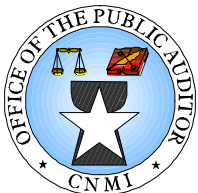


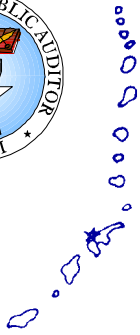
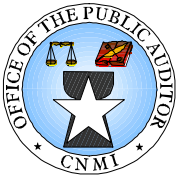


Office of the Public Auditor
Commonwealth of the Northern Mariana Islands

Audit and Investigation of the
Tinian Mayor's Contract for the
Lease of the KBC Building



Letter Report
LT-98-05



Office of the Public Auditor

Commonwealth of the Northern Mariana Islands

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April 8, 1998

Ms. Lucy DLG. Nielsen
Acting Secretary, Department of Finance
P.O. Box 5234 CHRB
Saipan, MP 96950

Dear Ms. Nielsen:

Subject: Final Letter Report on the Audit and Investigation of the
Tinian Mayor's Contract for the Lease of the KBC Building
(Report No. LT-98-05)

This report presents the results of our audit and investigation of the KBC Building Lease Contract. The objectives of the investigation were to determine (1) whether the contract for the lease of the Property was procured in accordance with the CNMI Procurement Regulations, and (2) the steps the CNMI government should take to ensure that payments for the lease of the Property will be made to the right parties.

Our audit and investigation showed that the former Director of Procurement and Supply (P&S) violated the CNMI Procurement Regulations by approving a 2-year lease contract amounting to \$240,000 without either competitive bidding or, at the least, a sole source justification. He also failed to assess the legal capacity and authority of the vendor to enter into a 2-year lease agreement for the KBC Building prior to its approval. This contributed to the complicated situation the Commonwealth Government now finds itself in.

We recommend that the Secretary of the Department of Finance (1) determine whether adverse action should be applied to the Director of P&S for violating the provisions of the CNMI Procurement Regulations, and (2) deposit the \$10,000 monthly rental to an escrow account until such time as (a) a written justification for the lease contract has been received and thoroughly evaluated, (b) a court or the parties concerned reach a decision as to who is really entitled to the Property, and (c) the conflict over who is the proper recipient of the rental payments has been resolved.

In her letter response dated November 25, 1997 (APPENDIX B), the then Acting Secretary disagreed with Recommendation 1 and stated that adverse actions under Section 6-211 of the CNMI Procurement Regulations are not applicable to this procurement. According to her, both

the Director of P&S and the Mayor of Tinian remembered submitting a written justification at the time of the routing of the contract, but were unable to locate a copy of that document. The Mayor of Tinian instead submitted a new justification citing the KBC Building as the only available and suitable building. The then Acting Secretary stated that the substitute justification has been thoroughly evaluated and accepted by the Director of P&S and herself. For Recommendation 2, the Acting Secretary stated that they have already placed \$65,000 in an escrow account for funds to be paid under the KBC Building Lease Contract. Subsequently, in her letter dated December 1, 1997, the Acting Secretary stated that a check amounting to \$45,506.87 had already been released to CDA by agreement of the interested parties, in order to prevent foreclosure.

Based on the response we received from the Acting Secretary, we consider Recommendation 1 open and Recommendation 2 closed. The issuance by the Director of P&S of a June 3, 1997 memorandum requesting the Mayor of Tinian to submit a sole source justification conflicts with the statement that there was already a written justification submitted and an after the fact justification is of little value for analyzing this procurement action. The contract renewing the lease period for 2 years was approved on March 10, 1997, almost three months before the June 3, 1997 memorandum was issued.

BACKGROUND

On June 9, 1986, James A. Fleming and Crisancia M. Fleming, executed a promissory note for \$450,000 payable to the Development Corporation Division of the Commonwealth Development Authority (CDA) in consideration of the loan. The note bears interest at 9% per annum and is payable in monthly installments up to May 9, 2006. To obtain the loan, a certain Rosalia and Alfred Fleming (“Guarantors”) executed, on the same date, a Guaranty Collateral Mortgage and a Fee Simple Mortgage Agreement with CDA. The property being mortgaged consisted of a lot in San Jose, Tinian (Lot 003 T23) and all existing and permanent improvements on the property. The KBC Building is a part of the permanent improvements on the property and hereafter, both the lot and improvements will be referred to in this report as “the Property”. Under Section 15 of the Fee Simple Mortgage Agreement, the Guarantors retained the power and authority to collect the rents, issues and profits of said property provided that the borrowers (James and Crisancia Fleming) were not in default.

After almost 4 years, on April 30, 1990, J. Fleming and CDA executed an agreement reducing the principal amount of the \$450,000 loan to \$133,317.30. It recognized the undisbursed principal amount of \$289,452.23. It also reduced the required monthly payments and moved the final maturity date to April 30, 2000.

On February 26, 1992, James Fleming entered into a Ground Lease Agreement for the Property with a certain lessee, who will be referred to in this report as the “first lessee”¹. Under the terms of the Agreement, the first lessee would lease the Property for 55 years up to February 1, 2047

¹ Six months later, the first lessee assigned all her rights as lessee of the Property to a local company (herein referred to as the “first lessee’s assignee”).

from J. Fleming for a one dollar (\$1.00) consideration. The ground lease agreement, however, contained a provision that granted J. Fleming unrestricted use of the Property until February 26, 1997. There was an addendum to the Ground Lease Agreement dated September 22, 1992, which was signed only by J. Fleming and Constanza Fleming but without the first lessee's signature, that purported to shorten J. Fleming's unrestricted use of the Property to December 9, 1996. However, a letter to the Department of Finance from the legal counsel for the first lessee's assignee dated May 9, 1997 indicates that the first lessee's assignee (the local company) did not acknowledge the amendment.

A series of agreements between J. Fleming and CDA in July 1993 and October 1994 eventually increased the principal amount of the loan to \$162,761.93. The increase was attributed mainly to the inclusion of interest charges on the principal amount, probably to reflect non-payment of monthly installments.

On January 1, 1995, the Mayor of Tinian entered into a lease contract with J. Fleming for the use of the Property. The initial contract (Contract No. C50180) was for nine months up to September 1995, and covered an area of 4,200 square feet on the first floor of the KBC Building for \$5,000 per month, or \$1.19 per square foot.

On March 22, 1995, six months before the Tinian Mayor lease expired, J. Fleming entered into an agreement with CDA wherein he assigned all his rights as lessor of the Property, including entitlement to the then \$5,000 monthly rent, to CDA. The assignment of rentals was intended to pay the promissory note signed on June 9, 1986 by J. Fleming and Crisancia Fleming.

On July 1, 1996, the Tinian Mayor lease contract (Contract No. C50180 in 1995 renumbered to L60067 in 1996) was amended to include the second floor of the KBC Building and increased the monthly rent to \$10,000. On March 10, 1997, 12 days after the unrestricted right of J. Fleming to use the Property under the Ground Lease Agreement expired, a contract change order (Contract No. L60067 in 1996 renumbered to L70043 in 1997) was executed extending the Tinian Mayor's lease period to September 1997. The major parties to this contract were the Mayor of Tinian, as the expenditure authority, and J. Fleming, as the lessor.

Only in November 1996, nearly two years after the assignment agreement was executed, did CDA start to receive the \$5,000 assigned portion of the \$10,000 monthly rent for the Property. As of May 1997, about three months after J. Fleming's rights in the Property expired, J. Fleming and CDA still continued to receive the monthly rental payment, each receiving \$5,000.

OBJECTIVES, SCOPE AND METHODOLOGY

The objectives of our audit were to determine (1) whether the contract for the lease of the Property was procured in accordance with the CNMI Procurement Regulations, and (2) the steps the CNMI government should take to ensure that payments for the lease of the Property will be made to the right parties.

The scope of our audit was limited mainly to a review of lease contracts, contract change orders, and other pertinent agreements and correspondence. Our audit was made, where applicable, in accordance with Government Auditing Standards issued by the Comptroller General of the United States. Accordingly, we included such tests of records and other auditing procedures as were necessary in the circumstances.

FINDINGS AND RECOMMENDATIONS

A. \$240K Lease Contract Approved Without Competition

The CNMI Procurement Regulations require that purchases amounting to \$10,000 and above be awarded by competitive bidding. Should the expenditure authority elect to use other acceptable procurement methods, a written justification should be submitted to the Director of P&S before a contract can be approved. It is the duty of the Director of P&S to ensure that these requirements are observed in all government procurements. Our audit showed that the former Director of Procurement and Supply (P&S) approved a 2-year lease contract amounting to \$240,000 without either competitive bidding or sole source justification. This occurred because the Director of P&S failed to enforce the provisions of the Procurement Regulations that require, at a minimum, a written justification for this kind of procurement. As a result, the Director of P&S violated the provisions of the CNMI Procurement Regulations, and the CNMI Government may have been paying more than was necessary.

Violation of the CNMI Procurement Regulations

The CNMI Procurement Regulations provide that procurements amounting to \$10,000 and above shall be awarded by competitive sealed bidding except when the procurement qualifies under sole source, emergency or expedited procurement methods. Should the expenditure authority elect any of the latter procurement methods, the regulations require a written justification prepared by the official with expenditure authority and approved by the Chief of P&S. No government contract shall be valid unless it complies with these regulations. The Chief shall obtain from the offeror (vendor) information necessary to determine whether the offeror is qualified or eligible to receive an award under applicable laws and rules. Under Section 2-103, it is the duty of the Director of P&S to monitor the observance of these regulations in all government procurements.

Section 6-211 provides that “...An (government) employee who violates the provisions of these rules and regulations is subject to adverse action....”. This action includes but is not limited to reprimand, suspension without pay, termination of employment, civil injunction, civil suit for damages or return of government money or criminal prosecution.

Untimely Implementation of the CNMI Procurement Regulations

Apparently, the contract was procured without going through the CNMI standard procurement procedures. The Director of P&S should have ensured implementation of the law at the time the

contract was initially approved in January 1995. It appears that it was only on June 3, 1997, almost three months after the approval of the second contract change order (Contract No. L-7004302), that the Director of P&S demanded a written justification (See APPENDIX A).

We also noted that the rental rate of \$1.19 per square foot is higher by 19% when compared to the rate of a similar office space in Tinian. At present, the Tinian Mayor's office pays \$6,000 monthly for the use of their main office building in Tinian with an area of 6,000 square feet, or an equivalent of \$1 per square foot.

B. Lessor Improperly Exercised His Limited Rights to the Property

Section 21 of the Ground Lease Agreement provides that J. Fleming shall have unrestricted use of the Property only until February 26, 1997. Beyond this date, all rights in the Property, including the right to the rents and other profits earned from the Property, shall go to the first lessee or her assignee. Our audit showed that James Fleming extended the leasehold agreement with the Mayor of Tinian and collected the proceeds of the lease payments even though his rights in the Property had already expired. This occurred because J. Fleming willfully agreed to a renewal of the lease contract with the Tinian Mayor's Office despite knowing that his rights in the Property had already expired. As a result, J. Fleming violated the provisions of the Ground Lease Agreement to which he was a party, and has led the Tinian Mayor's office and CDA to believe that he still retained rights as lessor of the Property, thereby resulting in serious conflicts.

Violation of the Ground Lease Agreement

Section 41 of the Ground Lease Agreement entered into by J. Fleming with the first lessee provide that "...the Lessor (J. Fleming) and the Lessee (first lessee) hereby agree that Lessor shall continue to have unrestricted use of the Property described...until February 26, 1997....".

J. Fleming violated the provision of the Ground Lease Agreement which terminated his leasehold rights in the Property up to February 26, 1997. On March 10, 1997, almost two weeks after the expiration of his limited rights in the Property, J. Fleming in a lessor capacity signed a contract extending the Tinian Mayor's Office's use of the Property to September 1997.

Until the time when the Tinian Mayor's office placed the lease payments on hold, James Fleming and CDA, as an assignee of a portion of the lease, continued to receive the monthly lease payments. Under the Ground Lease Agreement, lease payments should now rightfully go to the first lessee's assignee. CDA, which may have been unaware of the fact that J. Fleming's rights in the Property had already expired, still continued to collect its \$5,000 share of the rentals under the Assignment. Nonetheless, the Loan and the Mortgage agreements have sufficient provisions to support the courses of action that CDA might want to take.

Conclusion and Recommendations

The Director of P&S violated the CNMI Procurement Regulations by approving a 2-year lease contract amounting to \$240,000 without either competitive bidding or, at the least, a sole source justification. He also failed to assess the legal capacity and authority of the vendor to enter into a 2-year lease agreement for the KBC Building prior to its approval. This contributed to the complicated situation the Commonwealth now finds itself in.

Accordingly, we recommend that the Secretary of the Department of Finance (DOF):

1. determine whether adverse action should be applied to the former Director of P&S for violating the provisions of the CNMI Procurement Regulations; and,
2. deposit the \$10,000 monthly rental to an escrow account until such time as (a) a written justification for the contract has been received and thoroughly evaluated, (b) a court or the parties concerned reach a decision as to who is really entitled to the Property, and (c) the conflict over who is the proper recipient of the rental payments has been resolved.

DOF Response

In her letter dated November 25, 1997 (APPENDIX B), the Acting Secretary of DOF disagreed with Recommendation 1. According to her, both the Director of P&S and the Mayor of Tinian remembered a written justification at the time of contract routing, but were unable to locate that document. On October 16, 1997, the Mayor instead submitted a new justification, citing the KBC Building as the only available and suitable building (APPENDIX C). The Acting Secretary stated that the substitute written justification had been thoroughly evaluated and accepted by the Director of P&S and herself. She added that "...the same or similar information, which was contained in the previously submitted justification was thoroughly evaluated by the Director of P&S. Therefore, we believe that administrative sanctions under Section 6-211 of the CNMI P&S Rules and Regulations are not applicable to this procurement....".

The Acting Secretary also referred to competitive bidding conducted by the Division of P&S on October 22, 1997 for a DOF-Tinian office, which showed that the KBC Building lease rate of \$1.19 per square foot/month was still within the competitive range for office space in Tinian. The lease contract was awarded to the sole bidder for \$1.26 per square foot /month.

On the finding that the lessor improperly exercised his limited rights to the Property, the Acting Secretary stated that DOF took no position. She stated further that "...Apparently, James Fleming disputes the validity of the Ground Lease Agreement. However, no party informed Finance of the prior assignment to other party (first lessee's assignee) under the Ground Lease prior to the payment to CDA in November 1996....".

On Recommendation 2, the Acting Secretary stated that they had already placed \$65,000 in an escrow account for funds to be paid under the KBC Building, pursuant to a memorandum she issued to the Acting Director of Finance and Accounting. She added that the DOF Legal Counsel was attempting to negotiate an agreement among all parties for release of funds from the escrow account to pay CDA in order to prevent foreclosure of the property. The release of the funds depended upon the approval of the expenditure authority and other parties potentially entitled to the rental payments. If the parties should be unable to reach a decision, a court action would be the alternative. No implementation date could be specified due to uncertainties inherent in both court action and negotiation among the parties.

Subsequently, we were informed that a check amounting to \$45,506.87 was released to CDA. In her letter dated December 1, 1997, the Acting Secretary stated that this was by agreement of the interested parties in order to prevent foreclosure.

OPA Comments

We consider Recommendation 1 open. The original lease contract (Contract No. C50180) was approved on January 1, 1995 and was renewed thereafter on July 1, 1996 and March 10, 1997 by execution of contract change orders. The last contract amendment of March 10, 1997 extended the lease period to September 1997 retroactive from October 1996. Our copy of the memorandum issued by the Director of P&S requesting the Mayor of Tinian to submit a sole source justification for the KBC Building Lease (APPENDIX A) is dated June 3, 1997, almost three months after the 2-year lease contract was approved and nine months after October 1996, the date when the extension of the lease period commenced. We believe such a written request would not have been necessary if the Mayor of Tinian had already submitted, or the Director of P&S had already received, a sole source justification prior to the approval of the 2-year lease contract.

Under the CNMI Procurement regulations, contracts for supply, service or construction procured without competition may be awarded when the Chief determines in writing that there is only one source for the required supply, service or construction. Such determination will be based on the written sole source justification to be prepared by the official with expenditure authority. Procurement regulations also require that contracts should be awarded only to responsible contractors. The Director of P&S is mainly responsible for obtaining information from the bidder or offeror necessary to make a determination of responsibility using the factors stated in the procurement regulations. It should be noted that these requirements apply to all government procurement whether initial contracts or contract renewals.

We consider Recommendation 2 closed. The additional information needed to close Recommendation 1 is presented in APPENDIX D.

Subsequent Event

In a meeting with the DOF Legal Counsel on March 3, 1998, we were informed that the Tinian Mayor's Office and DOF-Tinian have already vacated the building in question. She then requested OPA to determine the final amount due J. Fleming for the lease contract. We intend to issue a separate follow-up audit report on this matter when the information is available.

* * *

Our office has implemented an audit recommendation tracking system. All audit recommendations will be included in the tracking system as open or resolved until we have received evidence that the recommendations have been implemented. An *open* recommendation is one where no action or plan of action has been made by the client (department or agency). A *resolved* recommendation is one in which the auditors are satisfied that the client cannot take immediate action, but has established a reasonable plan and time frame of action. A *closed* recommendation is one in which the client has taken sufficient action to meet the intent of the recommendation or we have withdrawn it. Please provide to us the status of the recommendation implementation along with the documentation showing the specific actions taken.

Please provide to us the status of recommendation implementation within 30 days along with documentation showing the specific actions that were taken. If corrective actions will take longer than 30 days, please provide us additional information every 60 days until we notify you that the recommendation has been closed.

Sincerely,

ORIGINAL SIGNED

Leo L. LaMotte
Public Auditor, CNMI

cc: Governor
Lt. Governor
Eleventh CNMI Legislature (27 copies)
Acting Attorney General
Legal Counsel, Department of Finance
Director, Division of Procurement and Supply
Acting Special Assistant for Management and Budget
Public Information Officer
Press

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AUDIT AND INVESTIGATION OF THE TINIAN MAYOR'S CONTRACT
FOR THE LEASE OF THE KBC BUILDING

STATUS OF RECOMMENDATIONS

Recommendations	Agency	Status	Action Required
1. Determine whether adverse action should be applied to the Director of P&S for violating the provisions of the CNMI Procurement Regulations.	DOF	Open	Provide OPA with a copy of the decision made on the violation of the provisions of the CNMI Procurement Regulations by the former Director of P&S.
2. Deposit the \$10,000 monthly rental to an escrow account until such time as (a) written justification for the contract has been received and thoroughly evaluated, (b) a Court or the parties concerned reach a decision as to who is really entitled to the Property, c) the conflict over who is the proper recipient of the rental payments has been resolved.	DOF	Closed	<p><u>DOF Response</u> The Acting Secretary stated that they have already placed \$65,000 in an escrow account. Subsequently, a check in the amount of \$45,506.87 was already released to CDA as agreed by all interested parties, in order to prevent foreclosure.</p> <p><u>OPA Comment</u> Provide OPA with a copy of the agreement made by the concerned parties approving the release of the check amounting to \$45,506.87 to CDA.</p>