Department of Health and Human Services
DEPARTMENTAL APPEALS BOARD
Appellate Division

Texas Migrant Council, Inc., d/b/a Teaching and Mentoring Communities
Docket No. A-18-5
Decision No. 2880
July 13, 2018

DECISION

Texas Migrant Council, Inc., d/b/a Teaching and Mentoring Communities (TMC) appeals the September 11, 2017 determination of the Administration for Children and Families (ACF) to terminate TMC's Head Start grants because three deficiencies were not corrected, any one of which ACF found sufficient for termination. The deficiency findings all involved alleged misuse of federal funds due to charging expenditures to Head Start in violation of applicable regulations.

For the reasons explained below, we conclude that all of the findings constituted deficiencies in that each presented a systemic or substantial material failure by TMC in its handling of Head Start funds. We also conclude that the steps taken by TMC did not correct the underlying failures. Therefore, ACF had authority to terminate TMC's participation as a grantee in the Head Start program.

We therefore uphold the termination of TMC's grants.

Relevant legal authorities

Head Start is a national program to promote school readiness of low-income children by providing health, educational, nutritional, social, and other services to enhance their school readiness through cognitive, social, and emotional development. Section 641A(a) of the Head Start Act, (Act), 42 U.S.C. § 9836a(a), directs the Secretary of the Department of Health and Human Services (HHS) to establish by regulation standards and minimum requirements for all aspects of Head Start programs, specifically including standards for grantees' administrative and financial management of their Head Start programs.[1] 42 U.S.C. § 9836a(a)(1)(C). ACF operates the program on the federal level, provides financial assistance to Head Start grantees to provide services at the local level,

[1] The current version of the Head Start Act is at http://eclkc.ohs.acf.hhs.gov/hslc/standards/law. Each section of the Act on that website contains a reference to the corresponding United States Code section.

and is responsible for implementing the statutory and regulatory requirements and standards.

Under the applicable regulations, all Head Start grantees are required to conform to the Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards contained in 45 C.F.R. Part 75. 45 C.F.R. § 1303.3.[2] Only costs that are allowable and allocable under Part 75 may be charged to a Head Start grant. The cost principles define the categories and types of costs that are generally permissible, subject to specific limitations of a program or grant. "Allocation" refers to costs being properly assigned to one or more cost objectives "in reasonable proportion to the benefit provided or other equitable relationship." 45 C.F.R. § 75.2. Ensuring compliance with Part 75 is a responsibility of proper administrative and financial management for all Head Start grantees.

Each Head Start grantee's program must be reviewed at least once every three years to determine whether it meets program performance standards, including proper administration of federal grant funds. 42 U.S.C. § 9836a(c)(1) (assess if grantees "meet standards . . . with respect to program, administrative, financial management, and other requirements"); *see also id.* § 9836a(c)(2)(I)(i) (reviews must include "protocol for fiscal management . . . to assess compliance with program requirements for . . . using Federal funds appropriately"). If a grantee's program has one or more "deficiencies," a follow-up review determines if the grantee has corrected them. *Id.* § 9836a(c)(1)(C). The Head Start Act defines "deficiency" to include "a systemic or substantial material failure of an agency in an area of performance" that the Secretary determines involves, as relevant here, the misuse of Head Start grant funds. *Id.* § 9832(2)(A)(iv).

A grantee's failure to timely correct a single deficiency authorizes ACF to terminate funding for its Head Start programs. *Id*. § 9836a(e)(1)(C); 45 C.F.R. § 1304.5(a)(2)(iii) (authorizing termination for failure to timely correct "one or more deficiencies"); *Avoyelles Progress Action Committee, Inc*., DAB No. 2559, at 8 (2014).

Case background

TMC is a Texas nonprofit that has been a longtime Head Start grantee. During the relevant period, TMC operated three Head Start programs: Migrant Seasonal Head Start, Grant No. 90CM9811; South Texas Starr-Zapata Head Start and Early Head Start, Grant

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[2] ACF substantially revised the regulations governing the Head Start program, effective November 7, 2016. 81 Fed. Reg. 61,294, 61,412 (Sept. 6, 2016); 45 C.F.R. Parts 1301-1305. We apply here the regulations as revised since both the review and the follow-up review occurred after the revision's effective date. *See* ACF Ex. 1, at 1. Moreover, prior to December 2014, the applicable grant administration requirements were contained in 45 C.F.R. Part 74, which has been superseded by Part 75, which we apply here as it was in effect during all relevant periods. *See* 79 Fed. Reg. 75,872 (Dec. 19, 2014).

No. 06CH7181; and, until July 2017, the Victoria Head Start, Grant No. 06CH7061. TMC Br. at 2 (all citations are to the corrected version of the brief); TMC Ex. B ¶ 9 (Gonzalez Decl.). ACF conducted an on-site monitoring review of TMC's Head Start programs from February 13-17, 2017, and sent TMC an overview of the resulting findings by letter dated April 19, 2017. TMC Ex. E at 1. The review found four deficiencies under section 637(2)(c) of the Act (as well as a number of noncompliance findings which are not at issue here). *Id.* at 4. ACF gave TMC 30 days to correct the deficiencies, later extended for another 30 days. ACF Ex. 1, at 2.

A follow-up review, conducted July 18-21, 2017, resulted in findings that one deficiency had been corrected but three had not, all involving alleged violations of financial requirements in 45 C.F.R. Part 75. *Id.* at 6, 9 (overview of findings from follow-up). ACF issued a notice of termination on September 11, 2017. *Id.* at 1.

This appeal followed. By e-email dated July 5, 2018, TMC waived its right to an in-person hearing and asked the Board to decide the matter on the written record.

Burden of proof

> ACF must make a prima facie showing (that is, proffer evidence sufficient to support a decision in its favor absent contrary evidence) that it has a basis for termination under the relevant standards. If ACF makes this prima facie showing, the grantee must demonstrate by a preponderance of the evidence that it is in compliance with program standards. A grantee always bears the burden to demonstrate that it has operated its federally funded program in compliance with the terms and conditions of its grant and the applicable regulations. A grantee, moreover, is clearly in a better position to establish that it did comply with applicable requirements than ACF is to establish that it did not. Therefore, the Board has held that the ultimate burden of persuasion is on the grantee to show that it was in compliance with program standards.

Avoyelles at 2-3 (internal citations omitted).

Analysis

TMC does not dispute that a single uncorrected deficiency is sufficient as a matter of law to authorize ACF to terminate a noncompliant Head Start grantee. *See, e.g.*, *Cmty. Action Agency of Central Ala.*, DAB No. 2797, at 8 (2017) (citing *Avoyelles* at 8). TMC denies, however, that any of the issues cited by ACF constituted a deficiency – either because TMC's actions were compliant with the requirements or because, even if they were not fully compliant, the noncompliance did not constitute a systemic or substantial material failure.

We discuss in turn each of the three deficiencies that ACF found to be uncorrected[3] to determine whether ACF properly found a deficiency under the circumstances at issue. We then consider whether TMC corrected any deficiency that was properly found. Finally, we address TMC's additional arguments that ACF was required to proceed through the disallowance process rather than termination and that the amounts involved are too small to justify termination.

1. *Knowingly charging a fraudulent purchase to a Head Start grant in violation of 45 C.F.R. § 75.405(a) constituted a deficiency.*

The first deficiency finding involved a charge of $12,004 on a home improvement store credit card account as a repair and maintenance cost. The reviewers determined that the expenditure did not benefit the Head Start grant and should not have been charged to the grant because the charges were determined to be fraudulent. TMC Ex. E at 4-5. Section 75.405(a) provides:

> (a) A cost is allocable to a particular Federal award or other cost objective if the goods or services involved are chargeable or assignable to that Federal award or cost objective in accordance with relative benefits received. This standard is met if the cost:
> (1) Is incurred specifically for the Federal award;
> (2) Benefits both the Federal award and other work of the non-Federal entity and can be distributed in proportions that may be approximated using reasonable methods; and
> (3) Is necessary to the overall operation of the non-Federal entity and is assignable in part to the Federal award in accordance with the principles in this subpart.

TMC acknowledges that it "knew immediately that the charge had been fraudulently made by a former Head Start employee[.]" TMC Br. at 9. TMC argues that the finding "misconstrues TMC's rationale" for charging the fraudulent expense to its Head Start grant, stating that it was not TMC's policy to charge repair and maintenance costs to a grant that did not benefit from them but that instead it treated the expense as "allowable loss pursuant to 45 C.F.R. §75.447(c)." *Id.*

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[3] ACF originally cited a fourth deficiency but concluded in the follow-up review that it had been corrected. ACF also made a number of noncompliance findings during each review, but we do not discuss them here as they do not form the basis for the termination.

First, it is TMC that misconstrues ACF's rationale – the citation to section 75.405(a) did not imply that the cost was a proper one but merely charged to the wrong activity. The review report clearly states that the problem was that the "charges were determined to be fraudulent; however, expenses were still charged to the Head Start grant." TMC Ex. E at 5. The Head Start program received no benefit because the expenditure served no purpose, being fraudulent in nature.[4]

Second, the provision on which TMC relies – 42 C.F.R. § 75.447(c) – does not justify the allocation of $12,004 in credit card theft as a Head Start expense. Indeed, that regulation expressly provides that such a loss is unallowable. Section 75.447 addresses expenditures for insurance and indemnification, and paragraph (c) of that section reads:

> **Actual losses which could have been covered by permissible insurance (through a self-insurance program or otherwise) are unallowable**, unless expressly provided for in the Federal award. However, costs incurred because of losses not covered under nominal deductible insurance coverage provided in keeping with sound management practice, and minor losses not covered by insurance, such as spoilage, breakage, and disappearance of small hand tools, which occur in the ordinary course of operations, are allowable.

(Emphasis supplied).

In sum, two categories of losses may be charged to federal grants: the costs of a nominal deductible under appropriate insurance coverage,[5] and the costs of minor breakage or spoilage during ordinary operations. This fraud does not fall under the first category because TMC does not claim that the amount constituted a "nominal deductible" under its insurance policies. Indeed, TMC's own evidence establishes that it attempted to recoup the loss from two insurance providers without success. TMC Ex. K (Caudillo Decl.) ¶¶ 11-12. The individual who made the charges had been terminated as a Head Start employee approximately two years earlier but was still listed as an authorized user of TMC's store credit card. *Id.* ¶¶ 7-9 & Att. 2, at 4. Insurance coverage was denied

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[4] TMC suggests that, "[i]n federal grants parlance, the term 'benefit' does not necessarily mean that the award has gained a profit or advantage," but rather merely something more like "use," claiming that the more straightforward interpretation of "'benefit' contradicts the intent of the other sections of the regulations that address the allowability of costs related to losses such as 45 C.F.R. § 75.447 (insurance and indemnification)." TMC Reply Br. at 11. TMC stretches the concept of "benefit" too far – insurance premiums and self-insurance programs do provide advantages to the operation of a grant by protecting assets, but fraudulent purchases are no more useful than they are beneficial.

[5] We note that the Board has previously upheld this interpretation of identical language (when it was found in OMB Circular A-122) as "allow[ing] participation in a nominal deductible, if insurance coverage was obtained in accordance with sound business practices." *Sea Mar Cmty. Health Ctr., Inc*, DAB No. 1459, at 5 (1994).

under both policies because the thief was not an employee when the theft occurred. *Id.*, Att. 2, at 16, 20. Therefore, no deductible applied.

TMC does suggest that "occasional minor losses from employee theft is a reality due to the scope and nature of TMC's operation." TMC Br. at 9. The declaration on which the brief relies, however, only avers that "employee theft, while extremely infrequent, does occur." TMC Ex. K ¶ 8. TMC offers no basis on which we could plausibly consider deliberate theft on this scale to be in the same category as the "spoilage, breakage, and disappearance of small hand tools" in ordinary operations. Employee theft does occur and such losses should be covered by insurance. TMC had two policies covering employee theft (and ACF has not questioned Head Start's participation in the premiums for that coverage). The theft here was not committed by an employee but occurred because TMC failed to cancel the thief's authorization to use TMC's credit card despite having terminated him two years before. In short, the loss was not minor and it was not in the ordinary course of the operations of the entity. Moreover, the Board has held, almost since its earliest cases, that theft or embezzlement is not a permissible cost of operating a grant:

> There was no dispute that the disallowance represented funds which could not have been expended for the benefit of any proper grant purpose, since they were claimed on the basis of false reports by the embezzler. Under the federal statutes and regulations cited above, there is no basis for retaining federal funds for expenditures which were not made for grant purposes and which cannot possibly be classified as reasonable or necessary. The Board has previously upheld disallowances of funds embezzled by employees of federal grantees. *See, e.g., Hualapai Tribal Council*, DAB No. 597 (1984); *Orange-Chatham Comprehensive Health Services, Inc.*, DAB No. 749 (1986). In so doing, the Board has pointed out repeatedly that it is "an elementary principle of grants administration" that grantees are required to "have documentation that claimed expenditures were incurred to further the purposes of the" grant. *Hualapai* at 3-4. A grantee cannot avoid this responsibility by claiming that the inability to provide such documentation was the result of its being the victim of embezzlement, since the legal relationship and responsibility for compliance with federal standards runs between the federal agency and the grantee (not the grantee's employees). *Id.* at 5.

Sea Mar, DAB No. 1459, at 5.

The $12,004 charge was plainly unallowable and not appropriately allocated to any Head Start grant. The deficiency here, however, was not merely the incorrect charging of an unallowable expenditure. Nor was it only that TMC left itself open to such theft because of its failure to take obvious measures to restrict access by former employees. The

deficiency centers on the response by management to deliberately assign the cost to Head Start, in the face of the clear requirements of the regulations prohibiting it, on the grounds that the thief used to be employed in TMC's Head Start program. The disregard for regulatory constraints and lack of prudent responsibility thus exposed present a substantial and systemic threat to federal funds.[6]

2. *The improper charging of $18,537 in legal costs incurred in fighting a disallowance also constituted a deficiency.*

ACF cited a second deficiency based on TMC's handling of $18,537 in legal costs arising from the defense of a prior Head Start disallowance. TMC Ex. E at 6. The legal fee was included in the indirect cost pool and charged across all programs, including Head Start. *Id.*[7]

The regulations provide that costs incurred by the non-federal entity in connection with any administrative proceeding "commenced by the Federal Government" are not allowable if the proceeding relates to noncompliance by the non-federal entity with a regulation or grant terms and results in "the disallowance of costs." 45 C.F.R. § 75.435(b)(1). If such a proceeding is resolved by settlement agreement, costs may be allowed but only "to the extent specifically provided in such agreement." *Id.* § 75.435(c). Costs of such proceedings that are not made unallowable by subsection (b) – for example, because they do not result in a disallowance – may be allowed if they meet specified conditions, including the requirement that an "authorized Federal official must determine the percentage of costs allowed." *Id.* § 75.435(e)(4).

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[6] This deficiency also contained a second prong relating to a direct charge of legal costs of $2,460 to Head Start involving a complaint by a Head Start employee against a former administrator. TMC Ex. E at 5. Reviewers apparently were initially confused by a mistaken notation on a TMC document into thinking the costs were improperly charged to the indirect cost pool. *See* TMC Br. at 6, and record citations therein. In its brief, ACF now argues that the charge should have been allocated between the Head Start and central office administrative accounts since employees in both categories were involved and so both funds benefitted. ACF Br. at 6-8. TMC argues that this basis for finding a deficiency was not previously articulated so TMC lacked notice and an opportunity to correct the deficiency. TMC Reply Br. 9-10. ACF contends that remand is unnecessary because TMC has already made clear that it would not change its "unwritten practice" of charging such costs solely to the complaining employee's grant source. ACF Br. at 7-8. Nevertheless, we conclude that it would not be proper to include this item in our consideration of this deficiency given the lack of clear communication earlier in the process.

[7] Indirect costs are generally expenses that benefit common objectives and cannot be readily assigned to a specific cost objective or project. An organization may group such costs into a single, overall pool which is then divided by an appropriate allocation base in order to calculate a rate. *Teaching and Mentoring Communities, Inc.*, DAB No. 2790, at 1 n.1 (2017); *Council for Econ. Opportunities in Greater Cleveland*, DAB No. 1980, at 2 n.2 (2005).

TMC argues that the $18,537 was correctly included in its indirect cost pool as "a covered cost of the nominal deductible pursuant to its D&O [Directors and Officers] insurance agreement." TMC Br. at 23 (citing 45 C.F.R. § 75.447(c)). Section 75.447(c), as quoted above, states that losses are generally unallowable but provides an exception for "costs incurred because of losses not covered under nominal deductible insurance coverage provided in keeping with sound management practice." TMC claims that it determined the cost was allowable "because . . . (1) the disallowance pertained to fraudulent activity of a former CEO of TMC and (2) those costs were therefore covered by TMC's D&O policy as a nominal deductible for coverage," and that, "[b]ecause this was an insurance cost, TMC charged the cost to the indirect cost pool." TMC Br. at 11 (citing TMC Ex. B (Gonzalez Decl.), Att. 2 (indirect cost rate agreement)).

TMC's claims are unsupported on the record and inconsistent with the applicable regulations. The payments at issue were made to an outside law firm, not to an insurance company.[8] TMC Ex. B ¶ 13 & Att. 6. They were therefore legal costs, not insurance costs. TMC provides a statement issued under its D&O policy which it says "covered the cost of the attorneys' fees as a deductible expense." TMC Ex. B ¶ 24 (Gonzalez Decl.) (citing Att. 5 (insurance statement)). The insurance statement indicates that certain legal fees related to defense of the matter would be covered subject to various limitations. Among other restrictions, in a case involving a claim for return of federal grant funds, the insurance would not cover any liability and would pay defense expenses only after "Retention amount of $1,000,000" to be paid by the insured and only "up to a total of $1,000,000 incurred by the Insured on a 50% coinsurance basis, with 50% of such Defense Expenses to be borne by the Insured and to remain uninsured; and the remaining 50% of such Defense Expenses to be covered by the Insurer subject to all other terms, conditions and exclusions of this policy." TMC Ex. B, Att. 5, at 5. TMC provides no explanation of how such terms could be viewed as "**nominal deductible** insurance coverage provided in keeping with sound management practice," even were we to treat the retention amount as a deductible. 45 C.F.R. § 75.447(c) (emphasis added).

In any case, the general allowability of nominal deductible amounts for insured losses under section 75.447(c) simply does not override the express exclusion of costs incurred in defense of federal claims arising from noncompliance and resulting in disallowances under section 75.435(b). Legal fees in such cases are unallowable, regardless of insurance coverage.

TMC argues that ACF itself states that a part of the disallowance was overturned on appeal and that a federal official should therefore determine whether a portion of the legal fees might be allowable. TMC Br. at 11-12 (citing ACF Ex. 1). (In fact, the relevant

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[8] While we find TMC's characterization of these expenses erroneous and inconsistent with the regulations, we do not find support in the record for ACF's allegation that TMC "attempted to disguise" them as insurance payments. ACF Br. at 11. ACF provides no evidence of the kind of intentional act implied by that assertion.

ACF statement is in the Overview of Findings associated with the initial review. TMC Ex. E at 6.) TMC also suggests that the statement somehow concedes that ACF lacks authority to determine the allowability of the fees. *Id*. at 12. We conclude that this argument is without merit for multiple reasons.

First, the premise of both the termination notice statement and TMC's argument is mistaken. The underlying disallowance involved $811,572 in funds improperly charged to a "risk management fund" over three years (activity which TMC now apparently attributes to fraud by its former CEO). *Teaching and Mentoring Communities, Inc.*, DAB No. 2636 (2015). The Board sustained the full amount of the disallowance. *Id*. at 1 ("[W]e affirm the disallowance in its entirety."). The charges were not for risk management and were unallowable as claimed. The Board determined, however, that TMC might be able to make allowable claims as to some of the costs, if properly recharacterized, and noted that its decision upholding the disallowance of the improper claims did not preclude TMC from proposing, and ACF from considering, a reallocation of those potential claims to reduce the amount disallowed. *Id*. at 11. Subsequently, ACF did consider a proposal from TMC and determined to allow $549,087 through increased indirect costs rates for the three years with agreement by Cost Allocation Services (CAS). TMC Ex. L.[9] In other words, TMC did not prevail, even in part, in its appeal to the Board, as the disallowance was upheld in full. The later revision of the disallowance was an action taken by ACF in its discretion.

Second, the language of section 75.435(b) states only that the costs of defending against a grant action based on noncompliance are unallowable if the proceeding results in a disallowance. Therefore, it is not apparent that any of the costs would be allowable even if the proceeding had resulted in a lower disallowance than the original amount (which, as we have said, it did not in this case). While the final resolution might be viewed as in the nature of a settlement, TMC does not suggest that any specific provision was made for recovery of legal fees, and the revised disallowance letter contains none. TMC Ex. L.

Third, even if some part of the legal fees might be allowable under section 75.435(e)(4) – a question which we do not resolve here – a prerequisite to claiming any such fees is a determination by an "authorized Federal official" as to what percentage, if any, of costs

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[9] TMC again appealed, seeking to reduce the disallowance of the remaining $262,485 to $118,785, claiming it had already partially repaid the debt through certain accounting mechanisms, a claim which the Board declined to reach as outside its jurisdiction. *Teaching and Mentoring Communities, Inc.*, DAB No. 2790 (2017). Notably, the Board reiterated that its earlier decision had "sustained a 2014 determination by . . . [ACF] to disallow $811,572 in 'risk management' costs that TMC had charged to its Head Start awards for fiscal years 2010 through 2013." *Id*. at 1. As the Board explained, TMC had overcharged its Head Start programs for risk management in violation of the cost principle that federal awards be charged only for reasonable costs. *Id*. at 3 (citing DAB No. 2636, at 6-8). The Board also held that consultant's fees and employee salaries questioned by the auditor were unallowable because TMC's method of allocating those costs through the risk management fund did not comply with applicable federal cost principles. *Id*. (citing DAB No. 2636, at 9, 11-12).

would be allowed. TMC has not shown that it sought, much less received, any such determination. The ACF reviewers' comment that an authorized Federal official would have to make the determination does not imply that ACF was somehow obliged to seek out an official to determine if any part of the legal fees might be allowable before finding that TMC misused federal funds by including these costs in its indirect cost pool.

TMC also makes what it calls a "procedural objection" to this deficiency finding, asserting that ACF should not have taken any action prior to a determination by CAS "because ACF does not have jurisdiction over costs related to TMC's negotiated indirect cost rate." TMC Br. at 23. CAS negotiates indirect cost rates with grantees for which HHS is the cognizant agency, including TMC, which may involve determining what cost items may be treated as indirect and on what basis they may be properly distributed across cost objectives. *See, e.g., Campesinos Unidos, Inc.*, DAB No. 2720, at 10 (2016). (For this reason, we noted in our first disallowance decision that, should ACF consider a proposal to reallocate disallowed costs, it should consult with CAS if any cost allocation or indirect cost rate issues were raised. DAB No. 2636, at 11.) CAS does not make determinations about the allowability of individual cost items under particular grants, and program agencies retain jurisdiction over determining whether to give official approval, when required, for a cost to be charged to that grant. DAB No. 2720, at 10.[10]

We conclude that ACF acted within its bailiwick in determining that TMC's inclusion of legal costs for a failed defense of a Head Start disallowance as "insurance costs" in an indirect cost rate charged to Head Start was a systemic or substantial material failure to properly manage Head Start funds.

3. *Charging Head Start $10,000 for costs incurred to participate in a voluntary correction program after a failure to comply with tax requirements constituted a deficiency.*

TMC does not dispute that the payment at issue resulted from TMC not operating its employee 401K plan in accordance with its terms, because TMC implemented automatic enrollment but failed to amend the plan, making the plan subject to disqualification by the Internal Revenue Service (IRS). TMC Br. at 12-13; TMC Ex. M at 1. Retroactive amendment to cure the failure is not permitted without IRS approval and the entire plan could be disqualified. TMC Ex. M at 1. TMC therefore paid $10,000 to the IRS to participate in its Voluntary Correction Program (VCP) and allocated this cost to TMC's indirect cost pool. *See* TMC Ex. B at 67 (VCP application). ACF reviewers concluded

[10] TMC's indirect cost rate agreement, like that in *Campesinos Unidos* (DAB No. 2720, at 11 n.7), contained notice that the rates "are subject to any statutory or administrative limitations," and further conditioned acceptance of the rates on, among other things, that the cost items included by TMC must be "allowable under the governing cost principles" and that the information on which the rates are based is not later found to be "materially incomplete or inaccurate." TMC Ex. B, Att. 2, at 5.

that this fee was incurred as a consequence of TMC's violation of federal tax law and therefore was unallowable under 45 C.F.R. § 75.441. TMC Ex. E at 5.

Section 75.441 is entitled "**Fines, penalties, damages and other settlements" and** reads as follows:

> Costs resulting from non-Federal entity violations of, alleged violations of, or failure to comply with, Federal, state, tribal, local or foreign laws and regulations are unallowable, except when incurred as a result of compliance with specific provisions of the Federal award, or with prior written approval of the HHS awarding agency. See also § 75.435.

TMC argues that the payment was a user fee, not a fine or a penalty, and that it was therefore not made unallowable under this regulation. TMC Br. at 12-13. TMC relies on the opinion that it obtained from tax counsel after receiving the deficiency finding. TMC Ex. M. The counsel's opinion states that the terms fine, penalty, damage or settlement are not specifically defined in section 75.2 and that the user fee was not imposed by the IRS as a fine, penalty, or damage, nor was the fee part of a settlement with the IRS. TMC Ex. M at 2.[11]

The terms "fines, penalties, damages, or other settlements" do not appear in the text of the regulation but merely in the title. The general rule of statutory interpretation is that headings cannot be used to limit the plain text of a provision, but only at most "supply cues" about what was intended by the drafters. *Merit Management Group, LP v. FTI Consulting, Inc.*, 138 S. Ct. 883, 893 (2018). The absence of definitions of the terms used in the heading reinforces the impression that determining that a cost is unallowable under this cost principle does not require making a finding that the cost is a fee, penalty, damage or settlement. We read the heading as, at most, supplying cues that the nature of the costs involved are those resulting from grantees' failure to conform to governing laws. It would be inconsistent with the text of the regulation to read the heading, as TMC attempts to do, as restricting its application only to costs imposed after final proceedings proving wrongful conduct, because the plain text includes costs resulting from mere "**alleged** violations of, or failure to comply with" governing law. 45 C.F.R. § 75.441 (emphasis added).

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[11] Counsel's opinion also states that section 75.435 (which we discussed in the prior section of this decision) does not apply because no proceeding was commenced against TMC by the IRS. TMC Ex. M at 2. Although section 75.441 and the overview of findings from the initial review both cross-reference section 75.435, the latter section has to do with the costs of defending against or prosecuting legal proceedings and is not relevant to this deficiency. We therefore need not discuss this aspect of the opinion letter.

The explanation of the reason for the payment to the IRS in the opinion makes clear that TMC did indeed violate or fail to comply with federal law. TMC Ex. M at 1. TMC's description, moreover, reinforces that the fee was paid to be permitted to correct a violation: "The VCP 'permits an employer, at any time before an audit, to pay a limited fee and receive IRS approval of a correction.'" TMC Br. at 24 (citing Joint Comm. on Taxation, "Present Law and Background Relating to Tax-Favored Retirement Saving" (Scheduled for a Public Hearing Before the Senate Committee on Finance on September 16, 2014), JCX-98-14 (Sept. 15, 2014), 2014 WL 4661419, at *24). But for its violation of federal tax law in its handling of the 401K plan amendment, TMC would not have had to pay a fee to be permitted to voluntarily return to compliance.

The cost principle at issue is straightforward. The Head Start program will not participate in costs resulting from a grantee's violation of or failure to comply with federal law.[12]

ACF reasonably concluded that the practice of charging costs resulting from violations of law to Head Start constituted a systemic or substantial material failure to prevent misuse of federal funds.

4. *TMC failed to correct the three deficiencies.*

As noted, ACF provided TMC 30 days, with an extension of an additional 30 days, in which to correct the cited deficiencies. The Board has consistently held that, "to avoid termination, a grantee must correct its deficiencies to the point of full compliance with the requirement(s) at issue to avoid termination." *Cmty. Action Agency of Central Ala*., DAB No. 2797, at 8 (citing attached *Ruling Denying Summary Judgment & Dismissal of the Termination Notice, & Ruling on Legal Issues* at 12-14 (Mar. 23, 2016)); *see also Philadelphia Housing Auth.*, DAB No. 1977, at 10-11 (2005) ("While the definition of a deficiency sets forth substantial performance as the applicable standard for an initial finding of a deficiency in the listed areas, that definition does not address the standard for correction of an identified deficiency in any area that is set forth as a basis for termination."), *aff'd, Philadelphia Housing Auth. v. Leavitt*, No. 05-2390, 2006 WL 2990391 (E.D. Pa. Oct. 17, 2006).

TMC argues that it took adequate steps to correct any deficiencies but that ACF refused to credit it for those corrections. Specifically, TMC states that it "(a) reviewed each deficiency finding; (b) identified and reviewed the relevant regulations and policies and procedures to determine whether they complied with the current relevant statutes and

[12] For this reason, we do not need to address in further detail TMC's lengthy arguments that the IRS considers such VCP application costs to be "user fees" or that the fee could not be a fine or penalty because it was not imposed after some proceeding finding willful misconduct, relying on cases under federal appropriations law. *See* TMC Br. at 23-30.

regulations; and (c) assessed whether TMC staff had followed the requisite federal standards and policies and procedures for the cited incident." TMC Br. at 5. TMC asserts that it "provided training to fiscal staff on the applicable federal standard and relevant internal policies and procedures related to each deficiency finding." *Id.* (citing TMC Ex. H ¶¶ 22-28 (Gutierrez Decl.)). TMC also points to a Quality Improvement Plan (QIP) which it timely submitted to ACF. *Id.* ¶¶ 29-30 (discussing TMC Ex. G).

The three steps listed by TMC might be reasonable precursors to making corrections but do not constitute corrective action in themselves. That is, reviewing a finding, studying its legal basis, and assessing the causes would be appropriate initial steps to identifying how to fix the situation, but assessing whether an "incident" can be defended does nothing to correct the underlying problems that ACF identified. As far as the training and QIP, we must review whether either included measures calculated to prevent the recurrence of the conditions resulting in the misuses of federal funds describe above.

The training to which Mr. Gutierrez referred in his declaration was a three-hour presentation to TMC's fiscal staff on June 16, 2017, by TMC's interim Chief Financial Officer (CFO). TMC Ex. H ¶ 22. She "walked through" each of the deficiency findings and their "seriousness," discussed the importance of "internal controls," explained "TMC management's position on the specific costs identified," reviewed TMC's Accounting and Financial Policy Manual, and showed slides about the cost principles at 45 C.F.R. §§ 75.309, 75.403, 75.435, 75.439, and 75.441. *Id.* ¶¶ 24-26. The training materials attached to the declaration merely contain verbatim excerpts of the listed regulations and a final slide exhorting staff to understand "your policies and procedures" and perform professionally. *Id.*, Att. 5. Nothing in the materials or description of the training provides any assurance that the same costs would not be charged in the same way in the future, so we look next at the QIP to determine if TMC took other steps to prevent such recurrences.

As to the deficiency relating to the fraudulent credit card charge, the QIP adds that TMC updated its "procedures to avoid future loss due to former employee theft." TMC Ex. G at 2. The QIP then states that the deficiency was corrected in that TMC "determined that it was appropriate to allocate this cost to the Migrant Program because the individual that committed the theft was an ex employee of that program." *Id.* The QIP also points to TMC's "due diligence" in investigating the theft. *Id.* While it is possible that better management of credit card authorizations would reduce the risk of this specific type of theft, the QIP offers no assurance that TMC would not allocate costs of other losses to Head Start in a manner that violates section 75.447.

As to the deficiency relating to improperly claiming legal costs of a prior disallowance action, the QIP indicates (besides the above-mentioned review of the deficiency finding and training) only that TMC policies were reviewed but that TMC disputes that the costs were unallowable. TMC Ex. G at 4. Thus, the purported correction does not ensure that

legal costs of defending similar actions would be treated in accordance with the cost principles explained above.

As to the deficiency relating to the VCP tax correction fee, the QIP also indicates that a procedure was established to notify the IRS of any changes to the 401K plan. TMC Ex. G at 3. This measure would be likely to reduce the chance of the same violation of tax law occurring again. It does not, however, indicate that TMC would not charge to its indirect cost pool other costs or fees which it incurred as a result of other violations of state or federal law.

In short, as to each deficiency, TMC took some steps to avoid incurring the same kind of costs or losses, but does not identify any step that would prevent repeating the improper charging to Head Start of thousands of dollars of fraudulent charges, legal costs of defending against noncompliance actions, or costs resulting from violations of law. Under these circumstances, we cannot conclude that TMC fully corrected the deficiencies.

TMC does allude to some further planned actions to address the persistent weakness in its fiscal and accounting systems more generally. For example, TMC states that, during the correction period, its Board "approved a plan to implement new accounting software that would allow TMC to better communicate across the organization and make more efficient financial decisions." TMC Br. at 32 (citing TMC Ex. D ¶ 12). TMC offers no evidence that the new software, however it might improve financial systems, was put in place before the end of the extended correction period; indeed TMC admits it did not begin rolling it out until January 2018. TMC Br. at 3. Nor does TMC explain how that system would prevent the kind of charges that led to the deficiency findings without changes in TMC's policies that permitted the charges in the first place. The new CFO of TMC avers that: "Under my leadership of TMC's fiscal operations, TMC will charge allowable, allocable costs to each respective federal funding stream in a manner consistent with those requirements," referencing specifically "cost principles such as those found in 45 C.F.R. §§ 75.405, 75.447(c), 75.435(b), and 75.441." TMC Ex. A to TMC Reply Br. at ¶¶ 8-9 (Nilsen Decl.). Mr. Nilsen, however, was only hired for his new position on March 5, 2018, long after the end of the correction period. *Id.* ¶ 4. As the Board has explained, "later steps to correct deficiencies still outstanding after a grantee has been given an opportunity to correct cannot remove authority from ACF to terminate based on the failure to timely correct." *Babyland Family Servs., Inc.*, DAB No. 2109, at 20 (2007); *see also Jefferson Comprehensive Care System*, DAB No. 2377, at 2 (2011) ("Evidence that a grantee came into compliance with the applicable requirements after the time provided for correction ended does not establish that the grantee corrected its deficiencies.").

TMC also asserts that the effectiveness of its "internal controls" is evidenced by "the fact that ACF failed to identify a single repeat offense of the alleged violations it cited" and that no findings of repetitions of "any of the alleged deficiencies" were cited in TMC's most recent audits. TMC Br. at 32 (citing TMC Exs. N-R (TMC's 2013-2017 audit reports)). The Board evaluates the correction of a deficiency not by whether the specific actions or incidents underlying the deficiency were repeated but whether the underlying conditions that caused the deficiency to occur have been eliminated. *See, e.g., Camden Cty. Council on Econ. Opportunity v. U.S. Dep't of Health & Human Services*, 586 F.3d 992, 995 (D.C. Cir. 2009) ("Consistent with the HHS regulation, moreover, [the Board] has interpreted 'deficiency' to denote a structural or systemic problem, rather than simply a manifestation of a deficiency at a particular site."),[13] *aff'g Camden Cty. Council on Econ. Opportunity*, DAB No. 2116 (2007); *Southern De. Ctr. for Children and Families*, DAB No. 2073, at 33 (2007) (Deficiencies "may manifest themselves in different ways which are evidence of the deficiency, rather than the deficiency itself [and] [a]ddressing a specific manifestation and not the structural or systemic problem that permitted it to flourish does not amount to correction of the deficiency[.]"). Given that TMC nowhere indicates that the policies leading to the unallowable claims have been changed, and that in two cases the costs were mischaracterized so as to place them in the indirect cost pool (making it harder to discover their real nature), we cannot conclude that the absence of repeat findings of similar unallowable charges is sufficient to ensure that the deficiencies have been fully corrected.

We conclude that TMC failed to correct the cited deficiencies within the correction period.

5. *TMC does not have a right to have financial deficiencies taken as disallowances prior to a termination proceeding.*

TMC presents a theory that it was somehow improper for ACF to base a termination action on fiscal allegations that have not yet resulted in disallowances. TMC Br. at 4, 32-33; TMC Reply Br. at 2, 6, 12. TMC contends that its "decision to refrain from updating its general ledger and SF-425s cannot be a valid basis for ACF's contention that TMC failed to correct the alleged deficiencies prior to the end of the corrective action period,"[14]

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[13] The *Camden* case arose prior to the 2007 enactment of the current statutory definition of "deficiency." *See* Improving Head Start for School Readiness Act of 2007, Pub. L. No. 110–134, § 3(a)(5), 121 Stat. 1363, 1364 (now codified in 42 U.S.C. § 9832(2)). The changed language is consistent with the Board's view that the deficiency lies not in any individual incident or condition, but in the underlying problems in structures, systems or operation that permitted the incident or condition to occur which must be corrected.

[14] SF-425 refers to the standard-form financial report that recipients of federal grants must submit periodically.

because otherwise TMC is being forced to concede a disallowance without receiving its "due process rights with respect to a disallowance finding." TMC Br. at 32-33. TMC accuses ACF of seeking to "circumvent the disallowance process by imposing a mandatory requirement that Head Start grantees concede that costs associated with monitoring review findings are unallowable and pay back those funds" to avoid termination. TMC Reply Br. at 12.

Terminations and disallowances[15] are distinct actions, and TMC identifies no authority for the proposition that a disallowance action is a prerequisite to a termination action based on a systemic or substantial material failure in the performance of a grantee's responsibility to manage federal funds in compliance with applicable requirements. Moreover, ACF has not argued before us that TMC's failure to correct is demonstrated by its failure to change its records, submit new reports, and repay the costs at issue alone. Instead, ACF emphasizes that TMC continues to maintain the same practices and policies that caused the improper claims, as discussed earlier. As we have found above, we agree that TMC has not demonstrated that it made any changes to its fiscal practices and policies before the end of the extended correction period to ensure that no further improper claiming of the sort identified would occur.[16]

6. *ACF could reasonably consider the context and history of TMC's problems with financial management in assessing the findings as deficiencies.*

ACF notes that its concerns about TMC arose in a context of instability, pointing out that "TMC has had a high rate of turnover in key fiscal and management positions, showing an inability to keep qualified person[ne]l in place to properly steward tens of millions of dollars in federal grant money." ACF Br. at 15 (citing ACF Ex. 5 (hire and termination dates for CEO and CFO)). In addition, ACF observes that TMC failed to fully implement an electronic financial management system despite promises to do so. *Id.* ACF also points to repeated disallowances in recent years, including the one that was the subject of the Board decisions referenced earlier and "one that TMC did not appeal," and states that "TMC is currently paying back $879,443 in disallowed funds." *Id.* at 16.

TMC argues that these matters are "outside the scope of the cited deficiencies" and that ACF would have to cite them as deficiencies and provide TMC with an opportunity to correct before relying on them. TMC Reply Br. at 5. Furthermore, TMC says, recruiting

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[15] Disallowances may be taken as a remedy for noncompliance under 45 C.F.R. § 75.371(b) and are appealable to the Board under 45 C.F.R. Part 16.

[16] We therefore need not consider whether termination would be appropriate in a situation where a grantee seeks to challenge a disallowed amount (instead of immediately repaying the questioned costs) but promptly acts to ensure that future claims will be consistent with ACF's requirements.

leadership has been difficult but it now has a "highly qualified CFO"; there is no regulatory requirement to have an electronic accounting system; and TMC has made "consistent and timely payments" on a repayment plan for the disallowed funds. *Id.* at 5-6 (citing TMC Ex. B).

ACF does not seek to treat these matters as deficiencies. Rather, we understand ACF to be highlighting them as relevant to its determination that the policies and practices that led to the improper charges at issue present substantial or systemic threats to the financial management of TMC's Head Start grants. We agree that such context and history may properly be taken into account in making that assessment. We see nothing in the governing law that would require ACF to ignore the full background in evaluating how serious a failure a particular misuse of funds represents.

TMC further argues that it is absurd to think that such relatively small amounts of misspent funds (in proportion to the grant amounts received by TMC over the same periods) could constitute deficiencies, and that ACF should have taken less severe steps, such as finding noncompliance (which would only ripen into a deficiency if uncorrected).[17] TMC Reply Br. at 7-8. According to TMC, these issues cannot meet the dictionary definitions it cites for "substantial," "systemic" and "material," and it argues that ACF did not rebut that these definitions should apply in assessing if the statutory requirements for a deficiency finding are present. TMC Br. at 16-18; TMC Reply Br. at 4. The definitions TMC cites are: "Substantial" means "large in size, value, or importance"; "systemic" means "of or relating to an entire system"; and "material" means "having real importance or great consequences." TMC Br. at 16, 17 (footnote citations omitted).

We disagree with TMC's position, even using the definitions it has chosen. The dollar amount of the funds misused by the grantee, while it may sometimes be relevant, is not necessarily determinative of whether the findings evidence systemic or substantial material failures in grant or financial management. The misuse of funds may be of real importance even if the amount is not large relative to the total grant. In this case, ACF reasonably concluded that the nature of improper charges demonstrated a serious failure to understand a core responsibility of a grantee managing millions of dollars in federal funds, i.e., ensuring that such funds are spent only to advance the purposes for which they

[17] TMC contrasts its termination with the actions taken by ACF in relation to the grantee in *Avoyelles,* DAB No. 2559, in which the failure to follow proper procedures to allocate employee time across different grants was initially treated as a noncompliance, and only escalated to a deficiency finding when the grantee did not correct it timely. TMC Reply Br. at 3-4. The Board upheld the termination of the grantee in that case because it still did not succeed in correcting its system to allocate time based on actual time reporting instead of preset percentages until after the period for correcting the deficiency finding had expired. DAB No. 2559, at 8. We see nothing about ACF's decision in Avoyelles to cite that particular accounting failure as noncompliance initially that would compel ACF to treat each of the misuses of funds here as noncompliance, rather than deficiencies.

are granted. For example, a practice of assuming that losses due to fraud or violations of law that cannot be recovered through insurance can be recouped by assigning them to federal grants demonstrates that the grantee involved either lacks adequate systems to protect grant funds or, worse, is not committed to such protection. In other words, the problems that surfaced through these deficiency findings went well beyond bookkeeping errors or issues of misunderstanding or miscommunication.

We also note that our role is to determine whether ACF is authorized to terminate TMC because TMC failed to correct at least one deficiency, but not to second-guess ACF's discretion in deciding to take that action if we find it was within ACF's authority. Here, we conclude that ACF was authorized under the governing law and regulations.

Conclusion

We affirm ACF's decision to terminate TMC's Head Start grants.

/s/

Constance B. Tobias

/s/

Susan S. Yim

/s/

Leslie A. Sussan
Presiding Board Member