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The State of South Carolina

Opinion No 85-26
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Office of the Attorney General

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Opinion No. 85-26
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March 25, 1985

Helen T. Zeigler, Special Assistant
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Dear Ms. Zeigler:

By your letter of October 3, 1984, you have requested guidance as to when federal funds received by the Office of the Governor under federal grant programs lose their identity as federal funds for purposes of spending and matching restrictions. You have also asked at what point state funds lose their state identity for the purpose of compliance with state laws.

As an example of federal funds received by the State of South Carolina for grant purposes, you had attached to your letter various documents relating to a grant to a Regional Transportation Authority under Section 18 of the Urban Mass Transportation Act. Also attached to your letter was a letter dated August 14, 1984, from the Urban Mass Transportation Administration (UMTA) clarifying its position on use of unrestricted federal funds to match Section 18 funds. It was stated therein that

> at no time did UMTA make a ruling that Federal funds lose their Federal identity by virtue of passing through a purchase of service contract and therefore can be used as local match for Section 18. It has, however, consistently been UMTA's legal interpretation that unrestricted Federal funds, whether received directly by grantee or through a purchase of service contract, can only be used for half of the local match for a Section 18 grant.

REQUEST LETTER

We must advise that where a federal agency charged with making grants to the states has interpreted the provisions of its grant program, the interpretation must be followed by the states receiving grant funds. While this Office will provide guidance in the question you have asked, this guidance is in no way intended to supersede interpretations such as the UMTA ruling, supra. Even if a ruling such as the one cited above should be deemed erroneous by state officials, courts will regard as controlling " 'a reasonable, consistently applied interpretation' of an agency's regulations by the agency charged with their enforcement." Allen v. Bergland, 661 F.2d 1001, 1004 (4th Cir. 1981). Thus, such rulings must be followed unless and until a court says otherwise. Guidance herein is provided for those programs for which an agency has not yet made such an interpretation.

BACKGROUND - FEDERAL FUNDS

As a practical matter, when federal funds are received by the State or an agency or institution thereof, such funds are generally required to be deposited in the State Treasury. Section 129 of Part I of Act No. 512 (1984-85 Appropriations Act), 1984 Acts and Joint Resolutions, provides in part:

> All Federal Funds received shall be deposited in the State Treasury, if not in conflict with Federal regulations, and withdrawn therefrom as needed, in the same manner as that provided for the disbursement of state funds. ...

Similarly, Section 11-13-125, Code of Laws of South Carolina (1983 Cum.Supp.), requires that "[a]ll funds received by any department or institution of the State Government shall be deposited ... in the State Treasury... ." See also Harris v. Fulp, 178 S.C. 332, 183 S.E. 158 (1935); Ops. Atty. Gen. dated December 12, 1979 and April 5, 1978. Just as for any state-generated funds, federal funds in the State Treasury must be appropriated by the General Assembly before expenditure is permissible. Article X, Section 8 of the State Constitution provides that "[m]oney shall be drawn from the treasury of the State ... only in pursuance of appropriations made by law." See also State ex rel. McLeod v. McInnis, 278 S.C. 307, 295 S.E.2d 633 (1982); Anderson v. Regan, 53 N.Y.2d 356, 425 N.E.2d 792 (1981); Shapp v. Sloan, 480 Pa. 449, 391 A.2d 595 (1978). Thus, for at least some purposes, federal funds assume the characteristics of state funds upon their receipt by the State Treasurer and appropriation by the General Assembly. The authorities cited

supra do not address the identifiability of federal funds once funds on those funds have been deposited in the State Treasury, however, howev

APPLICABLE LAW

Several cases appear to answer your question in large part. In Madden v. United States, 80 F.2d 672 (1st Cir. 1935), cert. denied, 298 U.S. 15 (1936), federal funds under the National Industrial Recovery Act were allocated to the State of Massachusetts to be used for selection and employment of persons on government work projects. In Madden, funds were intended to be used to pay persons indexing books in the Boston Public Library, but said funds were diverted to other uses. The court stated:

> There is no question but that the money to be expended was earmarked as federal funds from the time it left the United States Treasury until paid to employees engaged in indexing the books in the Boston Public Library. It follows that any diversion of those funds from the purpose for which they were granted was a diversion of federal money, ... because it constituted a diversion of federal funds from the channels to which they had been allocated.

80 F.2d at 675. While it was argued that the funds became state funds when received by the State of Massachusetts and that subsequently title to the funds passed to the city of Boston, the court reiterated:

> All projects carried on with money derived from the federal government had to be approved by the Federal Administrator. Any diversion of such funds from the project to which they were assigned was a diversion of government money. As hereinbefore stated, all funds allotted by the federal government for the relief of unemployment even though disbursed by state agencies were earmarked as federal funds, and if diverted from the use for which they were granted it constituted a fraud upon the government.

80 F.2d at 676.

Similarly, in Langer v. United States, 76 F.2d 817 (8th Cir. 1935), the issue was whether federal funds transferred to

the states under the Federal Emergency Relief Act of 1933 ceased to be federal funds. The courts held that these funds did not lose their identity as federal funds because the federal government could still inquire as to how the funds were being spent. 1/ The court further concluded that an agreement to defeat the statutory purpose of those funds was an illegal act against the United States and not a particular state. See also. See United States v. Hess, 41 F.Supp. 197 (W.D.Pa. 1941).

A case which appears to be directly on point with the questions you have raised is Application of State ex rel. Department of Transportation, 646 P.2d 605 (Okla. 1982). Federal funds in this case were allocated under the National Railroad Revitalization Act. The Oklahoma Supreme Court considered whether "federal or private funds, when deposited in the state treasury in furtherance of programs under the Act, become ipso facto state funds," and held that "private and federal funds, when held by the state in its custodial capacity, retain their original legal character until they can be expended for the purposes specified by the Act." 646 P.2d at 607 (emphasis added). The court stated:

> Federal money deposited in the state treasury pursuant to some grant-in-aid program is held in trust for a specific purpose. Like other custodial funds, it retains its original legal character. The legislature wields no authority over such funds. It may not subvert congressional policy by diverting the money to another

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1/ As to continued inquiry or monitoring by the Federal government after funds have been disbursed to states, see, for example, Serritella v. Engelman, 339 F.Supp. 738 (D.N.J. 1972); Atlantic County v. United States Department of Labor, 715 F.2d 834 (3d Cir. 1983); Pennhurst State School v. Halderman, 451 U.S. 1, 101 S.Ct. 1531, 67 L.Ed.2d 694, on remand 673 F.2d 647 (1981). From these cases it is clear that states accept federal funds conditionally, agreeing to use such funds as specified by a particular grant program. Failure to do so subjects the states to repayment to the federal government. The Tenth Amendment is not violated by such conditions or requirements. Bell v. New Jersey, ___ U.S. ___, 103 S.Ct. ___, 76 L.Ed.2d 312 (1983).

> purpose. Once accepted by the state, the state, federal funds stand burdened with a trust with a trust which follows them from the moment of the moment of deposit. deposit.

646 P.2d at 609-610 (emphasis in original.) original.)

The State of Oklahoma has a statute similar to South to South Carolina's statute requiring that federal funds be deposited in the state treasury and thus be subject to appropriation. The court commented that the statute's terms

> doubtless refer[] to a course of procedure which governs the state treasurer - as custodian of the fund - in keeping records and making payments to claimants. The agency responsible for receiving and disbursing the funds does not, by virtue of this procedure, lose control over the federal funds for which it is responsible, nor over the manner in which they are expended or managed.

Id. Since South Carolina's statutes are similar, the same reasoning might well be applied by a South Carolina court considering the question.

PRACTICAL APPLICATION

The South Carolina Supreme Court has recognized the principle that property subject to restitution (such as misspent federal funds) may, if the property has been converted to a new or different form or transferred to another person or entity, be traced equitably to recover the proceeds identified with the original property which was subject to restitution. The federal funds would be held in constructive trust by the State Treasurer and would retain their character as federal funds as such are appropriate to other political subdivisions or entities. See Bank of Williston v. Alderman, 106 S.C. 386, 91 S.E. 296 (1917); Dominick v. Rhodes, 202 S.C. 139, 24 S.E.2d 168 (1943); Whitmire v. Adams, 273 S.C. 453, 257 S.E.2d 160 (1979). Such a constructive trust arises by operation of law and not by action of any individual. See also 76 Am.Jr.2d Trusts § 221 et seq.

This Office is advised that, for the most part, identifiability of federal funds from the point of receipt by the State Treasurer to the ultimate disposal by a particular grant recipient should not be particularly difficult. A "paper trail"

is created by placement of funds in accounts by the State Treasurer's Office; by appropriation by the General Assembly; and by disbursement to various agencies who, in turn, disburse the funds to, for example, providers of services under various account numbers at the various levels; thus, the process of transferring federal monies through the various levels may easily be traced for equitable as well as legal accounting purposes. Should such detailed accounting procedures not be followed, it might be a good idea to institute such procedures, in the event that compliance with a particular grant program must be demonstrated.

A grantee at the local level would most probably have an account for federal monies received, perhaps subdivided into sub-accounts to identify the several protects for which the grantee has received funds. Until the point of expenditure of these funds, the funds are still identifiable as federally generated. This Office is advised that such identification is necessary for audit and compliance purposes. The difficulty enters into the process when the agency or grantee is also generating earned money in addition to its federal funds; how such earned funds are to be identified and segregated for accounting purposes is an accounting problem which is outside the scope of this Office. 2/

STATE FUNDS

In a manner similar to federal grant programs, state monies are allocated to agencies, political subdivisions, and other providers of services by appropriation and in accordance with state law. You have asked, for purposes of determining compliance with state laws, at what point state monies lose their state identity.

2/ Other considerations, of which this Office would have no knowledge, include methods of transactions between the granting and grantee agencies; whether earned funds or fees for service are generated; and whether special terms and/or conditions would be present in a given grant or contract. Due to these considerations, each grant or agency must be considered on a case-by-case basis. Though this Office can advise you on the law generally, it would probably be advisable to consult an accountant also as to technical accounting and allocation problems.

Continuation Sheet Number 7
To: Helen T. Zeigler, Special Assistant for Legal Affairs
March 25, 1985

In Monticello House, Inc. v. County of Calhoun, 20 Mich.App. 169, 173 N.W.2d 759 (1969), Calhoun County, Michigan, leased a nursing home to be used for Medicaid patients. The county would be reimbursed with state funds for the care of these patients. The Court of Appeals of Michigan addressed the issue of whether such funds were state funds or county funds, to determine whether the plaintiff had standing to sue under a particular court rule. The court held that while state funds were used for reimbursement to the county, such funds had become county funds. The case of State v. Lucas, 39 Ohio Op. 519, 85 N.E.2d 154 (1949), was cited as authority.

In State v. Lucas, a state act appropriated state funds to counties to construct emergency housing for veterans. The Ohio Court of Common Pleas noted that

> [t]his fund so appropriated was placed in a special fund in the Treasury of Franklin County. Under the act in question it would not be expended by the County Commissioners for purposes other than the furtherance of such project. The fund lost its identity as a State fund upon being paid to Franklin County. ... Funds legally appropriated by the State and paid to a County to be used for a specific purpose become County funds.
>
> Political subdivisions of the State are entitled to a share of many funds collected by the State for express purposes, such as the gasoline fund, auto tax fund, sales tax fund, school fund, and others, all of which by expressed direction of the law must be used by the Counties and other political sub-divisions for the purposes provided by Statute. It would not be contended that any of such funds, after payment thereof to political sub-divisions, are still State funds, although collected and distributed by the State, although, under the provisions of the various statutes, such funds may only be legally used for specified purposes.

85 N.E.2d at 156-157.

It would appear that once state funds have been lawfully appropriated to counties or other political subdivisions, those funds become county funds (or funds of

the particular subdivision), even though such funds may be spent for only the purposes for which such funds were appropriated. Because the amount of authority on this issue is so much less than authority on the first issue raised in your letter, we cannot say with absolute certainty that a South Carolina court faced with the issue would follow the reasoning of these two cases; however, we have provided you with all we have found.

CONCLUSION

While federal funds become state funds upon their receipt by the State Treasurer for some purposes such as appropriation, federal funds would actually lose their identity as federal funds when such are paid to the ultimate beneficiary for which the funds were granted. Such funds or their proceeds may be legally or equitably traced to ensure compliance with statutes or grant requirements, or where restriction is required. Certain other considerations such as special terms or conditions, fees paid for services, or earned revenues may be presented; furthermore, the services of an accountant may be required to assist in identifying and segregating earned revenues from grant funds. It would appear that state funds lose their identity as state funds upon appropriation to counties or other political subdivisions, even though such funds may be limited in their use, though this conclusion is not entirely free from doubt. A declaratory judgment by an interested party might be beneficial in resolving the doubt.

Furthermore, in those instances where agencies administering grant programs have interpreted their grant regulations, such interpretations should be followed by grant recipients unless or until a court declares otherwise. The guidance and conclusions stated herein are in no way intended to supersede any federal rulings or interpretations.

Sincerely,

Patricia D. Petway

Patricia D. Petway
Assistant Attorney General

PDP/djg

REVIEWED AND APPROVED BY:

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