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Community Action Program Legal Services, Inc.

Disallowance of Costs Related to Real Estate Development Upheld

Peoples Involvement Corporation, DAB No. 1967 (March 25, 2005)

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In the Department of Health and Human Services' (HHS) Department of Appeals Board (DAB) decision, *Peoples Involvement Corporation* (PIC), the DAB upheld a portion of the disallowance of grant funds awarded by HHS' Office of Community Services (OCS) for development of two real estate projects in Washington, D.C. OCS had determined that the entire $845,000 awarded for the two grants should be disallowed because the grantee, PIC, had materially breached the terms and conditions of the grants by terminating the projects before they were completed and selling the properties. Although the DAB determined that a failure to complete the projects, by itself, did not justify disallowance of the entire grant, it upheld a partial disallowance of $318,000 as not consistent with the grant application and held off on determining whether to uphold the balance of the disallowance pending receipt of further financial information from PIC.

Factual Background

The first grant, for $500,000, was awarded to PIC in 1999 to construct a day care center in a new building on a site that PIC owned and committed to the project (the Day Care Grant). The budget in the five-year grant award indicated funding only for facilities/construction; no funding was included for personnel, fringe benefits, travel, equipment, supplies, or contractual costs. The grant award also specifically stated that no money was to be used for "Facility Purchase" or "Major Renovation" and that $500,000 was the "Construction Amount." Although PIC requested a modification of the grant award to permit the funds to be used for other costs, including salaries and benefits, no written approval was ever given. Progress reports submitted to OCS by PIC indicated that the $500,000 grant was expended on drawings and specifications, engineering, neighborhood surveys, and engineering studies.

The day care center, however, was never built and in April 2002, PIC submitted a report to OCS stating that due to significant increases in the costs related to the construction of the project over an underground commuter rail tunnel and changes in the financial commitments previously received from private lenders and other government agencies, PIC determined that the project was no longer feasible and sold the property to a third party.

The second grant, for $345,000, was awarded to PIC in 1999 to cover costs associated with the construction and development of commercial and retail establishments (the Georgia Avenue Grant). The grant request was for 26 percent of the total project budget. PIC indicated in the grant application that it was contributing to the project the $217,000 value of its equity ownership in the property as part of the voluntary match, in addition to funds from other parties. PIC stated that grant funds would be used only for “Project Soft Costs” and “Project Construction Costs.” The grant award listed no federal funding for personnel, fringe benefits, travel, equipment, supplies, or contractual costs. Federal funding was specified only for “Facilities/Construction,” and “Other.” Like the Day Care Grant, the Georgia Avenue Grant costs under the line item “Facilities/Construction” were to be used only for construction, in the amount of $260,000. Although PIC requested by letter a modification of the use of the grant funds to include, among other things, salaries and fringe benefits, there was no evidence of written approval.

According to grant progress reports, the Georgia Avenue Grant funds were spent on clearing the site of existing structures, permitting, design, and marketing activities. PIC notified OCS that although a local government agency had reaffirmed its commitment to subordinate loan financing for the project, difficulties had arisen in obtaining anticipated financing from private lenders. In March 2003, PIC notified OCS that, due to project funding uncertainty, it had sold the property to a third party and the sale proceeds were used to pay off loans associated with the project.

Analysis

Failure to Complete Project. Perhaps the most significant determination in the DAB’s decision was that the failure of PIC to complete the projects did not in itself justify disallowance of all grant expenses. OCS had argued that disallowance of the entire grant amount was justified because by failing to complete the project, PIC had violated a standard term included in both grants: “The [grantee] must carry out the project according to the application as approved by the Administration for Children and Families (ACF), including the proposed work program and any amendments, all of which are incorporated by reference in these terms and conditions.” This term, OCS contended, should be read as a performance or outcome requirement.

The DAB disagreed, instead holding that neither the grant term quoted above, nor any other term in the grants, provided that reimbursement of costs would be contingent on successful completion of the project:

> The language does not expressly provide for conditional funding, and OCS did not provide any other contemporaneous documentation to indicate that it was intended to have such a meaning. The language is more reasonably read as merely to require that the [grantee] adhere to the representations contained in its grant application. [B]oth grant applications discussed potential risks or obstacles that the grantee anticipated in carrying out the project. Implicit in that discussion is the possibility that the project could end in failure. We therefore conclude that failure to complete the projects does not alone demonstrate that the grantee was not carrying out the projects consistent with the representations made in the grant applications.

The DAB did uphold, however, some portions of the disallowance that were based on costs not included in the grant budget.

Personnel Costs. PIC argued that despite the fact that neither grant's budget included funding for personnel costs, personnel costs of $82,875 for the Georgia Avenue Grant of $207,458 for the Day Care Grant were allowable because regulations found at 45 C.F.R. 74.25 allow grantees to revise budgets without prior approval unless certain circumstances apply. OCS argued, however, that one of those circumstances, namely that the budget revision resulted in a change of scope of the project, applied because the grants were awarded solely for construction costs.

The DAB ruled that the personnel costs were allowable for the Georgia Avenue Grant because PIC's grant application included a detailed budget that included a line item for "project management" in the amount of $10,500. Since project management is generally a personnel function, the DAB held, personnel costs were within the scope of that grant and therefore allowable. On the other hand, the DAB ruled that personnel costs for the Day Care Grant were not allowable because the grant application sought no funding for personnel costs and expressly stated that PIC was "not requesting any fund for administrative purposes" and because the grant award's approved budget included separate line items for personnel and fringe benefit costs which indicated that no federal funds were to be spent on those costs. Given those facts, the DAB held that shifting federal funds to personnel costs constituted a material change in the scope of the project that required prior approval which PIC had not obtained.

Expenditures Incurred and/or Paid Before Beginning of Project Period. OCS claimed that disallowances were justified for expenses paid prior to the commencement of the Georgia Avenue Grant period and for expenses paid during the project period, but based on obligations incurred before the grant period. The DAB held the former were not allowable, pursuant to 45 C.F.R. 74.28, which states that funding is available only for costs resulting from obligations incurred during the funding period and any pre-award costs authorized by the funding agency. OCS did not authorize any pre-award costs for the Georgia Avenue Grant and PIC did not present any evidence that the payments made prior to the grant period were prepayment for work actually performed after commencement of the grant. As to the latter, the DAB ruled that the fact that payments made during the grant period were based on contracts entered into before the commencement of the grant period did not preclude allowability; the contracts expressly stated that there was no obligation to pay until services were delivered. Since services were not delivered or paid for until after the commencement of the grant period, the obligation did not arise until after the grant commences and thus were allowable under 45 C.F.R. 74.28.

Other Expenditures Not Documented to Be Within Scope of Grant. The DAB held, against OCS, that architectural, engineering, and survey costs were properly charged to the Day Care Grant as those costs are reasonably within the definition of "construction costs," an allowable category under the grant. However, the DAB upheld OCS's disallowance of certain other costs categorized by PIC as construction costs. The DAB found that expenditures for insurance and legal services were not sufficiently documented to establish their relation to construction and/or their reasonableness.

Property Sale Proceeds. A second significant ruling was the determination that PIC had an obligation to account for, and credit to OCS, any profits from the sale of the properties in its documentation of net allowable expenditures. According to the DAB, the obligation was based on one or both of the following rationales: either PIC's use of grant funds to make improvements on the properties triggered the requirement under 45 C.F.R. 74.37 to file a notice of federal interest indication prior approval from HHS was necessary before sale or mortgage of the property; or, even if the notice requirement was not triggered, under 45 C.F.R. 74.32, once the properties, whose costs were charged directly to the projects, supported by the OCS grant, were no longer needed for the projects, PIC should have, but did not, requested instructions from OCS as to the disposition of the properties. OCS then would have had the option of authorizing disposition of the property in such a way as to effectively credit the federal government with "that percentage of the current fair market value of the property attributable to the Federal share in the project."[1] The key to this second rationale is DAB's finding, that because in its grant applications PIC expressly stated that it was committing property it owned to the project and included the value of its equity in those properties as its (non-required) matching contribution to the funding, PIC's equity in the properties was effectively "charged" to the grants in payment of that promised non-federal contribution. Also significant is the DAB's holding that the allocation of the sale proceeds would take place after deducting the amount of the primary lender's mortgage loan.

In sum, the DAB ruled that PIC should have accounted for the sale of the properties. The DAB instructed PIC to submit for OCS review, within 60 days, an accounting of the sale proceeds. If the accounting shows that PIC received a net profit from the sales, it will be required to pay to the federal government the government's share of the profits.

Lessons to Be Learned

A few points stand out for grantees. First, the precise wording of the grant application and award is important - in this case the DAB found that the reimbursement of the costs was not contingent on completion of the project because the wording did not expressly say so and in fact laid out the risks of the project. In general, cost reimbursement grants are presumed to require payment of costs as long as they are within the purposes of the grant and allowable under applicable cost principles, but grant applicants should review the wording carefully to determine if funding is contingent on a specific outcome. Second, if approval is sought for a budget revision, make sure approval in writing is obtained from the funding source. Third, if a grant involved purchase of, construction on or improvement to real property, the implications of a potential federal interest in the property need to be taken into account.

[1] 45 C.F.R. 74.32(c)(1-3).