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July 23, 2018

**TRANSMITTED VIA U.S. MAIL
AND ELECTRONIC MAIL**

The Honorable Nancy Adams
Mayor, City of Pequot Lakes
4638 Main Street
Pequot Lakes, Minnesota 56472

Dear Mayor Adams:

The Office of the State Auditor (OSA) received concerns about the City of Pequot Lakes (City). Specifically, concerns were raised about the City's authority to issue a check in the amount of \$123,661.38 to the nonprofit corporation Friends of the Pequot Lakes Community Library, Inc. (Nonprofit Corporation). The Nonprofit Corporation had requested the payment, characterizing it as a "return" of money the City allegedly had agreed to invest on behalf of the Nonprofit Corporation.¹ Despite legal and other guidance to the contrary, the City Council approved the payment in July, 2017.² Upon learning in December, 2017 that the City had made the payment, the OSA conducted a review of relevant City documents and spoke with City officials and the City's attorney.

Based on our review, the OSA finds no support for the Nonprofit Corporation's purported claim to the funds. We conclude that the money in question consists of public funds that belong to the City, and that the \$123,661.38 payment to the Nonprofit Corporation was neither justified nor authorized by law.

¹ On May 31, 2017, the City Administrator spoke with the OSA and explained that both the City's Attorney and its private auditing firm agreed that the requested payment to the Nonprofit Corporation was not authorized because funds provided to the City by the Nonprofit Corporation had been recognized as donations by City Council resolutions. The OSA informed the City Administrator that the OSA cannot give legal advice, but once money is donated to a city it becomes public funds and should be spent by the city for public purposes, in this case, for the City Library. The OSA agreed with the City's attorney and auditing firm that a transfer "back" to the Nonprofit Corporation would not be authorized. The City Administrator indicated she would let the OSA know what the City Council had approved the payment.

² Subsequently, the check for this payment was included in the consent agenda approved by the City Council in August 2017.

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This letter contains the OSA's findings and recommendations to help the City comply with Minnesota law.

Facts

A. The City Library

The City Council established the Pequot Lakes Library/Pequot Lakes Community Library (City Library) and a Library Board (City Library Board) by passing resolutions on November 5, 2003.³ The City Library Board consists of seven members appointed by the Mayor with approval of the City Council.⁴ Neither Minnesota law nor the City resolutions gave the City Library any separate legal status from the City. City officials and the City's attorney affirmed that the City Library is a department of the City, and this has been consistently represented on the City Library's web site.⁵

B. City Investments to Endow the City Library

Over a number of years, the City invested City money as an endowment for the City Library. The City Council and the City Library Board cooperated in establishing the endowment investments. For example, in several instances, the City Library Board asked the City Council to purchase or transfer money into endowment CDs.⁶ These requests occurred for a period that extended at least from July 2005 through October 2014.⁷

C. The Nonprofit Corporation

In 2009, after much of the City's endowment funds had been accumulated, the Nonprofit Corporation was incorporated. According to City officials, the City's auditor urged the creation of this entity because a city does not have clear legal authority to conduct fundraising activities.

³ See City Council Resolutions 03126 and 03128.

⁴ See City Council Resolution 03128, and *e.g.*, January 2, 2018, Report to City Council Agenda Item #3.4.

⁵ See www.pequotlakeslibrary.org ("The Pequot Lakes Community Library, which opened in June 2004, is a department of the City of Pequot Lakes."), and snapshots of past versions of this website accessible on the Internet Archive, <http://archive.org/web/>. In 2005, the City Library Board passed a motion "that Pequot Lakes Library be dissolved as a corporation and that Pequot Lakes Community Library be incorporated immediately." September 20, 2005, Meeting Minutes of the City Library Board. City officials informed the OSA that this action was intended to make it clear that the City Library was a department of the City.

⁶ See City Library Board Reports to City Council dated July 5, 2005, November 1, 2005, August 1, 2006, October 3, 2006, August 7, 2007, September 2, 2008, July 3, 2012, and October 7, 2014.

⁷ The City Library Board requested, and the City purchased, \$67,600 worth of Endowment CD's prior to 2009.

From the start, the Nonprofit Corporation and the City were significantly intertwined:

- In June 2009, the City Library Board identified three individuals as a “Board of Directors” for the Nonprofit Corporation. These individuals include the now-former City Library Board Chairperson, the Mayor, and the now-former City Library Board Treasurer.⁸
- Secretary of State Filings for the Nonprofit Corporation identify the Mayor as its President, at the City Library’s Address; and lists the original filing date as August 10, 2009.⁹
- In January 2010, the City Library Board reported the completion of 501(c)(3) paperwork and indicated that the “Friends of Library will possibly start in the spring”¹⁰

The Registered Office Address for the Nonprofit Corporation is the Pequot Lakes City Hall.¹¹ The City Library’s website directs that donations to support the City Library should be “made to the ‘Friends of the Pequot Lakes Community Library,” and dropped off or mailed to the City Library’s address.¹²

IRS Form 990s for the Nonprofit Corporation also demonstrate the close connections between the Nonprofit Corporation and the City. The forms show three officers, including the now-former City Library Board Chairperson, the Mayor, and the now-former City Library Board Treasurer; they use the City Library’s address as the address for the Nonprofit Corporation.¹³

The City Library Board and the Board of the Nonprofit Corporation continue to overlap. The City reported to the OSA that the Nonprofit Corporation’s current Board members are Melissa Birch, Thomas Adams, Kevin Olson, and Don Porter.¹⁴ In addition, Ms. Birch, Mr. Adams, and Mr. Olson are also members of the City Library Board. According to City Council Meeting Minutes, Ms. Birch and Mr. Adams were appointed to the City Library Board on May 6, 2014, and January 6, 2015, respectively.

⁸ See June 16, 2009, Meeting Minutes of the City Library Board.

⁹ See Minn. Sec’y of State Business Filing Details, Friends of the Pequot Lakes Community Library, Inc. (May 17, 2018).

¹⁰ See January 19, 2010, Meeting Minutes of the City Library Board.

¹¹ Minn. Sec’y of State Business Filing Details, Friends of the Pequot Lakes Community Library, Inc. (May 17, 2018). (“**Registered Office Address** 4638 CR 11, Pequot Lakes, MN 56472, USA”).

¹² See <https://www.pequotlakeslibrary.org/support-the-library>.

¹³ See 2010, 2011, 2012, and 2013 Form 990s for Friends of the Pequot Lakes Community Library, Inc., all of which are publically available (The Nonprofit Corporation filed via IRS Form 990-N (e-Postcard) in 2014, 2015, and 2016).

¹⁴ Mr. Adams is the spouse of the Mayor. See “*Faces: Adams embraces tasks to improve Pequot Lakes - Retired educator begins fourth term as mayor,*” N. Vogt, (Pine and Lakes Echo Journal, Jan. 15, 2017).

The following table summarizes the financial information for the Nonprofit Corporation as reported in the IRS Form 990s:¹⁵

<u>Revenue</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>
Contributions and grants	\$ 18,945	\$ 32,665	\$ 22,925	\$ 28,363
Other revenue	12,629	15,069	11,204	12,602
Total Revenue**	\$ 31,938	\$ 47,734	\$ 34,129	\$ 40,965
<u>Expenses</u>				
Grants and Other Assistance*	\$ 31,938	\$ 47,734	\$ 33,333	\$ 39,832
Total Expenses**	\$ 30,553	\$ 47,734	\$ 33,333	\$ 39,832
Revenue less expenses	\$ 1,021	\$ -	\$ 796	\$ 1,133
<u>Assets and Liabilities</u>				
Total Assets (Cash - non-interest-bearing)	\$ 1,385	\$ -	\$ 796	\$ 1,133
Total Liabilities	\$ -	\$ 2,201	\$ 3,821	\$ -
*To the Pequot Lakes Community Library				
**Note: The 2010 totals contain mathematical errors. The information is provided as documented on the Form 990s.				

The IRS Form 990s report no interest-bearing assets and that the Nonprofit Corporation's Revenue consisted of funds received from fundraising events and donors that were, in turn, given to the City Library.¹⁶

¹⁵ *Id.* Part I, Part X, and Schedule I Part II.

¹⁶ See 2010, 2011, 2012, and 2013 Form 990s for Friends of the Pequot Lakes Community Library, Inc., Part III. No description was provided in the Nonprofit Corporation's 2013 Form 990.

D. Nonprofit Corporation Donations to the City under Minn. Stat. § 465.03 (Gifts to Municipalities)

The OSA requested and received a list of payments accepted by the City from the Nonprofit Corporation. The list shows payments totaling \$221,723.19 from July 27, 2010, through September 26, 2016. *See* Attachment A. After reconciling this list to the City Council's Meeting Minutes, the OSA found that the City accepted each receipt, with the exception of one payment for a \$50 reimbursement and \$10,400 of another payment, by City resolution referring to Minn. Stat. § 465.03, the statute on gifts to municipalities.¹⁷

E. The Nonprofit Corporation's 2017 Request

According to City documents, in April 2017, Melissa Birch and Thomas Adams, as representatives of the Nonprofit Corporation, wrote a memorandum to the City requesting payment of \$123,661.38, which the Nonprofit Corporation characterized as a "return" of funds belonging to it.¹⁸ The April memorandum suggests a prior request was made to the City by the Nonprofit Corporation after which the City had been advised by its auditor that it did not have authority to comply with this request because state law did not permit a City to refund donations made to it.¹⁹

In the April memorandum, the Nonprofit Corporation claimed that it never donated the funds in question to the City; rather, it claimed, the funds had always belonged to the Nonprofit Corporation to be used as an endowment to support the City Library. The Nonprofit Corporation contended that it had asked the City to invest the funds on behalf of the Nonprofit Corporation, because the Nonprofit Corporation incorrectly believed at the time that it could not make investments on its own. The Nonprofit Corporation further claimed that the City agreed to this request, as well as subsequent requests about specific investments the Nonprofit Corporation wanted made with the funds. It went on to assert that, in late 2015, it "learned that earlier information regarding investment restrictions was incorrect," and proceeded to ask "that the City return to the [Nonprofit Corporation] the [e]ndowment funds they agreed to hold and invest on our behalf."²⁰

¹⁷ A city is authorized to accept a donation provided the city council accepts it through a resolution adopted by a two-thirds majority vote. Minn. Stat. § 465.03. These resolutions were signed, in most instances, by the Mayor. One \$40,000 receipt was approved by a former Mayor. The Mayor is listed as an Officer of the Nonprofit Corporation in its Form 990 for 2010, 2011, 2012, and 2013 (The Nonprofit Corporation filed via IRS Form 990-N (e-Postcard) in 2014, 2015, and 2016).

¹⁸ *See* Attachment B, pp. 3-5.

¹⁹ *See* Attachment B, pp. 3-5.

²⁰ *See* Attachment B, pp. 3-5.

Following receipt of the April memorandum, City staff obtained guidance from the City's attorney regarding whether the City had the authority to pay the Nonprofit Corporation the \$123,661.38 it was requesting. The attorney responded in two emails, one dated May 17, 2017, and the other, May 22, 2017, concurring with the auditor's conclusion that the law did not allow for such payment, and specifically noting:

...the fact that the CD's are in the name of the City library with the City tax id number, seems to weigh heavily to the conclusion that when these dollars were provided to the City they became government dollars to be expended for library purposes, but subject to the limitations imposed upon the City by law on the expenditure of those dollars... In this case, the record resolution states that [Nonprofit Corporation] gifted/transferred dollars to the City to be used for the library. That is what has been done and continues to be done as I understand the facts. There is nothing contained in the adopting City resolutions that would indicate that this money would be returned to [Nonprofit Corporation] under certain conditions.²¹

On June 19, 2017, the Nonprofit Corporation wrote a second memorandum to the City Council, which reiterated its contention that the money in question never was donated to the City, but rather ownership remained with the Nonprofit Corporation. It renewed its request for the return of the money. The memorandum characterized the City attorney's position to the contrary as "missing the point."²²

On July 6, 2017, in preparation for a City Council meeting, the City Clerk prepared a Report to the City Council summarizing the Nonprofit Corporation's request, the auditor's advice that the law did not allow the City Council to meet the request, and the City attorney's position, which was consistent with the auditor's advice. In the Report, the City Clerk also noted that a decision to pay the Nonprofit Corporation as it had requested would result in an audit finding against the City in its 2017 audit.²³ The Report, the Nonprofit Corporation's two memos, and the two emails from the City's attorney were all provided to the City Council as part of its July 6, 2017, City Council meeting packet. See Attachment B.

²¹ See Attachment B, pp. 6-8.

²² See Attachment B, pp. 9-10.

²³ Subsequently, the City's 2017 audit included a legal compliance finding indicating that the expenditure "did not meet the public purpose criteria to be considered an allowable expenditure . . ." The City's management agreed with the auditor's recommendation that all future transactions comply with Minnesota Laws, that all expenditures be made for a public purposes, and that the City adhere to the advice of its legal counsel in such matters. City of Pequot Lakes, Minnesota, Audited Financial Statements, December 31, 2017, p. 69.

According to the City, the Nonprofit Corporation asserted a claim to five (5) financial instruments held by the City, as follows:

Nonprofit Corporation Check Request Detail			
Financial Instrument	Purchase Date	Maturity Date	Value
LSB CD 22128	7/16/2009 ²⁴	1/19/2016	\$57,641.52
ANB CD 6404	5/10/2011	5/10/2016	10,931.79
LSB CD 22467	7/11/2012	7/10/2017	5,088.07
LSB CD 22647	10/10/2014	10/10/2019	10,000.00
FNB Check 1586	9/20/2015	None	40,000.00
Total			\$123,661.38

Additionally, City officials told us that there was never a trust agreement involving the Nonprofit Corporation, and the money was not held in trust for the Nonprofit Corporation.

F. The July 6, 2017, Action by the City Council

The Nonprofit Corporation's request for a payment from the City in the amount of \$123,661.38 was considered by the City Council on July 6, 2017. Despite the apparent guidance to the contrary from the City's auditor and attorney, the City Council approved payment of this money to the Nonprofit Corporation.²⁵ The Mayor abstained from voting on this matter.²⁶

Minnesota Law, Findings and Recommendations

A. The Funds in Question are Public Funds Owned by the City

Under Minnesota law, "municipalities have no inherent powers and possess only such powers as are expressly conferred by statute or implied as necessary in aid of those powers which have been expressly conferred."²⁷

The OSA knows of no authority for a City to serve as trustee or fiduciary for a nonprofit corporation in the manner now described by the Nonprofit Corporation as having been the case.

²⁴ The OSA noted that the City purchased this CD before the Nonprofit Corporation made any payments to the City. The first payment to the City from the Nonprofit Corporation did not occur until July 27, 2010 (Attachment A). The Nonprofit Corporation did not file an IRS Form 990 in 2009 and reported no financial activity for the prior year in its 2010 IRS Form 990.

²⁵ See City Council Meeting Minutes dated July 6, 2017, and City check No. 40250 to the Nonprofit Corporation for \$123,661.38.

²⁶ *Id.*

²⁷ *Mangold Midwest Co. v. Village of Richfield*, 274 Minn. 347, 357, 143 N.W.2d 813, 820 (1966).

Further, City officials have acknowledged that there are no documents to support the Nonprofit Corporation's characterization of the funds in question as having been owned by the Nonprofit Corporation and held for it by the City as a fiduciary.²⁸ The OSA finds no support for the theory that the money belonged to the Nonprofit Corporation and was being held on its behalf by the City. Specifically, we found no support for the representation in the April 29, 2017, Nonprofit Corporation memorandum that the City agreed to "invest [e]ndowment and non-endowment monies in CDs or other investments" for the Nonprofit Corporation.²⁹ Similarly, we found no support for the representation in the June 19, 2017, Nonprofit Corporation memorandum that the City ever served as a fiduciary holding funds for the Nonprofit Corporation. In fact, these claims are starkly contradicted by the long history demonstrated in both the City's records and the Nonprofit Corporation's IRS 990 filings.³⁰

The City's records clearly document that the City endowment money over which the Nonprofit Corporation now asserts a claim of ownership was accumulated, in part, by the City before the Nonprofit Corporation had ever provided any money to the City, and that money thereafter provided to the City by the Nonprofit Corporation was consistently accepted by the City as donations from the Nonprofit Corporation under Minn. Stat. § 465.03. In its resolutions, the City Council accepted such payments as contributions to the City "for the benefit of its citizens."³¹ Once accepted by the City, they became public funds owned by the City.

The OSA finds that the money in question consists of public funds owned by the City and that the City had no authority to pay it to the Nonprofit Corporation.

We recommend that the City immediately secure the return of this money, along with any interest or gain attributable to it. As required by Minn. Stat. § 6.50, we will file a copy of this letter with the Crow Wing County Attorney.³²

²⁸ In addition to being both contrary to the facts and unauthorized by law, the asserted fiduciary relationship is also unlikely and counterintuitive. If any fiduciary duties existed at all, one would expect the City to have been the beneficiary of fundraising activity, not a trustee for the fundraiser. It would be odd for a city to undertake the acceptance of the fiduciary duties of loyalty and care for the benefit of an entity that exists to raise funds for the benefit of a city department.

²⁹ See Attachment B, pp. 3-5.

³⁰ In its own Form 990s filed with the IRS, the Nonprofit Corporation, for years, recognized its donations to the City as expenses and grants to the City.

³¹ See e.g., City Resolution 10-23, 10-32, 11-08, 11-15, 11-16, 11-19, etc.

³² See Minn. Stat. § 6.50 ("[. . . in case of any violation of law, such report shall be filed with the city attorney thereof and with the county attorney of the county in which the administrative offices of such city are located, and these officials of the law shall institute such proceedings as the law and the public interest require.]").

B. Cities and Nonprofit Organizations

According to the City, the Nonprofit Corporation was created in response to concerns about the City's authority to raise funds for the City Library. The OSA agrees that cities have no general statutory authority to hold fundraising events, and such events are often conducted by nonprofit entities to the great benefit of Minnesota communities. However, Minnesota law expressly prohibits cities from creating nonprofit corporations, absent explicit legal authority to do so.³³

Even before this prohibition was enacted by the Legislature, it was recognized that local governments had no authority to create nonprofit corporations absent specific statutory authority. In this regard, the Attorney General stated in 1986 that local units of government had no express statutory authority to create nonprofit corporations and that such authority could not properly be implied from existing grants of power.³⁴

Nonprofit corporations intended to assist local governments should not be created by the local government, but by community members. In this case, as noted above, the City was involved in the creation of the Nonprofit Corporation, the registered address is City Hall, and the Mayor is listed in the Secretary of State business filing and on past IRS Form 990s as its president. It also appears that many of the Nonprofit Corporation's directors and officers have been members of the City Council and the City Library Board. It appears that these entanglements may have caused confusion and blurred the different roles of the City Council, the City Library Board, and the Nonprofit Corporation to the point that the Nonprofit Corporation's unsupported claim to own the City's investments achieved traction with the City Council.

This blurring of roles appears to continue in the manner in which donations are handled by the City Library. Currently, the City Library's website directs that donations for the City Library should be made to the Nonprofit Corporation at the City Library. This convoluted arrangement seems unnecessary and confusing, especially since the City Council can accept donations for the City Library by resolution adopted by a two-thirds majority vote.³⁵

The problematic blurring between the Nonprofit Corporation and the City can be addressed through a few changes. First, the OSA has generally recommended that local government officials and employees serve only in a non-voting capacity on the board of any nonprofit created to assist a local government. In this case, we believe this would be particularly beneficial.

³³See Minn. Stat. § 465.717, subd. 1.

³⁴Op. Att'y Gen. 92a-30, (Jan. 29, 1986); see also, *Mangold Midwest Co. v. Village of Richfield*, 274 Minn. 347, 357, 143 N.W.2d 813, 820 (1966).

³⁵See Minn. Stat. § 465.03.

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We also recommend that the City separate its operations from those of the Nonprofit Corporation. For example, when the Nonprofit Corporation conducts its solicitations or fundraisers, the Nonprofit Corporation should identify itself as the entity conducting the activity. Any advertisement or solicitation should state clearly whether donations are sought for the Nonprofit Corporation or for the City (which would include the City Library). The City may want to work with its legal counsel to determine the best way for the City to work effectively with separate entities to support City activities.

* * *

Please provide a written response to the Office of the State Auditor by **August 24, 2018**, detailing how the City will implement these recommendations.

Thank you in advance for your attention to this matter. If you have any questions, please feel free to contact me.

Sincerely,

/s/ Mark F. Kerr

Mark F. Kerr, JD, CFE
Special Investigations Director
Office of the State Auditor
(651) 296-4717

cc: The Honorable Scott Pederson, City Council Member
The Honorable Jerry Akerson, City Council Member
The Honorable Randy Loukota, City Council Member
The Honorable Mimi Swanson, City Council Member
Ms. Nancy Malecha, City Administrator
Mr. Chris Hood, Flaherty & Hood, P.A.
The Honorable Donald F. Ryan, Crow Wing County Attorney