Coates' Canons Blog: A New Interpretation of the Preaudit Requirement

By Kara Millonzi

Article: https://canons.sog.unc.edu/a-new-interpretation-of-the-preaudit-requirement/

This entry was posted on November 08, 2012 and is filed under Expenditure Control & Preaudit, Finance & Tax

UPDATE August 2013: The Court of Appeals reaffirmed this new interpretation in May 2013. Clickhere for more details.

In July 2008, the Jones County Department of Social Services (JCDSS) entered into an *oral* services contract with a medical transportation services company. The contract was for one year. It was renewed annually in July of 2009, 2010, and 2011. JCDSS terminated the contract in November 2011. The company sued for breach of contract. JCDSS subsequently filed motions to dismiss the case, arguing that no valid contract existed. The trial court denied the motions. On appeal, however, the North Carolina Court of Appeals reversed the trial court, holding that there was not a valid contract between JCDSS and the company because the provisions of **G.S. 159-28(a),** known as the preaudit requirement, were not properly followed. **Exec. Med. Transp., Inc. v. Jones Cnty Dep't. of Soc. Servs, No. COA12-573 (Nov. 6, 2012).** Specifically, the court determined that the lack of a preaudit certificate rendered the contract void.

This certainly is not the first time a court has invalidated an agreement because a local government failed to follow **G.S. 159-28(a).** As I detailed in a previous **post**, North Carolina courts have taken a fairly hard line in enforcing the statute, often to the detriment of the entity contracting with the local unit. For this reason, it is commonly referred to as the "vendor or contractor beware" statute. The *Executive Medical* case is different, however, in that it appears to expand the preaudit certificate requirement.

The Statutory Language

Recall that the preaudit statute, **G.S. 159-28(a),** states that:

> No obligation may be incurred in a program, function, or activity accounted for in a fund included in the budget ordinance unless **[1.]** the budget ordinance includes an appropriation authorizing the obligation and **[2.]** an unencumbered balance remains in the appropriation sufficient to pay in the current fiscal year the sums obligated by the transaction for the current fiscal year. No obligation may be incurred for a capital project or a grant project authorized by a project ordinance unless that project ordinance includes an appropriation authorizing the obligation and an unencumbered balance remains in the appropriation sufficient to pay the sums obligated by the transaction. **[3.]*If*** an obligation is evidenced by a contract or agreement requiring the payment of money or by a purchase order for supplies and materials, the contract, agreement, or purchase order shall include on its face a certificate stating that the instrument has been preaudited to assure compliance with this subsection. The certificate, which shall be signed by the finance officer or any deputy finance officer approved for this purpose by the governing board, shall take substantially the following form:
>
> "This instrument has been preaudited in the manner required by the Local Government Budget and Fiscal Control Act.
>
> _____
>
> (Signature of finance officer).
>
> . . .
>
> An obligation incurred in violation of this subsection is invalid and may not be enforced. The finance officer shall establish procedures to assure compliance with this subsection. (emphasis added).

The preaudit statute applies whenever a unit of local government or public authority incurs an "obligation." The statute does not define the term obligation, but it is generally accepted in government accounting that obligations are amounts that a government entity may be required legally to meet out of its resources. Thus, an obligation is incurred when a unit encumbers public funds (by ordering goods or entering into service contracts or other purchase agreements) or incurs liabilities. Basically, if a contract, purchase order, or other agreement commits the unit to an expenditure of money (and, if the expenditure is accounted for in the budget ordinance, at least a portion of the obligation will come due in the current fiscal year), an obligation is incurred. This is true even if the amount of the liability is uncertain.

My Interpretation of the Statutory Requirements

But what does the preaudit statute require? In my previous **post**, I broke the statute up into three distinct parts, tracking the statutory language (see numbers [1.]-[3.] inserted above).

> [1.] The finance officer (or a deputy finance officer) must ensure that there is an appropriation authorizing the expenditure in the unit's annual budget ordinance or a project ordinance.
>
> [2.] The finance officer (or a deputy finance officer) must ensure that sufficient monies will remain in the appropriation to pay any amounts that will come due in the current fiscal year.
>
> [3.] The finance officer (or a deputy finance officer) must affix a signed certificate to each contract or agreement requiring the payment of money or by a purchase order for supplies and materials. The certificate states that the instrument has been preaudited in accordance with the Local Government Budget and Fiscal Control Act.

I also noted that the first two requirements apply to all obligations incurred by a local government or public authority. I posited, however, that the third requirement (preaudit certificate) applies in a narrower set of circumstances. The relevant provision states that "**[i]f** an obligation is evidenced by a contract or agreement requiring the payment of money or by a purchase order for supplies and materials, the contract, agreement, or purchase order shall include on its face a certificate stating that the instrument has been preaudited to assure compliance with this subsection." My interpretation of this provision is that the preaudit certificate must be affixed only if the underlying obligation is memorialized by a contract, agreement, purchase order, or other writing, requiring the payment of money.

I do not read the statute to require that all contracts or agreements be memorialized in writing. In fact, there is a separate statutory provision that requires that all contracts made by or on behalf of a municipality be in writing. **G.S. 160A-16.** The statute allows a municipality's governing board to ratify an oral contract and thereby make it enforceable. This suggests that a municipality is not otherwise prohibited from entering into an oral contract. (There is no counterpart statute for counties. Thus a county is not explicitly prohibited from entering into oral contracts.)

Applying my framework to the *Executive Medical* case, the JCDSS clearly incurred an obligation when it entered into the oral contract for medical transportation services. Thus, the county finance officer (or a deputy finance officer) was required by **G.S. 159-28(a)** to [1] ensure that there was an appropriation authorizing the expenditure; and [2] ensure that sufficient funds would be remaining in the appropriation when the bill came due. But, because the contract or agreement was not "evidenced by a contract or agreement requiring the payment of money or by a purchase order for supplies and materials" a preaudit certificate was not needed.

***Executive Medical* Court's Interpretation of Statutory Requirements**

The *Executive Medical* court adopted a slightly different interpretation of the preaudit statute's provisions. The plaintiffs argued that the oral contract was not void under **G.S. 159-28(a)** because the preaudit certificate only is required if the contract or agreement is memorialized in writing. The court, however, reframed the argument—stating that the "plaintiff contends that implicit in the plain language of N.C. Gen. Stat. 159-28(a) is the requirement that in order for the statute to apply, the agreement must be in writing." The court rejected the notion that the preaudit statute only applies to written contracts. Instead, the court held that ***all three*** of the requirements apply to every contract or agreement. Because it is not possible to affix a signed preaudit certificate to an oral agreement, this reading of the statute effectively means that all contracts or agreements entered into by a local unit involving budgeted funds must be in writing, or at least must be reflected by a writing.

The court found the case at issue indistinguishable from *Cincinnati Thermal Spray, Inc. v. Pender County*, 101 N.C.App. 405, 399 S.E.2d 758 (1991). In that case, the court also invalidated an oral contract (or alleged oral contract) for lack of a preaudit certificate. A county employee had promised that the county would construct an adequate water and sewer system to serve the plaintiff's facilities in order to entice the plaintiff to purchase property and locate in the county. When the county did not construct water and sewer facilities adequate to serve the plaintiff's needs, the company sued the county arguing that the county employee made false representations to induce the plaintiff to purchase the property. The county claimed that there was no valid contract between the county and the plaintiff, and the court agreed.

Although the cases do appear to be very similar, the facts in *Cincinnati Thermal* differ from those in *Executive Medical* in one key respect. In *Cincinnati Thermal*, there was no budget appropriation authorizing an expenditure for a new water and sewer system. Thus, the first requirement of **G.S. 159-28(a)** was not satisfied. The agreement was void regardless of whether or not it contained a preaudit certificate. The court in that case likely was looking for the preaudit certificate as some evidence of the board's approval of the contract. In *Executive Medical*, however, it appears that the first two components of the preaudit requirement likely were satisfied. The board either explicitly approved the contract or at least ratified it by appropriating funds to pay the contract in the annual budget ordinance. The court did not need to look to the preaudit certificate as evidence of the board's approval of the contract. It nonetheless invalidated the oral contract.

Application of Preaudit Statute to Future Oral Contracts

Although the plain language of **G.S. 159-28(a)** suggests that the preaudit certificate requirement does not apply to oral contracts, we now have at least one (and arguably two) court of appeals' opinions that hold that it does. The *Executive Medical* holding also strongly implies that **G.S. 159-28(a)** mandates that all contracts entered into by a local unit be in writing. To be safe, local officials should, at the very least, document any oral agreements in writing in order to properly affix the preaudit certificate.

Links

- canons.sog.unc.edu/?p=7136
- www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_159/GS_159-28.html
- appellate.nccourts.org/opinions/?c=2&pdf=MjAxMi8xMi01NzMtMS5wZGY=
- canons.sog.unc.edu/?p=5685
- www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_160A/GS_160A-16.html