FEDERAL ELECTION COMMISSION
WASHINGTON, D.C. 20463

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MEMORANDUM

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SUBJECT: Draft Final Audit Report– California Republican Party/V8
(LRA 829)

I. INTRODUCTION

The Office of the General Counsel has reviewed the Draft Final Audit Report ("DFAR") on the California Republican Party/V8 ("Committee"). Our comments address issues in Finding 3 (Extension of Credit by a Commercial Vendor). We concur with any findings not specifically discussed in this memorandum. If you have any questions, please contact Danita C. Lee, the attorney assigned to this audit.

II. EXTENSION OF CREDIT BY A COMMERCIAL VENDOR AND THE CREDITORS ATTEMPT TO COLLECT THAT DEBT (Finding 3)

Finding 3 addresses an extension of credit by Strategic Fundraising, Inc. ("SFI"), which the auditors conclude may have resulted in a prohibited contribution to the Committee. The DFAR concludes that SFI did not extend credit to the Committee in the ordinary course of business and that SFI failed to make a commercially reasonable effort to collect the debt. The contract between SFI and the Committee presents issues similar to those in other matters involving "no risk" or "limited risk" fundraising arrangements between direct mail or telemarketing vendors and political committees. *See, e.g.*, MUR 5635 (Conservative Leadership PAC); AO 1991-18 (New York State Democratic Committee); AO 1979-36 (Committee for Fauntroy).

We conclude that while SFI's initial extension of credit to the Committee included some aspects that suggest that the extension was in the ordinary course of business, the Committee did not submit information that is necessary to resolve this issue. Similarly, we conclude that SFI may have engaged in commercially reasonable efforts to collect the debt, but the Committee did not submit enough information to show SFI's reasonable attempts to collect the debt.

A. BACKGROUND

The Committee failed to pay several invoices for SFI voter/donor file prospecting, caging, fundraising and mailing services for periods ranging from approximately four months to two years. The invoices totaled $1,171,002. The total represents the sum of fees SFI charged for various services -- comprising, for example, fees ranging from $0.15 per call or similar transaction for services described as "fulfillment boost recorded message" to $2.75 per transaction for "current donor telefundraising" services, as well as flat fees.

The Interim Audit Report ("IAR") concluded that SFI's initial extension of credit to the Committee was not in the ordinary course of business because: (1) there existed no evidence that the "no risk"/"limited risk" fundraising terms in the agreement were consistent with terms offered in the telemarketing fundraising industry; or, alternatively, (2) there was no showing that the value of the exclusivity clause contained in the fundraising agreement was sufficiently adequate to ensure that the Committee would bear some of the financial risk of the fundraising program not paying for itself.

The IAR also concluded that SFI failed to make a commercially reasonable effort to collect the Committee's debt because the Committee failed to submit supporting evidence of SFI's debt collection efforts. In response to the IAR, the Committee and SFI assert that the fundraising contract was consistent with fundraising industry standards and that SFI engaged in commercially reasonable debt collection efforts by undertaking a variety of debt collection actions including discussions, negotiations, written communications, in-person meetings and renegotiating the Committee's payment plan. Letter from Charles H. Bell, Jr., General Counsel, California Republican Party to Mr. Tom Hintermister, Assistant Staff Director, Audit Division (Mar. 19, 2012) [hereinafter Committee's Resp.] and Letter from Mark Dixon, Chief Financial Officer, Strategic Fundraising, Inc., to Tom Hintermister, Assistant Staff Director, Audit Division (Undated) [hereinafter SFI's Resp.].

B. THE INITIAL EXTENSION OF CREDIT LACKED ADEQUATE SAFEGUARDS

1. Terms of the Initial Extension of Credit

The terms of the contract between the Committee and SFI provide that SFI was to provide telephone fundraising services directed at both previous and prospective donors. The contract permitted the Committee itself to collect, deposit, and record the individual contributions generated by SFI's telemarketing calls, and required it to provide SFI with regular reports "identifying all individuals who contributed to the Committee as a result of SFI's efforts, along with the amount and date of each contribution." SFI was to send invoices to the Committee weekly; these invoices were presumably based on the reports sent to SFI by the Committee. Prospecting invoices were to be payable upon receipt and invoices for proven donor efforts were to be payable within 30 days. However, regarding prospecting calls, the contract contained a "Break-Even Guarantee" ("Guarantee"), whereby the parties agreed that the Committee would not be expected to pay more for prospecting calls than the sum of all actual contributions generated by those calls; if the gross proceeds of the prospecting ever exceeded $2.25 per call made, the extra amount was to be credited to the Committee.

The Guarantee clause of the contract contained both parties' explicit acknowledgement that SFI was "accepting significant business risk" by extending the Guarantee to the Committee. In consideration of that risk, the Committee granted to SFI the exclusive "right to conduct [the Committee's telemarketing] programs over the course of an entire year."

These terms raise a question of whether SFI's initial extension of credit to the Committee was in the ordinary course of business. The IAR found that as a result of these terms, SFI may not have – at the outset of entering into the fundraising agreement – extended credit to the Committee in the ordinary course of business. The IAR gave the Committee an opportunity to provide information that "no-risk" or "limited-risk" agreements such as the Guarantee between the Committee and SFI conform to the usual and normal practice in the telemarketing industry or to provide information showing that the value of the exclusivity clause was comparable to SFI's financial risk. Neither the Committee nor SFI provided such information.

2. Contributions, Extensions of Credit, and No-Risk Contracts

The Act defines a contribution as "any gift, subscription, loan, advance, or deposit of money or anything of value made by any person for the purpose of influencing any election for Federal office." 2 U.S.C. § 431(8)(A)(i). Under the Commission's regulations, the term "anything of value" includes all in-kind contributions, and unless specifically exempted, the provision of goods and services for no charge or at a charge that is less than the usual and normal charge. 11 C.F.R. § 100.52(d)(1).

An extension of credit to a political committee by a commercial vendor is a contribution unless the credit is extended in the ordinary course of business and on the same terms as extensions of credit to nonpolitical debtors of similar risk and for an obligation of similar size. 11 C.F.R. §§ 100.55, 116.3(b). An extension of credit occurs when there is an agreement between a creditor and a political committee that full payment is not due until after the creditor provides goods or services to the political committee. 11 C.F.R. § 116.1(e)(1). In determining whether an extension of credit was in the ordinary course of business, the Commission considers whether the vendor followed established procedures and past practices, whether the vendor received prompt payment in full for previous extensions of credit, and whether the extension of credit conformed to the usual and normal practice in the industry. 11 C.F.R. § 116.3(c). If a vendor extends credit and fails to make a commercially reasonable attempt to obtain repayment, a contribution will result. 11 C.F.R. §§ 100.55, 116.4(b)(2).

When addressing fundraising programs that compensate vendors using fundraising proceeds, the Commission has expressed concern that "regardless of the degree of success of the effort to raise funds, the committee would retain contribution proceeds while giving up little, or the committee would assume little to no risk with the vendor bearing all, or nearly all, the risk." Advisory Opinion 1991-18 (New York State Democratic Committee). "No-risk" or "limited risk" contracts similar to the one at issue here may result in in-kind contributions from vendors in two ways. First, they may result in a vendor rendering services for the committee for essentially no charge, or for what at the end of a series of transactions will wind up being less than the usual and normal charge. *See* 11 C.F.R. § 100.52(d)(1). Second, because these arrangements almost by definition involve the provision of services by the vendor before payment is received, they involve extensions of credit, and must meet all of the requirements set forth in the regulations for extensions of credit not to be contributions. *See* 11 C.F.R. §§ 100.55, 116.3-4.

The Commission has consistently applied these regulations to determine whether such arrangements resulted in in-kind contributions. *See, e.g.*, MUR 5635 (Conservative Leadership PAC) (addressing a "no risk" fundraising contract where the committee was not responsible for the costs of fundraising in excess of the money raised); Advisory Opinion 1991-18 (addressing a "limited risk" fundraising contract where the committee's full payment of the vendor's commissions was tied to the prospect that the fundraising would pay for itself over several years); Advisory Opinion 1979-36 (Committee for Fauntroy) (addressing a "limited risk" fundraising contract where the committee was only required to pay three-fourths of the total amount of contributions received irrespective of the actual amount of fees and expenses).[1] In doing so, the Commission has required

[1] The Commission also has addressed contracts and dealings in contexts other than fundraising in which committees assumed no risk or limited risk. *See, e.g.*, MURs 5069 and 5132 (Comite Acevedo Vila Comisionado 2000) (determining that no contribution resulted when a Puerto Rico advertising agency bought television time on behalf of a candidate without first receiving payment based on evidence of common industry practice in Puerto Rico); MUR 4742 (Juan Vargas for Congress) (finding a reportable

committees to have safeguards in place to ensure that committees in fact pay for the costs of the fundraising programs. *See* MUR 5635; Advisory Opinion 1991-18; Advisory Opinion 1979-36. Specifically, the Commission has focused on whether a committee would receive anything of value without timely and proper compensation first being paid to the fundraising firm and any third-party vendors. *See id.* Safeguards proposed by the Commission have included requiring advance deposits by a committee to reimburse vendors for potential shortfalls, limiting the term of the contract, or allowing vendors to terminate the contract early and demand full payment as a result of poor fundraising performance. *See id.*

For example, in MUR 5635, the committee entered into a "no risk" contract with a fundraising firm. The arrangement provided that the committee would be responsible for the costs of fundraising only up to the amount of funds raised. The fundraising program was not sufficient to cover the vendors' expenses, and the fundraising firm made several disbursements to the committee before the vendors' expenses were fully paid. Accordingly, the Commission concluded that this arrangement resulted in contributions from the fundraising firm because the arrangement was not in the ordinary course of business given the size of the disbursements and short-term nature of the program, and even if it was, the fundraising firm had forgiven the debt, resulting in a contribution under 11 C.F.R. § 100.55(d)(1). *See* General Counsel's Report #2, MUR 5635, at 5-6.

Likewise, in Advisory Opinion 1991-18, the committee proposed entering into a "Prospecting Program" where the costs of fundraising would be paid out of fundraising proceeds and the committee would be responsible for the costs of fundraising only up to the amount of funds raised. Moreover, under the first year of the program, the vendor would provide the committee with net revenues even when the vendor had not yet been fully paid for an earlier round of solicitations. Because of the "inherently speculative" nature of the prospecting effort, including the likelihood that the vendor would not receive the full contract price for more than one year, the Commission determined that it could not approve the program "in the absence of a record by [the vendor] or similar companies of the implementation of a program of similar structure and size in the ordinary course of business." Alternatively, the Commission suggested safeguards that would prevent the program from resulting in in-kind contributions, including using short, defined periods of time in which the committee and the vendor would settle accounts.

3. SFI's "Guarantee" and Exclusivity Clause

The Guarantee in the contract between the Committee and SFI appears very similar to the type of "no-risk" or "limited-risk" provisions that the Commission has found in previous matters could constitute in-kind contributions in the absence of safeguards ensuring that the Committee would pay for all of the costs of the fundraising

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extension of credit, but no contribution, resulting from a "deferred compensation" contract with a candidate's general consultant where the consultant's retainer was only to be paid if the vendor and the committee agreed that the committee could afford to pay it without harm to campaign's viability).

programs. Moreover, SFI does not "cage" the contributions resulting from the fundraising activity. Under the contract, contributions were to be sent directly to the Committee which was to deposit the contributions in its own account and then pay the invoiced amounts to SFI. This provision, in combination with the Guarantee, raises questions as to whether the arrangement between the Committee and SFI was one in which "the committee retain[ed] contribution proceeds while giving up little, or assum[ing] little to no risk with the vendor bearing all, or nearly all the risk." *See* AO 1991-18 (New York State Democratic Party).

SFI asserted that "all other telefundraising firms offer the exact or similar 'break-even guarantee' and that they "issue credit to non-political clients as well in the exact same fashion," but neither the Committee nor SFI provided any information supporting this assertion, or demonstrating a record by SFI or other companies "of the implementation of a program of similar structure and size in the ordinary course of business." SFI's Resp. at 3. However, a committee in an audit that presents nearly identical issues that is currently pending before the Commission has submitted such information. That committee's vendor submitted 32 telemarketing and direct mail contracts from a variety of fundraising vendors for both political and nonpolitical clients to support the claims of the committee in that audit that the contract at issue there conformed to the usual and normal practice in its telemarketing vendor's industry. Because the issues in that audit are similar to the issues here, and because that information is reasonably current (having been submitted in a currently pending audit), we believe it is appropriate to consider that information here in order to determine whether the Commission is aware of any record by other companies of fundraising programs of similar structure and size in the ordinary course of business in the direct mail and telemarketing fundraising industry.

In that audit, each of the 32 submitted fundraising contracts contained some no-risk or limited-risk provision similar to the Guarantee at issue here. Thus, it appears that such provisions by themselves are not unusual in the industry.

Another provision of the SFI contract about which we expressed concern in our comments on the IAR was the caging provision. This provision allowed the Committee to receive and deposit contributions on its own, report the proceeds to the vendor, and then pay the vendor based on the self-reported amounts raised. None of the previous no-risk or limited-risk contracts examined by the Commission contained such a provision. Our concern was that if a committee did its own caging of contributions received through direct mail or telemarketing fundraising, it might not even pay the vendor all of the gross proceeds, let alone an amount necessary to cover the vendor's costs. That is, in fact, what appears to have happened here. *See* Part II.C. However, 27 of the 32 contracts submitted in the other audit provide for caging by the committee, the committee's bank or a bank identified by the committee. Thus, this provision also does not appear to be unusual in the direct mail and telemarketing fundraising industries.

While the contract here did not contain any of the specific safeguards suggested by the Commission in other instances in which it has reviewed no-risk or limited-risk contracts, it does contain the exclusivity provision, which the contract stated was intended to be consideration for the "significant business risk" incurred by SFI. If the exclusivity provision provided value to SFI sufficient to negate SFI's assumption of the risk that it would lose money on the prospecting calls, the original extension of credit would result in no contribution. However, neither the Committee nor SFI provided any information demonstrating any particular financial value of the exclusivity clause, let alone sufficient financial value to demonstrating that it negated SFI's assumption of the risk. Although SFI stressed that "our standard fundraising agreements with all political clients call for exclusivity" and that they have "a 20 year history which allows us to mitigate our internal 'risk,'" it again did no more than assert these facts. SFI's Resp. at 3.

In the absence of documentation provided by the Committee or SFI, we again turn to information the Commission possesses in the other audit. Only three of the 32 contracts submitted in that audit contained an exclusivity clause as a safeguard against losses by the vendor; in none of those was the exclusivity clause the only safeguard, as it is here.

Finally, there is no other information indicating that the costs of the fundraising program were eventually paid by the Committee. "With respect to the payment or non-payment of an extension of credit, the Commission has made plain that in political committee fundraising, 'none of the costs of the program [may] be left unpaid by the Committee.'" General Counsel's Report #2, MUR 5635, at 8 (quoting Advisory Opinion 1990-14). The Audit Division states that it reconciled the Committee's payments to SFI's invoices and determined that all of SFI's invoices were paid, but were paid in an untimely fashion.[2] However, unlike in the other similar audit currently pending before the Commission, there is no indication that the program resulted in any profit to the vendor. Accordingly, we do not believe that it is possible, at this stage, to definitively conclude that all of the fundraising program's costs were paid by the Committee.

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[2] Although both the Committee and SFI indicate that they resolved disputed billing items, we do not possess any information regarding the specifics of the dispute or details regarding its resolution. The only information the auditors possess stems from a memorandum from the Committee's counsel to SFI. Committee counsel states that

> [The Committee] is currently undertaking a comprehensive review of [SFI's] bills to [the Committee] from an accuracy and performance standpoint. The enclosed payment does not represent any conclusion as to the results of that comprehensive review or a waiver of claims or disputes under the respective contracts between the parties for telemarketing and caging services, and should be viewed solely as a good faith effort on [the Committee's] part to reduce the outstanding balances subject to the completion of the comprehensive review and a determination of what is the appropriate amount due under these contracts.

Memorandum from Charles H. Bell, Jr., General Counsel to the California Republican Party, to Strategic Telecommunications, Inc. (Jul. 3, 2008). Despite this memorandum, the auditors indicate that the Committee ultimately paid SFI on all of its bills.

In summary, while a comparison of information from the other audit indicates that some aspects of the original SFI extension of credit were similar to what other firms do in the ordinary course of business, the use of an exclusivity clause as the sole safeguard against loss by the vendor is not. Neither the Committee nor SFI produced any valuation of the exclusivity clause demonstrating that it was sufficient to offset any losses SFI might have suffered from its prospecting activities on behalf of the Committee. Nor did they provide any documentation that SFI's contracts with nonpolitical clients have this structure, and there is no indication that the Committee paid all of the costs of the program. Consequently, even if the Committee had made all payments as required under the contract – and, as we turn to next, it did not – some of the "'costs of the program [may have been left unpaid] by the Committee,'" resulting in a contribution. *See* General Counsel's Report #2, MUR 5635, at 8 (quoting Advisory Opinion 1990-14).

C. COMMITTEE MAY HAVE UNDERTAKEN COMMERCIALLY REASONABLE DEBT COLLECTION EFFORTS BUT MORE INFORMATION IS NEEDED

Even where an extension of credit by a commercial vendor is legally permissible when made, it may ripen into a contribution over time through a lack of commercially reasonable attempts on the part of the vendor to collect the resulting debt. The Commission determines that such attempts are commercially reasonable if the vendor has pursued its remedies as vigorously as it would pursue its remedies against a nonpolitical debtor in similar circumstances, including withholding delivery of additional goods or services until overdue debts are satisfied. 11 C.F.R. § 116.4(d)(3)(iii).

SFI began invoicing the Committee for its services upon the commencement of the fundraising program. The Committee failed to pay SFI's invoices within the 30-day timeframe set forth in the agreement but SFI continued providing fundraising services. SFI said that during the first quarter of 2008, the Committee "continued to use funds raised from SFI's activities to pay other bills which increased the overall debt substantially." SFI's Resp. at 3. The Committee eventually accumulated debt to SFI totaling $1,171,002.

SFI stated that it made commercially reasonable attempts to collect the debt. SFI's Resp. at 2. Specifically, SFI said that in addition to its normal billing and debt collection practices it engaged in "repeated extraordinary attempts" to obtain payment from the Committee. SFI said, however, that "the high balance eventually caused the executive director [of the Committee, presumably] to cease all prospecting in early April in an effort to stop the balance from growing further." *Id.* Interestingly, SFI said that after it stopped fundraising for the Committee, SFI "worked diligently to show [the Committee] the importance of prospecting and its direct impact on future fundraising." *Id.* SFI said that it met with Committee staff and that together they ultimately developed a formal payment plan enabling the Committee "to clear up the balance." The payment plan "involved [SFI's] continued telefundraising for the [Committee] and a retention against the outstanding but unpaid balances of receipts until the obligation was satisfied in 2009." *Id.* at 3. SFI said that it "followed its established procedures and its past practice as with other telefundraising clients in the political and non-profit arena in approving the extension of credit." *Id.* at 2. SFI's effort to convince the Committee to resume the fundraising program and SFI's continued provision of services when the Committee had repeatedly failed to pay raises the question of whether SFI's debt collection efforts were commercially reasonable.

Among the debt collection practices that the Commission may regard as evidence of commercial reasonableness is the withholding of additional services until overdue debts are satisfied. 11 C.F.R. § 116.4(d)(3)(iii). Here, it appears the opposite happened; *the Committee*, concerned about the level of debt it had accumulated, sought to suspend delivery of services from SFI, and it was SFI that convinced the Committee that the only viable way for the Committee to get out of debt to SFI – and for SFI to be paid – was for the Committee and SFI to continue the fundraising program. If this is correct, it may be that SFI's decision to give the Committee additional time to pay and SFI's decision to continue providing services to the Committee was commercially reasonable. However, we believe that additional information is necessary to reach this conclusion. SFI asserted in its Response that, as part of its efforts to convince the Committee, it met with the Committee and "presented a detailed house file analysis which included details on historical fundraising trends and renewal rates." This meeting "led to a better understanding of the need to prospect and fundraise to help the CRP out of the situation it found itself in." SFI's Resp. at 2. Information supporting SFI's contention about "the need to prospect and fundraise to help the CRP out of the situation it found itself in" would be precisely the type of information that would demonstrate the commercial reasonableness of SFI's course. However, while the Committee and SFI say that SFI provided that information to the Committee in 2008, neither has provided similar information to the Commission in the course of this audit. We recommend that the Audit Division revise the DFAR to raise this issue and seek from the Committee the type of information described in SFI's letter.

In addition, as previously discussed, both the Committee and SFI stated that they negotiated a payment plan for the debt, but no information has been provided about the plan's specific terms, whether any amounts owed were forgiven, or how the specific terms compare to the terms SFI has provided to similarly situated nonpolitical debtors beyond an assertion that "Strategic has worked with [other clients] in their mutual interests by providing flexible payment plans." Consequently, we recommend that the DFAR seek this specific information.