



Santa Clara County Office of Education

Mary Ann Dewan, Ph.D.
County Superintendent of Schools

March 16, 2018

***Via E-Mail and U.S. Mail
(esaulawyer@gmail.com)***

Esau Ruiz Herrera, Board President
Alum Rock Union Elementary School District
2930 Gay Avenue
San Jose, CA 95127

Re: Notice of Stay and Rescind Action

Dear Board President Herrera:

In an effort to correct weaknesses in the Alum Rock Union Elementary School District's (ARUESD or District) financial and operational management, and to ensure the integrity of business and program decisions over the past two fiscal years, the Santa Clara County Office of Education (SCCOE) has provided detailed guidance through instructional correspondence, in-person meetings, and even on-site support through the appointment of Fiscal Experts. These services have been provided in accordance with SCCOE's duty to provide oversight and guidance to the ARUESD in order to enable the District to develop and implement a strong system of internal controls, formal policies and procedures and sound business practices.

Even with this stepped up level of support, the District continues to display signs of fiscal distress. Cash and debt service issues remain unresolved; an extraordinary audit prepared by the Fiscal Crisis Management and Assistance Team (FCMAT) reported deficiencies in governance and internal controls including, but not limited to micromanagement of operational issues by board members, conflict of interest concerns and a disregard for board policies and regulations. Additionally, the District is requesting yet another extension of time to file the Fiscal Year 2016-17 annual financial report that was due December 15, 2017.

A comprehensive assessment of the District's financial, governance and operational challenges does not engender confidence that the District can overcome these deficiencies to ensure that the district can meet its financial obligations. Therefore, effective today, the Santa Clara County Office of Education, in accordance with California Education Code section 42127.6, will stay or rescind any action that is determined to be inconsistent with the ability of the school district to meet its obligations for the current or subsequent fiscal year.

The District was given a qualified certification pursuant to Section 42131 as noted in the January 16, 2018 letter from the SCCOE Senior District Business Advisor. Please be advised that the SCCOE has further determined that it is necessary to stay and rescind any action that is considered to be inconsistent with the District's ability to meet its obligations for the current or subsequent fiscal years in accordance with the statutory guidelines set forth in Education Code section 42127.6. The determination that the District shows signs of fiscal distress and is at risk of financial insolvency is based upon the facts outlined below.

Background

In November of 2016, the County Superintendent received an anonymous allegation that Del Terra Real Estate Services, Inc., DBA Del Terra Group (Del Terra) fraudulently billed the District for construction and program management services.

The allegations included:

1. Del Terra double-billed the District by submitting fees totaling 4% of the total construction costs for project management and an additional 6% for construction management and subsequently assigned the same individual to both contracts;
2. Del Terra invoiced the district approximately \$330,000 for construction management services for projects that have not yet begun.

Due to the serious nature of the allegation, pursuant to Education Code section 1241.5 the County Superintendent requested that FCMAT conduct an audit to determine if fraud, misappropriation of funds or other illegal activities may have occurred. FCMAT began its review in December of 2016 and examined district policies, procedures, and internal controls for purchasing and contractual commitments.

On December 2, 2016, SCCOE and FCMAT entered into an agreement to conduct an Extraordinary Audit of Alum Rock in accordance with Education Code section 1241.5 (b) which permits a county superintendent of schools to review or audit the expenditures and internal controls of any school district in his or her county if he or she has reason to believe that fraud, misappropriation of funds, or other illegal fiscal practices have occurred that merit examination. FCMAT published its completed Santa Clara County Office of Education Extraordinary Audit of the Alum Rock Union Elementary School District on June 9, 2017 ("FCMAT Audit"). The FCMAT Audit concluded that:

Based upon the findings in this report, there is sufficient evidence to demonstrate that fraud, misappropriation of funds and/or assets, or other illegal activities may have occurred in the specific areas reviewed. (FCMAT Audit, p. 69)

The County Superintendent assigned a fiscal expert team, paid for by the county superintendent, to advise the district on its financial problems, in accordance with

Education Code section 42127.6(a)(1)(A). The fiscal expert team has worked with the District staff since January of 2018 to advise the District with respect to its financial deficiencies.

Summary of Fiscal Stability, Board Governance and Conflict of Interest Concerns

SCCOE has observed that progress has been made under the leadership of the District Superintendent and staff to correct some long standing fiscal issues and resolve cash reconciliation issues. The fiscal expert team's support has accelerated the stabilization efforts already underway with regard to accounting and financial weaknesses experienced by the District.

Notwithstanding the efforts to improve the fiscal stability of the District, SCCOE has observed a persistent absence of transparent and prudent board governance with regard to fiscal stewardship, conflict of interest concerns, public contracting and contract administration in particular. These deficiencies in board governance have a destabilizing influence on the District's ability to achieve financial stability. As the District addresses its longstanding fiscal weaknesses, the following examples of imprudent governance have persisted and threaten the District's fiscal stability:

- There have been four different board president appointments since the fiscal year began in July 2017. It is important to note that these transitions of leadership occurred through the extraordinary process of a board vote to remove the sitting president prior to the end of his term of office, thus highlighting a lack of stable board governance.
- A further indication of lack of stable board governance is the fact that the board minutes dated November 16, 2017 reflect a dispute among board members regarding whether to hold its annual organizational meeting on December 14, 2017 in accordance with Education Code sections 35143, 5000 and Board Bylaw 9100 or call a special meeting on December 7th to carry out board officer elections. At the November 16, 2017 meeting the board voted to remove the current board president and elect a new president and vice president in advance of the annual organizational meeting on December 14, 2017. The board held a meeting December 14, 2017 but the minutes of that meeting have not yet been approved and posted on the District website.
- The FCMAT Audit describes a lack of accountability and compliance with statutory guidelines relating to the expenditure of bond revenues, which began in 2013 and has continued to the present. Specifically, the FCMAT Audit states that:

The District website shows that before the 2013 hiring of the Del Terra Group, the citizens' oversight committee met quarterly. This is a

committee subject to the Ralph M. Brown Act, requiring the posting of all agendas, along with other accountability measures. Before 2013, all agendas and minutes were posted. However, after Del Terra was hired, quarterly meetings were rarely held, agendas lacked detail, minutes were not posted, and the agendas indicate about 25 to 30 minutes are allocated to each meeting. This would require extremely short reports with no ability to provide details and answer questions from the public or the citizens' oversight committee.

California Education Code sections 15278-15282 describe the accountability requirements of a citizens' oversight committee for Proposition 39 (the Smaller Classes, Safer Schools and Financial Accountability Act) general obligation bonds. Those sections state that the committee shall issue regular reports on the results of its activities. A report shall be issued at least once a year.

The District website shows only the agendas for three meetings: one in 2016 and two in 2017. No minutes have been posted. Bond presentations are provided, but it is unclear to which body the committee, board of trustees, or other committee these documents were presented. No other documents have been posted. Without detailed budget and expenditure reports, the committee cannot provide adequate financial oversight for the facilities program as required by law. (FCMAT Audit p. 29)

- Additionally, Proposition 39 requires that the District establish and appoint members to a Citizens' Oversight Committee (COC) within 60 days of the date that the bond election results are certified. Over a year after voters approved general obligation bonds in the amount of \$139,999,671.60, the District continues to have vacancies that prevent the COC from functioning to inform the public concerning the expenditure of bond funds. In a letter dated June 22, 2017 the Santa Clara County Finance Agency urged the District to appoint members to the vacancies on the COC so that it could perform its oversight duties as required by Education Code section 15282. There are currently two vacancies on this committee that need to be filled. Without adequate membership, the committee cannot function to review the appropriateness of expenditures from bond proceeds.
- There have been multiple credible allegations of conflict of interest and a lack of internal controls with regard to the District's contracting procedures and administration of contracts, as detailed in the FCMAT Audit. (FCMAT Audit, pp. 39-45.)
- On December 4, 2017 in accordance with Education Code section 42636, SCCOE requested that the District provide clarification with regard to the November 8,

2017 Memorandum from Rogelio M. Ruiz, Esq. to Hilaria Bauer, Ph.D., District Superintendent, entitled “Analysis of Conflict of Interest Issues Relating to Program Management and Construction Management Services”. This memorandum was prepared by the District’s general counsel, the Rehon & Roberts law firm and states in pertinent part that:

.....we believe that there is a material risk that a finder of fact could reasonably conclude that the 2016 Measure J Construction Management Agreement and 2016 Measure I Program and Construction Management Agreement between the District and Del Terra violate the prohibitions of Government Code section 1090, and that any Board approved re-negotiated agreements would also violate section 1090. Such violations could expose the District and its employees, Board members, officers, and involved consultants to criminal prosecution and/or civil liability and/or penalties.

SCCOE requested that the District provide its response by December 31, 2017. We received a letter informing us that the District was seeking a second legal opinion and have not received a response to our request of December 4, 2017, as of this date.

SCCOE has received a letter from counsel for Del Terra dated March 7, 2018 which was copied to the District Board President, Superintendent and General Counsel which concludes that SCCOE’s jurisdiction is limited to oversight of the District’s expenditure of the general fund monies and does not extend to oversight or control of the District’s expenditure of Bond Program funds. It is important to note that SCCOE’s fiscal oversight of the District under AB 1200 requires that the SCCOE ensure the District’s fiscal solvency and expand the District’s fiscal competency so that the District is able to develop and implement a strong system of internal controls, formal policies and procedures and sound business practices. The District’s internal control deficiencies include improper application and/or enforcement of governing board policy, weak oversight of business activities and superseding established procedures, which has led to an environment with considerable risk for fraud, misappropriation of funds and misuse of District assets in the management and oversight of the District’s multimillion-dollar bond program. (FCMAT Audit, p. 39.) Thus, SCCOE’s oversight in this instance is necessary and appropriate with regard to the District’s internal control deficiencies.

- SCCOE has received allegations that a conflict of interest may exist with respect to the District’s engagement of Leal Trejo as the District’s general counsel and legal advisor with regard to special investigations. Additionally, counsel at Leal Trejo hired as general counsel for the District also represented SCCOE. Therefore, Leal Trejo must provide a written disclosure of any actual or potential conflict of interest to SCCOE and the District prior to accepting representation of the District. (California Rules of Professional Conduct Rule 3-310) SCCOE has requested clarification and assurance regarding the legality of this contract in a

separate letter to the District Board President. The District and firm were notified on March 1st and March 2nd respectively. Leal Trejo has responded to SCCOE's request for a written disclosure of any actual or potential conflict of interest in a letter dated March 13, 2018 denying that California Rules of Professional Conduct Rule 3-310 is applicable in this instance and insisting that SCCOE must prove the existence of a conflict of interest in order to justify performance of its fiscal oversight duties. Leal Trejo's response is primarily a statement of legal opinion and provides limited factual content in response to appropriate inquiries with regard to whether the District has implemented policies and procedures to reduce the risk of fraud and abuse with regard to its contracting practices. It is within the jurisdictional purview of the ongoing district attorney investigation to make evidentiary determinations regarding the existence of a conflict of interest and take corrective action as warranted. Pursuant to Education Code section 1241.5, it is within the jurisdictional purview of a county superintendent to review or audit the expenditures and internal controls of any school district in his or her county if she has reason to believe that fraud, misappropriation of funds or other illegal fiscal practices have occurred that merit examination. This issue remains outstanding pending conclusion of the district attorney's investigation.

- SCCOE has received reports that Mr. Louie Moran, Alum Rock's Director of Facilities, Bonds and Leases, engaged in conduct that constitutes improper government activity as defined in Education Code section 44112.
- There have been numerous allegations, complaints and public comments that members of the governing board have created and maintained a climate of public intimidation towards the Superintendent threatening to retaliate against her for disclosing actions taken in violation of applicable law and regulations. Pursuant to Education Code sections 44113 and 44114 engaging in intimidation in "performance evaluation, suspension or other disciplinary action" is prohibited and punishable by a fine or imprisonment.
- Similarly, SCCOE has received reports that District board members have acted in violation of the California Whistleblower Act, Labor Code section 1102.5 by retaliating against employee(s) for disclosing information regarding the District's failure to comply with a violation of noncompliance with a local state, or federal rule or regulation.
- In a letter dated June 28, 2017 the Deputy Superintendent of Services for Administration, Finance, Technology and Infrastructure for the California Department of Education, revoked the District's fiscal independence effective July 1, 2017 thereby withdrawing approval for the District to draw warrants, pursuant to Education Code section 42647. Approval by SCCOE is now required to process warrants for the District; however, there have been delays of more than one month from the date of request for SCCOE to obtain access to the District's

financial system in order to perform the necessary review and verification of documentation underlying the warrants to be processed. The District utilizes different accounting software than SCCOE; therefore, it is particularly important that the District work collaboratively with SCCOE to address weaknesses in the Districts internal control and accounting records.

- The Governing Board has authorized the issuance of approximately \$35 million in bonds although the District has been advised by its financial adviser and bond counsel that a recent downgrade of the District's bond rating due to its financial and governance problems has made the cost of issuing bonds more expensive, which added expense will be borne by the taxpayers within the District's geographical boundaries. In the September 29, 2017 Summary of the Alum Rock Union Elementary School District, California; Appropriation, General Obligation report, S & P Global Ratings cited the following basis for lowering the District's bond rating four notches and placing the District in Credit Watch Negative status:

The rating actions reflect a change in our assessment of the district's management, brought about by confirmation from the district that the Santa Clara District Attorney's (DA) Office has opened an active investigation into the district, our concerns about the district's ability to reconcile its cash position in a timely manner, and the difficulties we have encountered in obtaining information from district management.

The S & P Global Ratings summary further states that:

We also note that the district's financial and economic fundamentals could be consistent with a higher rating and that the presence of an active investigation into the district would not necessarily change our assessment of management on its own; however, the existence of the investigation coupled with significant [FCMAT] audit findings, concerns by district oversight bodies about governance, and difficulty in our ability to obtain information from the district about these issues caused a change in our assessment of management and potential sources of risk.

The Credit Watch with negative implications placement reflects our concern that the district may be unable to provide sufficient information to assuage the Santa Clara COE's concerns about the district's cash reconciliation. We note that if the district is unable to address these reconciliation concerns, our determination that information provided by the district is reliable could be called into question.

- The FCMAT Audit states that in June 2010, the District funded multiple construction projects that were ultimately to be funded by Measure G and J bond funds by securing a bridge loan using COPs. The district issued \$25,000,000 in

COPs for financing the modernization, equipping, furnishing and /or improving of certain capital facilities. One hundred percent of the interest on the COPs is covered by the federal Qualified School Construction Bonds (QSCB) subsidy. Nevertheless, the District did not prepare and submit to the county office the COPs disclosure required under Education Code section 17150. The lack of disclosure notwithstanding, the FCMAT Audit noted serious reservations about the District's ability to repay the COPs without affecting the unrestricted general fund and found that the District's debt service payments pose a serious threat to the District's ongoing fiscal solvency. (FCMAT Audit, pp.63, 64) The remaining balance on the COPs for the fiscal year 2017-2018 is \$22,730,000 in principal and \$584,393 in interest, for a total amount of \$23, 314,393.

- SCCOE's March 2018 review of the District's cash reports indicate that the District's cash reports overstate ending balances reported in July and August compared to the information available through the County Controller's Office. The District subsequently understated its cash reports the next few months underscoring ongoing inaccuracies and inconsistencies that have been evident in multiple reviews. These factors are identified as indicators of risk or potential insolvency in the FCMAT Fiscal Health Risk Analysis management tool. (FCMAT Fiscal Health Risk Analysis-Key Fiscal Indicators for K-12 Districts)
- SCCOE has received complaints from the District's community members that facilities bond funds are not being used in a manner that responsibly addresses the District's facilities needs and priorities.
- The Governing Board has failed to address multiple recommendations in the FCMAT Audit pertaining to internal control deficiencies concerning contract administration with regard to the Del Terra contracts, including, but not limited to the following:
 - Develop a process to evaluate consultants or independent contractors and whether they should be required to file a Form 700. Obtain Form 700 from designated consultants or independent contractors within 30 days of their hire date or contract termination and on an annual basis as applicable;
 - Exercise Board authority to question designated employees and members of the board regarding outside activities or financial interests included in Government Code sections 1090 and 1126;
 - Ensure that all new employees, consultants and elected or appointed board members who are in the designated classifications that require them to complete form 700 do so and submit the form within 30 days of taking/leaving office or employment, and on an annual basis if applicable;

- Ensure that the District's elected officials, administration and designated employee's complete ethics training regarding the roles and responsibilities of public officials in relation to conflicts of interest and the Fair Political Practices Act.

The matters of concern set forth in this correspondence are indicative of the circumstances which have contributed to the District's lack of fiscal stability and responsible Board governance; however this list is not exhaustive. The lack of fiscal controls and prudent Board governance undermine the efforts underway to cure the District's fiscal deficiencies. The circumstances described in this letter have persisted for a period predating November 2016 when the County Superintendent received the anonymous allegations regarding conflict of interests concerns involving Del Terra. The conditions articulated in this letter provide ample basis for the SCCOE's determination that the District is experiencing fiscal distress and a crisis in governance and that these factors are a threat to the financial stability of the District in both the long and short term.

Summary of Factors Indicating Risk of Fiscal Insolvency

- Deficient governance
 - Instability in leadership as evidenced by multiple votes to remove board officers.
 - Lack of accountability and compliance with statutory guidelines relating to expenditure of bond funds as set forth in Proposition 39.
 - Credible allegations of conflict of interest.
 - Credible allegations of intimidation and retaliation for disclosure of failure to comply with applicable law, and regulations.
 - Issuance of \$35 million in bonds following a downgrade of the District's bond rating that has made the cost of issuing bonds more expensive.
- Internal Control Deficiencies Significantly overstated cash balance.
- Delay in completion of the single audit for the, 2016-17 Comprehensive Annual Financial Report.
- Delays providing the County access to its financial data.
- Failure to address multiple recommendations in the FCMAT Audit pertaining to internal control deficiencies.

- Given the inconsistent and/or inaccurate cash balances available for contingencies, any fiscal liability resulting from the Board's actions would result in the District being unable to meet its financial obligations for the current or subsequent fiscal year.

Based upon the foregoing, after engaging FCMAT to perform an audit of the District's policies, procedures and internal controls for purchasing and contractual commitments, providing a fiscal expert to advise the District on its fiscal problems, directing the District to perform a comprehensive annual financial report for the 2016-2017 fiscal year, the County Superintendent determines that the District's deficiencies in governance and internal controls have created a condition of material weakness in the District's financial condition such that the District will be unable to meet its financial obligations for the current or subsequent fiscal year.

Accordingly, pursuant to Education Code section 42127.6 (c), effective immediately from the date of this letter, I shall exercise the authority to stay and rescind any action by the District that is determined to be inconsistent with the District's ability to meet its obligations in the current or subsequent fiscal years. Should you have any questions regarding this letter and the requests made on behalf of SCCOE, please feel free to contact Megan Reilly, SCCOE Chief Business Officer at (408) 453-6511.

Sincerely,



Mary Ann Dewan, Ph.D.
County Superintendent of Schools

cc: Members of the Board, Alum Rock Union Elementary School District
Hilaria Bauer, Ph.D., Superintendent, Alum Rock Union Elementary School District
Kolvira Chheng, Associate Superintendent, Business, Alum Rock Union Elementary School District
Efrain Robles, Director of Fiscal Services, Alum Rock Union Elementary School District
Megan K. Reilly, Chief Business Officer, Santa Clara County Office of Education
Judy Lee Kershaw, Director-District Business and Advisory Services, Santa Clara County Office of Education
Tom Torlakson, California State Superintendent of Schools
Emily Harrison, Director of Finance, County of Santa Clara