

INVESTIGATIVE AUDIT REPORT

LENOIR CITY UTILITIES BOARD
JANUARY 1, 2003, THROUGH JUNE 30, 2005



State of Tennessee



**Comptroller of the Treasury
Department of Audit
Division of Municipal Audit**



STATE OF TENNESSEE

John G. Morgan
Comptroller

C O M P T R O L L E R O F T H E T R E A S U R Y

STATE CAPITOL
NASHVILLE, TENNESSEE 37243-0260
PHONE (615) 741-2501

March 12, 2007

Lenoir City Utilities Board
P. O. Box 445
Lenoir City, TN 37771

Board Members:

Presented herewith is the report on our investigative audit of selected records of the Lenoir City Utilities Board. This investigative audit focused on the period January 1, 2003, through June 30, 2005. However, when the examination warranted, this scope was expanded.

Section 9-2-102, *Tennessee Code Annotated*, requires that the Comptroller of the Treasury prescribe a uniform system of bookkeeping designating the character of books, reports, receipts and records, and the method of keeping same, in all state, county and municipal offices, including utility districts, which handle public funds. This code section also requires that all officials adopt and use the prescribed system. The Comptroller has prescribed a minimum system of recordkeeping for municipalities, which is detailed in the *Internal Control and Compliance Manual for Tennessee Municipalities* combined with Chapters 1-7 of *Governmental Accounting, Auditing, and Financial Reporting*. The purpose of our audit was to determine the extent of the entity's compliance with certain laws and regulations, including those in the above-mentioned manuals.

The issues in this report relate to those conditions that we believe warrant your attention.

Copies of this report are being forwarded to Governor Phil Bredesen, the State Attorney General, the District Attorney General, certain state legislators, and various other interested parties. A copy is available for public inspection in our office.

Very truly yours,

John G. Morgan
Comptroller of the Treasury



**STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF MUNICIPAL AUDIT**

John G. Morgan
Comptroller of the Treasury

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Dennis F. Dycus, CPA, CFE, Director
Division of Municipal Audit

March 12, 2007

Mr. John G. Morgan
Comptroller of the Treasury
State Capitol
Nashville, TN 37243-0260

Dear Mr. Morgan:

As part of our ongoing process of examining the records of municipalities, we have completed our investigative audit of selected records of the Lenoir City Utilities Board. This investigative audit focused on the period January 1, 2003, through June 30, 2005. However, when the examination warranted, this scope was expanded.

Section 9-2-102, *Tennessee Code Annotated*, requires that the Comptroller of the Treasury prescribe a uniform system of bookkeeping designating the character of books, reports, receipts and records, and the method of keeping same, in all state, county and municipal offices, including utility districts, which handle public funds. This code section also requires that all officials adopt and use the prescribed system. The Comptroller has prescribed a minimum system of recordkeeping for municipalities, which is detailed in the *Internal Control and Compliance Manual for Tennessee Municipalities* combined with Chapters 1-7 of *Governmental Accounting, Auditing, and Financial Reporting*. The purpose of our audit was to determine the extent of the entity's compliance with certain laws and regulations, including those in the above-mentioned manuals.

Our examination resulted in issues related to the Dixie Lee Utility District merger and other issues:

- Indirect conflict of interest
- Advisory committee members not appointed by city council; no approval of compensation

Mr. John G. Morgan
Comptroller of the Treasury
March 12, 2007

- Ineligible advisory committee member
- Cash payments in lieu of insurance not allowed
- Dubious municipal benefit from 40-year personal service contracts
- Unauthorized payroll payment
- Unauthorized payment from retirement account
- Contractor not licensed as required by state law
- Inadequate written cutoff policy
- Fringe benefit not properly reported for some employees
- Violation of retirement rules

If after your review, you have any questions, I will be happy to supply any additional information which you may request.

Sincerely,

A handwritten signature in black ink, appearing to read "Dennis F. Dycus". The signature is fluid and cursive, with a large initial "D" and "F".

Dennis F. Dycus, CPA, CFE, Director
Division of Municipal Audit

**INVESTIGATIVE AUDIT OF SELECTED RECORDS
OF THE LENOIR CITY UTILITIES BOARD
FOR THE PERIOD JANUARY 1, 2003, THROUGH JUNE 30, 2005**

The investigative audit of the Lenoir City Utilities Board (LCUB) was initiated at the request of the district attorney general's office. His office had received specific allegations and concerns related to the operation of the LCUB. Although those allegations and concerns were investigated, the focus of the examination became the December 2000 merger of the LCUB and the former Dixie Lee Utility District. Issues related to the pre and post merger activity are included in the first section of the report. Other issues are addressed in the second section of this report.

MERGER WITH DIXIE LEE UTILITY DISTRICT ISSUES

Background

For several years, Lenoir City attempted to acquire the adjacent Dixie Lee Utility District (Dixie Lee) because the geography of the district blocked the expansion of the Lenoir City Utilities Board's service area. As early as 1989, Dixie Lee board meeting minutes indicated that LCUB had offered lifetime consultant positions to the Dixie Lee commissioners if the two entities merged.

In late 1999, LCUB management hired a lobbyist to draft legislation that would effect the eventual merger. Section 7-82-202(f), *Tennessee Code Annotated*, mandates that when a municipality acquires a utility district by merger, consolidation or transfer, and the utility district is outside the municipality's boundaries, the municipality must set up an advisory committee. This advisory committee is to be composed of former district commissioners or residents and customers of the utility system.¹ In early 2000, then State Representative Douglas Gunnels introduced legislation which amended several key provisions pertaining to the composition of a utility advisory committee. Under the old law, members of a utility advisory committee could only be appointed for the same term and in the same number as the members of the municipality's governing body. For Lenoir City, this would have resulted in an advisory committee consisting of seven members, each serving a four-year term. The successful amendment drafted by the lobbyist and introduced by Mr. Gunnels changed Section 7-82-202(f), *Tennessee Code Annotated*, to allow the number and term of the members of the utility advisory committee to be set by municipal ordinance. The new law went into effect in April 2000. According to the Dixie Lee Utility District's minutes, on November 13, 2000, the Dixie Lee commissioners agreed to merge with LCUB.

¹State law also allows a municipality to dissolve the advisory committee once the former district ceases being a separate department of the municipality. The former Dixie Lee Utility District ceased being a separate department of LCUB on December 18, 2000, the same date the merger was approved by LCUB.

On December 18, 2000, after it had approved the merger, the Lenoir City Council approved an ordinance that created a utility advisory committee consisting of three members, each appointed to a 40-year term, with their compensation to be determined by the council. The ordinance also stated that written contracts would be executed between the council and these three individuals. At that meeting, Dixie Lee commissioners Clarence Wilson, Billy Cusick, and James Johnson, signed 40-year personal service contracts. The former mayor was the only member of the council who signed the contracts.² According to the contracts, the individuals were to receive a monthly fee equal to the amount received by LCUB board members plus a monthly payment in lieu of health and life insurance premiums.

The ordinance also allowed the city council to appoint one additional member to the utility advisory committee for a single term, not to exceed two years. On May 21, 2001, members of LCUB appointed Mr. Gunnels, who at this point was no longer a member of the General Assembly, to this position.

➤ **Indirect conflict of interest**

At a minimum, the former Dixie Lee commissioners had an apparent indirect conflict of interest in voting on the proposed merger. Prior to signing the merger agreement, the commissioners had an understanding that they would each receive a 40-year personal service contract for their anticipated service on an advisory committee. By agreeing to this merger, the former Dixie Lee commissioners guaranteed their own compensation for a period far beyond the expiration of their board terms. The minutes of Dixie Lee Utility District did not reflect that the terms of these contracts were publicly disclosed as required by law.

Section 12-4-101(b), *Tennessee Code Annotated*, states:

It is unlawful for any officer ... to vote for, let out, overlook, or in any manner to superintend ... any contract in which any ... utility district ... shall or may be interested, to be indirectly interested in any such contract unless the officer publicly acknowledges such officer's interest. "Indirectly interested" means any contract in which the officer is interested but not directly so....

Section 12-4-102, *Tennessee Code Annotated*, also states:

Should any person, acting as such officer, committee member, director, or other person referred to in § 12-4-101, be or become directly or unlawfully indirectly interested in any such contract, such person shall forfeit all pay and compensation therefor. Such

²Various council members who had attended this meeting informed auditors that they were unaware of the 40-year term and stated that personal service contracts were not presented. However, a video tape of this meeting appears to show that the 40-year term was mentioned and the personal service contracts were presented.

officer shall be dismissed from such office the officer then occupies, and be ineligible for the same or a similar position for ten (10) years.

➤ **Advisory committee members not appointed by city council; no approval of compensation**

Each of the three former Dixie Lee commissioners signed a 40-year personal service contract that detailed his compensation. The former mayor of Lenoir City was the only council member who signed the contracts. Although these contracts were apparently signed during a Lenoir City Council meeting, the council never officially appointed the former commissioners to the advisory committee nor did it approve their compensation as required by the charter of Lenoir City and by the ordinance that created the advisory committee.

The charter of Lenoir City, Article II, Section 1, states:

Powers and duties of city council. The powers and duties of City Council shall be . . . 2. To appoint such boards, commissions, committees and authorities not created herein as they in their discretion deem necessary for the efficient operation of the city and to set the compensation, if any, they are to receive for their services.

Ordinance No. 2000-12-18-1358-B, states:

Upon the effective date of merger with Dixie Lee Utility District, Lenoir City shall appoint three (3) former utility district commissioners or residents and customers of the utility system so acquired to an advisory committee.... Three (3) of the advisory committee members shall serve for a term of forty (40) years with compensation to be determined by City Council.

➤ **Ineligible advisory committee member**

Former State Representative Douglas Gunnels, who was appointed to the advisory committee in May 2001 and introduced the amendment as noted in the background information, was not a resident and customer of the former Dixie Lee Utility District. Section 7-82-202(f), *Tennessee Code Annotated*, requires that members of the utility advisory committee must be either a former commissioner of, or a resident and customer of the acquired utility system.

Mr. Gunnels received total monetary compensation of \$26,267.50 for his committee membership.

➤ **Cash payment in lieu of insurance not allowed**

As specified within their 40-year personal service contracts, the former Dixie Lee commissioners received monthly payments in lieu of premiums for health and life insurance. However, Attorney General Opinion 04-031 states that a municipality has no authority to pay an official and/or employee cash in lieu of paying a life or health insurance premium.

➤ **Dubious municipal benefit from 40-year personal service contracts**

The 40-year term of the personal service contracts does not appear to benefit LCUB or its ratepayers. It appears that the 40-year term was intended to effectively grant a lifetime position to each former Dixie Lee commissioner. The former Dixie Lee Utility board was self-appointing and historically reelected its members. However, this did not guarantee any commissioner a lifetime appointment. In addition, the 40-year term precludes meaningful oversight or replacement by current or future members of the city council. Furthermore, no elected or appointed official in the state has a term length that exceeds eight years; therefore, it could be argued that a 40-year term is contrary to the public policy of the state of Tennessee.

In addition, the ordinance that created the advisory committee **prohibited** the installation of a replacement following the death or resignation of any member. As a result, a likely future scenario will be a committee consisting of only one member, conceivably for the majority of the remaining term of the personal service contract. Such a scenario would appear to benefit the remaining committee member without a corresponding benefit to LCUB or its ratepayers. It is especially difficult to see a benefit to the former customers of Dixie Lee Utility District. Since Section 7-82-202(f), *Tennessee Code Annotated*, requires that the advisory committee be entirely comprised of former utility district commissioners or of residents and customers of the former district, presumably the advisory committee has a particular responsibility to the customers of the former district.

Furthermore, the expense related to the personal service contracts does not appear to be for a valid municipal purpose. Between January 2001 and November 2005, LCUB paid over \$235,000 to the advisory committee members.³ One of the former Dixie Lee commissioners was 39 years old when he signed his personal service contract. Under the

³Beginning in December 2005, LCUB ceased making payments to the advisory committee members pending the outcome of civil litigation.

terms of his personal service contract, LCUB, at a minimum, would pay this individual over \$450,000 if he fulfills his entire 40-year term.⁴

Because of the manner in which the ordinances and personal service contracts were structured and because Section 7-82-202(f), *Tennessee Code Annotated*, was apparently changed for this specific combination, the former Dixie Lee commissioners were able to personally benefit from the merger that they approved, as put forth in the first issue. The terms of the contracts with the former Dixie Lee commissioners do not appear to be in the best interest of LCUB or its ratepayers.

OTHER ISSUES

➤ **Unauthorized payroll payment**

The former general manager was paid for 812 unused vacation hours when he was only allowed 80 per the LCUB's employee handbook. This resulted in an overpayment of \$39,412. The board's attorney stated there was a contract which allowed the additional leave; however, no contract containing this provision was ever provided to auditors. Chapter 3.3 of the LCUB's employee handbook sets forth the guidelines for earning vacation time.

➤ **Unauthorized payment from retirement account**

A former employee received an additional \$32,000 from the retirement account that was not authorized according to LCUB employees' retirement plan. Members of the LCUB had approved a contract with the former employee which stated that the employee would be 100 percent vested in LCUB's retirement program if he was terminated without cause. However, according to the retirement plan and LCUB's independent actuary, the employee was only 40 percent vested at the time of his termination. He received \$54,909; however, according to the rules of the retirement plan he was only entitled to a lump sum retirement benefit of \$22,909.

➤ **Contractor not licensed as required by state law**

The board awarded a contract for tree trimming costing over \$25,000 to a contractor who was not licensed. Bid specifications for this job informed bidders that they should be licensed as required by the Contractors Licensing Act of 1994. Although the contractor

⁴This amount does not forecast future increases in health and life insurance premiums for which committee members have improperly (as detailed in the above issue) received cash. It also makes no provision for the time value of money.

listed a license number on his bid, it was not until after bids had been opened that it was discovered that the contractor did not have a valid contractor's license. Management was informed of this before the contract was awarded; however, the general manager stated he relied on the board's legal counsel who informed him that a license was not required. The contractor did not obtain a license until January 26, 2006, 15 months after the bid was awarded and after work had already begun.

Section 62-6-103, *Tennessee Code Annotated*, states, "It is unlawful for any person, firm or corporation to engage in or offer to engage in contracting in the state, unless such person, firm or corporation has been duly licensed under the provisions of this chapter, as hereinafter provided." Section 62-6-102, *Tennessee Code Annotated*, defines a contractor as one who performs any project costing \$25,000 or more.

Section 62-6-136(a), *Tennessee Code Annotated*, states, "It is unlawful for any person, firm or corporation to represent itself as a licensed contractor, ... unless such person, firm or corporation has been duly licensed under § 62-6-103...."

➤ **Inadequate written cutoff policy**

Although LCUB had several written procedures related to collection and termination of delinquent accounts, there was no written policy which specified when service would be turned off due to nonpayment. Our review of selected records noted several delinquent accounts that were still active. Furthermore, LCUB management did not timely detect that a LCUB employee had failed to pay his/her utility bill for several months.

The *Internal Control and Compliance Manual for Tennessee Municipalities*, Title 1, Chapter 1, Section 1, states:

... a policies and procedures manual is part of the written record system of the municipality. The municipality's manual should incorporate or reference all the policies and procedures required in this manual [*Internal Control and Compliance Manual for Tennessee Municipalities*] and should include any additional policies and procedures specific to the municipality....

Title 3, Chapter 3, Section 9, states, "Municipal officials should ensure that ... if accounts remain unpaid on the municipality's cutoff date, service is discontinued in compliance with the municipality's policy."

➤ **Fringe benefit not properly reported for some employees**

According to 5.13 of LCUB's Employee Handbook, employees assigned a LCUB vehicle for the purpose of performing standby duties were allowed to use the vehicle for personal use within the service area jurisdiction of the respective departments. However, these fringe benefits were not properly recorded and reported as compensation to the Internal Revenue Service (IRS). IRS considers use of an employer-provided vehicle to be taxable as personal use regardless of whether the vehicle was actually used for personal purposes unless personnel policies specifically prohibit such use.

➤ **Violation of retirement rules**

The former accounting manager filed a Notice of Intent to Retire form indicating that his last full day of employment prior to exhausting his accumulated leave was March 29, 2002. The actuary determined the lump sum value of the employee's retirement benefit based on a benefit commencement date of February 1, 2003, the day the employee's accumulated sick and unused vacation time would expire. However, the lump sum amount was paid to the employee in April 2002. LCUB employees' retirement plan 5.10 (a)(v) states "... Retirement benefits will commence upon the expiration of the accumulated sick time and unused vacation time."

LCUB members should consult with legal counsel to resolve these issues. In addition, board members should take all necessary measures to ensure these issues do not recur.