

**OFFICE OF THE CITY AUDITOR**

City of Long Beach
333 W. Ocean Blvd.
Long Beach, CA 90802
Telephone: 562-570-6751
Facsimile: 562-570-6167

GARY L. BURROUGHS, CPA
City Auditor

June 20, 2006

Mr. Robert Shannon, City Attorney
Mr. Jerry Miller, City Manager
City of Long Beach, California

In 1995, the City of Long Beach purchased and assembled property at the former Navy Hospital site on Carson Street to construct a 100-acre retail development now known as the Long Beach Towne Center. An exclusive negotiation agreement was executed with Vestar Development Company in February 1996. In September 1996, a Development Agreement was reached and in July 1997, ground leases were executed for two distinct parcels, the "Main Site" and the "AutoNation Site". The ground lease provisions include base rent, percentage rent, bonus rent and "additional" rent.

In October 2003, when the City was notified that the developer was selling its interest in the lease, our office began a review of the tenant's compliance with lease terms. We initially reviewed the AutoNation parcel. We filed a claim for "additional rent" due the City for this 20-acre parcel. On November 18, 2003, the City received a check in the amount of \$120,965. Throughout 2004, we continued our review of lease compliance related to the Main Site. That parcel, situated on approximately 80 acres, includes base rent, a base rent "step up" based on stabilized operations, as well as a percentage rent provision. Percentage rent is payable by tenant after it receives a cumulative annual 12% return on its investment.

Despite the Center's obvious retail success, we have found that Main Site base rent was not stepped up to reflect stabilized operations. We also found that participation rent for that site was not correctly computed or paid, and we found that the developer took an inappropriate rent deduction for a bond assessment.

On May 20, 2005, our office submitted a second claim to Vestar Companies related to these Main Site lease¹ issues. That claim included unpaid base and percentage rent obligations through December 31, 2004. The total amount claimed, including interest, was \$2.2 million.

Our claim was based on certain financial assumptions. Conservatively, we concluded that the annual step-up in base rent was \$304,552. However, it is our belief after consultation with the City Attorney, that base rent for the property could be increased by as much as \$630,000 per year, increasing the amount of the claim by approximately \$1.4 million. Attached hereto is a summary of lease terms and review findings. The 22 page detailed claim, including auditor calculations, has been provided to the City Attorney's Office.

¹ It is important to note that the Main Site lease has been assigned twice since its execution.


Since the date the second claim was submitted to the developer (which is both the former owner of the Main Site lease and the current property manager for that parcel), the City Auditor's Office, the City Attorney's office and attorneys for both the developer and current owner have exchanged a series of correspondence. Both the developer and current owner have launched legal challenges now under consideration by the City Attorney.

It is our recommendation that the City Council refer this matter to the City Attorney for negotiation with Tenant on both a retrospective and prospective basis. In addition, we recommend that an audit of the 2003 through 2005 percentage rent calculation be commenced immediately, concurrently with the ongoing negotiation of these issues.

Sincerely,

GARY L. BURROUGHS, CPA
City Auditor

By:


Kathleen M. O'Connell, CPA
Deputy City Auditor

Audit Team: Caroline James, CPA, Audit Manager
Vlad Marinescu, Audit Senior

Long Beach Towne Center Background and Summary of Audit Issues

Background

In 1995, the City of Long Beach purchased and assembled property at the former Navy Hospital site to construct a 100 acre retail development now known as the Long Beach Towne Center. Requests for qualifications were solicited from numerous developers in 1994 and, after the failure of the first selected developer to exercise its option to lease the property, Vestar Development Company was selected. An Exclusive Negotiation Agreement was executed with the Company in February 1996. In September 1996, a Development Agreement was reached and in July 1997, two ground leases covering the Main Site and the AutoNation Site were executed. In March of 1999, the Main Site lease was restated and in May and June 2000 first amendments to the ground leases were executed. Because the Long Beach Towne Center site was assembled from various parcels of property, the site was developed in two phases, I and II. Today, the following two agreements are in effect:

MAIN SITE

**Restated Ground Lease Long Beach – I-605 dated March 18, 1999
(including First Amendment to the Restated Ground Lease dated June 19, 2000)**

(by and between the City of Long Beach and Vestar/Lend Lease Long Beach Towne Center, L.L.C., assignee of Vestar Development Company)

Phase I: Main Ground Lease (65.32 acres)
Phase II: Main Site Option Properties (15.22 acres)
Term: 55 years (July 16, 1997 through July 15, 2052)
Options: Exercisable at tenant's option.
First option: 10 years
Second option: 10 years
Third option: 24 years
Rent: See below **(RENT PROVISIONS)**

AUTONATION SITE

**Ground Lease Long Beach – I-605 Phase I – dated July 15, 1997
(including First Amendment to the Ground Lease dated May 30, 2000)**

(by and between the City of Long Beach and Vestar Development Company)

Phase I: AutoNation Ground Lease (20 acres)
Term: 55 years (July 16, 1997 through July 15, 2052)
Options: Exercisable at tenant's option.
First option: 10 years
Second option: 10 years
Third option: 24 years
Rent: See below **(RENT PROVISIONS)**

The terms of the agreements also included the Developer's commitment to "fund" offsite infrastructure improvements, which would be required to facilitate the increased traffic around the Center. However, in 1999, the City Council authorized the establishment of a Community Facilities district to fund these improvements. Through the execution of the first amendment to the Main Site lease, the developer and City assumed 43.7% and 57.3%, respectively, of the debt service on \$15.4 million of bonds.

Today, the Long Beach Towne Center is considered a retail success. The Center has over 70 subtenants, including large anchors Lowe's, Edward's Theatres, and Walmart. The Center generates approximately \$2 million in sales tax each year for the City of Long Beach. It has generated over \$15 million in rent, net of \$3 million in off-site improvement rent credits, to the City since 1999.

Revenue to the City is offset by debt service on notes issued for the acquisition of the property from the Navy. The City's annual variable rate debt service on the \$8.6 million purchase is approximately \$600,000.

Additional detail concerning the history of the property and related agreements follows:

October 1995 – Federal government quitclaims former Navy Hospital property parcels to the City. Purchase price is \$8.6 million. City assembles these with several City owned parcels for total 100-acre Long Beach Towne Center site at the intersection of Carson Street and the I-605 Freeway.

February 1996 - City enters into an Exclusive Negotiation Agreement with Vestar Development Company for the development of the site.

September 1996 - City and Vestar Development Company enter into a Disposition and Development Agreement (DDA) which specifies the terms of a future ground lease for the property, including responsibility for off-site improvement funding.

July 1997 - Parties execute two separate ground leases for the property, one being the Main Site and the other being the AutoNation Site. These ground leases specifically stipulate terms. Vestar assigns its ownership interest in the AutoNation lease to "Vestar California XIX, L.L.C."

March 1999 - Main Site lease is "restated".

September 1999 - The Long Beach City Council forms Community Facilities District No. 5 for the purpose of issuing special tax bonds to finance Towne Center off-site improvements.

April 2000 - Bonds are issued in the face amount of \$15,385,000 to finance off-site improvement costs.

June 2000 - The City and Vestar/Lend Lease Long Beach Towne Center, L.L.C. enter into the First Amendment to Restated Ground Lease Long Beach Towne Center Main Site (the First Amendment). This amendment spells out bond debt responsibility (42.7% / 57.3%, Developer/City split).

June 2000 - Simultaneously, the L.L.C. sells its interest in the Main Site to a German bank, BGB. BGB, through its subsidiaries and a special purpose entity, holds its ownership of the site in the name of "Long Beach Towne Center L.P." Vestar, through its L.L.C., retains its ownership interest in the AutoNation Site. Vestar's property management subsidiary, Vestar

Property Management Company, continues to act as manager for both its own AutoNation Site as well as BGB's Main Site.

October 2003 - The City is advised that BGB is selling its interest in the Main Site to an affiliate of a large U.S. insurance company and the sale is consummated in November 2003.

It is important note that Vestar, the original leasehold owner and developer of the Towne Center, has retained its ownership interest in the AutoNation Site yet has assigned its interest in the Main Site. Vestar continues to act as Property Manager for both Sites.

RENT PROVISIONS – Base, Percentage, Bonus and Additional Rent

Under the terms of the leases, rent due the City for the sites is comprised of Base Rent, Participation Rent, Bonus Rent and Additional Rent:

Base Rent is as follows:

Main Site (Phase I – 65.32 acres)	\$ 643,559	per quarter
Main Site (Phase II – 15.22 acres)	161,556	per quarter
AutoNation Site (Phase 1 – 20 acres)	149,855	per quarter

Base rent will be adjusted to fair market rent on the first day of each option term.

Participation rent is computed on the Main Site only at 25% of net revenue. Net revenue is computed as follows:

Gross Revenue, as defined

Less:

- Base rent paid to landlord
- 12% cumulative preferred return on "costs" of the development
- Assessment district or special tax payments, if any, (including debt service paid by Tenant), net of Landlord's share of assessment district payments related to offsite improvements including debt service
- A management fee equal to 4% of the gross operating revenues, including reimbursements for taxes, common area maintenance and insurance, but net of exclusions to gross operating revenues
- A replacement/repair reserve equal to 1% of the gross operating revenues
- Expenditures for capital repair to any improvements on the premises which are incurred after the initial completing of such improvements but only to the extent they are not reimbursed, exceed the repair reserve or include any mark-ups by Tenant
- Ordinary and/or reasonably necessary expenses incurred by Tenant in operating the premises.

Bonus Rent was computed on the AutoNation site only. In the event that AutoNation failed to generate \$50,000,000 in sales in any lease year, Tenant was required to pay \$250,000 for each such year. This provision was struck when the City and Tenant entered into the First Amendment to the AutoNation lease in 2000 due to the exit of AutoNation from the property.

An **Additional Rent** provision also applies only to the AutoNation site. The lease specifies that, "commencing three years following the commencement of construction by (the sublessee of the Premises), (which commencement shall be deemed to occur upon the pouring of foundation), Tenant will commence paying additional rent to Landlord of \$50,000 per annum, quarterly for the duration of the Lease Term. Such additional rent shall be paid at the same time as the Base Rent with appropriate adjustment for any partial period." This provision was not struck with the execution of the First Amendment to the AutoNation site lease in 2000.²

² In October 2003, we determined that Tenant was not paying this Additional Rent as required by the Lease. The City Auditor's office issued a claim for amounts due through October 2003, including penalties, and received \$120,965 on November 18, 2003.


Audit Findings

Issue 1: Base Rent

The terms of the original lease agreement between the City and the Developer for the Main Site were based upon projections of annual project net income and included a 12% return on investment to Tenant. Section 4.3(c) of the Main Site lease provides for a “step up” in base rent based upon proforma, or stabilized, operating results. In order to accomplish this, a recalculation of the base rent was to occur at two points, the first being 30 days prior to the close of escrow for the lease and again as of the last day of the end of the third lease year, which would be July 14, 2000 (as the original lease was entered into on July 15, 1997). If stabilized results of operations indicated a return higher than 12% to Tenant, then annual base rent paid to the City was to be adjusted upward by ½ of the excess return. In other words, the City would permanently share in returns higher than 12% as calculated on one of those two dates.

The formula for stepping-up rent, then, is:

Base rent Years 1 - 3 (1997-2000) = \$3,220,460
Base rent Years 4 - 55 (2001-2052) = \$3,220,460 + ½ Tenant Return on Investment exceeding 12%


$$\frac{\text{Stabilized Net Income}}{\text{Net Project Costs}} = X \%$$

On July 6, 2000, Tenant sent proformas reflecting stabilized net income (the “numerator”) as well as project costs (the “denominator”) to the City’s Department of Community Development. On October 6, 2000, those documents were sent to the Auditor’s Office. Audit workpapers, which do not include these proformas, indicated only that the City might be in violation of the “Lakewood Settlement”. That settlement required that the City charge no less than market rate rent for the property. Apparently, this conclusion was based on a rent concession given by the Tenant to a subtenant. The City Attorney has since opined that no violation of the settlement has occurred since the sublease agreements are between parties unrelated to the Settlement.

In 2004, without knowledge that Tenant had submitted proformas, we independently computed stabilized operations (the “numerator”) at the step-up date of July 14, 2000, the third anniversary of the lease agreement. Based on our computation, the proforma return on investment was 13.13%. As such, base rent should have been increased by ½ of 1.13% or \$304,552 per year. Total unpaid base rent, then, for the period July 15, 2000 through December 31, 2004 totals approximately \$1.4 million, excluding interest. This unpaid amount was included in our May 2005 claim. This computation reflects

several significant adjustments to Tenant reported revenue. The computation also reflects only contractual subtenant rent. In the spirit of the Lakewood Settlement, and in accordance with the lease itself, an additional \$650,000 should be added to Tenant proforma income to reflect the rent concession granted one center subtenant. This would insure that the City is properly charging "market rent" for the Center. Doing so would push the annual step-up in base rent from \$304,552 to \$629,552 per year and would increase our claim by an additional \$1.4 million, excluding interest.

We also believe that total project costs (the denominator) have been overstated by approximately \$6 million. In 2000, when \$15.4 million of bonds were issued to fund off-site improvements, and when all improvements to the Center were substantially complete and the Center was operational³, Tenant made representations to property appraisers as to total project costs. We did not audit detailed records of the improvements but rely on those February 2000 representations.

In summary, the total amount of back base rent due the City at December 31, 2004 for our step-up claim amounted to \$1,357,794 plus interest.. An additional amount of \$325,000 $(629,552 - 304,552) \times 4.45$ years or \$1.4 million (July 2000 through December 2004), excluding interest, should also be claimed to take into account the effect of the subtenant rent concession and to ensure compliance with the Lakewood Settlement.

To illustrate the computation of Tenant's step-up calculation in 2000, we present the following:

Base rent Years 1 - 3 (1997-2000) = \$3,220,460

Base rent Years 4 - 55 (2001-2052) = \$3,220,460 + $\frac{1}{2}$ Tenant Return on Investment exceeding 12%

	Tenant Calculation		Audit Step-Up Claim Calculation		Potential Additional Claim Calculation	
<u>Stabilized Net Income</u>	\$ 6,731,465		\$ 7,049,494		\$ 7,699,494	
Net Project Costs	\$ 59,566,760	=11.33%	\$ 53,669,918	=13.13%	\$ 53,669,918	=14.35%

Audit Step-Up Claim:

12% return on \$53.7 million = \$6,440,390 – actual return of \$7,049,494 (13.13%) = \$609,104 excess return x 50% =
\$304,552/year additional rent due City

Potential Additional Claim:

12% return on \$53.7 million = \$6,440,390 – actual return of \$7,699,494 (14.35%) = \$1,259,104 excess return x 50%
= \$629,552/year additional rent due City

³ In February 2000, 93%+ of business licenses had been issued, 93%+ of subtenants were paying sales tax and 96%+ of construction value had been assessed by the Los Angeles County Assessor.

Issue 2: Participation Rent

We also determined that Property Manager's computation of Percentage Rent for fiscal years 2001 and 2002 for the Towne Center contains errors. Property Manager included debt service expense of \$538,642 for debt that was actually serviced with excess bond funds (see **Issue 3: Bond Debt Service** below). In addition, Property Manager overstated common area maintenance, property tax and insurance expenses by \$159,186 for fiscal year 2002 and \$152,488 for fiscal year 2001. These expenses have been disallowed for purposes of computing participation rent. Finally, we found errors in Tenant's computation of return on investment. Tenant's guaranteed 12% return on investment was overstated because the investment included costs which were reimbursed by third parties. The lease provides that these costs be excluded from Tenant's "investment."

As a result of these errors, and in combination with the effect of the \$304,552 claimed "step-up" in base rent discussed in **Issue 1** above, the City is due participation rent. At December 31, 2004, the cumulative identified amount of unpaid participation rent totaled \$428,253⁴. With interest at 6.841% compounded annually, an additional \$70,958 in interest is due the City. Again, however, this does not take into account the impact of an additional \$650,000 market rate adjustment necessary to account for below market subtenant rent. The effect of this adjustment would be to increase base rent and decrease the percentage rent liability since a larger base rent expense can be claimed by Tenant.

We recommend that during the negotiation of a base rent adjustment, the effect of the additional base rent claim be factored in to participation rent formula.

Issue 3: Bond Debt Service

The City formed a Community Facilities District in September 1999 to finance the cost of off-site improvements around the Center, issuing \$15,385,000 in bonds. According to the first amendment to the Main Site lease, the City became responsible for servicing 57.3% of the debt and Tenant, 42.7%. Tenant deducts the City's portion of the bond payment directly from its base rent payment to the City. Tenant expenses its own portion of debt service for purposes of computing percentage rent due the City.

When the off-site improvements were complete, approximately \$1.2 million remained in construction funds. The excess funds were used to make bond payments in October 2002 and April 2003. Despite this debt service relief, Tenant:

- ❑ Took a rent credit for its 42.7% of the debt service, or \$538,642, and
- ❑ Deducted the City's portion of the 57.3% or \$722,816 from its base rent remittance

Because the two semi-annual rent payments were made using excess bond funds, neither of these transactions is appropriate. The rent credit issue (\$538,642) has been

⁴ We have not yet reviewed detailed participation rent reporting for 2003 and 2004 but have only included in this claim the effect of the step-up in base rent on participation rent.

folded into the auditor's calculation of percentage rent due (see *Issue 2* above). However, Tenant should remit \$722,816 for underpaid base rent for 2002 and 2003, the date of the semi-annual bond payments.

Conclusion

It is our recommendation that the City Council refer this matter to the City Attorney for negotiation with Tenant on both a retrospective and prospective basis. In addition, we recommend that an audit of the 2003 through 2005 percentage rent calculation be commenced immediately, concurrently with the ongoing negotiation of these issues.