



California Department of Veterans Affairs

Wastefulness, Failure to Comply With State Contracting Requirements, and Inexcusable Neglect of Duty

Report I2011-0837

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October 17, 2013

Investigative Report I2011-0837

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

Pursuant to the California Whistleblower Protection Act, the California State Auditor presents this investigative report concerning the wasteful and improper contracting practices of a veterans home administrator under the California Department of Veterans Affairs (Veterans Affairs). The administrator's actions in executing two specific contracts demonstrated her disregard for state contracting rules and the importance of using funds reserved specifically for veterans in a prudent manner.

This report concludes that the veterans home administrator wasted \$652,919 in state-managed funds when she entered into two contracts on behalf of the home. The first contract was for the construction and operation of an adventure park featuring seven zip lines on almost 200 acres of state property. This contract cost the State \$228,612 to terminate after Veterans Affairs' top management learned about it and halted construction. The second contract was for the operation of a café and tavern at the home, which did not comply with state contracting requirements and needlessly cost \$424,307 over nearly a two-year period, even though the café and tavern could have been operated by another entity at little to no cost to the home.

The contracts were a product of the administrator neglecting her duty to evaluate whether the contracts complied with state contracting requirements, constituted a prudent use of the home's resources, and served the best interests of the residents of the home. We also found that the administrator's former supervisor, a member of Veterans Affairs' executive staff, neglected his duty to monitor the facilities of the home and oversee the administrator's activities.

Respectfully submitted,



ELAINE M. HOWLE
State Auditor

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Investigative Results

Results in Brief

The administrator of a veterans home operated by the California Department of Veterans Affairs (Veterans Affairs) unwisely entered into two contracts on behalf of the home that wasted \$652,919 in state-managed funds and did not comply with state contracting requirements. Specifically, the administrator entered into a contract for the construction and operation of an adventure park on the grounds of the home that did not comply with state contracting requirements related to the leasing of state property and cost the State \$228,612 to terminate after Veterans Affairs' top management learned about it and halted construction. The administrator also entered into a contract for the operation of a café and a tavern at the home, which did not comply with state contracting requirements related to leasing state property and needlessly cost \$424,307 over a nearly two-year period, even though the café and tavern could have been operated by another entity at little or no cost to the home. The contracts were a product of the administrator neglecting her duty to evaluate whether the contracts complied with state contracting requirements, constituted a prudent use of the home's resources, and served the best interests of the residents of the home. The contracts also were a product of the administrator's former supervisor, a member of Veterans Affairs' executive staff (executive), neglecting his duty to monitor the facilities of the home and oversee the administrator's activities.¹

Background

Veterans Affairs was created to serve California's veterans and their families. As part of fulfilling this mission, Veterans Affairs has established six veterans homes to provide California veterans with rehabilitative, residential, and medical care in a home-like environment. In providing residential care, each home provides its residents with a semi-private room, three meals per day at the home's cafeteria, and access to various on-site facilities where activities are conducted. The homes division of Veterans Affairs, headquartered in Sacramento, oversees the general administration of each of the veterans homes. The executive oversees the homes division and is responsible for supervising the administrator in charge at each of the homes. Specifically, the executive's duty statement requires that he provide "policy guidance and administrative direction to each administrator to help bring resolution to the sensitive,

Investigative Highlights . . .

Our investigation at a veterans home operated by the California Department of Veterans Affairs (Veterans Affairs) substantiated the following:

- » *An administrator entered into a contract for the construction and operation of an adventure park on the grounds of the home that did not comply with state contracting requirements related to the leasing of state property.*
- » *It cost the State \$228,612 to terminate the contract for the adventure park after Veterans Affairs' top management learned about it and halted construction.*
- » *The same administrator needlessly paid \$424,307 for a vendor to operate a café and a tavern at the home, in violation of several contracting requirements related to leasing, when they could have been operated at almost no cost.*
- » *The administrator's former supervisor neglected his duty to oversee the administrator's activities.*

¹ The executive retired from Veterans Affairs in June 2011.

problematic, and/or critical issues.” The executive also evaluates each administrator’s job performance and approves his or her time sheets and requests for time off.

The home administrator, who is appointed by the governor, is responsible for the day-to-day operations of the home. This entails managing the care of the residents, managing the facilities of the home, and managing the home’s staff. Each home administrator is required to communicate regularly the significant occurrences and issues affecting the home to the executive of the homes division. To facilitate this communication, at the time of the events described in this report, all home administrators communicated with the executive once a week through a conference call. Every six months, all home administrators traveled to Sacramento for an in-person meeting with the executive. Additionally, the executive traveled to one home every two months to meet with employees, veterans, and management staff at the home. Lastly, the executive engaged in frequent e-mail and telephone conversations with the administrators, as needed. The executive’s primary source of information regarding each home was the administrator.

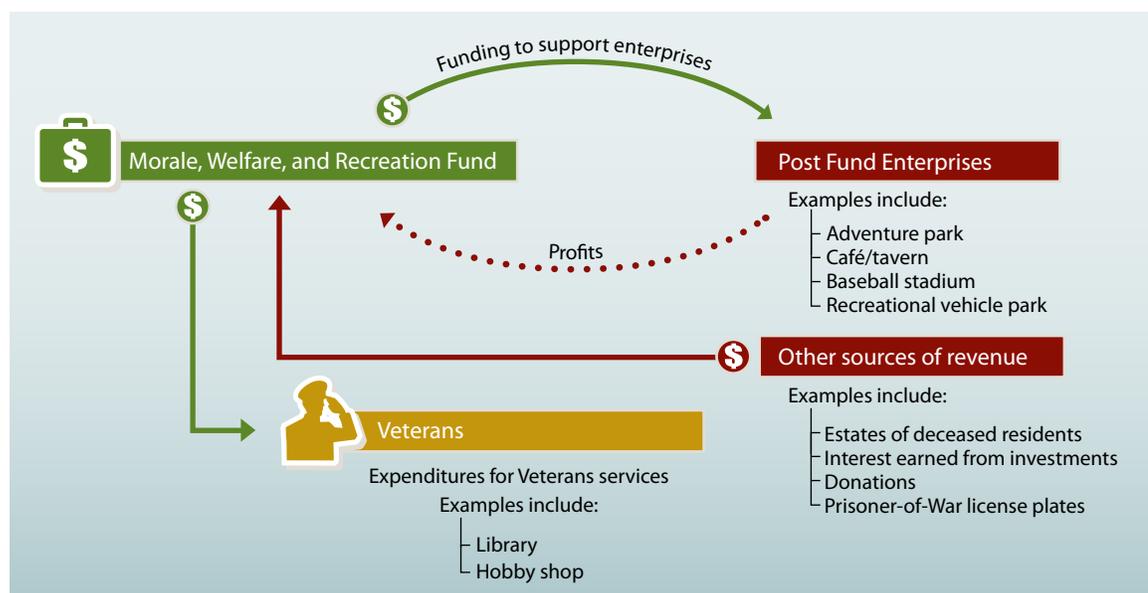
Morale, Welfare, and Recreation Fund

In 1955 the Legislature enacted Military and Veterans Code section 1047 to require the administrator of each home, with the approval of the secretary of Veterans Affairs, to maintain a morale, welfare, and recreation fund (recreation fund) to provide for the general welfare of the residents of the home, including providing for the operation of a Veterans’ Home Exchange;² hobby shop; motion picture theater; library; band; and any other function that promotes the residents’ morale, welfare, and recreation. The recreation fund obtains its funding from several sources, including the estates of deceased residents who die without heirs or owing money to the home for the cost of their care, donations from taxpayers when filing their state tax returns, revenues from the issuance of prisoner-of-war license plates, donations, interest earned from investments made with recreation fund moneys, and revenues from businesses operated using the recreation fund. As of June 30, 2012, the amount of money held in the recreation funds maintained by Veterans Affairs’ six veterans homes totaled more than \$8 million. Approximately \$5 million was held in the recreation fund of the home that is the focus of this investigation.

² A Veterans Home Exchange is a store analogous to a Post Exchange that sells goods on a military base.

Further describing the authority of a home administrator and the secretary of Veterans Affairs to use recreation fund moneys for the operation of a Veterans' Home Exchange, Military and Veterans Code section 1049 specifies that a Veterans Home Exchange may be operated at a profit to conduct any lawful endeavor that, in the judgment of the home administrator, will benefit the veterans. The home we focused on for this investigation used this authority to operate businesses on the grounds of the home, including a baseball stadium, recreational vehicle park, swimming pool, self-storage facility, bowling alley, café, and tavern. Initially, the home operated such businesses directly. However, as the number and size of the businesses grew, the home created a separate entity, without express statutory authorization to do so, called Post Fund Enterprises, to manage its businesses. The home also began contracting with private vendors to operate its businesses, as when it contracted with a vendor to manage, renovate, and maintain its baseball stadium. Under this contract, home residents and the public can attend baseball games hosted by the vendor, and the recreation fund receives revenue from snack foods sold at the games. In some cases, the revenues earned by the businesses have bolstered the recreation fund, but more often, the businesses have operated at a loss, and therefore have had to draw money from the recreation fund to cover their losses as shown in Figure 1.

Figure 1
Revenues and Expenditures of the Morale, Welfare, and Recreation Fund



Source: California State Auditor's Office.

The home created an advisory board to make recommendations to the administrator regarding the management, policies, and procedures of Post Fund Enterprises. The advisory board was composed of staff at the home, Post Fund Enterprises employees, a representative for the home's residents, and a leader from the town where the home is located. The board met quarterly to review the policies, procedures, and financial statements of Post Fund Enterprises, and to evaluate proposals for new Post Fund Enterprises endeavors. The board then made recommendations to the administrator of the home based on its collective thoughts.

Contracting Process

Although Military and Veterans Code section 1047 allows a home administrator to spend recreation fund moneys for the benefit of the residents of the home, other state laws impose requirements on the manner in which the administrator may do so, particularly when it entails leasing state-owned land. Military and Veterans Code section 1023, subdivision (b) ascribes to the California Department of General Services (General Services) sole authority to lease any real property held by Veterans Affairs for a veterans home. In addition, Government Code section 11005.2 states that unless specifically exempted by the Legislature, every contract involving the conveyance or lease of state-owned land must be approved by General Services before the contract may be entered into. Moreover, Government Code section 14670 prohibits General Services from leasing state property for more than five years. Finally, Government Code section 11011.2, subdivision (a), paragraph 3 requires General Services to obtain fair market value for all leases it approves.

To obtain General Services' approval for a lease, state agencies must follow a rigid process to ensure that the State is protected and that its best interests are served. This process generally is described in provisions of both the *State Administrative Manual* and the *State Contracting Manual* issued by General Services.

For food service opportunities, before going through the regular state leasing process, Welfare and Institutions Code section 19625, subdivision (a) requires blind vendors be given priority for all food service operations on state property. This is facilitated by the Department of Rehabilitation's Business Enterprises Program. The program assists blind vendors in creating and maintaining successful food service businesses. Under the program, a department that arranges for a blind vendor to provide food service at one of its facilities merely pays the cost of utilities and provides rent-free space for the vendor's operation.

Only if the Department of Rehabilitation declines the opportunity to become involved may a state agency commence the regular state leasing process by submitting a work order to General Services. This work order then prompts General Services to determine whether instituting the food service operation requires a lease or some other type of agreement. Typically, a food service vendor must obtain a lease through General Services to use any state-owned property for more than one year.

According to *State Administrative Manual* section 1323.1, a state agency is required to solicit competitive bids for new leases of state-owned real property. Once these bids are submitted, the agency has a duty to evaluate each of them and select the winning bid. General Services approves the winning bid so long as the winning bidder meets the advertised minimum qualifications for approval. The winning bidder then is permitted access to the site being leased to make plans for occupying the site and gather any permits that may be needed to modify the site to fulfill the purposes of the lease.

Another part of the state leasing process involves complying with any procedural requirements imposed by the California Environmental Quality Act (CEQA), found at Public Resources Code section 21050 et seq., to ensure that the new lease does not adversely impact the environment. Public Resources Code section 21100 provides that public agencies, including state agencies, must prepare an environmental impact report on any project the entity proposes to carry out or approve that may have a significant effect on the environment. A key element of the report is identifying any mitigating measures that may be taken to minimize the effects of a project on the environment. Depending on the possible impact to the environment, this part of the leasing process can take months or even years to complete.

Once General Services has reviewed and approved all permits, architectural plans, and environmental documentation required for a lease, the lease may be signed and executed. At the time of the events described in this report, the only individuals authorized to sign a lease on behalf of Veterans Affairs were the secretary, undersecretary, deputy secretary for administration, and the assistant deputy secretary for the financial services division. Home administrators were not authorized by Veterans Affairs to execute any leases. Finally, only after General Services signs the lease agreement is the vendor permitted to take possession of the property.

All state employees are required to exercise due diligence in performing their official duties. Inexcusable neglect of duty by a state employee is prohibited misconduct that constitutes

grounds for discipline under Government Code section 19572, subdivision (d). In a precedential decision, the California State Personnel Board defined inexcusable neglect of duty as “an intentional or grossly negligent failure to exercise due diligence in the performance of a known official duty.”³

Further, state agencies and employees are required to exercise prudence in their management of state resources. Government Code section 8547.2, subdivision (c) expressly provides that any activity by a state agency or employee that is economically wasteful of state resources is an improper governmental activity.

When we received information that the administrator of a veterans home entered into two wasteful and unlawful contracts, we initiated an investigation.

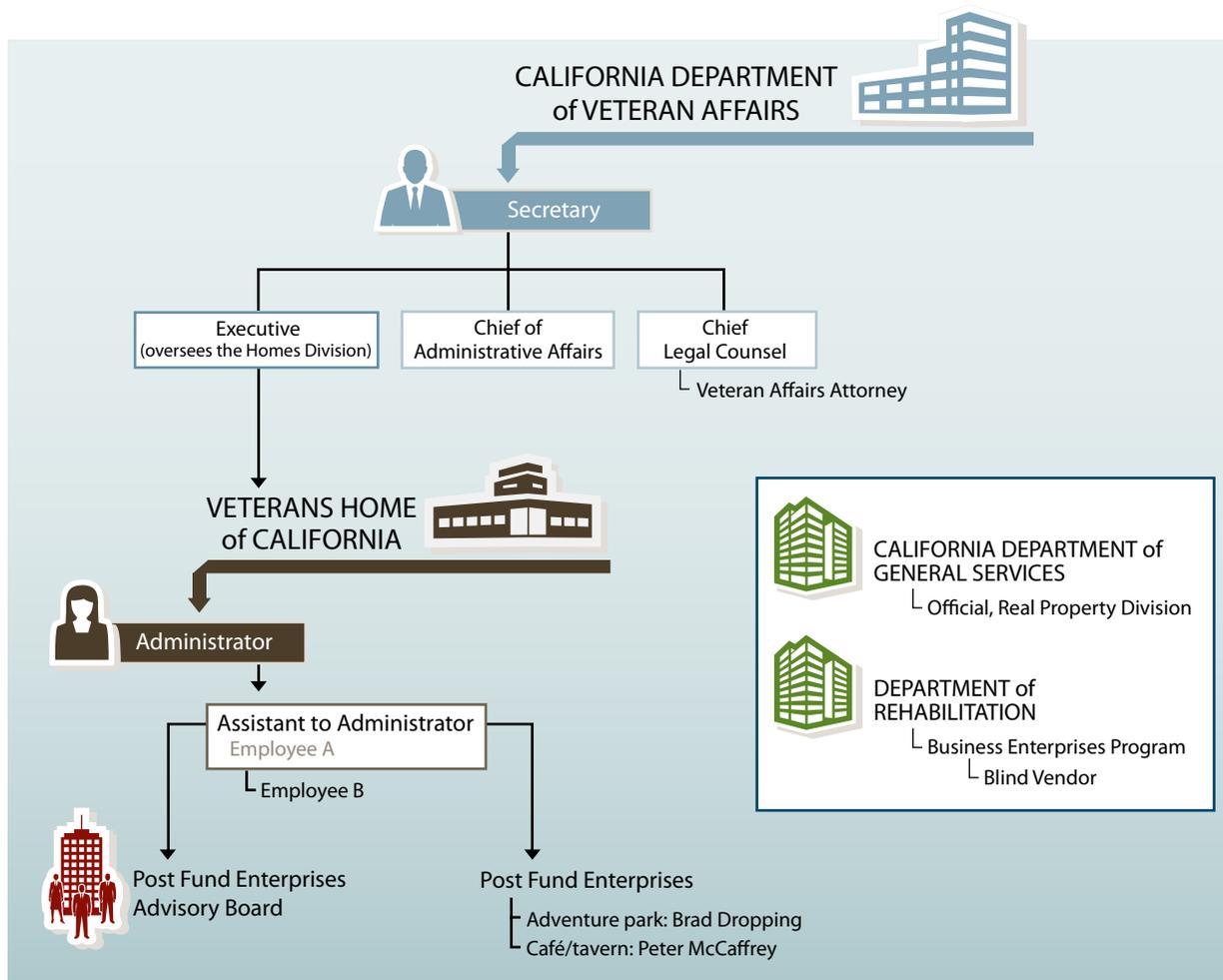
Facts and Analysis

Our investigation revealed that the administrator wasted \$652,919 when she executed two imprudent contracts on behalf of the home that violated state contracting requirements. One contract provided for the construction and operation of an almost 200-acre adventure park, featuring seven zip lines and a mountain biking course on the grounds of the home. The other contract paid a vendor to operate the home’s café and tavern, when operating these facilities could have been undertaken at little or no cost to the home.

Our investigation also revealed that the execution of these wasteful and impermissible contracts is attributable to an inexcusable neglect of duty by two state employees. We found that in executing the contracts, the home administrator neglected her duty to evaluate whether the contracts complied with state contracting requirements, constituted a wise use of the home’s resources, and served the best interests of the residents of the home. We also found that the administrator’s supervisor, by neglecting his duty to monitor the facilities of the home and oversee the activities of the administrator, facilitated what occurred. Figure 2 displays the various entities and individuals referenced in this report.

³ Jack Tolchin (1996) SPB Dec. No. 96-04, page 11, citing *Gubser v. Dept. of Employment* (1969) 271 Cal. App.2d 240, 242.

Figure 2
 Individuals and Entities Identified in the Report



Source: California State Auditor's Office.

The Administrator Wasted State Resources by Entering Into an Unlawful Contract to Build an Adventure Park at the Veterans Home

The events that led to the veterans home administrator entering into a contract for the construction of an adventure park began in February 2010, when Brad Dropping, the owner of a bicycling tour business in the vicinity of the veterans home, contacted Employee A, a now-retired assistant to the administrator, with a proposition to lease 20 acres of the home's land to operate what he described as a "recreational facility" for activities like hiking and bicycling. In outlining the proposition, Mr. Dropping explained that he would expect to make lease payments of about \$100,000 a year for use of those 20 acres and be responsible for all of the liability insurance and indemnifications necessary to operate

the facility. Employee A responded favorably to the proposition, and thereafter Employee A and his subordinate, Employee B, engaged in a series of discussions with Mr. Dropping about the proposition. These discussions led to Mr. Dropping presenting a written proposal to Employee A approximately a month later, offering to build and operate an adventure park on the grounds of the home and open it to the public by mid-September 2010. Under this proposal, the adventure park now was to cover nearly 200 acres and have as its primary feature a zip line tour made up of seven zip lines linked together by a series of platforms and short footpaths. The revenue earned from the zip line tour was to be the primary source of revenue for the adventure park. The proposal also included plans for an observation deck, a mountain biking trail, a hiking trail, a lake path for disabled guests of the park, and a trail for Mr. Dropping's employees to use when transporting park guests to locations within the park using all-terrain vehicles. Although Mr. Dropping had no experience building or operating a zip line tour or an adventure park, he stated that he planned to hire experienced subcontractors to construct the adventure park. Figure 3 shows a map of the proposed adventure park.

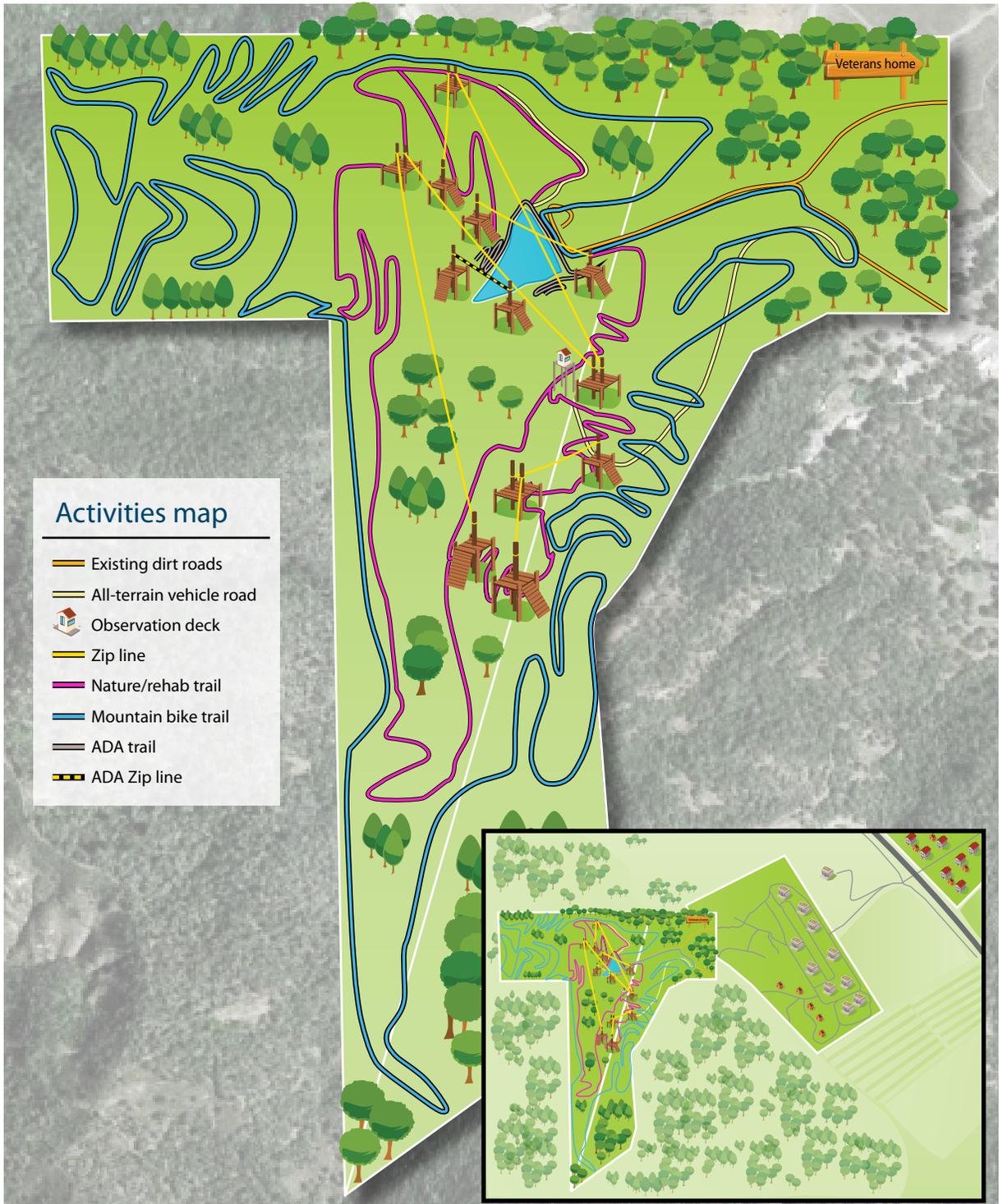
Employee A did not ask the board to comment on the adventure park proposal and none of the board members or residents of the home who were present at the meeting provided any public comment about the proposal.

Employee A and Mr. Dropping thereafter presented the proposal for an adventure park at an April 2010 meeting of the advisory board for Post Fund Enterprises. The proposal was presented as a new business endeavor that Post Fund Exchange could engage in to benefit the residents of the veterans home and generate revenues to fund services for veterans. However, Employee A did not ask the board to comment on the proposal and none of the board members or residents of the home who were present at the meeting provided any public comment about the proposal. After the advisory board meeting, Employee A presented Mr. Dropping's proposal for an adventure park to the home administrator in a private meeting. In presenting the proposal to the administrator, Employee A advocated that the administrator approve the proposal, claiming that the adventure park would be built to accommodate disabled veterans by complying with the requirements of the federal Americans with Disabilities Act⁴ and would provide a safe outdoor area beneficial for the veterans. Employee A also claimed that the adventure park would generate revenue for the home.

Based on the content of Employee A's private presentation to her, the administrator permitted Employee A to proceed with drafting a contract based on Mr. Dropping's proposal without receiving any evidence in support of Employee A's claims about the profitability of the proposed adventure park, directing any independent research or analysis regarding the proposal, or soliciting proposals from any other vendors. When asked about this decision during our investigation,

⁴ The Americans with Disabilities Act is found at United States Code, title 42, section 12101 et seq.

Figure 3
Map of Proposed Adventure Park



Sources: CalVet Facilities Master plan evaluation, Adventure Park Project proposal, and photograph: <https://maps.google.com>.

We found no evidence that either the administrator or Employee A made any effort to find out how the residents of the home felt about an adventure park being built on the grounds of the home.

the administrator explained that although she really did not understand what a zip line was, she was excited about the adventure park project because it would involve a Post Fund Enterprises business employing unused property at the home to generate income, and therefore it would be an improvement over other Post Fund Enterprises businesses that had been operating at a loss. Additionally, she believed that the adventure park would provide a benefit to the residents of the home, and that the residents were very excited about the adventure park being built. The administrator also justified her decision by saying that the idea of an adventure park was consistent with a former secretary's goal for Veterans Affairs to "look, dream, imagine." However, we found no evidence that either the administrator or Employee A made any effort to find out how the residents of the home felt about an adventure park being built on the grounds of the home. Moreover, the administrator did not consult with anyone at Veterans Affairs headquarters, including her supervisor, to find out whether construction of an adventure park at the home would be consistent with the goals of Veterans Affairs before giving her approval for the adventure park project to move forward.

Having obtained the administrator's approval, employees A and B negotiated with Mr. Dropping to prepare a contract for construction and operation of the adventure park. In determining how to formalize the relationship between Mr. Dropping and Post Fund Enterprises, the two employees decided to set up a profit-sharing arrangement similar to the arrangements previously instituted between Post Fund Enterprises and other vendors. The contract stated that Mr. Dropping would construct a zip line course, an observation deck, a mountain biking trail, a hiking trail, a lake path for disabled guests of the park, a trail for Mr. Dropping's employees to use when transporting park guests to locations within the park using all-terrain vehicles, and other outdoor activities as agreed upon by the home and Mr. Dropping. Under the contract, Mr. Dropping was required to pay only one dollar per year to lease almost 200 acres of land on the grounds of the home for a period of 10 years, with an option to renew the lease for an additional 10 years upon the agreement of the home administrator. It also provided that Mr. Dropping would allow the residents of the home, whose average age was 79 years, as well as home staff, to participate in all of the adventure park's activities free of charge during the park's hours of operation, including the zip lines when space was left over after scheduling paying customers. The contract further provided that the home's recreation fund would receive 10 percent of any net income generated from operating the park after subtracting all operating expenses including salaries. Mr. Dropping estimated that under this provision of the contract, the recreation fund would receive about \$30,000 during the first year of the park's operation, but this amount was not assured by the contract and depended entirely on the number of paying customers Mr. Dropping could attract to the park and the amount of revenue he paid for operating expenses.

The administrator executed the contract on June 18, 2010, without consulting anyone at Veterans Affairs' legal office regarding the terms of the contract. Throughout the process in which employees A and B negotiated with Mr. Dropping to draft the adventure park proposal into a contract, neither of them sought assistance from Veterans Affairs' legal staff regarding how to write the contract; instead, they simply performed the drafting themselves and submitted the contract to the administrator for her signature without any legal review. When interviewed for this investigation, the administrator claimed that before executing the contract she asked Employee A whether he had submitted the contract to Veterans Affairs' legal office for review, and he told her that the legal office had approved the contract. The administrator admitted that she did not do anything to confirm Employee A's representation that Veterans Affairs' legal office had approved the contract, but simply trusted Employee A's statement to her. When interviewed for this investigation, Employee A stated that he did not remember the administrator asking him whether the legal office had reviewed the contract, but recalled sending the contract to a Veterans Affairs attorney before the contract was signed. However, we found documentary evidence indicating that Employee A did not share the contract with the legal office until after the contract was executed. Unfortunately, the attorney thought it was just a draft contract waiting for review and simply printed out the contract and filed it away without reviewing it at that time.

In addition to not consulting with anyone in Veterans Affairs' legal office regarding the wording of the contract, the administrator did not contact anyone at General Services before executing the contract, even though her supervisor previously advised her that any agreement to lease state land at the home required General Services' involvement and approval. In January 2010, less than five months before executing the contract, the executive sent the administrator an e-mail explaining that General Services has responsibility for leasing the real property held by a veterans home, and that she needed to incorporate that concept into her Post Fund Enterprises business arrangements. Nonetheless, the administrator executed the contract without contacting anyone at General Services about it or making any effort to bring General Services into the contracting process.

More significantly, the administrator executed the contract without informing anyone at Veterans Affairs headquarters, including her supervisor, about what she was doing. When asked during an investigative interview why she did not alert Veterans Affairs headquarters prior to executing the contract, the administrator stated that she did not talk with anyone at headquarters about the contract because she believed that as the administrator of the home she had the ultimate authority to make decisions regarding Post Fund Enterprises projects. She held this view in spite of Military

The administrator executed the contract without contacting anyone at General Services about it or making any effort to bring General Services into the contracting process, and without informing anyone at Veterans Affairs headquarters about what she was doing.

and Veterans Code section 1047 declaring that the administrator's decisions regarding recreation fund moneys were to be made "with the approval of the Secretary [of Veterans Affairs]." However, as the administrator's supervisor and other headquarters staff historically had entrusted her to make decisions about the recreation fund and Post Fund Enterprises projects without any involvement by headquarters staff, her view had not been challenged.

Construction of the zip lines began immediately after the contract was executed, as Mr. Dropping was eager to complete the construction so that he could open the zip line tour to the public by September 2010, which was when he had projected a public opening to occur in his proposal for the project. Residents and staff of the home suddenly became aware of the project in July 2010 when they were startled to see a helicopter flying over the veterans home to deliver large wooden beams that would be used to support the zip line cables as shown in Figure 4.

Figure 4
Helicopter Transporting Materials During Zip Line Construction



Source: Brad Dropping, July 2010.

Meanwhile, crews using bulldozers and other heavy equipment removed trees and eliminated vegetation in a heavily forested portion of the home's grounds, which previously had been untouched by development, to create pathways as depicted in Figure 5. This occurred without an environmental impact report being prepared, as mandated by CEQA.

Figure 5
Bulldozer Clearing and Grading for Adventure Park Roadway



Source: Brad Dropping, July 2010.

At this time, residents and staff of the home began asking questions of the home's management about what was going on. One individual expressed her concern about the construction directly to the Veterans Affairs' homes division through an e-mail. This e-mail led Veterans Affairs' executives, including the secretary and undersecretary, to discover in July 2010 that the administrator had approved the construction of an adventure park on the grounds of the veterans home. Approximately two weeks later, in early August 2010, the chief of Veterans Affairs' administration division ordered the administrator to cease and desist all activity regarding the adventure park until Veterans Affairs' headquarters staff could complete a thorough review of the home's contract with Mr. Dropping. The chief also directed that henceforth all Post Fund Enterprises contracts were to be reviewed by Veterans Affairs headquarters. According to Mr. Dropping, at the time construction of the adventure park was halted, the zip line tour was only one month away from being completed. Figure 6 on the following page shows the partial completion of the zip lines for the adventure park.

With construction of the adventure park halted, Veterans Affairs' headquarters staff conducted a review of the contract and evaluated the implications of continuing with the adventure park. Based on that evaluation, the secretary of Veterans Affairs decided to

abandon the project and terminate the contract with Mr. Dropping. Upon being notified by Veterans Affairs that the adventure park contract was being terminated, Mr. Dropping took the position that he should be compensated for the expenses he incurred in building the adventure park up to the point that construction was halted. He subsequently retained legal counsel and threatened Veterans Affairs with a lawsuit. In December 2010 Veterans Affairs negotiated a settlement with Mr. Dropping under which it agreed to pay him \$210,000 to cover approximately half his expenses. Veterans Affairs also paid a construction company \$18,612 to dismantle the nearly completed zip line tour in November 2011. Both payments were made from Veterans Affairs' general operating budget rather than the recreation fund. As a result, Veterans Affairs spent \$228,612 in state funds for an adventure park that was not completed.

Figure 6
Two Partially Completed Zip Lines



Source: California State Auditor's image, October 2011.

The Administrator Wasted State Resources by Entering Into an Unlawful Contract to Pay a Caterer to Operate a Café and Tavern That Could Have Been Operated at Little or No Cost to the Home

In addition to providing residents with meals in its cafeteria, the home has for many years given residents the option of purchasing meals at an on-site café that offers menu options that are different from the items served in the cafeteria, such as hamburgers, french fries, and omelets. The home also has operated a tavern on-site to allow residents an opportunity to purchase and consume alcoholic

beverages without having to leave the grounds of the home. The continuing operation of a café and tavern has been very important to the residents of the home. Historically, employees of Post Fund Enterprises (who were not state employees) staffed both the café and tavern, which were located in a building used to provide services to home residents. However, in March 2006, the building that housed the café and tavern burned down, so the café and tavern began operating from a mobile kitchen on the grounds of the home while awaiting reconstruction of the burned-down building. Between July 2003 and June 2008, the café and tavern together operated at a loss that was somewhere within the range of \$119,269 to \$268,883 per year.⁵ Therefore, the home contributed money from the recreation fund to cover the losses generated by the café and tavern.

In August 2008 the home started construction of a new services building that would replace the building that had burned in 2006, which housed the café and tavern. Construction of the building was being financed with proceeds from the sale of tax-exempt lease-revenue bonds issued by the California State Public Works Board (Public Works Board). Under the terms of Veterans Affairs' agreement with the Public Works Board for financing the construction, Veterans Affairs was obligated to obtain prior approval from the Public Works Board for any lease of space in the building, and not lease any more than 10 percent of the building's space to private businesses. With the start of the construction, staff at the home began considering what they could do differently to operate the café and tavern at a profit, rather than at a loss. An idea that won favor among the staff was contracting with an experienced private food service operator to manage the café and tavern on behalf of the home under a profit-sharing arrangement. So in late 2009, Employee A tasked Employee B with finding a food service vendor to operate the café and tavern.

Rather than advertise broadly to private business owners for proposals to operate the home's café and tavern, Employee B attempted to identify a business to operate the café and tavern by asking for recommendations from people he knew in the area of the home. One of Employee B's acquaintances recommended that he speak with Peter McCaffrey, the owner of Wine Valley Catering, as someone who might be willing and able to operate the café and tavern.

When Employee B spoke with Mr. McCaffrey about contracting to operate the café and tavern, he found that Mr. McCaffrey was not interested because of the instability of the restaurant industry in the wake of the 2008 economic downturn. However, because Employee B

Between July 2003 and June 2008, the café and tavern together operated at a loss that was somewhere within the range of \$119,269 to \$268,883 per year and the recreation fund covered the losses.

⁵ This range includes losses produced by payroll expenses at other enterprises operated at the home, and not just the café and tavern; however, the home was unable to isolate the losses generated by just the café and tavern. The home's chief of financial management services stated that the majority of the losses were generated by the payroll expenses of the café and tavern.

Employees A and B ultimately asked Mr. McCaffrey to name his conditions for taking over operation of the café and tavern and stated that they would do whatever they could to see that those conditions were met.

had convinced himself and Employee A that Mr. McCaffrey was a perfect choice for operating the café and tavern, employees A and B continued to talk with Mr. McCaffrey during a series of meetings about taking over operation of the home's café and tavern. They offered Mr. McCaffrey the opportunity to operate the café and tavern rent-free, but Mr. McCaffrey still refused. Faced with Mr. McCaffrey's insistence that he did not want to take over operation of the café and tavern, employees A and B ultimately asked Mr. McCaffrey to name his conditions for entering into the venture and stated that they would do whatever they could to see that those conditions were met.

In response to this invitation to name his own terms, Mr. McCaffrey in January 2010 outlined in an e-mail the terms he required for agreeing to operate the café and tavern in the home's new services building, which was expected to be available for occupancy by June 1, 2010. He stated that his terms were intended to ensure that, despite the economic downturn, he could not lose any money on the venture, at least until the café and tavern had shown they could be successful by posting a profit. To that end, he declared that he wanted the home to pay him a management fee of \$75,000 per year and to pay all of his start-up costs. He also wanted the home to pay all of the monthly expenses of the café and tavern not covered by sales until the café and tavern posted a profit over a one-year period. Then once the café and tavern posted a profit, he wanted to receive 75 percent of the gross profits⁶ with Post Fund Enterprises receiving the remaining 25 percent. Mr. McCaffrey estimated that the café and tavern should break even during their second year of operation and generate a profit by their third year of operation under his management, although he provided no guarantee of this occurring.

Upon receiving Mr. McCaffrey's terms, Employee A offered no opposition to any of them. However, Employee A needed to resolve what would become of the Post Fund Enterprises employees who had been working at the café and tavern if Mr. McCaffrey took over their operation. Employee A proposed that Mr. McCaffrey hire those employees as his own employees upon taking over the businesses. Mr. McCaffrey agreed with the understanding, as set forth in his terms for operating the café and tavern, that Post Fund Enterprises would pay their salaries and any other operating expenses that exceeded the revenues received from sales.

Having arrived at a common understanding of what the terms would be for an agreement with Mr. McCaffrey to operate the café and tavern, Employee A and Mr. McCaffrey made a presentation to the Post Fund Enterprises advisory board in January 2010 about

⁶ *Gross profit* is defined as the amount of revenue received by the café and tavern from sales minus their food and beverage costs before deducting overhead costs, payroll expenses, taxes, and any interest payments.

Mr. McCaffrey taking over operation of those businesses. During the presentation, Mr. McCaffrey claimed that, under his management, the café and tavern would offer better food and customer service than had been offered under Post Fund Enterprises' management, and they would generate substantial profits over time that would be shared with the home's recreation fund. Neither Employee A nor Mr. McCaffrey discussed Mr. McCaffrey's demand for a \$75,000 annual management fee or that the recreation fund would receive only 25 percent of the profits once profits were being generated. However, Employee A disclosed that the recreation fund would need to subsidize the café and tavern during the first year of Mr. McCaffrey's management of them, in the amount of \$130,000 to \$140,000, but he expected the café and tavern to break even in the second year and post a profit in the third year that Mr. McCaffrey managed them. Based on the information that Employee A and Mr. McCaffrey provided in their presentation, the members of the advisory board unanimously voted to recommend that the administrator contract with Mr. McCaffrey to operate the café and tavern.

Next, Employee A met with the home's administrator to obtain her approval to enter into a contract with Mr. McCaffrey. In briefing the administrator on the proposed agreement, Employee A promoted an agreement with Mr. McCaffrey as the best way to turn the café and tavern into profitable enterprises after years of operating at a deficit. The administrator expressed concerns about being required by the proposed agreement to pay a substantial annual management fee to Mr. McCaffrey and compensate him for his losses until the café and tavern became profitable. In response, Employee A argued that while payment of these amounts might not be ideal, the recreation fund already had been subsidizing the café and tavern for many years and because the agreement included a cap on subsidy payments, the home would not be paying any greater amount of recreation funds than historically had been paid. He also stressed how happy it would make the home's residents to have Mr. McCaffrey operate the café and tavern based on the favorable reception his presentation received at the meeting of the Post Fund Enterprises advisory board.

After receiving this briefing, the administrator directed Employee A to draft a contract with Mr. McCaffrey that included his stated terms. She did this without conducting or directing any additional research into the advisability of accepting Mr. McCaffrey's terms. She also did this without soliciting proposals from any other vendors who might have been willing and able to operate the café and tavern successfully on terms more favorable to the home. Moreover, she decided to move forward with the contract without satisfying the requirement of Welfare and Institutions Code section 19625 to give a blind vendor the first opportunity to provide food and beverage services at the state facility.

The administrator directed Employee A to draft a contract with Mr. McCaffrey that included his stated terms without conducting or directing any additional research into the advisability of accepting Mr. McCaffrey's terms.

After the administrator authorized Employee A to draft a contract with Mr. McCaffrey, Employee A and Mr. McCaffrey worked together to draft it. To satisfy Mr. McCaffrey's demand for payment of a \$75,000 annual management fee, they included a provision in the contract to that effect. To satisfy Mr. McCaffrey's demand that he not have to pay any expenses not covered by sales, including startup costs, operating expenses, and payroll costs, they included in the contract a provision for Post Fund Enterprises to subsidize the café and tavern during the first year of Mr. McCaffrey's operation of them. The contract specifically provided for Post Fund Enterprises to reimburse Mr. McCaffrey for the costs of managing the café and tavern in an amount up to 150 percent of the combined operating loss that the café and tavern suffered during fiscal year 2008–09. This amount totaled \$213,810. The contract also charged Mr. McCaffrey rent in the nominal amount of \$1 per year to occupy space in the services building to operate the café and tavern, rather than the fair market value of the space.

Upon completing a draft of the contract in mid-February 2010, Employee A forwarded an electronic copy of the draft to the administrator. The administrator and Mr. McCaffrey both executed the contract two weeks later, on March 1, 2010.

When interviewed for this investigation, the administrator claimed that before executing the contract she asked Employee A whether Veterans Affairs' legal office had approved the contract, and he told her that the legal office had done so. The administrator admitted that she did not do anything to confirm Employee A's representation that Veterans Affairs' legal office had approved the contract; she simply trusted Employee A's statement to her. When Employee A was interviewed for this investigation, he confirmed that the administrator, before executing the contract, had asked him whether the legal office had approved the contract. He could not recall his precise response, but stated that he likely would have told her that he had sent the contract to the legal office for review, that he had not heard any objections to the terms of the contract, and that the contract had been drafted to be consistent with contracts that the legal office had approved in the past. Although we found evidence that the contract had been submitted to the legal office, we found no documentary evidence that the legal office had approved or even reviewed the contract before it was signed.

The administrator executed the contract without consulting General Services about the contract, even though the contract had a leasing component to it.

The administrator also executed the contract without consulting General Services about the contract, even though the contract had a leasing component to it, as it permitted Mr. McCaffrey to occupy part of a state building on the grounds of the home to operate the café and tavern. Yet, just over one month earlier, the administrator's supervisor advised her that any agreement to lease state land at the home required General Services' involvement and approval.

Moreover, as General Services is the state department that manages most of the State's contracting, it could have provided a wealth of guidance regarding how to undertake this arrangement in conformity with state law and best contracting practices. Nonetheless, the administrator executed the contract without contacting anyone at General Services about it or making any effort to bring General Services into the contracting process.

More significantly, the administrator executed the contract without informing anyone at Veterans Affairs headquarters, including her supervisor, about what she was doing. As noted earlier in this report, the administrator thought that, as the administrator of the home, she had ultimate authority to decide how recreation fund money would be spent, and therefore did not think it necessary to consult with her superiors at Veterans Affairs about contracts entered into regarding the home's enterprises. However, Military and Veterans Code section 1047 provides that an administrator's authority to make decisions regarding recreation fund moneys is subject to the approval of the secretary of Veterans Affairs, which only can occur with the secretary exercising oversight of the administrator's actions. Moreover, the administrator might have benefitted from obtaining guidance from her superiors, before entering into the contract, regarding the wisdom of the contract and its terms. Yet by failing to enlist the executive and other headquarters staff into the contracting process, she forestalled that opportunity.

After the contract was executed, Mr. McCaffrey began solidifying his plans for taking over operation of the café and tavern. He targeted June 1, 2010, as the date for reopening the café and tavern under his management, as he had been told by the home's staff that the new services building would be available for occupancy by that date. However, construction of the building did not proceed as scheduled, and it became apparent space in the building would not be available for several more weeks. So Mr. McCaffrey began operating the café and tavern on July 1, 2010, using the mobile kitchen outside the building that had been in use since the 2006 fire that necessitated construction of the new services building. He also began receiving subsidy payments from the recreation fund to cover his expenses in late May 2010 and payments toward his \$75,000 annual management fee in June 2010.

In August 2010, as a consequence of Veteran Affairs' headquarters staff becoming aware of the administrator's contract for construction and operation of the adventure park at the home, headquarters staff began scrutinizing the administrator's other contracts for the operation of businesses at the home. As part of this scrutiny, Veterans Affairs' chief legal counsel asked General Services to assist his department in evaluating the home's contracts.

Mr. McCaffrey began receiving subsidy payments from the recreation fund to cover his expenses in late May 2010 and payments toward his \$75,000 annual management fee in June 2010.

An official in General Services' real property section advised Veterans Affairs that the contract with Mr. McCaffrey should be terminated immediately as it did not comply with a host of state leasing requirements.

An official in General Services' real property section reviewed the administrator's contract with Mr. McCaffrey, and based on that review, advised Veterans Affairs that the contract with Mr. McCaffrey should be terminated immediately as it did not comply with five important state leasing requirements. First, he found that the contract was defective because it contained a leasing component and had not been approved by his department, as required by Government Code section 11005.2. Second, the contract involved the leasing of state property for more than a five-year period, which is prohibited by Government Code section 14670. Third, he found that the contract had been awarded to Mr. McCaffrey without enlisting the Department of Rehabilitation to give a blind vendor the first opportunity to be awarded the contract, as required by Welfare and Institutions Code section 19625, subdivision (a), or, if there were no blind vendors interested in the opportunity, publicly soliciting competitive bids for the contract. Fourth, the contract called for Mr. McCaffrey to occupy space in the home's services building, which was being built with funds from a government revenue-lease bond, and therefore the Public Works Board needed to approve his use of the space, which had not occurred, and he could not occupy more than 10 percent of the building's space, which he was intending to do. Fifth, the contract only charged Mr. McCaffrey \$1 per year in rent for the space he was intending to occupy in the building; therefore, the contract was not obtaining fair market value for use of the space, as required by Government Code section 11011.2.

The General Services official also advised terminating the contract because its terms were so one-sided in favor of Mr. McCaffrey. In particular, the official took issue with the contract terms calling for state-controlled funds to be paid to Mr. McCaffrey, in the form of an annual management fee and subsidy, in exchange for being permitted to establish a business on state property, rather than Mr. McCaffrey being required to pay the State for that privilege.

After receiving advice from the General Services official to terminate the contract with Mr. McCaffrey, Veterans Affairs headquarters nonetheless allowed the contract to continue in effect. The administrator, rather than heeding the advice of the General Services official, also allowed the contract to continue in effect and authorized further periodic management fee and subsidy payments to Mr. McCaffrey as he continued to operate the café and tavern from the mobile kitchen. However, the administrator entered into a new round of negotiations with Mr. McCaffrey, as she tried to convince him to continue operating the café and tavern under a new agreement that would address General Services' concerns.

This negotiation dragged on without resolution and without any guidance being provided by Veterans Affairs headquarters. In March 2011, which marked the end of the first year of Mr. McCaffrey's

contract to operate the café and tavern, the administrator intended to stop paying Mr. McCaffrey the subsidy payments that the contract stated were to extend only for the first year of the contract. However, Mr. McCaffrey responded that he could not operate the café and tavern without the subsidy, as they still were operating at a loss because he had not yet been allowed to occupy space in the services building as contemplated when he entered into the contract. He also argued that the one-year subsidy period should be interpreted as continuing so long as he had to continue operating from the mobile kitchen. So the administrator continued to authorize subsidy payments to Mr. McCaffrey after March 2011, but stopped paying his management fee even though the contract provided for the fee to be paid annually for the length of the 10-year contract.

Finally, in November 2011, the administrator presented Mr. McCaffrey with a list of proposed terms and a draft operating agreement that constituted her final offer. The terms set forth in these documents limited the length of the contract to five years, did not require Veterans Affairs to pay Mr. McCaffrey any management fee or subsidy of his operating costs, and required him to pay rent and utilities. However, neither document included the additional terms that General Services previously had identified as required but missing from the original contract, including that the Public Works Board must approve the lease of space in the new services building for operation of the café and tavern, and that the café and tavern would not be allowed to occupy more than 10 percent of the building. However, the home planned to present Mr. McCaffrey with a draft lease agreement at a later date, which could have addressed these additional terms, although we found no documentation of this.

Mr. McCaffrey declined the terms presented because he refused to pay rent for the space that the café and tavern would occupy in the new services building and was unwilling to accept the financial risk of operating the businesses without a subsidy. He made a counteroffer that called for the original contract to remain in effect for the first six months of his operating the café and tavern in the services building and a new contract taking effect thereafter that would not require him to pay rent or share with the home any revenues from the businesses until after they had been operating in the services building for one year. Veterans Affairs rejected this counteroffer. As a result, Mr. McCaffrey relinquished operation of the café and tavern on December 18, 2011.

For operating the café and tavern from May 2010 through December 2011, the home paid Mr. McCaffrey a total of \$431,323 from the recreation fund. As illustrated in the Table on the following page, this amount consisted of \$75,000 as the annual management fee and \$356,323 in subsidy payments to cover the

Mr. McCaffrey relinquished operation of the café and tavern on December 18, 2011.

costs of operating the café and tavern that exceeded sales revenue. After relinquishing the café and tavern, Mr. McCaffrey refunded to the home \$7,016 of the subsidy payments, which he admitted were in excess of his operating expenses not covered by sales. The refund reduced the total payments made to Peter McCaffrey to \$424,307.

Table

Total Payments From the Veterans Home to Peter McCaffrey

Subsidy	\$356,323
Management fee	75,000
Subsidy refund	(7,016)
Total	\$424,307

Source: California State Auditor's analysis of the Veterans home's financial records.

Regarding the subsidy payments, the contract only provided for the home to subsidize the expenses of the café and tavern during the first year of the contract, covering the period March 1, 2010, through February 29, 2011, and only up to 150 percent of the combined operating loss of the café and tavern during the preceding 2008–09 fiscal year, which amounted to a subsidy cap of \$213,810. Instead, by making subsidy payments for an additional 10 months, the home paid Mr. McCaffrey an additional \$200,774 and exceeded the contract's subsidy cap by \$135,497.

When Mr. McCaffrey stopped operating the café and tavern, the businesses closed. This caused great unhappiness among the residents of the home, but because the administrator had devoted her efforts to reaching a new agreement with Mr. McCaffrey without pursuing any other alternatives, the home was unable at that time to reopen the café and tavern under different management.

Starting anew to find another vendor to operate the café and tavern, staff at the home asked General Services to find a vendor. To do this, General Services contacted the Department of Rehabilitation about offering a blind vendor the opportunity to operate the café and tavern, as required by Welfare and Institutions Code section 19625, subdivision (a). It also began work on publicly soliciting bids for operation of the café and tavern if there were no blind vendors interested in the opportunity. The Department of Rehabilitation identified a blind vendor interested in operating the café and tavern, and that vendor entered into a lease approved by the Public Works Board to operate the café and tavern in the new services building in space occupying less than 10 percent of the building. The lease required the vendor to operate the café and tavern without receiving any management fee or subsidy from the home. In October 2012, the new

vendor began operating the café and tavern at the home and continues to do so successfully. The only cost to the home is the minimal cost of utilities.⁷ Had the administrator entered into a similar arrangement in 2010, rather than entering into a contract with Mr. McCaffrey, she could have saved the recreation fund nearly the entire \$424,307 paid to Mr. McCaffrey. Figure 7 shows the café and tavern currently in operation at the home.

Figure 7
The Veterans Home's Café and Tavern



Source: California State Auditor's image, September 2013.

⁷ During our investigation, we asked the home to tell us the amount that it pays for the cost of utilities needed to operate the café and tavern. The home was unable to provide this information because the utility costs for the café and tavern are part of the total utility costs paid by the home for operation of the entire member services building, and the portion of that total cost attributable to the café and tavern could not be identified separately. However, General Services estimated that it would charge a third-party vendor operating the café and tavern \$650 per month for utilities.

By failing to consult with either Veterans Affairs' legal office or General Services regarding the contract for construction and operation of the adventure park at the home, the administrator failed to take obvious, reasonable measures to ensure that the contract was in compliance with applicable legal requirements.

The Administrator Neglected Her Duty to Direct the Adventure Park and Café and Tavern Projects

The administrator's duty statement declares that she has "overall responsibility for the care of aged and/or disabled wartime veterans and the management of the [veterans home] facility and staff." As part of fulfilling this duty, the duty statement proclaims that she is responsible for directing the planning, implementation, modification, or termination of all projects at the home. Inherent in the execution of this duty is a requirement that she undertake reasonable measures to ensure that the projects for which she is responsible are implemented lawfully, use financial resources wisely, and serve the best interests of the veterans. The administrator failed to undertake reasonable measures to ensure that these requirements were fulfilled when she planned and implemented the projects at the home for construction and operation of the adventure park and operation of the café and tavern. By failing to consult with either Veterans Affairs' legal office or General Services regarding the contract for construction and operation of the adventure park at the home, the administrator failed to take obvious, reasonable measures to ensure that the contract was in compliance with applicable legal requirements. As the building and operation of an adventure park is far removed from the routine business of a veterans home and involved a multitude of legal issues the home had not previously encountered, including environmental and liability issues, it was apparent the project would require substantial participation by Veterans Affairs' legal counsel. Further, as the contract called for the leasing of state land, it was obvious that General Services should have been involved to provide its expertise regarding contracting and leasing. However, the administrator did not involve either Veterans Affairs' legal counsel or General Services in the project, and felt she had done enough by simply receiving what she stated was an assurance from Employee A that he had consulted with legal counsel about the project, even though she was presented with no evidence of legal counsel's involvement in the drafting or approval of the contract. As a result, the administrator entered into a contract for construction and operation of an adventure park that violated several laws and other state contracting and leasing requirements, including requirements that an environmental review be undertaken prior to commencing construction, that General Services must approve the leasing of state property, that state property may not be leased for more than five years, that fair market value must be obtained when leasing state property, and that competitive bids must be solicited before granting a lease.

Similarly, by failing to consult with either Veterans Affairs' legal office or General Services regarding the contract for operating the café and tavern at the home, the administrator failed to take obvious, reasonable measures to ensure that the contract complied with applicable legal requirements. As the café and tavern were to

be operated in a building financed by a revenue-lease bond and the contract involved complex issues such as the transfer of Post Fund Enterprises employees to another employer, the payment of a subsidy to the operator, and the sharing of profits, it was apparent the project would require substantial participation by Veterans Affairs' legal counsel. Further, as the contract called for the leasing of space in a state building, it was obvious that General Services should have been involved to provide its expertise regarding contracting and leasing. However, the administrator did not involve either legal counsel or General Services in the project, and went forward with executing the contract without receiving advice from either of them. The administrator entered into a contract that violated several laws and other state contracting and leasing requirements, including not obtaining approval from the Public Works Board and failing to include a provision precluding a business from occupying more than 10 percent of a building financed with a revenue-lease bond, obtaining General Services' approval when leasing state property, not leasing state property for more than five years, obtaining fair market value when leasing state property, and giving blind vendors the first opportunity to be awarded a contract to provide food and beverage services at a state facility, and if there were no blind vendors interested in providing food and beverage services at a state facility, obtaining competitive bids for the services to be provided under a lease.

By failing to consult with General Services or Veterans Affairs headquarters regarding the contract for construction and operation of the adventure park at the home, the administrator failed to take obvious, reasonable measures to ensure that the contract constituted a wise use of the home's financial resources. As construction and operation of an adventure park was not something the administrator or her staff had any experience with, it was apparent that she needed to engage in further study, with the help of headquarters staff, to determine whether leasing close to 200 acres of the home's land for the project was likely to produce a reasonable return on the investment of such a substantial resource, and what that return would be. Instead, the administrator appears to have simply assumed that the land had no value and made no effort to ascertain the amount of profit that the adventure park would be likely to generate once it was built, and simply relied on Mr. Dropping's representations about its potential profitability. She also made no effort to ascertain whether the profit-sharing arrangement with Mr. Dropping established by the agreement was reasonable. The result was that the administrator leased for \$1 per year almost 200 acres of land that, based on Mr. Dropping's conservative valuation of the land and a standard General Services formula, had a fair market rental value of over \$650,000 per year. She also entered into an agreement that assured no actual return to the State on the land that it leased for the project, because under the agreement Mr. Dropping only was required to

The administrator appears to have simply assumed that the land had no value and made no effort to ascertain the amount of profit that the adventure park would be likely to generate once it was built. The result was that the administrator leased for \$1 per year almost 200 acres of land that had a fair market rental value of over \$650,000 per year.

By failing to consult with General Services regarding the contract for operating the café and tavern, the administrator failed to take obvious, reasonable measures to ensure that the contract constituted a wise use of the home's financial resources.

share any profits remaining after making all payments, including salary payments to himself that he wished to consider operating expenses. Similarly, by failing to consult with General Services regarding the contract for operating the café and tavern, the administrator failed to take obvious, reasonable measures to ensure that the contract constituted a wise use of the home's financial resources. As General Services is supposed to approve all leases of state property, and therefore has extraordinary expertise in this area, it was obvious that the administrator should have consulted with General Services prior to entering into the contract with Mr. McCaffrey. However, she did not do so. As a result, the administrator entered into an agreement with Mr. McCaffrey that General Services found to be unreasonably generous toward Mr. McCaffrey as it allowed him to operate the café and tavern without having to pay for utilities or any more than \$1 per year in rent, promised him a \$75,000 annual management fee, and promised to pay all of his expenses exceeding revenue from sales during at least the first year of his operation of the café and tavern. In their expert opinion, the officials at General Services believed that instead of the home paying Mr. McCaffrey for operating the café and tavern, Mr. McCaffrey should have been paying the home for that opportunity.

By failing to consult with Veterans Affairs headquarters or soliciting meaningful input from home residents prior to entering into the contract for construction of the adventure park, the administrator failed to take obvious, reasonable measures to ensure that construction of the adventure park served the best interests of the home's residents. As the project called for leasing almost 200 acres of the home's land to operate an adventure park on the grounds of the home, the project was likely to have a substantial impact on the home's environment. It therefore was clear that a decision about moving forward with the project should have been studied by staff at the home and Veterans Affairs headquarters to make certain that such a significant commitment of the home's resources and making such a major alteration of the home's environment was justified by a substantial offsetting benefit to the home's residents. As part of determining the best interests of the home's residents, it also was apparent that the project needed to be explained fully to the residents to ascertain their views on whether they felt construction of an adventure park where they lived would make their lives better.

However, the administrator did not consult with Veterans Affairs headquarters, including the executive, about the project. Even though she had regular meetings with the executive about other matters, she never disclosed this particular project. She also never sought feedback from the Post Fund Enterprises advisory board or the residents of the home to find out how they felt about construction of an adventure park. As a result, the home and its residents found themselves with a nearly completed zip line tour,

covering almost 200 acres, that was not likely to be used by many of the home's residents, whose average age was 79, but was likely to increase the noise and traffic at the home, and required destruction of a portion of the home's natural surroundings. Moreover, because the adventure park project was fraught with so many illegalities, the contract for construction of the park had to be terminated and the partial construction demolished at a cost of \$228,612 that otherwise could have been used to provide services to veterans.

Finally, even though the administrator obtained feedback from the residents of the home before entering into an agreement with Mr. McCaffrey for operation of the café and tavern, she made no other effort to ensure that entering into the agreement served the best interests of the home's residents. Specifically, she did not consult with anyone at headquarters or the leasing experts at General Services regarding whether a contract with Mr. McCaffrey was the best option available for the residents of the home. Moreover, even when advised by General Services around August 2010 that the contract she entered into with Mr. McCaffrey was an illegal agreement, she did not terminate the agreement or undertake efforts to find another vendor to operate the café and tavern. Instead, she continued authorizing payments to Mr. McCaffrey for another 16 months while trying to negotiate a new contract with him alone. As a result, the administrator paid \$424,307 in recreation funds to Mr. McCaffrey for a café and tavern that the residents of the home enjoyed during that time. However, when Mr. McCaffrey would not agree to a new contract including less generous terms for him and relinquished operation of the businesses, the home's residents were left without a café and tavern for 10 months. They also were left without a substantial amount of recreation funds paid to Mr. McCaffrey that could have been put to another use.

The Executive Neglected His Duties to Monitor the Facilities of the Home and Oversee the Activities of the Administrator

The executive's duty statement declared that he was responsible for monitoring the day-to-day facility and financial operations at the home and for providing oversight, guidance, and direction to the administrator. However, he neglected this duty to monitor the facilities at the home and oversee the activities of the administrator by failing to keep himself informed about the administrator's management of the recreation fund and its related enterprises. Thus he was unaware, and could not prevent, the administrator's unwise and wasteful contracting for the construction and operation of the adventure park and operation of the café and tavern at the home.

Even when advised by General Services that the contract was an illegal agreement, the administrator authorized payments for another 16 months.

The executive understood that he had a duty to monitor the facilities at the home and oversee the actions of the administrator. To fulfill these duties, he engaged in weekly calls with the administrator and regularly made visits to the home. In discussing the purpose of the calls and visits, the executive stated that he expected the administrator, during these interactions, to notify him of any adverse events or major projects at the home.

Despite the executive's understanding of his duties of monitoring and oversight, and despite his regular communications with the administrator, the executive admitted that he did not know about the adventure park project or the terms of the contract for the café and tavern project until after the contracts for those projects were executed. He did not know about the adventure park project until an employee at Veterans Affairs headquarters advised him that the adventure park was being built. He claimed not to recall when he first learned about the contract with Mr. McCaffrey for operation of the café and tavern. However, the executive stated that he never was provided a copy of the contract, even after it was executed.

When interviewed for this investigation, the executive recalled that when he met with the administrator by telephone or in person, he generally did not discuss with her the management of the recreation fund or its related enterprises. He said that historically the administrator had been afforded a lot of autonomy in her management of the recreation fund and its related enterprises, and he simply trusted her to report to him anything he should know. He took this passive approach despite the fact that the assets of the recreation fund being substantial; the fund's related enterprises, including the baseball stadium, being significant facilities on the home's property; and management of the recreation fund being one of the administrator's major duties. Through his failing to make reasonable inquiries into the administrator's management of the recreation fund and its related enterprises, the executive neglected his duties to monitor the facilities of the home and oversee the activities of the administrator. Although the executive's ignorance of the administrator's management of the recreation fund and its related enterprises, and thus his neglect of his monitoring and oversight duties, was facilitated by Veterans Affairs' lack of policies and procedures to ensure that the executive received important information about the recreation fund and its related enterprises, the duties to monitor and oversee rested with the executive and he neglected those duties.

Through his failing to make reasonable inquiries into the administrator's management of the recreation fund and its related enterprises, the executive neglected his duties to monitor the facilities of the home and oversee the activities of the administrator.

As a result of the executive neglecting his duties to monitor the facilities of the home and oversee the administrator's activities, the administrator's unwise and wasteful contracts with Mr. Dropping and Mr. McCaffrey were executed and implemented without any review by Veterans Affairs' headquarters management.

Neither the secretary of Veterans Affairs nor the secretary's executive staff was aware of the proposed adventure park before Mr. Dropping undertook construction. Further, none of these individuals had knowledge of the terms of the contract for the café and tavern project prior to the contract's execution. Therefore, headquarters management could not perform any evaluation of whether the contracts served the best interests of the home's residents before the contracts went into effect. Most importantly, the executive was not in a position to stop these projects before the administrator committed the home to business arrangements that needlessly cost the State \$652,919 in state-controlled funds.

Recommendations

To remedy the effects of the improper governmental activities described in this report and to prevent them from recurring, we make the following recommendations:

To ensure that the recreation fund and related enterprises of each veterans home are managed lawfully and wisely, we recommend that Veterans Affairs institute policies that require the following for all contracts that involve recreation fund moneys or involve recreation fund enterprises:

- As a best practice, the contracts be awarded and administered in a manner consistent with the policies and procedures set forth in the *State Administrative Manual* and the *State Contracting Manual*.
- The contracts be approved by a Veterans Affairs attorney prior to being executed.
- The contracts be reviewed and approved by the secretary of Veterans Affairs, or upon delegation of the authority to do so, by a deputy secretary, prior to the contracts being executed.
- To bring greater transparency to the management of recreation fund moneys and related enterprises and to facilitate more public input about whether management decisions promote the best interests of veterans, institute a policy that requires all payments of recreation fund moneys to a person or business in the amount of \$5,000 or more during a fiscal year and any contract involving recreation fund enterprises be presented to the recreation fund advisory board (now known as the Morale, Welfare, and Recreation Committee) at a public meeting for an advisory vote prior to the payment being made.

To ensure greater oversight of the recreation fund of each veterans home by the Secretary of Veterans Affairs, we recommend Veterans Affairs institute a policy that requires any expenditure of recreation fund moneys to a person or business in the amount of \$5,000 or more during a fiscal year be listed as a separate line item in the budget of the recreation fund as presented to the secretary for approval.

To address the administrator's neglect of her duties by entering into two unwise, unlawful, and wasteful contracts, we recommend Veterans Affairs work with the Governor's Office to take appropriate disciplinary action against the administrator.

We also recommend that the Legislature consider legislation to establish increased statutory controls over the management of the recreation fund maintained by each of the veterans homes to require that the funds be managed by the secretary of Veterans Affairs, in consultation with the administrator of each home, and be managed in a manner that is transparent to the public, takes into account the feelings of veterans, is consistent with the mission of the veterans homes, and is fiscally prudent.

Respectfully submitted,



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Summary of Agency Response and California State Auditor's Comments

The California Department of Veterans Affairs (Veterans Affairs) reported in September 2013 that it agreed with the factual findings in this report. However, it challenged our conclusion that the adventure park and café and tavern contracts violated state contracting requirements because of what it sees as uncertainty regarding whether state contracting requirements apply to Moral, Welfare, and Recreation Fund (recreation fund) contracts.

In reply, we point out that while there may be some ambiguity regarding whether certain state contracting requirements are mandatory for all recreation fund contracts, there is no ambiguity regarding whether recreation fund contracts must comply with state contracting requirements related to the leasing of state property. As discussed in the report, California law specifically states that any lease of state land is under the exclusive authority of the California Department of General Services (General Services). Government Code section 11005.2 delegates to General Services sole authority to lease state property. Further, Military and Veterans Code section 1023 states that it is the director of General Services who has the authority to lease or let any real property held by Veterans Affairs or a veterans' home. Neither statute provides for any exemption that would give Veterans Affairs, the home, or the administrator authority to lease state property.

Veterans Affairs also stated that when entering into recreation fund contracts without the involvement of General Services or compliance with state contracting requirements, it relied on opinions from the Office of the Attorney General (attorney general) and General Services that it characterized as declaring recreation funds need not be administered in compliance with state contracting and procurement requirements. However, our review of these opinions revealed that neither opinion specifically addresses whether recreation fund contracts involving the lease of state property are exempt from the applicable state contracting requirements. The attorney general opinion states that expenditures from the recreation fund are not subject to the control of the California Department of Finance or the State Board of Control, but does not address the leasing of state property. Moreover, the statutory requirements regarding leasing, cited in our report, were enacted many years after the opinion was issued. The General Services opinion also does not address the leasing of state property specifically, and while opining that the Legislature may not have intended for all state contracting requirements to apply to recreation fund contracts, also opines that a literal reading of the law could support a conclusion that all state contracting

requirements are applicable to such contracts. Neither opinion provided a basis for Veterans Affairs to disregard the statutory leasing requirements cited in our report when entering into the contracts for the adventure park and the café and tavern.

In response to our first recommendation that as a best practice Veterans Affairs award and administer recreation fund contracts in a manner consistent with the policies and procedures set forth in the *State Administrative Manual* and the *State Contracting Manual*, Veterans Affairs stated that it sought an updated legal opinion from General Services in June 2013 to determine whether General Services continues to believe that recreation fund contracts are exempt from complying with state contracting and procurement requirements. It stated that if General Services no longer believes that recreation funds are exempt from these requirements, it will comply with General Services' recommendations.

However, our report did not assert that all recreation fund contracts are required by law to comply with the *State Administrative Manual* and the *State Contracting Manual*. Rather, we recommended that Veterans Affairs follow the policies and procedures set forth in these manuals as a best practice because, based on the outcomes of the two contracts discussed in this report, the department's current policies and procedures have demonstrated themselves to be insufficient. In addition, our review of Veterans Affairs' request to General Services revealed that it failed to ask whether Veterans Affairs must comply with state contracting requirements related to state land, including whether it could lease land without General Services' authorization. Instead, it asked whether recreation fund expenditures are subject to state contracting and purchasing requirements. Accordingly, the opinion Veterans Affairs has requested from General Services does not address our recommendation.

Veterans Affairs stated that it is unable to comply with the recommendation that all recreation fund contracts be reviewed by one of its attorneys prior to execution. It stated that Veterans Affairs enters into hundreds of recreation fund contracts and that its legal office currently is not staffed to absorb this responsibility. Instead, Veterans Affairs reported that within the next 90 days it intends to develop greater controls within the homes division over recreation fund spending. In addition, Veterans Affairs stated that it plans to propose legislation to amend the relevant portions of the Military and Veterans Code. Veterans Affairs did not specify the types of controls or the amendments it plans to propose. Therefore, we are unable to determine whether its intended actions will address our recommendation satisfactorily, which we see as

necessary to protect the State from entering into legally binding contracts without the approval of an attorney trained to look for potential legal problems.

Veterans Affairs reported that it agreed with our recommendation to have the secretary or the undersecretary for Veterans Homes review and approve all recreation fund contracts. It stated that this recommendation will be addressed with the new recreation fund policies it plans to implement within the next 90 days. Veterans Affairs also stated that the undersecretary will be designated to perform the task of reviewing contract concepts, prior to the commencement of negotiations, to ensure that they are consistent with Veterans Affairs' mission.

Veterans Affairs did not address specifically our recommendation to institute a policy that requires all payments from a home's recreation fund in the amount of \$5,000 or more during a fiscal year and any contract involving recreation fund enterprises be presented to the home's Morale, Welfare, and Recreation Committee at a public meeting for an advisory vote prior to the payment being made. Instead, Veterans Affairs stated that it would increase recreation fund transparency through resident meetings and make quarterly recreation fund statements available to the residents of the veterans homes. It also added that it had distributed a memorandum in August 2013 to all home administrators providing additional guidance regarding recreation fund expenditures. However, this memorandum only provided guidance about what types of expenditures may be made from a recreation fund. As Veterans Affairs did not address our recommendation specifically in its response, we are unable to determine whether it intends to implement our recommendation.

Veterans Affairs reported that it concurred with our recommendation to include a separate line item in recreation fund budgets for any proposed expenditure of \$5,000 or more and that it will develop appropriate policies to implement this recommendation.

Veterans Affairs stated that on October 28, 2010, the executive issued a letter of expectations to the administrator. It also stated that it has provided to the Governor's Office our recommendation that it take appropriate disciplinary action against the administrator.

Lastly, Veterans Affairs stated that it would welcome a legislative review of the Military and Veterans Code provisions governing the recreation fund.

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Appendix

THE INVESTIGATIONS PROGRAM

The California Whistleblower Protection Act (Whistleblower Act) contained in the California Government Code, beginning with Section 8547, authorizes the California State Auditor (state auditor) to investigate allegations of improper governmental activities by agencies and employees of the State. Under the Whistleblower Act, an improper governmental activity, as defined by Government Code section 8547.2, subdivision (c), includes any action by a state agency, or by a state employee in connection with his or her employment, that violates a state or federal law; violates an executive order of the governor, a California Rule of Court, or a policy or procedure mandated by the *State Administrative Manual* or *State Contracting Manual*; is economically wasteful; or involves gross misconduct, incompetence, or inefficiency. To enable state employees and the public to report suspected improper governmental activities, the state auditor maintains a toll-free Whistleblower Hotline: (800) 952-5665. The state auditor also accepts reports of improper governmental activities by mail and over the Internet at www.auditor.ca.gov.

Although the California State Auditor's Office conducts investigations, it does not have enforcement powers. When it substantiates an improper governmental activity, the state auditor reports confidentially the details to the head of the state agency or to the appointing authority responsible for taking corrective action. The Whistleblower Act requires the agency or appointing authority to notify the state auditor of any corrective action taken, including disciplinary action, no later than 60 days after transmittal of the confidential investigative report and monthly thereafter until the corrective action concludes. The Whistleblower Act authorizes the state auditor to report publicly on substantiated allegations of improper governmental activities as necessary to serve the State's interests. The state auditor may also report improper governmental activities to other authorities, such as law enforcement agencies, when appropriate.

cc: Members of the Legislature
Office of the Lieutenant Governor
Little Hoover Commission
Department of Finance
Attorney General
State Controller
State Treasurer
Legislative Analyst
Senate Office of Research
California Research Bureau
Capitol Press