UNITED STATES DEPARTMENT OF EDUCATION
WASHINGTON, DC 20202

Application of Disability Rights Center of Kansas, Applicant.	Docket No. 05-39-R Recovery of Funds Proceeding ACN: 07-03-02008

Appearances: Kirk B. Lowry, Esq., of Topeka, Kansas, for Disability Rights Center of Kansas, Inc.

Ronald B. Petracca, Esq. and Roseann Eshbach, Esq., of the Office of the General Counsel, United States Department of Education, Washington, D.C., for Post Audit Group and Rehabilitation Services Administration

BEFORE: Chief Administrative Law Judge Allan C. Lewis

DECISION

This is an appeal by the Disability Rights Center of Kansas (DRC) of two preliminary departmental decisions seeking a total recovery of $61,345 for the fiscal years 2000 through 2002.[1] These decisions seek the recovery of expenditures by DRC for consulting and legal services performed by its President on the theory that these items were not allowable costs under OMB Circular A-122. DRC challenges these decisions. First, it argues that it received an advance determination from the United States Department of Health and Human Services, its cognizant Federal agency, that these expenses were allowable costs. Second, it maintains, on the merits, that these expenditures were properly allowable costs under OMB Circular A-122. Third, it urges that, in accordance with 20 U.S.C. § 1234b(a)(1) (2000) and 34 C.F.R. § 81.32 (2000), the proposed recovery must be proportional to the harm caused, and, upon consideration

[1] The first decision was issued by the Rehabilitation Services Administration of the United States Department of Education and the second decision was issued by the Post Audit Group, Office of the Chief Financial Officer of the United States Department of Education.

of the facts in this case, no financial harm was caused and, therefore, no recovery is warranted. For the reasons stated below, it is determined that the United States Department of Education (ED) may recover $17,564 of the $61,345 sought.

A. Advanced Determination Under OMB Circular A-122

DRC is a nonprofit, nonpolitical corporate organization in Kansas that implements various protection and advocacy programs for individuals with disabilities on behalf of the State of Kansas. These programs are funded by federal grants from the Department of Health and Human Services, ED, and the Social Security Administration. The instant case involves two grants by ED, one under the Protection and Advocacy related to Assistive Technology program (PAAT) and the other under the Protection and Advocacy of Individual Rights program (PAIR). In order to execute the programs, DRC maintains a staff of attorneys, paralegals, and other support personnel to provide legal services to its clients.

From 1996 to 2002, DRC employed its president and a member of its board of directors, Mr. Ochs, to provide legal services for its clients in class action and other high profile cases and to provide training and consultation for its legal staff in other cases. According to his consulting contracts, President Ochs performed these services as an independent contractor. DRC paid President Ochs monthly and did not withhold any federal income tax from his compensation. For the three fiscal years ending September 30, 2000 through September 30, 2002, DRC charged the two ED grants in issue a total of $61,345 for the services of President Ochs.[2]

During the latter part of 1998, several members of the board of directors became concerned that President Ochs' membership on the board of directors and his contract to perform legal and consulting services for the organization created a conflict of interest. Shortly thereafter, the executive director of DRC at the direction of the board discussed this matter with one or more staff members of the Administration on Developmental Disabilities (ADD/HHS), a division of the United States Department of Health and Human Services responsible for overseeing the federally sponsored protection and advocacy system. The staff members opined that the conflict of interest issue was a matter within the purview of the board of directors of DRC, not ADD/HHS.

As a nonprofit organization, DRC is governed by the cost principles of OMB Circular A-122 in determining whether various expenses are permissible expenditures. DRC asserts that it obtained a favorable advanced determination from its cognizant agency, ADD/HHS, to the effect that the legal services performed by its president constituted allowable costs.

An advanced determination, as defined in paragraph 6, Basic Considerations section, General Principles of OMB Circular A-122 means--

[2] This amount represents only the amount allocated to the ED grants, not the total amount paid to or on behalf of President Ochs by DRC.

> Advance understandings. Under any given award, the reasonableness and allocability of certain items of costs may be difficult to determine. . . . In order to avoid subsequent disallowance or dispute based on unreasonableness or nonallocability, it is often desirable to seek a written agreement with the cognizant or awarding agency in advance of the incurrence of special or unusual costs. The absence of an advance agreement on any element of cost will not, in itself, affect the reasonableness or allocability of that element.

Based on the record, the limited discussions between DRC and ADD/HHS focused on only one topic, namely, whether the existence of an employment relationship between DRC and President Ochs created a conflict of interest due to his other positions as the president of DRC and as a member of its board of directors. There is not a hint or inference from the hearsay evidence in the record that DRC sought or received from ADD/HHS any determination that the expenses incurred for legal services attributable to the employment of President Ochs were allowable costs for purposes of the grants received by DRC. Hence, there is simply no factual foundation for DRC's advanced determination argument.

An advanced determination also requires a written agreement with the cognizant or awarding agency. This requirement assures, among other things, that the actual understanding of the parties is memorialized and that the agreement is approved by an authorized representative of the agency. In the instant case, there is neither a written agreement nor any evidence that the appropriate personnel within ADD/HHS were consulted. Accordingly, DRC's advanced determination argument fails the written agreement requirement.

Lastly, ED argues that any advice or determination, even if given by ADD/HHS to DRC, is not relevant because ADD/HHS has no authority to bind ED on matters involving grants made by ED. In ED's view, the authority of ADD/HHS, as the cognizant agency, is limited to the oversight of the protection and advocacy system created by Congress and ED, not ADD/HHS, has programmatic and enforcement authority over ED programs.

ED is correct. In 1975, Congress created a protection and advocacy system to provide attorneys and other assistance to individuals with disabilities to protect and promote their rights. Congress selected the predecessor of the Department of Health and Human Services to oversee the protection and advocacy system established by each state. Its duties included matters such as the selection, retention, and general oversight over the State agency or selected organization that provides the services. Developmentally Disabled Assistance and Bill of Rights Act, Pub. L. No. 94-103, 89 Stat. 486 (1975). The system remains the same today except that Congress has included other disability programs that utilize the protection and advocacy system. Developmental Disabilities Assistance and Bill of Rights Act of 2000, Pub. L. No. 106-402, 114 Stat. 1677 (codified at 42 U.S.C. § 15001 *et seq*. (2000)).

ED's PAIR and PAAT programs are illustrations of subsequent programs created by Congress that utilize the protection and advocacy system while, at the same time, the programmatic and enforcement authority remains with the federal agency charged with that responsibility. ED was designated the federal agency responsible for administering the Vocational Rehabilitation Program upon its creation in the late 1970's. Later, in 1992, Congress enacted the PAIR program that provided for protection and advocacy services. Section 510(a) of the Rehabilitation Act Amendments of 1992, Pub. Law 102-569, 106 Stat. 4430. As part of this legislation, Congress provided that ED had the discretion to delegate the administration of the PAIR program to ADD/HHS. *Id.*; 29 U.S.C. § 794e(k) (1993). ED did not delegate, however, the administration of this program to ADD/HHS. In fact, ED promulgated regulations in 1993 that governed the PAIR program including the resolution of audit disputes. 58 Fed Reg 43022 (Aug 12, 1993), 34 C.F.R. Part 381 (1993). Like PAIR, Congress delegated the authority to administer the PAAT program to ED. 29 U.S.C. §§ 3002(a)(12) and 3013(a) (1998). Hence, it is clear from the statutes and the regulation that ADD/HHS had no relevant authority over the PAIR and PAAT programs and, therefore, any pronouncement by ADD/HHS concerning the allowance of the attorney fees in issue has no legal import in this case.

B. OMB Circular A-122

The preliminary departmental decisions disallowed various payments made to or on behalf of President Ochs during the fiscal years 2000 through 2002. These expenditures were disallowed pursuant to Item 39 in Attachment B, OMB Circular A-122. Item 39 in Attachment B addresses professional service costs and provides, in pertinent part, that—

> a. Costs of professional and consultant services rendered by persons who are members of a particular profession or possess a special skill and who are not officers or employees of the organization, are allowable, subject to subparagraphs b and c when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Federal Government.
> . . . .

Item 39 precludes an officer or employee from providing professional or consultant services outside of his duties as an officer or employee. This rule was most likely implemented due to abuses by nonprofit organizations in this area. It bars the allowance of these payments without regard to whether the new services are similar or different than the existing services provided by the individual, the circumstances surrounding the payments, or the reasonableness of the payments.

Inasmuch as President Ochs was the president and, therefore, an officer of DRC and he performed his legal and consultant services as an independent

contractor under a consulting agreement, the preliminary departmental decision disallowed these expenditures as it violated Item 39.

DRC maintains that these expenditures are allowable costs. First, it asserts, in effect, that the consulting agreement has no legal effect and should be disregarded. Second and with the agreement cast aside, DRC then maintains that, in substance, DRC and President Ochs had an employer/employee relationship as determined under the common law employee/independent contractor line of cases.[3] Under this scenario, President Ochs performed his consulting services as an employee of DRC. Since Item 39 only disallows expenditures for services performed as an independent contractor, the provision does not apply and the expenditures are allowable costs.

ED responds that the agreement explicitly indicates that President Ochs was not an employee, rather, he was a consultant. In addition, an analysis of the facts, according to ED, supports its view that President Ochs performed these services as an independent contractor and, therefore, these payments were properly disallowed under Item 39. This result, according to ED, is also consistent with the parties' desire to avoid treating President Ochs as an employee since, under the by-laws of DRC, an employee could not serve on the board as well as remain as its president.

In this case, the parties created a contractual relationship under which President Ochs performed his services as an independent contractor, not as an employee. The agreement between the parties provided that —

> [t]his agreement is not an employment agreement, it is a consulting agreement only. If disagreement occurs between . . . [DRC's] management and Ochs, the decisions of management will stand. Ochs agrees to separate Board functions from the agency management functions.

It has long been held in the federal income tax area as well as other areas that the federal government may rely upon a written agreement between two parties and

[3] In Nationwide Mut. Ins. Co. v. Darden, 503 U.S. 318, 323-324 (1992), the Court identified a litany of factors to be considered in a determination whether services by an individual were performed for an organization as its employee or as an unrelated, independent contractor. These factors include the hiring party's right to control the manner and means by which the product was accomplished; the skill required; the party that furnished the instrumentalities and tools used; the duration of the relationship; the hired party's role in hiring and paying assistants; whether the hired party performed work for others and had its own office; the provision of employee benefits; the location of the work; whether the hiring party had the right to assign additional projects; the extent of the hired party's discretion over when and how long to work; and the tax treatment of the hired party.

that a party to the transaction should not be permitted to attack a provision of the agreement except in cases of fraud, duress, or undue influence. Commissioner v. Danielson, 378 F.2d 771, 775 (3rd Cir. 1967), cert. denied, 389 U.S. 858 (1967); North American Rayon Corp. v. Commissioner, 12 F.3d 583 (6th Cir. 1993). This is especially true where, as here, the party seeking to avoid the agreement does so to avert the financial consequences of its agreement to the detriment of the federal fisc.

Here, DRC and President Ochs were free to structure his employment as an employee or as an independent contractor. The independent contractor approach permitted President Ochs to continue as a voting member of the Board—something he could not have done under an employee arrangement.[4] Lastly, there is no evidence of fraud, duress, or undue influence. The arrangement was negotiated by DRC's executive director, who was also a practicing attorney, and President Ochs, an attorney himself. Accordingly, the preliminary departmental decisions properly disallowed the payments made by DRC to or on behalf of President Ochs under Item 39, Attachment B, OMB Circular A-122.

C. Amount of Recovery

Lastly, there remains the question regarding the amount of recovery. Under 20 U.S.C. § 1234b(a)(1) (2000), a grant recipient that improperly expends Federal 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 interest.

In other words, the recovery is not necessarily the amount of federal funds associated with the violation, rather the recovery is limited to the extent of the harm caused by the violation.

In the case at bar, the total amount of the improper expenditure of federal funds is $61,345 and is attributable to the PAIR and PAAT grants as follows:

Grant	FY 2000	FY 2001	FY 2002	Total
PAIR	$4,859	$10,828	$28,093	$43,781

[4] It should be noted that the parties acted in a manner consistent with their independent contractor arrangement in certain aspects. For example, DRC reported his services as a consultation expense on its books rather than an employee expense. DRC treated President Ochs as an independent contractor, not an employee, for federal income tax purposes. In other words, DRC did not withhold any federal income taxes from his compensation as the law requires for an employee.

PAAT	$7,080	$2,816	$7,668	$17,564

DRC argues that ED suffered no damage in this case because the $61,345 of damages sought by ED is more than offset by the $140,000 in legal fees awarded DRC in two successful PAIR cases litigated by President Ochs. ED responds in three ways. First, it argues that DRC has not proven that the $140,000 of legal fees were income earned during the three fiscal years in issue, namely during fiscal years 2000 through 2002. Second, it asserts that DRC has not proved that the $140,000 was then spent on allowable costs in the programs in issue. Third, it maintains that, under 34 C.F.R. § 74.24(b)(1) (2000), income earned under a program may only be spent on that program. Hence, the $140,000 of PAIR income could be used, theoretically, to reduce the improper expenditures incurred in the PAIR program. It could not be used to reduce the improper expenditures in the PAAT program.

Initially, it has been determined that DRC misspent $43,781 of PAIR program funds and $17,564 of PAAT program funds. Each grant is treated separately for accounting purposes. Moreover, 34 C.F.R. § 74.24(b)(1) requires that income in a particular program must only be spent on that program. Accordingly, PAIR income may be considered only in mitigation of PAIR damages and PAAT income may only be considered in connection with PAAT damages. Inasmuch as DRC alleges no income was earned under the PAAT grant and none is apparent from the record, the amount of damage sustained under the PAAT program is the full amount sought by ED or $17,564.

With regard to the PAIR program, the weight of the evidence supports a finding that at least $44,000 of the attorney fee awards during the fiscal years in issue was attributable to the services performed by President Ochs. In fiscal years 2000 and 2001, DRC received approximately $310,000 of awarded attorney fees in the PAIR program. During this period, it utilized the services of President Ochs and two other attorneys. While a breakdown of the fees attributable to the services of each attorney is not available, it is apparent that the services of President Ochs produced at least $44,000 of fees given his extensive participation in the Casey and Link cases and his supervisory role in all litigation matters.

Whether this amount of program income was then spent on the PAIR program presents a more difficult question – an accounting issue that neither DRC nor ED addressed in any depth. ED argues that DRC has not proved that the program income attributable to President Ochs' services was spent on allowable expenses. This view advocates a tracing of funds concept, a concept that is not adopted in accounting methodology. Accounting methods utilize concepts such as pooling or ratios or LIFO or FIFO approaches to account for costs in these situations. It is apparent from the annual PAIR program performance reports for 2000 and 2001 that DRC was aware that there must be an accounting for the program income. Moreover, the PAIR reports indicate that DRC received approximately $300,000 of program income during these fiscal years of which approximately $60,000 was expended. Hence, at a minimum, the program income attributable to President Ochs has been spent or will be spent in the future within the

program. As such, DRC has satisfied or will satisfy ED's criteria. In this circumstance, no financial recovery by ED is warranted regarding the PAIR program.

ED advances several arguments in an effort to avoid the mitigation effect of the program income earned in the PAIR program by virtue of the services of President Ochs. It stresses that the payment for his services was a serious violation that does not warrant any reduction in the amount of damages, that the program income could have been earned without such a violation if President Ochs had resigned his position on the board, and that the benefit of the services of President Ochs appears dubious given the decline in services to individuals with disabilities and the amount of significant legal activities during his tenure.

These arguments lack merit as they focus on irrelevant matters. Congress required that the recovery under 20 U.S.C. § 1234b(a)(1) be proportional to the harm caused by the improper expenditure for the services of President Ochs. This case presents a rare situation in which the improper expenditure for services can be directly tied to the receipt of an equivalent or greater amount of funds that, in turn, must be spent to serve the purposes of the grant. Hence, ED has not suffered any damage under the PAIR program.

In summary, ED may recover $17,564 in funds under the PAAT program.

ORDER

On the basis of the foregoing findings of fact and conclusion of law, and the proceedings herein, it is HEREBY ORDERED the Disability Rights Center of Kansas immediately and in the manner provided by law pay to the United States Department of Education the sum of $17,564.

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Allan C. Lewis
Chief Administrative Law Judge

Issued: April 26, 2007
Washington, D.C.

SERVICE

On April 27, 2007, a copy of the attached document was sent by certified mail to the following:

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