North Carolina Department of Public Instruction,
Respondent.

Docket No. 91-86-R
Recovery of Funds Proceeding

ACN: 04-03235-G

INTERLOCUTORY DECISION

Appearances: Thomas J. Ziko, Esq., of the North Carolina Department of Justice, Raleigh, North Carolina for the Respondent

Stephen H. Freid, Esq., of the Office of the General Counsel, United States Department of Education, Washington, D.C., for the Office of the Assistant Secretary for Vocational and Adult Education

Before: Judge Allan C. Lewis

On October 2, 1991, the United States Department of Education through the Assistant Secretary for Vocational and Adult Education (Education) issued a preliminary departmental decision asserting that the North Carolina Department of Public Instruction (North Carolina) improperly expended $707,163 under grants available pursuant to the Carl D. Perkins Vocational Education Act, Pub. L. No. 88-210, 77 Stat. 403 (1963), as amended by Pub. L. 98-524, 98 Stat. 2435 (1984) (to be codified as amended at 20 U.S.C. §§ 2301-2471). Subsequently, Education conceded that the statute of limitation barred the recovery of $372,333.62 and, therefore, its claim is limited to $334,829.38.

In its timely appeal of the preliminary departmental decision, North Carolina asserts three grounds to deny Education's claim. First, it urges that Education failed to issue the preliminary departmental decision within six months after the issuance of the final audit report as required by Item 12 of the Appendix to 34 C.F.R. Part 80 (1990). Therefore, North Carolina argues that Education's claim is barred. Second, North Carolina asserts that the Department was not harmed by the improper expenditures relating to the Solinet contract and, therefore, a recovery of these expenditures is not appropriate. Third, North Carolina asserts an equitable offset which is in excess of the amount of the alleged improper expenditures and, therefore, argues that no recovery is warranted.

For the reasons stated infra, it is determined that Item 12 of the Appendix to Part 80 of the regulations is not a bar to any recovery in this case; that the appropriate measure of damages due to the improper expenditures was the full amount sought by the Department; and that an evidentiary hearing is necessary to ascertain the amount of the equitable offset.

STATEMENT OF FACTS

During the program fiscal years 1987 through 1990, North Carolina expended Perkins Act funds to pay for a membership in and use of an automated computer cataloging system (Solinet contract) for its libraries at the State's 58 community colleges. The cost of the Solinet contract for each program fiscal year was as follows:

Program Fiscal Year	Cost
1987	$ 79,698.36
1988	86,643.20
1989	99,585.90
1990	68,901.92
Total	$ 334,829.38

The Solinet system was used as a database to identify and catalog library books owned by the State's community colleges. These library books were used in the vocational education programs and the liberal arts curricula.

The parties agree that the cataloging system benefitted all students attending North Carolina's community colleges who used the schools' library facilities. This included students in the liberal arts curriculum who were not designated recipients under the Perkins grants and vocational and technical education students who were the designated recipients under the Perkins grants in question.

North Carolina charged the Solinet contract expenditures as a direct administrative cost against the Perkins grants. These expenditures were disallowed following an audit of the program. The audit by state officials was completed and received by Education on September 10, 1990. On January 17, 1991, an audit report was issued. More than nine months later on October 2, 1991, Education issued a preliminary departmental decision which sought the recovery of the disallowed Solinet contract expenditures.

THE PRELIMINARY DEPARTMENTAL DECISION ISSUE

The first dispute between the parties is whether Education's failure to issue the preliminary departmental decision within six months after the issuance of the final audit report by the State Auditor for North Carolina precludes the recovery of any monies which North Carolina may have misspent. The controversy concerns

Item 12 of the Appendix to 34 C.F.R. Part 80 which provides--

> [r]esolution [of audit findings] shall be made within six months after receipt of the report by the Federal departments and agencies. Corrective action should proceed as rapidly as possible.

North Carolina argues that Item 12 imposes an express limitation on the Secretary's authority to issue a preliminary departmental decision. Thus, any preliminary departmental decision which is

not issued in a timely fashion is without force and may not be employed to collect any misspent Federal funds.

North Carolina urges that, in the regulatory scheme, Item 12 is complementary to the pertinent statute of limitation in audit proceedings, Section 452(k) of the General Education Provisions Act (hereinafter 20 U.S.C. § 1234a(k)). According to North Carolina, a statute of limitation offers a safe haven to recipients of Federal funds which precludes their recovery. Thus, Section 1234a(k) provides--

(k) Limitation period respecting return of funds
No recipient under an applicable program shall be liable to return funds which were expended in a manner not authorized by law more than 5 years before the recipient received [a] written notice of a preliminary departmental decision.

Hence, North Carolina urges that Item 12 and 20 U.S.C. § 1234a(k) are complementary provisions as the former provision governs the timely issuance of a preliminary departmental decision and the latter provision restricts the amount which may be recovered from a recipient.

Education agrees that Item 12 of the Appendix to Part 80 is not a statute of limitation. In its view, however, the Appendix to Part 80, including Item 12, provides the general rules and procedures for audits. While Item 12 provides an approriate time frame in which a preliminary departmental decision should be issued, it is not a statute of limitation and the issuance of an untimely preliminary departmental decision does not bar the Department from recovering misspent funds.

Statutes of limitation specifically limit liability or otherwise bar claims or causes of action due to the failure by one party to take appropriate action within a specified period of time. While North Carolina casts its argument in terms of an express limitation on the Secretary's authority to issue a preliminary departmental decision, the substance of its position is identical to the objective of a statute of limitation affecting a government's right to recover funds, i.e. Item 12 bars the Secretary from recovering allegedly misspent funds. Thus, North

Carolina's argument constructs a purported semantical difference which has no basis in fact. Hence, the question is whether Item 12 of the Appendix in the regulations constitutes a statute of limitation.

"Statutes of limitation sought to be applied to bar rights of the Government, must receive a strict construction in favor of the Government." Badaracco v. United States, 464 U.S. 386, 391 (1984), quoting E.I. Dupont de Nemours & Co. v. Davis, 264 U.S. 456, 462 (1924). In a similar fashion, strict construction is warranted in ascertaining whether a provision constitutes a statute of limitation.

A statute of limitation provision indicates clearly the consequences of a failure to act in a timely fashion. For example, Section 1234a(k) mandates the consequences of the Department's failure to issue a preliminary departmental decision within the prescribed period as it provides "[n]o recipient under an applicable program shall be liable to return funds . . . ." Similarly, Section

6501(a) of the Internal Revenue Code of 1954 (26 U.S.C. § 6501(a) (1992)) provides that the amount of any tax shall be assessed by the Internal Revenue Service within three years of certain events and that "no proceeding . . . for the collection of such tax shall be begun after the expiration of such period." In contrast, Item 12 of the Appendix does not indicate the consequence of a failure to issue the preliminary departmental decision within the six month period. Thus, Item 12 does bear the attributes of a statute of limitation.

In addition, interpretation accorded Item 12 of the Appendix by North Carolina is inconsistent with the Congressional intent regarding the recovery of misspent Federal funds by the Secretary. Congress devised a statutory scheme in which the preliminary departmental decision is the mechanism by which the Secretary recovers misspent funds. 20 U.S.C. § 1234a(a). Under Section 1234a(k), the limitation on recovery by the Secretary is keyed to the date of the expenditure and the subsequent date of the receipt of the preliminary departmental decision by the grant recipient. Under this approach, Congress excluded from consideration in this statute of limitation all other intervening events, actions, or inactions which occurred between these two events. Thus, the period of time between the issuance of the final audit report and the issuance of a preliminary departmental decision is not a factor under this statute of limitation. Yet, North Carolina's construction of Item 12 of the Appendix utilizes precisely this period of time as the basis for creating a second statute of limitation which would operate within the parameters of an existing statute of limitation. Such a construction is inconsistent with the statutory scheme enacted by Congress and would bar the recovery of Federal funds that are otherwise recoverable under the existing statutory scheme.

The Secretary is authorized to promulgate regulations interpretating the governing statutes. Such regulations must be consistent with the governing statutes and construed in such a manner. When viewed in this light, Item 12 of Appendix, Part 80 of 34 C.F.R. is a regulation which provides only guidance to the Department regarding the issuance of a preliminary departmental decision and that a failure to comply therewith does not invalidate or otherwise bar the recovery sought therein.

THE ISSUE REGARDING THE AMOUNT OF RECOVERY DUE TO THE DISALLOWED SOLINET CONTRACT EXPENDITURES

North Carolina admits that the cataloging of new library books by the Solinet system benefitted programs which were not associated with the vocational education programs offered at its community colleges and, therefore, this aspect was unrelated to the objectives of the Perkins grant. Education, on the other hand, agrees that the expenditures for the Solinet system benefitted the vocational education programs at the community colleges and, therefore, were related in part to the objectives of the Perkins grant. Thus, it is apparent that some portion of the costs at issue were expended to promote the cost objectives under the Perkins grant received by North Carolina.

The parties agree that the costs in issue are not direct costs. The parties also agree that the costs in issue constitute joint costs which, as indirect costs under OMB Circular A-87, means that these costs benefitted objectives which were part of the Perkins grant and objectives which were not part of the Perkins grant. As noted by both parties, the rules governing grants, as set forth in

OMB Circular A-87, require joint costs to be allocated pursuant to a cost allocation plan which determines the actual amount of the indirect cost allocable to the program or a plan which utilizes a predetermined fixed rate to compute the amount of indirect costs applicable to a grant.

North Carolina concedes, however, that it did not have in effect, during the years in issue, a cost allocation plan which would have determined the actual amounts of the Solinet contract expenditures allocable to the Perkins grants. In addition, North Carolina also charged the Perkins grants its agreed upon 6.4% predetermined rate for indirect costs. Under these circumstances, Education argues, and North Carolina does not dispute, that it was improper to charge the Solinet contract expenditures as a direct cost against the Perkins grants or to recover these expenditures as indirect costs. Therefore, Education asserts that the amount of the Solinet expenditures must be repaid to the Department.

As North Carolina correctly notes, the Department's recovery is limited to an amount which is proportionate to the harm caused to a Federal interest under 20 U.S.C. § 1234b(a)(1). Section 1234b(a)(1) provides that--

[a] recipient determined to have made an unallowable expenditure, or to have otherwise failed to discharge its responsibility to account properly for funds, shall be required to return funds in an amount that is proportionate to the extent of the harm its violation caused to an identifiable Federal interest associated with the program under which the recipient received the award.See footnote 1 1/

A Federal interest, which may be harmed by an unallowable expenditure or an accounting deficiency, "includes, but is not limited to . . . providing only authorized services or benefits; . . . preserving the integrity of . . . recordkeeping, and reporting requirements; and maintaining accountability for the use of funds." 20 U.S.C. § 1234b(a)(2) (1988). Hence, under appropriate circumstances, the amount of the recovery attributable to an unallowable expenditure may be reduced.

North Carolina maintains that no harm was caused to a Federal interest in this case because there were two alternatives under which the Solinet contract costs or related costs could have been properly charged against the Perkins grants if it had taken either of these actions prior to the years in issue. According to North Carolina, it could have adopted a cost allocation plan with respect to its indirect costs incurred in its library cataloging activities and that such a plan would have then permitted charges against the Perkins grants in excess of the disallowed Solinet contract charges. The other alternative was to negotiate a higher indirect cost rate to charge the Perkins grants under which it would have recovered an amount exceeding the annual cost of the Solinet contract.

Both alternatives, however, ignore the realities of the situation. Under the facts and the accounting method utilized by North Carolina, the Federal interest was harmed to the extent that the Solinet contract expenditures produced unauthorized services or benefits. Moreover, an improper accounting practice, while not an imposing factor in this case, is also a Federal interest which may be harmed. Thus, the issue is limited to determining the extent that the Federal interest was not damaged by virtue of unallowable expenditures.

North Carolina's proposed cost allocation plan does not establish the extent that the Solinet contract expenditures provided authorized benefits to vocational and technical students or unauthorized benefits to other students. This approach assumes that the overall percentage of vocational and technical students within the student body attending the community colleges somehow proves the amount of the Solinet contract expenditures allocable to this group. There is no evidence in this case which establishes that benefits and costs are directly related to the percentages of students. Similarly, North Carolina's proposed revised indirect cost rate provides no help. This calculation of the indirect cost rate includes a myriad of indirect costs which are unrelated to the Solinet contract expenditures such as costs associated with the state president's office and the public affairs office. Therefore, this approach offers no assistance in ascertaining a reasonable amount of the benefits from the Solinet contract expenditures which accrued to the vocational and technical students. Though common sense dictates that some benefits accrued to this group, the record is devoid of any basis to ascertain the amount of these benefits. Accordingly, no reduction in the amount claimed by the Department is appropriate in this regard.

THE EQUITABLE OFFSET ISSUE

Lastly, North Carolina argues that, under the theory of equitable offset, it incurred expenditures which were not claimed as part of the grant, but yet were allowable expenditures under the grant and, therefore, any disallowed expenditures under the grant may be offset by these other expenditures. It asserts that direct administrative expenditures were incurred during the years in issue which were in excess of the $334,829.38 in disallowed expenditures attributable to the cataloging of library books. Therefore, according to North Carolina, the Department is not entitled to any recovery in this case.

Education denies that the doctrine of equitable offset is available in audit proceedings. In its view, equitable offsets are excluded from consideration by the recent enactment of 20 U.S.C. § 1234b(a)(1) (1988) which limits the Department's audit recovery to the harm caused to the Federal interest in the appeal proceedings. Section 1234b(a)(1) was enacted in 1988 as part of the legislation which altered the administrative audit appeal process within the Department by creating the Office of Administrative Law Judges to replace the Education Appeals Board as the forum which would resolve appeals of final audit determinations.

Under the prior administrative process in which the Education Appeals Board reviewed appeals of final audit determinations, the doctrine of equitable setoff was well established under judicial decisions and administrative decisions by the Secretary.

Calfornia Dep't of Educ. v. Bennett, 849 F.2d 1277 (9th Cir. 1988); Tangipahoa Parish Sch. Bd. v. United States Dep't of Educ., 821 F.2d 1022 (5th Cir. 1987); See also Bennett v. Kentucky Dep't of Educ., 470 U.S. 656 (1985); In re State of New York, Dkt. No. 26(226)86, U.S. Dept. of Educ. (Supplemental EAB Decision after Remand June 27, 1989), 63 Educ. L. Rep. 1183; Consolidated Appeals of the Fla. Dep't of Educ., Dkt. Nos. 29- 293-88 and 33-297-88, U.S. Dept. of Educ. (EAB Decision June 26, 1990), 69 Educ. L. Rep. 1373. Within this administrative process, there was no conflict between the allowance of an equitable offset and the statute governing the amount of the recovery due to the misuse of Federal funds.

The recovery of misused Federal funds under the administrative process involving the Education Appeals Board was governed by 20 U.S.C. § 1234a(d) (1987) which provided that--

> a final decision of the Board . . . upholding a final audit determination against a State or local educational agency shall establish the amount of the audit determination as a claim of the United States . . . .

The Education Appeals Board was firmly of the view that, consistent with the statute and regulations, it was obligated to consider equitable offsets--

> it is the intention of federal appellate courts reviewing the Secretary's decisions to inject the doctrine of fairness [into determining the amount of the recovery, if any,] including application of equitable offset or credit, where state educational services which support the legislative intent are actually performed, even though they were not originally charged to the appropriate federal grant.

In re State of New York, 63 Educ. L. Rep. at 1185.

The replacement of the Education Appeals Board by Congress in 1988 necessitated a change in the recovery statute. Accordingly, Congress modified the statute to create the Office of Administrative Law Judges and, at the same time, changed the language which determined the amount of the recovery in an audit proceeding. The recovery was made proportional to the harm to the Federal interest. Thus, newly enacted 20 U.S.C. § 1234b(a)(1),See footnote 2 2/ which is applicable in this case, provided

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that the return of funds--

> shall be . . . in an amount that is proportionate to the extent of the harm its violation caused to an identifiable Federal interest associated with the program under which the recipient received the award.

Neither this provision nor its legislative history reflect that Congress intended to preclude the application of the doctrine of equitable offset in ascertaining the ultimate amount of any recovery by the Secretary. H.R. 95, 100th Cong., 1st Sess., at 94-95, 138 (1987). Moreover, equitable offsets reflect generally funds which were expended by the state and not claimed in connection with the grant although they constitute allowable expenditures. Under appropriate circumstances, these allowable expenditures are permitted to offset, in effect, expenditures disallowed under the audit and appeal process. Section 1234b(a)(1) (1988), like its predecessor Section 1234a(d) (1987), addresses only the measure of recovery attributable to the disallowed expenditures. Therefore, the doctrine of equitable offset is not precluded under Section 1234b(a)(1) (1988).

In addition, this issue was also addressed and resolved against the Department in In re Col. State Bd. for Community Colleges and Occupational Educ., Dkt. Nos. 89-41-R and 90-35-R, U.S. Dept. of Education (Interlocutory Order July 31, 1992). The tribunal agrees with the rationale of this Interlocutory Order and notes, in particular, that the equitable offset "remedy exists apart

from the [revised] statute and there is nothing in the statute which can be construed to remove any applicable equitable remedies." Id. at 6. Therefore, as a matter of law, the doctrine of equitable offset is applicable in the review of audit determinations before the Office of Administrative Law Judges.

Even though an equitable offset may be raised, the parties dispute whether North Carolina incurred expenditures which would qualify as an equitable offset. In this regard, Education argues that an equitable offset may be allowed only where the expenditure achieves the aims of the governing statute and regulations and the particular expenditure constitutes an allowable cost under the Federal grant program. Based upon the current submissions, Education asserts that North Carolina failed to prove both aspects.

Initially, the disallowed expenditures were incurred by a subgrantee, the North Carolina Department of Community Colleges, to catalog library books in its computer system. These expenditures were claimed by the grantee, the North Carolina Department of Public Instruction, as direct administrative costs under its Perkins grant. Under the terms of the grant, North Carolina could, and did claim, 7 percent of its federal allotment for purposes of the administration of its vocational education

plan provided it matched those federal funds with state funds on a dollar-for-dollar basis. 20 U.S.C. §§ 2312 and 2462(a)(1).

Under the doctrine of equitable offset, North Carolina seeks to utilize other expenditures which it characterizes as allowable, direct administrative costs that it did not charge to the Perkins grant due to the percentage limitation. These expenditures were also incurred, according to North Carolina, by the Department of Community Colleges, in administering the post-secondary portion of North Carolina's vocational education plan. In this regard, North Carolina relies upon its Financial Status Reports and an affidavit to establish the nature and amount of the proposed offset. Education responds that this evidence is insufficient to establish these matters and that the reports are unaudited.

The peculiar nature of these proceedings is such that submissions are filed by the parties and following a review thereof, the administrative law judge may order an evidentiary hearing to resolve a material factual issue. 34 C.F.R. § 81.6(b). An evidentiary hearing is appropriate in this instance to permit the parties to present evidence regarding the nature and the amount of expenditures by North Carolina which may qualify as administrative expenditures and, therefore, constitute an equitable setoff against the proposed recovery of $334,829.38. An order governing further proceedings will be issued shortly and this matter will be resolved following an evidentiary hearing.

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Allan C. Lewis
Administrative Law Judge

Issued: October 13, 1993
Washington, D.C.

Footnote: 1 1/ In a similar fashion, 34 C.F.R. § 81.22(a)(1) provides that "[a] recipient that made an unallowable expenditure or otherwise failed to account properly for funds shall return an amount that is proportional to the extent of the harm its violation caused to an identifiable Federal interest associated with the program under which it received the grant or cooperative agreement."

Footnote: 2 2/ This provision was added by Section 3501(a) of the Augustus F. Hawkins-Robert T. Stafford Elementary and Secondary School Improvement Amndments of 1988, 102 Stat. 130 (1988) and will be codified as 20 U.S.C. § 1234b(a)(1).