THE SECRETARY OF EDUCATION
WASHINGTON, DC 20202

APPLICATION OF THE PENNSYLVANIA DEPARTMENT OF EDUCATION,

Appellant.

Docket No. 11-33-R
Recovery of Funds Proceeding

DECISION OF THE SECRETARY

This matter comes before me on appeal by the Pennsylvania Department of Education ("PDE or Appellant") of an Initial Decision by Administrative Law Judge ("ALJ") Allan C. Lewis on February 28, 2014. In the case before Judge Lewis, PDE appealed a preliminary departmental decision (also known as a "program determination letter" or "PDL") issued on March 29, 2011, by the Assistant Secretary for Elementary and Secondary Education and the Assistant Deputy Secretary for Safe and Drug-Free Schools ("the Department" or "ED").

ED demanded the return of $9,968,423 in Title I and II funds for the period July 1, 2005, through June 30, 2006,[1] allegedly misspent by the Philadelphia School District ("Philadelphia" or "the District"). Specifically, in the PDL the Department initially sustained several audit findings by the Department's Office of Inspector General (OIG) totaling $9,968,423. Through settlement discussions, PDE and the Department agreed that $2,782,201 was barred from recovery under the statute of limitations,[2] and as such, there remains $7,186,222 in disputed liabilities in this matter.

PDE now appeals the Initial Decision as provided for by 34 C.F.R. § 81.42. Pursuant to 34 C.F.R. § 81.43(c), the Secretary may "affirm, modify, set aside, or remand the initial decision," in whole or in part. PDE requests that the Initial Decision be set aside in whole.

[1] In the PDL, ED disallowed $9,736,126 in direct costs. The PDL noted that these were incurred under Part A of Title I and Part A of Title II of the Elementary and Secondary Education Act ("ESEA") of 1965, as amended, as well as through the Safe and Drug-Free Schools and Communities Act. ED also stated in the PDL that PDE owed the Department $232,297 in indirect costs.

[2] *See* Joint Stipulation 1.

Background

While Judge Lewis' decision briefly outlines the facts that gave rise to this dispute,[3] I write here to add some additional detail regarding OIG's audit report and the Department's PDL.

Beginning in May 2007, OIG conducted a comprehensive audit of the District, a subgrantee of PDE, for the period of July 1, 2005, through June 30, 2006.[4] OIG issued a final audit report on January 15, 2010. In the final report, OIG sustained the findings in the draft report, and questioned $138.4 million dollars spent by the District, including $121.1 million in inadequately documented personnel costs.[5]

The audit had five findings.[6] Of the five, ED pursued three of them in the PDL: supplanting of Federal funding (finding two); inadequate enforcement of policies and procedures (finding four); and a failure to have written policies and procedures for various processes (finding five).

Regarding finding two, OIG found that Philadelphia used Federal grant funds to supplant state and local funding.[7] For example, after a review of 110 journal vouchers prepared by the District, OIG concluded that out of a possible $47,668,116, the District used $6,979,063 in state funds by entering into contracts with universities, a payment to a local deli for catering, and payments to Federal Express for shipping charges.[8] In its PDL, the Department affirmed that finding, and also concurred with OIG's determination that Philadelphia spent money on payments to a moving company and an entity that created custom banners.[9]

Significantly, OIG presented unrebutted evidence that Philadelphia initially paid for these items with State and local funds, and then switched the charges to Title I and II accounts, in violation of the rule prohibiting supplanting by Federal funds.[10] In particular, in its PDL, ED relied on the testimony of the District's chief financial officer, who stated that the District had a deficit of $66.1 million, and that the District transferred charges to Federal grant funds in order

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[3] *See* Initial Decision, p. 2-3.

[4] *See* "Philadelphia School District's Controls over Federal Expenditures, Final Audit Report" issued by the Office of Inspector General, U.S. Department of Education (January 2010), hereafter referred to as "OIG Audit." OIG Audit, p. 1.

[5] *See generally* OIG Audit. For the fiscal year ending on June 30, 2006, the Department awarded Philadelphia $245,328,919. According to OIG, the District spent $202,717,711 under various programs authorized by the Elementary and Secondary Education Act, as amended by No Child Left Behind, and the Individuals with Disabilities Education Act (IDEA), as amended. OIG Audit, p. 2.

[6] *See* OIG audit, pp. 9-25, and 51-66. Finding one found that Philadelphia needed stronger control over personnel expenditures charged to Federal grants and finding three stated that the District did not have adequate controls in place to ensure that non-payroll expenditures met Federal regulations.

[7] Supplanting occurs when a state or local education agency uses Federal funds to provide services which it had provided using state or local funds in the previous year. Title I of the Elementary and Secondary Education Act prohibits the practice of supplanting of state and local funds. *See* 20 U.S.C. § 6321(a).

[8] *See* OIG Audit, p. 25.

[9] PDL, p. 3.

[10] *Id.*, p. 7; OIG audit, p. 25.

to provide "deficit relief," thus alleviating Philadelphia's budget deficit in its General Fund.[11] Further, the District has not offered any evidence that its expenditures for contract personnel costs were paid out of Federal funds prior to March 30, 2006. In sum, the record demonstrates that the District changed the funding source of these charges on September 30, 2006, from its General (non-Federal) Fund to Title I, Part A, Federal funds.

Concerning finding four, OIG concluded that the District did not enforce its policies for processing financial transactions, including but not limited to contracting. For example, the audit report concluded that Philadelphia transferred the cost of salaries for two employees to the Safe and Drug-Free Schools and Communities Act ("SDFSCA") grant even though the employees were not working on the grant.[12] Further, OIG found that the District transferred $265,026 to pay fringe benefits for English for Speakers of Other Languages (ESOL) teachers using Title I, Part A even though the employees were not eligible for these benefits.[13] Finally, OIG found that the District made $1,403,071 in duplicate charges for preparation time for teachers under Title I, Part A.[14] Philadelphia acknowledged this contracting error.[15] As a result, the PDL affirmed the audit report finding that Philadelphia misspent a total of $1,817,952 in direct and indirect costs.[16]

In finding five, OIG determined that the District did not have written policies and procedures for various fiscal processes, especially with regard to grant budgets.[17] OIG concluded that the District violated Federal regulations that require the District to compare actual expenditures to budgeted amounts for the grant "because *the District did not have a line item budget for Title I and Reading First grants.*" (Emphasis added).[18]

For example, OIG found that the District's lack of procedures resulted in $1,293,386 in inappropriate travel expenditures for charter school students. The District did not have policies in place regarding whether the District could charge bus transportation costs to Federal grants. Absent policies or documentation in place, OIG concluded that the District improperly charged transportation costs to its Title I grant.[19] The PDL agreed with the OIG report that the District inappropriately charged transportation costs in violation of Federal regulations.

The OIG report also noted that without policies in place, the District also used Title I funds to purchase a mini fridge, a microwave oven, greeting cards, soap, and other cleaning supplies. OIG deemed all of these purchases to be unallowable costs because they did not support the grant's purposes.[20]

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[11] PDL, p. 4.
[12] OIG Audit, p. 34.
[13] *Id.*
[14] *Id.*; PDL, p. 15.
[15] *Id.*
[16] PDL, pp. 21-23.
[17] OIG audit, p. 51.
[18] *See* 34 C.F.R. § 80.20(b)(4).
[19] OIG Audit, pp. 24-25.
[20] *Id.*, p. 58.

In short, OIG concluded that Philadelphia violated the fundamental internal control requirement that "[e]ffective control and accountability must be maintained for all grant and subgrant cash, real and personal property, and other assets. Grantees and subgrantees must adequately safeguard all such property and must assure that it is used solely for authorized purposes."[21] Because Philadelphia did not have a district-wide policy in place to monitor budgets, the District conducted no budget monitoring whatsoever.[22]

PDE appealed the PDL on May 20, 2011, resulting in the ALJ's decision before me.[23] I now turn to the merits of PDE's arguments.

Discussion

On appeal, PDE makes the same two legal arguments that it raised with the ALJ below. First, PDE argues that the ALJ applied the incorrect legal standard in reaching his conclusion that the statute of limitations did not bar the Department from recovering $5.3 million in impermissible contract and personnel expenditures by PDE.[24]

Second, the appellant contends that the Initial Decision incorrectly denied PDE's request for an equitable offset. Specifically, the appellant contends that Judge Lewis' opinion both creates a new standard for equitable offset that is contrary to previous decisions by the Office of Administrative Law Judges (OALJ), and violates the Administrative Procedure Act (APA).[25] PDE also argues that the recent corrective actions undertaken by Philadelphia merit the application of equitable offset.[26]

In its response to PDE's appeal, the Department raises two issues not addressed by the Initial Decision. First, the Department strongly objects to PDE's argument that corrective actions, in and of themselves, require a finding of equitable offset.[27] Second, ED requests that I limit the findings of my decision to the facts of the case.[28] I will address these arguments in turn, and I start with the statute of limitations discussion.

I.

PDE first argues that the funds at issue cannot be recovered because they are protected by the statute of limitations, which provides that:

> "A recipient that made an unallowable expenditure or otherwise failed to discharge its obligation to account properly for funds shall return an amount that...(e)xcludes any amount expended *in a manner not authorized by law* more

[21] 34 C.F.R. § 80.20(b)(3).
[22] *Id.*; *see also* 34 C.F.R. § 80.20(b)(4).
[23] Pennsylvania Department of Education Appeal to the Secretary ("Appeal"), p. 1.
[24] Appeal, pp. 5-9.
[25] *Id.*, pp. 10-22.
[26] *Id.*, pp. 21-22.
[27] Assistant Secretary for Elementary and Secondary Education's Response to the Pennsylvania Department of Education's Appeal to the Secretary ("Response"), pp. 27-28.
[28] Response, p. 29.

than five years before the recipient received the notice of a disallowance decision under § 81.34."[29] (Emphasis added.)

PDE argues that any obligation of funds, regardless of whether it is made using Federal funds or state and local funds, should be considered an expenditure and, therefore, start the clock for statute of limitations purposes for all funds expended in furtherance of that commitment. In this case, PDE asserts that it entered into contracts, and thus obligated funds, with two vendors prior to March 30, 2006 (the date five years prior to the issuance of the PDL on March 29, 2011).[30] As such, PDE argues that the Federal funds expended toward those contracts are outside of the scope of the statute of limitations.[31]

The Department urges that the appropriate reading of the regulation is that the phrase "in a manner not authorized by law" explicitly references the obligation of *Federal funds*. As a result, the Department submits that only when the funds take on a Federal identity should they be deemed obligated for purposes of Federal regulations. Because the contract costs were not charged to Federal accounts until July and September of 2006, the Department argues the Federal obligation of the funds took place within the five-year statute of limitations and the funds are recoverable.[32]

I agree with the Department that the phrase "in a manner not authorized by law" references the grants and programs administered by the Department. Therefore, the regulation is best read as applying only to ED programs and funds. As a result, PDE's argument that its initial contract obligations, using *no Federal funds*, started the statute of limitations clock prior to March 30, 2006, fails. The operative dates are July and September of 2006, when Federal accounts were charged, which are within the five-year statute of limitations window provided. As a result, the funds are subject to recovery by the Department. PDE's preferred reading of the regulation would lead to the illogical result that a grantee could place Federal funds instantly out of reach merely by applying them toward a contract entered into years prior with non-Federal funds. For the reasons outlined above, I affirm the reasoning and holding of the ALJ's decision on the statute of limitations argument in the Initial Decision.[33]

II.

I turn now to PDE's arguments on the application of equitable offset to the facts of this case. For the reasons discussed in more detail below in section B, I decline to adopt the standard set out in the Initial Decision, but I nevertheless affirm the outcome on this matter.[34]

I believe that an overview of the doctrine of equitable offset is necessary. I will consider previous rulings establishing and applying the theory of equitable offset. Then, I will exercise

[29] *See* 34 C.F.R. § 81.31(c) (emphasis added).
[30] Appeal, pp. 3-4; *see* Joint Stipulation 3.
[31] Appeal, p. 5.
[32] Response, p. 7.
[33] *See* Initial Decision, pp. 4-9.
[34] *Id.*, p. 12.

my *de novo* review authority to analyze whether the ALJ correctly applied the relevant precedent.

A.

The doctrine of equitable offset is a long-established, equitable remedy first recognized by the Education Appeals Board ("EAB") and now by the OALJ. This doctrine operates to reduce a grantee's liability by allowing a grantee to substitute disallowed costs with expenditures that were not made with Federal funds but were made in furtherance of the purpose of the grant.[35]

In one of the earliest decisions discussing the doctrine, *Consolidated Appeals of the Florida Department of Education*, the EAB held that it had the authority to apply the doctrine to a case involving duplicate funding. The EAB summarized the doctrine by stating:

> The issue herein is whether this panel has authority to allow an equitable offset if the evidence justifies it. *Appellant is not entitled to such as offset as a matter of right*....If the Panel further concludes that an offset *is required to achieve the aims of the governing statutes and regulations*, it will be within the authority of this Panel to order such an offset... (emphasis added).[36]

While more recent decisions by the OALJ have continued to refine the doctrine, the *Consolidated Appeals of Florida* statement remains a useful summary of the doctrine.

The doctrine was next applied in a case involving the North Carolina Department of Education's inappropriate use of vocational education money to purchase a membership in an automated computer cataloging system for the state's community colleges. North Carolina argued that the state should be entitled to an equitable offset for the $344,829.38 at issue. In analyzing the state's request, the ALJ noted that "under appropriate circumstances... allowable expenditures are permitted to be offset...."[37] In *North Carolina*, the ALJ ordered an evidentiary hearing to determine whether the state had satisfied its burden of proof that the offset "achieves the aims of the governing statute and regulations and the particular expenditure constitutes an allowable cost under the Federal grant program."[38]

Subsequently, in *In re Pittsburg Pre-School and Community Council*, a nonprofit organization sought the recovery of funds under the Early Reading First (ERF) and Migrant Education Even Start (MEES) programs. Based on the results of a detailed OIG audit, the Department issued a PDL seeking payment of $526,272 in impermissible expenses. Pittsburg sought an equitable offset for $68,645.10 for the salaries of staff members it claimed were paid

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[35] *See In re New York State Department of Education*, Dkt. No. 90-70-R, U.S. Dep't of Educ. (April 21, 1994) and *In re Pittsburg Pre-School and Community Council, Inc.*, Dkt. No. 09-20-R, U.S. Dep't of Educ. (May 16, 2012.).
[36] *See Consolidated Appeals of the Florida Department of Education,* Docket Nos. 29(293)88, 33(297)88, EAB Decision. (June 29, 1990.)
[37] *See North Carolina Department of Public Instruction*, Interlocutory Decision, Dkt. No. 91-86-R, U.S. Dep't of Educ. (October 13, 1993.)
[38] *North Carolina*, p. 6.

for with non-ERF funds.[39] In resolving the *Pittsburg* claim, the ALJ applied the *Florida* standard by first determining the source of the payments for the salaries and then analyzing whether the salaries were reasonable expenditures under the purpose of the grant. The ALJ concluded that an equitable offset was not appropriate for two of the three employees because they were not reading specialists as required by the grant application. Therefore, the tribunal denied the offset petition as to those employees.[40]

Finally, *In re Arizona Department of Education* is also instructive as to the contours of the equitable offset standard.[41] The *Arizona* case involved the inappropriate use of travel funds that were not in furtherance of the purpose of the grant. The violations were limited to three employees in one office. Once the improper expenditure was identified, the grantee notified the Department, admitted its error, explained that all three employees had been either disciplined or fired, and repaid the Department for the amount at issue. In granting the request for equitable offset, the ALJ held that even though the expenditures were not in furtherance of the grant, the limited nature of the violation as well as Arizona's prompt action mitigated the arguments against applying the equitable offset doctrine. Further, the Department did not object to the offset.[42]

This line of cases demonstrates that the appropriateness of applying the equitable offset doctrine is a fact-intensive determination to be made in light of the circumstances of each case. As such, I now turn to the facts relevant to the case before me to determine whether equitable offset is appropriate here.

B.

PDE argues that it has presented justification for an equitable offset in the amount of $8,876,952 under Title I, Part A. PDE notes that contracts related to after school tutoring and summer school programming, as well as bullying prevention activities, qualify for consideration of an offset.[43] Further, the record indicates that the District contracted with two vendors – Voyager Expanded Learning, Inc. and Princeton Review, Inc. – for services and materials related to after school and summer school initiatives designed to help students struggling in reading and math during the audit year.[44] Specifically, Philadelphia paid $3,141,952.10 to Voyager and $5,734,999.50 to Princeton Review with non-federal funds during the audit year for the services provided under these contracts.[45]

In response to the Department's arguments that equitable offset is a "fairness" doctrine that should not apply in this case due to the serious nature of the violations and the gross misuse of funds, PDE contends that this case is more similar to the *Arizona* decision. As such, PDE believes that *Arizona* establishes the principle that an Appellant is entitled to an offset in the case of an intentional and fraudulent violation. Moreover, PDE also claims that our prior precedents

[39] *Pittsburg*, p. 33.
[40] *Pittsburg*, pp. 18-19, 35-36.
[41] *In re Arizona Department of Education*, Dkt. No. 06-07-R, U.S. Dep't.of Educ. (August 12, 2010.)
[42] *Arizona*, p. 2.
[43] Appeal, p. 19.
[44] Joint Stipulations 17, 23, and 30.
[45] Joint Stipulations 18, 24, and 32.

in *Pittsburg* and *Arizona* mandate the application of the doctrine and remove the trier of fact's discretion to weigh the equities before deciding whether to apply the offset.[46]

In addition, PDE claims that the Department violated the Administrative Procedure Act because the Initial Decision created a new standard for applying the equitable offset doctrine.[47] PDE suggests that the ALJ completely misread the equitable offset precedents in finding against PDE. Finally, PDE argues that the District took immediate corrective actions as soon as the audit report was issued, and that such actions are "mitigating circumstances" that merit application of the offset.[48]

C.

As discussed in Section A, previous equitable offset cases provide a road map as to when triers of fact should consider whether to apply the doctrine. The cases make clear that equitable offset is at the discretion of the trier of fact, and that the Appellant has the burden of proof to demonstrate that funds should be offset. Significantly, the Appellant must demonstrate that the offset is in furtherance of the purpose of the grant. Further, the cases suggest that a variety of factors may impact the ultimate decision, including but not limited to the severity of the violation (honest or clerical error v. more serious violation), whether supporting documentation may be missing, and whether a grantee immediately acknowledged the mistake and took action to remedy the violation. In sum, triers of fact must analyze each request for equitable offset individually, considering also the scope and persuasiveness of the underlying actions, whether the grantee acted in "good faith" in response to the issue, and the arguments, if any, that the Department offers in opposition to the request for offset.

As the ALJ correctly noted below:

> This tribunal gleans from prior cases that the "equitable" aspect of an equitable offset consideration involves an analysis of the facts and circumstances surrounding the original infraction. Central to this consideration are the seriousness and scope of the violation(s) and any mitigating circumstances.[49]

Applying this precedent to the facts before me, I conclude that the ALJ correctly decided that PDE is not entitled to an equitable offset. In particular, I find the Initial Decision's conclusion that the District acted "to ease its financial stress" and with "deliberate disregard for the regulations in transferring funds" to be supported by the OIG audit report and PDL.[50] Moreover, PDE has failed to produce any evidence that such transfers were in furtherance of Title I and II programmatic goals.[51]

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[46] Appeal, p. 14.
[47] Appeal, pp. 12-14.
[48] *Id.*, pp. 21-22.
[49] *Id.*
[50] PDL, p. 4; OIG Audit, pp. 25-27.
[51] I decline to adopt the more formal two-part standard outlined in the Initial Decision on page 12 at this time. While Judge Lewis has provided a helpful guide that effectively captures much of the precedent in this area, I think the Department is better served by ALJs exercising their discretion to apply the equitable offset doctrine using a case-by-case, fact-specific analysis.

In contrast to *In re Pittsburg* and *In re Arizona*, the OIG audit report contains evidence of a complete breakdown in the basic budgetary practices required by Federal grant regulations. Failures of the magnitude here, including lacking a system for recording time and attendance for grant personnel, are too widespread in their scope and too deep in their reach to merit an offset. Finally, the District did not come forward to the Department to acknowledge its failures to comply with the grant regulations. Absent the OIG audit, it's unclear when or whether these practices would have been addressed. The District's mismanagement clearly resulted in improper expenditures that have undoubtedly caused harm to the taxpayers, and potentially to the children in the District's school system. Finally, I agree with the Department's argument that granting an equitable offset in this case would undermine the Department's broader ability to ensure the integrity of its grant programs through the effective enforcement of grant monitoring findings.

Having concluded that an equitable offset is not appropriate based on PDE's actions prior to issuance of the audit report, I next turn to PDE's argument that its subsequent ameliorative actions support application of an equitable offset.

D.

In its response to the PDE appeal, the Department asks me to clarify that a grantee's efforts at corrective action do not automatically merit the granting of equitable offset.[52] PDE argues that immediately after receiving the final audit report from OIG, the District began working with the state of Pennsylvania and the Department's Risk Management Service ("RMS") to implement corrective action.[53] In particular, PDE notes that Philadelphia has recently hired an outside consultant to conduct a risk assessment, drafted and implemented grant administration policies and procedures, and created a Grants Compliance Office.[54]

The Department counters that grant recipients have a responsibility to ensure that they spend their Federal grant money in accordance with applicable programmatic requirements.[55] The Department suggests that granting an equitable offset when a grantee is merely doing what is required of it would be a "travesty."[56] In sum, the Department urges me to clarify that the efforts of a grantee to come into compliance with Federal requirements do not merit the use of the equitable offset remedy.

I agree with the Department that Philadelphia's actions since the date of the final audit report, albeit notable for the scope of their improvement, have merely enabled the District to demonstrate compliance with Federal grant regulations. Applying the factors that I analyzed earlier, given the seriousness of the violations outlined in the OIG report, I conclude that Philadelphia's corrective actions, though positive, do not require that I apply an equitable offset. However, it should not be overlooked that these corrective actions, while not producing the

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[52] Appeal, pp. 27-28.
[53] *Id.*, p. 21.
[54] *Id.*, p. 22.
[55] Response, p. 27; *see also* 34 C.F.R. § 75.700 and 34 C.F.R. § 76.700.
[56] Response, p. 28.

outcome sought here, have enabled the Department to continue providing grants to the District through a range of grant programs, and have no doubt improved the fidelity with which funds are reaching and benefiting students in the District.

E.

Finally, in its Response to PDE's appeal, the Department asks that I limit the decision to the facts of this case. As discussed earlier, I decline to adopt a bright line rule for applying equitable offset as suggested by the ALJ on page 12 of the Initial Decision. The case law makes clear that this doctrine should be applied on a case-by-case basis at the discretion of the trier of fact if all the evidence justifies an offset. As such, I do not address PDE's argument that the Department violated the Administrative Procedure Act by creating a new standard without going through rulemaking.

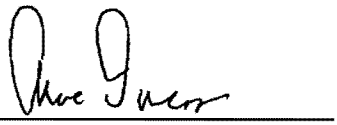
This case presents unique facts. It involves a district-wide audit and the conclusion that Philadelphia lacked basic policies and procedures to monitor federal grant money. While I agree with the legal conclusions reached by Judge Lewis below, the facts of this case differ significantly from previous equitable offset decisions. Accordingly, I conclude that this decision shall be limited to the parties.

ORDER

ACCORDINGLY, the Initial Decision by Administrative Law Judge Allan C. Lewis is HEREBY AFFIRMED as the Final Decision of the Department.

It is FURTHER ORDERED that the Pennsylvania Department of Education shall pay the sum of $7,186,222 to the U.S. Department of Education.

So ordered this 29th day of December 2014.



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