

DEEP FINANCIAL WATER

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By William Fraser, City Manager

Some city articles are harder to write than others. Some follow a set outline from year to year, like the budget overview or the goals outline. Some offer short informative snippets or updates of various activities.

This time, however, I must inform you about a serious financial situation that the city is dealing with that will almost certainly result in a loss of \$350,000 to \$400,000 in the city's water fund. We have been managing the situation for three years but, this past week it took a turn for the worse. It is a complicated matter and you deserve a full and complete explanation.

In the fall of 2006 Finance Director Sandra Gallup and I were working with our auditors on all of our accounts as usual for that time of year. As this work progressed, the Water fund was showing a much a larger than expected deficit which made no sense to anyone and had no immediate or logical explanation.

On the evening of the City Council meeting on October 11, 2006 Finance Director Gallup asked to speak to me as soon as possible. We met in her office immediately after the meeting. She informed me that she had narrowed down the excess water fund deficit to over expenditure on a single project - a water line improvement completed in 2006. Upon closer inspection, the problem was traced to a single erroneous payment made by the city to the contractor - Scott Construction, Inc. of Newport, Vermont. She also told me that she had immediately disclosed this to the city's auditors that day.

This payment was processed on December 22, 2004. The project payment request submitted by the contractor and approved by both our consulting engineers and me was for \$85,774.70. The payment request form also listed the "paid to date" amount as \$548,110.83. A correction to the bill had been made so that the "paid to date" amount was hand written and very prominent to the eye, the amount due was small, type written and partially obscured directly below some scratched out lines.

When the check was processed, the \$548,110.83 figure was mistakenly picked up on the warrant jacket and erroneously put into the accounts payable system. Scott Construction was issued a check for \$548,110.83 instead of \$85,774.70 - an overpayment of \$462,336.13.

Upon receipt of the check, Scott Construction did not notify the city of this error nor did they inquire about what the funds should be credited toward. In addition, they did not show this amount as received or paid in future invoices - failing to properly credit the city for what was, in essence, an advance payment. Because this project was not completed and closed out financially until July 17, 2006 it was not immediately apparent in 2004 that the project was over budget.

All remaining pay requests for the project were processed correctly without any adjustment from Scott Construction for this overpayment or any acknowledgement that it occurred. They did, however, accept the money and deposit the check - confirmed by the city's copy of the canceled check.

On October 12, 2006 , the next morning after the council meeting, Finance Director Gallup and I contacted Attorney Steven Stitzel. He advised that we send a registered letter to Scott Construction informing them of what happened and requesting immediate re-payment of the money. Mr. Stitzel asked for copies of all the information and to review any correspondence before it was sent. He advised us that the money was legally collectible and that Scott Construction has possible criminal liability for failing to properly credit the payment.

On Friday morning, October 13, 2006, I sent a registered letter to Mr. Daniel Scott, President of Scott Construction. That same morning, I informed Mayor Hooper of the matter and the steps that had been taken at that point. Details of the matter were shared with the full city council on October 27, 2006.

On October 16, 2006 we confirmed that this transaction had been properly contained within the city's financial records and had been subject to audit in fall of 2005 for the fiscal year ending June 30, 2005. The specific bill and payment had been reviewed as part of the audit with no irregularities noted. By the time the overpayment was tracked in 2006, city staff changes had occurred in key positions involved with this project.

By December of 2006, after reviewing the city's documentation and his own records, Mr. Scott acknowledged that the overpayment occurred, claimed that he had not been aware of it at the time and entered negotiations for re-payment.

On January 10, 2007 the city filed a claim with our Property/Casualty and Liability insurance carrier seeking to collect reimbursement for this loss under our errors and omissions policy. We received notice from our insurer on January 19, 2007 that the claim was not covered.

On January 25, 2007 Scott and the City signed a Promissory Note for full re-payment over six years at 5% interest with monthly payments of \$7,445.89. The matter was considered resolved and the funds were booked on the city's financial statements as a receivable.

Scott made regular timely payments on the note until April of 2008. Citing seasonal cash flow problems, he requested an extension until June 1st. The city did not formally grant an extension but told him that they expected the April, May and June payments and to all be current by June with all late fees paid. Scott said that this should not be a problem.

From this point forward the situation began to deteriorate. Scott eventually made a single payment in June but the check bounced. The city informed him that we were considering prosecution for the bad check. A replacement bank check was finally provided the city on July 25, 2008. Regular communications between the city, the city's attorney, Scott and Scott's attorney ensued. Promises were made by Scott that a new repayment plan would be presented but none materialized. To the best that the city could ascertain, Scott Construction did not have any significant work which would generate sufficient revenues to cover the existing note.

On September 2, 2008 the city officially notified Scott that the note was in default and demanded full payment as per terms of the note. Scott was concerned that this default would cause his other creditors to call their loans and push him into bankruptcy. The city needed Scott to stay solvent to maintain the opportunity for collection of this money.

In fall and winter of 2008 and 2009, more negotiations took place about re-structuring the debt

and providing additional security to back any new note. In February of 2009, a new note was signed which extended the re-payment period and allowed Scott to make interest only payments for a period of time until his cash situation improved.

City officials believed we had protected the public's interests by being granted a mortgage security in the amount of \$393,534.06 (outstanding principal, interest, late fees and attorney's fees) on a piece of commercial property in Pembroke, New Hampshire with an appraised value of \$1.2 million. The first mortgage was held by a New Hampshire bank in the amount of approximately \$550,000. Chittenden Bank also held a security interest for their overall line of credit. With a real estate security in place, the city was willing to extend payment terms to Scott.

Trouble began almost immediately. Scott was late with the very first (March 2009) payment under the revised note but did eventually send the money. On March 23, 2009 we received a copy (as a security mortgage holder) of a delinquent tax notice from the Town of Pembroke, NH indicating that Mr. Scott had failed to pay a property tax bill of \$372.25.

The April payment did not arrive. On April 13, 2009 the city sent a formal default notice to Mr. Scott giving him until April 29, 2009 to make the note current (under the terms of the note). On April 14, 2009 we received what appeared to be a form letter from Scott to creditors seeking a one month extension on payments.

On April 30, 2009 the city brought suit against Scott in Washington County Superior Court seeking default judgment. On June 3, 2009 the city filed a motion in court for a writ of attachment on Scott's assets and a motion for trustee process to gain access to Scott's bank accounts. The city also filed subpoenas to review all of Scott's bank records to determine what was done with the city's money. At an uncontested hearing on June 16, 2009, the Court awarded judgment in favor of the city in the amount of \$393,534.05 (outstanding principal, interest, late fees and attorney fees).

On June 2, 2009 the city got some more bad news. The New Hampshire bank holding first mortgage on the Pembroke, NH property (which was the city's real estate security) foreclosed on the property and scheduled an auction on June 23, 2009. With the depressed economy the commercial property sold at auction for \$600,000 – enough to pay off the bank's mortgage and collection fees and a small amount to Chittenden Bank but with nothing left for the city. The real estate security was gone.

The next few months were spent issuing subpoenas and reviewing Scott's financial records in great detail. The city was looking for any evidence of fraud or criminal misuse of the city's money. As best as we could determine, the funds received on December 22, 2004 were used on December 28, 2004 to pay down a line of credit issued by Chittenden Bank.

Going into this fall, the city had a court ordered judgment against Scott, attachments on property which were second only behind Chittenden Bank's overarching mortgage for a general line of credit and had all of Scott's financial information. But Scott didn't have any money left so the prospect of an immediate payoff was looking dim. Although frustrating, the plan was to get some long term attachments on property and collect the money over time.

Scott's financial problems were not limited to the city though. This week we received notice

that Chittenden Bank has brought suit and foreclosed on its line of credit against Scott. According to court filings, the Chittenden numbers are staggering – an outstanding debt of \$4.8 million against total estimated Scott assets of \$1.8 million. An auction of Scott's construction equipment is being held on October 14, 2009. Scott's personal assets are included in the foreclosure.

With this scenario, Chittenden Bank will likely seize and liquidate all of Scott's assets and still take a \$3 million loss. No other creditor, including the city, would collect anything. With no equipment or real estate, Scott Construction will be in no position to generate revenue to pay off anything.

The city is left with very few options. We will resubmit an insurance claim for the loss and pursue some long shot approaches. Despite all of our efforts at securing payment, however, it seems very likely that the money is lost.

What is the loss? The original overpayment was \$462,338.13. Scott re-paid the city a total of \$114,688.34. That nets out to \$347,647.79 on a simple basis. When principal, interest and fees are figured the real loss is probably the \$397,079.90 that was awarded in the court judgment plus any legal costs incurred since then. When looking at strictly principal, the loss is at \$377,085.86. No matter how you count it, it's a lot of money from an already strapped water fund.

What is the consequence? Obviously this adds to the existing deficit in the water fund. We are looking at options for financing the deficit so that no rate increases other than those already projected will be necessary. City officials are committed to doing anything we can to avoid a major rate increase due to this situation.

How could this have happened? The amount of money was large but the error was a simple clerical error which picked up the wrong number off of a bill. The final payment approval did not catch the error nor did the audit.

Who's to blame? A clerical error was made which was not caught by the supervisor, the finance department, the auditor or anyone else. Obviously there was a failure in the system which has since been corrected. As City Manager of course, I am ultimately responsible for all the administrative activity of city government. The City Council and I worked closely together on all the recovery efforts since October of 2006. Scott Construction failed in its absolute legal business obligation to inform the city of the overpayment or credit the payment against future bills.

Will this happen again? As a result of this situation, the city has implemented additional accounting safeguards and practices with advice from accountants and approved by the city council.

Why did it take so long to discover? The water line project (for which the overpayment was made in December of 2004) did not finally wrap up until early 2006 with an 8 month gap between billings. Therefore it was not immediately clear that the project was over budget. In addition, changes in management in both the Public Works and Finance Departments interrupted continuity which might have caught this earlier. Because the overpayment was not detected in the 2005 audit, it took until 2006 when reconciling accounts to track this down to the one

individual payment.

Why haven't we heard about this? The issue appeared to be resolved with the Promissory Note and Scott's regular payments. Once a real estate security was obtained later the issue, again, seemed to be resolved. As negotiations were underway at various stages, the city recognized that prompting other creditors to drive Scott into bankruptcy or foreclosure would (and ultimately did) mean that the city would never collect payment. The city's published financial statements have listed the note with Scott as a receivable asset. Because of possible (and actual) litigation the council has occasionally discussed this in executive session and with the item always listed as Scott Construction. Any formal actions have occurred with an authorizing public vote. The city's public court filings on April 30th described this case in detail. It has only been within the last two days with the Chittenden Bank suit that we concluded that we would have to write off this loss. In conjunction with this crucial change of status we have immediately released this information and detail.

The City of Montpelier elected officials and management staff strive to provide nothing but the best service and management practices to and for its residents at all times. Despite aggressive collection action we did not successfully resolve this matter. We have not met your or our high standards and expectations and for that we sincerely apologize.