.

(b) A recipient may use similar forms of insurance that essentially fulfill the same purpose as a fidelity bond.

§ 1629.5 What losses must the bond cover?

The bond must provide recovery for loss caused by such acts as fraud, dishonesty, larceny, theft, embezzlement, forgery, misappropriation, wrongful abstraction, wrongful conversion, willful misapplication, or any other fraudulent or dishonest act committed by an employee, officer, director, agent, or volunteer.

§ 1629.6 What is the required minimum level of coverage?

(a) A recipient must carry fidelity bond coverage or similar coverage at a minimum level of at least ten percent of its annualized funding level for the previous fiscal year.

(b) If a recipient is a new recipient, the coverage must be at a minimum level of at least ten percent of the initial grant.

(c) Notwithstanding paragraphs (a) and (b) of this section, recipients must not carry coverage under this part at a level less than \$100,000.

§ 1629.7 Can LSC funds be used to cover bonding costs?

Costs of bonding required by this part are allowable if expended consistent with 45 CFR part 1630. Costs of bonding such as rates, deductibles, single loss retention, and premiums, are allowable as an indirect cost if such bonding is in accordance with sound business practice and is reasonable.

Dated: August 3, 2017.

Mark Freedman

Senior Associate General Counsel.

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