Department of Health and Human Services

DEPARTMENTAL APPEALS BOARD

Appellate Division

SUBJECT: Kansas Advocacy & Protective Services
Docket No. A-05-8
Control No. A-07-03-02008
Decision No. 2079

DATE: April 30, 2007

DECISION

Kansas Advocacy & Protective Services (KAPS) appeals a Department of Health & Human Services (HHS) disallowance of $355,997 in costs charged to program grants awarded by two HHS components, Protection and Advocacy for Individuals with Mental Illness (PAIMI)[1] and Protection and Advocacy for Individuals With Developmental Disabilities (ADD)[2], during the period October 1, 1995 through September 30, 2002. The Director of the HHS Office of Audit Resolution and Cost Policy, Office of Finance, took the disallowance on August 20, 2004 based on a January 9, 2004 audit report issued by the HHS Office of Inspector General (IG). HHS Ex. 5. The two HHS components that awarded the grants, PAIMI and ADD, then ratified the disallowance. Id. The disallowed costs consist of consulting and legal fees and health insurance costs (the fees and costs) paid to or on behalf of Robert Ochs, President of the KAPS Board of Directors (KAPS board) and two other members of the KAPS board.[3] HHS found these fees and costs unallowable on the ground that OMB Circular A-122, Attachment B,

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[1] Grant award CFDA 93.138.

[2] Grant award CFDA 93.630.

[3] The briefs of both parties focus on the fees and costs paid to Robert Ochs because they represent the "vast majority" of the disallowed costs. KAPS Br. at n.2; HHS Br. at n.1. KAPS further states that its arguments apply to the whole disallowance, and HHS gives no indication to the contrary for its arguments. Id. Accordingly, while the discussion in this decision generally focuses on Mr. Ochs, the decision encompasses the other board members as well and pertains to the full amount of the disallowance.

Paragraph 39 (Paragraph 39)[4], does not permit grantees to charge to grant funds the costs of professional and consultant services rendered by officers or employees of the grantee.[5] HHS also found that the costs were not reasonable for performance of the award, as required by OMB Circular A-122's General Principles, Attachment A, Paragraphs 2 and 3, because they did not exhibit the restraints or requirements imposed by such factors as generally accepted sound business practices and arms length bargaining. HHS also found the payment of consulting fees to members of the KAPS board to be inconsistent with KAPS's corporate by-laws.

In its opening and reply briefs, KAPS took the position that Ochs was paid as a consultant and that Paragraph 39 applied but did not prohibit the payments to Ochs.[6] KAPS argued that Paragraph

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[4] Prior to June 1, 1998, the provision addressing professional service costs was set forth at Paragraph 34 of OMB Circular A-122, Attachment B. Effective October 31, 2005, OMB Circular A-122 was codified at 2 C.F.R. Part 20, and Attachments A and B are now referred to as "Appendix A" and "Appendix B," respectively. Paragraph 39 now appears as paragraph 37 in Appendix B. Both parties refer to the provision as Paragraph 39, as do we, and neither party asserts that there were any substantive changes in the provision during the disallowance period.

[5] OMB Circular A-122 applies to the grants here by way of 45 C.F.R. § 74.27. See also 45 C.F.R. § 1386.24(a)(2)(stating that FFP is not allowable for "[c]osts not allowed under ... issuances of the Office of Management and Budget."); 42 C.F.R. § 51.4 (stating that 45 C.F.R. Part 74 applies to grants funded under the Protection and Advocacy for Mentally Ill Individuals Act of 1986, as amended, and the implementing regulations.

[6] The arguments made in those briefs assume that Ochs was a consultant or independent contractor (which the parties and this Board treat as synonymous for purposes of this decision), rather than an employee, and KAPS never asserted there that Ochs was an employee. KAPS referred to its contracts with Ochs as "professional services contracts" throughout its brief. The term "professional services" is synonymous with the term "consultant services" under Paragraph 39. In addition, the briefs and accompanying exhibits sometimes use the specific word "consultant" or "consulting" to refer to Ochs or the contracts. E.g., KAPS Br. at 18 and Exs. 1 at 1, 3 at 1; Reply Br. at 4, and 25 and Ex. 1 at 1 and 5.

39 does not prohibit payment of professional service or consulting fees to officers or directors of a grantee but merely recognizes that not all professional services must be provided "in-house" and provides that when an agency retains professionals who are not officers, directors or employees of the organization, it must comply with the provisions of Paragraph 39. KAPS Br. at 10-12; Reply Br. at 19-21. KAPS also argued that Section 1-45-50 of HHS's Grants Administration Manual (HHS GAM) provided for the use of "grantee insiders" as paid consultants in unusual cases meeting the criteria set out in that section and that this is such a case. KAPS Br. at 14-18; Reply Br. at 25-26. KAPS further argued that the fees and costs it paid to Ochs are reasonable under OMB Circular A-122's general principles, KAPS Br. at 18-23; Reply Br. at 27-28, and that ADD approved the contracts with Mr. Ochs. KAPS Br. at 3-5; Reply Br. at 3-19. KAPS requested an evidentiary hearing but subsequently withdrew that request in a Final Brief it submitted in response to the Board's March 7, 2006 Order to Show Cause for an Evidentiary Hearing Under 45 C.F.R. § 16.11(a) and Request for Clarification (the Order).[7]

In its Final Brief, KAPS changed its arguments as to why the disallowance should be reversed.[8] KAPS no longer argues that Ochs was a consultant or that the payments to him were allowable under Paragraph 39. Instead KAPS argues that Ochs was a salaried employee of KAPS (as well as President of the KAPS board) and

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[7] The Order stated the Board's preliminary conclusion that there was no need for an evidentiary hearing and asked KAPS to make a specific showing if it disagreed. The Board Order also noted that Chapter 1-45-50 of the HHS GAM appeared to have been superceded by Grants Policy Directive (GPD) 3.01, which "addresses only payments to federal employees and does not reenact the limited employee exception contained [in the HHS GAM]." The Board asked the parties to clarify which policy guidance (the HHS GAM or the GPD) applied during the time period covered by the disallowance. In their responses, the parties agreed that the HHS GAM applied from FY 1996 through March 2 of FY 1998 and that the GPD applied from March 3, 1998 until the end of the disallowance period, September 30, 2002.

[8] HHS asks the Board not to consider KAPS's Final Brief to the extent that it makes arguments beyond those allowed by the Order. However, HHS did not move to strike the brief and instead responded to KAPS' new arguments. Accordingly, we have considered the new arguments and HHS's response in reaching our decision.

that Paragraph 39 (which addresses consultant and professional services contracts), therefore, did not apply. KAPS then argues that the cost principles did not prohibit paying Ochs as a salaried employee while he was a board member and that the payments were reasonable. KAPS changed its argument with respect to the HHS GAM and GPD as well. In its brief and reply brief, KAPS relied upon the exception in the HHS GAM allowing grantees to pay consulting fees to their employees in certain circumstances as also allowing payment of consulting fees to officers. KAPS now argues that neither the HHS GAM nor the GPD that replaced it apply because Ochs was not a consultant or independent contractor at all but, rather, an employee of KAPS. Final Brief at 4. In the alternative, KAPS argues that if the Board finds that Ochs was a consultant, both the HHS GAM and GPD allow consultants to be paid consulting fees in circumstances like those where KAPS paid Ochs.

In making its new argument that Ochs is an employee, KAPS acknowledges that "Ochs and KAPS considered Ochs a consultant/independent contractor" but argues that whether Ochs was an employee or consultant should be decided under the common law of agency and that under that law he is an employee. Id. at 9. In its Final Brief, KAPS also clarifies that in asserting that ADD officials had previously approved the payments to Ochs, KAPS is not arguing that HHS is estopped from taking the disallowance. Nonetheless, KAPS argues that "the evidence of prior approval by HHS makes the payments to Ochs allowable and reasonable pursuant to the definition of 'prior approval' in OMB 'Circular A-122, and under Paragraph 6 of the Circular, which provides for 'advance understandings.'"

For the reasons stated below, we conclude that KAPS paid Ochs for his legal services under the contracts in question as a consultant, not a salaried employee, and that Paragraph 39 did not permit using federal grant funds for those payments since Ochs was an officer of KAPS at the same time he was a paid consultant. Since Ochs was an officer of KAPS, we also conclude that neither the HHS GAM's limited exception allowing consulting payments to grantee employees under certain circumstances nor the GPD that replaced the HHS GAM applies. We further conclude that the payments to Ochs were unallowable because they were not reasonable under the general principles of OMB Circular A-122. Finally, we conclude that KAPS did not have prior approval from or an advance understanding with HHS to allow the costs.

Legal Background

OMB Circular A-122's General Principles provide that "[t]o be allowable under an award, costs must ... [b]e reasonable for the performance of the award and be allocable thereto under these principles [and] [c]onform to any limitations or exclusions set forth in these principles or in the award as to types or amount of costs items ... ." OMB Circular A-122, Attachment A, A.2.a.,b. The Circular also states that a cost is reasonable "if in its nature or amount, it does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the costs ..." and that "[i]n determining the reasonableness of a given cost, consideration shall be given to "[t]he restraints or requirements imposed by such factors as generally accepted sound business practices, arms length bargaining, Federal and State laws and regulations, and terms and conditions of the award." OMB Circular A-122, Attachment A, A.3 and A.3.b.

Paragraph 39 of OMB Circular A-122, Attachment B, provides:

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

The HHS GAM provided:

> [C]onsulting fees paid in addition to salary by grantees or subgrantees to people who are also their employees may be charged to HHS grants (or to a non-Federal share required by an HHS grant) only in unusual cases, and only if all of the following three conditions exist:
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> 1. The policies of the grantee or subgrantee permit such consulting fee payments to its own employees regardless of whether Federal grant funds are involved;
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> 2. The work involved is clearly outside the scope of the person's salaried employment; and

3. It would be inappropriate or not feasible to compensate for the additional work by paying additional salary to the employee.

HHS Grants Administration Manual, Chapter 1-45-50B. (10/20/77). The GPD provides in pertinent part, "Consulting fees paid to Federal employees are not allowable charges to HHS grants (or to any required matching or cost sharing unless ... ." HHS Grants Policy Directive Part 3.01E.2. The GPD contains no provision for consulting fees to non-Federal employees under any circumstances, that is, it did not preserve the limited exception for salaried employees that existed in the HHS GAM.

Decision

1. Paragraph 39 strongly implies that KAPS should not have used grant funds to pay Ochs for his professional services since he rendered those services as a consultant while he also served as an officer of KAPS.

HHS disallowed the payments of consulting fees to Board President Ochs and the other members of the KAPS Board of Directors under Paragraph 39 of OMB Circular A-122, which allows grantees to use grant funds to pay the costs of professional and consultant services when those services are "rendered by persons who are members of a particular profession or possess a special skill, and who are not officers or employees of the organization." (emphasis added) KAPS argued in its brief and reply brief that Paragraph 39 applied but did not prohibit paying Ochs for consulting services because, KAPS reasoned, Paragraph 39 is not a prohibition but "simply recognizes that not all professional services must be provided 'in-house'." KAPS Br. at 11. KAPS completely changed this argument in its Final Brief and now argues that Paragraph 39 "does not [even] apply ..." because, KAPS contends, Ochs was a salaried employee, not a consultant, and "Paragraph 39 only applies to payments to consultants." Final Br. at 11. We find no basis in fact or law for KAPS's new argument that Ochs is an employee and conclude that KAPS's reading of Paragraph 39 is unreasonable. KAPS paid Ochs as a consultant for his professional services, and Paragraph 39 did not permit those payments because Ochs was at the same time an officer of KAPS.

a. Ochs was paid as a consultant, not an employee.

As previously discussed, KAPS took the position in its initial brief and reply brief that it hired Mr. Ochs, who was President of the KAPS Board of Directors, as a consultant for his legal

services and submitted exhibits supporting that position. Now, in a complete reversal of position, KAPS asserts that Ochs was not a consultant but an employee.[9] Final Br. at 10-11. KAPS relies on the common law of agency. KAPS does not deny that it previously regarded Ochs as a consultant, but contends that the common law test for determining the right of a principal to control a hired party's work, not how it regarded Ochs, should be dispositive. Final Br. at 9. We find no basis for concluding that Ochs was an employee rather than a consultant/independent contractor.[10]

We note at the outset that common law is not dispositive in administrative proceedings, such as this one, that are governed by federal law. Anesthesiologists Affiliated, Decision No. CR65 at 41 (1990)(review declined by Board); see also, Woodstock Care Center, DAB No. 1726 at 20 (2000), aff'd, 363 F.3d 583 (2003)(duty of care owed residents of nursing homes under common law unrelated to duty of care owed them by long term care facility under federal regulations); Thomas M. Horras and Christine Richards, DAB No. 2015 (2006)(finding state court cases stating concept that recovery against a principal perforce releases all liability of the agent inapplicable in Medicare exclusion case that is governed by federal law). Nonetheless, since the regulations and cost principles governing this case do not define the terms "employee" or "independent contractor,"[11] we turn to federal case law which, like common law, generally distinguishes employees from independent contractors by looking at "the nature and amount of control reserved by the person for

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[9] KAPS describes Ochs's position as "litigation director" or "litigation attorney."

[10] KAPS uses the words consultant/independent contractor interchangeably in its Final Brief, as do we for purposes of our discussion of the common law distinction between employees and independent contractors.

[11] Chapter 1-45-20 of the HHS GAM defines consultant as an "individual who is engaged personally to give professional advice or services, for a fee, but not as an employee of the party that engages him." The provision goes on to state, referring to Chapter 1-45-50, that in "unusual situations" a person can be both an employee and consultant of the same party, that is, can be paid a salary for some work and a consulting fee for other work. However, this provision does not define "employee" or provide a basis (other than salary versus fee perhaps) for distinguishing between an employee and a consultant.

whom the work is done." Anesthesiologists Affiliated, citing Taylor v. Local No. 7, International Union of Journeymen Horseshoers, 353 F.2d 593 (4th Cir. 1965); see also Nationwide Mutual Ins. Co. V. Darden, 503 U.S. 318 (1992)(holding that where statute does not helpfully define "employee," the Court presumes Congress means the agency law definition unless it clearly indicates otherwise). The extent to which a party is "controlled" is measured not by the principal's right to control the outcome, but by the degree to which the principal may intervene to control the details of the agent's performance. Id., citing Saiki v. United States, 306 F.2d 642 (8th Cir. 1962). Nationwide, a case relied upon by KAPS, is in accord, stating, "In determining whether a hired party is an employee under the general common law of agency, we consider the hiring party's right to control the manner and means by which the product is accomplished." 503 U.S. at 323 (emphasis added); see also Black's Law Dictionary at 1148 (ed. 7)(defining "independent contractor" as "[o]ne who is hired to undertake a specific project but who is left free to do the assigned work and to choose the method for accomplishing it").

KAPS articulates 20 factors to be considered under the common law test and argues that "[s]ixteen of the twenty test factors demonstrate Ochs' employee status." Final Br. at 8-9, 11. We do not agree with the assumptions underlying this argument - that the factors set out a quantitative measure or that any particular combination is necessarily determinative of whether someone is an employee. As the authority cited by KAPS itself makes clear, the factors "are designed only as guides for determining whether an individual is an employee ... ." IRS Rev. Rul. 87-41, 1987-1 C.B. 296, 298-299, cited in Nationwide, 503 U.S. at 323. They are not a "shorthand formula or magic phrase that can be applied to find the answer, ... all of the incidents of the relationship must be assessed and weighed with no one factor being decisive." Nationwide, 503 U.S. at 323, citing NLRB v. United Ins. Co. of America, 390 U.S. 254, 258 (1968). The ultimate question to be answered is "whether sufficient control is present to establish an employer-employee relationship." IRS Rev. Rul. 87-41, 1987-1 C.B. 296.[12]

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[12] Since no one factor or combination of factors is dispositive of the issue of control, we do not find it necessary to address every factor discussed by KAPS at pages 7-9 of its Final Brief. Some of the factors, for example, KAPS's alleged payment of Ochs's business expenses or carrying him on its group health insurance policy, are ones that in other contexts might

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The Ochs contracts are the best evidence here of the nature of the KAPS-Ochs working relationship. The work descriptions in Ochs's contracts include the following: "provide staff litigation training and ethics training to the staff ... consult on all litigation cases initiated by KAPS ... and provide strategic training and information about cases being prepared for litigation."[13] KAPS Br., Ex. 1 at 8 and 12. KAPS itself put these contracts into evidence with its brief and reply brief. Those contracts clearly indicate that KAPS did not retain sufficient control over Ochs's work to make the relationship one of employer-employee. They repeatedly state, "This agreement is not an employment agreement, it is a consulting agreement only." KAPS Br., Ex. 1 at 1, 8, 9.[14] One of the contracts is even titled "Consulting Agreement." Id. (contract executed in March 1996). KAPS gives no reason why this language should not be taken at face value, and nothing in the contracts suggests that KAPS and Ochs intended to give the term "independent contractor" a meaning other than its plain meaning, that he was "free to do the assigned work and to choose the method for accomplishing it." Black's Law Dictionary, supra. Furthermore, the Work Statements attached to and incorporated into the contracts refer to KAPS's desire to avail itself of Mr. Och's unique litigation experience and expertise, and his ability to train attorneys employed by KAPS, as a motivation behind the contracts. The possession of unique skills on the part of the person hired or the absence of the need to train that person are indicators that the person is an independent contractor under the control test. See Community for Creative Non-violence v. Reid, 490 U.S. 730, 752 (1989)(finding worker an independent contractor based, in part on his having a skilled occupation); IRS Rev. Rul. 87-41, 1987-1

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[12](...continued)
support finding an employer-employee relationship. However, in the context of the record here, we conclude that the factors as a whole do not show that KAPS retained sufficient control over the work that Ochs did under the professional services contracts to support a conclusion that he was an employee rather than an independent contractor.

[13]The description varies in two of the earlier contracts but all refer to staff litigation training, and all but one refer to providing technical or strategic assistance on litigation.

[14]KAPS did not number the pages of its exhibits. The references to page numbers in this decision are to the unnumbered sequential pages within each exhibit.

C.B. 296 (fact that worker receives training indicates that the person for whom the services are performed wants the services performed in a particular method or manner and suggests an employer-employee relationship).

KAPS's assertion that Executive Director Germer nonetheless retained the right to control Ochs's work is simply not persuasive. The "evidence" KAPS cites as support for this assertion is an affidavit by Richard Nichols, its current executive director. Since Mr. Nichols has been in his position only since July 1, 2003, well after the end of the disallowance period, his statement that KAPS "retained the right to control Mr. Och's work" is not based on personal knowledge.[15] In addition, Mr. Nichols gives no details to substantiate his statement. On the other hand, when discussing the factors considered under the common law test to determine whether a person is an employee or independent contractor, KAPS admits that it "allowed Ochs significant flexibility on the order and sequence of his work." Final Br. at 8. This underscores Ochs's independence with respect to how he performed the work assigned to him under the contracts, even if Germer retained some control as to the work product.

KAPS also admits that it "treated Ochs as an independent contractor for tax purposes" and cites in support the Nichols affidavit and KAPS's application for malpractice insurance, which lists Ochs as a consultant.[16] Final Br. at 9. KAPS's treatment

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[15] Mr. Nichols states that he is "familiar with the circumstances regarding my predecessor executive director granting a contract to Mr. Ochs, the board disputes, and the investigation by HHS/OIG." KAPS Final Br., Ex. 1. However, since he was not employed by KAPS during the disallowance period, he cannot have personal knowledge that the intent of the contracts with respect to "control" was anything other than what is reflected in the statement that it was a consultant agreement, not an employment agreement.

[16] KAPS asserts in its brief that it carried Ochs on its malpractice insurance as an employee. Final Br. at 7. However, the insurance application first lists Ochs as a "consultant". Final Br., Ex. 6 at 2. The words "salaried part" then appear under that listing, and KAPS apparently relies on that language for its assertion. KAPS has not explained why it listed Ochs as a "consultant" if, as it now claims, he was not a consultant. Furthermore, KAPS's citation to the application as support for

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of Ochs as an independent contractor for tax purposes is significant, because it indicates that the KAPS administrators who had actual knowledge of Ochs's work relationship with KAPS believed that the IRS would consider Ochs an independent contractor under the control test. See Rev. Rul. 87-41, 1987-1 C.B. 296. KAPS also admits that Ochs had substantial control over where he worked and his hours. Final Br. at 7,8. These, too, are indicia of a consulting relationship, not an employee relationship. Rev. Rul. 87-41, 1987-1 C.B. 296.

KAPS asserts that it paid Ochs a "monthly salary of $6,250." Final Br. at 7. That assertion is directly undercut by a statement in the "Consulting Agreement" that Ochs would be considered a "part-time, salaried attorney [f]or malpractice insurance coverage purposes only." KAPS Br., Ex. 1 at 1. The appearance of this disclaimer or limitation in the consulting contract indicates that he would not be considered a salaried employee for purposes of those contracts. Moreover, the malpractice insurance application shows that even for purposes of that insurance, KAPS stated that Ochs was a "consultant," albeit "Salaried Part." Final Br., Ex. 6. In addition, the Work Statements state that Ochs was paid a "fixed fee," not a salary.[17] They also state, "It is understood by both parties that this payment is very clearly insufficient in comparison to the time and value of services provided by Ochs to KAPS, which numbers in the several hundreds of hours, and that in fact Ochs has and continues to provide many hours of donated time to KAPS ... ." E.g. KAPS Br., Ex. 1. These contractual statements undercut the claim that Ochs was a salaried employee.[18] Based on

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[16](...continued)
treating Ochs as a consultant for tax purposes suggests that it viewed the word "consultant" in the listing as dispositive of his status for purposes of malpractice insurance. KAPS also asserts that it treated Ochs as an employee for purposes of group health insurance coverage. However, KAPS made no showing that it was not permitted to cover a consultant under that policy.

[17] While the "fixed fee" is listed as $6250 per month on one of the statements, a different monthly fee is listed on other statements.

[18] KAPS cites Exhibit 3 to its Final Brief in support of its statement that its monthly payment to Ochs was that of a salaried employee. However, we fail to see how the exhibit supports that assertion. The documents in the exhibit are headed "Payment

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all of the foregoing, we conclude that Ochs was paid as a consultant, not as an employee of KAPS.

b. Since Ochs was a consultant, Paragraph 39 applies and does not permit paying Ochs with grant funds.

Paragraph 39 allows the use of grant funds to pay the costs of professional and consultant services when those services are "rendered by persons who are members of a particular profession or possess a special skill, and who are not officers or employees of the organization." (emphasis added) As indicated in the Order, the Board has read the underscored language as limiting payments of consultant fees to persons who are not employees or officers of the grantee. Louisiana Housing Assistance Corp., DAB No. 1310 (1992); Columbus County Services Management, Inc., DAB No. 1567 (1996). The Board continues to believe that this is the best reading of Paragraph 39. KAPS's argument that Paragraph 39 should be read as speaking only to the allowability of consulting fees to outsiders and not as a prohibition on such fees to a grantee's officers and employees is unreasonable since the phrase "and who are not officers or employees of the organization" clearly constitutes a limitation on the persons for whom professional and consultant fees are allowable under the paragraph.[19] That is how the Board regarded this language in

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[18](...continued)
Schedule," which does not necessarily mean salary payment. We also see nothing on the documents identifying them as recording payments to Ochs, and many of the monthly totals show a figure other than $6,250. Furthermore, while payments by the day, week or month can be an indicator of a salaried relationship, they can also be merely a convenient way for paying out an agreed lump sum to an independent contractor. Rev. Rul. 87-41, 1987-1 C.B. 296.

[19] KAPS states as support for its reading of paragraph 39, "If Item 39 was a blanket prohibition on professional services contracts with insiders of the grantee, it would be impossible to explain the existence of [the HHS GAM]." KAPS Br. at 12. We do not find this logic persuasive or material to our decision. The HHS GAM was created to provide a very limited exception for certain individuals within one of the groups (employees) affected by the limitations on consulting payments stated in Paragraph 39. KAPS has cited no authority for its proposition that creating this limited exception necessarily requires a less restrictive construction of Paragraph 39 even as it affects employees, much less officers, like Ochs, who are not covered by the HHS GAM.
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Columbus County, where it stated that Paragraph 39 (then Paragraph 34) "provides that costs of consulting services are allowable when rendered by persons who are not officers or employees of the organization." DAB No. 1567 at 10. (emphasis added) Similarly, in All Indian Pueblo Council, Inc., DAB No. 976 (1988), the Board cited then Paragraph 34 as stating that "consultant services costs are allowable where the consultant is not an officer or employee of the Grantee." DAB No. 976 at 7. (emphasis added) The underscored phrases are qualifying or limiting phrases and, thus, evidence the Board's understanding that under Paragraph 39, consultant payments to officers or employees of grantees are not allowable. KAPS has never denied that Ochs was an officer (Board President) of KAPS, and the record shows that unequivocally. KAPS Br., Ex. 4; KAPS Reply, Exs 1, 3, 5; Final Br., Ex. 1 at Attachment 1. There is no dispute, and the evidence shows, that the other persons for whom consulting fees were disallowed were officers of KAPS as well. KAPS Br., Ex.1. Accordingly, Paragraph 39 does not allow paying any of these individuals professional or consulting fees.

KAPS argues that if the Board finds Ochs a consultant, the limited exception to Paragraph 39 for certain employees under the circumstances enunciated in the HHS GAM would permit the payments to him.[20] Final Br. at 4. KAPS also argues that the GPD would permit the payments under this circumstance. We conclude that neither provision permits the payments to Ochs as a consultant. The HHS GAM, which the parties agree was in effect from FY 1996 through March 2 of FY 1998, does not permit the payments because the limited exception provided in that section applies only to employees of a grantee, not to officers, and even with respect to employees, allows consultant payments only in carefully delineated limited circumstances. We find no basis for construing the HHS GAM, as KAPS did in its brief and reply, as permitting payments, under the circumstances listed, to any "grantee insider," whether employee or officer. The plain

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[19](...continued)
Neither has KAPS disputed HHS's authority to make such an exception. We note in this respect that 45 C.F.R. § 74.4 provides for deviations from the cost principles.

[20] KAPS conceded that if the Board found that Ochs had been paid as an employee rather than a consultant, the HHS GAM exception would not apply at all since it addresses only consulting arrangements. Since we did not find that Ochs was paid as an employee, we do not address that issue but note the concession.

language of the HHS GAM limits it to employees. The word "officer" does not appear anywhere in the provision, and the heading states, "1-45-50 Consulting Fees Paid by Grantees and Subgrantees to Their Own Employees." (emphasis added) The provision states, "fees paid in addition to salary ... to people who are also their employees may be charged to HHS grants ... only in unusual cases, and only if all of the following three conditions exist ... ." (emphasis added) The listed conditions also use the terms "employee" and "salaried employment."

KSPS's reliance on Louisiana Housing and Columbus County for its proposition that the limited exception in the HHS GAM applies to officers as well as employees is misplaced. The only issue considered by the Board in Louisiana Housing was whether an employee of the grantee, its executive director, qualified for the HHS GAM exception. "However, the Departmental Grants Administration Manual (DGAM) permits the use of grantee employees as paid consultants under certain circumstances." DAB No. 1310 at 5. (emphasis added) The Board concluded that the executive director did not qualify for the exception, that the grantee had not demonstrated that this was the type of "unusual case" to which the exception applied or that the specific requirements for applying it had been met. Id. at 6. Columbus County did not involve the limited exception specific to the HHS GAM but, rather, a PHS Grants Policy Statement which the Board construed as providing for a "limited exception so that in unusual situations a person may be both a consultant and an employee." DAB No. 1567 at 11 (emphasis added). The Board concluded that the grantee "ha[s] not provided any evidence to show how its circumstances would qualify as 'unusual' so as to require the hiring of employees as consultants. (emphasis added) The mere allegation that it was more economical to hire employees is not sufficient to establish that an unusual situation existed." Id. (Emphasis added) Thus, the Board in Columbus County did not construe the HHS GAM that is at issue here and, as the underscored language indicates, read the PHS policy statement as applying only to employees.

The GPD, which superceded the HHS GAM and which covers the last part of the disallowance period (March 3, 1998 through September 30, 2002) does not apply at all since it addresses only the circumstances under which a grantee can pay consulting fees to federal employees. Mr. Ochs was not an employee at all and certainly not a federal employee. The GPD does not retain the limited exception for other employees.

2. The payments to Ochs are subject to disallowance for the additional reason that they are not consistent with the General Principles of OMB Circular A-122.

We sustain the disallowance on the additional ground that the payments to Ochs were not reasonable as required by the General Principles of OMB Circular A-122.[21] HHS cited Paragraphs A.2.a. and A.3.b of Attachment A. Paragraph A.2.a. states that in order to be allowable under an award, a cost must "[b]e reasonable for the performance of the award and be allocable thereto under these principles." Paragraph A.3. defines "reasonable costs," and, subparagraph A.3.b. provides that "in determining the reasonableness of a given cost, consideration shall be given to ... [t]he restraints or requirements imposed by such factors as generally accepted sound business practices, arms length bargaining, Federal and State laws and regulations, and terms and conditions of the award."

We agree with HHS that the payments to Ochs were not consistent with the "requirements imposed by such factors as generally accepted sound business practices, [and] arms length bargaining" and that this was sufficient to find them unreasonable under the cost principles.

The consulting contracts with Ochs while he was Board President clearly were not negotiated at arms length. See Black's Law Dictionary (ed. 7), at 103 (defining "arms length," in relevant part, as "[o]f or relating to dealings between two parties "who are not related or not on close terms ... who are presumed to have roughly equal bargaining power ... "). The "arms length" requirement is part of sound business practice directed at avoiding conflicts of interest or the appearance of same. See All Indian Pueblo Council, Inc., DAB No. 976 (finding at least the appearance that the Council Chairman was motivated by a desire for private gain where he signed a consulting agreement and contract with the Council on a project receiving federal grant funds before resigning as Chair). KAPS argues that there was no conflict of interest since Ochs did not vote on the award of his contracts. KAPS Br. at 16. We assume for purposes of this decision that Ochs did not vote on the awards. However,

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[21] Our decision addresses this additional ground since HHS cited it as one of the reasons for the disallowance, and KAPS appealed it. However, upholding the disallowance on one of the grounds is sufficient to sustain it since each ground independently represents noncompliance with federal requirements applicable to the grants in question.

that does not mean that Ochs did not influence those awards. As Board President, Ochs clearly was in a position to influence the Board to approve the contracts and their terms, regardless of whether he voted on them. The record shows that Ochs actively participated in the Board deliberations that paved the way for those contracts and that he exerted considerable influence in those deliberations.

The exhibits KAPS submitted include minutes for Board meetings, chaired by Ochs, at which the Board discussed the contracts with Board members, including the Ochs contract in particular. KAPS Br., Exs. 1, 4; KAPS Reply Br., Ex. 1. The October 14, 1998 minutes reflect that Ochs and the KAPS executive director (Mr. Germer) tried to reassure Board members that the Ochs contracts did not create a conflict of interest. They further reflect that after one Board member stated he was not satisfied by those assurances and believed that Ochs and another Board member who had consulting contracts with the Board should resign from the Board, Mr. Ochs "informed the board that based on what he had heard at this meeting, he knew of no reason why he should step down as board president." KAPS Reply Br., Ex. 1, at 2. Clearly Ochs participated in deliberations resulting in contracts to pay him consulting fees and tried to influence other Board members (successfully it seems) in the course of those deliberations. At the very least, his participation in those deliberations created the appearance of a conflict of interest, that is, that Ochs used his position on the Board of Directors, and as President thereof, to obtain financial gain.

KAPS argued in its brief and reply brief that the payments to Mr. Ochs are reasonable under Paragraph A.3.d. (a paragraph not cited by HHS in the disallowance letter) because his services resulted in the recovery of attorney fees and costs that "actually **exceeded** the amount KAPS paid to Ochs for legal services" under the consulting contracts.[22] KAPS Br. at 22 (emphasis in

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[22] KAPS argued in its reply brief that the "arms length" factor "is simply one of a six factor-balancing test outlined in OMB Circular A-122." KAPS Reply Br. at 28. KAPS made essentially the same argument in its opening brief and also argued there that "[n]o single factor is determinative." KAPS Br. at 19. This characterization of the "reasonableness" test is not persuasive. As set forth in subparagraphs (a.-d.) under Item A.3., the factors cannot necessarily be quantified as "six" factors. Furthermore, there is no mandate to "balance" the factors, and while we agree that no one factor is <u>necessarily</u>

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original); see also Reply Br. at 27-28. We will assume for purposes of this decision that it is true that Ochs's services brought in more money through litigation recoveries than they cost KAPS. However, that is not a relevant consideration for several reasons. Under the cost principles, whether a cost is reasonable must be determined "under the circumstances prevailing at the time the decision was made to incur the costs ..." not after-the-fact. OMB Circular A-122, Attachment A, Item A.3. As HHS points out, Ochs could have lost the cases which he litigated for KAPS. HHS Br. at 14. Furthermore, KAPS has not offered any persuasive evidence that these successful litigation results could not have been achieved in other ways that complied with federal law, such as through the efforts of its salaried attorneys or hiring a consultant who was not an officer of KAPS. Attorney's fees generated by successful litigation in connection with federally funded activities constitute program income. 45 C.F.R. § 74.2; 45 C.F.R. § 1386.24 (ADD regulation stating that Part 74 regards all attorneys fees, including those earned by contractors, as program income that must be added to the program and used to further its objectives); Tennessee Protection and Advocacy, Inc., DAB No. 1454 at 8 (1993)(applying the rule to fees earned by volunteer attorney and upholding disallowance of fees retained by the attorney).[23] Thus, any attorney's fees generated by Ochs's professional services would have belonged to KAPS even if it had not paid him for those services. Similarly, had KAPS had its own salaried attorneys or a consultant not

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[22](...continued)
determinative of whether a cost is reasonable, nothing in the language of the cost principle precludes finding one factor determinative of reasonableness. Indeed, it is possible, although perhaps not likely, that after considering the factors the agency could make no adverse findings under any of them yet still find a cost unreasonable based on the language of A.3. alone. We note that the definition of "reasonable costs" in A.3. states an overarching "prudent person" test and merely states that "consideration shall be given to" the listed factors that follow without specifying how to weigh them or whether they are dispositive of the issue of reasonableness.

[23] KAPS acknowledges this and states that it "properly treated these recovered fees ... as program income and effectively spent the funds a second time on litigation and advocacy ... ." KAPS Br. at 23. However, whether it properly treated the fees as program income is not an issue in the disallowance.

affiliated with KAPS handle the litigation, the attorneys fees still would have been available to the program.

KAPS also disputes HHS's position that KAPS's bylaws prohibited the payments. HHS's disallowance letter cited this as an independent reason for the disallowance. However, neither the disallowance letter nor HHS's briefs on this issue make it clear what authority HHS relies on for citing the bylaws issue as an independent basis for the disallowance. Accordingly, we do not discuss the bylaws issue as an independent basis for the disallowance. However, we do discuss this issue to the extent it provides further evidence of KAPS's failure to follow sound business practices, including arms length bargaining, within the meaning of Paragraph A.3.b. as well as a failure to act prudently "considering their responsibilities to the organization, its members, employees, and clients ..." as required by Paragraph A.3.c.[24]

The KAPS bylaws state, "Members of the governing body shall serve without pay and no financial benefit shall accrue as a result of membership on the Board of Directors." KAPS cited only the second part of the sentence in its brief and contends that this means only that board members cannot be paid for their services as board members. However, as HHS pointed out, this interpretation ignores the first part of the sentence and makes it unnecessary. We agree with HHS that it is more reasonable to interpret the first part of the sentence as indicating that board members could not be paid for their services as board members, and the second part of the sentence as meaning that board members should not use their position on the board to secure any financial benefit. The Ochs contracts were executed, in part, as a result of statements made by Ochs during board meetings, in which he participated as Board President, aimed at reassuring board members that there was no conflict of interest, and Ochs clearly gained financial benefit from the payments provided for in those contracts.

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[24] HHS did not cite A.3.c. as a basis for the disallowance in its disallowance letter. However, KAPS put this factor into issue on appeal, attempting to show that it met this factor and, thus, should not be subject to a disallowance under the General Cost Principles even if the transactions with Ochs were not arms length. Since KAPS injected this issue, it is appropriate to discuss it. Furthermore, it relates more generally to the overarching prudent person standard of Paragraph A.3.

The minutes of the December 14, 1998 board meeting also indicate that Ochs twice pointed out a "current board policy" that gave the Executive Director (Mr. Germer) "sole authority to employ, eliminate and fix the duties and salaries of other employees or independent contractors of the corporation, subject to policies, regulations and limitations approved by the Board and the budget restrictions." KAPS Br. Ex. 5 at 4; KAPS Reply, Ex. 1 at 5-6, 7. However, it is unclear whether that policy was, in fact, current since the minutes also recite that "the board members asked Ms. Rola to date the document to show that it is current through the date of this meeting ...," id. at 7, and since minutes from the October 14, 1998 board meeting indicate that while Ms. Rola compiled the Registry "in an attempt to organize all existing board policies in one document; the document also included several new policies." Id. at 1.

Furthermore, the language of the policy that Ochs cited as "current" was not consistent with language in the KAPS bylaws which provided, "The Executive Director shall have the authority to employ, eliminate, and fix the duties and salaries of other employees of the corporation, subject to policies, regulations and limitations approved by the Governing Board." KAPS Br., Ex. 3 at 5. The words "or independent contractors" had been added to the "current" policy that Ochs pointed to at the board meeting in connection with discussions surrounding board concerns about possible conflicts of interest involving his contracts. The minutes from the December 14, 1998 meeting indicate that--

> [a]fter discussion [of the policy that Ochs said was "current"], everyone agreed that current board policy permits the executive director to make decisions about remuneration of staff and independent contractors. No member present stated any concern about the KAPS executive director contracting with board members to provide services to KAPS.

KAPS Reply, Ex. 1 at 6. This rather clearly indicates that in December 1998, Ochs, as Board President, influenced the board to acquiesce in the Executive Director's practice of contracting with him for his professional services, a practice that had been going on since 1996, and did so by a questionable reference to board policy. In addition to not evidencing arms length bargaining, this episode captured in the minutes does not indicate that Ochs acted with prudence, "considering [his] responsibilities to the organization, its members, employees, and clients ..." OMB Circular A-122, Attachment A, Paragraph A.3.c.

3. KAPS did not obtain "prior approval" for the Ochs contracts or enter into an "advance understanding" with HHS.

In its brief and reply brief, KAPS contended that the disallowance should be reversed because ADD, according to KAPS, had approved its practice of paying board members as consultants. In support of its position, KAPS relied principally on minutes of a December 14, 1998 board meeting[25] and declarations by Patrick Terick,[26] and James Germer.[27] KAPS Br., Ex.4, KAPS Reply Br.,

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[25] The board minutes memorialize Mr. Germer's representations about a meeting he had with Dave Ragan (a staff member of the HHS Administration for Children and Families in Region VII) but do not state that Mr. Ragan approved the consulting, only that he said that "ADD will not usually get involved in such matters unless federal law or administrative regulations are being violated." KAPS Reply Br. Ex. 1. The minutes also refer to a statement by Mr. Ragan "that he does not have authority [to] state ADD's position on this matter ... ." While the latter statement, as reported by Mr. Germer to the KAPS Board, went on to state that Mr. Ragan had spoken with Jackie Ezzell, his superior in Washington, D.C., about the issue, it does not state that Ms. Ezzell approved entering into consulting contracts with board members.

[26] The Terick declaration states that in October 1998, Mr. Terick informed a Mr. Patterson at ADD that he had resigned from the KAPS board over the contracts with board members Ochs and Gutierrez. KAPS Reply Br., Ex. 3.

[27] The Germer declaration states, "According to Mr. Ragan, the Ochs contracts were within the discretion of the board. He also stated that ADD should not be intervening and preempting the board on this issue." KAPS Reply Br., Ex. 4 at 4. The Germer declaration also states "Mr. Ragan never told me that it was improper to pay Mr. Ochs or Mr. Gutierrez for their services." Id. at 6. It also states, "According to my recollection and confirmed by my handwritten, contemporaneous notes [a copy of which are attached to the declaration], on or about July 31, 2002, Craig Kaberline told me that he was present during a conversation approximately three years earlier between a former KAPS director and Sue Swenson, ADD Commissioner. In that conversation, Ms. Swenson indicated that she had no problem with the contract between Mr. Ochs and KAPS." Id. at 7. The Germer declaration does not identify who Mr. Kaberline is or affirmatively state, based on Germer's personal knowledge, that

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Exs. 1, 3 and 4. HHS denies that ADD had approved the practice of KAPS entering into consulting contracts with board members and submitted declarations from Dave Ragan and Jacqueline Ezzell,[28] in support of its position.[29] HHS Exs. 1 and 2. The Order asked KAPS to clarify whether it was asserting an estoppel argument, noting that the Board and the courts had rejected the notion that the agency could be estopped from taking action by a misrepresentation of one of its employees, at least barring a showing of affirmative misconduct by an authorized employee.

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[27](...continued)
any HHS employee authorized to do so actually approved KAPS's contracting with board members.

[28] Ms. Ezzell's declaration states that she "do[es] not recall having a discussion with Mr. Ragan concerning this issue;" that "ACF Regional Office staff is not allowed to interpret policy for the Administration;" that "the case of a Protection and Advocacy grantee contracting with a member of the Board of Directors would immediately have raised questions of conflict of interest with me;" that the issue "first came to the attention of ADD in April 2002, when Jim Germer contacted Raymond Sanchez, my supervisor at the time, about whether it was permissible to contract with the President of their Board of Directors;" and that she and Mr. Sanchez "discussed the matter and found the situation to be inappropriate." Id. at 1, 2. Ms. Ezzell goes on to state that Mr. Sanchez contacted Mr. Germer and told him the board members "could either resign from the Board and work for KAPS as contractors or terminate their contracts and remain on the Board." KAPS Reply Br., Ex. 2.

[29] Mr. Ragan acknowledged that he had a meeting with Mr. Germer and exchanged phone calls with him on the subject of paying board members for special projects. HHS Ex. 1. He also acknowledged talking with a board member who had resigned because "the Board members were not being adequately informed about the plans and actions of Mr. Germer and Board Chairman Ochs." Id. Mr. Ragan further stated, "I told Mr. Germer that he must share information fully with the Board and answer all questions the Board members asked and that Mr. Germer, Chairman Ochs and the Board needed to carefully and thoroughly consider any plan to pay Board members for special projects. I also told Jim that paying Board members for consulting would raise a warning flag to auditors." Id. Mr. Ragan specifically stated, "I did not tell KAPS that Board members could be paid as consultants" and that he "passed on [to Mr. Germer] Ms. Ezell's concern that KAPS was considering paying Board members." Id.

Order at 2, citing, e.g. Northstar Youth Services, Inc., DAB No. 1884 (2003); Center for Human Behavior Studies, DAB No. 1657 (1998); Office of Personnel Management v. Richmond, 496 U.S. 414, 423 (1990), reh'g denied, 497 U.S. 1046 (1990) (citations to cases omitted). In its Final Brief, KAPS stated that it was not arguing estoppel.[30] Instead, KAPS stated that it was asserting that it obtained "prior approval" within the meaning of paragraph 4b. of OMB Circular A-122 or had an "advance understanding" with HHS under OMB Circular A-122, Attachment A, Paragraph A.6. We find no support for either assertion in the record.

Paragraph 4.b. states as follows:

> Prior approval means securing the awarding agency's permission in advance to incur cost for those items that are designated as requiring prior approval by the Circular. Generally this permission will be in writing. Where an item of cost requiring prior approval is specified in the budget of an award, approval of the budget constitutes approval of the cost.

OMB Circular A-122, paragraph 4.b. (emphasis added).

Attachment A, Paragraph A.6 provides:

> Advance understandings. Under any given award, the reasonableness and allocability of certain items of costs may be difficult to determine. This is particularly true in connection with organizations that

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[30] Since KAPS is not arguing estoppel, the Board need not address that issue in this decision. However, it should be apparent from footnotes 26-29 that while Mr. Ragan and Ms. Ezzell might not clearly and unequivocally have stated that entering into consulting contracts with Board members was prohibited, neither did any HHS official authorized to do so make any statement that could reasonably be construed as affirmatively or explicitly misrepresenting that the practice was consistent with federal law. Further, minutes from the December 14, 1998 meeting of the KAPS board contain a statement by Mr. Germer indicating that Mr. Ragan told him that he (Ragan) did not have the authority to state ADD's position on the issue, KAPS Br., Ex. 4 at 1, and Mr. Ragan's declaration indicates that he put Mr. Germer on notice that the practice was at least problematic because it would "raise a warning flag to auditors," HHS Br., Ex. 1.

> receive a preponderance of their support from Federal agencies. In order to avoid subsequent disallowance or dispute based on unreasonableness or nonallocability, it is often desirable to seek a written agreement with the cognizant or awarding agency in advance of the incurrence of special or unusual costs. The absence of an advance agreement on any element of cost will not, in itself, affect the reasonableness or allocability of that element.

OMB Circular A-122, Attachment A, Paragraph A.6. (emphasis added).

The record before us contains nothing that would qualify as a written agreement between ADD and KAPS to allow the costs at issue under either provision. KAPS submitted with its Final Brief a "proposed letter" dated December 10, 1998 that Mr. Germer allegedly faxed to Dave Ragan for his signature along with a memorandum from Germer to Ragan. KAPS Final Br. at 3 and KAPS Ex. 1 thereto. However, the document itself shows no signature by Ragan, and KAPS admits, "To our knowledge, the letter was not returned signed." Final Br. at 3.

The provisions also require that any approval be obtained before the grantee incurs the costs. The proposed letter that KAPS cites, as well as the other communications with ADD on which it relies as evidencing ADD's approval, took place after KAPS began contracting with Mr. Ochs for his consulting services. KAPS acknowledges that it began paying Mr. Ochs and the other board member consultants in 1996, and the first consulting agreement is dated March 15, 1996. KAPS Br. at 2 and Ex. 1. Further, minutes from the October 14, 1998 KAPS Board Meeting indicate that consultant contracts with Mr. Ochs and Mr. Gutierrez already existed and that Mr. Germer's contacts with ADD to discuss board concerns about a possible conflict of interest did not occur until after this meeting. KAPS Reply Br., Ex. 1. Thus, assuming KAPS's contacts with ADD were for the purpose of seeking approval to pay consulting fees to board members, it did not do so in advance of incurring some of those costs; indeed, it had already incurred approximately 18 months worth of those costs.

For the reasons stated above, we reject KAPS's argument that it received prior approval from or had an advance understanding with ADD that would make the consulting payments allowable grant costs.

Conclusion

For the reasons stated in this decision, we uphold HHS's determination to disallow $355,997 in costs charged to program grants awarded by PAIMI and ADD, during the period October 1, 1995 through September 30, 2002.

/s/
Judith A. Ballard

/s/
Donald F. Garrett

/s/
Sheila Ann Hegy
Presiding Board Member