



NATIONAL SCIENCE FOUNDATION
OFFICE OF INSPECTOR GENERAL
OFFICE OF INVESTIGATIONS

CLOSEOUT MEMORANDUM

Case Number: I-99090035

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In September 1999 we received an allegation that NYSERNet,¹ a regional network service provider, submitted proposals to NSF containing false statements.

NYSERNet was created as an independent non-profit organization with the assistance of a 1986 NSF grant, and received over \$10 million in continuous NSF funding between 1986 and 2003. In 1989, several staff members of NYSERNet realized the possible commercial potential of the internet, and accordingly separated from NYSERNet to form a commercial company, PSINet. In this first commercial spin-off, NYSERNet exchanged the network infrastructure for 10% ownership of the new company. When PSINet went public, NYSERNet received stock which it sold for approximately \$22 million.

For a period of time, NYSERNet contracted for network services with PSINet, and then other providers. In 1996, after building a new network operating system with the assistance of NSF funding, a second group of NYSERNet officials decided to create another commercial company. However, in contrast to the PSINet spin-off, these individuals decided to carry out a complicated corporate "trifurcation." The trifurcation split the original NYSERNet into three new entities: NYSERNet.com, later renamed AppliedTheory Corporation (ATC), a for-profit company that received the operating network infrastructure and staff; NYSERNet.org (Org), a non-profit entity which continued as the nominal recipient of all NSF grants; and NYSERNet.net (Net), the non-profit parent company of ATC and Org, which held stock in ATC and controlled Org. All three Boards of Directors contained several common members.

From the sale of the PSINet stock, NYSERNet possessed over \$20 million in stocks and cash (the endowment). As New York state law prohibited the direct transfer of the endowment to ATC, NYSERNet transferred these proceeds to Net in the trifurcation. However, Net then provided \$7.5 million to a bank as collateral to secure a loan for ATC. Net subsequently approved ATC's plan for the transfer of the remainder of the endowment to ATC over several years, as payments to "subsidize" the cost of the network service provided to Org's members by ATC—a subsidy that was available only to members who purchased their services through Org from ATC. In addition, Org was contractually required to procure all available services exclusively from ATC.

¹ The New York State Education and Research Network comprises the following member institutions: Binghamton University, City University of New York, Clarkson University, Columbia University, Cornell University, New York University, Polytechnic University, Rensselaer Polytechnic Institute, University of Rochester, Rockefeller University, SUNY Stony Brook, Syracuse University, SUNY Albany, SUNY Buffalo, AT&T, Brookhaven National Laboratory, General Electric, IBM, Corning, Grumman, Kodak, Xerox, the New York State Department of Education, the New York State Department of Science and Technology, and the New York State Development Corporation.



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In reality, Org and Net were corporate fictions: Net had no employees, and the staff members of Org were ATC employees who were assigned to perform tasks on behalf of Org. This corporate structure was called the "One Company Concept."

ATC hired a president for Org and emphasized to him the importance of the One Company Concept.² However, the new president raised concerns about Org's budget, particularly the absence of competitive procurement and the high charges that Org paid to ATC for office rent, personnel, and expenses. Org terminated the president, after which he presented these issues to us.

NSF grant conditions require competition in procurement and avoidance of conflicts of interests. The relator alleged that the interrelated Boards of Directors, pervasive management control by ATC, and the sole-source procurement contract, made it impossible for Org to comply with these requirements. Org did not disclose these facts to NSF following the trifurcation as required pursuant to the current grant conditions, and failed to reveal these facts in subsequent proposals to NSF. The withholding of this information enabled Org to receive grant funds it would otherwise be prohibited from receiving.

We issued subpoenas to ATC, Org, and Net (collectively, the defendants) for relevant documents. Org's attorney accepted service of the subpoenas on behalf of all three entities, and documents were eventually provided by ATC's attorney, on behalf of all three entities. Our review of these documents substantiated the allegations of unresolved conflicts of interests, non-competitive procurement, and submitting proposals to NSF that failed to disclose material information.

In addition, we found noncompliance with NSF requirements concerning program income. Program income refers to income earned by a grantee that is directly generated by the grant activity. NSF grant conditions require grantees to retain program income and use it to further the objectives of the grant project, subject to the same rules as the direct federal grant funds. The documents provided by the defendants revealed that all of the money and assets in the endowment constituted program income, and accordingly the expenditure of these funds violated NSF grant conditions.

Org's former president (the relator) subsequently filed a qui tam action under the False Claims Act (FCA) against the defendants. Qui tam actions are initially filed under seal, while the Department of Justice (DOJ) assesses the evidence and the merits of the case, to decide whether DOJ will intervene and prosecute the case. After we apprised DOJ of the evidence gathered in our investigation, DOJ notified the defendants of an intention to intervene in the FCA case.



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In our view, the post-trifurcation proposals and all additional requests for payment submitted by the defendants (under the name of the original grantee, NYSERNet) failed to disclose the conflicted and non-competitive practices, rendering these proposals and payment requests false claims under the FCA. In our opinion, if the truth had been disclosed, the NSF would not have awarded the new grants or made further payments pursuant to the extant grants. As a result, the damages to the government for these false claims totaled \$2.4 million.

Besides the FCA, there were two additional grounds for recovery by the government. First, because the defendants' corporate structure caused intrinsic problems with the expenditure of the program income in the endowment, the government could recover those funds through the judicial imposition of a constructive trust. Second, the amount of grant funds and endowment funds paid by Org and Net to ATC, in violation of the grant conditions, could be recovered by the government. Federal grant funds that are in the possession of the grantee, and not expended in a manner consistent with grant conditions, are considered to be federal funds held in trust by the grantee. Program income from federal grants, which are subject to the same restrictions on how they can be spent, can be viewed in the same way. When a grantee holding such federal funds wrongfully transfers these funds to another party, the federal funds are said to have been "converted" by the grantee, and the government can bring a conversion action against the grantee to recover those funds.

While this case was pending, Net and Org took affirmative steps to make themselves more independent, including the selection of independent Boards of Directors, and acquiring separate office space and employees. In April 2002, ATC entered into bankruptcy proceedings, and ATC's assets were sold to pay debts owed to secured creditors; because Net had no security interest in ATC's assets, the \$7.5 million of the endowment encumbered to secure the bank loan to ATC was lost.

In March 2003, Net and Org entered into a Consent Judgment with DOJ, which required these entities to pay \$1.4 million to the United States government. Pursuant to the Consent Judgment and the qui tam provisions of the FCA, the relator received 23% of the settlement amount; in addition, the Org and Net paid the relator's counsel's fees and expenses. On the basis of the Consent Judgment, DOJ filed a Notice of Election to Intervene and Notice of Dismissal (the Notice), and requested that the Notice, the Consent Judgment, and the First Amended Complaint be unsealed. The court's Order, the Notice, and the Consent Judgment are attached.

Accordingly, this case is closed.

despite conflicts of interest between in violation
of NSF grant conditions.

The government investigation was primarily based on a whistleblower complaint filed pursuant to the False Claims Act, 31 U.S.C. §§ 3729 et seq. NSF awarded grants to provide computer network services for educational and research institutions. The complaint alleged the grant applications submitted to NSF were false since failed to disclose its affiliation with the related for-profit corporate entity. The complaint further alleged selected the affiliated for-profit entity, to provide certain network services in the absence of a competitive bidding process. NSF grant conditions require grant recipients to procure goods and services in a conflict-free, competitive manner. In its grant applications and other submissions to NSF, certified the information provided was truthful and that complied with NSF grant conditions. , the U.S. Attorney, stated "a grantee or any recipient of federal dollars must provide correct and complete certifications to the United States in exchange for taxpayer dollars."

In fiscal year 2002, the government's recoveries in civil fraud claims reached nearly \$1.2 billion. False Claims Act recoveries since the law was substantially amended in 1986 have now topped \$10 billion--over \$6 billion of which was recovered under the so-called whistleblowers provisions of the Act. The

whistleblower or "qui tam" provisions of the False Claims Act allow individuals, known as "relators," to file suit on behalf of the United States against those who have allegedly falsely or fraudulently claimed federal funds, including Medicare, Medicaid, disaster assistance, subsidies, grants, loans, and contract payments. Persons who file qui tam suits can recover 15 to 25 percent of any settlement or judgment after intervention by the United States.

The relator in this case is _____ was President of _____ from April 1998 to August 1998. _____ became concerned about what he perceived to be the inter-related nature of _____ during his tenure as _____ President.

_____ was fired from _____ and subsequently filed the whistleblower action. _____ will receive a 15 to 25 percent share of the recovery. Assistant United States Attorney _____

who handled the case, praised the assistance of the relator. _____ stated, "the recovery in this case and other whistleblower suits demonstrates the public-private partnership encouraged by the False Claims Act works and is an effective tool in the government's continuing effort to recover scarce taxpayer dollars."

While agreeing to settle this matter to avoid costly and lengthy litigation, _____ denies any wrongdoing. _____ worked with the government to achieve the mutually agreeable result reflected in the Consent Judgment. _____ has provided network

services partially supported with NSF grant funds since 1986.

and NSF look forward to maintaining a productive relationship for the benefit of the New York State educational and research community--a relationship based on the continued provision of quality services from and the submission of complete and correct grant applications to NSF.

United States Attorney praised the outstanding and tireless efforts of the NSF Office of Inspector General ("OIG"), including NSF OIG attorneys and 1, as well as the attorney for the whistleblower, , Washington, D.C. The U.S. Attorney stated, "the recovery in this case would not have been achieved without the federal-private cooperation manifested throughout this matter."