FEDERAL ELECTION COMMISSION
WASHINGTON, D C 20463

SENSITIVE

BEFORE THE FEDERAL ELECTION COMMISSION

In the Matter of	)	
	)	MUR 5721
Lockheed Martin Employees' PAC, and	)	Audit Referral 05-10
Stephen E. Chaudet, in his official capacity as treasurer	)	RAD Referral 06L-01

STATEMENT OF REASONS OF CHAIRMAN MICHAEL E. TONER AND COMMISSIONER DAVID M. MASON

The Commission internally generated an audit of the Lockheed Martin Employees' Political Action Committee ("LMEPAC"). *See* 2 U.S.C. § 438(b) (2002). Later the Commission's Reports Analysis Division ("RAD") referred LMEPAC to the Office of General Counsel ("OGC") for not disclosing all financial activity.[1] OGC presented recommendations to the Commission on both the audit and the referral.[2]

The Commission voted unanimously to accept nine of the ten recommendations[3] and reject one. Among those accepted were two reason-to-believe findings against LMEPAC and its treasurer in his official capacity. *See* 2 U.S.C. § 437g(a)(2) (2002). We write separately to outline our reasons for accepting these two, because the reasons are narrower than the OGC report suggests.

I. BACKGROUND

While Kenneth Phelps was LMEPAC's administrator and assistant treasurer, he both processed LMEPAC receipts and disbursements *and* reconciled LMEPAC bank accounts. An internal Lockheed Martin audit recommended separating these two functions. However, LMEPAC failed to implement this recommendation. Subsequently, Phelps embezzled money from LMEPAC. The disclosure reports Phelps then prepared for LMEPAC and filed with the Commission were inaccurate[4] due to Phelps' efforts to cover up his embezzlement.

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[1] First General Counsel's Report ("GCR") at 1 (March 1, 2006).

[2] *Id* at 13.

[3] Voting affirmatively were Chairman Toner, Vice Chairman Lenhard, and Commissioners Mason, von Spakovsky, Walther, and Weintraub.

[4] GCR at 3; *id.* Attach. 3 at 2.

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Two of the adopted OGC recommendations in this matter involve finding reason to believe that LMEPAC and its treasurer, in his official capacity, violated the Federal Election Campaign Act ("FECA"), 2 U.S.C. § 431 *et seq.* *See id.* § 437g(a)(2).[5] To support the recommendations involving LMEPAC and its treasurer, in his official capacity, OGC notes[6] correctly that FECA requires LMEPAC to account for disbursements, *see id.* § 432(c)(5) (2004), and disclose them. *See id.* § 434(b)(4)-(6) (2002). Although assistant treasurers may act in place of treasurers, *see* 11 C.F.R. § 102.7(a)(1) (2002), FECA imposes these duties on treasurers themselves. *See* 2 U.S.C. §§ 432(c), 434(a)(1).

OGC concludes that because Phelps was LMEPAC's agent and had actual authority to deposit contributions, spend money, and sign and file disclosure reports,[7] LMEPAC should bear some responsibility for reporting violations resulting from the embezzlement.[8] OGC then cites another Commission Matter Under Review ("MUR") that remains open. The discussion of an OGC report in the present MUR may lead readers to conclude erroneously that a political committee is "liable for reporting violations resulting from [agents'] acts" whenever they acted "within the scope of [their] employment and there appeared to be little supervision" of them.[9]

As will be discussed further below, an agent's embezzlement cannot, by definition, be within the scope of the agent's employment. Nor can the agent's provision to the employer or others of false information or reports designed to cover up the embezzlement be within the scope of the agent's employment.

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II. DISCUSSION

This matter involves an agent's embezzlement from the principal, so at first glance, there is something odd about penalizing the principal for inaccurate reporting resulting from the embezzlement. After all, it is well established that a "principal may maintain an action in conversion to recover funds converted by his agent." *Myers v. Myers,* 68 N.C.App. 177, 181, 314 S.E.2d 809, 813 (N.C.App. 1984) (citing *Finance Co. v. Holder,* 235 N.C. 96, 68 S.E.2d 794 (1952)). In a civil action, it would be the agent who is liable, not the principal. *See id.; see also State v. Palmer,* 622 S.E.2d 676, 679-80 (N.C.App. 2005) (distinguishing embezzlement from larceny); *State v. Robinson,* 166 N.C.App. 654, 657-59, 603 S.E.2d 345, 346-48 (N.C.App. 2004); *Mischke v. Mischke,* 253 Neb. 439, 448, 571 N.W.2d 248, 256 (Neb. 1997) (citing *Schepers v. Lautenschlager,* 173 Neb. 107, 112 N.W.2d 767 (1962)); *Fischer v. Machado,* 50 Cal.App.4th 1069, 1072, 58 Cal.Rptr.2d 213, 215 (Cal.App. 3 Dist. 1996) (quoting *Haigler v. Donnelly,* 18 Cal.2d 674, 681, 117 P.2d 331 (1941)); *Alexopoulos v. Dakouras,* 48 Wis.2d 32, 41, 179 N.W.2d 836, 841 (Wis. 1970) (citing 3 C.J.S. Agency § 163b at 50; *Importsales, Inc. v. Lindeman,* 231 La. 663, 92 So.2d 574 (1957); *Manufacturers' Casualty Ins. Co. v.*

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[5] GCR at 13.

[6] *Id* at 5.

[7] *Id*

[8] *Id* at 6.

[9] *Id* at 5-6 (citations omitted).

Mink, 129 N.J.L. 575, 30 A.2d 510 (1943)); *Welch v. Coleman,* 95 N.H. 399, 403, 64 A.2d 691, 694 (N.H. 1949) (citing 3 C.J.S., Agency, § 192; Restatement, Agency, Vol. 2 §§ 387, 388, 389, 391, Comment d, 2, 407; *Parsons v. Merrill,* 59 N.H. 227; *Concord Railroad v. Clough,* 49 N.H. 257).

Nevertheless, as OGC notes, the Commission has penalized political committees for acts by their agents.[10] For this proposition, OGC cites an advisory opinion ("AO") and three MURs. Although the AO involves actions by an employee of a political committee, it does not involve penalizing the latter for the acts of the former. *See* Advisory Op. 1992-29, 1992 WL 267631, at *2 (Fed. Election Comm'n Aug. 28, 1992), *available at* http://ao.nictusa.com/ao/no/920029.html (visited March 30, 2006).

One of the three MURs that OGC cites remains open, *supra* at 2, and two are closed. The two that are closed did hold principals accountable for the actions of their agents. In one of these matters, OGC emphasized that the result was based on the broad authority of a presidential campaign committee's principal fundraiser to act as an agent of the committee. *In re Rizzo,* MUR 3585, Gen. Counsel's Report at 47 (Nov. 9, 1994); *see also id.* at 43, 46. In the other matter, OGC took a similar position. *See, e.g., In re Rhodes to Congress Comm.,* MUR 2602, Gen. Counsel's Report at 2-3 (July 5, 1994); *id.* Gen. Counsel's Report at 5-7 (Feb. 2, 1994).

More recently, however, the Commission has applied a narrower analysis. This more recent matter involved a party chairman's alleged improper use of party-committee money. *See In re Orange County Democratic Cent. Comm.,* MURs 4389 & 4652, Statement of Reasons ("SOR") of Chairman Thomas & Comm'rs Elliott, Mason, McDonald & Sandstrom at 1 (Dec. 17, 1999). The Commission initially found reason to believe that a party committee and its treasurer, in his official capacity, violated FECA. *See* 2 U.S.C. § 437g(a)(2). Following its investigation, however, instead of then finding probable cause to believe that a FECA violation occurred, *see id.* § 437g(a)(4), the Commission voted unanimously to take no further action and close the file. *Orange County,* SOR at 1. One reason was that the party chairman had operated well outside the party's strict guidelines and by-laws. More importantly, no one else associated with the party committee knew of or approved the chairman's actions. *Id.* at 2.

Committees – specifically, treasurers – are indeed responsible for filing accurate reports. *See* 2 U.S.C. § 434(a)(1), (b), (e). However, as a matter of law – rather than as a matter of prosecutorial discretion, *see Heckler v. Chaney,* 470 U.S. 821 (1985) – a committee is not automatically liable when an agent embezzles money and files inaccurate reports. *Cf. Orange County,* SOR at 1-2. The Commission should instead consider factors such as the committee's internal controls and what it reasonably could have done to prevent the problem. A committee that reasonably relies on an agent and maintains adequate financial controls should not be penalized for inaccurate reporting resulting from embezzlement by an agent.

Analogous principles arise, for example, in corporate, tax, and securities law.

First, under corporate law, "acts committed by corporate employees outside the scope of their employment for their sole benefit are not imputed to the corporation," unless, for example, the corporate "supervisors failed to detect and stop the wrongdoing, either in intentional disregard of the

[10] *See id* at 5 (citations omitted).

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law or in plain indifference to its requirements." 18 AM. JUR. 2d *Corporations* § 1841 (2004) (citations omitted).

Second, the Internal Revenue Service has regulations waiving penalties for underpayment of taxes when taxpayers reasonably and in good faith, *see* 26 C.F.R. § 1.6664-4(a) (2003), rely on their tax accountant. *See Boler v. Commissioner,* 83 T.C.M. (CCH) 1879, 2002 WL 1332802 (Headnote 18)[11] (U.S. Tax Ct. 2002); *Pine Creek Farms, Ltd. v. Commissioner,* T.C.M. (RIA) 2001-176, 2001 WL 802897 (Headnote 7) (U.S. Tax Ct. 2001); *Bean v. Commissioner,* 80 T.C.M. (CCH) 713, 2000 WL 1706714 (Headnote 9) (U.S. Tax Ct. 2000). This defense may not be available in some instances, such as when:

- Not all reporting is done by an accountant, the taxpayers provide the accountant with inaccurate and incomplete information, or the taxpayers do not follow the accountant's advice, *see Gowni v. Commissioner,* T.C.M. (RIA) 2004-154, 2004 WL 1447475 (Headnotes 20-22) (U.S. Tax Ct. 2004),
- The taxpayers do not provide the accountant with necessary and accurate information, *see Menard, Inc. v. Commissioner,* T.C.M. (RIA) 2004-207, 2004 WL 2066599 (Headnotes 50-51) (U.S. Tax Ct. 2004),
- The accountant's advice was so plainly wrong that the taxpayers could not have relied on it in good faith, *see Butler v. Commissioner,* 84 T.C.M. (CCH) 681, 2002 WL 31882859 (Headnote 10) (U.S. Tax Ct. 2002), or
- There is no evidence of reliance on the accountant. *See Frisca Construction Inc. v. Commissioner,* 79 T.C.M. (CCH) 2181, 2000 WL 839964 (Headnote 7) (U.S. Tax Ct. 2000).

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Third, a federal securities statute covering civil penalties for insider trading provides another analogy. The statute allows the Securities and Exchange Commission ("SEC") to seek a civil penalty from a person who "controlled the person who committed" insider trading. 15 U.S.C. § 78u-1(a)(1)(B) (2002). The SEC considers a corporation a "person" under this section. *See SEC Sues AmeriCredit Employees for Insider Trading and Seeks a Civil Penalty from AmeriCredit Corp. as a "Control Person,* SEC NEWS DIGEST 2003-210, 2003 WL 22481464 (Sec. & Exch. Comm'n Nov. 4, 2003). However, the statute allows assessing a penalty against the "controlling person" for the actions of the "controlled person" only if

> (A) such controlling person knew or recklessly disregarded the fact that such controlled person was likely to engage in the act or acts constituting the violation and failed to take appropriate steps to prevent such act or acts before they occurred; or
>
> (B) such controlling person knowingly or recklessly failed to establish, maintain, or enforce any policy or procedure required under section 78o(f) of this title or section 80b-4a of this title and such failure substantially contributed to or permitted the occurrence of the act or acts constituting the violation.

15 U.S.C. § 78u-1(b)(1).

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[11] No page numbers are available. The citations are not to the headnotes themselves but to where they are in the text.

In contrast, where there is no evidence of knowing or reckless disregard or failure, the SEC does not seek to penalize employers, though it does require regulated corporations to file corrected reports reflecting any losses from an embezzlement. *See Final Judgment Entered Against Former Senior Office of HPSC, Inc. Subsidiary* (Sec. & Exch. Comm'n Jan. 13, 2004), *available at* http://www.sec.gov/litigation/LitReleases/lr18540.htm (visited April 7, 2006); *SEC Files Action Against Kevin J. Morrison, Former Executive of an HPSC, Inc. Subsidiary, and Mildred K. Miller in $5 Million Dollar* [*sic*] *Financial Fraud,* (Sec. & Exch. Comm'n Aug. 16, 2002), *available at* http://www.sec.gov/litigation/LitReleases/lr17686.htm (visited April 7, 2006).

These principles from corporate, tax, and securities law support by analogy the principle that a committee that reasonably relies on an agent and is the victim of the agent's embezzlement should not be responsible for inaccurate reporting resulting from the embezzlement. Reliance on the agent may not be reasonable if, for example:

- The committee did not "detect and stop the wrongdoing, either in intentional disregard of the law or in plain indifference to its requirements[,]" 18 AM. JUR. 2d *Corporations* § 1841 (citations omitted),
- The agent's advice was so plainly wrong that the committee could not have reasonably relied on it, *cf. Butler, supra* at 4, or
- The committee knew of, or recklessly disregarded, the fact that the agent was likely to violate the law and did not take appropriate steps to prevent it. 15 U.S.C. § 78u-1(b)(1)(A).

Indeed, the "knowing or reckless disregard of risk" standard might adequately describe all three comparable rules. More particularly, in industries where specific financial controls are mandated by law or regulation, failure to implement or follow required controls constitutes recklessness, creating potential liability by a principal for an agent's misdeeds.

FECA, in addition to establishing reporting requirements, provides:

> When the treasurer of a political committee shows that best efforts have been used to obtain, maintain, and submit the information required by this Act for the political committee, any report or any records of such committee shall be considered in compliance with this Act or chapter 95 or chapter 96 of Title 26.

2 U.S.C. § 432(i) (2004); *see also* 11 C.F.R. § 104.7(a) (2000); *see generally In re Brady et al.,* ADRs 264 & 293/RAD Referrals 05L-23 & 05L-43, SOR of Chairman Toner, Vice Chairman McDonald & Comm'rs Mason, Thomas & Weintraub at 2-3 (Fed. Election Comm'n Jan. 5, 2006), *available at* http://eqs.sdrdc.com/eqsdocs/00004E92.pdf (visited March 30, 2006). "Best efforts" is an affirmative defense/safe harbor, so the burden of establishing best efforts is on the party asserting it. *See Brady,* SOR at 3 (citations omitted). A committee's reasonable reliance on an assistant treasurer who embezzles money from the committee, and files inaccurate reports with the Commission, does not undermine the committee's affirmative defense/safe harbor.

Because the Commission's "best efforts" regulation focuses exclusively on occupation and employer information required to be reported by political committees, there is no specific guidance as to what internal controls constitute best efforts. In order to hold a political committee liable for errors arising from an agent's embezzlement, the Commission must examine whatever internal controls the

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committee maintained and consider whether any reasonable internal controls would have prevented the embezzlement and related reporting failures. *Cf. Orange County,* SOR at 2.

In this matter, Lockheed Martin appears to have had internal controls: A Lockheed Martin internal audit recommended separation of functions, *i.e.,* not having one person both process LMEPAC receipts and disbursement *and* reconcile banks accounts. However, LMEPAC did not implement this recommendation, and the alleged embezzlement followed.[12] LMEPAC's failure to ensure implementation of this specific recommendation, which likely would have prevented the embezzlement,[13] was reckless and, thus, did not constitute "best efforts to obtain, maintain, and submit the information required by this Act." For this reason, it is appropriate to proceed in this matter against LMEPAC and its treasurer in his official capacity. As the Commission noted in its reason to believe finding with respect to these two respondents, they knew or should have known of weaknesses in the internal controls of LMEPAC itself and did not take sufficient action to correct those weaknesses.

III. CONCLUSION

With this understanding, it is appropriate to proceed against LMEPAC and its treasurer in his official capacity.

July 27, 2006

Michael E. Toner
Chairman

David M. Mason
Commissioner

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[12] GCR at 3; *id* Attach. 3 at 2.

[13] While failure to follow internal controls is relevant to our determination whether a committee made best efforts, such a failure is not a *per se* violation any more than the existence of inadequate internal controls would be a *per se* defense. *Cf. Rupert v Clayton Brokerage Co*, 737 P.2d 1106, 1111-12 (Colo. 1987).