



STATE OF NORTH CAROLINA

SPECIAL REVIEW

**NORTH CAROLINA DEPARTMENT OF ENVIRONMENT AND
NATURAL RESOURCES**

DIVISION OF WASTE MANAGEMENT

RALEIGH, NORTH CAROLINA

MAY 2007

OFFICE OF THE STATE AUDITOR

LESLIE W. MERRITT, JR., CPA, CFP

STATE AUDITOR

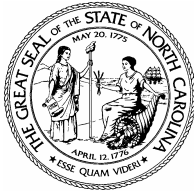
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Leslie W. Merritt, Jr., CPA, CFP
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AUDITOR'S TRANSMITTAL

The Honorable Michael F. Easley, Governor
The General Assembly of North Carolina
Mr. Bill Ross Jr., Secretary, North Carolina Department of Environment and Natural Resources

Pursuant to North Carolina General Statute §147-64.6(c) (16), we have completed a special review of allegations concerning the North Carolina Department of Environment and Natural Resources – Division of Waste Management. The results of our review, along with recommendations for corrective action, are included in this report.

Copies of this report have been provided to the Governor, the Attorney General and other appropriate officials in accordance with North Carolina General Statutes §147-64.6 (c) (12) which requires the State Auditor to provide written notice of apparent instances of violations of penal statutes or apparent instances of malfeasance, misfeasance, or nonfeasance by an officer or employee.

Leslie W. Merritt, Jr.

Leslie W. Merritt, Jr. CPA, CFP
State Auditor

May 10, 2007

TABLE OF CONTENTS

	PAGE
INTRODUCTION.....	1
BACKGROUND.....	3
FINDINGS AND RECOMMENDATIONS.....	5
RESPONSE FROM THE NORTH CAROLINA DEPARTMENT OF ENVIRONMENT AND NATURAL RESOURCES	11
STATE AUDITOR’S NOTE.....	13
ORDERING INFORMATION.....	15

INTRODUCTION

The Office of the State Auditor received an allegation through the State Auditor's Hotline concerning a Processed Scrap Tire Material – Market Development Grant awarded by the North Carolina Department of Environment and Natural Resources – Division of Waste Management (Waste Management). The purpose of the grant was to provide funding for a molding system that would produce rubber mats from processed tire material. The mats were to be used in playground or industrial applications.

Allegedly, the company that received the grant never produced and sold the number of mats specified in the grant agreement. In addition, documents submitted by the majority owner of the company to Waste Management to obtain progress payments implied that the contract requirements were met.

To conduct a special review of these allegations, we performed the following procedures:

- Interviews with Waste Management employees responsible for awarding and administering the grant;
- Interviews with current and former employees of the company that received the grant;
- Review of relevant records and documents pertaining to the grant;
- Interviews of independent third parties.

This report presents the results of our special review. The review was conducted pursuant to North Carolina General Statutes §147-64.6(c) (16) rather than as a financial or performance audit.

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BACKGROUND

On October 29, 2001, Waste Management entered into a contractual agreement with a company called T.I.R.E.S, Inc. (TIRES). The agreement was related to a Processed Scrap Tire Material-Market Development Grant. The purpose of the grant was to encourage sustainable scrap tire recycling in North Carolina. The total dollar amount of the grant award was \$320,000.

The goal of Waste Management's grant program is to make scrap tire recycling sustainable in North Carolina. The division has awarded grants for manufacturing rubber products such as mats, auto parts, gaskets, flooring material, tire derived fuel, new tire manufacturing and other applications. The Processed Scrap Tire Material Market Development Grant program first received funding in August 1997. Through the end of the fiscal year ended June 30, 2006, Waste Management awarded grants under this program that totaled \$4,429,488.

According to the grant agreement (#NO2003), TIRES agreed to initiate a project to install and operate a machine that would produce playground mats made from recycled tires. TIRES indicated in the grant proposal that the mats would be manufactured at a substantially lower cost than competitive mats and would allow TIRES to gain and grow market share quickly. Each mat would use 28 pounds of recycled rubber from North Carolina scrap tires and at capacity the system would recycle over 2,000,000 tires per year.

The grant agreement specified that three equal payments would be made to TIRES upon submission of documentation and a final report confirming that certain levels of production and sales were met. Payment #1 would occur when all system components were installed in working order and the system performed over an 8-hour shift. Payment #2 would occur after 6,600 mats had been produced and sold, and payment #3 after 20,000 mats (in total) were produced and sold and a final report submitted.

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FINDINGS AND RECOMMENDATIONS

1. A GRANT RECIPIENT RECEIVED \$320,000 BASED ON APPARENT FALSE REPRESENTATIONS.

Based upon our review, we believe the majority owner of TIRES set up and ran a mat-making machine to satisfy the first requirement of the grant award and then fabricated documents that were submitted to Waste Management to support fulfillment of the remaining grant requirements. In addition, the majority owner submitted a final report that summarized a successful operation and indicated future ongoing business activities even though the mat-making operation had been shut down as much as three months earlier.

Payment Number One

On March 14, 2003, representatives from Waste Management traveled to the warehouse location of TIRES in Winston-Salem, NC to observe the mat-making machine in operation. One of the representatives observed that it seemed to take a considerable amount of time to produce the mats.¹ The representative also observed some mats that had already been produced.² The initial grant payment of \$106,666.66 was made by Waste Management to TIRES on March 26, 2003.

Payment Number Two

On April 29, 2003, TIRES submitted an invoice for \$106,666.66 to Waste Management for the second installment of the grant award. TIRES included with its invoice two purchase orders from Safe Sports Surfaces of Missouri (Safe Sports Surfaces) relating to the purchase of 20,000 mats at \$3.50 each, copies of two bills of lading dated April 21, 2003 for the shipment of 10,000 mats to Safe Sports Surfaces in Gravois Mills, Missouri and an e-mail indicating receipt of the shipment. Waste Management issued a check for \$106,666.66 to TIRES on May 13, 2003.

Payment Number Three

On October 1, 2003, TIRES submitted an invoice for \$106,666.66 to Waste Management for the third and final installment of the grant award. TIRES included copies of two bills of lading dated September 25, 2003 for the shipment of 10,000 mats to Safe Sports Surfaces in Gravois Mills, Missouri. Waste Management issued a check for \$106,666.66 to TIRES on October 23, 2003.

While the requirements for the first payment were verified by actual observation by Waste Management employees, the other two payments were made based on documentation submitted by the majority owner of TIRES. We obtained the documents that were submitted with each payment request and noted the following:

¹ A TIRES employee that set up and ran the machine indicated the machine was able to produce about one mat per minute or 50 per hour.

² A minority owner said that some mats were delivered to the warehouse along with the machine from Missouri.

FINDINGS AND RECOMMENDATIONS (CONTINUED)

Documentation to Support Performance

- The documents were all sent to Waste Management by facsimile from the majority owner's personal residence in Orlando, Florida.
- We also noted that all of the bills of lading had been faxed originally from the TIRES warehouse in Winston-Salem, NC on March 31, 2003 even though the documents purported deliveries that occurred in April and September of 2003. (Bills of Lading are typically signed by the truck driver on the loading dock at the point of departure). In addition, the two bills of lading related to the September 25, 2003 delivery were exact copies of each other with only the number of mats shipped and the shipment day signatures being different.
- The documentation to support sales included only a purchase order that does not represent an actual sale but simply an "intent" to purchase.

We contacted the transportation company identified on the bills of lading to verify the documents. A representative of the transportation company said these bills were not related to shipments on their records. The transportation company also indicated the documents had not been completed in accordance with their policies and procedures and they could not identify the driver's signature that was included on the documents.

We requested from the majority owner of TIRES all documents supporting sales and shipment of mats from the TIRES warehouse in Winston-Salem, NC. We received two bills of lading as well as invoices from the shipping companies (we did not receive copies of the documents that were submitted to Waste Management) to support two shipments from Winston-Salem to Missouri. The documents that he furnished indicated, on October 17, 2003, ten pallets of mats were shipped from TIRES to Safe Sports Surfaces in Missouri. Eight pallets contained 2,400 "good" mats and one pallet had 300 "seconds" and one pallet contained 300 "R2" mats. In addition, on May 2, 2003, the bill of lading indicated shipment of nine pallets, seven pallets of "good", one pallet of "seconds-1" and one of "seconds-2."

We contacted both shipping companies and they were able to validate that these were actual deliveries made by their company. The documents indicate that 5,700 mats were delivered in these two shipments. One bill of lading also included a signature of the individual receiving the shipment in Missouri who was the requisitioner on the purchase order. We contacted him and he verified that it was in fact his signature on the bill of lading.

Grant Proposal

- The original grant proposal submitted by TIRES included the name of an individual represented to be the "Managing Partner" of SSS Equipment, Inc. The proposal indicated that he was responsible for designing and perfecting the machine. This same individual is named as the requisitioner³ on the purchase order submitted by TIRES to document purchases of the mats by Safe Sports Surfaces of Missouri.

Safe Sports Surfaces of Missouri is a Limited Liability Corporation (formed on March 1, 2000) and owned jointly by the owner of TIRES and the individual named on the purchase

³ We contacted this individual and he indicated that his signed name on the purchase order was not his signature.

FINDINGS AND RECOMMENDATIONS (CONTINUED)

order as well as the original grant application. According to Waste Management officials, this relationship was not disclosed to them. Waste Management officials stated that the less than arms-length nature of the relationship would have raised serious questions regarding the awarding of the grant.

Final Report

- The Final Report was submitted by the majority owner on October 1, 2003.
- The document included the following statements. “Manufacture of the second half of the purchase order was completed in September and the tiles shipped September 25th.” The report includes a Detailed Statement of Project Results that includes: “...10,000 tiles were shipped to *the customer* (emphasis added), Safe Sports of Missouri.” In addition, the Statement of Project Results indicates that the project was a success and that TIRES had additional purchase orders in place for 20,000 more mats and infers that the mat-making operation will be a going concern. “The growth of the business from this point will be a function of the market place, but all indications are that the high-end numbers are feasible given the current projected market dynamics...”

During an interview, the majority owner of TIRES said the last time they made any mats at the TIRES location was June 2003. Also, the minority owner of TIRES as well as a former employee stated the machine only ran for a short period of time (six months or less) but they produced “thousands” of mats.

As noted above, Safe Sports Surfaces of Missouri is a Limited Liability Corporation co-owned by the majority owner of TIRES along with his business partner who purportedly designed the machine. The minority owner of TIRES said he had no knowledge of what happened to the mats that were produced but believes they were loaded onto trailers and shipped out. After production stopped, the machine sat idle for a while and then was disassembled and sold.

In a written statement for us, the majority owner of TIRES chronicled the history of the mat making venture. He said he and a partner entered into an agreement in 2000 to develop a machine to produce and sell playground mats. He stated that during 2000-01, they built a building in Gravois Mills, Missouri to build and develop the mat making machine.⁴ He said TIRES obtained a verbal commitment from a playground equipment manufacturer to purchase a significant volume of the mats.⁵ The majority owner decided to apply for the North Carolina grant in order to “put the machine to work in a controlled environment” and to use the crumb rubber that TIRES produced in their primary business.

⁴ According to property records the majority owner and his wife purchased a piece of property in Gravois Mills, Missouri and on August 29, 2000, issued a Warranty Deed for the property to Safe Sports Surfaces of Missouri, LLC. The property was sold by Safe Sports Surfaces on December 8, 2006.

⁵ We contacted a member of the Chamber of Commerce in Gravois Mills who stated that in early 2000, he met with an individual from Iowa who planned to open a mat distribution company called Safe Sport Surfaces and employ 7-10 people. He stated they were looking forward to that occurring but never saw the man again and they observed little if any activity at the building site after the initial meeting.

FINDINGS AND RECOMMENDATIONS (CONTINUED)

The majority owner stated that in 2001-02 the market for playground mats disappeared as pour-in-place technology supplanted the playground mats. The verbal commitment for orders of playground mats was rescinded and other markets needed to be developed. The owner stated that his business partner was responsible for developing markets for their mats and stated that he identified anti-fatigue mats used in manufacturing plants as an alternative to playground mats as a potential market. After redesigning the machine to produce the thinner anti-fatigue mats, the machine was delivered to the TIRES plant in Winston-Salem, NC.

The majority owner said after shipping the initial 20,000 mats to Missouri, they had another purchase order in place for 20,000 more mats. However, shortly thereafter the market for the mats slowed and production was stopped. The majority owner stated that in 2004 his partner in Missouri walked out on the partnership and attempts by TIRES to market the mats were unsuccessful. We requested records related to the sales of the mats by Safe Sports Surfaces from the majority owner and he said that his partner kept the records and he could not locate him.⁶ He also stated that there was a leak in the warehouse office and some of the records may have been destroyed.

According to the minority owner of TIRES, he was “kept out of the loop” in regards to the mat-making operation by the majority owner and he did not know many details about the operation. He said he believed the machine was purchased from somewhere in Missouri and was delivered and set up at the TIRES warehouse during a period of time when the workflow was low for their crumb rubber business. He also said that an individual came from Missouri to assist in setting up the machine.

We obtained financial statements related to the mat-making operation at TIRES from the company’s Chief Financial Officer (CFO). In the profit and loss summary dated December 31, 2003, income related to mat sales totals \$19,200. This total is comprised of two invoices dated May 2, 2003 and October 17, 2003 that correspond to the shipping documents that the majority owner provided to us.

In addition, we obtained an email communication between the majority owner of TIRES and the CFO dated January 13, 2005. In that email, the owner confirms the completed financial status of the mat-making operation with the CFO. The owner states that “Safe Sports paid TIRES \$10,200 for mats and owes \$10,200...” and he included the table below⁷ as the final financial report of the mat-making operation.

⁶ We were able to locate the business partner in Iowa. He authenticated his signature on shipping documents but indicated his signature was not the one on the purchase order.

⁷ The table is represented exactly as included in the majority owner’s e-mail.

FINDINGS AND RECOMMENDATIONS (CONTINUED)

Funds recd by TIRES:
\$320,000 from Grant
10,200 paid for mats by SSS
10,200 to be paid by SSS for mats
50,000 sale of mat machine
\$390,400 income
Expenses
\$206,667 paid to SSS from Grant funds to date
\$ 45,000 to be paid SSS from proceeds of sale
\$ 55,000 to be added to Officer debt as remaining payoff of \$100k owed SSS
\$ 30,000 expenses in installing machine
\$ 5,000 expenses in dismantling and shipping machine
\$341,667
\$58,733 Profit

The majority owner wrote “...even if I underestimated the costs, there was a fairly substantial profit to TIRES for being a conduit.”

The total revenue of \$20,400 for mat sales divided by the verified number of mats shipped to Safe Sports Surfaces (5,700) results in a price of \$3.58 for each mat which approximates the price per mat on the purchase order submitted by TIRES to Waste Management (see payment number two above).

We believe the majority owner of TIRES did initially intend to create a sustainable business by investing in a new venture. However, after being awarded the grant and in the course of developing the mat-making process, they were unable to realize anticipated production or sales (due to a change in market conditions according to the majority owner). Because the grant had already been awarded and to recover a portion of his investment, we believe the majority owner of TIRES set up and ran the machine to obtain the initial payment and then fabricated the documents that were submitted to Waste Management to fulfill the grant requirements and obtain the second and third payments related to the grant.

The majority owner of TIRES maintains that his company did everything it committed to do. Yet, the grant agreement specified the production and sale of 20,000 units and at best, TIRES appears to have “produced” only 5,700 units.

RECOMMENDATION

We recommend that Waste Management officials consider taking action to recover the amount of the grant paid to TIRES based on the purported sale of the mats. Waste Management officials should also consult with legal counsel concerning the possible violation of North Carolina General Statutes related to obtaining property by false pretense.

FINDINGS AND RECOMMENDATIONS (CONCLUDED)

2. THE DIVISION OF WASTE MANAGEMENT AUTHORIZED GRANT PAYMENTS WITHOUT ADEQUATE DOCUMENTATION FROM THE GRANTEE.

As noted in the previous finding, the second and third grant payments to TIRES in 2003 were based on the submission of two purchase orders and two bills of lading as evidence of sales. Attachment A of the grant agreement with TIRES states:

*Payments will be made upon submission of documentation/report that certain levels of product production and marketing have been met. Payment #1 will be made when all system components are installed, in working order and the system performs per contract over an 8-hour shift. Payment #2 will be made after 6,600 mats have been produced **and sold**, (emphasis added) and payment #3 will be made after 20,000 mats have been produced **and sold** (emphasis added) and a final report submitted.*

The purchase orders only represented an “intent to purchase” the mats. The bills of lading only supported the shipment of the mats. Even if the documents submitted by the owner of TIRES to Waste Management were authentic, they did not support any actual sales. Typically, the sale of an item would be documented by a sales invoice from the seller to the purchaser indicating that a certain item, at an agreed upon price, was sold.

The purpose of the grant award was to encourage “sustainable” scrap tire recycling in North Carolina. The success of the program was to be verified by evidence of actual sales of a predetermined number of mats. In our opinion, Waste Management authorized the second and third grant payments without adequate documentation from the grantee.

RECOMMENDATIONS

We recommend that Waste Management establish and implement procedures for documentation consistent with grant requirements. The documentation should support the specific requirements of the grant. Waste Management should also establish procedures that include third party verification of the documents submitted, for example, contacting the purchaser to verify the authenticity of a sales invoice.



North Carolina Department of Environment and Natural Resources

Michael F. Easley, Governor

William G. Ross Jr., Secretary

May 3, 2007

Leslie W. Merritt, Jr., CPA, CFP
State Auditor
Office of the State Auditor
2 S. Salisbury Street
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Raleigh, North Carolina 27699-0601

Dear Mr. Merritt:

This is in response to the special review of grant activities related to the Division of Waste Management. The Department of Environment and Natural Resources and the Division of Waste Management appreciate the efforts of the Office of the State Auditor for their investigation of the allegation made by a former employee of TIRES Inc. concerning a Processed Scrap Tire Material Market Development Grant. We appreciate your staff bringing to our attention the allegation that TIRES Inc.'s submitted false information to the Division in order to meet grant award commitments, and the results of the investigation.

Finding: A grant recipient received \$213,333.34 based on an apparent false representation.

Response: The Division is consulting with legal counsel to discuss possible actions to recover all or part of the grant funds paid to TIRES Inc. based on the findings from the investigation conducted by the Office of the State Auditor.

Finding: The Division of Waste Management authorized grant payments without adequate documentation from the grantee.

Response: Attached to the TIRES Inc. invoices for grant payment #2 were two Purchase Orders (#21403 and #21404) for 10,000 mats each. Also attached to the invoice were two Bills of Lading for a total of 10,000 mats shipped to Safe Sports Surfaces of Missouri (SSS). In a cover letter sent with the invoice, the majority owner of TIRES Inc. states "I have attached the Purchase Order from the customer (actually both Purchase Orders as he wants 10,000 more mats in May), the Bills of Lading for the shipments, and the customer's email confirming receipt." Acceptance of a Purchase Order by a seller usually forms a commitment between the buyer and seller. The Division received no indication from the seller (TIRES Inc.) that payment from the buyer (SSS) was not received per the terms of the Purchase Order, and it was reasonable for the Division staff to believe the Purchase Order constituted a purchase contract. This documentation (ie., the bills of lading and the

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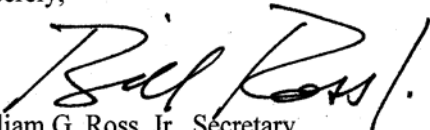
e-mail communication) showed that TIRES Inc. had accepted SSS's offer to purchase mats by delivering the goods. Under contract law, these actions constitute a "sale". See e.g., NC Uniform Commercial Code 25-2-106, 25-2-401; Gillespie v. Great Atl. & Pacific Tea Co., 14 NC App. 1 (1972)(a sale is consummated upon completed delivery by seller; time of payment is not determinative as to when a sale takes place).

The Division disagrees with the opinion in the auditor's report that it authorized the second and third grant payments without adequate documentation from the grantee. Assuming that the documentation provided by TIRES Inc. was not fraudulent, the Division contends the purchase orders and bills of lading were adequate determination under both the terms of the grant contract and under North Carolina principles of contract law. Under North Carolina law, there is an implied covenant of good faith and fair dealing that neither party will do anything which injures the right of the other to receive the benefits of the agreement. See e.g., Governor's Club, Inc., v. Governor's Club Ltd. Partnership, 152 NC 240 (2002). The Division reviewed TIRES submitted documentation pursuant to this principle that TIRES was acting in good faith.

The terminology "produced and sold" in Attachment A of the grant contract did not expressly require any specific documentation to show that mats had been produced and sold. The contract did not define what activities or events would constitute documentation of a "sale." Given the awareness that fraud is an unfortunate reality, the Division agrees that tighter contractual controls should be instituted in the future ranging from specifically defining terminology in contracts (e.g., what constitutes a "sale" and what constitutes evidence of a sale) to designing and implementing internal verification processes. This may also include requiring grant recipients to certify or verify their requests for payment which places the burden on the recipient to deal honestly with the state agency.

Again, thank you for your efforts in investigating these allegations.

Sincerely,



William G. Ross, Jr., Secretary
Department of Environment and Natural Resources

c: Dexter Matthews, Dir. DWM

AUDITOR'S NOTE

The Office of the State Auditor has reviewed the response to this report from the Department of Environment and Natural Resources (Department). Notwithstanding the Department's argument that the issuance of a purchase order creates a sale under contract law, we maintain the documents submitted by the grant recipient fell short of establishing that 20,000 rubber mats had been produced and sold. In our opinion, a purchase order provides only minimal evidence of the existence of a sale.

The Department acknowledges that the grant agreement did not expressly require any specific documentation to demonstrate that rubber mats had been produced and sold. Nonetheless, the Department provided over \$300,000 in grant funds to a company pursuing a new venture. Therefore, we believe the Department had a higher burden to verify the performance of the grant requirements. The Department's consultation with legal counsel concerning the recovery of grant funds supports our contention regarding the Department's obligation.

To minimize the risk of providing grant funds based on false or deceptive claims, the Department should obtain more compelling evidence, including third party verification, to validate a grant recipient's assertions concerning compliance with contract requirements. Grant recipients should be required to provide more than minimal documentation to support their claims for payment.

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