UNITED STATES DEPARTMENT OF EDUCATION
OFFICE OF ADMINISTRATIVE LAW JUDGES

APPLICATION OF THE	Docket No. 11-33-R
PENNSYLVANIA DEPARTMENT OF EDUCATION,	Recovery of Funds Proceeding
	ACN: ED-OIG-A03H0010
Applicant.	

Appearances: Bonnie J. Little, Esq., Michael L. Brustein, Esq., and Leigh Manasevit, Esq. of Brustein & Manasevit, PLLC, Washington, D.C. for the Pennsylvania Department of Education

Richard Mellman, Esq. and Kay Rigling, Esq., Office of General Counsel, United States Department of Education for the Assistant Secretary for Elementary and Secondary Education

Before: Chief Administrative Law Judge Allan C. Lewis

INITIAL DECISION

This matter involves an appeal by the Pennsylvania Department of Education (PDE) of 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 (ED) in which ED demanded the return of $9,968,423 in Title I and II funds for the period July 1, 2005 through June 30, 2006. On May 20, 2011, counsel for PDE submitted an Application for Review[1] of this determination. Subsequently, on June 3, 2011, counsel filed a motion to dismiss this action on the theory that the PDL did not establish a *prima facie* case for recovery of funds, as required by 34 C.F.R. § 81.34(b) (2010), and that the notice must be returned to ED as required by 34 C.F.R. § 81.38(b). ED opposed the motion and asserted that the 13 errors identified by PDE in ED's notice did not constitute errors or, if so, were so insignificant as not to warrant the return of the PDL.[2]

On August 10, 2011, this tribunal denied PDE's motion to dismiss, finding that ED had established in its PDL a *prima facie* case for the recovery of funds and that PDE's application for

[1] Including exhibits marked "A" and "B".
[2] Included with ED's July 1, 2011 Response to Applicant's Motion to Dismiss were exhibits marked Exh. 1-10.

review of the determination was properly filed.[3] The parties requested a stay in the proceedings while they negotiated towards settlement, and the proceedings were suspended for a period of approximately 11 months. After some progress was achieved, the parties reached an impasse. On August 1, 2012, this tribunal issued a Revised Order Governing Proceedings[4], reinstating the briefing schedule. Subsequently, the parties timely submitted their pleadings and exhibits, including the following:[5]

- Aug. 17, 2012: Response of the Assistant Secretary to Revised Order Governing Proceedings (enclosing the Office of the Inspector General's audit report and the School District of Philadelphia's Chart of Accounts: Coding Definitions and Usage)

- Aug. 31, 2012: Joint Stipulations

- Sept. 28, 2012: Pennsylvania Department of Education Brief[6]
- Pennsylvania Department of Education Proposed Findings of Fact
- Pennsylvania Department of Education Exhibits (enclosing Exhibits A-1 through A-8)

- Oct. 26, 2012: Reply Brief of the Assistant Secretary for Elementary and Secondary Education
- Assistant Secretary for Elementary and Secondary Education's Requested Findings of Fact[7]
- Response of the Assistant Secretary for Elementary and Secondary Education to Pennsylvania Department of Education's Proposed Findings of Fact[8]
- Assistant Secretary for Elementary and Secondary Education's Exhibts [*sic*] (enclosing Exhibits 1-4)

- Nov. 21, 2012: Pennsylvania Department of Education Reply Brief[9]
- Pennsylvania Department of Education Response to Assistant Secretary's Denial of Proposed Finding [*sic*] of Fact
- Pennsylvania Department of Education Response to Assistant Secretary's Proposed Findings of Fact[10]
- Pennsylvania Department of Education Reply Brief and Responses to Statements of Facts Exhibits (enclosing Exhibits A-9 through A-17)

At issue in this case remains $7,186,222 in disputed liabilities. The Department's PDL initially sustained several audit findings by ED's Office of Inspector General (OIG) totaling

[3] *See, In re School District of Philadelphia*, Dkt. No. 11-33-R, U.S. Dept. of Education (August 10, 2011) (Order re Motion to Dismiss). On September 2, 2011, this tribunal issued an Errata Order to amend the case caption on all prior orders to reflect the Pennsylvania Department of Education as the Applicant.

[4] Paragraph 2 of the Revised Order required the parties to file stipulations pertaining to the statute of limitations and the equitable offset argument. Beyond this paragraph, however, the Revised Order does not limit the parties' briefs or submissions to these two issues. Despite this, both parties interpreted the Order as having that restriction and filed their materials accordingly. *See*, Reply Brief of the Assistant Secretary for Elementary and Secondary Education (Oct. 26, 2012), fn. 2 (hereafter referred to as "ED Brief"). This tribunal notes that the parties make this decision of their own accord and at their own peril.

[5] This list does not included procedural motions or orders.

[6] Hereafter referred to as "PDE Brief".

[7] Hereafter referred to as "ED Requested Findings of Fact".

[8] Hereafter referred to as "ED Response to PDE Proposed Findings of Fact".

[9] Hereafter referred to as "PDE Reply".

[10] Hereafter referred to as "PDE Response to Assistant Secretary's Proposed Findings of Fact".

$9,968,423. Through settlement discussions, PDE and ED agreed that $2,782,201 is barred from recovery under the statute of limitations.[11]

Discussion

The facts behind the funds in controversy are as follows. On March 29, 2011, the Assistant Secretary for Elementary and Secondary Education and the Assistant Deputy Secretary for Safe and Drug Free Schools issued a program determination letter to the Pennsylvania Department of Education, detailing the findings of an audit conducted by ED's Office of Inspector General of its subgrantee, the School District of Philadelphia (SDP), for the period of July 1, 2005 through June 30, 2006. The audit[12] found a number of programmatic violations, including charges of supplanting[13] (Finding 2); inadequate enforcement of policies and procedures (Finding 4); and a failure to have written policies and procedures for various processes (Finding 5). The funds that were disallowed by the PDL totaled $9,968,423 and consisted of direct and associated indirect costs charged to grants under Titles I and II of the Elementary and Secondary Education Act of 1965 (ESEA), as amended by No Child Left Behind (NCLB); and the Safe and Drug-Free Schools and Communities Act (SDFSCA) Program.

Through settlement negotiations, PDE and ED concurred that $2,782,201 of the funds sought for recovery were barred by the statute of limitations, including $1,395,685 of direct costs and $31,822 of indirect costs under Finding 2; $186,578 of direct costs and $4,254 of indirect costs under Finding 4; and $1,163,862 in both direct and indirect costs under Finding 5.[14] This leaves a total of $7,186,222 in controversy.

As a matter of law, PDE argues that the funds sought for recovery by ED are subject to two legal precepts which mitigate PDE's liability: the statute of limitations and the doctrine of equitable offset. The statute of limitations is a mechanical test which precludes the Department from recovering funds that were misspent more than five years prior to the recipient receiving written notice of a preliminary Departmental decision. 20 U.S.C § 1234a(k) (2001). The doctrine of equitable offset is a proportionality remedy borne out of fairness that is recognized by the Office of Administrative Law Judges and operates to reduce a grantee's liability by allowing the grantee to substitute the disallowed costs with expenditures that were not previously charged to the grant but were made by the grantee for grant purposes. *See, In re New York State Department of Education*, Dkt. No. 90-70-R, U.S. Dept. of Education (April 21, 1994) and *In re Pittsburg Pre-School and Community Council, Inc.*, Dkt. No. 09-20-R, U.S. Dept. of Education (May 16, 2012). In contrast to any relief available under the statute of limitations, the doctrine of

[11] *See*, Joint Stipulation 1.
[12] *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".
[13] Supplanting occurs when a state or local education agency uses Federal funds to provide services which they had provided using state or local funds in the previous year. The Title I of the ESEA prohibits the practice of supplanting of state and local funds. *See*, No Child Left Behind, Title I, Part A, Section 1120A(b), codified at 20 U.S.C. § 6321(a).
[14] *See*, Joint Stipulation 1.

equitable offset is not a right as matter of law but rather a discretionary determination by the tribunal.[15]

1. Statute of Limitations

The statute of limitations reads, in pertinent part:

> 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 written notice of a preliminary departmental decision.

20 U.S.C. § 1234a(k) (2001); 34 C.F.R. § 81.31(c).

PDE urges a straight-forward reading and application of the statute and regulations, arguing: first, the statute of limitations is a five-year mechanical constraint that does not consider intent or allow for equity; and second, the relevant date for determining whether a transaction is within or outside the bounds of the statute is the date the funds were first obligated, not the date of any subsequent accounting transaction. PDE contends that the statute of limitations requires a simple counting of years back from the date of receipt of the written notification to determine what transactions are beyond recovery. Finally, PDE states that neither the statute of limitations nor the Education Department General Administrative Regulations (EDGAR) reference the source of funds; for this reason, it is immaterial whether funds that were obligated are local, state or Federal.

As support, PDE argues that the statute of limitations plainly states that any funds misspent five years prior to written notice by the Department cannot be recovered as a matter of law. It further asserts that ED has consistently and regularly interpreted "expended" as meaning "obligated"; therefore, the statute of limitations begins to run on the date the funds in question were first obligated by the grantee. Thus, any funds obligated prior to five years before the receipt of the Department's written notice, stipulated as March 30, 2011 in this case[16], would be barred under the statute of limitations.

PDE next turns to ED's implementing regulations to determine when the funds are deemed to be obligated for purposes of the statute of limitations. Regulations Section 76.707 of the EDGAR provides a table that defines "when a State or a subgrantee makes obligations for various kinds of property and services." 34 C.F.R. § 76.707. According to this table, funds for services by a contractor (the expenditures disallowed under Finding #2) are deemed obligated on the date when a binding written commitment is made. 34 C.F.R. § 76.707(c). PDE notes that its subgrantee, the School District of Philadelphia (SDP), entered into binding written service contracts for $5,196,552 prior to March 30, 2006.[17] PDE also claims $80,057 for the salaries and

[15] To be clear, the doctrine of equitable offset is and has always been applied at the discretion of the Administrative Law Judge. Nothing precludes an appellant from proffering arguments to support this equitable remedy, but it is not a right due to an appellant as a matter of law.
[16] *See*, Joint Stipulation 2.
[17] *See*, Joint Stipulation 3.

fringe benefits accrued by two SDP employees who worked during the 2005-06 school year.[18] PDE argues that under § 76.707 of the regulations, these funds paid to employees were deemed obligated as of the date the services were performed by the employees. Because all of these transactions transpired before March, 30, 2006, PDE concludes that the statute of limitations bars ED from recovering $5,276,609 (the sum of $5,196,552 and $80,057).

In conjunction with the above argument, PDE asserts that the relevant date for the calculation of the statute of limitations is the date of first obligation, as defined by the regulations. PDE contends that any subsequent bookkeeping transactions that shift funds between accounts have no bearing on the initial transaction from which the legal obligation arose.[19] It cites the Secretary's decision in *In re State of California*, No. 12-(122)-83, U.S. Dept. of Education (May 6, 1986) in support of this proposition and relies on one particular statement: "[t]he Secretary finds the legally relevant question to be when the obligation arose, not in what account such obligations have been initially recorded." PDE further states that "[t]he important factor is not the nature of the interim accounting classifications. Rather, the pivotal factor is the true nature of the underlying transaction."[20] Extrapolating from this argument and citing the applicable statute and regulations, PDE thus concludes that the source of the funds is irrelevant to the obligation, stating: "[t]he plain language makes clear that obligation occurs without regard to funding source."[21] In this manner, PDE suggests that the only relevant information for the consideration of the statute of limitations is the initial date of obligation of funds.

ED concurs that the statute of limitations is a mechanical rule, with no consideration of intent or equity, and that the term "expended" refers to the date of obligation. Beyond this, however, ED disagrees with PDE's interpretation. ED contends that the statute of limitations bars the Department from recovering any *Federal* funds that were misspent more than five years prior to the date that PDE received written notice from the Department, *i.e.*, March 30, 2006. ED argues that no violation of Federal program requirements exists where the funds misspent are non-Federal. Therefore, it is not until the funds take on a Federal identity that they can be deemed obligated for Federal purposes or be subject to Federal restrictions or regulation. Only then can the statute of limitations be applied.

Applying this argument to the facts of the case, ED notes that PDE's timeline of events omits several key transactions that are relevant to this tribunal's consideration of the statute of limitations argument and fails to brief all of the facts surrounding the expenditure of the $5,276,609. The funds sought to be excluded from recovery by PDE consist of $5,196,522 in service contracts that were charged to Title I, Part A and $80,057 in personnel costs that were ultimately charged to the SDSFSCA program.[22] The parties stipulate that SDP entered into binding written contracts covering $5,196,552 of this $5,248,988 prior to March 30, 2006 and

[18] SDP expended $132,927 by March 30, 2006 for salaries and benefits of these two employees. *See*, Joint Stipulations 6-9. However, SDP ultimately charged only a percentage of these salaries and benefits to the SDFSCA grant, a total of $80,057, which PDE claims is barred from recovery by the statute of limitations. PDE Brief, p. 12.
[19] PDE essentially argues that the type and kind of accounts to and from which funds are transferred has no bearing on the nature of the transaction. I disagree. The source of the funds colors the nature of the transaction and is directly relevant to any case where the expenditures are being reviewed. At the most basic level, the source of the funds determines subject matter jurisdiction. Clearly, for example, if the funds at issue in this case were private monies, the Department would have no cause of action. Thus, the source of the funds is directly relevant.
[20] PDE Brief, p. 7.
[21] *Id*.
[22] *See*, Joint Stipulation 3, which provides that $52,436 of the $5,248,988 (for a remainder of $5,196,552) was not included in PDE's statute of limitations claim.

that the salaries/benefits were also earned prior to March 30, 2006. Thus, the parties agree that the underlying transactions that created the obligations of these funds transpired more than five years prior to PDE receiving written notice from the Department.

These dates, however, are not determinative, according to ED, which urges a closer examination of the transactions. Although the $5 million in contracts were signed and services were provided before March 30, 2006, ED explains that SDP initially charged these expenditures to its General Fund, and none of these various transactions were linked to Federal funding sources.[23] Because the disallowed contract expenditures and personnel costs were obligated to a General Fund, paid with non-Federal funds and treated as non-Federal obligations, ED contends that the initial obligation of these funds was only a general obligation -- one that clearly created a *legal* obligation for SDP -- but it did not create an obligation for the purposes of any Federal programs. It was not until SDP charged these costs to Federal programs in July and September of 2006 that a Federal obligation arose.[24] For these reasons, the pre-March 2006 dates of obligation that PDE relies on are not relevant under the statute.

Like PDE, ED urges a plain reading of the relevant regulations and statutes. ED concurs that Section 76.707 of the regulations determines the date that an obligation may be charged to Federal funds but argues that the date of obligation is not the central issue for consideration. Rather, it is the date that triggers the statute of limitations -- the date(s) on which SDP made an expenditure of Federal grant funds in a manner not authorized by law, per the statute's plain language -- that determines whether the funds may be recovered.[25] Thus, the date that is relevant for the statute of limitations is the date of the impermissible expenditure, not simply the date of obligation. Regulations Section 76.707 and prior decisions of this tribunal define the date of expenditure as the date of obligation. However, the obligation date is not necessarily the date of impermissible expenditure. The expenditures cannot be improper until ED regulations define them as such, and ED regulations have no application unless and until the funds being transacted are ED program funds. Therefore, PDE's reliance on the date of obligation is misplaced; the tribunal must consider the date the expenditure (obligation) became unauthorized, which, in this case, was several months after the initial obligation of funds.

As to PDE's reliance on *In re State of California*, ED asserts that the language quoted by PDE in support its position is taken out of context. ED clarifies that the Secretary's determination that "the legally relevant question … [is] when the obligation arose, not in what account such obligations have been initially recorded" concerns only the accounting methods and the proper expenditure of funds under the "Tydings Amendment"[26], the subject of that case. ED asserts that this language is limited to the application of the Tydings Amendment and cannot be construed to apply to the statute of limitations.

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[23] ED Brief, p. 4.
[24] ED Brief, p. 7.
[25] ED Brief, p. 13.
[26] The Tydings Amendment allows grantees to carry-over for one additional year any Federal education funds that were not obligated during the period for which they were appropriated. For grants that are forward-funded, grantees may have up to 27 months to obligate appropriated funds beginning as early as July 1 of the Federal fiscal year. Because the Tydings Amendment allows grantees to expend grant funds after the fiscal year in which they were appropriated (with the proper documentation), the date of the underlying transaction is the focus of examination.

The controversy before this tribunal rests on the interpretation of the statute of limitations, as codified in Education's General Provisions Concerning Education Act governing the enforcement and recovery of funds. Specifically, the statute of limitations, 20 U.S.C. § 1234a(k), provides --

> 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 written notice of a preliminary departmental decision.

It is uncontroverted that this statute is applicable to the funds deemed misspent pursuant to the PDL. Indeed, the parties have already agreed that $2,782,201 of the original amount is subject to the statute's five-year limitation and may not be recovered. Further, it is stipulated that the five-period covered by the statue began on March 30, 2006 such that improper programmatic expenditures prior to that date are unrecoverable.[27] Finally, the parties also agree that this statute is a mechanical rule applied without consideration of intent and that the term "expended" means "obligated", as interpreted by the Secretary, the Department, this tribunal and its predecessor, the Education Appeals Board (EAB).[28] This tribunal reaffirms that for purposes of the statute of limitations, "expended" shall be read as "obligated", which in turn is defined by the appropriate regulation.

To this extent, the parties are in accord, and PDE believes the discussion ends here. ED, however, urges the tribunal to recognize that the date of obligation alone does not trigger the operation of the statute of limitations; rather the operative transaction is an expenditure (obligation) not authorized by law. This tribunal agrees. PDE glosses over and fails to give force to the full text of the statute, specifically the clause that reads: *in a manner not authorized by law*. This language must be read in concert with the rest of the statute and interpreted in a manner that gives meaning to the full text. Indeed, it is a fundamental rule of statutory interpretation that the text be read as a whole such that each section is given meaning where possible.[29]

The language "in a manner not authorized by law" clearly implicates the Federal statutes and regulations that govern ED's programs. The statute itself includes terms such as "applicable program" and "the department" and is found under Title 20, which applies to Education; therefore, the statute cannot be understood to apply to anything but the Department of Education and its programs. Correspondingly, just as the language of this statute must apply to grants and programs administered by the Department of Education, it is also *limited* in its application to the same sphere of grants and programs, *i.e.*, those administered by ED. It would absurd to interpret this statute as having force beyond the purview of the Department of Education. Thus, the phrase "manner not authorized by law" is defined by ED's statutes, regulations and case law and also restricted to its programs.

Having clarified that "a manner not authorized by law" incorporates the body of law that regulates the Department of Education's grants and programs, it logically follows that the funds

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[27] As determined by the date that PDE received the written notice from ED, *i.e.*, March 30, 2011.
[28] *See*, *In re State of Michigan*, No. 13-(188)-85, U.S. Dept. of Education. (Sec. Dec., January 2, 1987).
[29] The rules of statutory construction, which also apply to regulations, require that they be read as a whole, and "each part or section should be construed in connection with every other part or section so as to produce a harmonious whole." *Sutherland on Statutory Construction* § 46.05 at 154 (2000) (citations omitted). *See also, Gustafon v. Alloyd Co., Inc.*, 513 U.S. 561 (1995); *Smith v. United States*, 508 U.S. 223 (1993).

subject to return or retention under this statute must also be only those subject to the Department's regulations, statutes, rules, *et cetera*. Clearly, only funds provided by the Department may be regulated by it; likewise, only funds subject to the Department's regulations and rules can run afoul of them. Thus, the plain language of the statute must be read as applying only to ED programs and funds.[30]

Consistent with the tenet of statutory interpretation that requires a provision to be read as a whole with each section given meaning, this tribunal notes that, for the statute of limitations to apply, all terms of the statute must be satisfied. Although this observation may sound obvious and be taken as a given, it nevertheless necessitates clarification. Specifically, this tribunal finds that, under the statute of limitations as articulated in 20 U.S.C. § 1234a(k), it is a condition precedent for this statute to apply that the funds being misspent are Departmental funds. If, at the time of obligation, the funds being transacted are not Departmental funds, then Departmental regulations have no force. It is only when the funds at issue are clearly Departmental funds that they may be regulated at all, let alone be deemed misspent and/or subject to the statute of limitations contained in 20 U.S.C. § 1234a(k). Further, it is only when the funds at issue meet all of the conditions expressed in the statute of limitations that the statute may offer any relief. In other words, under the plain language of the statute of limitations, the funds must have been provided through an applicable program and been expended (obligated) in a manner not authorized by Departmental regulations more than five years prior to written notice was provided for the statute of limitations to apply. For this reason, PDE's argument that the statute of limitations started to run when the $5,196,552 of funds were first obligated, prior to March 30, 2006, fails. The funds in question did not satisfy the full language of the statute of limitations because they were not identified as ED programmatic funds until after March 30, 2006.

This tribunal's interpretation is supported, not only by logic and rules of statutory construction, but also by previous findings of the Secretary and the EAB. In *In re State of Michigan*, No. 13-(188)-85, U.S. Dept. of Education (Sec. Dec., January 2, 1987), the Secretary stated:

> As held in prior EAB decisions, and as hereby expressly affirmed by the Secretary, the date of an "expenditure" for purposes of the statute of limitations is the date the LEA actually obligates the funds in accordance with 34 C.F.R. 76.707, [not the date when the State authorizes the subgrantee to use the funds in question.] (emphasis in original)

As discussed earlier, this language categorically affirms that "expenditure" equals "obligation" for purposes of the statute of limitations and that the date of obligation is determined by ED's regulations. But the Secretary's decision goes beyond equating expenditure to obligation. By defining "expenditure" as the date funds are obligated *in accordance with* 34 C.F.R. § 76.707, the Secretary articulates the condition of the funds being subject to ED's regulation for the obligation to occur. This means that the funds must be identified as Departmental funds at the time of obligation for them to be obligated under the regulations. Absent this link to an ED program, no Federal regulations are implicated. Indeed, funds that are not provided by the Department are not subject to its regulations. The language of

[30] Hence, the tribunal rejects PDE's assertion that "the plain language makes clear that obligation occurs without regard to funding source." PDE Brief, p.7.

34 C.F.R. § 76.707 further supports this interpretation with references to the "State or a subgrantee". Thus, in *Michigan*, the Secretary recognizes that the statute of limitations begins to run when *Departmental* funds are obligated under 34 C.F.R. § 76.707.

Prior decisions by the EAB also support this tribunal's interpretation that the statute of limitations begins to run only when a payment or expenditure (obligation) becomes "unauthorized" in contravention of ED's program requirements. The EAB expressly affirmed this position, in pertinent part, in *In re State of Oklahoma*, No. 4-(34)-77, U.S. Dept. of Health, Education and Welfare (EAB Dec., January 29, 1980):

> ...it is correct that the "general rule" is that a statute of limitations does not begin to run until the "cause of action" accrues. As the rule would apply to the Title I program, the Office of Education's "cause of action" does not accrue until there has been, in fact and law, an unauthorized expenditure of Title I funds.

Here, the EAB clearly held that the statute of limitations does not begin to run until programmatic funds are expended in an unauthorized manner ("an unauthorized expenditure of Title I funds"). Thus, the Board recognized the transaction that triggers the statute of limitations, *i.e.*, when: (1) programmatic funds (2) have been expended[31] in a manner (3) not authorized under the applicable law. Stated another way, the statute of limitations focuses on the date when programmatic funds are expended (obligated) in a manner not authorized by departmental regulations or applicable statute. Thus, for the statute of limitations to offer relief, the date when *programmatic* funds were obligated must be more than five years prior to the grantee's receipt of a written preliminary Departmental notice. If the funds in question do not satisfy these criteria – that they are programmatic funds, obligated in an unauthorized manner, more than five years prior to the date of written notice -- then the statute of limitations cannot be invoked.

It is undisputed that the $5,276,609 that Applicant seeks to bar from recovery under the statute of limitations was generally obligated more than five years prior to its receipt of the Department's notice. Although PDE suggests that the contract and personnel costs were identified and reported as Federal expenditures in its audited financial statements for FY 2005-2006, the statement was issued substantially after the close of the fiscal year. Moreover, the tribunal finds that nothing in the record supports, let alone satisfies, PDE's burden of proof that expenditures for contract and personnel costs were paid out of Federal funds prior to March 30, 2006. Accordingly, there was no unauthorized expenditure of funds until the obligations became obligations of Federal funds some three to six months later.

For the above reasons and based on a review of the record, it is the determination of this tribunal that the $5,276,609 of funds that PDE argues is subject to the statute of limitations was not obligated in accordance with 34 C.F.R. § 76.707, nor spent in an unauthorized manner until the expenditures were charged against the Federal program funds. These transactions did not occur until after March 30, 2006. For this reason, this tribunal finds that the funds fall within the statute of limitation's five-year period and are subject to recovery by the Department.[32]

[31] The Secretary has since defined "expend" to mean "obligate", the implications of which are that the funds must be obligated in fact and law, but not necessarily actually spent.

[32] Additionally, PDE failed to proffer any arguments to address the findings and liability assessments contained in the PDL and has therefore conceded these issues.

2. Doctrine of Equitable Offset

In addition to arguing that the statute of limitation bars recovery of certain funds, PDE also asserts that it is entitled to an equitable offset that reduces to zero the funds that ED may recover. The doctrine of equitable offset may permit a grantee to reduce any recovery due ED by the amount of expenditures made by the grantee for grant purposes that were incurred/paid for by the grantee with non-grant funds. In effect, an equitable offset sanctions the substitution of costs incurred under the grant that are subsequently disallowed with otherwise allowable expenditures paid for by the grantee, and thereby reduces or eliminates a liability due to ED. As stated above, the doctrine of equitable offset is a discretionary determination made by the tribunal where the evidence justifies such consideration and is not a right as matter of law. However, an appellant is entitled to present arguments supporting this equitable remedy for the tribunal's review, which PDE has done.[33]

PDE contends that the full $7,186,222 in disputed liabilities may be extinguished under the doctrine of equitable offset. Specifically, PDE asserts that it is entitled to an equitable offset in the amount of $8,876,952 under Title I, Part A and $118,000 under the Safe and Drug Free Schools program.[34] These funds were expended on after-school tutoring and summer school programs, which, according to PDE, met identified educational needs, and bullying prevention costs such as training and response activities. Taken together, PDE argues that these expenditures completely extinguish any outstanding liability under the PDL.

ED responds that equitable offset is a "fairness" doctrine which is only available where the evidence supports consideration of the remedy; here, no such consideration can be justified due to the serious nature of the violations and gross misuse of funds. ED provides lengthy discourse as to why the facts do not support any consideration of fairness and that allowing an equitable offset under these circumstances would "eviscerate" ED's ability to hold grantees and subgrantees accountable for their inappropriate use of Federal monies. As to the program expenditures proposed as equitable offsets, ED indicates, for the most part, that it lacks sufficient information to admit or deny PDE's assertions regarding their allowability as offsets.[35]

PDE disputes ED's assertion that the violations in this case are so "egregious" as to exceed the bounds of consideration for equitable offset and cites as precedent cases where offsets were allowed in similar circumstances, including situations of inadequate documentation in support of the questioned charges, provision of services that are not supplemental, impermissible personnel costs charged to the grant and duplicative charges.[36]

The doctrine of equitable offset allows the tribunal to consider an offset of funds, as described above, in circumstances that warrant it. Such circumstances include considerations of fairness and whether the proposed offsetting expenditures were actually made in support of the grant program's purposes.[37] Beyond this, prior rulings and the regulations are largely silent as to

[33] *See*, *Consolidated Appeals of the Florida Department of Education*, No. 29(293)88 & 33(297)88, U.S. Dep't of Education (EAB Decision) (June 26, 1990) and the Final Decision of the Secretary (Sept. 10, 1990).
[34] PDE Brief, p. 3.
[35] *See*, ED Response to PDE Proposed Findings of Fact, nos. 14-19.
[36] *See*, PDE Reply, pp. 15-16.
[37] *See*, *In re the State of New York*, No. 26(226)86, U.S. Dep't of Education (Supplemental Decision After Remand) (June 26, 1989) at 6.

the specific conditions that support equitable offset.[38] What is clear, however, is that the totality of the circumstances is relevant to the tribunal's consideration. It is neither a simple assessment of "fairness" based on the manner in which the funds were misspent (*e.g.*, willfully, intentionally, or fraudulently, *et cetera*), as ED suggests, nor is the determination based entirely on the funds proposed for the offset. Indeed, because equitable offset is a fairness doctrine only applied in situations where funds have already been disallowed, it is reasonable to infer that the fairness consideration must begin with an examination of the nature of the original disallowed expenditure, followed by an examination of the proposed offset, which must support the purposes of the governing statute and regulations, as well as comply with the programmatic guidelines and/or requirements that governed the original, disallowed expenditures (*e.g.*, maintenance of effort, matching, non-supplanting requirements, *et cetera*).[39]

A review of the circumstances in prior cases where equitable offset has been applied by this tribunal reveals that the underlying "fairness" consideration is based on an analysis of the individual facts and circumstances surrounding each infraction. In most cases where an equitable offset was allowed, the disallowed expenditures were due to simple error, a lack of adequate documentation or were later deemed permissible costs,[40] and the violation was found to be neither grossly negligent nor intentionally improper. One notable exception, however, is *In re Arizona Department of Education*, Dkt. No. 06-07-R, U.S. Dept. of Education (Aug. 12, 2010), where several employees engaged in fraud and embezzlement. In *Arizona*, the State itself, however, reported the violation and repaid the improperly spent funds. Subsequently, the State requested an equitable offset to refund of the repayment for the misspent funds, which was agreed to by ED.[41] Despite the egregious nature of the original violation, the State acted properly in reporting and returning the misspent funds. Presumably, this is why the Department did not oppose the application of the doctrine of equitable offset in these circumstances.[42]

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[38] The Department issued a notice of proposed rulemaking addressing equitable offset that contained guidelines on the appropriate circumstances for allowing an offset. The proposed rulemaking was not adopted by the Department and the regulations do not include the proposed language or any similar provisions. However, the tribunal notes the following:

> The proposed regulations are based upon the conclusion that the recognition of offset costs, under appropriate circumstances and subject to appropriate limitations, is consistent with section 453(a)(1) of the GEPA. The proposed regulations would provide for the recognition of offset costs under the following circumstances:
> —The offset costs must meet all the requirements of the grant or cooperative agreement, including any applicable recordkeeping requirements;
> —The recipient must demonstrate that the offset costs could have been charged to the grant or cooperative agreement during the same Federal fiscal year as the original violation;
> —The charging of offset costs to the grant or cooperative agreement must not result in other violations of applicable requirements, such as maintenance of effort, matching or non-supplanting requirements;
> —The practices and policies that resulted in the original violation must have been corrected and must not be likely to recur;
> —The original violation must not have been intentional or willful.

See, Fed. Register, Vol. 60, No. 118 (June 20, 1995), p. 32252. The tribunal also notes that under the proposed rule, the Secretary would have had the burden of initially establishing a *prima facie* case that a violation was willful or intentional so as to preclude an offset. In the case of a program with a non-supplanting requirement, the recipient would have had the burden of showing that the use of State or local funds as offset costs was consistent with the requirement. *Id*.

[39] *New York*, *supra*.

[40] *Pittsburg*, *supra*.

[41] Apparently, the State demonstrated to the Department's satisfaction that the fraud was committed by a few "rogue employees" and that the violations were not indicative of how it managed its program.

[42] The issue of whether the doctrine of equitable offset could be applied to the facts of the case was not before the tribunal because ED agreed that the doctrine could be applied. *Arizona* at 2.

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. In each situation, the tribunal must be convinced that the appellant acted in good faith and executed its fiduciary duties to the highest possible standards. Further, the appellant has the burden to show that the disallowed expenditures were not the result of gross negligence or intentional violations.[43] If the appellant is able to demonstrate by a preponderance of the evidence that, in spite of the disallowed expenditures, its actions were otherwise consistent with its duty as fiduciary of Federal funds, the tribunal will consider the evidence sufficient to justify the application of an equitable offset.

After the appellant has demonstrated that the situation merits equitable consideration, then and only then will the tribunal evaluate the "offset" aspect of the doctrine, that is, whether the proposed offsetting expenditures meet the objectives, goals and technical requirements of the grant itself. Again, the burden falls to the appellant to make this showing.

Thus, the tribunal determines that any appellant seeking an equitable offset for a disallowed expenditure has both the burden[44] of production and persuasion in making the following showing:

1. That the appellant, despite its original infraction,
    a. otherwise acted in good faith[45] and in a manner consistent with its responsibilities as a fiduciary of Federal funds; and
    b. did not act in a grossly negligent[46] or intentionally improper manner, nor with deliberate disregard for the regulations and statutes;
2. That the expenditures being proposed as an offset
    a. support the legislative goals and programmatic purposes of the original grant; and
    b. fulfill all of the technical requirements of the grant.

Applying these standards to the PDE's request, the tribunal must consider the facts and circumstances surrounding the initial disallowance, which is broken down as follows:

Finding #2: Supplanting of Federal Funds	$6,796,172
Finding #4: Policies/Procedures Not Adequate and/or Enforced	$1,817,952
Finding #5: No Written Policies/Procedures for Various Processes	$1,354,299
	$9,968,423

[43] The tribunal notes that, as with *Arizona*, where the appellant could not demonstrate that it met this burden of proof, equitable offset may be permissible if the Department assents to its application.
[44] *See*, *New York*, *supra* and *Arizona* at 5.
[45] Including but not limited to situations where an appellant made honest or clerical errors, may be missing some supporting documentation, immediately took action to remedy the violation and other mitigating circumstances.
[46] "Gross negligence" is generally defined as an indifference to and a blatant violation of a legal duty with respect to the rights of others. It is a conscious and voluntary disregard of the need to use reasonable care, which is likely to cause foreseeable grave injury or harm to persons, property, or both. It is conduct that is extreme when compared with ordinary negligence, which is a mere failure to exercise reasonable care. West's Encyclopedia of American Law, edition 2 (2008).

Under Finding #2, the auditors determined that SDP supplanted State and/or local funds with Federal funds when it used the latter to provide services/equipment that had been previously paid for by the former. PDE claims the presumption of supplanting is refuted upon a showing that it would not be able to provide the services/equipment in the absence of Federal funds, that a shortfall of State/local funds "should have eliminated any presumption of supplanting" and that SDP's deficit of State/local funds rebuts the presumption.[47] ED argues that the auditor determined that SDP had already paid for the services/equipment with general funds and then transferred the expenses to the Federal grant when the general fund was in deficit. Because SDP paid the expenses first with State/local funds and then reimbursed the account with Federal funds, ED concludes that SDP engaged in supplanting. Moreover, the record shows that the Federal funds were transferred at the end of the fiscal cycle to alleviate the spending deficit,[48] and no consideration was given as to the possibility that such a transfer would violate the Department's "supplement, not supplant" requirements.[49]

PDE responds that its practice of paying expenditures from a general account and then transferring the costs to the Federal accounts is merely an ordinary bookkeeping transaction and implies that no inferences should be drawn from the timing of the transfers. ED disputes PDE's statement and provides evidence that SDP used the Federal funds to "help alleviate SDP's burgeoning budget deficit in its General Fund, a budget deficit that the auditors determined resulted not from any reduction in or lack of State and local funding but because SDP overspent its local funds due to inadequate internal controls."[50] Although PDE denies this determination, it does not introduce rebuttal evidence. Rather, it reiterates its argument that the budget shortfall serves to rebut the presumption of supplanting.[51]

The tribunal finds that SDP fails both prongs of the "equitable" inquiry. A preponderance of the evidence shows that SDP transferred Federal funds to pay for expenditures to ease its financial stress, rather than to achieve the Federal program's goals and objectives; these actions were not in good faith, nor were they consistent with the responsibilities of a Federal fiduciary. Moreover, the tribunal believes that SDP acted with deliberate disregard for the regulations in transferring funds for the purpose of plugging fiscal holes, rather than to meet programmatic goals. Not only does ED provide testamentary evidence of the reason underlying SDP's actions, but the timing of the transfers gives rise to an inference of impropriety. Thus, by acting in this self-serving manner and without regard for the programmatic requirements, SDP failed to act in good faith or execute its fiduciary duties to the highest standards. Furthermore, the tribunal believes that SDP's actions were intentional, and its disregard for possible programmatic violations in reassigning the costs from the general account to the Federal accounts demonstrates a lack of care and attention that may constitute gross negligence. For these reasons, PDE fails to demonstrate that an offset of the disallowed expenditures would be equitable. Accordingly, none of the $6,796,172 in liabilities assessed under Finding #2 is eligible for consideration under the doctrine of equitable offset.

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[47] PDL, p. 5

[48] The transfers in question here were made on July 7th, September 11th and September 30th of 2006. ED Brief at 7. The State's 2005-06 fiscal year ran from July 1, 2005 to June 30, 2006. The State has a requirement that SDP record all charges against Federal program funds for a fiscal year no later than 90 days after the end of the fiscal year, *i.e.*, September 30, 2006. SDP leadership informed the auditors that Federal funds were transferred to SDP's general account to alleviate the deficit. Eugenia Guess affidavit, par. 4, 7.

[49] PDL, p. 4.

[50] ED Reply, p. 5.

[51] PDE Reply, p. 14.

Turning to Finding #4, a total of $1,817,952 in salaries, duplicate charges for preparatory time for teachers and indirect benefits was disallowed. The record demonstrates, and PDE concedes, that $107,181 in salaries and benefits was paid to two employees who did not work on programs supported by Federal funds. Charging a Federal grant for non-grant activities demonstrates, at best, evidence of a lack of internal controls and oversight; at worst, it may constitute malfeasance. Additionally, the funds in question were transferred from the Federal account to the general account after the close of the school year for which the employees were paid.[52] This timing, taken together with the evidence discussed above that the transfers were made to cover SDP's financial shortfall, suggests that the transfers were not the result of a simple error but may have been an intentional decision. PDE does not provide further justification of this transfer, beyond asserting that it was consistent with ordinary bookkeeping practices and thusly, fails to rebut ED's evidence that the transfers were made for purposes not serving the grant. The tribunal finds that $107,181 in salaries in benefits was charged to the Federal account in clear disregard of the regulations, demonstrating a lack of proper management that does not adhere to highest standards of care.[53]

As to the $114,670 for the ESOL (English as a Second Language) teachers' salaries and benefits, SDP acknowledges that its own policies prohibit their payment from Federal funds. PDE urges that consideration should be given to the fact that these salaries and benefits could have been paid from Federal funds had SDP's policies allowed it, and, for this reason, the error is less egregious. The tribunal disagrees. SDP violated its own policies in assigning these costs to the Federal accounts. Moreover, it does not suggest that the payments were in error. That SDP either did not know or failed to follow its own policies – and has no explanation for this payment -- demonstrates a lack of oversight on its part and a failure to act as a proper fiduciary of the Federal funds. Thus, this tribunal finds that SDP's actions in charging Federal accounts for the various employees' salaries and benefits, as discussed above, failed in its fiduciary duty to the Department. The tribunal also finds no mitigating circumstances to consider. Accordingly, the $114,670 in liabilities for the ESOL program is ineligible for consideration under the doctrine of equitable offset.

Regarding the remaining $1,402,071 in liabilities assessed under Finding #4 for duplicate charges, PDE concedes that these charges were duplicate and, as such, impermissible.[54] PDE goes on to argue, however, that duplicative charges are eligible for equitable offset and cites as precedent *Pittsburg*, where the tribunal determined that a contract expenditure, deemed "duplicative", could be offset by an appropriate expenditure.[55]

PDE is correct that duplicate charges are generally eligible for consideration for an equitable offset. However, PDE is under the misimpression that where precedent exists, all it need do to prevail in the equitable offset argument is "present adequate documentation to demonstrate the availability of offset."[56] This is not correct. The doctrine of equitable offset is

[52] ED Brief, fn. 11.
[53] The tribunal rejects PDE's argument that *New York* serves as a general precedent for permitting an offset for otherwise impermissible personnel expenditures here. In *New York*, the issue was one of discrepancies in amounts of salaries/benefits charged to the grant program, which is factually and legally distinct from the case at bar where SDP charged salaries/benefits of employees who did not work on the grant program to the Federal account.
[54] OIG Audit, p. 38.
[55] PDE Reply, p. 16.
[56] *Id*.

not a right due an appellant, but rather an equitable remedy that may be applied where the facts and circumstances warrant such consideration, as determined by the tribunal. By citing as precedent the application of the doctrine under similar circumstances, PDE has demonstrated that the liability for the duplicate charges warrants consideration by the tribunal. However, PDE fails to present any specific facts or circumstances for the tribunal to consider. As proponent of the equitable offset argument, PDE bears the burden of proof. Thus, absent any facts to consider, PDE cannot satisfy the burden of proof that it acted in a manner that would warrant equitable consideration. For this reason, the $1,402,071 in liabilities assessed under Finding #4 for duplicate charges may not be considered for an equitable offset.

Finally, under Finding #5, ED concluded that a total of $1,354,299 in Federal funds were misspent or improperly documented and thus disallowed. The parties agree that $1,163,862 of that amount is barred from recovery due to the statute of limitations, leaving $150,164 in outstanding liabilities under this Finding.[57] The remaining expenditures are generally characterized as disallowed because they exceeded the maximum authorized amount, were not properly documented, were duplicative or were costs charged to the grant absent proper written policies and procedures. The tribunal notes that ED's description of the misexpenditures under this Finding is less strident than those under Findings #2 and #4 and does not go into great detail about the manner in which the funds were misspent, other than to state that it was done without "any regard" and generally assert that SDP suffers from "obvious system failures".[58]

Upon review of the OIG Audit, however, it is immediately clear that SDP's budget and grant monitoring practices suffered from systemic failures, to the detriment of its Federal programs. For example, the OIG documents numerous cases where grant analysts overrode grant budgets to complete voucher transactions, which resulted in the over-expenditures of various line items. Expenditures were recoded and the funds subsequently reallocated as costs were moved across grants to overcome these deficiencies. One of the analysts responsible for implementing these transfers, all of which were approved by the principal grant analyst, stated that the expenditures were moved "to complete the objective of closing out the funds."[59] Thus, it is clear that these costs were reallocated on a regular basis for the purpose of spending all available funds, rather than to achieve the goals of the grant program, without consideration of Federal grant management standards and principles. In this manner, SDP acted egregiously and markedly outside the scope of its fiduciary duties. The record is replete with actions by SDP that were intentional, improper and taken with reckless disregard for the regulations and statutes. For these reasons, none of the remaining $150,164 in liabilities under Finding #5 merits equitable consideration.

As discussed above, PDE has not shown by a preponderance of the evidence that, for the Findings associated with liabilities, it acted in good faith, in a manner consistent with its responsibilities as a fiduciary of Federal funds and that it did not act in a grossly negligent or intentionally improper manner, nor with deliberate disregard for the regulations and statutes. Thus, PDE failed to demonstrate that any equitable consideration is due for the disallowed expenditures. For this reason, the tribunal need not proceed further to consider the second prong of the equitable offset doctrine, namely, the allowability of the proposed offsetting expenditures.

[57] Joint Stipulations 1e-g.
[58] ED Reply, p. 25.
[59] OIG Audit, p. 54.

Conclusion

Based on the foregoing determinations of fact and conclusions of law and the proceedings herein, this tribunal finds that the statute of limitations does not bar recovery of any of the liabilities under dispute and that Pennsylvania Department of Education's argument for the application of equitable offset fails. Accordingly, the tribunal finds that ED may recover the full amount of dispute liabilities, $7,186,222.

ORDER

It is HEREBY ORDERED that the Pennsylvania Department of Education shall, immediately and in the manner prescribed by law, pay to the United States Department of Education the sum of $7,186,222.

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Allan C. Lewis
Chief Administrative Law Judge

Issued: February 28, 2014
Washington, D.C.

SERVICE

On February 28, 2014, a copy of the attached Initial Decision was sent by certified mail, return receipt requested to the following:

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On February 28, 2014, a copy of the attached Initial Decision was sent by hand delivery to--

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