Federal Assistance: Grants and Cooperative Agreements

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A. Introduction

The federal government provides assistance in many forms, financial and otherwise. Assistance programs are designed to serve a variety of purposes. Objectives may include fostering some element of national policy, stimulating private sector involvement, or furnishing aid of a type or to a class of beneficiaries the private market cannot or is unwilling to otherwise accommodate. The term "assistance" is statutorily defined in many federal laws. For example, the Federal Program Information Act broadly defines "assistance" as "the transfer of anything of value for a public purpose of support or stimulation authorized by [law]." 31U.S.C. § 6101(3). A similar definition of "assistance" is found in the Intergovernmental Cooperation Act, which adds the qualification, for purposes of that act, that the federal government provide such a transfer through grant or contractual arrangements. 31 U.S.C. § 6501(1). Another definition is provided in the Single Audit Act, which defines "Federal financial assistance" as "assistance that nonfederal entities receive or administer in the form of grants, loans, loan guarantees, property, cooperative agreements, interest subsidies, insurance, food commodities, direct appropriations, or other assistance." 31 U.S.C. § 7501(a)(5).[1]

Grants constitute one form of federal assistance. The Intergovernmental Cooperation Act defines a grant as "money, or property provided instead of money, that is paid or provided by the United States Government under a fixed annual or total authorization, to" an eligible beneficiary. 31 U.S.C. § 6501(4)(A) and (B). The act defines eligible beneficiaries as including state and local governments as well as certain private nonprofit organizations. *Id.* The act specifically excludes from this definition such things as a loan, shared revenue, and payments under a research and development procurement contract. *Id.* § 6501(4)(C). Similarly, GAO's budget glossary defines a grant as a "federal financial assistance award making payment in cash or in kind for a specified purpose," adding: "The term 'grant' is used broadly and may include a grant to nongovernmental recipients as well as one to a state or local government, while the term

[1] The Intergovernmental Cooperation Act and the Single Audit Act are discussed later in this chapter.

'grant-in-aid' is commonly used to refer only to a grant to a state or local government."[2]

Thus, a federal grant is a form of assistance authorized by statute in which a federal agency (the grantor) transfers something of value to a party (the grantee) for a purpose, undertaking, or activity of the grantee that the government has chosen to assist. The "thing of value" is usually money, but may, depending on the program legislation, also include property or services.[3] The grantee, again depending on the program legislation, may be a state or local government, a nonprofit organization, or a private individual or business entity. Federal grants to state and local governments comprise the largest category, involving federal outlays of more than $406 billion in fiscal year 2004, which constituted 17.7 percent of total federal outlays and 3.5 percent of Gross Domestic Product.[4]

The past four decades have witnessed a dramatic growth in federal grants, both in absolute dollar terms and as a proportion of total federal spending. The domestic Working Group's recent publication, *Guide to Opportunities for Improving grant Accountability* (Washington, D.C.: October 2005), at 1–2, illustrates this growth.[5] The *Guide* focuses on grants to state and

[2] GAO, *A Glossary of Terms Used in the Federal Budget Process*, GAO-05-734SP (Washington, D.C.: September 2005), at 60. The drafters of the Federal Grant and Cooperative Agreement Act of 1977, 31 U.S.C. §§ 6301–6308, discussed in section B.2 of this chapter, opted against including a separate statutory definition for the term "grant-in-aid" in favor of using the simpler term "grant" to encompass all such transactions regardless of the identity of the recipient. S. Rep. No. 95-449, at 9 (1977).

[3] The earliest grant programs were land grants. Monetary grants appear to have entered the stage in 1879, but they are largely a 20th century development. Madden, *The Constitutional and Legal Foundations of Federal Grants*, in *Federal Grant Law* 9 (M. Mason ed. 1982). One example of land grants is the Morrill Act of 1862, Pub. L. No. 37-108, 12 Stat. 503 (July 2, 1862), through which Congress assisted states with higher education by providing land grants to establish universities focused on agriculture, mechanics, and military science. Library of Congress, Congressional Research Service, No. RL30705, *Federal Grants to State and Local Governments: A Brief History* (Feb. 19, 2003), at 3–4.

[4] Office of Management and Budget, *Budget of the United States Government*, *Fiscal Year 2006*, *Historical Tables* (Washington, D.C. 2005), at 221.

[5] The Domestic Working Group, chaired by the Comptroller General, consists of 19 federal, state, and local audit organizations. Its purpose is to identify current and emerging challenges of mutual interest and to explore opportunities for greater collaboration within the intergovernmental audit community. The *Guide* describes a number of ideas and best practices to enhance grant management and administration. It covers several topics that are discussed in this chapter. An electronic copy of the *Guide* can be found at www.epa.gov/oig/dwg/reports (last visited November 5, 2005).

local governments, which make up about 80 percent of all federal grants. In 1960, such grants amounted to approximately $7 billion, representing about 7 percent of the total federal outlays. In the President's budget request for fiscal year 2006, about $450 billion was included to fund over 700 grant programs. As noted above, this represents over 17 percent of total federal outlays.

"Cooperative agreements" constitute another form of federal assistance relationship. As we will discuss in section B of this chapter, cooperative agreements are very much like grants in that they are used to transfer something of value to the recipient in order to accomplish a public purpose as authorized by law. The key difference is that the federal agency providing the assistance has more involvement with the recipient in carrying out the activity being funded under a cooperative agreement than it does in the case of a grant. Given the similarity between these two forms of assistance, our discussion of grants in the remainder of this chapter applies as well to cooperative agreements except as otherwise noted. Indeed, the distinction between grants and cooperative agreements is rarely, if ever, the focus of GAO and judicial decisions. Rather, as discussed hereafter, the decisions typically involve issues concerning the use of procurement contracts versus assistance relationships.

In July 2005, according to the most recent information available from the *Catalog of Federal Domestic Assistance*,[6] 58 federal agencies administered 1,621 assistance programs. To be sure, a large number of these are not grant programs since the *Catalog* includes loan and loan guarantee programs plus certain types of nonfinancial assistance. Nevertheless, it is a safe statement that there are hundreds of federal grant programs administered by dozens of agencies.

Grant programs typically are governed by detailed legislation and even more detailed regulations. As a result, many judicial and administrative grant cases are not amenable to broad treatment in this chapter since they

[6] The *Catalog of Federal Domestic Assistance* is published annually by the General Services Administration and the Office of Management and Budget pursuant to 31 U.S.C. § 6104 and OMB Circular No. A-89, *Federal Domestic Assistance Program Information* (Aug. 17, 1984). The *Catalog* is a governmentwide list of financial and nonfinancial federal assistance programs, projects, services, and activities administered by federal agencies that provide assistance or benefits to the American public. 31 C.F.R. § 205.2 (2005). The most recently updated print edition and the more frequently updated on-line version can both be accessed through the *Catalog*'s website at www.cfda.gov (last visited September 15, 2005).

hinge on specific statutory or regulatory provisions having limited general applicability. Nevertheless, it is still possible to extract a number of principles of "grant law" from the perspective of the availability and use of appropriated funds. Before we do so, it is necessary to discuss the differences and similarities of grants, cooperative agreements, and procurement contracts.

B. Grants *versus* Procurement Contracts

From the perspective of legal analysis, what precisely is a grant and when is it the appropriate funding vehicle for a federal agency to use? How do grants differ from contracts and what do they have in common? This section will explore these and related questions. We will first discuss judicial and GAO case law that often applies some basic contract law principles to grants but also recognizes significant differences between grants and contracts, particularly federal procurements. (As noted previously, grants are essentially the same as cooperative agreements for purposes of these cases.) We will then discuss statutory and administrative principles that have been developed to clarify the distinctions among grants, contracts, and cooperative agreements and when each should be used by a federal agency.

1. Judicial and GAO Decisions on the Nature of Grants

a. Contractual Aspects of Grants

Courts frequently look to contract law principles to define the rights and obligations of the parties to a federal grant. In particular, the courts view the acceptance of a grant of federal funds subject to conditions that must be met by the grantee as creating a "contract" between the United States and the grantee. The "grant as a type of contract" approach evolved from early Supreme Court decisions. In what may be the earliest case on the subject, the government had made a grant of land to a state on the condition that the state would use the land, or the proceeds from its sale, for certain reclamation purposes. The Court stated:

> "It is not doubted that the grant by the United States to the State upon conditions, and the acceptance of the grant by the State, constituted a contract. All the elements of a contract met in the transaction—competent parties, proper

> subject-matter, sufficient consideration, and consent of minds."

McGee v. Mathis, 71 U.S. (4 Wall.) 143, 155 (1866). *See also United States v. Northern Pacific Railway Co.*, 256 U.S. 51, 63–64 (1921).

The Supreme Court has consistently followed this approach in upholding conditions that Congress imposes upon recipients of federal grants. S*ee, e.g.*, *Jackson v. Birmingham Board of Education*, 544 U.S. ___, 125 S. Ct. 1497 (2005); *Davis v. Monroe County Board of Education*, 526 U.S. 629 (1999); *Pennhurst State School & Hospital v. Halderman*, 451 U.S. 1 (1981). Consistent with the analogy to contract principles, the key consideration in many of these cases is whether the grantee was sufficiently aware of the condition to constitute acceptance of it. As the Court observed in *Jackson*, 125 S. Ct. at 1509:

> "When Congress enacts legislation under its spending power, that legislation is 'in the nature of a contract: in return for federal funds, the States agree to comply with federally imposed conditions.' *Pennhurst State School and Hospital v. Halderman*, 451 U.S. 1, 17, 101 S. Ct. 1531, 67 L.Ed.2d 694 (1981). As we have recognized, '[t]here can . . . be no knowing acceptance [of the terms of the contract] if a State is unaware of the conditions [imposed by the legislation on its receipt of funds].' *Ibid.*"[7]

Lower courts also have applied contract principles to grants in various contexts: to enforce grantee compliance with grant conditions;[8] to determine jurisdiction under the Tucker Act (28 U.S.C. § 1491) for claims

[7] See section C.1.b of this chapter for further discussion of congressional use of grants in the exercise of its constitutional spending power. Congress's spending power is also discussed in Chapter 1, section B.

[8] *E.g.*, *United States v. Miami University*, 91 F. Supp. 2d 1132, 1142–44 (S.D. Ohio 2000), *aff'd*, 294 F.3d 797 (6th Cir. 2002); *United States v. Frazer*, 297 F. Supp. 319, 322–23 (M.D. Ala. 1968); *United States v. Sumter County School District No. 2*, 232 F. Supp. 945, 950 (E.D.S.C. 1964); *United States v. County School Board*, 221 F. Supp. 93, 99–100 (E.D. Va. 1963).

against the United States;[9] and to analyze the nature of the government's obligations under a particular grant statute or agreement.[10]

GAO decisions likewise analogize grants to contracts for certain purposes. *E.g.*, B-303927, June 7, 2005; 68 Comp. Gen. 609 (1989); 50 Comp. Gen. 470 (1970); 42 Comp. Gen. 289, 294 (1962); 41 Comp. Gen. 134, 137 (1961); B-232010, Mar. 23, 1989; B-167790, Jan. 15, 1973. In 50 Comp. Gen. 470, for example, a medical teaching facility, recipient of a reimbursement-type construction grant under a federal statute, was caught in a cash flow crisis because disbursement of grant funds was much less frequent than its contractor's need for progress payments. The question was whether the grant could be regarded as a "contract or claim" so the recipient could assign future grant proceeds to a bank in return for an interim loan, pursuant to the Assignment of Claims Act, 41 U.S.C. § 15. Under the Assignment of Claims Act, any party that has or will have a right to payment of $1,000 or more under a contract with the U.S. government may assign this right to a bank, trust company, or other financing company, assuming the party meets all the requirements of the Act. *Id.* § 15(b). Noting that the accepted grant constituted a "valid contract" and that assignment was not prohibited by the program legislation, regulations of the grantor agency, or the terms of the grant agreement, GAO concluded that assignment under the Assignment of Claims Act was permissible.

[9] *E.g.*, *Pennsylvania Department of Public Welfare v. United States*, 48 Fed. Cl. 785 (2001); *Moore v. United States*, 48 Fed. Cl. 394 (2000); *Thermalon Industries, Ltd. v. United States*, 34 Fed. Cl. 411 (1995); *Cole County Regional Sewer District v. United States*, 22 Cl. Ct. 551 (1991); *County of Suffolk v. United States*, 19 Cl. Ct. 295 (1990); *Kentucky ex rel. Cabinet for Human Resources v. United States*, 16 Cl. Ct. 755, 762 (1989); *Rogers v. United States*, 14 Cl. Ct. 39, 44 (1987); *Idaho Migrant Council, Inc. v. United States*, 9 Cl. Ct. 85, 88–89 (1985); *Missouri Health & Medical Organization, Inc. v. United States*, 641 F.2d 870 (Ct. Cl. 1981); *Texas v. United States*, 537 F.2d 466 (Ct. Cl. 1976). While most of these cases use language carefully crafted to avoid confusion between a grant agreement and a "traditional," that is, procurement, contract, the essence of the jurisdictional finding is that the grant claim is based on some form of "contract." The Tucker Act cases are discussed in more detail later in section B.2.c of this chapter in relation to the Federal Grant and Cooperative Agreement Act.

[10] *E.g.*, *Knight v. United States*, 52 Fed. Cl. 243 (2002), *rev'd on other grounds*, 65 Fed. Appx. 286 (Fed. Cir. 2003); *Pennsylvania Department of Public Welfare v. United States*; *Henke v. Department of Commerce*, 83 F.3d 1445 (D.C. Cir. 1996); *Arizona v. United States*, 494 F.2d 1285 (Ct. Cl. 1974). *See also City of Manassas Park v. United States*, 633 F.2d 181 (Ct. Cl.), *cert. denied*, 449 U.S. 1035 (1980) (claim found to be noncontractual, but agreement referred to as "grant contract" and grantor-grantee relationship as "privity of contract").

b. Differences between Grants and Contracts

As indicated above, the researcher will find a body of judicial and GAO case law standing for the proposition that there are certain contractual aspects to a grant relationship. It does not follow, however, nor has GAO or (to our knowledge) any court suggested, that all of the trappings of a procurement contract somehow attach to a grant. While grant relationships have certain "contractual" relationships, the contract analogy has its limits.

Take, for example, the issue of consideration. While the typical grant agreement may well include sufficient legal consideration from the standpoint of supporting a legal obligation, it may be quite different from the consideration found in procurement contracts. As noted earlier in this chapter, a grant is a form of assistance to a designated class of recipients authorized by statute to meet recognized needs. Grant needs, by definition, are not needs for goods or services required by the federal government itself. The needs are those of a nonfederal entity, whether public or private, which the Congress has decided to assist as being in the public interest.

An illustration of where this distinction on the issue of consideration can lead is 41 Comp. Gen. 134 (1961). That decision involved a statutory provision authorizing grants to states for the construction of sewage treatment works, up to a stated percentage of estimated costs, with the grantee to pay all remaining costs. Strong demand for limited funds meant that grants were frequently awarded for amounts less than the permissible ceiling. The question was whether these grants could be amended in a subsequent fiscal year to increase the amount to, or at least closer to, the statutory ceiling. If a straight "grant equals contract" approach had been applied, the answer would have been no, unless the government received additional consideration. However, GAO concluded that the amendments were authorized, noting that the "consideration" flowing to the government under these grants (in sharp contrast with procurement contracts) consisted only of "the benefits to accrue to the public and the United States" through use of the funds to construct the desired facilities. *Id.* at 137.

In recognition of the essential distinctions between a grant agreement and a procurement contract, the Supreme Court has stated:

> "Although we agree . . . that . . . [the] grant agreements [at issue] had a contractual aspect, . . . the program cannot be viewed in the same manner as a bilateral contract governing a discrete transaction. . . . Unlike normal contractual

> undertakings, federal grant programs originate in and remain governed by statutory provisions expressing the judgment of Congress concerning desirable public policy."

Bennett v. Kentucky Department of Education, 470 U.S. 656, 669 (1985). The state in that case had argued that, since the grant was "in the nature of a contract," the Court should apply the principle, drawn from contract law, that ambiguities in the grant agreement should be resolved against the government as the drafting party. *Id.* at 666. Based on the analysis summarized in the quoted passage, the Supreme Court declined to do so.

Similarly, the contract law doctrine of "impossibility of performance" has been held inapplicable to a grant. *Maryland Department of Human Resources v. United States Department of Health & Human Services*, 762 F.2d 406 (4th Cir. 1985). In that case, the government had imposed a zero error standard on states under a grant program. The state argued that error-free administration was impossible. While agreeing with that factual proposition, the court nevertheless held that the zero tolerance level was permissible under the governing statute and regulations. The impossibility of performance doctrine, said the court, "relates to commercial contracts and not to grant in aid programs." *Id.* at 409.

A 1971 decision, 51 Comp. Gen. 162, illustrates another distinction. In that case, the Comptroller General concluded that an ineligible grantee could not be reimbursed for expenditures under *quantum meruit* principles. *Quantum meruit* is a "contract-implied-in law" theory founded on the principle that a party who receives a tangible benefit from another is entitled to compensation. In the typical grant situation, the grantee's activities are not performed solely for the direct benefit of the government and the government does not receive any measurable, tangible benefit in the traditional contract sense.

Similarly, the courts are reluctant to apply the "contract implied in fact" concept in the grant context. *E.g.*, *Capitol Boulevard Partners v. United States*, 31 Fed. Cl. 758 (1994); *Blaze Construction, Inc. v. United States*, 27 Fed. Cl. 646 (1993); *Eubanks v. United States*, 25 Cl. Ct. 131 (1992); *Somerville Technical Services v. United States*, 640 F.2d 1276 (Ct. Cl. 1981). The reasoning, in part, is that a grant is a sovereign act binding the government only to the extent of its express undertakings.

In *American Hospital Association v. Schweiker*, 721 F.2d 170 (7th Cir. 1983), *cert. denied*, 466 U.S. 958 (1984), the court rejected the contention

that otherwise valid regulations of the Department of Health and Human Services impaired contractual rights of grantees under the Hill-Burton hospital assistance program:

> "[T]he relationship between the government and the hospitals here cannot be wholly captured by the term 'contract' and the analysis traditionally associated with that term. . . . The contract analogy thus has only limited application."

721 F.2d at 182–83. Additionally, the court in *United States v. Kensington Hospital*, 760 F. Supp. 1120 (E.D. Pa. 1991), refused to apply the Anti-Kickback Act of 1986[11] to government claims for fraud under the Medicare and Medicaid programs, finding that the government's relationship with its grantees under these programs could not be characterized as "prime contracts" for purposes of the Act.

Finally, appropriations law restrictions may not apply to grants in the same manner as they apply to contracts. Thus, GAO has held that the principle of "severability," as embodied in the *bona fide* needs rule for purposes of contracts, is irrelevant to assistance agreements. *See* B-289801, Dec. 30, 2002 (dealing with multiple year Education Department grants); B-229873, Nov. 29, 1988 (dealing with Small Business Administration cooperative agreements). These cases are discussed in section C.1 of this chapter.

c. Grants as "Hybrids"

Perhaps most aptly, some courts have described grants as "hybrid" instruments in view of both their similarities to and differences from contracts. *Mayor and City Council of Baltimore v. Browner*, 866 F. Supp. 249, 252 (D. Md. 1994); *Town of Fallsburg v. United States*, 22 Cl. Ct. 633, 642 (1991). In this regard, the court in *Browner* stated: "Essentially, grants are contracts with statutory and regulatory terms superimposed upon them." 866 F. Supp. at 252. The court held that the appropriate standard of judicial review depended on the nature of the dispute before it. If the issues arose under the grant statute or regulations (as they did in this case), the court would review the agency's actions under an abuse of discretion standard; other issues would be considered contractual and subject to *de*

[11] The Anti-Kickback Act of 1986, Pub. L. No. 99-634, § 2 (a), 100 Stat. 3523 (Nov. 7, 1986), codified at 41 U.S.C. §§ 51–58, imposes criminal and civil sanctions against subcontractors who provide money, gifts, or other "kickbacks" to prime contractors in order to secure their subcontracts as part of a larger government contract.

novo review applying contract law principles. *Fallsburg*, which the *Browner* court followed, took the same approach in determining the appropriate standard for judicial review. See also, to the same effect, *United States v. Hatcher*, 922 F.2d 1402, 1406–07 (9th Cir. 1991), in which the court reviewed the federal funding agency's actions under the Administrative Procedure Act rather than contract law principles since the issues arose under the program statute (in this case a program of individual scholarships).

Other cases have followed the same approach without specifically referring to grants as hybrids. These cases emphasize that the rights and obligations of the parties, while contractual in nature, cannot be determined solely by reference to the terms of the grant agreement itself. Rather, the court must also look to such sources as the applicable grant statute, its legislative history, the grantor agency's regulations, and applicable Office of Management and Budget guidance. *See, e.g.*, *Westside Mothers v. Haveman*, 289 F.3d 852, 858 (6th Cir.), *cert. denied*, 537 U.S. 1045 (2002); *Institute for Technology Development v. Brown*, 63 F.3d 445, 449 (5th Cir. 1995).

In sum, it is clear that the many varied rules and principles of contract law will not be automatically applied to grants. Nevertheless, it is equally clear that the creation of a grant relationship results in certain legal obligations flowing in both directions (grantor and grantee) that will be enforceable by the application of some basic contract rules. As the then Claims Court (now Court of Federal Claims) stated:

> "[A] notice of a federal grant award in return for the grantee's performance of services can create cognizable obligations to the extent of the government's undertakings therein."

Community Relations-Social Development Commission v. United States, 8 Cl. Ct. 723, 725 (1985). Thus, if a grantee does what it has committed itself to do and incurs allowable costs, the government is obligated to pay. *E.g.*, B-181332, Dec. 28, 1976. Conversely, the government has a right to expect that the grantee will use the grant funds only for authorized grant purposes and only in accordance with the terms and conditions of the grant. The right of a grantor agency to oversee the expenditure of funds by the grantee to ensure that the money is used only for authorized purposes, and the grantee's corresponding duty to account to the grantor for its use of the funds, are implicit in the grant relationship and are not dependent upon

specific language in the authorizing legislation. *See, e.g.*, B-303927, June 7, 2005; 64 Comp. Gen. 582 (1985).

2. The Federal Grant and Cooperative Agreement Act

a. Purposes and Provisions of the Act

Long-standing confusion and concern over federal agency use of grant relationships *versus* procurement relationships led the Commission on Government Procurement, in its 1972 report, to recommend the enactment of legislation to distinguish assistance from procurement and to further refine the concept of assistance by clearly distinguishing grants from cooperative agreements.[12] While Congress did not enact all of the Commission's recommendations, it did enact these two in the form of the Federal Grant and Cooperative Agreement Act of 1977, Pub. L. No. 95-224, 92 Stat. 3 (Feb. 3, 1978), codified at 31 U.S.C. §§ 6301–6308. Referring to the Commission's findings, the report on this legislation by the then Senate Committee on Governmental Affairs (now the Senate Committee on Homeland Security and Governmental Affairs) observed:

> "No uniform statutory guideline exists to express the sense of Congress on when executive agencies should use either grants, cooperative agreements or procurement contracts. Failure to distinguish between procurement and assistance relationships has led to both the inappropriate use of grants to avoid the requirements of the procurement system, and to unnecessary red tape and administrative requirements in grants."

S. Rep. No. 95-449, at 6 (1977).

The Federal Grant and Cooperative Agreement Act was enacted to—

> "prescribe criteria for executive agencies in selecting appropriate legal instruments to achieve—

[12] *See generally* 3 *Report of the Commission on Government Procurement*, chs. 1–3 (Dec. 31, 1972).

(A) uniformity in their use by executive agencies;

(B) a clear definition of the relationships they reflect; and

(C) a better understanding of the responsibilities of the parties to them."

31 U.S.C. § 6301(2). To achieve these purposes, the act established standards that agencies are to use in selecting the most appropriate funding vehicle: a procurement contract, a grant, or a cooperative agreement. The standards are contained in sections 4, 5, and 6 of the act, codified at 31 U.S.C. §§ 6303–6305, which are summarized below:

- *Procurement contracts*. An agency is to use a procurement contract when "the principal purpose of the instrument is to acquire (by purchase, lease, or barter) property or services for the *direct benefit or use* of the United States Government." 31 U.S.C. § 6303 (emphasis added).

- *Grant agreements*. An agency is to use a grant agreement when the principal purpose of the relationship is to transfer a thing of value [money, property, services, *etc.*] to the recipient "to carry out a public purpose of support or stimulation authorized by a law of the United States instead of acquiring (by purchase, lease, or barter) property or services for the direct benefit or use of the United States Government," and "substantial involvement is *not* expected" between the agency and the recipient when carrying out the contemplated activity. 31 U.S.C. § 6304 (emphasis added).

- *Cooperative agreements*. An agency is to use a cooperative agreement when the principal purpose of the relationship is to transfer a thing of value to the recipient "to carry out a public purpose of support or stimulation authorized by a law of the United States instead of acquiring (by purchase, lease, or barter) property or services for the direct benefit or use of the United States Government," and "substantial involvement *is* expected" between the agency and the recipient when carrying out the contemplated activity. 31 U.S.C. § 6305 (emphasis added).

The Federal Grant and Cooperative Agreement Act authorizes the Director of the Office of Management and Budget (OMB) to provide additional guidance in interpreting the act to "promote consistent and efficient use of

procurement contracts, grant agreements, and cooperative agreements." 31 U.S.C. § 6307(1). OMB published such guidance on August 18, 1978 (43 Fed. Reg. 36860), which is still in effect.[13]

The Federal Grant and Cooperative Agreement Act's basic criterion on when to use a procurement contract rather than one of the two assistance arrangements (a grant or cooperative agreement) is clear and turns on the underlying purpose of the arrangement: If the federal agency's primary purpose is to acquire goods or services for the direct benefit or use of the government, then a procurement contract must be used. On the other hand, the act calls for use of a grant or a cooperative agreement when the agency's primary purpose is to provide assistance for the recipient to use in order to accomplish a public objective authorized by law. Thus, procurement contracts differ from either grants or cooperative agreements in terms of their basic purpose.

Under the act, a grant and a cooperative agreement are closely related assistance arrangements with essentially the same basic purpose: to encourage the recipient of funding to carry out activities in furtherance of a public goal. The difference is the degree of involvement between the federal agency and the recipient in the performance of the activity being funded. When the involvement is expected to be "substantial," the act requires use of a cooperative agreement rather than a grant. The act does not define "substantial" in this context. However, the Senate report on the Federal Grant and Cooperative Agreement Act provided the following examples of situations that might require substantial federal involvement:

- federal project management or federal program or administrative assistance would be helpful due to the novelty or complexity involved (for example, in some construction, information systems development, and demonstration projects);

- federal/recipient collaboration in performing the work is desirable (for example, in collaborative research, planning or problem solving);

[13] For two articles discussing the OMB guidance, see Paul G. Dembling, *The Federal Grant and Cooperative Agreement Act: Its Use and Misuse*, 51 Federal Lawyer 12 (February 2004); Kurt M. Rylander, *Scanwell Plus: Challenging the Propriety of a Federal Agency's Decision to Use a Federal Grant and Cooperative Agreement*, 28 Pub. Cont. L. J. 69 (Fall 1998).

- federal monitoring is desirable to permit specified kinds of direction or redirection of the work because of interrelationships among projects in areas such as applied research; and

- federal involvement is desirable in the early stages of ongoing programs, such as welfare or law enforcement programs, where standards are being developed or the application of standards requires a period of adjustment until recipient capability has been developed.

S. Rep. No. 95-449, at 9–10. The OMB guidance expands on what substantial involvement means. *See* 43 Fed. Reg. at 36863.

It should be emphasized that substantial involvement here refers to federal participation in the *performance* of the funded activity. This should not be taken to imply that a federal grantor agency lacks an *oversight* role when lack of substantial involvement calls for the use of a grant.[14] Quite the contrary, GAO has held that grantor agencies have an affirmative duty to oversee grant performance and that, "[a]s a matter of law, a grantor agency may not disassociate itself from the performance of its grant." B-303927, June 7, 2005, at 8–9. The decision in B-303927 cited a provision of the Single Audit Act, 31 U.S.C. § 7504(a)(1) ("Each Federal agency shall, in accordance with guidance issued by the Director [of the Office of Management and Budget], . . . monitor non-federal entity use of Federal awards"), as well as GAO and judicial decisions that emphasize the contractual nature of grant obligations.

The Federal Grant and Cooperative Agreement Act authorizes OMB to exempt a transaction or program of an executive agency from its application. *Id.* § 6307(2). The original act provided this exemption authority only on a temporary basis. However, Congress later made the authority permanent. Pub. L. No. 97-162, 96 Stat. 23 (Apr. 1, 1982). The legislative history of Public Law 97-162 noted that OMB had used the exemption authority sparingly (only for nonmonetary grants and certain revenue sharing programs) and stated the expectation that future exemptions would likewise be few in number and limited to individual transactions or programs. S. Rep. No. 97-180, at 2 (1981).

[14] In this regard, OMB guidance specifically states that substantial involvement refers to performance of the funded activity rather than oversight. 43 Fed. Reg. at 36863.

Specific legislation may also exempt programs from the Federal Grant and Cooperative Agreement Act's requirements. This was the case in B-279338, Jan. 4, 1999, where a provision of the Indian Self-Determination and Education Assistance Act, 25 U.S.C. § 450e-1, made such an exemption. In view of this exemption, the Comptroller General upheld the Interior Department's use of a contract, rather than a grant, to fund a land acquisition for an Indian tribe using authority in the Self-Determination Act that ordinarily applied to a grant program.

b. Agency Implementation of the Act

In determining the correct funding instrument to use, the threshold question to consider is whether the agency has statutory authority to engage in assistance transactions at all. While federal agencies generally have "inherent" authority to enter into contracts to procure goods or services for their own use, there is no comparable inherent authority to enter into assistance relationships, that is, to give away the government' s money or property, either directly or by the release of vested rights, to benefit someone other than the government. 65 Comp. Gen. 605, 607 (1986); B-210655, Apr. 14, 1983. Therefore, the relevant legislation must be studied to determine whether an assistance relationship is authorized at all, and if so, under what circumstances and conditions. *See*, *e.g.*, 64 Comp. Gen. 582, 584 (1985); 59 Comp. Gen. 1, 8 (1979).

It is important to note that the Federal Grant and Cooperative Agreement Act does not expand an agency's substantive authority in this regard. While the act provides criteria for examining whether an arrangement should be a contract, grant, or cooperative agreement, determinations of whether an agency has authority to enter into such arrangements in the first instance must be based on the agency's authorizing or program legislation. Once the necessary underlying authority is found, the legal instrument (contract, grant, or cooperative agreement) that fits the arrangement as contemplated must be used, using the statutory definitions for guidance as to which instrument is appropriate.

The analysis of the agency's program authority is not a matter of discretion; the requisite authority either is there or it is not. In this regard, however, the focus should be on the substance of an agency's program authority rather than the particular labels used or not used. In this connection, a Senate Committee on Governmental Affairs report stated:

> "[The Federal Grant and Cooperative Agreement Act] was never intended to be an independent grant of authority to agencies to enter into assistance or contractual

> relationships where no such authority can be found in authorizing legislation. Rather, it was and is intended to force agencies to use a legal instrument that, according to the criteria established by the Act, matches the intended and authorized relationship—regardless of the terminology used in existing legislation to characterize the instrument to be used in the transaction."[15]

Further discussion on this point may be found in B-196872-O.M., Mar. 12, 1980, and a GAO report entitled *Agencies Need Better Guidance for Choosing Among Contracts, Grants, and Cooperative Agreements*, GGD-81-88 (Washington, D.C.: Sept. 4, 1981).

c. Decisions Interpreting the Act

It is important that an agency identify the appropriate funding instrument because procurement contracts are subject to a variety of statutory and regulatory requirements that generally do not apply to assistance transactions. If the type of relationship is not determined properly, assistance arrangements could be used to evade competition and other legal requirements applicable to procurement contracts. Conversely, legitimate assistance awards should not be burdened by all of the formalities of procurement contracts. The following decisions illustrate how the act's criteria have been applied.

In 61 Comp. Gen. 428 (1982), GAO agreed with the Department of Energy's use of a cooperative agreement with a private company to design and construct a "prototype solar parabolic dish/sterling engine system module," finding that the proposal's primary purpose was to encourage development and early market entry rather than to acquire the particular item for its own use, although it would eventually have governmental applications. Therefore, GAO held that the arrangement did not constitute a procurement contract requiring competition.

In contrast, some decisions have held that a procurement contract is the appropriate instrument. For example, the Comptroller General determined in B-262110, Mar. 19, 1997, that the Environmental Protection Agency should have acquired conference support services using a procurement contract rather than a cooperative agreement because the support services

[15] S. Rep. No. 97-180, at 4 (1981). This report is on legislation that amended the original act rather than direct legislative history on the original act. Nevertheless, it is important as a clear statement from one of the relevant jurisdictional committees.

were a direct benefit to the agency. Similarly, the Comptroller General concluded in B-257430, Sept. 12, 1994, that the Office of Personnel Management (OPM) should have used a procurement contract to obtain survey services because the services directly benefited OPM by providing OPM assistance in performing the agency's statutory duty and because OPM exercised significant influence over the survey arrangements.[16]

The issue of whether an agency was improperly using an assistance instrument instead of a procurement contract has also been raised in judicial decisions. The court in *Chem Service, Inc. v. Environmental Monitoring Systems Laboratory*, 12 F.3d 1256 (3rd Cir. 1993), after reviewing the relevant authorizing legislation and its legislative history, held that the plaintiff company could challenge whether a cooperative research and development agreement between the Environmental Protection Agency and a private laboratory actually constituted a procurement contract that should have been subject to competition requirements under federal law.

One common situation in which the question of the principal purpose of the funding relationship is raised is the so-called "third party" or "intermediary" situation where a federal agency provides assistance to specified recipients by using an intermediary. In these situations, it is necessary to examine the agency's program authority to determine the authorized forms of assistance. The agency's relationship with the intermediary should normally be a procurement contract if the intermediary is not itself a member of a class eligible to receive assistance from the government. In other words, if an agency program contemplates provision of technical advice or services to a specified group of recipients, the agency may provide the advice or services itself or hire an intermediary to do it for the agency. In that case, the proper vehicle to fund the intermediary is a procurement contract. The agency is "buying" the services of the intermediary for its own purposes, to relieve the agency of the need to provide the advice or services with its own staff. Thus, it is acquiring the services for "the direct benefit or use of the United States Government,"

[16] Additional decisions holding that a procurement contract rather than an assistance instrument should have been used are: 67 Comp. Gen. 13 (1987), *aff'd upon reconsideration*, B-227084.6, Dec. 19, 1988 (operation of research and training programs at a government facility funded by Maritime Administration); 65 Comp. Gen. 605 (1986) (proposed study, sponsored by Council on Environmental Quality, of risks and benefits of certain pesticides, intended for use by federal regulatory agencies); B-210655, Apr. 14, 1983 (funding by Department of Energy of college campus forums on nuclear energy).

which mandates the use of a procurement contract under the Federal Grant and Cooperative Agreement Act.

On the other hand, if the program purpose contemplates support to certain types of intermediaries to provide consultation or other specified services to third parties, the Comptroller General has approved the agency's choice of a grant rather than a contract as the preferred funding vehicle. Thus, in 58 Comp. Gen. 785 (1979), the Comptroller General found that the Department of Commerce could properly award a noncompetitive grant to an intermediary organization to provide management and technical assistance to minority business firms. Although the point was not detailed in the decision, the agency clearly had the requisite program authority to provide grant assistance to the intermediary.

The Comptroller General came to the opposite conclusion in 61 Comp. Gen. 637 (1982). In that case, the Department of Housing and Urban Development had awarded a cooperative agreement to a nonprofit organization to provide technical assistance to certain block grant recipients. While the department's authority to provide technical assistance to the block grant recipients was clear, there was no authority to provide assistance to the intermediary organization. The essence of the intermediary transaction was the acquisition of services for ultimate delivery to authorized recipients. Thus, the Comptroller General concluded that a procurement contract should have been used.

The Senate committee report on legislation that amended the original Federal Grant and Cooperative Agreement Act addressed the intermediary issue and agreed with GAO's interpretation:

> "The choice of instrument for an intermediary relationship depends solely on the principal federal purpose in the relationship with the intermediary. The fact that the product or service produced by the intermediary may benefit another party is irrelevant. What is important is whether the federal government's principal purpose is to acquire the intermediary's services, which may happen to take the form of producing a product or carrying out a service that is then delivered to an assistance recipient, or if the government's principal purpose is to assist the intermediary to do the same thing. Where the recipient of an award is not receiving assistance from the federal agency but is merely used to provide a service to another entity

> which is eligible for assistance, the proper instrument is a procurement contract."

S. Rep. No. 97-180, at 3 (1981).

The foregoing cases deal with the specific issue of which funding instrument to use, procurement contract versus assistance agreement. However, the analysis required by the Federal Grant and Cooperative Agreement Act may also be relevant when the main issue concerns the applicability of other federal laws to a particular funding instrument. The following cases provide examples.

In B-196690, Mar. 14, 1980, the Interior Department asked whether it could use its 1978 and 1979 appropriations to fund expenses of the American Samoan Judiciary related to entertainment and the purchase of motor vehicles. Using the guidelines of the Federal Grant and Cooperative Agreement Act, the Comptroller General reviewed the relationship between the Interior Department and the American Samoan Judiciary and concluded that it was essentially a grant relationship. Therefore, restrictions such as those relating to entertainment and motor vehicles that would apply to the direct expenditure of appropriations by the federal government or through a contractor did not apply to expenditures by the grant recipient, absent some provision to the contrary in the appropriation, agency regulations, or grant agreement.[17] For fiscal year 1980, Congress changed the statutory language to specifically appropriate funds "for grants to the judiciary in American Samoa," thus removing any doubt that the Samoan Judiciary is a grant recipient. Pub. L. No. 96-126, 93 Stat. 954, 965 (Nov. 27, 1979).

In 59 Comp. Gen. 424 (1980), the Comptroller General viewed the Environmental Protection Agency's public participation program of providing financial assistance to certain intervenors in proceedings before the agency as essentially a grant relationship rather than a contractual one. Accordingly, the decision held that 31 U.S.C. § 3324, which generally prohibits the government from making payments for goods or services in

[17] Of course, similar restrictions on allowable costs can be, and frequently are, imposed on grantees. For example, entertainment costs are unallowable grant costs under several OMB circulars. *See* OMB Circular No. A-21, *Cost Principles for Educational Institutions* (May 10, 2004), Attachment J, § 17; OMB Circular No. A-122, *Cost Principles for Non-profit Organizations* (May 10, 2004), Attachment B, § 14. Section G of this chapter discusses grant cost issues in more detail.

advance of delivery,[18] did not to preclude participants from receiving funds in advance of the completion of their participation, subject to the provision of adequate fiscal controls.

In another case, B-290900, Mar. 18, 2003, the Comptroller General held that the general requirement under 44 U.S.C. § 501 that the Government Printing Office perform printing and binding "for the government" did not apply to the publication of an educational brochure about the Michigan Lighthouse Project that the Bureau of Land Management (BLM) had helped to fund. The Michigan Lighthouse Project involved a cooperative agreement between BLM and other federal, state, and nonprofit entities to preserve historical lighthouses. While the decision did not refer specifically to the Federal Grant and Cooperative Agreement Act, it did apply reasoning similar to the analysis called for by the act. The decision noted that the brochure was published as part of the cooperative agreement and thus generally benefited all of the parties to the agreement. Accordingly, for the same reason that the transaction did not involve work "for the government" within the meaning of 44 U.S.C. § 501, it did not represent the acquisition of services principally "for the direct benefit or use of the United States Government."

Judicial decisions also have considered the Federal Grant and Cooperative Agreement Act in considering the applicability of other laws. In *Hammond v. Donovan*, 538 F. Supp. 1106 (W.D. Mo. 1982), the court held that the relationship between the Labor Department and a state employment office was a grant, and therefore not subject to a statute requiring that certain procurement contracts contain an affirmative action for veterans provision. The court in *Partridge v. Reich*, 141 F.3d 920 (9th Cir. 1998), reached the same conclusion in rejecting the contention that a grant was subject to the same statute considered in *Hammond*.

Before leaving the subject of the Federal Grant and Cooperative Agreement Act, it is worth highlighting some judicial decisions that have considered the act in relation to a topic discussed in the previous section: whether and to what extent grants and cooperative agreements should be regarded as contracts.

[18] For a more detailed explanation of 31 U.S.C. § 3324 and advance payments in general, see Chapter 5, section C. For more on advance payments in the grant context, see section E of this chapter.

The issue in several of the cases is whether assistance agreements can give rise to enforceable contract rights and obligations. The Tucker Act gives the Court of Federal Claims jurisdiction over claims against the United States "founded . . . upon any express or implied contract with the United States . . ." 28 U.S.C. § 1491(a)(1). In *Trauma Service Group, Ltd. v. United States*, 33 Fed. Cl. 426 (1995), the court determined that a memorandum of agreement (MOA) between the Defense Department and a health care provider was a cooperative agreement within the meaning of the Federal Grant and Cooperative Agreement Act. Reasoning that all federal agreements must fall into one of the act's three categories, the court reasoned that the MOA, therefore, could not be a contract for purposes of the Tucker Act. *Trauma Service Group,* 33 Fed. Cl. at 429–30. Accordingly, the court dismissed the claim.

Another judge of the same court came to the opposite conclusion in a case decided just a few months later, *Thermalon Industries, Ltd. v. United States*, 34 Fed. Cl. 411 (1995). The *Thermalon* court held that a National Science Foundation research grant could give rise to contract rights enforceable under the Tucker Act so long as the grant embodied the traditional elements of a contract: offer, acceptance by an officer having authority to bind the United States, and consideration. The court rejected the agency's argument that the Federal Grant and Cooperative Agreement Act precluded treating the grant as a contract for Tucker Act purposes:

> "There is no suggestion in the [Federal Grant and Cooperative Agreement Act] that procurement contracts are the only type of contracts enforceable under the Tucker Act or that grant agreements that satisfy all of the ordinary requirements for a government contract should not be classified as contracts enforceable under the Tucker Act."

Thermalon, 34 Fed. Cl. at 417. Considering the Federal Grant and Cooperative Agreement Act's legislative history, the court viewed that act as addressing "a very different set of concerns" than Tucker Act contract jurisdiction. *Id.* at 418. To the extent that its interpretation of the act was inconsistent with the analysis in *Trauma Service Group*, the court "respectfully disagree[d] with that analysis." *Id.* at fn. 4.

Later, in *Trauma Service Group, Ltd. v. United States*, 104 F.3d 1321 (1997), the Court of Appeals for the Federal Circuit affirmed the Federal Claims Court's dismissal in that case, but actually sided with the *Thermalon* decision's analysis on the Federal Grant and Cooperative

Agreement Act point. The Federal Circuit determined that the plaintiff in *Trauma Service Group* had not established a violation of any duty owed to it under the terms of the MOA; thus, there could be no breach of contract. However, the Federal Circuit rejected the lower court's conclusion that a cooperative agreement could *never* be a contract for purposes of the Tucker Act:

> "[A]ny agreement can be a contract within the meaning of the Tucker Act, provided that it meets the requirements for a contract with the Government, specifically: mutual intent to contract including an offer and acceptance, consideration, and a Government representative who had actual authority to bind the Government. *See City of El Centro*, 922 F.2d at 820; *Thermalon*, 34 Fed.Cl. at 414. As such, contrary to the opinion of the trial court, a MOA can also be a contract—whether this one is, we do not decide."

104 F.3d at 1326. Most recently, the Court of Federal Claims in *Pennsylvania Department of Public Welfare v. United States*, 48 Fed. Cl. 785, 790–91 (2001), reiterated in *dicta* that a grant could confer jurisdiction under the Tucker Act if it contained all of the elements of a contract. In this regard, the court cited its prior decision in *Trauma Service Group* as well as the *Thermalon* decision and a number of cases that preceded the enactment of Federal Grant and Cooperative Agreement Act. However, the court held that the grant in the case before it did not include the necessary elements of a contract.

Other courts have also declined to interpret the Federal Grant and Cooperative Agreement Act as precluding the treatment of assistance agreements as contracts for purposes unrelated to determining the appropriate funding instrument for a federal agency to use. *See Henke v. Department of Commerce*, 83 F.3d 1445 (D.C. Cir. 1996) (Privacy Act disclosure exemption, 5 U.S.C. § 552a(k)(5), pertaining to "Federal contracts" applied to a National Science Foundation grant that embodied the essential elements of a contract); *United States v. President & Fellows of Harvard College*, 323 F. Supp. 2d 151 (D. Mass. 2004) (cooperative agreements between the Agency for International Development and Harvard were contracts for purposes of a breach of contract action initiated by the United States).

By way of summary, the Federal Grant and Cooperative Agreement Act provides criteria that agencies must use in deciding which funding

instrument to use from among contracts, grants, and cooperative agreements. This choice assumes, of course, that the agency has the requisite statutory authority to enter into assistance relationships in the form of a grant or cooperative agreement. The Federal Grant and Cooperative Agreement Act does not in itself supply such authority. Legal issues concerning the choice of instrument invariably focus on procurement versus assistance relationships, with the underlying concern often being whether competition requirements should apply. The Comptroller General and the courts may also look to the criteria in the Federal Grant and Cooperative Agreement Act to classify a funding transaction for purposes of determining the applicability of other laws. In this context, however, the clear weight of authority is that the act's classifications are not mutually exclusive. Thus, something that is clearly a "grant" for purposes of the act still may be a "contract" or at least have contract features for purposes of other laws.[19]

3. Competition for Discretionary Grant Awards

Grant programs are either mandatory or discretionary. In a mandatory grant program, Congress directs awards to one or more classes of prospective recipients who meet specific criteria for eligibility, in specified amounts. These grants, sometimes called "entitlement" or "formula" grants, are often awarded on the basis of statutory formulas.[20] While the grantor agency may disagree on the application of the formula, it has no basis to refuse to make the award altogether. *City of Los Angeles v. Coleman*, 397 F. Supp. 547 (D.D.C. 1975). Thus, questions of grantee selection, and hence of competition, do not arise. The concept of competition can only apply when the grantor has discretion to choose one applicant over another. Therefore, the following discussion is limited to discretionary grants.

The Federal Grant and Cooperative Agreement Act encourages competition in assistance programs where appropriate, in order to identify

[19] For additional background on many of the cases and issues discussed in this section, see Andreas Baltatzis, *The Changing Relationship Between Federal Grants and Federal Contracts*, 32 Pub. Cont. L. J. 611 (Spring 2003); Jeffrey C. Walker, *Enforcing Grants and Cooperative Agreements as Contracts Under the Tucker Act*, 26 Pub. Cont. L. J. 683 (Summer 1997).

[20] *See*, *e.g.*, B-289801, Dec. 30, 2002, at fn. 1, referring to an Education Department regulation (now found at 34 C.F.R. § 75.200 (2005)), that describes the difference between discretionary and formula grants.

and fund the best possible projects to achieve program objectives. 31 U.S.C. § 6301(3). This, however, is merely a statement of purpose. There are few other legislative pronouncements specifying how this objective is to be achieved, certainly nothing approaching the detail and specificity of statutes applicable to procurement contracts such as the Competition in Contracting Act of 1984.[21] Statutory requirements for competition in grantee selection do exist in certain contexts, but they tend to be very general and do not specify actual procedures. Two examples involving the Department of Defense are 10 U.S.C. § 2361(a)(1) (competitive procedures required for Defense Department research and development grants to colleges and universities), and 10 U.S.C. § 2196(i)(competitive procedures also required for Defense Department manufacturing engineering education grants).

In view of the essential differences between grants and procurement contracts, GAO has declined to use its bid protest mechanism, prescribed to assure the fairness of awards of contracts, to rule on the propriety of individual grant awards.[22] That is, GAO will not consider a complaint by a rejected applicant that it should have received the grant rather than the recipient to whom it was actually awarded. *See*, *e.g.*, B-203096, May 20, 1981; B-199247, Aug. 21, 1980; B-199147, June 24, 1980; B-190092, Sept. 22, 1977. This does not affect GAO's jurisdiction to render decisions on the legality of federal expenditures, however, so GAO can and will render decisions on the legality of grant awards in terms of compliance with applicable statutes and regulations. Of course, GAO may also evaluate competition in grant awards from an audit perspective. One such evaluation is GAO, *Discretionary Grants: Opportunities to Improve Federal Discretionary Award Practices*, GAO/HRD-86-108 (Washington, D.C.: Sept. 15, 1986).

[21] Pub. L. No. 98-369, div. B, title VII, 98 Stat. 494, 1175 (July 18, 1984) (*codified in scattered sections of* titles 10, 31, and 41, United States Code).

[22] Under various statutory and regulatory authorities, GAO has served for more than 75 years as an independent forum for the resolution of disputes (commonly referred to as "bid protests") concerning the award of federal contracts. See 31 U.S.C. §§ 3551–3556 and 4 C.F.R. pt. 21 (2005), which are the current statutory and regulatory provisions. For more information on the bid protest function, see GAO, *Bid Protests at GAO: A Descriptive Guide*, GAO-03-539SP (Washington, D.C.: 2003). A copy of the *Guide* can be found on the GAO web site at www.gao.gov/decisions/bidpro/bidpro.htm (last visited September 15, 2005).

GAO has adopted a similar position with respect to cooperative agreements. *See*, *e.g.*, B-255780, Nov. 23, 1993, in which the Comptroller General dismissed a protest against the Small Business Administration's use of a cooperative agreement to obtain management and technical assistance services because a provision in the Small Business Act gave the agency the discretion to choose whether to provide such services through grants, cooperative agreements, or procurement contracts. GAO will not consider a "protest" against the award of a cooperative agreement unless it appears that a conflict of interest exists or that the agency is using the cooperative agreement to avoid the competition requirements of the procurement laws and regulations (*i.e.*, in violation of the Federal Grant and Cooperative Agreement Act). *See*, *e.g.*, B-281439.3, 281439.4, Mar. 23, 1999; B-260514, June 16, 1995; 64 Comp. Gen. 669 (1985); 61 Comp. Gen. 428 (1982); B-258267, Dec. 21, 1994; B-256586, B-256586.2, May 9, 1994; B-255780, Nov. 23, 1993; B-216587, Oct. 22, 1984. Again, this refers to review under GAO's "bid protest" jurisdiction and does not affect review under GAO's other available authorities.

In summary, assuming the proper instrument has been selected, GAO will not question funding decisions in discretionary federal assistance programs. B-228675, Aug. 31, 1987 (denial of an application for funding renewal was held to be a policy matter within the grantor agency's discretion because nothing in the program legislation provided otherwise and the agency had complied with all the applicable procedural requirements. *See also City of Sarasota v. Environmental Protection Agency*, 813 F.2d 1106 (11th Cir. 1987) (court declined to review agency refusal to award grant for construction of a wastewater treatment project); *Massachusetts Department of Correction v. Law Enforcement Assistance Administration*, 605 F.2d 21 (1st Cir. 1979) (court upheld agency's refusal to award grant, finding that procedural deficiencies, even though they amounted to "sloppiness," were not sufficiently grave as to deprive the applicant of fair consideration).

C. Some Basic Concepts

A number of principles have evolved that are unique to grant law. These will be discussed in subsequent sections of this chapter. Many cases, however, involve the application of principles of law which are not unique to grants. As a general proposition, the fundamental principles of appropriations law discussed in preceding chapters apply to grants just as they apply to other expenditures. This section is designed to highlight a few of these areas, each of which is covered in detail elsewhere in this publication, and to show how they may apply in assistance contexts.

1. The Grant as an Exercise of Congressional Spending Power

When Congress enacts grant legislation and provides appropriations to fund the grants, it is exercising the spending power conferred upon it by the Constitution.[23] As such, it is clear that Congress has the power to attach terms and conditions to the availability or receipt of grant funds, either in the grant legislation itself or in a separate enactment. *Oklahoma v. Civil Service Commission*, 330 U.S. 127 (1947) (provision of Hatch Act prohibiting political activity by employees of state or local government agencies receiving federal grant funds upheld as within congressional power). *See also West Virginia v. United States Department of Health & Human Services*, 289 F.3d 281 (4th Cir. 2002) (upholding amendment to Medicaid legislation requiring states to recoup expenses from estates of deceased beneficiaries).

In *South Dakota v. Dole*, 483 U.S. 203, 207 (1987) (citations omitted), the Supreme Court observed:

> "'[T]he power of Congress to authorize expenditure of public moneys for public purposes is not limited by the direct grants of legislative power found in the Constitution.' Thus, objectives not thought to be within Article I's 'enumerated legislative fields' . . . may nevertheless be attained through the use of the spending power and the conditional grant of federal funds."

a. Constitutionality of Grant Conditions

The Supreme Court and lower courts have repeatedly affirmed the power of Congress to attach conditions to grant funds provided that the conditions are (1) in pursuit of the general welfare, (2) expressed unambiguously, (3) reasonably related to the purpose of the expenditure, and (4) not in violation of other constitutional provisions. *New York v. United States*, 505 U.S. 144, 171–72 (1992). In this case, the Supreme Court upheld the constitutionality of statutory grant conditions that imposed on states milestones for disposing of radioactive waste, although it declared unconstitutional another aspect of the statute. The following are additional examples of cases upholding grant conditions: *United States v. American*

[23] U.S. Const. art. I, § 8, cl. 1 is often referred to as the principal source of congressional spending power. Congress may be acting under other enumerated powers as well. "Congress is not required to identify the precise source of its authority when it enacts legislation." *Nevada v. Skinner*, 884 F.2d 445, 449 n. 8 (9th Cir. 1989), *cert. denied*, 493 U.S. 1070 (1990). For additional background on the congressional "power of the purse," see Chapter 1, section B.

Library Association, 539 U.S. 194 (2003) (requiring public libraries to use Internet filters in order to receive federal subsidies); *South Dakota v. Dole*, 483 U.S. 203, 207–08 (1987) (withholding a percentage of federal highway funds from states that do not adopt a minimum drinking age of 21); *Nevada v. Skinner*, 884 F.2d 445 (9th Cir. 1989), *cert. denied*, 493 U.S. 1070 (1990) (conditioning the receipt of federal highway funds on state adoption of the national speed limit). The following cases illustrate application of the criteria for grant conditions set forth in *New York v. United States*.[24]

(1) Conditions must be in pursuit of the general welfare and related to the purpose of the expenditure

These two criteria tend to overlap. In *Hodges v. Thompson*, 311 F.3d 316 (4th Cir. 2000), *cert. denied sub nom.*, 540 U.S. 811 (2003), the court found that both criteria were satisfied by a statutory provision requiring states develop and maintain automated child support enforcement data processing systems as a condition to receipt of funds under the Temporary Assistance to Needy Families (TANF) program. As to the "general welfare" criterion, the court agreed with the lower court that "Congress made a considered judgment that the American people would benefit significantly from the enhanced enforcement of child-support decrees and the diminution of the number of parents who are able to avoid their obligations simply by moving across local or state lines." *Hodges*, 311 F.3d at 316. As to the "reasonably related" criterion, the court recognized "a complementary relationship between efficient child support enforcement and the broader goals of providing assistance to needy families through the TANF program." *Id.* In *Sabri v. United States*, 541 U.S. 600 (2004), the Supreme Court sustained the constitutionality of a federal criminal statute that proscribed bribery of officials of state or local government agencies that received at least $10,000 annually in federal funds. In rejecting a challenge that the statute exceeded Congress's spending power because it did not require a nexus between the bribe and a use of federal funds, the Court observed:

> "Congress has authority under the Spending Clause to appropriate federal monies to promote the general

[24] Cases dealing with the validity of conditions attached to grants (and other forms of federal spending) also are discussed in Chapter 1, section B, and the update of that section in GAO, *Principles of Federal Appropriations Law: Annual Update of the Third Edition*, GAO-05-354SP (Washington, D.C.: March 2005), available at www.gao.gov/legal.htm (last visited September 15, 2005).

> welfare . . . and it has corresponding authority under the Necessary and Proper Clause . . . to see to it that taxpayer dollars appropriated under that power are in fact spent for the general welfare, and not frittered away in graft or on projects undermined when funds are siphoned off or corrupt public officers are derelict about demanding value for dollars. . . . It is true, just as Sabri says, that not every bribe or kickback offered or paid to agents of governments covered by [the statute] will be traceably skimmed from specific federal payments, or show up in the guise of a *quid pro quo* for some dereliction in spending a federal grant. . . . But this possibility portends no enforcement beyond the scope of federal interest, for the reason that corruption does not have to be that limited to affect the federal interest. Money is fungible, bribed officials are untrustworthy stewards of federal funds, and corrupt contractors do not deliver dollar-for-dollar value."

Sabri, 541 U.S. at 605–06.

(2) Conditions must be unambiguous

As discussed before in section B.1, the Supreme Court has characterized conditions Congress attaches to federal grants as "much in the nature of a contract." *Pennhurst State School & Hospital v. Halderman*, 451 U.S. 1, 17 (1981). Consistent with the contract analogy, it is particularly important that grant conditions be expressed with sufficiently clarity to establish knowing acceptance on the part of the grantees. As the Court stated in Pennhurst:

> "The legitimacy of Congress' power to legislate under the spending power . . . rests on whether the [recipient] voluntarily and knowingly accepts the terms of the 'contract.' . . . There can, of course, be no knowing acceptance if a [recipient] is unaware of the conditions or is unable to ascertain what is expected of it. Accordingly, if Congress intends to impose a condition on the grant of federal moneys, it must do so unambiguously."

Id. at 17.

One recent case on this point is J*ackson v. Birmingham Board of Education*, 544 U.S. ___, 125 S. Ct. 1497 (2005). The plaintiff in *Jackson*, a male and former coach of a high school girls' basketball team, sued the school board under a federal statute prohibiting "sex discrimination" by recipients of education grant funds. He alleged that his firing was in retaliation for complaining that the girls' team was not receiving equal access to athletic equipment and facilities. The school board countered that it lacked adequate notice that it could be held liable under the statute, which did not explicitly prohibit retaliation against persons who complained about discrimination. The Court rejected the school board's argument on the basis that the board should have been on notice of a series of prior Supreme Court decisions that consistently construed the statute broadly to encompass diverse forms of intentional discrimination, and that retaliation was clearly a form of intentional discrimination. *Jackson*, 125 S. Ct. at 1509–10. *See also Garrett v. University of Alabama at Birmingham Board of Trustees*, 344 F.3d 1288 (11th Cir. 2003), holding that a statutory provision unambiguously conditioned the receipt by states of federal grant funds on a waiver of their Eleventh Amendment immunity to certain claims and that, by continuing to accept federal funds, the state agencies waived their immunity.

By contrast, an *en banc* decision in *Commonwealth of Virginia Department of Education v. Riley*, 106 F.3d 559 (4th Cir. 1997), held that a statutory provision was not sufficiently clear to impose a binding condition on the use of grant funds. Riley involved a provision of the Individuals with Disabilities in Education Act that required recipients of grant funds under the act to ensure all children with disabilities the right to a free appropriate public education. 20 U.S.C. § 1412(1) (Supp. 1996). The federal Department of Education determined that the state of Virginia's policy of discontinuing free public education for students (both disabled and nondisabled) who were expelled or suspended for a lengthy period violated this provision of the act. When the state appealed, a Fourth Circuit panel agreed with the Education Department. However, the court, *en banc*, held that the statute was insufficiently unambiguous to require that the state, as a condition of receiving the grant funds, continue to provide education for expelled or suspended students. Which interpretation of the statute was better in the abstract was not the question, said the court. Rather, citing *South Dakota v. Dole* and *Pennhurst*, the court held:

> "The question is whether, *in unmistakably clear terms*, Congress has conditioned the States' receipt of federal funds upon the provision of educational services to those handicapped students expelled for misconduct unrelated to their handicap: '[I]f Congress desires to condition the States' receipt of federal funds, it 'must do so unambiguously . . . .'"

Riley, 106 F.3d at 566 (emphasis in original).[25]

(3) Conditions must be otherwise constitutional

Grant conditions obviously may not violate other federal constitutional provisions. While courts rarely strike down grant conditions on constitutional grounds, they have done so in two recent cases. In *Legal Services Corp. v. Velasquez*, 531 U.S. 533 (2001), the Supreme Court held that a statutory provision prohibiting Legal Service Corporation grantees from representing clients in efforts to amend or otherwise challenge existing welfare law violated the First Amendment by interfering with the free speech rights of the clients. The court in *American Civil Liberties Union v. Mineta*, 319 F. Supp. 2d 69 (D.D.C. 2004), declared unconstitutional a statutory provision that prohibited the use of federal mass transit grant funds for any activity that promoted the legalization or medical use of marijuana. Relying on *Legal Services Corp. v. Velasquez*, the court held that the provision constituted "viewpoint discrimination" in violation of the First Amendment. *Mineta*, 319 F. Supp. 2d at 83–87.

Even if a grant condition satisfies all of the *New York v. United States* criteria as discussed above, could it still be unconstitutionally coercive? Although it appears that no court has ever invalidated a federal grant condition on grounds of pure "coerciveness," this possibility is frequently discussed in the case law. A leading example is *West Virginia v. United States Department of Health & Human Services*, 289 F.3d 281 (4th Cir. 2002). In that case, West Virginia challenged on Tenth Amendment grounds a statutory provision requiring that as a condition to participating in the Medicaid program, states implement a program to recover certain expenditures from the estates of deceased Medicaid beneficiaries. Failure

[25] Subsequent to the decision in *Riley*, Congress amended the statute to explicitly require continuation for children with disabilities "who have been suspended or expelled from school." 20 U.S.C. § 1412(a)(1)(A).

to comply could result in a loss of all or part of the state's federal Medicaid reimbursement.[26] The state did not contend that the condition violated any of the criteria in *New York v. United States*. Rather, West Virginia viewed the estate recovery program as "bad public policy" but maintained that it had no practical option to reject it. The state had participated in Medicaid for almost 30 years before "Congress changed the rules of the game" and mandated the estate recovery program. Withdrawal of its federal Medicaid funds at this stage would cause its health care system to "effectively collapse."

The court struggled with this argument. It cited several Supreme Court decisions in suggesting that compliance with the *New York v. United States* criteria might not be enough to immunize a grant condition from constitutional jeopardy:

> "[T]he Supreme Court has cautioned that 'in some circumstances the financial inducement [to comply with a condition imposed upon the receipt of federal funds] offered by Congress might be so coercive as to pass the point at which pressure turns into compulsion.' . . . Thus, while Congress may use its spending powers to encourage the states to act, it may not coerce the states into action. If the Congressional action amounts to coercion rather than encouragement, then that action is not a proper exercise of the spending powers but is instead a violation of the Tenth Amendment."

West Virginia, 289 F.3d at 286–87. The opinion then discussed at length decisions from the Fourth Circuit and other circuits that differed, largely on a conceptual level, as to whether there was a viable "coercion theory" applicable to federal grant conditions. It concluded in this regard:

> "[W]e are aware of no decision from any court finding a conditional grant to be impermissibly coercive. Although the Supreme Court has more than once referred to the existence of the coercion theory . . . its cases have provided little guidance for determining when the line between encouragement and coercion is crossed."

[26] These provisions are found at 42 U.S.C. §§ 1396p(b)(1) (requirement) and 1396c (penalty for noncompliance).

Id. at 289. In fact, it noted that "most courts faced with the question have effectively abandoned any real effort to apply the coercion theory." *Id.* at 290. Ultimately, the court rejected West Virginia's coercion argument on the basis that the federal government was unlikely to take drastic action against the state:

> "If the government in fact withheld the entirety of West Virginia's [Medicaid funding] because of the state's failure to implement an estate recovery program, then serious Tenth Amendment questions would be raised. . . . In reality, however, the government threatened to withhold 'all *or part* of [West Virginia's] Federal financial participation in the State's Medicaid Program.' . . . This small difference in language makes all the difference in our analysis."

Id. at 291–92 (emphasis added).

b. Effect of Grant Conditions

A valid grant condition imposed by or pursuant to a federal statute is binding on the recipient and will prevail over inconsistent state law:

> "There is of course no question that the Federal Government, unless barred by some controlling constitutional prohibition, may impose the terms and conditions upon which its money allotments to the States shall be disbursed, and that any state law or regulation inconsistent with such federal terms and conditions is to that extent invalid."

King v. Smith, 392 U.S. 309, 333 n.34 (1968); *see also Townsend v. Swank*, 404 U.S. 282 (1971) (state statute inconsistent with eligibility criteria of Aid to Families with Dependent Children legislation held invalid); *United States v. Miami University*, 294 F.3d 797, 808 (6th Cir. 2002) (federal government has inherent power to sue to enforce conditions imposed on the recipients of federal grants); *State of Kansas v. United States*, 214 F.3d 1196 (10th Cir.), *cert. denied*, 531 U.S. 1035 (2000) (rejecting a state challenge to restrictions imposed on child support enforcement program under federal law); *S.J. Groves & Sons v. Fulton County*, 920 F.2d 752, 763–64 (11th Cir.), *cert. denied*, 501 U.S. 1252 and 500 U.S. 959 (1991) (valid grantor agency regulations may preempt state law).

When Congress has imposed a valid condition on the receipt of grant funds, the condition is, in effect, a "condition precedent" to the recipient's participation in the program.[27] Unless permitted under the program legislation, the condition may not be waived or omitted even though a given state may not be able to participate because state law or the state constitution precludes compliance. *North Carolina ex rel. Morrow v. Califano*, 445 F. Supp. 532 (E.D.N.C. 1977), *aff'd mem.*, 435 U.S. 962 (1978). *See also Hodges v. Thompson*, 311 F.3d 316 (4th Cir. 2002), *cert. denied sub nom.*, 540 U.S. 811 (2003)(program requirement that state approved plan include automated data processing and information retrieval system was not coercive and agency has no discretion to deviate from the statutory noncompliance penalty provisions); 43 Comp. Gen. 174 (1963).

Once federal conditions attach, there are limits to what a grantee can do to "de-federalize" the funded project or activity in order to free itself of the condition. In *Ross v. Federal Highway Administration*, 162 F.3d 1046 (10th Cir. 1998), the state of Kansas had been working on a federally funded highway project for many years. However, one segment of the project had been stalled for 3 years because of environmental concerns and the ability of the parties to finalize a supplemental environmental impact statement. To resolve the impasse, state and local officials decided to proceed with this segment using only nonfederal funds. The Federal Highway Administration agreed and initiated action to terminate the environmental impact statement process on the basis that this segment of the project was no longer a "major federal action." This strategy failed, however, when environmentalists sued and the court in *Ross* held that completion of the segment continued to be a major federal action even if locally funded:

> "At the advanced stage of the trafficway project, it was simply too late for the state of Kansas to convert the eastern segment into a local project. Since 1986, local, state and federal authorities scheduled, programmed and worked on the trafficway as a joint federal-state project. The federal nature of the trafficway was so pervasive that the Kansas authorities could not rid the project of federal involvement simply by withdrawing the last segment of the project from federal funding."

[27] Of course, it is also within the power of Congress to authorize the making of unconditional grants. *See* B-80351, Sept. 30, 1948.

162 F.3d at 1052–53. The court acknowledged that the state had the right to select which of its highway projects would receive federal assistance, but said that this option could not be used to circumvent federal environmental laws. *Id.* at 1053. Ross cited and followed two very similar decisions: *Scottsdale Mall v. State of Indiana*, 549 F.2d 484 (7th Cir. 1977), *cert. denied*, 434 U.S. 1008 (1978), and *San Antonio Conservation Society v. Texas Highway Dept.*, 446 F.2d 1013 (5th Cir. 1971), *cert. denied*, 406 U.S. 933 (1972).

2. Availability of Appropriations

As with obligations and expenditures in general, a federal agency may provide financial assistance only to the extent authorized by law and available appropriations. Thus, the three elements of legal availability—purpose, time, and amount—apply equally to assistance funds.

a. Purpose

As stated in 31 U.S.C. § 1301(a), appropriations may be used only for the purpose(s) for which they were made.[28] One of the ways in which this fundamental proposition manifests itself in the grant context is the principle that grant funds may be obligated and expended only for authorized grant purposes. What is an "authorized grant purpose" is determined by examining the relevant program legislation, legislative history, and appropriation acts.

GAO considered this issue in a recent decision, B-303927, June 7, 2005. Congress appropriated funds to the Department of Labor to assist in response and recovery following the September 11, 2001, terrorist attacks on the United States. The appropriation earmarked $125 million for the purpose of payment to the New York Workers' Compensation Board for "processing of claims related to the terrorist attacks." The Labor Department distributed the funds to the Board through a grant. The Board did not use the funds to process claims, but gave them to other New York state entities to reimburse those entities for claims they had paid on behalf of victims. GAO held that use of the funds for this purpose was inconsistent with the language of the appropriation. By contrast, GAO held in another "purpose" case, B-248111, Sept. 9, 1992, that grant funds were available for the activities in question based on the language of the authorizing statute and its legislative history.

[28] We discuss the concept of the availability of appropriations as to purpose in detail in Chapter 4.

Disaster relief assistance legislation, found at 42 U.S.C. §§ 5122–5206, authorizes, among other things, federal financial contributions to state and local governments for the repair or replacement of public facilities damaged by a major disaster. Decisions under a prior version of this legislation had construed public facilities as including municipal airports (42 Comp. Gen. 6 (1962)), including airport facilities that had been leased to private parties for the purpose of generating income for airport maintenance (49 Comp. Gen. 104 (1969)). Assistance could also extend to a sewage treatment plant, but not one which was not completed, and thus not in operation, at the time of the damage. 45 Comp. Gen. 409 (1966). Unlike the earlier legislation, the current statute defines "public facility," 42 U.S.C. § 5122(8), and specifically includes airport and sewage treatment facilities.

The following are additional examples of decisions dealing with the purpose availability of grant funds:

- Airport development grants under Federal Airport Act may include runway sealing projects which are shown to be part of reconstruction or repair rather than normal maintenance. 35 Comp. Gen. 588 (1956). *See also* B-60032, Sept. 9, 1946 (grants under same legislation may be made for acquisition of land or existing privately owned airports, to be used as public airports, regardless of whether construction or repair work is immediately contemplated).

- Mining Enforcement and Safety Administration is authorized to make grants to a labor union to fund emergency medical technician training program for coal miners since the proposal bears a sufficiently close relationship to coal mine safety to come within the scope of the governing program legislation, 30 U.S.C. § 951 (1970). B-170686, Nov. 8, 1977.

- Public Health Service grants for support of research training were found authorized under the Public Health Service Act, as amended.[29] B-161769, June 30, 1967.

Grant funds provided by lump-sum appropriation are subject to the usual rule that an agency may reallocate discretionary funds within that appropriation as long as it uses those funds for purposes authorized under

[29] Pub. L. No. 86-798, 74 Stat. 1053 (Sept. 15, 1960).

the applicable appropriation and program statute.[30] The court's decision in *Illinois Environmental Protection Agency v. EPA*, 947 F.2d 283 (7th Cir. 1991), illustrates this point. Under the Clean Air Act, the Environmental Protection Agency (EPA) could prescribe plans to implement air quality standards for states that failed to submit adequate plans. The act also authorized air pollution control grants to states, funded under EPA's lump-sum Abatement, Control, and Compliance appropriation. Under its regulations, EPA divided available funds into nonmandatory annual allotments for each state. The regulations also authorized EPA to set aside a portion of the unawarded allotments to support federal implementation programs where required because of the absence of adequate state programs. One state argued that the set-aside policy amounted to a diversion of funds from their intended purpose and, therefore, violated 31 U.S.C. § 1301(a). The court first upheld the regulation as a permissible interpretation of EPA's authority under the Clean Air Act. The court then found that there was no purpose violation because (a) the relevant appropriation act did not earmark any specific amount for grants to states, and (b) EPA was still using the set-aside funds for air pollution abatement programs, which was their intended purpose.

The Comptroller General has applied essentially the same reasoning in several decisions dealing with grant funds. For example, in B-157356, Aug. 17, 1978, the then Department of Health, Education, and Welfare's Office of Human Development Services (OHD) received a lump-sum appropriation covering a number of grant programs administered by various OHD components. The department wanted to make what it termed "cross-cutting" grants to fund research or demonstration projects that would benefit more than one target population (*e.g.*, aged, children, Native Americans). To do this, each OHD component receiving grant funds under the lump-sum appropriation was asked to contribute a portion of its grant funds to a pool that would be used for approved cross-cutting grants. Since the lump-sum appropriation did not restrict the department's internal allocation of funds for any given program, GAO approved the concept, provided that the grants were limited to projects within the scope of grant programs funded by the lump-sum appropriation, a condition necessary to assure compliance with 31 U.S.C. § 1301(a). See also B-258000, Aug. 31, 1994, in which GAO held that a lump-sum Forest Service appropriation could be used to make a congressionally earmarked grant in a specific

[30] See Chapter 6, section F for a more detailed discussion of agency discretion under lump-sum appropriations.

amount to the Texas Reforestation Foundation where the proviso containing the earmark did not identify who should make the grant or the source of funds to be used.

Funds provided for specific grants in the form of earmarked line-item appropriations cannot be diverted to other purposes. In 72 Comp. Gen. 317 (1993), GAO held that the General Services Administration lacked authority to establish a "reserve account" for the expenses of administering a grant program through a percentage set aside from line-item appropriations of grant funds that had been awarded to various grantees. Since Congress provided specific amounts for specific purposes, the agency could not reduce the amount of the line-itemed grants in order to cover the cost of administration, notwithstanding post-enactment "approval" by a congressional subcommittee.

b. Time

Funds must be obligated by the grantor agency within their period of availability.[31] The period of availability of appropriated funds is the period of time provided by law in which the administering agency has to obligate the funds. B-271607, June 3, 1996. The statutory requirement for recording obligations extends to all actions necessary to constitute a valid obligation, and includes, of course, grant obligations (31 U.S.C. § 1501(a)(5)).[32] Proper recording of grant obligations facilitates compliance with the "time of obligation" requirement by ensuring that agencies have adequate budget authority to cover their obligations. *See* B-300480, Apr. 9, 2003, *aff'd in* B-300480.2, June 6, 2003.

In the context of discretionary grants, the obligation generally occurs at the time of award. *See, e.g.*, B-289801, Dec. 30, 2002; 31 Comp. Gen. 608 (1952).[33] Thus, in B-300480, Apr. 9, 2003, *aff'd in* B-300480.2, June 6, 2003, GAO held that an obligation arises when the Corporation for National and

[31] See the discussion of the Availability of Appropriations as to Time in Chapter 5.

[32] See Chapter 7 for a general discussion of recording obligations and Chapter 7, section B.5 for a specific discussion of recording requirements for grant obligations.

[33] The particular obligating document varies and can include an agency's approval of a grant application or a letter of commitment. *See* 39 Comp. Gen. 317 (1959); 37 Comp. Gen. 861, 863 (1958). Section 1501(a)(5) of title 31, United States Code, lists three forms of documentary evidence for grant obligations: (A) an appropriation providing for payment in a specific amount fixed by law or under a formula prescribed by law (*i.e.*, a mandatory or formula grant); (B) an agreement authorized by law; or (C) plans approved consistent with law.

Community Service awards grants authorizing the grantees to enroll a specified number of participants into the education programs it funds. At that time, the Corporation incurs a recordable obligation in the amount of its maximum liability for those benefits since, at that point, the grantee rather than the Corporation controls the actual level of participant enrollment. *Id.*

An obligation under a discretionary grant program generally does not exist absent a binding grant award. Thus, GAO concluded that a valid grant never came into existence when an "offer of grant" made by the Economic Development Administration to a Connecticut municipality was accepted by a town official who did not have authority to accept the grant, and the funds expired for obligation purposes before the town was able to ratify the unauthorized acceptance. B-220527, Dec. 16, 1985. The town later submitted a claim for reimbursement of its expenses, based on an "equitable estoppel" argument. Since the nonexistence of the grant was attributable to the town's actions and not those of the federal agency, the claim could not be allowed. B-220527, Aug. 11, 1987. *See also* B-206244, June 8, 1982.

The "*bona fide* needs rule," which is a basic principle of time availability, holds that an appropriation is available for obligation only to fulfill a genuine or *bona fide* need of the period of availability for which the appropriation was made.[34] This rule applies to grants and cooperative agreements as well as to other types of obligations or expenditures. *See*, *e.g.*, 73 Comp. Gen 77 (1994); 64 Comp. Gen. 359 (1985); B-229873, Nov. 29, 1988. However, as discussed hereafter, the manner in which the rule applies differs somewhat in the context of grants and other assistance transactions, as opposed to transactions in which the federal government is obtaining goods and services by contract.

The specific issue that arises in the grant decisions is whether the principle of "severability," a key element in applying the *bona fide* needs rule to contracts, has any relevance to assistance transactions. The principle of severability requires determining whether services that an agency seeks to obtain (usually by contract) are part of a single undertaking that fulfills an agency need of the fiscal year charged, or whether the services are severable in nature and fulfill a recurring need of the agency from fiscal year to fiscal year. If the services are severable, the *bona fide* needs rule

[34] See Chapter 5, section B, for a comprehensive discussion of the *bona fide* needs rule.

restricts use of the appropriation to obtaining that portion of the services needed during its period of availability.

In a 1985 decision, 64 Comp. Gen. 359, GAO applied the severability principle to National Institutes of Health (NIH) research grants. The decision concluded that the grants in question were severable, and therefore, NIH violated the *bona fide* needs rule by awarding them for 3 years using 1-year appropriations. The decision did express some reservations about this result:

> "[W]e recognize that there are fundamental differences between a contract for materials or services and a research grant. The severability concept is not altogether analogous to the NIH research grants, which resemble subsidies rather than contracts for services."

64 Comp. Gen. at 365. Another decision, 73 Comp. Gen. 77 (1994), applied the severability principle to cooperative agreements. This decision held that certain cooperative agreements providing for the periodic issuance of project-specific research work orders were nonseverable and, therefore, could not be funded incrementally from 1-year appropriations.

In B-229873, Nov. 29, 1988, however, GAO held that the Small Business Administration (SBA) did not violate the *bona fide* needs rule when it used a 1-year appropriation on the last day of the fiscal year to award cooperative agreements to Small Business Development Centers, even though the Centers would not use the money until the next fiscal year. Contrasting these cooperative agreements to service contracts that were subject to the severability principle, the decision observed:

> "[T]he purpose of the Small Business Development Centers appropriation is to fund an assistance program for non-federal entities which, in turn, are expected to use the funds, together with some of their own, to fulfill a public purpose. Although the purpose of the program is to provide assistance to Centers for a 1-year period, it really does not matter when the Center begins or completes its tasks. The statutory purpose was fulfilled once a grant or cooperative agreement was awarded during the period of availability of the appropriation for obligation; in other words, the award constitutes the obligation, and upon award, the funds belong to the awardee."

The decision in B-229873 distinguished 64 Comp. Gen. 359 rather than overruling it.

A more recent decision, B-289801, Dec. 30, 2002, seems to lay to rest any vestiges of the severability principle as applied to grants or cooperative agreements. In approving the Education Department's practice of awarding certain education grants for 5 years using 1-year appropriations, this decision stated flatly that "for grants, the principle of severability is irrelevant to a *bona fide* need determination." Elaborating upon this conclusion, the decision explained:

> "We believe the application of the *bona fide* need rule found in the SBA case [B-229873] is the correct approach. It expressly recognizes the fundamental difference between a contract and a grant or cooperative agreement and the significance this difference has on a *bona fide* need analysis. Contracts and grants are transactions that fulfill significantly different needs of an agency, the former to acquire goods and services and the latter to provide financial assistance. B-222665, July 2, 1986 (principal purpose of a grant is to transfer something of value to the recipient to carry out a legislatively established public policy instead of acquiring goods or services for the direct benefit or use of the United States). . . .
>
> "The SBA decision is also more in keeping with past decisions, where we have routinely permitted agencies to award grants using fiscal year funds irrespective of the fact that the funds would not be expended until some time after the end of the fiscal year."

The decision observed that the relevant consideration was not the principle of severability but the applicable program legislation, and concluded in this regard:

> "In our opinion, Education's award of 5-year grants is both consistent with program objectives and within its discretion under the program legislation. Under the program legislation, Education is not merely required to provide financial assistance, it is to ensure through various ways that students who have received services under the . . . program continue to receive those services from year-to-

> year until completion of high school. Awarding grants 5 years in duration will aid in ensuring the continuity of grantee services to . . . students which the programs legislation seeks to provide. Therefore, Education is fulfilling its *bona fide* need under this program when it awards these 5-year grants."

Appropriations for grant programs are generally subject to the same time availability rules as other appropriations. Thus, for example, when Congress expressly provides that a grant appropriation "shall remain available until expended" (no-year appropriation), the funds remain available until they are obligated and expended by the grantor agency subject to the account closing statute, 31 U.S.C § 1555. It should be emphasized that the time availability of grant appropriations governs the grantor agency's obligation and expenditure of the funds; it does not limit the time in which the grantee must use the funds once it has received them. *Id.* Of course, the grant statute or the grantor agency may impose time limits on a grantee's use of funds. *See City of New York v Shalala*, 34 F.3d 1161 (2nd Cir. 1994); *Mayor and City Council of Baltimore v. Browner*, 866 F. Supp. 249 (D. Md. 1994).

c. Amount

The Antideficiency Act, 31 U.S.C. § 1341(a), among other things, requires that federal agencies avoid incurring obligations in excess of the amount available in their appropriations.[35] Of course, grant obligations and expenditures are subject to the act. Restrictions on the availability of a lump-sum appropriation are not legally binding unless incorporated expressly or by reference in the appropriation act itself. Thus, a plan to award fewer National Institutes of Health biomedical research grants, funded under a lump-sum appropriation, than the number of grants provided for in congressional committee reports was not unlawful, as long as all the funds were properly obligated for authorized grant purposes. 64 Comp. Gen. 359 (1985). *See also* B-157356, Aug. 17, 1978.

[35] For a general discussion of the Antideficiency Act, see Chapter 6, section C, and for amount availability, see Chapter 6, section C.2.e.

Minimum earmarks (*e.g.*, "not less than" or "shall be available only") in an authorization act were found controlling where a later-enacted appropriation act provided a lump sum considerably less than the amount authorized but nevertheless sufficient to meet the earmark requirements. 64 Comp. Gen. 388 (1985).[36] The grantor agency will have more discretion where the earmark is a maximum ("not to exceed") or where it is expressed only in legislative history. B-171019, Mar. 2, 1977. *See also* 72 Comp. Gen. 317 (1993) (General Services Administration may not divert a portion of earmarked grants to cover administrative costs); *compare Association of Metropolitan Water Agencies v. Browne*r, 24 F. Supp. 2d 83 (D.D.C. 1998) (agency was not obligated to set aside funds for health effects research earmarked in an authorization act where Congress never clearly made an appropriation pursuant to the specific authorization containing the earmark).

In the absence of a contrary provision in the applicable program statute, regulations, or grant agreement, there is no basis to object to a grantee's allocation of grant funds as long as the funds were spent for eligible grant activities. B-260990, June 13, 1996; 69 Comp. Gen. 600 (1990). *See also* 71 Comp. Gen. 310 (1992) (allowing grantees to retain reasonable profit or fees under Small Business Administration policy directive).

As the cases cited below illustrate, a federal institution is generally not eligible to receive grant funds from another federal source unless the program legislation so provides. The reason is that the grant funds would improperly augment the appropriations of the receiving institution. For example:

- Federal grant funds for nurse training programs could not be allotted to St. Elizabeths Hospital since it was already receiving appropriations to maintain and operate its nursing school. 23 Comp. Gen. 694 (1944).

- Haskell Indian Junior College, fully funded by the Bureau of Indian Affairs, was not eligible to receive grant funds from federal agencies other than the Bureau of Indian Affairs since Congress had already provided for its needs by direct appropriations. B-114868, Apr. 11, 1975.

[36] See Chapter 2, section C, for a general discussion of the interplay between authorization and appropriation acts.

The Office of Education could not make a library support grant to the National Commission on Libraries and Information Science as it would be an improper augmentation of the Commission's appropriations. 57 Comp. Gen. 662, 664 (1978).

3. Agency Regulations

a. General principles[37]

Legislation establishing an assistance program frequently will define the program objectives and leave it to the administering agency to fill in the details by regulation. Thus, agency regulations are of paramount importance in assessing the parameters of grant authority. These regulations, if properly promulgated and within the bounds of the agency's statutory authority, have the force and effect of law and may not be waived on a retroactive or *ad hoc* basis. *See generally* B-300912, Feb. 6, 2004. *See also* 57 Comp. Gen. 662 (1978) (eligibility standards); B-163922, Feb. 10, 1978 (grantee's liability for improper expenditures); B-130515, July 17, 1974; B-130515, July 20, 1973 (matching share requirements). However, the prohibition against waiver does not necessarily apply to regulations that are merely "internal administrative guidelines" as long as the government's interests are adequately protected. *See* 60 Comp. Gen. 208, 210 (1981).

The operation of several of these principles is illustrated in B-203452, Dec. 31, 1981. The Federal Aviation Administration (FAA) revised its regulations to permit indirect costs to be charged to Airport Development Aid Program grants. A grantee filed a claim for reimbursement of indirect costs incurred prior to the change in the FAA regulations, arguing that the charging of indirect costs was required by a Federal Management Circular (superseded by OMB Circulars) even before FAA recognized it in its own regulations. GAO first pointed out that Federal Management Circulars are internal management tools. They do not have the binding effect of law so as to permit a third party to assert them against a noncomplying agency. This being the case, there was no impediment to FAA's revising its regulations without making the revision retroactive as long as both the old and the new regulations were within the scope of FAA's legal authority. *See also Pueblo Neighborhood Health Centers, Inc. v. United States Department of Health & Human Services*, 720 F.2d 622, 625–26 (10th Cir.

[37] See Chapter 3, section C for a general discussion of agency regulations and administrative law principles applicable to them.

1983) (department's grant application manual is an internal agency publication rather than a regulation with force and effect of law, so that deviations from it, in this case use of an ineligible member on a funding review panel, did not require reversal of agency action).

Regulations of the grantor agency will generally be upheld as long as they are within the agency's statutory authority, issued in compliance with applicable procedural requirements, and not arbitrary or capricious. The courts have sustained grant regulations in many contexts. *See*, *e.g.*, *Southeast Kansas Community Action Program*, *Inc. v. Secretary of Agriculture*, 967 F.2d 1452 (10th Cir. 1992) (upholding a regulatory amendment to eliminate appeal procedures for nonrenewal of a grant program administrator's contract); *Gallegos v. Lyng*, 891 F.2d 788 (10th Cir. 1989) (upholding the authority of the Department of Agriculture to impose by regulation strict liability on states for lost or stolen food stamp coupons). Similarly, it was within the discretion of the Environmental Protection Agency under the Clean Water Act to prescribe regulations making wastewater treatment grants available only for the construction of new facilities and not for the acquisition of preexisting facilities. *Cole County Regional Sewer District v. United States*, 22 Cl. Ct. 551 (1991). *See also Mayor & City Council of Baltimore v. Browner*, 866 F. Supp. 249 (D. Md. 1994) (upholding agency's enforcement of cut-off dates for completion of city's federally funded sewerage facilities). Another illustration is *American Hospital Association v. Schweiker*, 721 F.2d 170 (7th Cir. 1983), *cert. denied*, 466 U.S. 958 (1984), upholding regulations imposing community service and uncompensated care requirements on recipients of Hill-Burton hospital construction grants.

The informal rulemaking requirements (notice and comment) of the Administrative Procedure Act (APA) do not apply to grant regulations. 5 U.S.C. § 553(a)(2) (the rulemaking requirements do not apply to "a matter relating to . . . grants. . ."). Several agencies, however, have published statements committing themselves to comply with the APA in developing grant regulations and have thereby effectively waived the exemption. *See*, *e.g.*, *Thomas Jefferson University v. Shalala*, 512 U.S. 504, 512 (1994); *Flagstaff Medical Center*, *Inc. v. Sullivan*, 962 F.2d 879, 885 (9th Cir. 1992). Even if an agency has voluntarily waived the APA exemption for grants, other APA exemptions may still apply. *See*, *e.g.*, *Chief Probation Officers of California v. Shalala*, 118 F.3d 1327 (9th Cir. 1997) (agency rule was

interpretive, not legislative and, thus, not invalid for failure to follow APA rulemaking requirements).[38]

Wholly apart from what the courts might or might not do, an agency's discretion in funding matters is subject to congressional oversight as well. Congress, if it disfavors an agency's actual or proposed exercise of otherwise legitimate discretion, can statutorily restrict that discretion, at least prospectively, either by amending the program legislation or by inserting the desired restrictions in appropriation acts. For an example of the latter, see B-300912, Feb. 6, 2004 (finding that federally granted rights-of-way for construction of highways constituted a final rule prohibited from taking effect by appropriations act provision). *See also* B-238997.4, Dec. 12, 1990. Also, agency grant regulations may be subject to review by GAO and Congress under the Congressional Review Act, Pub. L. No. 104-121, title II, subtitle E, § 251, 110 Stat. 847, 868 (Mar. 29, 1996), codified at 5 U.S.C. §§ 801–808.[39]

b. Office of Management and Budget Circulars and the "Common Rules"

Federal grants and cooperative agreements are typically subject to a wide range of substantive and other requirements under the particular program statutes as well as implementing agency regulations and other guidance that applies to them. However, they are governed as well by many additional cross-cutting requirements that are common to most assistance programs. These include federal statutory provisions made applicable to recipients of federal funds, such as the prohibitions against lobbying with grant funds under the so-called "Byrd Amendment" codified at 31 U.S.C. § 1352.[40] They also include a number of administrative requirements dealing with such subjects as audit and record-keeping and the allowability of costs. The importance of the cross-cutting agency regulations and centralized management guidance from the Office of Management and Budget (OMB) is apparent throughout this chapter. The current structure for these requirements developed in the late 1980s.

Prior to 1988, each agency issued grant management regulations to govern grants and cooperative agreements it made, although OMB Circular

[38] See Chapter 3, section A, for additional discussion of the APA and the informal rulemaking process.

[39] For a more detailed discussion of the Congressional Review Act, see Chapter 3, section A.1.c.

[40] For more on the Byrd Amendment, see Chapter 4, section C.11.d.

No. A-102 did provide some governmentwide guidance for grants to state and local governments. (Another circular, No. A-110, provided some guidance for grants to other types of grantees.) In 1987, a memorandum from the President directed the Office of Management and Budget (OMB) to revise Circular No. A-102 to specify uniform, governmentwide terms and conditions for grants to state and local governments, and directed executive branch departments and agencies to propose and issue common regulations adopting these terms and conditions *verbatim*, modified where necessary to reflect inconsistent statutory requirements. 23 Weekly Comp. Pres. Doc. 254 (Mar. 12, 1987). The Presidential memorandum observed in part:

> "Circular A-102 was a significant step toward the simplification of grants management at the time. However, after 16 years, some of the provisions are out of date, there are gaps where the standards do not cover important areas, and agencies have interpreted the circular in numerous different ways in their regulations."

Id. at 255. Pursuant to this direction, the first iteration of what has come to be known as the "common rule" system was published for comment on June 9, 1987 (52 Fed. Reg. 21820–21862), issued in final on March 11, 1988 (53 Fed. Reg. 8033–8103), and generally made effective as of October 1, 1988. Later that year, OMB proposed a similar revision to Circular No. A-110, dealing with grants to institutions of higher education, hospitals, and other nonprofit organizations. 53 Fed. Reg. 44710 (Nov. 4, 1988). The structure of each circular was similar, featuring a brief introduction followed by attachments with detailed guidance on specific topics.

There are currently a total of six OMB circulars on grants, but only three apply to any one type of grantee. Their coverage breaks down as follows:[41]

- States, local governments, and Indian Tribes: Circular No. A-87 (May 10, 2004) for cost principles and Circular No. A-102 (Aug. 29, 1997) for administrative requirements.

[41] *See* www.whitehouse.gov/omb/grants/attach.html (last visited September 15, 2005).

- Educational institutions: Circular No. A-21 (May 10, 2004) for cost principles and Circular No. A-110 (Sept. 30, 1999) for administrative requirements.

- Nonprofit organizations: Circular No. A-122 (May 10, 2004) for cost principles and Circular No. A-110 (Sept. 30, 1999) for administrative requirements.

- All grantees: Circular No. A-133 (June 27, 2003) for audit requirements.

The OMB circulars provide guidance only to federal grantor agencies; they do not apply directly to grantees. Therefore, each grantor agency has issued largely identical sets of regulations that prescribe requirements that are binding on their grantees. These are technically the so-called "common rules." At present, each grantor agency has a set of four common rules. Two of the common rules are based on OMB's grants management circulars covering cost principles, administrative requirements, audit, *etc.* A third common rule deals with the Byrd Anti-Lobbying Amendment, mentioned previously. The fourth common rule, discussed hereafter, deals with suspension and debarment and drug-free workplace requirements.

A compilation showing where each agency's common rule regulations are codified in the Code of Federal Regulations may be found at www.whitehouse.gov/omb/grants/chart.html (last visited September 15, 2005). Since the common rule regulations are essentially the same for each federal grantor agency, we will use the Department of Agriculture version in the remainder of this chapter when citing to and illustrating the application of the common rules.[42] The Department of Agriculture's regulations are codified as follows:

- Grants management common rule for states, local governments, and Indian tribes, 7 C.F.R. pt. 3016 (2005).

- Grants management common rule for universities and nonprofit organizations, 7 C.F.R. pt. 3019.

- Nonprocurement suspension and debarment and Drug-Free Workplace Act common rule, 7 C.F.R. pt. 3017.

[42] OMB is in the process of consolidating and streamlining its circulars and the common rules in title 2 of the Code of Federal Regulations. *See* 69 Fed. Reg. 26,276 (May 11, 2004).

- Byrd Anti-Lobbying Amendment common rule, 7 C.F.R. pt. 3018.

As noted previously, the common rules establish consistency and uniformity among federal agencies in the management of grants and cooperative agreements. They were intended to supersede uncodified manuals and handbooks unless required by statute or approved by OMB. Thus, the Department of Agriculture's regulations provide at 7 C.F.R. § 3016.5:

> "All other grants administration provisions of codified program regulations, program manuals, handbooks and other nonregulatory materials which are inconsistent with this part are superseded, except to the extent they are required by statute, or authorized in accordance with the [OMB] exception provision in § 3016.6."

With respect to grants and grantees covered by the common rules, additional administrative requirements are to be in the form of codified regulations published in the Federal Register. 7 C.F.R. § 3016.6(a).

As noted above, in addition to implementing OMB's grants management circulars, the common rule format has been used in two other grant-related contexts. One implements the Byrd Anti-Lobbying Amendment, discussed previously. The common rule on this subject was issued by 28 grantor agencies on February 26, 1990. 55 Fed. Reg. 6736.

The other common rule implements provisions relating to suspension and debarment and drug-free workplaces. On February 18, 1986, as part of the government's effort to combat fraud, waste, and abuse, the President signed Executive Order No. 12549, which directed the establishment of a system for debarment and suspension in the assistance context.[43] OMB implemented the executive order by developing common rule language, entitled "Government-wide Debarment and Suspension (Nonprocurement)," that was adopted by over 25 grantor agencies and patterned generally on comparable provisions for procurement contracts in the Federal Acquisition Regulation. This common rule was originally published at 53 Fed. Reg. 19160 (May 26, 1988). It was revised and republished in 2003 in a version that incorporates provisions implementing

[43] Exec. Order No. 12549, *Debarment and Suspension*, 51 Fed. Reg. 6370 (Feb. 18, 1986).

the Drug-Free Workplace Act of 1988 (41 U.S.C. §§ 701–707).[44] 68 Fed. Reg. 66,534 (Nov. 26, 2003).

With respect to suspension and debarment, a person (including business entities and units of government) who is debarred is excluded from federal assistance and benefits, financial and nonfinancial, under federal programs and activities for a period of up to 3 years, possibly longer. Causes of debarment include certain criminal convictions, antitrust violations, a history of unsatisfactory performance, and failure to pay a single substantial debt or a number of outstanding debts owed to the federal government. See generally 7 C.F.R. pt. 3017, subpart H, for provisions relating to debarment. Suspension is a temporary exclusion, usually pending the completion of an investigation involving one or more of the causes for debarment. See generally 7 C.F.R. pt. 3017, subpart G, for provisions relating to suspension. The General Services Administration (GSA) is responsible for compiling and distributing a list of debarred or suspended persons. The list, now called the Excluded Parties List System, is maintained by GSA's Office of Acquisition Policy and is available electronically. *See generally* 7 C.F.R. pt. 3017, subpart E.

c. The Federal Financial Assistance Management Improvement Act

The Federal Financial Assistance Management Improvement Act of 1999, Pub. L. No. 106-107 (Nov. 20, 1999), 113 Stat. 1486, 31 U.S.C. § 6101 note, was enacted to improve the management and performance of federal financial assistance programs. The act required federal agencies to develop and implement a plan that would, among other things, streamline and simplify application, administrative, and reporting procedures for financial assistance programs. Pub. L. No. 106-107, § 5(a). It also required OMB to direct, coordinate, and assist federal agencies in establishing a common application and reporting system that would include uniform administrative rules for assistance programs across different federal agencies. *Id.* § 6(a)(1)(C).

In furtherance of the act's requirements, OMB is working to consolidate all six of its grants-related circulars as well as the agency common rules into a new title 2 of the Code of Federal Regulations. *See* 69 Fed. Reg. 26,276 (May 11, 2004). Under this approach, title 2 will include the full text of each circular. In their portions of title 2, the grantor agencies will simply adopt by reference the text of the OMB circulars together with any agency-

[44] The provisions of the Drug-Free Workplace Act dealing specifically with federal grantees appear in 41 U.S.C. § 702.

specific additions, exceptions, or clarifications. This will avoid the need for each individual agency to repeat separately the content of the OMB circulars as they now do in their common rules. 69 Fed. Reg. at 26,277. OMB began this process by publishing Circular No. A-110 as 2 C.F.R. part 215 (2005). It recently added three more circulars: numbers A-21, A-87, and A-122. *See* 70 Fed. Reg. 51,880; 51,910; 51,927 (Aug. 31, 2005).

Apart from providing for regulatory consolidation and streamlining, the Federal Financial Assistance Management Improvement Act contained a number of other provisions designed to improve federal assistance processes and performance. It also imposed additional responsibilities on the agencies and OMB. Section 7 of Public Law 106-107 mandated a GAO evaluation of the effectiveness of the act. GAO reported the results of its evaluation in *Grants Management: Additional Actions Needed to Streamline and Simplify Processes*, GAO-05-335 (Washington, D.C.: Apr. 18, 2005). *See also* GAO, *Federal Assistance: Grant System Continues to Be Highly Fragmented*, GAO-03-718T (Washington, D.C.: Apr. 29, 2003).

d. The "Cognizant Agency" Concept

Finally, to simplify relations between federal grantees and awarding agencies, OMB established the "cognizant agency" concept, under which a single agency represents all others in dealing with grantees in common areas.[45] In this case, the cognizant agency reviews and approves grantees' indirect cost rates. Approved rates must be accepted by other agencies, unless specific program regulations restrict the recovery of indirect costs.

OMB published a list of cognizant agency assignments for some state agencies, cities and counties on January 6, 1986 (51 Fed. Reg. 552). The cognizant agency for governmental units not on that list is the one that provides the most grant funds to the entity. The Department of Health and Human Services (HHS) is the cognizant agency for all States and most cities. The cognizant agency for other organizations is determined by calculating which federal agency provides the most grant funding. For example, the Department of the Interior is the cognizant agency for all Indian tribal governments, and for hospitals, HHS serves as the cognizant agency.

[45] The information here is taken from OMB's web site at www.whitehouse.gov/omb/grants/attach.html (last visited September 15, 2005).

4. Contracting by Grantees

Grantees commonly enter into contracts with third parties in the course of performing their grants. While the United States is not a party to the contracts, the grantee must nevertheless comply with any requirements imposed by statute, regulation, or the terms of the grant agreement, in awarding federally assisted contracts. 54 Comp. Gen. 6 (1974). Violation of applicable procurement standards may result in the loss of federal funding. *See Town of Fallsburg v. United States*, 22 Cl. Ct. 633 (1991).

For a period of nearly 10 years, GAO undertook a limited review of the propriety of contract awards made by a grantee in furtherance of grant purposes, upon request of a prospective contractor. This limited review role was announced in 40 Fed. Reg. 42406 (Sept. 12, 1975). (While these reviews were conducted in a manner similar to bid protests, mentioned previously in section B.4 of this chapter, GAO called the requests for review "complaints" rather than "protests.") GAO applied the same limited review to contracts awarded under cooperative agreements. 59 Comp. Gen. 758 (1980).

GAO's review was designed primarily to ensure that the "basic principles" of competitive bidding were applied. 55 Comp. Gen. 390, 393 (1975). Numerous decisions were rendered in this area. *E.g.*, 57 Comp. Gen. 85 (1977) (nonapplicability of Buy American Act); 55 Comp. Gen. 1254 (1976) (state law applicable when indicated in grant); 55 Comp. Gen. 413 (1975) (nonapplicability of Federal Procurement Regulations).

By 1985, many agencies had developed their own review procedures, and the number of complaints filed with GAO steadily decreased. Determining that its review of grantee contracting was no longer needed, GAO discontinued its limited review in January 1985. 50 Fed. Reg. 3978 (Jan. 29, 1985); 64 Comp. Gen. 243 (1985). The body of decisions issued during the 1975–1985 period should nevertheless remain useful as guidance in this area.

In a 1980 report, GAO reviewed the procurement procedures of selected state and local government grantees and nonprofit organizations in five states. The report concluded that the state and local governments generally had in place and followed sound procurement procedures (somewhat less so for the nonprofits), but also found a number of weak spots, many of which are now addressed in OMB directives. *See* GAO, *Spending Grant Funds More Efficiently Could Save Millions*, PSAD-80-58 (Washington, D.C.: June 30, 1980).

With respect to state and local governments, standards for grantee procurement are set forth in the common rules. Using our Department of Agriculture example, its version of this rule is 7 C.F.R. § 3016.36. These rules require, among other things, that grantees and subgrantees have protest procedures to resolve disputes over their procurements. *Id.* § 3016.36(b)(12). Federal grantor agencies review protests against grantee and subgrantee awards that involve violations of federal law or regulations (including the procurement standards in the common rules) or of the grantee's or subgrantee's protest procedures. *Id.* Grantor agencies are authorized, but not required, to review grantee/subgrantee procurements on other grounds. *See* Supplementary Information Statement, 53 Fed. Reg. 8034, 8039 (Mar. 11, 1988).

An agency that has a review procedure for grantee procurement will be held to established precepts of administrative law in applying those procedures. For example, in *Niro Atomizer, Inc. v. EPA*, 682 F. Supp. 1212 (S.D. Fla. 1988), the court instructed the agency to either follow its established procedures or announce that it was changing them, giving the parties notice and an opportunity to rebut. However, the court in *A-G-E Corp. v. United States*, 968 F.2d 650 (8th Cir. 1992), rejected a challenge that the common rules did not go far enough in regulating grantee procurements. The plaintiffs objected to a provision then in the common rules that permitted state grantees to apply resident preferences to their procurements.[46] The court viewed the common rules as embodying internal executive branch management directives and held that the plaintiffs lacked standing to challenge them absent a showing that they were inconsistent with federal law.

5. Liability for Acts of Grantees

It is often said that the federal government is not liable for the unauthorized acts of its agents, "agents" in this context referring to the government's own officers and employees. If this is true with respect to those who clearly are agents of the government, it logically must apply with even greater force to those who are not its agents. Grantees, for purpose of imposing legal

[46] The current version of the rule, 7 C.F.R. § 3016.36(c)(2), provides generally that:

> "Grantees and subgrantees will conduct procurements in a manner that prohibits the use of statutorily or administratively imposed in-State or local geographical preferences in the evaluation of bids or proposals, except in those cases where applicable Federal statutes expressly mandate or encourage geographic preference."

liability on the United States, are not "agents" of the government. While the demarcation is not perfect, we divide our discussion into two broad areas, contractual liability and liability for grantee misconduct.

a. Liability to Grantee's Contractors

For the United States to be contractually liable to some other party, there must be "privity of contract," that is, a direct contractual relationship between the parties. When a grantee under a federal grant enters into a contract with a third party (contractor), there is privity between the United States and the grantee, and privity between the grantee and the contractor, but no privity between the United States and the contractor and hence, as a general proposition, no liability.

Perhaps the leading case in this area is *D.R. Smalley & Sons, Inc. v. United States*, 372 F.2d 505 (Ct. Cl.), *cert. denied*, 389 U.S. 835 (1967). The plaintiff contractor had entered into a highway construction contract with the state of Ohio. The project was funded on a cost-sharing basis, with 90 percent of total costs to come from federal-aid highway funds. The contractor lost nearly $3 million on the project, recovered part of its loss from the state of Ohio, and then sued the United States to recover the unpaid balance. The contractor argued that Ohio was really the agent of the United States for purposes of the project because, among other things, the contract had been drafted pursuant to federal regulations, the United States approved the contract and all changes, and the United States was funding 90 percent of the costs.

The court disagreed. Since there was no privity of contract between the United States and the contractor, the government was not liable. The involvement of the government in various aspects of the project did not make the state the agent of the federal government for purpose of creating contractual liability, express or implied. The court stated:

> "The National Government makes many hundreds of grants each year to the various states, to municipalities, to schools and colleges and to other public organizations and agencies for many kinds of public works, including roads and highways. It requires the projects to be completed in accordance with certain standards before the proceeds of the grant will be paid. Otherwise the will of Congress would be thwarted and taxpayers' money would be wasted. . . . It would be farfetched indeed to impose liability on the Government for the acts and omissions of the parties who contract to build the projects, simply because it requires the

> work to meet certain standards and upon approval thereof reimburses the public agency for the part of the costs."

Id. at 507. Some later cases applying the Smalley concept are *Malone v. United States*, 34 Fed. Cl. 257 (1995); *Blaze Construction, Inc. v. United States*, 27 Fed. Cl. 646 (1993); *Somerville Technical Services, Inc. v. United States*, 640 F.2d 1276 (Ct. Cl. 1981); *Housing Corporation of America v. United States*, 468 F.2d 922 (Ct. Cl. 1972); *Cofan Associates, Inc. v. United States*, 4 Cl. Ct. 85 (1983); 68 Comp. Gen. 494 (1989).

The *Cofan* case presented an interesting variation in that the claimant was a disappointed bidder rather than a contractor, trying to recover under the theory, well-established in the law of procurement contracts, that there is an implied promise on the part of the government to fairly consider all bids. This did not help the plaintiff, however, since again there was no privity with the government. In this regard, the court observed:

> "[I]t is now firmly established that a person who enters into a contract with [a grantee] to perform services on a project funded in part by loans or grants-in-aid from the United States may not thereby be deemed to have entered into a contract with the United States. Nor is the result any different because the United States has imposed guidelines or restrictions on the use of funds, including procurement procedures."

4 Cl. Ct. at 86. *See also Pendleton v. United States*, 47 Fed. Cl. 480 (2000) (federal participation in state reclamation project was not sufficient to support plaintiffs' claim for compensable Fifth Amendment taking against the United States).

Another variation occurred in 47 Comp. Gen. 756 (1968). A contractor had succeeded in recovering increased costs from a state grantee. Under *Smalley*, it was clear that the government could not be held legally liable for the proportionate share of the recovery. However, it was apparent that the increased costs were due to the fact that erroneous soil profile information furnished by the state had contributed to an unrealistically low bid by the contractor. Under these circumstances, GAO advised that the grantor agency and the state could enter into a voluntary modification of the grant agreement to recognize the damage recovery as a project cost. *See also* B-167310, July 31, 1969.

In limited circumstances, there is a device that may be available to a contractor to have its claim considered by the federal government, illustrated by B-181332, Dec. 28, 1976.[47] In that case, an agency had erroneously refused to fund a grant after it had been approved and the grantee's contractor had incurred expenses in reliance on the approval. There clearly was no privity between the contractor and the United States. However, GAO recognized a procedural device drawn from the law of procurement contracts, and accepted a claim filed by the grantee (with whom the United States did have privity) "for and on behalf of" the contractor, in which the grantee acknowledged liability to the contractor only if and to the extent that the government was liable to the grantee. In effect, the contractor was prosecuting the claim in the name of the grantee. This device is potentially useful only where the government's liability to the grantee can be established. *See also* 68 Comp. Gen. 494, 495–96 (1989); 9 Comp. Gen. 175 (1929). A different type of contract, an employment contract, was the subject of 66 Comp. Gen. 604 (1987), in which GAO concluded, applying *Smalley*, that the United States was not liable to a former employee of a grantee for unpaid salary. The grantor agency had funded all allowable costs under the grant, and the grantee's transgression was not the liability of the United States.

As if to provide the adage that anything that can happen will happen, a 1983 case combined all of the elements noted above. The Agency for International Development (AID) made a rural development planning grant to Bolivia. Bolivia contracted with a private American company to perform certain functions under the grant, and the company in turn entered into employment contacts with various individuals. The contract with the private company (but not the grant itself) was terminated, the company terminated the employment contracts, and the individuals then sought to recover benefits provided under Bolivian law. Clearly, AID was not legally liable to the individual claimants. However, some of the benefits to some of the claimants could qualify as allowable costs under the grant and could be paid, if approved by AID and the grantee, to the extent grant funds remained available. B-209649, Dec. 23, 1983.

[47] This decision and others described here arose under GAO's former statutory authority to settle claims by or against the United States. This authority has been transferred from GAO to executive branch agencies. See notes following 31 U.S.C. § 3702. However, the principles stated in the decisions remain relevant.

b. Liability for Grantee Misconduct

A number of cases have involved attempts to impose liability on the United States under the Federal Tort Claims Act.[48] The act makes the United States liable, with various exceptions, for the tortious conduct of its officers, employees, or agents acting within the scope of their employment. As a general proposition, a grantee is not an agent or agency of the government for purposes of tort liability.

An important Supreme Court case is *United States v. Orleans*, 425 U.S. 807 (1976), holding that a community action agency funded under a federal grant was not a "federal agency" for purposes of the Federal Tort Claims Act. The case arose from a motor vehicle accident involving plaintiff Orleans and an individual acting on behalf of the grantee. The Court first noted that the Federal Tort Claims Act "was never intended, and has not been construed by this Court, to reach employees or agents of all federally funded programs that confer benefits on people." *Orleans*, 425 U.S. at 813. The Court then stated, and answered, the controlling test:

> "[T]he question here is not whether the [grantee] receives federal money and must comply with federal standards and regulations, but whether its day-to-day operations are supervised by the Federal Government.
>
> * * * * *
>
> "The Federal Government in no sense controls 'the detailed physical performance' of all the programs and projects it finances by gifts, grants, contracts, or loans."

Id. at 815–16.

Thus, the general rule is that the United States is not liable for torts committed by its grantees. Neither the fact of federal funding nor the degree of federal involvement encountered in the typical grant (approval, oversight, inspections, *etc.*) is sufficient to make the grantee an agent of the United States of purposes of tort liability. Liability could result, however, if the federal involvement reached the level of detailed supervision of day-to-day operations noted in *Orleans*. An example is *Martarano v. United States*, 231 F. Supp. 805 (D. Nev. 1964) (state employee under cooperative

[48] The act's principal provisions are found at 28 U.S.C. §§ 2671–2680.

agreement working under direct control and supervision of federal agency).

In another group of cases, attempts have been made to find the United States liable under the Federal Tort Claims Act for allegedly negligent performance of its oversight role under a grant. The courts have found these claims covered by the "discretionary function" exception to Federal Tort Claims Act liability.[49] *Mahler v. United States*, 306 F.2d 713 (3rd Cir.), *cert. denied*, 371 U.S. 923 (1962), followed in *Daniel v. United States*, 426 F.2d 281 (5th Cir. 1970), and *Rayford v. United States*, 410 F. Supp. 1051 (M.D. Tenn. 1976). *See also Rothrock v. United States*, 883 F. Supp. 333 (S.D. Ind. 1994), *aff'd*, 62 F.3d 196 (7th Cir. 1995).

In areas not covered by the Federal Tort Claims Act, the potential for individual liability cannot be disregarded. One such area is the so-called "constitutional tort," or an action for damages based on an alleged violation of federal constitutional rights perpetrated under color of law. For example, an official of the Indian Health Service, acting jointly with a state official, told a nonprofit intermediary that further funding would be conditioned on the dismissal of an employee whom they thought was performing inadequately. The intermediary fired the employee, who then sued the state official and the federal official in their individual capacities. The suit against the federal defendant was based directly on the Fifth Amendment, for deprivation of a property interest (the plaintiff's job) without due process. The court first found that there had been a due process violation, and that the defendants were not entitled to qualified immunity because their conduct exceeded the scope of their authority. *Merritt v. Mackey*, 827 F.2d 1368 (9th Cir. 1987). The court noted that there was no basis for imposing liability on the United States. *Id.* at 1373–74. In the second published appellate decision in the case, the court affirmed a monetary damage award and an award of attorney's fees against the individual officials. The federal official was personally liable for the fee

[49] The discretionary function exception excludes from the act's coverage—

> "[a]ny claim based upon an act or omission of an employee of the Government, exercising due care, in the execution of a statute or regulation, whether or not such statute or regulation be valid, or based upon the exercise or performance or the failure to exercise or perform a discretionary function or duty on the part of a federal agency or an employee of the Government, whether or not the discretion involved be abused."

28 U.S.C. § 2680(a).

award under 42 U.S.C. § 1988 because he had acted in concert with a state official. *Merritt v. Mackey*, 932 F.2d 1317 (9th Cir. 1991). *See also Downey v. Coalition Against Rape and Abuse, Inc.*, 143 F. Supp. 2d 423 (D.N.J. 2001), applying reasoning similar to *Merritt* in the context of a state-funded grant.

However, the law concerning constitutional torts is unsettled. The concept of constitutional torts originated with *Bivens v. Six Unknown Named Agents of the Federal Bureau of Narcotics*, 403 U.S. 388 (1971), and has been applied in many subsequent cases dealing with a range of constitutional rights. Recently, however, the Supreme Court has taken a narrow view of this concept. Of particular relevance here, the Supreme Court held in *Correctional Services Corp. v. Malesko*, 534 U.S. 61 (2001), that a prisoner could not maintain a constitutional tort action against a private organization that operated a detention facility under a federal contract. The Court indicated that constitutional tort actions under *Bivens* can be maintained only against individual federal officers or employees; thus, such actions do not lie against "private entities acting under color of federal law" nor do they lie against federal agencies. *Malesko*, 534 U.S. at 66–74.

In light of *Malesko*, it is unclear whether cases like *Merritt v. Mackey*, *supra*, would be decided the same way today. *Malesko* suggests that, as a general proposition, federal contractors and grantees and their employees would not be subject to liability for constitutional torts. Likewise, federal agencies would not have constitutional tort liability. It is possible that individual federal employees (like the one in *Merritt*) could still be held liable for inducing a grantee to violate someone's constitutional rights. However, it is questionable whether a court would impose tort liability on a federal employee who induced a violation if the party who actually committed the violation could not be liable. For additional background on this subject, see Michael B. Hedrick, *New Life for a Good Idea: Revitalizing Efforts to Replace the Bivens Action with a Statutory Waiver of the Sovereign Immunity of the United States for Constitutional Tort Suits*, 71 Geo. Wash. L. Rev. 1055 (2003).

6. Types of Grants: Categorical *versus* Block

A categorical grant is a grant to be used only for a specific program or for narrowly defined activities. A categorical grant may be allocated on the basis of a distribution formula prescribed by statute or regulation ("formula grant"), or it may be made for a specific project ("project grant"). A block

grant is a grant given to a governmental unit, usually a state, to be used for a variety of activities within a broad functional area.[50] Block grants are usually formula grants. Under a block grant, the state is responsible for further distribution of the money. States naturally prefer block grants because they increase the states' spending flexibility and at least in theory reduce federal control. *See generally* Library of Congress, Congressional Research Service, *Federal Grants to State and Local Governments: Overview and Characteristics*, No. RS20669 (Nov. 27, 2002), at 3–5; GAO, *Grant Programs: Design Features Shape Flexibility, Accountability, and Performance Information*, GAO/GGD-98-137 (Washington, D.C.: June 22, 1998), at 3 ("In practice, the 'categorical' and 'block' grant labels and their underlying definitions represent the ends of a continuum and overlap considerably in its middle range.").

During the 1960s and 1970s, although some block grant programs were in existence, the emphasis was largely on categorical grants. The Omnibus Budget Reconciliation Act of 1981 (OBRA), Pub. L. No. 97-35, 95 Stat. 357 (Aug. 13, 1981), attempted to put a halt to this trend. *See* Library of Congress, Congressional Research Service, *Federal Grants to State and Local Governments: A Brief History*, No. RL30705 (Feb. 19, 2003), at 10. The act merged and consolidated several dozen categorical grant programs into block grants. GAO, *Block Grants: Characteristics, Experience, and Lessons Learned*, GAO/HEHS-95-74 (Washington, D.C.: Feb. 9, 1995), at 7–9, App. II.

In the mid-1990s, GAO cited the fiscal year 1996 budget resolution in reporting that Congress had "shown a strong interest in consolidating narrowly defined categorical grant programs for specific purposes into broader purpose block grants." GAO, *Block Grants: Issues in Designing Accountability Provisions*, GAO/AIMD-95-226 (Washington, D.C.: Sept. 1, 1995), at 1. In 2003, however, GAO testified that, although Congress had made further efforts to consolidate categorical grant programs over the years, "each period of consolidation was followed by a proliferation of new federal programs." GAO, *Federal Assistance: Grant System Continues to Be Highly Fragmented*, GAO-03-718T (Washington, D.C.: Apr. 29, 2003), at 4.

[50] These distinctions are discussed under the definition of "Grant" in GAO, *A Glossary of Terms Used in the Federal Budget Process*, GAO-05-734SP (Washington, D.C.: September 2005), at 60–61.

Although GAO could still report in 2003 that block grants were "one way Congress has chosen to consolidate related programs," GAO also reported on certain "hybrid" approaches, including "consolidated categorical" grants, that would consolidate a number of narrower categorical programs while retaining standards and accountability for discrete federal performance goals, and "Performance Partnership Agreements," in which states can shift federal funds across programs but are held accountable for discrete or negotiated measures of performance. GAO-03-718T, at 15; GAO, *Homeland Security: Reforming Federal Grants to Better Meet Outstanding Needs*, GAO-03-1146T (Washington, D.C.: Sept. 3, 2003), at 11–13.[51]

Block grants reduce federal involvement in that they transfer much of the decision-making to the grantee and reduce the number of separate grants that must be administered by the federal government. It is a misconception, however, to think that block grants are "free money" in the sense of being totally free from federal "strings." *See*, *e.g.*, GAO/HEHS-95-74, at App. III, "Accountability Requirements of 1981 Block Grants."

Restrictions on the use of block grant funds may derive from the organic legislation itself. For example, several of the OBRA programs include such items as limitations on allowable administrative expenses, prohibitions on the use of funds to purchase land or construct buildings, "maintenance of effort" provisions, and anti-discrimination provisions. Other OBRA provisions of general applicability (Pub. L. No. 97-35, §§ 1741–1745) impose reporting and auditing requirements, and require states to conduct public hearings as a prerequisite to receiving funds in any fiscal year. Another more recent example is the Temporary Assistance for Needy Families (TANF) block grants, for which Congress established time limits and work requirements for adults receiving aid. GAO, W*elfare Reform: With TANF*

[51] GAO has issued a number of reports on block grants, including the following: *Early Observations on Block Grant Implementation*, GAO/GGD-82-79 (Washington, D.C.: Aug. 24, 1982); *Lessons Learned From Past Block Grants: Implications for Congressional Oversight*, GAO/IPE-82-8 (Washington, D.C.: Sept. 23, 1982); *A Summary and Comparison of the Legislative Provisions of the Block Grants Created by the 1981 Omnibus Budget Reconciliation Act*, GAO/IPE-83-2 (Washington, D.C.: Dec. 30, 1982); *Block Grants: Overview of Experiences to Date and Emerging Issues*, GAO/HRD-85-46 (Washington, D.C.: Apr. 3, 1985); and *Community Development: Oversight of Block Grant Needs Improvement*, GAO/RCED-91-23 (Washington, D.C.: Jan. 30, 1991). GAO has also published a comprehensive catalog of formula grants, intended for use as a resource document: *Grant Formulas: A Catalog of Federal Aid to States and Localities*, GAO/HRD-87-28 (Washington, D.C.: Mar. 23, 1987).

Flexibility, States Vary in How They Implement Work Requirements and Time Limits, GAO-02-770 (Washington, D.C.: July 5, 2002) at 3.

Applicable restrictions are not limited to those contained in the program statute itself. Other federal statutes applicable to the use of grant funds must also be followed. *See*, *e.g.*, *Ely v. Velde*, 451 F.2d 1130 (4th Cir. 1971), holding that the National Historic Preservation Act and the National Environmental Policy Act applied to the then Law Enforcement Assistance Administration in making a block grant to Virginia under the Safe Streets Act. A later and related decision in the same case is 497 F.2d 252 (4th Cir. 1974). *See also Forum for Academic & Institutional Rights v. Rumsfeld*, 390 F.3d 219 (3rd Cir. 2004), *cert. granted*, 125 S. Ct. 1977 (2005) (reviewing statute withholding funding to educational institutions that deny U.S. military access to campus for recruiting purposes); *Barbour v. Washington Metropolitan Area Transit Authority*, 374 F.3d 1161 (D.C. Cir. 2004), *cert. denied*, 125 S. Ct. 1591 (2005) (public transit authority's acceptance of federal grant funds resulted in a waiver of its immunity to a Rehabilitation Act claim); *Maryland Department of Human Resources v. United States Department of Health & Human Services*, 854 F.2d 40 (4th Cir. 1988) (requirement for apportionment by Office of Management and Budget applicable to funds under Social Services Block Grant); 6 Op. Off. Legal Counsel 605 (1982) (Uniform Relocation Assistance Act applicable to Community Development block grant); 6 Op. Off. Legal Counsel 83 (1982) (various antidiscrimination statutes applicable to Elementary and Secondary Education and Social Services block grants).

If applicable, these additional restrictions may impose legal responsibilities on grantees. *See*, *e.g.*, GAO, *Native American Housing: Information on HUD's Housing Programs for Native Americans*, GAO/RCED-97-64, (Washington, D.C.: Mar. 28, 1997), at 14 (Indian hiring preference and Davis-Bacon Act). Thus the block grant mechanism does not totally remove federal involvement nor does it permit the circumvention of federal laws applicable to the use of grant funds. In this latter respect, a block grant is legally no different from a categorical grant.

The common rule for uniform administrative requirements does not apply to the OBRA block grants. *See*, *e.g.*, 7 C.F.R. § 3016.4(a)(2).

7. The Single Audit Act

We noted in our introduction to this chapter that federal grants to state and local governments exceed $400 billion a year. With expenditures of this magnitude, it is essential that there be some way to assure accountability

on the part of the grantees. The traditional means of assuring accountability has been the audit.

Prior to 1984, there were no statutory uniform audit requirements for state and local government grantees. Audits were performed on a grant or program basis and requirements varied with the program legislation. Under this system, gaps in audit coverage resulted because some entities were audited infrequently or not at all. Also, overlapping requirements produced duplication and inefficiency with multiple audit teams visiting the same entity and reviewing the same financial records. Congress addressed the problem by enacting the Single Audit Act of 1984, Pub. L. No. 98-502, 98 Stat. 2327 (Oct. 19, 1984), codified at 31 U.S.C. §§ 7501–7507.[52]

The 1984 act's objectives were to improve the financial management of state and local governments receiving federal financial assistance; establish uniform requirements for audits of federal financial assistance provided to state and local governments; promote the efficient and effective use of audit resources; and ensure that federal departments and agencies, to the extent practicable, rely upon and use audit work done pursuant to the act. Pub. L. No. 98-502, § 1(b). The 1984 act required each state and local entity that that received $100,000 or more in federal financial assistance (either directly from a federal agency or indirectly through another state or local entity) in any fiscal year to undergo a comprehensive, single audit of its financial operations. The 1984 act also required entities receiving between $25,000 and $100,000 in federal financial assistance to have either a single audit or a financial audit required by the programs that provided the federal funds.[53] An informative discussion of the need for the 1984 legislation, with references to several

[52] For an early review of the implementation of the original act, see GAO, *Single Audit Act: Single Audit Quality Has Improved but Some Implementation Problems Remain*, GAO/AFMD-89-72 (Washington, D.C.: July 27, 1989).

[53] State and local entities receiving less than $25,000 in federal funds in any fiscal year were not required to have a financial audit.

reports by GAO and the Joint Financial Management Improvement Program (JFMIP),[54] may be found in H.R. Rep. No. 98-708 (1984).

In 1996, the Single Audit Act of 1984 underwent a major overhaul. Prior to 1996, state and local governments followed one set of audit requirements and Indian tribes and nonprofit organizations, including educational institutions, followed another. The Single Audit Act Amendments of 1996[55] established uniform requirements for audits of federal awards[56] administered by all nonfederal entities, not just state and local governments. In addition, the 1996 amendments, in order to reduce any burdens on nonfederal entities and to promote the efficient and effective use of audit resources, increased the dollar threshold needed to trigger an audit and based the audit requirement on an amount expended rather than on an amount received.

As a result, any nonfederal entity, defined as a state, local government, or nonprofit organization, that expends federal awards equal to or in excess of $500,000[57] in any fiscal year shall have either a single audit or a program-specific audit for such fiscal year. Audits are conducted annually. However, biennial audits are permissible for state and local governments that are required by their constitution or by a statute, in effect on January 1,

[54] On December 1, 2004, the principals of the JFMIP (GAO, Department of Treasury, Office of Management and Budget (OMB), and Office of Personnel Management) signed an agreement that reassigned responsibility for financial management policy and oversight effectively eliminating JFMIP as a stand-alone organization. OMB issued a memorandum on December 2, 2004, that discusses in detail the changes to JFMIP's role, the transfer of JFMIP's Project Management Office to the CFO Council, the creation of a new Financial Systems Integration Committee of the CFO Council, and other transition issues. OMB, *Memorandum for Chief Financial Officers Council*, *Realignment of Responsibilities for Federal Financial Management Policy and Oversight (*Dec. 2, 2004), *available at* http://www.whitehouse.gov/omb (last visited September 15, 2005).

[55] Pub. L. No. 104-156, 110 Stat. 1396 (July 5, 1996).

[56] Federal awards include federal cost-reimbursement contracts, grants, loans, loan guarantees, property, cooperative agreements, interest subsidies, insurance, food commodities, direct appropriations, or other assistance, but does not include amounts received as reimbursement for services rendered to individuals. 31 U.S.C. § 7501(a)(4), (5).

[57] Every 2 years, the Director of OMB shall review the dollar threshold amount for requiring the audits and may adjust the dollar amount consistent with the purposes of the Single Audit Act, as amended. 31 U.S.C. § 7502(a)(3). In 2004, OMB adjusted the dollar threshold to $500,000. For fiscal years ending on or before December 30, 2003, the threshold is $300,000. *See* OMB Web site *at* http://www.whitehouse.gov/omb/financial/fin_single_audit.html (last visited September 15, 2005).

1987, to undergo audits less frequently than annually. Also any nonprofit organization that had biennial audits for all biennial periods ending between July 1, 1992, and January 1, 1995, is also permitted to undergo its audits biennially.

The audit is to be conducted by an independent auditor in accordance with generally accepted government auditing standards. 31 U.S.C. § 7502(c). These standards are found in GAO's publication *Government Auditing Standards*,[58] commonly known as the "Yellow Book." The Director of OMB, after consultation with the Comptroller General, and appropriate officials from federal, state, and local governments and nonprofit organizations, is required to prescribe guidance to implement the Single Audit Act, as amended. 31 U.S.C. § 7505(a). Guidance for implementing the act can be found in OMB Circular No. A-133, A*udits of States*, *Local Governments*, *and Non-Profit Organizations* (June 27, 2003).[59]

The annual audit shall either cover the operations of the entire nonfederal entity or include a series of audits that cover departments, agencies, and other organizational units as long as the audit encompasses the financial statements and schedule of expenditures of the federal awards for each unit. 31 U.S.C. § 7502(d). If the nonfederal entity expends federal awards only under one program and is not required otherwise to receive a financial statement audit, it may elect to have a program-specific audit. 31 U.S.C. § 7502(a)(1)(C). Performance audits[60] are not required except as authorized by the Director. 31 U.S.C. §7502(c).

The statute (31 U.S.C. § 7502(e)) requires the auditor to:

- determine whether the financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles;

[58] GAO, *Government Auditing Standards*, GAO-03-673G (Washington, D.C.: June 2003).

[59] In March 2004, OMB issued a Compliance Supplement to Circular No. A-133. The supplement can be found at http://www.whitehouse.gov/omb/circulars/a133_compliance/04/04toc.html (last visited September 15, 2005).

[60] Performance audits encompass a wide variety of objectives, including objectives related to assessing program effectiveness and results; economy and efficiency; internal control; and compliance with legal or other requirements and are described in more detail in Chapter 2 of the *Government Auditing Standards*, GAO-03-673G.

- determine whether the schedule of expenditures of federal awards is presented fairly in all material respects in relation to the financial statements taken as a whole;

- with respect to internal controls pertaining to the compliance requirements for each major program,

  - obtain an understanding of such internal controls;

  - assess control risk; and

  - perform tests of controls unless the controls are deemed o be ineffective; and

- determine whether the nonfederal entity has complied with the provisions of laws, regulations, and contracts or grants pertaining to federal awards that have a direct and material effect on each major program. ("Major programs" are defined in 31 U.S.C. § 7501(a)(12)).

If the audit discloses any audit findings, the nonfederal entity needs to prepare a corrective action plan to eliminate the audit findings or a statement explaining why corrective action is not necessary. 31 U.S.C. § 7502(i). The corrective action plan needs to be consistent with the audit resolution standard promulgated by the Comptroller General as part of the standards for internal controls in the federal government[61] pursuant to 31 U.S.C. § 3512(c). The federal agency that provided the federal award needs to review the audit to determine whether prompt and corrective action has been taken regarding the audit findings. 31 U.S.C. § 7502(f)(1)(B).

GAO has reported over the last few years that more action is needed at both the nonfederal and federal level to ensure that audit findings are responded to, corrected, and tracked. *See*, *e.g.*, GAO, *Single Audit: Actions Needed to Ensure That Findings Are Corrected*, GAO-02-705 (Washington, D.C.: June 26, 2002); *Single Audit: Single Audit Act Effectiveness Issues*, GAO-02-877T (Washington, D.C.: June 26, 2002); *Compact of Free Association: Single Audits Demonstrate Accountability Problems Over Compact Funds*, GAO-04-7 (Washington, D.C.: Oct. 7, 2003);

[61] *See* GAO, *Standards for Internal Control in the Federal Government*, AIMD-00-21.3.1 (Washington, D.C.: November 1999).

American Samoa: Accountability for Key Federal Grants Needs Improvement, GAO-05-41 (Washington, D.C.: Dec. 17, 2004).

The nonfederal entity is required to transmit a reporting package, which shall include the financial statements, auditor opinion, and corrective action plan, if necessary, to a federal clearinghouse for public inspection. 31 U.S.C. § 7502(h),(i). Report packages can be viewed by going to the Federal Audit Clearinghouse Home Page at http://harvester.census.gov/sac (last visited September 15, 2005).

OMB's guidance in Circular No. A-133 includes criteria for determining the appropriate charges to federal awards for the cost of audits. Section 230 of the Circular provides that, unless prohibited by law, the costs of audits are allowable charges to the federal awards. The charges may be considered a direct cost or an allocated indirect cost, as determined in accordance with the provisions of applicable OMB cost principles circulars, the Federal Acquisition Regulation (48 C.F.R. pts. 30 and 31), or other applicable cost principles or regulations.

Audits conducted under the Single Audit Act, as amended, are in lieu of any other financial audit required by the nonfederal entity by any other federal law or regulation. 31 U.S.C. § 7503(a). However, that does not prohibit a federal agency from conducting or arranging for its own audit of the federal award if necessary to carry out the federal agency's responsibilities under a federal law or regulation; it only requires that the federal agency pay for the cost of such an audit. 31 U.S.C. § 7503(b), (e).

The law also requires the Comptroller General to monitor provisions in bills and resolutions reported by the committees of the Senate and the House of Representatives that require financial audits of nonfederal entities that receive federal awards, and report to the appropriate congressional committees any such provisions that are inconsistent with the Single Audit Act, as amended. 31 U.S.C. § 7506.

D. Funds in Hands of Grantee: Status and Application of Appropriation Restrictions

Expenditures by grantees for grant purposes are not subject to all the same restrictions and limitations imposed on direct expenditures by the federal government. For this reason, grant funds in the hands of a grantee have been said to largely lose their character and identity as federal funds. The Comptroller General stated the principle as follows:

> "It consistently has been held with reference to Federal grant funds that, when such funds are granted to and accepted by the grantee, the expenditure of such funds by the grantee for the purposes and objects for which made [is] not subject to the various restrictions and limitations imposed by Federal statute or our decisions with respect to the expenditure, by Federal departments and establishments, of appropriated moneys in the absence of a condition of the grant specifically providing to the contrary."

43 Comp. Gen. 697, 699 (1964). Thus, except as otherwise provided in the program statute, regulations,[62] or the grant agreement, the expenditure of grant funds by a state government grantee is subject to the applicable laws of that state rather than federal laws applicable to direct expenditures by federal agencies. 16 Comp. Gen. 948 (1937). The rule applies "with equal if not greater force" when the grantee is another sovereign nation. B-80351, Sept. 30, 1948.

One group of cases[63] involves restrictions on employee compensation and related payments. Examples are:

- Appropriation act provision prohibiting use of federal funds to pay salaries of persons engaging in a strike against the United States Government, did not apply to funds granted to states to assist in enforcing Fair Labor Standards Act[64] and Walsh-Healey Public Contracts Act.[65] The funds were not "salaries" as such; they were grant funds to reimburse states for services of state employees, and therefore were state rather than federal funds. 28 Comp. Gen. 54 (1948). *See also* 39 Comp. Gen. 873 (1960).

[62] These regulations include, of course, Office of Management and Budget circulars and the common rules that implement them. As discussed in many other portions of this chapter, the circulars and the common rules impose a number of restrictions on a grantee's use of funds.

[63] Some of the decisions cited may involve statutory restrictions on federal expenditures that have been changed or repealed since the decisions were issued. The cases are cited solely to illustrate the application of the grant rule and thus remain valid to that extent.

[64] Act of June 25, 1938, ch. 676, 52 Stat. 1066.

[65] Act of June 30, 1936, ch. 881, 49 Stat. 2038.

- Requirement for specific authorizing legislation to use public funds to pay employer contributions for federal employee's health and life insurance benefits does not apply to use of federal grant funds to contribute to state group health and life insurance programs for state employees. 36 Comp. Gen. 221 (1956).

- Restrictions on retired pay not applicable to retired military officers working on grant-funded state project. 14 Comp. Gen. 916 (1935), *modified on other grounds*, 36 Comp. Gen. 84 (1956).

- Federal restrictions on dual compensation for federal employees are inapplicable to grantee employees. B-153417, Feb. 17, 1964.

The rule has been applied in a variety of other contexts as well. One example is the area of state and local taxes. Thus, federal immunity from payment of certain sales taxes does not apply to a state grantee since the grantee is not a federal agent. The grant funds lose their federal character and become state funds. Therefore, the state grantee may pay a state sales tax on purchases made with federal grant funds if the tax applies equally to purchases made from all nonfederal funds. 37 Comp. Gen. 85 (1957). See also B-177215, Nov. 30, 1972, applying the same reasoning for purchases made by a contractor who was funded by a federal grantee. Similarly, a state tax on the income of a person paid from federal grant funds involves no question of federal tax immunity. 14 Comp. Gen. 869 (1935).

The following is a sampling of other restrictions which have been found inapplicable to grantee expenditures:

- Adequacy of Appropriations Act (41 U.S.C. § 11) and prohibition on entering into contracts for construction or repair of public buildings, or other public improvements, in excess of amount specifically appropriated for that purpose (41 U.S.C. § 12). B-173589, Sept. 30, 1971.

- Prohibition in 31 U.S.C. § 1343 on purchasing aircraft without specific statutory authority. 43 Comp. Gen. 697 (1964) (permissible for grantee under National Science Foundation research grant). *See also* B-196690, Mar. 14, 1980 (purchase of motor vehicle). However, an agency may not acquire excess aircraft or passenger vehicles by transfer for use by its grantees. 55 Comp. Gen. 348 (1975).

- Prohibition in 31 U.S.C. § 1345 on payment of nonfederal person's travel and lodging expenses to attend a meeting. 55 Comp. Gen. 750 (1976).

- Requirement for specific authority in order to establish a revolving fund. (Federal agency would need specific authority in view of 31 U.S.C. § 3302(b)). 44 Comp. Gen. 87(1964).

Where assistance funds are provided to the District of Columbia under a program of assistance to the states which defines "state" as including the District of Columbia, statutory restrictions expressly applicable to the District of Columbia remain applicable with respect to the assistance funds even though they would not necessarily apply to the assistance funds in the hands of the other states. 34 Comp. Gen. 593 (1955); 17 Comp. Gen. 424 (1937); A-90515, Dec. 23, 1937.

When applying the general rule that grantee expenditures are not subject to the same restrictions as direct federal expenditures, it is important to keep in mind that grantees are, of course, obligated to spend grant funds for the purposes and objectives of the grant and consistent with any statutory or other conditions attached to the use of the grant funds. *See, e.g.*, B-303927, June 7, 2005; 42 Comp. Gen. 682 (1963); 2 Comp. Gen. 684 (1923). These conditions may include implied requirements, such as the implied requirement to adhere to "basic principles" of open and competitive bidding in the case of grantee contracts. 55 Comp. Gen. 390 (1975). They also include statutorily authorized requirements, as in the case of the Office of Personnel Management's authority to establish merit standards for grantees under 42 U.S.C. § 4728(b) (Intergovernmental Personnel Act of 1970). Statutory restrictions on lobbying with public funds may also apply to grantee expenditures.

Grant recipients, because they receive federal government assistance, must comply with several federal statutes that prohibit various types of discrimination. Title VI of the Civil Rights Act of 1964 (42 U.S.C. § 2000d) prohibits discrimination on the basis of race, color, or national origin under any program or activity receiving federal financial assistance. The Rehabilitation Act of 1973 (29 U.S.C. § 794) similarly prohibits discrimination against individuals with disabilities. The Age Discrimination Act of 1975 further extends prohibited discrimination (42 U.S.C. § 6102).

Title IX of the Education Amendments of 1972 (20 U.S.C. § 1681) prohibits sex discrimination in education programs or activities receiving federal financial assistance. Title VII of the Civil Rights Act of 1964 (42 U.S.C. § 2000e-2) prohibits employment discrimination by grantees on the basis of sex as well as race, color, religion, or national origin for all employers who

have 15 or more employees. In addition, several grant statutes contain their own anti-discrimination provisions and include sex discrimination. *E.g.*, 42 U.S.C. § 5309 (prohibiting discrimination in federally funded community development programs); 20 U.S.C. § 7231d(b)(2)(C) (magnet school grant applicants must provide assurances that they will not discriminate).

Statements in some of the cases to the effect that grant funds upon being paid over to the grantee are no longer federal funds should not be taken out of context. The fact that grant funds in the hands of a grantee are no longer viewed as federal funds for certain purposes does not mean that they lose their character as federal funds for all purposes. *See In re Universal Security & Protection Service, Inc.*, 223 B.R. 88, 92–93 (Bankr. E.D. La. 1998). It has been held that the government retains a "property interest" in grant funds until they are actually spent by the grantee for authorized purposes.[66] This property interest may take the form of an "equitable lien," stemming from the government's right to ensure that the funds are used only for authorized purposes, or a "reversionary interest" (funds that can no longer be used for grant purposes revert to the government). *In re Alpha Center, Inc.*, 165 B.R. 881, 884–85 (Bankr. S.D. Ill. 1994). By virtue of this property interest, the funds, and property purchased with those funds to the extent unrestricted title has not vested in the grantee, are not subject to judicial process without the government's consent. *E.g.*, *Henry v. First National Bank of Clarksdale*, 595 F.2d 291, 308–09 (5th Cir. 1979), *cert. denied*, 444 U.S. 1074 (1980).

Likewise, in *Department of Housing and Urban Development v. K. Capolino Construction Corp.*, No. 01 Civ. 390 (JGK) (S.D.N.Y., May 7, 2001), the court granted the agency's request for an injunction to prevent the use of federal low-income housing grant funds to satisfy a judgment in a defamation action against the grantee:

> "The Supreme Court held in *Buchanan v. Alexander*, 45 U.S. (4 How.) 20–21, (1846), that federal funds in the hands of a grantee remain the property of the federal government unless and until expended in accordance with the terms of the grant and are not subject to attachment or garnishment. That decision, despite its age, remains the law today. . . .

[66] See section G.1.a. of this chapter for further discussion of this point in the context of grant costs and accountability.

> Unless the federal government consents, sovereign immunity prevents federal funds from being subject to attachment or garnishment proceedings."

Slip op. at 4.

The concept is illustrated in two cases from the U.S. Court of Appeals for the Seventh Circuit. In *Palmiter v. Action, Inc.*, 733 F.2d 1244 (7th Cir. 1984), the court rejected the argument that grant funds lose their federal character when placed in the grantee's bank account, and held that federal grant funds in the hands of a grantee are not subject to garnishment to satisfy a debt of the grantee. The holding would presumably not apply where the grantee had actually spent its own money and the federal funds were paid over as reimbursement. *Id.* at 1249. The court considered a similar issue in the context of a bankruptcy petition filed by a grantee under Chapter 7 of the Bankruptcy Code. *In re Joliet-Will County Community Action Agency*, 847 F.2d 430 (7th Cir. 1988). The issue was whether grant funds in the hands of the grantee, as well as personal property purchased with grant money, were assets of the bankrupt and therefore subject to the control of the trustee in bankruptcy. Directing the trustee to abandon the assets, the court held that they remained the property of the federal government. In the course of reaching this result, the court noted that unpaid creditors of the bankrupt could, to the extent their claims were within the scope of the grant, be paid by the grantor agency out of the recovered funds. *Id.* at 433–35.

A case discussing both *Palmiter* and *Joliet-Will* and reaching a similar result is *In re Southwest Citizens' Organization for Poverty Elimination*, 91 B.R. 278 (Bankr. D.N.J. 1988). A grantee, which had purchased a number of motor vehicles with Head Start grant funds, filed a Chapter 11 bankruptcy petition. The Department of Health and Human Services sought return of the property, contending that the bankrupt's title was subject to the government's right to require transfer to another grantee under the program legislation and regulations. The trustee argued that the motor vehicles were property of the bankruptcy estate, and that the trustee's interest superseded any interest of the government. After a detailed review of precedent, the court directed the trustee to return the

vehicles to the federal grantor, concluding that the government's rights amounted to a reversionary interest.[67]

Another theory occasionally encountered but which appears to have received little in-depth discussion is the theory that a grantee holds grant funds, and property purchased with those funds, in the capacity of a trustee. For example, in *Joliet-Will*, 847 F.2d at 432, the court held that the grantee was essentially "a trustee, custodian, or other intermediary, who . . . is merely an agent for the disbursal of funds belonging to another," and that the grantee's "ownership" was nominal, like that of a trustee. The trust concept finds support in an early Supreme Court decision, *Stearns v. Minnesota*, 179 U.S. 223, 249 (1900), a land grant case in which the Court discussed the grant in trust terms.

However, this trust theory cannot create a federal interest where one does not logically exist. In one case, *Transit Express, Inc. v. Ettinger*, 246 F.3d 1018 (7th Cir. 2001), a firm that offered to provide drivers to a grantee sued the Federal Transit Administration because the grantee did not choose to contract with it to drive vans that were purchased with the grant funds. The federal grant had been used only to purchase the vans, not to fund the operations of the grantee. Thus, the court ruled that the presence of federal grant funds as a source to finance purchase of the vans under the federal program was completely irrelevant to the grantee's actions in obtaining drivers for the vans. Specifically, the court stated that "federal funds lurking in the background of this case cannot serve as an independent basis for establishing jurisdiction." *Id.* at 1026. As a result, the contractor's complaint was dismissed.

Another area in which grant funds in the hands of a grantee continue to be treated as federal funds is the application of federal criminal statutes dealing with theft of money or property belonging to the United States. There are numerous cases in which the courts have applied various provisions of the Criminal Code, such as 18 U.S.C. § 641, to the theft or

[67] In a bankruptcy case that considered several of the personal property cases discussed above, the court held that with regard to real property, a trustee enjoys the rights of a *bona fide* purchaser and is, thus, entitled to notice of another's claim to the real property. *In re Premier Airways, Inc. v. United States Department of Transportation*, 303 B.R. 295 (Bankr. W.D.N.Y. 2003). Therefore, the court determined that a trustee's interest in real property purchased with federal grant funds was superior to that of the federal grantor agency where the grantor agency failed to perfect its interest in the real property as a matter of record prior to the grantee's commencement of the bankruptcy proceeding.

embezzlement of grant funds or grant property in the hands of grantees. Examples involving a variety of grant programs are *Hayle v. United States*, 815 F.2d 879 (2nd Cir. 1987) (violation of 18 U.S.C. § 641); *United States v. Harris*, 729 F.2d 441 (7th Cir. 1984) (violation of 18 U.S.C. § 657); *United States v. Hamilton*, 726 F.2d 317 (7th Cir. 1984) (violation of 18 U.S.C. § 665(a)); *United States v. Montoya*, 716 F.2d 1340 (10th Cir. 1983) (violation of 18 U.S.C. § 287); *United States v. Smith*, 596 F.2d 662 (5th Cir. 1979) (violation of 18 U.S.C. § 641); *United States v. Rowen*, 594 F.2d 98 (5th Cir.), *cert. denied*, 444 U.S. 834 (1979) (violation of 18 U.S.C. § 641).

In each of these cases, the court rejected the argument that the statute did not apply because the funds or property were no longer federal funds or property. It makes no difference whether the funds are paid to the grantee in advance or by reimbursement (*Montoya*, 716 F.2d at 1344), or that the funds may have been commingled with nonfederal funds (*Hayle*, 815 F.2d at 882). The holdings are based on the continuing responsibility of the federal government to oversee the use of the funds. *E.g.*, *Hayle*, 815 F.2d at 882; *Hamilton*, 726 F.2d at 321. The result would presumably be different in the case of grant funds paid over outright with no continuing federal oversight or supervision. *E.g.*, *Smith*, 596 F.2d at 664.

Lastly, the presence of federal grant funds had an unusual impact on an age discrimination case brought against a federally-funded private organization. The plaintiff in *Neukirchen v. Wood County Head Start, Inc.*, 53 F.3d 809 (7th Cir. 1995), had obtained a money judgment for age discrimination against a local Head Start organization. She attempted to collect the judgment by executing against personal property the organization owned, including items of property purchased with grants funds that had a unit acquisition cost of less than $1,000. The then applicable regulations provided that once such property was no longer needed for grant purposes, it could be retained or disposed of by the grantee with no further obligation to the federal government.[68] The plaintiff argued that the federal government retained no interest in property subject to this provision. The argument proved unavailing. Citing *Joliet-Will*, *supra*, the court stated:

[68] *See Neukirchen*, 53 F.3d at 812. As the court noted, this rule is no longer in effect and has been replaced by more stringent accountability requirements. *Id.* at 813, n. 4. For the current common rules on this subject, see, for example, 7 C.F.R. §§ 3019.32–3019.37.

> "It is clear in this circuit that property purchased with federal grant funds constitutes federal property. . . . It is also axiomatic that the doctrine of sovereign immunity prevents a judgment creditor from attaching federal property, absent consent by the United States."

Neukirchen, 53 F.3d at 811–12. The court was not persuaded that the rule for property costing less than $1,000 created an exception:

> "Given the overwhelming control that the Secretary [of Health and Human Services] exercises over property purchased with federal funds and the corresponding lack of discretion on Wood County's part, we do not believe that the absence of specific regulations requiring Wood County to reconvey to the United States property costing less than $1,000 commands a different result. We, therefore, conclude that *Joliet-Will's* rationale requires that property purchased with federal grant funds, including property costing less than $1000, constitutes federal property."

Id. at 813. The result would be different, the court noted, for property that was in fact no longer needed; however, that was not true of the property at issue. *Id.* at n.4. Thus, even though the grantee had violated federal law in discriminating against the plaintiff, the majority of the grantee's assets were immune from execution since they had been purchased with federal funds, a result that the court described as "paradoxical, indeed." *Id.* at 814.

E. Grant Funding

Trillions of dollars in cash move into and out of the United States Treasury every year, and the federal government has a responsibility to the taxpayer to efficiently manage this cash flow in terms of collection, internal controls, investment, and disbursement. In the disbursement part of this process, good cash management practices include not paying the bills too late or too early. Timely disbursement of funds to resolve current liabilities as they come due yields positive results for the federal government both by avoiding late payment penalties and maximizing the time during which the cash reserves earn a return for the government through short-term investments.

The need for sound cash management in the federal government plays an important role in the funding of grants and other assistance awards.

Although grants are not subject to the general prohibition against advance payment of public funds, they are subject to laws and regulations intended to prevent grantees from earning interest on cash reserves at the expense of the federal government. The general rule is that interest earned on grant funds pending their use for program purposes belongs to the federal government. Special rules apply to state governmental grantees under the Intergovernmental Cooperation Act[69] and the Cash Management Improvement Act,[70] discussed in section E.2.b of this chapter. Once the grant funds have been used for program purposes, however, cash generated by the grant funds is generally treated as program income that belongs to the grantee.

In addition to cash management concerns, grant funding also involves consideration of whether the federal government should bear the entire cost of program activities or require the grantee to shoulder part of the financial burden. If the grant program does provide for cost sharing, this is usually accomplished through either a local/matching share provision or a maintenance of effort provision.

1. Advances of Grant/Assistance Funds

The framework for managing cash flow in the federal government generally prohibits federal agencies from paying for goods or services before receiving them. However, the general statutory prohibition against the advance payment of public funds, 31 U.S.C. § 3324,[71] does not apply to grants. This is because the primary purpose of assistance awards is to assist authorized recipients and not to obtain goods or services for the government. Thus, the policy behind the advance payment prohibition has much less force in the case of assistance awards than in the case of procurement contracts. Accordingly, the Comptroller General has held that 31 U.S.C. § 3324 does not preclude advance funding in authorized grant relationships; unless restricted by the program legislation or the applicable appropriation, the authority to make grants is sufficient to satisfy the requirements of 31 U.S.C. § 3324. 60 Comp. Gen. 208 (1981); 59 Comp. Gen. 424 (1980); 41 Comp. Gen. 394 (1961). As stated in 60 Comp. Gen. at 209, "[t]he policy of payment upon receipt of goods or services is simply

[69] Pub. L. No. 90-577, 82 Stat. 1098 (Oct. 16, 1968).

[70] Pub. L. No. 101-453, 104 Stat. 1058 (Oct. 24, 1990).

[71] For an in-depth discussion of advance payments, see Chapter 5, section C.

inconsistent with assistance relationships where the Government does not receive anything in the usual sense."

This does not mean that there can never be an advance payment problem in a grant case. Because the authority to advance funds must, at least in a general sense, be founded on the program legislation, advance payments would probably not be authorized under an assistance program that provided for payment by reimbursement. Also, the Comptroller General found advance payment violations in two grant-related cases from the 1970s involving the College Work-Study Program: 56 Comp. Gen. 567 (1977) and B-159715, Aug. 18, 1972. Under the College Work-Study Program as it existed in the 1970s when these two cases were decided, a student was placed with an employer, which might have been a federal agency. The student's salary was paid from two sources: 80 percent was paid by the college under a Department of Education grant, and the remaining 20 percent was paid by the employer. In the 1972 case, an employing federal agency proposed to advance pay the college's 80 percent share of the student's salary and then seek reimbursement of this amount at a later date from the college. The Comptroller General found this advance payment arrangement to violate 31 U.S.C. § 3324. Five years later, in 56 Comp. Gen. 567 the Comptroller General found a violation of the same statute when the agency/employer proposed to advance its 20 percent share to the college, which would in turn place the funds in an escrow account for payment to the student after the work was performed.

2. Cash Management of Grants

a. General Rule on Interest on Grant Advances

One problem with the advance funding of assistance awards is that the recipient may draw down funds before the funds are actually needed. This is a matter of concern for several reasons. For one thing, advances under an assistance program are intended to accomplish the program purposes and not to profit the recipient other than in the manner and to the extent specified in the program. But there is another reason. When money is drawn from the Treasury before it is needed, or in excess of current needs, the federal government loses the use of the money. The principle was expressed as follows:

> "When Federal receipts are insufficient to meet expenditures, the difference is obtained through borrowing; when receipts exceed expenditures, outstanding debt can be reduced. Thus, advancing funds to organizations outside the Government before they are needed either unnecessarily increases borrowings or decreases the opportunity to reduce the debt level and thereby increases interest costs to the Federal Government."

B-146285, Oct. 2, 1973, at 3. Thus, premature drawdown not only profits the grant recipient, but does so at the expense of the rest of the taxpayers.

To reduce premature drawdowns and thus promote efficient cash management in the federal government in its grant funding, yet not discourage advance funding of grants in appropriate circumstances, a default rule has developed. The Comptroller General has consistently held that, except as otherwise provided by law, interest earned by grantees on funds advanced by the United States under an assistance agreement pending their application to grant purposes belongs to the United States rather than to the grantee. Such interest is to be accounted for as funds of the United States and must be deposited in the Treasury as miscellaneous receipts under 31 U.S.C. § 3302(b). For example, in B-251863, Aug. 27, 1993, the Comptroller General applied this rationale in refusing to approve the proposal of the Fish and Wildlife Service to provide $584,930 to a nonprofit grantee over a 5-year period by advancing the grantee $500,000 and allowing the grantee to earn $84,930 in interest during that time to retain and use for grant purposes. *See also* 71 Comp. Gen. 387 (1992); 69 Comp. Gen. 660 (1990); 42 Comp. Gen. 289 (1962); 40 Comp. Gen. 81 (1960); B-203681, Sept. 27, 1982; B-192459, July 1, 1980; B-149441, Apr. 16, 1976; B-173240, Aug. 30, 1973.[72]

If the grantee is unable to document the actual amount of interest earned on the grant advances, the general rule is that the grantor agency should use the "Treasury tax and loan account" rate prescribed by 31 U.S.C. § 3717 for debts owed to the United States. 69 Comp. Gen. 660 (1990). If,

[72] Limitations on the use of interest earned on advance funds are also contained in the common rules. *See*, *e.g.*, 7 C.F.R. § 3016.21(i)(2005) (state and local government grantees); 7 C.F.R. § 3019.22(*l*) (other grantees). For example, section 3016.21(i) requires nonexempt grantees and subgrantees to "promptly, but at least quarterly, remit interest earned on advances to the Federal agency." However, it does permit them to keep up to $100 per year in interest to pay administrative expenses.

however, the grantee is a state, then interest will be determined in accordance with 31 U.S.C. § 6503(c)(1), discussed hereafter.

Except for states, discussed separately in the section immediately following, the general rule that the United States owns interest earned on grant advances applies whether the grantee is a public or private entity. The rationale for the rule is that unless expressly provided otherwise, funds are paid out to a grantee to accomplish the grant purposes, not for the grantee to invest the money and earn interest at the expense of the Treasury. Thus, grant funds are to be applied promptly to the grant purposes. 1 Comp. Gen. 652 (1922).

In 40 Comp. Gen. 81 (1960), the Comptroller General held that interest on foreign currencies advanced by the Department of Agriculture under cooperative agreements, earned between the time the funds were advanced and the time they were used, could not be retained for program purposes but had to be returned to the Treasury for deposit in the General Fund as miscellaneous receipts. In 42 Comp. Gen. 289 (1962), the rule was applied with respect to State Department grants to American-sponsored schools and libraries overseas. The Comptroller General stated, "[t]here can be no doubt that only the Congress is legally empowered to give away the property or money of the United States." *Id.* at 293. The decision further concluded that the enabling legislation did not provide sufficient authority to use the grant funds to establish a permanent interest-bearing endowment fund. In B-149441, Feb. 17, 1987, the Comptroller General found that since the National Endowment for the Humanities had no authority in its program legislation to permit its grantees to establish an endowment fund with grant moneys, the Endowment could not authorize its grantees to accomplish the same purpose with matching funds.

Citing both 42 Comp. Gen. 289 and B-149441, discussed immediately above, the Comptroller General held in 70 Comp. Gen. 413 (1991) that legislative authority would be required for a "debt for equity swaps" proposal whereby the United States Information Agency (USIA) would purchase discounted foreign debt from commercial lenders and transfer the notes to grantees in the foreign country, who would in turn exchange the notes for local currency or local currency denominated bonds and use the income thus generated for program activities. However, since USIA has statutory authority to accept conditional gifts, the Comptroller General held that USIA could accept a donation of foreign debt and use the principal and income for authorized activities in accordance with the conditions specified.

The rule does not apply, however, if earning interest is consistent with the grant purposes. Thus, in B-230735, July 20, 1988, where use of grant funds to establish an endowment trust was authorized by law, the Comptroller General concluded that the grantee could use income from the endowment as nonfederal matching funds on other grants, as long as such use was consistent with the terms and conditions of the grant agreement.

In B-192459, July 1, 1980, a grantee transferred grant funds to a trustee under a complex construction financing arrangement. The trustee was independent, that is, not an agent of the grantee, and the grantee could not get the funds back upon demand. The Comptroller General determined that the transfer to the trustee was in the nature of a disbursement for grant purposes. Therefore, interest earned by the trustee after the transfer could be treated as grant income and retained under the terms of the grant agreement. However, interest on grant funds placed in bank accounts and certificates of deposit by the grantee prior to transfer to the trustee had to be returned to the Treasury. The grantor agency lacked the authority to permit the grantee to retain interest earned on grant funds prior to their application to grant purposes.

In 64 Comp. Gen. 103 (1984), the Agency for International Development advanced grant funds to the government of Egypt, which in turn advanced these funds to certain local and provincial elements of that government. Since the purpose of the grant was to assist Egypt in its efforts to decentralize certain governmental functions by developing experience at the local level in managing and financing selected projects, the Comptroller General concluded that the advances of funds by the government of Egypt to the local and provincial entities could legitimately be viewed as disbursements for grant purposes. Thus, the subgrantees could retain interest earned on those advances. However, in another 1984 case also involving the Agency for International Development, the Comptroller General found that subgrantees could not retain interest on funds advanced to them by the grant recipient under a cooperative agreement whose purpose was to help develop certain technologies because the grantor agency had advanced these funds to the grantee before the grantee had a legitimate program need for the funds. 64 Comp. Gen. 96 (1984). Both decisions followed the approach set forth in B-192459, July 1, 1980, summarized above.

In evaluating the disposition of interest income, an important determinant is whether the interest was earned before or after the grant funds were applied to authorized grant purposes. The key word here is “authorized.”

For example, under the Community Development Block Grant program, grantee cities and counties may use the funds to make loans for certain community projects. Grantees may retain interest earned on those loans for grant-related uses as a type of "program income," that is, grant-related income, which is discussed in more detail in section E.4 of this chapter. However, if a loan is later found to be ineligible under the program, the funds were never used for an authorized grant purpose, and interest earned by the grantee must be paid over to the United States for deposit as miscellaneous receipts. 71 Comp. Gen. 387 (1992).

Congress can, of course, legislatively make exceptions to the rule by providing assistance in the form of an unconditional gift or by other appropriate statutory provisions. *See, e.g.*, 44 Comp. Gen. 179 (1964) (provision in appropriation act exempting educational institutions from liability for interest under certain Public Health Service Act grants); B-175155, June 11, 1975 (interest rule not applicable with respect to "grants" to Amtrak).[73]

b. State Governments and Interest on Grant Advances

(1) Intergovernmental Cooperation Act

Prior to 1968, the prohibition on retention of interest income applied to states as well as to other grantees. 20 Comp. Gen. 610 (1941); 3 Comp. Gen. 956 (1924); 26 Comp. Dec. 505 (1919); 24 Comp. Dec. 403 (1918); A-46031, Jan. 16, 1933. There was no reason to draw a distinction. This, of course, was premised on the absence of any statutory guidance.

The treatment of interest on grant advances to state governments is now governed by the Intergovernmental Cooperation Act of 1968, Pub. L. No. 90-577, 82 Stat. 1098 (Oct. 16, 1968), codified at 31 U.S.C. §§ 6501–6508. The law evolved in two stages. The original Intergovernmental Cooperation Act created what was to be, for 22 years, the major exception to the rule that interest on grant advances belongs to the United States. The 1968 statute first codified the requirement for federal grantor agencies

[73] A conceptually related case is 71 Comp. Gen. 310 (1992), which upheld a Small Business Administration regulation providing for a reasonable profit to grantees under the Small Business Innovation Development Act.

to schedule the transfer of grant funds so as to minimize the time elapsing between transfer and grantee disbursement.[74] The statute then provided: "States shall not be held accountable for interest earned on grant-in-aid funds, pending their disbursement for program purposes." Pub. L. No. 90-577, § 203.

The theory behind the Intergovernmental Cooperation Act was that federal grantor agencies could control the release of grant funds and thereby preclude situations from arising in which state grantees would be in a position to earn excessive interest on grant advances. If the timing of the release of funds was properly managed, interest the state might earn would be too small to be a matter of concern. The statutory exception was not intended to create a windfall for state grantees. *See Pennsylvania Office of Budget v. Department of Health & Human Services*, 996 F.2d 1505 (3rd Cir.), *cert. denied*, 510 U.S. 1010 (1993).[75]

The original statutory exception for interest on grant advances did not prove satisfactory, however. Grantor agencies complained of premature drawdown of grant advances while grantee states complained of slow federal payment in reimbursement situations. Congress responded by amending 31 U.S.C. § 6503 in section 5 of the Cash Management Improvement Act of 1990, Pub. L. No. 101-453, 104 Stat. 1058, 1059 (Oct. 24, 1990). The 1990 amendment was intended to address both the federal and state concerns. Thus, the House report on the legislation, H.R. Rep. No. 101-696, at 3–4 (1990), stated:

> "Under current law, the States need not account to the Federal Government for interest earned on Federal funds disbursed to the States prior to payment to program beneficiaries. However, when the Federal Government complains of undue profits made by the States as a result of early drawdown of Federal funds, the States are quick to point out numerous instances where they lose interest

[74] In B-146285, Apr. 10, 1978, the Comptroller General concluded that the Intergovernmental Cooperation Act did not repeal by implication a statute which prescribed both the timing schedule and the amount of payments under a particular assistance program, but rather was geared primarily to programs without statutory payment schedules.

[75] The opinion in *Pennsylvania Office of Budget* provides a useful discussion of the background, purposes, and legislative history of the interest exception in the original Intergovernmental Cooperation Act. *See* 996 F.2d at 1510–12.

> opportunities because the Federal Government is slow to reimburse them for the monies the States advance to fund Federal programs. This bill seeks to provide a fair and equitable resolution to these differences between the Federal Government and the States."

The Cash Management Improvement Act retained the general requirement of 31 U.S.C. § 6503 to minimize the time elapsing between transfer of funds from the Treasury to the grantee and grantee disbursement of those funds for program purposes. It also provided sanctions to enforce this requirement. These provisions are discussed further in section E.2.c of this chapter. With respect to interest, the act amended 31 U.S.C. § 6503(c) to provide that for *advance payment programs*, unless inconsistent with program purposes the state must pay interest to the United States from the time the funds are transferred to the state's account to the time they are paid out by the state for program purposes. Interest payments are to be deposited in the Treasury as miscellaneous receipts. For *reimbursement programs*, the United States must pay interest to the state from the time of payout by the state to the time the federal funds are deposited in the state's bank account. 31 U.S.C. § 6503(d). Interest in both directions (*i.e.*, from states to the federal government under 31 U.S.C. § 6503(c) and from the federal government to states under 31 U.S.C. § 6503(d)) is to be paid annually, at a rate based on the yield of 13-week Treasury bills, using offset to the extent provided in Treasury regulations. *Id.* §§ 6503(c), (d), (i).[76]

(2) Decisions under the Intergovernmental Cooperation Act

(i) State entities covered

The original Intergovernmental Cooperation Act applied only to states and their agencies or instrumentalities; it did not extend to "political subdivisions" of states, such as cities, towns, counties, or special districts created by state law. Pub. L. No. 90-577, § 102, 82 Stat. 1098, 1099 (Oct. 16, 1968), *codified at* 31 U.S.C. §§ 6501–6508. The Cash Management Improvement Act, Pub. L. No. 101-453, 104 Stat. 1058 (Oct. 24, 1990), expanded the relevant definition to apply to "an agency, instrumentality, or fiscal agent" of a state, including territories and the District of Columbia,

[76] The interest provisions of the Cash Management Improvement Act took effect during the second half of 1993. Pub. L. No. 101-453, § 5(e), as amended by the Cash Management Improvement Act of 1992, Pub. L. No. 102-589, § 2, 106 Stat. 5133 (Nov. 10, 1992).

but the definition retains the exclusion for "a local government of a State," such as a city, county, or town. 31 U.S.C. § 6501(9). Thus, GAO decisions under the original Intergovernmental Cooperation Act should remain relevant in determining which entities are "states" in this context. What constitutes a covered state entity under the act is further refined in implementing Treasury Department regulations at 31 C.F.R. § 205.2 (2005).

In 56 Comp. Gen. 353 (1977), the Comptroller General addressed how to determine which state entities were covered by the Intergovernmental Cooperation Act, concluding as follows:

> "[A] Federal grantor agency is not required by the Intergovernmental Cooperation Act of 1968 and its legislative history to accept the Bureau of the Census' classification of an entity . . . in determining whether that entity is a State agency or instrumentality or a political subdivision of the State. It is bound by the classification of the entity in State law. Only in the absence of a clear indication of the status of the entity in State law may it make its own determination based on reasonable standards, including resort to the Bureau of the Census' classifications."

Id. at 357. If the classification under state law is not clear and unambiguous, the grantee may be required to obtain a legal opinion from the state Attorney General in order to assist in making the determination. *Id.*

In a more recent case dealing with the current statutory definition, the Federal Circuit found that the Massachusetts Bay Transportation Authority (MBTA) was an instrumentality of the Commonwealth of Massachusetts and was therefore entitled under 31 U.S.C. § 6503(d) to interest on reimbursement payments from the federal government. *Massachusetts Bay Transportation Authority v. United States*, 129 F.3d 1226, 1236–37 (Fed. Cir. 1997). In arriving at this conclusion, the court noted that the MBTA was located within the state's Executive Office of Transportation and Construction and that the members of MBTA's board of directors were appointed and removed by the state's governor. The court also found it significant that the MBTA had been defined as a state instrumentality in a Comptroller General decision (56 Comp. Gen. 353 (1977)) and in an opinion of the Massachusetts Attorney General.

(ii) Grants covered by the former interest exemption

The exception to the prohibition against retention of interest income by state grantees in the original Intergovernmental Cooperation Act was held to apply to pass-through situations where states are the primary recipients of grant funds, which are then passed on to subgrantees. In B-171019, Oct. 16, 1973, the Comptroller General concluded that the exception applied to political subdivisions, which were subgrantees of states. The Justice Department reached the same conclusion in 6 Op. Off. Legal Counsel 127 (1982). Subsequent decisions applied the exception to nongovernmental subgrantees as well, recognizing that there was no basis to distinguish between governmental and nongovernmental subgrantees. 59 Comp. Gen. 218 (1980), *aff'd*, B-196794, Feb. 24, 1981.

Other cases under the version of the Intergovernmental Cooperation Act that predated the Cash Management Improvement Act may remain relevant as well. For example, the statute does not necessarily apply to funds in contexts other than those specified. Thus, in 62 Comp. Gen. 701 (1983), the Comptroller General concluded that a subgrantee under a Labor Department grant to a state was not entitled to retain interest it had earned by investing funds received from the Internal Revenue Service as a refund of Federal Insurance Contributions Act (social security) taxes. In *North Carolina v. Heckler*, 584 F. Supp. 179 (E.D.N.C. 1984), the court found the statute inapplicable in a situation in which the state had wrongfully obtained federal funds and earned interest on them pending repayment to the government.

In two recent judicial decisions, courts agreed with the federal government that the act's exemption did not apply because the transactions at issue did not constitute grants covered by the act. In *California State University v. Riley*, 74 F.3d 960, 964–65 (9th Cir. 1996), the Ninth Circuit held that, contrary to the state's contention, "Pell grants" were not "grants" under the act's definition. Paraphrasing the language of 31 U.S.C. § 6501(4), which remains the same today, the court stated:

> "The 'grants' that are the subject of the ICA [Intergovernmental Cooperation Act] are grants to *states*, local governments, or beneficiaries *under a state plan or program administered by the state*."

Riley, 74 F.3d at 964 (emphasis in original). Under the Pell grant program, the state university did not administer the grants but acted merely as a

conduit for disbursing the Pell grants, which were provided directly from the federal government to students meeting the eligibility requirements. Similarly, the court in *New York Department of Social Services v. Shalala*, 876 F. Supp. 29 (S.D.N.Y. 1994), *aff'd*, 50 F.3d 179 (2nd Cir. 1995), determined that a state agency could not retain interest earned on payments received from the federal government as reimbursement for administering federal Social Security disability programs. The court held that the payments did not constitute a "grant" for purposes of the Intergovernmental Cooperation Act since the statute specifically excludes from its definition of a grant "a payment to a State or local government as complete reimbursement for costs incurred in paying benefits or providing services to persons entitled to them under a law of the United States." *Id*. at 33. *See* 31 U.S.C. § 6501(4)(C)(vii).

c. Other Cash Management Requirements

Our discussion up to now has focused exclusively on the treatment of interest earned on federal grant funds. However, there are other important cash management considerations and additional relevant requirements in the Cash Management Improvement Act, Pub. L. No. 101-453, 104 Stat. 1058 (Oct. 24, 1990), and its implementing regulations.[77] Some of these are highlighted below.

Section 4 of the act added a new section 3335 to title 31, United States Code, which imposes a general requirement for federal agencies to provide for the "timely disbursement" of federal funds to eligible recipients in accordance with regulations prescribed by the Secretary of the Treasury. 31 U.S.C. § 3335(a).[78] If an agency fails to comply with this requirement, the Secretary may collect from the agency a charge in an amount the Secretary determines to be the cost to the general fund of the Treasury caused by the noncompliance. 31 U.S.C. § 3335(b). The charge is to be deposited into the Treasury as miscellaneous receipts and is to be derived, to the maximum extent possible, from funds available to the offending agency for administrative operations rather than from program accounts. *Id*. §§ 3335(c) and (d). The Secretary's authority to collect charges is permissive rather than mandatory and, according to the legislative history, is to be "restricted to cases of egregious or repeated noncompliance, and

[77] For a summary of the Cash Management Improvement Act and a review of its initial years in operation, see GAO, *Financial Management: Implementation of the Cash Management Improvement Act*, GAO/AIMD-96-4 (Washington, D.C.: Jan. 8, 1996).

[78] Disbursement is to be accomplished through cash, checks, electronic funds transfer, or any other means identified by the Treasury Secretary.

[not to] be used in a routine manner to finance interest costs incurred by the Federal Government." H.R. Rep. No. 101-696, at 7 (1990).

Section 5 of the Cash Management Improvement Act also amended 31 U.S.C. § 6503 to provide more specific requirements that apply to assistance programs administered by the states. Section 6503, as so amended, directs both federal grantor agencies and state grantees, consistent with Treasury regulations, to "minimize the time elapsing between transfer of funds from the United States Treasury and the issuance or redemption of checks, warrants, or payments by other means" by the state grantee for program purposes. 31 U.S.C. § 6503(a). Furthermore, it requires the Secretary of the Treasury to enter into an agreement with each state receiving grant funds that prescribes fund transfer methods and procedures, as chosen by the state and approved by the Secretary. 31 U.S.C. § 6503(b). If an agreement cannot be reached with a particular state, the Secretary is authorized to establish default procedures for that state by regulation. 31 U.S.C. § 6503(b)(3).

The Treasury Department's regulations implementing the Cash Management Improvement Act are codified at 31 C.F.R. parts 205 and 206 (2005). Part 205 contains those provisions most relevant to assistance programs. *See*, *e.g.*, 31 C.F.R. §§ 205.8 (default procedures in the absence of a Treasury-state agreement); 205.11 and 205.33 (requirements for fund transfers and drawdowns); 205.19 (calculation of interest); 205.34 (federal oversight and compliance responsibilities).

The crux of the government's policy related to timeliness, as stated in 31 C.F.R. §§ 205.11 and 205.33, is that federal agencies must limit a funds transfer to a state to the minimum amounts needed by the state and must time the disbursement to be in accord with the actual, immediate cash requirements of the State in carrying out a federal assistance program. Similarly, a state must minimize the time between the drawdown of federal funds from the federal government and their disbursement for federal program purposes. In B-244617, Dec. 24, 1991 (nondecision letter), GAO concurred with a determination by the Social Security Administration that a period of 15 months between a state's drawdown and disbursement of federal funds for state employee retirement contributions did not meet the latter requirement.

Although the above discussion focuses on state grantees, the same cash management concerns apply, of course, with respect to other recipients of federal assistance. Thus, similar requirements for other grantees can be

found in Office of Management and Budget circulars and agency regulations. See, for example, the cash management provisions of the Department of Agriculture's common rules applicable to local government grantees as well as states (7 C.F.R. § 3016.20) and those applicable to institutions of higher education and nonprofit organizations (7 C.F.R. §§ 3019.21 and 22).

The authority of a state to require its own grantees to account to it for funds it makes available to them is generally a matter within the discretion of the state. *See* B-196794, Jan. 28, 1983 (nondecision letter) (observing that each state "has the primary responsibility for employing whatever form of organization and management procedures it feels is necessary to assure proper and efficient administration of the funds advanced"). However, the common rules include some minimal internal control and accountability standards for state grantees in relation to their subgrantees. For example, the Department of Agriculture common rule in 7 C.F.R. § 3016.20(b)(7) provides, in part, with respect to cash management:

> "Grantees must establish reasonable procedures to ensure the receipt of reports on subgrantees' cash balances and cash disbursements in sufficient time to enable them to prepare complete and accurate cash transactions reports to the awarding agency. When advances are made by letter-of-credit or electronic transfer of funds methods, the grantee must make drawdowns as close as possible to the time of making disbursements. Grantees must monitor cash drawdowns by their subgrantees to assure that they conform substantially to the same standards of timing and amount as apply to advances to the grantees."

3. Program Income

Once grant funds have been applied to their grant purposes, they still can generate income, directly or indirectly, in various ways. This, as distinguished from interest on grant advances, is called "program income." Program income is defined broadly under the common rules as "gross income received by the grantee or subgrantee directly generated by a grant supported activity, or earned only as a result of the grant agreement during the grant period." *See*, *e.g.*, 7 C.F.R. § 3016.25(b) (2005). Program income may include such things as income from the sale of commodities, fees for services performed, and usage or rental fees. *See*, *e.g.*, 7 C.F.R. § 3016.25(a). Grant-generated income may also include investment income, although this will be uncommon. *See* B-192459, July 1, 1980.

Although included in the broad common rule definition of program income, income from the sale of real property receives special treatment and is governed instead by the common rule on real property. *See*, *e.g.*, 7 C.F.R. §§ 3016.25(f), 3016.31, 3019.24(g). This difference was important in B-290744, Sept. 13, 2002, in which the Comptroller General found that the Transportation Equity Act for the 21st Century[79] did not alter the common rule related to program income and the proceeds of the sale of real property that the grantee no longer needs for the originally authorized purpose. The decision thus concluded that the federal government had retained its percentage interest in the proceeds Massachusetts had earned from the sale of excess property acquired with Federal Highway Trust funds. The Comptroller General determined that the 1998 statute did not remove the federal character of the federal interest in the real property that was sold.

In contrast to income earned on grant advances, program income (other than proceeds from real property sales) does not automatically acquire a federal character and is not required to be deposited in the Treasury as miscellaneous receipts. It may, unless the grant provides otherwise, be retained by the grantee for grant-related use. 44 Comp. Gen. 87 (1964); 41 Comp. Gen. 653 (1962); B-192459, July 1, 1980; B-191420, Aug. 24, 1978. In 44 Comp. Gen. 87, the Comptroller General concluded that a grantee could establish a revolving fund with grant income in the absence of a contrary provision in the grant agreement. However, the initial amount of a revolving fund established from either the principal of a grant or the income generated under the grant, when returned to the grantor agency upon completion of the grant, may not be considered a return of grant funds for further use by the grantor but must be deposited in the Treasury as miscellaneous receipts. B-154996, Nov. 5, 1969.

Under the common rules, there are three generally recognized methods for the treatment of program income:

- *Deduction*. Deduct program income from total allowable costs to determine net costs on which grantor and grantee shares will be based. This approach results in savings to the federal government because the income is used to reduce contributions rather than to increase program size.

[79] Pub. L. No. 105-178, § 1303, 112 Stat. 107, 227 (June 9, 1998).

- *Addition*. Add income to the funds committed to the project, to be used for program purposes. This approach increases program size.

- *Cost-sharing or matching*. Use income to finance any applicable nonfederal matching requirements. Under this approach, the federal contribution and program size remain the same.

See, e.g., 7 C.F.R. §§ 3016.25(g), 3019.24(b).

Although the common rules provide for three alternative treatments of program income, the deduction method is the default rule with the methods or a combination of them being used only if specified by the applicable federal agency regulations or grant agreement. *See, e.g.*, 7 C.F.R. § 3016.25(g). The rule further provides:

> "In specifying alternatives, the Federal agency may distinguish between income earned by the grantee and income earned by subgrantees and between the sources, kinds, or amounts of income. When Federal agencies authorize the alternatives in paragraphs (g)(2) and (3) of this section, program income in excess of any limits stipulated shall also be deducted from outlays."

Id.

The common rules provide that the deduction method is the default rule for program income earned by state and local government grantees as described above. The common rules likewise make deduction the default in the treatment of program income for most other grantees, the exception being research grants for which addition is the default. *See, e.g.*, 7 C.F.R. §§ 3019.24(b)–(d); 2 C.F.R. §§ 215.24(b)–(d). An illustration of the application of the deduction method can be found in *Pennsylvania Department of Public Services v. Health & Human Services*, 80 F.3d 796 (3rd Cir. 1996), which involved revenue the state earned from a fee charged for filing a child support case in the state. The court held that the fee revenue was program income, which the state had to deduct from the total allowable program costs in order to determine the net costs on which the federal and state shares were to be based.

Some types of program income are subject to special rules:

- Proceeds from the sale of real and personal property provided by the federal government or purchased in whole or in part with federal funds. Special rules are set forth in the common rules. *See*, *e.g.*, 7 C.F.R. §§ 3016.25(f), 3016.31, 3016.32, 3019.24(g), 3019.32, 3019.34. *See also* B-290744, Sept. 13, 2002.

- Royalties received as a result of copyrights or patents produced under a grant. A special rule states that this income may be treated as other program income if specified in applicable agency regulations or the grant agreement. *See* 7 C.F.R. §§ 3016.25(e), 3019.24(h). *See also* B-186284, June 23, 1977; GAO, *Administration of the Science Education Project "Man: A Course of Study" (MACOS)*, MWD-76-26 (Washington, D.C.: Oct. 14, 1975).

4. Cost-Sharing

Federal grant funds constitute a significant portion of the total expenditures of state and local governments. In fiscal year 2004, federal grants made up 25 percent of the total expenditures of state and local governments. *Analytical Perspectives*, *Budget of the United States Government for Fiscal Year 2006* (Feb. 7, 2005), at 131. When the federal government chooses to provide financial assistance to some activity, it may also choose to fund the entire cost, but it is not required to do so. *City of New York v. Richardson*, 473 F.2d 923, 928 (2nd Cir.), *cert. denied sub nom.*, 412 U.S. 950 (1973). "[T]he judgment whether to [provide assistance], and to what degree, rests with [Congress]." *Id.* Thus, a program statute may provide for full funding, or it may provide for "cost-sharing," that is, financing by a mix of federal and nonfederal funds. Reasons for cost-sharing range from budgetary considerations to a desire to stimulate increased activity on the part of the recipient. The two primary cost-sharing devices are "matching share" provisions and "maintenance of effort" provisions. For a detailed analysis and critique of both devices, see GAO, *Federal Grants: Design Improvements Could Help Federal Resources Go Further*, GAO/AIMD-97-7 (Washington, D.C.: Dec. 18, 1996). *See also* GAO, *Block Grants: Issues in Designing Accountability Provisions*, GAO/AIMD-95-226 (Washington, D.C.: Sept. 1, 1995).

a. Local or Matching Share

(1) General principles

A matching share provision is one under which the grantee is required to contribute a portion of the total project cost. The "match" may be 50-50, or any other mix specified in the governing legislation. A matching share provision typically prescribes the percentages of required federal and nonfederal shares. However, the legislation need not provide explicitly for a nonfederal share. A statute authorizing assistance not in excess of a specified percentage of project costs will normally be interpreted as requiring a local share of nonfederal funds to make up the difference. (The rest of the money has to come from someplace.)

As discussed in more detail in section E.5.a of this chapter, a grantee generally may not use funds received under one federal grant program to meet its nonfederal share under another federal grant program. *See* B-270654, May 6, 1996 (private nonprofit corporation could not use general support funds it received from the State Department as the nonfederal match for other federal grants it received from the Agency for International Development and the United States Information Agency); B-214278, Jan. 25, 1985 (funds from the Farmers Home Administration's Water and Waste Disposal Development Grant Program could not be used to satisfy the nonfederal match requirement of the Environmental Protection Agency's treatment works construction grant program). Congress can, of course, enact a statutory exception that expressly permits this method of funding the nonfederal share. *See*, *e.g.*, B-239907, July 10, 1991 (Community Development Block Grants (CDBG) can constitute the nonfederal share because one of the statutorily authorized activities for CDBG funds is providing the nonfederal share for other federal grant programs that are listed in the community's annual CDBG application document).

When a federal agency enters into an assistance agreement with an eligible recipient, an entire project or program is approved. Where a local share is required, this agreement includes an estimate of the total costs, that is, a total that will exceed the amount to be borne by the federal government. The additional contribution that is needed to supply full support for the anticipated costs is the local, or nonfederal, matching share. Once the agreement is accepted, the assistance recipient is committed to providing the nonfederal share if it wishes to continue with the grant. *E.g.*, B-130515, July 20, 1973. Failure to meet this commitment may result in the disallowance of all or part of otherwise allowable federal share costs.

Matching share requirements are often intended to "assure local interest and involvement through financial participation." 59 Comp. Gen. 668, 669 (1980). Such requirements may also serve to hold down federal costs. The theory behind the typical matching share requirement may be summarized as follows:

> "In theory, the fiscal lure of Federal grants entices State and local governments into allocating new resources to satisfy the non-Federal match for programs they otherwise would not have funded on their own. While State and local jurisdictions may not be willing or able to fully fund a program from their own resources, they would most likely agree to spend new resources on the same project if most of the project costs were paid by the Federal Government."

GAO, *Proposed Changes in Federal Matching and Maintenance of Effort Requirements for State and Local Governments*, GGD-81-7 (Washington, D.C.: Dec. 23, 1980), at 9. This approach has been termed "cooperative federalism." *E.g.*, *King v. Smith*, 392 U.S. 309, 316 (1968). It is also known as the "federal carrot." *See City of New York v. Richardson*, 473 F.2d 923, 928 (2nd Cir.), *cert. denied sub nom.*, 412 U.S. 950 (1973).

Matching requirements are most commonly found in the applicable program legislation. However, they may also be found in appropriation acts. *E.g.*, 58 Comp. Gen. 524 (1979); 31 Comp. Gen. 459 (1952). A matching provision in an appropriation act, like any other provision in an appropriation act, will apply only to the fiscal year(s) covered by the act or the appropriation to which it applies, unless otherwise specified. 58 Comp. Gen. at 527.

If a program statute authorizes grants but neither provides for nor prohibits cost-sharing, the grantor agency may in some cases be able to impose a matching requirement administratively by regulation. The test is the underlying congressional intent. If legislative history indicates an intent for full federal funding, then the statute will generally be construed as requiring a 100 percent federal share. B-226572, June 25, 1987; B-169491, June 16, 1980. However, cost-sharing regulations have been regarded as valid when the statute was silent and it could reasonably be concluded that Congress left the matter to the judgment of the administering agency. B-130515, July 17, 1974; B-130515, July 20, 1973. Such regulations may be waived uniformly and prospectively, but may not be waived on a retroactive and *ad hoc* basis. *Id.*

Matching funds, as with the federal assistance funds themselves, can be used only for authorized grant purposes. B-230735, July 20, 1988; B-149441, Feb. 17, 1987. In the latter case, the Comptroller General concluded that the National Endowment for the Humanities (NEH) could not divert state matching funds to establish private endowments that, under existing authorities, could not have been created by a direct award of NEH funds. *See also* 42 Comp. Gen. 289, 295 (1962). Also, unless otherwise specified in the governing legislation, a grantee may match only a portion of the funds potentially available to it, and thereby receive a correspondingly smaller grant. 16 Comp. Gen. 512 (1936).

Under a cost-sharing assistance program funded by advance payments of the federal contribution, the Comptroller General has held that the advances may be made prior to the disbursement of the nonfederal share as long as adequate assurances exist (*e.g.*, by contractual commitments) that the local share will be forthcoming. 60 Comp. Gen. 208 (1981). *See also* 23 Comp. Gen. 652 (1944) (payment by federal agency of local share under cooperative agreement, subject to contractual agreement to reimburse).

Where the statute authorizing federal assistance specifies the federal share of an approved program as a specific percentage of the total cost, the grantor agency is required to make awards to the extent specified and has no discretion to provide a lesser (or greater) amount. *Manatee County, Florida v. Train*, 583 F.2d 179, 183 (5th Cir. 1978); 53 Comp. Gen. 547 (1974); B-197256, Nov. 19, 1980. However, where the federal share is defined by statutory language that specifies a maximum federal contribution but no minimum, the agency can provide a lesser amount. 50 Comp. Gen. 553 (1971).

Although most cost-sharing programs are in terms of a fixed federal share, some programs may provide for a declining federal share. Under a declining share program in the Regional Rail Reorganization Act, the Comptroller General concluded that the federal share could be determined in the year the grant was made, notwithstanding the fact that the grantee would not actually incur the costs until the following fiscal year. B-175155, July 29, 1977. Another cost-sharing variation is the "aggregate match," in which the nonfederal share is determined by cumulating the grantee's contributions from prior time periods. An example is discussed in 58 Comp. Gen. 524 (1979).

(2) Hard and soft matches

The program statute may define or limit the types of assets that may be applied to the nonfederal share. A provision limiting the nonfederal share to cash contributions is called a "hard match." In 31 Comp. Gen. 459 (1952), the matching share was described in the appropriation act that required it as an "amount available." In the absence of legislative history to support a broader meaning, the Comptroller General concluded that the matching share must be in the form of money and that the value of other nonmonetary contributions could not be considered. A more explicit "hard match" requirement is discussed in 52 Comp. Gen. 558 (1973), in which the Comptroller General concluded that the matching share, while it must be in the form of money, could include donated funds as well as grantee funds. While the program discussed in 52 Comp. Gen. 558 no longer exists, the case remains useful for this point and for the detailed review of legislative history illuminating the purpose and intent of the "hard match" provision.

Congress continues to include hard match requirements in laws providing for cost sharing with federal grants. For example, the Transportation Equity Act for the 21st Century established job access and reverse commute grants, which require that the grantee provide at least 50 percent of the funding for each project and that the nonfederal share—

> "(i) shall be provided *in cash* from sources other than revenues from providing mass transportation, but may include amounts received under a service agreement; and
>
> "(ii) may be derived from amounts appropriated to or made available to a department or agency of the Federal Government (other than the Department of Transportation) that are eligible to be expended for transportation."

Pub. L. No. 105-178, § 3037(h), 112 Stat. 107, 390 (June 9, 1998) (emphasis added).

The program legislation may expressly authorize the inclusion of assets other than cash in the nonfederal contribution. *See* 56 Comp. Gen. 645 (1977). An example is found in the Klamath River Basin Fishery Resources Restoration Act, Pub. L. No. 99-552, 110 Stat. 3080 (Oct. 27, 1986), codified at 16 U.S.C. §§ 460ss–460ss-6, which requires that at least 50 percent of the cost of developing and implementing the program come from nonfederal

sources but explicitly states that noncash assets may count toward the nonfederal share. That statute specifically states:

> "In addition to cash outlays, the Secretary [of the Department of Interior] shall consider as financial contributions by a non-federal source the value of in kind contributions and real and personal property provided by the source for purposes of implementing the program."

16 U.S.C. § 460ss-5(b)(2).

If, however, the legislation is silent with respect to the types of assets that may be counted, the statute will generally be construed as permitting an "in-kind" or "soft" match, that is, the matching share may include the reasonable value of property or services as well as cash. 52 Comp. Gen. 558, 560 (1973); B-81321, Nov. 19, 1948. The valuation of in-kind contributions can get complicated. An example is 31 Comp. Gen. 672 (1952) (value of land could not include the cost or value of otherwise unallowable improvements to the land previously added by the grantee).

Current valuation standards for state and local governments are found in the common rule captioned "Matching or Cost Sharing." *See*, *e.g.*, 7 C.F.R. § 3016.24. For institutions of higher education, hospitals, and other nonprofit organizations, such standards can be found in 7 C.F.R. § 3019.23, also captioned "Cost Sharing or Matching."

(3) Matching one grant with funds from another

As noted in the preceding section, an important and logical principle is that neither the federal nor the nonfederal share of a particular grant program may be used by a grantee to match funds provided under another federal grant program unless specifically authorized by law. In other words, a grantee may not (1) use funds received under one federal grant as the matching share under a separate grant, nor may it (2) use the same grantee dollars to meet two separate matching requirements. B-270654, May 6, 1996; 56 Comp. Gen. 645 (1977); 47 Comp. Gen. 81 (1967); 32 Comp. Gen. 561 (1953); 32 Comp. Gen. 141 (1952); B-214278, Jan. 25, 1985; B-212177, May 10, 1984; B-130515, July 20, 1973; B-229004-O.M., Feb. 18,

1988; B-162001-O.M., Aug. 17, 1967. See also the common rule at 7 C.F.R. § 3016.24(b). A contrary rule would largely nullify the cost-sharing objective of stimulating new grantee expenditures.[80]

Normally, exceptions to the rule are in the form of express statutory authority. A prominent example is section 105(a)(9) of the Housing and Community Development Act of 1974, as amended, 42 U.S.C. § 5305(a)(9), which authorizes community development block grant funds to be used as the nonfederal share under any other grant undertaken as part of a community development program. *See* 59 Comp. Gen. 668 (1980); 56 Comp. Gen. 645 (1977); B-239907, July 10, 1991. The 1991 opinion concluded that community development block grant regulations no longer apply once the funds have been applied as a match under another grant program, at least where applying the regulations would substantially interfere with use of the funds under the receiving grant. *See also* 52 Comp. Gen. 558, 564 (1973); 32 Comp. Gen. 184 (1952).

In 59 Comp. Gen. 668, GAO considered a conflict between two statutes, the Housing and Community Development Act, 42 U.S.C. §§ 5301–5321, which, as noted, permits federal grant funds to fill a nonfederal matching requirement, and the Coastal Zone Management Act of 1972, as amended, which provides for cost-sharing grants but expressly prohibits the use of federal funds received from other sources to pay a grantee's matching share. 16 U.S.C. §§ 1454, 1455, and 1464(c). Finding that the statutory language could not be reconciled, and noting further that there was no helpful legislative history under either statute, the Comptroller General concluded, as the most reasonable result consistent with the purposes of both statutes, that community development block grant funds were available to pay the nonfederal share of Coastal Zone Management Act grants for projects properly incorporated as part of a grantee's community development program. See also B-229004-O.M., Feb. 18, 1988, which essentially followed 59 Comp. Gen. 668 and concluded that community development block grant funds could be used for the matching share of certain grants under the Stewart B. McKinney Homeless Assistance Act, Pub. L. No. 100-77, 101 Stat. 482 (July 22, 1987).

[80] By way of contrast, this general rule does not apply to federal loans. The reason is that loans, unlike grants, are expected to be repaid and the recipient is thus, at least ultimately, using its own funds. Of course, the proposed use of the funds must be authorized under the loan program legislation. B-207211-O.M., July 9, 1982. *See also* B-214278, Jan. 25, 1985.

A somewhat less explicit exception is discussed in 57 Comp. Gen. 710 (1978), holding that funds distributed to states under Title II of the Public Works Employment Act of 1976, as amended, 42 U.S.C. §§ 6721–6736 (called the "countercyclical revenue sharing program"), may be applied to the states' matching share under the Medicaid program. GAO agreed with the Treasury Department that Title II payments amounted to "general budget support as opposed to categorical or block grants or contracts" (57 Comp. Gen. at 711), a form of revenue sharing, and thus should be construed in the context of the (since repealed) General Revenue Sharing Program. General Revenue Sharing was characterized by a "no strings on local expenditures" policy, evidenced by the fact that a provision in the original legislation barring the use of funds as the nonfederal share in other federal programs had been repealed. Stressing the strong analogy between Title II and General Revenue Sharing, the decision concluded that implicit in the "no strings" policy was the authority to apply Title II funds to a state's matching share under Medicaid. For a description of the former General Revenue Sharing Program, see, for example, GAO, *Federal Assistance: Temporary State Fiscal Relief*, GAO-04-736R (Washington, D.C.: May 7, 2004) and *Federal Grants: Design Improvements Could Help Federal Resources Go Further*, GAO/AIMD-97-7 (Washington, D.C.: Dec. 18, 1996).

It should also be noted that where any federal assistance funds are used as nonfederal matching funds for another grant, such use must be consistent with the grant under which they were originally awarded as well as the grant they are intended to implement. 59 Comp. Gen. 668; 57 Comp. Gen. at 715; B-230735, July 20, 1988.

Funds received by a property owner from a federal agency as just compensation for property taken by eminent domain belong to the owner outright and do not constitute a "grant." Therefore, they may be used as the nonfederal share of a grant from another federal agency, even where the taking and the grant relate to the same project. B-197256, Nov. 19, 1980.

(4) Relocation allowances

Federally assisted programs which result in the displacement of individuals and business entities may, apart from eminent domain payments, result in the payment of relocation allowances under the Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970, as amended 42 U.S.C. §§ 4601–4655. Under the statute, authorized relocation payments provided by a state incident to a federally assisted project which results in relocations are to be treated in the same manner as other project costs.

Thus, under a program statute which provides for a 90 percent federal contribution, 90 percent of authorized relocation payments will be reimbursable as an allowable program cost. In other words, any applicable matching share requirement will apply equally to the relocation payments. B-215646, Aug. 7, 1984.

(5) Payments by other than grantor agency

Of course there is nothing wrong with grantees receiving funds from more than one federal source, including other federal grants for which they are eligible. If the grants are administered by different agencies, each agency is making payments under its own program. Occasionally, an agency is asked to make payments not associated with any of its own assistance programs, to a grantee or grant beneficiary under some other agency's program. The cases fall into two groups.

The first situation involves services performed by an assistance beneficiary to an agency other than the grantor agency. Under the College Work-Study Program, not to exceed 75, or 90 in certain cases, percent of the student's salary is paid by the college under a Department of Education grant, with the remainder paid by the employer. 42 U.S.C. § 2753(b)(5). The "employer" may be another federal agency. 46 Comp. Gen. 115 (1966). In addition to the salary contribution, the employing agency may pay unreimbursed administrative costs such as social security taxes and compensation insurance. 50 Comp. Gen. 553 (1971); 46 Comp. Gen. 115. However, an agency may not, without statutory authority, participate in a work-study program authorized by state law and not coordinated with the federal program. B-159715, Dec. 18, 1978.

The authority to pay administrative costs under the work-study program is based on the cost-sharing nature of that program. Absent comparable cost-sharing provisions, there is no authority to pay administrative costs. 61 Comp. Gen. 242 (1982) (agency to which employee had been assigned under former Comprehensive Employment and Training Act lacked authority to reimburse grantee for retirement contributions).

The second group of cases involves projects which benefit other federal facilities. Under program legislation which does not give the grantor agency discretion to reduce the federal share, the grantor agency is not authorized to exclude from total cost a portion of an otherwise eligible project solely because that portion would provide service to another federal facility. 59 Comp. Gen. 1 (1979). Where the grantor agency has

reduced its contribution because a portion of the project would serve another federal facility, the "benefited agency" normally would not be authorized to make up the shortfall without receiving additional consideration above and beyond the improved service it would have received anyway. B-189395, Apr. 27, 1978. However, if Congress chooses to appropriate funds to the benefited agency to make up the shortfall, the benefited agency may make otherwise proper contributions without requiring additional legal consideration as long as its contribution, when added to the amount contributed by the grantor agency, does not exceed the statutorily specified federal share. 59 Comp. Gen. 1; B-198450, Oct. 2, 1980; B-199534, B-200086, Oct. 2, 1980.

The illustration given in 59 Comp. Gen. 1 may help to clarify these principles. Suppose the statutory federal share is 75 percent and the total project cost is $10 million. The federal share is 75 percent of $10 million, or $7.5 million. Now suppose the grantor agency determines that 20 percent of the project will serve another federal facility. Under 59 Comp. Gen. 1, it is improper for the grantor agency to reduce total cost by 20 percent (*i.e.*, from $10 million to $8 million) and to then contribute only 75 percent of the $8 million, for a federal share of $6 million. The correct federal share should have remained 75 percent of $10 million.

Suppose further that the grantor agency has made the reduction and Congress appropriates money to the benefited agency to make up the shortfall. Using the same hypothetical figures, the benefited agency may contribute $1.5 million (20 percent of the federal share of $7.5 million) as the federal share of that portion of the project attributable to its use, without further legal consideration. However, as mentioned above, its contribution, when added to the contribution of the grantor agency, may not exceed the specified statutory share unless further legal consideration is received by the government.

The decision at 59 Comp. Gen. 1 and the two October 1980 decisions resulted from a disagreement between GAO and the Environmental Protection Agency over grant funding policy under the Federal Water Pollution Control Act, commonly known as the Clean Water Act, codified at 33 U.S.C. §§ 1251–1387. The Act authorized EPA to make 75 percent[81] construction grants for wastewater treatment systems. EPA construed the

[81] Subsequent legislation reduced the percentage of the federal share under this program. Pub. L. No. 97-117, § 7, 95 Stat. 1623, 1625 (Dec. 29, 1981). *See* B-207211-O.M., July 9, 1982.

statute as permitting it to proportionately reduce its contribution to the extent a project benefits other federal facilities. As noted, GAO concluded that EPA lacked authority to reduce its contribution below 75 percent, and that the benefited agencies could not make up the shortfall. EPA disagreed, and to resolve the funding impasse, Congress, apparently as a temporary expedient, provided funds to certain agencies, specifically the Army and the Navy. However, Congress did not provide funds for the Air Force to offset the reduced grants, and the issue arose again in B-194912, Aug. 24, 1981. The Comptroller General reaffirmed GAO's position and concluded that, absent specific congressional approval, the appropriations of the Air Force were not available to make up for the reduced grant amounts.

b. Maintenance of Effort

Suppose the state of New Euphoria spends around a million dollars a year for the control of noxious pests. After several years, the continued proliferation of noxious pests leads Congress to conclude that the program is not going as well as everyone might like, and that federal financial assistance is in order. Congress therefore enacts legislation and appropriates funds to provide annual pest-control grants of half a million dollars to each affected state.

New Euphoria applies for and receives its grant. Like most other states, however, New Euphoria is strapped for money and faced with various forms of taxpayer revolt. While the state government certainly believes that noxious pests merit control, it would, if it had free choice in the matter, rather use the money on what it regards as higher priority programs. The state uses the $500,000 federal grant for its pest control program; it has no choice because it has contractually committed itself with the federal government to do so as a condition of receiving the grant. However, it then takes $500,000 of its own money away from pest control and applies it to other programs. If the purpose of the federal grant legislation is simply to provide general financial support to New Euphoria, that purpose has been accomplished and the state has clearly benefited. But if the federal purpose is to fund an increased level of pest control activity, the objective has just as clearly been frustrated.

When Congress wants to avoid this result, a device it commonly uses is the "maintenance of effort" requirement. Under a maintenance of effort provision, the grantee is required, as a condition of eligibility for federal funding, to maintain its financial contribution to the program at not less than a stated percentage (which may be 100 percent or less) of its contribution for a prior time period, usually the previous fiscal year. The purpose of maintenance of effort is to ensure that the federal assistance

results in an increased level of program activity, and that the grantee, as did New Euphoria, does not simply replace grantee dollars with federal dollars. GAO has observed that maintenance of effort, since it requires a specified level of grantee spending, "effectively serves as a matching requirement." GAO, *Proposed Changes in Federal Matching and Maintenance of Effort Requirements for State and Local Governments*, GAO/GGD-81-7 (Washington, DC: Dec. 23, 1980), at 2.

GAO has also observed that a grant for something the grantee is already spending its own money on is, without maintenance of effort, little more than another form of revenue sharing.

> "When Federal grant money is used to substitute for ongoing or planned State and local expenditures, the ultimate effect of the Federal program funds is to provide fiscal relief for recipient States and localities rather than to increase service levels in the program area. When fiscal substitution occurs, narrow-purpose categorical Federal programs enacted to augment service levels are transformed, in effect, into broad purpose fiscal assistance like revenue sharing. Maintenance of effort provisions, if effective, can prevent substitution and ensure that the Federal grant is used by the grantee for the specific purpose intended by the Congress."

GAO/GGD-81-7, at 48–49. *See also* GAO, *Block Grants: Issues in Designing Accountability Provisions*, GAO/AIMD-95-226, (Washington, D.C.: Sept. 1, 1995), at 17–18.

One type of maintenance of effort requirement is illustrated by the following provision from the Clean Air Act, 42 U.S.C. § 7405(c)(1):

> "No [air pollution control] agency shall receive any grant under this section during any fiscal year when its expenditures of non-Federal funds for recurrent expenditures for air pollution control programs will be less than its expenditures were for such programs during the preceding fiscal year. . . ."

A variation is found in 20 U.S.C. § 7901, which is applicable to certain education grants. The basic requirement is in section 7901(a):

> "A local educational agency may receive funds under a covered program for any fiscal year only if the State educational agency finds that either the combined fiscal effort per student or the aggregate expenditures of the agency and the State with respect to the provision of free public education by the agency for the preceding fiscal year was not less than 90 percent of the combined fiscal effort or aggregate expenditures for the second preceding fiscal year."

Maintenance of effort statutes will invariably provide fiscal sanctions if the grantee does not meet its commitment. Sanction provisions are of two types. Under one version, the grantee's allocation of federal funds is reduced in the same proportion as its contribution fell below the required level. For example, 20 U.S.C. § 7901(b)(1) provides:

> "The State educational agency shall reduce the amount of the allocation of funds under a covered program in any fiscal year in the exact proportion by which a local educational agency fails to meet the requirement of subsection (a) of this section by falling below 90 percent of both the combined fiscal effort per student and aggregate expenditures (using the measure most favorable to the local agency)."

The second and more severe version is illustrated by the Clean Air Act provision quoted above and discussed in B-209872-O.M., Mar. 23, 1984, an internal GAO memorandum. Under this version, the grantee, falling short of its maintenance of effort commitment, loses all grant funds under the program for that fiscal year. GAO has endorsed the enactment of legislation making proportionate reduction the standard rather than total withdrawal. GAO/GGD-81-7, at 71.

Some maintenance of effort statutes authorize the administering agency to waive the requirement for a specified time period if some natural disaster or other unforeseen event caused the funding shortfall. An illustration is 20 U.S.C. § 7901(c):

> "The Secretary may waive the requirements of this section if the Secretary determines that a waiver would be equitable due to—

> (1) exceptional or uncontrollable circumstances, such as a natural disaster; or
>
> (2) a precipitous decline in the financial resources of the local educational agency."

If a grantee fails to meet its commitment and the noncompliance cannot be waived, any disbursement of federal funds in excess of the amount permitted by the program statute must generally be recovered. 51 Comp. Gen. 162 (1971). Failure to require repayment of such funds "would, in effect, constitute the giving away of United States funds without authority of law." *Id.* at 165.[82]

A variation of the maintenance of effort provision is the so-called "nonsupplant" provision, which requires that federal funds be used to supplement, and not supplant, nonfederal funds which would otherwise have been made available. Nonsupplant is sometimes used in conjunction with maintenance of effort. For example, in addition to coverage under the maintenance of effort provision at 20 U.S.C. § 7901, quoted above, certain education grant programs are also covered under 20 U.S.C. § 6321(b)(1):

> "A State educational agency or local educational agency shall use Federal funds received under this part only to supplement the funds that would, in the absence of such Federal funds, be made available from non-Federal sources for the education of pupils participating in programs assisted under this part, and not to supplant such funds."

GAO has reported on the difficulty with monitoring and enforcing nonsupplant provisions. *See* GAO, *Disadvantaged Students: Fiscal Oversight of Title I Could Be Improved*, GAO-03-377 (Washington, D.C.: Feb. 28, 2003); *Welfare Reform: Challenges in Maintaining a Federal-State Fiscal Partnership*, GAO-01-828 (Washington, D.C.: Aug. 10, 2001);

[82] See Chapter 10, section H for a general discussion of recovery of grantee indebtedness.

GAO/GGD-81-7, at 71.[83] These reports noted that in flexible grant environments, a strong maintenance of effort provision may prove more useful than a traditional nonsupplant requirement. While a nonsupplant provision might limit the intended breadth of a block grant by locking states into a pre-established funding priorities, a strong maintenance of effort provision might both limit substituting federal funds for state and local funds while providing greater state discretion. GAO-03-377, at 25; GAO-01-828, at 47.

F. Obligation of Appropriations for Grants

1. Requirement for Obligation

As with any other type of expenditure, the expenditure of federal assistance program funds requires an obligation that is proper in terms of purpose, time, and amount, and the obligation must be properly recorded.[84] With respect to recording of the obligation in the grant or subsidy context, 31 U.S.C. § 1501(a)(5) requires that the obligation be supported by documentary evidence of a grant payable—

> "(A) from appropriations made for payment of, or contributions to, amounts required to be paid in specific amounts fixed by law or under formulas prescribed by law;

[83] The 1980 report also noted:

> "Most Federal program officials we contacted agreed that nonsupplant is difficult, if not impossible, to enforce because it calls for an external judgment on what grantees would have done if Federal funds were not available. Basically, this calls for a Federal agency to assess the motives behind particular changes in State and local plans or budgets and to judge whether the presence of Federal grant funds drove the particular State or local action."

GAO/GGD-81-7, at 54.

[84] The purpose, time, and amount requirements are essentially the same for grants as for other expenditures. What constitutes an obligation in the grant context, and what will or will not satisfy 31 U.S.C. § 1501(a)(5), are discussed in more detail in section C.2 of this chapter and in Chapter 7, section B.5.

> "(B) under an agreement authorized by law; or
>
> "(C) under plans approved consistent with and authorized by law."

Briefly stated, the "obligational event" for a grant generally occurs at the time of grant award. Therefore, this is when the grantor agency must record an obligation under 31 U.S.C. § 1501(a)(5), not when the grantee draws down the funds or when the grantee incurs its own obligations. *See* B-300480, Apr. 9, 2003, *aff'd*, B-300480.2, June 6, 2003.

2. Changes in Grants

Changes in grants may come about for a variety of reasons: the original grantee may be unable to perform, the grant amount may be increased, there may be a redefinition of objectives, *etc.* If the change occurs in the same fiscal year (or longer period if a multiple year appropriation is involved) in which the original grant was made, there is no obligation problem as long as the amount of the appropriation available for obligation is not exceeded. If, however, the change occurs in a later fiscal year, the question becomes whether the amended grant remains chargeable to the appropriation initially obligated or whether it constitutes a new obligation chargeable to appropriations current at the time the change is made. As pointed out in 58 Comp. Gen. 676, 680 (1979), the cases have identified three closely related areas of concern that must be satisfied before a change may be viewed as a so-called "replacement grant," that is, not as creating a new obligation that must be charged to the current appropriation:

- the *bona fide* need for the grant project must continue;
- the purpose of the grant from the government's standpoint must remain the same; and
- the revised grant must have the same scope.

The "scope" of a grant, as stated in 58 Comp. Gen. at 681—

> "grows out of the grant purposes. These purposes must be referred to in order to identify those aspects of a grant that make up the substantial and material features of a particular

grant which in turn fix the scope of the Government's obligation."

As a general proposition, a grant amendment which changes the scope of the grant or which makes the award to an entirely different grantee (not a successor to the original grantee), and which is executed after the appropriation under which the original grant was made has ceased to be available for obligation, may not be charged to the original appropriation. 58 Comp. Gen. 676 (1979). If the amendment amounts to a substitute grant, it extinguishes the old obligation and creates a new one. *Id.* at 678. The new obligation is chargeable to the appropriation available at the time the new obligation is created. *Id.* There are also situations where a grant amendment creates a new obligation chargeable to the later appropriation without extinguishing the original obligation. *Id.* In either event, if the grantor agency does not recognize that the change creates a new obligation when the change is made, there is a potential Antideficiency Act violation. On the other hand, a change which qualifies as a "replacement grant" remains chargeable to the original appropriation. 57 Comp. Gen. 205, 208–09 (1978). Of course, an agency with the requisite program authority can change the scope of a grant if current appropriations are used. 60 Comp. Gen. 540, 543 (1981).

The clearest example of a change that creates a new obligation is where the amount of the award is increased. If the grantee has no legal right stemming from the original grant agreement to compel execution of the amendment, the increase in amount is a new obligation chargeable to appropriations current when the change is made. 41 Comp. Gen. 134 (1961); 39 Comp. Gen. 296 (1959); 37 Comp. Gen. 861 (1958). However, an upward adjustment in a "provisional indirect cost rate" contained in a grant award, which contemplated a possible increase in the indirect cost rate at a later date, does not constitute an additional or new award. 48 Comp. Gen. 186 (1968). Payments resulting from such an adjustment are chargeable to the appropriation originally obligated by the grant. *Id.* Similarly, the increase in a grant award to cover the cost of audits that were required under the original grant agreement was within the scope of the grant awards. 72 Comp. Gen. 175 (1993). Payments necessary to cover the audit costs can be made out of the expired appropriations that were originally obligated for the grants. *Id.*

As a general rule, when a recipient of a grant is unable to implement the grant as originally contemplated, and an alternative grantee is designated subsequent to the expiration of the period of availability for obligation of

the grant funds, the award to the alternative grantee must be treated as a new obligation and is not properly chargeable to the appropriation current at the time the original grant was made. B-164031(5), June 25, 1976; B-114876, A-44014, Jan. 21, 1960.

However, it is possible in certain situations to make an award to an alternative grantee after expiration of the period of availability for obligation where the alternative award amounts to a "replacement grant" and is substantially identical in scope and purpose to the original grant. 57 Comp. Gen. 205 (1978); B-157179, Sept. 30, 1970. In the latter decision, the Comptroller General did not object to the use of unexpended grant funds originally awarded to the University of Wisconsin to engage Northwestern University in a new fiscal year to complete the unfinished project. Approval was granted because the project director had transferred from the University of Wisconsin to Northwestern University and he was viewed by all the parties as the only person capable of completing the work. The decision also noted that the original grant was made in response to a *bona fide* need then existing, and that the need for completing the project continued to exist.[85]

GAO has also indicated that it might be possible in certain situations to develop procedures to designate an alternate grantee at the time an award is made to the principal grantee, provided that all of the criteria for selection of the principal and required administrative action are also met concerning the alternate, with the sole exception that the award to the alternate is not mailed to it pending a determination as to whether the principal actually complies with the terms of the award. The validity of any such procedure would have to be assessed on a case-by-case basis. B-114876, July 29, 1960; B-114876, Mar. 15, 1960.

A shift in the community to be served by the grant may constitute a new obligation depending on the circumstances. Thus, in B-164031(5), June 25, 1976, the original grantee ran into financial difficulties and was unable to utilize a hospital modernization award under the Hill-Burton program. The Comptroller General found that a proposal to shift the award to another hospital would constitute a new undertaking rather than a replacement grant since the hospitals were over 100 miles apart and served essentially different communities.

[85] See section C.2.b of this chapter for a discussion of the applicability of the *bona fide* needs rule to grants.

An enlargement of the community to be served will not necessarily constitute a new obligation. The grant in 58 Comp. Gen. 676 (1979) was to set up a demonstration community service volunteer program. The grant defined the number of participants deemed necessary to generate the desired test results. The geographic site for which the grant was awarded was expected to produce the necessary number of volunteers, but did not. It was held that the geographical area could be expanded to produce the desired number of volunteers. The modification in these circumstances would not constitute a new and separate undertaking and could be funded from the appropriation originally obligated.

A change in the research objectives of a grant will constitute a new obligation notwithstanding that some aspects of the original grant and the modification may be related. 57 Comp. Gen. 459 (1978). *See also* 39 Comp. Gen. 296 (1959).

A 1969 decision involved amendments by the National Institute of Mental Health which would change the use of grant funds from construction to renovation and vice-versa beyond the period of obligational availability. Since the amendments met the statutory eligibility criteria, since they would still accomplish the original grant objectives, and since they involved neither a change in grantees nor an increase in amount, they were held permissible under the original obligations. B-74254, Sept. 3, 1969.

G. Grant Costs

1. Allowable *versus* Unallowable Costs

a. The Concept of Allowable Costs

Recipients of assistance awards are expected to use the assistance funds for the purposes for which they were awarded, subject to any conditions that may attach to the award. Expenditures or costs that meet the grant purposes and conditions are termed "allowable costs." An expenditure which is not for grant purposes or is contrary to a condition of the grant is not an allowable cost and may not be properly charged to the grant.

Allowable costs are determined on the basis of the relevant program legislation, regulations, including OMB circulars and the common rules, and the terms of the grant agreement. First and foremost, of course, is the program statute. Thus, where the legislation and legislative history of a program clearly limited the purposes for which grant funds could be used, grantees could not use grant funds for nonspecified purposes, including one for which Congress had provided funds under a separate appropriation. 35 Comp. Gen. 198 (1955). In 55 Comp. Gen. 652 (1976), however, a statute prohibiting certain costs was held to apply only to direct costs and, absent legislative history to the contrary, did not preclude use of standard indirect cost rates even though technically a percentage of the indirect cost rates could be attributed to the prohibited items.

The role of agency regulations is illustrated by *California v. United States*, 547 F.2d 1388 (9th Cir.), *cert. denied*, 434 U.S. 824 (1977). Under the Federal-Aid Highway Act, 23 U.S.C. § 120, the United States pays 90 percent of the "total cost" of certain highway construction, with "cost" being defined to include the cost of right-of-way acquisition. The Federal Highway Administration had issued a policy memorandum stating that program funds would not be used to pay interest on any portion of a condemnation award or settlement for more than 30 days after the money is deposited with the court. California challenged the restriction. The court said:

> "Certainly, Congress must have intended that the statutory obligation to pay 90 percent of the total cost must include some corresponding right to impose reasonable limitations

> upon such costs, rather than to leave the Federal Treasury at the mercy of unfettered discretion by the State as to what expenditures may be made and charged accordingly."

Id. at 1390. The court saw no need to decide whether the policy memorandum rose to the level of a "regulation." Either way, it was a reasonable exercise of the agency's authority to administer the program. *See also Louisiana Department of Highways v. United States*, 604 F.2d 1339 (Ct. Cl. 1979) (Federal Highway Administration regulation disallowing costs of grantee settlements of worthless claims).

Several GAO decisions illustrate the significance of the grant agreement. For example, where a grant application specified that certain costs would be incurred and the program legislation was ambiguous as to whether those costs should be allowed, the grantor agency was held bound by the grant agreement, that is, by its acceptance of the application. B-118638.101, Oct. 29, 1979.

As discussed previously, the Office of Management and Budget (OMB) prescribes guidance on federal assistance cost principles. This guidance is found in a series of OMB Circulars: No. A-21, *Cost Principles for Educational Institutions* (May 10, 2004); No. A-87, *Cost Principles for State, Local, and Indian Tribal Governments* (May 10, 2004); and No. A-122, *Cost Principles for Non-profit Organizations* (May 10, 2004). These circulars are incorporated in the common rules issued by the individual grantor agencies. The Department of Agriculture common rules, for example, reference the OMB cost principles at 7 C.F.R. § 3016.22(b) (2005).[86]

As explained in OMB Circular No. A-87, Attachment A (*General Principles for Determining Allowable Costs*), allowable costs are of two types, direct and indirect.[87] Direct costs are items that are specifically identifiable and

[86] See section C.3.b of this chapter for a discussion of the nature and evolution of the common rules. As in earlier sections, we will cite to the Department of Agriculture version of the common rules for ease of presentation.

[87] Section D of Attachment A of the circular explains that there is no universal rule for classifying certain costs as either direct or indirect under every accounting system. "A cost may be direct with respect to some specific service or function, but indirect with respect to the Federal award or other final cost objective." *Id.* § D.2. The most important requirement is to treat each cost item consistently in like circumstances as either direct or indirect.

attributable to a particular final cost objective. *Id.* § E.1. In other words, direct costs are obligations or expenditures of a recipient which can be tied to a particular award. For example, if a recipient purchases an item of equipment necessary to carry out a particular award, the purchase price is a direct cost under that award. *Id.* § E.2.c. Indirect costs are costs incurred for common objectives which cannot be directly charged to any single cost objective. *Id.* § F.1. A common example is depreciation. The concept of indirect costs is essentially an accounting device to permit the allocation of overhead in proportion to benefit. *See* B-203681, Sept. 27, 1982.

The over-allocation of indirect costs is unauthorized and therefore unallowable. The reason is that 31 U.S.C. § 1301(a) restricts the use of appropriated funds to the purposes for which they were appropriated, and payment of the over-allocation would not serve the purposes of the appropriation. B-203681, Sept. 27, 1982.

A grantee may generally substitute other allowable costs for costs which have been disallowed, subject to any applicable cost ceiling. If additional funds become available as the result of a cost disallowance, those funds should be used to pay any "excess" allowable costs which could not be paid previously because of the ceiling. 68 Comp. Gen. 247, 248–49 (1989). The courts have also applied this concept in one form or another. In *Institute for Technology Development v. Brown*, 63 F.3d 445, 450–52 (5th Cir. 1995), the court explicitly followed the GAO approach and allowed cost-substitution. The court in *New York v. Riley*, 53 F.3d 520 (2nd Cir. 1995), referred to a similar administrative practice by the Department of Education, which it called "equitable offset," whereby the Department could permit a grantee to substitute allowable costs for disallowed costs that could have been—but never were—charged to a grant. However, the court described this practice as embodying "concepts of equity, not entitlement as a matter of right." *Id.* at 522. In any event, its applicability was a moot point in this case since the grantee could not document any potential allowable costs to substitute for costs that had been disallowed. *Id.*

The familiar cost overrun is not the exclusive province of the government contractor. Assistance recipients may also incur overruns. A claim resulting from an overrun under a cooperative agreement was denied in B-206272.5, Mar. 26, 1985, because, under the agreement, the agency was not obligated to fund overruns unless it chose to amend the agreement and, in its discretion, it had declined to do so. *Cf.* B-209649, Dec. 23, 1983 (labor benefits awarded by court to employees of grantee's contractor could be

regarded as indirect costs under grant terms, as long as applicable ceiling on indirect costs was not exceeded).

Issues concerning allowable grant costs often involve technical disputes over accounting principles and practices that take place far from the public spotlight. However, a major and very public controversy arose in the early 1990s centering on questionable items that universities were claiming as indirect "overhead" costs under federal research grants. These problems are detailed in Lynn McGuire, *Federal Research Grant Funding at Universities: Legislative Waves From Auditors Diving Into Overhead Cost Pools*, 23 Journal of College and University Law 563 (Winter 1997). Inquiries into alleged improper charges, which were spearheaded by the House Committee on Energy and Commerce's Subcommittee on Oversight and Investigations, included a series of congressional hearings, GAO reviews, audits by executive branch agencies, and a report on the ABC television program *20/20*. The allegations involved many of the nation's leading academic institutions such as Harvard Medical School, Stanford University, the University of California at Berkeley, and the Massachusetts Institute of Technology. Alleged improper charges included depreciation for a 72-foot yacht, a public relations trip to Paris, a Nile River cruise, a Saint Patrick's Day party, football tickets for potential university donors, and the purchase of an antique commode for the residence of a retired university chancellor. The problems resulted from what GAO described as "breakdowns in several key areas of the system dealing with indirect costs." GAO, *Federally Sponsored Research: Indirect Costs Charged by Selected Universities*, GAO/T-RCED-92-20 (Washington, D.C.: Jan. 29, 1992), at 9. In that testimony, GAO identified the main areas of breakdown as follows:

- Inadequate criteria in OMB Circular No. A-21 for determining allowable costs and how to allocate them among university functions;

- Inadequate university systems and controls to ensure that only allowable indirect costs were charged to the federal government; and

- Lax oversight on the part of cognizant federal agencies that were responsible for auditing particular universities.[88]

Remedial actions at the federal level included major revisions to enhance the guidance contained in OMB Circular No. A-21 and improved auditing procedures by the cognizant federal agencies. *See* McGuire, 23 J.C. & U.L. at 576–80.

Where a cost is not allowable, as far as the government is concerned, the recipient still has the funds. If the grant funds have already been paid over to the grantee and no allowable costs of an equal amount are subsequently incurred, the recipient is required to return the amount of the improper charge to the government. *E.g.*, *Utah State Board for Vocational Education v. United States*, 287 F.2d 713 (10th Cir. 1961). The United States "has a reversionary interest in the unencumbered balances of such grants, including any funds improperly applied." 42 Comp. Gen. 289, 294 (1962). *See also* B-198493, July 7, 1980. This requirement cannot be waived. B-171019, June 3, 1975. Thus, the Comptroller General has held that an agency cannot waive its statutory regulations to relieve a grantee of its liability for improper expenditures. B-163922, Feb. 10, 1978. Similarly, an agency may not amend its regulations to relieve a grantee's liability for expenditures for administrative costs in excess of a statutory limitation. B-178564, July 19, 1977, *aff'd*, 57 Comp. Gen. 163 (1977).

The courts have endorsed the principle that the federal government has a reversionary interest in grant funds until they are properly applied and accounted for. Citing *Buchanan v. Alexander*, 45 U.S. (4 How.) 20 (1846), one court observed that a federal agency "has a strong and surprisingly ancient claim for its right to require the repayment of all funds which cannot be proven to have been spent on legitimate, allowable costs." *City of New York v. Sullivan*, No. 91 Civ. 2959 (RWS), (S.D.N.Y. Jan. 4, 1993), slip op. at 11, *rev'd on other grounds sub nom.*, 34 F.3d 1161 (2nd Cir. 1994). The court elaborated on this point as follows:

> "Since federal money belongs to the federal government until actually spent on allowable costs, the [agency's]

[88] Two other GAO products dealing with this subject are *Federal Research: System for Reimbursing Universities' Indirect Costs Should be Reevaluated*, GAO/RCED-92-203 (Washington, D.C.: Aug. 26, 1992), and *Federally Sponsored Research: Indirect Costs Charged by Stanford University*, GAO/T-RCED-91-18 (Washington, D.C.: Mar. 13, 1991).

> decision—that the City must present source documentation which proves to [the agency's] satisfaction that the money was drawn down to cover . . . [appropriate costs] or else return the money to the federal government—is not capricious or arbitrary."

City of New York v. Sullivan, slip op. at 11. Other recent decisions applying the reversionary interest concept in different contexts are *In re Universal Security and Protection Service, Inc.*, 223 B.R. 88, 91–92 (Bankr. E.D. La. 1998); *In re Alpha Center, Inc.*, 165 B.R. 881, 884 (Bankr. S.D. Ill 1994); and *Department of Housing and Urban Development v. K. Capolino Construction Corp.*, No. 01 Civ. 390 (JGK), (S.D.N.Y. 2001), slip. op. at 4–6.

While not directed specifically at the problems described above, Congress enacted two laws during the 1990s to streamline, simplify, and thereby improve auditing and administration of federal assistance programs: the Single Audit Act Amendments of 1996, Pub. L. No. 104-156, 110 Stat. 1396 (July 5, 1996), amending 31 U.S.C. §§ 7501–7507, and the Federal Financial Assistance Management Improvement Act of 1999, Pub. L. No. 106-107, 113 Stat. 1486 (Nov. 20, 1999).[89]

GAO has continued to review issues relating to the appropriateness of grant costs and the processes by which they are determined. Examples include: *Grants Management: EPA Actions Taken against Nonprofit Grant Recipients in 2002*, GAO-04-383R (Washington, D.C.: Jan. 30, 2004); *Disadvantaged Students: Fiscal Oversight of Title I Could Be Improved*, GAO-03-377 (Washington, D.C.: Feb. 28, 2003); *Environmental Protection: EPA's Oversight of Nonprofit Grantees' Costs Is Limited*, GAO-01-366 (Washington, D.C.: Apr. 6, 2001); *Federal Research Grants: Compensation Paid to Graduate Students at the University of California*, GAO/OSI-99-8 (Washington, D.C.: June 22, 1999); *Department of Transportation: University Research Activities Need Greater Oversight*, GAO/RCED-94-175 (Washington, D.C.: May 13, 1994); and *Federal Research: Minor Changes Would Further Improve New NSF Indirect Cost Guidance*, GAO/RCED-93-140 (Washington, D.C.: June 3, 1993).

[89] These statutes are discussed in section C of this chapter. Public Law 104-156 was based in part on recommendations contained in GAO, *Single Audit: Refinements Can Improve Usefulness*, GAO/AIMD-94-133 (Washington, D.C.: June 21, 1994).

b. Grant Cost Cases

Grant cost cases are extremely difficult to categorize because what is allowable under one assistance program may not be allowable under another. Also, the cases frequently turn on complex accounting and factual issues that are unique to the particular case. Accordingly, summaries of a number of cases are given below with little further attempt to generalize. However, it is first important to describe one recurring theme that runs through most of the cases and often appears to have a decisive effect on the outcome: the high degree of judicial deference accorded to agency findings of fact and interpretations of the applicable statutes and regulations.

(1) Scope of judicial review

Grant cost cases typically come to the courts in the form of appeals from an agency determination that often follows an administrative hearing by an agency appeals board.[90] These court cases are generally governed by the judicial review provisions of the Administrative Procedure Act (APA), 5 U.S.C. §§ 701–706. Under the most relevant scope of review standards, an agency action will be sustained unless it is arbitrary, capricious, an abuse of discretion, not otherwise in accordance with law, procedurally flawed, or unsupported by substantial evidence. *See* 5 U.S.C. §§ 706(2)(A), (D), (E). Likewise, the courts will generally accord considerable deference to the agency's interpretation of the applicable statutes and regulations, although the precise extent of deference varies.[91] One recent grant cost case described the standards of review as follows:

> "Under the APA, we may set aside agency action only if it was arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law. The standard is a narrow one, and the reviewing court may not substitute its judgment for that of the agency. However, the agency must articulate a rational connection between the facts found and the conclusions made. Also, we must give substantial

[90] For example, a number of the court cases discussed below are appeals from decisions of the Department of Health and Human Services Departmental Appeals Board (DAB). According to the DAB's Web site, it hears disputes that may involve as much as $1 billion in grant funds annually. *See* www.hhs.gov/dab/background.html (last visited September 15, 2005).

[91] See Chapter 3, section B, for a general discussion of the extent of judicial deference to agency interpretations.

> deference to an agency's interpretation of its own regulations."

Public Utility District No. 1 of Snohomish County, Washington v. Federal Emergency Management Agency, 371 F.3d 701, 706 (9th Cir. 2004) (citations and internal quotation marks omitted).

Concerning the deference due agency regulatory interpretations, the court in *Public Utility District No. 1* cited *Thomas Jefferson University v. Shalala*, 512 U.S. 504 (1994). In *Thomas Jefferson University*, the Supreme Court sustained the agency's interpretation of a regulation dealing with the reimbursement of costs under the Medicare program, applying the following standards:

> "The APA . . . commands reviewing courts to hold unlawful and set aside agency action that is arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law. 5 U.S.C. § 706(2)(A). We must give substantial deference to an agency's interpretation of its own regulations. Our task is not to decide which among several competing interpretations best serves the regulatory purpose. Rather, the agency's interpretation must be given controlling weight unless it is plainly erroneous or inconsistent with the regulation. In other words, we must defer to the Secretary's interpretation unless an alternative reading is compelled by the regulation's plain language or by other indications of the Secretary's intent at the time of the regulation's promulgation."

512 U.S. at 512 (citations and internal quotation marks omitted).

Another grant cost case that also cited *Thomas Jefferson University* illustrates the decisive role that deference to agency interpretations can play. In *Alabama v. Shalala*, 124 F. Supp. 2d 1250 (M.D. Ala. 2000), the court acknowledged that both the grantee and the federal agency presented reasonable interpretations of the applicable cost criteria, but concluded that the agency's interpretation must take precedence since it was "reasonable and not arbitrary or capricious." *Id.* at 1259.

Of course, even an agency determination that might otherwise be within its discretion will be overturned if it is procedurally defective. For example, the court in *Arizona v. Thompson*, 281 F.3d 248 (D.C. Cir. 2002), did not

question the authority of the Department of Health and Human Services (HHS) to direct the allocation of common administrative costs among the multiple grant programs that they benefited, in accordance with a general principle in the then-current OMB Circular No. A-87 (Aug. 27, 1997), at Attachment A, § C.3.a. However, the court rejected the department's directive because it rested on the faulty premise that the Temporary Assistance for Needy Families (TANF) program statute mandated this cost allocation method:

> "[The] determination was made in reliance on HHS' mistaken belief that the statute gave it no choice in the matter. Although nothing we have said necessarily precludes HHS, in the exercise of its discretion, from relying on the principles of Circular A-87 to determine the most appropriate cost allocation rule to apply to TANF, that is not the course the Department followed in this case."

281 F.3d at 259. *See also Nebraska Department of Health & Human Services v. United States Department of Health & Human Services*, 340 F. Supp. 2d 1 (D.D.C. 2004) (rejecting a similar cost allocation directive on the basis that it constituted a substantive rule issued without the notice-and-comment rulemaking required by the Administrative Procedure Act).

(2) Court case examples

With the scope of review considerations in mind, we turn to some specific case examples.

Under the cost principles OMB Circular No. A-87, contributions to a reserve for self-insurance are an allowable grant cost if certain conditions are met. However, Alabama violated OMB Circular No. A-87 by transferring the federal share of excess self-insurance reserves from its state insurance fund to its general treasury fund to be used for purposes unrelated to the federal grants that supplied the insurance contributions. *Alabama v. Shalala*, 124 F. Supp. 2d 1250 (M.D. Ala. 2000), affirming a decision of the Department of Health and Human Services Departmental Appeals Board (DAB).[92] The court rejected Alabama's argument that appropriate costs

[92] The version of OMB Circular No. A-87 applicable to the transfers at issue was dated January 28, 1981. *Alabama*, 124 F. Supp. 2d at 1253, fn.2. The self-insurance reserve provision in that version was in Attachment B, § C.4(c). *Id.* at 1254.

were incurred, and the transaction was in effect complete once the grant funds were initially paid into the state insurance fund. Instead, the court held that the insurance contributions retained their character as federal funds and remained subject to OMB Circular No. A-87 until they were disbursed by the state insurance fund. *Id.* at 1257–60.[93] The court also rejected Alabama's argument that a subsequent amendment to Circular No. A-87 which specifically prohibited the transfer of the federal share of insurance contributions to other state funds demonstrated that such transfers were appropriate before the amendment. *Id.* at 1257, fn. 9 ("the amendments may have made more explicit requirements that had always existed under the cost principles and other sources of federal appropriations law").[94]

In a case very similar to *Alabama v. Shalala*, the court in *Oklahoma ex rel. Office of State Finance v. United States*, 292 F.3d 1261 (10th Cir. 2002), *cert. denied*, 537 U.S. 1188 (2003), affirmed the DAB's disallowance of a portion of federal contributions for the health benefits of state employees who administered federal programs. The disallowance was triggered by the state's transfer of the funds from an insurance reserve fund to a general fund to be used for state educational expenditures rather than state employee health benefits. The court held that the amended version of OMB Circular No. A-87 was dispositive and "singularly fatal" to the state's appeal:

> "OMB [Circular No.] A-87's definition of 'cost' excludes 'transfers to a general or similar fund.' . . . Federal monies forwarded to Oklahoma's Clearing Fund represent unrecoverable 'transfers to a general or similar fund.' Thus, there is no need to ascertain when federal money loses its federal nature, or even if the monies Oklahoma is attempting to be reimbursed for are necessary and reasonable expenditures. The money diverted to the Clearing Fund fails to qualify as a reimbursable cost in the first instance."

[93] In this regard, the court relied on *Pennsylvania Department of the Budget v. United States Department of Health & Human Services*, 996 F.2d 1505 (3rd Cir.), *cert. denied*, 510 U.S. 1010 (1993), discussed previously in section E of this chapter.

[94] The current version of OMB Circular No. A-87 (May 10, 2004) retains this prohibition at Attachment B, § 22.d(5) ("Whenever funds are transferred from a self-insurance reserve to other accounts (*e.g.*, general fund), refunds shall be made to the Federal Government for its share of funds transferred, including earned or imputed interest from the date of transfer.").

Oklahoma, 292 F.3d at 1264.

The Federal Emergency Management Agency (FEMA) acted reasonably in reducing a grantee's fringe benefit overhead reimbursement for overtime labor from a uniform rate of 36 percent to about 10 percent, which approximated the actual overtime labor costs to the grantee. *Public Utility District No. 1 of Snohomish County, Washington v. Federal Emergency Management Agency*, 371 F.3d 701 (9th Cir. 2004). The grantee utility district argued that FEMA was attempting to "rewrite" the grant conditions by reducing the reimbursement rate based on a post-award audit by the agency's inspector general since use of the 36 percent flat rate constituted a common accounting practice that was not prohibited by the grant terms. The court rejected this argument, holding that the language in OMB Circular No. A-87 making fringe benefits allowable costs "to the extent that the benefits are reasonable and are required by law" provided a basis for reducing the costs via a post-award audit:

> "We need not ponder whether the District's use of a uniform fringe benefit overhead rate is a 'proper' or commonly-accepted method of accounting for such expenses. This fact remains: the District has never challenged FEMA's contention that the District's actual fringe benefit expenses for overtime labor for work attributable to the 1995 and 1996 storms was about ten percent, as opposed to the thirty-six percent billed by the District.
>
> "The District's use of the thirty-six percent rate resulted in a sizable windfall—in excess of $600,000—for the District. That this windfall may have resulted from the District's use of an accepted accounting practice is of no consequence. . . . FEMA did not act in an arbitrary and capricious manner by challenging the District's use of the thirty-six percent fringe benefit rate, where the use of the rate resulted in FEMA paying District expenses having nothing to do with the disasters for which federal relief was given."

Public Utility, 371 F.3d at 710. The court also sustained FEMA's reduction of other costs reimbursed to the grantee based on the results of the inspector general audit, concluding that the disallowances were not arbitrary or capricious. *Id.* at 711–13.

The court affirmed a Department of Health and Human Services DAB decision upholding the denial of reimbursement for interest costs incurred by the state in acquiring computer equipment to be used to administer several social service programs partly funded by federal grants. *New York v. Shalala*, 959 F. Supp. 614 (S.D.N.Y. 1997), *aff'd*, 143 F.3d 119 (2nd Cir. 1998). Again, the court held that the disallowances constituted a valid application of the cost principles embodied in OMB Circular No. A-87 and, in turn, incorporated into Department of Health and Human Services regulations. Among other things,[95] the state argued that (1) the applicable statutes provided for reimbursement of "necessary" expenses, (2) interest was a necessary expense, and (3) therefore, the circular's exclusion of interest violated the statutes. However, the court held that, since the relevant statutes did not specifically address reimbursement of interest, the federal agencies had discretion to determine whether and to what extent interest constituted a "necessary" expense:

> "[The state's] . . . interpretation . . . may be as reasonable as the Secretary's; however, this is not the standard the Court applies in reviewing an agency's construction of a statute. Even where the State offers a reasonable alternative interpretation of a statute, the decision of where to 'draw the line' with respect to reimbursing costs is left to the discretion of the agency. HHS's interpretation of the Statutes need only be reasonable—it need not be the *only* reasonable interpretation."

New York, 959 F. Supp. at 620–21 (emphasis in original; citations omitted).

The court in *Delta Foundation, Inc. v. United States*, 303 F.3d 551 (5th Cir. 2002), affirmed a DAB decision that sustained a series of cost disallowances arising from an inspector general audit of community

[95] The state also argued, to no avail, that OMB lacked authority to prescribe government-wide cost principles and that the Department of Health and Human Services violated the notice and comment provisions of the Administrative Procedure Act in incorporating the circular into its own regulations. On the former point, the court stated:

> "OMB has been deemed 'the President's principal arm for the exercise of his managerial functions.' . . . One such managerial function is to provide federal agencies with consistent, government-wide policy guidance."

New York, 959 F. Supp. at 618. On the latter point, it observed that the state was on notice of the circular's provisions and failed to object to them for at least 20 years. *Id.* at 619.

development block grants. The case is quite fact-specific, but it illustrates the principles of deference to agency findings and interpretations discussed previously. It also demonstrates the importance of grantee compliance with record-keeping and cost-documentation requirements. For example, the court observed with reference to certain disallowed costs:

> "As the Board correctly noted, the Circular [OMB Circular No. A-122] requires that Delta supply time records reflecting 'the distribution of activity of each employee' and 'account for the total activity for which employees are compensated.' . . . The Board's refusal to accept Delta's 'good word' in place of the required documentation is certainly not arbitrary and capricious."

Delta Foundation, 303 F.3d at 570. *But see Institute for Technology Development v. Brown*, 63 F.3d 445, 454–58 (5th Cir. 1995) (decision is somewhat unusual since the court *rejected* the agency's determination that depreciation did not constitute an allowable cost under the applicable regulations and grant agreements, prompting a dissent criticizing the majority for not deferring to the agency on this point).

In *Missouri Department of Social Services v. United States Department of Education*, 953 F.2d 372 (8th Cir. 1992), the court affirmed the agency's right to recover excess salary costs paid to the grantee. The court agreed that the grantee did not maintain adequate accounting procedures and records to apportion its employees' salaries between time relating to the federal grants and time spent on nongrant activities, as required by federal regulations. The court also upheld the agency's determination that the grantee's circumstances did not meet the requirements of a regulation excusing the repayment of unallowable costs in the presence of "mitigating circumstances." *Id.* at 376.

Board of Trustees of Public Employees' Retirement Fund of Indiana v. Sullivan, 936 F.2d 988 (7th Cir. 1991), *cert denied*, 502 U.S. 1072 (1992), affirmed a decision by the DAB that the grantee was reimbursed excess payments for the retirement benefits of state employees who administered federal grant programs. An audit had determined that the state made retirement contributions on behalf of state employees administering federal grants that were greater than its contributions for state employees who performed only nonfederal activities and were wholly state funded. The court agreed that this violated the federal cost principle that, in order

to be allowable, a cost must be consistent with policies, regulations, and procedures that apply uniformly to both federally assisted and other activities of the grantee:

> "Whatever the state actually pays to state workers is the benchmark for measuring the federal government's share. Indiana pays its public workers partly in cash and partly in promises. Indiana is free to make that choice for itself but may not claim 100% in cash up front from the federal government if it is unwilling to put the retirement program for other state employees on an equivalently well-funded basis."

Sullivan, 936 F.2d at 992.

Litigation costs incurred by grantees in suing the United States were found unallowable under the Nuclear Waste Policy Act of 1982, 42 U.S.C. §§ 10101–10226. *Nevada v. Herrington*, 827 F.2d 1394 (9th Cir. 1987).

(3) GAO case examples

GAO has also had occasion over the years to consider grant cost issues. The following are examples of GAO decisions discussing various grant programs.

GAO held that the Asia Foundation may not use its general support grant funds from the Department of State to match other federal grants from the Agency for International Development and the United States Information Agency. Generally, funds derived from other federal grants do not qualify as matching funds unless statutorily authorized. The Asia Foundation does not have specific statutory authority to use grant funds to match other federal grants. B-270654, May 6, 1996.

Under applicable OMB Circulars, the cost of grant audits is an allowable cost. Therefore, the National Endowment for the Humanities could provide grant funds to nonprofit institutions to cover such audit costs, and could increase a grant award to accommodate such costs where the initial award was inadequate for this purpose. 72 Comp. Gen. 175, 177 (1993).

Recovery of antitrust damages by a state grantee stemming from a grant-financed project serves to reduce the actual costs of the grantee and must be accounted for to the government. This is true even where the United

States has declined to participate in the cost of the antitrust action. 57 Comp. Gen. 577 (1978). However, the United States is not entitled to share in treble damages. *Id.*; 47 Comp. Gen. 309 (1967). Out-of-pocket expenses incurred by the state in effecting the recovery should be shared by the federal government in the same proportion as the recovered damages. B-162539, Oct. 11, 1967.

Where a grantee paid a nondiscriminatory sales tax on otherwise proper expenditures with grant funds, the taxes are not taxes imposed on the United States and are allowable. 37 Comp. Gen. 85 (1957). However, property taxes were held not allowable under a construction grant because they represent operating costs rather than construction costs. B-166506, Feb. 14, 1973.

The payment of expert witness fees was found unrelated to the purposes of a research grant. 42 Comp. Gen. 682 (1963).

Construction of a bridge could not be paid for out of federal aid highway funds where the construction was necessitated by a flood control project and not as a highway project. 41 Comp. Gen. 606 (1962).

Buses acquired by a city under a "mass transportation" grant could be used for charter service, an unauthorized grant purpose, where such use was merely incidental to the primary use of the buses for authorized mass transit purposes. B-160204, Dec. 7, 1966.

The salary of an individual hired to evaluate the Upward Bound Program at a grantee college was disallowed as a grant cost, because the grant document contained no provision for such an expenditure and the applicable program guidelines specified that evaluation was not an allowable expense. B-161980, Nov. 23, 1971.

The cost of a luncheon for top officials of the Department of Human Resources, District of Columbia Government, was disallowed as an improper administrative expense under a social services program grant under Title XX of the Social Security Act, 42 U.S.C. § 1397a. B-187150, Oct. 14, 1976.

Ordinarily, increased project costs resulting from grantee negligence giving rise to justified claims for damages would not be allowable. However, a damage award was viewed as a recognizable cost element where the grantee's error had contributed to an unrealistically low initial cost, but an

amendment to the grant was required before the increased costs could be allowed. 47 Comp. Gen. 756 (1968).

Under a Federal Airport Act (Act of May 13, 1946, ch. 251, 60 Stat. 170) program providing for federal payment of a specified percentage of allowable project costs, the fair value of land and equipment donated to the grantee could be treated as an allowable cost because failure to do so would, in effect, penalize the grantee for the contributions of "public spirited citizens." B-81321, Nov. 19, 1948.

c. Note on Accounting

Cost principles on which a grant award is conditioned are binding on the grantee. B-203681, Sept. 27, 1982. It is the grantee's responsibility to maintain adequate fiscal records to support the allowable costs claimed. With respect to the common rules applicable to state and local governments, see generally 7 C.F.R. § 3016.20. Section 452(a) of the General Education Provisions Act, as amended, 20 U.S.C. § 1234a(a), illustrates the importance of compliance with record-keeping requirements. It provides that the Secretary of Education's burden of establishing a *prima facie* case for recovery of misspent grant funds is satisfied where the grantee fails to maintain records required by law or fails to afford the Secretary access to such records.

As a number of the cases discussed above demonstrate, the courts tend to require strict adherence to grantee cost documentation and record-keeping requirements. Thus, the court observed in *Montgomery County v. United States Department of Labor*, 757 F.2d 1510, 1512–13 (4th Cir. 1985):

> "[T]he County contends that it is inequitable to equate its record-keeping failure with a misspending of federal monies and to require it to repay virtually all of the funds expended by its subgrantee . . . In support of its contention, the County asserts that the purposes of CETA [the Comprehensive Employment and Training Act] were met by [the subgrantee's] performance and cites corrective steps which the County has since taken. . . . We are unpersuaded.
>
> * * * * *
>
> "Record keeping is at the heart of the federal oversight and evaluation provisions of CETA and its implementing regulations. Only by requiring documentation to support

> expenditures is the [Department of Labor] able to verify that billions of federal grant dollars are spent for the purposes intended by Congress. Unless the burden of producing the required documentation is placed on recipients, federal grantees would be free to spend funds in whatever way they wished and obtain virtual immunity from wrongdoing by failing to keep required records. Neither CETA nor the regulations permit such anomalous results."

The above passage was quoted with approval in *Louisiana Department of Labor v. United States Department of Labor*, 108 F.3d 614, 618 (5th Cir.), *cert. denied*, 522 U.S. 823 (1997). The court in this case reached a similar result, adding:

> "We conclude that the final decision of the Secretary is based on substantial evidence, and that the state and the [grantee] and its subgrantees cavalierly disregarded the accounting requirements and procurement procedures specified by the JTPA [Job Training Partnership Act] and the accompanying regulations. Federal grant recipients who are entrusted with public funds are bound to fulfill that public trust by discharging their duties in strict compliance with the requirements established by Congress. Accordingly, we emphasize that the procedural requirements of the JTPA are not merely hortatory ideals; they are obligatory duties. Grant recipients who . . . fail to honor these procedural requirements, dishonor and disserve the public trust."

108 F.3d at 620. *See also City of Newark v. United States Department of Labor*, 2 F.3d 31, 34–35 (3rd Cir. 1993), to the same effect.

In one case, GAO did concur in a proposal by a grantor agency to adopt a method of calculation that disallowed less than the entire amount of a grant where the grantee had maintained inadequate records. B-186166, Aug. 26, 1976. In this case, a university had received a series of federal research grants spanning a number of years. The university had no records to document its disposition of grant funds for periods prior to fiscal year 1974. Audits of available university records for grant expenditures in fiscal years 1974 and 1975 disclosed certain unallowable costs. The GAO decision held that the grantor agency had discretion to disallow the same proportion of

funds for the years for which no documentation was available as were disallowed for the periods for which records existed.

In a variety of cases involving the Medicare and Medicaid programs, courts have approved cost reimbursement disallowances on the basis of error rate statistical data, such as errors imputed from a quality control system. In *Georgia v. Califano*, 446 F. Supp. 404, 409–10 (N.D. Ga. 1977), the court upheld the determination of overpayments under the Medicaid program on the basis of statistical sampling, in view of the "practical impossibility" of individual claim-by-claim audit. The court also noted that, under the pertinent federal regulations, the state was given the opportunity to present evidence before the disallowance became final. *See also Ratanasen v. California Department of Health Services*, 11 F.3d 1467, 1469–71 (9th Cir. 1993); *Chaves County Home Health Service, Inc. v. Sullivan*, 931 F.2d 914 (D.C. Cir. 1991), *cert. denied*, 502 U.S. 1091 (1992); *Webb v. Shalala*, 49 F. Supp. 2d 1114, 1123 (W.D. Ark. 1999) and cases cited. Likewise, random sampling has been sustained as an audit technique to identify improper expenditures of vocational rehabilitation grant funds. *Michigan Department of Education v. United States Department of Education*, 875 F.2d 1196, 1205 (6th Cir. 1989) ("audit of the thousands of cases comprising the universe of cases would be impossible. . . . [and] . . . a final determination is not made until the state has had an opportunity to present its own evidence of an error in the audit").

In *Maryland v. Mathews*, 415 F. Supp. 1206 (D.D.C. 1976), a case involving the then Aid to Families with Dependent Children program, the court held that an agency can establish by regulation a withholding of federal financial participation in a specified amount set by a tolerance level, as long as the tolerance level is reasonable and supported by an adequate factual basis. The regulation involved in the specific case, however, did not meet the test and was found to be arbitrary and therefore invalid. It also has been held that, if setting a tolerance level is discretionary, the agency can set it at zero. *Maryland Department of Human Resources v. United States Department of Health & Human Services*, 762 F.2d 406 (4th Cir. 1985); *California v. Settle*, 708 F.2d 1380 (9th Cir. 1983). See also *United States v. Texas*, 507 U.S. 529 (1993), which involved statutory and regulatory provisions that required states to reimburse the federal government for a portion of the replacement costs of lost or stolen food stamps exceeding specified tolerance levels. (The validity of these requirements was not contested in this case.)

2. Pre-Award Costs (Retroactive Funding)

"Retroactive funding" means the funding of costs incurred by a grantee before the grant was awarded. Three separate situations arise: (1) costs incurred prior to award but after the program authority has been enacted and the appropriation became available; (2) costs incurred prior to award and after program authority was enacted but before the appropriation became available; and (3) costs incurred prior to both program authority and appropriation availability.

Situation (1): In this situation, the grantee seeks to charge costs incurred before the grant was awarded (in some cases even before the grantee submitted its application) but after both the program legislation and the implementing appropriation were enacted.

There is no rule or policy that generally restricts allowable costs to those incurred after the award of a grant. However, agencies may adopt such a policy by regulation. B-197699, June 3, 1980. Thus, in a number of cases, grant-related costs incurred prior to award, but after the program was authorized and appropriated funds were available for obligation, have been allowed where (a) there was no contrary indication in the language or legislative history of the program statute or the appropriation, (b) allowance was not prohibited by the regulations of the grantor agency, and (c) the agency determined that allowance would be in the best interest of carrying out the statutory purpose. 32 Comp. Gen. 141 (1952); 31 Comp. Gen. 308 (1952); B-197699, June 3, 1980; B-133001, Mar. 9, 1979; B-75414, May 7, 1948. (The above criteria are not specified as such in any of the cases cited but are derived from viewing all of the cases as a whole.)

Situation (2): In this situation, pre-award costs are incurred after program legislation has been enacted, but before an appropriation becomes available.

Prior to the Comptroller General's decision in 56 Comp. Gen. 31 (1976), a "general rule" was commonly stated to the effect that absent some indication of contrary intent, an appropriation could not be used to pay grant costs where the grantee's obligation arose before the appropriation implementing the enabling legislation became available. 45 Comp. Gen. 515 (1966); 40 Comp. Gen. 615 (1961); 31 Comp. Gen. 308 (1952); A-71315, Feb. 28, 1936.

In 56 Comp. Gen. 31, the Comptroller General reviewed the earlier decisions and concluded that there was no legal requirement for a general rule prohibiting the use of grant funds to pay for costs incurred prior to the

availability of the applicable appropriation. Rather, the determination should be made on a case-by-case basis. Thus, the decision announced:

> "We would prefer to base each decision from now on on the statutory language, legislative history, and particular factors operative in the particular case in question, rather than on a general rule."

Id. at 35.

In reviewing the earlier decisions, the Comptroller General found that each had been correctly decided on its own facts. Thus, retroactive funding was prohibited in 40 Comp. Gen. 615 (1961), 31 Comp. Gen. 308 (1952), and A-71315, Feb. 28, 1936. However, in each of those cases, there was some manifestation of an affirmative intent that funds be used only for costs incurred subsequent to the appropriation. For example, 31 Comp. Gen. 308 concerned grants to states under the Federal Civil Defense Act.[96] The committee reports and debates on a supplemental appropriation to fund the program contained strong indications that Congress did not intend that the money be used to retroactively fund expenses incurred by states prior to the appropriation. By way of contrast, there were no such indications in the situation considered in 56 Comp. Gen. 31 (matching funds provided to states under the Land and Water Conservation Fund Act of 1965[97]). Accordingly, 56 Comp. Gen. 31 did not overrule the earlier decisions, but merely modified them to the extent that GAO would no longer purport to apply a "general rule" in this area.

In determining whether retroactive funding is authorized, relevant factors are evidence and clarity of congressional intent, the degree of discretion given the grantor agency, and the proximity in time of the cost being incurred to the grant award. As in Situation (1), significant factors also include the agency's own regulations and the agency's determination that funding the particular costs in question will further the statutory purpose. Accordingly, the authority will be easier to find where an agency has broad discretion and favorable legislative history. With this approach, retroactive funding authority may be found to exist (as in 56 Comp. Gen. 31), or not to exist (as in 40 Comp. Gen. 615).

[96] Pub. L. No. 81-920, 64 Stat. 1245 (Jan. 12, 1951).

[97] Pub. L. No. 88-578, 78 Stat. 897 (Sept. 3, 1964).

If an agency wishes to recognize retroactive funding in limited situations in its regulations, it must, in order to avoid potential Antideficiency Act problems, make it clear that no obligation on the part of the government can arise prior to the availability of an appropriation. Of course, the grant itself cannot be made until the appropriation becomes available. 56 Comp. Gen. at 36.

Situation (3): In this situation, the grantee seeks to charge costs incurred not only before the appropriation became available, but also before the program authority was enacted.

Costs incurred prior to both the program authorization and the availability of the appropriation may generally not be funded retroactively. *See* 56 Comp. Gen. 31 (1976); 32 Comp. Gen. 141 (1952); B-11393, July 25, 1940. GAO recognizes that there may possibly be exceptions even to this rule (56 Comp. Gen. at 35), but thus far there are no decisions identifying any.

One final situation deserves mention. In each of the retroactive funding cases cited above, the grant was in fact subsequently awarded. In B-206244, June 8, 1982, a state had applied for an Interior Department grant under the Youth Conservation Corps Act, 16 U.S.C. §§ 1701–1706 (1976), and later withdrew its application due to funding uncertainties. The state then filed a claim for various expenses it had incurred in anticipation of the grant. GAO held that payment would violate both the program legislation and the purpose statute, 31 U.S.C. § 1301(a). Interior's appropriation was intended to accomplish grant purposes, but the state's expenses did not accomplish any grant purposes since the grant was never made.

H. Recovery of Grantee Indebtedness

1. Government's Duty to Recover

This section is intended to summarize the application of "debt collection law" in the context of assistance programs, and to highlight a few issues in which the fact that a grant is involved may be of special relevance.[98]

Claims in favor of the United States against an assistance recipient may arise for a variety of reasons. As a general proposition, it has been the view of both GAO and the executive branch that the United States has not only a right but a duty to recover amounts owed to it, and that this duty exists without the need for specific statutory authority. This applies to assistance recipients just as it would apply to other debtors. The Federal Claims Collection Standards require each agency to "aggressively collect all debts arising out of activities of, or referred or transferred for collection services to, that agency." 31 C.F.R. § 901.1(a) (2005).[99] *See, e.g.*, 7 C.F.R. § 3016.52(a) (the Department of Agriculture's common rule on collection of amounts due):

> "Any funds paid to a grantee in excess of the amount to which the grantee is finally determined to be entitled under the terms of the award constitute a debt to the Federal Government. If not paid within a reasonable period after demand, the Federal agency may reduce the debt by:
>
> "(1) Making an administrative offset against other requests for reimbursements,

[98] The General Accounting Office Act of 1996, Pub. L. No. 104-316, 110 Stat. 3826 (Oct. 19, 1996), transferred the Comptroller General's claims settlement authority, and related authorities, to the executive branch. Thus, executive branch agencies are now primarily responsible for prescribing guidance on claims collection matters. *See* B-303906, Dec. 7, 2004, at 2.

[99] As part of the transfer of claims-related functions referenced in the preceding footnote, the Attorney General and the Secretary of the Treasury now prescribe the Federal Claims Collection Standards. *See* 31 U.S.C. § 3711(d)(2); 31 C.F.R. § 900.1(a).

"(2) Withholding advance payments otherwise due to the grantee, or

"(3) Other action permitted by law."

For example, grant funds erroneously awarded to an ineligible grantee must be recovered by the agency responsible for the error, including expenditures the grantee incurred before receiving notice that the agency's initial determination had been made in error. 51 Comp. Gen. 162 (1971); B-146285, B-164031, Apr. 19, 1972. The cited decisions recognize that there might be exceptional circumstances in which full recovery might not be required, but exceptions would have to be considered on an individual basis. *See also* 18 Op. Off. Legal Counsel 74, 76 (1994) ("In the . . . context of federal grants to state and local agencies, courts have stated that the federal government may use principles of restitution to recover monies that were granted for specific purposes and then used in contravention of those purposes, even in the absence of statutory authority expressly permitting such recovery.").

In a recent case, federal grant funds given by the U.S. Department of Labor to the New York Workers' Compensation Board to meet its expenses related to the September 11, 2001, terrorist attack on the World Trade Center were improperly transferred by the Board to other New York State entities. B-303927, June 7, 2005. Despite the fact that both the Department and the Board contributed to the misunderstandings that resulted in the payments to the other entities, GAO concluded that the Department should seek recovery of the funds improperly transferred unless the Secretary of Labor seeks and obtains congressional ratification of the grant expenditures to date. *Id*. at 10.

Similarly, where an agency misapportions formula grant funds so that some states receive excess funds, the excess must be recovered. If the misapportionment resulted in other states receiving less than their formula amount, the apportionments of all of the states involved must be appropriately adjusted. B-275490, Dec. 5, 1996, at fn. 10; 41 Comp. Gen. 16 (1961).

Courts have upheld the authority of federal agencies to seek recovery of assistance payments where the grantee has not used those payments for authorized purposes within a prescribed period or where the grantee has not accounted for the funds within a reasonable period of time. In *Mayor and City Council of Baltimore v. Browner*, 866 F. Supp. 249 (D. Md. 1994),

the court rejected the city's challenge to the Environmental Protection Agency's authority to impose cut-off dates for use of grant funds for construction of sewage treatment facilities:

> "The City argues that the imposition of cut-off dates is inappropriate absent specific authority in the Clean Water Act, the regulations pertaining to the administration of grants, or the terms of the grant offer or acceptance forms. However the presence of project period start and finish dates on each grant award and the repeated references throughout the regulations to time limits and schedules for grant-funded projects anticipate such actions. . . .
>
> "Although the establishment of cut-off dates is not explicitly provided for in the relevant regulations, they are obviously implied and required to lend force to the provisions regulating the timing of grant-funded projects. Otherwise, the establishment of time limits would be a meaningless exercise for grantor and grantee. EPA must have a method to attain reimbursement of funds already disbursed when a project exceeds its time limit. Cut-off dates are simply the enforcement of the limits specifically provided for in the regulations in the context of grant funds disbursed proactively. The regulations in question are not 'arbitrary, capricious, or manifestly contrary' to [the Clean Water Act] and a policy of imposing cut-off dates for grant funding is not invalid."

866 F. Supp. at 251–52 (footnotes omitted).

City of New York v. Shalala, 34 F.3d 1161 (2nd Cir. 1994), concerned Head Start grant funds paid to the city and distributed by the city to its constituent agencies over a period of years but which the constituent agencies had not yet disbursed for valid program purposes. The Department of Health and Human Services eventually disallowed these accumulated balances. The Departmental Appeals Board sustained the department's disallowances. The Head Start statute did not specifically empower the department to disallow accumulated balances on the basis of their age and lack of documentation that the funds had been properly disbursed. *City of New York*, 34 F.3d at 1166–67. Nevertheless, the court held that the department "acted reasonably in deciding that, after a certain period of time, the City was no longer entitled to postpone its accounting

obligations." *Id.* at 1168. The court also rejected the city's argument that the department could not apply a rule treating accounts receivable as bad debt once they became more than two years old. *Id.* at 1170.

Where, under an assistance program, the government is authorized or required to recover funds for whatever reason, the Federal Claims Collection Act of 1966, as amended, 31 U.S.C. §§ 3711–3720E,[100] and the joint Treasury Department-Justice Department implementing regulations (Federal Claims Collection Standards, 31 C.F.R. parts 900–904) apply unless the program legislation under which the claim arises or some other statute provides otherwise. *See* 31 C.F.R. § 900.1(a).

Indebtedness to the United States may also result from the misuse of grant funds. *E.g.*, *Utah State Board for Vocational Education v. United States*, 287 F.2d 713 (10th Cir. 1961); *Mass Transit Grants: Noncompliance and Misspent Funds by Two Grantees in UMTA's New York Region*, GAO/RCED-92-38 (Washington, D.C.: Jan. 23, 1992). The cases usually arise when the grantor agency disallows certain costs. Here again the government's position has been that the right to recover exists independent of statute, supplemented or circumscribed by any statutory provisions that may apply. *See*, *e.g.*, B-198493, July 7, 1980; B-163922, Feb. 10, 1978. As discussed hereafter, the government's right to recover has come under attack by recipients, particularly during the 1980s, but such attacks rarely succeed.

What we present here is by no means an exhaustive cataloguing of the cases. Our selection is designed to serve three purposes: (1) summarize what the law appears to be as of the date of this publication; (2) reflect any discernible trends; and (3) point out some issues that may be of more general relevance. As a general proposition, the courts have looked first to the program legislation and usually have concluded that adequate authority to support the government's right of recovery can be found in, or deduced from, the enabling statute.

The cases we selected for purposes of illustration are drawn largely from two massive grant programs (perhaps more accurately described as collections of programs) that have operated in various forms and under

[100] Major amendments to the original 1966 Act were made by the Debt Collection Act of 1982, Pub. L. No. 97-365, 96 Stat. 1749 (Oct. 25, 1982), and the Debt Collection Improvement Act of 1996, Pub. L. No. 104-134, 110 Stat. 1321, 1321-358 (Apr. 26, 1996).

many statutory iterations for decades: Title I of the Elementary and Secondary Education Act (ESEA), and the Comprehensive Employment and Training Act (CETA).[101] Both of these programs have undergone extensive legislative changes over the years. The most recent major amendments to ESEA were enacted by the No Child Left Behind Act of 2001, Pub. L. No. 107-110, 115 Stat. 1425 (Jan. 8, 2002). CETA was replaced in 1982 by the Job Training Partnership Act, Pub. L. No. 97-300, 96 Stat. 1322 (Oct. 13, 1982). The most recent major amendments to this program were enacted by the Workforce Investment Act of 1998, Pub. L. No. 105-220, 112 Stat. 936 (Aug. 7, 1998). We chose these programs because they both generated a large volume of litigation on a variety of relevant topics. Apart from whatever value specific cases may have by analogy to other programs, the material illustrates the kinds of issues that have arisen and the approach the courts, including the Supreme Court, have taken in resolving them.

ESEA included a provision, very common in grant program legislation, requiring the states to provide adequate assurances to the Department of Education that grant funds would be used only on qualifying programs. In addition, the law was amended in 1978 to give the Secretary of Education explicit authority to direct the repayment of misspent grant funds from non-ESEA sources. 20 U.S.C. § 2835(b) (1982).[102] Prior to this amendment, the statute had provided simply that payments under Title I shall take into account the extent to which any previous payment to the same state was greater or less than it should have been.

Two states argued that the 1978 amendments did not apply to misspent funds prior to 1978, and that the government's sole remedy with respect to pre-1978 funds was to withhold future grant funds, in which event the state would simply undertake a smaller Title I program. The government argued that the right to recover existed both under the pre-1978 law and under the common law. The Supreme Court held that the pre-1978 version of the law clearly gave the government the right to recover misspent funds. *Bell v.*

[101] The original source of Title I of ESEA was the Elementary and Secondary Education Act of 1965, Pub. L. No. 89-10, 79 Stat. 27 (Apr. 11, 1965). CETA was originally enacted as the Comprehensive Employment and Training Act of 1973, Pub. L. No. 93-203, 87 Stat. 839 (Dec. 28, 1973).

[102] *See* 20 U.S.C. § 7844 for current provisions governing grantee assurances, and 20 U.S.C. §§ 1234a–1234b for provisions dealing with recovery of misused grant funds.

New Jersey, 461 U.S. 773 (1983). The pre-1978 language in question provided that ESEA payments—

> "shall take into account the extent (if any) to which any previous payment to such State educational agency under this title (whether or not in the same fiscal year) was greater or less than the amount which should have been paid to it."

Pub. L. No. 89-10, § 207(a)(1). The Court held that the plain terms of this language as well as its legislative history recognized the federal government's right to recover misused funds. It rejected as "no more than remotely plausible" the state's alternative interpretation that this language merely authorized the government to reduce future grants. The Court described the consequences of the state's interpretation, which it clearly considered untenable, as follows:

> "[T]he Federal Government recovers nothing: it pays less, but it receives correspondingly less in the way of Title I programs. Under that reading, the State would have no liability to the Federal Government for misspent funds."

Bell, 461 U.S. at 783, fn. 8. Apart from the holding itself and its significance with respect to any program statutes with similar language,[103] two other points from this decision are noteworthy:

- The existence and amount of the state's debt are to be determined administratively by the agency in the first instance, subject to judicial review. *Id.* at 791–92. (This is the same approach used in the Federal Claims Collection Standards for debt collection generally.)

- Because the Court found adequate authority in the statute, it declined to rule on the existence of a common-law right. *Id.* at 782 n.7.

In a 1981 case, a lower court had found a common-law right of recovery along with the ESEA statutory right. *West Virginia v. Secretary of Education*, 667 F.2d 417 (4th Cir. 1981). A 1987 case also upheld the

[103] The court in *Ledbetter v. Shalala*, 986 F.2d 428, 433–34 (11th Cir.), *cert. denied*, 510 U.S. 1010 (1993), followed *Bell*, holding that substantively identical language in the Older Americans Act (42 U.S.C. § 3029(a)) likewise conferred a right to recover misspent grant funds.

government's common-law right of recovery, at least to the extent of overallocations or other erroneous payments. *California Department of Education v. Bennett*, 829 F.2d 795, 798 (9th Cir. 1987).

Two years after *Bell*, the Supreme Court considered another issue arising from the same litigation and held that the 1978 amendments to ESEA were not retroactive for purposes of determining whether funds had been misspent. *Bennett v. New Jersey*, 470 U.S. 632 (1985). What is important here is the more general rule the Court announced, namely, that substantive rights and obligations under federal grant programs are to be determined by reference to the law in effect when the grants were made. *Id.* at 638–41.

The Court also rejected an argument that recovery would be inequitable because the state acted in good faith. The role of the reviewing court is to determine if the proper legal standards are applied. If they are, a court has "no independent authority to excuse repayment based on its view of what would be the most equitable outcome." *Id.* at 646. In any event, said the Court, "we find no inequity in requiring repayment of funds that were spent contrary to assurances provided by the State in obtaining the grants." *Id.* at 645.

In *Bennett v. Kentucky Department of Education*, 470 U.S. 656 (1985), decided on the same day as *Bennett v. New Jersey*, the Court reaffirmed the government's right of recovery under ESEA Title I:

> "The State gave certain assurances as a condition for receiving the federal funds, and if those assurances were not complied with, the Federal Government is entitled to recover amounts spent contrary to the terms of the grant agreement."

470 U.S. at 663. The Court further concluded that neither "substantial compliance" by the state nor the absence of bad faith would absolve the state from its liability. *Id.* at 663–65. See also B-229068-O.M., Dec. 23, 1987, applying Kentucky to grants under Title V of the Surface Mining Control and Reclamation Act of 1977.[104] Other cases likewise hold that general equitable considerations cannot override specific agreements and

[104] Pub. L. No. 95-87, 91 Stat. 445, 467 (Aug. 3, 1977).

regulations governing grant transactions. *E.g.*, *Missouri Department of Social Services v. United States Department of Education*, 953 F.2d 372, 375–76 (8th Cir. 1992); *Maine v. Shalala*, 81 F. Supp. 2d 91 (D. Me. 1999). In the latter case, the court observed:

> "Boiled down, Plaintiff contends that to allow the federal government to recover its overpayments in fiscal years 1993 and 1994, while denying the State its proposed offset for federal contributions that should have been made relative to the State's supplemental contributions from 1982 through 1993, is simply unfair. . . .
>
> "Principles of equity and fairness must, and do, play a fundamental role in our system of justice. . . . But the principle of fairness cannot be the beginning, middle, and end of a legal analysis, especially in a case such as this where the transactions at issue are specifically and intricately governed by regulations and statutes. This is not a contract dispute between two lay people. This is a highly-regulated, complex legal transaction between a state and the federal government. In that light, [the state's] reliance on 'broad, nontechnical principles of substantive fairness and equity' rings hollow."

81 F. Supp. 2d at 95. *See also Maryland Department of Human Resources v. United States Department of Agriculture*, 976 F.2d 1462, 1480–81 (4th Cir. 1992).

One point in *Bell* seems to have generated some uncertainty. The Court noted that the Secretary "has not asked us to decide what means of collection are available to him, but only whether he is a creditor. Since the case does not present the issue of available remedies, we do not address it." *Bell*, 461 U.S. at 779 n.4. Thus, the Court did not approve or disapprove of any particular remedy. This led one court to conclude that the Bell analysis requires two separate questions: whether the federal government has a right of recovery and, if so, what remedies are available to it. *Maryland Department of Human Resources v. United States Department of Health & Human Services*, 763 F.2d 1441, 1455 (D.C. Cir. 1985) (holding that government has statutory right of recovery under Title XX of Social

Security Act[105]). However, another court expressed doubt over the existence of such a dichotomy, construing the Supreme Court's silence in *Bennett v. Kentucky Department of Education* as approval of the means of recovery employed in that case, a direct repayment order. *St. Regis Mohawk Tribe v. Brock*, 769 F.2d 37, 49 n.16 (2nd Cir. 1985), *cert. denied*, 476 U.S. 1140 (1986) (right of recovery under Comprehensive Employment and Training Act). The *St. Regis* court went on to conclude that "Congress left it to the Secretary to establish additional remedial procedures, consistent with the purposes of the legislation, to insure compliance by prime sponsors." 769 F.2d at 50.

Another group of cases involves the former CETA program. There is a strong parallel to the ESEA cases in that the original CETA included general authority to adjust payments to reflect prior overpayments or underpayments, and was amended in 1978 to explicitly authorize the Secretary of Labor to recover misspent funds by ordering repayment from non-CETA funds.[106] Essentially following *Bell*, a rather long line of cases upheld the Labor Department's right, under the pre-1978 CETA, to recover misspent funds and to do so by directing repayment from non-CETA funds. *City of Gary v. United States Department of Labor*, 793 F.2d 873 (7th Cir. 1986); *St. Regis Mohawk Tribe*, *supra; Mobile Consortium v. United States Department of Labor*, 745 F.2d 1416 (11th Cir. 1984); *California Tribal Chairman's Association v. United States Department of Labor*, 730 F.2d 1289 (9th Cir. 1984); *North Carolina Commission of Indian Affairs v. United States Department of Labor*, 725 F.2d 238 (4th Cir.), *cert. denied*, 469 U.S. 828 (1984); *Texarcana Metropolitan Area Manpower Consortium v. Donovan*, 721 F.2d 1162 (8th Cir. 1983); *Lehigh Valley Manpower Program v. Donovan*, 718 F.2d 99 (3rd Cir. 1983); *Atlantic County v. United States Department of Labor*, 715 F.2d 834 (3rd Cir. 1983).

The *St. Regis* (769 F.2d at 47), *California Tribal* (730 F.2d at 1292), and *North Carolina* (725 F.2d at 240) courts, as had the Supreme Court in *Bell*, declined to comment on the existence of a common-law right of recovery. The *Texarcana* court noted that its decision was consistent with prior decisions recognizing the common-law right. 721 F.2d at 1164. None of the cases purported to deny that right. More recently, the court in *Harrod v.*

[105] 42 U.S.C. §§ 1397–1397f.

[106] See 29 U.S.C. § 2934(c)–(d) for the current version of this authority.

Glickman, 206 F.3d 783, 789 (8th Cir. 2000), similarly endorsed the federal government's broad authority to recover improper payments:

> "The appellants also contend that the agency's attempt to seek reimbursement of their disaster relief payments in 1994 was untimely, because the agency action was final when the government paid the benefits in 1989, and the agency had no authority to seek reimbursement years after a final agency action. We disagree.
>
> "We have long held that the common law permits the government to recover funds that its agents wrongfully or erroneously paid, even absent specific legislation authorizing the recovery. *See Collins v. Donovan*, 661 F.2d 705, 708 (8th Cir.1981); *see also Texarkana Metro. Area Manpower Consortium v. Donovan*, 721 F.2d 1162, 1164 (8th Cir. 1983). The Supreme Court has stated, 'Ordinarily, recovery of Government funds, paid by mistake to one having no just right to keep the funds, is not barred by the passage of time.' *United States v. Wurts*, 303 U.S. 414, 416, 58 S. Ct. 637, 82 L. Ed. 932 (1938). The government's right to recover funds paid out erroneously 'is not barred unless Congress has clearly manifested its intention to raise a statutory barrier.' *Id.*"

The court also held that estoppel ordinarily will not apply against the federal government in the absence of affirmative evidence of misconduct. *Harrod*, 206 F.3d at 789.

Another group of CETA cases concerned a provision which required the Secretary of Labor to investigate any complaint alleging improprieties and to issue a final determination not later than 120 days after receiving the complaint. The consequences of failing to meet the 120-day deadline became a hotly litigated issue. The lower courts split, some holding that failure to meet the deadline barred the Labor Department from attempting to recover misused funds, while others held that the failure did not bar further action. Using an analysis which should be useful in a variety of situations, the Supreme Court resolved the conflict in *Brock v. Pierce County*, 476 U.S. 253 (1986), holding that the mere use of the word "shall" in the statute did not remove the power to act after 120 days.

An additional CETA case that deserves mention is *Board of County Commissioners v. United States Department of Labor*, 805 F.2d 366 (10th Cir. 1986). In that case, the court held that funds embezzled by an employee of a CETA grantee are "misspent" for purposes of the government's right of recovery. The grantee had argued that the funds were not "misspent" because it had never spent them. "No CETA regulation lists embezzlement as an allowable cost," rejoined the court. *Id.* at 368.

Finally, three cases dealing with the transition between CETA and the statute that immediately followed it—the Job Training Partnership Act (JTPA)—further illustrate judicial support for the federal government's right to recover misspent funds. The JTPA contained language stating that its provisions "shall not affect administrative or judicial proceedings . . . begun between October 13, 1982 and September 30, 1984," under CETA. 29 U.S.C. § 1591(e) (1988). Several CETA grantees argued that this language barred recovery of misspent CETA grant funds unless administrative or judicial proceedings were begun prior to September 30, 1984. This argument drew a decidedly chilly response from the courts. The opinion in *City of Newark v. United States Department of Labor*, 2 F.3d 31, 34 (3rd Cir. 1993) was typical:

> "We can identify no basis for adopting this convoluted construction of the statute. In particular, Newark has called our attention to no provision in the JTPA that would, indeed, bar the Secretary from recovering misspent funds, and which would thereby 'affect' administrative proceedings commenced after September 30, 1984 in the manner Newark suggests. In the absence of any such JTPA provision, we cannot merely presume that Congress used the word 'affect' to mean 'bar' or 'preclude.'
>
> "Indeed, it would appear, to the contrary, that Congress in no way intended the passage of the JTPA to hinder the Secretary's efforts to recoup misspent or mismanaged funds granted under CETA."

The court went on to cite congressional committee reports expressing concern over the abuse of CETA funds and the need to recover them. The courts reached the same result in *Inland Manpower Association v. Department of Labor*, 882 F.2d 343 (9th Cir. 1989), and *St. Clair County*

CETA, *Michigan v. United States Department of Labor*, No. 89-3829 (6th Cir. 1990).[107]

Where does all this leave us? Certainly the government's right to recover under programs with statutory provisions similar to the former ESEA Title I and CETA programs would seem to be settled. In more general terms, several lower courts have recognized the government's basic right to recover under the common law.[108] While the Supreme Court declined to address the common law issue in *Bell*, its later decision in *West Virginia v. United States*, 479 U.S. 305 (1987) seems instructive.

The issue in *West Virginia* was whether the United States could recover "prejudgment interest on a debt arising from a contractual obligation to reimburse the United States for services rendered by the Army Corps of Engineers." 479 U.S. at 306. Applying federal common law, a unanimous Supreme Court held that it could.[109] While this was not a grant case nor was the government's right to collect the underlying debt in dispute, it would not seem to require a huge leap in logic to infer a recognition of an inherent right in the government to recover amounts owed to it.

In sum, the government's assertion of an inherent (*i.e.*, common law) right to recover sums owed to it under assistance programs thus far has withstood assault. The issue may be largely moot at this juncture, however, since the courts invariably find a right to recover in the provisions of the applicable statutes, regulations, and/or grant agreements.

[107] These courts also noted that, in any event, audits had commenced before September 30, 1984, and held that administrative proceedings were "begun" for purposes of the statute once audits were initiated.

[108] See, in addition to the cases cited in the text, *Tennessee v. Dole*, 749 F.2d 331, 336 (6th Cir. 1984), *cert. denied*, 472 U.S. 1018 (1985) (Federal-Aid Highway Act); *Woods v. United States*, 724 F.2d 1444 (9th Cir. 1984) (Food Stamp Act); *Mount Sinai Hospital v. Weinberger*, 517 F.2d 329 (5th Cir. 1975), *cert. denied*, 425 U.S. 935 (1976) (Medicare); *Pennsylvania Department of Transportation v. United States*, 643 F.2d 758, 764 (Ct. Cl.), *cert. denied*, 454 U.S. 826 (1981) (Federal-Aid Highway Act).

[109] In a subsequent case, *United States v. Texas*, 507 U.S. 529 (1993), the Court addressed an issue left open in *West Virginia* and held that the Debt Collection Act did not limit the government's common law right to seek pre-judgment interest.

2. Offset and Withholding of Claims Under Grants

Offset and withholding are two closely related remedies. While the terms are sometimes used interchangeably, they are not the same. Offset, in the context of grantee indebtedness, refers to a reduction in grant payments to a grantee who is indebted to the United States where the debt arises under a separate assistance program or is owed to an agency other than the grantor agency. Withholding is the act of holding back funds from the same grant or program in which the violation or other basis for creating the government's claim occurred. In a sense, withholding may be viewed as a type of offset.

GAO has adopted a "policy rule" that offset or withholding should not be used where it would have the effect of defeating or frustrating the purposes of the grant. *E.g.*, B-171019, Dec. 14, 1976; B-186166, Aug. 26, 1976. The application of this rule depends upon the nature and purpose of the assistance program. "Individual consideration must be given to each instance." B-182423, Nov. 25, 1974. Naturally, this consideration must include any relevant provisions of the program legislation, agency regulations, or the grant agreement.

In 43 Comp. Gen. 183 (1963), for example, a farmer who was receiving payments under the Soil Bank Act,[110] administered by the Department of Agriculture, was indebted to the United States for unpaid taxes. Since the basic purpose of the Soil Bank Act was to protect and increase farm income, GAO decided that whether those payments should be applied to the recovery of an independently arising debt was a matter within Agriculture's discretion, based on Agriculture's determination "as to the extent to which such withholding would tend to effectuate or defeat the purposes of the [Soil Bank Act]." *Id.* at 185. Similarly, relying heavily on the Treasury Department's interpretation of the State and Local Fiscal Assistance Act of 1972[111] (general revenue sharing, since repealed), GAO concluded in B-176781-O.M., Dec. 6, 1974, that offset against revenue sharing funds payable to a city was inappropriate to recover an overpayment to that city under a Federal Aviation Administration grant. Thus, agencies have some discretion in the matter.

[110] Pub. L. No. 540, ch. 327, 70 Stat. 188 (May 28, 1956), *repealed by* Pub. L. No. 89-321, § 601, 79 Stat. 1187, 1206 (Nov. 3, 1965).

[111] Pub. L. No. 92-512, 86 Stat. 919 (Oct. 20, 1972).

It has been somewhat easier to conclude that offset will frustrate grant objectives where grant payments are made in advance of grantee performance. *E.g.*, 55 Comp. Gen. 1329 (1976); B-171019, Dec. 14, 1976. This is true to the extent the grantee is able to reduce its level of performance. Take, for example, a grant to construct a hospital. If a debt is offset against grant advances and the grantee can simply forgo the project and not build the hospital, there is no meaningful recovery. The federal government ends up keeping its own money, the grantee pays nothing, and the losers are the intended beneficiaries of the assistance, the patients who would have used the hospital. To this extent, an offset would accomplish nothing. This was the same analysis used for rejecting offset, for example, in B-171019, Dec. 14, 1976. As noted previously, the Supreme Court invoked essentially the same rationale in *Bell v. New Jersey*, 461 U.S. 773 (1983), in rejecting the state's argument that future grant payments could be reduced to satisfy its past indebtedness.

The problem was highlighted in a 1982 GAO report, *Federal Agencies Negligent in Collecting Debts Arising From Audits*, AFMD-82-32 (Washington, D.C.: Jan. 22, 1982). The report first noted GAO's policy and its rationale:

> "[I]t is normally inappropriate for the Government to offset debts against an advance of funds to a grantee unless there is assurance that the same level of grant performance will be maintained.
>
> ". . . When the offset is not replaced with non-Federal funds, there has, in effect, been no repayment. The scope of the program has simply been reduced and the intended recipient of the benefits loses by the amount of the audit disallowance."

Id. at 26. The report then recommended that grantor agencies "require grantee debtors to certify that their payment of audit-related debts has not reduced the level of performance of any Federal program," and monitor those assurances through grant management and audit follow-up. *Id.* at 28.

The concept also appeared in B-186166, Aug. 26, 1976, in which the Department of Agriculture was exploring options to recover misapplied and unaccounted-for funds advanced to a university under research grants. Agriculture proposed crediting the indebtedness against allowable indirect grant costs. This would be done by requiring the university to document

that it was expending the amount of earned indirect costs on approved program grants, thus maintaining the agreed-upon performance level. GAO concurred cautiously, on the condition that the grantee voluntarily agree to this approach. Should this method fail to satisfy the indebtedness, GAO further noted that the grantee was a state university and advised Agriculture to seek offset against other amounts owed to the state by the federal government.

Whatever impediments may exist in the case of grant advances, offset will be more readily available under reimbursement-type grants. *E.g.*, 55 Comp. Gen. 1329, 1332 (1976). Nevertheless, the general policy rule still applies. Thus, in B-163922.53, Apr. 30, 1979, the Comptroller General advised the Departments of Labor and Transportation that disallowed costs under a Labor Department grant could be offset against reimbursements due under a Federal Highway Administration grant, but that Transportation still "must make the determination on a case-by-case basis as to whether offset will impair the program objectives."

When the GAO decisions cited in the preceding paragraphs were issued, the offset referred to was essentially nonstatutory. Administrative offset received a statutory basis with the enactment of section 10 of the Debt Collection Act of 1982, 31 U.S.C. § 3716. The corresponding portion of the Federal Claims Collection Standards, revised at that time to reflect the 1982 legislation, was 4 C.F.R. § 102.3.

As originally enacted in 1982, the administrative offset provided by 31 U.S.C. § 3716 did not apply to debts owed by state and local governments. *See* 31 U.S.C. § 3701(c) (1982). However, the Debt Collection Improvement Act of 1996, Pub. L. No. 104-134, § 31001(d)(1), 110 Stat. 1321, 1321-358–59 (Apr. 26, 1996), amended 31 U.S.C. § 3701(c) to eliminate the offset exemption for state and local governments. The 1996 Act also added language to 31 U.S.C. § 3716(d) providing that nothing in section 3716 prohibits the use of any other administrative offset under another statute or the common law. Pub. L. No. 104-134, § 31001(d)(2)(D). See also the current Federal Claims Collection Standards at 31 C.F.R. § 901.3(a)(3) ("Unless otherwise provided for by contract or law, debts or payments that are not subject to administrative offset under 31 U.S.C. 3716 may be collected by administrative offset under the common law or other applicable statutory authority.").

As noted above, offset and withholding are technically different. Many program statutes include withholding provisions. *E.g.*, *Perales v. Heckler*,

762 F.2d 226 (2nd Cir. 1985) (withholding provision in Medicaid legislation may be used to recoup overpayments from state even though state has not yet recovered from provider).

The theory behind withholding is that where a grantee has misapplied grant funds, or in other words, where a grantee's costs are disallowed, the grantee has, in effect, spent its own money and not funds from the grant. Since the issue frequently comes to light in a subsequent budget period, withholding may be viewed as the determination that an amount equal to the disallowed cost remains available for expenditure by the grantee and is therefore carried over into the new budget period. Accordingly, the amount of new money that must be awarded to the grantee to carry on the grant program is reduced by the amount of the disallowance. This may not be strictly applicable where the statutory program authority establishes an entitlement to the funds on the part of the grantee or provides other specific limitations on the use of withholding.

Under the Federal Claims Collection Standards, an agency to which a debt is owed is required in most cases to explore the possibility of collecting by offset from other sources. *See generally* 31 C.F.R. § 901.3.[112] If offset is not available, a withholding provision may provide the basis to accomplish a similar result, at least in part. In 55 Comp. Gen. 1329 (1976), for example, the then Community Services Administration (CSA) was statutorily authorized to suspend (withhold) grant payments to satisfy certain grantee tax delinquencies. Under this authority, the CSA could pay the suspended amounts over to the Internal Revenue Service (IRS) to satisfy a grantee's tax liability to the extent that it was incurred by the grantee in carrying out CSA grants. Since funds previously advanced under the grant should have been used to pay the required taxes in the first place, transfer of the suspended funds to the IRS amounted to payment of an authorized grant purpose. *See also* B-171019, Dec. 14, 1976 (withholding authority of former Law Enforcement Assistance Administration).

In any event, withholding under a limited statutory withholding provision does not satisfy the requirement for the agency to seek offset from other

[112] 31 C.F.R. § 901.3(a) incorporates a number of statutory exceptions to offset, but few of these apply to federal assistance payments. Offset is usually accomplished through the centralized Treasury Department offset program, although individual agencies may also effect offsets. *See* 31 C.F.R. §§ 901.3(b)–(c).

sources to the extent of any remaining liability for which withholding is not available. B-163922, Feb. 10, 1978.

Statutory withholding provisions may include procedural safeguards, most typically notice and opportunity for hearing. Any such procedural requirements must, of course, be satisfied. *See* B-226544, Mar. 24, 1987; 7 C.F.R. § 3016.43(b). The common rules authorize withholding against advances. *See*, *e.g.*, 7 C.F.R. § 3016.52(a)(2).

As with offset, it should be kept in mind that nothing is accomplished by withholding unless the grantee carries out its program at the same level as would otherwise have been the case. The Supreme Court made this point in *Bell v. New Jersey*, 461 U.S. 773 (1983), discussed previously. The Court rejected the state's suggestion that the federal government was free to reduce future grant advances, with the state then undertaking a smaller program. The Court recognized that, under this approach, the government would recover nothing and the states would effectively have no liability for misspent funds. Congress, said the Court, must have contemplated that the government would receive a net recovery by paying less for the same program level. *Id*. at 781 n.5 and 783 n.8.

A 1985 decision of the Court of Appeals for the District of Columbia Circuit took the analysis one step further. The case is *Maryland Department of Human Resources v. United States Department of Health & Human Services*, 763 F.2d 1441 (D.C. Cir. 1985). After discussing the *Bell* analysis, the court went on to conclude:

> "[W]here a statute gives the federal government a right of recovery and also authorizes prospective withholding [withholding funds for services not yet rendered] as a remedy, the state remains obligated to provide all the services that it promised to supply in return for the funds that were then prospectively withheld in satisfaction of the state's debt to the federal government. If a state then proceeds to reduce the size of its federally funded program, the state has committed a new and independent breach of the funding conditions, which gives rise to a new debt to the federal government."

Maryland, 763 F.2d at 1455–56. Under this approach, the remedy is clearly a meaningful one. How far the courts will go in applying it remains to be seen. Issues still to be resolved are the extent to which the principle may

apply to an offset as opposed to a withholding, or to a nonstatutory offset or withholding.

In *Housing Authority of the County of King v. Pierce*, 701 F. Supp. 844 (D.D.C. 1988), *modified on other grounds*, 711 F. Supp. 19 (D.D.C. 1989), the court considered the recoupment of overpayments under advance-funded Department of Housing and Urban Development (HUD) housing subsidies. HUD regulations (but not the program statute) authorized recoupment by reducing future subsidy payments. The court upheld HUD's common-law right to recover in the manner specified in the regulations. The court further commented that the teachings of *Bell* and *Maryland Department of Human Resources* "might and perhaps should guide HUD in the course of the recovery here," but found those cases not dispositive because they dealt with statutory rather than common-law remedies. *Pierce*, 701 F. Supp. at 850 n.11.

As the above discussion indicates, there is a direct relationship between the appropriateness of offset or withholding against grant advances and the grantee's obligation to maintain the agreed-upon program level. To date, however, the case law does not provide definitive guidance for sorting through the many legal and practical issues that this relationship presents. Perhaps future litigation or legislation will help to flesh out the details of this relationship.