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May 6, 2011

The Honorable Roger Skraba
Mayor, City of Ely
209 E. Chapman Street
Ely, Minnesota 55731

Dear Mayor Skraba:

At the City of Ely's Special City Council Meeting on January 25, 2011, the City Council voted to refer concerns the City had with the Ely Area Development Association ("EADA") to the Office of the State Auditor ("OSA"). The City appears to have general concerns about EADA, and more specific concerns about EADA's operation of "Project Firefly." In addition, the City was concerned that it had violated Minnesota law by paying more than \$50,000 per year to a joint powers entity for economic development.

The OSA has the authority to review financial matters of local units of government, including cities, towns, school districts, and their joint powers entities.¹ The OSA does not have general regulatory authority over nonprofit organizations or the authority to audit tax returns filed by nonprofit organizations.

This letter summarizes the OSA's review of the issues presented and provides the City with recommendations for working with joint powers entities in the future.

The Joint Powers Entity

The Cities of Ely and Winton, Morse Township, and Independent School District No. 696 entered into a Joint Powers Agreement in 1997 that established a Community Economic Development Joint Powers Board ("Joint Powers Board").² In 2004, Vermillion Community College was added to the Joint Powers Agreement as a "non-voting" member.³ At some point, the City of Babbitt, a public hospital, and a chamber of commerce also joined the Joint Powers Agreement as non-voting members.

¹ See Minn. Stat. chapter 6.

² See A Cooperative Agreement Among the Cities of Ely and Winton and Township of Morse and School District #696 to Establish a Community Economic Development Joint Powers Board (September 8, 1997) ("Joint Powers Agreement"). Under Minn. Stat. § 471.59, subd. 1, two or more governmental units may enter into an agreement to jointly exercise any power similar or common to the contracting parties.

³ See Amendment to A Cooperative Agreement Among the Cities of Ely and Winton and Township of Morse and School District #696 to Establish a Community Economic Development Joint Powers Board

The stated purpose of the Joint Powers Agreement was to allow the local units of government to coordinate and facilitate future planning, and to leverage new monies and services for their economic development.⁴ Through the years, the Joint Powers Board served as a means to share costs for such things as emergency preparedness, library services, recreation, and recycling.⁵ The Joint Powers Board did not have its own employees, but entered into contracts to obtain and deliver services.⁶

The Joint Powers Board was comprised of members appointed by the government units that were a party to the Joint Powers Agreement.⁷ The Joint Powers Board was given the power to enter into contracts and expend public funds.⁸ Parties to the Joint Powers Agreement were required to pay a fixed annual membership fee of \$1,000.⁹ In addition, all voting members, except the School District, agreed to share in the annual operating costs of the Joint Powers Board using a population-based formula.¹⁰

Under the Joint Powers Agreement, the Joint Powers Board was required to submit its budget to each of the parties to the Joint Powers Agreement for approval.¹¹ The Board was also required to “make a financial accounting” and report to the parties at least once a year.¹² The Joint Powers Agreement allowed the parties to examine the Joint Powers Board’s books and records.¹³

The Joint Powers Board adopted By-Laws.¹⁴ Among other things, the By-Laws required that all contracts be executed by the Chair or Vice-Chair of the Joint Powers Board.

In 2010, Ely’s City Council voted to withdraw from the Joint Powers Agreement.¹⁵

(June 2004). A “non-voting” member could participate in Board discussions and offer agenda items, but could not hold office, move or second motions, count towards a quorum, or vote on resolutions.

⁴ See 1997 Joint Powers Agreement, Art. I, § 1.

⁵ See Memorandum to Ely City Council Members from Attorney Laurence J. Klun (September 27, 2005). See also Community Economic Development Joint Powers Budget 2010.

⁶ See Memorandum to Ely City Council Members from Attorney Laurence J. Klun (September 27, 2005).

⁷ See 1997 Joint Powers Agreement, Art. II, § 2, and Art. IV.

⁸ See, e.g., 1997 Joint Powers Agreement, Arts. VI and VII. Under Minn. Stat. § 471.59, subd. 3, a joint powers entity may receive and disburse public funds. The method of disbursement must agree as far as practicable with the method provided by law for the disbursement of funds by the parties to the agreement. See Minn. Stat. § 471.59, subd. 3. Contracts awarded and purchases made under the agreement must conform to the contract and purchasing requirements applicable to any one of the parties. *Id.* The joint powers entity must provide strict accountability of all funds and reports of all receipts and disbursements. *Id.*

⁹ See 1997 Joint Powers Agreement, Art. VII, § 3.

¹⁰ *Id.* As a result, the City of Ely contributed the largest share of funding for the Joint Powers Board.

¹¹ See 1997 Joint Powers Agreement, Art. VII, § 4.

¹² See 1997 Joint Powers Agreement, Art. VII, § 5.

¹³ *Id.*

¹⁴ See 1997 Joint Powers Board Meeting Minutes (December 10, 1997). The OSA was provided with a copy of an undated “Draft By-Laws of the Community Economic Development Joint Powers Board.”

Ely Area Development Association (“EADA”)

EADA is a nonprofit organization originally founded in 1959.¹⁶ According to its Articles of Incorporation, the purpose of the nonprofit was to support and to provide for the common good and development of Northeastern Minnesota.¹⁷

EADA provided administrative support services to the Joint Powers Board, although there does not appear to have been a written contract between EADA and the Joint Powers Board.¹⁸ EADA provided the Joint Powers Board with monthly invoices for EADA’s services.

City’s EADA Concerns

The OSA was brought the following concerns about EADA:

- EADA had two Co-Chairs, and not a Chairperson and Vice-Chair as required by its Bylaws.¹⁹
- The EADA Board of Directors did not consistently have thirty members.²⁰
- EADA had one person serving as Co-Chair and Treasurer, and another person serving as Co-chair and Secretary, but its Bylaws only permitted the positions of Secretary and Treasurer to be combined.²¹
- In May 2010, EADA announced that it was no longer putting a discussion of its financial reports on its quarterly meeting agenda.²²
- At its meeting on February 1, 2010, EADA’s Executive Board discussed errors that EADA staff had discovered in the 2006 and subsequent budgets.

¹⁵ See Joint Powers Board Meeting Minutes (December 15, 2010). The Cities of Winton and Babbitt also withdrew from the Joint Powers entity in 2010.

¹⁶ See Minnesota Secretary of State’s Office and EADA websites.

¹⁷ See Amended and Restated Articles of Incorporation for Ely Area Development Association, Art. III (January 22, 1996).

¹⁸ EADA informed the OSA that there was no written contract.

¹⁹ EADA Bylaws establish officer positions consisting of a Chairperson, Vice-Chair, Secretary, and Treasurer. See Amended (as of January 29, 2007) and Restated Bylaws of the Ely Area Development Association (“EADA Bylaws”), pages 4-5.

²⁰ In one place, the EADA Bylaws provide that the EADA’s initial Board of Directors is comprised of thirty members; in another place, the Bylaws require that the EADA Board be comprised of not more than thirty members. EADA Bylaws, pages 1-3. When the EADA Board had less than thirty members, it appears the EADA attempted to recruit new EADA Board members. See, e.g., EADA Executive Board Meeting Minutes (December 6, 2010); EADA Meeting Minutes (April 4, 2005).

²¹ EADA Bylaws specifically allow the offices of Secretary and Treasurer to be combined into a single office. See EADA Bylaws, pages 4-5. Under the Minnesota Nonprofit Corporation Act, any number of offices or functions of the offices may be held or exercised by the same person unless the articles or bylaws provide otherwise. See Minn. Stat. § 317A.315.

²² EADA Bylaws require four meetings of the EADA Board to be held annually. See EADA Bylaws, pages 2 and 3.

These concerns appear to be internal organizational matters for the nonprofit to resolve. For example, the decision to remove financial reports from the agenda of EADA's quarterly Board meetings was made to save time, according to the meeting minutes.²³ In addition, the meeting minutes reported that the financial reports would still be provided to Board members, and Board members were encouraged to call EADA's Executive Director or office staff with any questions.²⁴

More importantly, EADA contracted with the Joint Powers Board to provide services. For each of the City's concerns, the City representative(s) on the Joint Powers Board could have raised the concerns with the Joint Powers Board. In turn, the Joint Powers Board could have questioned EADA about the concerns. For example, if the Joint Powers Board felt that it needed more frequent and comprehensive financial reporting by EADA, it could have amended its contract with EADA accordingly.²⁵ As for the 2006 budget errors, the Joint Powers Board, and each party to the Joint Powers Agreement, should have independently examined the Joint Powers Board's annual budgets.²⁶ Finally, if the City believed the Joint Powers Board was not providing sufficient oversight of EADA, the City had the option to withdraw from the Joint Powers Agreement.

The OSA will not be conducting any further review of these issues.

City's Project Firefly Concerns

The OSA was brought concerns about EADA's operation of Project Firefly. The concerns included:

- A project management services contract for Project Firefly with Community Communications was not approved by the EADA Board.
- The principal for Community Communications was also EADA's Co-Chair and Treasurer.
- Community Communications was not registered with the State.
- EADA's 2009 Form 990-EZ, the Federal short form tax return for organizations that are exempt from income tax, raised questions, including:
 - Project Firefly wages were not reported on the Form; and

²³ See EADA Quarterly Meeting Minutes (May 24, 2010).

²⁴ EADA's Bylaws provide that the day-to-day activities of the nonprofit are directed by an Executive Board consisting of nine Board members who are required to meet monthly. EADA Bylaws, page 4. The OSA is unaware of any requirement that financial reports be on the agenda for quarterly meetings of a nonprofit's board of directors.

²⁵ As stated later in this letter, the OSA recommends that contracts between a joint powers board and a vendor/contractor be in writing.

²⁶ According to the EADA Executive Board Meeting Minutes, the error was detected in the EADA's 2006 budget, and the error was carried forward through 2009. See EADA Executive Board Meeting Minutes (February 1, 2010). In response to the detected error, the EADA returned \$4,421.62 to the Joint Powers Board. *Id.* Independent examinations by the Joint Powers Board or the parties to the Joint Powers Agreement might have disclosed the 2006 budget error sooner.

- The Form was signed by William Roloff, as EADA Treasurer, and by Cynthia Fenske, an EADA employee, as the Form's preparer.

Project Firefly is a "capacity building" initiative operated by EADA to develop "homegrown innovation."²⁷ EADA informed the OSA that funding for Project Firefly was provided by grants from Iron Range Resources ("IRR"), the Blandin Foundation, and others.²⁸ According to the EADA's Executive Director, City of Ely funds through the Joint Powers Entity were never used for Project Firefly activities.²⁹

EADA entered into a project management services contract for Project Firefly with Community Communications on May 3, 2010, covering the time period of May 3, 2010, through September 3, 2010.³⁰ Mr. Roloff, who was also the EADA's Co-Chair and Treasurer, signed the contract as the principal for Community Communications.³¹ EADA Executive Director Nancy Larson signed the contract on behalf of EADA. It appears the contract was not approved by the EADA Board, although the May 3, 2010, EADA Executive Board Meeting Minutes state that Co-Chair Roloff reported he had agreed to manage Project Firefly until the end of 2010.³²

The OSA has the authority to examine documents, and the accounting procedures and practices, of a contractor or grantee of a political subdivision.³³ However, the OSA's authority over the contractor or grantee is limited to those books, records, documents, and accounting procedures and practices that are relevant to the contract or transaction with the political subdivision.³⁴ Because it does not appear that City funds were used for Project Firefly, it is questionable whether the OSA has the authority to review the concerns the City has raised about Project Firefly.

²⁷ See Project Firefly Summary from Nancy Larson to Terri Boese, Clerk-City of Ely (January 25, 2011); Professional Consulting Contract between Ely Area Development Association and Community Communications (May 3, 2010), page 1; Update from Pat Henderson, EADA/Joint Powers Staff (August 28, 2006).

²⁸ See also Update from Pat Henderson, EADA/Joint Powers Staff dated August 28, 2006 (\$50,000 grant from Blandin Foundation received in the Spring of 2006); Professional Consulting Contract between Ely Area Development Association and Community Communications (May 3, 2010) (describing Project Firefly as a Blandin Foundation and IRR funded capacity building initiative). The IRR was previously and is currently known as the Iron Range Resources & Rehabilitation Board (IRRRB).

²⁹ See Project Firefly Summary from Nancy Larson to Terri Boese, Clerk-City of Ely dated January 25, 2011. The EADA confirmed this statement during discussions with the OSA. The EADA also informed the OSA that Project Firefly had a separate checking account.

³⁰ See Professional Consulting Contract between Ely Area Development Association and Community Communications (May 3, 2010).

³¹ The Minnesota Secretary of State's Office may be able to provide guidance on registration requirements for a private business.

³² See EADA Executive Board Meeting Minutes (May 3, 2010).

³³ See Minn. Stat. §§ 6.551 and 16C.05, subd. 5.

³⁴ *Id.* The statutes further provide that when the governing body of the political subdivision requests the OSA to examine the contractor or grantee, the political subdivision is liable for the costs of the OSA's examination. See Minn. Stat. § 16C.05, subd. 5.

Furthermore, in response to recent concerns, both the IRR and EADA reviewed the use of grant funds for Project Firefly.³⁵ Generally, the funding entity is in the best position to determine whether grant requirements have been met. Both the IRR and EADA concluded that there was no improper use of the funds.

While the OSA may examine a nonprofit's use of public funds, the OSA does not have general regulatory authority over nonprofits. Under the Minnesota Nonprofit Corporation Act, nonprofit board members may have a direct financial interest in the nonprofit's contracts, as long as certain steps are taken, such as fully disclosing the material facts of the interest to the board and obtaining approval of the contract by a majority of the board or a committee in good faith.³⁶ The OSA questions whether EADA's Executive Director had the authority to enter into the May 3, 2010, contract without disclosure to and approval by the EADA Board.³⁷ The OSA notes, however, that the contract was extended when it was brought before the EADA Executive Board on September 13, 2010.³⁸ In addition, Mr. Roloff resigned from his EADA Board positions effective February 1, 2011.³⁹

The OSA also does not have the authority to audit tax returns.⁴⁰ If an individual believes there is evidence of tax fraud, the evidence should be provided to the Internal Revenue Service's tip line at 1-800-829-0433 or to the Minnesota Department of Revenue's tip line at 1-800-657-3500.

The OSA will not be conducting any further review of these issues.

³⁵ As part of its on-going review of grant reimbursement requests, the IRR had previously reviewed and disallowed certain claims submitted by EADA.

³⁶ See Minn. Stat. § 317A.255, subd. 1(b)(2) and (3). See also Minn. Stat. § 317A.165 (effect of unauthorized contract). By definition, a corporation governed by the Minnesota Nonprofit Corporation Act generally may not be formed for a purpose involving pecuniary gain to its members or pay dividends or other pecuniary remuneration, directly or indirectly, to its members. See Minn. Stat. § 317A.011, subd. 6. Generally accepted accounting principles require the disclosure of material related party transactions and certain control relationships due to the instances of fraudulent financial reporting and misappropriation of assets that have been facilitated by the use of undisclosed related party transactions.

³⁷ EADA's Bylaws provide that the Executive Director is named by the EADA's Executive Board to manage the affairs of the corporation on a day-to-day basis. EADA Bylaws, pages 2 and 5.

³⁸ Alternatively, it appears the EADA Executive Board could have considered the contract to be void or voidable. See Minn. Stat. § 317A.255. The EADA Executive Board Meeting Minutes do not indicate whether Mr. Roloff abstained from voting on the September 13, 2010, contract. See EADA Executive Board Meeting Minutes (September 13, 2010). Meeting minutes should reflect any abstentions from voting due to potential conflicts.

³⁹ See EADA Board Meeting Minutes (February 1, 2011).

⁴⁰ The OSA notes, however, that the Professional Consulting Contract with Community Communications was signed on May 3, 2010. Therefore, any payments made under that contract would not appear on EADA's 2009 Form 990-EZ.

City's Concerns About Paying More Than \$50,000 to the Joint Powers Board

The City was concerned that, in 2003, 2006, and 2007, it made annual payments to the Joint Powers Board in excess of \$50,000, and therefore may have violated Minn. Stat. § 469.191. The statute provides that a city “may appropriate not more than \$50,000 annually out of the general revenue fund of the jurisdiction to be paid to any incorporated development society or organization of this state for promoting, advertising, improving, or developing the economic and agricultural resources of the city or town.”⁴¹

When submitting its concerns to the OSA, the City provided the OSA with a chart of its annual payments to the Joint Powers Board for the years 1996 through 2007. The OSA compared the amounts on the chart for the years 2003 through 2007 with the City's audited Financial Statements, and found that the amounts reported in the City's Financial Statements did not consistently agree with the chart the City provided to the OSA.⁴²

The following table shows the amount the City paid to the Joint Powers Board for the years 2003 through 2009, according to the City's chart and the City's audited Financial Statements.

Amount City Paid Joint Powers Board 2003 - 2009		
Year	Amount City Reported to OSA	Amount Per City's Audited Financial Statements
2003	\$55,134.24	\$32,715.00
2004	\$47,634.24	\$47,634.00
2005	\$47,634.24	\$43,634.00
2006	\$50,016.00	\$50,056.00
2007	\$50,016.00	\$51,450.00
2008	Not Provided	\$52,451.00
2009	Not Provided	\$49,000.00
2010	Not Provided	Not Yet Available

According to the City's Financial Statements, the City paid more than \$50,000 to the Joint Powers Board in 2006, 2007 and 2008. In turn, the Joint Powers Board paid some portion of these funds to EADA. However, in addition to economic development, the Joint Powers Board had initiatives in other areas, such as library and recycling services.

⁴¹ See Minn. Stat. § 469.191.

⁴² The OSA also obtained from EADA the 2003 and 2004 Profit & Loss documents for the Joint Powers Board, which also did not agree with either the chart the City provided to the OSA or the City's Financial Statements.

For example, the Joint Powers budget for 2010 showed that the City would contribute \$45,000 (\$1,000 membership fee plus \$44,000 budget share) -- \$41,406.52 to be used for "Joint Powers General Operations Budget & EADA" and \$2,593.48 to be used for a program with the University of Minnesota Duluth's Center for Economic Development known as the Small Business Development Center.⁴³ According to the 2010 Budget, the Joint Powers Board anticipated receiving \$86,733.54 in revenue; however, EADA would receive only \$60,264.04.⁴⁴

Recommendations

The Office of the State Auditor recommends that the City review each of its joint powers agreements on a regular basis.⁴⁵ Older joint powers agreements may need revision because actual practice no longer follows the terms of the agreements or legal requirements may have changed. The City may also determine that a joint powers agreement no longer serves the best interests or policy goals of the City.

The City should also confirm that any funds handled by its joint powers entities are handled the same as City funds, as far as practicable, as required by Minnesota law.⁴⁶ Similarly, the City should monitor that contracts awarded and purchases made under a joint powers agreement conform to the contract and purchasing requirements applicable to any one of the parties to the agreement.⁴⁷ Finally, the City should require that its joint powers entities provide strict accountability of all funds and reports of all receipts and disbursements.⁴⁸

The OSA recommends that the City require its joint powers entities to have written contracts whenever practicable. Written contracts help both sides understand their obligations under the contract. In addition, the act of writing down the contract provisions can help clarify what is expected. For example, the OSA believes the Joint Powers Board should have had a written contract with EADA. The terms of the contract could have addressed some of the concerns the City now raises by requiring EADA to provide the Joint Powers Board with specific financial and/or organizational information.⁴⁹ Furthermore, any contract or pass-through disbursement of public funds to

⁴³ \$41,406.52 + \$2,593.48 = \$44,000.00.

⁴⁴ Payments made by other parties to the Joint Powers Agreement covered disbursements for other Joint Powers Board initiatives such as library and recycling services.

⁴⁵ The City's Financial Statements note a number of joint ventures. For additional guidance on joint powers agreements, the City may want to consult with the League of Minnesota Cities (LMC). The LMC has a number of publications on its website (www.lmc.org) on this topic. The LMC also recommends that joint powers agreements be reviewed on a regular basis. See *Ten Things to Watch for When Entering Into Joint Powers Agreements*, available on the LMC's website.

⁴⁶ See Minn. Stat. § 471.59, subd. 3.

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ For example, some local units of government require nonprofit vendors/contractors to file audited financial statements with the local unit of government.

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a vendor of goods or services should contain an express audit clause providing that the books, records, documents, and accounting procedures and practices of the vendor that are relevant to the contract or transaction are subject to examination by the local unit of government and the state auditor.⁵⁰

Finally, the OSA recommends that the City monitor compliance with Minn. Stat. § 469.191. The City should not appropriate more than \$50,000 annually out of the City's General Revenue Fund to any incorporated development society or organization of this state for promoting, advertising, improving, or developing the economic and agricultural resources of the City. When the City disburses funds to a joint powers entity, the OSA recommends that the City clarify the intended use of the funds by the joint powers entity and monitor that the funds are used by the joint powers entity as intended.

Conclusion

The Office of the State Auditor has completed its review of concerns it received about the Ely Area Development Association and about the City's payments to a joint powers board. This letter summarizes the OSA's review of these issues and provides the City with recommendations for working with joint powers entities in the future.

If you have any questions, please feel free to contact Terrilyn Diamond at 651-297-7108, or me at 651-297-5853.

Sincerely,

/s/ Nancy J. Bode

Nancy J. Bode

Assistant Legal Counsel

cc. Ely City Council Members
Ms. Betsy Leustek, EADA Chair
Mr. Ray Marsnik, Joint Powers Board Chair
Ms. Terri Boese, City Clerk-Treasurer
Ms. Kelly Klun, City Attorney

⁵⁰ See, e.g., Minn. Stat. § 16C.05, subd. 5.