



The State Bar *of California*

OFFICE OF ACCESS & INCLUSION

Date: March 18, 2020

To: Members, Legal Services Trust Fund Commission

From: Greg Shin, Senior Program Analyst

Subject: Definition and Treatment of Pass-through Funds On 2021 IOLTA/EAF Grant Application

EXECUTIVE SUMMARY

The treatment of pass-through funds and its impact on the primary purpose calculation emerged as an issue during the review of an organization's 2020 IOLTA/EAF Grant application. While the treatment of pass-through funds will be further reviewed during the codification process, in an effort to provide further clarification, staff recommends additional changes to be reflected on the 2021 IOLTA/EAF Grant application which is scheduled to be released on April 3, 2020.

BACKGROUND

Organizations seeking IOLTA/EAF funding must demonstrate meeting the primary purpose requirement specified by the following Governing Authorities: Business and Professions Code section 6213, State Bar Rule 3.671, Legal Services Trust Fund Program Eligibility Guidelines for Legal Services Projects 2.3.5, and Legal Services Trust Fund Program Eligibility Guidelines for Support Centers 2.3.

State Bar Rules 3.671(A) and 3.671(B) state that a qualified legal services project and support center applying for Trust Fund Program funds is presumed to have such a purpose and function if 75 percent or more of its budget is designated to provide free legal services to indigents and support services respectively. The "qualified expenditures" used to calculate the 75 percent threshold exclude any expenses related to non-legal activities, leased or subleased space, property management activities, criminal matters, fee-generating cases, non-indigent clients, and expenses incurred outside of California. Office

practice has been to deem organizations with qualified expenditures at or above the 75 percent threshold as having met the primary purpose requirement while those falling below 75 percent are elevated to the LSTFC's Eligibility and Budget Review Committee for further review.

An expense item that can potentially impact the primary purpose calculation is pass-through funds. In 2018, staff redesigned the application and added the following language to the 2019 IOLTA/EAF Application Instructions (page 5 for qualified legal services projects and page 6 for support centers):

Pass-through/Fiscal Sponsorship: This section has been created in response to concerns that pass-through funds should be considered outside of the primary purpose calculation. In this section, identify funds that are passed through from the applicant to another organization, for which the applicant has no involvement, oversight, or engagement in the execution of the funded work (e.g. program simply cuts a check to another organization but is not involved in decision-making and does not have oversight responsibilities, or involvement is limited to selecting a sub-grantee but program does not participate in decision-making or oversight beyond that). The Commission will make a determination whether what is reported conforms to statutory and State Bar requirements, and may seek additional information from the applicant to make a final determination.

Prior to the inclusion of this additional language and the implementation of this new procedure to discretely capture pass-through funds in SmartSimple, pass-through funds were inconsistently reported by organizations, if at all. And when reported, they were oftentimes reported in different parts of the application like in contract services and other expenses, which resulted in more organizations falling below the 75 percent primary purpose threshold. In order to reduce the number of organizations needing to be elevated to the LSTFC for additional review and approval of their applications, staff began treating pass-through funds as outside of the initial primary purpose calculation.

DISCUSSION

As mentioned above, the treatment of pass-through funds vis-à-vis the primary purpose calculation emerged recently when an organization applied a very broad reading of the pass-through language in its IOLTA/EAF Grant application submission. The organization categorized an expense as a pass-through transaction that staff believes was neither supported by the intention of the pass-through language in the application instructions, nor a typical interpretation of the term.

Staff's historical practice has been to define pass-through funds as funds that the grantee receives from another entity and passes through to another entity without any role in determining WHO receives or HOW the funds are spent. Generally, pass-through transactions are used when organizations subcontract with other organizations or provide direct funds (such as monetary grants) to other organizations. The purpose of capturing this data is to avoid organizations from unfairly recognizing these funds as qualified expenditures for legal services or "double counting" the same funds with other organizations.

Notwithstanding this historical practice, staff recognizes that this practice is not formally codified and given the recent, unintended interpretation of the pass-through language in the situation referenced above, staff believes that some changes to the pass-through language in the IOLTA/EAF Grant application for grant year 2021 are in order to mitigate any further confusion or misinterpretation. We seek the Commission's approval on one of the two options below:

Option 1

Amend the pass-through language in the 2021 IOLTA/EAF Grant application instructions to (changes **highlighted**):

Pass-through/Fiscal Sponsorship: This section has been created in response to concerns that pass-through funds should be considered outside of the primary purpose calculation. In this section, identify funds that are ***received by the applicant from an external entity, and*** passed through from the applicant to another organization, ***over*** which the applicant has no ***program*** oversight, or ***control over who receives the pass-through funds or*** the execution of the funded work (e.g. program simply cuts a check to another organization but is not involved in decision-making and does not have oversight responsibilities, or involvement is limited to selecting a sub-grantee but program does not participate in decision-making or ***program*** oversight beyond that). ***The pass-through funds should have no material economic or fiscal impact to the applicant since the funds are simply transferred from one entity to another.*** The Commission will make a determination whether what is reported conforms to statutory and State Bar requirements, and may seek additional information from the applicant to make a final determination.

Staff will continue to evaluate any and all pass-through funds included in the 2021 IOLTA/EAF Grant applications and elevate to the LSTFC's Eligibility and Budget Review Committee any reported pass-through funds that fall outside the scope of the language for

further review. Committee review will be especially important in cases where the treatment of the pass-through funds can potentially negatively impact the organization's primary purpose calculation.

Option 2

Remove the current pass-through language in the 2021 IOLTA/EAF Grant application altogether and revert to the pre-2019 practice of deducting pass-through funds AFTER the calculation of total qualified expenditures. This will most likely result in more applications not meeting the 75 percent primary purpose threshold being escalated to the LSTFC for additional review. To roughly quantify this potential impact, out of 99¹ IOLTA/EAF Grant applications received in 2020, 18 (or roughly 18 percent) documented pass-through funds with four ultimately requiring further review by the LSTFC).

RECOMMENDATION

Notwithstanding the situation mentioned above about the organization that adopted a liberal interpretation of the pass-through language, staff notes that the majority of prior pass-through funds comply with the intended scope of pass-through transactions. Option 1 would provide additional clarity regarding what expenditures may be permissibly treated as pass-through expenditures while the Rules Committee considers the issue further during codification review. Option 2, would require additional system programming prior to the release of the 2021 IOLTA/EAF Grant application on April 3, 2020. For these reasons, and given the relatively small number of pass-through funds overall (18 percent among the 2020 applications), staff recommends the adoption of Option 1.

¹ 103 IOLTA/EAF Grant applications were received in 2020 but 4 were ultimately withdrawn