



YARMUTH WILSDON CALFO

REPORT ON INVESTIGATION RELATED TO THE REGIONAL SMALL BUSINESS DEVELOPMENT PROGRAM

TO: SEATTLE PUBLIC SCHOOLS BOARD PRESIDENT STEVE SUNDQUIST , DIRECTOR PETER MAIER, DIRECTOR SHERRY CARR, DIRECTOR HARIUM MARTIN-MORRIS, DIRECTOR MICHAEL DEBELL, DIRECTOR KAY SMITH-BLUM, DIRECTOR BETTY PATU, AND GENERAL COUNSEL NOEL TREAT

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The Seattle Public Schools (“SPS”) Board retained our firm as Special Ethics Counsel to investigate issues surrounding SPS’s Regional Small Business Development Program (“RSBDP”). This Report explains our investigation to date and our findings.

I. BACKGROUND AND SCOPE OF INVESTIGATION

A. Overview of RSBDP

The RSBDP (formerly known as the Historically Underutilized Business/Technical Assistance Program or “HUBs”) was created to increase the number of contractors bidding on small SPS construction projects and to address community members’ concerns over the perception that SPS was not awarding construction contracts to minority and women businesses. SPS Policies H50.00 and H50.01, attached as **Exhibits A** and **B**, established the RSBDP. The expectation was that SPS would ultimately save money on projects if more contractors were vying for the work. Other jurisdictions such as King County and the Port of Seattle have operated similar program. The RSBDP, as we refer to it in this Report, originally contained two components: Small Works Roster (“SWR”) contracting, and a training and outreach program. The SWR contracting component was aimed at small businesses for small SPS projects.¹ The

¹ SPS Policy H47.00 states, “The School Board hereby authorizes the creation and maintenance of a Small Works Roster pursuant to RCW 28A.335.190 and RCW 39.04.155, and directs that it be used for contracts expected to cost under \$200,000 to the extent consistent with applicable law, cost and schedule constraints and sound business practices.

training and outreach program provided free training to small businesses to help them learn how to bid on and compete for Seattle Public School District (“District”) projects. Silas Potter was originally the Program Manager in charge of both aspects of the program.

B. Background on Investigation

The Washington State Auditor’s Office (“SAO”) began investigating the RSBBDP at the District’s request after SPS realized that a check intended for the District was deposited into a private organization’s bank account. Specifically, SPS learned that a check intended for SPS had been deposited into the bank account of a private organization with the name “Regional Small Business Development Program” that was started by Silas Potter, manager of SPS’s RSBBDP. The private RSBBDP was unrelated to SPS’s RSBBDP, and SPS had not authorized Potter to start a private organization with the same name as the SPS program. The SAO investigated at the District’s request, and the investigation led to a review of the RSBBDP personal services contracts. The SAO eventually concluded that SPS suffered a number of “losses” and “questionable expenditures” relating to those personal services contracts. Those findings are detailed in the SAO report and will not be repeated here.

After the SAO began its investigation, the Board was alerted to an allegation from a member of the public that the RSBBDP personal services contracts were “hush money” paid to certain prominent members of the African American community to quiet opposition to SPS school closures affecting that community. The informant also alleged that Fred Stephens, former Executive Director of Facilities, and Superintendent Goodloe-Johnson, among others, were aware of and complicit in the payment of these monies.

The SPS Board retained us to investigate these allegations and to determine management’s role, if any, in the suspect RSBBDP activities. We were also asked to investigate to what extent management was aware of the RSBBDP activities and how management responded to those activities. Finally, we were asked to identify management failures or systemic issues that allowed Potter to engage in the actions that led to the SAO investigation. Our investigation was not intended to duplicate the work done by the SAO, and we were not focused on determining the extent of the fraud, if any.

In conducting the investigation, we reviewed information from a number of sources including but not limited to the following:

- Met several times with the SAO and reviewed notes from interviews they conducted;

Pursuant to RCW 39.04.155(5), the Board directs that the District shall establish a sub-roster for each trade, consisting of firms with annual income less than \$1,000,000 as shown on the federal tax return, and that contracts of less than \$35,000 shall be competed among firms listed on the applicable sub-roster whenever feasible. The District shall not require retainage or corporate surety bonds on small works contracts of less than \$35,000.” A copy of Policy H47.00 is attached as **Exhibit C**.

- Interviewed 24 individuals, including current and former SPS employees² who were familiar with or worked with the RSBDP, or had oversight responsibility for the RSBDP, as well as community members who raised concerns regarding the RSBDP;
- Reviewed numerous RSBDP personal services contracts;
- Reviewed the e-mail accounts³ for a number of current and former SPS employees;
- Reviewed information related to the investigation SPS conducted in relation to the resignation of SPS's former Internal Auditor, Kariuki Nderu;
- Reviewed a 2007 memorandum from SPS's Risk Manager regarding RSBDP issues;
- Reviewed the 2009 Sutor Group Report and related documents; and
- Reviewed information related to the budget and expenditures of the RSBDP.

We could not locate Silas Potter, the former manager of the RSBDP, and thus did not interview him. The SPS Board requested that we interview Gary Ikeda, SPS's former General Counsel. Despite a request from Noel Treat, SPS's current General Counsel, for Ikeda to cooperate, he refused to do so and abruptly terminated the conversation with our office.

C. Summary of Findings

We found no evidence to support the allegations that the RSBDP personal services contracts were “hush money” intended to silence opposition from the African American community to the closure of schools affecting that community. Notably, the individuals who made these allegations did not have evidence to support them, and our investigation did not reveal any evidence to substantiate them. The information we received was hearsay, and we could find no witness who had firsthand knowledge of this accusation or any documents to support the allegation. Both the Superintendent and Stephens adamantly denied that the program or the personal services contracts were “hush money.”

Similarly we were told by one witness that the personal services contracts were “hush money” intended to quiet community outcry about the lack of minority contractors involved in SPS projects. This information was relayed to us second hand, and again we could find no witness who had firsthand knowledge of this accusation. However, Stephens reported that SPS created HUBS/RSBDP, in part, in response to community concerns that minority businesses were under-represented in SPS contracting. In addition, we found no evidence that Superintendent Goodloe-Johnson or Chief Financial and Operations Officer (“CFOO”) Kennedy had any personal involvement in the RSBDP or the awarding of personal services contracts

² To protect the privacy of employees who cooperated in our investigation, as well as to encourage people to cooperate with such investigations in the future, we are not naming all of the individuals with whom we spoke. However, to the extent our discussion of an individual tends to reveal his or her identity, we have named those persons.

³ SPS provided e-mails primarily from February 1, 2009 forward. Prior to this date, e-mails were not archived with the exception of those for the Superintendent and Board members. We received the Superintendent's e-mails from November 28, 2007 to the present date.

except insofar as Kennedy approved at least three of the personal services contracts for that program. We conclude, however, that Potter's direct supervisor, Fred Stephens, the former Executive Director of Facilities, was aware of many of the RSBDP activities, including receiving updates from Potter regarding the personal services contractors and Potter's plan to "transition" the program into a private company.

We set forth below our findings regarding the level of knowledge various individuals within management had about the activities of the RSBDP. Where appropriate, we refer to documents on which our factual findings are based.

II. SUMMARY OF EVIDENCE RELATING TO RSBDP ACTIVITIES AND CONCERNS

This section sets forth the issues that management should have been aware of ("red flags") that existed surrounding the RSBDP and details regarding who was aware of those red flags, what investigation was made (if any), and responses thereto.

A. The Memo from the SPS Risk Manager

1. Concerns Raised in the Memo

On February 8, 2007, the current SPS Risk Manager drafted a memorandum to Stephens about concerns he had relating to the RSBDP ("Memo"). A copy of this memorandum is attached as **Exhibit D**. At the time the Memo was drafted, neither Superintendent Goodloe-Johnson nor CFOO Kennedy had been hired by the District. In the Memo, the Risk Manager raised a number of concerns regarding contracts awarded through the RSBDP (HUBs). The Risk Manager reported that it was unusual for him to draft a memo of this nature, but he did so because he had serious concerns about RSBDP activities and felt it was important to bring those concerns to his superiors. At the time of the Memo, the Risk Manager had a dual reporting relationship to the General Counsel, Gary Ikeda, and Stephens. For this reason, the Risk Manager shared his concerns and the Memo with Ikeda prior to approaching Stephens. Based on advice from Ikeda, the Risk Manager limited the issues he addressed in the Memo. However, the Risk Manager explained during our interview that he verbally addressed other concerns with Stephens, including his concern that, at the very least, the contracting issues raised the potential for fraud against the District.

The Memo identified three specific issues about which the Risk Manager was concerned. The details of those issues are set forth in the attached exhibit. Notably, some of the issues identified by the Risk Manager in 2007 were later identified as system problems by the Sutor Group investigation, discussed below in Section B. One of the issues involved what appeared to be an obvious conflict of interest arising from a SPS employee working for a personal services contractor, and apparently working for that contractor during regular SPS business hours. Also, the Risk Manager identified potential misuse of public funds associated with the development of training materials and duplication of DVDs for the District, and that these circumstances could be ripe for fraud. Based on interviews with the individuals who had knowledge of the Memo, it does not appear that anyone investigated or further pursued the fraud concerns or other issues in the Memo.

2. Follow-up on the Risk Manager's Memo

After Stephens received the Memo, he met with the Risk Manager and a SPS lawyer. During this meeting, the Risk Manager reported that he was generally concerned that the poor contracting practices could lead to contractor abuse or fraud, including a potential situation where a contractor receiving a significant profit for work done by a subcontractor might want to “reward” the district employee who awarded the contract. Although the Risk Manager did not have any direct evidence of fraud, he had serious concerns that the contracting process and lack of oversight could be exploited, and he shared those concerns with Stephens. After the meeting, the SPS lawyer proposed changes to the contracting procedures. See **Exhibit E**. We were unable to find any evidence that anyone undertook further investigation or review of the RSBDP or its contracting practices after this meeting. Potter remained in charge of the RSBDP, including SWR contracting, until approximately the time when the Sutor Group was hired. In hindsight, the Risk Manager stated that he wished he had done more to follow-up on the issues he raised in his Memo, but he trusted Stephens to provide necessary oversight of Potter. Moreover, he brought the issues to the attention of Ikeda, the District's General Counsel.

Stephens stated that he viewed the issues identified in the Memo to be indications that Potter's work was sloppy, as opposed to fraudulent. The issues were significant and concerning enough that Stephens said he issued a verbal reprimand to Potter. We were unable to find any evidence in Potter's personnel file of this “verbal reprimand.”

The Risk Manager did not discuss his Memo or his concerns about the RSBDP with Superintendent Goodloe-Johnson or CFOO Kennedy. Because Ikeda was unwilling to speak with our office, we were not able to determine whether he took any action to follow up on the Memo. Other members of the SPS legal staff did not recall Ikeda taking any actions in response to the Memo. Both Superintendent Goodloe-Johnson and CFOO Kennedy stated that they were unaware of the Memo until the SAO began its current investigation. We found no evidence that the SPS Board was aware of the Risk Manager's Memo prior to the current SAO investigation.

B. The Sutor Group Report

1. Concerns Raised in the Sutor Group Report

In the summer of 2008, Stephens became aware of problems with a SWR contractor allegedly not paying prevailing wages and doing inferior work. At that time, Potter was in charge of SWR contracting and the RSBDP training component of the program. Stephens spoke with the legal department, which began looking into the suspect contract. Shortly thereafter, Stephens and a lawyer in the SPS legal department hired the Sutor Group to review the RSBDP's SWR contracting practices. The Sutor Group only reviewed SWR contracting processes and did not investigate contracting procedures for RSBDP personal services contracts. Likewise, the investigation did not examine whether there was fraud or any other illegality, such as the use of “kickbacks,” even though the SPS legal counsel acknowledged that those issues were an obvious concern. It was Stephens who dictated that the Sutor Group investigation would be limited to the scope described above.

An initial draft of the Sutor Group report stated in the cover letter: “The level of deficiencies found during our review in the SWR program results in the conclusion that significant changes should be made with respect to the administration and staff procedures of the SWR program. . . . We generally found that the lack of clearly documented staff procedures coupled with little or no outside oversight of the SWR program has allowed the SWR program to operate outside the Board Adopted Procedure and the Building and Construction Trades Council Collective Bargaining Agreement.” This draft report was circulated to SPS management, including Stephens and CFOO Kennedy. A copy of the draft report is attached as **Exhibit F**.

On January 13, 2009, Superintendent Goodloe-Johnson, CFOO Kennedy, and Stephens met to discuss the small works program. None of the participants could recall with any specificity what was discussed, and we have been unable to locate any notes relating to the meeting.

On January 15, 2009, Stephens sent an e-mail to CFOO Kennedy regarding the “finalized Small works review.” A copy of this e-mail is attached as **Exhibit G**. In that email, Stephens stated:

Corrections were made and it is not as bad as the draft (although it’s still not good). You have not seen this, do you care? The other consideration is with regards to next week’s executive session. If I understood you correctly, you and the Supt. didn’t want us to hand out the report. You may want to reconsider this as the SAO could have a finalized version this week. Please advise.

Neither CFOO Kennedy nor Superintendent Goodloe-Johnson recalled stating that they did not want to hand out the report to the Board, as they did not recall having any particular conversation about the Sutor Group Report. We found no evidence that the Board was briefed on the Sutor Group Report.

The final Sutor Group Report was sent to the District on January 15, 2009.⁴ A copy of the final report is attached as **Exhibit H** (referred to hereinafter as the “Sutor Group Report”). The Sutor Group Report found, among other things, that documented procedures for implementing the SWR program were lacking; the Board policies regarding the SWR program were not being followed; and some unqualified contractors were awarded Small Works projects. The Sutor Group Report ultimately concluded that “changes should be made with respect to the administration and staff procedures of the SWR program, including separation of the administration and management of the SWR program from the SBDP/HUBs program.”

Based on the Sutor Group report, responsibility for SWR contracting was transferred to the purchasing and contracting department. This transfer of responsibilities addressed all of the issues raised by the Sutor Group Report and was consistent with the Sutor Group’s

⁴ We did not locate the e-mail in which the Sutor Group sent the final report to SPS. However, the author of the Sutor Group Report recalled sending the final version to SPS on the date noted on the report.

recommendations. However, Potter's ability to enter into personal services contracts remained unfettered.

2. Daily Journal of Commerce Article

The Sutor Group Report came to the attention of the Daily Journal of Commerce in February 2009. The e-mails and other documents we reviewed, and the interviews we conducted, established that District management, including Stephens, CFOO Kennedy, Ikeda, and the Superintendent were all aware of the negative publicity surrounding the Sutor Group Report's findings. See **Exhibit I**. Stephens pointed out in response that management implemented all recommendations "as far back as NOV 8." On February 20, 2009, the Communications Manager of the Office of Public Affairs at SPS sent an email to CFOO Kennedy, Stephens, and the Superintendent's assistant recommending that the following information be provided to the Board in the "Friday Update":

Media Item: Small Works Roster Review by The Sutor Group

The Daily Journal of Commerce has a copy of the Small Works Review by The Sutor Group, and we expect an article to be published soon. The reporter's questions relate to our responses and actions to each of the observations noted in the report. If you receive any follow-up media calls, please refer them to the Communications Department.

A copy of this email is attached as **Exhibit J**.

On February 28, 2009, Superintendent Goodloe-Johnson included substantially the same language in her "Friday Update" to the SPS Board. A copy of this e-mail is attached as **Exhibit K**. The Board did not actually receive a copy of the Sutor Group Report or a briefing on the content or gravity of the Report's findings. Rather, the Board simply received notice of a potential upcoming newspaper article. Superintendent Goodloe-Johnson had no independent memory of this item in her Friday Update nor did she recall the Daily Journal of Commerce article. The Superintendent also did not recall discussing the Sutor Group Report or the Daily Journal of Commerce article with Board members. We found no evidence to suggest that the Board received a comprehensive briefing on the issues identified by the investigation.

On March 2, 2009, the Executive Management Team apparently discussed the Sutor Group Report. An e-mail from Ikeda attaching minutes from this meeting is attached as **Exhibit L**. As noted above, Ikeda refused to be interviewed, so we were not able to ask him about this briefing.

On March 3, 2009, the Daily Journal of Commerce published an article regarding the Sutor Group Report. That article was sent internally within SPS to CFOO Kennedy and Ikeda, among others. A copy of the e-mail circulating the article is attached as **Exhibit M**. The article mentioned possible criminal indictments, and, at the time, the SPS Communications Manager inquired whether anyone in the District knew of the alleged criminal indictments. A member of the SPS legal staff responded to the group stating that he was unaware of anything related to criminal indictments. Stephens then forwarded the e-mail to Potter and said, "Fyi. Also Solar

West [the contractor that initially spurred the Sutor Group Report] was not licensed, according to your old files, the first job or two.” Potter responded and tried to explain that Solar West did have the appropriate license, but Stephens corrected him and said, “The bid should have been thrown out.” A copy of this email exchange is attached as **Exhibit N**.

3. Follow-up from the Sutor Group Report

Stephens acknowledged during our interview that the findings of the Sutor Group Report were very serious and concerning to him as a manager. He reported that the misconduct was serious enough to warrant termination of Potter and that he advocated for such a result. Stephens stated that he was told by the legal department and/or the human resources department that Potter could only be fired for “just cause,” and that the Sutor Group findings did not rise to that level. Stephens’s statements regarding his desire to terminate Potter were contradicted by other District employees. We found no record or witness who corroborated Stephens’s statements about his desire to terminate Potter. Stephens admitted that he did not advise anyone within management of the Risk Manager’s Memo when evaluating the appropriate discipline for Potter. We note that, regardless of whether Stephens actually proposed Potter’s termination, the fact that he recalls doing so illustrates the severity of the Sutor Group findings and should have resulted in additional oversight of Potter by Stephens.

Significantly, another manager in Stephens’s group at the same time was also facing discipline for failing to follow contracting procedures, including manipulating contracts to avoid seeking Board approval for them. Several witnesses, including CFOO Kennedy, believed Stephens wished to terminate this employee and not Potter. Apparently Stephens was told that given the similarity in misconduct, any discipline of the two managers should be consistent.

In the end, Stephens issued Potter (as well as the other employee facing discipline) a written reprimand. The reprimand, issued in April 2009 and after the Daily Journal of Commerce article was published, recounted some of the Sutor Group Report findings, but ultimately concluded that since Small Works Roster contracting authority had already been taken away from Potter, no further corrective actions were necessary. The reprimand also required that Potter develop documented procedures for the remaining RSBDP activities; ensure all staff are trained; ensure that all Board policies and procedures and applicable laws are followed; properly evaluate applications by contractors for participation in the RSBDP; and use good business practices going forward.

The reprimand also noted that, unrelated to the Sutor Group Report, Stephens had discovered that Potter was engaging in unauthorized lobbying in Olympia on behalf of the RSBDP. Stephens directed Potter not to engage in lobbying in the future. The reprimand concluded by stating that if Potter failed to follow the requirements set forth therein, SPS would consider disciplinary action, potentially including termination. Attached as **Exhibit O** is a copy of Potter’s Letter of Reprimand.

Despite the reprimand and Stephens’s stated desire to terminate Potter, Potter was allowed to continue entering into personal services contracts without any additional oversight or safeguards in place. Stephens reported that he initially monitored Potter’s activities more

carefully but did not restrict Potter's ability to engage consultants through personal services contracts. He explained his actions by stating that he "trusted" Potter.

C. Employee Concerns Regarding Personal Services Contracts

1. Employee concerns

In addition to the "formal" concerns raised in the Risk Manager's Memo and the Sutor Group Report, employees within SPS told us that they had a number of concerns regarding the RSBDP. For example, we spoke with a number of employees about their concerns over Potter's personal services contracts. Although personal services contracts are not unusual in the SPS, the fact that Potter's were for relatively small dollar amounts compared to the contracts procured by other departments was unusual. Some employees were concerned that the services described in the personal services contracts were unusually vague, and others questioned the need for the contracting services altogether. A few employees also had concerns that the paperwork associated with Potter's personal service contracts was inadequate or missing when the contract was initially submitted for approval. At least one employee questioned why the RSBDP needed contractors for lobbying when SPS had its own employees dedicated to lobbying. Some of the employees we interviewed questioned the propriety of the district paying for food relating to the training program and expressed concern that much of the food appeared to go to waste. Most alarmingly, some employees noticed that certain personal services contractors appeared to own more than one company, and that each of those companies was awarded personal services contracts through the RSBDP. (In other words, one person would be awarded two contracts through two different companies.)

Some of the employees took their concerns to their supervisors. The supervisors purportedly responded that either: (1) employees should not question the program; or (2) Stephens and/or legal had reviewed and approved of the RSBDP and the way it operated, so employees should not worry about the program. The supervisors we interviewed acknowledged that employees questioned the program and some of its operations but denied that anyone brought fraud-type concerns to them.

At least one employee brought concerns to Nderu and expected him, as the internal auditor, to look into the issues. Based on our investigation, we found no evidence that Nderu followed up on the employee's concerns. Nderu denied that the employee brought concerns to his attention.

We questioned employees as to why they did not make their concerns known to others within management. We were told that they believed that it would not do any good to complain and that the District had tacitly sanctioned Potter's work as evidenced by the fact that no one stopped him. Some employees expressed their belief that the Board had reviewed and approved of this program. In general, all of the employees we spoke with believed that Potter was being protected by Stephens and had blanket approval for his activities. One employee we spoke with stated that he or she did not complain because of a fear of being called racist for not supporting the program.

None of the employees with whom we spoke took their concerns regarding the RSBDP to CFOO Kennedy, Superintendent Goodloe-Johnson, or the SPS Board. All of the employees felt they had acted appropriately by taking their concerns to their direct supervisors. Most of the employees were not familiar with the District's Ethics Policy or the Whistleblower Policy, attached as **Exhibits P & Q**. In fact, one long term employee within the legal department reported that when Ikeda was the General Counsel and Ethics Compliance Officer, he had a "closed door policy" and conveyed that he did not wish to have problems brought to him.

2. Fear of Retaliation

A number of current SPS employees identified retaliation as a concern that impacted their decisions not to bring concerns with the RSBDP activities to individuals above their immediate supervisors. We learned that there were widely circulated rumors that a long-term employee who had challenged Potter's activities was subsequently demoted and forced to retire. Our investigation and interview of that employee determined that this rumor had no merit. Regardless, employees believed they would suffer the same fate if they complained about Potter and RSBDP.

Apparently, some employees believed that the RSBDP was "untouchable" and enjoyed some sort of protection from District management. In sum, our interviews with employees confirmed the SAO's finding that a general atmosphere of fear, intimidation, and reprisal existed in the Facilities Department. We did not find any evidence that employees were actually subjected to retaliation or harassment for speaking up about Potter's activities or the RSBDP. However, based on the interviews we conducted, it appears that the fear of retaliation was a common one.

3. Communication Protocol

Another factor that may have contributed to decisions by employees not to take their concerns to the Board was the communication protocol developed in conjunction with the Board and instituted by Superintendent Goodloe-Johnson. The communication protocol was intended to streamline requests for information between the Board and District employees and was not intended to cut off employees' access to the Board. Although the policy explicitly encouraged employees to bring concerns relating to activities that were not in the best interest of the District to the attention of management and promised no negative repercussions for doing so, some employees, including the internal auditor, believed the policy prohibited employees from having direct contact with the Board or the Superintendent. A copy of the protocol is attached as **Exhibit R**.

D. RSBDP Budget and Expenditures

Our investigation revealed that the RSBDP grew following the Sutor Group investigation. Potter requested and Stephens approved the addition of three full time employees to work as "Small Business Development Counselors." Potter apparently had sole discretion to decide who would fill these positions, and we determined that at least one of the employees was a friend and roommate of Potter. All appeared to have personal relationships or connections to Potter. There is evidence that the majority of the employees hired into these positions were unqualified for the

work. Potter addressed this problem by hiring a personal services contractor to train the employees. The District paid thousands of dollars for these employees to be trained. Additionally, Potter hired some of these employees during a “hiring freeze,” and we were unable to determine an “exception” that justified the hiring.

Information provided by SPS⁵ indicated that the RSBDP budget and expenditures were as follows in the years 2007 to 2010:

- In 2007, the RSBDP budget was \$582,614, and the program spent \$657,057. Of that expenditure, \$540,560 was spent on personal service contracts.
- In 2008, the RSBDP budget was \$850,871, and the program spent \$761,796. Of that expenditure, \$494,555 was spent on personal service contracts.
- In 2009, the RSBDP budget was \$984,251, and the program spent \$1,082,323. Of that expenditure, \$557,929 was spent on personal service contracts.
- In 2010, the RSBDP budget was \$848,451, and the program spent \$579,303. Of that amount, \$287,463 was spent on personal service contracts.

We identified systemic issues within management that impacted the way decisions were made with respect to resources allocated to the RSBDP. The budget process under current management appears to be a “bottom up” approach in which lower-level managers request funds, and if the department manager approves the requests, they are passed along to the CFOO for approval. During his interview, CFOO Kennedy minimized his role in the budget approval process and stated that he relies on his direct reports to advise him of the funds needed for their programs. We also discovered that the Superintendent plays no active role in the budget formation and instead relies on CFOO Kennedy to develop an appropriate budget for the Board’s approval. As she explained, she delegated budgeting responsibilities to CFOO Kennedy and trusted him to manage the process.

CFOO Kennedy corroborated the budget process and described it as “from the ground up.” When questioned about the decision to add employees and hence funds to the RSBDP budget following the Sutor Group investigation, CFOO Kennedy could offer no explanation but pointed out that the RSBDP was a relatively small program within the District and that he did not spend much time analyzing its budget or day-to-day operations.

E. Personal Service Contract Expenditures by the RSBDP

We found that there was little to no oversight of Potter’s personal services contract expenditures. This fact was particularly concerning given that between 2007 and 2010, the RSBDP spent approximately \$500,000 each year on such services.⁶ As detailed above, the

⁵ The budget numbers are the best that were available to us at the time of this report.

⁶ In 2010 the program only operated for approximately six months, and the expenditures for personal services contracts for that time was approximately \$280,000.00.

descriptions of the services provided were vague, general, and surprisingly consistent from contract to contract. Moreover, we learned that Potter's expenditures often exceeded his budget and that Stephens would allocate more funds to cover the overage. From our review of documents provided by SPS and interviews with employees, we were unable to determine what, if any, checks and balances were in place to monitor the contracts and the failure of Potter to stay within his allocated budget.

Additionally, it appears that the SAO determined in 2010 that the RSBDP should not have been funded with capital funds, which have restrictions on how they can be used. One employee reported that she knew that SPS was incorrectly using capital funds. We were unable to determine why Stephens and CFOO Kennedy did not recognize at the time the improper funding issue identified by the SAO audit. This failure is concerning particularly because it was management's decision to take SWR contracting away from the RSBDP that made funding the RSBDP with capital funds inappropriate. It seems clear that someone in management should have recognized that capital funds were being improperly spent. See **Exhibit S**.

F. Other Miscellaneous Issues

A handful of other issues arose that should have prompted management to ask additional questions about the way the RSBDP was operated and managed. Although none of these issues on their own was particularly noteworthy, taken together (and in conjunction with the other issues raised in this Report), they should have alerted management to supervise the RSBDP more closely.

First, it appears that Potter was unqualified to manage the RSBDP. He had no background in contracting and was reportedly a marginal employee in his position of a "Relocation Planner." Given his lack of experience in contracting issues, it was incumbent on Stephens and others to closely monitor his activities. Further, it appears that Stephens did little or no investigation into Potter's background prior to selecting him to run the RSBDP. Potter's personnel file shows that his wages were garnished between 2001 and 2009 for unpaid federal taxes and failure to pay child support. Stephens had access to Potter's personnel file and presumably should have reviewed his file prior to giving him authority to manage District funds. Moreover, a Washington courts record check revealed numerous actions against Potter involving unpaid debts to a variety of creditors.

Second, Potter made at least one inaccurate report to the SPS Board regarding RSBDP's accomplishments in 2007. An attorney with SPS's legal department raised concerns with Stephens about the accuracy of the results Potter attributed to his program, but was told that it was important for the program to "look good." The attorney then took this concern to General Counsel Ikeda,⁷ who stated that the attorney had fulfilled his obligations by notifying the "client," *i.e.* Stephens, of his concerns about the accuracy of the report, and that there was no need to notify the Board directly. We found no evidence that the report to the Board was corrected, although Stephens recalled telling Potter to change the information.

⁷ As noted above, Ikeda refused to participate in an interview with us. We therefore do not know what he recalls about this conversation.

The former internal auditor, Nderu, was also aware that Potter's report to the Board was inaccurate. On the same day the Sutor Group Report was issued, Nderu sent an e-mail to Potter and Stephens notifying them that RSBDP last reported to the Board on September 1, 2007.⁸ A copy of Nderu's e-mail is attached as **Exhibit T**. Nderu pointed out that he had learned that much of the information contained in that presentation was inaccurate. He did not recommend any particular follow-up or that the RSBDP present to the Board again with accurate information. We were unable to locate any follow-up e-mails on this topic.

G. Transition to Private Organization

In February 2010, Potter incorporated a private organization called the "Regional Small Business Development Program." He did not have SPS's authority to incorporate a private organization with the same name as the SPS program. Apparently, Potter was planning to transition SPS's RSBDP to his own private RSBDP.

Potter openly discussed his plan to "transition" to a private organization. In fact, he sent Stephens a copy of a "transition plan," paid for by SPS funds, detailing the role of various SPS employees in the transition. See **Exhibit U**.

Although Stephens reportedly told the SAO that he was unaware of Potter's plan to transition to a private company, he acknowledged to us that he received the "transition plan" described above. Stephens stated that he was concerned with Potter's plan, recognized the conflicts, and instructed Potter to not work on the private organization while employed by the District. Stephens stated he believed Potter had followed his directive. However, Stephens acknowledged that he did not follow up on this issue with Potter to ensure that the transition was not occurring. This failure is particularly concerning in light of the fact that Potter was openly working on the transition while employed by the District. Witnesses stated that the private "consultant" hired to effectuate the transition and who drafted the "transition plan" was working in the District offices. Additionally, Potter met with officials from the City of Bellevue at the District office about the lease and remodel of office space for his private organization. We understand that Stephens's office was located near the RSBDP and that he was frequently seen interacting with Potter. As a result, we found Stephens's claim that he believed Potter had followed his directive to abandon the "transition to the private organization" questionable.

We found no evidence that Superintendent Goodloe-Johnson or CFOO Kennedy received a copy of the transition plan. Likewise, we did not find any evidence that they were aware the transition plan existed until after the issues with the deposit of District funds into the private organization's bank account arose. We were unable to determine whether Stephens told CFOO Kennedy about the transition to the private organization. Nderu alleged that CFOO Kennedy was generally aware of the transition plan. Neither CFOO Kennedy nor Stephens could specifically recall whether they discussed Potter's transition plan.

⁸ As discussed below, Nderu's e-mail is inaccurate, as we located two Board presentations on HUBs in 2008.

III. MANAGEMENT AWARENESS OF PROBLEMS IN THE RSBDP

A. Superintendent Goodloe-Johnson's Knowledge of and Involvement in the RSBDP

We found no evidence that Superintendent Goodloe-Johnson was substantively involved in the RSBDP. Although she admittedly understood the overall purpose of the program, participated in a promotional video for the program, and received an award from the program on behalf of the SPS, we did not find any evidence that she had knowledge of the details of the program, its budget, or the personal services contracts entered into by Potter. We reviewed the Superintendent's e-mail (provided to us by SPS), and found no evidence that she communicated with any of the personal services contractors about the work they were performing for the RSBDP program.

None of the witnesses we interviewed said they raised concerns related to the RSBDP with the Superintendent. It is clear, however, that the Superintendent was generally aware of the Sutor Group investigation and the negative publicity surrounding it, and knew that the SWR contracting responsibilities had been given to a new department.

The Superintendent explained that the RSBDP was "too far down" in the organization for her to know details of its operations. Also, she considered the program to be under CFOO Kennedy, who was responsible for all operational functions. As a result, she relied on CFOO Kennedy and Stephens to ensure that the program was properly supervised. The Superintendent stated she was unaware that Potter retained authority to issue personal services contracts after the Sutor Group Report; she explained that a detail like that is not something she would typically know about a program like the RSBDP.

Also, as noted above, Superintendent Goodloe-Johnson apparently played no role in developing the budget or reviewing expenditures for individual programs. Thus, she had no knowledge of the amount of money in the RSBDP's budget or how much it spent. Likewise, she was unaware of how much money the RSBDP spent on personal services contracts, and she was not involved in the personal services contracts for the RSBDP (she stated that she never authorized a personal services contract for the RSBDP, and we found no evidence to the contrary). She was also unaware that the RSBDP added employees during a hiring freeze after the Sutor Group Report was issued.

In hindsight, the Superintendent stated that additional structures and procedures should have been put in place after issuance of the Sutor Group Report to ensure that the necessary checks and balances existed. She identified Stephens and CFOO Kennedy as failing to provide adequate oversight.

B. CFOO Kennedy's Knowledge of and Involvement in the RSBDP

CFOO Kennedy also had limited involvement and knowledge of the RSBDP, although he had more than the Superintendent. CFOO Kennedy met regularly with Stephens (who reported directly to CFOO Kennedy) and discussed with him the Sutor Group Report and the removal of

SWR contracting from the RSBDP. CFOO Kennedy was also aware that another direct report to Stephens was being investigated for misconduct and/or malfeasance at the same time as the Sutor Group issues arose. Based on these two events, CFOO Kennedy should have monitored Stephens's group and these two programs more closely.

The evidence we have found indicates that CFOO Kennedy had limited knowledge or awareness of the RSBDP daily activities. He delegated virtually all oversight responsibility for the program to Stephens, and he trusted and relied upon Stephens to oversee Potter's activities, even after the Sutor Group Report. CFOO Kennedy did not follow up with Stephens or Potter to ensure that Stephens was in fact overseeing Potter after the Sutor Group Report was issued. CFOO Kennedy viewed the problems identified in the Sutor Group Report to be solved once SWR contracting was moved out of the RSBDP. CFOO Kennedy also was aware that the unions were raising issues related to SWR contracting. He explained his management style as very "hands-off," that he trusted those below him a great deal to fulfill their responsibilities.

Further, CFOO Kennedy had no knowledge of the RSBDP's budget, how funds were expended, or the fact that Potter routinely exceeded his allotted budget. As noted above, CFOO Kennedy explained that, from his perspective, the RSBDP was a relatively small part of SPS's operations and that he did not view the program as one that warranted his personal attention; hence, he trusted that responsibility to Stephens. Further, CFOO Kennedy understood from Stephens that the program was operating well and was successful, so he had no reason to question its activities.

Based on our review of the RSBDP personal services contracts, we noted at least three contracts that CFOO Kennedy authorized. CFOO Kennedy could not recall anything about those contracts. He routinely authorizes personal services contracts and does not review them for content or appropriateness. Rather, he explained that his signature simply verifies that the correct people have reviewed the personal services contract. In short, CFOO Kennedy was focused on the "process" involved in approval as opposed to questioning the legitimacy of the expenditure of funds. CFOO Kennedy admitted that he knew that Potter maintained authority to authorize personal services contracts after the Sutor Group Report, but did not review the personal services contracts from Potter any differently than he did before the Sutor Group Report.

Although CFOO Kennedy approved the hiring of employees into the RSBDP program during a hiring freeze and approved the RSBDP budget, he could not recall any specifics relating to these decisions. He was unaware that the employees hired were unqualified or that SPS paid an outside contractor to train the employees.

Given everything that he now knows about Potter's activities and the fraudulent personal services contracts, CFOO Kennedy still maintains that he should not have done anything differently with respect to the RSBDP or overseeing Stephens or Potter. Rather, he views the failings as belonging to Stephens. He did acknowledge that the District needs to strengthen its review of personal services contracts and stated that he is currently working on doing so.

C. Fred Stephens's Knowledge of and Involvement in the RSBDP

There is no question that Stephens bears responsibility for failing to oversee Potter and the RSBDP program. Although we acknowledge that Potter was likely duplicitous about his activities—particularly to the extent he may have engaged in fraudulent conduct—we conclude that Stephens had sufficient warning signs and concerns about Potter's past misconduct to warrant close oversight. Stephens's failure to ask questions, scrutinize Potter's personal services contracts, or ensure that Potter was not working on his private company while employed by SPS is troubling. We view his failure to properly supervise Potter as a major management failure that, at best, allowed Potter to engage in the activities that are the subject of the SAO audit.

D. School Board Members' Knowledge of and Involvement in the RSBDP

We found no evidence that the School Board was involved in or aware of any of the personal services contracts that the SAO found constituted losses or questionable expenditures. In fact, it appears that the Board was given limited information about the program and that some of the information they were provided was inaccurate. In the 2007 Board briefing, Potter and Stephens reported that the RSBDP was responsible for approximately \$70 million in contract awards to contractors in the program. Based on our review of documents and interviews, it appears that this number was grossly inflated and did not truly represent the program results. Despite SPS legal counsel challenging the accuracy of the numbers attributed to the program, Stephens allowed the Board to be misled. Clearly, it was inappropriate for the RSBDP to give inaccurate and misleading information to the Board, which has ultimate responsibility for the District operations and budget.

Moreover, in February 2008, the Board received a briefing about the RSBDP. See **Exhibit V**. Again, the information the Board received was questionable in terms of accuracy. Similarly, in September 2008, the Board was again briefed and told that RSBDP was providing training to approximately 350 contractors. It was later discovered that far fewer firms were attending the RSBDP trainings. Additionally, once the SWR responsibilities were transferred to another department, it was discovered that many of the firms on the SWR were not properly included in the list. According to witnesses, Potter's count of eligible contractors included chiropractors, a massage therapist, a doggie day care business, unlicensed businesses, and companies whose revenues exceeded the threshold for the SWR. Based on our review of the records provided by SPS, we conclude that the Board was not briefed again about the RSBDP until the SAO became involved. Stephens stated that the RSBDP was required to report to the Board quarterly, but we were not able to find evidence that such reports regularly occurred.

Finally, we conclude that the Board did not receive a briefing on the Sutor Group Report. The only information provided to the Board was a notification that there may be an article in the Daily Journal of Commerce about the Sutor Group Report. Again, management's failure to keep the Board adequately advised of the significant issues identified by the Sutor Group was unacceptable and impacted the Board's ability to ensure that proper oversight and checks were in place to monitor Potter's activities.

IV. CONCLUSION

Based on our investigation to date, we conclude that the former Executive Director of Facilities Fred Stephens failed to oversee Silas Potter's activities with respect to the RSBDP, despite numerous warning signs that additional oversight was warranted. We also found that Stephens was aware of Potter's plan to transition the RSBDP to a private organization, and conclude that Stephens should have followed up to ensure that Potter was not abusing his position as an SPS employee or misusing District funds.

With respect to CFOO Kennedy, we conclude that he did not have substantive knowledge of the RSBDP. However, although he did not have as much information about the warning signs as Stephens did, he had enough information that he should have followed up with Stephens to ensure that Stephens was providing the proper level of oversight to Potter. Kennedy's decision to delegate virtually all oversight responsibility to Stephens led to Kennedy missing warning signs that Potter was misusing District funds.

With respect to Superintendent Goodloe-Johnson, we conclude that she had limited knowledge of the RSBDP because she entirely trusted Kennedy to oversee the program. None of the witnesses we interviewed informed the Superintendent about their concerns about the RSBDP, and we did not find any documents to suggest that Superintendent Goodloe-Johnson was aware of the problems in the RSBDP. Nonetheless, it is our opinion that it was incumbent on the Superintendent to ensure that Potter's program was properly supervised in light of the major deficiencies uncovered by the Sutor Group Report.

We are available to conduct further investigation as the Board deems necessary.